INFLATION REPORT:

January 2008

Recent trends and macroeconomic forecasts

CENTRAL RESERVE BANK OF PERU

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Central Reserve Bank of Peru
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CONTENT

This Inflation Report was drawn up using preliminary data on gross domestic product, balance of payments, operations of the non-financial public sector, and monetary accounts up to December 2007; and data on inflation, exchange rate, and financial markets up to January 2008.

Foreword

- According to the Peruvian 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 sustained economic growth of the country.

- In order to consolidate this goal, since 2002 the Bank's monetary policy has been based on an inflation targeting scheme. In 2007 the inflation target was reduced from 2.5 to 2.0 percent, plus or minus one percentage point (between 1.0 percent and 3.0 percent). The reduction of the Central Bank's inflation target contributes to anchor inflation expectations at the level of inflation in developed countries and also expresses the BCRP's commitment with monetary stability, regardless of temporary shifts caused by factors beyond the control of monetary policy.

- Until 2005, compliance with the inflation target was measured through the annual change observed in the Consumer Price Index for Metropolitan Lima by December. Since January 2006, this is measured in a more continuous manner, that is, last twelve-month inflation is measured every month and not only in December each year. In the event of any deviation of inflation from the target, the Central Bank implements the necessary measures to return inflation to the target considering the lags with which monetary policy operates.

- At the beginning of each month, and according to a previously announced schedule, the Board of the BCRP approves a reference 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 based on which monetary policy decisions are made are disseminated to generate the public's

understanding of the consistency of the decisions adopted and to ensure that economic agents' expectations take these forecasts and simulations into account. With this aim, the Central Bank publishes its Inflation Report every four months. The previous Inflation Report was released on October 5, 2007 and the next Inflation Report will be published on June 13, 2008.

- This Inflation Report analyzes the evolution of the main economic developments observed in 2007. The forecast scenario included herein is consistent with monetary policy lags during the 2008-2009 macroeconomic forecast horizon.

Summary

i. During 2007 the world saw higher inflation rates which included rates unseen in many countries over the past 10 years. This evolution was mainly the consequence of significant rises in the international prices of fuel observed in several years and, more recently, of food price rises at magnitudes unheard of since the seventies.

ii. In this context, inflation in Peru continued to be above our previous inflation forecast (Inflation Report, September 2007), although within the inflation range considering the contingencies analyzed in our previous balance of risks (higher imported inflation). Since October 2007, accumulated last 12-month inflation has been above the target range (4.15 percent in January 2008) mainly due to the impact of the rise of the international prices of food and fuel. The price increases of these imported goods had a direct impact on inflation through the food products considered in the consumer basket and an indirect impact on inflation through firms' production costs and inputs. Imported inflation increased from 0.3 percent in 2006 to 10.5 percent in 2007.

iii. These rises should not have permanent effects on inflation as long as they do not affect the expectations of economic agents nor the rest of prices in the economy. In this sense, the Central Bank's communiqués on its Monetary Program have emphasized that the Central Bank will continue to oversee the evolution of inflation and its determinants, distinguishing the factors with temporary effects from those with permanent impacts. The BCRP communiqués have also emphasized that any necessary monetary adjustment will be implemented to ensure that inflation converges to the target range and to control inflationary expectations.

iv. The Board of the Central Bank decided to raise the reference interest rate for the interbank market on three occasions -in July and September 2007 and in January 2008-, increasing this rate from 4.5 percent in June 2007 to 5.25 percent in January this year. These preventive measures, which take

monetary policy lags into account, are aimed at preventing that the strong growth of domestic demand might generate inflationary pressures and at maintaining inflation expectations anchored around the target.

Additionally, the rates of reserve requirements for banks' obligations in both domestic and foreign currencies have been raised since February this year. This measure was a necessary monetary adjustment in a context of the significant inflow of short-term capitals observed in early January.

v. Domestic demand grew at a faster pace than GDP in 2007. Private consumption and private investment maintain high growth rates, reflecting consumer and business optimism, a higher national disposable income, the growth of employment, the high prices of the main commodities exported by Peru, and the expansion of credit. In 2007, domestic demand is estimated to have grown 11.0 percent, while GDP is estimated to have grown 8.5 percent. Both growth rates are higher than the ones forecast in September 2007.

vi. The evolution of the international environment shows an economic slowdown as world economic growth declined from 4.9 percent in 2007 to 4.1 percent in 2008. The impact of the evolution of world markets would mainly be expressed through a lower external demand -which will deepen if the United States goes into recession-, as well as through the lower relative prices of the goods exported by Peru compared to the goods that the country imports.

vii. This less favorable international environment would generate a slowdown in the growth of economic activity and domestic demand, determining more sustainable rates in the long run. Thus, GDP is forecast to grow 7.0 and 6.3 percent in 2008 and 2009 respectively.

viii. A fiscal surplus of nearly 3.0 percent of GDP was recorded at the close of 2007. Moreover, the public sector is also expected to post positive fiscal results in 2008 and 2009 (1.8 and 1.0 percent of GDP respectively), which will also contribute to macroeconomic stability. However, although positive, these fiscal results would be lower since the general government non-financial spending is expected to increase. Compared with the forecasts of our last Inflation Report (September 2007), these economic results in 2008 and 2009 imply lower financing requirements and, therefore, the reduction of the public debt as a percentage of GDP to levels close to 23 percent by the end of the forecast horizon.

ix. The evolution of the Nuevo Sol/dollar nominal exchange rate continued reflecting the positive position of our external accounts, the process of financial dedollarization,

the weakness of the dollar in international markets, and expectations of an appreciation of the nuevo sol (given that the yield on local financial assets should show a higher growing trend than financial assets in developed markets). The Central Bank continued to intervene in the exchange market in order to offset volatility in this market, to preventively accumulate international reserves, and to compensate the sales of foreign currency to the public treasury.

x. The main risks that could deviate our inflation forecasts from the central scenario include the following:

- **A greater slowdown of the world economy**. A reversal of terms of trade (mainly due to the higher prices of imports), a transitory slowdown of the economy in 2008, and a slight recovery in 2009 would be the main aspects characterizing the international environment. A situation of economic recession in the United States -with a severe correction in the prices of export raw materials- could generate volatility in the flow of external capitals to emerging economies and cause an additional "contractive impulse" on demand's dynamism. For this reason, the BCRP maintains a high level of international reserves and would continue intervening in the exchange market to reduce an excessive volatility of exchange. If necessary, the Bank will loosen its monetary policy stance to offset downward demand pressures on inflation in the forecast horizon.

- **Higher prices of fuels**. The central forecast considers a partial reversal of the recent rises in the international prices of fuel (the price of crude oil was nearly US$ 100 per barrel on January 2, 2008). A scenario with a higher upward volatility in the oil market would imply fuel prices above the levels considered in the forecast scenario.

  In this case, the BCRP would maintain its monetary policy stance unchanged as long as inflation expectations remain anchored around the target.

- **Higher domestic demand pressures**. The forecast scenario considers a positive evolution of economic activity sustained mainly by a dynamic performance of spending in both the private and public sectors. However, if private consumer expenditure -driven in part by a higher credit- and public expenditure should increase significantly beyond our forecast, the Central Bank will adopt a more restrictive monetary stance to maintain a pace of sustained economic growth.

- **Higher prices of food commodities**. The central scenario considers that no supply shocks would be generated due to weather conditions. However, the risk that higher

prices may persist over time or that they may increase even further cannot be eliminated if supply conditions should deteriorate or if the demand for biofuels should continue to grow, in which case the domestic prices of food would tend to increase.

In this context, the monetary policy stance would remain unchanged as long as inflation expectations continue to be anchored around the target.

- **Increased appreciatory pressures on the Nuevo Sol**. In a scenario of significant increased appreciation of the Nuevo Sol, which could pressure inflation downward below the target, the Bank would reduce its current reference rate.

- **Constraints in the supply of electric energy**. This report considers the risk of constraints in the supply of electric energy toward the end of the forecast horizon. This would have an adverse impact on electricity rates and on firms' costs. Should this occur, the monetary policy stance would remain unchanged as long as inflation expectations continue to be in line with the target.

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

I. Monetary policy

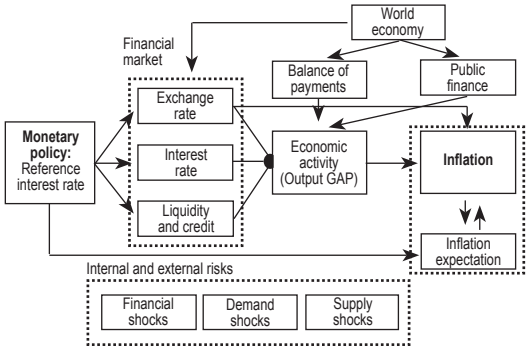
In recent months, the communiqués on the Central Bank's Monetary Program have emphasized that the BCRP oversees the evolution of inflation and its determinants, distinguishing the factors with temporary effects from those with permanent impacts, and that any necessary adjustments will be made in the reference interest rate should inflation expectations increase or should domestic demand grow at a faster pace than productive capacity.

The BCRP increased the monetary policy interest rate by 25 bps in both July and September 2007. Thus, the reference interest rate was 5.0 percent until end 2007. This period allowed the Central Bank to analyze the response of the economy and to assess the impact of turbulence in international markets that originated in the crisis of the subprime mortgage market in the United States.

However, the prices of imported food and fuels and domestic demand increased more than forecast in the central scenario of our Inflation Report of September 2007, a possibility that had been considered in our risk balance. The evolution of imported inflation contributed to increase core inflation during the last months of 2007, leading economic agents to revise their inflation expectations upwards. Therefore, in January 2008 the Central Bank raised the monetary policy reference rate from 5.0 to 5.25 percent. Moreover, in February the BCRP increased the rate of reserve requirements to curb the growth of liquidity and credit in a context of high inflows of short-term external capitals.

1. Based on the analysis of the evolution of inflation and inflation forecasts, as well as on the analysis of inflation's domestic and external determinants, a reference interest rate for the interbank market is set each month by the BCRP in order that inflation remains at 2.0 percent in the monetary policy horizon (one or two years). However, inflation may deviate away from the target and even eventually fall outside the target range (2 percent, plus or minus one percentage point).

Graph 1
MONETARY POLICY TRANSMISSION CHANNELS

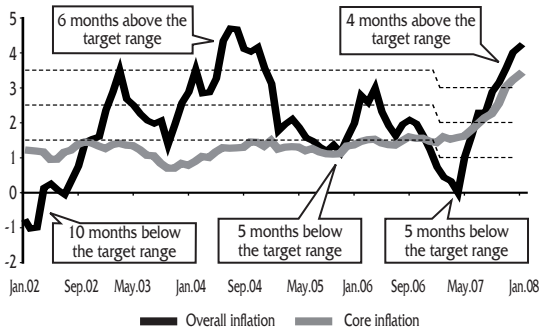


Therefore, the BCRP is continuously monitoring the evolution of inflation to determine if these deviations may have a permanent nature in order to adopt the necessary corrective adjustments to ensure that inflation returns to the target, considering the lags with which monetary policy affects the economy and prices.

2. The Board's communiqués on the BCRP Monetary Program pointed out that 12-month accumulated inflation was being influenced by rises in the international prices of grains and petroleum, and that, like in previous episodes (2004 and 2006), these price rises associated with supply factors were expected to be transitory.

   The Board expressed concerns about the possibility that the rises in international prices might translate into inflationary expectations, and considered that the higher prices of soy bean, wheat, and petroleum should have no permanent or generalized impact on the prices of the consumer basket as long as inflation expectations remained anchored around the inflation target.

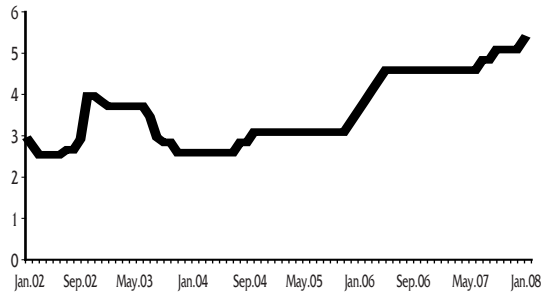
Graph 2
OVERALL INFLATION AND CORE INFLATION
(Percentage change over the last 12 months)



3. The deviation of accumulated annual inflation above the upper band of the inflation target (3 percent) observed in the fourth quarter of 2007 was mainly associated with imported inflation. Thus, the risks pointed out in our Inflation Report of September 2007 materialized.

   This higher inflation rate, caused by the persistence of rises in food prices, would have partially translated into higher inflation expectations as well as into some components of core inflation (i.e. evaporated milk), as reflected in the evolution of annual core inflation which increased from 1.5 percent in May to 3.1 percent in December. Moreover, this would also be explained by the high growth of domestic demand which exceeded previous estimates (11 percent in 2007 versus the 10 percent growth rate forecast in our Inflation Report of September 2007). The strong dynamism of domestic demand would have facilitated that the rise in the international prices of food, food inputs, and fuels translate into the rest of prices in the economy, as a result of which core inflation without foodstuffs showed a rate of 2.4 percent in 2007.

Graph 3
CENTRAL BANK REFERENCE INTEREST RATE
(In percentage)



4. In this context of strong growth of domestic demand, in January 2008 the Board raised the reference interest rate from 5.0 to 5.25 percent to reduce the risks that the high inflation observed during the fourth quarter of 2007 might spread further onto expectations, as well as to ensure that inflation would return to the target range in the forecast horizon. With the same aim, the Board also increased the rates of reserve requirements for both domestic and foreign currency obligations in February 2008.

BOX 1

ECONOMIC EFFECTS OF RECENT MEASURES ADOPTED IN TERMS OF RESERVE REQUIREMENTS

The changes in the regime of reserve requirements in domestic and foreign currencies announced by the Central Bank on January 16 -in force since February 1- are aimed at reinforcing monetary control and at reducing sterilization needs in a context marked by a strong inflow of short-term external capitals and by international turbulence. The higher reserve requirements in domestic currency imply a more restrictive monetary policy stance, as this would translate into higher active interest rates and lower credit funds, which would favor a more moderate growth of credit in the financial system.

The measures implemented include the following:

- Marginal reserve requirements have been raised from 30 to 40 percent for obligations in foreign currency and to 15 percent for deposits in domestic currency.
- The average daily amount of banks' current accounts at the BCRP will be 2 percent of banks' obligations instead of 1 percent.
- The minimum legal reserve for obligations subject to reserve requirement has been raised from 6 to 7 percent.
- New sterilization instruments have been introduced. These include term deposits at the BCRP and Certificados de Depósito de Negociación Restringida -CDBCRP-NR (Certificates of Deposit Subject to Limited Negotiation). The latter replace the CDBCRP.
- The transfer of ownership of BCRP Certificates is now subject to a commission.

Effects on interest rates

These modifications of the reserve requirement regime affect the interest rates through the impact they have on banks' financial margins (a higher rate of reserve requirements would reduce the financial margin). Banks would seek to stabilize their margins by increasing the spread between active and passive rates, that is, by increasing the active rate and/or reducing the passive rate.

These changes will have a greater initial impact as they modify the average and additional reserve requirements subject to remunerations. The increase in the marginal reserve requirement will have a gradual impact as the expansion of deposits increases the average reserve requirements.

In line with the impacts on the financial margin, the initial impact of these measures is estimated to be equivalent to rising the reference rate by 25 bps (mainly due to the increase of the minimum legal reserve) and by approximately 25 additional bps in the next months due to the effect of the marginal reserves (a total of 50 bps).

$$\textit{Financial margin} = (1 - \textit{Reserve rate}) * i_{active} + (\textit{Reserve rate} - \textit{Minimun legal reserve rate}) * i_{rem.reserve} - i_{pasive}$$

EQUIVALENT ESTIMATED EFFECT AT THE REFERENCE RATE

Measure	Nuevos Soles (bps)
1° Effect of minimun legal reserve requirements	25
2° Effect of minimun legal and marginal reserve requirement 1/	59
3° Long run effect 2/	210

1/ As of December 2008.
2/ The means reserve requirement converge to the marginal in long run.

COMMUNIQUÉS ON THE MONETARY PROGRAM:

September 2007 - January 2008

September: The Board of the BCRP approved to raise the monetary reference rate from 4.75 to 5.0 percent. This preventive measure is taken considering the lags with which monetary policy operates in order to continue maintaining expectations anchored at low inflation levels, in view of the robust growth shown by domestic demand in a context market by an increase in the price of imported inputs. The Board will continue to oversee the evolution of inflation and its determinants, differentiating the factors that have temporary impacts from those with permanent effects.

October: The Board of the Central Bank approved to maintain the monetary policy reference rate at 5.0 percent. The Board also pointed out that should expectations about inflation increase or should domestic demand grow at a faster pace than productive capacity and productivity gains, the Bank will adopt additional preventive adjustments in the reference interest rate.

November: The Board of the Central Bank approved to maintain the monetary policy reference rate at 5.0 percent. The Board pointed out that inflation's recent increase above the target is basically associated with rises in the international prices of some basic food inputs. Therefore, the Bank continues to keep a close watch on international economy developments and on their repercussions on inflation in the country.

December: The Board of the Central Bank approved to maintain the monetary policy reference rate at 5.0 percent. The Board pointed out that inflation's recent increase above the target is mainly associated with rises in the international prices of some basic food inputs. However, inflation in November has decreased to 0.11 percent, a rate compatible with the inflation target.

January 2008: The Board of the Central Bank approved to raise the monetary policy reference rate from 5.0 to 5.25 percent. This measure has been adopted to maintain inflation expectations within the inflation target range, given the increase seen in the international prices of food products in a context of strong growth of domestic demand. The Board continues to oversee the evolution of inflation and its determinants, both domestic and external, distinguishing the factors with temporary impacts from those with permanent effects. As in previous occasions, the Board will adopt any necessary adjustment required to ensure that inflation converges to the target range.

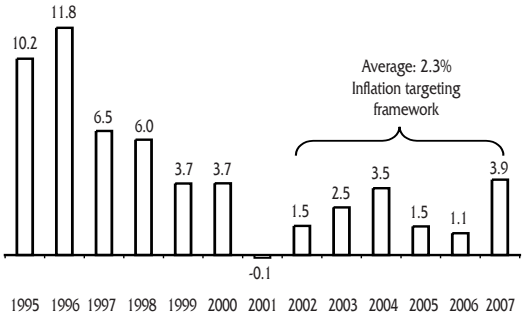
II. Inflation

Inflation in 2007 showed a rate of 3.9 percent, the highest annual rate observed since 1998. This higher inflation rate was mainly due to the impact of the rise in the prices of food and imported inputs (wheat, soy bean oil, and petroleum), as reflected in the evolution of imported inflation, which reached 10.5 percent in 2007 after showing a 0.3 percent increase in 2006. On the other hand, core inflation -trend indicator of price growth- increased from 1.4 to 3.1 percent between 2006 and 2007 due to the higher prices of food products. Excluding food and beverages, the rate of inflation was 2.0 percent.

The rise in the price of food is an international phenomenon. Both supply factors -such as lower planted areas and droughts in the main producer countries- and demand factors -such as increased consumption in some countries of Asia-have generated a strong increase in the international price of food and food inputs.

In Peru, this phenomenon takes place in a context of strong dynamism of domestic demand and has directly affected the prices of some final goods included in the consumer basket (bread, "eating out", evaporated milk), as well as firms' production costs (fuels, related inputs such as plastics and fertilizers, and inputs used in the production of food).

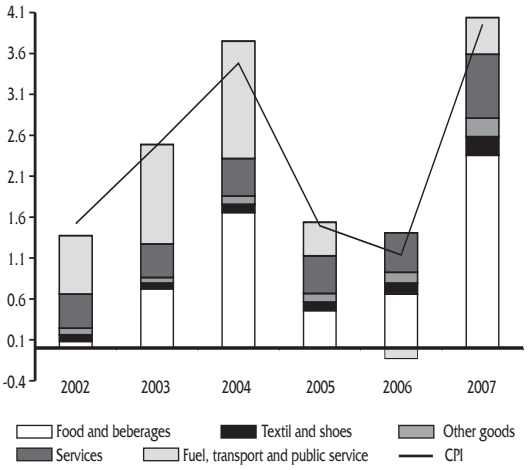
Graph 4
INFLATION
(Percentage change)



Inflation

5. The items that contributed most heavily to the 3.9 percent inflation rate observed in 2007 are associated with the evolution of the international prices of food and imported inputs, and included bread, "eating out", fuel, evaporated milk, and eggs. On the other hand, the inflation rate was slightly offset by other items, such as sugar, fresh legumes, telephone rates, potato, and onion that had a negative contribution to inflation.

Graph 5
WEIGHTED CONTRIBUTION TO ANNUAL CPI
(Percentage points)



The average inflation rate since the inflation targeting scheme was implemented in January 2002 is 2.3 percent, with an average core inflation rate of 1.5 percent.

Table 1

WEIGHTED CONTRIBUTION TO INFLATION 2007
(Percentage points)

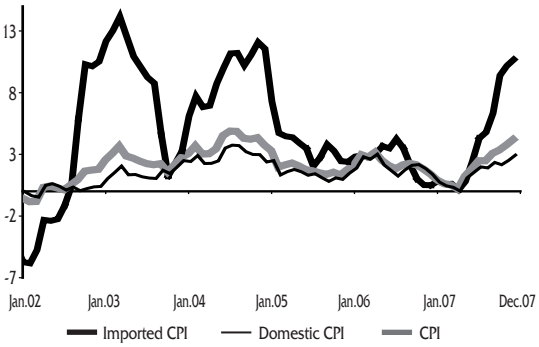
Items	Weight	% Change	Positive contribution	Items	Weight	% Change	Negative contribution
Bread	3.7	19.2	0.84	Sugar	1.4	-9.2	-0.14
Eating out	10.2	4.1	0.41	Fresh vegetables	0.4	-13.1	-0.07
Fuel	3.9	6.4	0.36	Telephone	1.3	-7.2	-0.07
Evaporated milk	2.2	11.3	0.24	Potato	1.5	-4.0	-0.07
Eggs	0.7	33.1	0.23	Onion	0.4	-14.4	-0.07
Total			**2.08**				**-0.42**

Food and beverages consumed at home accounted for 2.4 percentage points of CPI change (equivalent to 59 percent of inflation) and was the highest contribution to CPI change seen since the nineties.

Inflation in January 2008 showed a rate of 0.22 percent, with the higher prices of potato and "eating out" accounting for over 50 percent of this increase. With this result, last 12-month inflation was 4.15 percent. On the other hand, imported inflation was 0.5 percent, accumulating a rate of 10.7 percent in the last 12 months.

Core inflation in January was 0.25 percent and last 12-month core inflation was 3.27 percent. The higher prices of foodstuffs, reflected in the higher prices of beef and evaporated milk, contributed to this evolution.

Graph 6
INFLATION, DOMESTIC INFLATION AND IMPORTED INFLATION
(Percentage change over the last 12 months)



Imported inflation

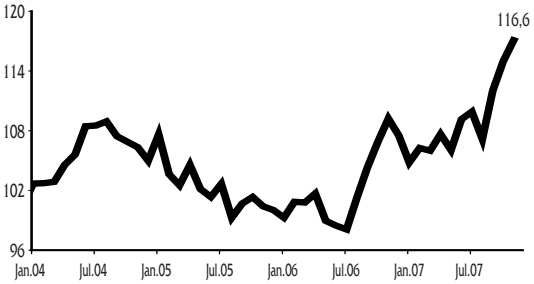
6. Imported inflation -which reflects the evolution of the prices of imported food and imported inputs- increased from 0.3 percent in 2006 to 10.5 percent in 2007, due to the higher prices of foodstuffs (bread, noodles, and oil) and fuels. In terms of imported inflation, it is worth pointing out that the prices of food increased from 2.1 percent in 2006 to 18.8 percent in 2007, and that the price of fuels increased from a negative change in 2006 (1.5 percent) to 6.4 percent in 2007.

Table 2

DOMESTIC AND IMPORTED INFLATION: 2002-2007
(Accumulated percentage change)

	Weighted	2002	2003	2004	2005	2006	2007
I. IMPORTED CPI	**12.1**	**10.3**	**3.0**	**11.3**	**2.2**	**0.3**	**10.5**
Food	5.4	10.0	-0.1	10.9	-1.5	2.1	18.8
Fuel	3.9	15.6	8.9	17.8	6.9	-1.5	6.4
Domestic appliance	1.0	3.4	-1.9	-2.8	-1.2	-1.3	-1.5
Other	1.8	3.4	1.4	3.2	2.3	0.6	0.5
II. DOMESTIC CPI	**87.9**	**0.3**	**2.4**	**2.3**	**1.4**	**1.3**	**2.8**
III. CPI	**100.0**	**1.5**	**2.5**	**3.5**	**1.5**	**1.1**	**3.9**
Exchange rate		**2.3**	**-1.2**	**-5.5**	**4.4**	**-6.4**	**-7.0**

Graph 7
PRICE INDEX INPUTS (Origin: China): 2004-2007*
(Dec. 2003 = 100)



* Up to November 2007.

7. The rise in the international price of food and fuels also led to an increase in the prices of some imported inputs, such as plastics and fertilizers. In other cases, such as imported inputs made in China (i.e. yarns and knitted garments, steel and iron laminated products, metal and chemical inputs, and plastics), the price rise (7.5 percent on average in 2007) was associated with salary increases and with several environmental regulations, as well as with the higher cost of raw materials in this country.

Table 3

MAIN INPUTS CUOTATION FOR INDUSTRY 1/

	% Change annual average		
	2005	2006	2007
PLASTIC AND CHEMICALS SUPPLIES			
Polypropylene	24.0	11.9	5.0
METAL SUPPLIES			
Cables, braids, aluminum, without isolating for electricity	11.8	29.9	27.4
Valves spherical taps	-8.1	27.1	26.4
Electric copper (tension between 80 and 1000 V)	47.8	20.6	21.8
TEXTILES AND YARN			
Tissue denim color	-11.3	10.1	21.3
PAPERS, AND PULP PAPER			
Paper and cardboard multilayer	7.0	4.3	7.5
Coniferous wood pulp	0.0	4.0	19.7

1/ Value per unit.

Core inflation

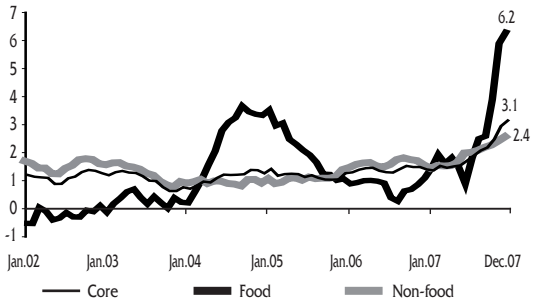
8. Core inflation increased from 1.4 percent in 2006 to 3.1 percent in 2007 mainly due to the higher prices of the foodstuffs included in this index. The inflation rate of the latter increased from 1.0 percent in 2006 to 6.2 percent in 2007.

Table 4

INFLATION: 2002-2207
(Percentage change)

	Weighted	2002	2003	2004	2005	2006	2007	Annual average 2002-2007
I. Core inflation	**60.6**	**1.23**	**0.73**	**1.23**	**1.23**	**1.37**	**3.11**	**1.48**
1. Food	10.7	0.02	0.14	3.24	0.98	0.98	6.24	1.91
2. Non food	49.9	1.49	0.85	0.80	1.28	1.45	2.44	1.39
a. Goods	23.3	1.39	0.08	-0.29	0.71	0.97	1.92	0.80
b. Services	26.6	1.57	1.53	1.75	1.77	1.85	2.88	1.89
II. Non core inflation	**39.4**	**1.96**	**5.16**	**6.75**	**1.87**	**0.83**	**5.07**	**3.58**
1. Food	22.5	0.28	3.73	5.82	1.62	2.06	7.25	3.43
2. Non food	16.9	4.22	7.00	7.90	2.17	-0.67	2.37	3.79
a. Fuel	3.9	15.60	8.94	17.77	6.89	-1.50	6.45	8.84
b. Transport	8.4	0.11	10.99	3.49	1.29	1.12	0.82	2.90
c. Public services	4.6	1.96	-1.98	6.19	-1.72	-3.22	0.24	0.20
III. Total	**100.0**	**1.52**	**2.48**	**3.48**	**1.49**	**1.14**	**3.93**	**2.33**

Graph 8
CORE INFLATION, CORE FOOD AND CORE NON-FOOD
(Percentage change over the last 12 months)



9. As regards the foodstuffs included in the core inflation index, the price increase of dairy products was noteworthy. Dairy products showed an accumulated change of 11.3 percent, especially in the last quarter of the year, due to the higher prices of national fresh milk used to elaborate them. This higher price of fresh milk would be reflecting the higher production costs associated with price rises in the inputs used to feed livestock (wheat bran, maize, and cotton paste), as well as rises in the costs of energy and fuels.

