INFLATION REPORT

January 2007

Recent trends and macroeconomic forecast

CENTRAL RESERVE BANK OF PERU

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CENTRAL RESERVE BANK OF PERU

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BOXES

This Inflation Report was drawn up using data on gross domestic product as of November 2006; data on trade balance, operations of the non-financial public sector and monetary accounts as of December 2006; and data on inflation and exchange rate as of January 2007.

Inflat

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Foreword

- According to the Peruvian Political Constitution, the Central Reserve Bank of Peru (BCRP) is a public autonomous entity whose role is to preserve monetary stability. In this way, the Central Bank contributes to establishing the necessary stable macroeconomic conditions required for the economic development of the country.

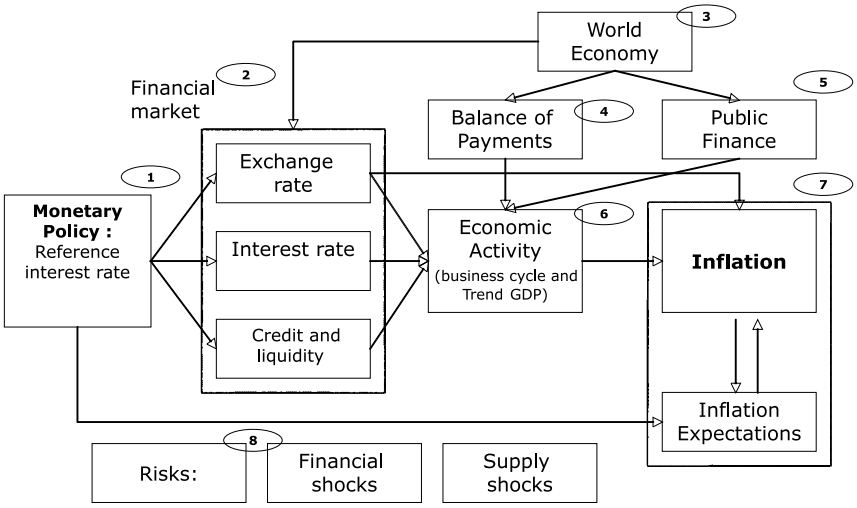
- In order to consolidate the achievement of this goal, the Central Bank will from now on design and implement its monetary policy to lead inflation to an annual rate of 2.0 percent, plus or minus one percentage point (3.0 percent - 1.0 percent).

- Reducing the inflation target from 2.5 to 2.0 percent will allow the nuevo sol to better perform its functions as a medium of exchange, unit of account and store of value as this will allow our currency to maintain a higher purchasing power. As a result of this, confidence in the domestic currency strengthens while the economy's vulnerabilities associated with dollarization decrease, and thus the economy not only has greater flexibility to face adverse macroeconomic shocks, but can also reduce the magnitude and duration of recessive impacts. Furthermore, an inflation target of 2 percent equates the pace of price rises to that of the main developed economies, thus preventing a relative devaluation of the nuevo sol.

- At the beginning of each month, and according to a schedule announced in January, the Board of the BCRP approves a reference interest rate for the interbank lending market. This interest rate affects the entire array of domestic economic variables and inflation through several channels in different timeframes and, therefore, this rate has to be determined on the basis of forecast studies and macroeconomic simulations.

- The economic studies on which monetary policy decisions are taken are disseminated to generate the public's understanding of the consistency of the decisions adopted and to ensure that economic agents' expectations take these projections and simulations into account. With this aim, the Central Bank has regularly published its Inflation Report since 2002.

- This Inflation Report supports the rationality on which modifying the inflation target is based and outlines the factors explaining the evolution of inflation in 2006. Moreover, the analysis horizon covered by this Report has been extended to 2 years in order that the forecast scenario be consistent with monetary policy lags. Therefore, the macroeconomic forecasts contained herein cover the years 2007 and 2008.



Summary

i. Five years after the Inflation Targeting framework was first adopted, the Board of the Central Bank has decided that the design and implementation of the monetary policy from 2007-on will be oriented towards the convergence of the last-12-month inflation to an annual target level of 2.0 percent, plus or minus one percentage point (3.0 percent - 1.0 percent).

By reducing the inflation target, the Central Bank reinforces its commitment to maintaining the purchasing power of the nuevo sol while strengthening confidence in this currency and reducing the vulnerabilities associated with the economy's financial dollarization. Furthermore, an inflation target of 2 percent is closer to the inflation rates of our main trading partners.

ii. During 2006, the annual inflation rate was within the inflation target range (between 1.5 and 3.5 percent) until November. However, better conditions in the supply of food products and the lower prices of fuels and public utilities caused annual inflation in December (1.14 percent) to fall below the target.

iii. This price evolution, with particularly low rates over the last months, has taken place in a context that is also characterized by a strong dynamism of economic activity, an increase in the productive capacity as a result of higher investment and productivity, an appreciation of the nuevo sol, greater competition reflected in lower margins, and lower expectations of inflation. The Inflation Targeting framework is aimed at anchoring inflation expectations at the inflation target rate. Throughout the period of implementation of the Inflation Targeting framework, economic agents have maintained inflation expectations in line with the target range announced by the Central Bank.

iv. In line with these developments, the inflation forecast considered in our Inflation Report of September 2006 has

been revised downwards. The last-12-month inflation rate is expected to remain below the lower band of the target range in the first half of 2007 due to the reversal of the price rise observed in food products in the first four months of 2006. These factors have a one-time impact on the inflation rate and therefore these price deviations are estimated to be transitory. Driven by the dynamic performance of economic activity and by inflation expectations in line with the target, inflation is expected then to converge to the inflation target. In contrast with previous years, the baseline forecast scenario does not consider upward pressures on inflation as a result of supply-related factors or imported inflation.

v. **Economic activity** is estimated to have grown 7.9 percent in 2006, posting the highest rate of growth observed in the last 11 years, and with an overall growth of all components of domestic demand. This economic expansion has taken place in the context marked by an extraordinarily favorable international environment, high levels of consumer and business confidence, a faster pace of growth of private investment, productivity and employment, as well as by increased financing of the financial system.

   Private investment in 2007 and 2008 is expected to continue showing strong dynamism with rates that would increase GDP growth twofold, in line with a potential growth of GDP in the range of 6 percent. In 2007-2008, the expansionary economic cycle is forecast to moderate (particularly in 2008) in line with a less favorable international environment and with a growth pace in line with the potential GDP.

vi. The **international context** in 2006 was one of the best scenarios in terms of the Peruvian economy since the fifties. Favored by this context, terms of trade increased 26 percent, thus positively stimulating the growth of the output which was coupled by improvements in fiscal accounts and in the balance of payments. A moderate correction downwards is anticipated in the prices of our main commodities in the following years due to the lower pace of growth forecast for the world economy. A high volatility in these prices is also expected given uncertainty regarding some restraints in the supply of some metals and the increasing importance of speculative movements observed in some commodity markets.

vii. The result in the **current account of the balance of payments** in 2006 is estimated at 2.3 percent of the product, which is one of the third highest levels of surplus recorded since 1950. A reversal of the terms of trade and a slowdown in the growth of the product of our main trading partners is expected in the following years. In this context, a surplus

equivalent to 0.7 percent of GDP is expected in 2007 in the current account, mainly as a result of the growth of exports which would recover in the case of metal mining exports as a result of copper operations onset at Cerro Verde. In 2008, the current account of the balance of payments is estimated to post a deficit equivalent to 0.6 percentage points of GDP, thus maintaining the growth trend observed in the volumes of exports.

viii. A **fiscal surplus** equivalent to 1.9 percent of GDP has been estimated for 2006 as a result of the dynamism of economic activity, the high prices of the minerals exported, and the lower execution of public expenditure relative to programmed spending. This economic result implies an anti-cyclical fiscal stance that has promoted a more stable growth of the economy. Taking into account that a less favorable international scenario is considered for the following years, a nil fiscal deficit is forecast for 2007 while a deficit of 0.5 percent of the product is forecast for 2008.

The fiscal stance forecast for 2007 is pro-cyclical and involves a 10 percent increase in central government expenditure in real terms. As long as the Peruvian economy continues to benefit from the expansionary phase of the economic cycle, the possibility of maintaining a fiscal surplus -as in 2006- would allow to stabilize economic fluctuations, consolidate long-term fiscal sustainability and generate important savings to face situations under less favorable economic conditions.

ix. The Board of the BCRP decided to maintain the **reference interest rate** at 4.5 percent since May 2006, after raising the reference rate for six consecutive times between December 2005 and May 2006 (for a total of 1.5 percentage points). This rate remained stable in a context of a decreasing tendency of inflation, a relative stability of core inflation (between 1.3 and 1.5 percent) and an appreciatory trend of the nuevo sol. In its communiqué, the Central Bank emphasized the transitory nature of inflation's decline and the lack of clear signals of current inflationary pressures in a context of high growth of domestic demand. Moreover, the Central Bank is permanently monitoring the various indicators of inflationary pressures of demand.

x. New downward pressures on the nominal **exchange rate** were observed again since July as a result of the exceptionally favorable results posted in external accounts and of agents' portfolio movements towards assets in soles, given the improvements observed in the country risk indicators and the perception of lower depreciatory expectations. In this context, the Central Bank resumed its interventions in the exchange market in order to offset excessive volatility in this

market and accumulate international reserves as prevention. Thus, between August and December 2006, the Central Bank purchased a total of US$ 3,577 million of foreign currency and sold US$ 813 million to the public sector, as a result of which the BCRP annual exchange position and international reserves reached unprecedented levels (US$ 3,636 million and US$ 17,275 million respectively).

xi. The BCRP considers that the main risks that could divert projections from the central scenario include the following:

- **Demand shock**: Economic activity in the baseline scenario will grow at a sustained pace of 5.5 - 7 percent during 2007 and 2008. However, should domestic spending increase so as to generate inflationary pressures, the BCRP will adopt a less expansionary or a contractive monetary stance.

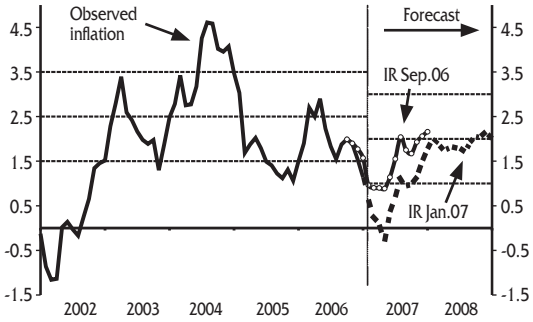
- **Supply shock**: This Report considers a mild occurrence of El Niño and a normal agricultural year in 2007. In 2008, although the probability of occurrence of a "strong" El Niño episode is small, it would have a highly detrimental impact on agricultural conditions and, hence, on the prices of food products.

  The inflationary pressures that might be caused by an eventual El Niño episode of a high magnitude, or by any other unexpected climatic event, would only alter the anticipated evolution of monetary policy should these supply shocks affect inflation expectations and the formation of other prices in the economy. The BCRP would not react vis-à-vis transitory shocks of this nature.

- **External shock**: The international environment observed in 2006 was extraordinarily favorable for the Peruvian economy, sustained by an increased growth of terms of trade and the high growth experienced by Peru's trading partners. Forecasts in this Report consider a slight reversal downwards for both terms of trade and for the expansion of our trading partners.

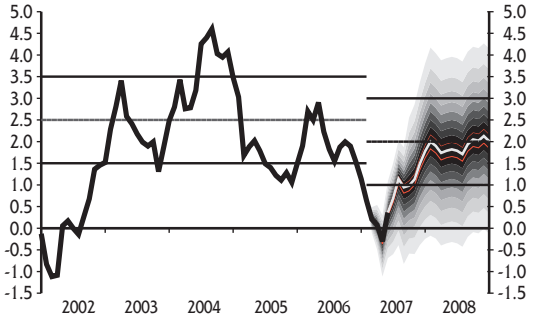
  However, a severe correction in the prices of commodities should be considered. This risk scenario would imply an initial pressure towards the depreciation of the nuevo sol and then a downward pressure on demand. In the short term, the impact of higher exchange rate would affect inflation upwards, but then the contractive effect of demand would prevail.

12 MONTH INFLATION FORECAST



IR: Inflation Report.

INFLATION FORECAST
(Percentage change 12 months)



Note: The graph shows the inflation prediction bands along the forecast horizon. The darkest band around the central forecast represents a 10 percent probability of occurrence, while all the other bands represent a 90 percent probability of occurrence.

Under these circumstances, the monetary policy would react in a contractive manner in the short term to neutralize initial inflationary effects, provided that these effects are severe. However, a monetary stimulus position would be required in the medium term to counterbalance the negative pressures resulting from a lower aggregate demand.

- **Increased appreciatory pressures on the nuevo sol**: The balance on the major determinants of exchange allows forecasting that, should any factors divert conditions away from the main scenario, these diversions are more likely to generate appreciations, as a result of which the impact on the forecast inflation would be downward pressures.

  In view of this risk scenario, if achieving the target in the relevant monetary horizon were threatened, the BCRP would maintain its current monetary stance for a longer period of time and would accumulate international reserves.

Weighing the various risks both upwards and downwards against the baseline scenario shows a neutral balance in the case of the inflation forecast and an upward asymmetry in the case of GDP.

STATISTICAL ANNEX
INFLATION REPORT FORECASTS

	2005	2006[1/]		2007[1/]		2008[1/]
		IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Sep.07
Real % change						
1. GDP	6.4	6.6	7.9	5.7	6.8	5.8
2. Domestic demand	5.5	9.3	10.0	6.4	8.1	6.4
a. Private consumption	*4.4*	*5.4*	*6.0*	*4.6*	*5.7*	*5.4*
b. Public consumption	*9.8*	*8.3*	*8.8*	*8.3*	*8.8*	*4.9*
c. Private fixed investment	*13.9*	*19.4*	*19.9*	*12.0*	*16.3*	*12.2*
d. Public investment	*12.2*	*29.9*	*14.6*	*21.1*	*34.7*	*8.6*
3. Exports (goods & services)	14.9	1.0	1.6	6.8	6.8	7.2
4. Imports (goods & services)	10.6	14.0	11.8	10.0	13.3	9.9
5. Main trade partner´s economic growth	4.4	4.6	4.6	3.5	3.9	4.0
% change						
6. Consumer price index as of December	1.5	1.5-2.5	1.1	1.5-2.5	1.5-2.0	1.5-2.0
7. Core inflation	1.2	1.3	1.4	2.3	1.5-2.0	1.5-2.0
8. Nominal exchange rate[2/]	4.4	-5.0	-6.4	1.2	-0.2	1.6
9. Multilateral exchange rate[2/]	3.8	-1.0	-1.2	0.7	0.6	2.1
10. Terms of trade	5.2	23.8	26.2	-5.3	-3.7	-6.3
a. Export price index	*16.3*	*33.5*	*35.7*	*-1.2*	*-1.6*	*-3.7*
b. Import price index	*10.6*	*7.8*	*7.5*	*4.4*	*2.2*	*2.8*
% of GDP						
11. Current account balance of payments	1.4	1.3	2.3	0.2	0.7	-0.6
12. Trade balance	6.6	8.9	9.5	7.2	7.1	5.0
13. Gross external finance of the private sector[3/]	4.0	4.3	4.4	2.8	3.6	4.2
14. Non-financial expenditure of the central government	14.7	14.8	14.2	15.4	14.9	14.9
15. Non-financial public sector primary balance	1.6	2.8	3.9	1.3	2.0	1.4
16. Non-financial public sector overall balance	-0.3	0.8	1.9	-0.8	0.0	-0.5
17. Central government tax revenues	13.6	15.0	14.9	14.3	14.6	14.1
18. Total public debt balance	37.7	33.1	32.2	31.3	29.7	27.5
19. External public debt balance	28.1	24.2	23.5	22.5	21.2	19.3
Nominal % change						
20. Monetary base (annual average)	28.3	16.5	17.2	10.0	13.0	11.0
21. Banks' loans to the private sector	17.8	8.5	7.9	8.5	9.5	8.7
22. Liquidity	22.5	6.5	11.9	9.6	11.4	10.2

IR: Inflation Report.
1/ Forecast.
2/ Expectations regardins the exchange rate according to the survey on macroeconomic expectations.
3/ Includes foreign direct investments and private sector's long run disbursements.

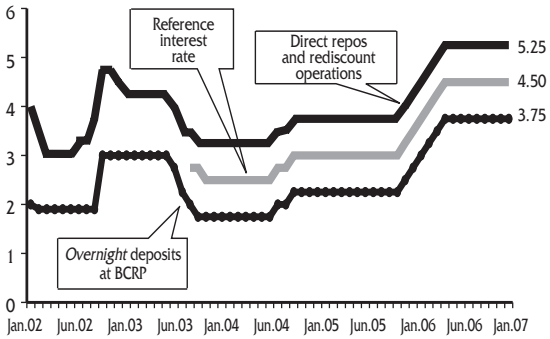
I. Monetary policy

Since the latest Inflation Report was published in September 2006, the Central Bank has maintained its monetary policy reference interest rate at 4.5 percent, a rate established in May 2006 after the Central Bank decided to raise the interest rate on six different occasions (with rises of 25 basis points each) between December 2005 and May 2006. The decision of maintaining the reference interest rate was based on the absence of inflationary pressures despite the expansion of domestic demand, a situation explained by sustained low expectations of inflation, the higher productivity observed in the economy and the appreciation of the nuevo sol.

1. At the beginning of each month, the Board of the BCRP evaluates macroeconomic forecasts to approve a reference interest rate that will allow inflation to converge to the inflation target. The indicator used to determine the inflation target is the last-twelve-month accumulated change in the consumer price index for Metropolitan Lima. On the other hand, ever since the Inflation Targeting framework was adopted in 2002, the inflation target has been 2.5 percent, plus or minus one percentage point. This rate was established in order to assimilate the upward or downward impacts on prices generated by factors that cannot be influenced by monetary policy actions and whose impact on inflation is transitory.

2. The monetary programs for the months of October 2006 through January 2007 have maintained the reference interest rate at 4.5 percent due to the absence of inflationary pressures. In fact, accumulated inflation in 2006 was 1.1 percent, a rate lower than the target range (between 1.5 and 3.5 percent) due to the impact of the price falls of fuels, electricity and telephone rates, and some food products. The impacts of these factors on inflation is temporary and therefore do not require monetary policy actions to counterbalance them.

Graph 1
CENTRAL BANK REFERENCE INTEREST RATE 1/
(In percentage)



1/ Before September 2003, the rates on direct repos, rediscount operations and *overnight* deposits were used as the monetary policy reference interest rates.

3. The BCRP carries out monetary operations in order that the interest rate for the interbank market reaches the level announced as the reference interest rate by its Monetary Program for each month. In order to do so, excess liquidity is sterilized through the placement of Certificates of Deposits (CDBCRP), while requirements of liquidity are covered through temporary repurchases of CDBCRP or Treasury bonds, an operation called REPO. Additionally, The Public Treasury and Banco de la Nación deposit funds at the BCRP, thus modifying the volume of available liquidity in the financial system. Finally, the Central Bank intervenes in the exchange market to accumulate international reserves and to deal with situations of excessive volatility in the exchange rate performance, thus contributing to achieve a sound international position and to consolidate the financial system's stability.

4. The issuance of bills and coins increased 18.3 percent in 2006, a rate lower than the one recorded the previous year (25.7 percent), partly due to the impact of the 150 percentage points increase in the reference interest rate (from 3 to 4.5 percent) between December 2005 and May 2006. The flow of the monetary base in 2006 was S/. 2,140 million. The main source of the expansion of the monetary base was the BCRP exchange operations (S/. 9,140 million, or US$ 2,861 million), while the main factors contributing to the contraction of the monetary base were the higher public sector deposits, the reversal of REPO operations with banks and the placements of CDBCRP.

Graph 2
MONETARY BASE
(Percentage change last 12 months)

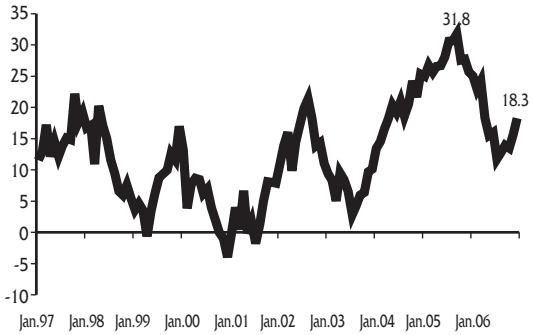


Table 1

MONETARY BASE
(Millions of nuevos soles)

	2002	2003	2004	2005	2006
1. Flow of the monetary base	672	682	1,886	2,397	2,140
(% change)	11.0	10.1	25.3	25.7	18.3
2. Foreign exchange operations	436	3,465	6,239	2,360	9,140
(In millions of US$)	128	998	1,854	767	2,861
3. Monetary operations	236	-2,783	-4,353	37	-7,000
a. BCRP Certificates of deposits (CDBCRP)	205	-2,462	-4,158	579	-390
b. REPOS	170	-170	0	2,850	-2,850
c. Public sector deposits	-81	-921	-721	-2,821	-5,434
d. BCRP indexed certificates of deposits (CDR)	-319	319	0	-1,201	1,201
e. Other	261	450	526	631	473
Note: Balance at the end-of-period					
- BCRP certificates of deposits	1,635	4,097	8,255	7,676	8,066
- Public sector deposits	275	1,196	1,918	4,738	10,172

Inflation target

5. The constitutional objective of the BCRP is to preserve monetary stability. To achieve this, the inflation rate must be low and stable so that the domestic currency can adequately act as a medium of exchange, unit of account and store of value.

   Between 1990 and 2001, the Central Bank's monetary policy was based on targets for the expansion of the monetary base. As a result of this policy, not only was hyperinflation eliminated, but low levels of inflation were also reached. However, with the reduction of inflation, difficulties arose for communicating monetary decisions through this scheme given that there no longer was a systematic association between inflation and the growth of the monetary base. Therefore, since 2002 the monetary policy has been conducted following an inflation targeting scheme, according to which the Central Bank announces its macroeconomic projections to promote that the public's inflationary expectations are associated with the inflation target. Furthermore, this scheme is also sustained by the idea that the BCRP will have a timely intervention to revert any potentially permanent deviation from the target.

6. Over the five years of implementation of inflation targeting, the average annual inflation rate has been 2.02 percent, with a standard deviation of 1.3 percentage points, which shows that inflation has been within the target range (between 1.5-3.5 percent) in this period. Moreover, this control of inflation is also evidenced by the fact that inflation has been within the target range in 62 percent of the time under the inflation targeting regime (60 months). As the last-twelve-month inflation was nil at the beginning of the implementation of inflation targeting and as there was an initial period of inflation's convergence towards the target range (January-October 2002), this period could be excluded and thus the standard deviation would be 1.0 percentage point and the percentage of time when inflation was within the target range would rise to 73 percent.

7. In order to reinforce the BCRP's commitment to preserving monetary stability, the Board of the Central Bank has approved that from now-on the inflation target -measured as the last-12-month increase in the CPI- will be 2.0 percent, plus or minus one percentage point, instead of 2.5 percent. In this way, monetary policy will be aimed at achieving a 2 percent rate in the last-12-month inflation. This decision considers the possibility that some events may transitorily divert the official measure of inflation from the 2 percent target as a result of, for example, changes in the prices of imported goods or products subject to abrupt changes in terms of their local supply, and therefore considers a tolerance margin of plus or minus one percentage point.

The reasons explaining the adoption of this new target are that:

a. A lower inflation rate will contribute to dedollarize transactions and savings as a result of a stronger currency.

b. The country's inflation rate is equated to the inflation rates orienting the monetary policies of our main trading partners, and therefore the value of the nuevo sol will not depreciate in the long-term against other currencies to compensate for a higher level of inflation in the country.

The big economic blocks with which our country is involved in trade relationships -representing over 60 percent of our trade exchange- have inflation rates of 2.0 percent or less. Moreover, this 2.0 percent rate is used (explicitly or implicitly) by central banks that have proved to be successful in maintaining inflation expectations under control, such as the Federal Reserve of the United States, the European Central Bank (ECB), the Bank of Canada, the Bank of England, etc.

Table 2

TRADING PARTNERS AND INFLATION REFERENCE LEVELS

Country	Reference levels	Comments
United States of America	Core deflator on per capita consumption in the 1-2% range.	FED considers this range as a "comfortable zone".
Eurozone	Lower inflation target, but close to 2%.	Central European Bank (CEB) has like target the stability of prices.
Japan	Low inflation (annual average inflation of 0.6% over last 20 years).	The Bank of Japan (BoJ) has like target the stability of prices and the stability of financial system.
China	No explicit inflation target. The annual average inflation has been 0.9% over last 10 years.	The Popular Bank of China indicate take only one target to keep the currency stability.

Source: Central banks.

Table 3

TRADE WITH COUNTRIES HAVING LESS THAN 2% INFLATION RATES
(In percentage)

	X + M 2005
USA	25.5
China	9.9
Canada	4.2
Japan	3.5
Eurozone	14.6
Switzerland	3.0
TOTAL	**60.7**

X:Exports.
M:Imports.

c. The credibility generated by the BCRP's control of inflation allows establishing an inflation target of 2.0 percent. On average, last-12-month inflation over the last 60 months has been 2.02 percent, with a maximum level of 4.6 percent and a minimum level of -1.1 percent, and a standard deviation of 1.3 percentage points.

d. Developing the country's capital market and promoting greater savings requires having a stronger currency to prevent the devaluation of long-term investments. Therefore, although reducing the inflation target from 2.5 to 2.0 percent may seem to be a small change, the impact of this measure in a long-term period of 20 years means that this would allow to prevent a loss of value in the nuevo sol of nearly 10 percent.

8. The 2.0 percent inflation target, plus or minus one percentage, does not neglect the possibility that an exogenous shock might divert the official record of inflation from the target range. Evidence shows that 38 percent of inflation's monthly results over the last five years posted rates outside the target range. If deviations were caused by supply shocks (domestic or imported) that have transitory impacts on consumer prices, it would be quite costly to try to counter these transitory effects by means of monetary policy. Given that inflation is understood as a continuous and overall rise of prices in the economy, it is inefficient to try to tackle one-time or transitory rises as they are not sustained or expanded into the rest of the economy.

9. Under Inflation Targeting, monetary policy seeks to achieve that the public's inflationary expectations are associated with the target range. Monetary decisions translate into changes in the reference interest rate so that inflation deviations from the target range may be anticipated and prevented. The period of time required for the Central Bank' actions to have an impact on inflation is called a policy lag and is estimated to range between 12 and 18 months[1]. Therefore, the BCRP not only seeks to anticipate any deviation of inflation, but also disseminates forecasts and studies that may contribute to anchor inflation expectations and contribute to generate a better understanding of the variables determinating inflation.

