CENTRAL RESERVE BANK OF PERU

INFLATION REPORT: RECENT DEVELOPMENTS AND PROSPECTS January 2005

This inflation report has been drawn up using gross domestic product and trade balance information up to November 2004; from the monetary and operational accounts of the central government as at December of the same year and inflation to January 2005.

CENTRAL RESERVE BANK OF PERU

FOREWORD

- Since 2002, the monetary policy of the Central Reserve Bank of Peru (BCRP) has pursued explicit inflation targets. The annual inflation target is 2.5 percent with a margin of plus or minus one percentage point. This target is measured by the annual variation in the consumer prices index (CPI) for Metropolitan Lima as at December of each year.
- One of the fundamental elements of the explicit inflation target method is the transparency of monetary policy, which enables account to be given to the public on compliance with the constitutional mandate to preserve monetary stability. As part of this transparency, the Bank publishes an inflation report three times a year (in January, May and August) aimed at sharing with other economic agents the information it uses in taking its decisions. This first report of 2005 contains a description of the factors explaining inflation in 2004 and the macroeconomic forecasts for 2005.
- Since 2001, the BCRP has published a calendar of meetings of its board of directors at which decisions on monetary policy are taken. These are held on the first Thursday of each month. This calendar of meetings is published at the beginning of each year with the January press release containing the monetary program.
- Monetary policy decisions are made public through announcements of the reference rates of interest for the BCRP's lending operations (loans for monetary regulation and direct repos) and deposits (*overnight* deposits) with commercial banks. These interest rates set by the BCRP establish a reference corridor for the interbank interest rate. The monetary operations carried out daily by the BCRP are aimed at maintaining the interbank interest rate in the center of the reference corridor.
- For 2005, the calendar of meetings in which the board of directors will approve the monetary program for each month is as follows:

3rd February	3rd March	7th April	5th May
2nd June	7th July	4th August	1st September
6th October	3rd November	1st December	

The BCRP will publish its inflation report on the following dates:

4th February	3rd June	2nd September

CENTRAL RESERVE BANK OF PERU

EXECUTIVE SUMMARY

- This first inflation report of the year analyses the performance of monetary policy during 2004 and macroeconomic forecasts for 2005.

- For the third consecutive year the Bank has met its inflation target within the explicit inflation target policy implemented in 2002. During 2004, the rate of inflation was 3.48 percent, within the target range (2.5 percent plus or minus one percent).

- Supply shocks in the agriculture sector caused by adverse weather conditions and higher international prices for fuel and foodstuffs (wheat and soya oil) exerted an upward pressure on the inflation rate in 2004. It is estimated that imported inflation (approximately 12 percent of the CPI basket of products) explains 1.5 percentage points of total inflation for the year.

- This upward pressure was concentrated in the January - July period in which inflation accelerated. The 12 month inflation rate temporarily exceeded the target range (3.5 percent) between June and November, which in certain months (between July and October) raised inflation expectations for 2005 above the target figure of 2.5 percent.

- During this period the Central Reserve Bank twice raised its reference interest rates (August and October), from 2.5 to 3.0 percent. This was a preventive measure to guarantee that inflation would remain at its target level and to prevent core inflation to absorb the effect of temporary rises in the prices of certain products.

- As the supply shocks began partially to reverse, and as the nuevo sol appreciated, annual inflation has been falling since August, from a maximum of 4.6 percent in July, in line with the forecast given in the August 2004 Inflation Report.

- The forecasts in the August 2004 Inflation Report have been maintained for 2005 as the partial reversal of the supply shocks of last year should continue, with inflation rates over the last twelve months in the lower part of the target range (1.5 - 2.5 percent) for most of this year.

- As far as the determinants of inflation in 2005 are concerned, a rate of 2.5 percent continues to be expected with moderate imported inflation and economic growth of 4.5 percent, driven by greater growth in domestic demand (4.5 percent). Although external conditions will not be as favorable as in 2004, economic growth in 2005 will benefit from an absence of adverse shocks affecting the agriculture sector. A recovery in margins is also expected this year, after they absorbed cost pressures caused by higher fuel prices in 2004.

- The fiscal scenario for 2005 considers a fiscal deficit of 1.0 percent of GDP, which is consistent with the Multi-annual Macroeconomic Framework with no pressure to finance it. Similarly, a better balance of payments position is expected, with a current account surplus of 0.5 percent of GDP. This macroeconomic environment assumes that the financial markets continue operating smoothly as they have been doing in recent years. Towards the end of the year and with elections approaching, uncertainty and volatility may affect the financial markets, and with this in mind the Bank has been increasing its levels of international reserves.

I. MACROECONOMIC PERFORMANCE IN 2004

I.1 Inflation

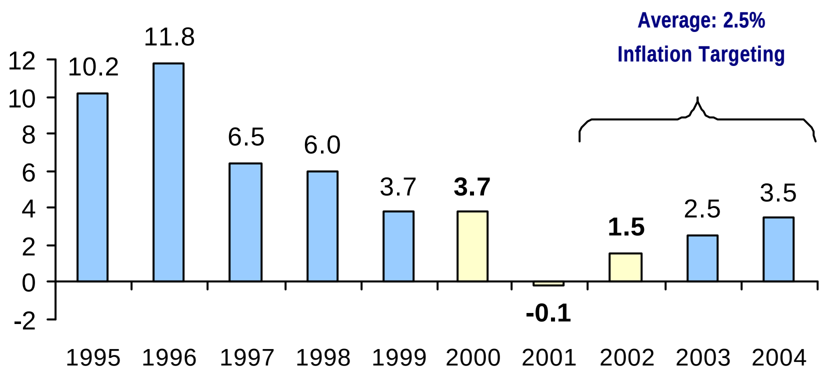
In 2004 inflation was 3.48 percent, within the Central Bank's target range of 1.5 to 3.5 percent. This result is principally a reflection of supply shocks (significant rises in the international price of petroleum, wheat and soya oil as well as some domestic foodstuffs such as rice and sugar caused by the weather and restrictions on imports); factors which together explain 2.5 percentage points of annual inflation. These factors were partially attenuated by an appreciation of Peru's currency.

During the year, the annual rate of inflation at times exceeded the target range. In this context, the Central Bank twice raised its reference interest rate by 25 base points (August and October) in order to prevent the price increases caused by supply shocks affect the consumer basket as a whole.

1. Inflation in 2004, measured by changes in the consumer prices index for Metropolitan Lima (CPI) was 3.48 percent, within the target range established by the Central Bank (1.5 - 3.5 percent). This means that for the third consecutive year the target established in the explicit inflation target regime announced in 2002 has been met.

Figure 1

INFLATION: 1995-2004



BOX 1

MEASURING THE INFLATION TARGET

The explicit inflation target regime, in addition to requiring an announcement of the target level or range of inflation, must state, among other factors, the frequency with which the target is evaluated (monthly or annually, for example) and the time horizon within which the rate must return to the target when a temporary variation occurs. Thus it is accepted that rates of inflation other than the target rate may occur temporarily and, furthermore, that the action taken by the Central Bank to meet the target have a delayed effect.

In our case, compliance with the target is evaluated using the annual accumulated rate of inflation as at December each year. Other central banks evaluate compliance month by month but explicitly accept the possibility of variation, which is corrected within the time horizon over which monetary policy is effective.

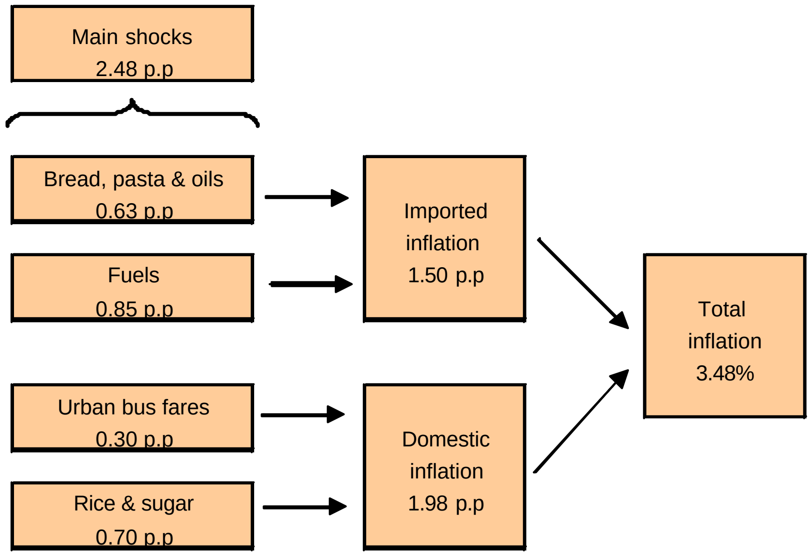
Evaluation of inflation targets in countries with low inflation

Country	Indicator	Inflation target	Horizon	Measuring compliance
Australia	CPI	2-3 %	Medium term	The target should be met on average over the economic cycle.
Canada	CPI	Mid point of the range: 1-3%	Medium term	Monetary policy decisions are aimed at keeping inflation in the middle of the target range.
Chile	CPI	2-4 % centered on 3%	Medium term (2 years)	The target should be met permanently over a medium term horizon.
United Kingdom	CPI	2.00%	Medium term	The target should be met at all times. Monetary policy decisions are taken considering a horizon of two years.
Mexico	CPI	3% with an interval of variability of +/- 1 percentage point	Medium term	From 2004 the inflation target will operate continually and will not just be used for inflation at the close of the year.
Norway	CPI	2.5 % with a margin of fluctuation of +/- 1%.	Medium term, with emphasis on 2 years	The target should be met at all times. It is thought that over a period of 2 years monetary policy can achieve the target after a deviation.
New Zealand	CPI	1-3 %	Medium term	The target must be met on average over the medium-term horizon.
Poland	CPI	2.5 % with a margin of tolerance of +/- 1%	Medium term	Evaluation of the inflation target at the end of each year has been replaced by a continual evaluation over a medium-term horizon.
Cheq Republic	CPI	A fixed band of 3-5% in January 2002 which should end 2005 at 2-4%.	Medium term	Monetary policy is evaluated periodically in the light of inflation forecasts carried out 12 to 18 months beforehand, in which monetary policy decisions are taken aimed at achieving the inflation target for this period.
Sweden	CPI	2% with a margin of fluctuation of +/- 1 percentage points	1 or 2 years	The 12 month percentage variation and the variation of a moving average based on the last 12 months are evaluated continually.

2. As the last two Inflation Reports anticipated, the dynamics of the rate of inflation in 2004 were determined both by increased imported inflation - drastic rises in international prices for oil and foodstuffs - and reduced domestic agriculture production caused by drought on the north coast which affected rice and sugar production. Together, these shocks contributed 2.5 percentage points to inflation, with the contribution of imported inflation being 1.5 percentage points.

Figure 2

MAIN INFLATIONARY SHOCKS IN 2004



Imported inflation, which includes components of the consumer prices index that are affected either directly or indirectly by international prices and the exchange rate, accumulated a variation of 11.3 percent in 2004 (3.0 percent in 2003). The principal variations in imported inflation were caused by fuels and foodstuffs such as bread, pasta and cooking oils. The magnitude of these international price rises (35 percent in the case of fuels) greatly exceeded the compensatory effect of a 5.5 percent appreciation in the nuevo sol.

Table 1

IMPORTED AND DOMESTIC INFLATION

(Cumulative percentage change)

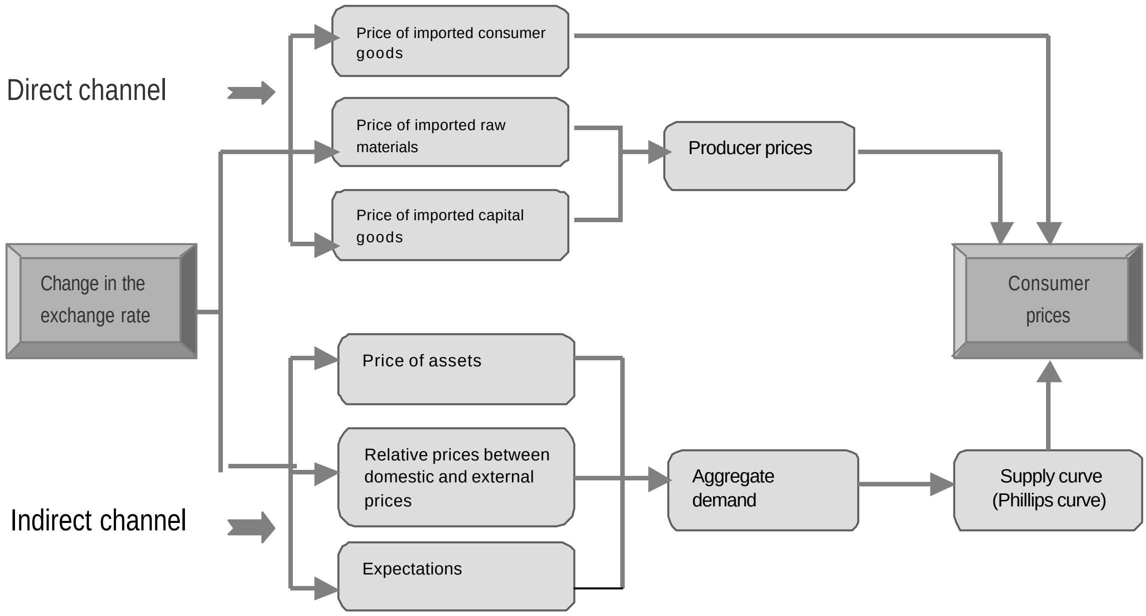
	Weighting	2002	2003	2004
I. IMPORTED CPI	**12.1**	**10.30**	**3.03**	**11.33**
Food	5.4	9.98	-0.10	10.90
Fuels	3.9	15.60	8.94	17.77
Domestic appliances	1.0	3.42	-1.91	-2.83
Medicines	1.4	3.60	1.74	5.22
Vehicle purchases	0.4	2.70	0.29	-3.50
II. DOMESTIC CPI	**87.9**	**0.30**	**2.40**	**2.28**
III. CPI	**100.0**	**1.52**	**2.48**	**3.48**
Note:				
Depreciation of the nuevo sol		2.30	-1.20	-5.50

Source: INEI.
Prepared by: BCRP.

BOX 2
EFFECTS OF NOMINAL APPRECIATION ON INFLATION

Variations in the exchange rate can have a direct effect on prices through their impact on the cost structure of production and enterprises profit margins.

A variation in the exchange rate is directly transferred to prices of imported goods (known as first level *"pass-through"*). Variations in the prices of imported consumer goods are transferred directly to final prices, according to their share of the consumer prices index (CPI). In addition, the prices of imported raw materials and capital goods directly affect the cost structure of producers and they, in turn, can translate into changes affecting final consumers (second level pass-through) or assume the cost in the form of a reduction in profit margins.



The magnitude of the pass-through can vary depending on the inflationary environment, exchange rate volatility and how open the economy is, among other factors.

Empirical evidence on the degree of pass-through caused by the exchange rate to the consumer in Peru suggests that it is low and depends on the position in the economic cycle. Thus, during recessions a depreciation of one percentage point translates into an increase of 0.15 percentage points in inflation. When the economy is expanding, the effect of depreciation on inflation is estimated to be about 0.30 percentage points.

In 2004, the nominal annual appreciation of the nuevo sol (5.5 percent) was concentrated in the second half, so it is expected to have an impact in 2005 as well.

3. The products that have made the greatest contribution to inflation include:

Table 2

WEIGHTED CONTRIBUTION TO INFLATION: 2004

(Percentage points)

Items	Weighting	% change	Positive contribution	Items	Weighting	% change	Negative contribution
Fuels	3.9	17.8	0.85	Potato	1.5	-21.8	-0.41
Bread	3.7	12.9	0.51	Personal care products	4.5	-3.4	-0.14
Rice	2.3	18.8	0.41	Newspapers	0.7	-9.2	-0.06
Urban bus fares	8.0	3.5	0.30	Chicken	4.0	-1.1	-0.04
Sugar	1.4	23.3	0.29	Home rental	2.3	-1.6	-0.03
Electricity	2.2	12.0	0.26				
Pasta	1.0	8.4	0.08				
Oils	0.8	4.1	0.03				
Total			**2.62**				**-0.68**

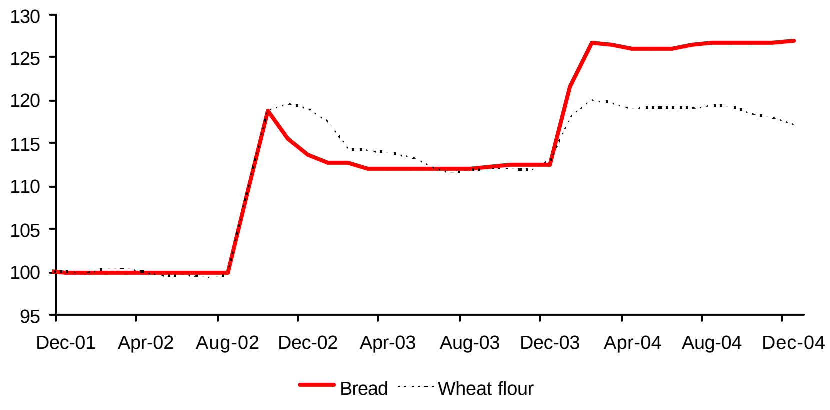
Source: INEI.
Prepared by: BCRP.

Bread (3.7 percent of the CPI) The increase in the price of bread during 2004 (12.9 percent) took place in January and February and was caused by the effect of an increase in the international price of wheat from US$ 116 to US$ 147 per metric tone, between July 2003 and January 2004.

This change in the international price of wheat was explained by reduced production in the United States and Europe as a result of poor weather affecting sowing and yields, as well as an increase in demand from China. Consequently, inventories fell to their lowest levels in five years. Better prospects for the 2004 - 2005 season caused the price to fall and as at December 2004 it was US$ 123 per metric tone.

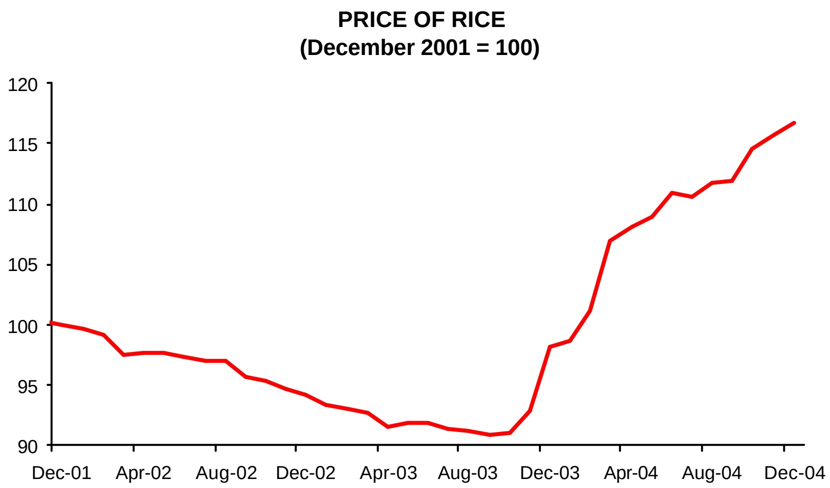
Figure 3

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



Rice (2.3 percent of the CPI) The accumulated variation in the price of rice was 18.8 in 2004, reflecting reduced production of hulled rice (16 percent) after a smaller area was planted as a result of drought on the north coast of Peru, principally in Lambayeque and Piura. Lower areas sown with rice in this region were partially offset by an increase in the area under cultivation in the jungle, principally the department of San Martin.

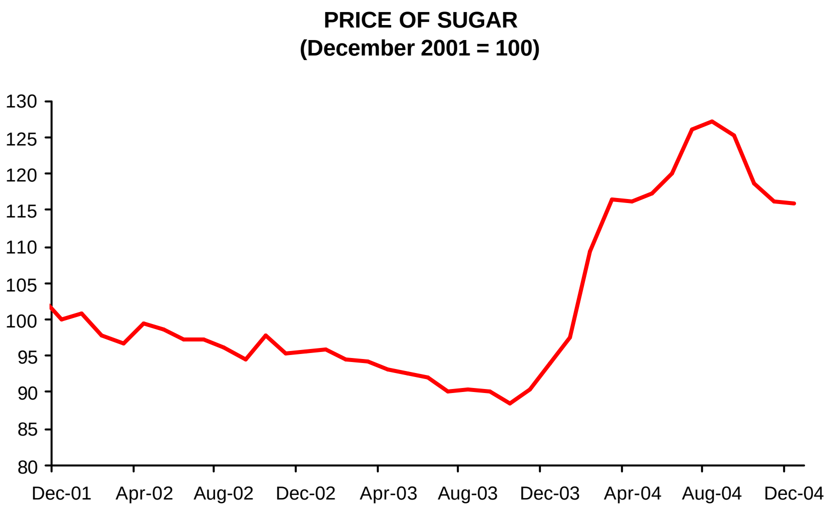
Figure 4



High rice prices, principally the ordinary variety were also maintained because of restrictions on imports. Since March 2004 phytosanitary measures were imposed which restricted imports of rice from Asia (Resolutions Nº 064, Nº 141 and Nº 194-2004-AG-Senasa). Nevertheless, towards the end of the year imports of "extra" and "superior" rice varieties arrived from Uruguay and the United States. It should be mentioned that approximately 80 percent of rice imports during 2004 (77,000 M.T.) entered Peru in the last quarter of the year, reducing the price of these varieties of rice.

Sugar (1.4 percent of the CPI) The price of sugar showed an upward trend between November 2003 and August 2004, because of reduced yields caused by the weather, as well as stoppages by agro-industrial companies caused by financial and management problems. For these reasons production fell 22.3 percent between January and November 2004 compared to the same period in 2003.

Figure 5

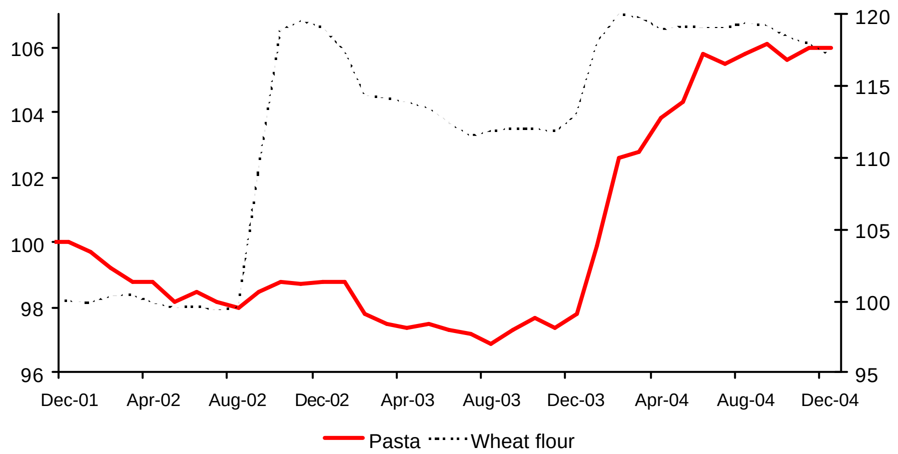


Nevertheless, in September the price of sugar started to fall because of an improvement in supply due to imports from Bolivia (57,000 M.T.), Colombia (50,000 M.T. Ecuador (53,000 M.T.) and Brazil (10,000 M.T.) Thus, imports rose from 12,000 to 170,000 M.T. between 2003 and 2004, representing the equivalent of 25 percent of Peruvian sugar production.

Pasta (1.0 percent of the CPI) Pasta prices rose from December 2003 principally until June 2004. As with bread, this was the result of a rise in the international price of wheat between July 2003 and January 2004 and its impact on the price of wheat flour.

Figure 6

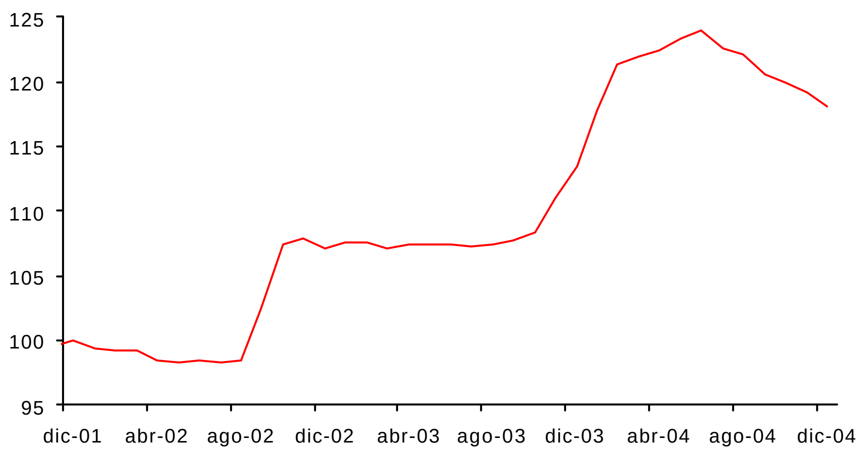
PRICE OF PASTA AND WHEAT FLOUR
(December 2001 = 100)



Edible oils (0.8 percent of the CPI); The price of edible oil rose principally between November 2003 and February 2004 (12 percent), reflecting the international price of soya oil, which rose from US$ 445 to US$ 754 per metric tone between August 2003 and March 2004, before falling to US$ 473 per metric tone in December. The developments in the price of soya were a response to increased demand from China.