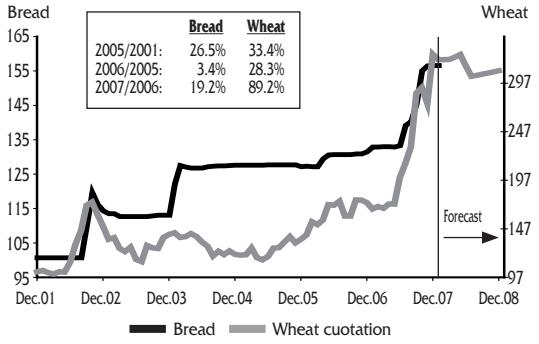
   The prices of the other components of core inflation increased by 2.4 percent in 2007 showing a higher increase than the one observed in 2006 (1.5 percent). This result was influenced by the higher prices of services, including "eating out" related services (4.1 percent) and education (3.6 percent).

10. Core inflation has been increasing at a faster pace since November 2005 (1.0 percent), which -in addition to the effect of increased imported inflation-coincides with a higher growth of domestic demand (10 percent in 2006 y 11 percent in 2007).

Non-core inflation

11. Non-core inflation, which represents all the goods and services affected by supply shocks or whose prices are controlled, accumulated a 5.1 percent variation in 2007. This increase was mainly due to the higher prices of bread, fuels,

Graph 9
WHEAT AND BREAD PRICES
(December 2001=100)

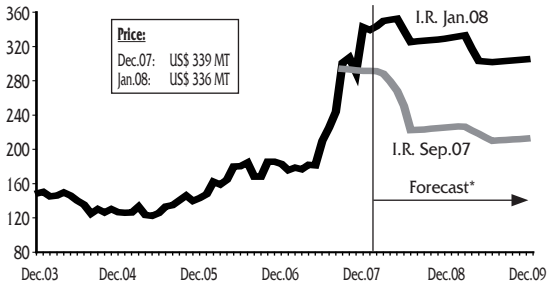


and eggs, and partially offset by the lower prices of sugar, telephone rates, potato, and onion.

Bread: The price of bread increased 19.2 percent in 2007 due to the higher price of wheat meal, the main input used to elaborate it. The wholesale price of wheat meal increased 43 percent due to the higher international price of wheat (89 percent).

This increase in the international price of wheat was offset by two factors, the reduction of tariffs on imports and the appreciation of the Nuevo Sol. This tariff reduction eliminated the tariff on wheat (which was 12 percent in July 2007) and also the 5 percent surcharge it was subject to. Had the tariff reduction and the appreciation of the Nuevo Sol not occurred, the impact of the price increase of wheat, its derivatives and substitutes on inflation would have been 1.5 percentage points instead of 0.9 percent.

Graph 10
WHEAT PRICE
(US$ per MT)



Source: Bloomberg.
* Based on futures positions.
IR: Inflation Report.

The price of wheat rose due to greater supply constraints than the ones considered in the base scenario of our Inflation Report of September 2007, although within the range of contingencies included in our risk balance. Factors contributing to the evolution of the price of this commodity included the reduction of wheat sown areas in Canada and unfavorable weather conditions, especially in Australia, Ukraine, and some countries of Western Europe.

According to estimates of the US Department of Agriculture for the 2007/08 crop year, these supply constraints would continue in these years, although slightly offset by a higher production in some Asian countries (mainly India, China, and Russia) as well as by a reduction of global non-human consumption. The high prices of wheat have generated that maize be used as a substitute of this crop in the elaboration of animal feed (livestock), particularly in Western Europe.

Moreover, supply constraints would cause final inventories of wheat to fall to their lowest level since the late seventies, and if the ratio of these inventories is considered in terms of world consumption, inventories would drop to their lowest historical level. In this scenario, and without considering severe climatic alterations, the price of wheat is forecast to remain high in 2008 but would show a slight downward correction after the first half of the year. This trend would continue during 2009.

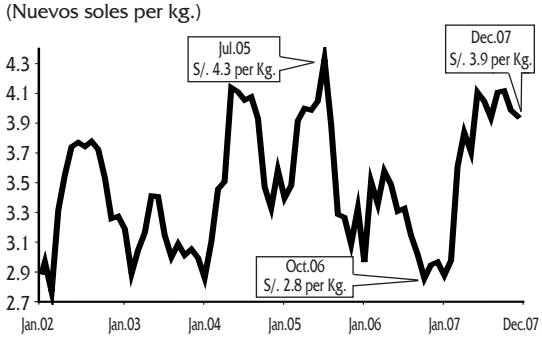
Table 5

WORLD WHEAT SUPPLY AND DEMAND BALANCE
(Millions of MT)

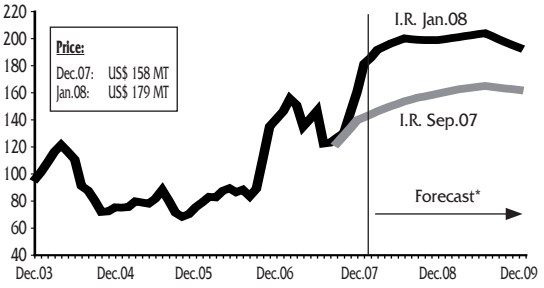
	Term 2004/05	Term 2005/06	Term 2006/07	Term 2007/08
1. Initial inventories	133	151	148	124
2. World production	629	621	594	603
3. World consumption	610	624	617	616
4. Final inventories (1+2-3)	**150**	**148**	**124**	**111**

Source: US Department of Agriculture (USDA report, January 2008).

Graph 11
PRICE OF EGGS
(Nuevos soles per kg.)



Graph 12
PRICE OF MAIZE
(US$ per MT)



Source: Bloomberg.
* Based in futures positions.
IR: Inflation Report.

Eggs: The rise in the price of eggs is associated with increased domestic demand and with a lower placement of laying hens (down 4 percent compared to 2006). This lower supply would be explained by a higher sale of laying hens (17 percent in January-November 2007 compared to the same period in the previous year).

The price increase of some food inputs (maize and soy bean) caused some firms -basically small firms- to leave the market. As a result of this lower supply, the price of eggs recovered both in real and relative terms compared with the prices of substitute products (due to their high protein content), such as chicken and yellow mackerel.

The international price of maize rose 47 percent mainly due to international demand-related factors. Maize consumption for ethanol production in the United States (main producer and consumer) and non-human consumption for the elaboration of animal feed (replacing wheat) have been generating a significant increase in the global demand for maize. Additionally, the higher price of petroleum generated greater expectations of a higher use of biofuels in the United States, which materialized thereafter when the new Energy Act which is intended to promote the use of biofuels was passed in December 2007.

According to estimates of the US Department of Agriculture for the 2007/08 crop year, the global consumption of maize should increase as a result of the higher capacity of elaborating ethanol in the United States. Likewise, non-human consumption of maize would continue to be driven by the high prices of wheat.

Moreover, a strong increase is estimated in global production of maize basically as a result of larger sown areas (in detriment of areas planted with soy bean) and of high yields in the United States given favorable climatic conditions. The US production of maize would reach record levels. Despite all this, global inventories would decrease to levels unobserved since the early eighties (below 13

percent of global consumption, a rate unheard of since the seventies).

In this context, prices are forecast to maintain an upward trend in 2008 and 2009, given the growth prospects of demand associated with the future goals of production of biofuels in the United States.

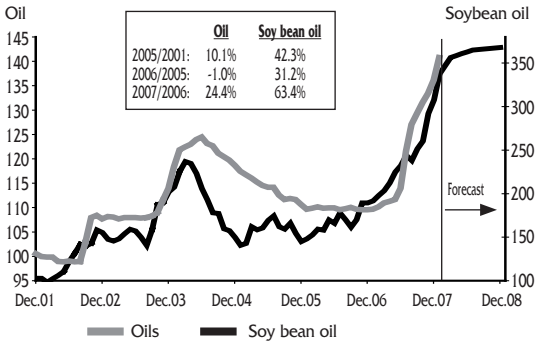
Table 6

WORLD MAIZE SUPPLY AND DEMAND
(Millions of MT)

	Term 2004/05	Term 2005/06	Term 2006/07	Term 2007/08
1. Initial inventories	103	131	124	107
2. World production	712	696	704	767
3. World consumption	685	704	720	773
4. Final inventories (1+2-3)	**131**	**124**	**107**	**101**

Source: US Department of Agriculture (USDA Report, January 2008).

Graph 13
PRICE OF OILS AND SOY BEAN OIL
(December 2001=100)



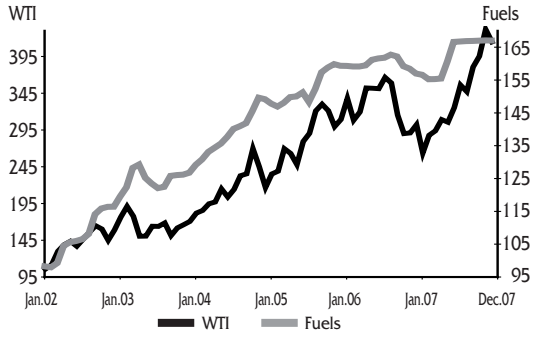
Oils: The price of oils increased 24 percent in 2007 due to the higher international price of soy bean oil (63 percent), which is the main input used for the elaboration of oils. This price increase could have been higher if competition in this sector had not been so strong and if tariffs had not been reduced in 2007.

Like in the case of wheat, the rise in the price of soy bean oil was in part offset by a tariff reduction on imports, as well as by the appreciation of the nuevo sol. The tariff on this product was reduced from 17 to 9 percent. Should neither the tariff reduction nor the appreciation of the sol have occurred, the impact of this price rise on inflation would have been 0.8 percentage points instead of 0.6 percent.

The price of soy bean increased 43 percent in 2007, showing a higher upward trend since the last quarter of 2006. This increase is explained by both supply and demand related factors. Supply-related factors included smaller sown areas (due to the substitution of this crop by maize to produce ethanol), unfavorable weather conditions in the United States (main producer and consumer of soy bean), and China's lower production due to adverse climatic conditions (China is the world's fourth producer and second consumer of soy bean).

Demand-related factors included a higher consumption in Asia, driven by the depreciation of the dollar, and the strong economic growth observed in this region, particularly in China. Additionally, the high prices of petroleum have boosted the demand of soy bean for the elaboration of biofuels derived from this crop.

Graph 14
PRICES OF WTI OIL AND DOMESTIC FUELS
(Dec. 2001 = 100)



Fuels: The domestic price of fuels increased 6.4 percent on average in 2007. The price of West Texas Intermediate oil (WTI) in the international market increased from US$ 62 in December 2006 to US$ 91 in December 2007 (up 47 percent).

To mitigate the impact of the rise in the international price of oil on inflation, the government has been using the Fuel Price Stabilization Fund. In 2007 this contingent fund increased by S/. 770 million. Had this mechanism not been applied during the year, the impact on inflation would have been of 0.8 additional percentage points.

Table 7

FUEL PRICES
(Annual percentage change)

	2002	2003	2004	2005	2006	2007
Fuels	**15.6**	**8.9**	**17.8**	**6.9**	**-1.5**	**6.4**
Gasoline	15.7	9.7	17.7	9.2	-6.2	10.7
Gas	11.3	4.2	15.3	-10.9	0.3	1.3
Kerosene	20.4	13.0	20.3	21.0	2.2	5.8
Price of WTI oil at year end (per barrel)						
US Dollars	29.4	32.1	43.3	59.4	61.9	91.7
Nuevos soles	103.5	111.3	142.0	203.3	198.6	273.4

Source: INEI, Bloomberg.

Public utility rates: The higher rates of electricity (1.9 percent) and water (3.2 percent) and the reduction of telephone rates (7.2 percent) are worth highlighting in 2007. Electricity rates dropped 2.8 percent between April and May due to the annual update of band rates, which considered new energy generation projects. Between June and July, electricity rates increased 2.3 percent due to the approval of the rural electrification law which considers a contribution equivalent to 2/1000 of 1 tax unit (UIT) for residential users. This rate was again increased by 1.6 percent in August due to the quarterly adjustment that considers the higher prices of fuel.

The drop in telephone rates reflects mainly the reduction in the basic monthly rent of the classic residential telephone line and a series of rate plans resulting from negotiations between the State and Telefonica.

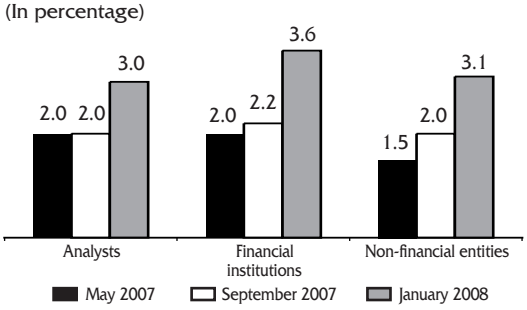
Table 8

PUBLIC UTILITY RATES
(Percentage change)

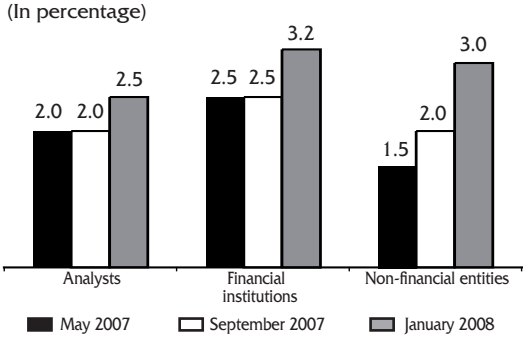
	2002	2003	2004	2005	2006	2007
Public utilities	**2.0**	**-2.0**	**6.2**	**-1.7**	**-3.2**	**0.2**
Electricity	7.9	-4.6	12.0	-2.5	-7.3	1.9
Telephone	-8.3	0.3	-2.0	-7.0	-6.2	-7.2
Water	2.3	0.9	3.0	5.2	8.5	3.2

Source: INEI.

Graph 15
INFLATION EXPECTATIONS FOR 2008
(In percentage)



Graph 16
INFLATION EXPECTATIONS FOR 2009
(In percentage)



Inflation expectations

12. The forecast considers inflation expectations as these influence price formation in the economy. The results of the Survey on Macroeconomic Expectations show that expectations regarding inflation in 2008 and 2009 have been revised upwards, influenced by the rate of inflation by January 2008. Thus, according to the results of the surveys carried out in September 2007 and in January 2008, inflation expectations for 2008 were revised upwards from 2.2 to 3.6 percent in the case of financial entities, while economic analysts and non-financial firms revised their expectations from 2.0 percent to 3.0 and 3.1 percent respectively. Moreover, inflation expectation for 2009 range between 2.5 and 3.2 percent (whereas in September 2007 they ranged between 2 and 2.5 percent).

Input prices

13. Several results on the evolution of input prices and firms' sale prices may be drawn from the information collected through the Surveys on Macroeconomic Expectations. The number of firms that said that the prices of the inputs they use had increased by September (37 percent) and by December (36 percent) of last year is relatively stable. On the other hand, the number of firms expecting rises in the prices of inputs in the following 3 or 4 months decreased from 40 percent in September to 31 percent in December.

    The opposite occurred in the case of sale prices. The number of firms whose prices had already increased in the last month or are expecting prices to increase in the following 3 or 4 months grew from 17 to 21 percent and from 29 to 32 percent respectively.

Table 9

INPUT AND SALE PRICE
(% of firms that answered the survey)

	September 2007			December 2007		
	Increased	No change	Decreased	Increased	No change	Decreased
Price of inputs (month of survey / previous month)	37	60	3	36	61	3
Sale price (month of survey / previous month)	17	76	7	21	74	5
Price of inputs (next 3 to 4 months / month of survey) 1/	40	57	3	31	66	3
Sale price (next 3 to 4 months / month of survey)	29	66	5	32	63	5

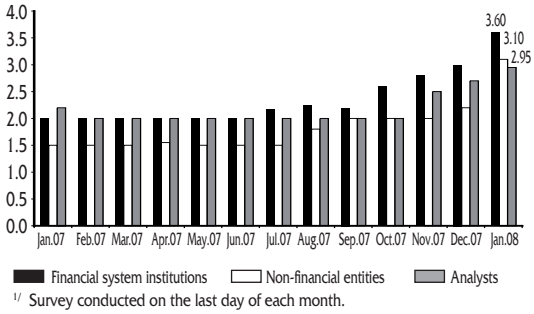
1/ Survey applied in October 2007.
Source: Survey on Macroeconomic Expectations, BCRP.

Inflation forecasts

14. The main determinants used to forecast inflation include supply and domestic demand conditions, imported inflation, and inflation expectations. The faster pace of inflation seen over the last months has mainly been determined by the higher imported inflation (10.5 percent in 2007) observed in a context of high growth of domestic demand (11 percent), driven mainly by consumption and private investment (7.6 and 23.2 percent).

15. In this context, the inflation forecast for 2008-2009 has been revised upwards in terms of the central scenario considered in the Inflation Report of September 2007. The higher imported inflation would have been partially offset by the appreciation of the Nuevo Sol and by the tariff reduction implemented in October 2007. As in our previous inflation report, the rises in the prices of international commodities (particularly foodstuffs such as wheat, soy bean, and maize) are expected to have a transitory impact on inflation. Thus, inflation should return to the target range once the impact of these rises on the average level of prices has dissipated. Inflation should converge to the target range by the end of the year and remain within said range during the rest of the forecast horizon.

Graph 17
EVOLUTION OF EXPECTED INFLATION RATES IN 2008 1/
(Percentage change over the last 12 months)



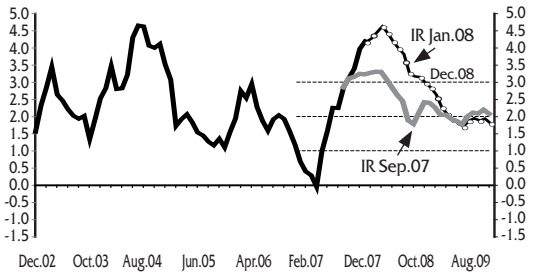
1/ Survey conducted on the last day of each month.

16. Some of the inflationary risks discussed in our September Report have materialized. Our previous report indicated a high probability that the prices of food commodities and oil could be higher than the ones considered in the central scenario or that they could have a higher impact on domestic prices and inflation. In fact, the imported component of inflation increased from an estimated 8.8 percent to 10.5 percent. This scenario has brought about higher inflation expectations in the short run, as shown in the graph.

17. Given the significant increase observed in imported inflation, its impact on non-tradable goods could be accelerated due to higher inflation expectations. In this sense, monetary policy efforts will continue to be oriented at maintainin inflation expectations aroung the target range. Moreover, as monetary policy lags are considered, any deviation of expectations should be temporary, and expectations should converge thereafter towards the target.

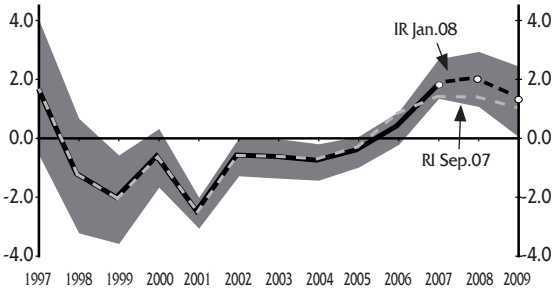
18. Imported inflation comprises the determinants of inflation that are more sensitive to the evolution of international prices, such as the prices of fuels and foodstuffs. The average price of WTI oil is expected to be US$ 89 and US$ 84 per barrel in **2008** and **2009** respectively. On the other hand,

Graph 18
FORECAST 12-MONTH INFLATION
(In percentage)



IR: Inflation Report.

Graph 19
OUTPUT GAP
(In percentage)



Note: The shaded are represents uncertainty in the calculation and forecast on the output gap (plus or minus one standard deviation).

the prices of food commodities that have a strong impact on the various food items considered to measure domestic inflation have increased compared to our previous report estimates. Thus, for example, the international price of wheat is expected to increase in 2008 from US$ 248 to US$ 333 per ton. However, a reduction in the prices of fuels and wheat is expected for next year in the base scenario. The downward trend of the price of these commodities could deepen if the slowdown of economic activity in the United States should be greater.

The high level of the international price of crude has generated pressures on the domestic prices of fuels. The extent of the impact of the international price of crude on domestic prices will depend on the resources available to the Oil Derived Fuel Price Stabilization Fund. The Fund is expected to have resources throughout 2008 and 2009.

19. Due to lower economic activity in the United States, the international environment would be less favorable in the next years. Therefore, lower terms of trade and a lower growth in the world economy are expected. This would cause a slowdown in the growth of domestic demand and GDP, although the latter would still show high rates that are close to the estimated growth of the potential output (approximately 7.0 percent).

BOX 2

FOOD PRICES AND INFLATION

In line with the rise in the price of petroleum, the prices of the main food products associated with the production of biofuels have sustainedly increased since 2003.

These price increases, which were particularly high in 2006 and 2007, have impacted on the domestic prices of the main food products and services associated with them (such as “eating out”, for example) and have also generated pressures on inflation in many countries.

INTERNATIONAL CUOTATIONS (ACCUMULATED CHANGE UP TO DECEMBER)

	2006	2007	2006-07
Sugar	-17.3	0.2	-17.1
Petroleum (WTI)	4.4	47.4	53.8
Wheat	28.4	89.0	142.8
Maize	89.2	14.4	116.5
Soy bean	11.2	70.7	89.7

Source: Bloomberg.

According to the October 2007 update of the IMF's World Economic Outlook (WEO), the global contribution of food prices on inflation -considering only the first round direct impact- has grown from 27 percent in the 2000-2006 period to 36 percent in the January-April 2007 period. The case of Asia, where this figures rose from 34 to 56 percent due to China's contribution, is worth highlighting. In the Western Hemisphere, said impact increased from 26 to 37 percent. In Peru, the impact of food throughout 2007 increased from 25 to 58 percent.

DIRECT IMPACT OF FOODSTUFFS PRICES ON INFLATION

	Percentage contribution (%)	
	2000 - 2006	Jan.-Apr. 2007
World	26.6	36.4
Developed economies	14.2	18.4
Africa	46.5	37.9
Developed economies in Asia	34.1	55.9
East-central Europe	29.9	33.0
Middle East	37.4	52.2
Western Hemisphere	25.6	37.2
Peru*	**25.2**	**57.6**

* Corresponds to food and beverages: January-December 2007.
Source: IMF (Oct. 2007) and BCRP.

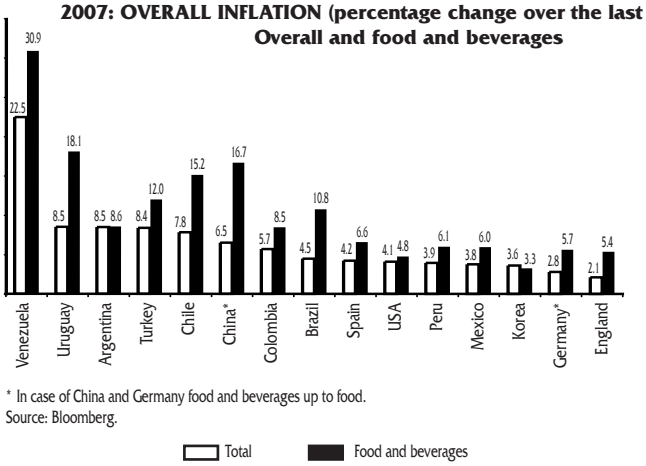
This dispersion in the contribution of food prices on overall inflation in part reflects different policy actions, such as price control agreements, quotas or taxes on exports to improve the domestic supply of food products, etc. It also reflects the weight of food in the CPI basket. Food accounts for roughly 10 percent of the basket in developed countries, for approximately 30 percent in emerging countries, and for over 60 percent of the consumer basket in many countries in Africa. In Peru, food represents 33 percent of the basket, with food products and beverages accounting for 48 percent of the CPI basket.

The inflationary impact of the recent supply shock in the case of basic foodstuffs has been a generalized phenomenon in both developed and emerging countries. In a great number of countries, this has implied an increase in the level of prices and, in some cases, it has even implied inflation rates above the central banks' inflation targets and at levels not observed since the past decades in many cases.

Thus, for example, if monthly inflation (12-month change) is considered, the inflation rates posted in Singapore, Chile and China had not been seen since 1982, 1996, and 1996 respectively. On the other hand, if end-year inflation (annual variation by December) is considered, Chile, China, Peru, Taiwan, USA, Singapore and Japan reached inflation levels that had not been observed since 1997. Moreover, inflation showed record levels in the Eurozone (3.1 percent in 2007), and in terms of countries, many economies recorded inflation rates that had not been seen for over a decade.

In Latin America, inflation rose significantly in most countries and even generated pressures on inflation's core component in some countries (i.e. Mexico, Colombia, and Chile). In some cases, in economies with inflation targets (either explicit or implicit), the inflation rates observed were higher than the central banks' inflation targets (i.e. Chile, Colombia, and Venezuela) and, in other cases, the inflation rates recorded reverted the downward trend previously observed, although inflation still remains within the target range (as in Brazil, for example).

2007: OVERALL INFLATION (percentage change over the last 12 months)
Overall and food and beverages



* In case of China and Germany food and beverages up to food.
Source: Bloomberg.

BOX 3
PRICE FORMATION: MAIN DETERMINANTS

The outcomes considered here were obtained from the surveys applied to 292 firms operating in four sectors: the primary sector -which includes agriculture, fisheries, and mining-, manufacturing, commerce, and services. The sector with the highest representativity in the survey (55 percent) was the manufacturing sector, with 160 firms.

Therefore, a Survey on Price Formation has been carried out in order to understand the mechanisms originating inflationary pressures and the effect of monetary policy on economic activity.

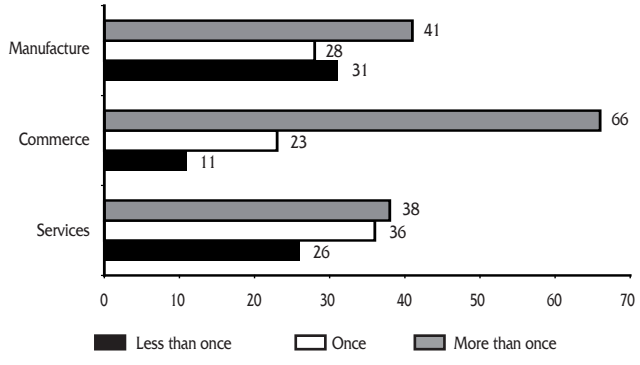
This survey has been carried out in several countries (England, Canada, Spain and Mexico, among other countries) with the main purpose of explaining price rigidity. In these countries, the survey results are a complementary source of information to assess the performance of monetary policy. In Peru, this source of information would be particularly relevant given that a Producer Price Index (PPI) is still not available.

The Central Bank conducts a Survey on Macroeconomic Expectations every month which includes firms operating in the Primary, Manufacturing, Commerce, and Service sectors. For the purpose of carrying out the Survey of Price Formation, it was deemed convenient to work with the same sample and to distribute the questions relative to price formation between the months of June and October 2007. The results discussed below are part of an ongoing wider study.

How often do firms adjust prices?

Most firms adjust prices more than once a year in all the sectors, but 31 percent of the firms operating in the manufacturing sector adjust their prices less than once a year.

FREQUENCY OF PRICE ADJUSTMENTS IN THE YEAR



What are the main factors firms take into account to raise or lower their prices?

Of the total number of firms surveyed, 89 percent determine their prices according to market conditions (costs, demand, and competition) and 11 percent try to maintain fixed margins on their costs. The main factor considered to raise prices is an increase in the prices of inputs. In addition to this, to increase their prices companies also consider the prices of the products sold by their competitors, while seeking to increase the demand for their product would be the main reason considered to cut prices.

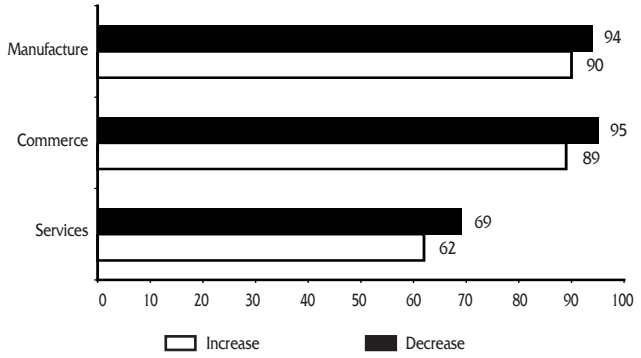
MARKET CONDITIONS 1/

	Price increase	Price decrease
Increase/decrease in laboral costs	47	41
Increase/decrease in financial costs	44	36
Increase/decrease in costs of inputs	85	80
Increase/decrease in costs of energy	57	54
Increase/decrease in demand	76	83
Increase/decrease in competition	75	80
Increase in labor productivity		68
Increase in market participation		65

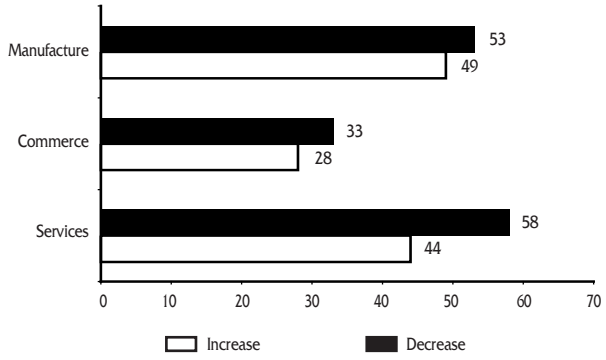
1/ It refers to 89 percent companies. It could choose more than one choise.

