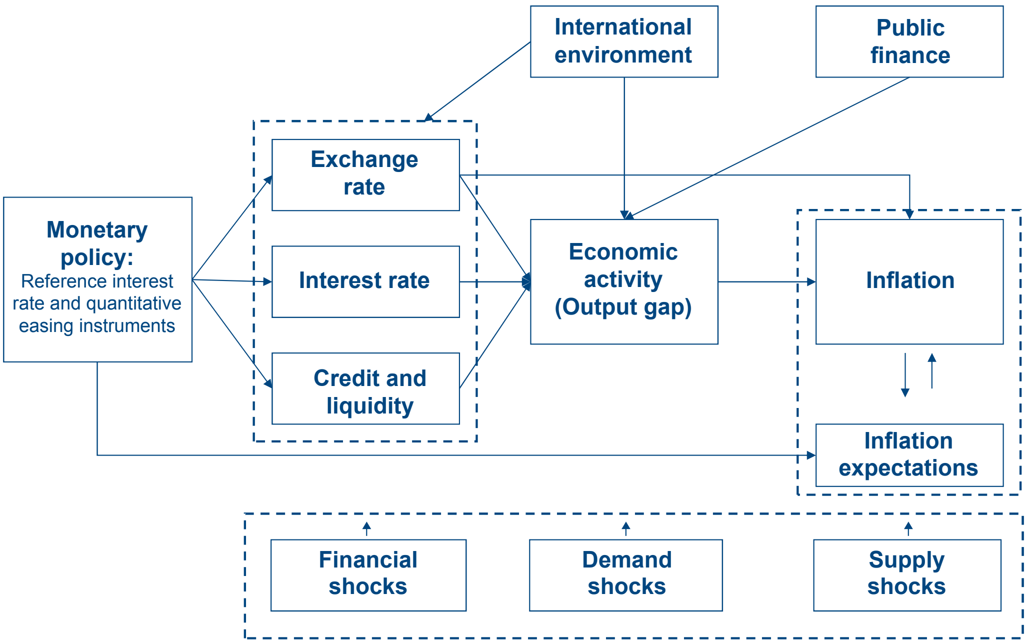
INFLATION REPORT:

Recent trends and macroeconomic forecasts 2011-2013

June 2011



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INFLATION REPORT
Recent trends and macroeconomic forecasts

CENTRAL RESERVE BANK OF PERU

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This ***Inflation Report*** was drawn up using data on gross domestic product, balance of payments, and operations of the non-financial public sector as of April 2011, and data on monetary accounts, inflation, financial markets and exchange rate as of May 2011.

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 order to consolidate this goal, the Bank's monetary policy is based on an inflation targeting scheme, with an inflation target of 2.0 percent, plus or minus one percentage point (between 1.0 percent and 3.0 percent). The Central Bank's inflation target is aimed at anchoring inflation expectations at a similar level to the inflation rate in developed countries and reflects the BCRP's permanent commitment with monetary stability.

- The nature of monetary policy is preventive and therefore is aimed at anticipating inflationary or deflationary pressures, taking into account that inflation may be influenced by factors beyond the control of the Central Bank, such as supply shocks or the prices of imported products, which may result in transitory deviations of inflation from the target. The Central Bank considers the annual increase in the consumer price index recorded in each month and not only at year's end.

- 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, which is the monetary operational target, affects the rate of inflation through several channels in different timeframes and, therefore, is determined on the basis of macroeconomic forecasts and simulations. The Central Bank also uses other monetary policy tools that affect the volume of liquidity and credit in a more direct manner, such as reserve requirements in domestic currency and in foreign currency.

- Additionally, the Central Bank implements preventive measures to preserve financial stability and monetary policy transmission mechanisms. Through interventions in the foreign exchange market, the Central Bank reduces excessive volatility in the exchange rate and accumulates international reserves, thus developing strengths to face negative events in an economy with still a high level of financial dollarization.

- The forecasts on which monetary policy decisions are based are disseminated through the Inflation Report to show the consistency of the decisions adopted with the aim that economic agents' expectations take these forecasts into account. The Central Bank also disseminates the studies analyzing the risk factors that may cause deviations in the forecasts of the economic variables considered.

- The Central Bank will publish its next Inflation Report in September 2011.

Summary

i. During the first five months of the year, the Board of the Central Bank continued raising the reference rate by 25 basis points each month, as a result of which the rate was raised from 3.0 percent in December to 4.25 percent in May 2011. The adjustments in the reference rate continued to be coupled by rises in the average rate of reserve requirements in domestic currency and in foreign currency. In June, the reference rate was maintained at 4.25 percent.

   These measures were adopted in a context of high growth of domestic demand –whose pace of growth has been slowing down– and rising international food and fuel prices with the aim that inflation expectations will converge to the inflation target range.

ii. In Q1 GDP recorded an expansion of 8.7 percent, a lower growth than the one observed in previous quarters. A similar slowdown was observed in most components of domestic demand. Private investment grew 15.4 percent in Q1 after growing 24.1 percent in Q4-2010, while government spending showed a deceleration (from 13.3 to 2.0 percent), especially in investment expenditure.

   Considering the slight deceleration observed in the indicators of activity during Q2, the forecast on the growth of GDP in 2011 has been revised downwards from 7.0 percent (Inflation Report of March) to 6.5 percent in this Report, in line with the estimated potential growth of the economy. On the other hand, the forecast of GDP growth in 2012 remains unchanged: GDP would grow 6.5 percent.

iii. Global GDP in Q1 showed a higher-than-expected growth, recording a rate of 4.2 percent. However, recent indicators of activity would be showing a moderation of growth in Q2 due to the disruption of the supply chains of the automotive industry caused by the earthquake in Japan, the rise of commodity prices, and the weakness of the real estate market and high unemployment in the United States. Additionally, international financial markets were affected by the situation of public finances in some European countries, as well as by the volatility of the price of crude associated with the geopolitical situation in North Africa and the Middle East.

   Because of this evolution, the forecast of global growth in 2011 has been revised downwards from 4.1 to 3.9 percent.

iv. The operations of the non financial public sector (NFPS) in Q1-2011 recorded an economic surplus of 5.6 percent of GDP, a result 2.6 percentage points higher than the one recorded in the same period in 2010. This improvement is associated with the increase in the current revenues of the general government and also with lower non financial expenditure, especially capital expenditure.

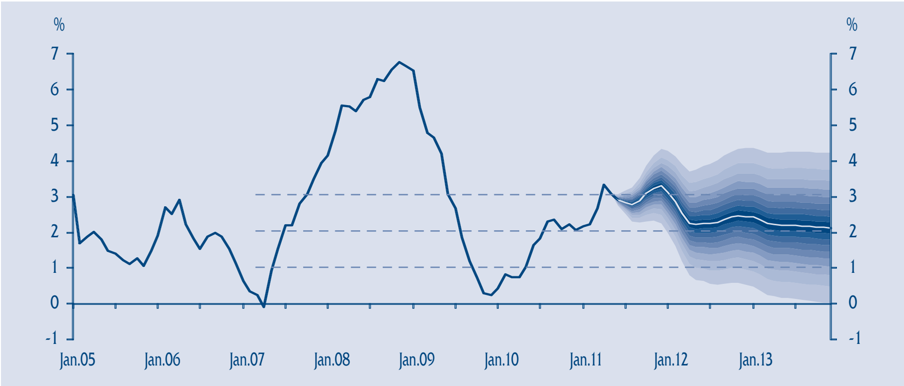
A surplus of 0.2 percent of GDP is forecast for 2011 in the non financial public sector. This better result than the deficit estimated in our March Report (0.3 percent of GDP) is associated with the projected higher revenues of the general government, which have continued growing, particularly in the case of revenues from the income tax, despite the tax changes approved in Q1 (reduction of the VAT and ITF tax rates). The non financial spending of the general government would grow 5.5 percent in real terms in 2011 and 4.6 percent in 2012. In nominal terms, the non financial expenditure of the general government would amount to S/. 91 billion in 2011 and to S/. 98 billion in 2012.

v. The deficit in the current account of the balance of payments in 2011 has been revised downwards from 3.3 percent of GDP in our March Inflation Report to 3.0 percent of GDP in this Report, considering higher exports as a result of the upward revision of terms of trade, which would more than offset the rise in imports. The current account deficit in 2012 would decline compared with the deficit estimated in the March Report from 3.5 to 3.3 percent of GDP due to a lower growth in terms of the volume of imports of goods and to a lower factor income due to lower export prices.

vi. Recent data on inflation have been in line with the projections contained in our March Report. In May inflation registered an annual rate of 3.1 percent, reflecting the short term effect of the evolution of some food products.

The revision and update of data of the main factors that would affect inflation during the next years suggests that inflation in 2011 would fall within the upper band of the inflation target range. In 2012, inflation would fall within the target range (between 2.0 and 3.0 percent). This scenario implies a growth of economic activity in line with the economy's potential growth; that is, the output gap is estimated to remain at levels close to zero during the forecast horizon.

INFLATION FORECAST
(12-month % change)



vii. The main risks that could divert the rate of inflation from the baseline scenario in the forecast horizon are associated with the possible pressure of the prices of imported food and fuels and with the financial volatility that international markets could experience. In contrast with our previous Report which considered the possibility of demand inflationary pressures as a risk, it is now estimated that this risk has dissipated.

a. **Imported inflation.** The recent evolution of the prices of food commodities and fuels continues indicating a high probability that these goods will continue to show high prices in the future. Even though part of these price increases have already been observed since our last Inflation Report was published in March and although they are reflected in the baseline forecast scenario, the risk of a higher imported inflation persists.

   Persistent shocks in the prices of sensitive goods that are part of the CPI basket could affect economic agents' expectations and contribute to an upward revision of inflation expectations.

   If signals were observed that imported inflation is being translated into economic agents' expectations, the Central Bank would adjust its monetary position.

b. **Uncertainty about the evolution of the world economy.** The baseline scenario considers a global growth rate of 3.9 percent, which would contribute to maintain terms of trade in a favorable position for the Peruvian economy. However, due to uncertainty in international markets as a result of the fiscal situation in some Eurozone countries, among other factors, this recovery may not take place, which would imply a stagnation in our main trading partners' demand. Should this be the case, the resulting scenario would be one of lower prices for a great deal of our primary exports and consequently a deceleration of growth in the domestic economy.

The Central Bank maintains a high level of international reserves and has several liquidity injection mechanisms to face this contingency. Thus, should this risk materialize, the Central Bank would ease monetary conditions.