Figure 7

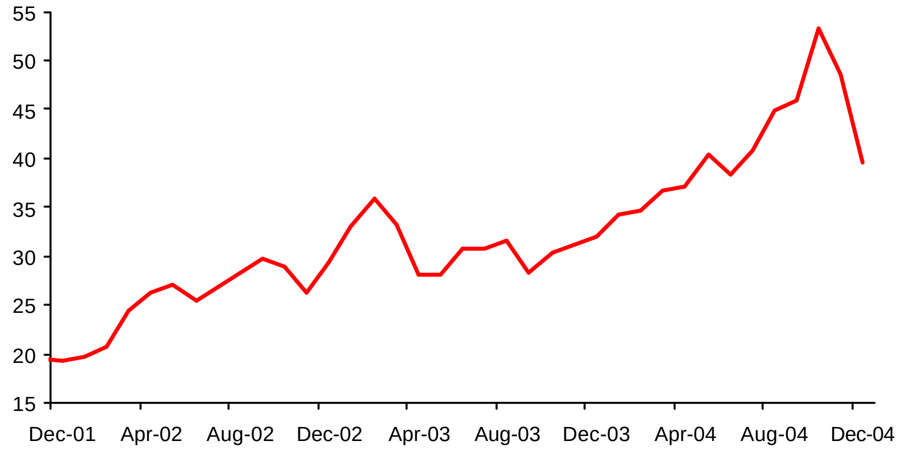
PRICE OF EDIBLE OILS
(December 2001 = 100)



Fuels (3.9 percent of the CPI) The international price of West Texas Intermediate (WTI) petroleum increased from US$ 32.1 to US$ 53.2 a barrel on average between December 2003 and October 2004, before falling to US$ 43.2 in December. Thus during 2004 the accumulated variation in the international oil price was 35 percent. Petroleum quotations were influenced by security problems in the Middle East, growing world demand (particularly from China) and speculative transactions.

Figure 8

INTERNATIONAL PRICE OF WTI CRUDE
(US$ per barrel)



The developments in the price of WTI petroleum were reflected in domestic fuel prices, which rose on average 17.8 percent in 2004. In order to prevent further increases in domestic prices the government promulgated Emergency Decrees 003-2004 (May 2004) and 010-2004 (September 2004), which established a mechanism for stabilizing fuel prices through a reduction in excise tax and the creation of a stabilization fund, respectively. The fiscal impact of these measures was offset by increased revenue from value-added tax, customs duties and royalties generated by higher fuel prices.

Table 3

FUEL PRICES INCLUDED IN THE CPI
(Monthly percentage change)

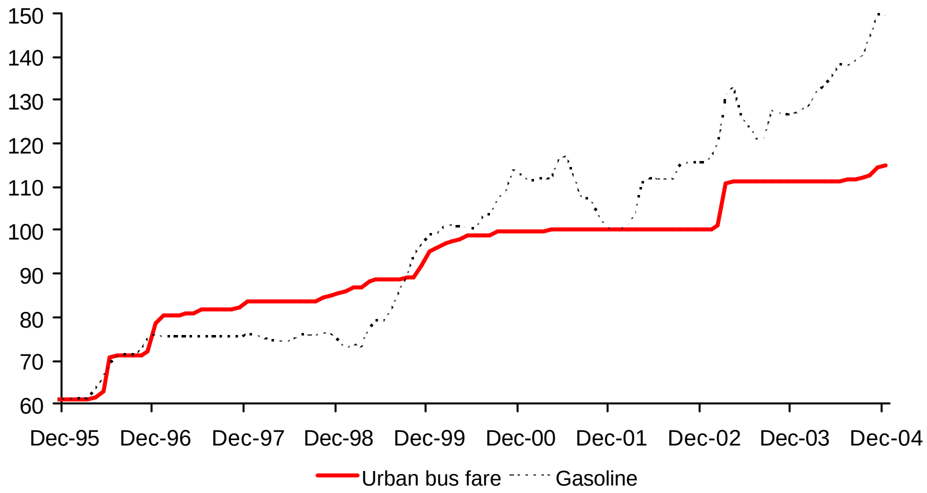
	2003	2004												
	Jan.-Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.-Dec.
Fuels	**8.9**	**1.9**	**1.3**	**1.8**	**1.0**	**1.0**	**1.5**	**1.8**	**0.6**	**0.7**	**2.6**	**2.8**	**-0.3**	**17.8**
Gasoline	9.7	0.8	0.8	2.4	1.1	1.6	2.0	-0.2	0.7	0.9	3.3	3.3	-0.2	17.7
Gas	4.2	2.7	2.2	1.2	0.7	0.2	0.7	5.5	0.0	-0.4	1.7	0.9	-1.1	15.3
Kerosene	13.0	2.5	0.9	1.6	1.0	0.9	1.6	0.6	0.9	1.4	2.7	4.2	0.2	20.3
Note:														
WTI price 1/														
- US$ per barrel		34.2	34.8	36.7	37.1	40.3	38.3	40.7	44.9	45.9	53.2	48.5	43.2	
- % change	8.9	6.8	1.5	5.5	1.1	8.5	-4.9	6.3	10.2	2.3	15.9	-8.9	-10.9	34.9

1/ West Texas Intermediate.

Urban bus fares (8.0 percent of the CPI) Urban bus fares increased 3.5 percent in 2004, principally between September and December, in response to the increase in the price of gasoline (18 percent) and diesel 2 (22 percent). It should be pointed out that urban bus fares increased by 15 percent between December 2002 and December 2004, a smaller variation than that in the prices of gasoline (29 percent) and diesel 2 (42 percent) over the same period, which implies that part of the cost was absorbed, cutting margins.

Figure 9

PRICE OF GASOLINE AND URBAN BUS FARES
(December 2001 = 100)



Public services (4.6 percent of CPI) Tariffs for public services rose 6.2 percent in 2004. Electricity prices (12 percent) rose because of increases in generating and distribution costs (January, February, April, September and November). The regulation of generating tariffs in November implied an increase in increase in prices caused by excess demand for electricity in the period 2005 – 2008 estimated by the regulating entity (Osinerg) using a methodology established by the Ministry of Energy and Mines. Water tariffs (3 percent) were adjusted in line with the wholesale prices index whilst telephone charges (-2 percent) fell principally because of the application of a productivity factor to fixed-line telephony.

Table 4

PUBLIC SERVICES TARIFFS

(Monthly percentage change)

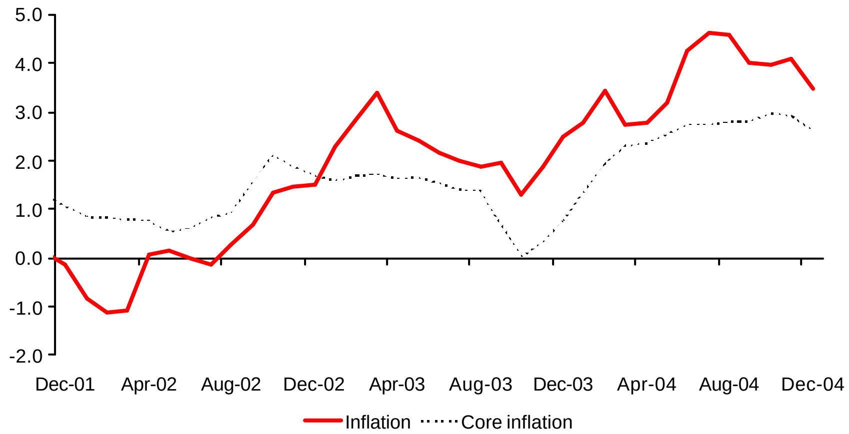
	2003	2004												
	Jan.-Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.-Dec.
Public services	**-2.0**	**0.3**	**0.1**	**0.0**	**0.5**	**-0.2**	**0.3**	**0.3**	**0.8**	**0.6**	**0.1**	**3.7**	**-0.3**	**6.2**
Electricity	-4.6	0.7	0.1	0.0	0.9	-0.5	0.6	0.5	0.4	1.3	0.1	7.4	0.3	12.0
Telephone	0.3	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.1	0.0	-2.0	-2.0
Water	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0	3.0

Core inflation

4. **Core inflation**, an inflation trend indicator that excludes from the CPI those foodstuffs whose prices vary most, fuels, public services and transport costs, accumulated an annual variation of 2.63 percent. The lower rate of core inflation (2.6 percent) compared to the variation in total CPI (3.5 percent) reveals the transitory nature of the latter. Therefore, **non-core inflation**, which represents the set of goods and services that face supply shocks or whose prices are subject to regulation, accumulated an annual variation of 5.20 percent (6.21 percent in 2003).

Figure 10

INFLATION AND CORE INFLATION
(% change, last 12 months)

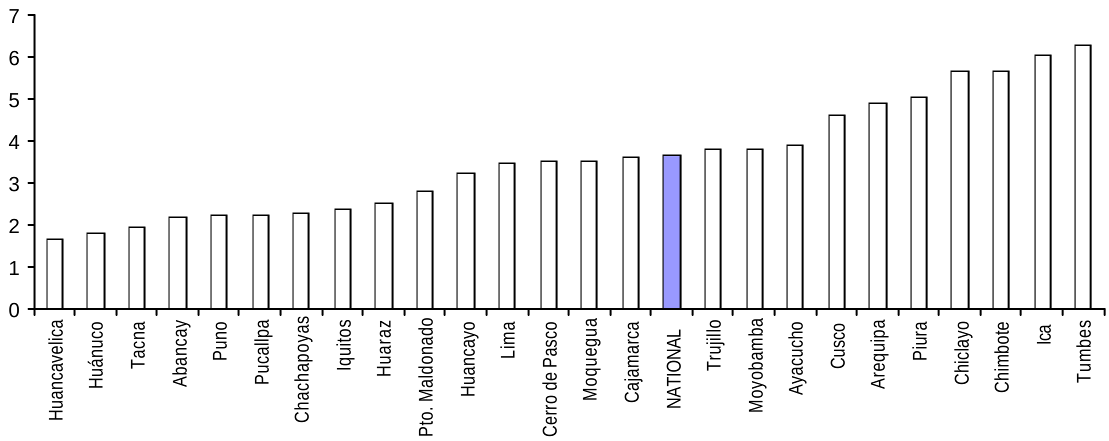


Domestic inflation

5. In January 2003, the National Statistics and Information Technology Institute (INEI) began to draw up an aggregate domestic index of consumer prices, based on price indices from 25 cities. The accumulated increase in prices during 2004 was 3.66 percent: 15 cities saw an increase lower than the average while the remaining 10 experienced inflation that was higher than the average.

Figure 11

INFLATION IN PERU 2004
(Cumulative percentage change)



BOX 3

THE DOMESTIC CURRENCY PRICING ACT

On the 23rd July 2004 Law N° 28300 was promulgated[1], establishing an obligation by suppliers of products or services that display their prices in dollars, to disseminate them also in Peruvian currency, under the same conditions.

A fundamental aspect of competition in markets is the existence of well informed consumers and therefore the availability of information on quality, quantity and prices is ever more relevant. The importance of information as an element of equilibrium between the parties to a transaction and for the protection of consumers is enshrined in Peruvian legislation.

Thus the purpose of this regulation is to provide greater transparency in transactions between vendors and purchasers, which has contributed to the adoption of better informed decisions in the acquisition of goods and services by consumers. Given that the majority of consumers receive their income in Peruvian currency, publication of prices in nuevos soles enables them to compare their income directly with prices expressed in nuevos soles.

1/ "Law modifying article 7- A of the approved text of Legislative Decree Nº 716, the Consumer Protection Law", in force from the 23rd of August.

I.2 Exchange rate

During 2004, the nuevo sol appreciated 5.5 percent in nominal terms, this movement being concentrated in the second half year, which attenuated the upward trend in inflation. Nevertheless, in real terms, multilateral exchange rate appreciated 1.3 percent, principally as a result of a weakening of the dollar compared to other currencies.

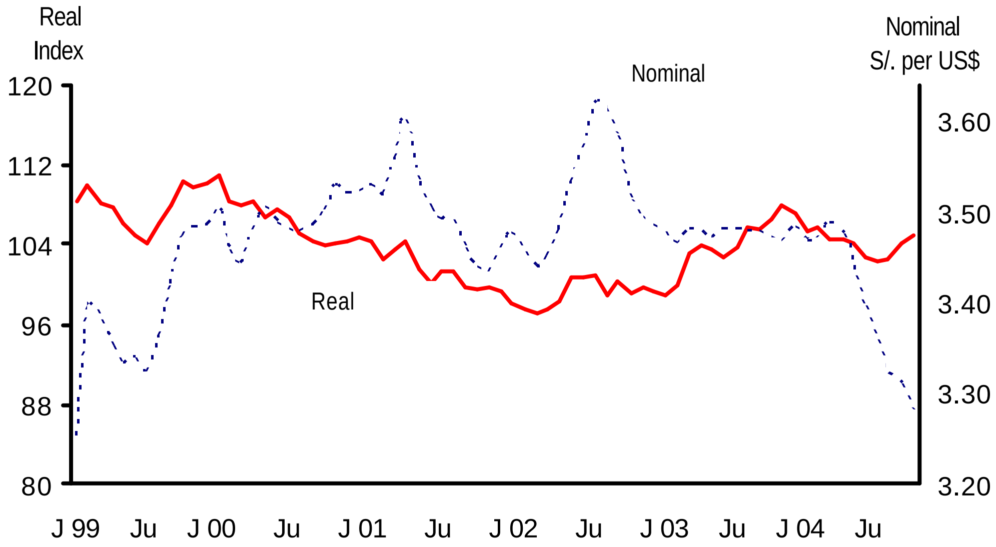
The fall in the nominal exchange rate reflects an improvement in our external accounts (improvement in the terms of trade and increased exports, reaching a historic record in the trade balance and increased remittances from abroad), the process of "dedollarization" and the weakness of the dollar caused by he United States' fiscal and external imbalances. This reduction in the exchange rate has generated an expectation that it will continue to fall, thus strengthening the conversion of portfolios into domestic currency and thus further accentuating the tendency for the nuevo sol to appreciate.

In this context, the Central Bank intervened in the foreign exchange market purchasing US$ 2,340 million, enabling it to continue strengthening its international reserves, repositioning the currency of the private portfolio and reducing exchange rate fluctuations.

6. During 2004, the nuevo sol appreciated 5.5 percent to end the year at S/. 3.28 to the dollar. The behavior of the exchange rate during the year was erratic. In the first half year it showed a certain stability, oscillating around S/. 3.45 and S/. 3.51 to the dollar; whilst in the second half year there was a clear appreciating trend.

Figure 12

**MONTHLY NOMINAL AND REAL EXCHANGE RATE
1999-2004**



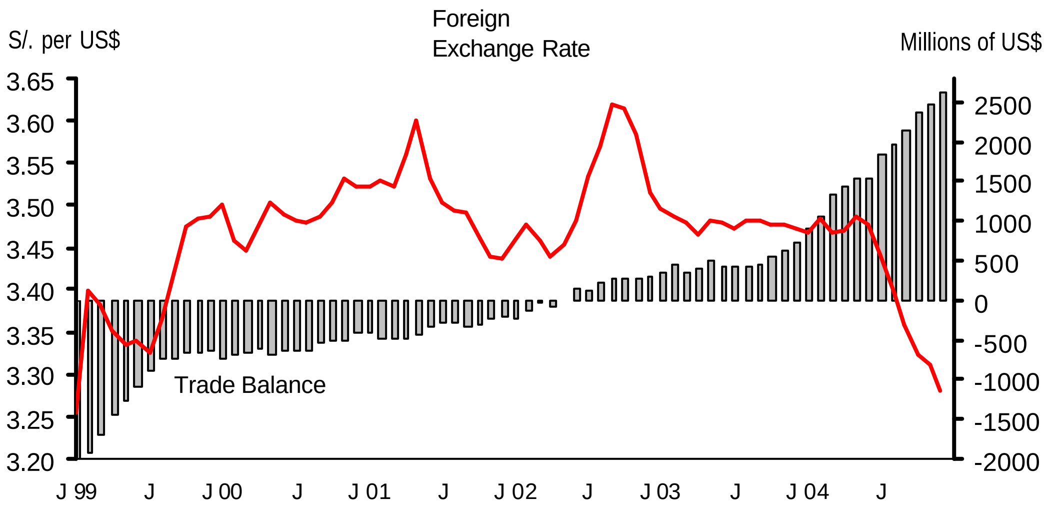
7. In real terms the multilateral exchange rate fell 1.3 percent, reflecting the weakness of the dollar in international markets incorporated into external inflation.

8. The following factors were behind the developments of the exchange rate:

   a) **Improved trade balance:** As at December 2004 the trade balance recorded its twentieth month in surplus, amounting in 2004 to US$ 2,697 million, equivalent to three and a half times the figure for the previous year. This result was influenced by dynamic exports, which reached the record annual figure of US$ 12,513 million. This improvement in the trade balance was noteworthy for an increase in the terms of trade of 8.0 percent, the largest since 1979. This latter incorporates an improvement in the relative prices of Peru's principal export products compared to its main imports and the effect of this was an increase of US$ 1,500 million in the trade balance.

Figure 13

TRADE BALANCE AND EXCHANGE RATE
(1999-2004)



The increase in the **terms of trade** is explained by greater dynamism in the world economy led by economic growth in the United States and China, as well as various structural factors in the balance of supply and demand for raw materials. The increase in the terms of trade mainly reflects an increase in the price of exports (17 percent), which exceeded that of imports (8 percent).

Higher **export prices** include an increase in the price of copper (62 percent, because of greater demand from China and the United States and the lowest inventories levels for 14 years), gold (13 percent, associated with significant appreciation of the euro) and zinc (26 percent caused be higher demand from China, which could become a net importer).

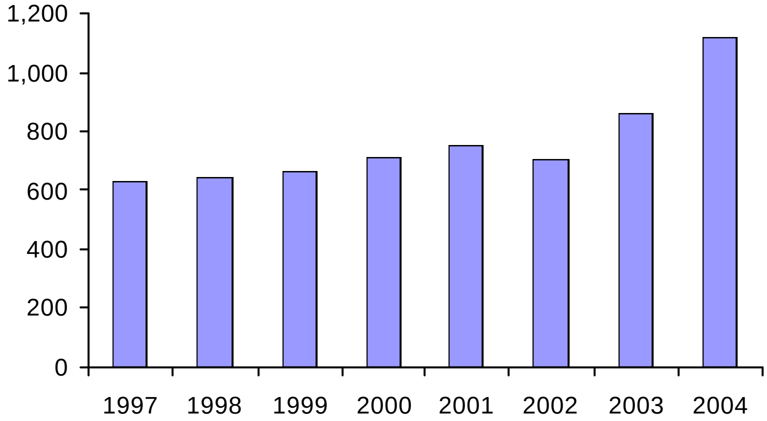
The increase in **import prices** was produced by higher average petroleum and derivatives prices (24 percent), sustained by different factors such as the conflict in the Middle East, low inventories in the United States and the political situation in Venezuela and Nigeria. Similarly, higher prices for foodstuffs such as soya (15 percent), wheat (13 percent) and maize (3 percent) were influenced - in the case of soya and wheat - by poor harvests at the beginning of 2004 whilst the price of maize reflects increased demand from the United States and Asia, which forced prices up in the first two quarters of the year.

b) **Remittances from Peruvian living abroad** amounted to around US$ 1,117 million, that is, 30 percent more than in the previous year.

Figure 14

REMITTANCES FROM ABROAD: 1997-2004

(Milllons of US$)



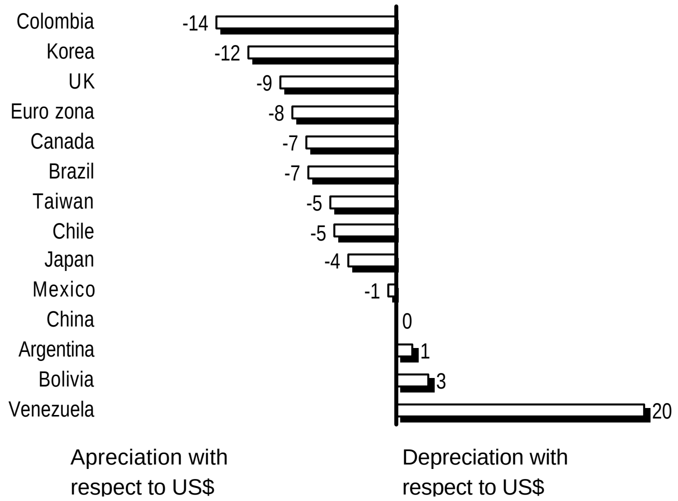
c) **Considerable depreciation of the dollar in international markets**: in a context of serious fiscal and external imbalances in the United States, the dollar depreciated with respect to most strong currencies as well as the currencies of the region. In the first group the dollar's depreciation with respect to sterling (9 percent) and the euro (8 percent) were most noteworthy; whilst in the second group of regional currencies it weakened against the Colombian peso (14 percent), the Brazilian real (7 percent) and the Chilean peso (5 percent). It was precisely these currencies against which the nuevo sol depreciated in 2004.

Figure 15

EXCHANGE TRADE OF TRADE PARTNERS

(Monetary units per US$)

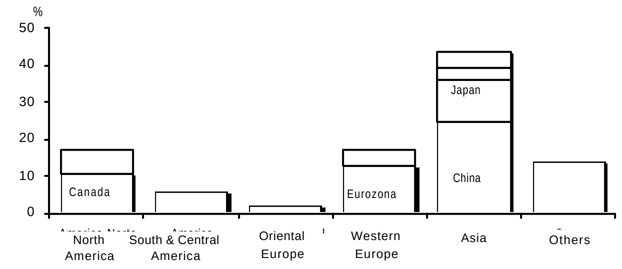
(% Chg. Dec.04-Dec.03)



BOX 4
INTERNATIONAL WEAKNESS OF THE DOLLAR

Between 1996 and 2001, the dollar appreciated at international level, a trend that started to reverse in 2002. This behavior is associated with serious fiscal and external account imbalances in the United States; the way in which this deficit is financed and the lack of flexibility of the exchange rate regimes of Asian economies. This has counteracted the effect of higher interest rates that result in better yields from dollar-denominated assets and should prevent further depreciation.

USA: COMMERCIAL BALANCE DEFICIT BY REGIONS



Source: US Department of Commerce.

DOLLAR EXCHANGE RATE: 2001-2004
(Average of the month of December)

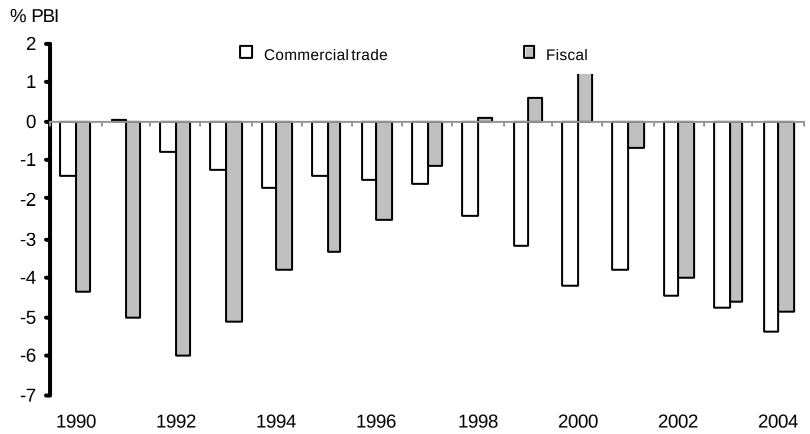
	2001	2002	2003	2004
US$ per Euro	0.892	1.018	1.229	1.341
US$ per pound sterling	1.439	1.586	1.750	1.930
Yen per US$	127.36	122.27	107.94	103.78
$Can per US$	1.577	1.560	1.313	1.218
	Percentage change			
	2002	**2003**	**2004**	**2002-2004**
US$ per Euro	14.1	20.7	9.2	50.3
US$ per pound sterling	10.2	10.3	10.3	34.1
Yen per US$	-4.0	-11.7	-3.9	-18.5
$Can per US$	-1.1	-15.8	-7.3	-22.8

Source: IMF & Reuters.

For almost a decade (1989 - 1997) the United States' current account has shown a deficit of less than 2 percent of GDP. Since 1998 this deficit has been increasing continually from around 2.5 percent of GDP to more than 5 percent of GDP in 2004. It is worth pointing out that this deficit is explained fundamentally by trade deficits, mainly with Asian countries. The Asia Pacific countries account for 43 percent of the total trade deficit, particularly China, Japan and the new industrialized economies.

This current account deficit reflects an imbalance between savings and investment in the economy, particularly by the public sector. Thus part of the deterioration in the United States' current account can be explained by a reverse in the results of the public sector. In 2000 the public sector recorded a surplus of 1.3 percent; whilst in 2004 a deficit of more than 4 percent is predicted.

USA: TRADE AND FISCAL BALANCES



Source: IMF and US Department of Commerce.

The deteriorated fiscal situation was reflected in greater external financing through debt issues in the international markets. The United States' current account deficit, which was being financed by surpluses in the financial and capital accounts have changed from direct foreign investment flows to capital flows resulting from debt issues. The inflow of capital in the form of investment in shares, mergers and/or acquisitions in the nineteen nineties has been transformed into an inflow of capital through the acquisition of *Treasury bonds*, principally by central banks. Participation by Asian countries has again been significant. Increased issues of debt paper in the international markets has been mirrored by a deterioration in net international investment (it is estimated that this will change from 16 percent of GDP in 2000 to around 28 percent in 2004).

Continued imbalances in the United States' external and fiscal accounts, which are at historically high levels, has generated a high degree of expectation about the relationship between the dollar and the euro. Thus, a survey of international analysts conducted by *Consensus Economics* reveals that by January 2006 estimates of the exchange rate vary up to a maximum of US$ 1.455 to the euro, with an average of US$ 1.328.