The table above shows that there is an asymmetry in the effect produced by a cost variation. In the case of inputs, any policy measure reducing the price of inputs does not translate completely into prices, but also into higher margins. In the case of labor costs, a certain downward rigidity is also observed mainly in the service sector. In all the sectors in general, the effects of a cost variation are higher than the effects of a variation in labor costs.

ASYMMETRIES ON PRICE ADJUSTMENT BY VARIATION OF COSTS OF INPUTS



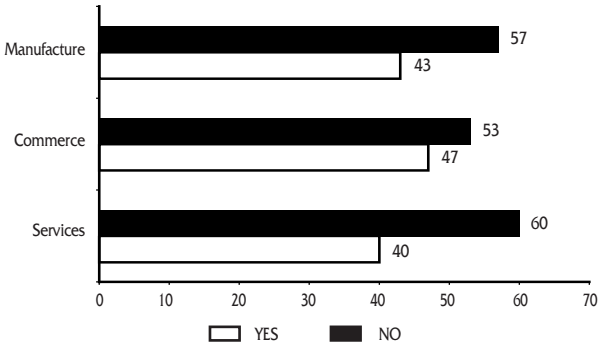
ASYMMETRIES ON PRICE ADJUSTMENT BY A VARIATION IN LABOR COSTS



As regards demand, firms' prices respond more to a demand reduction than to a demand increase. Moreover, they also respond more to a reduction in the prices of their competitors' products than to an increase of these prices.

One of the main reasons considered to adjust prices is companies' participation in the market.

PROBABILITY OF LOSING MARKET'S PARTICIPATION DUE TO A PRICE INCREASE



In the manufacturing sector -which is the most homogeneous sector and which represents 55 percent of the sample-, over 90 percent of the companies surveyed answered that the main determinant for raising prices is an increase in the cost of inputs, while the price of their competitors' products ranks second as a determinant.

MARKET CONDITIONS MANUFACTURE SECTOR 1/

	Price increase	Price decrease
Increase/decrease in labor costs	52	49
Increase/decrease in financial costs	48	44
Increase/decrease in cost of inputs	93	89
Increase/decrease in cost of energy	68	65
Increase/decrease in demand	73	82
Increase/decrease in competition demand	78	85
Increase in labor productivity		71
Increase in market participation		69

1/ It could choose more than one choise.

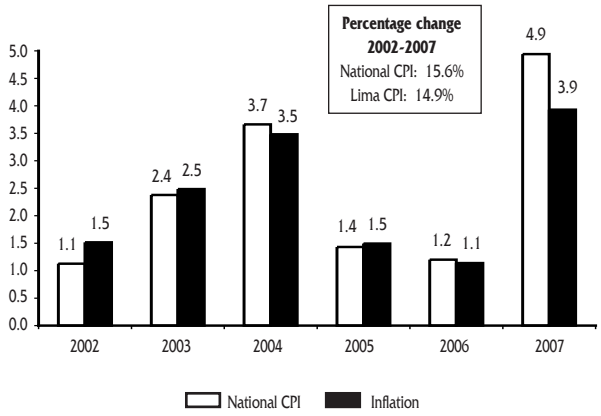
BOX 4

CPI OF METROPOLITAN LIMA AND NATIONAL CPI

In the frame of the BCRP's inflation targeting scheme, the monetary policy target variable is the Consumer Price Index (CPI) of Metropolitan Lima, which is calculated by the Instituto Nacional de Estadística (INEI) and published in the official daily El Peruano on the first day of each month.

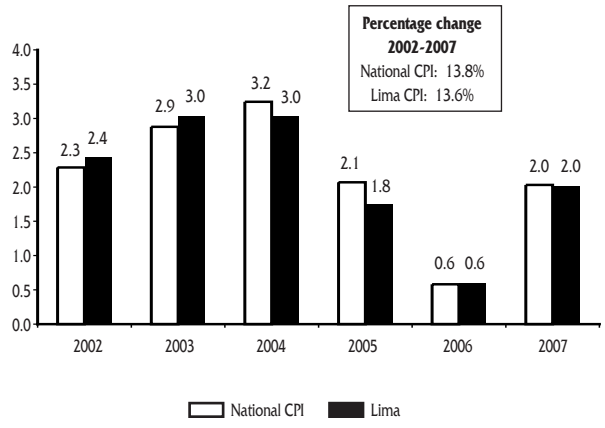
Since January 2003, the INEI publishes the National Price Index (National CPI), which is the weighted average of the price indices of Peru's 25 main cities (24 department capitals and Chimbote).

NATIONAL CPI AND INFLATION
(Annual percentage change)



By December 2007, the CPI of Lima showed an accumulated change of 3.9 percent, while the National CPI had an accumulated change of 4.9 percent.

INFLATION NON FOOD AND BEVERAGES
(Annual percentage change)



In fact, if the percentage change in food and beverages is excluded from inflation, the variation is 2 percent both in the CPI of Metropolitan Lima and in the National CPI, and the dispersion among cities declines.

The National CPI still has methodological limitations so that it cannot be used by BCRP. Among these limitations are: (i) the weights of most cities don't reflect the structure current consumption, but from the period 1993-1994, and (ii) the size of the sample.

The base year used to calculate the National CPI is 2001, and the weight structure is the one of expenditure according to the 1993-1994 ENAPROM survey. On the other hand, the weights in the case of CPI of Metropolitan Lima were revised in 2001; one of the main changes was the reduction of the weight of Food and Beverages. Over 36 thousand data are recorded every month to calculate the CPI of Metropolitan Lima, while approximately 41 thousand data are recorded every month for all the other 24 cities. Thus, the CPI of Lima would be more representative and more reliable.

The CPI of Metropolitan Lima is representative of the National CPI since expenditure in Metropolitan Lima accounts for 70 percent of domestic expenditure.

CPI and inflation target

The inflation target is measured by the annual percentage change of the CPI of Metropolitan Lima -which is calculated by the INEI- because the quality of this index is better than that of the National CPI. Given that the former is based on more complete and detailed information than the latter, it allows a better analysis of prices.

Other countries with inflation target schemes consider only a determined urban area. For example, the CPI of Chile refers to the Great Santiago area. This is the indicator used in monitoring the inflation target.

CHARACTERISTICS OF CONSUMER PRICE INDEX

Country	Geographical coverage	Baseline basket	Number of stores	Number of observations
Argentina	Federal capital and 24 parties that make up the Gran Buenos Aires.	1996 - 1997	8,000	100,000
Bolivia	Main cities: La Paz, Cochabamba, El Alto and Santa Cruz.	1990	7,135	
Brazil	Metropolitan Area of 9 states, the Federal District and the city of Goiana.	2002 - 2003	27,500	500,000
Chile	Great Santiago (Santiago province Puente Alto and San Bernardo).	1996 - 1997	2,489	100,000
Colombia	Capitals of 13 departments: Bogotá, Medellín, Cali, Barranquilla, among others.	1998	15,408	40,000
Ecuador	8 cities representing 67% of the population.	2003 - 2004	2,392	10,010
Mexico	46 cities.	2000	15,000	190,000
Peru	Metropolitan Lima	1994	7,275	36,000
	Other cities.	1994		41,000
Uruguay	Capital city of Montevideo.	1997	1,470	10,900

Source: Statistics institutes, Central banks, and IMF.

Finally, it is advisable to update the structure of weights of the consumer basket used to calculate inflation which requires dealing a new survey. For reference, in tlhe Socio-Economic Level Survey Ipsos Apoyo for Metropolitan Lima, food and Beverages within the household has a weighting of 27.8 percent, lower than the 35.5 percent of the INEI. Using weights fron Apoyo, the inflation in 2007 would be 3.4 percent, lower than the 3.9 percent calculated by INEI.

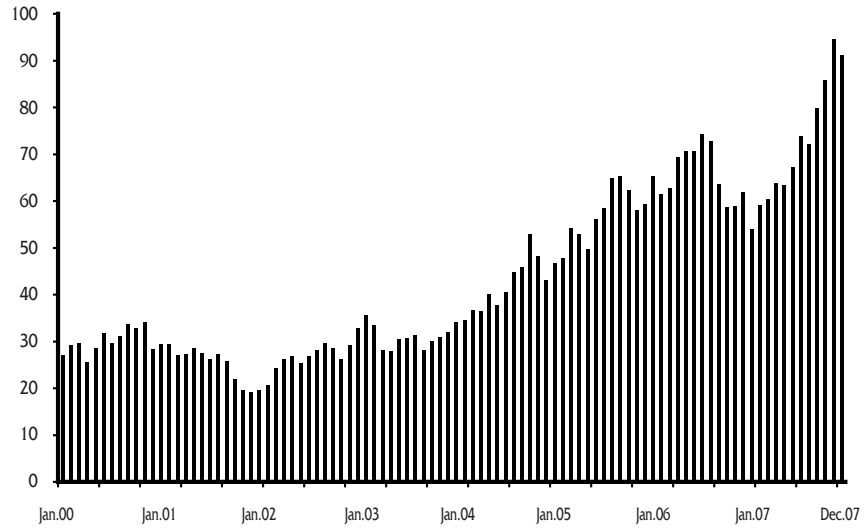
The INEI will carry out the National Survey of Family Budgets which will be able to calculate a New 2008-based CPI.

BOX 5

THE FUEL PRICE STABILIZATION FUND

During 2007 the international price of crude oil and crude oil derivatives showed an upward trend with high volatility, a phenomenon observed since end 2003. The price of oil at the beginning of 2007 was US$ 54.2 per barrel. After reaching an average price of US$ 94.8 per barrel in November, the price of oil fell to US$ 91.4 per barrel in December. This implied an accumulated increase of 47.3 percent.

INTERNATIONAL PRICE OF CRUDE OIL (WTI)
(US$ per barrel)



In this context, the Peruvian government has used the Fuel Price Stabilization Fund as an instrument to mitigate the impact of the higher prices of petroleum derivatives on domestic prices.

This mechanism, which has been used since October 2004, allows compensating producers when the reference international price -published every week by OSINERGMIN- is above the upper band of a price band discretionally set by the Ministry of Energy and Mining (MINEM). Similarly, producers contribute to the Fund when the price is below the lower band of this price band.

To operate, the Fund requires that refineries and fuel importers pay on a weekly basis the difference between the contributions of producers and the compensations they are entitled to have. If this difference is a net compensation (that is, if compensations are higher than contributions), the Fund will pay the difference if the Fund has liquid resources. Otherwise, companies will accumulate credit against the Fund.

In 2007 the contingent amount allocated by the Treasury to cover the Fund's equity increased by S/. 770 million. These resources ensure that the Ministry of Energy and Mining -which administers the Fund- have enough resources to cover the liabilities with refineries and fuel importers that the Fund has generated.

This sum was higher than those allocated in previous fiscal years (S/. 40 million in 2004, S/. 150 million in 2005, and S/. 80 million in 2006), which reflected the rise in the price of crude oil and oil derivatives seen mainly in the second half of the year. Moreover, if we consider the S/. 200 million allocated to the Fund in

January 2008, the total amount authorized to the Fund since it was first established is S/. 1,260 million, of which S/. 373 million have been paid to producers and importers.

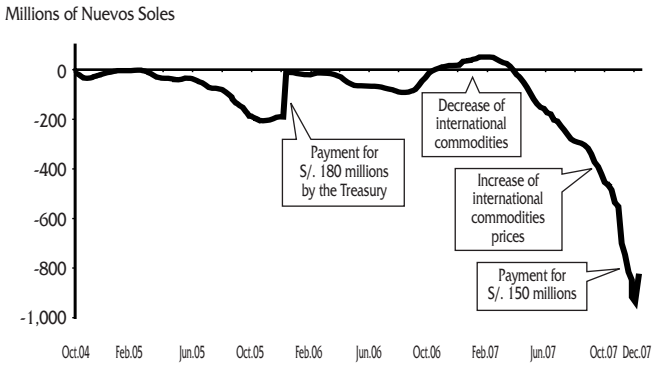
AMOUNT ALLOCATED BY TREASURY TO FUND'S EQUITY: 2007
(Millions of Nuevos Soles)

Norm	Date	Amount
D.U.017-2007	05-31-2007	70
D.U.021-2007	07-12-2007	100
D.U.028-2007	08-22-2007	150
D.U.034-2007	10-18-2007	100
D.U.042-2007	11-15-2007	150
D.U.047-2007	12-06-2007	200
TOTAL		**770**

Due to the lower international prices of fuels in the fourth quarter of 2006, the Fund's equity was positive at the beginning of 2007. However, the subsequent increase in the international prices of oil generated an accumulation of liabilities since February 2007. To contain this accumulation of liabilities, the price band was adjusted upwards by end April and May, which led fuel prices to increase by 3.4 and 3.7 percent in June and July respectively.

No significant changes were made in the price bands following these adjustments until the month of December, when the price bands for 90 and 84 octane gasoline, kerosene and diesel were increased. This had no impact on prices since this increase was compensated by an equivalent reduction of the excise tax on said products. According to preliminary information provided by the MINEM, the Fund would have a negative equity of roughly S/. 830 million at the close of fiscal year 2007.

FUND BALANCE



During 2007 the prices of fuels with impact on the CPI showed an increase of 6.4 percent, and the price crude of refinery increase 11 percent a result reflecting both the increase in the price of crude (47.3 percent) -offset by the appreciation of the nuevo sol (6.3 percent)- and the application of the Fund. The Fund would have mitigated the increase of the international price of oil on domestic prices by 7.2 percent in the case of gasolines, by 11.5 percent in the case of kerosene, and by 26.7 percent in the case of LPG. Thus, the direct impact on the CPI is estimated at 0.8 percentage points.

III. International environment

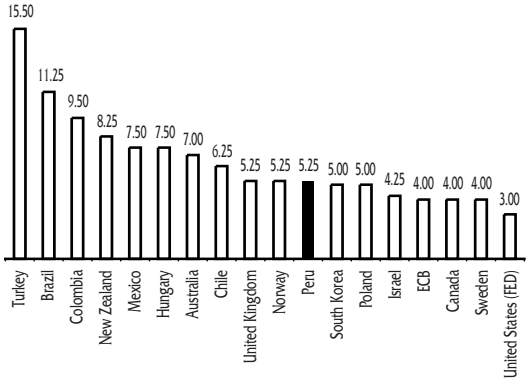
The low dynamic performance of the U.S. economy was compensated by the robust growth of emerging countries and, to a lesser extent, by the sound growth of some developed countries. In most cases, this higher growth was coupled by inflationary pressures that were accentuated by the evolution of the international prices of food and petroleum.

International financial markets saw a period of high volatility since the second half of 2007. This volatility was associated with the deterioration of the high-risk mortgage segment in the United States -the subprime mortgage market-, which affected credit and brought about a downward correction on real estate prices.

In 2008, the global economy would show a higher slowdown than the one forecast in our Inflation Report of September due to lower growth in the United States and to the tightening of credit conditions in developed economies.

Given uncertainty about the future evolution of international financial markets and the U.S. economy, forecasts on global economic growth are biased downwards in this report.

Graph 20
REFERENCE INTEREST RATE TO 2008



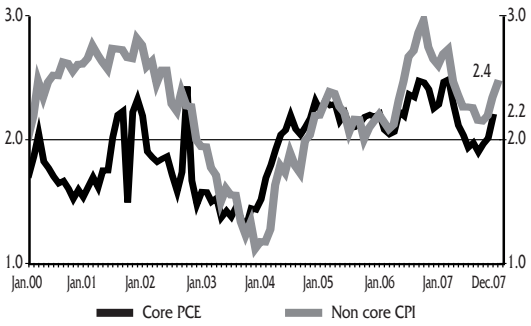
Source: Central banks and Bloomberg.

Growth, inflation, and interest rates

20. The outlook on growth in the **United States** has been revised downwards after several financial institutions reported losses associated with assets in the subprime mortgage market in the last months of 2007, increasing uncertainty about the magnitude of the real estate crisis in this country.

21. This perception of increased risk -due to the potential effects of this crisis on financial markets- has been coupled by greater concerns on the future evolution of economic activity. Data show an upward trend in unemployment (4.9 percent in

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



Source: Bureau of Labor Statistics.

January 2008), while GDP growth decreased significantly to 0.6 percent after having recorded a 4.9 percent change in the previous quarter.

Moreover, core inflation reached 2.4 percent between December 2006 and December 2007, while PCE[1] core inflation posted 2.2 percent in the same period -a rate above the Federal Reserve's tolerance margin of 2 percent indicating the presence of inflationary pressures.

Table 10

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

	Weighted trade 2006	2006	2007		2008		2009	
			IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
Trade partners 2/	***100%***	***4.6***	***4.3***	***4.4***	***4.0***	***3.6***	***3.8***	***3.8***
North America	***29%***	***2.9***	***2.1***	***2.3***	***2.3***	***1.6***	***3.0***	***2.5***
USA	24%	2.9	2.0	2.2	2.2	1.5	3.0	2.5
Canada	5%	2.8	2.5	2.6	2.6	2.1	3.0	2.5
Europe	***20%***	***3.0***	***2.7***	***2.8***	***2.3***	***2.0***	***2.0***	***2.0***
Germany	4%	2.9	2.6	2.5	2.3	1.8	1.9	1.9
United Kingdom	1%	2.8	2.8	3.1	2.1	1.8	2.2	2.0
Asia	***21%***	***7.6***	***7.7***	***7.7***	***7.3***	***7.0***	***6.7***	***6.8***
China	11%	11.1	11.3	11.4	10.6	10.4	9.8	9.8
Japan	5%	2.2	2.3	1.9	2.1	1.5	1.5	2.0
Latin America	***30%***	***5.3***	***5.3***	***5.4***	***4.4***	***4.5***	***4.0***	***4.2***
Argentina	2%	8.5	7.6	8.5	5.4	6.5	4.7	4.5
Brazil	7%	3.7	4.8	5.3	4.5	4.7	4.3	4.5
Chile	7%	4.0	5.9	5.2	5.2	4.7	4.9	4.9
Colombia	4%	6.8	6.4	6.8	5.3	5.5	4.6	5.0
Mexico	3%	4.8	2.9	3.1	3.4	2.9	3.8	3.7
Venezuela	3%	10.3	8.2	8.4	4.5	4.7	1.5	3.3
Note:								
India		9.7	8.5	8.6	8.3	8.2	7.0	7.0
Peru		7.6	7.5	8.5	6.4	6.9	6.1	6.5
World economy: ***a)*** [3/]		***4.0***	***3.6***	***3.7***	***3.5***	***3.2***	***3.3***	***3.3***
b) [4/]		***5.0***	***4.7***	***4.9***	***4.4***	***4.1***	***4.3***	***4.3***

IR: Inflation Report
1/ Executed data of WEO and Consensus Forecast data as of the corresponding month, IMF, and BCRP.
2/ Weighted according to the 2006 trade.
3/ Using nominal exchange rate (Source: Consensus Forecast).
4/ Using exchange rates of purchase power parity (Source: WEO).
* Forecast.

1 Personal Consumption Expenditures.

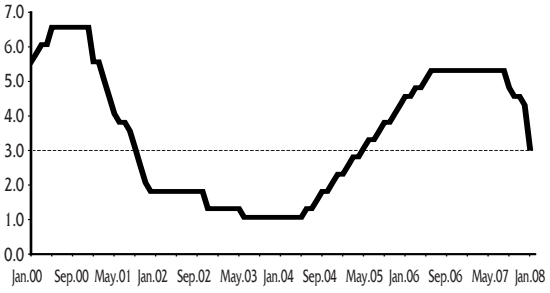
Table 11

MAIN INDICATORS ON THE USA AND CANADA 1/

	2006	2007*		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
GDP (percentage change)							
USA	2.9	2.0	2.2	2.2	1.5	3.0	2.5
Canada	2.8	2.5	2.6	2.6	2.1	3.0	2.5
Inflation (average)							
USA	3.2	2.7	2.9	2.3	2.8	2.0	2.1
Canada	2.0	2.3	2.2	2.3	1.6	2.0	2.0
Current account (percentage of GDP)							
USA	-6.2	-6.0	-5.7	-6.0	-5.0	-	-4.5
Canada	1.6	1.6	1.8	1.2	0.2	-	0.5
Fiscal deficit of the government (percentage of GDP)							
USA	-2.6	-1.7	-2.6	-1.9	-2.9	-	-2.9
Canada	1.0	0.6	0.9	0.6	0.3	-	0.3

1/ Source: Consensus Forecast, IMF, Investment banks and BCRP.
* Forecast.

Graph 22
FED MONETARY POLICY RATE
(In percentage)



22. In a context of turbulence in financial markets and uncertainty about the economic slowdown, the Federal Reserve (FED) cut its policy rate by 225 points between September 2007 and January 2008. Given increased indications of a recession in the United States, the FED lowered its policy interest rate by 75 basis points in an extraordinary meeting in mid-January 2008. Furthermore, the FED reduced its rate again by 50 bps to 3.0 percent on its meeting of January 30.

23. Considering these developments, the forecast on growth in the United States for 2008 and 2009 has been revised downwards. In 2008 the U.S. economy would show a slowdown (a process that already started in the fourth quarter of 2007) due to the correction of the real estate market, as well as an anticipated downswing in consumption and a more moderate growth in investment.

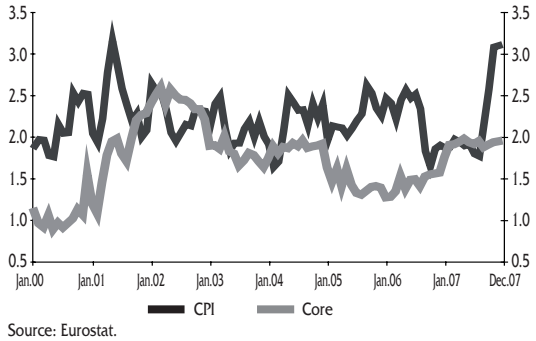
    Consumption would be affected by the drop of house prices, the high prices of fuels, and by the weakening of employment, while investment would be affected by lower corporate gains and by adjustments in credit conditions.

24. The rate of growth among our main trading partners in **Europe** would have been 2.8 percent in 2007, and is estimated at 2.0 percent in 2008 and 2009.

    The Eurozone has been growing in line with forecasts and would show a slowdown in the next two years. Germany has maintained a sustained pace of growth during 2007. However, lower rates of growth would be seen in 2008 and

2009 due to a deceleration of industrial activity, a lower contribution of exports, and lower spending in investment (associated with lower corporate gains and adjustments in credit conditions). Thus, Germany should growth rates of 1.8 and 1.9 percent in 2008 and 2009 respectively.

Graph 23
EUROZONE: INFLATION
(Percentage change over the last 12 months)



Source: Eurostat.

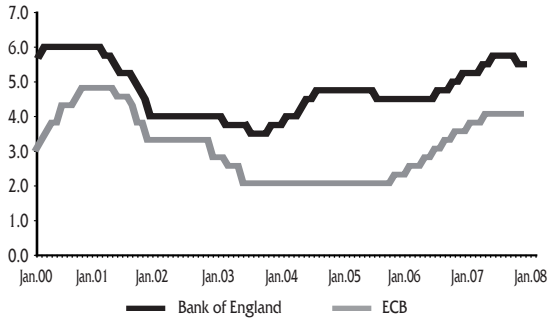
Table 12

MAIN INDICATORS ON EUROPE 1/

	2006	2007*		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
GDP (% change)							
Germany	2.9	2.6	2.5	2.3	1.8	1.9	1.9
Spain	3.9	3.8	3.8	2.9	2.6	2.5	2.4
United Kingdom	2.8	2.8	3.1	2.1	1.8	2.2	2.0
Inflation							
Germany	1.7	1.6	2.2	1.6	2.1	1.6	1.7
Spain	3.5	2.6	2.8	2.7	3.3	2.7	2.6
United Kingdom	2.3	1.9	2.3	1.9	2.3	1.9	2.0

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

Graph 24
MONETARY POLICY RATE OF EUROPEAN CENTRAL BANK AND BANK OF ENGLAND
(In percentage)

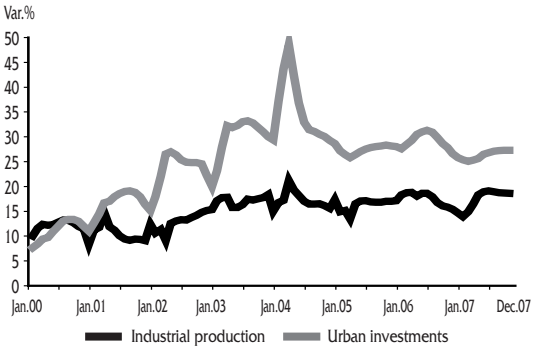


Growth in the Eurozone was coupled by higher inflationary pressures, explained in part by the higher prices of energy and food. In this context, the European Central Bank (ECB) raised its interest rate in March and June to 4.0 percent (a total of 50 basis points). The CBE has then maintained its rate given the deterioration of credit conditions and the risks of a greater economic slowdown. However, the presence of inflationary pressures (inflation in January 2008 was 3.2 percent) has generated uncertainty about how the ECB will manage monetary policy rates in the future.

25. **Japan** showed a recovery in the third quarter of 2007 due to a higher contribution of its exports. However, recent indicators of economic activity would be pointing to a growth slowdown due to the weakness of consumption and investment (especially in real estate, as a result of new regulations for construction standards). The economy would grow at a rate of 1.5 percent in 2008 (below previous forecasts) and would slightly recover in 2009 (2.0 percent).

26. **China** would have grown 11.4 percent in 2007, driven basically by higher investment and consumption. However, this growth has taken place in a context of growing inflationary pressures. Influenced by the higher prices of food

Graph 25
CHINA: ECONOMIC ACTIVITY
(Movil average at 3 months)



Source: National Bureau of Statistics.

-accounting for one third of its consumer basket-, inflation in 2007 increased to 6.5 percent between December 2006 and December 2007 (an increase equivalent to an average annual rate of 4.7 percent), the highest rate seen since 1996.

Because of this higher inflation and with the aim of moderating growth, the Central Bank adopted restrictive monetary policy measures. During 2007, the Bank raised the rate of reserve requirements on ten occasions -the rate, which accumulated an increase of 450 bps, was raised to 14.5 percent- and raised the interest rate on loans by 135 bps (to 7.47 percent). In January, the Central Bank announced an additional increase of 0.5 percentage points in reserve requirements. Moreover, the government froze the prices of energy and the prices of public service companies. Therefore, growth in China is expected to gradually slow down in 2008 and 2009, although it would still show high growth rates. Other factors contributing to China's lower growth would include a lower global growth and the impact of an appreciation of the yuan on exports.

Table 13

MAIN INDICATORS ON ASIA 1/

	2006	2007*		2008*		2009*	
		IR Sep. 07	IR Jan. 07	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
GDP (% change)							
China	11.1	11.3	11.4	10.6	10.4	9.8	9.8
South Korea	5.0	4.8	4.9	5.1	4.9	4.8	5.0
Japan	2.2	2.3	1.9	2.1	1.5	1.5	2.0
India	9.4	8.5	8.6	8.3	8.2	-	-
Inflation							
China	1.5	2.5	4.7	2.5	4.3	2.2	3.5
South Korea	2.2	2.6	2.5	2.6	3.0	2.5	2.8
Japan	0.2	0.4	0.0	0.6	0.4	1.6	0.5
India	6.7	5.7	5.7	5.4	5.4	-	-

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

27. Growth in **Latin America** maintained high levels in 2007. A moderate slowdown is expected in the next two years, in line with the withdrawal of monetary stimulus seen in several economies and with lower global growth. In some countries, growth was mainly driven by domestic demand which, in addition to the higher inflationary pressures associated with some commodities (particularly petroleum and foodstuffs), resulted in inflation levels that in some cases were above central banks' inflation target ranges.

28. Amongst countries with inflation targeting schemes, Chile and Colombia showed inflation rates that were higher than their respective inflation targets (1-4 percent and 3.5-4.5

percent), while inflation in Brazil and Mexico fell within the target range (2.5-5.5 percent and 2-4 percent respectively). In this context, some central banks in the region raised their rates (Chile, Colombia and Mexico) and other central banks stopped lowering these rates (Brazil).