I. International Environment

1. Global GDP continued showing a favorable trend during Q1-2011, recording a higher-than-expected growth rate of 4.2 percent. However, recent indicators of activity would be showing a moderation of growth in Q2. In financial markets, the expectations of a deceleration of growth influenced a correction in commodity prices in April, stock markets partially reversed the gains recorded in Q1, and the dollar depreciated in the main foreign exchange markets.

Graph 1
GDP GROWTH

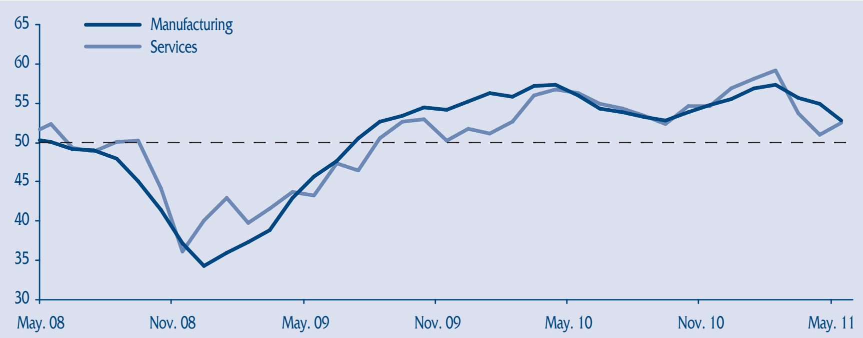
These developments have led us to revise the forecast on global growth in 2011 and 2012 downwards, from 4.1 to 3.9 percent in both years. This downward revision is basically based on the execution of the first semester in the case of year 2011 and on the moderation of growth in the emerging economies as a result of the greater withdrawal of monetary stimulus being implemented in the major economies to reverse inflationary pressures in the case of year 2012.

Global growth

2. The moderation of global growth in Q2-2011 is due in part to factors of a temporary nature, such as the problems generated by the earthquake in Japan and unfavorable weather conditions in the south of the United States. However, there are also other factors that prevent a greater expansion of economic activity, such as imbalances in the real estate market, the slow growth of credit, and the negative fiscal impulse in the main developed countries. The higher profits registered in the corporate sector have not been sufficient to offset these imbalances and to boost aggregate demand, particularly consumption.

3. At the sector level, the Purchasing Managers Index (PMI) shows a moderation of industrial activity since March. The manufacturing sector would have been affected by supply disruptions originated in Japan that affected the supply chain in some industries. On the side of expenditure, private consumption would have been affected by the high prices of fuels and, in emerging countries, by the rise of food prices. A lower contribution of inventories to growth has also been observed since Q1.

Graph 2
JP MORGAN: GLOBAL PMI



Source: Bloomberg.

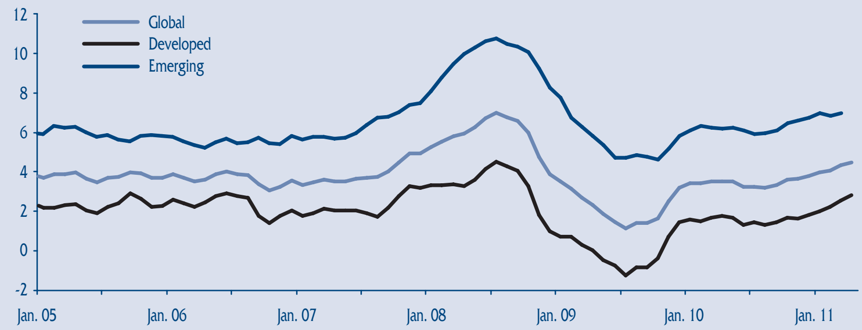
4. Despite the correction observed in April, oil and food prices remain high and generate a risk in terms of inflation. Global inflation has risen from 3.8 percent

in December 2010 to 4.5 percent in April. This rate of inflation –the highest rate observed since November 2008– is basically explained by inflation in emerging economies. In a context of growth above potential growth in emerging countries, these higher inflationary pressures have led to the implementation of adjustment policies in countries like China and India, which has also contributed to moderate global growth.

Moreover, additional adjustments in monetary policy rates are foreseen due to the increase of inflation in many emerging countries, while low interest rates and a gradual withdrawal of monetary stimulus continue to be expected in developed countries. The spread between interest rates and the still high commodity prices would indicate that appreciatory pressures will continue to be observed in most emerging markets.

The persistence of tensions in North Africa and the Middle East and climate effects on food products generate uncertainty about the evolution of prices which, together with expectations about the debt crisis in European countries, determine a downward bias in the central growth forecast.

Graph 3
INFLATION
(12-month % change)



Source: IMF.

5. In this context the forecast on global growth in 2011 and 2012 has been reduced slightly downwards, from 4.1 to 3.9 percent in both cases. This is based on the signals of deceleration of growth in the first semester in the case of the forecast for 2011 and on the moderation of growth in emerging economies due to the effect of the higher withdrawal of monetary stimulus in response to growing inflationary pressures in the case of the forecast for 2012. It is worth pointing out that the forecast on growth in developed countries in 2012 has remained unchanged, basically because the moderation of growth in European regions and the United States would be offset by a higher growth in Japan associated with the reconstruction process.

Table 1
WORLD GDP GROWTH
(Annual % change)

	2010	2011*		2012*		2013*
		IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
Developed countries	**3.0**	**2.3**	**2.1**	**2.3**	**2.3**	**2.3**
1. United States	2.9	3.0	2.5	2.8	2.7	2.7
2. Eurozone	1.7	1.3	1.4	1.4	1.3	1.3
Germany	3.6	2.2	2.6	1.5	1.6	1.6
France	1.6	1.4	1.4	1.5	1.4	1.4
3. Japan	3.9	1.4	0.1	1.7	2.0	1.6
4. United Kingdom	1.3	1.7	1.6	2.0	1.9	2.0
5. Canada	3.1	2.6	2.8	2.4	2.4	2.4
6. Other developed countries	5.7	3.5	3.8	3.8	3.7	3.7
Developing countries	**7.2**	**6.1**	**6.1**	**6.1**	**5.9**	**5.9**
1. Sub-Saharian Africa	5.0	5.5	5.5	5.5	5.1	5.5
2. Central and Eastern Europe	4.2	3.6	3.7	4.1	3.9	3.7
3. Community of Independent Countries	4.6	4.5	4.7	4.5	4.4	4.3
Russia	4.0	4.2	4.4	4.2	4.2	4.0
4. Developing Asia	9.5	7.9	7.8	7.9	7.7	7.7
China	10.3	8.9	8.8	8.8	8.6	8.6
India	10.4	8.0	7.9	8.0	7.7	7.7
5. Middle East and Northern Africa	3.8	4.6	3.8	4.6	3.8	4.2
6. Latin America and the Caribbean	6.0	4.2	4.4	3.9	3.8	3.8
Brazil	7.5	4.5	4.5	4.0	3.9	4.0
World Economy	**4.9**	**4.1**	**3.9**	**4.1**	**3.9**	**3.9**
Memo:						
BRICs 1/	9.2	7.5	7.5	7.4	7.2	7.2
Peru's trading partners 2/	4.4	3.6	3.5	3.4	3.4	3.4

Source: Bloomberg, IMF, Consensus Forecast.
1/ Brazil, Russia, India and China.
2/ Basket of Peru's 20 main trading partners.
* Forecast.

6. Growth in **developed countries** in Q1 improved slightly on average, rising from an annual rate of 1.3 percent in the previous quarter to a rate of 1.7 percent.

Table 2

	Growth					Unemployment			Inflation		
	Quarterly annualized rates (%)					Annual rates (%)			Annual rates (%)		
	1Q.10	2Q.10	3Q.10	4Q.10	1Q.11	Dec.10	Mar.11	Apr.11	Dec.10	Mar.11	Apr.11
USA	3.7	1.7	2.6	3.1	1.8	9.4	8.8	9.0	1.5	2.7	3.2
United Kingdom	0.8	4.3	2.9	-1.9	2.0	7.9	7.7	7.7	3.7	4.1	4.5
Eurozone	1.6	4.0	1.4	1.1	3.3	10.0	9.9	9.9	2.2	2.7	2.8
Germany	2.1	8.7	3.2	1.5	6.1	7.4	7.1	7.1	1.7	2.1	2.4
France	0.6	2.0	1.8	1.4	3.9	9.6	9.7	-	1.8	2.0	2.1
Japan	9.1	0.2	3.8	-3.0	-3.7	4.9	4.6	4.7	0.0	0.0	0.3

Source: Bloomberg.

In the **United States (USA)**, growth in Q1 declined by over one percentage point compared to Q4-2010 due to lower consumption, affected by the high prices of fuels. This deceleration would have intensified in recent months due in part to transitory factors, such as the earthquake in Japan and unfavorable climate conditions in the South and Mid-west areas of the country.

Table 3
USA: GDP GROWTH
(Annualized quarterly rates)

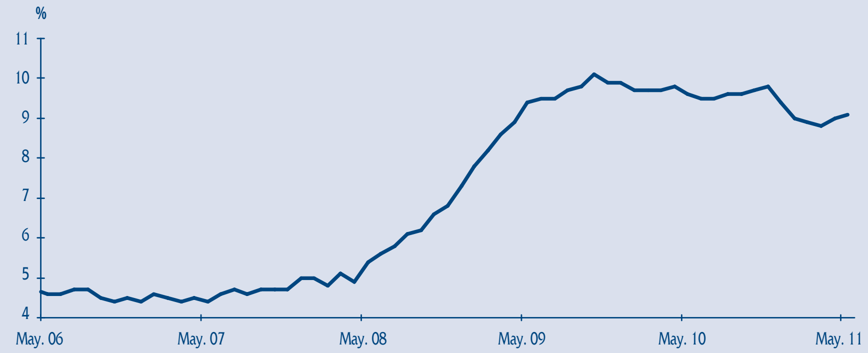
	1Q.09	2Q.09	3Q.09	4Q.09	1Q.10	2Q.10	3Q.10	4Q.10	1Q.11
GDP	**-4.9**	**-0.7**	**1.6**	**5.0**	**3.7**	**1.7**	**2.6**	**3.1**	**1.8**
Personal consumption	-0.5	-1.6	2.0	0.9	1.9	2.2	2.4	4.0	2.2
Durable goods	4.8	-3.1	20.1	-1.1	8.8	6.8	7.6	21.1	8.9
Non-durable goods	0.4	-0.7	1.7	3.1	4.2	1.9	2.5	4.1	1.1
Services	-1.6	-1.7	-0.5	0.5	0.1	1.6	1.6	1.5	1.5
Gross investment	-42.2	-18.5	11.8	26.7	29.1	26.2	15.0	-18.7	12.3
Fixed investment	-35.4	-10.1	0.7	-1.3	3.3	18.9	1.5	6.8	2.1
Non-residential	-35.2	-7.5	-1.7	-1.4	7.8	17.2	10.0	7.7	3.4
Residential	-36.2	-19.7	10.6	-0.8	-12.3	25.7	-27.3	3.3	-3.3
Exports	-27.8	-1.0	12.2	24.4	11.4	9.1	6.8	8.6	9.2
Imports	-35.3	-10.6	21.9	4.9	11.2	33.5	16.8	-12.6	7.5
Government expenditure	-3.0	6.1	1.6	-1.4	-1.6	3.9	3.9	-1.7	-5.1

Source: BEA.