1 This has been documented in the following research papers: Bigio, S. and Salas, J. (2006) "Efectos no lineales de choques de política monetaria y de tipo de cambio real en economías parcialmente dolarizadas", BCRP; Castillo, Pérez and Tuesta (2006) "Identificando el mecanismo de transmisión de política monetaria en el Perú", BCRP; and Salas, J. (2006) "Transmisión de la política Monetaria", BCRP.

BOX 1
THE CENTRAL BANK'S INDEPENDENCE AND INFLATION TARGETING

According to Article 84 of the Peruvian Constitution, the unique objective of the Central Bank is to preserve monetary stability. The Central Bank's autonomy, as stated in the BCRP Charter, allows the Central Bank to accomplish this mandate. In this context, the design of the monetary policy in recent years was first implemented through the control of monetary aggregates and, since 2002, through an Inflation Targeting (IT) framework that implies that an annual inflation target is announced. Under the IT regime, the BCRP announced an inflation target of 2.5 percent, plus or minus one percentage point.

Key factors in terms of the monetary stability achieved and ensuring its permanence in the long-term have been the Central Bank's reputation, credibility and autonomy: The BCRP's autonomy in implementing monetary policy has allowed posting an average inflation rate of 2.0 percent over the last 5 years. These factors not only play an essential fundamental role in maintaining the purchasing capacity of the nuevo sol, but also constitute fundamental elements of macroeconomic stability. Therefore, Article 84 of the Constitution provides the Central Bank with autonomy in the frame of its own Charter, while Article 86 establishes that the Bank is governed by a Board integrated by members who do not represent any particular entities or interests and who may only be removed by the Congress due to "serious wrongdoing".

Walsh (2005) says that: "Central Bank independence refers to the freedom of monetary policymakers from direct political or governmental influence in the conduct of policy". The literature on monetary policy emphasizes the Central Bank's autonomy, highlighting that this autonomy is required to accomplish explict objectives. Thus, for example, Cukierman (1992) argues that low levels of independence of a Central Bank are associated with a higher volatility of inflation and to higher inflation on average[2].

Jácome and Vázquez (2005) complement Cukierman's insights and expand the indicators used to measure the degree of independence of a Central Bank. One of the main elements modified refers to a central bank's financial independence in order that it may not be limited in its re-capitalization -in the event of operational losses-; its profit holding -in the event of recording net operational gains-; or in terms of budget-related matters that could be detrimental to its operational independence.

Moreover, the autonomous budget of a central bank has two important components: the part used in the implementation of monetary policy and the part allocated to operational costs and payment of salaries. Both have to be autonomously established by the central bank to ensure monetary stability and to make it sustainable.

Independence of Central Banks [1/]

Countries	Political autonomy [2/]			Economic autonomy [3/]			Cukierman Modified index
	Administrative	Targets	Total (a)	Financial	Total (b)	Accountability (c)	(a + b+ c)
Peru	0.766	1.000	0.303	1.000	0.490	0.069	0.862
Chile	0.934	0.750	0.299	1.000	0.447	0.100	0.846
Mexico	0.866	1.000	0.323	0.670	0.382	0.100	0.805
Brazil	0.600	0.250	0.158	0.500	0.270	0.069	0.496

1/ The value of 1 responds to the optimun level or adequate autonomy.
2/ The administrative autonomy and targets are main components of political autonomy. The total figure on political autonomy includes the relative weight considered in the total index.
3/ The financial autonomy is one of the main components of economic autonomy. The total figure on political autonomy includes the relative weight considered in the total index.
Source: Jacome. L. y Vazquez. F. (2005).

2 In its measure of the degree of independence of a central bank, Cukierman includes the aspect of whether the bank is autonomous in determining its budget and the salaries of its officials (grade 1), whether these decisions are coordinated between the central bank and the treasury (grade 0.5), or whether these decisions are mainly determined by the treasury or an entity integrating the legislative power (grade 0).

Beblavy (2003) summarizes the importance of budget independence for a central bank in the following terms: “If the budget is determined by the government or parliament, there is significant scope for influencing the actual monetary policy execution. Relevance on this issue depends on the particular nature of a given economy and the way its monetary system is set (...). Similar argument can be applied to the personnel budget or budget for running costs -if the government or parliament determine these, there is a significant scope for influencing the bank officials.”

Moser-Boehm (2006) emphasizes that policy coordination, information exchange and communications between the Central Bank and the Ministry of Economy would contribute to a better economic performance if carried out respecting the objectives and institutional autonomy of the Central Bank. Moreover, he says that among the three most important aspects of the financial independence of a central bank seeking price stability are its capacity to cover its operational costs in general and the autonomy to determine the salaries of its staff, so that central banks may attract and retain professionals with the required training and qualifications. Additionally, he finds that central banks in most of the 30 countries covered by his study have independence to determine their budget and the salaries of their officials. Only in approximately 20 percent of the surveyed countries does the Ministry of Economy have a bearing on the matter of the operational budget of the central bank.

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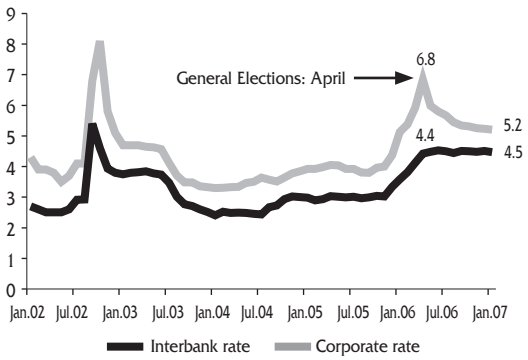
II. Financial markets

Interest rates in soles have stabilized since the second half of 2006, particularly rates involving lower risks and with lower maturity-terms. On the other hand, reflecting better economic prospects in the country, longer-term rates in the capital market continued to decline.

10. The BCRP's reference rate for operations in the interbank market acts as a benchmark for the formation of the other interest rates in soles, influencing particularly lower-risk and shorter-term operations because these operations depend less on other components of the interest rate (such as credit risks or long-term inflation expectations).

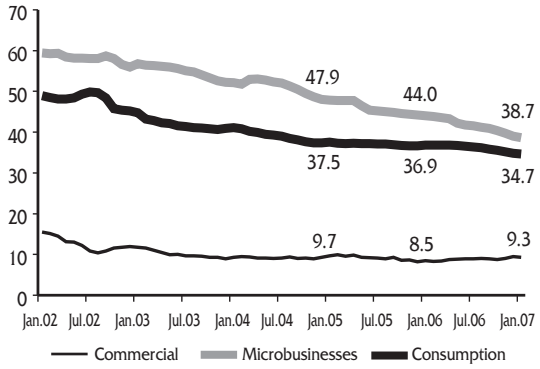
Graph 3
INTERBANK AND CORPORATE INTEREST RATE IN DOMESTIC CURRENCY
(In percentage)



11. The 90-day corporate prime rate continued to show the downward tendency that it started exhibiting in May 2006 and reached an annual level of 5.2 percent in January 2007. As a result of this, the differential between the interbank rate and the corporate prime rate in nuevos soles was 73 basis points, a level even lower than the one recorded prior to April (until then, the differential had been nearly 1 percentage point). The highest differential since September 2002 was reached in April, due to the tightness of liquidity that resulted from both exchange operations aimed at hedging depreciation risks in an electoral period and payment of income tax. This reduction in the differential between both rates reflects a higher connection between the reference rate and short-term rates in soles in the money market.

12. The transmission of the reference rate has a lower response in the case of other operations. Mainly reflecting the increase of the reference rate in the first half of the year, the average interest rate in soles for commercial loans increased from 8.9 to 9.3 percent between September 2006 and January 2007, thus increasing 1.0 percentage point with respect to December 2005.

Graph 4
INTEREST RATE ON COMMERCIAL MICROBUSINESS AND CONSUMER LOANS IN DOMESTIC CURRENCY
(In percentage)



13. The average active rate (FTAMN[3]) on the credit operations carried out in this period -including operations with different levels of risk- fell from 22.8 percent in September to 21.5 percent in January 2007. This decrease was due to the reduction of interest rates in soles for loans to microenterprises, consumer loans and mortgage loans given the better situation of borrowers as a result of the dynamism observed in economic activity, as well as the greater competition observed in the financial system for these segments.

Table 4

INTEREST RATES IN DOMESTIC AND FOREIGN CURRENCIES: 2005 - 2006
(In percentage)

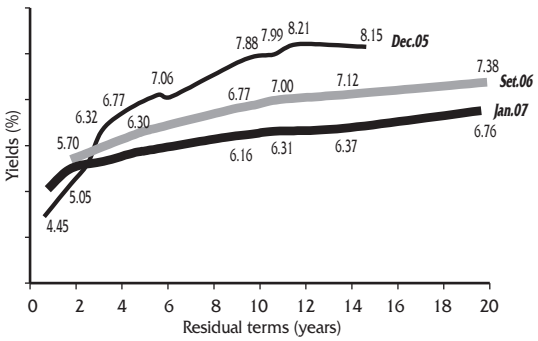
	(A) Nuevos soles					(B) Dollars					Differential (A) - (B)				
	Dec. 2005	Apr. 2006	Sep. 2006	Dec. 2006	Jan. 2007	Dec. 2005	Apr. 2006	Sep. 2006	Dec. 2006	Jan. 2007	Dec. 2005	Apr. 2006	Sep. 2006	Dec. 2006	Jan. 2007
1. Reference rate and FED funds rate	3.3	4.3	4.5	4.5	4.5	4.3	4.8	5.3	5.3	5.3	-1.0	-0.5	-0.8	-0.8	-0.8
2. Deposits up to 30 days	3.6	5.5	4.6	4.6	4.5	3.6	4.0	4.2	4.3	4.4	-0.1	1.5	0.5	0.3	0.2
3. Term deposits between 31 to 180 days	3.6	5.0	4.9	4.8	4.8	2.9	3.1	3.5	3.4	3.4	0.7	1.9	1.5	1.3	1.3
2. Term deposits between 181 to 360 days	4.6	5.2	5.8	5.7	5.7	2.9	3.2	3.5	3.6	3.7	1.7	2.0	2.3	2.1	2.1
4. Corporate prime	4.4	6.8	5.3	5.2	5.2	5.5	6.1	6.1	6.1	6.1	-1.1	0.8	-0.8	-0.9	-0.9
5. Average lending up to 360 days	13.9	14.5	14.7	13.8	14.0	9.4	9.7	9.9	10.1	10.0	4.6	4.9	4.7	3.7	4.0
6. Average lending constant structure	17.0	17.3	17.1	17.1	16.9	10.3	10.4	10.5	10.6	10.5	6.8	7.0	6.6	6.5	6.4

14. In January 2007, the interest rates in dollars for most maturity terms increased slightly relative to September. As a result of this, the differential between the interest rates in soles and the interest rates in dollars decreased for all terms, except for the 90-day corporate prime rate.

Bond market

15. Since it was first issued in May 2006, the yield on the 20-year Public Treasury bond declined from 8.25 percent to an average of 7.38 percent en September and to 6.76 percent in January 2007. Likewise, the average yield on the 15-year bond fell from 7.12 percent in September to 6.37 percent in January 2007. This sustained reduction in the yield on longer-maturity bonds would be associated with better economic prospects in the country, as reflected by a lower country risk premium, for instance.

Graph 5
SECONDARY MARKET FOR PUBLIC TREASURY SOVEREIGN BONDS 1/
(In percentage)



1/ Average yield observed in transactions in the secondary market during the period.

3 Average weighted active rate on operations in domestic currency made in the last 30 days.

16. These better prospects are consistent with lower expectations of inflation in the long run, as inflation appears to be anchored to the target range. The rate of expected annual depreciation -estimated on the basis of data on the yield on sovereign bonds in soles and in dollars maturing in 2015- has declined from 1.2 to 0.5 percent between December 2005 and December 2006. Assuming a constant exchange rate in the long-term and an external inflation rate of around 2 percent, these figures are consistent with an expected inflation rate of 3.2 percent in December 2005 and of 2.4 percent in December 2006.

Table 5

DEPRECIATION AND INFLATION EXPECTATIONS BASED ON THE YIELD ON SOVEREIGN BONDS
(Average monthly data in percentages)

	Nominal bonds BTP in nuevos soles May 2015 (a)	Global bonds in dollars February 2015 (b)	Expected depreciation (a) - (b)	Expected inflation 1/
Dec-05	7.88	6.66	1.22	3.20
Dec-06	6.09	5.64	0.45	2.40

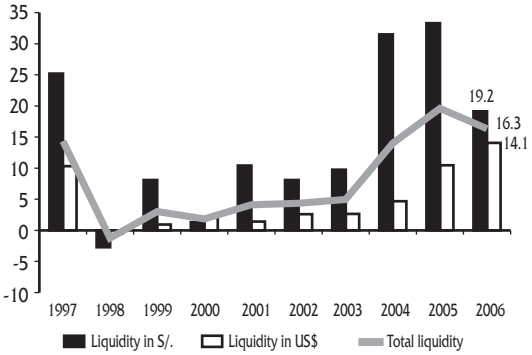
1/ Assuming constant real exchange rate and external inflation of 2 percent.

Liquidity and credit

17. In 2006, liquidity in the private sector showed a slower pace of growth and declined from 19.6 percent in 2005 to 16.3 percent in 2006. Moreover, the growth rate of currency decreased from 25.6 percent in 2005 to 16.6 percent in 2006 and deposits in nuevos soles fell from 37.6 percent to 20.5 percent in the same period.

18. The dedollarization process continued to occur for the sixth consecutive year. The dollarization degree of liquidity and credit decreased by 3 and 7 percentage points respectively.

Graph 6
LIQUIDITY IN THE PRIVATE SECTOR
(Change of the last 12 months, to the constante nominal exchange 1/)



1/ Considering the monthly average ask price of the exchange rate.

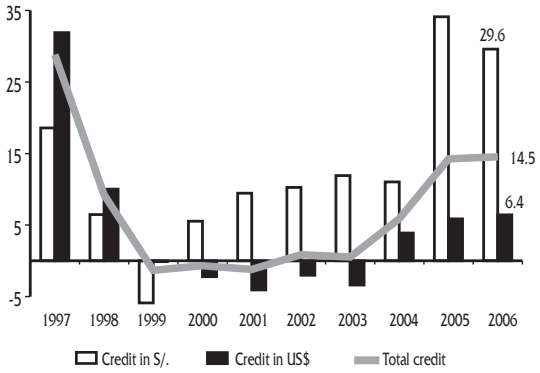
Table 6

FINANCIAL DOLLARIZATION INDICATORS
(As a percentage of total monetary aggregates)

Year	Private sector liquidity *	Financial system loans to the private sector
1997	67	75
1998	71	79
1999	72	82
2000	72	81
2001	69	78
2002	69	76
2003	67	73
2004	60	71
2005	57	67
2006	54	60

* Includes circulating currency.

Graph 7
FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR
(Last 12-month change, at a constante exchange rate[1/])



1/ Considering the monthly average ask price of the exchange rate in December.

19. Banks' credit to the private sector continued to be coupled by increased economic activity. Although exhibiting a slight slowdown by the end of the year, the expansion of credit showed a similar dynamism than in the previous year and grew at an annual rate of 14.5 percent (measured at a constant exchange rate) in December 2006. The flow of credit from the financial system to the private sector observed during the year is equivalent to 3 percentage points of the product.

It is worth pointing out that part of this expansion was based on the increase of deposits made by public entities. In other words, fiscal savings (particularly of public enterprises and other public sector entities) has allowed a higher flow of funds to the financial system.

Credit in domestic currency continued to be the most dynamic component, although this performance, which started in December 2005, had slightly decreased by the end of the year. Thus, credit in soles increased 29.6 percent (S/. 6,532 million) in 2006, while credit in dollars increased 6.4 percent (US$ 826 million).

Table 7

FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR IN DOMESTIC CURRENCY

	Balance in millions of Nuevos Soles				Rates of growth	
	Dec.04	Dec.05	Sep.06	Dec.06	Dec.05/ Dec.04	Dec.06/ Dec.05
Banks [1/]	**8,464**	**11,690**	**14,022**	**15,690**	**38.1**	**34.2**
Banco de la Nacion	**1,051**	**1,277**	**1,330**	**1,331**	**21.5**	**4.2**
Microfinance institutions	**4,329**	**5,882**	**6,863**	**7,563**	**35.9**	**28.6**
Banks (microfinance loans)	1,120	1,545	1,749	1,959	37.9	26.8
Municipal savings banks	1,376	1,848	2,201	2,405	34.3	30.2
Rural savings banks	253	348	425	457	37.5	31.6
Cooperatives	511	634	723	723	24.1	14.1
Edpymes	229	351	473	581	53.2	65.3
Financial companies	840	1,156	1,292	1,437	37.7	24.3
Institutional investors [2/]	**2,307**	**2,900**	**3,647**	**3,683**	**25.7**	**27.0**
Private pension funds (AFPs)	1,337	1,821	2,523	2,568	36.2	41.0
Insurance companies	812	751	697	671	-7.5	-10.7
Mutual funds	158	328	427	444	107.1	35.6
Leasing companies and others	**306**	**323**	**440**	**337**	**5.6**	**4.2**
Total financial system	**16,457**	**22,072**	**26,302**	**28,604**	**34.1**	**29.6**

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

Table 8

FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR IN FOREIGN CURRENCY

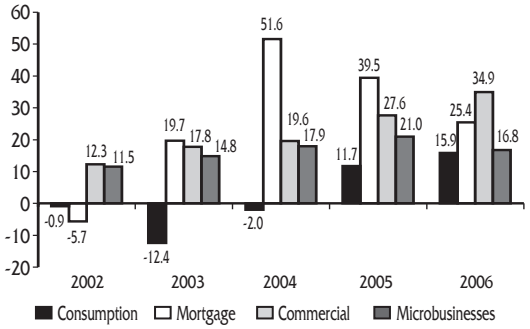
	Balance in millions of dollars				Rates of growth	
	Dec.04	Dec.05	Sep.06	Dec.06	Dec.05/ Dec.04	Dec.06/ Dec.05
Banks[1/]	**9,465**	**9,845**	**10,276**	**10,180**	**4.0**	**3.4**
Banco de la Nacion	**22**	**22**	**22**	**14**	**-1.0**	**-37.4**
Microfinance institutions	**665**	**804**	**872**	**912**	**20.9**	**13.3**
Banks (microfinance loans)	126	177	193	211	40.1	19.2
Municipal savings banks	250	292	327	341	16.9	16.8
Rural savings banks	55	56	54	54	0.7	-2.2
Cooperatives	154	188	193	193	22.5	2.3
Edpymes	49	55	61	67	12.4	22.9
Financial companies	32	37	44	46	16.0	22.5
Institutional investors[2/]	**1,333**	**1,497**	**1,714**	**1,910**	**12.3**	**27.6**
Private pension funds (AFPs)	729	733	871	1,025	0.5	39.9
Insurance companies	89	151	168	175	68.8	15.7
Mutual funds	515	613	674	711	19.2	15.9
Leasing companies and others	**639**	**669**	**621**	**647**	**4.7**	**-3.2**
Total financial system	**12,125**	**12,836**	**13,505**	**13,662**	**5.9**	**6.4**

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

20. Although credit has grown at a fast pace, it should be taken into account that the levels of credit in the country are still low in comparison with other Latin American countries. This growth of credit has been diversified, both in terms of the higher number of borrowers and the higher number of financial intermediaries. As regards financial intermediaries, intermediation has grown particularly in the case of microfinance entities and institutional investors, reflecting a higher development of the market of capitals.

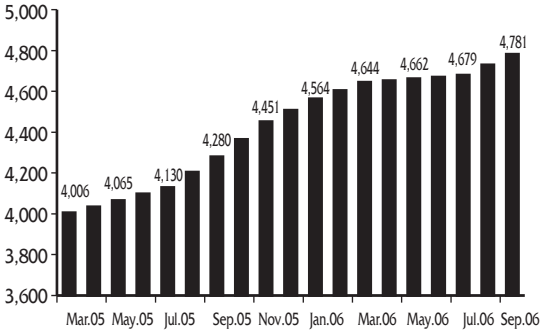
21. The dynamism of economic activity was also reflected in indicators on the soundness of the banking system, which showed a favorable evolution in 2006. The nonperforming loan indicator as a percentage of total banks' placements decreased from 9.0 percent in December 2001 to 1.6 percent in December 2006. Likewise, return of capital (net profit over average equity) has increased from 4.5 to 23.9 percent during the same period. Together with the compliance of prudential requirements in terms of liquidity and hedging, these indicators show that the current evolution of credit takes place in a context marked by the solvency and soundness of the Peruvian financial system.

Graph 8
GROWTH OF CREDIT IN COMMERCIAL BANKS
(Last 12-month change, at a constante exchange rate[1/])



1/ Considering the monthly average ask price of the exchange rate in December.

Graph 9
PERCAPITA CONSUMPTION LOANS IN THE OVERALL FINANCIAL SYSTEM
(Nuevos soles)



Source: SBS.

Graph 10
SALE PRICE OF BUILDINGS IN CURRENT DOLLARS
(Index II Quarter 1998 = 100)

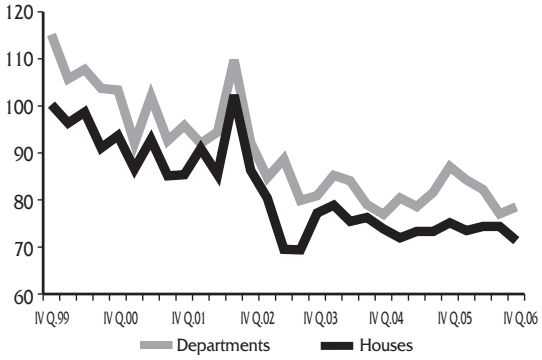


Table 9

COMMERCIAL BANKS' INDICATORS ON FINANCIAL SOUNDNESS
(In percentage)

	Dec.01	Dec.02	Dec.03	Dec.04	Dec.05	Dec.06
1. PORTFOLIO QUALITY						
Non performing, reestructured, refinance loans / Gross loans	9.01	7.58	5.80	3.71	2.14	1.63
Provisions / Non performing, reestructurated, refinance loans	118.93	133.16	141.10	176.46	235.26	251.40
2. LIQUIDITY						
Liquidity Ratio in domestic currency	22.55	23.47	32.85	44.76	38.58	43.08
Liquidity Ratio in foreign currency	45.96	49.26	43.63	43.92	49.23	44.99
3. CAPITALIZATION						
Leverage (times)	7.84	7.98	7.53	7.15	8.35	8.01
Net profits / Average equity	4.46	8.43	10.85	11.26	22.16	23.86
4. OPERATIONAL EFFICIENCY						
Administration expenditure / Average profitable asset	4.71	4.86	4.93	4.66	4.56	3.44

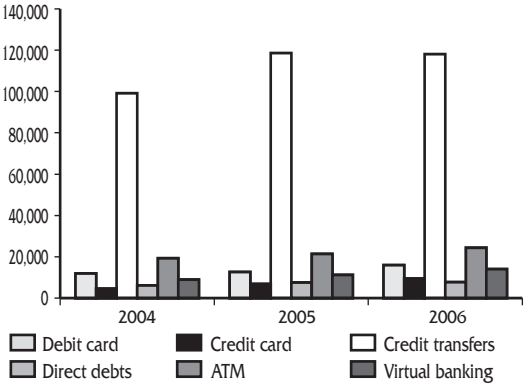
Source: SBS.

22. However, mortgage credit continues to show high levels of dollarization (89 percent in November), and therefore steps should be taken to reduce exposure to exchange risks in these type of loans given the magnitude they exhibit. It is worth pointing out that mortgage loans in soles started to show some dynamism in 2006. Thus, credit in soles grew from S/. 275 million in January 2006 to S/. 793 million in December 2006, while credit in dollars increased from US$ 1,807 to US$ 1,962 million in the same period. A key element to begin the process of dedollarization of mortgage credit has been the issuance of 20-year sovereign bonds in nominal soles as these bonds have favored the establishment of loans in soles with similar maturity terms than the ones offered for mortgage loans in dollars.

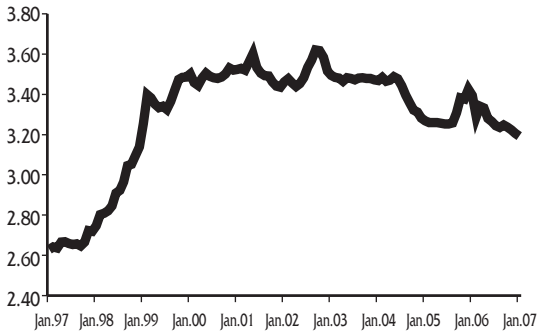
    A second element that requires monitoring is the growth of consumer loans which expanded at a rate of 35 percent last year. Moreover, the levels of per capita indebtedness have continued to show an increasing tendency in 2006. In view of this, the Peruvian Superintendency of Banks and Insurance has recently modified the provisions for credit cards.

23. The greater economic activity and the higher prices of exports are also reflected in the evolution of the Lima Stock Exchange (LSE). The General Index grew 167 percent during the year, while the Blue Chip Index grew 260 percent. Moreover, the market capitalization of the enterprises listed in the LSE increased 55 percent. As regards the real estate market, after the prices of housing exhibited a decline during the first half

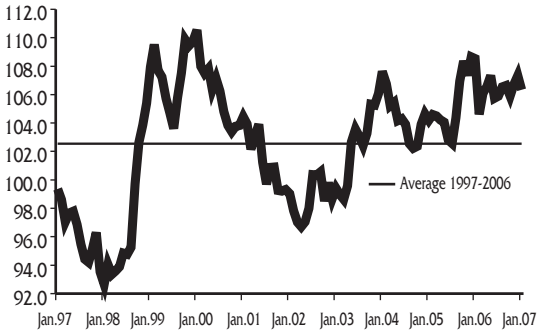
Graph 11
ELECTRONIC MEANS OF PAYMENTS
(Millions of nuevos soles)



Graph 12
NOMINAL EXCHANGE RATE
(S/. per US$)



Graph 13
MULTILATERAL REAL EXCHANGE RATE
(Index 1994=100)



of 2003 due to a greater supply associated with Mi Vivienda program, these prices have been quite stable and no demand pressures have been observed as a result of a possible wealth effect.

24. The use of electronic payment systems maintained an increasing trend during 2006. This contributes to reduce transaction and financial costs, stimulating efficiency in the economy.

Exchange rate

25. As a result of increased terms of trade for 3 consecutive years, the weakness of the dollar in international markets, better macroeconomic fundamentals, and a rate of domestic inflation lower than that of the United States that in recent years implied an appreciatory trend of the nuevo sol -temporarily interrupted due to uncertainty generated during the electoral period-, the nominal exchange rate increased from S/. 3.28 in 2004 to S/. 3.43 at the end of 2005 (depreciation of 4.4 percent) and then fell to S/. 3.20 per dollar in December 2006 (appreciation of 6.4 percent).

26. The multilateral real exchange rate fell 1.2 percent in 2006, although its level is above the average level posted in the last 10 years. Even though in nominal terms the exchange rate decreased by 6.4 percent during 2006, the strengthening of other currencies against the dollar and the lower rate of domestic inflation counterbalanced this trend.