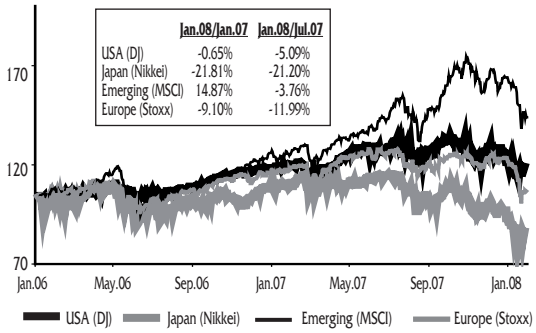
Table 14

MAIN INDICATORS ON LATIN AMERICA 1/

	2006	2007*		2008*		2009*	
		RI Sep. 07	IR Jan. 08	RI Sep. 07	IR Jan. 08	RI Sep. 07	IR Jan. 08
GDP (% change)							
Argentina	8.5	7.6	8.5	5.4	6.5	4.7	4.5
Brazil	3.7	4.8	5.3	4.5	4.7	4.3	4.5
Chile	4.0	5.9	5.2	5.2	4.7	4.9	4.9
Colombia	6.8	6.4	6.8	5.3	5.5	4.6	5.0
Ecuador	3.9	2.4	2.0	2.4	2.4	2.8	2.6
Mexico	4.8	2.9	3.1	3.4	2.9	3.8	3.7
Venezuela	10.3	8.2	8.4	4.5	4.7	1.5	3.3
Inflation							
Argentina	9.8	8.6	8.5	10.9	10.8	9.7	10.5
Brazil	3.1	4.0	4.5	4.1	4.4	3.9	4.2
Chile	2.6	5.8	7.8	3.2	4.3	2.9	3.3
Colombia	4.5	5.1	5.7	4.4	4.5	3.6	4.1
Ecuador	2.9	2.7	3.3	3.1	3.5	3.1	3.5
Mexico	4.1	3.7	3.8	3.5	3.9	3.5	3.5
Venezuela	17.0	17.8	22.5	21.1	27.6	20.5	26.8

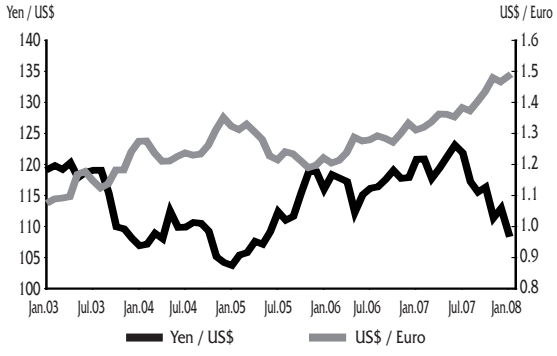
1/ Source: Consensus Forecast and BCRP.
*Forecast.

Graph 26
WORLD STOCK EXCHANGE
(January 2006 = 100)



Source: Bloomberg.

Graph 27
US DOLLAR AGAINST OTHER MAIN CURRENCIES



Source: Bloomberg.

Evolution of financial markets

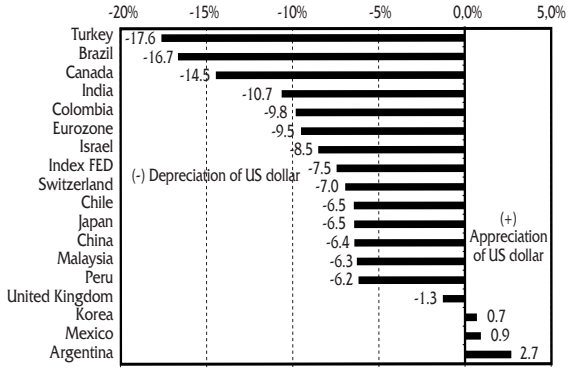
29. During 2007, and particularly in the second half of this year, financial markets showed increased volatility due to the crisis of the subprime mortgage market and to the risk that its effects could spread onto other economies. Investors' showed greater risk aversion, which translated into the fall of stock markets, a drop in the yield on the U.S. Treasury Bonds and on the bonds of other developed countries, as well as into an increase in the spreads of the bonds of emerging countries and the reversal of *carry trade*[2] operations.

30. **Stock markets** recorded significant losses in the last months of 2007 and in January 2008 (especially in developed economies), which totally or partially reverted the gains achieved in the previous months.

31. The **dollar** continued to depreciate in international markets, particularly against the euro, the pound, and the Canadien

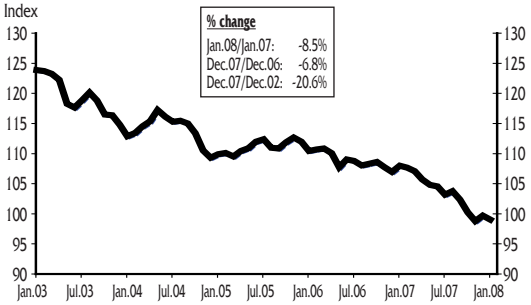
2 The term carry trade refers to a financial strategy whereby investors borrow low-yielding currencies and buy financial assets in countries with high-yielding currencies.

Graph 28
ACCUMULATED EVOLUTION OF EXCHANGE RATE AGAINST THE US DOLLAR: 2007



Source: Bloomberg.

Graph 29
US DOLLARS AGAINST MAINS COMMERCIAL PARTNERS CURRENCY BASKET*



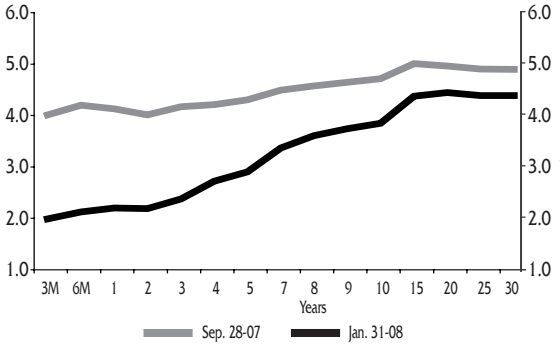
* Index of nominal exchange rate againsts main commercial partners (Jan.97=100).

Source: Federal Reserve Board.

Graph 30
YIELDS OF US TREASURIES

Source: Federal Reserve Board.

Graph 31
US TREASURIES YIELD CURVE
(In percentage)



dollar. This is mainly explained by the differentiated conduct of monetary policy interest rates throughout most of the year. While the ECB raised its rates in 2007, the FED has cut them on 5 occasions since 2007 (the FED rates accumulated a reduction of 225 basis points), as a result of which the spread swung from 175 basis points in favor of the United States to 100 basis points in favor of the Eurozone by the close of January 2008.

Furthermore, expectations of additional cuts in the FED rates in the first quarter of the year generated further pressures on the dollar. The dollar showed a minimum historical record against the euro on January 14, (considering the German mark as reference for the period prior to the adoption of the euro).

The **yen** also strengthened as of the second half of 2007, as investors' perception of increased risk brought about a reversal of speculative currency operations -carry trade-, which had been one of the causes explaining the depreciation of the yen in the last years.

Latin American currencies also faced appreciatory pressures due to the generalized depreciation of the dollar, the better economic fundamentals seen in the region, and, in some cases, also due to carry trade operations. Despite volatility in financial markets, Latin American currencies are still subject to appreciatory pressures in January 2008.

The global indicator of the US dollar exchange rates against other currencies, measured by the FED, fell 7 percent in 2007, accumulating a 21 percent drop since December 2002.

32. The yield on the U.S. Treasury bonds has dropped since the second half of 2007. The recent turbulence observed in financial markets has accentuated this trend since investors seek less risky assets (flight to quality). The yield on 2-year bonds and on 10-year bonds reached levels that had not been seen since March 2004 (the former reached 1.99 percent on January 8 and the latter has reached 3.43 percent).

33. The yield curve of U.S. Treasury bonds has moved down between September 2007 and January 2008. The yield on short-term securities showed a higher reduction due to their greater correlation with the FED's policy interest rate, which fell from 5.25 percent at early September 2007 to 3.0 percent at end January 2008.

On the other hand, the yield on long-term bonds showed a lower reduction (nonetheless, they reached levels unseen since July 2003).

34. As regards **emerging countries' debt**, the second half of 2007 saw the impacts -although moderate- of the financial problems associated with the U.S. subprime mortgage market on emerging countries, particularly in the region.

The EMBI+ *spread* and the cost of Credit Default Swap increased slightly. Most countries in the region were favored by their better fundamentals (international reserves, debt reprofiling and reduction, improved fiscal positions, among other aspects) which, in turn, was reflected by the better risk ratings they were assigned by the main rating agencies. In this sense, it is worth pointing out the better debt rating assigned to Chile, Mexico and Brazil between September and December.

Table 15

RATIOS OF EMERGING MARKETS*
(In basis points)

	2003	2004	2005	2006	2007	2008 Jan.	Change 2007- 2006	Change 2008-2007
EMBI+ 1/	**418**	**356**	**245**	**169**	**239**	**273**	**70**	**34**
Latin America	**521**	**420**	**283**	**186**	**268**	**302**	**82**	**34**
Brazil	463	382	311	192	221	255	29	34
Colombia	431	332	238	161	195	256	34	61
Mexico	199	166	126	98	149	179	51	30
Argentina	5 632	4 703	504	216	410	466	194	56
Peru	312	220	206	118	178	205	60	27
CDS (Credit Default Swap) 5 years 2/								
Brazil	404	305	225	100	103	136	4	33
Colombia	441	341	167	114	130	182	16	52
Mexico	122	80	63	41	69	110	29	41
Argentina	n.a.	n.a.	367	203	462	479	259	17
Peru	292	204	221	91	116	145	25	30

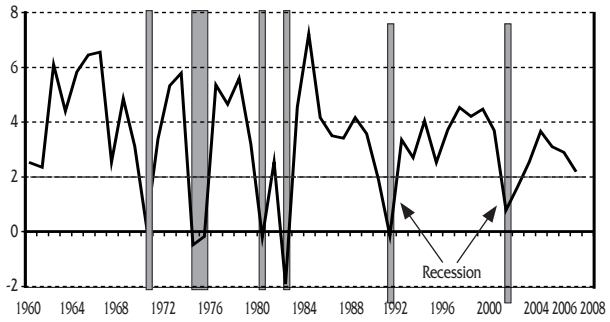
1/ Measure the spread between a portfolio of debt of a emerging country and the US Treasury bond for equivalent maturities.
2/ Measure the cost of insurance to cover the credit risk to the likelihood of impact of a debt.
* Data at the End-of-Period.
Source: Bloomberg and Reuters.

BOX 6

RECENT DEVELOPMENTS IN THE UNITED STATES AND THEIR POSSIBLE IMPACT ON THE REST OF THE WORLD

The probability that the U.S. economy could go into recession has been discussed recently. The data published by the National Bureau of Economic Research shows that USA has gone through six periods classified as recessions (1971, 1974, 1979-80, 1981-82, 1991, and 2001) over the past 46 years, 1981 being the most severe period of recession (annual growth of -1.9%).

UNITED STATES: REAL GDP 1960-2007
(Percentage change)



Source: Bureau of Economic Analysis

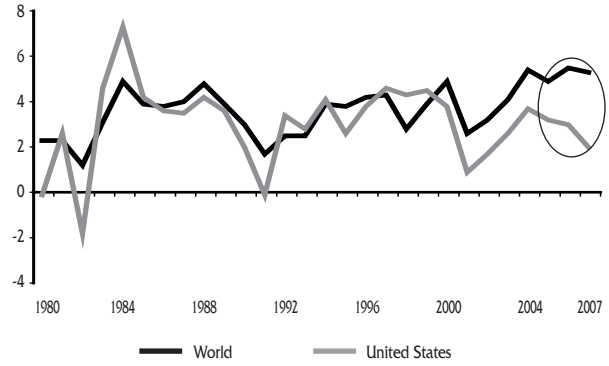
The causes of these recessions have not always been the same. Some were associated with supply problems (oil crisis) or with the implementation of corrective measures face inflation. The recessive periods of 1971, 1974 and 1981-1982 were noteworthy. Others arose as a result of crises in the financial markets (with the 2000-2001 reversal of the technological bubble) that led to monetary policy responses. Furthermore, another important event, although not classified as recession, was observed in 1998 with the Russian crisis and the collapse of long-term capital management.

The current context of economic slowdown resembles more the situations observed in 1998 and 2001, which resulted from financial market-related factors. However, the financial turbulence and credit constraints that are currently observed are also coupled by high oil prices.

So far, the slowdown of the U.S. economy has not been reflected in a significant slowdown in the rest of the world. On the contrary, during the first quarters of 2007 the economies of some developed countries and emerging countries (particularly China) showed a favorable evolution and grew at even higher rates than initially forecast. This apparent lessening of correlation or dependence between developments in the United States and the rest of the world has been called *"decoupling"*.

The dynamics of the U.S. economy would be one of the factors underlying this phenomenon. Most of the recent slowdown is explained by the evolution of the real estate sector; particularly by the drop seen in residential investment (its contribution to GDP has been negative by roughly one percentage point in the last quarters). As this sector demands few resources from abroad, the impact on other countries' exports has been moderate.

WORLD AND UNITED STATE GDP
(Percentage change)



On the contrary, recent developments in international markets would point to the reversal of decoupling. Some factors indicating this include: (i) the slowdown of consumption in the United States; the imported component of consumption is higher than that of residential investment; (ii) the extension of financial problems -associated with the subprime market- to other developed economies, as in the case of Germany and the United Kingdom; (iii) the strong depreciation of the dollar -particularly against the euro and the yen- which would have an impact on exports in the Eurozone and Japan; (iv) the plunge of stock markets, which is a more global phenomenon affecting wealth directly and, hence, consumption, and (v) the higher prices of oil, which is a factor that could affect a broader number of economies (including Europe, Japan, and China).

IMF studies (World Economic Outlook, October 2007) show that, despite the growing weight of other economies in GDP, the impact of the United States is still high. A drop of 1 percent in the GDP of the United States implies a drop of 0.16 percent in the rest of the world. This sensitivity will vary from country to country and will depend on the margin each country has to implement anti-cyclical policies, as well as on its degree of trade integration with the United States, among other factors.

IV. Economic activity

Peru has been showing annual growth rates of over 6 percent since 2005. This growth has been sustained by the evolution of domestic demand, driven by consumption and private investment.

In 2007 the Peruvian economy grew 8.5 percent -the highest growth rate observed in the last 12 years- in a context of increased private spending and favorable expectations on the future evolution of the economy.

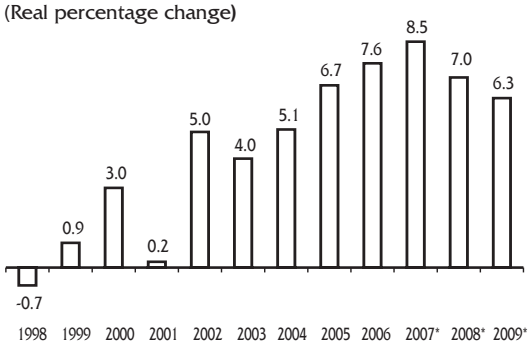
Consumption and private investment are forecast to show a more moderate growth in 2008 considering the deterioration of external conditions, a downward correction in terms of trade, and an offset in the expansion of liquidity and credit. Therefore, economic activity would gradually converge to more sustainable rates in terms of the trend output by 2009. Thus, GDP would grow 7.0 percent in 2008, falling thereafter to a growth rate of 6.3 percent in 2009.

35. The high growth of domestic demand in 2007 is explained by consumers' and business optimistic expectations, in a context of macroeconomic stability, favorable credit conditions, higher employment in all sectors and in most of the regions of the country, as well as by firms' increased announcements of investment plans in all the economic sectors.

    These factors have implied a faster pace of growth of consumption and private investment, which reached similar rates as the ones observed in the mid-nineties.

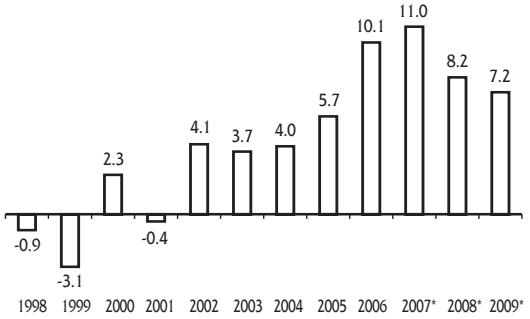
36. A series of investment plans implemented during 2007 have brought about the expansion of productive capacity and productivity improvements. Hence, the forecasts on GDP growth have been revised upwards. Particularly, GDP would grow 7.0 percent in 2008 and 6.3 percent in 2009, compared with our previous forecasts of 6.5 and 6.0 percent respectively (Inflation Report of September 2007). Additional investment would allow the expansion of potential output

Graph 32
GDP GROWT RATE
(Real percentage change)



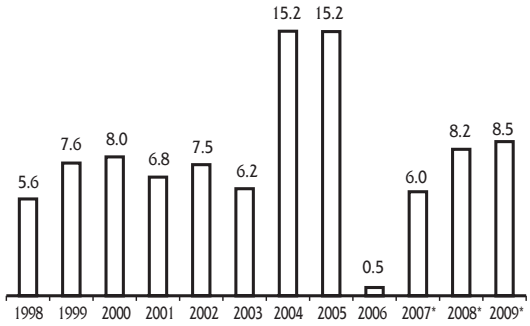
* Forecast.

Graph 33
DOMESTIC DEMAND GROWTH RATE
(Real percentage change)



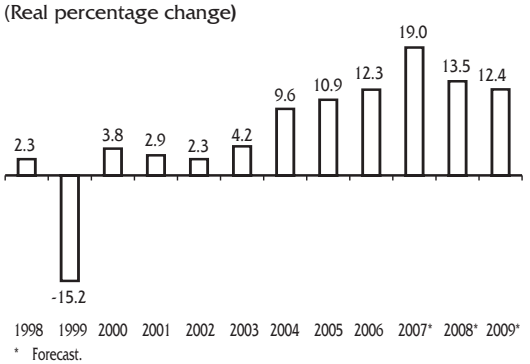
* Forecast.

Graph 34
GOODS AND SERVICES EXPORTS GROWTH RATE
(Real percentage change)



* Forecast.

Graph 35
GOODS AND SERVICES IMPORTS GROWTH RATE
(Real percentage change)



* Forecast.

which, in addition to the lower drive of demand foreseen for 2008 and 2009, should result in a rate of GDP growth closer to the potential output.

Table 16

GLOBAL DEMAND AND SUPPLY
(Real percentage change)

	2006	2007*		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
1. Domestic demand	**10.1**	**10.0**	**11.0**	**7.2**	**8.2**	**6.9**	**7.2**
a. Private consumption	6.2	7.2	7.6	5.7	5.8	5.3	5.3
b. Public consumption	8.7	6.0	4.3	3.8	5.0	3.8	5.4
c. Private investment	20.1	23.7	23.2	15.0	20.0	12.1	12.1
d. Public investment	12.7	25.0	19.8	25.0	33.0	15.0	16.6
2. Exports	0.5	5.3	6.0	8.2	8.2	6.1	8.5
3. Imports	12.4	17.4	19.0	11.8	13.5	10.2	12.4
4. GDP	**7.6**	**7.6**	**8.5**	**6.5**	**7.0**	**6.0**	**6.3**

IR: Inflation Report.
* Forecast.

37. In 2007 the growth of national disposable income also exceeded previous forecasts (9 versus 8 percent), which explains the favorable trend observed in the growth of private and public spending. In contrast with the concept of GDP, national disposable income also considers the effect of international prices and the transfers of Peruvians residing abroad. Moreover, this concept also deducts the profits generated by foreign investments and therefore offers a more accurate indicator on the economic transactions generating incomes for the country. The national disposable income should grow less in 2008 than in 2007 due to lower terms of trade and to lower remittances from abroad.

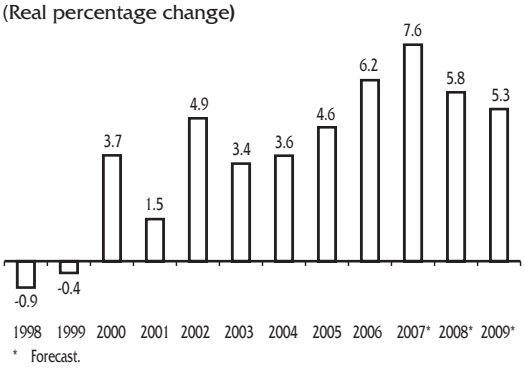
Table 17

NATIONAL DISPOSABLE INCOME
(Real percentage change)

	2006	2007*		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
1. Gross domestic product	**7.6**	**7.6**	**8.5**	**6.5**	**7.0**	**6.0**	**6.3**
2. Gross national product	4.9	7.9	8.8	8.2	8.4	8.0	7.6
3. Gross national income	11.1	8.0	9.0	6.2	5.7	6.8	7.0
4. National disposable income 1/	**11.3**	**8.0**	**8.9**	**6.2**	**5.4**	**6.8**	**7.0**
5. Absorption 2/	14.1	10.4	11.5	6.9	6.6	7.7	7.9

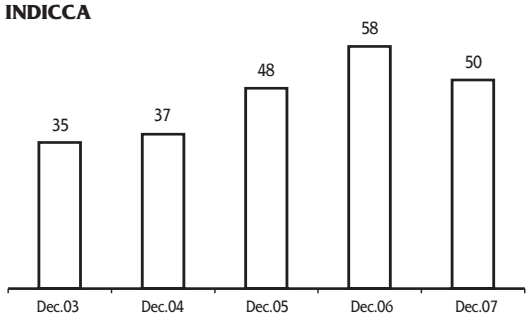
IR: Inflation Report.
* Forecast.
1/ Includes investment income, gains and losses due to change in terms of trade and net transfers from non-residents.
2/ Measure the purchasing power of residents peruvians. It is obtained by adding discounted exports and imports to national income disposable.

Graph 36
PRIVATE CONSUMPTION GROWTH RATE
(Real percentage change)



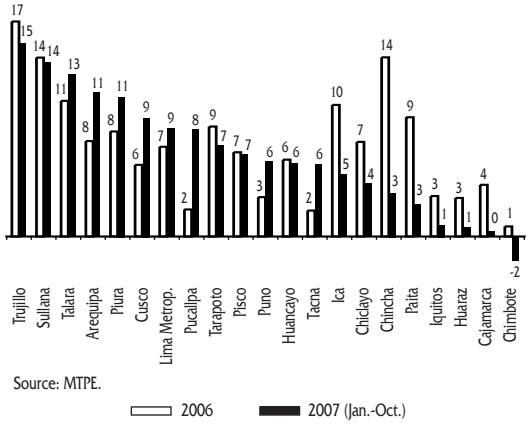
* Forecast.

Graph 37
CONSUMER CONFIDENCE INDEX
INDICCA



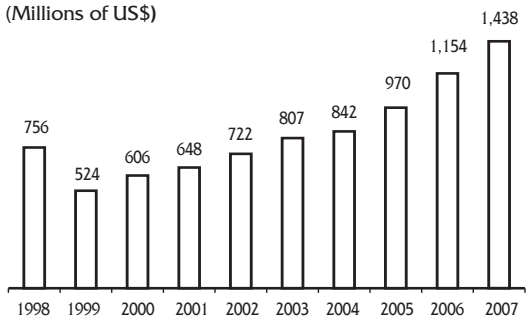
Source: Apoyo.

Graph 38
URBAN EMPLOYMENT IN COMPANIES WITH 10 OR MORE WORKERS
(Percentage change)



Source: MTPE.

Graph 39
DURABLE CONSUMER GOODS IMPORTS
(Millions of US$)



38. **Private consumption** is estimated to have grown 7.6 percent in 2007, showing the highest growth rate observed since 1995 (9.7 percent). Thus, this component would account for most part of GDP growth (61 percent) observed in the year.

The faster pace of growth of private consumption is explained by several factors. First, the high prices of export products increased the economy's purchasing capacity, which translated into a higher national disposable income. Second, a decentralized increase of formal employment that consolidated the positive trend of employment in several cities of the country, especially in activities such as commerce, transport, and services, added to higher incomes. Employment in the main cities of the country has grown at rates of over 4 percent. The cities showing the highest rates of employment were Trujillo, Sullana, Talara, Arequipa and Piura, with rates of over 11 percent, as well as Cuzco, Pucallpa, Lima, and Tarapoto, with rates ranging between 7 and 10 percent.

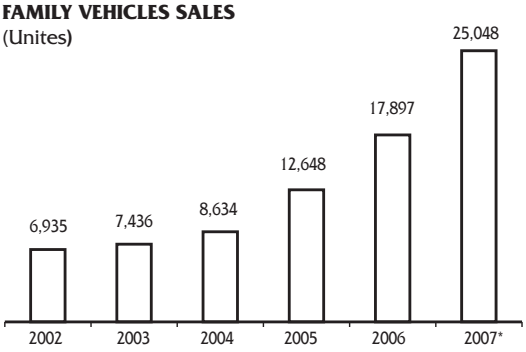
39. Consumer confidence remained at high levels during the year, which favored household decisions to buy durable goods, as reflected in the higher imports of this type of goods, particularly car purchases (imports of durable goods had increased 25 percent by December, while car purchases had increased by 40 percent by November 2007).

The demand for these products was also driven by the high growth of consumption loans, which increased 37 percent in 2007.

Private consumption is expected to slow down from 7.6 percent in 2007 to 5.8 percent in 2008 and to 5.3 percent in 2009. This forecast considers the correction foreseen in terms of trade and its impact on national disposable income, as well as a more moderate growth of liquidity and credit.

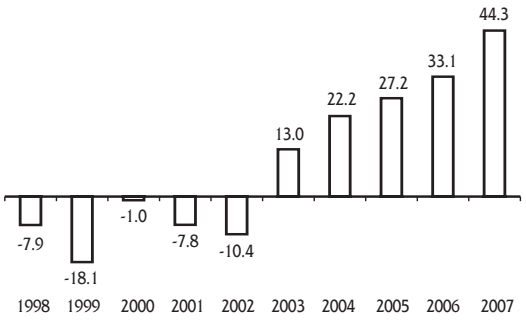
40. **Private investment** grew at a faster pace in 2007 -showing a rate of 23 percent after having increased 20 percent in 2006- and accounted for around 4.1 percentage points of growth. This result reflects favorable expectations on the growth of domestic demand in the following years, firms' greater access to credit, favorable prospects associated with the signing of trade agreements and the ratification of the trade agreement between Peru and the United States.

Graph 40
FAMILY VEHICLES SALES
(Unites)



Source: Araper.
* January-November.

Graph 41
CAPITAL GOODS IMPORTS
(Percentage change)[1/]



1/ Not considered construction materials.

In the short term, the higher growth of domestic demand relative to GDP growth has brought about an increase in the rate of use of productive capacity. In addition to competition, this has generated an additional incentive for firms' implementation of their expansion plans and for the installation of new plants. Moreover, optimistic expectations on the evolution of the economy and macroeconomic stability continue incentivating the implementation of new businesses nationwide.

The high growth rates of private investment were coupled by the adoption of more modern technologies, as reflected in the fact that imports of capital goods have grown at rates of over 30 percent since 2006. This pace of growth not only increases the economy's capital assets, but also productivity, which results in an increase of the potential output in the next years.

Higher investment and increased productivity are the factors accounting for the increase of productive capacity, all of which contribute to potential growth. In this sense, firms' productivity increased 4 percent on average between 2006 and 2007 according to the BCRP Survey on Macroeconomic Expectations carried out in September 2007.

According to the survey carried out in December 2007, significant investments were made in the mining and hydrocarbon sector (Yanacocha's gold mill project, expansions at Southern and Volcan), in manufacturing (expansions at Backus, the Cajamarquilla refinery, and Cementos Lima, among other enterprises), and in transport and telecommunications, all of which totaled US$ 2,924 million. New facilities and new businesses were opened in the commerce sector, with investments amounting to US$ 476 million.

Manufacturing would be the sector with higher investment in 2008, as investments for a total of US$ 1,570 million have been announced. The mining and hydrocarbon sector would rank second with a total investment of US$ 1, 411 million. In terms of growth rates, the sectors with higher investments would be services, agriculture, electricity, and commerce.

Investments of over US$ 29 billion have been announced for 2007-2010, including commitments for investments

in various concession processes. Significant amounts will be invested in mining and hydrocarbon projects, as well as in transport, energy and industrial infrastructure. This remarkable evolution of private investment is in part explained by business optimistic expectations (49 percent of entrepreneurs expect improvements in the following 3 months), as reflected in investment announcements. Considering these factors, the forecast on the growth of private investment has been revised upwards to 20 percent for 2008.

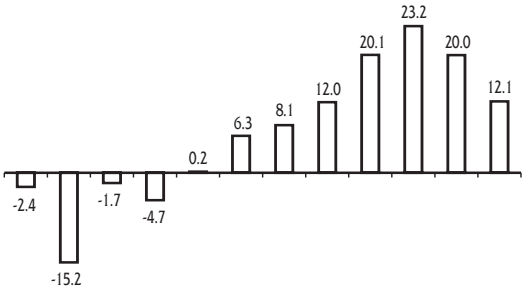
Table 18

PRIVATE INVESTMENT
(Millions of US$)

Sector	N° of businesses	2007	2008	% Change
Agriculture and livestock	19	160	238	48.9
Fishing	12	224	149	-33.3
Mining and fuel	26	1,146	1,411	23.1
Manufacturing	126	1,142	1,570	37.5
Electricity	6	310	457	47.5
Construction	11	96	122	26.7
Commerce	35	476	679	42.7
Transport and telecomunications	28	636	811	27.5
Services	11	28	55	97.3
Total	**274**	**4,217**	**5,492**	**30.2**

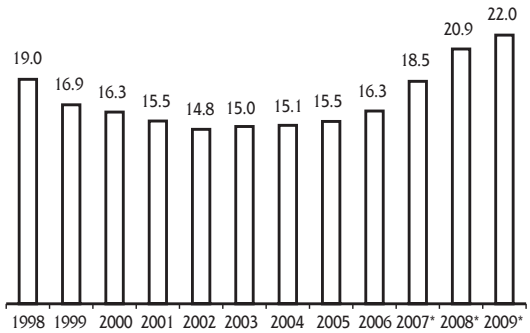
Source: Macroeconomic Expectation Survey, BCRP December 2007.