At the sector level, the recent slowdown of growth in the industrial sector stands out, particularly in the automotive industry, affected by the impact that the earthquake in Japan had on the supply of auto parts. Production in the automotive sector dropped 8.9 percent in April. Moreover, the real estate sector and construction continue showing weakness, which is reflected in the slow and volatile recovery of sales of houses, constructions initiated and house building permits.

However, the US economy is expected to grow at higher rates as from the second semester of the year, assuming that employment would continue recovering in the next months –the rate of unemployment has declined from 9.7 to 9.1 percent in the last fifteen months– and would have a positive impact on household consumption. A greater rebound is expected in non-real estate investment due to the favorable corporate balances registered in the last quarters. Another factor that would influence in the recovery of activity in USA would be the maintenance of the Federal Reserve's expansionary monetary policy in a context of controlled inflationary pressures. The rise of fuel prices constitutes the main risk factor due to the negative effects it has on personal consumption and inflationary pressures.

Graph 4
USA: UNEMPLOYMENT RATE



Source: Bloomberg.

Therefore, due to the results observed in the first months of the year, the forecast on growth in USA in 2011 has been revised downwards, from 3.0 to 2.5 percent, and the forecast on growth in 2012 has been reduced from 2.8 to 2.7 percent.

Compared with the previous two quarters, the **Eurozone** recorded a higher growth in Q1. This was particularly noteworthy in Germany which registered a rate of 6.1 percent, driven by the dynamism of construction and exports. The forecast on growth in the Eurozone in 2011 has been adjusted slightly upwards, from 1.3 to 1.4 percent, due to the favorable evolution of the main economies of the region, while the risks associated with the debt crisis faced by some economies would be affecting slightly the forecast on growth in 2012, which has been revised from 1.4 to 1.3 percent.

The outlook for growth in the economies with debt problems, such as Greece, Ireland and Portugal, are less favorable due not only to the fiscal adjustment program being implemented, but also due to the stricter financing conditions faced by these countries after the continuous downgrading of their risk ratings. An additional deterioration of the debt situation of these countries is the main risk factor for the Eurozone, not only because of the direct impact this would have on these economies, but also because of the financial exposure of other more important economies, such as Germany and Italy.

Growth recovered in the United Kingdom in Q1 with an annual rate of 2 percent annual (versus a contraction of 1.9 percent in the previous quarter), basically due to the increased contribution of exports and government expenditure. Recent indicators of activity show a moderation of growth in Q2, while some indicators of consumption show an improvement after the contractions observed in Q1.

In this context, the forecasts of growth in the UK in 2011 and 2012 have been reduced slightly, from 1.7 to 1.6 percent in 2011 and from 2.0 to 1.9 percent in 2012. Moreover, the Bank of England has indicated that inflation could reach 5 percent this year –above its inflation target– and that it would only decline to the 2 percent target by the end of next year. The rise in inflation is associated with the depreciation of the pound, the increase of taxes, and the rise of commodity prices, which could imply that the Bank of England may initiate the cycle of rate adjustments sooner.

Japan showed an annual contraction of 3.7 percent in Q1-2011, associated with the earthquake of March 11. According to most recent indicators, a recovery is expected only as from Q3 if the energy problems and the interruptions in the supply chain are solved. Because of this, the growth forecast for 2011 has been revised on the downside, from 1.4 to 0.1 percent. However, the forecast on growth in 2012 has been revised upwards, from 1.7 to 2.0 percent, since higher growth is expected in connection with the reconstruction process.

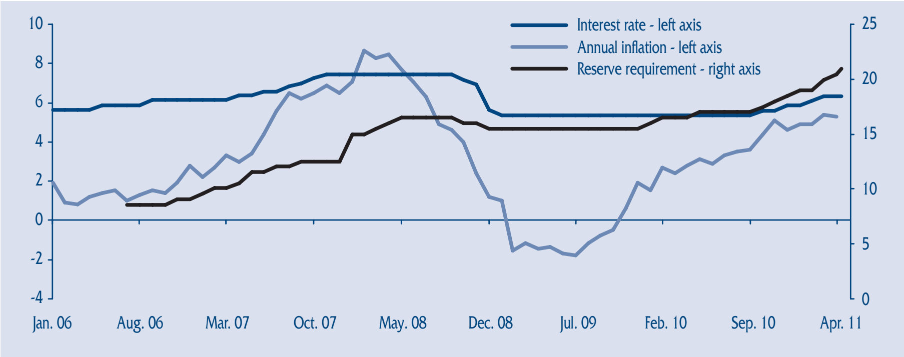
7. **Emerging economies** grew 7 percent in Q1 and are expected to moderate their growth rates since Q2, in line with the gradual withdrawal of monetary stimulus. A growth rate of 6.1 percent is estimated for 2011 and rates of 5.9 percent are estimated for 2012 and 2013.

China continues growing at high rates. In Q1-2011, China grew nearly 9 percent (10 percent in Q4-2010), driven mainly by higher investment. This strong growth has generated concerns among the authorities about a probable overheating of the economy and its inflationary pressures. Annual inflation reached 5.5 percent in May (2.9 percent in June 2010), influenced by the rise in food prices (11.7 percent).

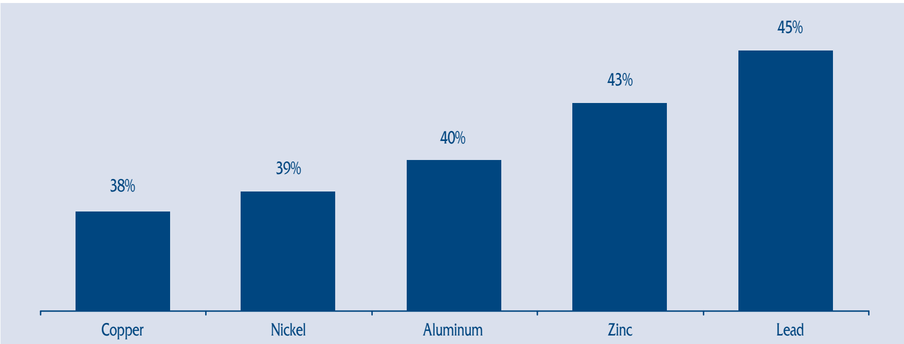
Because of this, the government has continued to gradually withdraw monetary stimulus and has implemented a series of regulatory measures to prevent the acceleration of inflation, an excessive growth of credit and the formation of an asset bubble. Furthermore, so far this year, China has raised its interest rate twice (50 bps.), has raised the rate of reserve requirements on five occasions (250 bps.), and has established limits for bank loans, rate increases and quotas for mortgage loans, among other measures[1]. It is expected that these measures will contribute to moderate growth in China and that the country registers growth rates lower than 9 percent in 2011 and 2012, which is consistent with the moderation being observed in recent indicators of industrial activity.

1 China started raising rates in October 2010 and has been increasing the rate of bank reserve requirements since January 2010. The rate of reserve requirements have been raised on 11 occasions between January 2010 and May 2011 by a total of 550 bps.

Graph 5
CHINA: INFLATION, INTEREST RATE AND RESERVE REQUIREMENTS
(%)



Graph 6
CHINA: CONSUMPTION OF REFINED METALS 2010
(% of global consumption)



Source: Barclays Capital (May 2011).

India recorded a growth rate of over 9 percent in Q1-2011. This growth was led by private investment and by increased exports, while the indicators of industrial production and exports grew at an annual rate of over 20 percent. Because the increased dynamism of activity and the higher prices of food and crude translated into higher inflationary pressures, several measures were implemented: interest rates were raised (from 4.75 to 5.50 percent), the rate of reserve requirements was raised, and higher subsidies to fuel prices were established. Growth in India is expected to moderate in 2011 and 2012 and to record rates lower than 8 percent, in line with the restrictive demand measures that will continue to be implemented.

Growth in the emerging economies of **Eastern Europe** so far this year has been driven by the dynamism of exports, favored mainly by the high prices of oil and, to a lesser extent, by Germany's growth. In the case of Russia, growth has been associated with increased private investment, coupled by the credit granted by the major banks. South Eastern Europe countries have had positive growth rates, although activity has slowed down due to lower capital inflows and the fiscal austerity measures, while growth in Central Europe countries is generalized and has been driven by exports, oriented mainly to Germany. Because of these developments, the central forecast of growth in this region in 2011 and 2012 has been only slightly corrected.

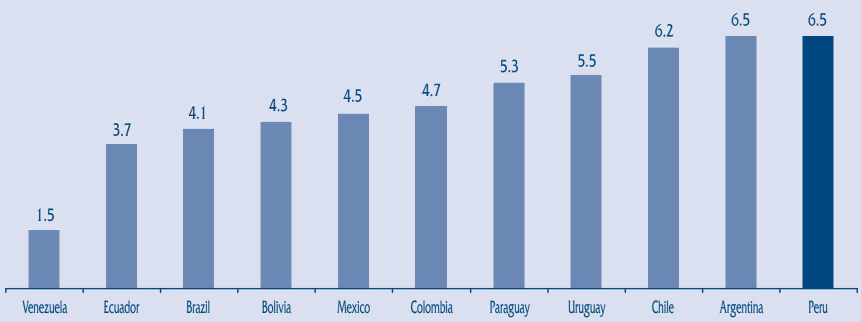
Most countries in **Latin America** continue showing an economic expansion and higher inflationary pressures due to the growth of domestic demand and the high prices of exports. It is estimated that many of these economies would be growing at rates close to their potential growth levels, which explains the gradual withdrawal of monetary stimulus initiated in the second semester of 2010 and which has continued during 2011.

Table 4
QUARTERLY GDP
(Annual % change)

	Q1-2011	Potential
Peru	8.7	6.0
Brazil	4.2	4.0
Chile	9.8	4.2
Colombia*	4.6	4.5
Mexico	4.2	2.5

* Q4-2010.
Source: JP Morgan.

Graph 7
LATIN AMERICA: GDP GROWTH FORECAST FOR 2011*
(%)



* Consensus Economics and BCRP (Peru).