Table 5

BILATERAL EXCHANGE RATE VARIATIONS WITH RESPECT TO MAIN TRADING PARTNERS' CURRENCIES

(Rates with respect to December 2004)

	Nominal		Real	
	From: 2002	From: 2003	From: 2002	From: 2003
USA	-6.6	-5.5	-7.1	-5.7
Euro zona	23.0	3.2	19.9	1.4
Japan	10.0	-1.7	3.7	-4.6
Brazil	24.6	1.8	37.8	5.5
UK	13.6	4.2	13.1	3.4
Chile	14.2	-0.6	12.0	-1.2
China	-6.6	-5.5	-5.1	-4.6
Colombia	9.3	10.5	15.8	12.6
Mexico	-15.0	-4.9	-12.1	-3.2
Argentina	8.1	-6.8	11.8	-4.7
Korea	7.3	7.3	7.9	6.8
Taiwan	0.7	-0.2	-3.3	-1.8
Venezuela	-35.7	-21.2	-8.1	-9.3
Canada	19.6	1.9	17.9	0.9
Bolivia	-13.1	-8.0	-11.3	-7.4
IPC *	**5.5**	**-1.3**	**6.1**	**-1.3**

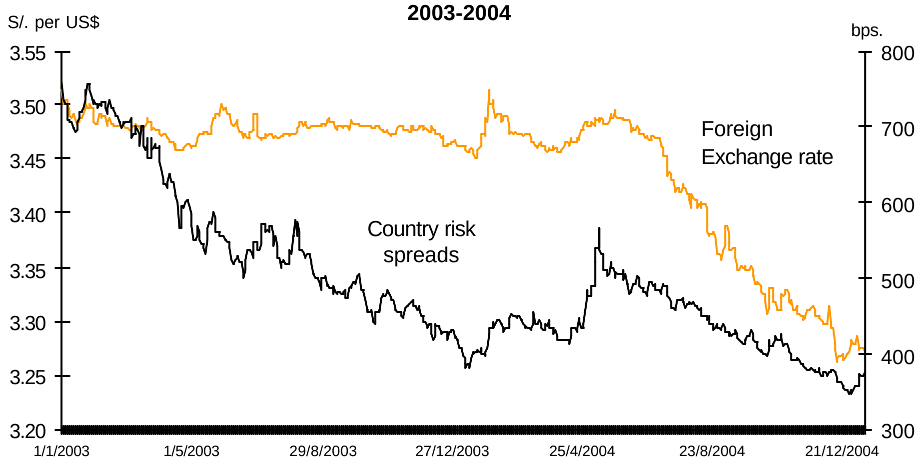
* Weight with respect to trade in 1994.

d) **Fall in country risk**: Expectations regarding the FED's policy to increase interest rates were revised downwards in the second half of 2004. This, added to economic expansion in emerging economies, abundant international liquidity and improved yields from low-risk securities had a significant influence on the demand for emerging country bonds. For this reason, together with an appreciation by the principal currencies, a substantial reduction in *spreads* was observed, which reached successive historic lows during the year.

In the particular case of Peru, the reduction in *spreads* was also favored by an improved country risk rating by rating agencies Standard and Poor's (S&P) and Fitch and favorable events such as the beginning of the Camisea gas operation and the solidity of the external sector. On the 27th of December Peru's *spread* reached a historic minimum value of 214 base points.

Figure 16

PERU: FOREIGN EXCHANGE RATE AND COUNTRY RISK SPREADS 2003-2004



BOX 5
INTERNATIONAL ENVIRONMENT 2004

In 2004 the world economy will have grown by around 5 percent, the highest rate in almost three decades. The world economy responded to the fiscal and monetary stimuli applied by the United States and the growth of China. Our trade partners experienced growth of 4.6 percent.

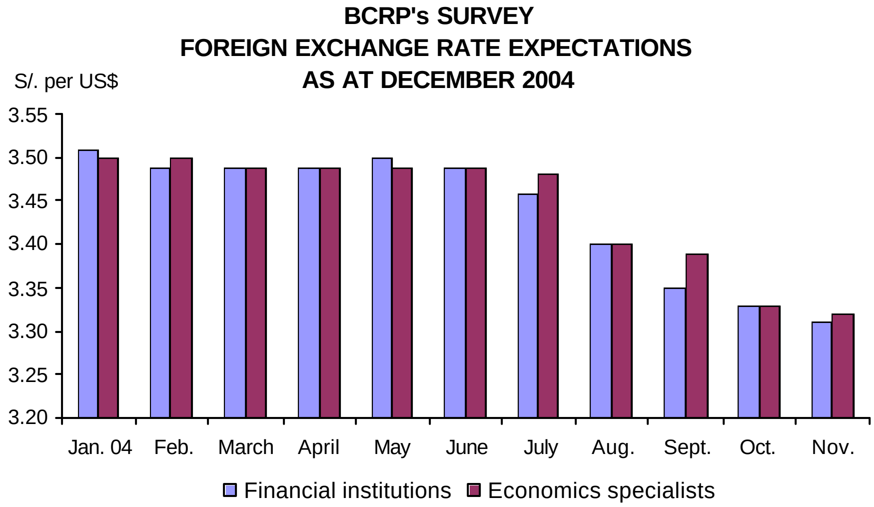
As far as the United States, our principal trading partner, was concerned, growth in 2004 would be around 4.4 percent because of improved private sector consumption. This occurred despite increased fuel prices and the beginning of a cycle of interest rate increases by the FED in the second half year (the FED increased rates by 25 base points on five opportunities, from 1 percent at the start of June to 2.25 percent in December). Despite significant economic growth, uncertainty regarding the United States' external and fiscal imbalances persisted and this led the dollar to depreciate considerably against other strong currencies such as the euro and yen, which in turn affected growth in Europe and Japan, which reached 2.4 and 3.9 percent, respectively.

Among the developing economies, China stood out with a growth rate of 9.3 percent during 2004 in spite of taking certain measures to prevent its economy overheating. China, which represents around 13 percent of world GDP, became an important consumer of raw materials, contributing to high prices for basic export products.

Low rates of interest and high commodity prices had a positive impact on Latin American economies, which saw both the volume and price of their exports rise (in the case of Peru, the terms of trade increased 8 percent) and favorable conditions arose for external financing. To these factors can be added an improvement in the credit rating of emerging economies (fourteen economies improved their rating in 2004) which led the financial markets to increase their demand for emerging economy bonds, enabling high levels of debt issue and minimal *spreads*.

e) **Low expectations of depreciation**: This favorable international developments also contributed to continued low expectations that the nuevo sol would depreciate. The rate of depreciation implied in *forward* contracts dropped from 1.9 percent to 1.5 percent between the end of July and December 2004, whilst exchange rate forecasts were continually revised downwards.

Figure 17

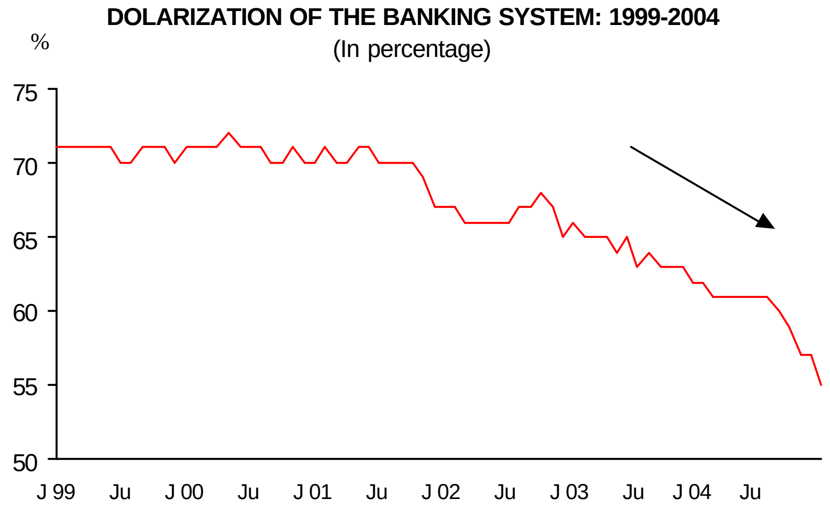


Sources: BCRP monthly surveys

Likewise, low expectations of depreciation meant that fewer *forward* operations were carried out in 2004 compared to 2003 and a significant increase in *forward* purchases, which rose from US$ 225 to US$ 523 million, although the balance of *forward* sales remained relatively stable.

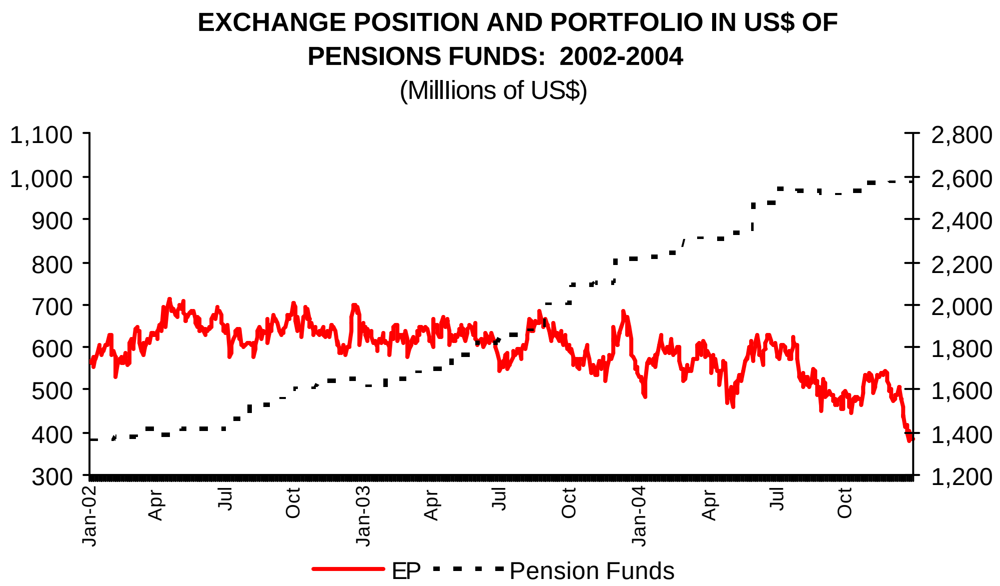
f) **Portfolio restructuring**: In this context, economic agents in general switched their portfolios from foreign currency denominated assets to those denominated in domestic currency. Thus, the coefficient of dollarization of the banking system fell from 62 to 55 percent between December 2003 and December 2004.

Figure 18



Commercial Bank's exchange position[1] fell from US$ 536 to US$ 387 million, whilst pension fund managers ceased increasing their dollar-denominated portfolios in the second half year.

Figure 19



[1] Assets less liabilities in dollars of banks, including future contracts in dollars.

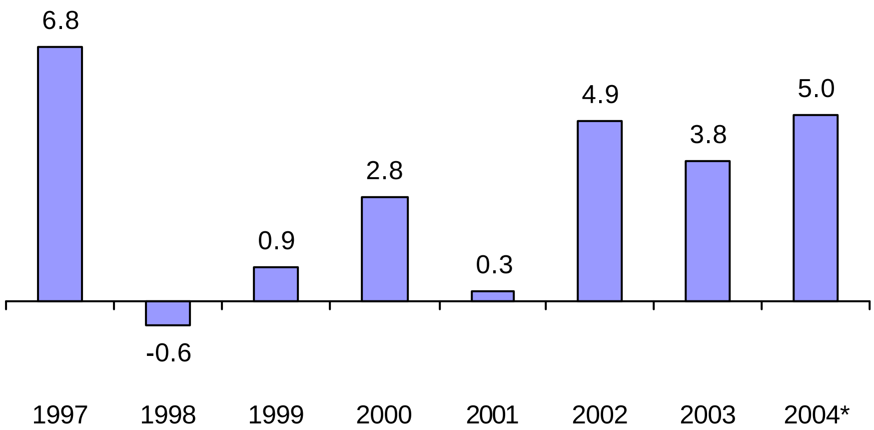
I.3 Domestic demand and GDP

In 2004 economic activity would have risen 5.0 percent, continuing with the tendency towards inflation-free growth that has been seen in the last 3 years. This behavior reflects the surge in exports in a favorable international context, as well as an increase in private investment whose high rate of growth contributed to an expansion in the production capacity of the economy.

Broken down by sector, non-primary activities drove growth (5.6 percent), particularly non-primary manufacturing (7.2 percent) whilst the primary sectors saw a lower rate (2.8 percent) because of a fall in agriculture sector production associated with the weather, which affected the prices mainly of rice and sugar.

Figure 20

GDP GROWTH RATE: 1997-2004



9. In seasonally adjusted terms, GDP grew steadily from the beginning of 2001 and mirrored this tendency from 2003. This dynamism was accompanied by increases in domestic demand and non-primary manufacturing.

Figure 21

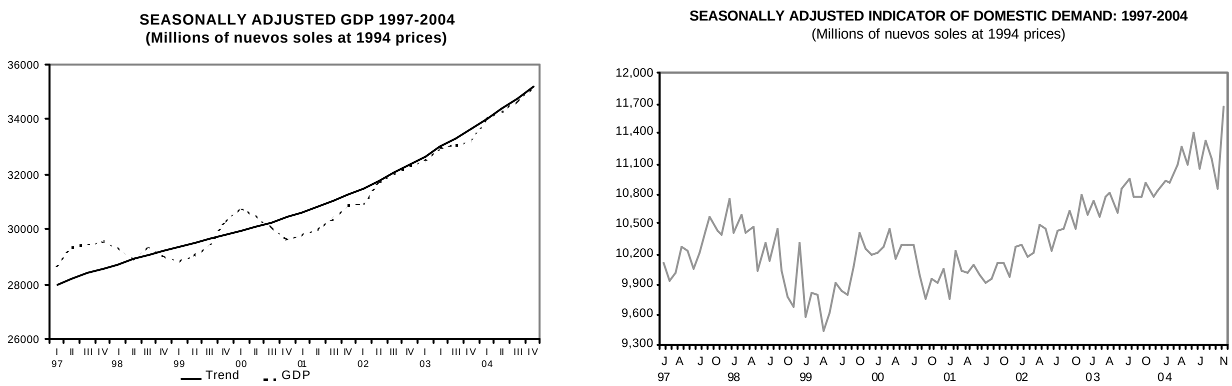
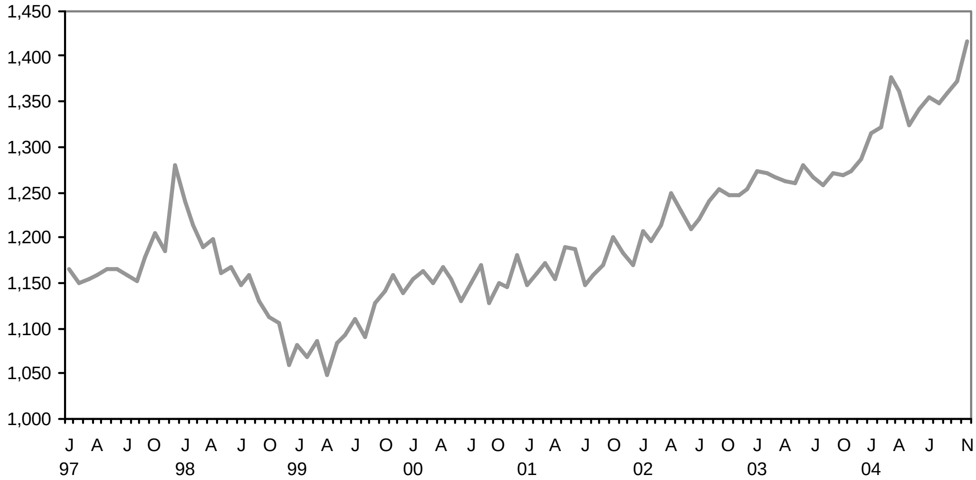


Figure 22

SEASONALLY ADJUSTED NON-PRIMARY MANUFACTURE: 1997-2004
(Millions of nuevos soles at 1994 prices)



10. The recovery in domestic demand over the last two years has also been driven by **private investment**. After the contraction in private investment over the 1998 - 2001 period, a gradual recovery began in 2002, with a growth rate of 0.1 percent, which continued during 2003 and 2004 at rates of expansion of 5.4 percent and 9.4 percent, respectively. This recovery in private investment is explained by a favorable economic environment characterized by price stability, sustained economic growth and greater penetration by Peruvian products in the international market. Low interest rates, as well as better credit conditions deriving from greater competition in the financial sector, have also favored the growth in private investment.

    During the year the growth in private investment was driven by development of the Alto Chicama project, investment by Minera Yanacocha, completion of the Camisea project, the modernization of Ilo refinery and modernization work at Jorge Chavez airport. Other important projects were those carried out by telecommunications companies such as TIM, Telefonica and Nextel and manufacturers such as Corporacion Aceros Arequipa and Alicorp. This greater dynamism was reflected in an increase in imports of capital goods for industry which, during 2004, increased 16.4 percent in a context of 7.2 percent growth in the non-primary manufacturing sector. Worth noting was the increase of around 15 percent in machinery imports for the textile sector.

    Thus private investment as a percentage of GDP may have reached 15.3 percent in 2004, higher than the 15 percent recorded in 2003.

Table 6

GLOBAL SUPPLY AND DEMAND

(Real percentage variation)

	2002	2003	2004*
I. GLOBAL DEMAND (1 + 2)	**4.4**	**3.7**	**5.6**
1. Domestic demand	4.0	3.3	3.8
a. Private consumption	4.4	3.1	3.3
b. Public consumption	0.2	2.9	3.9
c. Private investment	0.1	5.4	9.4
d. Public investment	-4.8	5.0	3.1
2. Exports	6.8	5.9	15.2
II. GLOBAL SUPPLY (3 + 4)	**4.4**	**3.7**	**5.6**
3. Gross domestic product	**4.9**	**3.8**	**5.0**
4. Imports	2.1	3.3	9.5

* Forecast.

Source: INEI & BCRP.

11. **Private consumption** continued its upward trend throughout 2004. This growth was associated with an increase in **national disposable income** of 5.7 percent, higher than the growth in GDP, as a consequence of better terms of trade and higher net transfers from non-residents which increased by 13.1 percent.

Table 7

NATIONAL DISPOSABLE INCOME

(Real percentage variation)

	2002	2003	2004*
I. Gross domestic product (GDP)	4.9	3.8	5.0
II. Gross national product (GNP) 1/	4.3	2.9	3.5
III. Gross national income (NI) 2/	4.5	3.4	5.6
IV. National disposable income (NDI) 3/	4.4	3.6	5.7

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

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

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

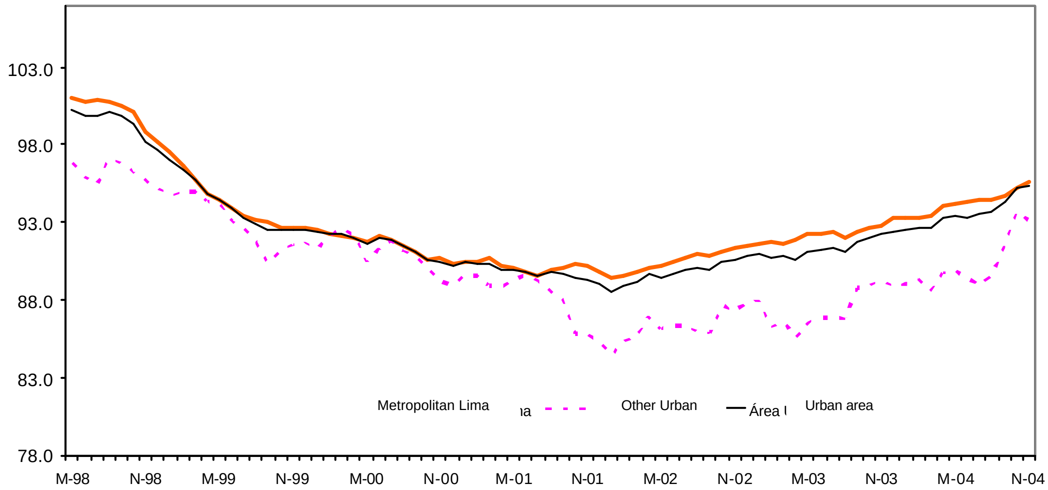
* Forecast.

Source: INEI & BCRP.

An increase in urban employment in 2004 also affected the increase in private consumption. According to the Ministry of Labor, companies with 10 or more workers in urban areas, created 2.6 percent more jobs in 2004. The growth in employment was greater in cities in the interior of the country, where growth averaged 3.4 percent, whilst employment in metropolitan Lima grew 2.4 percent. The cities which recorded the highest increase in employment were: Ica, Piura and Trujillo (associated with agribusinesses) and Iquitos (associated with forestry activities).

Figure 23

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



Source: ENVME, MTPE.

Table 8

URBAN EMPLOYMENT IN MAIN CITIES
COMPANIES WITH 10 OR MORE EMPLOYEES
(Percentage annual variation)

	November 2004/ November 2003	Jan.-Nov.2004/ Jan.-Nov. 2003
Urban Peru	**3.4**	**2.6**
Metropolitan Lima	3.0	2.4
Other urban	4.4	3.4
Ica	14.0	8.8
Iquitos	11.5	6.1
Piura	10.9	8.7
Pisco	6.4	1.6
Trujillo	6.0	5.7
Paita	5.1	8.4
Arequipa	2.9	2.5
Chincha	2.8	4.6
Pucallpa	2.2	0.2
Huancayo	2.1	2.7
Cusco	0.0	0.4
Cajamarca	-0.4	1.4
Chimbote	-0.4	2.9
Chiclayo	-1.8	-1.2
Puno	-2.8	-4.8
Tarapoto	-3.2	-0.9
Tacna	-3.6	-3.4

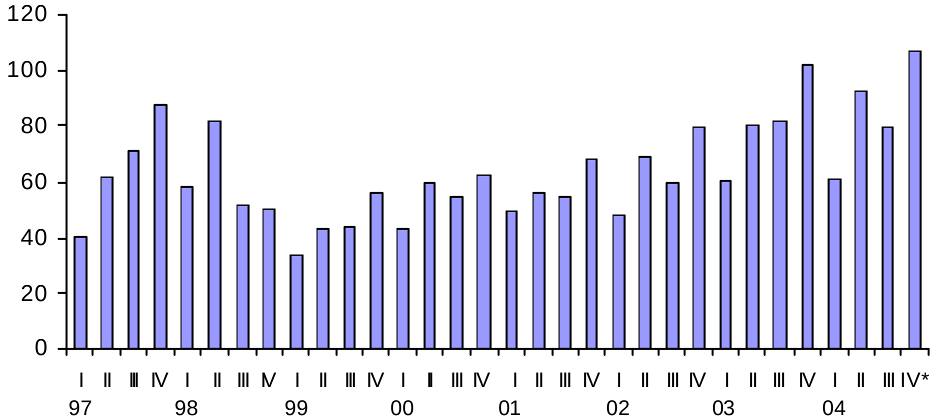
Source: MTPE monthly statistical report.

Some indicators of increased private consumption are growth in sales of new automobiles and pick-up trucks, which had increased 20.8 percent by November, as well as an increase in imports of consumer goods, which may have risen 4.4 percent in 2004. Furthermore, consumer loans granted by finance companies had increased 15.4 percent by October.

Figure 24

ELECTRICAL APPLIANCES IMPORTS

(Millions of US$)



12. **Public consumption** should have risen 3.9 percent in 2004 because of an increase in both wages and expenditure on goods and services by central government, regulatory entities and public records offices. Public investment should have increased 3.3 percent, principally the result of increased spending by central government in the second half of the year, as well as by Sedapal, Enapu and regional electricity companies.

13. The favorable international environment contributed to a growth in **exports** in 2004 of 15.2 percent, the highest figure for 10 years. Among traditional exports, copper, lead and iron ore stand out, together with coffee and fish meal. Among non-traditional products, which showed an upward trend throughout the year, were textiles, chemical products, agriculture and livestock products, iron and steel and jewelry.

14. **Imports** were also dynamic during 2004, with a rate of growth that should have reached 9.5 percent. Significant among them were purchases by industry, of both raw materials (21.3 percent) and capital goods (16.4 percent). To these were added imports of vehicles, which rose 42.2 percent.

GDP broken down by sector

15. In 2004 the **non-primary sectors** drove economic growth, with a rate of 5.6 percent, non-primary manufacturing stood out with an increase of 7.2 percent. As far as the **primary sectors** were concerned, the rate was lower (2.8 percent) because of a contraction in the agriculture and livestock sector in the first half year associated with adverse weather, which was reversed in the second half year and partially counteracted the effect of supply shocks on agriculture prices.

Table 9

GROSS DOMESTIC PRODUCT

(Real percentage variation)

	2002	2003	2004*
Agricultural & livestock	**6.0**	**2.3**	**-1.0**
Fishing	**5.7**	**-12.6**	**28.3**
Mining & fuel	**12.5**	**6.9**	**5.4**
Metals	12.3	7.7	5.2
Fuel	0.6	-4.5	7.1
Manufacturing	**4.0**	**2.1**	**6.7**
Based on raw materials	0.0	-1.8	4.6
Non-primary	5.2	3.2	7.2
Electricity and water	**5.0**	**4.2**	**4.5**
Construction	**7.9**	**4.2**	**4.8**
Commerce	**4.3**	**3.8**	**4.2**
Other Services	**3.8**	**4.0**	**5.8**
GROSS VALUE ADDED	**5.0**	**3.6**	**5.0**
Taxes on products and import duties	3.7	5.3	4.2
GDP	**4.9**	**3.8**	**5.0**
Primary gross value added	7.0	2.8	2.8
Non-primary gross value added	4.4	3.8	5.6

* Forecast.
Source: INEI.

16. The **Agriculture and Livestock sector** faced adverse weather conditions (lack of rain and abrupt changes in temperature), which resulted in a fall of 3.2 percent in agriculture production in 2004.

    The north coast (from Tumbes to La Libertad) faced an acute shortage of water. Reservoirs in the north were 60 percent empty during the first 10 months of the year compared to 2003, and this discouraged planting and affected yields. Rice production fell (14.9 percent), as did that of sugar cane (21.6 percent) and hard yellow maize (12.3 percent) which are grown mainly in this part of Peru (they represented 56, 72 and 32 percent respectively of total national production in 2003).

    In the central highlands freezing temperatures and thaws in the early months of 2004 affected the production of potatoes, maize, wheat and natural pastures. Potato production fell 4.9 percent and that of maize 15.9 percent mainly during April - July, in which months approximately 68 and 83 percent respectively of these crops is harvested.