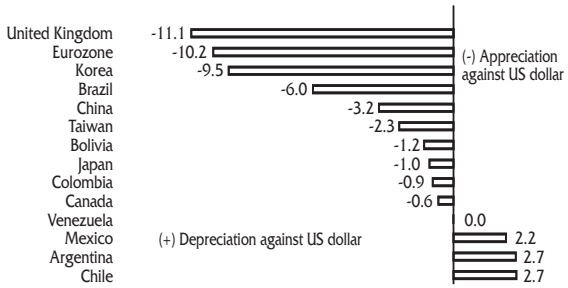
Table 10

BREAKDOWN BY COMPONENTS OF THE REAL MULTILATERAL EXCHANGE RATE
(Percentage change)

	Real multilateral exchange rate	Nominal exchange rate S/. per US$	External multilateral inflation			Domestic inflation
			Currency effect 1/	Price effect	Total	
1996	1.4	11.1	-4.4	6.6	2.1	11.8
1997	-5.4	5.1	-8.8	4.2	-4.2	6.5
1998	12.6	15.4	0.1	3.3	3.4	6.0
1999	4.1	11.0	-6.0	3.0	-2.9	3.7
2000	-5.3	1.0	-6.1	3.3	-2.7	3.7
2001	-4.3	-2.4	-4.3	2.1	-2.1	-0.1
2002	-0.7	2.3	-6.2	4.7	-1.4	1.5
2003	7.5	-1.2	7.6	3.1	11.5	2.5
2004	-1.5	-5.5	4.1	3.5	7.9	3.5
2005	3.8	4.4	-2.4	3.4	0.9	1.5
2006	-1.2	-6.4	3.6	2.9	6.7	1.1

1/ Positive (negative) sign suggests depreciation (appreciation) of dollar against the currencies of our main trading partners.

Graph 14
CURRENCY DEPRECIATIONS AND APPRECIATIONS OF PERU'S MAIN TRADING PARTNERS AGAINST US DOLLARS
(Dec.06/Dec.05)



27. During 2006, the dollar depreciated against other strong currencies (the euro, the yen, the Canadian dollar and the pound). However, the dollar appreciated against the currencies of some countries in the region, such as the Mexican peso, the Argentine peso and the Chilean peso.

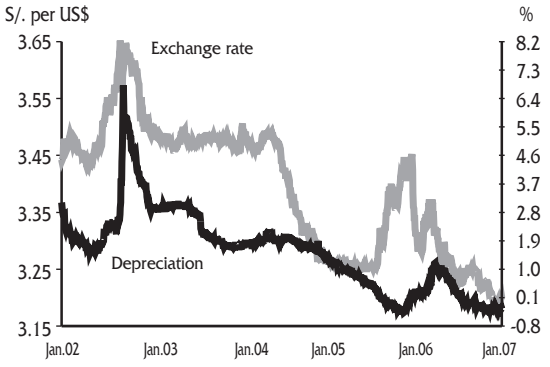
Table 11

BILATERAL EXCHANGE RATES: 2006
(Percentage change)

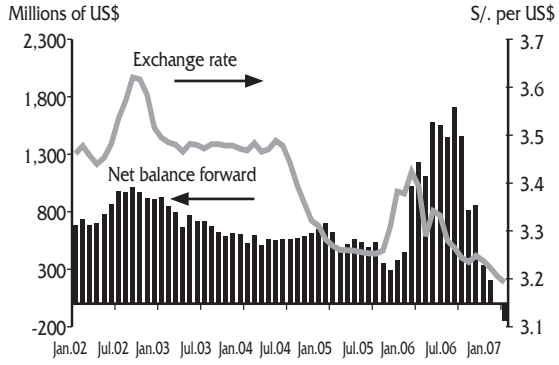
	Weight *	Nominal relative to:		Real relative to:	
		Dec.04	Dec.05	Dec.04	Dec.05
USA	25.1	-2.3	-6.4	0.9	-5.1
Eurozone	20.1	-3.6	4.2	-2.4	4.7
Japan	10.3	-13.6	-5.4	-15.7	-6.2
Brazil	6.4	23.5	-0.5	31.2	1.4
United Kingdom	5.8	-0.6	5.3	3.4	8.7
Chile	4.8	6.6	-8.8	10.4	-7.6
China	4.3	3.4	-3.4	5.2	-1.8
Colombia	4.0	4.6	-5.6	11.6	-2.4
Mexico	3.4	0.9	-8.4	5.7	-5.7
Argentina	3.4	-6.2	-8.8	12.7	-1.0
Korea	3.3	10.9	3.5	13.3	4.5
Taiwan	2.5	-3.3	-4.2	-3.0	-4.6
Venezuela	2.5	-12.7	-6.4	13.7	8.2
Canada	2.4	3.1	-5.8	4.3	-5.3
Bolivia	1.8	-1.1	-5.2	5.6	-2.1
Basket	**100.0**	**-1.1**	**-2.9**	**2.5**	**-1.2**

* Weigth relative to trade values in 1994.

Graph 15
DAILY NOMINAL EXCHANGE RATE AND FORWARD IMPLICIT DEPRECIATION (3 MONTHS)



Graph 16
BALANCE OF FORWARD NET SALES AND EXCHANGE RATE

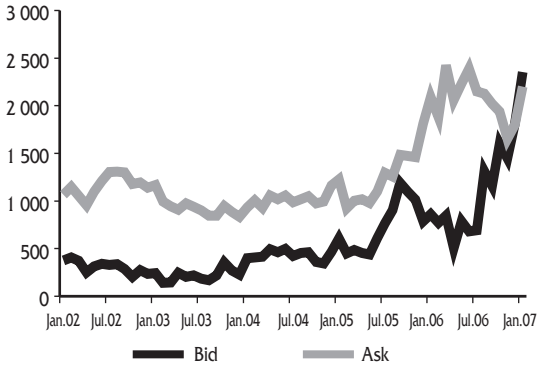


28. Factors contributing to the evolution of the nominal exchange rate included the continuously favorable development of external accounts and portfolio movements towards assets in soles, the latter of which were influenced by improved country risk indicators and lower depreciatory expectations.

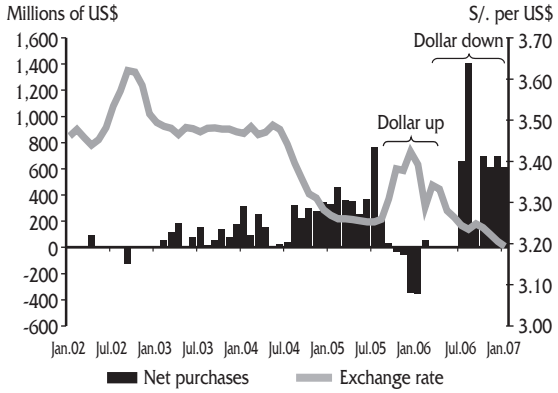
In line with the above-mentioned results, the tendency observed showed lower expectations of depreciation of the nuevo sol. This tendency was only interrupted during the electoral period. Thus, expectations of depreciation (implicit in 3-month forward operations) were negative (appreciatory) by 0.26 percent at end-2006 and have remained stable since January 2007.

This was reflected in the evolution of hedging operations. Banks' **net *forward* sales of foreign currency** to the public decreased from US$ 860 million in September 2006 to US$ -152 million in January 2007, posting a new historical minimum level of US$ -344 million on January 19 of 2007. It should be pointed out that the forward market was characterized by an asymmetry given that the balance of banks' sales

Graph 17
BID-ASK PRICES OF FORWARDS FOR THE PUBLIC
(Millions of US$)



Graph 18
NET PURCHASES OF US$ AND EXCHANGE RATE



(contracts against depreciation risks) was significantly higher than the balances of purchases (contracts against appreciation risks). This asymmetry decreased until it disappeared at the end of last year (the balance of net forward sales has become negative) in a context of appreciatory expectations regarding the nuevo sol.

The development of exchange hedging markets, such as forwards, favors the mitigation and elimination of exchange appreciatory and depreciatory risks, thus strengthening the financial system and business balances.

29. The BCRP intervened in the exchange market purchasing dollars for a total of US$ 2,001 million in the fourth quarter of 2006. Likewise, in January 2007, the BCRP purchased US$ 610 million. These purchases allow a preventive accumulation of international reserves to deal with eventual negative external shocks in the future.

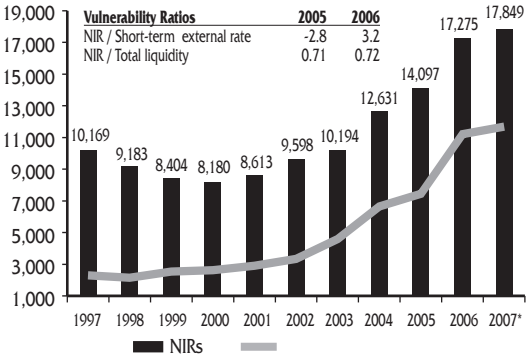
A part of these purchases of dollars in the exchange market have served to meet the Public Treasury's demand for foreign currency to repay the external debt (US$ 370 million between October 2006 and January 2007). The remaining amount has been included in the Central Bank's exchange position, which today amounts to US$ 11,7 billion.

Table 12

VARIATION OF NET INTERNATIONAL RESERVES
(Millions of US$)

	2004	2005	2006		
			Jan.-Sep.	IV-Quarter	Year
I. Foeign exchange operations	**1,854**	**767**	**1,179**	**1,682**	**2,861**
1. Over the counter	2,340	2,699	1,942	2,001	3,944
a. Purchases	2,340	3,130	2,298	2,001	4,299
b. Sales	0	-431	-355	0	-355
2. Operations with the public sector	-487	-1,935	-764	-320	-1,084
3. Other net purchases	2	3	0	1	1
II. FINANCIAL SYSTEM DEPOSITS	**23**	**1,251**	**-491**	**-193**	**-684**
III. PUBLIC SECTOR DEPOSITS	**359**	**-587**	**-125**	**369**	**245**
IV. OTHERS	**201**	**35**	**512**	**244**	**756**
V. TOTAL	**2,437**	**1,466**	**1,075**	**2,102**	**3,178**

Graph 19
NET INTERNATIONAL RESERVES AND INTERNATIONAL POSITION
(Millions of US$)



* As of January.

30. The BCRP net international reserves increased by US$ 3,178 million in 2006, reaching a balance of US$ 17,275 million. This result is mainly explained by a US$ 3,636 million increase in the BCRP's exchange position and by a US$ 245 million increase in public sector deposits, offset by lower deposits in the financial system amounting to US$ 684 million. International reserves continued to accumulate in January and reached a balance of US$ 17,849 million.

As a result of this evolution, the percentage of liquidity of the private sector covered by international reserves increased from 71 percent in 2005 to 72 percent in 2006. Moreover, external obligations with short-term maturities continue to be well covered by international reserves.

BOX 2
CRITERIA FOR FOREIGN EXCHANGE MARKET INTERVENTION

A flexible exchange scheme allows monetary policy to be oriented to maintaining price stability and stabilizing the economy, as the impacts of external shocks on the economy are absorbed through fluctuations of the exchange rate.

A regime with little exchange fluctuations can encourage mismatches in the balances of economic agents, given that firms will not seek to limit the exposure of their dollar-denominated liabilities to such a risk.

Although maintaining a flexible exchange system is beneficial, a high degree of financial dollarization generates insolvency and illiquidity risks in the economy. Therefore, as pointed out by Goldstein (2002), it is necessary to adapt the benefits obtained as a result of a flexible exchange system to abrupt fluctuations of exchange that could deteriorate the balances of economic agents with currency mismatches. As currency mismatches decrease, exchange can fluctuate more.

Therefore, actions oriented to dedollarized the economy include a greater exchange flexibility as this reduces currency mismatches. The real return on assets in soles becomes more stable relative to assets in dollars when there is greater exchange fluctuation, thus incentivating investment in domestic currency-denominated assets. Thus, a virtuous circel is generated that contributes to dedollarize the economy and reduce currency mismatches in the balances of economic agents.

However, as long as the economy continues to show a high level of financial dollarization and in the absence of a developed exchange hedging market, the Central Bank has to maintain a precautionary high level of international reserves and soften abrupt exchange fluctuations while respecting its medium-term tendency to prevent a negative impact on the balances of economic agents and, hence, on economic activity. It should be pointed out here that foreign exchange interventions should not be perceived as an exchange "insurance", since this would prevent economic agents from internalizing the risks generated by financial dollarization.

Moreover, exchange interventions have to be in line with the inflation targeting scheme, giving priority to meeting the inflation target should any conflict arise between these two schemes. The Central Bank's interventions in the exchange market have been consistent with the IT scheme. The credibility of economic agents regarding the inflation target continues to be sound, as evidenced by the results of the surveys on macroeconomic expectations, and place inflationary expectations within the range of the inflation target.

The flexibility of exchange has gradually increased in recent years. In the most recent episodes of high exchange volatility, an increasingly higher part of the shocks affecting the exchange market has been absorbed by the exchange rate, thus maintaining

the interbank interest rate stable given that this rate is established at a level compatible with the inflation target. The relative variability of exchange in terms of the interbank interest rate has increased, favoring dedollarization as the return on assets in soles is more stable and predictable.

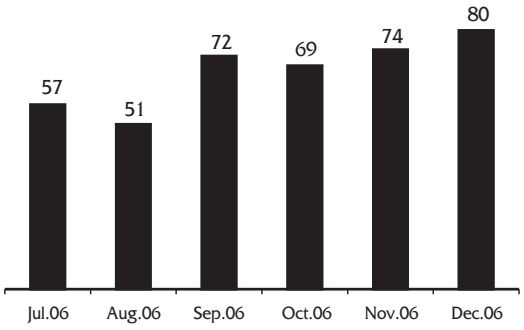
VARIABILITY RATIO OF THE INTERBANK RATE AND THE EXCHANGE RATE: 1999-2006 1/

Year	Interbank interest rate (a)	Exchange rate (b)	Ratio (%) (b) / (a)
1999	0.31	0.005	1.6
2000	0.21	0.003	1.7
2001	0.11	0.003	2.8
2002	0.15	0.004	2.8
2003	0.03	0.001	4.9
2004	0.03	0.003	12.2
2005	0.02	0.002	12.7
2006	0.02	0.004	22.2

1/ Defined as the standard deviation divided by the average value of the variable.

From the fourth quarter the intervention of the BCRP in the exchange market has been emphasizing the need of preserving exchange flexibility in order to prevent that economic agents consider that there is an implicit exchange insurance. Because of this strategy, the exchange market is now operating more fluently without concentrating operations at the close of each day.

OPERATIONS IN THE EXCHANGE MARKET CARRIED OUT BEFORE 13 HOURS (%) 1/



1/ The exchange market operates until 13.30 hours. Operations closed at DATATEC.

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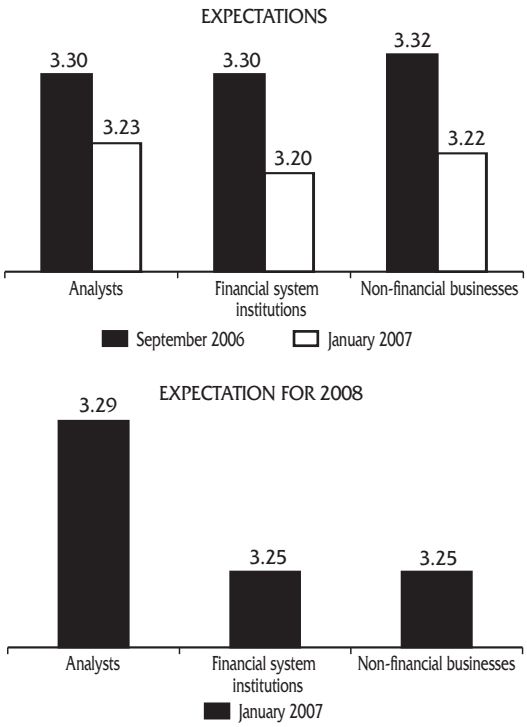
Graph 20
EXPECTATIONS REGARDING THE EXCHANGE RATE
(S/. per US$)



Exchange rate expectations

31. The expectations of economic agents regarding what the exchange rate will be at end 2007 has been corrected downwards from a range between S/. 3.30 and S/. 3.32 per dollar in September to a range between S/. 3.20 and S/. 3.23 per dollar in January 2007. In 2008, economic agents expect the exchange rate to range between S/. 3.25 and S/. 3.29 per dollar.

III. International environment

The world economy continued to show a favorable environment during 2006 due to the dynamism of some emerging economies, such as China, and greater economic activity in some developed countries, such as Germany which posted a higher growth than expected. This evolution was reflected in a higher demand for commodities, which allowed our terms of trade to record a historical increase of 26 percent with a 36 percent growth of export prices.

A moderate slowdown in global growth is expected for 2007 and 2008, mainly as a result of the cooling of the real estate market in the United States. This lower global growth is expected to impact on the international quotations of commodities and, therefore, a reduction of 4 and 6 percent is forecast in the terms of trade for 2007 and 2008.

Table 13

FORECAST ON GDP GROWTH IN OUR MAIN TRADING PARTNERS [1/]
(In percentage)

	Weighted trade 2005	2004	2005	2006		2007		2008
				IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Jan.07
Trade partners [2/]	100%	5.3	4.4	4.6	4.6	3.8	3.9	4.0
North America	*34%*	*3.8*	*3.2*	*3.4*	*3.2*	*2.6*	*2.4*	*3.0*
USA	29%	3.9	3.2	3.5	3.4	2.6	2.4	3.0
Canada	5%	3.3	2.9	2.9	2.7	2.7	2.3	2.9
Europe	*17%*	*2.1*	*1.6*	*2.6*	*2.8*	*2.0*	*2.2*	*2.2*
Germany	4%	1.2	0.9	2.2	2.5	1.2	1.5	2.0
United Kingdom	1%	3.3	1.9	2.6	2.7	2.4	2.5	2.4
Asia	*19%*	*7.5*	*7.3*	*7.6*	*7.6*	*6.7*	*6.9*	*7.0*
China	11%	10.1	10.2	10.4	10.7	9.1	9.6	9.4
Japan	4%	2.3	2.6	2.8	2.2	2.2	1.8	2.3
Latin America	*30%*	*7.3*	*5.4*	*5.0*	*5.2*	*4.4*	*4.8*	*4.2*
Argentina	3%	9.0	9.2	7.7	8.4	5.6	7.2	4.7
Brazil	6%	4.9	2.3	3.5	2.8	3.6	3.4	3.6
Chile	7%	6.2	6.3	5.3	4.3	5.2	5.2	5.0
Mexico	3%	4.2	3.0	4.4	4.7	3.4	3.4	3.7
Venezuela	3%	17.9	9.3	8.5	9.8	6.2	6.9	5.0
Note:								
World economy		**3.9**	**3.3**	**3.8**	**3.8**	**3.2**	**3.2**	**3.3**

IR: Inflation Report.
1/ Executed data of WEO and Consensus Forecast data as of the corresponding month.
2/ Weighted according to 2005 trade.

Global economic situation

32. The growth of our main trading partners in 2006 is estimated to be approximately 4.6 percent, a level slightly higher than the one posted in 2005 and similar to the one forecast in our Inflation Report of September 2006. Exceeding initial forecasts and despite the measures taken to slow down the economy, the growth of China, with an expansion of over 10 percent, is noteworthy. A moderate deceleration in the rate of growth of the world economy is expected in 2007 and 2008, particularly in the United States where the real estate market would grow at a slower pace as a result of the Federal Reserve's correction of its interest rates between June 2004 and June 2006 (from 1.0 to 5.25 percent).

33. After growing at a rate of 5.6 percent in the first quarter of 2006, the economy of the **United States** recorded rates of 2.6 and 2.0 percent in the second and third quarters respectively. These lower rates of growth are explained by the cooling of the real estate market and its impact on consumption and investment. However, the positive evolution of employment and the low levels of unemployment have contributed to prevent a greater fall of consumption. In the fourth quarter, the U.S. economy grew 3.5 percent, and thus, the annual growth rate in 2006 would be 3.4 percent. Various forecast sources estimate that the U.S. economy would reduce its growth to a rate of 2-3 percent.

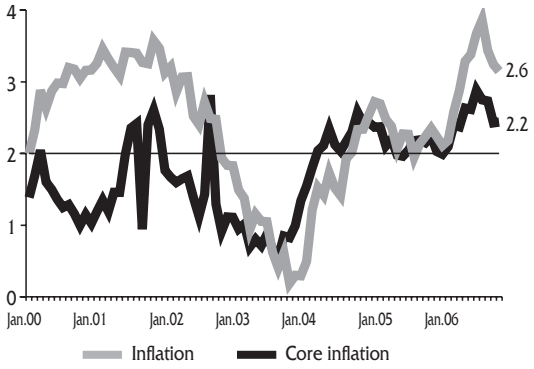
Table 14

MAIN INDICATORS ON THE USA AND CANADA 1/

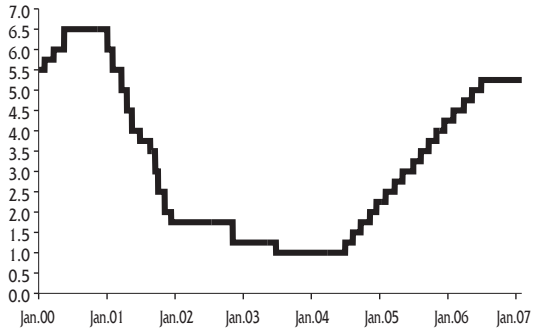
	2004	2005	2006*	2007*	2008*
GDP (% change)					
USA	3.9	3.2	3.4	2.4	3.0
Canada	3.3	2.9	2.7	2.3	2.9
Inflation					
USA	3.3	3.4	2.5	2.3	2.3
Canada	2.1	2.2	1.6	2.2	2.0
Current account (in percentage)					
USA	-5.7	-6.4	-6.6	-6.0	-5.6
Canada	2.1	2.3	2.0	1.2	1.0
Fiscal deficit of the government (in percentage)					
USA	-4.6	-3.7	-3.1	-3.2	-2.9
Canada	0.7	1.7	1.1	1.0	0.9

1/ Source Consensus Forecast. IMF and BCRP.
* Forecast.

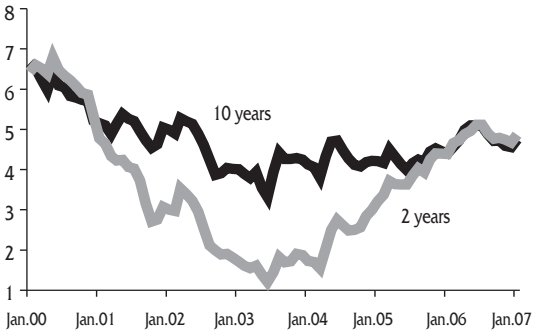
Graph 21
USA: INFLATION AND CORE INFLATION
(Percentage change last 12 months)



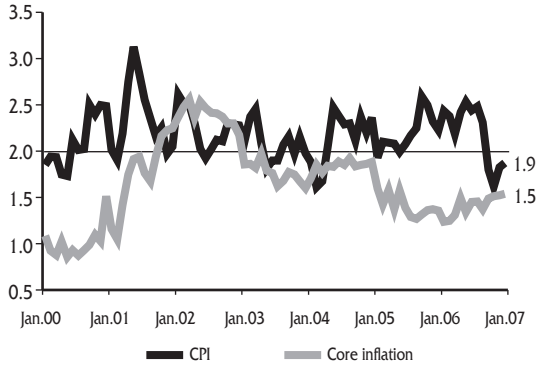
Graph 22
FED'S FUND INTEREST RATE
(In percentage)



Graph 23
USA: TREASURY YIELDS



Graph 24
EUROZONE: INFLATION
(Percentage change last 12 months)



Inflation in the U.S. has been decreasing since July 2006, mainly due to declines in the prices of oil and other commodities, whereas core inflation -excluding food products and energy- began to grow at a slower pace only since the month of October. Despite this evolution, core inflation still maintains a rate of above 2 percent, a higher level than the one considered to be a comfortable level by the FED.

In 2006, the FED continued with its policy of moderate rises of the interest rate, raising its rates by 25 basis points on four different occasions until it reached a level of 5.25 percent in June 2006. In its latest communiqués and Minutes of the Monetary Policy Committee, the FED maintained its bias for inflationary pressures, although these are expected to gradually decrease as a result of the anticipated slowdown of the economy and therefore, the current monetary stance would be consistent with moderate growth rates. Furthermore, the current forecast considers a cut in the FED's rate to 5 percent in the second quarter of 2007 and that this rate will be maintained during 2008.

Long-term interest rates have decreased, influenced by prospects of a lower rate of growth in the United States. Over the last months, the rates on 2-year bonds have declined more than the 10-year bonds, thus generating an inversion in the yield curve since June (short-term rates are above longer-term rates).

34. In **Europe**, the rate of growth is estimated at 2.8 percent for 2006 and is expected to be around 2.2 percent in 2007 and 2008.

In 2006, the **Eurozone** has been growing at rates unseen since the first quarter of 2001. Thus, after growing at rates of 2.2 and 2.9 percent in the first and second quarters respectively, the Eurozone posted a growth of 2.7 percent in the third quarter. Within the Eurozone, Germany has shown an important recovery associated with the dynamism of export manufacturing and the recovery of investment. The growth of the **United Kingdom**, fueled by domestic demand, is also noteworthy.

Forecasts for 2007 and 2008 consider a lower rate of growth associated with the cycle of interest rate rises in Europe, the impacts on tax measures in Germany, and the slowdown of the economy in the United States.

In the second quarter of 2006, inflation in the Eurozone decreased from rates of 2.5 percent in June to 1.9 percent in December, posting inflation rates below the 2 percent inflation

Table 15
MAIN INDICATORS ON EUROPE 1/

	2004	2005	2006*	2007*	2008*
GDP (% change)					
Germany	1.2	0.9	2.5	1.5	2.0
Spain	3.2	3.5	3.7	3.2	2.9
United Kingdom	3.3	1.9	2.7	2.5	2.4
Inflation					
Germany	2.1	2.1	1.4	2.4	1.0
Spain	3.2	3.8	2.6	3.1	2.2
United Kingdom	1.6	1.9	3.0	1.5	2.0

1/ Source: Consensus Forecast and BCRP.
* Forecast.

target for the first time since 1999. Core inflation remained at 1.5 percent. These results are consistent with the **European Central Bank** (ECB) forecasts, according to which inflation is expected to be near the 2 percent target in 2007.

During 2006, the ECB raised its interest rate on five different times, from 2.25 percent in December 2005 to 3.5 percent in December 2006. Additional increases of up to 50 basis points are anticipated in 2007, given the various signals indicating that inflation will be closely watched.