Terms of trade and commodity prices

8. Year to date, most of the international prices of commodities –i.e. gold, oil, and some food products, such as maize– have continued showing an upward trend in a context of increased uncertainty, persistence of problems in the Middle East and North Africa, climate problems in the main producing regions (USA and China), and higher investments in commodities for portfolio diversification purposes.

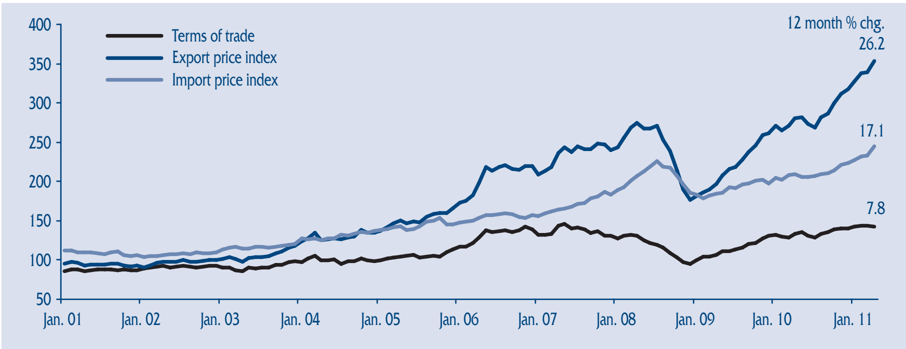
   However, a downward correction was observed mainly in the prices of metals –i.e. copper and zinc–and some foodstuffs between mid-April and mid-May due to the liquidation of investors' positions. This was associated with fears of higher adjustments in China and India given inflationary pressures in these countries, with uncertainty about the effects of the earthquake that hit Japan, and with the persistence of debt problems in Europe. As a result of this, the prices of our main export and import products registered even higher volatility than the one observed during 2010 in the first five months of 2011.

9. Terms of trade are estimated to rise 3.2 percent in 2011, correcting slightly thereafter since 2012 with the effect of the higher interest rates of developed economies on investment funds' demand for commodities.

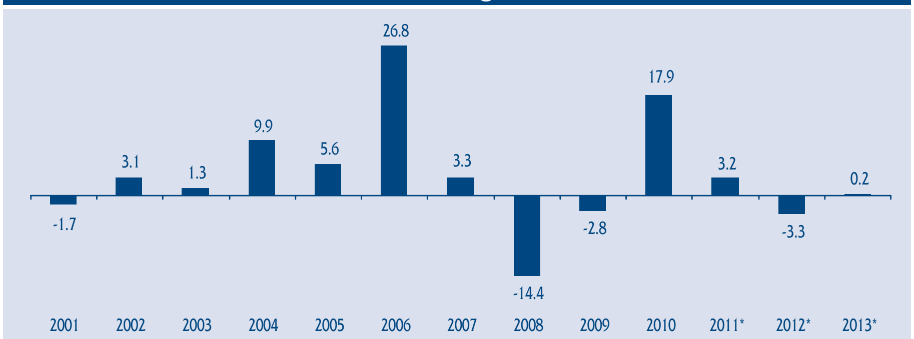
Table 5
TERMS OF TRADE
(Change and average prices)

	2010	2011		2012		2013
		IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
Terms of trade	**17.9**	**1.8**	**3.2**	**-2.4**	**-3.3**	**0.2**
Price of exports (Annual average % change)	**29.9**	**12.5**	**16.1**	**-0.7**	**-2.1**	**-0.3**
Copper (US$ cents per pound)	342	425	415	415	408	407
Zinc (US$ cents per pound)	98	105	101	105	100	101
Lead (US$ cents per pound)	98	107	113	105	109	108
Gold (US$ per ounce)	1,225	1,369	1,475	1,370	1,517	1,511
Price of imports (Annual average % change)	**10.1**	**10.4**	**12.5**	**1.8**	**1.2**	**-0.5**
Oil (US$ per barrel)	79	97	99	99	99	99
Wheat (US$ per MT)	195	336	311	334	325	325
Maize (US$ per MT)	157	259	274	228	258	235
Soybean oil (US$ per MT)	859	1,260	1,251	1,262	1,290	1,290
Rice (US$ per MT)	503	535	504	524	500	500
Sugar (US$ per MT)	597	671	578	561	483	481

Graph 8
TERMS OF TRADE, EXPORT AND IMPORT PRICE INDICES
(1994=100)



Graph 9
TERMS OF TRADE
(% change)



* Forecast.

Copper

The price of copper fell 3 percent during the first five months of the year to an average price of US$ 4.03/pound in May. However, this price level is 28.6 percent higher than the one recorded in May 2010.

After registering successive maximum historical levels during Q1, the price of copper corrected downwards due to the liquidation of investors' positions, which decided to take profits given high prices[2], uncertainty about Japan's demand after the earthquake, and fears of greater adjustments in consumer countries like China. The price of copper has been recovering since mid-May and shows levels of over US$ 4.00/pound.

It is estimated that in 2011 the international price of copper would reach an average level of US$ 4.15/pound and that it would correct slightly downwards in the forecast horizon.

2 Non commercial positions dropped 25 percent compared to December 2010 at the close of April 2011.

Graph 10
COPPER
(US¢ per pound)

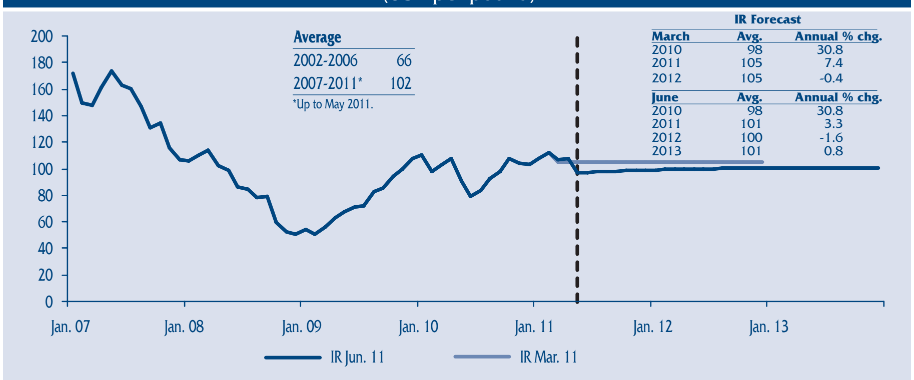
Zinc

The price of zinc dropped 6 percent between January and May 2011, reaching an average monthly price of US$ 0.97 per pound in May. The price of zinc has remained volatile so far this year, affected by production restrictions in China (refineries were closed due to regulatory problems) and by uncertainty about Japan's demand after the earthquake, in a context of increased production.

The outlook for the price of zinc is that it would drop during this year since demand is not expected to grow at the same pace than supply. The onset of new operations in Australia, Canada, and India and higher production in existing mines in China, Kazakhstan, Mexico, Russia, and USA is foreseen to generate a production that will exceed the pace of growth of consumption in China (lower dynamism of activity) and Japan (impacts of the earthquake).

Therefore, this price in 2011 has been revised slightly downwards compared to our March Report and is estimated to stabilize around US$ 1.00/pound in the forecast horizon.

Graph 11
ZINC
(US¢ per pound)



Gold

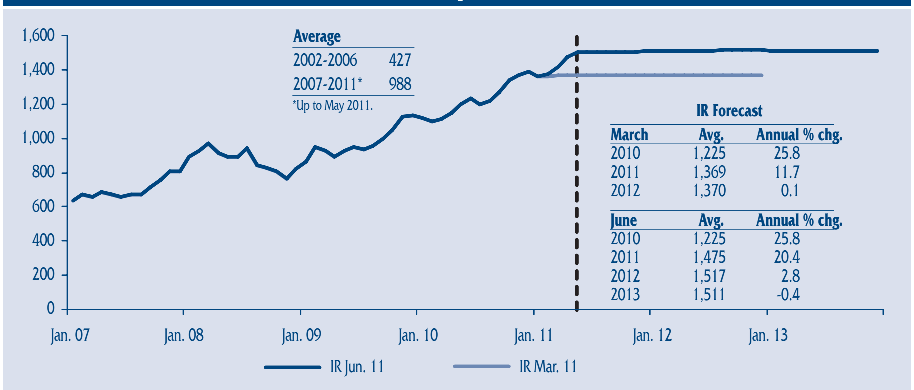
Between January and May 2011, the price of gold rose over 8 percent and recorded an average level of US$ 1,506/troy ounce in May, which constitutes a new historical record. In contrast with other commodities, the price of gold showed an upward trend throughout the year. The uncertain international context, the weakening of the dollar, and inflationary pressures led investors to increase their demand for gold, whose investment demand grew 26 percent in terms of volume in Q1-2011 compared to the same period in 2010. Likewise, the demand for gold for jewelry increased by an annual 7 percent in Q1, led by a 21 percent increase in the demand from China's jewelers[3].

On the other hand, the supply of gold declined 4 percent in Q1-2011 compared to the same period in the previous year due to the reduction of the supply of recycled gold and the increase of public sector purchases. Central banks' purchases of gold in Q1-2011 outnumbered the ones observed in Q1-2010.

The outlook for the price of gold in 2011 remains relatively stable, with fears of inflation, the debt problems faced by European countries, and the geopolitical problems in the Middle East and North Africa accounting for this.

It is estimated that the price of gold would close at an average level of US$ 1,475/ troy ounce in 2011 –higher than the price estimated in our March Report– and that it would be higher than US$ 1,500 per troy ounce in 2012.

Graph 12
GOLD
(US$/troy ounce)



3 However, the price correction observe in January 2011 was associated with the small sale of gold recorded by Exchange Trade Funds (ETFs) mainly in that month.

Oil

The price of WTI oil rose 13 percent in the first five months of 2011 and reached an average of US$ 101 per barrel in May. The crude market is experiencing a relative scarcity of oil due to the growing demand of emerging countries and to supply constraints in producing regions. The risk of supply interruptions due to the problems in the Middle East and North Africa, as well as uncertainty about the reaction of the OPEC led to a significant rise in the price of crude (the maximum price registered so far this year was US$ 114 per barrel at the end of April).

The outlook shows that the supply of crude will not be capable of growing at the same pace than the demand. The high economic cost of oil extraction will affect the growth of production in the economies that are not members of the OPEC. Furthermore, global demand will continue growing given that consumption in emerging countries will increase, offsetting the lower pace of growth of consumption in developed countries. In this context, the price of oil is estimated to remain around US$ 100 per barrel in the forecast horizon.

Graph 13
WTI OIL
(US$/bl.)