Graph 42
PRIVATE INVESTMENT GROWTH RATE
(Real percentage change)



* Forecast.

Graph 43
FIXED PRIVATE INVESTMENT
(Percentage of GDP)



* Forecast.

Given that private investment grew nearly three times more than the output in 2007, the ratio of private investment as a percentage of GDP reached levels that had not been observed since the mid-nineties. Although investment is expected to continue growing at a similar pace in the following years due to the investments announced in the aforementioned sectors, private savings would grow at lower rates, since lower terms of trade would affect the national disposable income. Therefore, requirements of external savings would increase to 2.4 percent of GDP in 2009.

Table 19

MAIN INVESTMENT PROJECTS: 2007-2010
(Millions of US$)

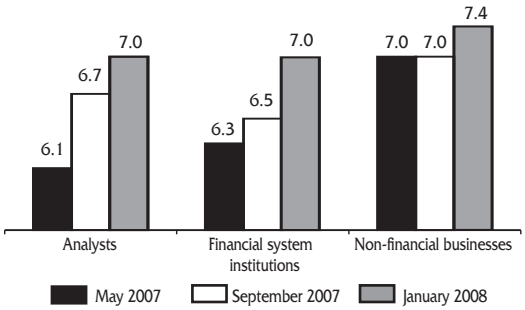
Sector / Businesses		Proyect	Amount
MINING			**12,527**
From which:	Peru Copper S.A.	Toromocho	1,500
	Zijin Mining Group	Río Blanco	1,400
	Southern Copper Corp.	Los Chancas	1,100
	Southern Copper Corp.	Expansion of mines, smelters and refineries	980
	Minera Yanacocha	Minas Conga	935
	Xstrata	Las Bambas	930
	Southern Copper Corp.	Tía María	750
FUEL			**5 051**
From which:	Perú LNG	Camisea II	2,200
	Barret Resources	Lote 67	1,600
	Petrobras - PetroPerú	Planta Petroquímica	800
TELECOMUNICATIONS			**2,148**
From which:	Telefónica del Perú	Expansion of mobile network and broadband	1,000
	America Movil (Claro)	Works in mobile phone	560
	For concession	Wi-max Project	110
	For concession	Broadband satelital	45
INDUSTRIAL			**2,479**
From which:	Votorantim Metais	Expansion of Cajamarquilla Refinery	500
	Vale	Fosfatos de Bayóvar	450
	Camargo-Correa	Construction of cement plant	200
	SAB Miller	Expansion of plant	250
	Refinería La Pampilla	Modernization of Refinery	350
INFRAESTRUCTURE			**2,636**
From which:	Dubai Ports World Callao	Muelle Sur - Callao	617
	For concession	Sea and river port terminals	558
	For concession	Electric train	280
	For concession	Majes- Siguas II	280
	Grupo Romero	Ancon Port	200
	For concession	Eje Amazonas Centro	160
	For concession	Regional airports	157
	For concession	Red Vial Nº 4	150
ELECTRICITY			**2,337**
From which:	Endesa	Several projects, including expansion of Santa Rosa central	500
	Egechilca	Termoeléctrica Egechilca	500
	For concession	Transmission Line Mantaro – Caravelí - Montalvo	393
	For concession	Transmission Line Vizcarra - Huallanca Cajamarca - Carhuaquero	321
	For concession	Transmission Line Chilca - Planicie - Zapallal	208
	Cementos Lima	El Platanal	180
	Kallpa Generacion	Expansion of Kallpa	90
	Enersur	Expansion of Chica Uno	80
OTHER SECTORS			**2,173**
From which:	For concession	Planta de Tratamiento La Taboada	280
	For concession	Planta de Tratamiento La Chira	127
	Tottus	24 stores in Lima, Trujillo y Chiclayo	100
	Grupo Brescia	30 floor Hotel in San Isidro (Westin)	100
	Casagrande	Distillery and development farmlands	66
	Sodimac - Grupo Falabella	Several stores	60
	C.C. Jockey Plaza	Expansion of commercial areas	55
	Parque Arauco	Complejo Comercial San Isidro	54
	Corporación Pesquera Inca	Boats and plants	50
	Parque Arauco, Gloria, Wiese	Mega Plaza Arequipa	40
	Grupo Wong	Centro Comercial Lima Plaza Norte	35
	Graña y Montero	Concession of Programa Vial Costa-Sierra I (Piura)	31
	Agroindustrial Laredo	Sugar project Arena Dulce	20
		TOTAL	**29,351**

Source: Proinversion and announcement of investments.

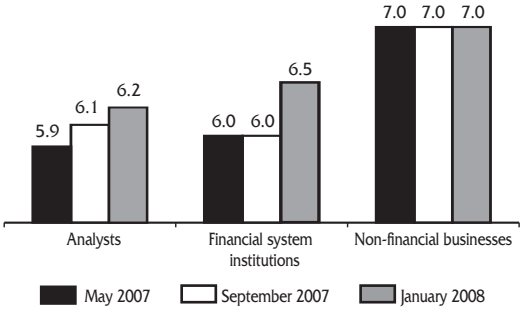
41. Domestic savings showed growth rates of 22.7 and 23.9 percent of GDP in 2006 and 2007 respectively due to the increase seen in the national disposable income, which contributed to finance business investments. The higher savings observed in both the private sector (17.8 percent of GDP) and the public sector (6.2 percent of GDP) translated into lower external financing requirements.

Savings should continue growing in 2008 and 2009 due to economic growth and to increased access to banking services, thus facilitating investment financing and contributing to sustainability in the balance of payments.

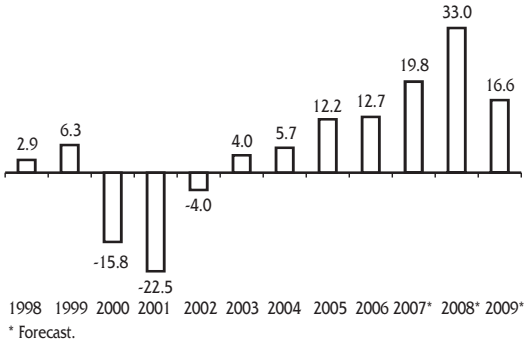
Graph 44
GDP GROWTH EXPECTATIONS 2008



Graph 45
GDP GROWTH EXPECTATIONS 2009



Graph 46
PUBLIC INVESTMENT GROWTH RATE
(Real percentage change)



* Forecast.

Table 20

SAVINGS - INVESTMENTS
(Percentage of GDP)

	2006	2007*	2008*	2009*
External saving	**-2.8**	**-1.0**	**1.9**	**2.4**
Domestic saving	**22.7**	**23.9**	**23.0**	**23.8**
Public sector	4.9	6.2	5.8	5.4
Private sector	17.8	17.8	17.2	18.5
Domestic gross investment	**19.9**	**22.9**	**24.9**	**26.3**
Public sector	2.8	3.1	3.9	4.4
Private sector	17.1	19.8	21.0	21.9

* Forecast.

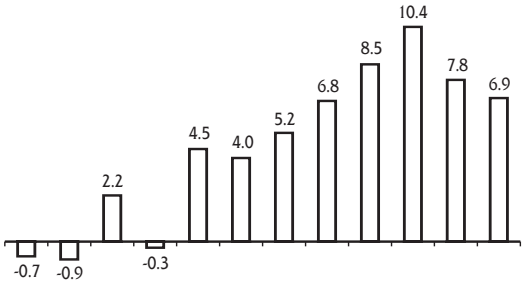
Economic agents have also revised their growth forecasts upwards. According to economic analysts and financial institutions, in 2008 GDP should grow 7.0 percent, while non-financial entities estimate a higher growth: 7.4 percent. Lower growth rates are expected for 2009, with forecasts ranging between 6.2 and 7.0 percent.

42. As regards public expenditure, the central scenario considers a higher pace of spending in executing units, particularly in terms of investment, which also has a positive impact on the accumulation of productive capital in the economy. Expected investment in infrastructure would allow increasing productivity in private sector activities, thus multiplying the benefits of trade agreements.

43. The **potential output** would continue growing in the following years due to increased capital assets and increased overall factor productivity, showing a growth rate of around 7 percent in the forecast horizon. Approximately half of this

growth is explained by capital accumulation derived from increased investment in the private and public sectors, in a context of favorable expectations on the future evolution of the economy and greater access to credit. Additionally, productivity -which accounts for a third of potential growth in the economy- would also increase as a result of a better allocation of resources and of efficiency gains resulting from technological transfer and trade agreements.

Graph 47
NON PRIMARY SECTORS GROWTH RATE
(Real percentage change)



* Forecast.

Sector production

44. In 2007 **non-primary sectors** continued to be the most dynamic sector due to the impulse of domestic demand. Construction showed the highest growth rate as a result of increased employment, higher incomes, and higher mortgage credit which favored the construction of new houses, as well as due to the greater investment seen in the industrial and commerce sectors. Non-primary manufacturing ranked second, boosted by higher consumption spending (as reflected in the higher production of food and beverages) and by the demand for inputs in the construction sector, reflecting the high growth of inputs such as cement.

Table 21

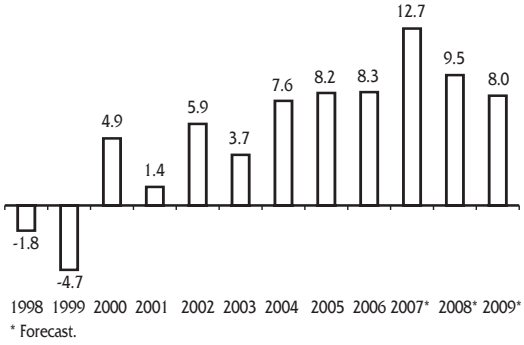
GROSS DOMESTIC PRODUCT

(Real percentage change)

	2006	2007*		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
Agriculture and livestock	**7.4**	**2.9**	**2.3**	**3.9**	**3.9**	**3.8**	**3.8**
Agriculture	8.3	2.6	1.4	4.0	4.0	4.0	4.0
Livestock	7.6	3.5	3.4	3.9	3.9	3.6	3.6
Fishing	**2.4**	**2.6**	**6.9**	**3.5**	**3.5**	**4.0**	**5.0**
Mining and fuel	**1.4**	**1.8**	**2.1**	**5.2**	**5.2**	**4.2**	**4.2**
Metallic mining	1.1	1.3	1.5	5.1	5.1	4.0	4.1
Natural gas and oil	5.7	7.1	6.5	6.3	6.3	5.5	5.5
Manufacturing	**7.4**	**9.4**	**10.3**	**7.3**	**8.5**	**6.5**	**7.4**
Based on raw materials	4.1	0.8	-0.9	4.4	4.1	4.4	4.7
Non-primary industries	8.3	11.4	12.7	8.0	9.5	7.0	8.0
Electricity and water	**6.9**	**8.8**	**8.7**	**6.5**	**7.0**	**5.5**	**5.5**
Construction	**14.8**	**16.0**	**16.6**	**12.0**	**13.0**	**11.0**	**11.0**
Commerce	**11.1**	**8.2**	**9.6**	**6.6**	**7.4**	**6.4**	**6.6**
Other services	**7.0**	**7.8**	**9.1**	**6.1**	**6.6**	**6.0**	**6.1**
Global GDP	**7.6**	**7.6**	**8.5**	**6.5**	**7.0**	**6.0**	**6.3**
Primary	**4.5**	**2.1**	**1.8**	**4.4**	**4.4**	**4.0**	**4.2**
Non-primary	**8.5**	**9.2**	**10.4**	**7.0**	**7.8**	**6.6**	**6.9**

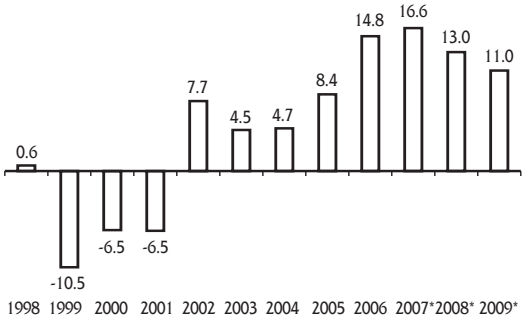
IR: Inflation Report.
* Forecast.

Graph 48
NON PRIMARY MANUFACTURE GROWTH RATE
(Real percentage change)



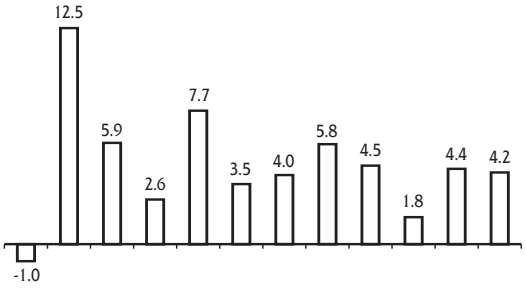
* Forecast.

Graph 49
CONSTRUCTION SECTOR GROWTH RATE
(Real percentage change)



* Forecast.

Graph 50
PRIMARY SECTOR GROWTH RATE
(Real percentage change)



* Forecast.

Considering the lower impulse expected in demand and a less favorable international context, non-primary sectors should show a more moderate growth in 2008 and 2009. This would be offset by the implementation of the trade agreement between Peru and the United States, as well as by prospects of signing other trade agreements with other countries, which would boost manufacturing production.

The construction sector would continue to be the sector showing the highest growth considering the expansion of cement plants to meet the demand associated with the construction of malls, hotels, and housing projects, especially in cities other than Lima. In addition to dynamism in the construction and manufacturing sectors, the commerce sector is also expected to grow given that increased access and the opening of new facilities are foreseen in the main cities of the country.

45. Although lower than forecast, **primary sectors** showed a slight growth in 2007. The factors explaining this evolution included a combination of variable climatic conditions which affected the agricultural sector and specific factors in the mining sector, such as Yanacocha's lower production of gold since Yanachocha is currently operating in areas with lower mineral content. These negative factors were offset by the expansion of Cerro Verde's copper mine.

A recovery of primary sectors is expected in the following years, considering better climatic conditions and the maturing of projects. After having fallen slightly in the first months of the 2007 - 2008 crop year, production in the agricultural sector is currently normalizing and should show higher yields due to the investments made over the past few years. This would be coupled by a higher production of agroexports, given that modern technologies continue to be implemented in farming areas and that no significant effects are expected to be caused by cold weather conditions associated with La Niña due to an adequate storage of water in reservoirs.

No significant climatic alterations should affect growth in the fishing sector, and given the policy of prohibition periods for anchovy catch established by the Production Ministry, growth in this sector would be mainly associated with fish capture to elaborate canned and frozen products. Other factors contributing to this would include the effect of increased efficiency resulting from corporate mergers and acquisitions carried out in 2006 and 2007, as well as new investments made in terms of fish processing. On the other hand, full capacity operation at Cerro Verde's expanded plant and the onset of activities at Cerro Corona in 2008, as well as a steady production of gold at Yanacocha -including Yanacocha's oxide project- are considered in the mining sector.

BOX 7

SUPPLY AND DEMAND BALANCE FOR THE ELECTRICITY SECTOR

In line with the current drive exhibited by economic activity, the demand for electric energy grew 10.1 percent in 2007. Although this growth has not caused problems in the supply of electricity, congestion problems have been observed in electricity transmission to the northern and southern areas of the country. Our previous Inflation Report warned about the congestion problems that are currently observed, but so far no significant progress has been made in terms of the processes that would offset these situations.

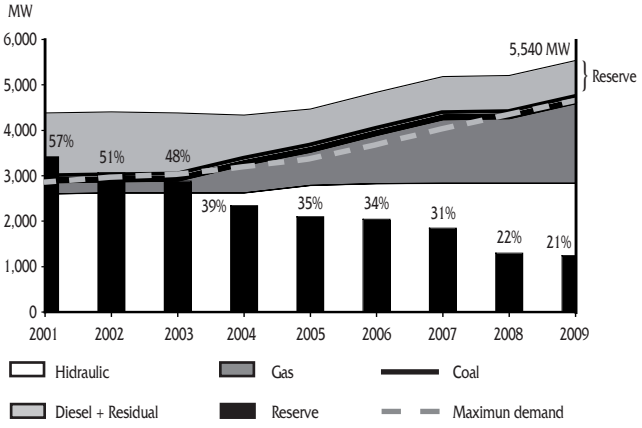
Congestion problems in the Centro-Norte transmission line are being dealt with through the expansion of the Zapallal-Paramonga-Chimbote transmission line, which should be completed by April this year. Additionally, the concession of the Vizcarra-Cajamarca-Carhuaquero transmission line is currently in the process of being implemented. On the other hand, problems in the case of the Centro-Sur transmission line could be reduced in the short-term if complementary equipment were installed to allow the current 300 MW Mantaro-Socabaya transmission line operate at full capacity. In the medium-term, the installation of a second parallel line is indispensable. The tender process for the construction of said line should be completed in May this year.

Given that at least 18 months would be required for the installation of these lines after the winning bid is awarded, decree DU N° 046-2007 has been enacted to prevent that congestion problems might translate into higher generation costs in the north and south of the country. According to this regulation, the less efficient generation plants that will start operating in the areas with congestion problems will not be considered to calculate marginal costs in these areas and a special mechanism would be applied to compensate said costs. Likewise, supply of electric energy from Chilca to Lima could also face transmission problems in the future. Currently existing transmission facilities would only allow the operation of one additional power station in the south of Lima, and at present there are four projects that could start operations in the area next year: Chilca Uno-Stage III, with a power of 176 MW; Kallpa-Stage II, with a power of 176 MW; Egechilca, with a power of 538 MW; and El Platanal hydropower station, located in Yauyos, with an installed power of 220 MW. Hence, the importance of giving the Chilca-La Planicie-Zapallal transmission line in concession, which is expected to take place in June this year. The completion of this process would allow the actual operation of these power stations.

Moreover, the expansion of the Santa Rosa thermal power station, with an additional power of 190 MW, is expected to be completed in 2009. This power station would not be affected by the above-mentioned transmission constraints as it is located in the urban area of Lima. It is worth pointing out that Camisea's gas pipeline is currently being expanded so that it may adequately supply gas to this power station and the other stations that will be installed in Chilca.

In line with the aspects discussed above, the following graph shows the projected evolution of power supply and demand in 2008 and 2009. Demand would grow between 7 and 8 percent in this period, while supply would be higher in 2009 due to the implementation of stage III of Chilca Uno and the expansion of the Santa Rosa thermal power station. Moreover, these projects are not only the ones that are most likely to be implemented, but also the ones with sufficient transmission facilities. This evolution of supply and demand would imply a reduction in the reserve margin reserve required for the system's operation (from 31 percent in 2007 to 21 percent in 2009). Therefore, and in order to prevent bottle-necks that may affect economic growth, it is important to accelerate the completion of the ongoing processes associated with awarding the contracts for these projects.

DEMAND AND SUPPLY
FOR EFFECTIVE SOURCE OF ENERGY



Source: MEM, Osinergmin, COES and BCRP.
Made by BCRP.

Finally, it should be pointed out that, in the medium-term, the execution of programmed investments in transmission and generation projects would ensure the efficient operation of the electricity sector and a supply-demand balance in this market. On the one hand, the operation of additional transmission lines as of 2010 will facilitate the efficient operation of the national electricity system (seven new lines will start operating in 2010-11, including the Chilca-La Planicie-Zapallal transmission line). On the other hand, an annual growth of about 300 MW in electricity demand may be absorbed by the operation of new generation projects (thermal power plants using natural gas, such as Egechilca and Nueva Esperanza, with a power of 700 MW, and fourteen hydroelectric power stations with a power of 1,305 MW[3]) that have been programmed to be implemented.

3 Hydroelectric power stations with already established concession contracts include El Platanal (220 MW), Santa Rita (174 MW), Cheves (159 MW), Pucará (130 MW), San Gaban (120 MW), Quitaracsa (112 MW), and Marañon (96 MW).

V. Balance of payments

The surplus in the current account of the balance of payments would have been equivalent to 1.0 percent of GDP in 2007, lower than the 2.8 percent rate observed in 2006. This lower result is mainly associated with the impact of strong domestic demand on imports, which grew by approximately 32 percent. Together with the current account result, the significant inflow of both short-term and long-term capitals that was also observed during this period generated upward pressures on the Nuevo Sol.

Deficits in the current account of the balance of payments are forecast for 2008 and 2009 (1.9 and 2.4 percent of GDP respectively) given that a less favorable international environment is expected due to the lower growth of our trading partners, and that terms of trade are expected to drop by 11 percent and 3 percent respectively in these years.

Current account

46. In **2007** the current account of the balance of payments would have posted a surplus of 1.0 percent of GDP, explained mainly by a positive result in the trade balance and by increased remittances from abroad. The international context was characterized by the higher prices of food and fuels, by the persistence of high levels in the prices of minerals, and by uncertainty about the evolution of economic activity in some countries. Exports of goods increased 17 percent, given that export prices increased 14 percent and the volume of exports increased 3 percent. On the other hand, imports of goods increased 32 percent.

    The supply constraints that have driven the prices of food and fuel upwards would continue to be seen in **2008**. On the other hand, a higher demand for imported goods is expected given the current drive of private investment. Therefore, the forecast on the current account deficit has been raised from the 0.4 percent of GDP estimated in our previous Inflation

Report to 1.9 percent of GDP in this report. This new forecast considers that the surplus in the trade balance would decline from US$ 6.0 billion to US$ 5.2 billion.

Considering the same factors, the current account result in **2009** has also been revised to an estimated deficit of 2.4 percent of GDP, instead of the 0.9 percent deficit estimated in our September Report.

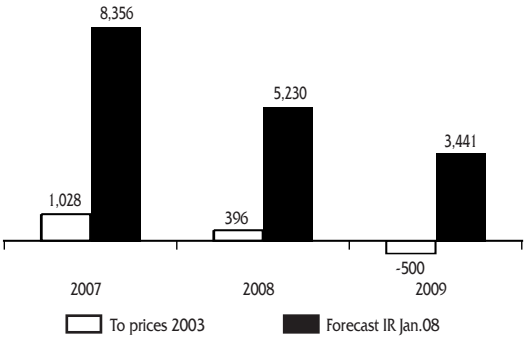
Table 22

BALANCE OF PAYMENTS
(Millions of US$)

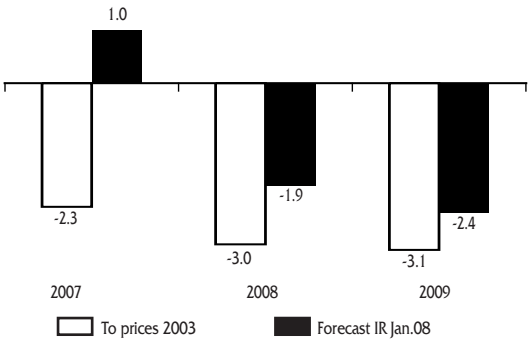
	2006	2007*		2008*		2009*	
	Year	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
I. CURRENT ACCOUNT BALANCE	**2,589**	**1,329**	**1,092**	**-528**	**-2,485**	**-1,240**	**-3,570**
As percentage of GDP	*2.8*	*1.3*	*1.0*	*-0.4*	*-1.9*	*-0.9*	*-2.4*
1. Trade balance	8,934	8,461	8,356	5,973	5,230	3,802	3,441
a. Exports	23,800	27,399	27,956	28,424	30,174	28,987	31,725
b. Imports	-14,866	-18,938	-19,599	-22,451	-24,944	-25,184	-28,283
2. Services	-949	-1,253	-1,025	-1,415	-1,370	-1,483	-1,414
3. Investment income	-7,581	-8,405	-8,707	-7,945	-9,087	-6,760	-8,653
4. Current transfers	2,185	2,526	2,466	2,859	2,742	3,201	3,055
Remittances	1,837	2,153	2,103	2,468	2,320	2,800	2,622
II. FINANCIAL ACCOUNT	**589**	**5,171**	**9,323**	**1,528**	**7,485**	**2,240**	**4,570**
III. NIRs FLOWS (=I+II)	**3,178**	**6,500**	**10,414**	**1,000**	**5,000**	**1,000**	**1,000**
Memo:							
International reserves balance (Millions of US$)	17,275	23,775	27,689	24,775	32,689	25,775	33,689

IR: Inflation Report.
* Forecast.

Graph 51
TRADE BALANCE
(Millions of US$)



Graph 52
CURRENT ACCOUNT
(Percentage of GDP)

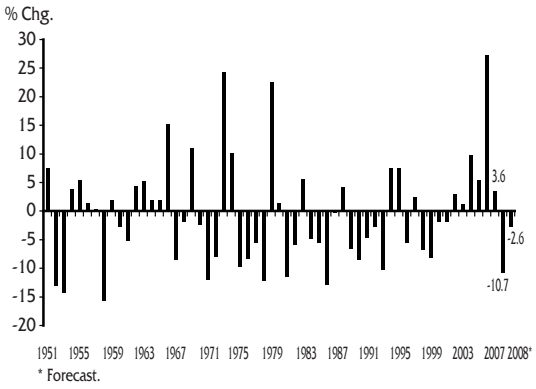


47. In order to measure the effect of an extreme reversal of commodity prices, the trade balance and the balance of the current account have been estimated at 2003 prices -as metal prices started showing a significant increase since 2004. The results obtained through this show that the current account would remain at sustainable levels during the following years. The trade balance would by lower by approximately US$ 4.5 billion on average between 2007 and 2009. On the other hand, the adjusted current account would show negative results in 2008 and 2009 (-3.0 and -3.1 percent of GDP respectively).

Terms of trade

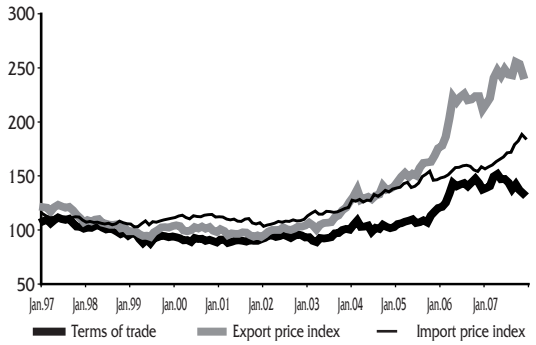
48. In **2007**, terms of trade grew for the sixth consecutive year and showed a 3.6 percent increase due to the higher prices of exports, which increased by 14 percent. This was offset by the higher prices of imports, which increased 10 percent.

Graph 53
TERMS OF TRADE
(Percentage change)



* Forecast.

Graph 54
EXPORT AND IMPORT INDICES, AND TERMS OF TRADE
(1994 = 100)



49. A reduction of 10.7 percent and 2.6 percent is forecast in the index of terms of trade for 2008 and 2009 respectively. This reduction is explained by upward pressure on the prices of imported food and fuels in the case of 2008, and by lower export prices in the case of 2009.

50. As a result of global economic slowdown, a slight reduction of export prices is expected in **2008** given that a reversal would be seen in the price rises of basic metals (i.e. copper and zinc), although offset by higher prices of gold. The prices of imports would show a faster pace of growth due to the higher prices of food and oil.

    The prices of food and oil should start showing a decline by **2009** as demand pressures subside. As regards export prices, mining products -except precious metals, such as gold and silver- would show a downward trend in a context of better global supply-demand balances.

Table 23

TERMS OF TRADE
(Annual percentage change)

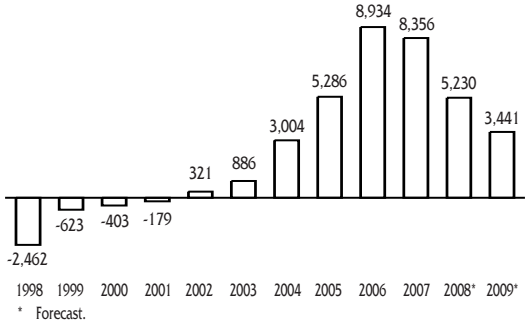
	2006	2007		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
Terms of trade (% Chg.)	**27.4**	**3.0**	**3.6**	**-8.1**	**-10.7**	**-4.8**	**-2.6**
1. Export price index	**36.9**	**11.1**	**13.9**	**-4.2**	**-0.2**	**-4.4**	**-2.9**
Annual average price							
- Copper (cents per pound)	305	320	323	290	280	265	255
- Zinc (cents per pound)	149	149	147	124	106	110	106
- Gold (US$ per ounce)	605	670	697	700	820	720	849
- Fishmeal (US$ per MT)	1,080	1,064	1,075	907	924	824	843
2. Import price index	**7.4**	**7.8**	**9.9**	**4.3**	**11.7**	**0.5**	**-0.3**
Annual average price							
- Petroleum (US$ per barrel)	66	69	72	74	89	71	84
- Wheat (US$ per MT)	169	225	231	248	333	214	308
- Maice (US$ per MT)	94	135	138	149	193	161	198
- Soy bean (US$ per MT)	214	295	307	343	458	333	437

IR: Inflation Report.
* Forecast.