In 2006, the **Bank of England** (BOE) raised its interest rate by 25 basis points -on two separate occasions- to a level of 5 percent. In January 2007, the BOE raised its rate again by 25 points. The market expects the rate to increase up to 5.5 percent at end 2007 in order to control inflation which is currently above the 2 percent inflation target .

35. **Japan** exhibited an important recovery in the first quarter of 2006 (annual growth of 2.9 percent) to then experience a significant slowdown in the second and third quarters (1.6 percent), an evolution consistent with indicators showing a reduction in the growth of capital spending. According to these results, growth in 2007 is forecast to be 1.8 percent.

The **Bank of Japan** has stated that there is no categorical evidence that the deflationary process is over, pointing out in particular that, measured with a new methodology, inflation would have grown less than expected[4]. Since May 2006, inflation in terms of the Consumer Price Index (CPI) has been positive and logged an annual rate of 0.3 percent, while core inflation has remained negative during all the year.

4 The methods used to measure the CPI vary every 5 years and include restructuring the components of the consumer basket of goods and the weight attributed to each of these goods. The new method also use 2005 as the base year, instead of year 2000.

Table 16

MAIN INDICATORS ON ASIA 1/

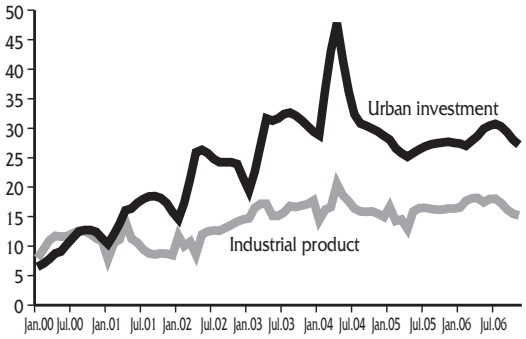
	2004	2005	2006*	2007*	2008*
GDP (% change)					
China	10.1	10.2	10.5	9.6	9.4
South Korea	4.7	4.0	5.0	4.4	4.9
Japan	2.7	1.9	2.2	1.8	2.3
Inflation					
China	2.4	1.6	2.8	2.4	2.0
South Korea	3.0	2.6	2.2	2.5	2.4
Japan	0.2	-0.4	0.3	0.3	1.0

1/ Source Consensus Forecast and BCRP.

* Forecast.

The Bank of Japan (BOJ), which in March decided to base its monetary policy on an interest rate target scheme instead of on monetary aggregates, announced a gradual withdrawal of liquidity in line with having raised the interest rate by 0.25 percent in July. However, recent evidence of a slow down and uncertainty regarding inflation have led the BOJ to put off further rate increases until 2007.

Graph 25
CHINA: ECONOMIC ACTIVITY
(Mobile average over 3 months)

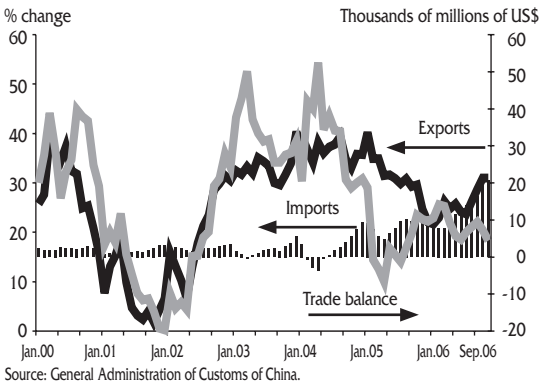


Source: National Bureau of Statistics of China.

36. With respect to emerging economies, it is worth highlighting the significant dynamism shown by **China**, which posted its highest growth since the mid-nineties with a rate of 10.7 percent in 2006. This important outcome observed in the Chinese economy continues to the based on the growth of investment and exports.

The measures aimed at making the yuan more flexible, as well as other monetary policies aimed at moderating growth to more sustainable rates would be effective since 2007, which could be reflected in lower prices for commodities.

Graph 26
CHINA: TRADE BALANCE
(Mobile average over 3 months)



Source: General Administration of Customs of China.

37. In **Latin America**, economic activity continued to show a dynamic performance in 2006. This dynamic performance is explained by a strong expansion of domestic demand, in a context characterized by high prices for commodities and abundant international liquidity. As a result of these evolutions, several upward corrections have been made in growth forecasts in the region for 2006 and 2007. On the other hand, growth is expected to slow down slightly in 2008.

Table 17

MAIN INDICATORS ON LATIN AMERICA 1/

	2004	2005	2006*	2007*	2008*
GDP (% change)					
Argentina	9.0	9.2	8.4	7.2	4.7
Brazil	4.9	2.3	2.8	3.4	3.6
Chile	6.2	6.3	4.3	5.2	5.0
Colombia	4.9	5.2	5.8	5.0	4.2
Mexico	4.2	3.0	4.7	3.4	3.7
Inflation					
Argentina	6.1	12.3	9.8	10.3	10.2
Brazil	7.6	5.7	3.1	4.0	4.1
Chile	2.4	3.7	2.6	2.9	2.9
Colombia	5.5	4.9	4.5	4.1	3.9
Mexico	5.2	3.3	4.1	3.5	3.5

1/ Source: Consensus Forecast.
* Forecast.

Central banks in Latin America adopted different monetary policy actions. In countries with less inflationary pressures and low levels of growth, such as **Brazil** and **Mexico**, interest rates continued to decline in 2006, although Mexico maintained its rates in the second quarter. On the other hand, Chile and Colombia raised its reference interest rates, although this was a more gradual process in Chile in the second half of 2006.

Emerging countries' debt

Emerging market debt spreads continued to show a downward tendency. The persistence of high commodity prices, the improvements observed in the macroeconomic fundamentals of emerging economies and the shift of expectations with respect to the FED's policy on interest rates led the spreads to post several historical minimum levels.

38. Emerging market debt spread showed a prominently downward tendency that was briefly interrupted between May and June. The EMBI+ Brazil, the EMBI+ Argentina and the EMBI+Peru spreads logged several historical minimum records in 2006.

This downward trend of spreads is mostly explained by improved fundamentals in these economies which, in turn, were reflected in the improved risk ratings that the main rating agencies assigned to these countries.

According to *Emerging Portfolio Fund Research*, the net flows of mutual funds engaged in stock exchange operations in

emerging markets amounted to US$ 22 billion as of December 2006, reaching a higher level than the historical maximum recorded in 2005 (US$ 20 billion). JP Morgan reported that capital inflows to bond markets totaled US$ 24 billion, of which US$ 19 billion were geared towards external debt markets and US$ 5 billion towards local debt.

Table 18

EMERGING BOND MARKET SPREAD INDEX (EMBI+)*

	2002	2003	2004	2005	2006	Bps. change 2006-2005
Emerging economies	**765**	**418**	**356**	**245**	**169**	**-76**
Latin America	1,007	521	420	283	186	-97
Brazil	1,446	463	382	311	192	-119
Colombia	645	431	332	238	161	-77
Mexico	331	199	166	126	98	-28
Argentina	6,391	5,632	4,703	504	216	-288
Peru 1/	610	312	220	206	118	-88

* Data as of end of the period.

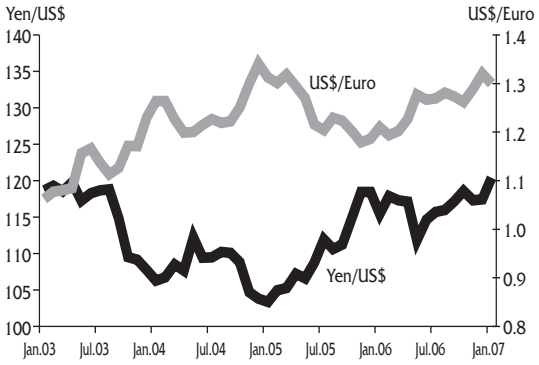
1/ Since September 29, JP Morgan included the 2025 and 2033 global bonds in the calculation of the EMBI, resulting in an increase of approximately 40 pbs.

Source: Reuters.

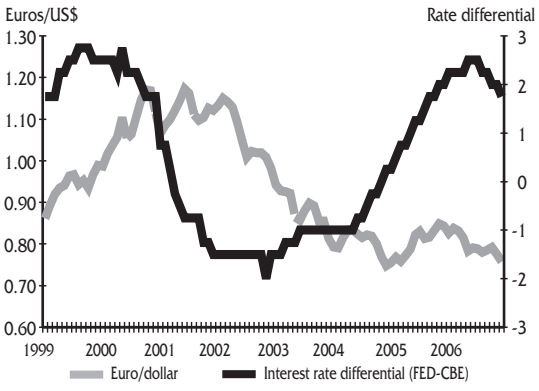
Evolution of the dollar in international markets

The dollar resumed its depreciatory tendency during 2006, affected by expectations that the differential in the rates favoring this currency would be reduced. These developments take place in a context where the external imbalances of the United States persist and generate uncertainty regarding the evolution of the dollar in 2007 and 2008. However, no abrupt correction is expected in the market in the short run.

Graph 27
US DOLLAR AGAINST EURO AND YEN



Graph 28
QUOTATION OF US DOLLAR (EURO/US$) AND INTEREST RATE DIFFERENTIAL



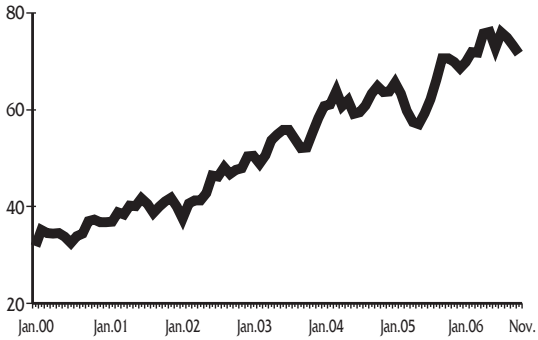
39. Since June 2006, the **dollar** resumed the depreciatory tendency that had been interrupted in 2005. The lower differential between interest rates in the United States and the rest of the world, together with expectations of an increased reduction of this differential in 2007, contributed to the depreciation of the dollar against the euro and other currencies, such as the pound. Other factors contributing to this evolution included the likelihood of further rises of interest rates in the rest of economies, and an eventual recomposition of central banks' currency portfolios which would favor the euro.

The dollar depreciated 10 percent against the euro in 2006. The differential between interest rates (which is currently 175 bps.) is expected to decrease given expectations that the ECB will raise its rates in 2007. On the other hand, the dollar has only depreciated 1 percent against the yen.

Moreover, this weakness of the dollar has almost been generalized relative to the currencies of emerging economies.

Graph 29
USA: NON-RESIDENTS PURCHASES OF LONG-TERM NET ASSETS

(Mobile average over 12 months, thousand of millions of US$)



Source: Department of the Treasury/Federal Reserve Board.

40. It should be pointed out that the adjustment of the dollar is taking place in a context marked by strong imbalances in the US balance of payments. The U.S. current account deficit in 2006, estimated at an equivalent of 6.6 percent of GDP, would continue to be financed by sales of assets in dollars to foreigners.

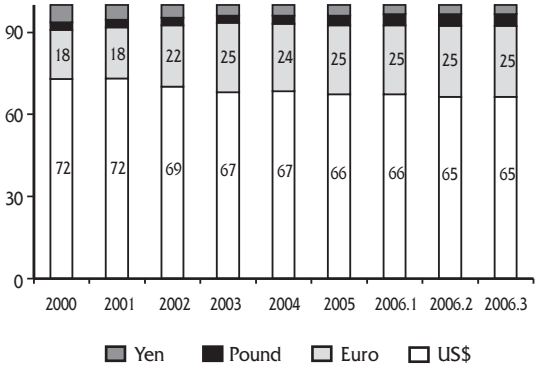
A slight appreciation of the dollar against the euro and other strong currencies is forecast to take place in 2007 and in 2008, while a higher depreciation against the main Asian currencies (the yen, the yuan and other currencies) is expected. This would reflect expectations that the US imbalances will be gradually corrected and, particularly, that the dollar will be basically adjusted against Asian currencies.

BOX 3
THE EVOLUTION OF THE DOLLAR AND GLOBAL IMBALANCES

The term "global imbalance" refers to the sustained current account deficit of the United States that has led this country to increase its debtor position. The US debtor position as of December 2006 is estimated to come close to US$ 3 trillion (equivalent to approximately 25 percent of GDP). On the other hand, some countries (such as China, Japan, Germany, and oil-exporting countries) have posted surpluses and are accumulating securities denominated in dollars.

There is no consensus about the magnitude of these imbalances. Some authors say the US debtor position is overestimated (Haussman and Sturzenegger, 2006[a]) as estimates do not include the higher revenues obtained by US investments abroad relative to the yield on their external liabilities (such as the US Treasury bonds, for example). Others (Caballero 2006[b], Dooley 2003[c]) argue that this situation may be sustained in the medium-term because the demand for assets in dollars in countries currently growing at a fast pace and which do not have developed financial markets is likely to remain in the future. In contrast, some economists (Roubini and Setser 2004[d], and Obtsfeld and Rogoff 2005[e]) say that a depreciation of the dollar -along with lower expenditures- is required to balance the US current account deficit and reduce it to sustainable levels. Rogoff and Obtsfeld estimate that a real depreciation of at least 20 percent would be necessary to correct the current account imbalances.

NET INTERNATIONAL RESERVES IN CENTRAL BANKS: COMPOSITION BY CURRENCIES
(In percentage)



Source: IMF (COFER).

Today, nearly two thirds of the reserves held in currencies are denominated in dollars, while euro-denominated assets represent 25 percent. Therefore, any significant recomposition of central banks' portfolio could affect the quotation of the dollar. Moreover, the share of US Treasuries held by foreigners central banks as of October 2006 is estimated at US$ 2 trillion, which represents approximately 25 percent of the public debt.

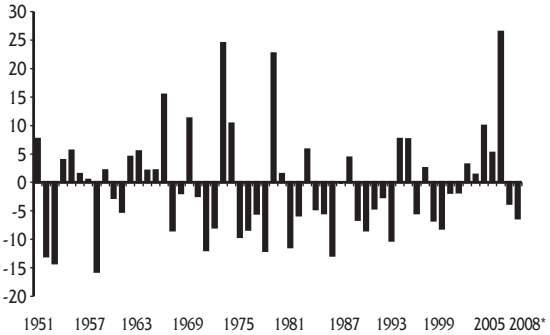
There are several ways in which the US deficit could be reduced. For instance, this could require a spending reduction in the US and an increase of expenditures in countries with a high surplus. However, this might also require an adjustment of relative prices through a depreciation of the dollar.

There have been other cases where the dollar depreciated significantly. In a context of external imbalance in the US during the eighties, for example, coordinations were made with Germany and Japan so that these countries would allow their currencies to appreciate. The resulting appreciation of the D.Mark and the yen was even higher than 50 percent, and led to a new agreement (the Louvre agreement) to avoid a further appreciation of these currencies. Several analysts consider that this was an orderly adjustment that was not very costly in terms of the output. However, in the particular case of Japan, the appreciation of the yen strongly affected the export sector. This led to the implementation of expansionary monetary measures that contributed to develop a bubble in the real estate sector that had to be corrected later, and affected the growth of Japan in the nineties.

References:

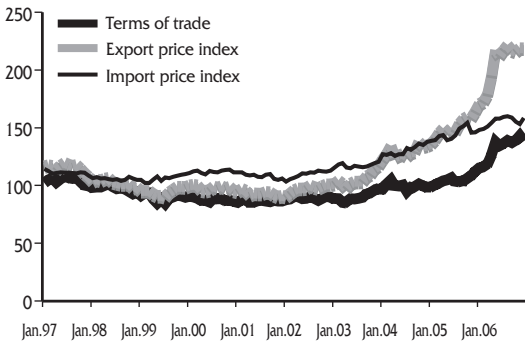
a. Haussmann, Ricardo and Federico Sturzenegger. 2005. "Global imbalances or bad accounting? The missing dark matter in the wealth of nations", mimeo, Harvard University.
b. Caballero, Ricardo; Farhi, Emmanuel; Gourrinchas, Pierre-Olivier (2006). An equilibrium model of global imbalances and low interest rates. MIT Department of Economics, Working Paper No. 06-02.
c. Dooley, Michael, Folkerts-Landau and Garber, Peter. An Essay on the Revived Bretton Woods System. Working Paper 9971, NBER, September 2003.
d. Roubini, Nouriel and Setser, Brad. The US as a Net Debtor: The sustainability of the US External Imbalances. November 2004.
e. Obstfeld, Maurice and Rogoff, Kenneth. Global current account imbalances and Exchange Rate Adjustments. May 2005.

Graph 30
TERMS OF TRADE: 1951-2008
(Percentage change)



* Forecast.

Graph 31
EXPORT AND IMPORT PRICE INDICES AND TERMS OF TRADE
(1994=100)



Terms of trade

After posting the highest historical increase in 2006 (26 percent), our terms of trade are expected to go through a moderate correction in 2007 and 2008.

The higher prices of exports in 2006 reflected both the increase of global demand and situations that limited the supply of certain products and, consequently, implied a higher volatility in the prices of these goods. This high volatility is expected to continue in the 2007-2008 forecast horizon. In the long-term, the onset of new mining projects is expected to increase the global supply of commodities in a context of gradual slowdown of global economic activity.

In 2007, the low levels of inventories would generate upward pressures in some basic metals (particularly, lead and tin), thus offsetting the lower price of copper in the global market. Moreover, because of gold's condition as a reserve asset, gold would show an upward tendency due to uncertainty with respect to the dollar, whereas increases in the price of oil would be determined by a context of scarce idle capacity.

Table 19

TERMS OF TRADE
(Annual percentage change)

	2004	2005	2006		2007 1/		2008 1/
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Jan.07
Terms of trade	**9.9**	**5.2**	**23.8**	**26.2**	**-5.3**	**-3.7**	**-6.3**
1. Exports price index	22.4	16.3	33.5	35.7	-1.2	-1.6	-3.7
of which:							
- Gold (US$ / troy ounce)	410	445	605	605	627	637	661
- Copper (US$ / pound)	1.30	1.67	3.11	3.05	3.01	2.57	2.32
- Zinc (US$ / pound)	0.48	0.63	1.38	1.49	1.37	1.65	1.31
- Fishmeal (US$ / MT)	625	686	1 045	1 080	922	1 074	1 062
2. Import price index	11.4	10.6	7.8	7.4	4.4	2.2	2.8
of which:							
- Petroleum (US$ / barrel)	41	57	69	66	71	62	65
- Weath (US$ / MT)	134	130	167	169	172	183	175

IR: Inflation Report.
1/ Forecast.

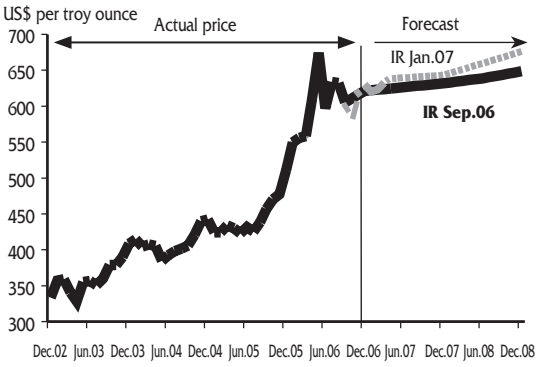
41. The quotations of the main metal exhibited an upward trend during the first half of 2006, reaching historical peaks. However, a differentiated conduct by products was observed in the second half of this year. While the quotations of gold and copper fell with respect to their levels in the first 6 months of the year, the other basic metals (zinc, tin and lead) increased significantly in the second half of 2006.

    This differentiated conduct by products shows that the dynamics of commodity prices observed in the last months of 2006 -and which is likely to continue during 2007- will, for the most part, be explained by specific factors and not by a common trend. The analysis of correlations related to the main metals since the second half of 2006 shows that these correlations have decreased significantly with respect to the high correlations observed over the past four years. Thus, for example, the correlation between the prices of gold and copper decreased from 0.97 in the last 4 years to -0.22 since the second half of 2006.

Gold

42. The average quotation of gold rose 36 percent in 2006, posting an average price of US$ 605 per troy ounce that reached its highest peak in 26 years on May 11 when the troy ounce reached a price of a US$ 721. This result is explained by investors' higher demand for this metal as a reserve asset

Graph 32
GOLD PRICES: FORECAST



IR: Inflation Report.

given inflationary pressures and the weakening of the dollar. Other factors explaining this result include global geopolitical uncertainty (the Middle East conflict, North Korea's nuclear tests and tensions originated by Iran's nuclear program) and the lower sales of gold reserves by central banks.

All these factors offset the weakening of the jewelry industry demand, particularly in India and the Middle East, and the decline in the price of oil during the last months of 2006.

The average price of a troy ounce of gold is expected to increase from US$ 605 in 2006 to US$ 637 in 2007. Moreover, production is expected to show a moderate growth in 2007 (higher production in Australia, the United States and Latin American countries offset the continuous fall recorded by South Africa), in line with a recovery of demand -especially in the jewelry industry- after the strong drop of production observed in 2006. Investors' demand would continue to be high as conditions would be similar to those of 2006. Likewise, sales of gold by central banks are expected not to exceed the limit of 500 tons during the year, and a moderate position is also expected from the IMF in terms of its financing its deficit through sales of gold. All these factors could also explain a moderate increase in the gold quotation in 2008.

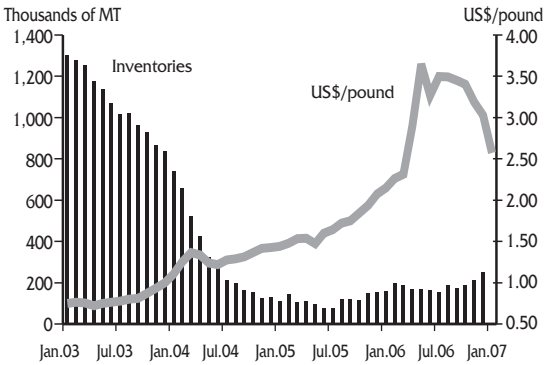
Copper

43. During 2006, the average quotation of copper -a metal demanded mainly by the energy and the construction sectors- was US$ 3.05 per pound, a price level that was 84 percent higher than that of 2005. However, after reaching a peak price of US$ 4 per pound in May 2006, the price of copper has been showing a downward tendency.

This increase in the price of copper is explained by both supply-related and demand-related factors. The former include strikes in support of salary demands in the most important mines, production interruptions caused by landslides (Chuquicamata-Codelco), technical problems (Grasberg, Indonesia), and the temporary stoppage of production at mine La Caridad (Mexico). All these factors account for a loss in annual production equivalent to 500 thousand MT (3 percent of total production).

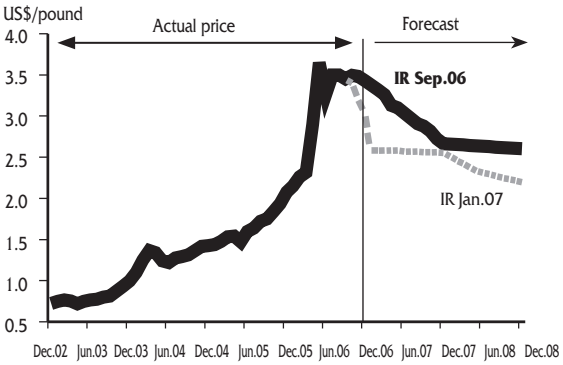
On the demand side, factors contributing to the high prices of copper were associated with the dynamism exhibited by the main copper-consuming economies, especially China, in a context of low global inventories. Although inventories have been showing a recovery lately, they are still far from reaching a coverage of 41 days of consumption that there were able to cover at the beginning of 2003.

Graph 33
COPPER PRICE AND INVENTORIES



Source: Bloomberg, London Metal Exchange, COMEX and Shangai Stock Exchange.

Graph 34
COPPER PRICE: FORECAST



IR: Inflation Report.

The copper quotation decreased in the second half of 2006, thus reflecting a slight recovery of inventories, a lower-than-expected demand from China, and the slowdown in the US economy.

According to these developments, the price of copper is expected to gradually decrease to an average of US$ 2.57 per pound in 2007. This evolution would be mainly associated with the decline of real estate activity in the US -which accounts for nearly 50 percent of copper demand in this country- and to the measures implemented in China to with the purpose of moderating growth.

Moreover, global production is expected to recover, particularly in the case of the mines that were affected by various factors in 2006, and the onset of new projects is also expected, including the Chilean mine Spence and the Peruvian mine Cerro Verde, which will increase production by 200 thousand tons each. A lower price for copper is expected in 2008, in a context of an improved balance between demand and supply.

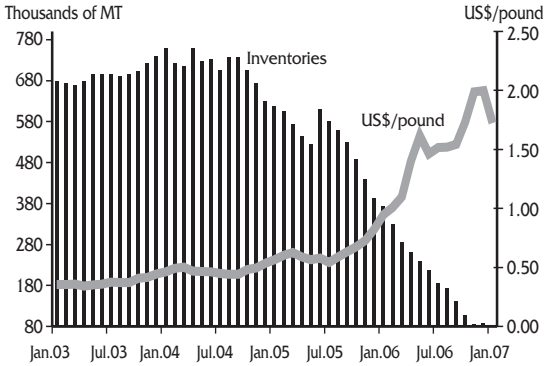
Table 20

BALANCE OF WORLD'S SUPPLY AND DEMAND OF MAIN COMMODITIES
(Thousands of MT)

	2004	2005	2006*	2007*
Copper				
- Supply	11,689	11,891	12,266	12,910
- Demand	12,537	11,929	11,979	12,640
Gap (Supply - Demand)	-848	-38	287	270
Inventories	488	451	738	1 008
Consumption weeks	2.1	2.0	3.2	4.2
Zinc				
- Supply	7,296	7,015	7,226	7,595
- Demand	7,548	7,316	7,590	7,792
Gap (Supply - Demand)	-252	-301	-364	-197
Inventories	1 039	811	447	250
Consumption weeks	7.3	6.0	3.2	1.7
Oro				
- Supply	3,361	3,983	2,467	
- Demand	3,497	3,734	2,512	
Gap (Supply - Demand)	-136	249	-46	

* Forecast. In the case of gold, the information corresponds to January-September 2006.
Source: World Gold Council. Metal Bulletin Reserch (Base Metals Monthly. Dec. 2006).

Graph 35
ZINC PRICE AND INVENTORIES

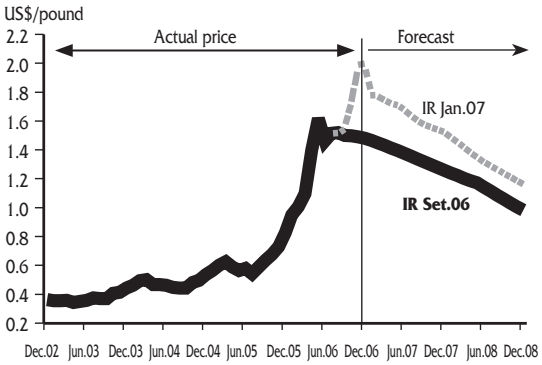


Source: Bloomberg and London Metal Exchange.