Situation in the Middle East and North Africa

After the overthrow of the presidents of Egypt and Tunisia in the early months of the year, protests and unrest spread to several countries in the region. The situation calmed down in most of them later on. Calm in Egypt has been favored by the financial aid offered by some international agencies (the World Bank and the International Monetary Fund) and politically close countries (USA, Saudi Arabia, and Qatar). The situation in Bahrain improved thanks to the military assistance of the Gulf Cooperation Council. In countries like Saudi Arabia, Jordan, and Oman, the disturbances ceased after promises were made to increase employment opportunities, businesses, and subsidies.

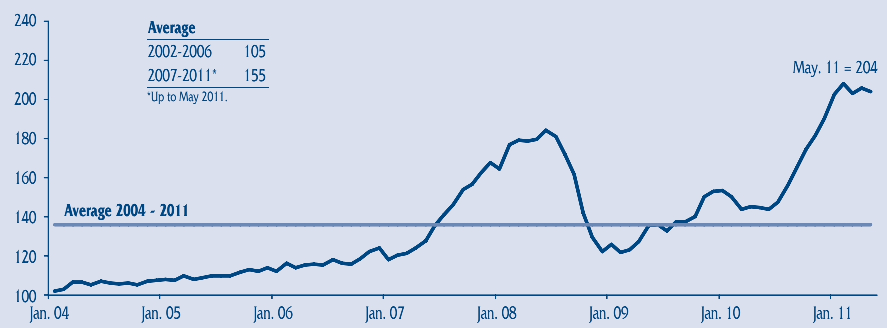
Current expectations regarding the region depend on the result of the elections for the parliament in Tunisia (in July) and in Egypt (in September), as well as on the evolution of the situation in Libya, Syria, and Yemen. Libya, which produced about US$ 1.8 million barrels of oil –about 2 percent of global production–, is practically in a situation of civil war. The critical situation in Syria has intensified after USA and the European Union imposed economic sanctions on the country. In Yemen, the poorest country in the Arab world, riots have increased due to tribal clashes. These events could compromise the security of Saudi Arabia.

Food products

Food prices have been mainly affected by the depreciation of the dollar and by expectations of lower supply due to adverse climate conditions in producing areas and restrictions on grain exports in producing countries. In addition to this, the demand in emerging economies continues to grow, especially in China, in a context of tight global inventories. Price volatility has increased in the last three months due to higher risk aversion associated with the situation in the Middle East and North Africa and with the earthquake in Japan. The prices of some foodstuffs have even partially reversed due to investors' lower demand and profit-taking.

After reaching a record high in February 2011, FAO's index of food prices has partially reversed in March and April. However, food prices have increased by 4.2 percent compared to December 2010 and by 36.5 percent compared to April 2010. The prices of cereals have increased the most in the first five months of the year, offsetting declines in the prices of sugar and edible oils.

Graph 14
FAO REAL FOOD PRICE INDEX*
(Base 2002-2004 =100)



* The real price index is the index of nominal prices deflated by the World Bank's Manufactured exports unit value (MUV) index.

Wheat

The price of wheat rose 11 percent between January and May 2011 and closed with an average price of US$ 305/ton in May. The price of wheat continued experiencing upward pressures due to tight inventories as a result of a 7.1 percent drop in global production caused by unfavorable climate conditions, high temperatures and drought in Ukraine, Russia, and USA (Ukraine and Russia imposed restrictions on wheat exports in 2010).

In April and May the price of wheat corrected its upward trend following the liquidation of non commercial positions in wheat and after the US Department of Agriculture (USDA) revised the projection of the global production of wheat in 2011 on the upside. Recently, Ukraine and Russia announced that wheat exports restrictions would be lifted.

The average price of wheat in 2011 is estimated at US$ 311/ton, a lower price than the one estimated in our March Inflation Report (US$ 336/ton).

Graph 15
WHEAT
(US$/ton)

Maize

The price of maize increased 24 percent during the first five months of the year, closing May at an average price of US$ 274/ton. This increase reflects the perception of an increasingly tighter market due to continuous downward adjustments in the estimates of inventories in USA, the world's largest producer and exporter of this grain. Consumption in this country has been increasing mainly due to higher demand for maize to produce ethanol. Concerns associated with the delay of the spring sowing season due to an atypical humid weather in this time of the year have added on to this.

The global maize inventories-to-consumption ratio reached levels unheard of since the Great Depression. This situation intensifies if China is excluded from the global balance.

The projections of the price of maize have been revised on the upside compared to our March Inflation Report due to the tightness observed in the market, but it is estimated that they will gradually correct in the forecast horizon.

Graph 16
MAIZE
(US$/ton)

Soybean oil

The price of soybean oil recorded an increase of 8 percent between January and May 2011, closing May with an average price of US$ 1,230/ton. This increase was associated with the rise in the price of crude, as well as with concerns that the recent rains and floods in Brazil will delay the harvest and affect the quality of soybean.

Graph 17
SOYBEAN OIL
(US$/ton)

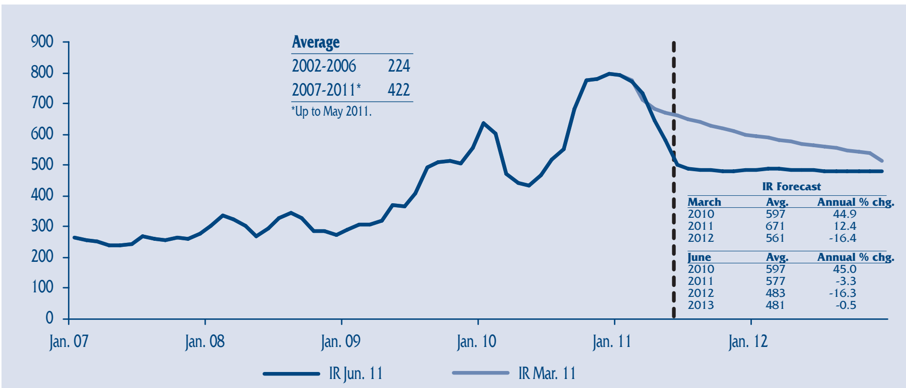
The soybean oil market is currently tight. Final global inventories declined 18 percent in the 2010/2011 season and the USDA estimates that they will drop 19 percent in 2011/2012 given that the demand has been growing at higher rates than the supply due to the rise in the price of crude.

The prices of soybean oil are expected to remain high following the prices of crude.

Sugar

The price of sugar fell 27 percent during the first five months of 2011, recording an average price of US$ 591/ton in May. The main factors accounting for this price drop include the rapid increase in the availability of sugar in the global market after a record harvest in Thailand, India's resumption of sugar exports, and the beginning of the harvest period in Brazil, the world's largest producer and exporter of sugar. After two seasons with a production deficit, the sugar inventory-to-consumption ratio declined to its lowest level since the 1989/90 season. The production of sugar in the 2011/12 season is expected to be significantly higher and to generate an important surplus. The price of sugar is estimated to decline to levels even lower than US$ 500/ton in the forecast horizon.

Graph 18
SUGAR
(US$/ton)



Financial markets

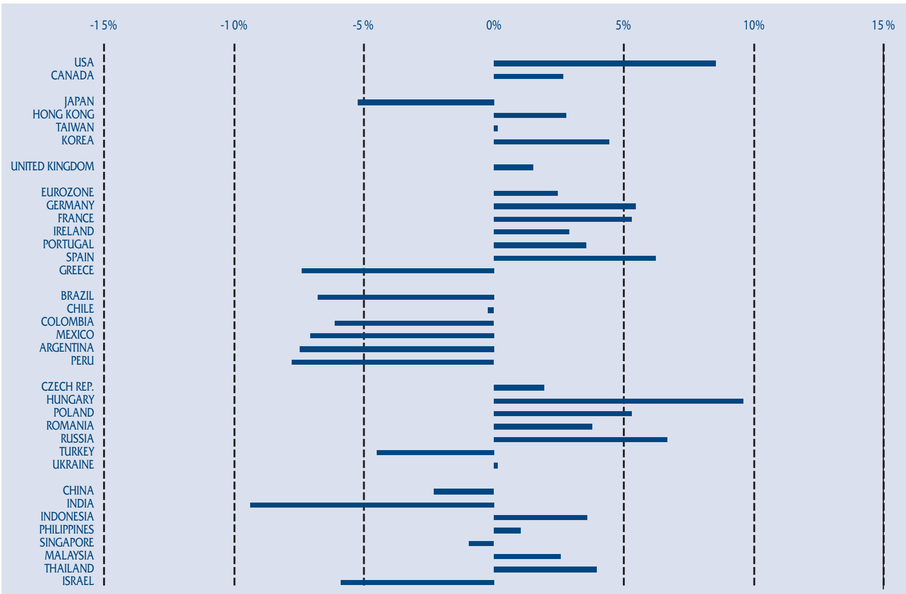
10. In general, international **financial markets** have had a positive evolution since end 2010 due to the growth of economic activity, high international liquidity levels, and the corporate results recorded in Q1. Seventy percent of the firms included in the S&P'500 index reported higher than expected profits in Q1-2011. Moreover, corporate profits are expected to grow 9.3 percent this year.

In this context, money markets remained stable and fixed income markets continued recording low profitability rates. The continuation of the monetary adjustment cycle in some economies facing higher inflationary pressures –i.e. Western Europe and some emerging economies– has maintained the depreciatory trend of the dollar.

However, since April, a series of signals indicating a moderation of global growth and higher inflationary pressures have influenced lower gains in the major stock markets. In addition to this, the stabilization of commodity prices (associated with the anti-inflationary policies implemented in China) has influenced the losses observed in some of the stock markets of the emerging economies and in the rise of credit spreads. The intensification of the debt crisis in some Eurozone countries has generated a slight reversal in the depreciatory trend of the dollar against the euro.

11. So far this year, developed countries' **stock markets** have been favored by the reports indicating the corporate profits recorded in USA and Europe in Q1. Additionally, several economic groups have been consolidating themselves through greater acquisitions of equity and mergers, or through their public bids. However, higher inflationary pressures added onto the moderation of global growth since April. Both factors have contributed to the decline of the main stock exchange indices, particularly due to the evolution of the sectors associated with commodities. In this context, gains in developed stock markets have declined and some emerging stock markets have recorded losses.

Graph 19
STOCK EXCHANGES
(% change Dec-10 to May-11, end of period)



Source: Bloomberg.

12. The signals of moderation of global growth have also generated a greater preference for US Treasury bonds, which has had an impact in reducing the yields of long-term securities.

Graph 20
10 YEAR US TREASURY BOND YIELD
(%)

Source: Bloomberg.