Trade balance

51. In **2007** the trade balance would have shown a result of US$ 8.4 billion, a sum slightly lower than the one considered in our previous report (US$ 8.5 billion). In the case of exports, the higher price of exports would have compensated by

Graph 55
TRADE BALANCE
(Millions of US$)



far the lower volume of traditional exports (mainly mining and fishing products), while the increase seen in the case of imports would be associated with the higher growth observed in the Peruvian economy.

52. In **2008** and **2009**, the trade should continue to show surpluses (US$ 5.2 billion and US$ 3.4 billion respectively). These results have been revised downwards relative to the results estimated in our previous Inflation Report based on the new information considered regarding the future evolution of commodity prices and estimates of a higher demand for imports.

Table 24

TRADE BALANCE
(Millions of US$)

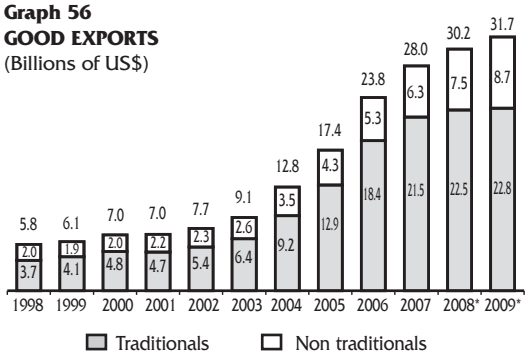
	2006	2007		2008*		2009*	
	Year	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
EXPORTS	**23,800**	**27,399**	**27,956**	**28,424**	**30,174**	**28,987**	**31,725**
Of which:							
Traditional products	18,374	20,996	21,493	21,056	22,524	20,662	22,805
Non-traditional products	5,271	6,245	6,288	7,202	7,467	8,156	8,731
IMPORTS	**14,866**	**18,938**	**19,599**	**22,451**	**24,944**	**25,184**	**28,283**
Of which:							
Consumption goods	2,611	3,161	3,191	3,712	3,778	4,153	4,304
Raw material	7,987	9,876	10,416	11,334	12,900	12,399	14,198
Capital goods	4,145	5,814	5,885	7,315	8,155	8,539	9,668
TRADE BALANCE	**8,934**	**8,461**	**8,356**	**5,973**	**5,230**	**3,802**	**3,441**
Note: % Change							
Exports	37.0	15.1	17.5	3.7	7.9	2.0	5.1
Imports	23.0	27.4	31.8	18.6	27.3	12.2	13.4
Export volume index	-0.1	3.5	3.3	8.2	8.2	6.1	8.3
Import volume index	14.5	19.0	19.9	13.9	15.5	11.5	13.7

IR: Inflation Report.
* Forecast.

Exports

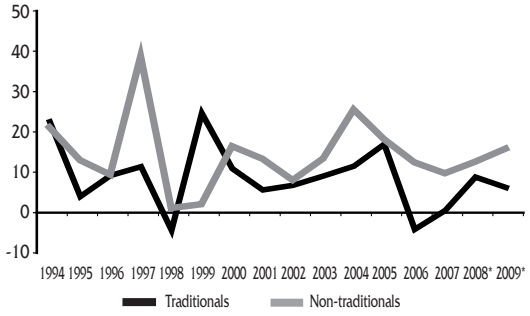
53. **Exports** of goods in 2007 increased by 17 percent compared to 2006 and posted a new historical record of US$ 28.0 billion (US$ 23.8 billion in 2006). This result was influenced not only by a favorable evolution of prices in external markets (traditional exports increased 16 percent, while non-traditional exports increased 9 percent), but also by a greater diversification of products and by access to new markets, which contributed to the growth of non-traditional products.

Graph 56
GOOD EXPORTS
(Billions of US$)



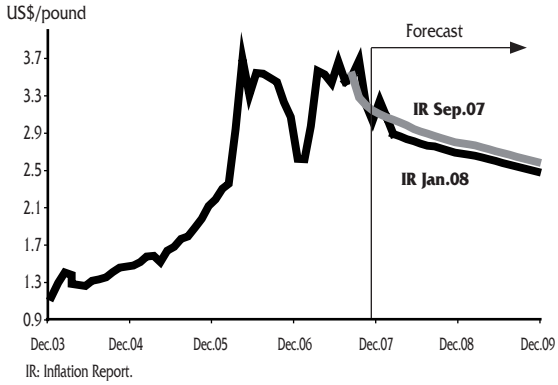
Note: Total exports include other exports.
* Forecast.

Graph 57
VOLUME INDEX: TRADITIONALS AND NON-TRADITIONAL EXPORTS
(Percentage changes)



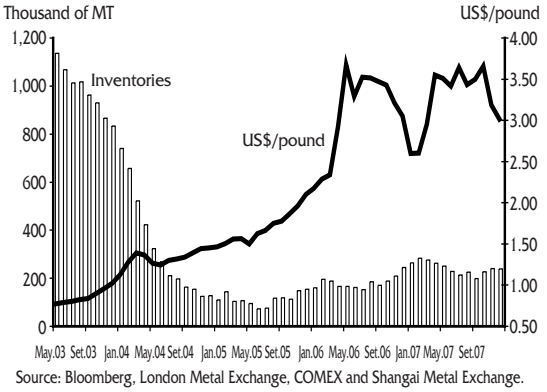
* Forecast.

Graph 58
COPPER PRICE: FORECAST



IR: Inflation Report.

Graph 59
COPPER PRICE AND INVENTORIES



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

Non-traditional exports increased by approximately 19 percent, mainly due to the contribution of agricultural, chemical, steel and metal, and jewelry exports which accounted for over 50 percent of this growth. The volume of exports of this type of products grew 10 percent, while prices increased 9 percent. On the other hand, **traditional exports** would have grown 17 percent, reflecting the positive impact of the higher prices of raw materials in international markets. On average, prices increased 16 percent in 2007 -driven by the higher prices of commodities-, while volumes increased only 1 percent.

54. Total exports would grow 8 y 5 percent in nominal terms in 2008 y 2009 respectively, mainly as a result of higher sales of non-traditional products (19 and 17 percent in **2008** and **2009** respectively), especially agricultural and fishing products, while exports of traditional products would grow by 5 percent in 2008 and by 1 percent in 2009 due to the lower prices of metals.

Copper

Copper exports accounted for roughly 26 percent of total exports in 2007. The volume of these exports increased approximately 14 percent mainly due to the higher production associated with Cerro Verde's expansion.

The average price of copper in 2007 was US$ 3.23 per pound, which represented a 6 percent increase relative to 2006. This price increase would be explained by a supply deficit in the copper market (copper inventories declined to levels that would only meet consumption demands during a week and a half).

This shortage of copper was associated with a growth of demand in China, which showed higher levels than the ones forecast in early 2007. China's consumption increased an annual 35 percent in the first eleven months of the year, while China's net imports of refined copper grew 135 percent (to 1.37 million tons) in 2007. Supply reductions -mainly associated with labor or operation problems in the main producer countries (Chile, Peru, Mexico, Indonesia, and Canada) also contributed to the upward pressures observed in the year. Moreover, some natural phenomena affected production in some mines in Chile.

In **2008** and **2009** the price of copper should decline as the market would show a better supply given that a lower demand is estimated in the United States and Europe. Moreover, the onset of new projects would also contribute to improve supply.

Demand in the United States and Europe would be affected by the slowdown of the U.S. real estate market. The consumption of copper in the United States fell 6 percent in the first nine months of 2007 and this trend would aggravate should the U.S. economy go into recession. However, this effect would be compensated by an expected higher demand in China, given the growth of construction, the expansion of electricity generation capacity, and the government's demand for this metal to replenish strategic reserves observed in this country.

On the other hand, supply would increase due to the onset of operations in new projects and to production expansions. The new big projects that would start operating in Chile, United States, Zambia, and Congo would have an estimated yearly production of 870 thousand tons. Moreover, the production of refined copper would grow 6 percent in 2008, due to increased capacity in Chile and China.

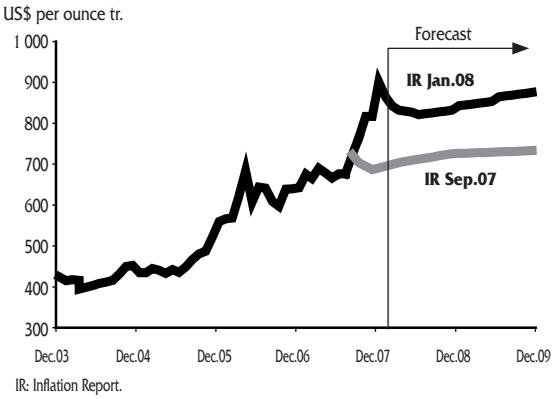
Gold

Gold exports accounted for 15 percent of total exports in 2007. The volume of these exports, which decreased nearly 11 percent, totaled approximately 5,900 thousand troy ounces.

The price of gold increased 15 percent in 2007, showing an average price of US$ 697.41 per ounce. This increase was influenced by a higher physical demand (India, China, and Middle East countries), by investors' higher demand, as well as by a lower than expected production, especially in South Africa and Peru. These factors led to a supply deficit in the first nine months of the year.

Since September, the price of gold showed an upward trend which was aggravated by the depreciation of the dollar associated with the FED's reduction of its interest rates and by increased demand for gold as a hedge against the higher prices of oil.

Graph 60
GOLD PRICE: FORECAST



IR: Inflation Report.

The price of gold should continue increasing during 2008 and 2009 given that demand is expected to remain at high levels due both to the demand of the jewelry industry and to investors' demand. Factors explaining the latter would include geopolitical uncertainty, the weakness of the dollar, and problems in U.S. markets. On the other hand, supply would remain stable in aggregate terms given that supply constraints in South Africa would be compensated by an expected increase of production in other countries.

Zinc

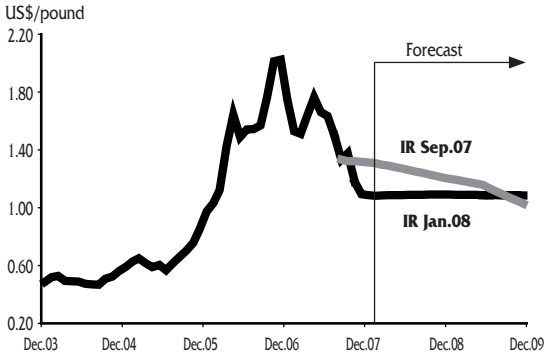
Zinc exports accounted for nearly 9 percent of total exports in 2007. The volume of zinc exports increased

by approximately 19 percent due to Antamina's higher production.

The price of zinc declined 0.9 percent in 2007 to an average price of US$ 1.47 per pound. Zinc production in China -the world's first producer of zinc- Increased by an annual 23 percent to 344 thousand tons (data up to October 2007), while China's zinc imports decreased 17.4 percent in the first 11 months of the year. Another factor contributing to this lower demand for zinc was the substitution of galvanized steel (coated with zinc) by stainless steel (nickel is used with this metal).

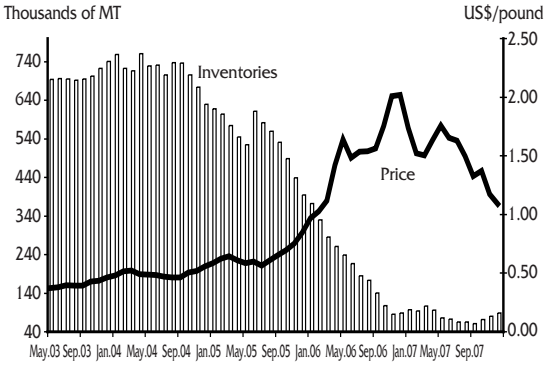
The average price of zinc should decrease during 2008 and 2009 mainly due to the onset of operations in new mining projects, which would consolidate a supply surplus in this market. The main projects that would start operating include Sotkamo in Finland and Peñasquito in Mexico, with an annual production of 195 thousand tons. It is worth pointing out that Hindustan Zinc (the world's third major producer of zinc) announced that production would be increased by 50 percent in 2008. This higher mining supply would also be coupled by a greater refining capacity, basically in China.

Graph 61
ZINC PRICE: FORECAST



IR: Inflation Report.

Graph 62
ZINC PRICE AND INVENTORIES



Source: Bloomberg and London Metal Exchange.

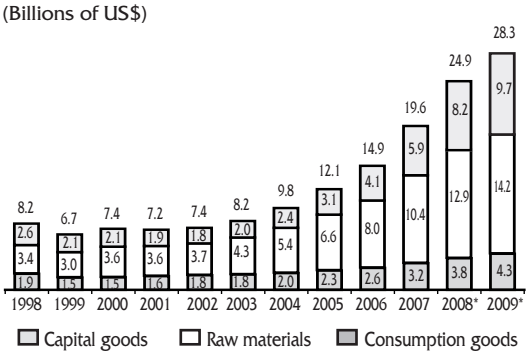
Table 25

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

	2004	2005	2006	2007*	2008*
Copper					
- Supply	11,689	16,657	17,529	18,101	19,147
- Demand	12,537	16,750	17,418	18,134	19,102
Gap (Supply - Demand)	-848	-93	111	-33	45
Inventories	488	425	536	503	548
Consumption weeks	2.1	1.3	1.6	1.4	1.5
Zinc					
- Supply	7,296	7,015	7,150	7,401	7,940
- Demand	7,548	7,316	7,465	7,534	7,886
Gap (Supply - Demand)	-252	-301	-315	-133	54
Inventories	1,039	828	548	415	469
Consumption weeks	7.3	6.1	3.9	2.9	3.2
Oro					
- Supply	3,361	4,025	3,557	2,629	n.d.
- Demand	3,497	3,731	3,386	2,766	n.d.
Gap (Supply - Demand)	-136	294	171	-137	n.d.

* Forecast in the case of gold, the information corresponds to January-September 2007.
Source: World Gold Council, Metal Bulletin Research (Base Metals Monthly, December 2007).

Graph 63
GOOD IMPORTS
(Billions of US$)



Note: Total imports include other imports.
* Forecast.

Imports

55. The growth of imports observed in **2007** (32 percent) was mostly associated with the evolution of private investment, which grew approximately 23 percent during this year, as reflected in the increase seen in imports of capital goods. Given the correlation of these imports and the dynamism of private investment, this reflects higher capital and productivity levels that favor the growth of potential GDP in the medium term.

By economic sectors, the higher imports of capital goods for industry (42 percent), the higher imports for the transport sector (50 percent), and the higher imports of machinery for the construction sector (24 percent) were noteworthy.

56. In **2008** and **2009**, imports should show growth rates of 27 and 13 percent respectively, given that various sectors would see the onset of the pre-operation stages of several investment projects. Thus, important projects to be implemented in this period would include Camisea II (in the south of Peru), Toromocho (Junín), Río Blanco (Piura), Minas Conga (Cajamarca), Lot 67 (Amazonas), Bayovar's Phosphate Plant (Piura), among other projects.

Financial account

57. In **2007** the financial account of the balance of payments was characterized by a strong increase in the flow of external resources associated with direct private investment and long-term disbursements, in line with the drive of economic activity. As a result of this, a positive flow of US$ 8.7 billion would be seen in the financial account of the balance of payments.

58. Investments of over US$ 6.2 billion each year are expected in **2008** and **2009** given favorable expectations on the evolution of economic activity which, although showing a more moderate pace, would grow at rates closer to those of the potential GDP. The main flow of foreign investment would be oriented to the mining and hydrocarbon sector -where important projects will be developed-, as well as to the sectors of telecommunications, electricity, road infrastructure, agroindustry, the petrochemical industry, etc.

In line with the drive of economic activity, increased private long-term disbursements would add to the higher flows of direct investment. Moreover, local institutional investors' portfolio should continue to diversify toward financial assets abroad during the following years.

Table 26

PRIVATE FINANCIAL ACCOUNT

(Millions of US dollars)

	2003	2004	2005	2006	2007
PRIVATE FINANCIAL ACCOUNT	**42**	**1,167**	**1,582**	**1,446**	**10,995**
1. INFLOWS	**1,799**	**2,247**	**3,378**	**4,331**	**11,741**
A. Direct investments	1,275	1,599	2,579	3,467	6,310
B. Long term disbursement	559	726	647	709	3,771
C. Portfolio investment received by the country	-35	-78	152	155	1,660
2. OUTFLOWS	**-1,904**	**-1,310**	**-1,559**	**-2,257**	**-1,320**
A. Portfolio investment abroad	-1,179	-304	55	-1,722	-701
B. Amortization of long-term	-725	-1,007	-1,614	-535	-619
3. SHORT TERM CAPITAL	**147**	**230**	**-236**	**-628**	**574**
A. Banking system	118	103	64	-468	1,585
B. Rest	30	127	-301	-161	-1,011

VI. Public finances

Fiscal forecasts for the 2007-2009 period show better results for the operations of the Non-Financial Public Sector (NFPS) than those considered in our Inflation Report of September 2007, basically because of lower non-financial expenditure in 2007.

Expected economic results should include a surplus equivalent to 1.8 percent of GDP in 2008 and a surplus equivalent to 1.0 of GDP in 2009. Economic results would show higher rates than the ones forecast in our previous report, despite the fact that the forecast considers a gradual recovery of expenditure, with expenditure growing at even higher rates than economic activity.

In this forecast scenario, the structural economic result -indicator that excludes the total impact of the economic cycle- would show a downward trend in the following years. Furthermore, the fiscal impulse -which was nil in 2007- would be positive in the next two years, particularly in 2008, and would suggest that fiscal expenditure would have an impact on the growth of domestic demand despite the fact that higher surpluses than the ones forecast in our previous report are considered here.

Overall balance

59. In 2007, the Non-Financial Public Sector (NFPS) showed a positive result equivalent to 3.0 percent of GDP (0.9 percentage points higher than in 2006). This surplus is explained mainly by central government operations (1.7 percentage points), while the rest of general government entities -which include local governments- accounted for 1.2 percentage points of this surplus. Moreover, the overall balance of public enterprises was 0.1 percent of GDP.

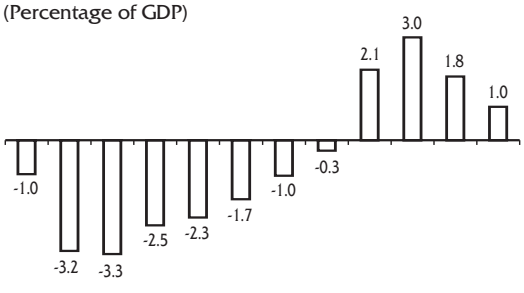
    The economic surplus in 2007 was higher than the one forecast in our previous Inflation Report (3.0 percent versus 2.0 percent of GDP), basically due to lower non-financial spending. The general government's current revenues

remained at 20.5 percent of GDP -a similar level than the one considered in our previous report-, but increased in nominal terms due to the greater drive of economic activity, the favorable international prices for our commodities, and the growth of imports, which showed a higher increase than the one forecast in our previous report.

60. Executed non-financial expenditure -forecast at 16.8 percent of GDP in our September Inflation Report- was 15.9 percent, given that the different levels of government NFPS did not fully execute their current expenditure or capital spending budgets.

61. Economic surpluses equivalent to 1.8 percent and 1.0 percent of GDP are estimated for 2008 and 2009 respectively. This estimates are 0.8 and 0.7 percent higher than the ones considered in the September report.

Graph 64
OVERALL BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR
(Percentage of GDP)



* Forecast.

Table 27

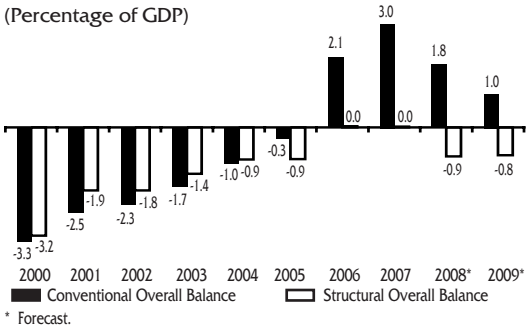
NON-FINANCIAL PUBLIC SECTOR
(Percentage of GDP)

	2006	2007		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
1. General government current revenue	**19.7**	**20.5**	**20.5**	**20.4**	**20.5**	**20.0**	**20.0**
Real percentage change	*23.1*	*12.6*	*13.5*	*2.7*	*2.9*	*1.8*	*2.5*
2. General government non-financial expenditure	**16.2**	**16.8**	**15.9**	**17.8**	**17.1**	**18.2**	**17.7**
Real percentage change	*8.7*	*12.3*	*7.0*	*9.4*	*11.3*	*6.5*	*8.1*
Of which:							
a. Current	*13.4*	*13.7*	*12.8*	*14.1*	*13.3*	*14.1*	*13.5*
Real percentage change	*7.3*	*10.2*	*4.5*	*6.6*	*6.8*	*4.3*	*6.3*
b. Capital	*2.6*	*3.0*	*2.8*	*3.6*	*3.7*	*4.0*	*4.1*
Real percentage change	*14.2*	*25.4*	*20.0*	*25.1*	*34.2*	*15.1*	*15.3*
3. Other	**0.4**	**0.2**	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**
4. Primary balance (1-2+3)	**3.9**	**3.9**	**4.8**	**2.7**	**3.4**	**1.8**	**2.4**
5. Interests	**1.9**	**1.9**	**1.8**	**1.7**	**1.6**	**1.5**	**1.4**
6. Overall balance	**2.1**	**2.0**	**3.0**	**1.0**	**1.8**	**0.3**	**1.0**
Central government current revenues	17.3	18.0	18.0	17.9	18.0	17.4	17.5
Central government non-financial expenditure	14.2	15.2	14.8	15.5	15.1	15.6	15.3

IR: Inflation Report.

* Forecast.

Graph 65
CONVENTIONAL AND STRUCTURAL OVERALL BALANCE OF THE NFPS
(Percentage of GDP)



* Forecast.

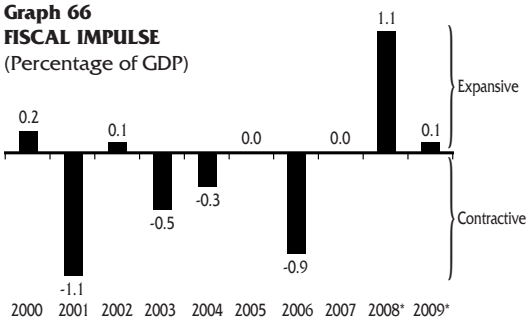
Structural overall balance

62. The structural economic result is an indicator that isolates the effects of the economic cycle and of the higher prices of mining and hydrocarbon exports on the fiscal result. This indicator shows a downward trend in the period of analysis,

declining from zero in 2007 to a deficit of 0.9 and 0.8 percent of GDP in 2008 and 2009 respectively.

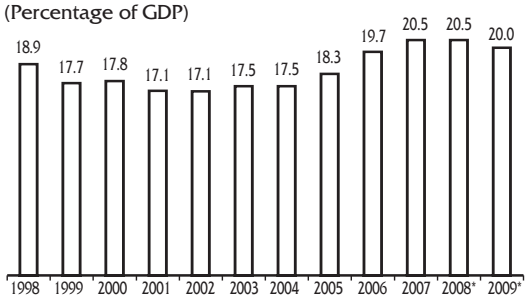
Furthermore, the fiscal impulse -indicator showing the net effect of fiscal policy on domestic demand- was lower in 2007 than previously forecast due to lower non-financial expenditure. This indicator would be positive in 2008 and 2009 (1.1 and 0.1 respectively), which suggests that, despite the higher levels of surpluses estimated, fiscal expenditure would be a source of expansion for domestic demand, especially in 2008.

Graph 66
FISCAL IMPULSE
(Percentage of GDP)



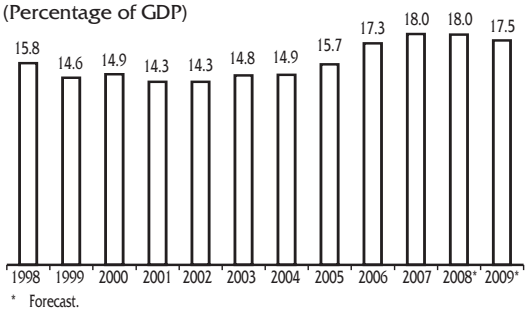
* Forecast.

Graph 67
GENERAL GOVERNMENT CURRENT REVENUE
(Percentage of GDP)



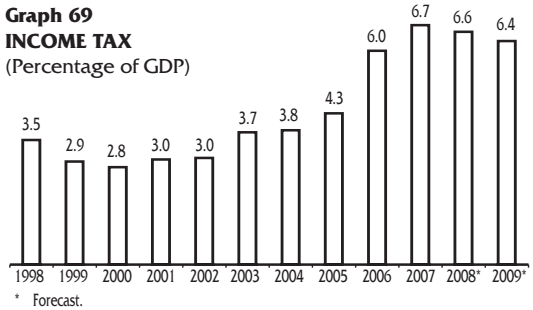
* Forecast.

Graph 68
CENTRAL GOVERNMENT CURRENT REVENUE
(Percentage of GDP)



* Forecast.

Graph 69
INCOME TAX
(Percentage of GDP)



* Forecast.

Evolution of fiscal revenues

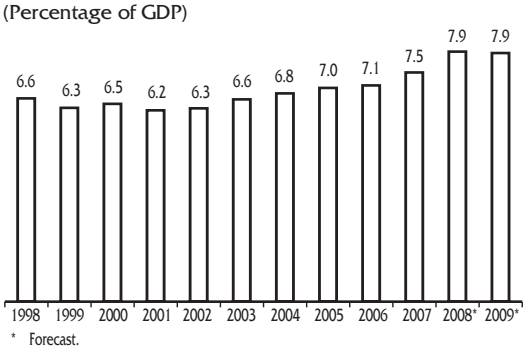
63. In 2007 the current revenues of the general government increased a real 14 percent due to the greater drive of economic activity and to favorable international prices for our main exports, as reflected in firms' greater profits, particularly in the mining sector. Central government revenues in 2007 (18.0 percent of GDP) showed the highest level observed since 1980.

The revenues contributing most heavily to this evolution were the income tax (including regularization), which grew 22 percent in real terms, and value added tax (associated with domestic operations), which grew 12 percent. The taxes associated with imports showed different conducts: while the external VAT increased by 20 percent due to higher imports during the year, revenues for tariffs decreased by a real 24 percent mainly due to the tariff reduction established at end 2006.

Forecasts for **2008** and **2009** consider current revenues of 20.5 percent and 20.0 percent of GDP respectively - the estimate for 2008 is 0.1 percent higher than the one considered in our September Inflation Report, while the estimate for 2009 is similar to our previous forecast. Factors contributing to this higher level of revenues would include greater economic activity, a lower fall of export prices, and increased imports.

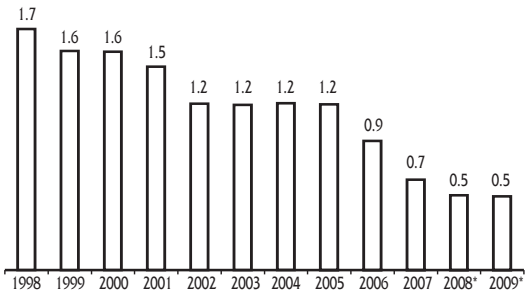
Revenues should increase despite the implementation of some tax modifications in the last quarter of 2007 that would affect tax collection in the following years. For example, the tariff reduction implemented in October modified the rates for 4,224 groups of products; this would represent an annual cost of 0.2 percentage points of GDP on fiscal accounts. Moreover, the tax modifications affecting the excise tax on fuels and automoviles that were implemented in December would represent an overall cost of 0.1 percent of GDP on revenues.

Graph 70
VALUE ADDED TAX
(Percentage of GDP)



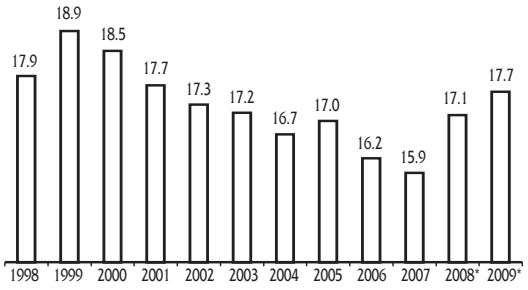
* Forecast.

Graph 71
IMPORT TAX REVENUE
(Percentage of GDP)



* Forecast.

Graph 72
GENERAL GOVERNMENT NON-FINANCIAL EXPENDITURE
(Percentage of GDP)



* Forecast.

Furthermore, although the Peru-US Trade Promotion Agreement should come into force in the second half of 2008, this is no longer considered to be an important fiscal cost given the tariff reductions established over the past two years. The forecasts also consider the reductions of the Tax on Financial Transactions -ITF- (from 0.08 percent in 2007 to 0.07 percent in 2008 and to 0.06 percent in 2009) and of the Temporary Tax on Net Assets -ITAN- (from 0.5 percent in 2008 to 0.4 percent in 2009).