Zinc

44. The quotation of zinc -a metal used mainly for galvanizing steel in the automotive and construction sectors- maintained its upward tendency throughout 2006 and increased 137 percent on average, reaching a historical maximum of US$ 2.1 per pound on November 24. The evolution of zinc prices reflected uncertainty in terms of a possible demand and supply gap in

Graph 36
ZINC PRICE: FORECAST



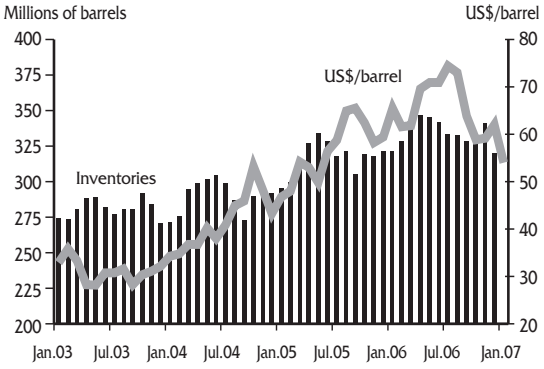
IR: Inflation Report.

the next two years, in a context marked by no new investments and by historical minimum levels of inventories, equivalent to 2.8 days of global consumption (in contrast with the 18 day-coverage of inventories in early 2002).

Prospects for 2007 indicate that the market would close, for the fourth consecutive year, with a deficit as the consumption of zinc is expected to remain strong in the long-term due to increased demand in developing countries. Furthermore, there are not many projects that could meet future demand, particularly of refined zinc. In addition to this, there are concerns that technical problems, labor conflicts, and new regulations in the sector might cause production interruptions in mines. Therefore, the price of zinc is expected to reach an average of US$ 1.65 per pound in 2007, while a better market balance is expected for 2008, as a result of which the price of zinc could fall by 2 percent.

Oil

Graph 37
PETROLEUM PRICE AND INVENTORIES IN THE USA



Source: Bloomberg and the US Energy Department.

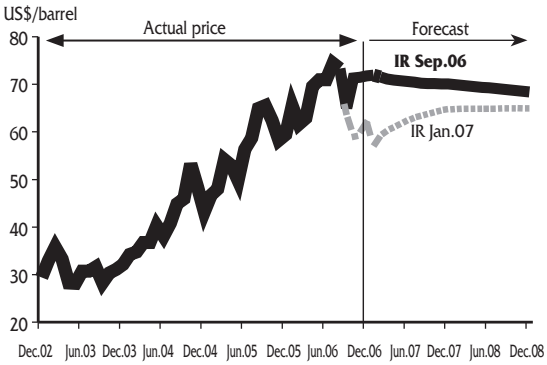
45. In 2006, the average price of WTI oil grew 17 percent on average (US$ 66 per barrel). The quotation of oil maintained an upward tendency during the first half of the year, posting a historical maximum on July 14 (US$ 77 per barrel). Thereafter, this quotation decreased significantly reaching levels even below US$ 60 per barrel.

The rise in the price on oil in the first six months was associated with: (i) geopolitical tensions originated by conflicts in the Middle East, Iran and North Korea; (ii) a lower production of oil in Nigeria due to domestic conflicts; (iii) a temporary interruption of oil supply through a pipeline in Russia given an oil spill and a technical stoppage of operations in the largest oil field (Prudhoe Bay, Alaska) to solve a problem of corrosion of its pipes. All these factors took place in a context marked by uncertainty on whether gasoline inventories in the US would be sufficient to meet demand in the summer season.

On the other hand, the lower quotation of oil in the second half of 2006 was associated with the following factors: (i) fewer concerns of interruptions of oil exports from the Middle East; (ii) a hurricane season that was milder than expected; (iii) warmer temperatures, which generated expectations of a lower demand for the winter season in the US; and (iv) a lower global demand in 2007, given signals of a slowdown in the global economy.

As regards the **balance of demand and supply**, the International Energy Agency estimates that demand will grow

Graph 38
PEROLEUM PRICE: FORECAST



IR: Inflation Report.

by 1.5 million b/d in 2007 (to 86.3 million b/d), and that half of this growth will respond to a higher demand of the US and China. On the supply side, production is estimated to increase by 1.1 million b/d (to 85.8 million b/d) as Russia and Saudi Arabia (the latter being the only country with excess capacity) are forecast to increase their production.

In a context of scarce excess capacity, any potential problem in the supply of crude could considerably affect prices, the highest risk being the interruption of Iran's exports. Moreover, the OPEC has also provided signals of taking actions to prevent a significant drop in oil quotation. In this context, an average price of US$ 62 per barrel is forecast for 2007 and a moderate increase in this price is forecast for 2008.

Wheat

46. The price of wheat increased 30 percent in 2006, with an average quotation of US$ 169 per MT. This upward trend in the price of wheat is associated with problems in wheat yield in most producing countries in the Southern Hemisphere -due to droughts in Australia and Argentina, and to financial restraints in Brazil- and with Ukraine's announcement that its exports will be limited due to adverse weather conditions.

Global wheat demand and supply balance, according to the US Department of Agriculture shows that global production would have fallen 9 million MT in the 2005-2006 period. A drop of 31 million MT is forecast for 2007, which would cause inventories to drop in the same proportion in the two following farming years.

The price of wheat is expected to increase in the first half of 2007, although this trend would reverse in the second half.

Table 21

BALANCE OF WORLD'S SUPPLY AND DEMAND OF WHEAT
(Millions of MT)

	2005	2006	2007*
World production	629	620	589
Initial inventories	133	151	147
Total supply	**762**	**771**	**736**
World demand	**610**	**624**	**615**
Final inventories	**151**	**147**	**121**

* Forecast.

The rise in the price of wheat in the futures market would be associated not only with its own fundamentals, but also with the continuous rise in the price of maize as a result of its potential use as a fuel -which has generated expectations of a possible crop substitution in lands traditionally sown with wheat-, as well as by important purchases of this product by hedging funds. Nevertheless, this price rise would be corrected in 2008.

Fishmeal

47. The higher average quotation of fishmeal in 2006 (58 percent) is explained by a lower supply and a higher demand. Factors contributing to a higher demand include China's increased consumption, particularly for the aquaculture industry. On the supply side, the main producers, Peru and Chile, have posted lower productions mainly due to lower availability of marine resources.

A slight decrease in the average price is expected for 2007, due to the gradual normalization of supply conditions as a weak El Niño event is considered for this year. On the other hand, demand conditions are expected to remain similar, as in the case of the soja market which is one of the main substitutes for this product[5]. The prices of fishmeal would continue to be high in 2008, but with a falling tendency.

5 Although soja has a lower price than fishmeal, the international quotation of soja follows a paralel trend to that of fishmeal. Soja is increasingly been used to produce fuels.

IV. Balance of payments

The surplus in the current account of the balance of payments is estimated to have been equivalent to 2.3 percent of GDP in 2006, the third highest level of surplus recorded since 1950.

A current account surplus equivalent to 0.7 percent of GDP is expected in 2007, boosted mostly by the growth of exports and remittances from abroad. A less favorable international context, characterized by a reversal in terms of trade and a slowdown in the pace of growth of our main trading partners, is expected in 2008. In this context, the current account of the balance of payments would post a deficit estimated at an equivalent of 0.6 percent of GDP.

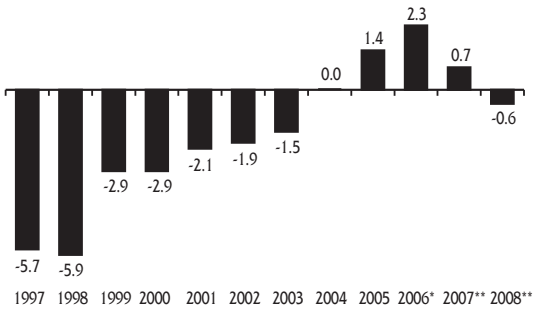
48. In **2006**, the surplus in the current account of the balance of payments would have been equivalent to 2.3 percent of GDP. This represents the third highest surplus since the 50s, after recording a positive result of 6.9 percent of GDP in 1979 and of 2.6 percent of GDP in 1970.

    The 2006 result reflected an unprecedented surplus in the trade balance as well as increased remittances from abroad. Exports increased 37 percent, propelled both by the growth of traditional exports (42 percent) and by non-traditional exports (23 percent). On the other hand, imports grew 23 percent, mainly as a result of increased imports of capital goods (36 percent) and raw materials (21 percent).

    The private sector's financial account logged a positive flow of US$ 1.9 billion, explained by an increase in Foreign Direct Investment (US$ 3.4 billion) within a favorable domestic and international context that favored the reinvestment of part of the profits generated by foreign companies. The capital contributions by SAB Miller, Scotiabank and BHP BillitonTintaya

should be highlighted. This result in the private financial account also reflects important amounts used by Private Pension Funds (AFPs), insurance companies and mutual funds to purchase assets abroad (US$ 1.6 billion).

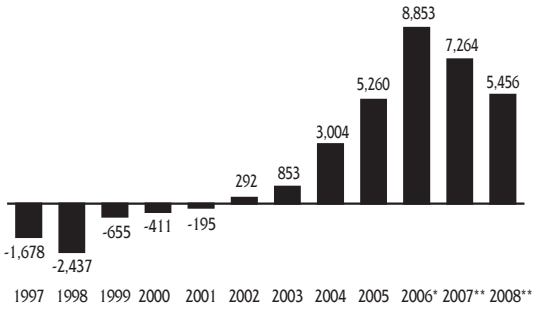
Graph 39
CURRENT ACCOUNT
(Percentage of GDP)



* Preliminary.
** Forecast.

49. A current account surplus equivalent to 0.7 percent of GDP is forecast for this year. This result, lower than the one posted in 2006 (2.3 percent), would be influenced by a macroeconomic context where demand would continue to grow above GDP and by increased profits generated by non-residents. However, this surplus is 0.5 percentage points of GDP higher than the rate estimated in our Inflation Report of September due to an improvement in the trade balance favored by better terms of trade than the ones expected in September. Therefore, a positive trade balance of US$ 7.3 billion is estimated as a result of the growth of exports. Likewise, a growth of remittances from abroad is considered, estimating these to amount to US$ 2.4 billion.

Graph 40
TRADE BALANCE
(Millions of US$)



* Preliminary.
** Forecast.

50. **Exports** would amount to US$ 24.8 billion in 2007 (increasing by 4 percent), particularly because of larger non-traditional external sales (16 percent), while traditional exports are expected to grow by 0.9 percent. The increase in the case of traditional external sales would be associated with the onset of operations of several mining projects, such as Cerro Verde (copper) and Cerro Lindo (zinc).

Table 22

TRADE BALANCE
(Millions of US$)

	2004	2005	2006*		2007**		2008**
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Jan.07
EXPORTS	**12,809**	**17,336**	**23,262**	**23,750**	**24,705**	**24,771**	**25,481**
Of which:							
Traditional products	9,199	12,919	18,109	18,332	18,867	18,497	18,216
Non-traditional products	3,479	4,277	4,992	5,262	5,664	6,101	7,078
IMPORTS	**9,805**	**12,076**	**15,176**	**14,897**	**17,625**	**17,507**	**20,026**
Of which:							
Consumption goods	1,995	2,318	2,664	2,613	3,072	2,926	3,405
Raw materials	5,364	6,603	8,080	7,989	8,834	8,945	9,936
Capital goods	2,361	3,060	4,319	4,145	5,599	5,479	6,520
TRADE BALANCE	**3,004**	**5,260**	**8,086**	**8,853**	**7,080**	**7,264**	**5,456**

IR: Inflation Report.
* Preliminary.
** Forecast.

The 4.3 percent growth of exports of goods in 2007 is broken down into a 6 percent increase of volume and a 1.6 percent price drop.

51. In line with the dynamism of economic activity and the development of investment projects, **imports** would grow 17.5 percent in 2007. By components, imports increasing the most would be capital goods (32 percent) and commodities for industry (26 percent). As a result, imports this year are estimated at US$ 17.5 billion.

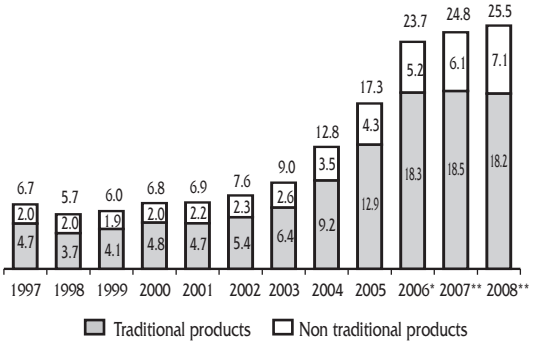
The growth of imports by 17.5 percent in 2007 breaks down into a 15 percent increase in volumes and a 2.2 percent increase in prices.

52. In 2007, the private sector's **financial account** would log a positive flow of US$ 1,601 million, mainly as a result of investment projects, such as Yanacocha (sulfide plant) and Camisea II (export of natural gas), and thus, the flow of Foreign Direct Investment would amount to US$ 3.3 billion. On the other hand, the public sector's capital flows would depend on the management of public sector liabilities during the year. It should be pointed out that the weight of the foreign currency-denominated public debt has decreased in 2005 and 2006 as a result of swap operations and repurchases of external debt.

53. A less favorable international context is expected for **2008**, as a result of which the trade surplus would decrease to US$ 5.5 billion and the current account would show a deficit of 0.6 percent of GDP. Exports would grow at a rate of 3 percent, mainly due to increased sales of non-traditional goods (16 percent) under the scenario of the implementation of the Free Trade Agreement with the US, while exports of traditional products would drop by 1.5 percent due to the decline in the price of our main exports of metals (8 percent). On the other hand, imports would grow 14 percent, led by exports of capital goods (19 percent), considering the onset of the construction stage of mining projects such as Cerro Corona, Toromocho, Minas Conga and Río Blanco. Furthermore, imports of consumer goods would be boosted by increased purchases of US made products (increasing by 16 percent).

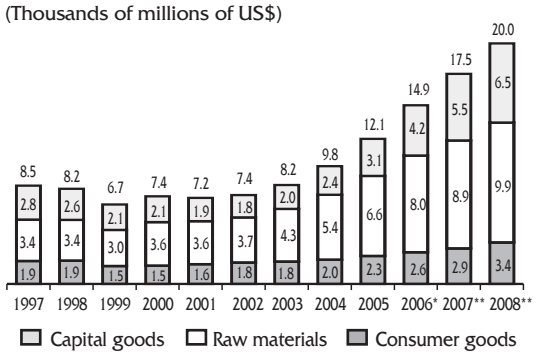
54. In 2008, **the financial account** of the private sector would amount to US$ 1.4 billion, considering the increase of Foreign Direct Investment in the sectors of mining, hydrocarbons and telecommunication (US$ 3.9 billion). The forecast for the balance of payments considers an increase in international reserves of US$ 1.8 billion in 2007 and US$ 500 million in 2008.

Graph 41
EXPORTS
(Thousands of millions of US$)



* Preliminary.
** Forecast.

Graph 42
GOOD IMPORTS
(Thousands of millions of US$)



* Preliminary.
** Forecast.
Nota: Total imports include other imports.

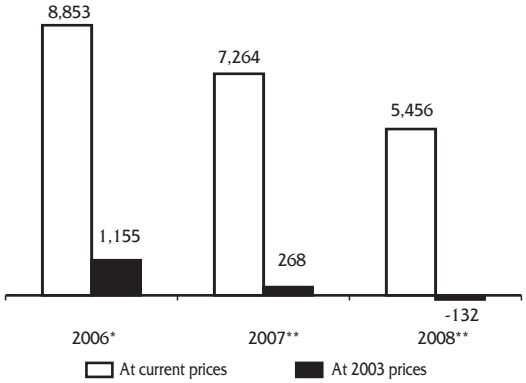
Table 23

BALANCE OF PAYMENTS
(Millions of US$)

	2004	2005	2006*		2007**		2008**
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Jan.07
I. CURRENT ACCOUNT BALANCE	**19**	**1,105**	**1,219**	**2,136**	**151**	**752**	**-617**
As a *percentage of GDP*	*0.0*	*1.4*	*1.3*	*2.3*	*0.2*	*0.7*	*-0.6*
1. Trade balance	3,004	5,260	8,086	8,853	7,080	7,264	5,456
a. Exports	12,809	17,336	23,262	23,750	24,705	24,771	25,481
b. Imports	-9,805	-12,076	-15,176	-14,897	-17,625	-17,507	-20,026
2. Services	-732	-834	-1,038	-950	-1,233	-1,248	-1,400
3. Investment income	-3,686	-5,076	-7,894	-7,916	-7,934	-7,628	-7,320
4. Current transfers	1,433	1,755	2,065	2,149	2,239	2,364	2,648
II. FINANCIAL ACCOUNT	**2,418**	**361**	**281**	**1,042**	**1,049**	**1,048**	**1,117**
III. CHANGE IN NIRs	**2,437**	**1,466**	**1,500**	**3,178**	**1,200**	**1,800**	**500**
Memo:							
International reserves balance (Millions of US$)	12,631	14,097	15,597	17,275	16,797	19,075	19,575
NIR/Short-term external liabilities	1.6	2.8	3.1	3.2	3.3	3.3	3.6
NIR/Total liquidity (%)	73%	72%	70%	78%	69%	73%	68%
NIR/GDP (%)	18%	18%	17%	19%	17%	19%	18%

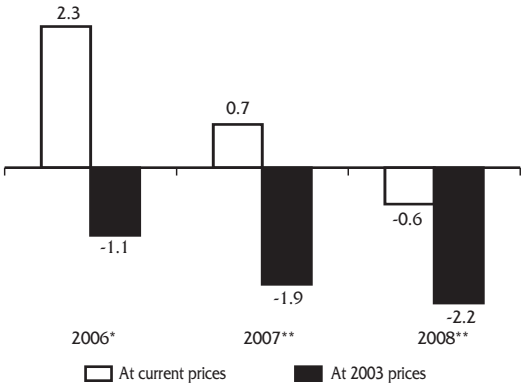
IR: Inflation Report.
* Preliminary.
** Forecast.

Graph 43
TRADE BALANCE
(Millions of US$)



* Preliminary.
** Forecast.

Graph 44
CURRENT ACCOUNT
(Percentage of GDP)



* Preliminary.
** Forecast.

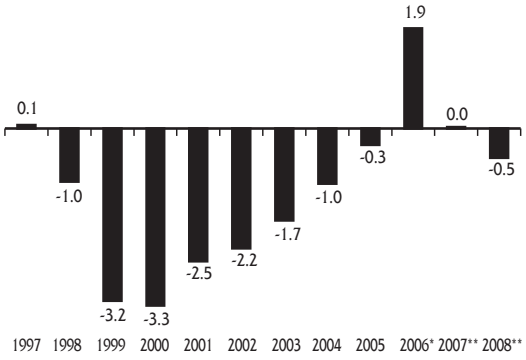
55. To measure the effect that a price reversal might have, the value of the trade balance and the balance of current accounts have been estimated at 2003 prices, as this period saw a 93 percent increase in the prices of exports. The results indicate that the trade balance would be over US$ 7 billion lower between 2006 and 2007, but would still exhibit surplus levels. On the other hand, the current account -adjusted also to 2003 prices of minerals and hydrocarbons- would show negative levels (equivalent to 1.1 and 1.9 percent of GDP in 2006 and 2007 respectively), while the deficit in 2008 would represent 2.2 percent of GDP. These levels of current account deficit at 2003 terms of trade values are moderate and show that the improvement observed in external accounts is partially due to the higher exported volumes. The growth of exported volumes since 2004 is estimated at 35 percent.

V. Public finances

The greater dynamism of economic activity, the high prices of export minerals, and the lower pace of public spending were the factors contributing most heavily to the Non-Financial Public Sector's posting a surplus of 1.9 percent of GDP in 2006. This result is consistent with a fiscal anti-cyclical stance as the structural deficit would have decreased from 1.0 percent in 2005 to 0.3 percent of GDP in 2006.

The forecast scenario for the following years considers a less favorable international context, with terms of trade gradually adjusting downwards. The Treasury is forecast to exhibit a balanced economic result in 2007, while a deficit of 0.5 percent of the product is estimated for 2008. As long as the terms of trade are above their trend level, this fiscal position scenario would imply an additional stimulus of domestic demand in a context of an expansionary economic cycle.

Graph 45
OVERALL BALANCE OF THE NON FINANCIAL PUBLIC SECTOR
(Percentage of GDP)



* Preliminary.
** Forecast.

Overall balance

56. The overall balance of the public sector went from a deficit of 0.3 percent of GDP in 2005 to a surplus of 1.9 percent of GDP in 2006, reflecting mainly the strong increase observed in tax collection, which rose nearly 25 percent in real terms due to higher payment on account of income tax and value-added tax. On the other hand, non-financial expenditure grew at a lower pace than expected.

    This economic outcome is higher than the one forecast in our Inflation Report of September (0.8 percent of GDP), principally due to a better primary result of the rest of the general government (higher by 0.5 points of GDP with respect to September, associated with lower the spending of state enterprises) and to the lower capital expenditures of the central government (lower by 0.3 points of GDP).

    In general, a fiscal anti-cyclical position has the property of stabilizing the fluctuations of the economic cycle, providing more certainty to the evolution of economic activity and to investment decisions. It also allows a better combination of the fiscal and monetary policies, which results in lower interest

rates. In this sense, the increased fiscal savings recorded during the year allowed to increase the deposits of both the central government and subnational governments, thus contributing to indirectly sterilize resources in domestic currency in a context of the Central Bank's intervention in the exchange market to reduce to downward volatility of exchange. Finally, an increased prudential fiscal stance during periods of economic expansion contributes to strengthen public finances and to deal with periods of lower fiscal revenues without having to resort to cut public expenditure abruptly.

57. The forecast on the economic outcome for 2007 has been revised from a deficit of 0.8 percent of GDP to a nil result. This new forecast is based on a an estimation of a lower decrease in terms of trade than the one previously considered and to a lower fiscal cost resulting from postponing the signing-off of the Free Trade Agreement with the United States (FTA).

58. In **2008**, a **fiscal deficit** of 0.5 percent of GDP is foreseen in the Non-Financial Public Sector. This result is mainly explained by a drop of 0.5 points of GDP in public revenues relative to the previous year, due to the decrease of terms of trade and the fiscal cost resulting from the signing off of the FTA, along with a faster pace in spending in public investment.

Table 24

NON-FINANCIAL PUBLIC SECTOR
(Millions of nuevos soles)

	2004	2005	2006*		2007**		2008**
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Jan.07
1. Current revenue	**35,381**	**41,046**	**51,384**	**52,409**	**52,142**	**53,864**	**55,406**
(% of GDP)	*14.9*	*15.7*	*17.2*	*17.2*	*16.4*	*16.7*	*16.2*
Real percentage change	*8.1*	*14.2*	*22.7*	*25.2*	*-0.2*	*2.0*	*0.9*
2. Non-financial expenditure	**-34,165**	**-38,468**	**-44,156**	**-43,320**	**-48,746**	**-48,052**	**-50,925**
(% of GDP)	*-14.4*	*-14.7*	*-14.8*	*-14.2*	*-15.4*	*-14.9*	*-14.9*
Real percentage change	*4.8*	*10.8*	*12.5*	*10.4*	*8.6*	*10.1*	*4.0*
Current	*-29,870*	*-33,577*	*-37,352*	*-37,270*	*-40,303*	*-39,621*	*-41,589*
(% of GDP)	*-12.6*	*-12.8*	*-12.5*	*-12.2*	*-12.7*	*-12.3*	*-12.2*
Real percentage change	*5.3*	*10.6*	*9.0*	*8.8*	*6.1*	*5.5*	*3.0*
Capital	*-4,295*	*-4,891*	*-6,805*	*-6,050*	*-8,443*	*-8,431*	*-9,337*
(% of GDP)	*-1.8*	*-1.9*	*-2.3*	*-2.0*	*-2.7*	*-2.6*	*-2.7*
Real percentage change	*1.5*	*12.1*	*36.3*	*21.3*	*22.0*	*38.3*	*8.7*
3. Others	**1,193**	**1,699**	**1,102**	**2,658**	**575**	**613**	**288**
(% of GDP)	*0.5*	*0.6*	*0.4*	*0.9*	*0.2*	*0.2*	*0.1*
4. Primary balance	**2,409**	**4,277**	**8,330**	**11,747**	**3,971**	**6,425**	**4,769**
(% of GDP)	*1.0*	*1.6*	*2.8*	*3.9*	*1.3*	*2.0*	*1.4*
5. Interests	**-4,867**	**-5,066**	**-5,916**	**-5,814**	**-6,401**	**-6,304**	**-6,430**
(% of GDP)	*-2.0*	*-1.9*	*-2.0*	*-1.9*	*-2.0*	*-2.0*	*-1.9*
6. Overall balance	**-2,458**	**-789**	**2,413**	**5,932**	**-2,430**	**121**	**-1,662**
(% del PBI)	*-1.0*	*-0.3*	*0.8*	*1.9*	*-0.8*	*0.0*	*-0.5*
Mill. US$	*-$ 752*	*-$ 196*	*$ 701*	*$1,781*	*-$ 749*	*$ 38*	*-$ 531*
Current revenues of General Government	17.5	18.3	19.5	19.7	18.7	19.2	18.8
Non-financial expenditure of General Government	16.7	17.0	16.9	16.1	17.6	17.2	17.3

* Preliminary.
** Forecast.

Structural overall balance

59. The conventional measure of fiscal deficit -the difference between non-financial public sector revenues and expenditures- may lead to biased conclusions regarding the impact of fiscal policy on domestic demand and the sustainability of public finances.

    Thus, for example, a reduction of the fiscal deficit is not necessarily and indicator of a contractionary fiscal policy as this indicator may be influenced by several revenue and expenditure entries that respond automatically to changes in the macroeconomic environment. Thus, a higher production level increases tax collection as a result of higher levels of consumption and sales, just as a substantial increase in the international prices of exports may increase taxed profits and the revenues of the public treasury. In none of these cases does a reduction of the deficit resulting from these factors generate necessarily a negative impact on aggregate demand.

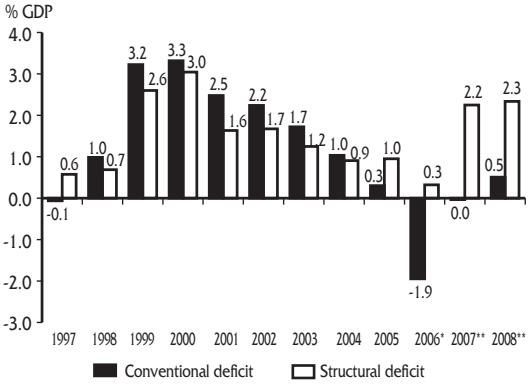
60. In order to isolate the effect of these temporary changes on economic activity or in the international environment in terms of government accounts, the concept of **structural economic outcome** is used. This indicator is the most commonly used indicator by international organizations, such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD).