This greater preference for US Treasury bonds has not been affected by the fact that Standard & Poor's downgraded the US credit rating outlook from stable to negative due to the scarce progress made by the government in the medium term fiscal adjustment plan. Moreover, the government reached the debt ceiling allowed (US$ 14.3 trillion) on May 16. Moody's warned that it would revise the country's sovereign rating and consider a possible downgrading of the country's rating if no progress has been made by mid-July in the negotiations between the US legislative and the executive to raise the indebtedness limit before August 2.

13. Higher inflationary pressures in emerging markets and fears of increased adjustments in China have had an impact on the evolution of sovereign debt markets. The spreads in the region have increased since April and in some cases have even reached higher levels than those observed at end 2010, while the insurance premiums for default –credit default swaps (CDS)– have risen since May.

Table 6
EMERGING MARKET SOVEREIGN BOND SPREAD
(Basis points)

	End of period data					Difference at May relative to:			
	Dec.08	Dec.09	Dec.10	Mar.11	May.11	Mar.11	Dec.10	Dec.09	Dec.08
EMBIG									
Peru	509	165	165	173	189	16	24	24	-320
Brazil	429	189	189	174	177	3	-12	-12	-252
Chile	343	95	115	117	131	14	16	36	-212
Colombia	498	203	172	153	144	-9	-28	-59	-354
Emerging markets	724	294	289	299	312	13	23	18	-412
Credit Default Swap									
Peru	303	124	113	139	134	-4	21	10	-168
Brazil	299	123	111	111	104	-7	-7	-19	-194
Chile	203	69	84	61	67	6	-17	-2	-136
Colombia	308	144	113	109	99	-10	-14	-44	-208
Mexico	292	134	113	105	102	-3	-11	-32	-190

Source: Bloomberg.

14. Concerns about the restructuring of the Greek debt and about a contagion effect have influenced the rise of the sovereign credit spreads of Greece, Portugal, and Ireland, countries that have requested to be included in the assistance programs of the European Union and the IMF. The markets are already considering a restructuring and a possible trim of Greece's debt of between 20 and 50 percent.

Table 7
CREDIT DEFAULT SWAP
(Basis points)

	End of period data						Difference at May relative to:			
	Dec.07	Dec.08	Dec.09	Dec.10	Mar.11	May.11	Mar.11	Dec.10	Dec.09	Dec.08
Greece	22	232	283	1,026	994	1,419	425	393	1,136	1,187
Portugal	18	96	92	497	579	682	103	185	590	586
Ireland	n.d.	181	158	619	644	672	28	53	514	491
Spain	18	101	113	348	234	252	18	-96	139	151

Source: Bloomberg.

Table 8
PUBLIC DEBT AND FISCAL BALANCE
(% of GDP)

	Public Debt					Fiscal Balance				
	2007	2008	2009	2010	2011*	2007	2008	2009	2010	2011*
Japan	188	195	216	220	229	-2.9	-4.2	-10.3	-9.5	-10.0
Italy	104	106	116	119	120	-1.5	-2.7	-5.3	-4.5	-3.9
Greece	105	111	127	143	152	-6.4	-9.8	-15.4	-10.5	-8.5
USA	53	57	69	79	89	-3.0	-4.2	-10.8	-9.7	-11.7
France	64	68	78	82	85	-2.7	-3.3	-7.5	-7.0	-5.8
Portugal	68	72	83	93	102	-3.3	-3.6	-10.1	-9.2	-5.9
Germany	105	111	74	83	82	0.3	0.1	-3.0	-3.3	-2.0
United Kingdom	45	54	70	80	85	-2.7	-5.0	-11.4	-10.4	-9.0
Ireland	25	44	66	96	112	0.1	-7.3	-14.3	-32.4	-10.5
Spain	36	40	53	60	70	1.9	-4.2	-11.1	-9.2	-6.6

* Forecast.
Source: Moody's.

15. Emerging economies are currently facing significant capital inflows. After the volatility observed in the months of February and March as a result of the problems in North Africa and the Middle East, capital flows have resumed the trend observed during 2010. Although all the regions face positive flows, emerging Asian countries are the main recipients of these flows.

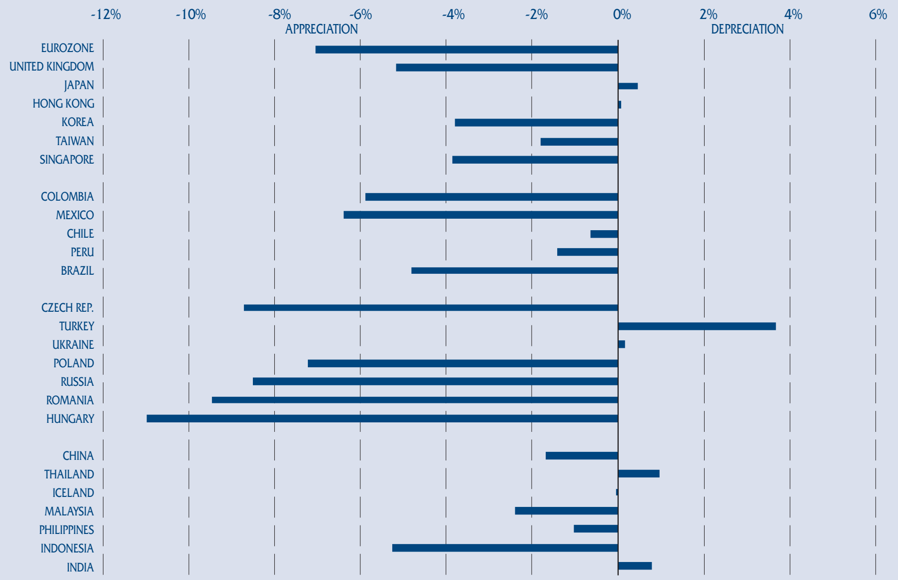
These capital inflows are due, in the first place, to the spread between interest rates. While developed economies maintain rates at historical low levels, emerging economies have been withdrawing monetary stimulus due to the closing of the output gap and inflationary pressures, which have intensified due to the rise in the international prices of food and crude. In the second place, capital inflows are also associated with the differential observed in terms of growth: while developed economies grew 3 percent in 2010, emerging economies grew by over 7 percent, and this differential is expected to continue in 2011.

Capital inflows have been generating an increase in appreciatory pressures, which may affect the economy through different channels. The probability of a reversal of these highly volatile flows, which are pro-cyclical in nature, may lead to disorderly adjustments in domestic financial markets, especially in highly dollarized economies. They can also affect the tradable sector which, in many cases, has led the economic recovery after the international financial crisis.

In response to these capital flows, most emerging economies have been implementing a series of measures. Most central banks have intervened in foreign exchange markets through direct purchases of foreign currency or through placements of indexed securities. Other mechanisms, such as adjusting the rates of reserve requirements, have also been used to moderate the growth of credit and prevent the formation of bubbles in asset markets. Some countries have applied administrative measures to discourage capital inflows or have eased capital outflows.

16. In **foreign exchange markets**, the dollar continued showing the depreciatory trend observed since the beginning of the year due in part to the increase observed in rate spreads.

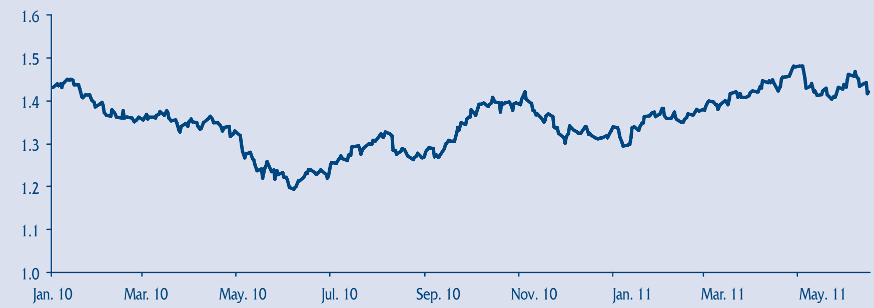
Graph 21
EXCHANGE RATE
(Monetary units per US$, end of period, % change at May-11 relative to Dec-10)



Source: Reuters.

While the FED has reiterated that it will maintain monetary stimulus for a long time, several economies have continued to adjust their policy interest rates to reverse inflationary pressures. In the developed economies, the European Central Bank (ECB), which began its rate hike cycle in April, said that it was prepared for future increases, and the Bank of England, which is facing high inflation rates, would also start a cycle of adjustments before the FED does.

Graph 22
US$ PER EURO



Source: Bloomberg.

17. The dollar halted its depreciatory trend against the euro due to the deepening of the debt crisis in some Eurozone countries, particularly Greece. On the other hand, the correction and subsequent stabilization of commodity prices has recently led some currencies to moderate or even to reverse their appreciatory trends during May.

Table 9
MONETARY POLICY INTEREST RATE

	Dec. 10	Apr. 11	May. 11	Jun. 11
Australia	4.75	4.75	4.75	4.75
ECB	1.00	1.25	1.25	1.25
Indonesia	6.50	6.75	6.75	6.75
New Zealand	3.00	2.50	2.50	2.50
United Kingdom	0.50	0.50	0.50	0.50
Brazil	10.75	12.00	12.00	12.25
Poland	3.50	4.00	4.25	4.50
Thailand	2.00	2.75	2.75	3.00
Canada	1.00	1.00	1.00	1.00
Chile	3.25	4.50	5.00	5.25
China	5.81	6.31	6.31	6.31
Colombia	3.00	3.75	4.00	4.25
South Korea	2.50	3.00	3.00	3.00
United Kingdom	0.25	0.25	0.25	0.25
Philippines	4.00	4.25	4.50	4.50
Hungary	5.75	6.00	6.00	6.00
India	6.25	6.75	7.25	7.25
Israel	2.00	3.00	3.25	3.25
Japan	0.10	0.10	0.10	0.10
Malaysia	2.75	2.75	3.00	3.00
Mexico	4.50	4.50	4.50	4.50
Norway	2.00	2.00	2.25	2.25
Czech Republic	0.75	0.75	0.75	0.75

Source: Reuters and Bloomberg.