    The fall in the production of the sector was attenuated by greater rice production in the department of San Martin, replacing the drought-affected zones in the north, which rose 59 percent, and higher coffee production, which rose 6.5 percent in the jungle region. This later crop was stimulated by higher international prices, which increased on average 25 percent during the year. Another product which offset reduced agriculture production was cotton, production of which rose 25.7 percent to supply an expanding textile industry.

17. Growth in the **fishing sector** in 2004 was 28.3 percent, based on a significant recovery in Peruvian anchovy catches resulting from favorable oceanographic conditions and more young fish among the adult population. An increase in fresh and frozen fish production was also observed, whilst canned production fell because of lower catches, particularly of mackerel.

18. The **mining and hydrocarbons sector**, in a context of favorable international prices, recorded an increase of 5.4 percent based on increased copper production, principally by Antamina, the restarting of mining at Tintaya and expansion by Southern Peru; increased gold production by Yanacocha; and iron ore production to meet higher demand from China. In contrast, zinc production fell 11.9 percent as Antamina reduced its share. Crude oil production in 2004 increased 3.3 percent whilst that of natural gas increased 64.2 percent as production from Camisea got under way.

19. During 2004, **manufacturing industry** should have increased 6.7 percent, with a 7.2 percent increase in non-primary manufacturing, whilst primary processing should have grown 4.6 percent.

    Growth in **non-primary manufacturing** was led by the textile, leather and footwear industries; as well as by paper manufacture and printing, chemical products, rubber and plastics and non-metallic minerals. This was the result of an increase in non-traditional exports (36 percent), the development of certain mining projects, dynamism in the construction sector and an increase in domestic demand stimulated by the introduction of new products.

    In the case of the **primary resources processing industry**, higher production reflects a greater availability of resources, principally for the manufacture of fish oil and fishmeal.

BOX 6
NON-PRIMARY MANUFACTURING IN 2004

2004 saw a likely increase in non-primary manufacturing of 7.2 percent, the highest rate since 1995 - in which it grew 8.2 percent. The growth observed in non-primary manufacturing over five years of continued expansion, is due to a number of factors both macroeconomic and microeconomic. In addition to these factors, the international context was favorable, meaning an increase in terms of trade of 8.0 percent, thanks to a 17 percent increase in export prices.

The role of monetary stimulus through historically low interbank interest rates should also be noted. Among the macroeconomic factors, macroeconomic stability and the application of coherent policies (monetary, fiscal, customs and foreign trade) were important and made possible a continuous increase in production and employment, which led in turn to a growth in consumption.

The conduct of monetary policy – consistent with the inflation target - permitted interest rates to be kept low, this is reflected in the corporate 90 day prime interest rate in soles, which went from an average of 4.1 percent during 2003 to 3.5 percent in 2004. Similarly, in a context of prudent fiscal policy designed to keep public expenditure within the limits set by law, it was possible to increase the Mivivienda fund. This fund granted 6,842 mortgage loans in 2003 and 7,958 in 2004, an increase of 20 percent in the amount loaned, from S/. 470 million in 2003 to S/. 565 million in 2004 with the consequent stimulation of the building industry.

Foreign trade policy, through the signing and/or negotiation of new commercial agreements has given Peruvian products access to new markets or under more competitive conditions. An outstanding example was the signing of the ATPDEA agreement with the United States, which included textiles within the system of preferential customs tariffs and duplicated non-traditional exports to that country, principally textiles. Also, regional trade agreements (CAN, Chile and, recently, MERCOSUR) favor an expansion of exports to these markets; particularly in the case of Bolivia and Colombia, with rates of the order of 30 percent in 2004.

One factor contributing to he competitiveness of manufacturing was a reduction in customs duties in December 2003 and February 2004 principally applying to capital goods and non manufactured supplies. Imports of supplies and capital goods benefiting from the reduction in customs duties grew between 20 and 40 percent.

CUSTOMS ITEMS BENEFITING FROM THE REDUCTION IN DUTIES

Level customs	Items	Latest reduction	Increase in imports		
			2002	2003	2004
0	115	Feb-04	41.5%	8.4%	40.4%
4	2,603	Dec-03	6.0%	6.0%	23.2%
7	122	Mar-02	-1.3%	1.4%	21.1%

The application of safeguards on textile products imported from China in December 2003, significantly reduced imports from that country from US$ 38 million in 2003 to US$ 1 million in 2004.

The favorable macroeconomic conditions described above - in a context of improved terms of trade that meant a 5.6 percent increase in national income and stimulating consumption - would not have produced these results were it not for the presence of microeconomic factors such as continual adaptation by businessmen to new market conditions.

On the one hand more demanding consumers requiring higher quality products at reduced prices, and on the other a more open, more competitive market with important changes in business ownership that freed up capital from one sector - in which foreign capital has entered (Ambev, the Bavaria group, Alto Chicama, Camisea, Lima Airport Partners, among others) to be invested in other sectors (the Brescia Group in fishing) and lower financing costs, made possible an expansion of domestic manufacturing capacity that was able to respond to the increased demand.

As can be seen in the table, between January and November non-primary manufacturing grew 6.8 percent with 3.5 percentage points of this growth driven by higher domestic demand - which, by the end of the year had increased 3.8 percent - and 3.3 percentage points due to higher exports, particularly non-traditional ones which, between January and November grew by 35 percent, that is, an increase of US$ 818 million compared to the same period in the previous year.

NON-PRIMARY MANUFACTURING PERCENTAGE CONTRIBUTION TO GROWTH BY DESTINATION MARKET AND BY INDUSTRIAL GROUP PERIOD JANUARY - NOVEMBER 2004 1/

(In percentage points)

	Growth per domestic market	Growth per external market	Contribution to total growth
Food, beverages and tobacco	0.2	0.3	0.5
Textiles, leather and footwear	0.9	1.1	2.0
Timber and furniture	0.7	0.2	0.9
Paper manufacture and printing industry	0.8	0.2	1.0
Chemical products, rubber and plastics	-0.1	0.9	0.8
Non-metallic minerals	1.0	0.2	1.1
Iron and steel industry	0.1	0.1	0.2
Metal products, machinery and equipment	0.0	0.2	0.2
Manufactured goods, various	-0.1	0.2	0.1
Total non-primary manufacturing	**3.5**	**3.3**	**6.8**

1/ Not including indirect effects.

Breaking down this growth by industry, we can see the impact of higher textile exports under the ATPDEA agreement with the United States on industrial growth in 2004, the main component (1,1 percentage points) of the global rate of 6.8 percent. Textile exports grew by US$ 247 million in the period January - November. In addition, exports of chemicals, which increased by US$ 147 million, had an important role and explained all of the growth of the sector. This heading includes cleaning and beauty products.

The **construction sector** should have achieved a growth rate of 4.8 percent in 2004, as a consequence of a more dynamic mortgage loan market driven by the Mivivienda program - financial system mortgage loans rose 12.5 percent in November compared to the same month in the previous year - as well as a number of investment projects, principally Camisea and Alto Chicama.

I.4 External accounts

2004 was characterized by a very favorable international context. Higher world growth, particularly by China, caused an 8 percent increase in our terms of trade and 2004 saw the trade balance and exports reach record levels. This latter was reflected in the growth in demand for our exports, which was the most dynamic component of GDP growth during 2004.

The high trade surplus and increased remittances from abroad were reflected in an improved balance of payments current account balance, which almost wiped out the deficit (the lowest figure for 25 years).

20. Favorable developments of the terms of trade was decisive in producing a positive balance of payments and, in particular, in obtaining a record surplus in the trade balance during 2004, which exceeded the forecasts contained in the last Inflation Report.

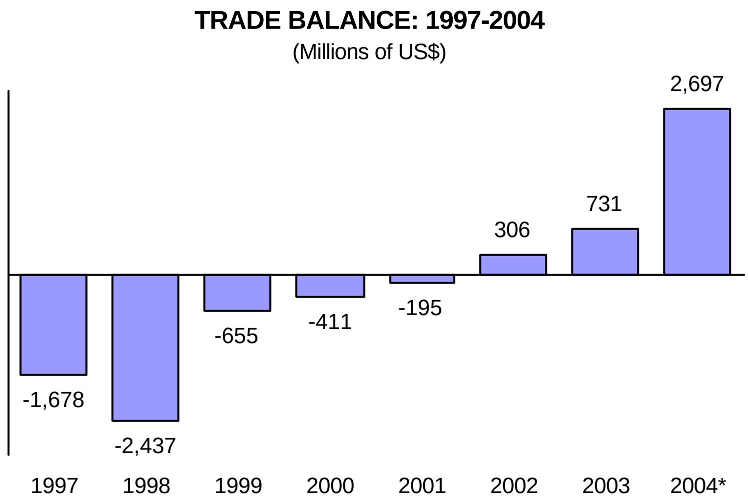
Table 10
BALANCE OF PAYMENTS
(Millions of US$)

	2003	2004				
		I Q.	II Q.	III Q.	IV Q.	Year
I. CURRENT ACCOUNT BALANCE	**-1,061**	**-129**	**-223**	**167**	**171**	**-13**
Percentage of GDP	*-2*	*-1*	*-1*	*1*	*1*	*0*
1. Trade balance	731	605	405	827	860	2,697
a. Exports	8,986	2,736	2,823	3,368	3,586	12,513
b. Imports	-8,255	-2,131	-2,418	-2,542	-2,726	-9,816
2. Services	-931	-246	-251	-226	-229	-952
3. Investment income	-2,082	-812	-724	-802	-878	-3,216
4. Current transfers	1,221	324	346	368	419	1,458
II. FINANCIAL ACCOUNT	**1,476**	**335**	**664**	**122**	**1,174**	**2,296**
1. Private sector 1/	791	370	391	257	252	1,271
2. Public sector	685	-34	272	-135	922	1,025
III. EXCEPTIONAL FINANCING	**64**	**2**	**1**	**1**	**22**	**26**
IV. NET FLOW OF CRBP RESERVES (1-2)	**-479**	**-209**	**-441**	**-291**	**-1,368**	**-2,309**
(Increase with negative sign)						
1. Variation in NIR balance	-596	-217	-444	-332	-1,444	-2,437
2. Valuation changes and monetization of gold	-118	-8	-3	-41	-77	-128

*/ Forecast.
1/ Includes short term capitals and net errors & omissions.

21. In 2004 the **trade balance** registered a surplus for the third consecutive year, amounting to US$ 2,697 million, higher by US$ 1,966 million of the previous year and a historic record. This result was explained by a 39 percent increase in exports, 19 higher than imports. It is worth pointing out that this figure is US$ 648 million higher than the forecast included in the August Inflation Report.

Figure 25



* Forecast.

22. In 2004 **exports** also reached the unprecedented level of US$ 12,513 million, a figure US$ 3,527 million higher than in 2003. It should be pointed out that this is explained not only by increases in international prices (17 percent) but also by the volumes exported (19 percent). Traditional exports grew 41 percent whilst the non-traditional sort grew 36 percent. Exports were US$ 1,003 million higher than the level forecast in the August Inflation Report.

23. Traditional exports were led by copper, because of higher prices (62 percent) and higher volumes (20 percent) as well as gold exports driven by an increase in the price (13 percent). Also, a recovery in fish stocks enabled increased production of fishmeal (28 percent). As far as non-traditional exports were concerned, 2004 was characterized by dynamic textile exports, which grew 33 percent within the framework of the ATPDEA agreement. Nevertheless, all sectors recorded growth in excess of 20 percent, with the agriculture and livestock sector (28 percent), chemicals (55 percent) and iron and steel products and jewelry (49 percent) particularly prominent. The greater dynamism of the chemicals sector during the year was related to sales of naphtha from Camisea.

24. **Imports** grew by 19 percent, reaching US$ 9,816 million, particularly prominent being increases in raw material (23 percent) driven by increased fuel purchases, whose prices increased by an average of 24 percent and purchases of supplies for industry. Capital goods increased by 19 percent particularly vehicles and capital goods for industry, associated with acquisitions by the mining, telecommunications and information technology services sectors.

25. The **balance of payments current account** should be almost zero in 2004, with a deficit of only US$ 13 million, equivalent to 0.0 percent of GDP and less by US$ 1,048 million of the previous year. This is principally the result of an improved trade balance, helped by a 30 percent increase in remittances from Peruvians living abroad (which reached US$ 1,117 million), counteracting the greater profits generated by foreign companies, largely because of higher international prices for basic products.

26. The **financial account** recorded a flow of US$ 2,296 million during 2004, higher than the figure of US$ 820 million for the previous year. This increase is explained by a greater flow of private and public capital. Private **capital** reached US$ 1,271 million, US$ 480 million higher than in the previous year. This increase is explained by higher direct investment associated with profits generated and retained by foreign companies to finance new projects such as Alto Chicama, and reduced investment by the financial sector such as the pension fund managers (AFPs) in assets abroad. **Public capital** recorded a flow of US$ 1,025 million, greater than in the previous year and mainly explained by eurobond placements valued at US$ 796 million in October, at a dollar rate of 8.54 percent, as part of the pre-financing for 2005 carried out in a context of sovereign risk that fell continually throughout the year.

27. With this placement net international reserves for 2004 increased by US$ 2,309 million to give a net balance of US$ 12,631 million, equivalent to 2.7 times foreign debt due in one year and 15 months of imports.

I.5 Public finances

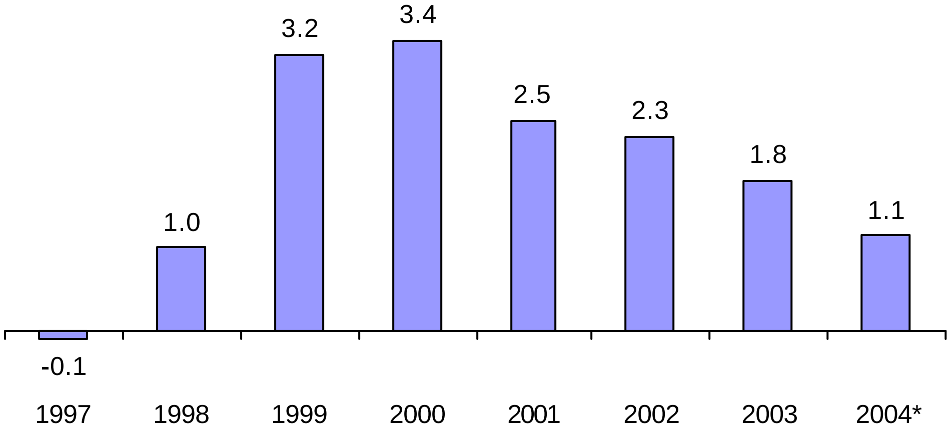
The fiscal deficit in 2004 fell to 1.1 percent of GDP, 0.7 percentage points of GDP lower than the 2003 deficit (1.8 percent of GDP) and the lowest level for 6 years.

28. The **fiscal deficit** in 2004 fell to 1.1 percent of GDP, 0.7 percentage points of GDP lower than the 2003 deficit (1.8 percent of GDP). The **primary balance** was equivalent to 1.0 percent of GDP, 0.6 percentage points higher than the previous year and explained by a real increase in current income (8.2 percent), higher than non-financial expenditure (4.8 percent). These latter were more dynamic during the second half year, largely reversing the problems of lower performance experienced in the first half year. Also during the year interest payments were lower by 0.1 percent of GDP as a consequence of exchange rate appreciation.

Figure 26

FISCAL DEFICIT: 1997-2004

(Porcentage of GDP)



29. The improved primary balance is basically the consequence of two macroeconomic factors that have increased tax revenue: on the one hand economic growth has had a favorable effect on tax revenues as companies sold more and made more profits; and on the other hand, better terms of trade caused by higher raw materials prices increased the income tax take. The policy of saving temporary income has contributed to the long-term sustainability of the public finances, which reduces country risk and creates better financing conditions for the treasury and the rest of the economy.

30. The improved **primary balance of the public sector** is principally due to improved central government operations, particularly more dynamic current revenues. An improvement can also be seen in regulatory authority accounts and the operations of state-owned companies, especially the accounts of Petroperu and the regional electricity companies.

Table 11

NON-FINANCIAL PUBLIC SECTOR

(Millions of nuevos soles)

	2002	2003	2004 *				
			I Q.	II Q.	III Q.	IV Q.	YEAR
1. Current income	**28,559**	**31,551**	**8,205**	**9,190**	**8,814**	**9,169**	**35,377**
(% of GDP)	14.4	15.0	15.1	14.8	15.4	15.5	15.2
Real % change	5.3	8.0	6.8	12.3	7.3	6.2	8.2
2. Non financial costs	**-29,241**	**-31,460**	**-6,784**	**-7,896**	**-9,102**	**-10,400**	**-34,182**
(% of GDP)	-14.7	-14.9	-12.5	-12.7	-15.9	-17.5	-14.7
Real % change	2.1	5.2	-2.7	0.2	10.7	8.9	4.8
Current	-25,285	-27,375	-6,306	-7,115	-7,851	-8,598	-29,870
(% of GDP)	-12.7	-13.0	-11.6	-11.5	-13.8	-14.5	-12.8
Real % change	3.6	5.9	1.2	2.9	7.5	8.4	5.3
Capital	-3,956	-4,084	-478	-781	-1,251	-1,802	-4,312
(% of GDP)	-2.0	-1.9	-0.9	-1.3	-2.2	-3.0	-1.9
Real % change	-6.7	1.0	-35.3	-19.0	36.1	11.6	1.8
3. Others	**437**	**814**	**469**	**475**	**321**	**-58**	**1,207**
(% of GDP)	0.2	0.4	0.9	0.8	0.6	-0.1	0.5
4. Primary balance	**-245**	**905**	**1,890**	**1,769**	**33**	**-1,289**	**2,403**
(% of GDP)	-0.1	0.4	3.5	2.8	0.1	-2.2	1.0
5. Interest	**-4,281**	**-4,633**	**-1,415**	**-1,136**	**-1,217**	**-1,160**	**-4,927**
(% of GDP)	-2.2	-2.2	-2.6	-1.8	-2.1	-2.0	-2.1
Of which:							
Pension recognition bonds	144	-235	-204	-86	-19	-17	-326
External debt (millions of US$)	-$999	-$1,082	-$311	-$251	-$305	-$292	-$1,158
6. Overall balance	**-4,526**	**-3,728**	**475**	**633**	**-1,184**	**-2,448**	**-2,524**
(% of GDP)	-2.3	-1.8	0.9	1.0	-2.1	-4.1	-1.1
Millions of US$	-$1,279	-$1,072	$137	$182	-$348	-$741	-$771

* Forecast.

31. **Central government current income** amounted to 15.2 percent of GDP, 0.2 percentage points of GDP higher than in 2003. This improvement was due to an increase in income tax revenue of S/. 1,055 millions and value-added tax revenue (VAT) of S/. 2,095 million. As far as income tax was concerned, the increase was due to higher payment on account coefficients, greater economic activity and improvements in mineral prices. Increased VAT revenue came from an increase in the rate from 16 to 17 percent in the second half year of 2003, measures to widen the tax base and increased economic activity.

In addition, this growth reflected the application of the financial transaction tax (ITF) created in March 2004, which produced S/. 650 million. This was partially offset by lower revenue from customs duties and excise tax on fuels, as the rates were reduced.

32. **Central government non-financial expenditure** expanded 4.8 percent in real terms, because of increases granted to the education, defense and interior portfolios, with remuneration rising 4.8 percent in real terms compared to 2003. Goods and services increased 8.1 percent in real terms, principally because of increased assignments to the ministries of defense and the interior and payment of debts owed by Petroperu for fuels. Purchases for the Food Aid Program also increased. Central government capital expenditure rose 1.8 percent in real terms compared to the previous year, fundamentally because of higher gross capital formation (a real 5.4 percent) linked to greater spending by regional governments and those administered by Foncodes.

33. Longer due dates for payment of foreign and domestic debt were attenuated by a reduction in the fiscal deficit (US$ 301 million), which meant that the financial requirements of the public sector rose to US$ 2 839 million. It should be pointed out that this demand for funds was covered by external financing amounting to US$ 2,471 million, including US$ 1,176 million in disbursements and US$ 1,295 in sovereign bonds (this amount includes US$ 796 million in forward financing for 2005). Domestic bonds denominated in Peruvian currency were also issued for the equivalent to US$ 766 million and revenue from privatizations amounted to US$ 114 million.

Table 12

NON-FINANCIAL PUBLIC SECTOR FINANCING

	2002	2003	2004 *				
			I Q.	II Q.	III Q.	IV Q.	YEAR*
1. Overall balance (Million of nuevos soles)	**-4,526**	**-3,728**	**475**	**633**	**-1,184**	**-2,448**	**-2,524**
(% of GDP)	-2.3	-1.8	0.9	1.0	-2.1	-4.1	-1.1
Millions of US$	-$1,279	-$1,072	$137	$182	-$348	-$741	-$771
2. Amortization (Millions of US$)	**-$1,084**	**-$1,743**	**-$420**	**-$578**	**-$438**	**-$633**	**-$2,069**
Redemption of pension recognition bonds	-$55	-$172	-$51	-$77	-$38	-$49	-$215
Internal repayments	-$138	-$385	-$72	-$179	-$91	-$162	-$505
External repayments	-$891	-$1,187	-$297	-$321	-$309	-$421	-$1,349
3. Borrowing requirement (Millions of US$)	**$2,364**	**$2,815**	**$284**	**$396**	**$786**	**$1,374**	**$2,839**
External disbursement	$1,961	$2,101	$260	$645	$244	$1,323	$2,471
Free disposal funds	$1,609	$1,765	$201	$579	$181	$1,196	$2,157
Investment projects	$352	$336	$59	$66	$63	$127	$315
Domestic bonds	$213	$508	$173	$97	$172	$324	$766
Privatization	$421	$52	$70	$5	$4	$36	$114
Others	-$231	$154	-$219	-$351	$366	-$309	-$512

* Forecast.

I.6 Interest rates and monetary aggregates

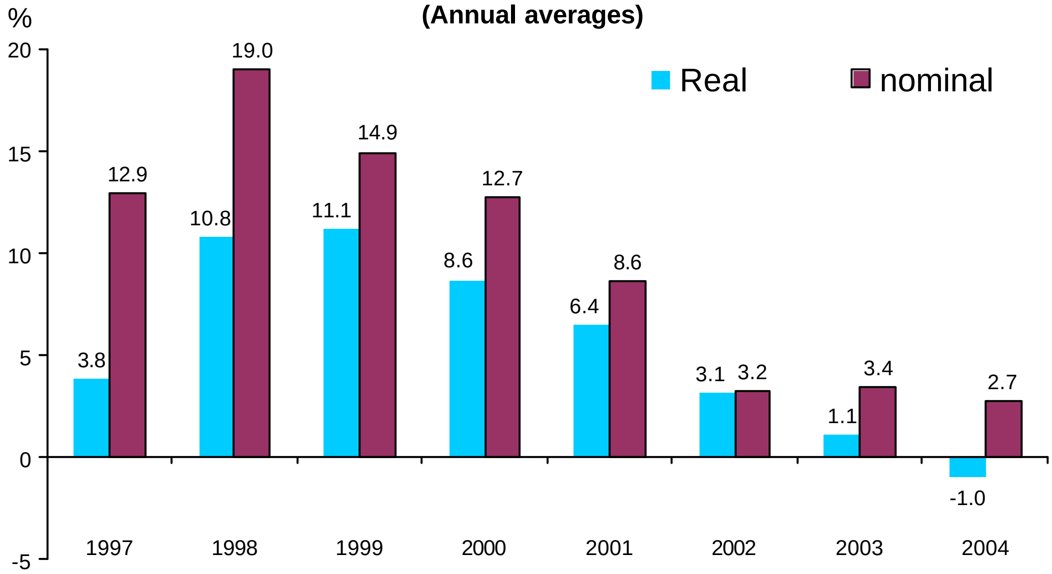
During 2004, the economy was affected by successive inflationary supply shocks. Given the transitory character of these shocks, the Central Bank thought it unnecessary to modify its monetary position. However, such was the magnitude and persistence of the inflation rate's deviation from the target that the BCRP increased its reference rate twice to prevent these increases from affecting the other components of the retail prices index. This decision was in line with the need to gradually reduce monetary stimulus.

Interbank interest rate

34. The Central Reserve Bank establishes its monetary position through a reference rate of interest for the interbank market. Consistent with its inflation target, monetary policy over the last 3 years has been the use of monetary stimulus, which also favored a recovery of economic activity in the period of recession between 1998 and 2001. This monetary stimulus was reflected in historically low real interbank interest rates.

Figure 27

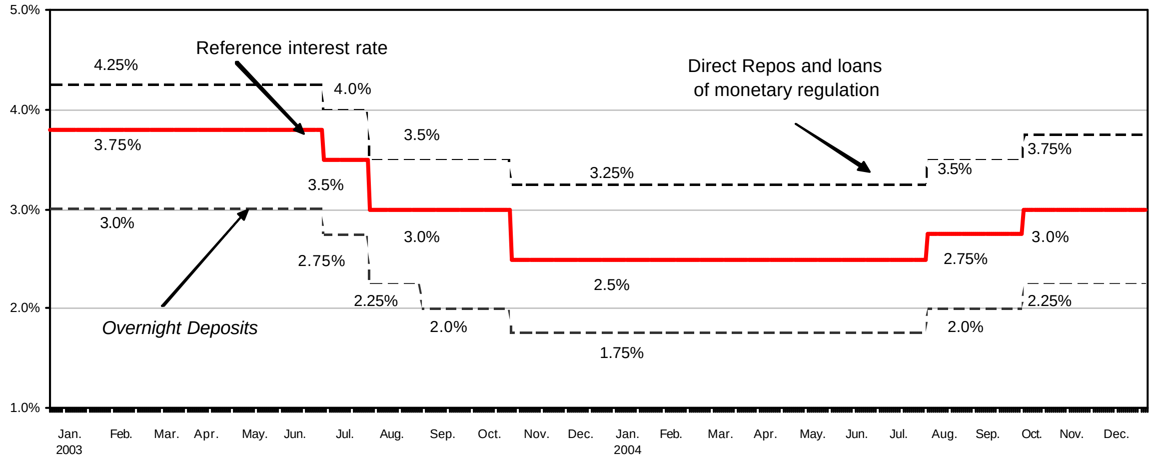
INTERBANK INTEREST RATE, REAL AND NOMINAL: 1997-2004
(Annual averages)



35. Up to July 2004, the Central Reserve Bank kept its reference interest rate constant at 2.5 percent. The accumulated rate of inflation over the last 12 months has since June been above the upper limit of the target range (3.5 percent), but given the temporary nature of the source of this variation (supply shocks associated with foodstuffs and fuel), the BCRP thought it unnecessary to modify its monetary position, and this was reported in the January and May inflation reports.