61. To estimate the structural outcome, the general government revenues are adjusted due to the impact of the economic cycle and the prices of mining exports and hydrocarbons. Under the assumption that they do not respond automatically to the economic environment where the public treasury operates, the expenditure of the general government and the results of state enterprises are not adjusted. Therefore, its changes respond to a public authority decision.

    The economic cycle is estimated as the difference between the observed GDP and the potential GDP. The cycle of mineral prices is estimated as the difference between the price index of export mining products (based on the export basket of products of 2005) and the average of this index between 1987-2006. The cycle of hydrocarbon prices is estimated as the difference between the price of observed WTI oil and the average price in the 1987-2006 period.

    As a result of applying this methodology to data on the operations executed by the Non-Financial Public Sector between 2000 and 2006 and to data on the forecast horizon of 2007-2008, the structural deficit declined from 3.0 percent of GDP in 2000 to 0.3 percent of GDP in 2006.

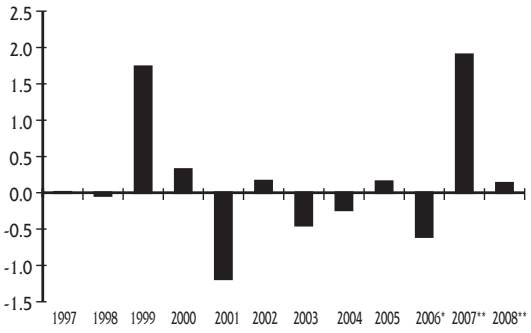
Graph 46
CONVENTIONAL AND STRUCTURAL DEFICIT OF THE NFPS: 1997-2008



* Preliminary.
** Forecast.

Particularly, in 2006, although this implied increasing from a conventional deficit of 0.3 to a surplus of 1.9 percent of GDP, in terms of a structural deficit this implied a reduction of 0.7 percentage points, since a great deal of the deficit reduction was due to a 36 percent increase in the prices of exports that generated a higher tax collection on account of income taxes. In 2007 and 2008, the structural deficit would exceed the conventional measure, thus indicating an expansionary fiscal position in a period of an expansionary cycle of economic activity.

Graph 47
FISCAL IMPULSE: 1997-2008
(Percentage of GDP)

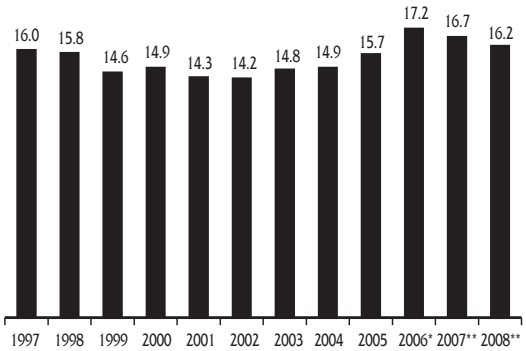


* Preliminary.
** Forecast.

62. To measure the expansionary or contractionary position of fiscal policy, the indicator used is the change observed in the primary structural deficit, measured as the difference between the structural deficit and expenditure on account of interests. The exclusion of interests is aimed at eliminating the effect of previous policy decisions on government's accounts, which is reflected in the balance of the public debt and its corresponding service flows.

This indicator shows that the fiscal policy in 2006 was countercyclical, given that a negative fiscal stimulus was observed in a scenario of high growth in which the GDP gap is positive. According to forecasts, in 2007 and 2008, fiscal policy would be procyclical and would thus boost domestic demand. In this sense, it is worth mentioning that a counter-cyclical fiscal policy allows moderating the contractions of spending in the contractionary stages of the economic cycles, generating lower interest rate and supporting the economy's competitiveness.

Graph 48
CENTRAL GOVERNMENT CURRENT REVENUE
(Percentage of GDP)



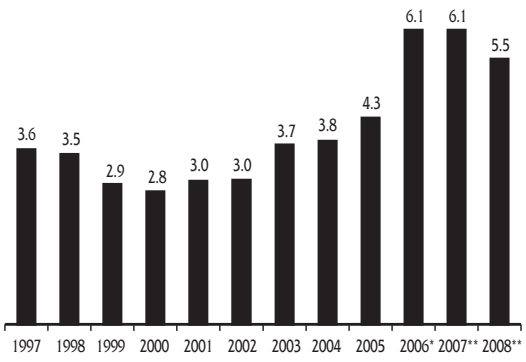
* Preliminary.
** Forecast.

Evolution of fiscal revenue

63. In 2006, the **current revenue** of the Central Government amounted to 17.2 percent of GDP, a level higher by 1.5 points of GDP than the one recorded in 2005. The growth of revenue was basically explained by revenues resulting from income tax -as a result of the higher prices of exports-, by the greater dynamism of economic activity and by higher ratios of down payments for income tax than in the previous year. Other factors contributing to this result included revenue on account of mining (canon) and other royalties transferred to subnational governments. Some tax measures were also adopted during the year that affected revenues for import duties and the excise tax on fuels, which offset revenue by 0.4 percentage points.

Revenue on account of **income tax** amounted to 6.1 percent of GDP, a level higher by 1.8 points of GDP than that of 2005. Revenues from the mining sector were particularly noteworthy -associated with the strong increase in the prices

Graph 49
INCOME TAX
(Percentage of GDP)



* Preliminary.
** Forecast.

of minerals-, as were also those in the hydrocarbon, telephone, and financial sectors. Moreover, some extraordinary revenues (equivalent to 0.2 percent of GDP) were also recorded, such as extraordinary revenues resulting from a sale of shares of a company that generated a capital gain. Other extraordinary revenues included some regularization of taxes for previous years.

Since an important part of the increase observed in revenues on account of income tax in 2006 (1.8 points of GDP) was associated with the higher prices of minerals, it is important to take into account that a strong reversal in these prices could translate into a significant deterioration of fiscal results. This highlights the importance of maintaining a prudential fiscal policy and of saving the increased fiscal revenues that have a transitory nature in order to be able to use them in periods of low prices for our export products.

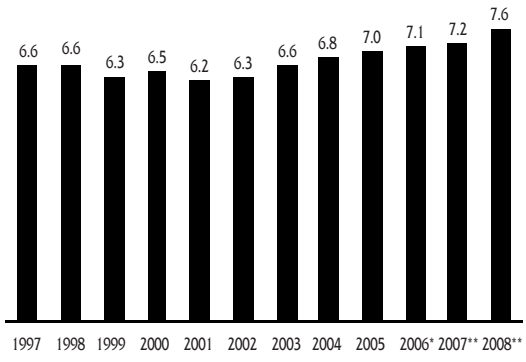
Table 25

COLLECTION OF INCOME TAX, BY SECTORS
(Millions of nuevos soles)

	2005	2006	Real % change 2006/2005
Mining	2,168	5,767	160
Hydrocarbon	413	970	130
Financial system	372	814	114
Manufacturing	1,110	1,597	41
Telecommunications	559	717	26
Others	2,601	3,234	22
Total	**7,223**	**13,100**	**78**

Source: SUNAT.

Graph 50
VALUE ADDED TAX
(Percentage of GDP)

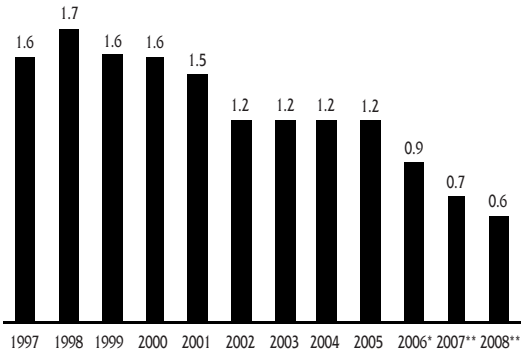


* Preliminary.
** Forecast.

Revenue on account on value-added tax amounted to 7.1 percent of GDP, increasing by 0.1 points of GDP with respect to their level in 2005, mainly as a result of the dynamism of domestic demand. During 2006, the excise tax (ISC) on fuels was reduced on three opportunities, thus generating that revenue on account of the excise tax decreased by 0.2 points of GDP. These reductions were aimed at offsetting the impact of oil price increase in international markets.

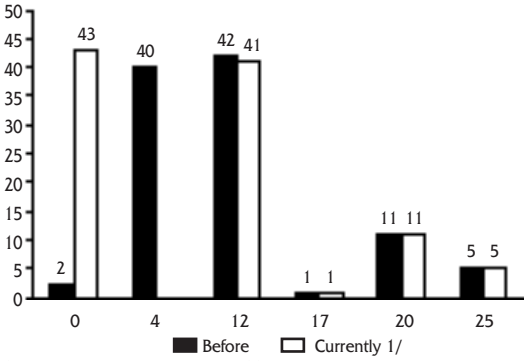
64. In 2007, Central Government's **current revenues** are expected to decrease to 16.7 percent of GDP, that is, to a level 0.5 points of GDP lower than that of 2006. This lower revenue considers the impact of reducing tariffs on capital goods, a measure in force since the beginning of this year that reduces tariffs on 2,894 items and which would have an effect equivalent to 0.2

Graph 51
IMPORT TAX REVENUE
(Percentage of GDP)



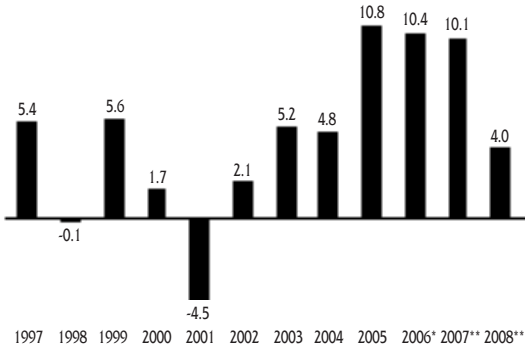
* Preliminary.
** Forecast.

Graph 52
DISTRIBUTION OF ITEMS ACCORDING TO TARIFF LEVEL
(In percentage)



1/ After enactment of S.D. No. 211-2006-EF
Source: Aduanas and BCRP.

Graph 53
NON FINANCIAL EXPENDITURE OF THE CENTRAL GOVERNMENT
(Real percentage change)



* Preliminary.
** Forecast.

percent of GDP. The impact of the three cuts on the excise tax on fuels implemented last year is also considered and would be equivalent to 01 percent of GDP, should no further changes be made. Furthermore, the product is estimated to fall by 0.2 points, given that there were extraordinary revenues last year.

Moreover, the lower prices of metals and oil this year are also estimated to be reflected in decreased revenues on account of income tax, mining royalty and other royalties, although this is expected to be offset by a higher ratio of down payments and regularization of income tax. Preliminary estimates of revenue on account of the regularization of income tax payments during 2007 point to a range between S/. 4.0 and S/. 4.5 billion.

Current revenues of the Central Government are expected to drop by 0.5 points of GDP in 2008. This reduction would mainly be observed in income tax, due to the fact that the higher payment ratios to be applied in 2007 would determine that down payments be considered a high proportion of the income generated in the same year and, therefore, projected regularization in 2008 would be lower than the one observed in 2007. This would take place in a context where terms of trade would have been gradually reversing since 2007.

65. The tariff relief measures approved in December 2006 established zero tariffs for 2,894 tariff items, reduced the average simple tariff from 10.05 percent to 8.28 percent and increased tariff dispersion from a standard deviation of 7.5 to 9.5 percent. Particularly, all tariff items that were subject to a tariff rate of 4 percent now have a zero tariff.

Tariff relief includes capital goods and raw materials, which represented 40 percent of imports in 2006 and whose import has significantly grown over the past few years. As a result of this measure, the average weighted tariff on imports decreased from 7.1 to 5.3 percent between November and December of 2006[6].

Evolution of fiscal expenditure

66. In 2006, the **non-financial expenditure** of the Central Government increased 10.4 percent in real terms, decreasing by 0.4 percent with respect to 2005. Current expenditure grew 8.8 percent in real terms, a 1.8 percentage points lower growth than that of 2005, while capital spending increased

6 The structure of imports in the January-November 2006 period was used to calculate this estimate. This calculation does not include the impact of trade agreements or treaties on tariffs.

by 21.3 percent in real terms, increasing by 9.2 percentage points with respect to the previous year. The latter was boosted by a shock of public investment and by capital transfers to Agrobanco and the Fondo Consolidado de Reserva.

In 2066, the non-financial public sector was exempted from compliance with the fiscal rule applied to growth of the General Government's non-financial expenditure (real growth not exceeding 3 percent on the basis of the GDP deflator). This rule has been modified for 2007 so that "the real annual increase of Central Government's current expenditure, once maintenance expenditure is deducted, shall not by higher than a real 3.0 percent increase, which is determined using the average Consumer Price Index for Metropolitan Lima".

Central Government's **non-financial expenditure** in **2007** is expected to increase by 10.1 percent in real terms with respect to 2006, boosted mainly by public investment. Capital spending is estimated to grow by 38.3 percent in real terms.

Financial requirements

67. The economic surplus of 2006 allowed the treasury to accumulate deposits in the financial system. This situation would revert in the period of 2007-2008 as the treasury would used its savings to meet its financial requirements.

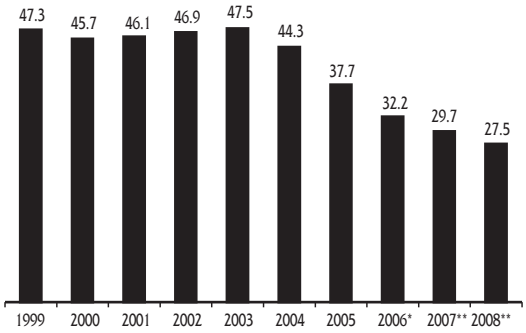
Table 26

FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR
(Millions of US$)

	2004	2005	2006*		2007**		2008**
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	IR Jan.07
I. Uses	**2,820**	**4,656**	**1,858**	**,856**	**2,212**	**1,493**	**2,728**
1. Amortization	2,068	4,460	2,559	2,637	1,463	1,531	2,197
a. External	1,348	3,678	1,205	1,197	1,174	1,174	1,673
b. Internal	720	783	1,354	1,440	289	357	523
Of which: Pension Bonds	215	192	154	244	80	81	94
2. Overall balance (negative sign indicates surplus	752	196	- 701	-1,781	749	- 38	531
)							
II. Sources	**2,820**	**4,656**	**1,858**	**856**	**2,212**	**1,493**	**2,728**
1. External	1,205	1,046	770	635	1,077	1,034	1,046
2. Internal 1/	-446	- 168	- 566	-1,520	363	- 240	782
3. Bonds 2/	2,061	3,778	1,654	1,741	772	700	900

IR: Inflation Report.
* Preliminary.
** Forecast.
1/ Positive sign indicates overdraft and negative sign indicates greater deposits. The impact of exchanging the maturity of Treasury bonds for longer maturity terms in the second quarter of 2006 has been isolated.

Graph 54
PUBLIC DEBT
(Percentage of GDP)



* Preliminary.
** Forecast.

68. In this context, if debt repayment operations were made under market mechanisms, these could contribute to improve the profile of the debt service and translate into lower financial requirements for the 2010-2015 period. In addition to contributing to extend the debt maturity term, an early repayment of the debt would allow a recomposition of the public debt portfolio into domestic currency-denominated debt, which would also reduce exposure to other currencies, thus reducing exchange risks due to exchange fluctuations. Consequently, investors' perception of country risk would decline and this would contribute to improve the rating assigned to sovereign debt by risk rating agencies.

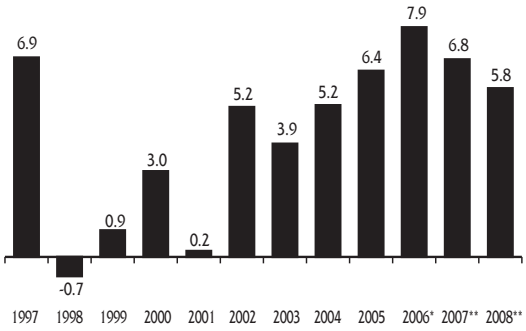
69. This fiscal scenario, in a context of dynamic performance of economic activity and high levels of terms of trade, would allow reducing public debt as a percentage of GDP from 32 percent in 2006 to 27 percent by 2008.

VI. Economic activity

Economic activity is estimated to have grown 7.9 percent in 2006, posting the highest rate in the past 10 years, boosted by an overall increase of all components of domestic demand. This dynamic performance of economic activity has taken place in a favorable international environment, with low inflation rates, favorable conditions for accessing financing, and improved productivity in several sectors, which, in turn, is reflected by the high levels of consumer confidence, a more optimistic business outlook, and a sustained growth of employment in the major cities in the country.

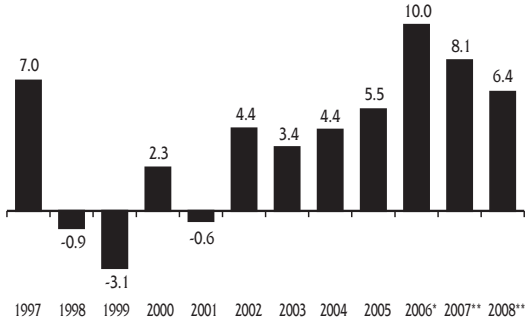
Given both this greater economic dynamism and investment projections, the forecast on growth has been revised upwards from a range of 5.5-6.0 percent to a range of 6.5-7.0 percent for 2007, while a growth rate between 5.5 and 6.0 percent is expected for 2008. In this way, an economic growth closer to projected rates of growth of potential GDP (nearly 6 percent) is forecast in this period.

Graph 55
GDP GROWTH
(Real percentage change)



* Preliminary.
** Forecast.

Graph 56
DOMESTIC DEMAND GROWTH
(Real percentage change)

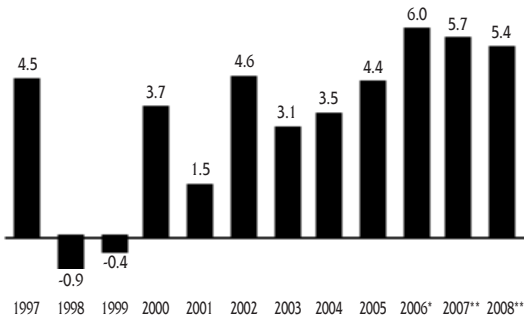


* Preliminary.
** Forecast.

70. The growth observed during 2005 - 2006 has been characterized by a significant increase of domestic spending. The high growth rates of private consumption and investment indicate that the economy is undergoing a phase of expansion, with a pace of growth that is above the trend. As pointed out in our Inflation Report of August 2003, five expansion stages have occurred since the mid-sixties, all of which were characterized by rates of growth of nearly 5 percent for private consumption and 15 percent for private investment.

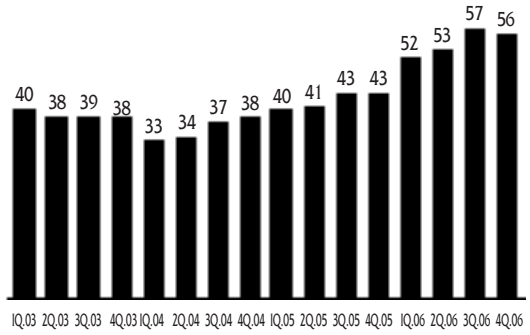
71. Forecasts on the growth of GDP for 2007 have been revised upwards, estimating a growth in the range of 6.5-7.0 percent instead of a growth of 5.5-6.0 percent as previously forecast. Particularly, the growth of domestic demand has been revised upwards from 6.4 to 8.1 percent in 2007. A growth in line with the dynamic of the potential product, in the range of 5.5 - 6.0 percent, is forecast for 2008.

Graph 57
PRIVATE CONSUMPTION GROWTH RATE
(Real percentage change)



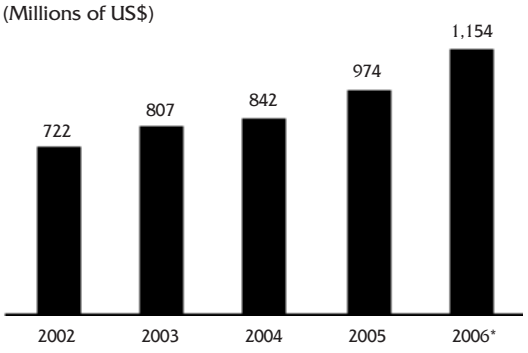
* Preliminary.
** Forecast.

Graph 58
CONSUMER CONFIDENCE INDEX: INDICCA



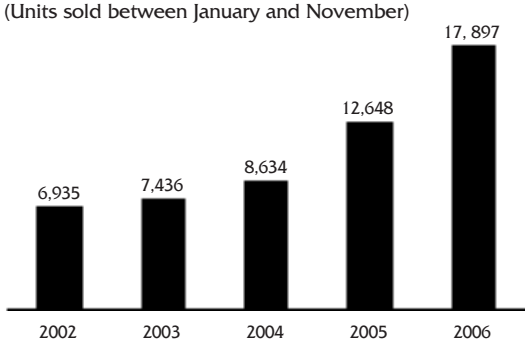
Source: Apoyo.

Graph 59
IMPORTS OF DURABLE GOODS
(Millions of US$)



* Preliminary.

Graph 60
SALES OF FAMILY CARS
(Units sold between January and November)



Source: Araper.

Table 27

GLOBAL DEMAND AND SUPPLY
(Real percentage changes)

	2004	2005	2006*		2007*		2008*
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	
1. Domestic demand	**4.4**	**5.5**	**9.3**	**10.0**	**6.4**	**8.1**	**6.4**
a. Private consumption	3.5	4.4	5.4	6.0	4.6	5.7	5.4
b. Public consumption	4.1	9.8	8.3	8.8	8.3	8.8	4.9
c. Private investment	9.1	13.9	19.4	19.9	12.0	16.3	12.2
d. Public investment	5.7	12.2	29.9	14.6	21.1	34.7	8.6
2. Exports	14.7	14.9	1.0	1.6	6.8	6.8	7.2
3. GDP	**5.2**	**6.4**	**6.6**	**7.9**	**5.7**	**6.8**	**5.8**
4. Imports	10.6	10.6	14.0	11.8	10.0	13.3	9.9

IR: Inflation Report.
* Forecast.

72. Private consumption is estimated to have grown at a rate of 6.0 percent in 2006, exhibiting an increasing tendency throughout the year that posted 5.4 percent in the first half of the year and rose to 6.6 percent in the second half of 2006 in a context marked by high consumers' confidence in the whole year and a high dynamic performance of consumer loans. This faster pace of growth of private consumption would be associated with a 11.2 percent growth of the disposable national income in 2006, which also considers an increased return on production factors as a result of greater economic activity and higher employment levels, better terms of trade, and transfers as a result of remittances.

73. Disposable national income, estimated to have grown 11.2 percent in 2006 due to improved terms of trade, is expected to show a more moderate growth in the next years. Considering this slow down, private consumption would increase by 5.7 percent in 2007 and by 5.4 percent in 2008.

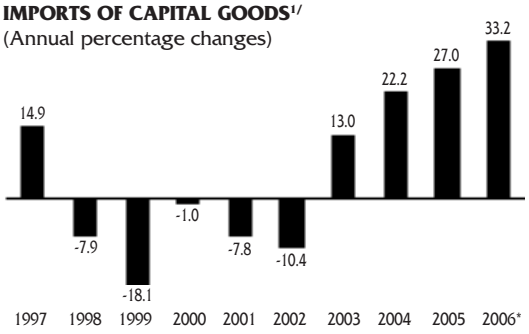
Table 28

NATIONAL DISPOSABLE INCOME
(Real percentage changes)

	2004	2005	2006*		2007*		2008*
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	
Gross domestic product	5.2	6.4	6.6	7.9	5.7	6.8	5.8
National disposable income[1/]	5.4	6.5	8.6	11.2	5.1	6.9	5.5

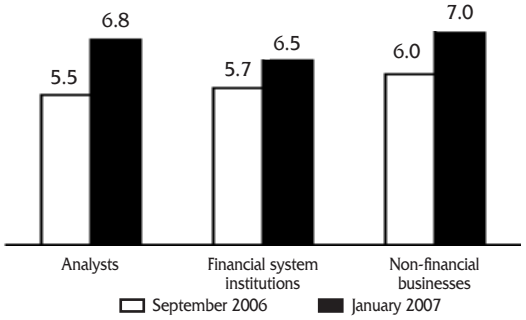
IR: Inflation Report.
* Forecast.
1/ Includes investment income, gains and losses due to changes in terms of trade and net transfers from non-residents.

Graph 61
IMPORTS OF CAPITAL GOODS[1/]
(Annual percentage changes)

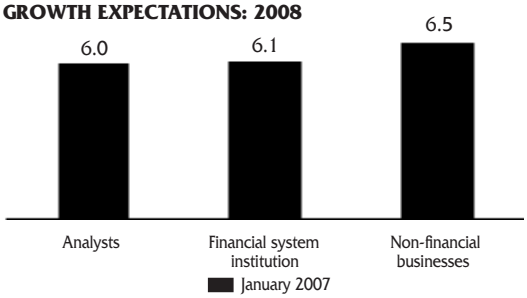


* Preliminary.
1/ Construction materials are not included.

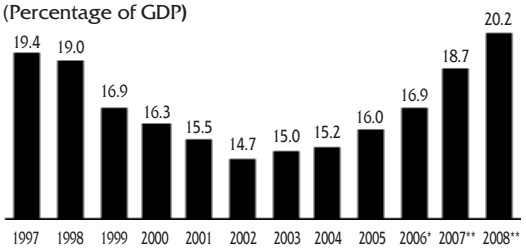
Graph 62
GROWTH EXPECTATIONS: 2007



GROWTH EXPECTATIONS: 2008

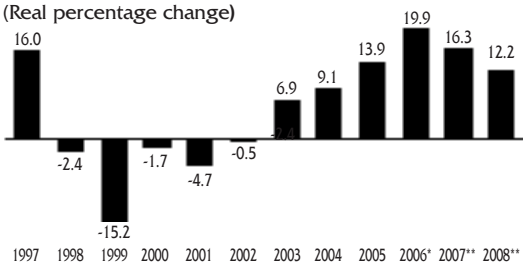


Graph 63
PRIVATE FIXED INVESTMENT
(Percentage of GDP)



* Preliminary.
** Forecast.

Graph 64
PRIVATE FIXED INVESTMENT
(Real percentage change)



* Preliminary.
** Forecast.

74. An important component explaining the higher pace of GDP growth estimated for the following years is the level of investment. Responding to increased demand, firms continued to expand their facilities in sectors such as manufacturing, energy, commerce and mining, as a result of which private investment would have grown 19.9 percent. This was reflected in the 33.2 percent increase in imports of capital goods that was posted in the year.