BOX 1

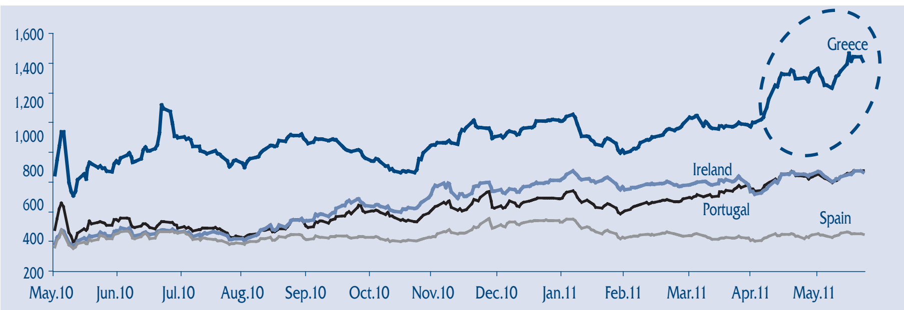
RECENT DEVELOPMENTS IN THE ECONOMIES WITH DEBT PROBLEMS

Volatility in international markets in the last quarter has been associated in part with the development of the crisis in Eurozone countries with debt problems: Greece, Portugal, and Ireland and, to a lesser extent, Spain. Lack of consensus within the European Union regarding the support to be provided to these countries and concerns about the size of the fiscal adjustments required by these economies, as well as about their social impact, exacerbated worries regarding the fiscal sustainability of these countries in a context of growing funding costs and difficult access to the international market of capitals. This led to a continuous reduction in risk ratings and the sovereign outlook ratings, which extended even to other economies in the region due to fears of contagion.

	S&P	Moody´s	Fitch
GREECE			
Dec.10	BB+	Ba1	BBB-
Mar.11	BB-	B1	BB+
May.11	B	B1	B+
PORTUGAL			
Dec.10	A-	A1	A+
Mar.11	BBB-	A3	A-
May.11	BBB-	Baa1	BBB-
SPAIN			
Dec.10	AAA	Aa1	AA+
Mar.11	AA+	Aa2	AA+
May.11	AA	Aa2	AA+
IRELAND			
Dec.10	A	Baa1	BBB+
Mar.11	A-	Baa1	BBB+
May.11	BBB+	Baa3	BBB+

Fears of a possible restructuring of the debt prevailed in Greece and doubts about the future of the economy increased significantly. Sovereign spreads showed a sharp increase as from the first week of April due to speculations about Portugal's request for financial assistance and the difficulty that implementing a new package for Greece entailed. In this context, sovereign spreads reached their maximum level so far this year on May 23 (1,400 bps) when the ruling party lost the elections in Spain and S&P revised the outlook of the Italian debt from stable to negative.

CREDIT DEFAULT SWAP (5 YEAR CONTRACTS)
(Basis points)



After the increase in sovereign spreads and the greater financial gap resulting from this, the possibility of a restructuring of Greece's debt acquired greater importance. Although the government and supranational organizations denied such possibility, uncertainty in markets continued growing because the debt was perceived to remain in an unsustainable path and government efforts were perceived as insufficient. Several possibilities would have been discussed to face this situation, including the possible extension of the debt maturity period (approximately € 340 billion). This option was disregarded due to the possible "contagion effect" that it would entail for the Eurozone. After this, in order to give signals of commitment, the government continued implementing the plans for the privatization of public assets for a total of € 3.5 to 5.5 billion in 2011 and for a total of € 4-6 billion in 2012.

In this context, there is growing consensus that the best option after the current program expires (mid 2013) would be a new financial aid package for an additional year from the European Union and the International Monetary Fund (IMF) in the frame of EFSF (European Financial Stability Facility) and EFSM (European Financial Stability Mechanism) schemes. This scheme would be similar to the Vienna Initiative, that is, investors should voluntarily keep their positions in Greek bonds while the financial program is in effect and buy even new bonds to replace the ones that may mature within the program period.

In **Portugal**, after the Prime Minister resigned (March 23, 2011) when his proposition of implementing a new package of fiscal austerity measures was not approved, political uncertainty added onto the severe fiscal situation. This generated greater skepticism about the economic viability of the country, especially when one considers that the government's obligations in Q2 include maturities for € 5 billion and that these funds may not be obtained through financing in the market.

Thus, the government began negotiations with the European Union and the IMF for a program of financial assistance under the scheme of the EFSM and EFSF, which culminated in an agreement for € 78 billion (of which € 26 billion would be provided by the IMF) with an interest rate of 5 percent in the first three years and an interest rate of 5.2 percent thereafter (the program will last 7.5 years). The program includes greater austerity measures, including those rejected by the parliament.

The situation in **Spain** has become more complicated after the government lost most of the regional governments in the recent elections, which has given rise to fears that higher regional deficits will be found. This has also reduced the legitimacy of the government to promote further reforms aimed at cleaning up the fiscal accounts.

Moreover, unemployment remains high (21.3 percent in Q1) even though the growth rate recorded in this quarter was 0.3 percent. This would suggest that problems in the labor market are structural.

As regards other European countries, S&P revised **Italy's** outlook to negative, considering that growth projections and the commitment to pursue structural reforms are weak. **Belgium's** debt rating was revised from stable to negative by Fitch due to the slow pace of structural reforms and the complicated political situation, given that 11 months before the elections political parties have not yet reached an agreement regarding the new government to be established. This has led to a reduction in the pace of reforms needed to reduce the levels of debt and fiscal deficit.

The magnitude of the debt problem in these countries can be measured through the fiscal surplus (primary balance) that would have to be generated to ensure a solvency position, that is, a position that will allow them to repay the public debt.

SOLVENCY INDICATORS
(% of GDP)

	Primary Result		Public Debt	
	2010	Solvency**	2010	2011*
Greece	-4.9	7.8	143	152
Portugal	6.1	3.7	93	91
Ireland	-29.2	1.8	96	114
Spain***	-7.3	n.a.	60	64

Source: Eurostat. WEO (April 2011) and Deutsche Bank.
(*) Estimate for the year.
(**) Assuming a debt ratio of 80% in 2020, a growth of 4% and an interest rate of 5%.
(***) In contrast with the other three countries, Spain's debt ratio (60%) is even lower than Germany's (80%).

The solution formulas are still a combination of fiscal adjustment and increased liquidity that may allow these countries to recover voluntary funding flows. However, the discussion broadens with the possibility of adopting some form of restructuring that involves some level of participation in the cost of the bondholders. This possibility generates uncertainty about the impact of such arrangements because, for example, German banks have about 41 percent of the total Greek sovereign debt, while French banks have about 28 percent of Greece's debt[4].

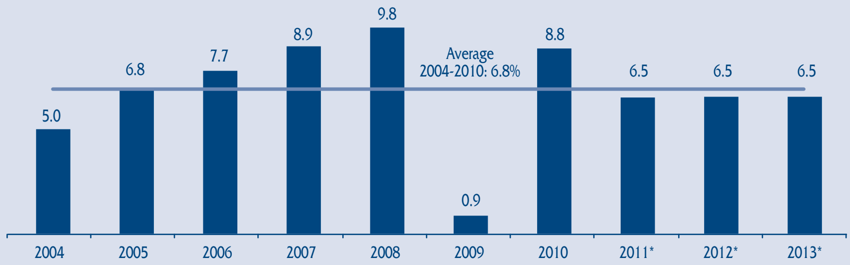
4 According to the last quarterly report of BIS (June 2011), table 9E.

II. Economic Activity

18. After GDP recorded a growth rate of 10 percent in Q2-2010, economic activity has continued showing still high although lower rates, which is consistent with a more neutral monetary policy position and with a lower fiscal impulse. Thus, GDP growth is converging to its potential level. In the first quarter of this year, GDP grew 8.7 percent with a growth rate of domestic demand of 10.6 percent and a growth rate of private investment of 15.4 percent.

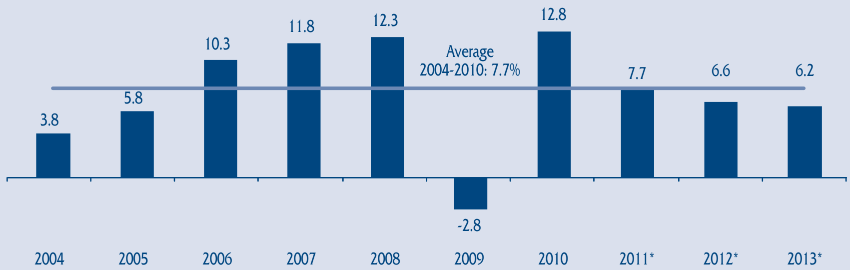
19. Economic activity in Q2 would have shown a higher slowdown than the one foreseen in our last Inflation Report due mainly to the lower dynamism of private investment and to the contraction of government spending. Taking this into account, the forecast on GDP growth in 2011 has been revised downwards from 7.0 percent (March Inflation Report) to 6.5 percent in this Report. The growth forecast for 2012 remains at 6.5 percent and the same growth rate is projected for 2013.

Graph 23
GDP
(Average % change)



* Forecast.

Graph 24
DOMESTIC DEMAND
(Real % change)



* Forecast.

20. Recent indicators of economic activity show that:

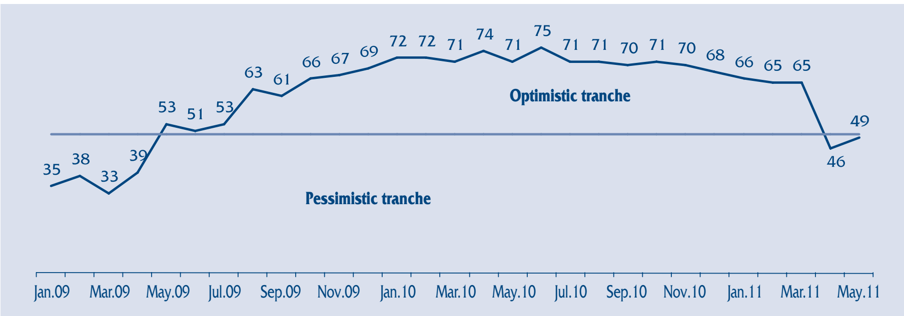
a. Economic agents' **expectations of GDP growth** in 2011 and 2012 have declined slightly downwards compared to the expected rates pointed out in our March Report due to the slowdown of economic activity observed in the first months of the year. Growth rates of between 6.1 and 6.5 percent are expected for 2013, in line with the growth estimates foreseen in this Report.