Figure 28

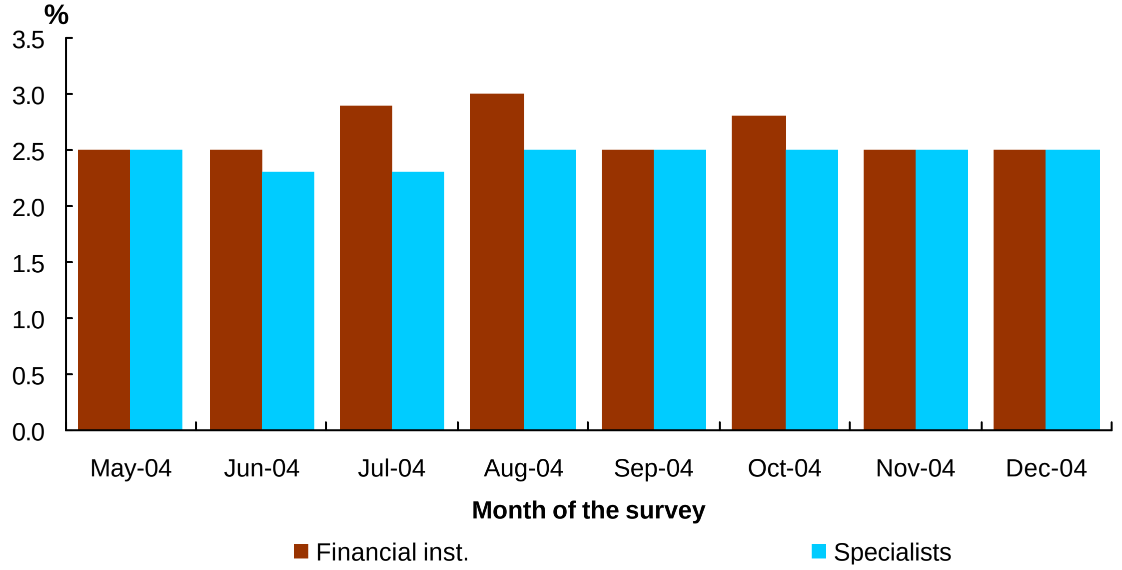
REFERENCE INTEREST RATE
(January 2003 - December 2004)



36. In the face of a succession of supply shocks and accelerated accumulated inflation in the last 12 months, which reached 4.6 percent in July, the BCRP twice raised its reference interest rate (in August and October), from 2.5 percent in July to 3.0 percent in October seeking to avoid the price increases of products affected by the supply shock from influencing core inflation. This decision was in line with the need to gradually reduce monetary stimulus.

Figure 29

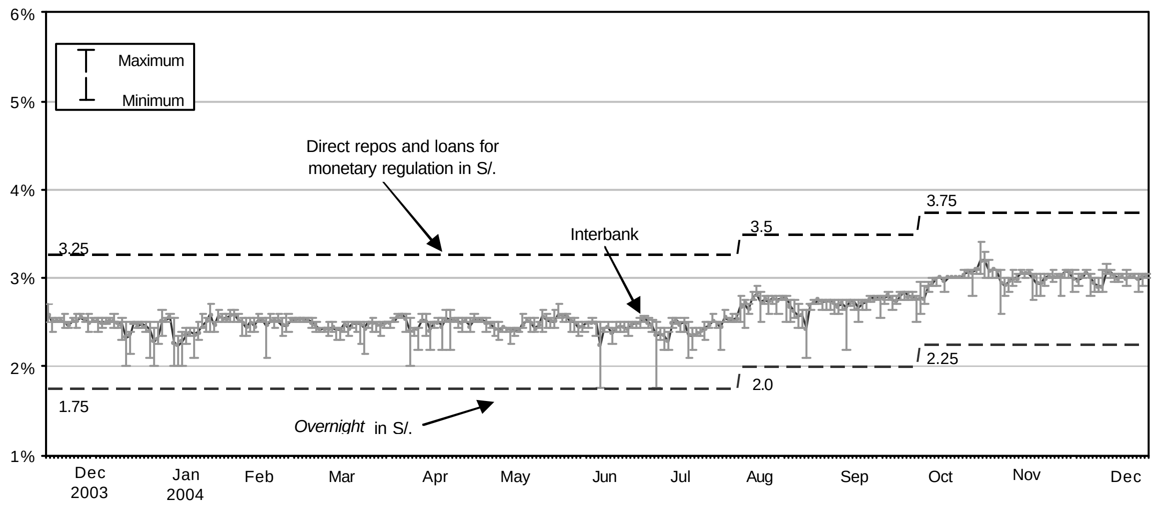
EXPECTATIONS OF INFLATION FOR DECEMBER 2005
Monthly macroeconomic expectations survey



37. Since November, the public's expectations regarding inflation have come into line with the 2.5 percent target and in December the accumulated rate of inflation for the last 12 months was equal to the upper limit of the target range. Thus, the BCRP has coaxed inflation gradually towards its target as the inflationary effect of the supply shocks is reversed.

Figure 30

DOMESTIC CURRENCY INTEREST RATES
(December 2003 - December 2004)



38. The modifications in monetary policy resulted in the interbank interest rate rising from around 2.5 percent until July, to 2.67 percent in August (when the reference rate was increased to 2.75 percent) and to 2.93 percent in October (when the reference rate was raised to 3.0 percent). Since then, the interbank interest rate has fluctuated around the current reference level of 3.0 percent.

Table 13

INTERBANK INTEREST RATE IN NUEVOS SOLES

	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
2003												
Average (%)	3.75	3.80	3.82	3.84	3.78	3.74	3.47	3.01	2.77	2.71	2.55	2.51
Standard deviation (pp)	0.13	0.10	0.06	0.05	0.07	0.05	0.09	0.25	0.06	0.08	0.11	0.05
Coefficient of variability	3.6	2.6	1.6	1.3	1.8	1.3	2.5	8.2	2.2	2.9	4.3	2.0
2004												
Average (%)	2.41	2.52	2.48	2.49	2.48	2.46	2.44	2.67	2.73	2.93	3.02	3.00
Standard deviation (pp)	0.10	0.04	0.04	0.06	0.05	0.07	0.08	0.10	0.04	0.12	0.07	0.04
Coefficient of variability	4.2	1.7	1.5	2.6	1.9	2.7	3.1	3.8	1.4	4.2	2.3	1.4

Source: BCRP.

Yield curve

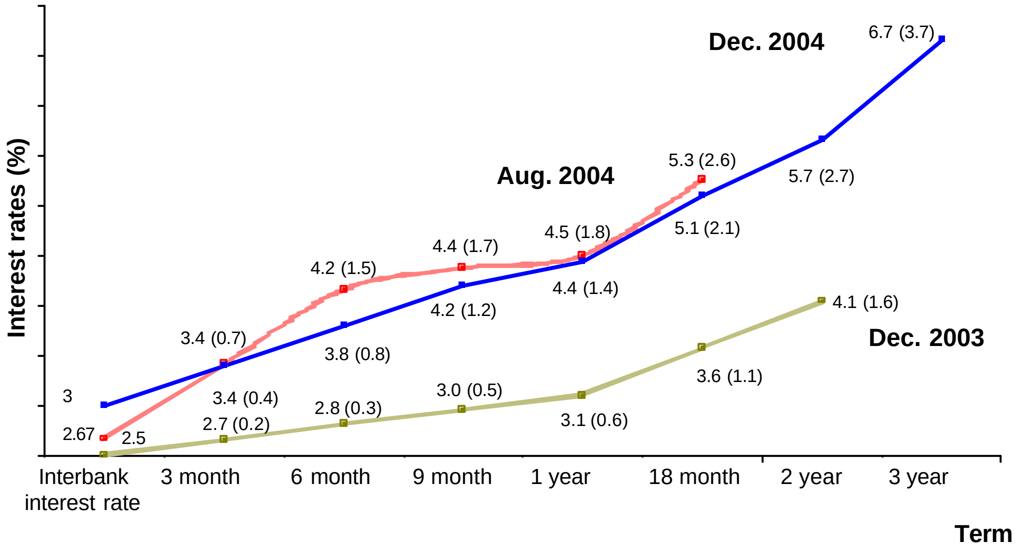
39. The structure of different term interest rates (the yield curve) of CDBCRPs and Treasury Bonds (BTP) in the last months of 2004 partially reversed the upward trend seen in the first part of the year. This initial upward trend was related to an increase in country risk, both for Peru and for the rest of the region's countries, as well as expectations that the United States Federal Reserve would raise interest rates.

40. The reduction between August and December of interest rates on CDBCRPs and BTPs occurred in a context in which country risk fell to its former levels, the Federal Reserve increased interest rates at a slower rate that first expected and public expectations regarding inflation realigned with the target rate after the two increases in the reference rate imposed by the BCRP. Thus, longer term

interest rates also fell and this was reflected in a flatter yield curve for CDBCRPs and Peruvian Treasury Bonds in December 2004 compared to August of the same year.

Figure 31

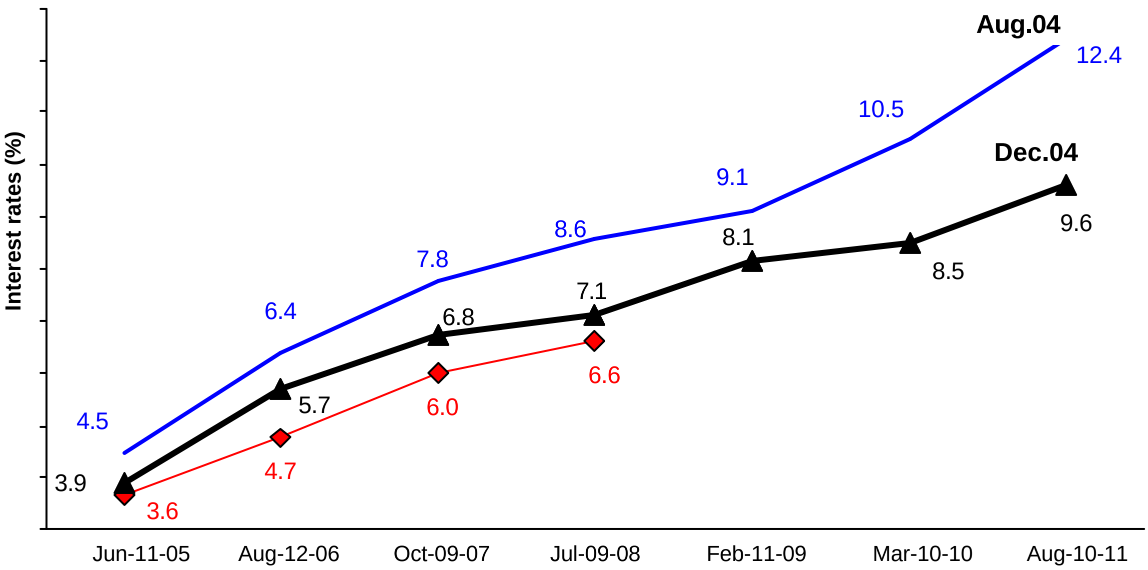
CDBCRP's YIELD CURVE



1/ Numbers in parehtheses show the difference with respect to the interbank interest rate.

Figure 32

PUBLIC TREASURY BONDS' YIELD CURVE



41. In the case of CDBCRPs, the fact that in recent months lower interest rates applied to placements favored an increase in the average maturity of these securities. Thus, the percentage of CDBCRPs balance having a maturity equal to or greater than one year increased from 65 percent of the total number of CDBCRPs in August to 69 percent in December.

Table 14
CDBCRP BALANCE BY MATURITY
(Million of nuevos soles)

	2003	2004							
	Dec.	Mar.	Jun.	Aug.		Sep.		Dec.	
				Amount	%	Amount	%	Amount	%
Up to 18 weeks	32	305	130	395	6.5	245	3.6	155	1.9
4 to 6 months	790	955	615	425	7.0	405	6.0	495	6.0
7 to 10 months	180	523	393	1,290	21.1	1,605	23.8	1,870	22.7
1 year and 18 months	2,280	3,031	2,816	2,756	45.2	3,116	46.3	3,985	48.3
2 & 3 years	815	1,185	1,235	1,235	20.2	1,360	20.2	1,750	21.2
Total	**4,097**	**5,998**	**5,188**	**6,100**	**100.0**	**6,730**	**100.0**	**8,255**	**100.0**
Memo:									
Balance of treasury bonds	**2,660**	**3,040**	**2,855**	**3,054**		**3,250**		**3,751**	
Average CDBCRP balance interest rate	3.0%	3.1%	2.8%	3.8%		4.4%		4.1%	

Source: BCRP.

The balance of CDBCRPs rose from S/. 6,100 million in August to S/. 8,255 million in December. These placements sought to sterilize the excess of liquidity in the monetary market, generated principally by the CDBCRP's interventions in the exchange rate.

Even when the rates of interest of CDBCRPs with the different maturities placed between September and December 2004 fell with respect to August, the fact that many of these placements were at long maturities had an influence on the increase in the average interest rate for placements of CDBCRPs. Thus this average interest rate rose from 3.8 percent in August to 4.1 percent in December.

42. Throughout 2004 the Peruvian treasury gradually extended the maturities of its BTP placements, combining securities nominally denominated in soles (of up to 7 years) with securities indexed to inflation (up to 20 years). Between September and December the government placed BTPs valued at a total of S/. 1,188 million under the market makers scheme. This amount includes a security exchange operation carried out in December, in which bonds maturing in January 2005 were redeemed early (S/. 444 million), to be replaced with bonds maturing in August 2011 (S/. 366 million) and bonds maturing in July 2019 (S/. 31 million). Thus, the balance of sovereign bonds denominated in Peruvian currency at the close of the year was S/. 3,751 million, exceeding the figure for December 2003 (S/. 2,660 million) by S/. 1,091 million (41 percent).

Table 15
SOVEREIGN BONDS INTEREST RATES IN THE SECONDARY MARKET BY DATE OF MATURITY
(In percentages)

	Jan. 05	Jun. 05	Aug. 05	Oct. 07	Jul. 08
2004					
January	3.18	3.50	4.56	5.69	6.45
February	3.39	3.67	4.88	5.55	6.43
March	3.27	3.52	4.68	5.53	6.27
April	3.32	3.67	4.74	5.74	6.41
May	3.74	4.36	5.82	7.71	8.00
June	3.92	4.39	6.11	8.23	9.07
July	3.85	4.57	6.47	8.43	9.20
August	3.76	4.46	6.39	7.79	8.56
September	3.35	4.05	5.80	6.75	7.60
October	3.34	3.89	5.51	6.50	7.23
November	3.47	4.11	5.52	6.59	7.17
December	2.30	3.88	5.70	6.76	7.11

Rates of interest

43. Average bank lending interest rates in nuevos soles continued the downward trend seen in previous years, falling from 19.0 percent in December 2003 to 18.2 percent in December 2004. Nevertheless, during the first quarter of the year there was a temporary increase which coincided with the steepening of the yield curve for instruments denominated in soles observed in that period.

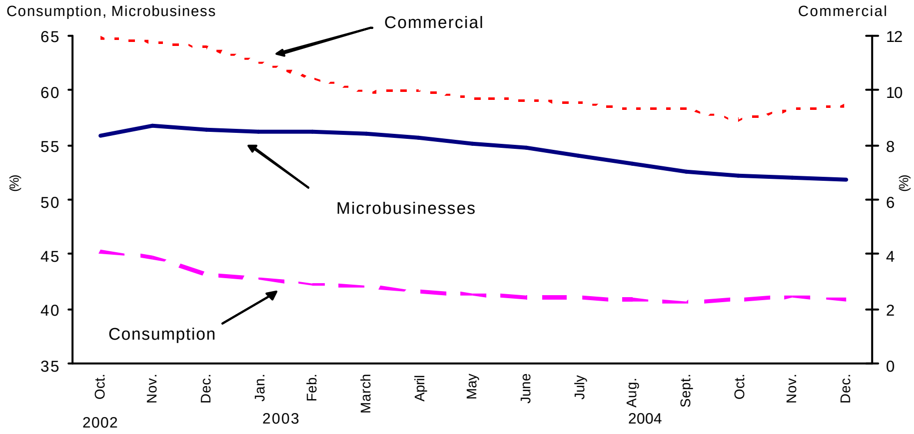
Table 16
INTEREST RATES FOR SOL-DENOMINATED OPERATIONS
(In percentages)

	2002				2003				2004			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Interbank	2.5	2.6	5.4	3.8	3.8	3.7	2.8	2.5	2.5	2.5	2.7	3.0
Savings deposits	1.8	1.7	1.7	1.7	1.7	1.5	1.3	1.3	1.4	1.3	1.2	1.3
Preferential lending	3.9	3.7	6.8	5.1	4.7	4.6	3.5	3.3	3.3	3.5	3.5	3.8
360 day average lending	15.5	14.1	14.0	14.8	14.3	14.0	14.3	14.0	14.8	14.7	14.3	14.7
Average lending rate, constant structure	25.0	23.6	22.5	22.3	21.1	20.1	19.6	19.0	19.3	18.7	18.3	18.2

Source: BCRP.

Figure 33

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



Interest rates in Peruvian for consumer loans and loans to microbusinesses behaved similarly in 2004. Thus the average interest rate for consumer loans in soles fell from 40.9 percent in December 2003 to 37.4 percent in December 2004. In the same period, the average interest rate for loans to microbusinesses fell from 52.2 percent to 48.1 percent. As far as commercial loans were concerned, the average interest rate remained relatively stable throughout the year, closing at 9.3 percent (compared to 8.9 percent in December 2003).

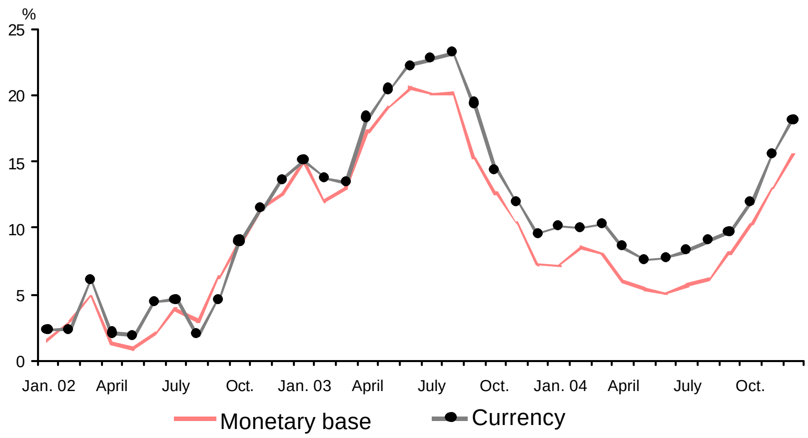
Monetary aggregates

44. During 2004 an upward trend was observed in the annual rates of growth of the monetary base and currency in circulation. Thus, the rate of growth of the monetary base compared to the same month in the previous year rose from 10.0 percent in December 2003 to 25.3 percent in December 2004. As far as money in circulation was concerned, the annual rate of growth rose from 13.5 percent to 26.1 percent over the same period.

The increase in these monetary aggregates was associated with greater public demand, reflecting a greater preference on the part of the public for domestic currency over foreign currency as well as growth in economic activity.

Figure 34

MONETARY BASE AND CURRENCY GROWTH: 2001-2004
(% change with respect to the same month of the previous year)



BOX 7
THE RELATIONSHIP BETWEEN MONEY AND INFLATION

The recent developments of growth in the monetary base and currency in the Peruvian economy (1994 - 2004), shows that these monetary aggregates have had no close relationship to inflation. In particular we can see that a higher rate of growth of the monetary base has not been translated into higher inflation:

MONETARY BASE, CURRENCY AND INFLATION IN PERU:
1994-2004 1/
(Percentage variation, last 12 months)

Year	Monetary base	Currency	Inflation
1994	48.2	49.9	15.4
1995	36.9	27.6	10.2
1996	9.2	6.6	11.8
1997	19.1	17.9	6.5
1998	5.5	3.2	6.0
1999	17.0	17.2	3.7
2000	-4.0	-2.0	3.7
2001	7.9	9.0	-0.1
2002	11.0	13.5	1.5
2003	10.1	13.5	2.5
2004	25.3	26.1	3.5

1/ Data from end of period.

At an empirical level the work of De Gregorio (2004)[1/] shows that the relationship between monetary growth and inflation is a weak one, especially in economies with low inflation. In the case of an economy which is partially dollarized, the relationship between inflation and growth in the monetary base is further weakened during the process of dedollarization.

In order to analyze the relationship between money and inflation at an international level, the relationship between the rates of growth of the two monetary aggregates (monetary base and currency) and the expected rate of inflation in Argentina, Australia, Brazil, Chile, Colombia, the European Union, Japan, Mexico and the United States using information for 2004. The results suggest that, in the short term, there is no one to one relationship between the rate of growth of the monetary aggregates considered and the rate of inflation. In other words, increased growth in the monetary base (or currency) does not necessarily translate into an increase of the same magnitude in inflation in the short term. For example, in July 2004, Chile recorded a rate of growth of its monetary base and currency of 17.1 and 16.5 percent, respectively; nevertheless, the rate of inflation was 2.7 percent.

MONETARY BASE, CURRENCY AND INFLATION: INTERNATIONAL EVIDENCE 1/
(Percentage variation, last 12 months)

	Monetary base	Currency	Forecast of inflation 2004 2/
Argentina	23.9	35.4	6.4
Australia	6.8	6.5	2.3
Brazil	7.8	21.7	7.2
Chile	17.1	16.5	2.7
Colombia	13.6	17.8	5.8
UE	9.5	18.6	2.2
Japan	3.7	1.6	-0.1
Mexico	16.3	17.9	5.2
USA	4.0	5.9	2.6

1/ Source: IMF and central banks. Information as at July 2004.
2/ Source: Consensus Forecast. Forecasts made in October 2004 (average of the year).

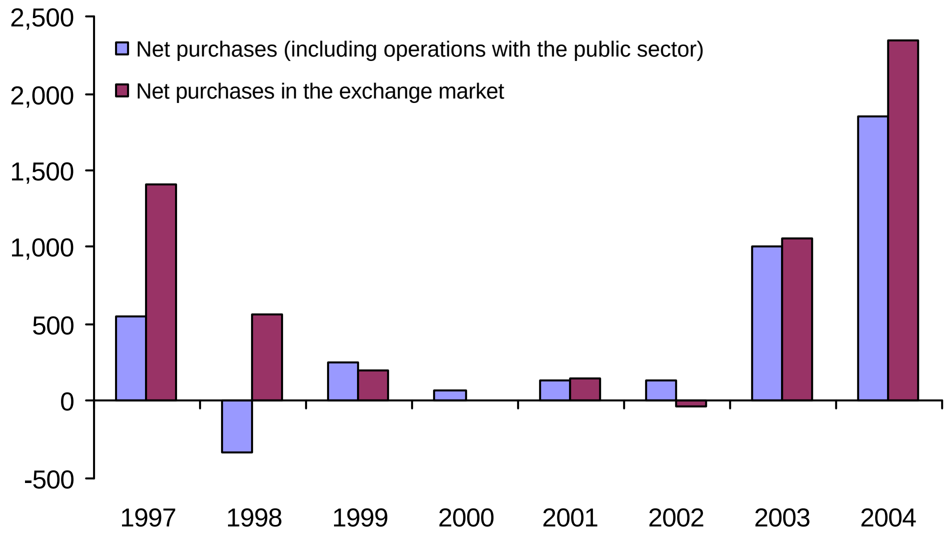
1/ De Gregorio, José, “Rapid Growth of Monetary Aggregates and Inflation: The International Evidence”, Working paper No. 256, Banco Central de Chile, 2004.

45. These rates of growth in monetary aggregates in domestic currency, greater than those of monetary aggregates in foreign currency, implied a reduction in the dollarization of the economy. Thus, for example, dollarization of monetary aggregates in the banking system fell from 62 percent in December 2003 to 55 percent in December 2004.

46. In this context of readjustment of portfolios, the Central Bank purchased US$ 2,340 million in the foreign exchange market, a historic high. Part of these purchases enabled it to meet the demand for dollars from the public sector (US$ 487 million net) and with them net purchases of dollars by the Central Reserve Bank amounted to US$ 1,854 million.

Figure 35

FOREIGN EXCHANGE OPERATIONS OF THE BCRP
(Millions of US$)



These interventions were concentrated in August and December, during which a total of US$ 1,463 million were purchased (two thirds of the year's total) a daily average of US$ 13 million.

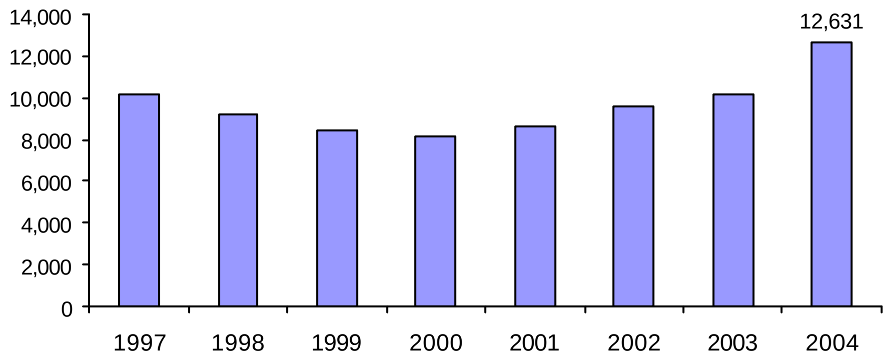
The Bank's intervention enabled it to strengthen the international reserves, restructure its private portfolio to emphasize assets denominated in Peruvian currency and to smooth fluctuations in the exchange rate (Box 8).