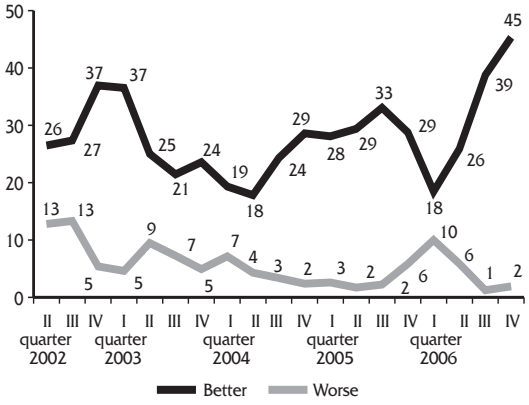
75. The forecast also considers that the Trade Promotion Agreement (FTA) between Peru and the United States will be ratified by the US Congress and that this agreement will replace the extension of the ATPDEA, which will continue to be in force during the first half of 2007. As mentioned in our Inflation Report of September, the impact of this trade agreement will not only provide greater access for Peruvian products to the US market but will also contribute to increase productivity and technological transfer.

76. Most entrepreneurs in the country feel that the business environment is favorable and in line with observed growth, and because of prospects of increased access to international markets, are planning on expanding the capacity of their businesses. Considering both this favorable domestic context and the correction of terms of trade, a 16.3 percent increase is forecast in terms of private investment.

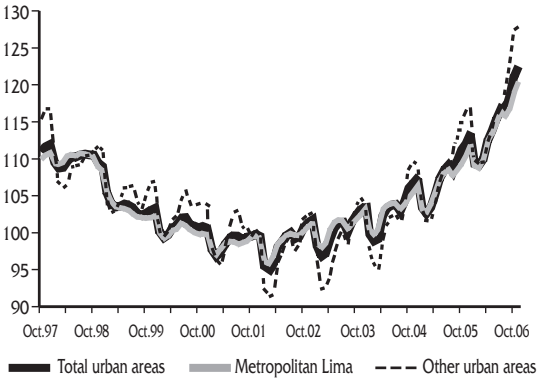
77. Main investments in the private sector would be associated with enhancing the capacity of manufacturing companies, as well as with infrastructure, energy and telecommunications projects, coupled by the construction of new facilities for retail commerce and tourism activities, mainly in cities other than Lima. Investments in mining companies are also considered, including Yanacocha, which is building a sulfide treatment plant; Southern Copper Corporation, which is investing in the Ilo smelter; and the second stage of Camisea, a project oriented at exporting natural gas derivatives.

Private investment in **2008** is forecast to grow 12.2 percent, particularly as a result of the development of projects in the sector of mining and hydrocarbons, the second stage of Camisea, the construction of installations at Lot 67 for the extraction of crude, several projects aimed at producing ethanol, and some projects oriented to constructing petrochemical plants. Several entrepreneurial groups have announced investment projects, including the Ajegroup, Grupo Gloria and Grupo Brescia in Cañete, Petrolex in Quillabamba and Petrobras in Matarani. These projects would contribute to the dynamism of house construction and the expansion of small commerce shops observed throughout the country.

Graph 65
ECONOMIC SITUATION IN THE NEXT 3 MONTHS
Quarter average (in percentage)



Graph 66
URBAN EMPLOYMENT IN COMPANIES WITH 10 OR MORE WORKERS
(Index January 2000=100)



Source: Ministry of Labor.

78. According to the BCRP's Monthly Survey on Macroeconomic Expectations, in the fourth quarter of 2006, 45 percent of non-financial firms forecast an improvement of the Peruvian economy in the first quarter of 2007, while only 2 percent anticipated a worsening of the economic situation.

79. In addition to the positive evolution of capital, the **labor** component has also shown a growing tendency since 2002. Employment has grown at a faster pace in firms with ten or more workers (4.5 and 7.2 percent in 2005 and 2006 respectively). On average, these companies have a higher productivity than smaller enterprises, which would also support the 3 percent increase in productivity estimated for the last 2 years (one of the highest historical increased estimated). Maintaining these high rates of growth of productivity in the future will depend on the efficiency of the new investments to be made, on counting on an increased supply of skilled labor and on the flexibility of factor markets. Since 2005, the levels of labor engaged in firms of 10 or more workers have recovered the levels observed in 1997.

During the second half of November 2006, the Central Bank carried out its survey among 270 firms of diverse sectors in 14 regions of the country. According to this survey, 16 percent of entrepreneurs perceive difficulties in finding skilled labor. In the agricultural sector, 29 percent perceive that these difficulties concentrate in areas such as the management of organic crops, the production of dairy products and technified irrigation, as is the case in Cajamarca and La Libertad. In manufacturing, some 22 percent perceive difficulties in terms of the availability of skilled labor, which could reflect an obstacle for the growth of this sector. Furthermore, 74 percent of entrepreneurs considered that their labor costs are similar.

BOX 4
INVESTMENT IN 2007-2011

The most important studies on economic growth[7] point to a direct relationship between investment and growth rates. Thus, high economic growth with low inflation rates will be sustainable provided that investment grows as required so as to simultaneously increase the potential GDP. According to recent public information, the investment projects to be implemented in the following five years (2007-2011) would amount to over US$ 21 billion dollars.

The major investment projects identified in the last years represent nearly 20 percent of total investment. Additionally, although involving smaller amounts but a larger number of projects, other investments projects are being implemented in these and other economic sectors, including agriculture, industry, construction, and services as a result of the incentives provided by the domestic market and the international context.

7 See, for example, "Determinants of economic growth: a cross country empirical study" by Robert Barro (NBER 1996, WP 5698) or "I just run four million regressions" by Xavier Sala-i-Martin (Columbia University and Universitat Pompeu Fabra 1997).

MAIN INVESTMENT PROJECTS BY ECONOMIC SECTOR

Productive sector	Investment 1/ Millions of US$
Mining	9,902
Hydrocarbons	3,150
Industry	2,820
Energy	2,574
Commerce and services	1,685
Infrastructure	1,318
TOTAL	**21,449**

1/ Estimated on the basis of announced investment.

The major investments to be made in the next five years will be implemented in the mining sector and have been announced to amount to nearly US$ 10 billion (46 percent of total investment). This dynamism in the mining sector will be coupled by investment projects in other sectors, including the hydrocarbon sector (15 percent), industry (13 percent), energy (12 percent), commerce (8 percent) and infrastructure (6 percent), all of which are estimated to total over US$ 11 billion.

MAIN MINING AND FUEL PROJECTS

Projects	Operator in Peru	Investment (millions of US$)	Actual state
Mining		**9,849**	
Las Bambas	Xtrata Peru	1,500	Exploration
Toromocho	Peru Copper	1,500	Feasibility study
Minas Conga	Minas Conga SRL.	1,100	Environmental impact
Rio Blanco	Minera Majaz	1,000	Feasibility study
Quellaveco	Cia. Minera Quellaveco	1,000	Feasibility study
La Granja	Rio Tinto Minera Perú	700	Exploration
Michiquillay	To privatize	700	To privatize
Yanacocha	Newmont-Buenaventura	677	In execution
Cerro Verde	Soc. Minera Cerro Verde	560	In operation
Fundicion de Ilo y Tantahuatay	Southern Copper Corporation (SPCC)	435	In execution
Los Chancas	SPCC	300	Prefeasibility study
Cerro Corona	Minera Gold Fields	227	Construction
Tia Maria	SPCC	150	Exploration
Hidrocarburos		**3,150**	
Camisea II	Peru LNG	2,150	Construction
Lote 67	Barret Resources Peru	1,000	Feasibility study

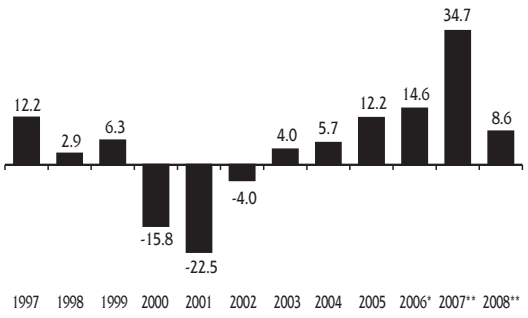
In order to guarantee the continuity of investment and of its positive impact on economic activity, the expansion of aggregated supply should not be hindered. The main component that may facilitate such an expansion is an efficient supply of electricity. Investment plans in the energy sector today amount to over US$ 2,500 million and will allow to cover the increase of demand in the following 5 years.

MAIN POWER GENERATION AND TRANSMISSION PROJECTS

Projects	Operator
Generation	
Central Térmica Chilca II (174 MW)	Enersur
Turbogas Kallpa I. II y III (504 MW)	Globeleq
Turbogas Tumbes (170 MW)	BTZ Energy
Central Hidroeléctrica El Platanal (220 MW)	Cementos Lima
C.H. Santa Rita (173 MW)	Electricidad Andina
Transmission	
Reforzamiento línea Chilca-San Juan (220 kV)	REP
Línea de transmisión Zapallal-Paramonga-Nueva Chimbote (220 kV)	REP

REP: Red Eléctrica del Perú.

Graph 67
PUBLIC INVESTMENT
(Real percentage change)



* Preliminary.
** Forecast.

80. The public expenditure component assumes a nil result in fiscal accounts in 2007 and a deficit of 0.5 percent in 2008. Considering these factors, the forecast scenario assumes that public investment would show a greater dynamism in the first half of this year, associated with the execution of expenditure not spent during 2006. In 2008, public investment would grow 8.6 percent. On the other hand, public consumption, estimated to have grown 8.8 percent in 2006, would increase 8.8 percent in 2007, declining to 4.9 percent in 2008.

Sector production

81. In **2006**, the most dynamic sectors were the non-primary sectors, which posted a rate of 9.1 percent, the highest rate since 1994, especially because of the growth of non-primary manufacturing (7.7 percent) and construction (14.9 percent). A faster pace of growth was observed in both cases in the second half of the year, but particularly in the case of non-primary manufacturing.

82. This sector increased from a rate of 5.6 percent in the first 6 months to 9.7 percent in the second half of the year, mainly due to the increased dynamism shown by products associated with private consumption, such as food products, beverages and tobacco, and the production of inputs such as paper and printing products, and chemicals, rubber and plastics. Construction, on the other hand, was propelled by the dynamism of home self-construction, mining projects such as Cerro Verde in Arequipa, and the enhancement of Southern Copper Corporation's smelter plant in Ilo, the expansion of the mortgage market, the construction of housing projects, mainly in the Northern Coast, and the implementation of civil works by local governments.

On the other hand, the primary sectors are estimated to have grown 3.7 percent in 2006, particularly due to the agricultural sector which increased 7.2 percent. A factor contributing to this rate was good climatic conditions, which allowed to increase sown areas with crops such as potato, sugar cane, hard yellow maize and coffee. A considerable increase in production was also observed in the second half of the year due to gaps in the sowing season in the North Coast, as in the case of cotton in Piura. Furthermore, the hydrocarbon sector would have increased 5.7 percent due to the higher production of natural gas. Conversely, little dynamism was observed in the sector of metal mining given that no new project initiated operations during this period and that Yanacocha reduced its gold production.

Table 29

GROSS DOMESTIC PRODUCT
(Percentage changes)

	2004	2005	2006*		2007*		2008*
			IR Sep.06	IR Jan.07	IR Sep.06	IR Jan.07	
Agriculture and livestock	**1.7**	**4.8**	**3.6**	**7.2**	**4.0**	**4.0**	**3.5**
Agriculture	-3.2	4.0	2.5	7.7	3.7	3.7	3.2
Livestock	2.0	6.6	5.1	6.6	4.6	4.6	3.9
Fishing	**33.9**	**1.2**	**-0.7**	**2.7**	**4.2**	**4.3**	**3.8**
Mining and fuel	**5.2**	**8.1**	**1.2**	**0.9**	**5.6**	**3.3**	**5.1**
Metallic mining	5.2	7.4	1.1	0.3	5.6	3.1	5.0
Natural gas and oil	7.1	23.4	2.9	5.7	5.6	5.6	6.1
Manufacturing	**7.4**	**6.5**	**5.6**	**6.4**	**5.6**	**6.5**	**6.2**
Based on raw materials	7.3	2.1	1.9	1.0	2.5	2.6	3.9
Non-primary industries	7.4	7.7	6.6	7.7	6.4	7.6	6.8
Electricity and water	**4.6**	**5.3**	**5.7**	**6.8**	**5.0**	**6.8**	**5.5**
Construction	**4.7**	**8.4**	**12.6**	**14.9**	**9.0**	**11.5**	**10.2**
Commerce	**5.8**	**5.2**	**9.1**	**10.7**	**6.1**	**7.9**	**6.2**
Other services	**4.4**	**6.3**	**7.3**	**8.2**	**5.7**	**7.4**	**5.8**
GLOBAL GDP	**5.2**	**6.4**	**6.6**	**7.9**	**5.7**	**6.8**	**5.8**
Primary	4.6	5.4	2.3	3.7	4.3	3.5	4.1
Non primary	5.2	6.5	7.8	9.1	6.1	7.8	6.4

IR: Inflation Report.
* Forecast.

83. Growth in **2007** would continue to be led by **non-primary sectors** which would maintain an important dynamism (7.8 percent), although posting a lower growth rate than in 2006, consistent with the anticipated evolution of domestic demand.

Considering also the expected evolution in terms of household consumption, the prospects for increased access of our products to external markets, and tariff reduction for raw materials in 2007, non-primary manufacturing is expected to grow 7.6 percent. As a result, this sector would be posting rates higher than 7 percent for four consecutive years.

An increase of 11.5 percent is forecast for the construction sector, considering the growth of residential construction both as a result of home self-construction projects -in line with the growth of employment and incomes in the country- and as a result of the housing programs Mivivienda and Techo Propio, addressed at lower-income segments In addition, it is worth mentioning some road infrastructure projects, such as Trasvase Olmos, IIRSA Norte and IIRSA Sur, as well as the continuation of the State's concession programs.

BOX 5

METAL MINING PRODUCTION

Metal mining production in 2006 is expected to post similar levels to those of 2005. Except for the Alto Chicama Project (which started operations in June 2005), there have been no new projects between June and October 2005) as most of the major projects are currently in the stage of investment or exploration.

The evolution of the production of gold and copper is analyzed here since these metals account approximately for 50 percent of the output in the metal mining sub-sector. As shown in the table below, the mining company Yanacocha increased its production of gold in 2005 and programmed a lower production for 2006.

GROWTH OF MINING AND NEW GOLD AND COPPER PROJECTS
(Percentage changes)

Years	Mining sector	Metallic mining	Gold	Copper	New projects
1993	10.2	10.9	25.1	-0.5	August 1993: Onset of Yanacocha (Yacimiento Carachugo)
1994	12.0	15.2	57.2	2.2	Yanacocha: Maqui Maqui mine
1995	4.2	7.2	18.3	8.0	
1996	5.1	6.8	11.6	5.0	Yanacocha: San José mine
1997	9.0	10.8	20.7	3.0	Yanacocha: Cerro Yanacocha mine
1998	3.7	4.3	19.9	-6.0	Barrick: Pierina mine at the end of year
1999	13.1	15.9	36.9	11.7	
2000	2.4	3.4	2.4	1.9	
2001	9.9	11.1	4.1	35.0	October 2001: Antamina. Yanacocha (Yacimiento La Quinua)
2002	12.0	13.0	13.9	16.0	
2003	5.4	6.2	9.7	-2.2	
2004	5.2	5.2	0.4	29.0	Southern: Expansion of Toquepala. Restart of BHP Billiton
2005	8.1	7.4	20.0	-2.8	June 2005: Barrick. Alto Chicama mine
2006[1/]	0.9	0.3	-2.3	3.6	

1/ Preliminary.

Consequently, the lower growth of mining production in 2006 would be mainly explained by the lower contribution of Yanacocha, which reduced its production by 20.0 percent with respect to the previous year. This reduction was partly caused by Yanacocha's decision to cancel the expansion of operations to Cerro Quilish due to social problems with the community. Other factors contributing to this reduction included the exhaustion of the areas richly endowed with oxide ores and the high content of sulfides in the areas currently being exploited by the mining company. The high content of sulfides has delayed production as Yanacocha will have to wait until the construction of a treatment plant is completed around mid-2007 to solve this problem. The mining company expects to implement two new projects at La Zanja and Tantahuatay in 2008, should no further conflicts arise.

Metal mining production is estimated to grow by 3.1 percent in 2007. However, the higher production of copper -an additional 180 thousand tons representing a 25 percent increase in the national production of this metal- would be partially offset by a lower production of gold given Yanacocha's announcement that total extraction of gold this year will only amount to 1.6 million ounces.

84. As regards **primary sectors**, a slow down in the agricultural sector relative to 2006 is forecast. This slow down is associated with the high comparison base and with the current development of the crop year, which has been showing a 2.3 percent reduction of sown areas in the August-November period, mainly in the case of crops such as rice and hard yellow maize, although offset by increased sown areas of potato. However, in contrast with the previous crop year, the levels of water stored in reservoirs this year exceed requirements. It is worth pointing out here that the Comité Multisectorial del

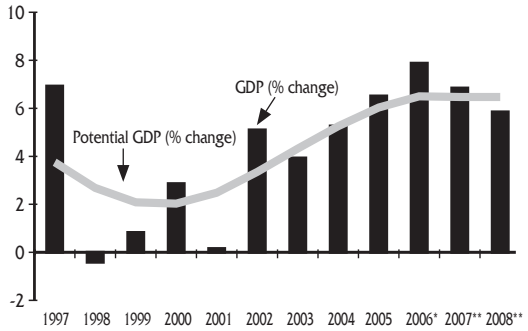
Estudio Nacional del Fenómeno del Niño (ENFEN) reported on January 8, 2007 that temperatures along the Peruvian Coast in the next three months will range from slightly warm to normal. On the other hand, a recovery of fisheries relative to last year is forecast considering that the impact of El Niño on anchovy would be limited. This resource has been recovering after it decreased last year due to a mismatch in the spawn period.

The mining and hydrocarbon sector would grow 3.3 percent, particularly as a result of the onset of operations at the enhanced plant of Cerro Verde in Arequipa, which will increase annual copper production by 200 thousand tons when it reaches full capacity (in the second half of this year), and the onset of the zinc project at Cerro Lindo, in Ica, in the second quarter. The onset of operations of these projects would offset the decline in gold production programmed by Yanacocha (from 2.6 million ounces in 2006 to 1.6 million ounces in 2007).

85. In **2008**, non-primary sectors are expected to moderate growth to a rate of 6.4 percent. Non-primary manufacturing would grow 6.8 percent, while construction would maintain a high rate (10.2 percent), considering the expected private investment evolution.

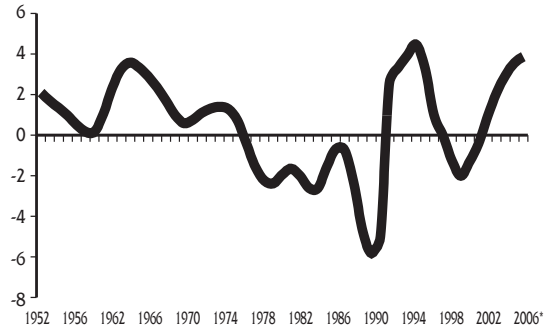
As regards primary sectors, mining and fuels would grow at a rate of 5.1 percent, considering full capacity production of Cerro Verde's enhanced plant during all the year. In the case of the agricultural and fishing sectors, the central forecast scenario considers normal climatic conditions.

Graph 68
GDP AND POTENTIAL GDP GROWTH
(Real percentage change)



* Preliminary.
** Forecast.

Graph 69
TOTAL FACTORS PRODUCTIVITY
(Percentage points of contribution to the growth of the GDP)



* Preliminary.

Potential GDP

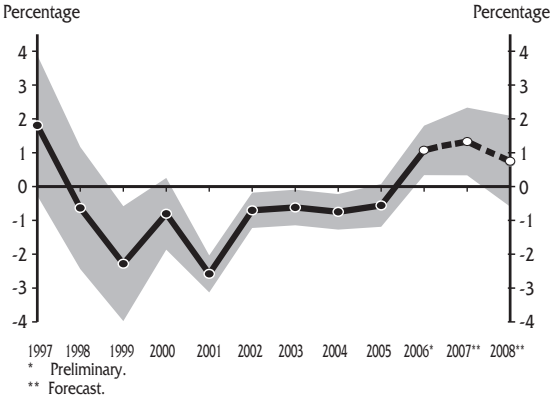
86. Potential GDP is defined as the output level that would generate no inflationary pressures. This definitions is associated with GDP's trend of growth, that is, growth not resulting from transitory and/or transitional factors. The Central Bank currently uses three methods to calculate the potential GDP: 1) Linear filters, such as the Hodrick-Prescott filter; 2) the production function method, based on a specification of the production function with the intervention of capital, labor and the productivity of these productive factors; and 3) a method based on a model that identifies the gap between the output and its potential level on the basis of the evolution of inflationary pressures (Kalman filter). The current estimate of the growth of potential GDP is 6 percent, a rate that includes the contribution of increased productivity observed in the economy lately, which is estimated at nearly 3 percentage points of growth of potential GDP. Determinants of the dynamism of productivity

of productive factors include the process of renovation and expansion of machinery and equipment, the increase of formal activity, access to new markets (such as markets for exports) and, in general, the establishment of favorable environment for business.

87. The Inflation Report of September 2006 discussed the indicator called the output gap, measured by relating the level of GDP with its potential level. A positive gap would indicate a boom, while a negative indicates a recession. This indicator is important to define macroeconomic policy positions as these policies should seek a balance between expansionary stages and recessions. In the case of monetary policy, this is one of the possible indicators of the presence of excess demand.

Measures of the output gap are subject to uncertainty regarding the parameters used to estimate it, which is reflected in a range of reliability. As shown in the graph below, the annual average output gap in 2006 was in the range of 0.5 and 1.5 percent.

Graph 70
OUTPUT GAP



* Preliminary.
** Forecast.

The shaded area indicates uncertainty in the calculation and forecast of the output gap.

88. The Unit Labor Cost (ULC), defined as the ratio between salary (wages and salaries) and productivity, is an indicator reflecting inflationary pressures on the side of the labor market given that they capture the impact of salary increases above productivity. In this sense, a ULC index has been developed based on information provided by the Ministry of Labor on employment and salary (wages and salary) for Metropolitan Lima, and the value of non-primary production (excluding government and public utilities).

Results show that the ULC has been declining since the last quarters of 2004. However, although still negative, a reversal of the trend has been observed since the second quarter of 2006.

Table 30

UNIT LABOR COST
Metropolitan Lima (% change)

	ULC	Wages and salaries	Workers' productivity
1998-2000	1.0	3.8	2.7
2001-2005	-1.1	3.0	4.1
2006	-1.9	0.6	2.5

The table above breaks down the ULC into two components: the "salary" effect and the "productivity" effect. As we can see, the growth of productivity is higher than the growth of salaries (wages and salaries), and therefore the ULC decreases.

This indicator refers only to workers in the formal sector. In sectors where no much skill is required, there is a large labor supply that prevents wages and salaries from increasing more. Therefore, salary increases would be taking place in sectors where much more specialization is required (electricity, gas and water-related activities).

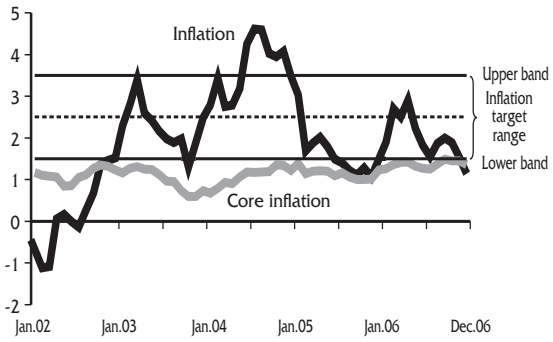
VII. Inflation

In 2006, inflation posted a rate of 1.1 percent -a lower level than the one recorded in 2005 (1.5 percent)-, mainly due to the correction in the prices of food products after the price increase observed in 2005, the drop in the prices of gasoline and kerosene, and the reduction of electricity rates. Core inflation was 1.4 percent in 2006, a rate slightly higher than those of 2004 and 2005 (1.2 percent in each case).

Two different periods were observed in the evolution of inflation in 2006: the first, between January and April, when accumulated inflation was 2.0 percent; and the second, between May and December, when inflation was -0.9 percent. This different conduct of inflation was associated with the reversal of shocks that affected the prices of the non-core component of the basket of goods included in the Consumer Price Index (CPI).

Inflation evolution

Graph 71
INFLATION AND CORE INFLATION
(Percentage change over the last 12 months)



89. As forecast in our Inflation Report of September, inflation in 2006 was expected to remain in the lower band of the inflation target. Moreover, the press releases announcing the monetary program after said Report forecast informed that inflation rates in the first months of 2007 would be below this range and confirmed that no monetary policy actions would be taken because the low inflation levels were associated with factors that had no permanent impact on inflation. Therefore, a 1.1 percent inflation rate in 2006 did not require reducing the reference interest rate.

Inflation's evolution may be explained by trend factors (core inflation) and transitory factors (estimated through core inflation). The latter are mostly responsible for the level and variability of inflation over the last 5 years. Thus, the average inflation rate since inflation targeting was adopted in 2002 has been 2.0 percent, with an average core inflation of 1.2 percent.

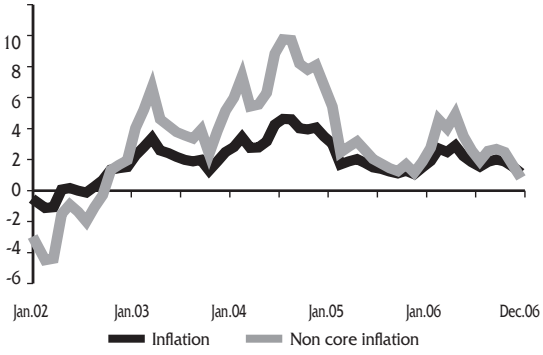
The rate of **core inflation** has gradually increased from 0.7 percent in 2003 to 1.2 percent in 2004 and 2005, and to

1.4 percent in 2006, in a context of a faster pace of growth (increasing from 4.0 percent in 2003 to 6.4 percent in 2005, and to an estimated rate of 7.9 percent in 2006). In January 2007, core inflation was 0.1 percent, accumulating a last-12-month rate of 1.3 percent.

In this period, the economy underwent a transition from a recessive cycle to an expansionary stage that was coupled be a growth of potential GDP. Potential GDP grew from estimated levels of 3 percent 4 years ago to an annual rate of nearly 6 percent today, due to the recent dynamism of investment and productivity improvements, which would account for the gradual increase of core inflation despite the faster pace of economic growth and the increase in the price of fuels and petrochemical raw materials (plastics, fertilizers, etc) and other commodities (wheat and maize for agribusiness).

Following this acceleration that took place between November 2005 (1.0 percent) and April 2006 (1.4 percent) -which coincided with an increased growth of domestic demand (8.7 percent on average between the fourth quarter of 2005 and the first quarter of 2006) and a depreciation of exchange (2.9 percent)-, core inflation remained between 1.3 and 1.5 percent in May-November despite the fact that domestic demand continued to show a faster pace of growth with rates of 10 percent in a context of appreciation of the nuevo sol (3.8 percent).