Evolution of fiscal expenditure

64. In 2007, the general government's non-financial expenditure was equivalent to 15.9 percent of GDP, 0.3 percentage points lower than in 2006. In real terms, it grew 7 percent. Analyzing non-financial expenditure by components, the general government's investment grew a real 20 percent during 2007, while current expenditure increased a real 5 percent.

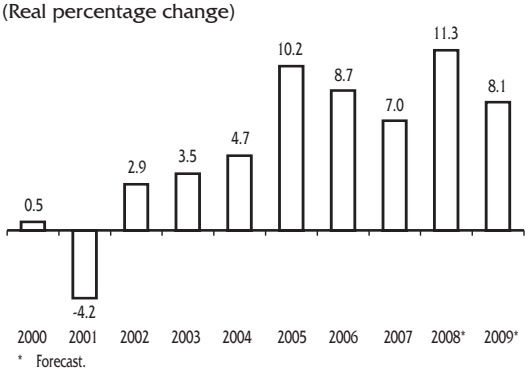
    The general government's non-financial expenditure should increase by a real 11 percent in 2008 and by a real 8 percent in 2009. The forecast for 2008 has been revised upwards relative to our previous report (11 percent vs. 9 percent) basically because government expenditure in investment is expected to increase from 25 to 34 percent. This is associated with the fact that the Budget Law for 2008 (Law N° 29142 enacted on December 10, 2007) authorized that the funds for investment projects that had not been executed by December 2007 could be re-allocated as ordinary financing resources for 2008.

65. The forecasts on expenditure for the 2008-2009 period consider the limits set forth in the Fiscal Accountability and Transparency Act, which in its last amendment established that the annual increase of the central government' expenditure in consumption shall not be higher than 4 percent in real terms, including total spending in salaries, goods, and services.

    In the frame of the strategy implemented to offset the effect of the high volatility of fuel prices, in 2007 the Public Treasury assigned S/. 190 million to reduce the amount of resources committed to the Fuel Price Stabilization Fund. As provided by several legal regulations, contingent funds assigned to the Fund for the 2009 budget amount to S/. 900 million.

66. Transfers from the 2007 fiscal year to the Fiscal Stabilization Fund (FSF) are estimated at approximately US$ 1,000

Graph 73
GENERAL GOVERNMENT NON-FINANCIAL EXPENDITURE
(Real percentage change)



* Forecast.

million. This sum results mainly from the difference between ordinary incomes and ordinary expenditure, and includes 2007 unexecuted investments that have been reprogrammed for 2008. The balance of the FSF by December 31, 2007 was US$ 485 million, equivalent to 0.4 percent of GDP. Furthermore, according to the Fiscal Accountability and Transparency Act and its amendments, any amount exceeding 2 percent of the GDP ratio may be used for debt reduction operations.

Financing requirements

67. During 2007 the government implemented a strategy aimed at improving the debt profile and at reducing exchange risks. The following operations were carried out with this aim:

- In February 2007, Brady bonds and 2012 Global Bonds were exchanged by longer maturing conds, which included an issue of global bonds maturing in 2037. The total involved in this bond exchange operation amounted to US$ 2,262 million.

- In October, Peru prepaid US$ 1,794 million to the Paris Club through the issue of 30-year sovereign bonds for a total of S/. 4,750 million (approximately US$ 1,504 million). The structure of our liabilities was modified with this operation, replacing 5.3 percent of the external debt by internal debt denominated in Nuevos Soles.

- In December 2007, Peru prepaid US$ 261 million to the Andean Development Corporation (CAF). This operation was financed through a new debt with the CAF for the a total of US$ 250 million and the remainder was prepaid with own resources. The aim of this operation was to reduce the spread of this initial debt.

The reduction of the external debt achieved through these transactions in 2007 was approximately US$ 2,000 million compared to the previous year. Moreover, these operations have also enabled increasing the total debt in domestic currency from 24.4 percent to 36.5 percent in terms of the total public debt in the same period.

Table 28

FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR 1/
(Millions of US$)

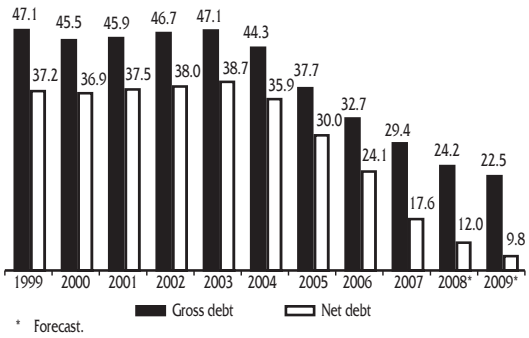
	2006	2007		2008*		2009*	
		IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08	IR Sep. 07	IR Jan. 08
I. Uses	**-247**	**-642**	**-1,681**	**769**	**-291**	**917**	**-181**
1. Amortization	1,636	1,459	1,512	2,007	1,992	1,311	1,259
a. External	1,107	1,115	1,175	1,489	1,413	1,001	923
b. Internal	530	344	337	518	580	310	336
Of which: Pension Bonds	145	149	138	163	180	183	192
2. Overall Balance (negative sign indicates surplus)	-1,883	-2,101	-3,192	-1,238	-2,283	-394	-1,440
II. Source	**-247**	**-642**	**-1, 681**	**769**	**-291**	**917**	**-181**
1. External	535	928	969	1,160	1,158	1,089	1,089
2. Bonds 2/	820	725	840	972	1,046	987	1,053
3. Internal 3/	-1,602	-2,295	-3,490	-1,363	-2,496	-1,160	-2,324
Memo: In percentage of GDP							
Gross public debt balance	32.7	28.4	29.4	25.6	24.2	24.0	22.5
Net debt balance 4/	24.1	18.3	17.6	15.5	12.0	13.9	9.8

IR: Inflation Report.
* Forecast.
1/ In amortization, as well as disbursements, has isolated the effect of exchange Treasure Bonds for long maturities.
2/ Includes domestic and external bonds.
3/ Positive sign indicates overdraft and negative sign indicatges greater deposits.
4/ Defined as the difference between gross public debt and NFPS deposits.
Source: BCRP and MEF.

68. A total of US$ 840 million corresponding to the balance of Brady bonds should be repaid in 2008. This operation will be financed through issues of sovereign bonds of up to US$ 486 million, and the rest will be obtained through Public Treasurs's own resources. Moreover, another prepayment for a total of US$ 189 million will be made to the CAF. This operation -similar to the one carried out in December 2007- will include negotiating a new debt contract with the CAF for a total of US$ 150 million.

69. The net debt -indicator of the position of public sector's net liabilities, as well as of public sector's solvency- decreased from 24.1 percent of GDP in December 2006 to 17.6 percent in December 2007. This reduction was associated with the public sector increased deposits (over US$ 5,000 million) in the financial system due to the accumulation of resources observed during the year due to the economic surplus achieved in 2007. This indicator should continue to show a downard trend and should reach a level of 9.8 percent of GDP in 2009. Said level would be associated with a level of liquid assets in the public sector that would be higher than that of the public debt as a result of the dynamism forecast in terms of economic actvity and the effects of this on fiscal accounts.

Graph 74
PUBLIC DEBT
(Percentage of GDP)



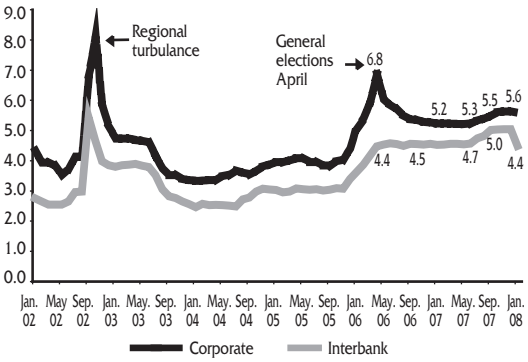
* Forecast.

70. This executed and expected position of public sector's assets and liabilities provides the economy with sounder grounds to face adverse macroeconomic contingencies, particularly in the current context of uncertainty about the immediate performance of the global economy.

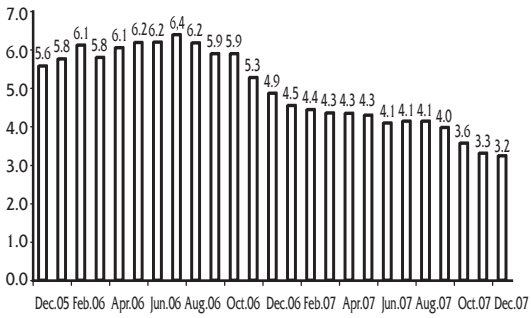
VII. Financial markets

Short-term and long-term interest rates in Nuevos Soles have been increasing in money and capital markets since September 2007. Changes in short-term interest rates were associated with preventive adjustments in the Central Bank's reference interest rates implemented between September 2007 and January 2008 (25 basis points each time). On the other hand, changes in long-term rates responded to a context of increased uncertainty in international markets and to higher spreads in emerging countries.

Graph 75
INTERBANK AND CORPORATE INTEREST RATE IN DOMESTIC CURRENCY
(In percentage)



Graph 76
RATIO NON-PERFORMING LOANS/DIRECT CREDITS OF LOANS AUTHORIZED BY BANKS AND MICROBUSINESSES
(In percentage)

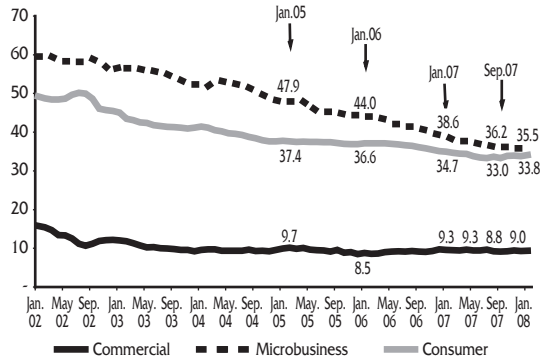


71. The monetary operations made by the BCRP are aimed at regulating liquidity in the money market in order to influence the interbank interest rate to converge towards the monetary policy reference rate. The interbank interest rate serves as a guide to set other rates in nuevos soles (for active and passive operations) affecting especially operations with lower risks and shorter maturities, given that these type of operations depend less on other factors, such as credit risks or inflation expectations in the long run.

72. The corporate prime rate increased from 5.5 to 5.6 percent between September 2007 and January 2008, given that the reference interest rate was raised from 5.0 to 5.25 percent in said period. In January 2008, a downward change was observed in the interbank interest rate relative to the reference rate in a context of significant inflows of short-term external capitals.

The rest of interest rates on banks' active operations showed a mixed conduct between September 2007 and January 2008. The rates on commercial and consumer loans increased from 8.8 to 9.0 percent and from 33.0 to 33.8 percent respectively. However, the rates on loans to micro businesses declined from 36.2 to 35.5 percent in the same period. This reduction was due to the good economic performance and to the better financial situation of micro businesses -in part reflected in the lower ratio of non-performing loans-, as well

Graph 77
INTEREST RATE IN COMMERCIAL MICROBUSINESS AND CONSUMER LOANS IN DOMESTIC CURRENCY
(In percentage)

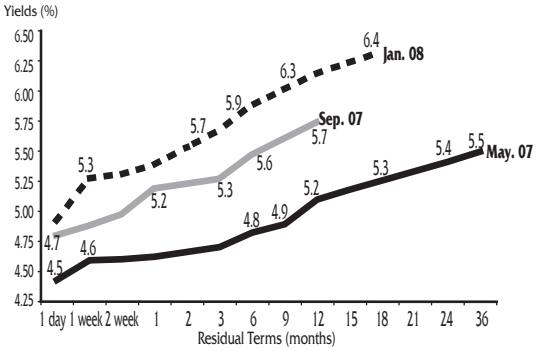


as to increased competition among financial entities in this segment.

In the same period, the rates of mortgage loans in Nuevos Soles continued to show a downward trend (rates declined from 9.9 to 9.8 percent), an evolution explained by increased competition and by a higher confidence on monetary stability.

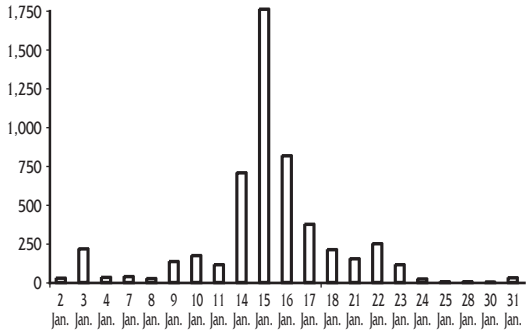
In January 2008, the rates on deposits in soles and in US Dollars for most maturity terms increased compared to the levels observed in September, particularly in the case of rates in Nuevos Soles.

Graph 78
PRIMARY MARKET FOR CDBCRP 1/



1/ Yield of netplacements closer to the end of months.

Graph 79
TRADING VOLUME IN THE SECONDARY MARKET FOR CDBCRP: JANUARY 2008
(Millions of Nuevos Soles)



Source: DATATEC

Bond market

73. The fixed income bond market showed a trend of higher short-term and long-term interest rates given that the Central Bank raised its reference rate and given increased global inflationary expectations.

74. Short-term interest rates increased relative to September after the Central Bank raised the reference interest rate by 25 bps. in early January. By mid-January the Central Bank approved to increase the rates of reserve requirements in Nuevos Soles and dollars in a context marked by a strong inflow of short-term foreign capitals and global financial turbulence in order to reduce its sterilization needs. These capitals generated demand pressures on short-term securities, particularly on BCRP Certificates of Deposit (CDBCRP). For this reason, the BCRP stopped issuing CDBCRP and replaced them with auctions of deposits (non-transferable) and then with Certificates of Deposit Subject to Limited Negotiation (Certificados de Depósito de Negociación Restringida).

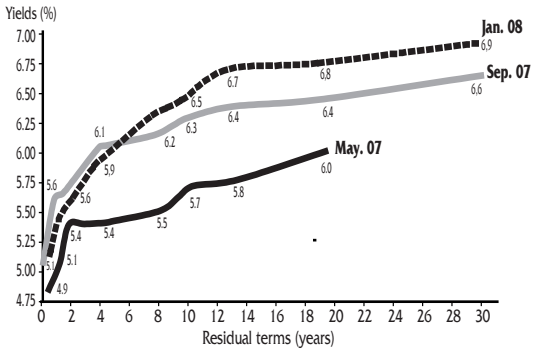
Table 29

TRADING VOLUME IN THE SECONDARY MARKET FOR CDBCRP
(Millions of Nuevos Soles per day)

2007	
March	48
April	88
May	59
June	53
July	42
August	66
September	52
October	82
November	116
December	208
2008	
January	249

Source: Datatec.

Graph 80
SECONDARY MARKET OR PUBLIC TREASURY SOVEREIGN BONDS 1/



1/ Yields of placements closer to the end of months.

75. The increase in the yield on domestic long-term bonds has taken place in a context of higher international uncertainty and global inflationary pressures.

Table 30

TRADES VOLUME IN THE CONDARY MARKET FOR BONDS 1/
(Millions of nuevos soles per day)

2006	
September	44
December	79
2007	
April	97
May	93
June	85
July	35
August	93
September	124
October	73
November	103
December	41
2008	
January	95

1/ Includes primary transfers by markets investors.
Source: Datatec.

76. International investors' favorable view on Peru's external accounts and pace of growth, as well as on the favorable prospects that the Peruvian public debt will soon be assigned an investment grade have brought about an increase in the flow of international capitals seeking to obtain in the short run higher gains than in industrialized economies. This was reflected in the increase observed in the external participation of holdings in Treasury bonds, CDBCRP, corporate bonds, and stocks in the stock market.

Table 31

SHARES OF NON-RESIDENT HOLDINGS OF FINANCIAL ASSETS

Financial Assets	Dec. 07
Treasury bonds	27%
CDBCRP Non residents 1/	30%
Investments in the stock market	
Fixed income	14%
Equities	48%

Source: Cavali, MEF, and BCRP.
1/ Up to January 31, 2008.

Monetary operations

77. Sterilization operations were mainly carried out in the last quarter of 2007 in order to maintain the interbank interest rate at the level of the reference rate, in a context of appreciation of the Nuevo Sol and of intervention in the exchange market in order to reduce excessive volatility in the exchange rate. Given the permanent injection of nuevos soles originating in said exchange interventions, the sterilization process was carried out gradually through the placement of CDBCRP with maturity terms ranging between one day and two years.

Monetary base

78. The issue of banknotes and coins increased 29.4 percent between January 2007 and January 2008, in a context of greater economic activity and a process of dedollarization.

Graph 81
MONETARY BASE
(Percentage change over the last 12 months)

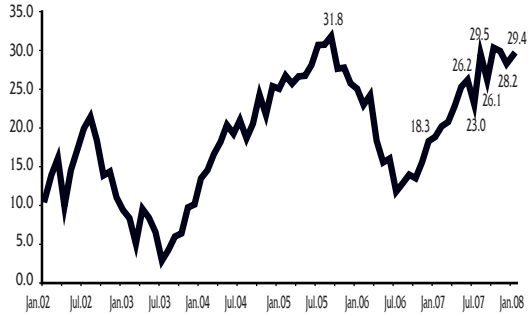


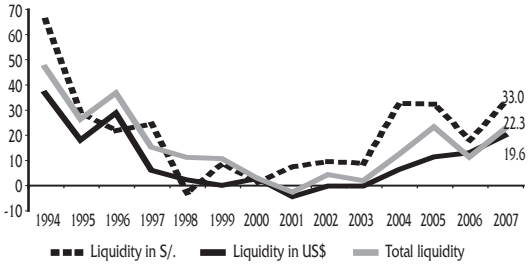
Table 32

MONETARY BASE
(Millions of Nuevos Soles)

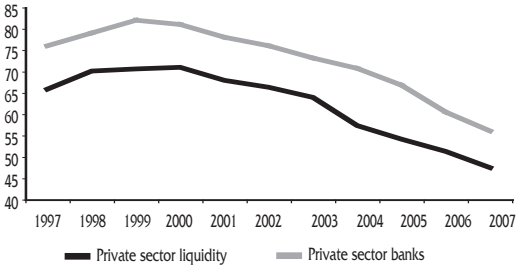
	2002	2003	2004	2005	2006	2007	2008*
1. Flow of the monetary base	**672**	**682**	**1,886**	**2,397**	**2,140**	**3,916**	**-1,057**
(% annual change)	11.0	10.1	25.3	25.7	18.3	28.2	29.4
2. Foreign exchange operations	**436**	**3,465**	**6,239**	**2,360**	**9,140**	**21,930**	**9,092**
(In millions of US$)	128	998	1,854	767	2,861	7,067	3,087
a. Over the counter	-32	1,050	2,340	2,699	3,944	10,306	3,270
b. Public sector purchases	157	-51	-487	-1,935	-1,084	-3,273	-200
c. Other operations (net)	3	-1	2	3	1	34	17
3. Monetary operations	**236**	**-2,783**	**-4,353**	**37**	**-7,000**	**-18,014**	**-10,149**
a. Deposits of the Public Sector	-81	-921	-721	-2,821	-5,434	-6,750	-1,325
b. Net placements CDBCRP	205	-2,462	-4,158	578	-389	-13,393	-2,513
c. Net placements CDRBCRP	-319	319	0	-1,202	1,202	0	0
d. Deposits in the BCRP	0	0	0	0	0	0	-6,583
e. Inyection operations (repos)	170	-170	0	2,850	-2,850	0	0
f. Other	261	451	526	631	471	2,129	272
Note: Balance at the end of period							
Monetary base	6,759	7,441	9,327	11,724	13,864	17,779	16,722
Total balance sterilized	**2,342**	**5,355**	**10,321**	**13,788**	**18,598**	**38,712**	**49,305**
(In % monetary base)	34.6	72.0	110.7	117.6	134.2	217.7	294.8
+ BCRP Certificates of Deposits (CDBCRP)	1,635	4,097	8,255	7,676	8,066	21,458	23,971
+ Deposits of Public Sector	275	1,196	1,918	4,738	10,172	16,922	18,247
+ BCRP indexed Certificates of Deposits	319	0	0	1,202	0	0	0
+ Deposits in the BCRP	0	0	0	0	0	0	6,583
+ Rest	112	62	149	172	360	332	503

* Up to January.

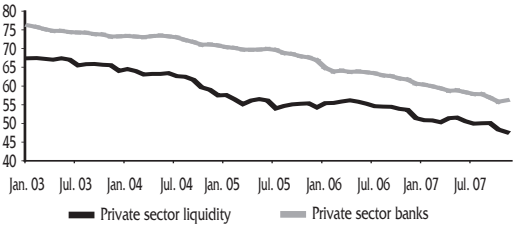
Graph 82
PRIVATE SECTOR LIQUIDITY
(Percentage change over the last 12 months)



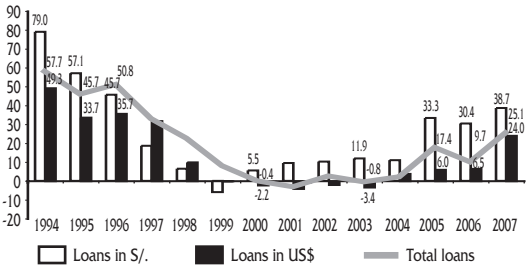
Graph 83
FINANCIAL DOLLARIZATION INDICATORS
(In percentage)



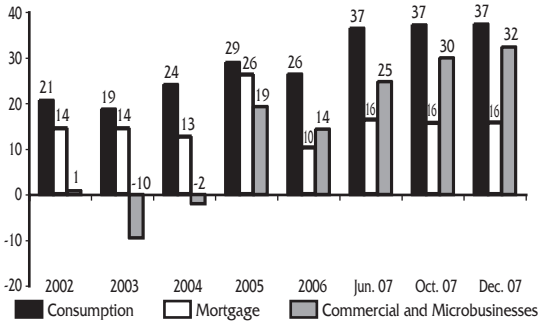
Graph 84
FINANCIAL DOLLARIZATION INDICATORS
(In percentage)



Graph 85
FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR
(Percentage change over the last 12 months)



Graph 86
GROWTH OF FINANCIAL SYSTEM LOANS
(Percentage change over the last 12 months)



Liquidity and credit

79. Liquidity in the private sector grew 22.3 percent between December 2006 and December 2007, maintaining the dynamism observed since August (liquidity grew 23.8 percent relative to August 2006). This result is mainly explained by the growth of liquidity in domestic currency (33.0 percent) as a result of the higher relative preference for nuevos soles as an asset to store value.

Table 33

FACTORS OF LIQUIDITY DEMAND
(Annual percentage change)

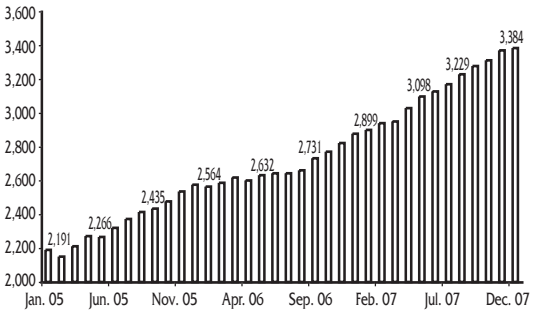
	Liquidity	Velocity	Prices	Real GDP
1994	45,8	-2,4	26,2	12,8
1995	31,6	-6,8	12,9	8,6
1996	33,4	-15,0	10,6	2,5
1997	21,7	-5,5	7,5	6,9
1998	12,6	-6,3	6,3	-0,7
1999	12,7	-6,9	3,9	0,9
2000	4,3	2,4	3,7	3,0
2001	0,0	1,7	1,4	0,2
2002	0,7	4,8	0,5	5,0
2003	2,7	4,1	2,8	4,0
2004	6,4	4,8	6,1	5,1
2005	15,3	-4,6	3,1	6,7
2006	15,4	0,8	8,1	7,6
2007	19,1	-6,7	2,5	8,5

80. The levels of financial dollarization continued declinining during 2007. The dollarization of liquidity in the private sector decreased from 51.3 percent in December 2006 to 47.0 percent in December 2007. On the other hand, the ratio of dollarization of credit in the private sector decreased by 3.0 percentage points in the same period, reaching a level of 56.8 percent in December 2007.

81. Banks' total credit to the private sector increased its pace of annual growth during 2007, reflecting both increased financial depth and greater economic activity during this year. The flow of credit by December represented 6.2 percent of GDP -a level 3.1 points higher than the one observed at end 2006 (3.1 percent of GDP).

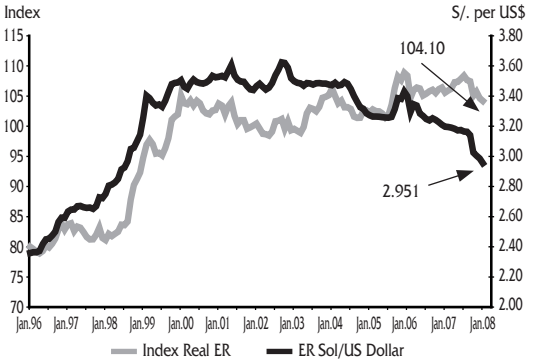
82. If placements are classified according to their destination, an increase is observed in all credit components, particularly in consumer loans which grew 37.4 percent between December 2006 and December 2007. The growth of consumer loans was coupled by both an increase in the average level of per capita indebtedness and by the incorporation of new

Graph 87
CONSUMPTION LOANS BY ORROWER IN THE OVERALL FINANCIAL SYSTEM [1/]
(Nuevos soles)



Source: SBS
1/ It corresponds to the sum of each debtor company for the industry benchmark. Therefore, if a debtor has an obligation to more than one company, it is seen as many times as the number of companies with which it has debt.

Graph 88
MULTILATERAL AND BILATERAL REAL EXCHANGE RATE



economic agents to this market. The credit card system continues being the most dynamic component in this segment. On the other hand, mortgage loans increased 15.7 percent in the same period.

Exchange Rate

83. In 2007 the Nuevo Sol appreciated 7.0 percent against the dollar. This increased strength of the domestic currency reflects better domestic macroeconomic fundamentals, the favorable evolution of external accounts, and portfolio movements toward the local currency, in a context of a higher weakening of the dollar in the international financial market. A strong inflow of capitals was seen in January 2008, as a result of which the nuevo sol appreciated 1.0 percent.

84. The real exchange rate fell 1.7 percent, mainly due to the nominal appreciation of the nuevo sol against the currency baskets of our main trading partners[4] (2.5 percent) and to the increase in the index of domestic prices (3.9 percent), in a context in which average external prices increased significantly (4.8 percent). In January 2008, the overall effect of the nominal appreciation of the Nuevo Sol-currency basket (0.4 percent) and domestic inflation (0.2 percent) brought about a 0.4 percent decline of real exchange.

Table 34

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

	Real multilateral exchange rate	Nominal exchange rate with currency basket	Trading partners inflation	Domestic inflation
1996	3.4	6.7	8.4	11.8
1997	-4.1	-3.0	5.2	6.5
1998	14.1	15.4	4.9	6.0
1999	6.4	4.9	5.3	3.7
2000	-2.3	-4.8	6.4	3.7
2001	-2.6	-5.7	3.1	-0.1
2002	-0.8	-3.9	4.8	1.5
2003	5.9	4.9	3.4	2.5
2004	-2.4	-2.4	3.5	3.5
2005	6.1	4.0	3.5	1.5
2006	-2.3	-4.0	3.0	1.1
2007	-1.7	-2.5	4.8	3.9

4 The weighing structure considers Peru's main trading partners in 2006. Moreover, the base period used for the real multilateral exchange index is December 2001.

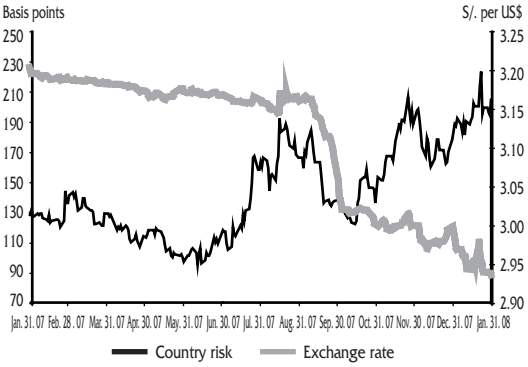
Table 35

BILATERAL EXCHANGE RATE (S/. per U.M.)
(Percent change)

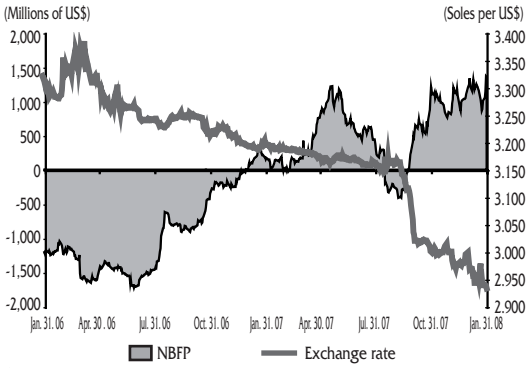
	Weighted *	Nominal		Real	
		Var. Dec. 06/ Dec. 05	Var. Dec. 07/ Dec. 06	Var. Dec.06/ Dec. 05	Var. Dec. 07/ Dec. 06
USA	29.2%	-6.4	-7.0	-5.1	-7.0
Eurozone	12.3%	4.3	2.4	4.9	1.2
Japan	4.0%	-5.2	-3.1	-6.0	-6.5
Brazil	5.5%	-0.5	11.8	1.4	12.1
United Kingdom	1.3%	5.3	-4.6	7.2	-6.4
Chile	6.7%	-8.7	-1.6	-7.5	1.7
China	11.4%	-3.4	-1.3	-1.8	2.2
Colombia	4.2%	-5.8	4.6	-2.7	5.9
Mexico	2.9%	-8.5	-6.9	-5.9	-6.9
Argentina	2.6%	-7.8	-10.5	0.2	-6.5
Korea	2.2%	3.5	-7.7	4.5	-8.0
Taiwan	1.9%	-4.2	-6.7	-4.6	-7.5
Venezuela	3.1%	-6.4	-7.0	8.3	9.6
Canada	4.8%	-5.7	7.0	-5.2	5.8
Ecuador	4.6%	-6.4	-7.0	-5.9	-8.1
Switzerland	3.4%	1.1	-1.4	0.6	-3.5
Basket	100.0%	-4.0	-2.5	-2.3	-1.7

* Weight relative to the commercial year 2006.