BOX 8

LEVEL OF NIR AND COST OF STERILIZATION

At the close of 2004, the net international reserves (NIR) held by the BCRP amounted to US$ 12,631 million, which represents 4,4 times the monetary base and 73 percent of total liquidity in the banking system. This NIR balance gives the economy an adequate capacity to respond to turbulence in the foreign exchange and financial markets.

NET INTERNATIONAL RESERVES
(Millions of US$)



A financial system that is partially dollarized has to use prudent measures to address two risks:

i) The possibility of a run on dollar deposits, in which case the Central Bank must quickly provide funds in foreign currency to restore depositors' confidence.

ii) Sharp movements in the exchange rate that have a permanent effect on the solvency of economic agents, in which case the Central Bank must have the capacity to reduce exchange rate volatility, without establishing as its aim the defense of a given exchange rate.

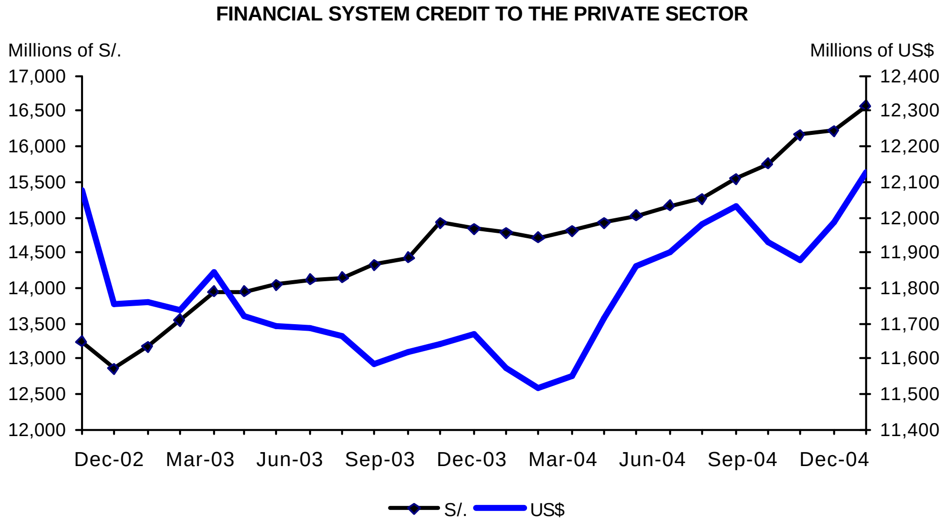
The preventive measures enabling it to face these two risks linked to partial dollarization include keeping net international reserves at an adequate level.

Nevertheless, in order to avoid excessive expansion of the supply of nuevos soles, the BCRP practices liquidity sterilization. The instrument used for sterilization is the Central Reserve Bank of Peru Deposit Certificate (CDBCRP) which, depending on its maturity, accrues a yield which is determined by the conditions in the domestic market.

It should be mentioned that the Bank's actions are aimed at preserving monetary stability and not at maximizing its profits. Therefore, the Central Bank can make a profit or a loss, though it has seldom made a loss.

47. During 2004, following the trend of the previous year, more vigorous growth was recorded in domestic currency denominated loans by the financial system to the private sector, than in those denominated in dollars. The first grew at an annual rate of 11.8 percent, similar to that obtained in 2003. On the other hand loans in foreign currency grew at an annual rate of 3.9 percent as at December 2004, reversing the 3.4 fall experienced in the previous year.

Figure 36



In domestic currency the expansion of credit to the private sector during 2004 was driven by microfinance institutions (S/. 557 million), the Banco de la Nacion (S/. 524 million), and the banks (S/. 472 million) and institutional investors (S/. 138 million). These results show that the annual rate of growth of loans granted by microfinance institutions to the private sector decelerated from 25.3 percent in 2003 to 15.2 percent in 2004. The annual rate of growth of loans by institutional investors to the private sector fell from 31.9 percent in 2003 to 6.4 percent in 2004.

Table 17

EVOLUTION OF DOMECTIC CURRENCY BANK LOANS TO THE PRIVATE SECTOR

	Balances in millions of nuevos soles			Rates of growth	
	dic03	nov04	dic04	Dec.04/ Dec.	Dec.04/ Nov.
Banks 1/	8,221	8,461	8,693	5.7	2.7
Banco de la Nacion	511	983	1,035	102.7	5.4
Microfinance institutions	**3,666**	**4,146**	**4,223**	**15.2**	**1.9**
Banks (microfinance loans)	730	1,091	1,121	53.5	2.8
Municipal savings and loans	1,083	1,335	1,334	23.2	-0.0
Rural savings and loans	181	246	245	36.0	-0.2
Cooperatives	459	477	477	3.9	-.-
Edpymes	172	220	219	27.4	-0.4
Finance companies	1,042	778	827	-20.6	6.2
Institutional investors 2/	**2,180**	**2,307**	**2,318**	**6.4**	**0.5**
AFPs	1,449	1,338	1,340	-7.5	0.1
Insurance companies	568	814	823	44.9	1.1
Mutual funds	163	155	155	-4.9	-.-
Leasing companies and others	**247**	**306**	**310**	**25.7**	**1.6**
Total financial system	**14,824**	**16,202**	**16,580**	**11.8**	**2.3**

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

The recovery of foreign currency loans to the private sector last year was due principally to increased lending by institutional investors (US$ 236 million), microfinance institutions (US$ 130 million) and banks (US$ 100 million).

BOX 9
DEDOLLARIZATION OF LOANS TO THE PRIVATE SECTOR

At present a significant percentage of loans to families and companies are denominated in foreign currency. Thus at the end of 2004, around 74 percent of bank loans were denominated in foreign currency. If financing for the private sector from other financial intermediaries (municipal savings and loans, among others) is taken into account, as well as that provided by institutional investors such as pension fund managers, the coefficient of dollarization falls to 71 percent.

This high dollarization of loans generates a currency imbalance for families and companies, given that most of them have their income denominated in Peruvian currency or their income is linked to the dynamism of the domestic market. This imbalance implies an exchange rate risk: if the exchange rate rises, dollar-denominated liabilities increase in domestic currency terms but the same does not happen to income. Thus, dollarization of loans to the private sector makes the economy vulnerable.

In recent years the process of financial dedollarization has become important. Both public deposits in the financial system and loans granted by the latter to the private sector have seen gradual dedollarization.

INDICATORS OF FINANCIAL DOLLARIZATION

(In percentages of the total monetary aggregate)

Year	Total liquidity of banking system	Banking system loans to private sector	Finance system loans to 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

Nevertheless, banks have seen deposits in soles increase by more than bank loans in the same currency. Thus bank loans in Peruvian currency rose by around S/. 0.7 billion during 2004 (from S/. 9.5 billion to S/. 10.2 billion), whilst sol-denominated liabilities to the private sector rose at more than double this rate (from S/. 11.3 billion to S/. 12.9 billion). In other words, the increase in bank funds in soles during 2004 has only partially been channelled into sol-denominated loans to the private sector.

A possible explanation for the lower level of loans in domestic currency compared to the increase in funds in soles is the fact that economic agents (financial intermediaries and debtors) may not fully understand the exchange rate risks associated with indebtedness in foreign currency. In particular, this bias towards debts in foreign currency may be greater in an environment in which it is expected that the local currency will continue to appreciate in the short term.

Thus, for example, bank mortgage lending in dollars increased by US$ 234 million, whilst that in Peruvian currency only increased by S/. 10 million in 2004. A significant part of this behavior is explained by loans from the Mivivienda fund, which increased by US$ 156 million in foreign currency and only S/. 8 million in Peruvian currency in 2004.

Equally, significant growth has been recorded in dollar-denominated financing to the private sector by microfinance institutions (26 percent in 2004 compared to growth in soles of 15 percent) and by institutional investors (22 percent in dollars compared with 6 percent in soles).

A second effect of this imbalance between dedollarization of bank liabilities and loans to the private sector is that it puts pressure on the sol to appreciate, as savers choose to save in soles but this money is not used to grant loans in soles. The dedollarization of bank liabilities implies an undesired increase in their dollar position (assets minus liabilities in dollars), which translates into pressure in the exchange rate market for the sol to appreciate. In order to accommodate these portfolio movements, the BCRP intervenes in the market to reduce exchange rate volatility and sterilize its purchases by placements of CDBCRPs.

Therefore, deepening intermediation in Peru's currency should strengthen the ability of the country's economy to respond to adverse macroeconomic shocks.

It should be mentioned that in order to reduce the risk involved in granting dollar loans currency to companies and individuals who do not generate income in that currency, the Banking and Insurance Regulator has started to issue regulations covering this field. The Rules for the Management of Loans and Exchange Rate Risk establishes an additional provision of up to 1 percent for loans classified as normal, to take effect on the 1st of July 2006, and only of the finance institution cannot accurately identify whether a debtor is or is not exposed to exchange rate risk.

Table 18

EVOLUTION OF FOREIGN CURRENCY BANK LOANS TO THE PRIVATE SECTOR

	Balances in millions of dollars			Rates of growth	
	dic03	**nov04**	**dic04**	**Dec.04/ Dec.**	**Dec.04/ Nov.**
Banks 1/	9,409	9,364	9,509	1.1	1.5
Banco de la Nacion	22	22	22	-1.0	-0.0
Microfinance institutions	**511**	**636**	**641**	**25.6**	**0.8**
Banks (microfinance loans)	87	122	123	42.6	1.4
Municipal savings and loans	186	245	245	31.7	-0.3
Rural savings and loans	48	54	54	12.7	-0.0
Cooperatives	116	141	141	20.9	-.-
Edpymes	40	47	47	17.0	-0.2
Finance companies	34	28	32	-6.6	14.1
Institutional investors 2/	**1,091**	**1,330**	**1,327**	**21.7**	**-0.2**
AFPs	517	726	728	40.9	0.3
Insurance companies	60	91	86	43.8	-5.4
Mutual funds	514	514	514	-0.1	-.-
Leasing companies and others	**637**	**631**	**630**	**-1.2**	**-0.2**
Total financial system	**11,670**	**11,984**	**12,130**	**3.9**	**1.2**

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

48. In the final months of the year, the Central Bank carried out modifications to the reserve requirements in order to stimulate the process of financial dedollarization and reduce the risks to the economy associated with dollarization.

49. Firstly, it ordered an increase in the marginal reserve requirement in foreign currency from 20 percent to 30 percent commencing in November 2004. Given that the current marginal reserve requirement (30 percent) is similar to the average reserve requirement in the base period (31.6 percent) this latter will tend to stabilize around the first. This measure is aimed at strengthening the financial system's ability to respond to temporary illiquidity in foreign currency.

Table 19

EVOLUTION OF RESERVE REQUIREMENTS IN FOREIGN CURRENCY

Period	Reserve requirements (US$ million)	Reserve requirement rate
Dec. 1994	2,293	42.9%
Dec. 1995	2,791	43.3%
Dec. 1996	3,653	43.6%
Dec. 1997	3,948	43.7%
Dec. 1998	3,518	38.3%
Dec. 1999	3,447	37.6%
Dec. 2000	2,935	34.0%
Dec. 2001	3,039	32.8%
Dec. 2002	2,979	32.0%
Dec. 2003	2,811	31.5%
Dec. 2004	2,840	29.5%

50. Also, in October 2004 the Central Bank modified the rate of remuneration paid on reserves in dollars by 1/8th of a percentage point (12.5 base points), from LIBOR - 1/8th to LIBOR - 1/4. Beginning in February 2005, in order to continue supporting the process of dedollarization of the economy, the additional reserve in foreign currency deposited with the BCRP will accrue interest at a rate equivalent to LIBOR -¾ (a reduction of 50 base points).

BOX 10
RATE OF REMUNERATION OF THE RESERVE REQUIREMENT IN DOLLARS

The Central Bank recompenses the funds that constitute additional reserves, that is, the excess reserve in foreign currency over the minimum statutory reserve (6 percent of the average TOSE). The remuneration paid to the funds constituting additional reserves in foreign currency takes effect from February 2005 and is equal to the LIBOR interest rate applicable to three-month loans in dollars, minus ¾ of a percentage point. The reserve funds must be deposited in the current accounts of the finance companies at the Central Bank in order to receive remuneration, in other words, reserve funds kept in the banks' own vaults do not receive remuneration.

The modified remuneration paid to additional reserves in foreign currency are aimed at influencing financial intermediation in this currency. Thus, for example, in September 1996 the remuneration was reduced in order to decelerate growth of monetary aggregates in foreign currency with a rate equivalent to the LIBOR rate minus one percentage point. Furthermore, in July 1998 and October 1999 the BCRP increased the remuneration, seeking to stimulate the recovery in financial intermediation in foreign currency.

Remuneration on marginal reserve requirement in foreign currency
(%)

Date	*Remuneration*	*Legal basis (CRBP circular)*	*LIBOR*	*Reasons behind the modification*
Dec-93	LIBOR 1/	033-93-EF/90	3.4	The new Banking Act enables the CRBP to establish the remuneration earned by the statutory reserve (L. 770).
Sep-96	LIBOR - 1	029-96-EF/90	5.7	Acceleration of the growth in foreign-currency-denominated deposits.
Dec-96	LIBOR - 9/8	041-96-EF/90	5.5	Change in the methodology for calculating the LIBOR rate. Before this date the reference was the lower LIBOR rate (LIBID rate).
Apr-97	LIBOR - 11/8	013-97-EF/90	5.8	Neutralize the effect of the reduction in minimum statutory reserve from 9 percent to 7 percent on the financial margin.
Jul-98	LIBOR - 1	014-98-EF/90	5.7	To encourage intermediation of deposits (which coincided with a reduction in the marginal reserve rate from 35 percent to 20 percent).
Oct-99	LIBOR - 1/8	025-99-EF/90	6.1	To favor a reversion in the downward trend in interest paid on deposits in a context in which the gap between international interest rates and deposit rates in Peru is widening.
Oct-04	LIBOR - 1/4	017-04-EF/90	2.1	To support the process of financial dedollarization.
Feb-05	LIBOR - 3/4	002-05-EF/90	2.8	To support the process of financial dedollarization and discourage intermediation in foreign currency.

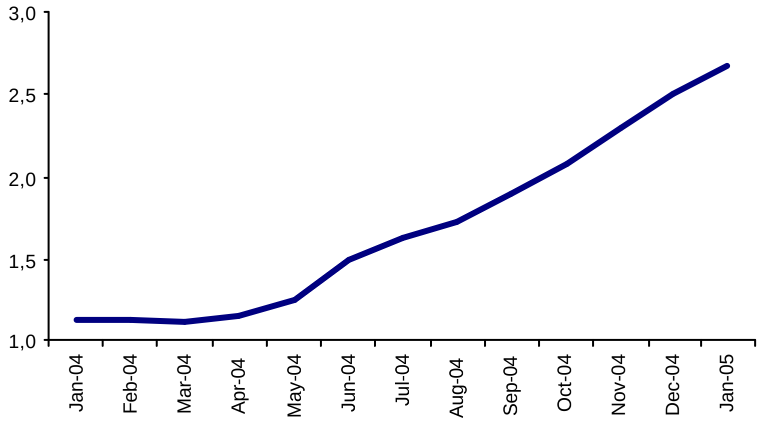
1/ LIBOR interest rate for interbank loans at three months, in dollars.

Because of an increase in international rates in the United States, the interest rate on remuneration paid for reserves has increased, even with the modified *spread* on the LIBOR rate made last October (the rate in force until September was LIBOR minus 1/8th of one percent). Thus in April 2004 reserves accrued interest at a rate of 1.02% annually, in December of the same year this rose to 2.25% and in January 2005 to 2.41%. With the modification in effect from February 2005, the forecast rate of remuneration for that month is 2.23%, similar to the level at the end of 2004. This should enable banks to maintain the income paid on the reserves.

In a context of rising international interest rates in the United States, this measure will prevent increased yields from dollar savings in the local market, as well as discouraging the granting of loans in foreign currency.

3 MONTHS LIBOR RATE

January 2004 - January 2005



51. In the period between September and December 2004 there was an increase in private sector fixed-interest instruments, though to a lesser degree than in the same period of the previous year. In Peruvian currency net placements amounted to S/. 115 million, less than that registered in the same period of 2003 (S/. 576 million); whilst net placements in foreign currency amounted to almost zero when, in the same period of 2003 it was US$ 145 million. It should be indicated that all placements in domestic currency were short term instruments.

52. Over the course of the year, net placements of fixed-income instruments by private sector companies was S/. 1,940 million, a figure 12 percent higher than that of the previous year (S/. 1,727 million in 2003). Net placements in Peruvian currency amounted to S/. 515 million, less than in the previous year (S/. 866 million in 2003).

Table 20

NET PLACEMENTS OF FIXED INCOME SECURITIES 1/

(Millions of soles or US$)

	2003			2004		
	Soles	US$	Total	Soles	US$	Total
Private sector	**866**	**248**	**1,727**	**515**	**412**	**1,940**
Placed	1,962	887	5,044	1,648	757	4,230
Amortized	1,096	639	3,316	1,133	345	2,291
Treasury	**927**	**-**	**927**	**891**	**-**	**891**
Placed	2,932	-	2,932	2,495	-	2,495
Amortized	2,005	-	2,005	1,604	-	1,604
CDBCRP	**2,461**	**-**	**2,461**	**4,158**	**-**	**4,158**
Placed	7,084	-	7,084	15,655	-	15,655
Amortized	4,623	-	4,623	11,497	-	11,497
TOTAL	**4,254**	**248**	**5,115**	**5,564**	**412**	**6,989**
Placed	11,978	887	15,060	19,798	757	22,380
Amortized	7,724	639	9,944	14,234	345	15,392

1/ Including bonds, commercial paper, negotiable certificates and treasury instruments.

II. FORECASTS

Macroeconomic forecasts are made taking into consideration the recent performance of the different determinants of inflation and based on the expected behavior of public finances, the international environment and global conditions of supply and demand.

II.1 The international context and external accounts

The growth in the world economy, the terms of trade and international interest rates will continue to provide a favorable environment for economic growth.

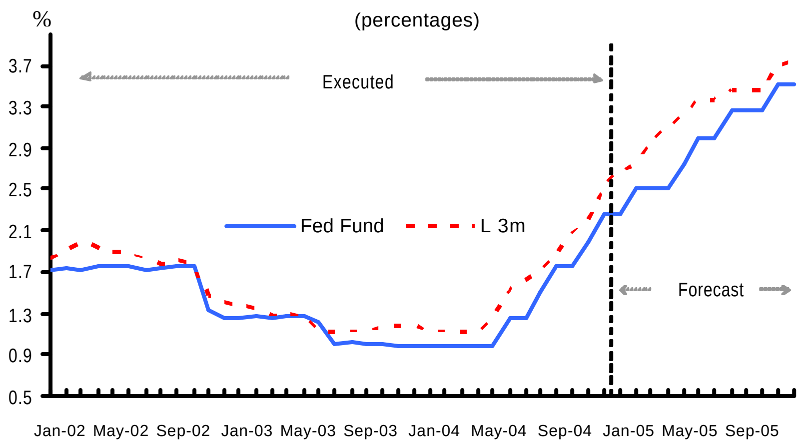
International environment

53. In the United States futures markets, investors expect additional rate increases in 2005. It is forecast that United States federal fund interest rates will be 3.0 percent by the middle of the year and 3.5 percent towards the year end. The three month LIBOR rate, on the other hand, could be around 3.75 percent.

Figure 37

INTERNATIONAL INTEREST RATES: 2002-2005

(percentages)



54. This scenario of higher interest rates is compatible with an expansion of economic activity in 2005, but less than could be seen in 2004. It is expected that average growth of our main trading partners will be 3.5 percent:

- In the case of the United States, growth of 3.5 percent is expected, a lower rate than in 2004 but consistent with a reversal of fiscal and monetary stimulus. A certain deceleration could be seen in Japan and Europe. Apart from existing structural factors, a negative effect could be caused by the strengthening of their currencies against the dollar.

- The increase in FED interest rates and favorable forecasts of economic growth in the United States should contribute to a reduction in the downward pressure on the dollar in international markets, pressures which are associated with the trade and fiscal deficit and the fact that this country is a net debtor.

- As far as China is concerned, its economy should grow slightly lower than that observed in 2004, the result of measures applied by the authorities to restrain growth. Nevertheless, the magnitude of this deceleration is uncertain because of a possible appreciation of the yuan, which could affect the country's export sector.

- In this context, Latin America could see a reduction in growth, which could fall from 6.7 percent in 2004 to 4.5 percent in 2005. However it should be pointed out that all countries should see their economies expand and that the prospects for the region are favorable, particularly after fourteen countries have been given an improved risk rating.

Table 21

GROWTH AMONG PERU´S MAIN TRADING PARTNERS 1/
(In percentages)

	Inflation Report, August 2004		**Infllation Report, January 2005**	
	2004	**2005**	**2004**	**2005**
Trading partners*	**4.3**	**3.5**	**4.6**	**3.5**
North America	***4.3***	***3.6***	***4.3***	***3.5***
United States	4.4	3.6	4.4	3.5
Canada	2.9	3.4	2.7	3.0
Europe	***2.5***	***2.3***	***2.4***	***2.1***
United Kingdom	3.3	2.6	3.2	2.5
Germany	1.8	1.6	1.7	1.3
Asia	***6.0***	***4.5***	***6.0***	***4.4***
Japan	4.3	1.9	3.9	1.5
China	8.8	7.7	9.3	8.0
Latin America	***5.2***	***4.1***	***6.7***	***4.5***
Chile	5.0	5.0	5.7	5.4
Brazil	3.6	3.4	5.0	3.7

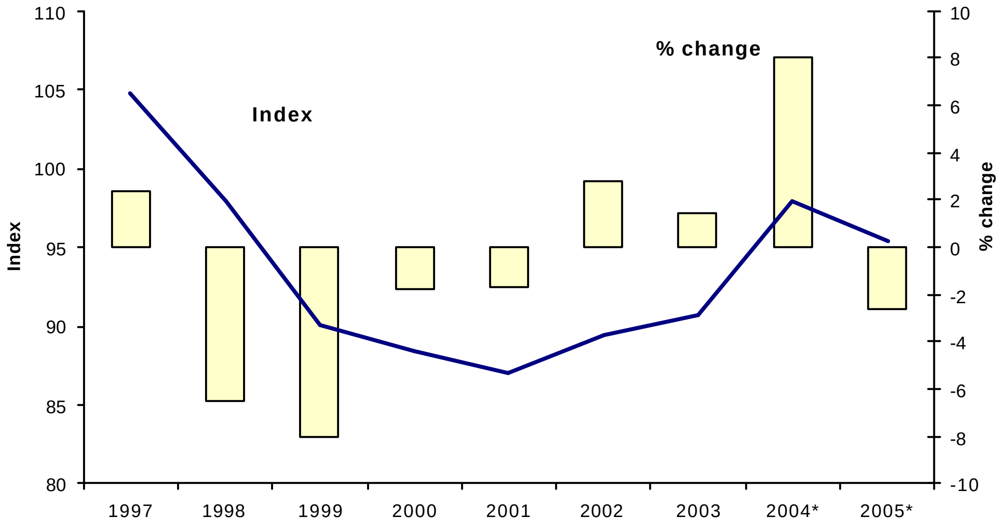
* Weighted in accordance with trade (including oil) in 2001.
1/ Data from the *Consensus Forecast.*

Terms of trade

55. A reduction of 2.6 percent in the terms of trade for 2005 is forecast, although it should continue to be the second highest of the last seven years. Export prices should rise by 0.4 percent, whilst import prices should rise 3.1 percent.

Figure 38

TERMS OF TRADE: 1997-2005



* Forecast.

Table 22

TERMS OF TRADE

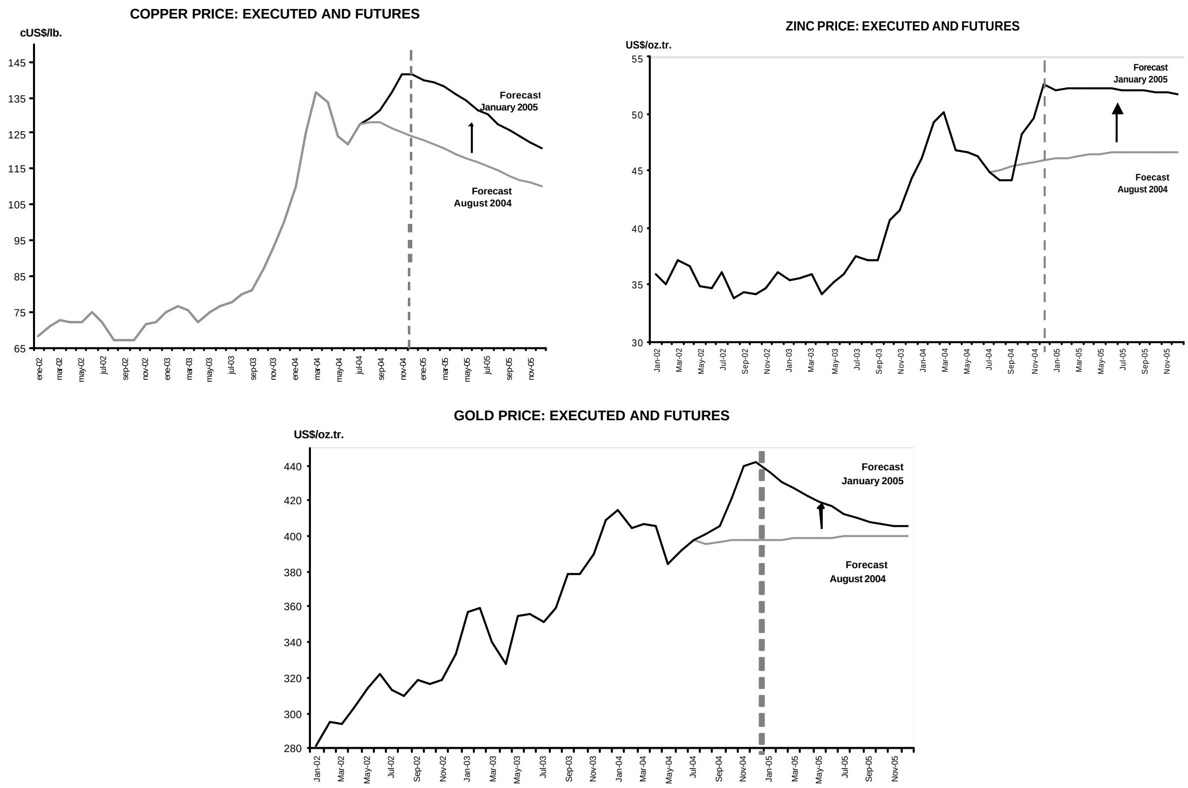
(Annual variation)

	2003	Forecasts			
		August 2004		January 2005	
		2004	2005	2004	2005
Terms of trade	**1.4**	**7.2**	**-4.4**	**8.0**	**-2.6**
Index of export prices	7.1	15.6	-2.4	17.0	0.4
Index of import prices	5.6	7.8	2.1	8.4	3.1

Source: BCRP.