Graph 72
INFLATION AND NON CORE INFLATION
(Percentage change over the last 12 months)



90. The volatility of the inflation rate stems from supply shocks, usually transitory and with a one-time impact on the level of prices, especially in terms of food products and fuels that represent 33 and 4 percent of the consumer basket respectively. **Non-core inflation**, representing the evolution of the group of goods and services affected by these supply shocks or whose prices are not subject to price control, accumulated 0.8 percent in 2006.

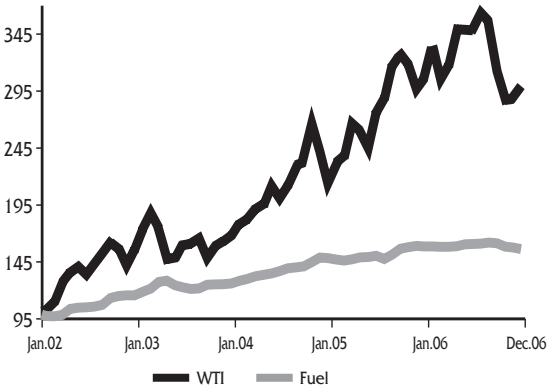
Table 31

INFLATION 2002-2006
(Percentage change)

	Weighted	2002	2003	2004	2005	2006			Annual average 2002-2006
						Jan.-Apr.	May.-Dec.	Year	
I. Core inflation	**60.6**	**1.23**	**0.73**	**1.23**	**1.23**	**0.71**	**0.65**	**1.37**	**1.16**
1. Food products	10.7	0.02	0.14	3.24	0.98	0.20	0.78	0.98	1.06
2. Non-food products	49.9	1.49	0.85	0.80	1.28	0.82	0.62	1.45	1.18
a. Goods	23.3	1.39	0.08	-0.29	0.71	0.79	0.18	0.97	0.57
b. Services	26.6	1.57	1.53	1.75	1.77	0.85	0.99	1.85	1.69
II. Non core inflation	**39.4**	**1.96**	**5.16**	**6.75**	**1.87**	**3.85**	**-2.91**	**0.83**	**3.29**
1. Food products	22.5	0.28	3.73	5.82	1.62	6.98	-4.60	2.06	2.68
2. Non-food products	16.9	4.22	7.00	7.90	2.17	0.05	-0.72	-0.67	4.07
a. Fuel	3.9	15.60	8.94	17.77	6.89	0.07	-1.56	-1.50	9.32
b. Transportation	8.4	0.11	10.99	3.49	1.29	0.23	0.89	1.12	3.32
c. Public utilities	4.6	1.96	-1.98	6.19	-1.72	-0.32	-2.91	-3.22	0.19
III. Total	**100.0**	**1.52**	**2.48**	**3.48**	**1.49**	**2.03**	**-0.88**	**1.14**	**2.02**

The evolution of the main items included in the non-core component of inflation is described below:

Graph 73
QUOTATION OF WTI oil and fuel prices
(Index December 2001 = 100)



- **Fuels:** A reduction in the price of average domestic prices of fuels was observed for the first time in 5 years in 2006 (-1.5 percent) since the moderate rise in international prices of fuels was by far compensated by the appreciation of the nuevo sol (6.4 percent) and the reduction of the excise tax (ISC) on gasoline and kerosene. In the international market, the price of West Texas Intermediate (WTI) oil increased from US$ 59 per barrel in December 2005 to US$ 74 per barrel in July 2006, declining thereafter to US$ 62 per barrel in December 2006.

  This volatility of international quotations along the year were not translated into increases in domestic prices of fuels due to the compensation mechanism of the fuel Stabilization Price Fund[8] which, as a result of the contributions that started in the last months of 2006 and early 2007 will allow to offset contingencies of future rises in the international quotations of fuels.

Table 32

FUEL PRICES
(Monthly percentage variation)

	2002	2003	2004	2005	2006
Fuels	**15.6**	**8.9**	**17.8**	**6.9**	**-1.5**
Gasoline	15.7	9.7	17.7	9.2	-6.2
Gas	11.3	4.2	15.3	-10.9	0.3
Kerosene	20.4	13.0	20.3	21.0	2.2
Cuotation WTI					
US dollars	29.4	32.1	43.3	59.4	61.9
Nuevos soles	103.5	111.3	142.0	203.3	198.6

Source: INEI and Bloomberg.

- **Electricity rates**: These rates are controlled by Osinerg and are modified according to conditions of anticipated supply and demand and to a cost structure. The rates are generally revised annually in the month of May, except if any important change occurs in terms of the cost structure. In 2006, electricity rates decreased by 7.3 percent. Following a price drop in May (6.8 percent) due to Osinerg's decision to reduce the tariff system for the May 2006 - April 2007 period, electricity rates decreased again in November (2.4 percent). The latter reduction reflected the readjustment of electricity production due to the decline in the prices of heating oil 6 and fuel oil 2 between July and October 2006.

8 For further information on this Fund, see Box 1 of the Inflation Report of August 2005.

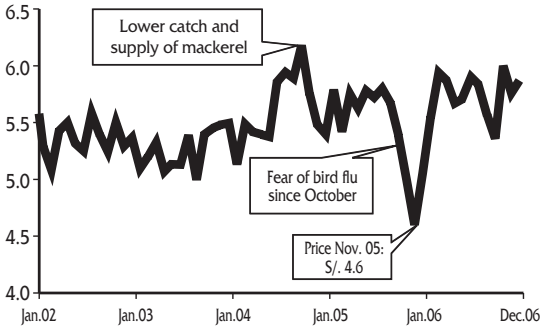
- **Food products**: Highlights include the reduction in the prices of onion (30.5 percent) and papaya (32.5 percent), in both cases due to the recovery of production levels.

Table 33

WEIGHTED CONTRIBUTION TO THE DIFFERENCE IN INFLATION 2005 - 2006
(Percentage points)

Items	Weight	% change		Negative	Items	Weight	% changes		Positive
	2005	2006	contribution			2005	2006	contribution	
Onion	0.4	68.0	-31.8	-0.48	Chicken meat	4.0	-6.2	14.5	0.68
Papaya	0.2	79.7	-32.5	-0.36	Heating	1.3	-10.9	0.3	0.18
Kerosene	1.2	21.0	2.2	-0.32	Bread	3.7	-0.3	3.4	0.16
Fuel and lubricants	1.5	9.2	-6.2	-0.32	Rice	2.3	-6.1	-1.2	0.13
Electricity	2.2	-2.5	-7.3	-0.11					
Total				**-1.59**					**1.15**

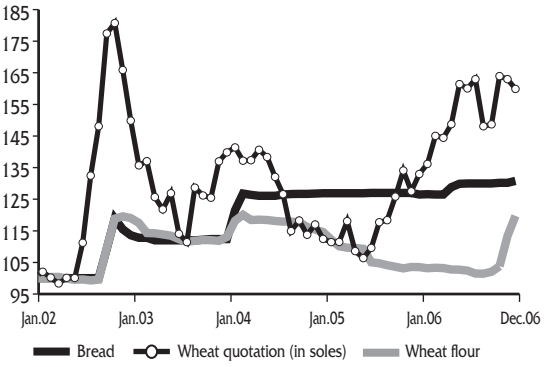
Graph 74
PRICE OF CHICKEN MEAT
(Nuevos soles per kg.)



- **Chicken meat**: This increase was basically due to the recovery of demand, following the strong contraction observed between October and November 2005 originated by fear of bird flu.

  It should be pointed out that the average price of chicken meat has been S/. 5.5 per kg, with a standard deviation of 0.3. Today, the price is S/. 5.9 per kg., that is, a level close to the upper band of this statistical measure.

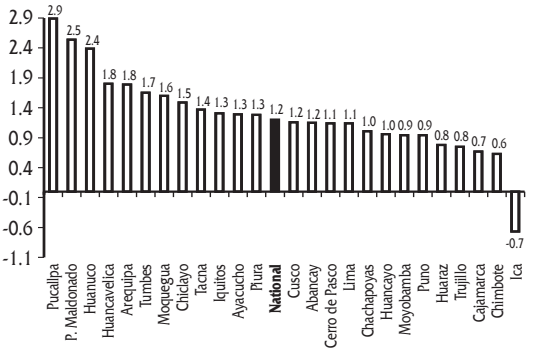
Graph 75
BREAD AND WHEAT QUOTATIONS
(Index December 2001 = 100)



- **Bread**: The price of bread increased 3.4 percent in 2006, although its main input, wheat flour, increased by 16 percent. The international quotation of wheat, expressed in soles, increased 20 percent in the same period.

  The main input for the elaboration of bread is wheat flour, which is prepared using imported wheat. Wheat flour accounts for approximately 60 percent of the total cost of bread. Moreover, wheat is the main input of flour, representing between 70 and 75 percent of its cost.

Graph 76
NATIONAL INFLATION RATE 2006
(Percentage change accummulated)



Domestic inflation

91. The domestic aggregate consumer price index is elaborated by the National Statistics and Information Institute (INEI) since 2003 on the basis of price indices of 25 cities. The accumulated price increase in 2006 was 1.2 percent. A lower than average increase was observed in 12 cities, while the other 13 cities showed a mean increase higher than the average one.

The cities with higher price increases were Pucallpa (2.9 percent), Puerto Maldonado (2.5 percent) and Huánuco (2.4 percent). Conversely, the cities that posted lower price increases were Ica (-0.7 percent) and Chimbote (0.6 percent).

Expectations

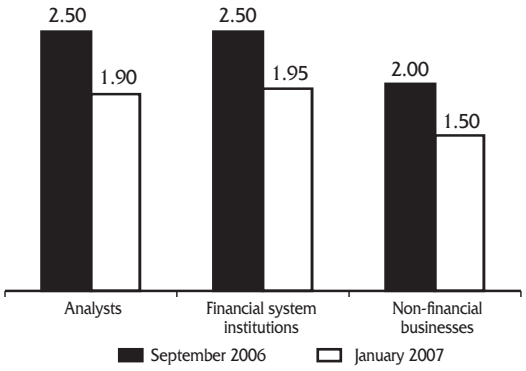
92. An additional element influencing inflation forecasts is expectations regarding the future evolution of this variable, as expectations have an impact on price formation in the economy. Expectation surveys show that the credibility of monetary policy continues to be robust, anchoring expectations around 2.0 percent in the forecast horizon in the case of non-financial enterprises. This result is consistent with the convergence of forecasts by the end of said horizon.

93. Factors, such as the prices of raw materials or salary costs, may also generate pressures in the market of goods, thus causing changes in relative prices or general prices increases. Therefore, the results of the survey on macroeconomic expectations are discussed below.

In November 2006, a set of questions regarding increases in the prices of raw materials (inputs) was included in the BCRP' Survey on Macroeconomic Expectations in order to evaluate if there were inflationary pressures resulting from the price rises of raw materials in a context of increased prices for oil and commodities.

According to the Survey results, only 33 percent of interviewed enterprises experienced higher prices for their inputs in the second half of 2006, while 5 percent recorded price cuts.

Graph 77
INFLATION EXPECTATION: 2007



INFLATION EXPECTATION: 2008

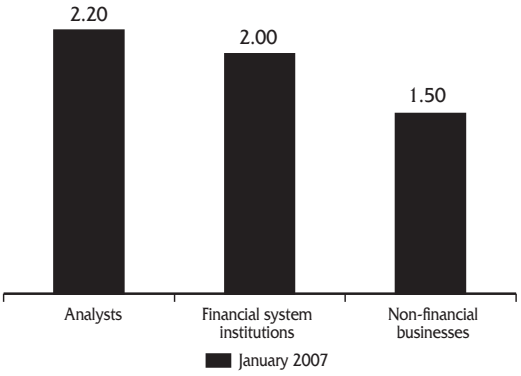


Table 34

RESULTS OF THE MACROECONOMICS EXPECTATIONS SURVEY
Module: Prices

	All sectors		Manufacture	
	N° of firms	%	N° of firms	%
Total	**385**	**100**	**215**	**100**
Input prices increased	129	33	85	40
Input prices did not increase	238	62	118	55
Input prices decreased	18	5	12	6

Source: BCRP Survey on Macroeconomic Expectations, November 2006.

The enterprises that experienced price increases in their inputs responded by reducing their margins in 46 percent of the cases; by improving productivity and reducing other costs or seeking different alternatives, such as changing inputs, suppliers, or eliminating discounts and promotions for their clients in 28 percent of the cases. Only 26 percent opted for raising their prices.

Table 35

RESULTS OF THE MACROECONOMICS EXPECTATIONS SURVEY
Businesses where input prices increased

	All sectors		Manufacture	
	N° of firms	% firms	N° of firms	%
Businesses where input prices increased	**129**	**100**	**85**	**100**
Reduced margins	60	46	35	41
Raised prices of products or final services	33	26	26	31
Increased productivity	22	17	14	16
Reduced other costs	9	7	7	8
Other actions	5	4	3	4

Source: BCRP Survey on Macroeconomic Expectations, November 2006.

These results allow identifying that inflationary pressures are focalized in sectors with high components of imported inputs whose prices have experienced important rises in the international market (wheat, plastics, oil derivatives and other raw materials).

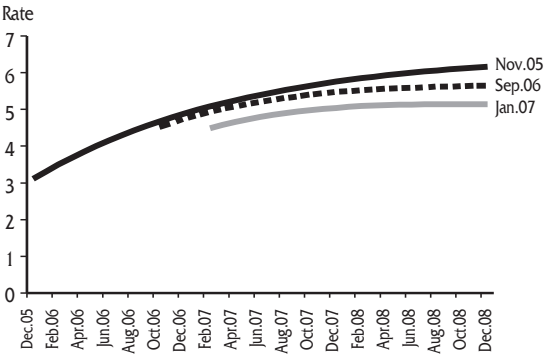
In general, these results do not differ significantly when a distinction is made between manufacturing and other sectors, primary and non-primary manufacturing, non-primary manufacturing oriented to the domestic and external markets and non-primary manufacturing oriented to the production of consumer goods and capital and intermediate goods.

Inflation forecasts

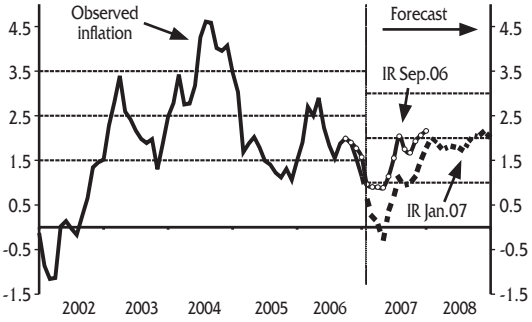
94. The inflation forecast for 2007 has been revised downward. Inflation is expected to continue below the target range during the first half of 2007. As explained in the Report of September 2006, part of this result is due to a comparison effect with respect to the first half of 2006. In this report, the aforementioned deviation anticipated for the first months of 2007 are more acute due to the downward revision of the

international prices of fuels and of public utilities, the higher agricultural supply and the lower exchange rate with respect to the scenario in our September Report. These factors have a one-time effect on the inflation rate, and therefore do not affect its subsequent convergence towards the target range. Thereafter, inflation would return to be within the target range and would exhibit a course of convergence towards the target. This convergence course would depend on the expected future evolution of macroeconomic determinants.

Graph 78
EXPECTED OVERNIGHT INTERBANK RATE IMPLICIT IN CDBCRPs



Graph 79
LAST-12-MONTH INFLATION FORECAST



IR: Inflation Report.

95. The inflation forecast in this Inflation Report considers a 2-year horizon, given that the monetary policy lag is estimated between 12 and 18 months.

The forecasts are consistent with a previsional monetary policy that considers the upward or downward inflationary pressures that may appear in the economy according to the data available to date which is used in this report. This scenario considers that monetary stimulus will gradually decrease during the forecast horizon in a similar way as will the evolution of implicit expectations regarding the interbank interest rates, which have been calculated on the basis on the yield curve on BCRPCDs and bonds in soles.

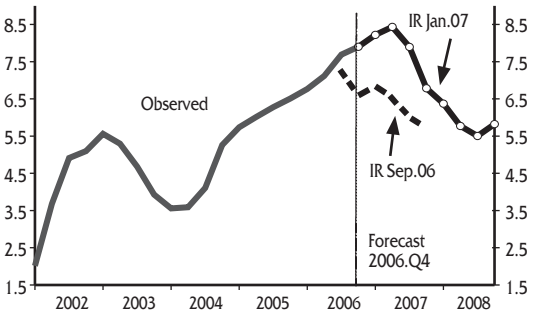
The expectations regarding the future interbank rate have been declining during 2006. Thus, in 2006 the interbank rate at the beginning of this year was expected to be approximately 5.0 percent, with an upward trend for 2008 and 2009. Today, expectations for the next 2 years are that the reference rate will be within a range of 5.0 and 5.25 percent.

It is worth mentioning here that the monetary policy stance will be adjusted in order to maintain consistency with the inflation target as the BCRP updates its information on the state of the economy.

96. The convergence of inflation towards a rate of 2 percent is based on the expected pace of growth of economic activity, and the expectations of economic agents regarding the evolution of inflation and exchange. All this factors are sensitive to the BCRP's monetary policy. In contrast with the 2003-2005 period, non-core prices are expected not to pressure inflation upwards in the forecast horizon as normal supply conditions are forecast in the agricultural sector and relatively moderate rises are forecast in the international prices of fuels.

97. The dynamism of economic activity considered in the forecast horizon is expected to boost inflation's convergence to the

Graph 80
GDP GROWTH
(Average variation rate to the last 4 quarters)



IR: Inflation Report.

target during 2008. This dynamism is supported by a growth estimated at 7.9 percent in 2006, which would then continue to show sustained rates of growth that are close to the growth of potential GDP. Over the past 3 years, core inflation has been recovering, partly influenced by an increase in the output gap which went from a recessive position in the economic cycle to an expansionary position during this period. Although declining by 2008, this boost of demand would continue to allow inflation's convergence to the inflation target. This implies that the growth of GDP would follow a sustainable course in line with the evolution of potential GDP, that is, depending on the growth of productive capital, the supply of skilled labor and productivity in the economy.

Two factors are essential to the performance of economic activity in this forecast: on the one hand, the international environment continues to be favorable, and although terms of trade show negative rates, the levels of terms of trade are still higher than the average ones in 2004. On the other hand, the growth of trend GDP is expected to be around 6 percent in the forecast horizon, mainly as a result of increased overall factor productivity and higher fixed gross investment (19.0 percent in 2007).

As regards the forecasts included in the Inflation Report of September, GDP growth in 2007 has been revised upwards considering the higher dynamism observed in 2006. In this way, the outlook of an economic slowdown is maintained, but on the basis of higher levels of growth. This evolution reflects the outlook vis-à-vis a global economic slowdown and a reduction of terms of trade in 2007-2008, which would also induce a slowdown in the domestic pace of economic expansion, although maintaining rates above the trend GDP rates observed over the past few years.

98. As regards imported inflation, the factors that could affect the evolution of inflation most are the international prices of fuels and the exchange rate. The forecast for the quotation of the WTI oil has been revised downwards (it is expected to decrease from US$ 72 to US$ 62 per barrel in 2007). Likewise, the nuevo sol is expected to reduce its appreciatory pace and to remain relatively stable, given that the reduction of terms of trade is expected to be gradual. These elements represent lower upward pressures on prices, thereby offsetting the boost resulting from an expansionary economic cycle.

BOX 6
UNCERTAINTY REGARDING THE RATE OF INFLATION

The rate of inflation is generally associated with uncertainty regarding the future level of inflation. This relationship reflects some of the costs inflation poses on the economy. Thus, for example, increased uncertainty regarding inflation generates a higher dispersion of relative prices and, therefore, greater inefficiencies in production. Likewise, increased uncertainty induces higher stabilization costs as this implies not only that inflation is harder to forecast but also that it is more persistent.

In order to understand these costs of inflation, it is important to assess empirically the relationship between the rate of inflation and uncertainty regarding it. It is quite likely that both the dynamics of inflation and the relationship between the rate and the volatility of inflation have changed as a result of the changes made in the design and implementation of the monetary policy.

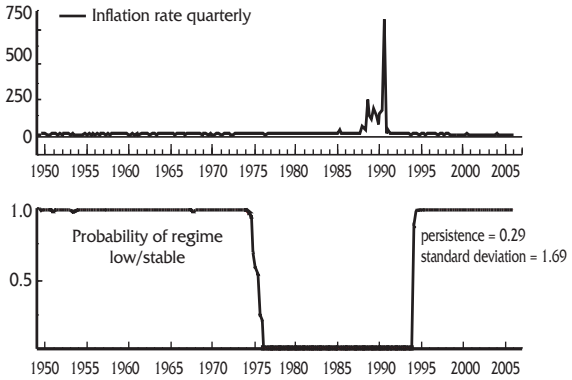
One way of exploring whether there is a systematic connection between the rate of inflation and uncertainty is to breakdown a series of data on inflation into its permanent stochastic component (long-term) and its transitory component (short-term). The former is associated with the concept of core inflation, reflecting the monetary stance, while the latter is associated with non-core inflation, which may be affected by supply shocks. Both components may be subject to changes in terms of the level and volatility of inflation.

In this sense, Castillo, Humala and Tuesta (2006) have analyzed the dynamics of inflation since 1949, using an econometric model on the (unobserved) components of inflation that have been subject to regime switching. The authors find evidence indicating that periods with high (low) inflation are coupled by periods with short and long-term high (low) uncertainty, as well as with higher (lower) inflation persistence.

Another relevant finding of the study is that three clearly differentiated regimes on the dynamics of this variable are identified when a prolonged inflation series (since 1949) is analyzed: first, a price stability regime that is not exclusive of recent years and also includes a significant part of the fifties and the sixties; a second regime, with high and volatile inflation between the mid-seventies to the early nineties (periods corresponding to an acceleration of inflation and deflation respectively); and a third regime, which includes the period of hyperinflation experienced since the late eighties.

Considering the impact of these relationships on inflation, the single objective of price stability contributes directly to reduce the level and volatility of inflation's permanent component. Furthermore, maintaining inflation-intolerant policies contributes to anchor the expectations of economic agents vis-a-vis inflation (and also to strengthen the credibility of the central bank) which, in turn, contributes to reduce the level and volatility of inflation's transitory component. In other words, findings point to the fact that not only has inflation's long-term volatility decreased since the mid-nineties, but inflation's transitory volatility would have also declined significantly.

REGIME-SWITCHING MODELS OF INFLATION



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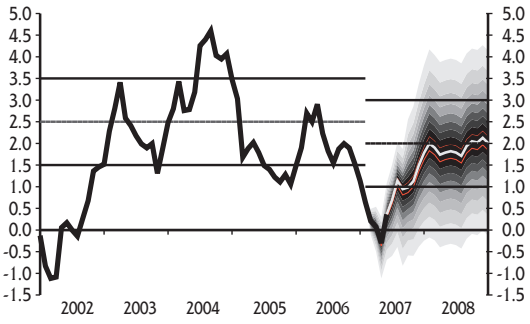
VIII. Balance of risks

Graph 81
INFLATION FORECAST
(Annual percentage change)



Note: The graph shows the inflation prediction bands over the forecast horizon. The darkest band around the central forecast represents a 10 percent probability of occurrence, while all the other bands represent a 90 percent probability of occurrence.

99. The forecast scenario analyzed herein is considered to be the most likely scenerario in the forecast horizon. However, the results of these projections are sensitive to the evolution of the exogenous variables considered, which could alter the central scenario. The balance of risks is the evaluation and weighing of the different scenarios of risk that may divert the forecast from the base scenario. These diversions may impact on inflation causing either upward or downward pressures.

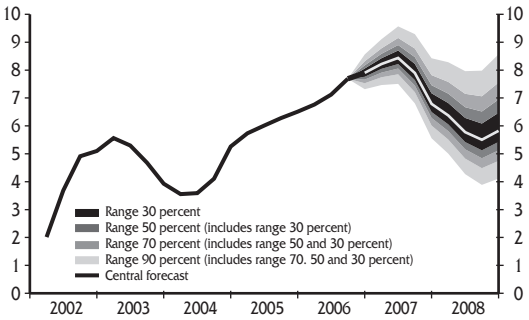
- **Demand shock**: Economic activity in the base scenario has a sustained growth in the range of 5.5 - 7 percent during 2007 and 2008. However, if an expansion of domestic expenditure occurred that created inflationary pressures, the BCRP will adopt a less expansionary or a contractionary monetary policy stance.

- **Supply shock**: This Report considers the occurrence of a weak El Niño event and a normal farming year for 2007. Although the probability of a "strong" El Niño episode in 2008 is not high, its occurrence would be highly detrimental on the conditions of food supply and, therefore, on the prices of food products.

  The inflationary pressures that might be caused by an eventual El Niño episode of a high magnitude, or by any other unexpected climatic event, would only alter the anticipated evolution of monetary policy should these supply shocks affect inflation expectations and the formation of other prices in the economy. The BCRP would not react vis-à-vis transitory shocks of this nature.

- **External shock**: The international environment observed in 2006 was extraordinarily favorable for the Peruvian economy, sustained by an increased growth of terms of trade and the high growth experienced by Peru's trading

Graph 82
GDP GROWTH FORECAST
(Annual percentage change in every quarters)



Note: The graph shows the projection of GDP growth bands over the forecast horizon. The darkest band around the central forecast represents a 30 percent probability of occurrence, while all the other bands represent a 90 percent probability of occurrence.

partners. Forecasts in this Report consider a slight reversal downwards for both terms of trade and for the expansion of our trading partners.

However, a severe correction in the prices of commodities should be considered. This risk scenario would imply an initial pressure towards the depreciation of the nuevo sol and then a downward pressure on demand. In the short term, the impact of higher exchange rate would affect inflation upwards, but then the contractive effect of demand would prevail.

Under these circumstances, the monetary policy would react in a contractive manner in the short term to neutralize initial inflationary effects, provided that these effects are severe. However, a monetary stimulus position would be required in the medium term to counterbalance the negative pressures resulting from a lower aggregate demand.

- **Increased appreciatory pressures on the nuevo sol**: The balance on the major determinants of exchange allows forecasting that, should any factors divert conditions away from the main scenario, these diversions are more likely to generate appreciations, as a result of which the impact on the forecast inflation would be downward pressures.

  In view of this risk scenario, if achieving the target in the relevant monetary horizon were threatened, the BCRP would maintain its current monetary stance for a longer period of time and would accumulate international reserves.

Weighing the various risks both upwards and downwards against the baseline scenario shows a neutral balance in the case of the inflation forecast and an upward asymmetry in the case of GDP.

CONCLUSION

100. Inflation will remain temporarily at low levels as a result of transitory shocks that are beyond the control of monetary policy, in a context of a high dynamic performance of economic activity. Taking into account the information analyzed in this Report, inflation is forecast to gradually come closer to the BCRP's inflation target of 2 percent.