Graph 89
EXCHANGE RATE AND COUNTRY RISK



Graph 90
NET BALANCE OF FORWARD PURCHASES BY BANKS AND EXCHANGE RATE 1/



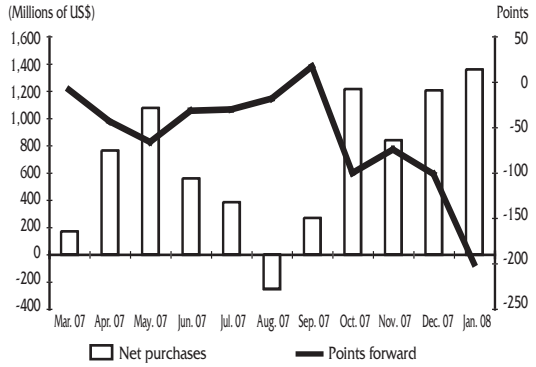
1/ Positive sign.

85. It should be pointed out that the appreciatory trend of the Nuevo Sol against the dollar was temporarily interrupted between August and mid-September due to increased uncertainty in international financial markets, associated with the problems of the U.S. mortgage market. However, after the FED decided to lower its reference rate (on September 18), the exchange rate went through a period of downward pressures. These pressures continued to be seen during January, particularly in the second week of this month, even though the country risk indicator continued increasing.

86. These appreciatory pressures were also reflected in the *forward* market. Thus, the average balance of *net forward* sales declined from US$ 1,043 million in 2006 to an average balance of US$ 467 million during 2007. A reversal in the balance of *forward* operations was observed between August 16 and September 21: these operations swung from a risk of appreciation (*forward* purchases) to a risk of depreciation (*forward* sales), coinciding with the period when the international crisis of the *subprime* market aggravated.

87. Then, as the perception of risk in emerging markets subsided after the FED cut its reference rate, the balance of net *forward* sales increased again and reached US$ 1,213 million at end October 2007. A maximum historical balance of long

Graph 91
NET BALANCE OF FORWARD PURCHASES BY BANK AND POINTS FORWARD



forward *positions* in Nuevos Soles (US$ 1,333 million) was recorded in January.

88. The increase seen in long *forward* positions in soles (futures contracts to hedge against appreciation risks) has generated a more costly implicit cost for investors. This may be better understood if we consider that the *forward* exchange rate (when buying goods) in equilibrium is equal to the current (spot) exchange rate multiplied by the ratio of interest rates in soles and dollars:

$$e^f = e\frac{1 + i}{1 + i^*}$$

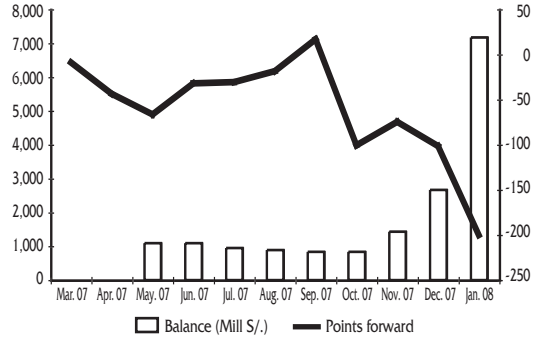
Where e^f represents the *forward* exchange; e is the *spot* exchange; i is the interest rate in soles, and i^* the local rate in dollars. Thus, if the interest rate in soles is lower than the rate in dollars, the *forward* exchange rate will be lower than the *spot* exchange rate. An investor with a long *forward* position in soles will benefit from this if the market's exchange rate by the contract's maturity is lower than the pre-agreed *forward* exchange rate. In Peru, the spread between short-term rates is currently negative, that is, the local interest rate in dollars is higher than the interest rate in Nuevos Soles.

The expression above may reformulated as follows:

$$\frac{e^f - e}{e} = \frac{i - i^*}{1 + i^*}$$

The numerator on the left is known as the *forward* premium or *forward* points (*swap*). As the premium became more negative, the *forward* operation became more costly, so in order that an investor could obtain benefits from a forward operation it was necessary that a greater appreciation be generated.

Graph 92
BALANCE OF CDBCRP FROM NON RESIDENTS INVESTORS



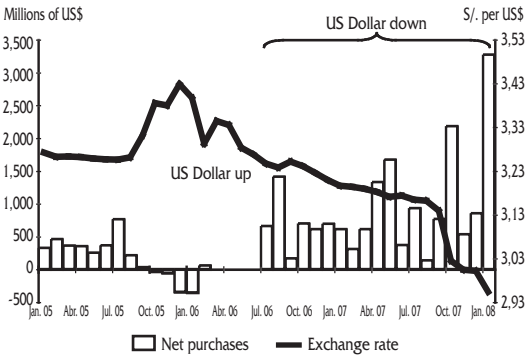
89. A greater flow of capitals oriented to buying short-term securities in local currency, particularly CDBCRP, were seen during the months of December and January. Thus, non-residents' holdings of CDBCRP increased from S/. 839 million in September to S/. 2,668 million in December 2007 and to S/. 7,170 million at end January 2008.

Table 36

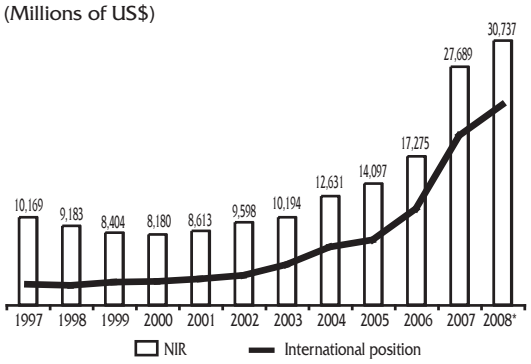
NON RESIDENTS' HOLDING OF CDBCRP
(Millions of S/.)

	Nov. 30-07	Feb. 05-08
A. Mutual and Investment Funds	157	1 741
B. Investment banks	1,262	5,342
C. Other	13	129
D. Total	1,432	7,212
Memo: Participation respect to the total balance of CDBCRP	7%	30%

Graph 93
NET BALANCE OF US DOLLARS AND EXCHANGE RATE



Graph 94
NET INTERNATIONAL RESERVES AND INTERNATIONAL POSITION
(Millions of US$)



This higher presence of non-resident investors in terms of holdings of CDBCRP took place in a context of an implicit "growing cost" of long *forward* operations in Nuevos Soles.

90. In this context of volatility of exchange, the BCRP intervened in the exchange market purchasing dollars for a total of US$ 10,306 million during 2007. On the other hand, a total of US$ 3, 275 million was sold to the Public Treasury. It is worth pointing out that most of these operations were made in the months of April (US$ 1,330 million), May (US$ 1,671 million), and October (US$ 2,181 million).

91. In January, in a scenario of strong exchange volatility associated with capital inflows, the BCRP increased its intervention in the exchange market buying a total of US$ 3,270 million. These purchases of foreign currency were mostly carried out between January 8 and 15, when the inflows of short-term external capitals generated higher appreciatory pressures on exchange.

92. Net international reserves increased by US$ 10,414 million in 2007 and reached a balance of US$ 27,689 million. As a result of the exchange operations carried out in January, net international reserves amounted to US$ 30,737 million. Because of this, the ratio of liquidity in the private sector covered by international reserves continued to grow, increasing from 80 percent in December 2006 to approximately 107 percent in January 2008.

Table 37

NET INTERNATIONAL RESERVES FLOWS
(Millions of US$)

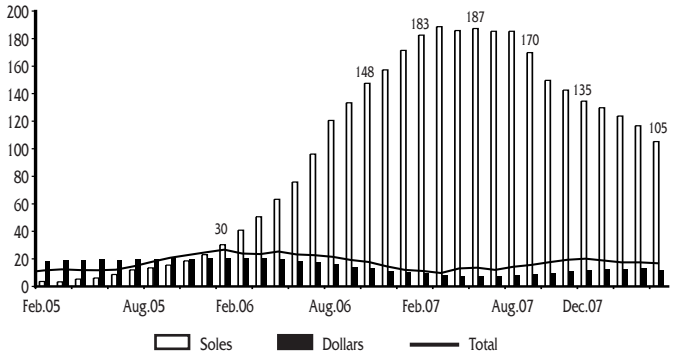
	2004	2005	2006	2007
I. FOREIGN EXCHANGE OPERATIONS	**1,854**	**767**	**2,861**	**7,070**
1. Over the counter	2,340	2,699	3,944	10,306
a. Purchases	2,340	3,130	4,299	10,306
b. Sales	0	-431	-355	0
2. Operations with the public sector	-487	-1,935	-1,084	-3,275
3. Other net purchases	2	3	1	39
II. FINANCIAL SYSTEM DEPOSITS	**23**	**1,251**	**-684**	**1,154**
III. PUBLIC SECTOR DEPOSITS	**359**	**-587**	**245**	**630**
IV. OTHER	**201**	**35**	**756**	**1,561**
V. TOTAL	**2,437**	**1,466**	**3,178**	**10,414**

BOX 8

DOLLARIZATION OF MORTGAGE LOANS

The mortgage credit market in the Peruvian financial system has shown a significant drive over the past five years, growing by 103 percent during this period as a result of increased economic activity, favorable financial conditions, and governmental social programs. The MiVivienda Fund has contributed to the initial drive of the mortgage market since it first started operating in 1999 and has continued to support its growth through financial intermediaries since last year. In November 2007 the Fund accounted for 23 percent of total mortgage loans.

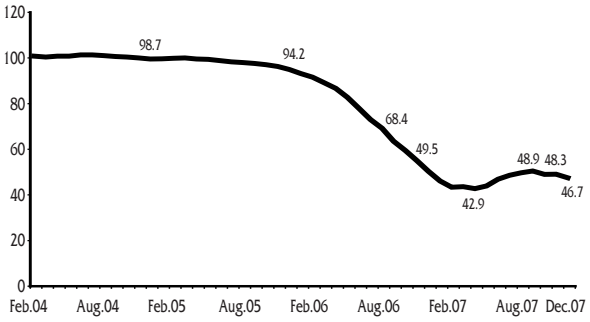
MORTGAGE LOANS
(Percentage change over the last 12 months)



However, in comparison with other countries, the mortgage credit market in Peru is still quite small; it barely represents one fourth of the size of these markets in Mexico and Colombia and only 16 percent of the size of this market in Chile. Moreover, while these countries have developed this market in their domestic currencies, the mortgage credit market in Peru is still significantly dollarized.

However, it is worth highlighting that in terms of annual flows in new placements of mortgage loans dollarization has decreased from 94.2 percent at end 2005 to 46.7 percent at end of December 2007. As a result of this, the dollarization of the balance of mortgage loans relative to the overall balance of placements in the Peruvian financial system has declined from 95.8 percent in December 2005 to 80.7 percent in November 2007.

EVOLUTION OF ANNUAL FLOWS OF MORTGAGE LOANS
DOLLARIZATION IN THE FINANCIAL SYSTEM
(In percentage)



Dollarization-related risks and recommendations

The high relative importance of mortgage loans in dollars entails a series of risks for the Peruvian economy. These risks are mainly associated with the vulnerability of economic agents in terms of the balance sheet and, therefore, it is essential to consolidate the dedollarization process observed recently in this market.

Mortgage credit should be promoted on the basis of mechanisms that are sound and sustainable over time to prevent risks that can make the program and the economy vulnerable. In this sense, greater efforts should be made so that borrowers internalize the risks associated with dollarization. The main effects of financial dollarization include the following:

The "balance sheet" effect (exchange-credit risk), which is generated by currency mismatches in the borrower's balance. In other words, although the borrower receives his incomes in Nuevos Soles, his main monthly financial obligations are mostly denominated in dollars.

Thus, an increase in real exchange (caused by an increase in nominal exchange) could have a negative impact on borrowers' payment capacity. This is explained by the fact that the increase in the local currency value of liabilities in dollars is higher than the increase in the value of borrower's assets or in his flow of incomes, thus increasing the probability of non-payment of loans in foreign currency (higher credit risk). This is particularly relevant in the case of mortgage loans in dollars since borrowers are families that receive their incomes mainly in domestic currency.

MONTHLY BORROWER'S PAYMENT CAPACITY [1/]
(In nuevos soles)

	SEL B	SEL C
Income	2,079	1,527
Household expenditure	1,542	1,089
Disposable resurces	537	438
Fee average	**501**	**426**
in US$	167	142
% of monthly familiar income	24	28
Average credit for houses	**81,000**	**54,000**
in US$	27,000	18,000
Average interest rate	11.5%	11.5%
Number of average quote	166	129
Deadline average (years)	14	11

Source: Fondo MIVIVIENDA S.A.
Made by BCRP.
[1/] E.R.: S/. 3.00

The average household payment capacity in the different socioeconomic levels may be estimated using the data of the Estudio de mercado de la vivienda social en Lima, which was elaborated by the MiVivienda Fund in 2006. The data shows that household monthly payments represent 24 and 28 percent of families' montlhy incomes in socioeconomic sectors B and C respectively (target publics of the MiVivienda program) and nearly all of their disposable resources. Then, we assess the impact of a 20 percent depreciation of exchange (assuming that incomes remain constant since they are denominated in Nuevos Soles). The results show that the incomes

families use to pay their debts will increase by 29 and 33 percent respectively. Moreover, on average terms, families' new monthly payment amount in soles would be above their disposable resources (S/. 601 vs. S/. 537 in Level B and S/. 511 vs. S/. 438 in Level C)[5], causing them problems to pay their obligations or forcing them to reduce other expenses, thus affecting families' welfare.

PARTICIPATION IN THE MONTHLY FEE ON HOUSEHOLD INCOME

	SEL B			SEL C		
	Base	Depreciation of 20%	Difference	Base	Depreciation of 20%	Difference
Monthly average fee (nuevos soles)	501	601	100	426	511	85
% Household income	24	29	5	28	33	6

It is worth mentioning that the crisis episodes seen in Asia in 1998, in Argentina in 2001 and 2002, and in Uruguay in 2002 have shown the negative consequences of an oversized growth of credit in foreign currency, particularly in the mortgage market.

Cristini and Moya (2004)[6] say that, in the case of Argentina, the development of the mortgage market was interrupted by an acute economic crisis, which resulted in the default of its external debt and in the adoption of a managed floating exchange regime, marking the end of the second episode of growth of the mortgage market. The nonperformance of mortgage contracts, which led pesification to the level observed prior to devaluation, benefited borrowers indiscriminately producing a transfer of incomes from lenders, bank depositors, and risk investors. The suspension of security enforcement, in turn, eliminated transitorily the possibility that banks and private lenders could recover their loans. On the other hand, a strong growth of the ratio of nonperforming loans was seen in Uruguay in the year of the crisis (2002). Particularly, nonperforming loans in foreign currency increased twice as much as those in domestic currency.

Risk of dollar illiquidity. This risk is associated with a maturity mismatch. Financial entities have liabilities in foreign currency (the public's deposits and obligations with financial entities abroad) which, on average, have shorter maturity terms than banks' placements. Although the maturity mismatch -and the consequent risk of illiquidity- is a phenomenon inherent to banking systems, the risk is higher when the liabilities are not denominated in domestic currency, that is, when the central bank issuing the intermediated currency is a foreign bank. Given this vulnerability, the premium for country risk rises and the cost of external financing increases, as a result of which several projects are no longer profitable.

Therefore, relevant incentives should be established in order that economic agents internalize the effects of dollarization and opt for credit in local currency. Given that the public debt maturity has bee extended to thirty years, to similar and even longer terms than those of mortgage loans, there is space for the expansion of credit in domestic currency.

Peru issued a 30-year sovereign bond through primary offer for the first time in July 2007. This bond issue is intended to contribute to form a yield curve in the security market that will serve as reference for private sector's bond issues in nominal soles with increasingly longer maturity terms. Additionally, this yield curve may serve as reference for mortgage loans in soles with longer maturities, given that these longer maturities

5 An exchange rate of S/. 3.00 per US dollar is considered for the base scenario.
6 Cristini, M. and Moya, R. (2004): "Las instituciones del financiamiento de la vivienda en Argentina", IADB, January 2004.

may allow reducing the quota amounts borrowers must pay. This would favor the dynamism of this kind of loans in nominal nuevos soles, thus contributing to financial dedollarization. Since reference interest rates are already available for long-term credit in nominal soles -with similar maturity terms to those of mortgage loans in dollars-, the convenience of "solarizing" the loans in foreign currency that banks have already granted should be evaluated.

VIII. Balance of risks

93. The different factors and scenarios that could lead our forecasts away from the baseline scenario are evaluated and weighed in this section. Different factors may impact on inflation, causing either upward or downward pressures.

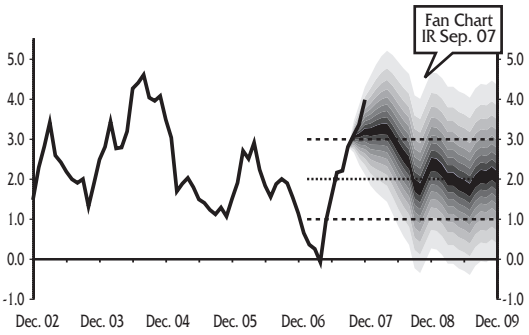
94. The risks pointed out in our previous Inflation Report (September 2007) that could lead the inflation risk to the upside have been materializing over the past three months. Recent evolutions show that some contingent scenarios have totally or partially materialized, including the higher international prices of oil, the higher prices of imported food inputs -especially wheat, soy bean, and maize-, and an increased growth of domestic demand.

95. The recent evolutions of domestic economic activity and the international environment make it necessary to change the emphasis given to each of these variables. The risks associated with the deterioration of external conditions have become more important, increasing the risks that external financial shocks might persist for a longer period of time and that the higher prices of oil and imported foodstuffs might have a greater impact on the economy.

96. The main risks that could deviate the inflation forecasts away from the central scenario in the next quarters include the following:

- **A greater slowdown of the global economy.** The international environment would currently be characterized by a gradual reversal of terms of trade (mainly due to the higher prices of imports), a transitory slowdown of the economy in 2008, and a slight economic recovery in 2009. A situation of economic recession in the United States -involving a severe correction in the prices of exports of raw materials- could generate volatility in the flow of external capitals in emerging countries and cause an additional contractive impulse on demand's dynamism. For this reason, the BCRP maintains a high level of international reserves and

Graph 95
HISTORIC INFLATION AND FORECAST DENSITY
INFLATION FROM INFLATION REPORT SEPTEMBER



would continue intervening in the exchange market to reduce an excessive volatility of exchange. If necessary, the Bank will loosen its monetary policy stance to offset downward demand pressures on inflation in the forecast horizon.

- **Higher prices of fuels**. The central forecast considers a partial reversal of the recent rises in the international prices of fuel (the price of crude oil was nearly US$ 100 per barrel on January 2, 2008). A scenario with a higher upward volatility in the oil market would imply fuel prices above the levels considered in the forecast scenario.

  In this situation, the BCRP would maintain its monetary policy stance unchanged as long as inflation expectations remain anchored around the target.

- **Higher domestic demand pressures**. The forecast scenario considers a positive evolution of economic activity sustained mainly by a dynamic performance of spending in both the private and public sectors. However, if private consumer expenditure -driven in part by a higher credit- and public expenditure should increase significantly beyond our forecast, the Central Bank will adopt a more restrictive monetary stance to maintain a pace of sustained economic growth.

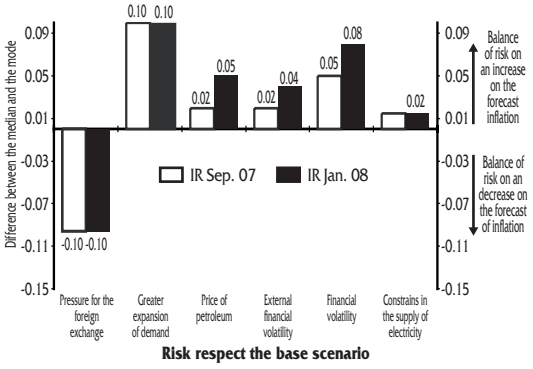
- **Higher prices of food commodities**. The central scenario considers that no supply shocks would be generated due to weather conditions. However, this does not imply ruling out the risk that higher prices may persist over time or that they may increase even further if supply conditions should deteriorate or if the demand for biofuels should continue to grow, in which case the domestic prices of food would tend to increase.

  In this context, the monetary policy stance would remain unchanged as long as inflation expectations continue to be anchored around the target.

- **Increased appreciatory pressures on the nuevo sol**. In a scenario of significant increased appreciation of the nuevo sol, which could pressure inflation downward below the target, the Bank would reduce its current reference rate.

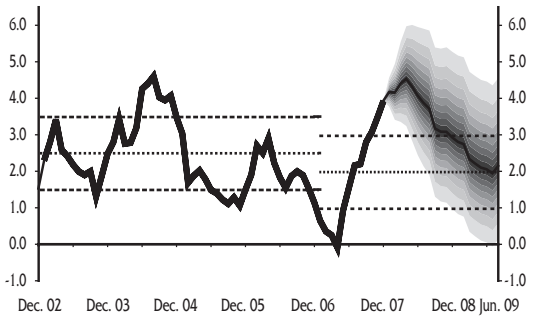
- **Constraints in the supply of electric energy**. This report considers the risk of constraints in the supply of electric energy toward the end of the forecast horizon. This would have an adverse impact on electricity rates and on firms' costs. Should this occur, the monetary policy stance would remain unchanged as long as inflation expectations continue to be in line with the target.

Graph 96
FACTORS THAT CAN AFFECT THE INFLATION FORECAST[1/]
(Percent points of deviation from inflation)



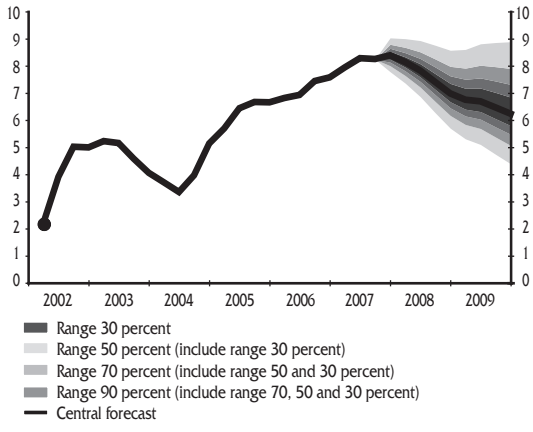
1/ Shows the change in the risk perception between IR Sep. 07 and the current report. The size and position of the bars shows the asymetry produced by each risk factor to the inflation forecast. Compared with the prior report, the total added effects produce an asymetry of 0.2 percent in the inflation forecast.

Graph 97
INFLATION FORECAST
(Annual percentage change)



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

Graph 98
GDP GROWTH FORECAST
(Annual percentage change)



Note: The graph shows the inflation prediction bands along the forecast horizon. The darkest band around the central forecast represent a 30 percent probability of ocurrence, while all the other bands represent a 90 percent probability of ocurrence.

Table 38

RISK VALUATION COMPARED WITH IR SEPTEMBER 2007

Risks	IR Sep.07		IR Jan.08
	Balance	Expost	Balance
Pressures for the foreign exchange	upward	Materialized	upward
Greater expansion of demand	upward	Materialized	upward
Price of petroleum	Appreciation	Materialized	Appreciation
External financial volatility	upward	Materialized slightly	upward
Financial volatility	upward	Materialized	upward
Constrains in the supply of electricity	upward		upward

97. Weighing the various risks both upwards and downwards against the baseline scenario shows an upward balance in the inflation forecast. This is illustrated in the next graph, which shows that upward factors outweigh downward factors compared to the balance of risks of our Inflation Report of September 2007.

98. This implies an inflation density with an upward asymmetry in the short- and medium-terms. The risk of higher pressures on inflation than those considered in the central scenario configurates the pattern of risks discussed in this report.

99. The balance of risks shows a neutral balance in terms of GDP growth given the deterioration of international conditions for growth.

CONCLUSION

100. Inflation is expected to reach the upper band of the inflation target (3.0 percent) at end 2008 and to converge towards the 2,0 percent target by mid-2009, stabilizing thereafter near the inflation target in the rest of the forecast horizon. This context of stable prices should continue to be coupled by a sustained growth of GDP at rates close to those of potential GDP. The different risk factors point to a slightly upward risk balance in the inflation forecast.

Annex

INFLATION REPORT FORECAST

	2006	2007 [1/]		2008 [1/]		2009 [1/]	
		IR Sep.07	IR Jan.08	IR Sep.07	IR Jan.08	IR Sep.07	IR Jan.08
Real % change							
1. GDP	7.6	7.6	8.5	6.5	7.0	6.0	6.3
2. Domestic demand	10.1	10.0	11.0	7.2	8.2	6.9	7.2
a. Private consumption	6.2	7.2	7.6	5.7	5.8	5.3	5.3
b. Public consumption	8.7	6.0	4.3	3.8	5.0	3.8	5.4
c. Private fixed investment	20.1	23.7	23.2	15.0	20.0	12.1	12.1
d. Public investment	12.7	25.0	19.8	25.0	33.0	15.0	16.6
3. Exports (Goods and services)	0.5	5.3	6.0	8.2	8.2	6.1	8.5
4. Imports (Goods and services)	12.4	17.4	19.0	11.8	13.5	10.2	12.4
5. Main trade partner's economic growth	4.6	4.3	4.4	4.0	3.6	3.8	3.8
Note:							
Product gap (%) [2/]	0.35	1.38	1.66	1.36	1.5 - 2.0	1.01	0.75-1.25
% change							
6. Forecast inflation	1.1	3.0-3.5	3.9	2.0-2.5	2.5-3.0	1.5-2.5	1.5-2.5
7. Forecast core inflation	1.4	2.0-2.5	3.1	2.0-2.5	2.5-3.0	1.5-2.5	1.5-2.5
8. Forecast non core inflation	0.8	4.0-4.5	5.1	2.5-3.0	3.0-3.5	1.5-1.9	1.5-1.9
9. Average price of petroleum	17.0	4.7	9.4	7.4	23.5	-4.4	-5.6
10. Average price of wheat	30.4	33.3	36.7	10.0	44.0	-13.9	-7.4
11. Nominal exchange rate [3/]	-6.4	-1.7	-6.3	1.3	-3.2	0.3	0.0
12. Multilateral exchange rate [3/]	-2.3	1.0	-3.3	0.7	0.0	0.2	-0.9
13. Terms of trade	27.4	3.0	3.6	-8.1	-10.7	-4.8	-2.6
a. Export price index	36.9	11.1	13.9	-4.2	-0.2	-4.4	-2.9
b. Import price index	7.4	7.8	9.9	4.3	11.7	0.5	-0.3
Nominal % exchange							
14. Monetary base	18.3	22.0	28.2	14.0	17.0	12.0	14.0
15. Loan to the private sector	8.1	19.0	27.9	16.0	17.9	14.0	16.9
% of GDP							
16. Domestic saving rate	22.7	23.5	23.9	23.3	23.0	24.4	23.8
17. Domestic investment rate	19.9	22.3	22.9	23.8	24.9	25.3	26.3
18. Current account of the balance of payments	2.8	1.3	1.0	-0.4	-1.9	-0.9	-2.4
19. Trade balance	9.6	8.0	7.7	5.0	4.0	2.9	2.4
20. Gross external finance of the private sector [4/]	4.4	7.1	9.2	3.9	6.3	3.5	5.6
21. Current income of the general government	19.7	20.5	20.5	20.4	20.5	20.0	20.0
22. Non-financial expenditure of the general government	16.2	16.8	15.9	17.8	17.1	18.2	17.7
23. Non-financial public sector economics overall	2.1	2.0	3.0	1.0	1.8	0.3	1.0
24. Total public debt balance	32.7	28.4	29.4	25.6	24.2	24.0	22.5
25. External public debt balance	23.6	18.6	18.5	16.3	14.4	14.7	13.1

IR: Inflation Report.
[1/] Forecast.
[2/] Differential between GDP and potential GDP (percentage).
[3/] Expectations regarding the exchange rate according to the survey on macroeconomic expectations.
[4/] Includes foreign direct investments and private sector's long run dibursements.