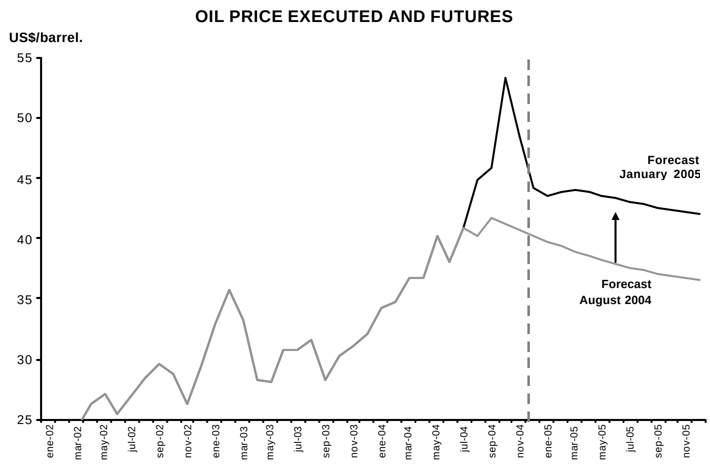
56. The deceleration of the world economy, particularly in those countries that headed growth in 2004, such as China and the United States, as well the prospect of a weaker euro in 2005 could be the principal determinants of lower international raw materials prices. Thus, based on quotations in the futures markets, it is expected that copper will reach US$ 1.21 per pound by the end of the year (currently US$ 1.47) and that gold will reach US$ 406 an ounce (currently US$ 427) whilst the price of zinc is forecast to be US$ 0.52 a pound (currently US$ 0.57). In the case of copper, it is hoped that the supply deficit will start to be covered by the second half of 2005; in the case of gold a weaker euro and lower inflationary pressure generated by oil could cause a fall in price. A sustained recovery in the price of zinc began towards the end of 2004 and in 2005 it is thought that this will continue, as China is expected to become a net importer of zinc.

Figure 39



57. As far as oil is concerned, futures prices estimate a gradual reduction of 5 percent by December 2005, although on average a 4 percent increase is expected because of a 3 percent increase in world demand (according to US Department of Energy forecasts), in a context of slow reactions to price increases and uncertainty concerning the political situation in Nigeria and the Middle East, which indicates that the fall with respect to December 2004 may have been a market correction. For foodstuffs, it is expected that world production of soya and wheat will reach record levels during the 2004/2005 season (according to the US Department of Agriculture) whilst demand should remain stable, as a result of which the prices of both *commodities* will tend to fall during 2005.

Figure 40



Trade balance

58. Taking into account growth forecasts for the world economy and a slight reduction in the terms of trade, it is estimated that the trade balance will continue to be in surplus for the fourth consecutive year and could rise to US$ 3,018 million. It should be mentioned that this forecast considers that the elimination of textile quotas in the North American market will have a limited impact (see Box 11).

Table 23

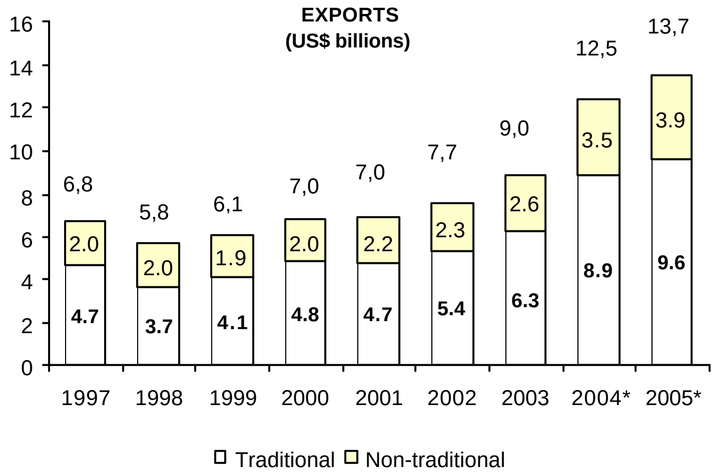
TRADE BALANCE
(Millions of US$)

	2003	2004*	2005*	Var. % 2004*	Var. % 2005*
1. EXPORTS	**8,986**	**12,513**	**13,652**	**39**	**9**
Traditional products	6,267	8,862	9,583	41	8
Non-traditional products	2,602	3,532	3,937	36	11
Others	117	119	132	2	11
2. IMPORTS	**8,255**	**9,816**	**10,633**	**19**	**8**
Consumer goods	1,851	1,980	2,109	7	7
Raw materials and intermediate goods	4,344	5,358	5,700	23	6
Capital goods	1,984	2,366	2,719	19	15
Other goods	75	112	104	48	-7
3. TRADE BALANCE	**731**	**2,697**	**3,018**	**269**	**12**

* Forecast

59. It is estimated that exports will be less dynamic than in the previous year because of lower raw materials prices, growth is forecast at 9 percent. This growth should be based on an 8 percent increase in traditional exports as higher volumes of minerals are exported, principally gold and, to a lesser extent, zinc and copper. In the case of gold, the commissioning of the Alto Chicama project would be the main cause of the increase, whilst on the case of zinc renewed production by Volcan after the financial problems affecting the company since the beginning of 2004 should explain the increase.

Figure 41



Note: Total exports includes other exports.
* Forecast.

60. Non-traditional exports, on the other hand, should grow by 11 percent (compared to 36 percent in 2004) within a context of slowing world growth. In particular, it is thought that exports of clothing will slow as textile quotas are eliminated in January 2005 (see box 11). A similar development is expected for products affected by lower international prices, such as iron and steel and jewelry, and agriculture and fish products, which grew significantly in 2004 because of new export markets and good fish stocks respectively.

61. Imports are forecast to grow 8 percent in 2005, compatible with the 4.5 percent growth in GDP and a recovery in private investment and consumption. This would make a total of US$ 10,633 million in acquisitions from abroad, headed by imports of capital goods and supplies for industry (16 and 11 percent respectively). A slight reduction in fuel imports is estimated, associated with the partial replacement of liquids (butane and propane gas) as a result of domestic production from Camisea.

62. It is worth pointing out that as the Camisea project has been brought on stream since 2004, given the conditions of demand by gas purchasers, exports of derivatives have taken precedence over the substitution of imports.

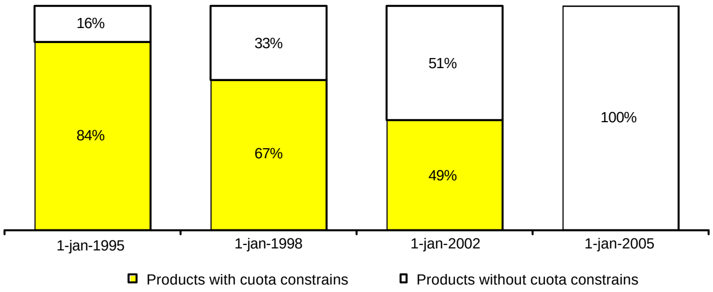
Balance of payments current account.

63. Consolidating the results of the previous year and consistent with the improved trade balance, a balance of payments current account surplus is forecast for 2005 of US$ 340 million (0.5 percent of GDP). It should be noted that an annual current account surplus has not been achieved since 1979, which saw the biggest increase in terms of trade for 30 years.

BOX 11
ELIMINATION OF TEXTILE QUOTAS

The Uruguay Round approved the progressive elimination of quotas being applied by a number of countries, including the United States, to imports of textiles and clothing. A fixed period of 10 years was agreed for eliminating quotas, which began on the 1st of January 1995 and ended on the 1st January 2005, apart from which 100 percent of the textile trade is free from restraints.

CUOTA REDUCTION
(As a percentaje of imported volumen in 1990)



Source: IMF (2002).

The elimination of quotas should favor certain countries such as China, which are capable of exporting much larger volumes than those stipulated in the quotas. According to private estimates, growth in exports of textile products by China could reach 24 percent in 2005, amounting to US$ 100 billion, consistent with a 40 percent increase in investment in fixed assets by the textile industry. Furthermore, the International Monetary Fund[1/] estimates that three years after complete elimination of quotas Chinese clothing exports could have increased 101 percent and those of the rest of Southern Asia 95 percent. A study carried out by the United States International Trade Commission concludes that China could become a major supplier to the US due to its low labor costs and high productivity. Recent evidence also shows that for products whose quotas have already been eliminated, Chinese imports have substantially increased.

The items freed before 2005 are not those exported by Peru. For 2005 – the year in which the final phase will be implemented – quotas will be eliminated from precisely the products which Peru exports, such as shirts and blouses for men and women, T-shirts, sweaters and similar knitted items. It should be mentioned that the North American market is the most important for such products, as it takes 85 percent of Peru's exports of T-shirts, 91 percent of its knitted blouses, 86 percent of knitted shirts and 74 percent of exports of sweaters, pullovers and similar articles. China's share of the American market for these products is small (between 2.0 and 12.7 percent depending on the product), which gives it room to increase its market share when quotas are eliminated.

It is estimated that the price of a Peruvian garment in the North American market is 21 percent higher than one from China. The principal difference is the lower cost of labor in China, around 40 percent of the cost in Peru. There is also a significant difference in the cost of yarn. Nevertheless, this difference would lessen if China's currency were to be revalued. In this regard, various studies estimate that the yuan is 20 percent undervalued.

PRICE OF A PLEDGE IN THE AMERICAN MARKET
(US$ per pledge type)

Items	China	Peru
Yarn	0.70	1.23
Labour	0.74	1.68
Chemicals	0.05	0.06
Electricity	0.11	0.09
Others 1/	1.34	1.44
Total cost	**2.94**	**4.50**
Margin (15%)		
-Net margin	0.52	0.48
-Income tax and profit sharing	0.00	0.28
Drawback (5% of FOB)	0.00	-0.16
Freight	0.13	0.12
US tariff (21%)	0.71	0.00
Price delivered in US	4.30	5.22

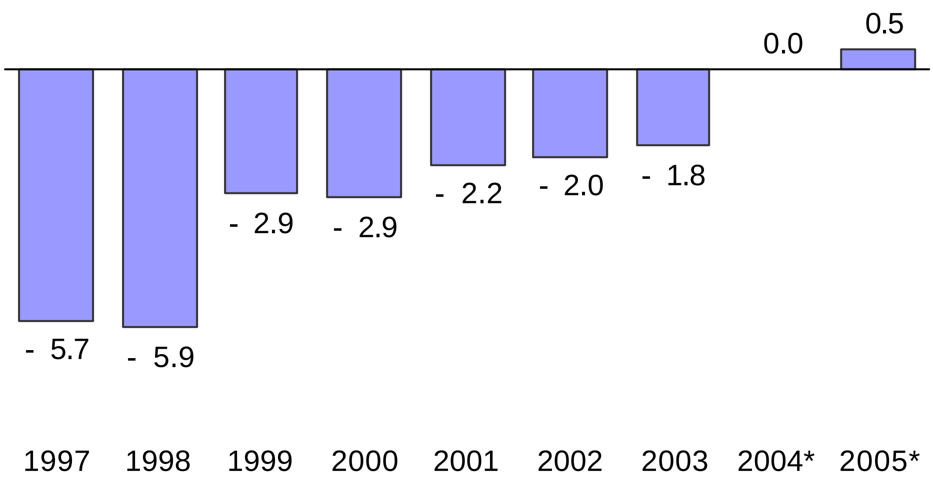
Source: Gherzi et al.
1/ IMF Working Paper, (2004), "The end of textiles quotas: A case study of the impact on Bangladesh", (WP/04/108).

The elimination of quotas may, therefore, imply an increased demand for Chinese products given their lower production cost, although it is likely that this effect will not be seen immediately. The impact on Peru's export sector will depend on the effects of certain fiscal measures such as the elimination of IES, to improve competitiveness and reduce production costs, as well as the successful signing of a free trade agreement that would ensure duty free access to the North American market. It is also possible that we can maintain our advantages in higher value added niche markets, and future protective measures (safeguards) imposed by the United States will have a decisive impact in the developments of textile exports.

1/ IMF Working paper (2004), "The end of textiles quotas: A case of study of the impact on Bangladesh" (WP/04/108).

Figure 42

BALANCE OF PAYMENTS' CURRENT ACCOUNT
(Percentage of GDP)



* Forecast.

II.2 Economic activity

64. GDP is expected to grow at around 4.5 percent sustained by higher growth in consumption linked to a moderate but sustained recovery in employment, higher agriculture incomes and consumer credit. Private investment will continue to grow at sustainable levels, driven by an increase in profits and the better terms of trade achieved in 2004. Growth is also expected in public investment given a foreseeable improvement in access to external financing for investment projects.

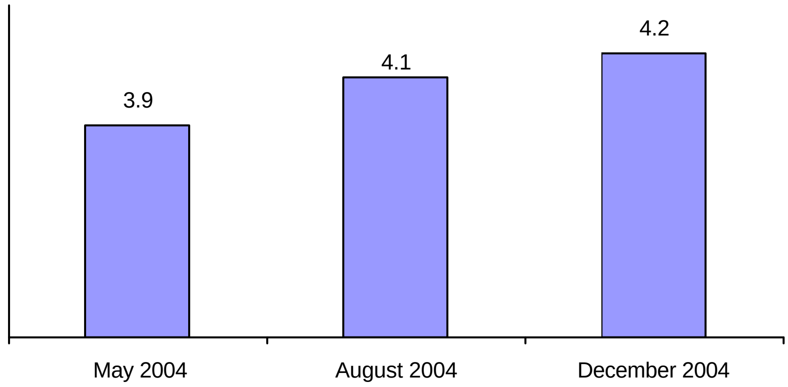
    In contrast to 2004, agriculture GDP will recover and, therefore, there will be no shortages in the supply of foodstuffs to push prices upwards.

65. According to a survey of expectations carried out by the BCRP, economic analysts expect GDP growth in 2005 to be 4.5 percent, non-financial entities expect it to be 4.3 percent and financial institutions expect it to be 4.2 percent. Also, in accordance with the *Consensus Forecast* expectations of GDP growth for 2005 have increased from 3.9 percent in May 2004 to 4.2 percent in December of the same year.

Figure 43

GDP GROWTH EXPECTATIONS FOR 2005

(Real % change)



Source: *Consensus Forecast.*

66. In contrast to 2004, in 2005 exports should increase at a lower rate because of a less favorable international context than in the previous year, whilst domestic demand grows at a faster rate. This expansion in domestic demand could be the result of more dynamic private consumption and sustained growth in private investment.

Table 24

GLOBAL SUPPLY AND DEMAND

(Real percentage change)

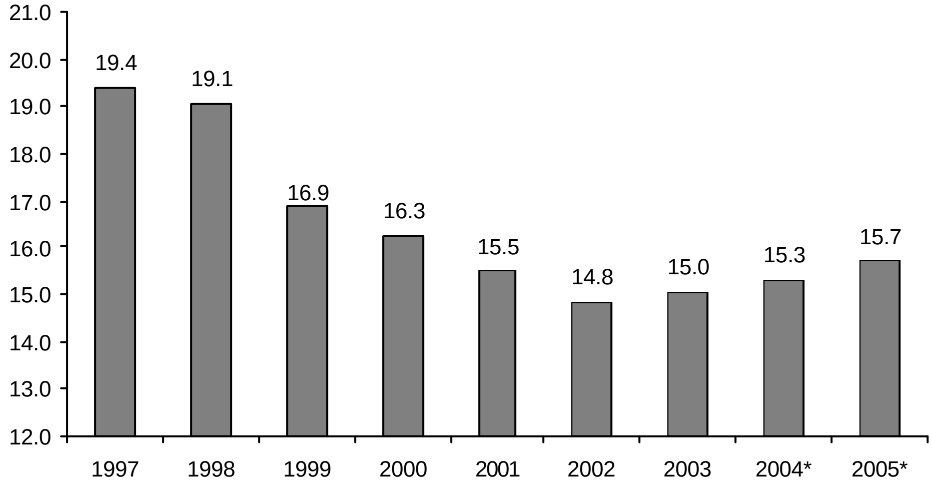
	2003	2004*	2005*
I. Global demand (1+2)	**3.7**	**5.6**	**4.7**
1. Domestic demand1/	3.3	3.8	4.5
a. Private consumption	3.1	3.3	3.8
b. Public consumption	2.9	3.9	3.8
c. Fixed private investment	5.4	9.4	8.0
d. Public investment	5.0	3.1	9.0
2. Exports	5.9	15.2	5.5
II. Global supply (3+4)	**3.7**	**5.6**	**4.7**
3. Gross domestic product	**3.8**	**5.0**	**4.5**
4. Imports	3.3	9.5	5.5

1/ Includes change in inventories.
* Forecast.
Source: INEI and BCRP estimates.

67. Private **investment** should continue as dynamic as it has been since 2002, progressively recovering its share of gross domestic product, it is therefore envisaged that by the end of 2005 it will be responsible for 15.7 percent of GDP.

Figure 44

GROSS FIXED PRIVATE INVESTMENT
(Percentage of nominal GDP)



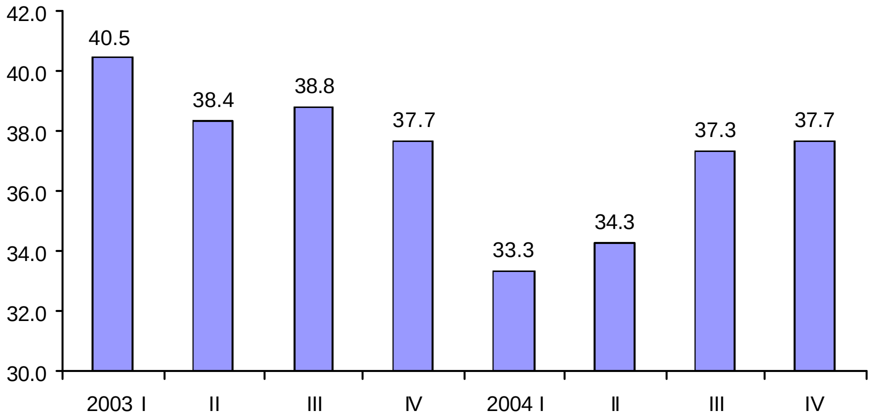
* Forecast.

Proinversión signed private investment commitments during 2004 valued at US$ 1,240 million to be disbursed in the medium and long term. It is expected that in 2005 the figure of US$ 2,000 million will be exceeded with adjudication of Highway Networks Nº 1, Nº 4, Nº 6, the multimodal hubs to integrate trade with Brazil and concession agreements for regional airports, among others.

68. **Private consumption** should grow 3.8 percent in 2005, which should be reflected in a 6.5 percent increase in consumer goods imports. This considers the high level of confidence among consumers in Metropolitan Lima, shown by an index drawn up by Apoyo. The INDICCA[2] recorded an average level of 38 points in the fourth quarter of 2004, higher than the figure for the three previous quarters.

Figure 45

CONSUMER CONFIDENCE INDEX
INDICCA



Source: Apoyo.

[2] Index of Consumer Confidence, which measures families' perception of their future income situation.

Table 25

PRINCIPAL PROJECTS TO BE OFFERED IN CONCESSION 1/

Project	Estimated investment (US$ Million)	Selection of the winning bidder	Description
INFRASTRUCTURE	**2094**		
Northern Amazon multi-modal corridor - South American Infrastructure Integration (IIRSA)	158	2nd quarter 2005	This is the second road linking with Brazil, starting at the port of Paita, its road section ends at Yurimaguas. From here river transport is used to connect with Brazil. The project includes rebuilding and maintenance of various sections between the cities mentioned.
Central Amazon multi-modal corridor - South American Infrastructure Integration (IIRSA).	62	3rd quarter 2005	This corridor starts in Lima and ends at Pucallpa, from which river traffic connects with Brazil. The project includes the rebuilding of certain sections between Lima and Pucallpa and maintenance of the whole road.
Road Network Nº. 4	100	4th quarter 2005	This project covers the construction of a ring road for Chimbote, rebuilding the Pativilca-Conococha, Huaraz-Caraz road and rebuilding and maintenance of the Pativilca-Casma-Trujillo road.
Road Network Nº. 1	104	4th quarter 2005	The project covers the rebuilding of the Piura and Sullana road, which will be upgraded to highway classification; the construction of a ring road for the city of Piura; rebuilding of the Sullana-La Tina-Puente Macara and Sullana-Aguas Verdes stretchs.
Road Network Nº. 6	180	1st quarter 2005	This project covers maintenance of the Puente Pucusana-Cerro Azul stretch (74 Km); the construction of a highway from Cerro Azul to Ica (149 Km) and maintenance of the Cañete-Lunahuaná stretch (40 Km).
Regional airports 2/	148	3rd and 4th quarters 2005	For airports managed by CORPAC a public-private partnership is proposed in which the State sets quality standards for service and safety that must be met at each airport and will transfer the services under a DBFOT scheme (design, build, finance, operate and transfer).
New ocean terminal at the port of Callao	108	4th quarter 2005	Construction, operation and maintenance of a new container and grain terminal in the southern zone of the port of Callao.
Coast Highlands 2/	342	2nd & 3rd quarters 2005	The program consists of offering under concession the existing 28 roads connecting production centers in the valleys with markets located in the 10 departments on the Peruvian coast. The roads belong to the National, Departmental and Local networks. An invitation to bidders to submit an integrated project for each route to be given in concession, withthe concessionaire responsible for arriving at a technical solution.
Peru- Brazil inter-ocean corridor project	892	2nd quarter 2005	
HYDROCARBONS	**320**		
Regional gas pipelines	320	2nd quarter 2005	Handing over under concession of the design, construction and operation of transport and distribution pipelines for natural gas from Camisea, to various zones included in the following regions: Ayacucho, Cusco, Ica & Junin
TELECOMMUNICATIONS	**153**		
Mobile telephony fourth band	120	1st quarter 2005	
Access to the Internet for district capitals	33	1st quarter 2005	Transfer of the "Access to the Internet for district capitals of Peru" project to an operator who will be responsible for: a) Installation, operation and maintenance of the infrastructure required for access to the Internet in 800 district capitals of Peru and b) awareness raising, training and publication among the population. Expected to be executed in two stages, the first stage to include around 70 district capitals.
LAND AND AGRICULTURE	**216**		
Sale of land in Jequetepeque and Zaña	10	2nd quarter 2005	The project consists of transferring to the private sector land without the provision of water in the regions of Lambayeque and La Libertad.
Casa Grande	21	N.D.	Incorporation of a private investor into Empresa Agroindustrial Casa Grande S.A.A. in which the State holds 31.36% of the capital in the company.
Olmos	185	N.D.	The Olmos project includes a hydro electricity and irrigation complex, involving the transfer to the Pacific watershed of an annuall viçolume of 2,050 million m3 of water from the river Huancabamba and other rivers in the Amazon basin.
MINING	**910**		
Bayóvar 3/	300	1st quarter 2005	The project involves the exploitation of a phosphates deposit with reserves equivalent to 262 million tons of phosphate rock concentrates.
La Granja trender process	300	2nd quarter 2005	La Granja is a deposit of porphyry with gold and silver as the main minerals. The mining concession covers 3,900 hectares.
Michiquillay tender process	300	3rd quarter 2005	Michiquillay is a deposit of copper porphyry containing gold and silver. The mining concession covers 18,978 hectares and ownership of 1,206 hectares.
San Antonio tender process	10	3rd quarter 2005	San Antonio possesses 193 million m3 of gold-bearing gravel having a gold content of 0.25 g/m3, equivalent to 48,000 Kg of fine gold.
Public hygiene	**719**		
EPS Grau	252	2nd quarter 2005	Provision of water and sewage services in the EPS Grau area.
EMFAPA Tumbes	67	1st quarter 2005	Provision of water and sewage services in the EPS Tumbes area
Water supply for Lima	300	2nd quarter 2005	
Hygiene services provided by SEDAM Huancayo S.A.C	100	4th quarter 2005	The project aims to promote participation by a private operator to provide drinking water and sewage services to EPS SEDAM HUANCAYO S.A.C.
TOURISM	**63**		
Lima Civic Center	20	N.D.	The purpose of the project is to find a private operator to refurbish akll the buildings of the Civic Center - except for the tower - and implement a shopping mall and multi-screen cinema. The promotion of private investment will take place through a leasing or usufruct agreement.
Playa Hermosa tourist complex	36	N.D.	The project consists of tourist infrastructure on the coastal strip denominated the National Tourist Zone, covering basically all the coast of the region of Tumbes.
El Chaco- La Puntilla tourist complex	7	1st quarter 2005	The project covers the design, construction and operation of a tourist complex in the Chaco - La Puntilla area located on the bay of Paracas, on land belonging to the State.
Total	**4,475**		

1/ Drawn up using information published on the website of Proinversión as at 18/01/2005
2/ First and second package
3/ The lower range has been used.

69. Taking into account the rainfall forecasts issued by SENAMHI and the progress already made in planting this season (by November 46 percent had been completed), which reveal an increase in agricultural land of 53,000 hectares, equivalent to 5.9 percent, it is expected that the supply of agriculture produce will recover and with this increased growth in the primary sectors, which should grow 4.7 percent instead of the 2.8 percent achieved in 2004.

The **non-primary sectors** should grow 4.5 percent in 2005 after showing 5.6 percent growth in 2004. This lower rate of growth is explained by a weaker external stimulus that could be felt in 2005 compared to the previous year. Thus non-primary manufacturing may grow by 5.5 percent compared to the 7.2 percent recorded in 2004.

Table 26
GROSS DOMESTIC PRODUCT
(Real percentage variation)

	2003	2004*	2005*
Agricultural & livestock	**2.3**	**-1.0**	**3.4**
Fishing	**-12.6**	**28.3**	**1.8**
Mining & fuel	**6.9**	**5.4**	**7.0**
Metals	7.7	5.2	5.7
Fuel	-4.5	7.1	26.2
Manufacturing	**2.1**	**6.7**	**5.0**
Based on raw materials	-1.8	4.6	3.4
Non-primary	3.2	7.2	5.5
Electricity and water	**4.2**	**4.5**	**4.0**
Construction	**4.2**	**4.8**	**6.0**
Commerce	**3.8**	**4.2**	**4.6**
Other services	**4.0**	**5.8**	**4.1**
GROSS VALUE ADDED (GVA)	**3.6**	**5.0**	**4.6**
Taxes on products and import duties	5.3	4.2	4.5
GLOBAL GDP	**3.8**	**5.0**	**4.5**
Primary GVA	**2.8**	**2.8**	**4.7**
Non-primary GVA	**3.8**	**5.6**	**4.5**

* Forecast.
Source: INEI and BCRP estimates.

The recovery of the **agriculture and livestock sector** in 2005 (3.4 percent) will be driven by the recovery of areas that were not planted in the previous season because of a drought which began to improve in November 2004. SENAMHI predicts that a weak "Niño" will occur, based on information from the NOAA (*National Oceanic and Atmospheric Administration*), and this will imply wet conditions in Northern Peru during March to April 2005.

A Ministry of Agriculture survey in December showed that farmers intend to plant 16 percent more land in 2004 - 2005 than in the previous season. It is expected that livestock activities and agriculture exports (2 percent annually) will continue to be dynamic with more fruit and vegetables exported, such as lucuma, watermelon, melon, artichokes, avocados and paprika, together with mangoes and citrus fruit as farming methods become more sophisticated.

Meteorological conditions in January were better than in the previous season. Water levels in the Tinajones and Gallito Ciego reservoirs are favorable and northern reservoirs in general contain 41 percent more water than in the previous year, which means better conditions for farmers.

Table 27

VOLUME OF WATER STORED ON THE LAST DAY OF EACH MONTH

(Million m3)

Reservoir	Years	Jan.	Feb.	Mar.	April	May.	June	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan. - Dec.
Poechos	2003	202	213	383	512	538	532	518	427	331	226	132	158	4,014
Piura	2004	167	125	115	206	203	278	319	265	224	183	148	184	2,416
	2005	102												
Var % 2004/03		-18	-41	-70	-60	-62	-48	-38	-38	-32	-19	12	16	
Var % 2005/04		-39												
San Lorenzo	2003	128	139	166	218	243	255	230	184	139	86	57	57	1,844
Piura	2004	72	60	79	97	93	103	112	63	40	36	35	50	838
	2005	49												
Var % 2004/03		-44	-57	-52	-56	-62	-60	-51	-66	-72	-58	-38	-13	
Var % 2005/04		-33												
Tinajones	2003	203	167	84	86	98	110	88	59	56	44	39	60	1,033
Lambayeque	2004	49	24	47	59	68	42	39	17	21	50	131	167	713
	2005	108												
Var % 2004/03		-76	-86	-44	-32	-31	-62	-56	-71	-63	13	239	178	
Var % 2005/04		123												
Gallito Ciego	2003	338	342	362	420	443	441	422	394	378	252	222	158	4,014
La Libertad	2004	80	74	69	100	114	118	104	84	77	73	211	186	1,291
	2005	261												
Var % 2004/03		-76	-78	-81	-76	-74	-73	-75	-79	-80	-71	-5	18	
Var % 2005/04		226												
Total	2003	872	861	994	1236	1322	1338	1258	1064	904	608	449	433	10,906
	2004	367	283	310	461	478	540	574	429	361	342	525	587	5,257
	2005	520												
Var % 2004/03		-58	-67	-69	-63	-64	-60	-54	-60	-60	-44	17	35	
Var % 2005/04		41												

Source: MINAG.

Growth during 2005 in the **fishing sector** of 1.8 percent is forecast. Peruvian anchovy landings could fall from 8.6 to 8.3 million M.T., when it is considered that landings in 2004 were exceptional compared to the previous five years. On the other hand a recovery in landings of mackerel for canning is envisaged together with increased fresh and frozen fish production, in the latter case the result of higher landings of giant squid and hake.

The **mining and hydrocarbons sector** could see growth of 7.0 percent caused by higher hydrocarbons production (Camisea in stream all year) and gold production. In the case of gold the Alto Chicama project (Barrick) in La Libertad is expected to start production while Cerro Negro (Yanacocha) should be producing all year. Zinc, lead and silver production could show moderate growth driven by a recovery on the part of Volcan and other medium-sized mining companies as a result of higher base metal prices.

Manufacturing production could grow 5.0 percent, principally because of a 5.5 percent increase in non-primary manufacturing, a lower rate than in 2004 as it is expected that the textile industry will be less dynamic in the second half year as growth in its exports falters. The increase in non-primary manufacturing in 2005 may be driven by increased production of chemical products, rubber and plastics and non-metallic minerals. Primary resources processing should rise 3.4 percent with a recovery in the sugar industry and that of canned and frozen fish products.

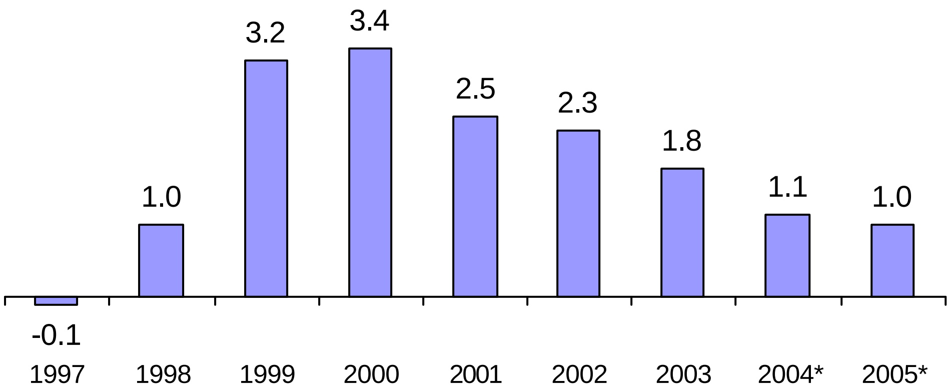
The **construction** sector could grow 6.0 percent as private investment continues to be dynamic, particularly housing, mining projects and road building.

II.3 Public sector economic results

70. In 2005 it is expected that the fiscal deficit will fall to 1.0 percent of GDP in accordance with the forecasts contained in the Multi-annual Macroeconomic Framework for 2005 - 2007. The primary balance should rise from 1.0 percent of GDP in 2004 to 1.2 percent of GDP in 2005 because of higher tax revenue, which should grow by 5.5 percent in real terms compared to a rise in non-financial expenses of 3.3 percent. In contrast to 2004, in which the primary balance rose by 0.6 percent of GDP compared to 2003 – 0.3 percentage points higher than forecasts contained in the inflation reports for May and August - it is expected that this year the fiscal stimulus will have a lower contractive effect. This position is compatible with favorable development of economic activity.

Figure 46

FISCAL DEFICIT: 1997-2005
(Percentage of GDP)



* Forecast.

71. The improvement in current income reflects the impact of economic activity and measures such as an increase in the rate of corporate income tax from 27 to 30 percent – the effect of which will only be seen this year - an extension of mechanisms for collection of value-added tax and higher income deriving from mining royalties. It should be mentioned that replacing income tax payments in advance with the temporary tax on net assets should imply a net loss of S/. 250 million.

72. As far as non-financial expenditure is concerned, the forecast considers growth of 3.3 percent in real terms, associated with greater dynamism on the part of regional governments. It also considers growth in current transfers to local governments given that more resources will be available from surcharges and royalties.

Table 28
NON-FINANCIAL PUBLIC SECTOR
(Millions of nuevos soles)

	2003	2004 *	2005 *
1. Current income	**31,551**	**35,377**	**38,112**
(% of GDP)	15.0	15.2	15.3
Real % change	8.0	8.2	5.5
2. Non financial costs	**-31,460**	**-34,182**	**-36,055**
(% of GDP)	-14.9	-14.7	-14.5
Real % change	5.2	4.8	3.3
Current	-27,375	-29,870	-31,493
(% of GDP)	-13.0	-12.8	-12.7
Real % change	5.9	5.3	3.3
Capital	-4,084	-4,312	-4,562
(% of GDP)	-1.9	-1.9	-1.8
Real % change	1.0	1.8	3.6
3. Others	**814**	**1,207**	**898**
(% of GDP)	0.4	0.5	0.4
4. Primary balance	**905**	**2,403**	**2,955**
(% of GDP)	0.4	1.0	1.2
5. Interest	**-4,633**	**-4,927**	**-5,405**
(% of GDP)	-2.2	-2.1	-2.2
Of which:			
Pension recognition bonds	-235	-326	-236
External debt (millions of US$)	-$1,082	-$1,158	-$1,346
6. Overall balance	**-3,728**	**-2,524**	**-2,450**
(% of GDP)	-1.8	-1.1	-1.0
Millions of US$	-$1,072	-$771	-$732

* Forecast.

73. Public sector interest payments are estimated at 2.2 percent of GDP, this implies higher interest on foreign debt of US$ 188 million compared to 2004.

74. The improvement in the fiscal deficit will partly offset the increase in amortization. The borrowing requirement of US$ 3,026 million could be covered by further foreign debt of US$ 1,523 million and the placement of domestic bonds in soles equivalent to US$ 1,027 million, including repurchasing bonds of the Financial Consolidation Program valued at US$ 393 million. This financing scenario could imply a higher demand for dollars by the Peruvian treasury in 2005 compared to the previous year. This forecast does not include the possibility of restructuring the country's debt with the Paris Club, which could imply an additional demand for dollars by the treasury, financed by further placements of bonds in the domestic market.

Table 29
FINANCING FROM NON-FINANCIAL PUBLIC SECTOR
(Millions of US$)

	2003	2004 *	2005 *
1. Overall balance (Million of nuevos soles)	**-3,728**	**-2,524**	**-2,450**
(% of GDP)	-1.8	-1.1	-1.0
Millions of US$	-$1,072	-$771	-$732
2. Amortization (Millions of US$)	**-$1,743**	**-$2,069**	**-$2,295**
Redemption of pension recognition bonds	-$172	-$215	-$194
Internal	-$385	-$505	-$571
External	-$1,187	-$1,349	-$1,529
3. Borrowing requirement (Millions of US$)	**$2,815**	**$2,839**	**$3,026**
External disbursement	$2,101	$2,471	$1,523
Free disposable funds	$1,765	$2,157	$1,023
Investment projects	$336	$315	$500
Domestic bonds	$508	$766	$1,027
Privatization	$52	$114	$87
Others	$154	-$512	$389

* Forecast.

II.4 Inflation

75. The inflation forecast takes into account the aggregate macroeconomic conditions described above, which could influence the likely developments of prices throughout 2005.

    Inflation is especially determined by inflationary expectations within the forecast horizon, the inertia inherent in inflation, imported inflation, inflationary or deflationary pressures arising from the developments of aggregate demand and supply factors.

    The expectation concerning inflation for 2005, obtained from the monthly macroeconomic expectations survey carried out by the BCRP, remains in line with the inflation target of 2.5 percent. It is expected that it will remain in line with the inflation target during 2005.

76. Inflationary inertia refers to the importance of past inflation in determining future inflation. If we consider that a sharp change in prices lasts a short time, then it will not propagate into the future; if, on the other hand the shock is prolonged, then it will tend to have a stronger effect on future inflation. This inflation report considers that the increase and later fall in foodstuff prices have not affected other prices in the economy. It is envisaged that the inertia of the economy is in line with the inflation target of 2.5 percent.

77. According to the monthly Macroeconomic Expectations Survey carried out by the BCRP among economic analysts, the exchange rate by December 2005 is expected to be S/.3.34 to the dollar. This expectation of the value of the sol is consistent with the real exchange rate remaining similar to its current level and assumes that the dollar will remain relatively stable in the currency markets. In this year it is expected that some of the fundamental factors causing the sol appreciation will be partially reversed, such as an expected fall in the terms of trade and an increase in international interest rates. Nevertheless, it is expected

that new investment projects such as Alto Chicama and full working capacity of the Camisea project will continue to improve Peru's balance of payments position.

78. It is thought that imported inflation will have no effect during 2005, because the appreciation of the exchange rate in the second half of 2004 will continue pushing prices downwards during the first half of this year. The impact of the appreciating sol on inflation considers the direct effect of the imported component of the CPI (approximately 12.1 percent) as well as its indirect effect via the cost of intermediate goods (estimated through the imported component of the wholesale prices index).

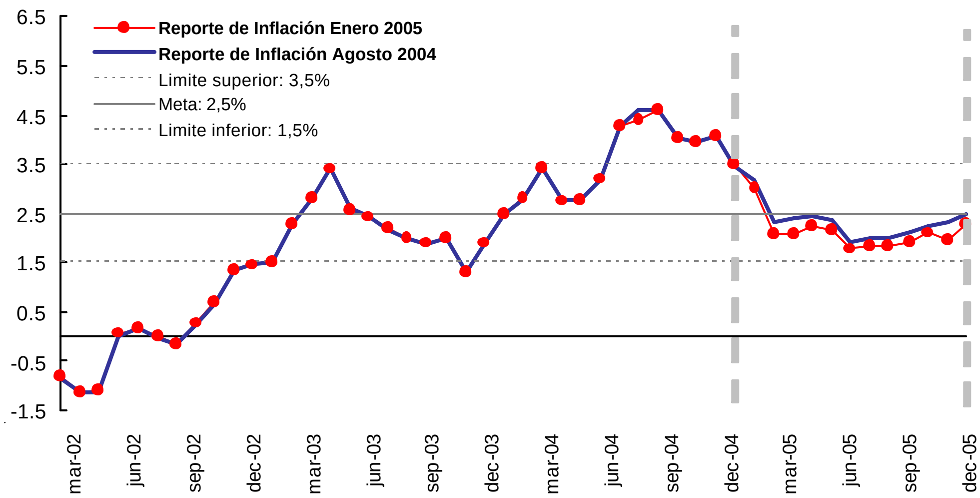
79. From July to December 2004, the sol appreciated 5.7 percent. In this same period inflation of the imported component of the wholesale price index fell 2.1 percent, it is forecast that the effect of this monetary appreciation on inflation will continue to have an effect in the first half of 2005.

80. Forecast inflation during 2005 will be in the lower part of the target range (1.5 to 2.5 percent) for most of the months of the year. By December 2005, 12 month inflation should be around 2.3 percent. This forecast assumes that the reference interest rate will continue at 3 percent.

This working assumption represents a possible policy scenario in line with the actual position of the economy and information available when this report was drawn up. It in no way represents a commitment by the Bank to sustain this scenario in the future. In practice, as new information on inflationary or deflationary pressures appears, monetary policy is adjusted in order to meet the inflation target.

Figure 47

INFLATION FORECAST
- With constant interbank rate -
(accumulated variation of CPI over 12 months)



Note: The forecasts assume a constant interbank rate of 3 percent throughout the forecast period.

III. BALANCE OF RISKS

81. The forecast scenarios are considered the most probable over the next few months. The results of these forecasts are susceptible to changes in the external variables considered, which could alter the central scenario described. The Central Reserve Bank's balance of risks enables a probability analysis to be made of the way in which external variables could diverge from the central scenario. The result is a distribution of forecast inflation. The external variables that will have the greatest impact on the balance of risks are the future international price of oil, international interest rates, the weakness of the dollar and the possibility of better than expected supply conditions.

82. In this report the principal risks that could force inflation up, given the central scenario, come from the international environment and are:

    - A more pronounced increase in federal fund rates than is assumed in the forecast of inflationary pressure in the United States and the possibility of a further sharp fall in the dollar become more likely (for more details see box 12). This risk of a rise in Federal Reserve rates will affect the Libor rates and domestic dollar interest rates, which will in turn tend to make the nuevo sol depreciate against the dollar. In addition, as an election draws near, there could be some uncertainty and volatility in the financial markets, for which reason the Bank maintains a high level of international reserves.

BOX 12
RISK FACTORS IN THE WORLD ECONOMY

The principal risk factors in the international context are could be associated with the performance of the world's two most important economies at present: the United States and China.

In the first case, the greatest risk factors are associated with the FED increasing interest rates more rapidly. This risk may occur if inflationary pressure increases (given the rate of growth of the economy and the possibility that an expansive fiscal policy will be maintained) and the current account deficit remains high. The impact on emerging economies of higher international interest rates would be lower capital inflows (either private or public) and, therefore, a lower rate of appreciation of the domestic currency.

The significant current account and fiscal deficits of the United States, as well as its position as an international debtor, could lead to a greater than expected fall in the dollar in 2005, accompanied by further adjustments to interest rates. If exchange rate regimes in Asia are not made more flexible, the risk of an appreciating euro is greater. This effect could translate into fewer sources for financing the US trade deficit which, in turn, would lead to an aggressive change in interest rates that could decelerate growth in the world economy. The impact of this scenario on the Peruvian economy would be through trade, in the form of a larger reduction in the terms of trade (though partially offset by a higher expected gold price) and lower traded volumes. Financially, a reduction in international liquidity could be expected and, therefore, greater debt *spreads* and higher interest rates, which would have a negative impact on the balance of foreign debt and debt servicing. In summary, an abrupt increase in United States interest rates could generate certain volatility in financial markets, faced with which the Peruvian economy is fundamentally sounder in its macroeconomic aspects than in previous years.

China is also a factor for uncertainty because of the process of smoothing its high growth rates observed in recent years. Despite the restrictive measures applied during the year, rates of growth continue high and there is a latent danger of a sharp change that have an impact on demand for Peruvian exports.

In this scenario, purchases by the BCRP in the foreign exchange market may be reduced, or the Central Bank may stop intervening altogether. A change in the monetary policy stance towards lower monetary stimulus could occur insofar as the behavior of the exchange rate affects future rates of inflation.

- A new cycle of international fuel price rises. The central scenario considers that the price of crude oil will be around US$ 42 a barrel by the end of 2005; nevertheless, uncertainty concerning the oil price continues to be high.

  An additional risk factor is that the expected slight fall in oil prices will not occur and, indeed, prices may rise. This risk is associated with the situation in the Middle East (the continued conflict makes exports from Iraq uncertain, given that they have been interrupted several times). the policy of OPEC (it has announced that if the dollar continues to fall against the euro, it may reduce production as the purchasing power of its sales declines). These risks become more acute in the context of a near match between supply and demand for crude oil. Thus world demand for oil is forecast to rise by 3 percent, led by China (9 percent), whilst total world supply could increase by 2 percent.

  Any further rise in fuel prices would imply a temporary upward pressure on inflation which would not merit a change in monetary policy, unless such a supply shock increased inflationary expectations and affected the setting of prices in the economy.

83. Furthermore, risks that could cause inflation forecasts to be revised downwards are:

- Expectation surveys assume that the nominal exchange rate will recover in 2005. Nevertheless, it is possible that improved macroeconomic fundamentals and the weakness of the dollar caused by the US economic position would tend to cause the nuevo sol to appreciate.

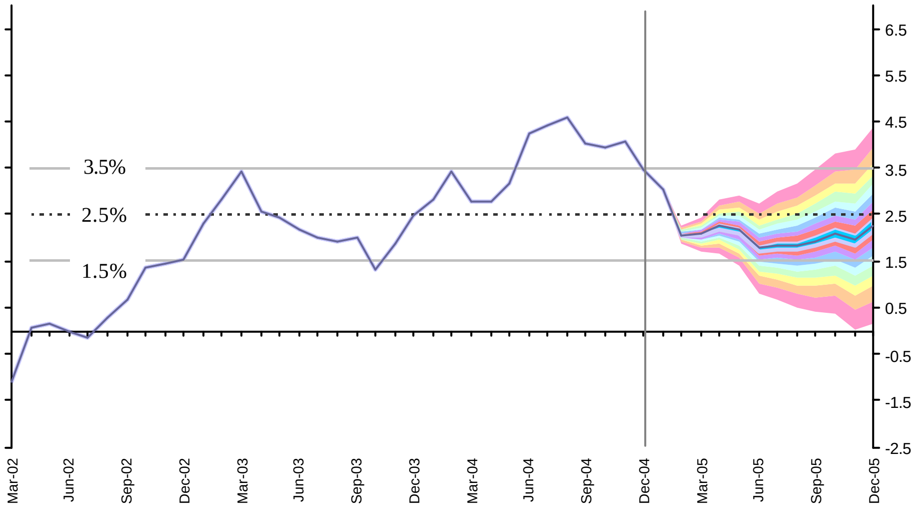
  The BCRP's response in such a context will depend on the possible impact of this appreciation on inflation. This reaction could mean that the current flexible monetary policy would be maintained for a longer period or could cause that policy to be made even more flexible.

- The central scenario assumes that agriculture production will recover in 2005 at a rhythm consistent with demand and will not, therefore, tend to push inflation upwards. A reversion of stronger than expected supply shocks could lead to the inflation rate over the last 12 months falling below the lower limit of the target range in certain months. The monetary policy response would only change if these supply shocks affected inflationary expectations and the setting of prices in the rest of the economy.

84. Weighing the various risks of both an increase and a fall with respect to the central scenario, we consider that the aggregate balance will remain neutral.

Figure 48

INFLATION FORECAST
(Accumulated variation of CPI over 12 months)



Note: The Figure shows the forecast inflation bands over the forecast horizon. The darkest band around the central forecast shows a 10 percent probability of occurrence whilst all the colored bands represent 90 percent probability.

CONCLUSIONS

85. Forecast inflation for 2005 is in the bwer part of the target range (1.5 - 2.5 percent) principally as a result of a partial reversion of the supply shocks of 2004. This forecast was drawn up assuming that monetary policy would remain constant over the forecast horizon: interbank interest rate at 3.0 percent (the current position).

86. The current interbank interest rate is a monetary stimulus and is historically low (3.0 percent). With the information available when this report was drawn up, this monetary policy stance is consistent with the inflation target for the following twelve months. As new information on inflationary or deflationary pressure becomes available, monetary policy will be adjusted to take account of it and in a manner that is consistent with the inflation target.

CENTRAL RESERVE BANK OF PERU

STATISTICAL ANNEX

STATISTICAL ANNEX

INFLATION REPORT FORECASTS: JANUARY 2005 vs AUGUST 2004

	2002	2003	2004 1/		2005 1/	
			August 2004 Report	January 2005 Report	August 2004 Report	January 2005 Report
			Var. real %			
1. Gross domestic product	4.9	3.8	4.3	5.0	4.5	4.5
2. Domestic demand	4.0	3.3	4.0	3.8	4.3	4.5
a. Private consumption	4.4	3.1	3.5	3.3	4.0	3.8
b. Public consumption	0.2	2.9	4.0	3.9	3.2	3.8
c. Fixed private investment	0.1	5.4	9.1	9.4	7.2	8.0
d. Public investment	-4.8	5.0	4.7	3.1	5.4	9.0
3. Exports of goods and services	6.8	5.9	9.0	15.2	5.4	5.5
4. Imports of goods and services	2.1	3.3	7.5	9.5	4.0	5.5
5. Growth among Peru's trading partners	1.6	2.5	4.3	4.6	3.5	3.5
			Var. %			
6. Inflation	1.5	2.5	3.5	3.5	2.5	2.3
7. Nominal depreciation	2.3	-1.2	-0.9	-5.5	2.3	1.8
8. Real depreciation (multilateral)	-0.6	7.5	-2.3	-1.3	2.1	0.5
9. Terms of trade	2.8	1.4	7.2	8.0	-4.4	-2.6
			% of GDP			
10. Balance of payments current account	-2.0	-1.8	-0.5	0.0	-0.5	0.5
11. Trade balance	0.5	1.2	3.1	4.0	3.1	4.0
12. Gross private sector external borrowing 2/	4.7	3.2	2.8	3.5	2.8	0.9
13. Primary balance of the non-financial public sector	-0.1	0.4	0.7	1.0	1.3	1.2
14. Overall balance of the non-financial public sector	-2.3	-1.8	-1.4	-1.1	-1.0	-1.0
15. Central government tax revenue 3/	11.9	13.0	13.4	13.3	13.5	13.2
16. External public debt balance	36.7	37.6	34.6	34.8	33.9	31.5
			Var. % Nominal			
17. Central government non-financial expenditure	2.3	7.6	8.1	8.7	6.3	5.5
18. Average annual monetary base	15.8	7.4	16.5	18.8	8.0	11.0
19. Bank loans to private sector	0.1	-4.3	4.7	-0.4	5.0	4.7

1/ Forecast.
2/ Including direct foreign investment and long-term disbursement to the private sector.
3/ Excludes tax on State shareholdings.