Table 10
SURVEY ON MACROECONOMIC EXPECTATIONS
GDP GROWTH
(%)

		Survey date		
		March 31	April 30	May 31
FINANCIAL ENTITIES				
	2011	7.0	7.0	6.7
	2012	6.5	6.5	6.2
	2013	6.5	6.5	6.1
ECONOMIC ANALYSTS				
	2011	7.1	7.0	6.6
	2012	6.5	6.5	6.3
	2013	6.5	6.3	6.5
NON-FINANCIAL FIRMS				
	2011	7.0	7.0	6.5
	2012	7.0	6.4	6.5
	2013	7.0	6.0	6.5

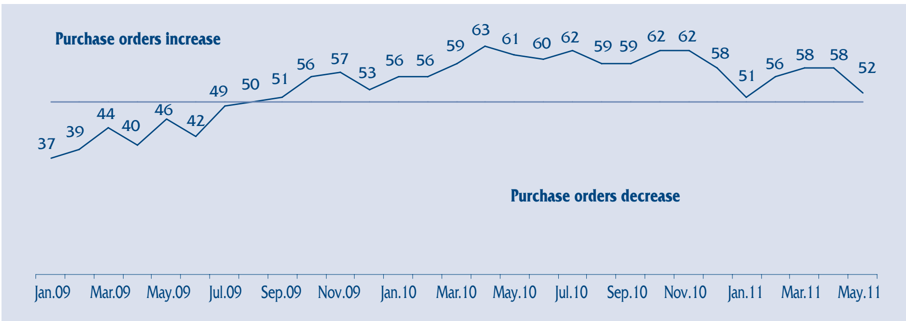
b. The **indicators of business expectations** in the quarter ahead deteriorated in the months of April and May, in a context of uncertainty for economic agents. The business confidence index dropped from 65 points in March to 46 points in April and to 50 points in May. A decline was also observed in terms of expectations of staff recruitment and purchase orders, although both indicators remain in the positive tranche. These indicators reflect perception at a specific moment and could be showing a temporary situation.

Graph 25
EXPECTATIONS ABOUT THE ECONOMY IN THE NEXT 3 MONTHS



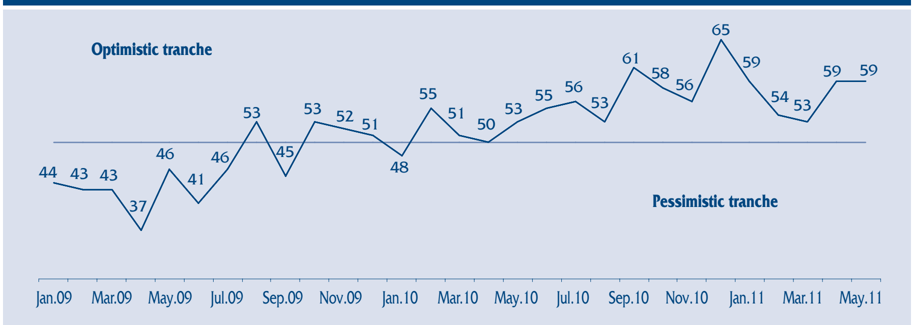
Graph 26
HIRING EXPECTATIONS IN THE MONTHS AHEAD

Graph 27
PURCHASE ORDERS COMPARED TO THE PREVIOUS MONTH



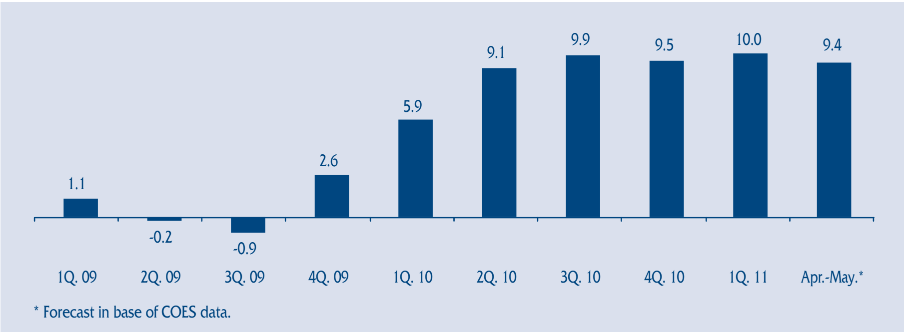
c. The **consumer confidence index** recorded a level of 59 points in May, showing an improvement compared to the level observed in our previous report (54 points).

Graph 28
CONSUMER CONFIDENCE INDEX
(Household economic situation)



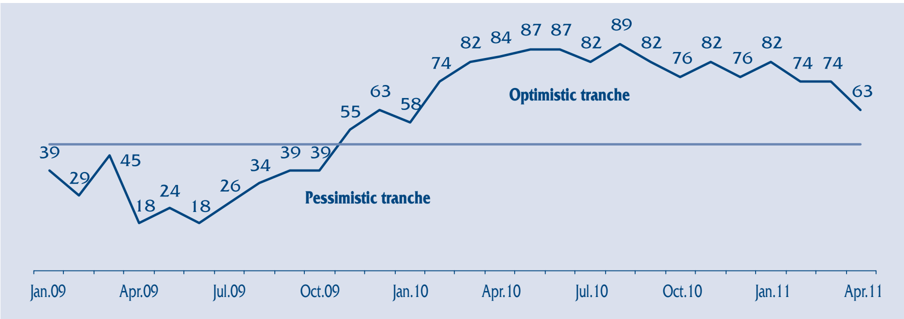
d. The indicator of **electricity** showed an annual growth of 9.4 percent between April and May 2011, a lower rate than in Q1.

Graph 29
ELECTRICITY PRODUCTION
(% Change relative to the same month of the previous year)



e. The indicator of the **number of non primary manufacturing branches with higher growth** registered a level of 63 in April, declining slightly compared to the average level of 80 recorded during 2010.

Graph 30
NUMBER OF NON-PRIMARY MANUFACTURING BRANCHES WITH POSITIVE GROWTH



f. **Domestic consumption of cement** grew 5.1 percent in May. A lower growth associated with the lower budget execution of the recently elected municipal and regional authorities was observed until April, but this trend reversed in May.

Graph 31
DOMESTIC CONSUMPTION OF CEMENT
(Annual % change)

Projection of spending components

21. **Domestic demand** is projected to grow 7.7 percent in 2011 and would converge to a rate closer to the growth rate of GDP in the forecast horizon, in line with the evolution of private consumption and private investment.

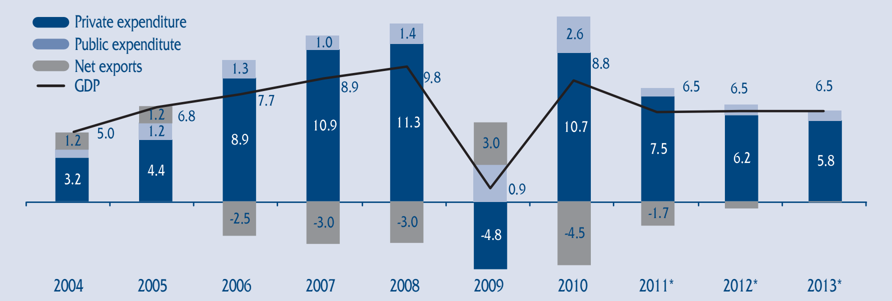
22. Lower growth rates than the ones foreseen in our March Report are projected in private investment in 2011 and 2012, in a context in which growth rates would be closer to the rates of potential GDP. This forecast is consistent with the data collected in the surveys on business expectations. Moreover, lower growth rates are projected in the components of government expenditure in 2011, in line with the recovery of the fiscal space considered in the forecast.

Table 11
GLOBAL DEMAND AND SUPPLY
(Real % change)

	2010		2011*			2012*		2013*
	1Q.	Year	1Q.	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
1. Domestic demand	**8.5**	**12.8**	**10.6**	**8.1**	**7.7**	**6.5**	**6.6**	**6.2**
a. Private consumption	5.4	6.0	6.4	5.6	5.7	5.3	5.7	5.9
b. Public consumption	14.0	10.6	5.3	5.0	4.4	2.7	4.1	4.0
c. Private investment	11.5	22.1	15.4	15.0	10.4	12.5	11.6	8.3
d. Public investment	19.9	27.3	-6.3	8.8	3.3	4.4	6.1	6.1
2. Exports	**0.2**	**2.5**	**3.4**	**5.2**	**3.8**	**8.4**	**7.8**	**9.0**
3. GDP	**6.2**	**8.8**	**8.7**	**7.0**	**6.5**	**6.5**	**6.5**	**6.5**
4. Imports	**12.3**	**23.8**	**13.5**	**11.2**	**10.4**	**8.0**	**8.1**	**7.3**
Memo:								
Public expending	*15.6*	*16.7*	*2.0*	*6.5*	*3.9*	*3.4*	*4.9*	*4.8*

*Forecast.

Graph 32
CONTRIBUTIONS TO GDP GROWTH
(% points)



* Forecast.

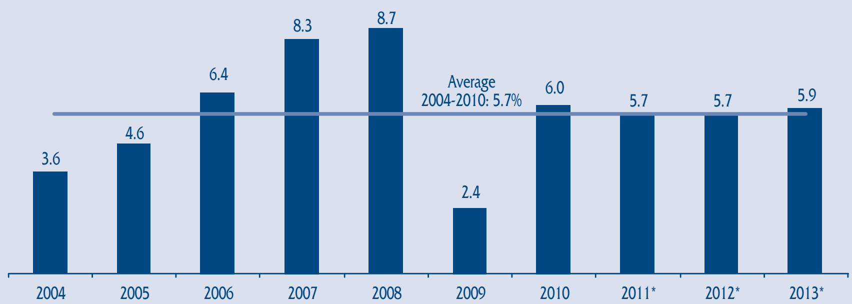
Table 12
GLOBAL DEMAND AND SUPPLY
(Contributions to real % change)

	2010		2011*			2012*		2013*
	1Q.	Year	1Q.	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
1. Domestic demand	**8.5**	**12.8**	**10.9**	**8.4**	**8.0**	**6.8**	**7.0**	**6.6**
a. Private consumption	3.8	4.1	4.5	3.8	3.8	3.5	3.8	3.9
b. Public consumption	1.2	1.0	0.5	0.5	0.4	0.3	0.4	0.4
c. Private investment	2.4	4.2	3.4	3.2	2.2	2.9	2.6	1.9
d. Public investment	0.6	1.5	-0.2	0.6	0.2	0.3	0.4	0.4
2. Exports	**0.0**	**0.5**	**0.6**	**0.9**	**0.7**	**1.5**	**1.4**	**1.6**
3. GDP	**6.2**	**8.8**	**8.7**	**7.0**	**6.5**	**6.5**	**6.5**	**6.5**
4. Imports	**2.4**	**4.5**	**2.8**	**2.4**	**2.2**	**1.8**	**1.8**	**1.7**
Memo								
Public expending	*1.8*	*2.5*	*0.3*	*1.0*	*0.6*	*0.5*	*0.8*	*0.7*

*Forecast.

23. **Private consumption** would grow 5.7 percent in 2011 and 2012 and 5.9 percent in 2013, in line with the evolution of the national disposable income and stable consumer expectations, which remain on the optimistic tranche and showing higher levels than the ones recorded in the March Inflation Report.

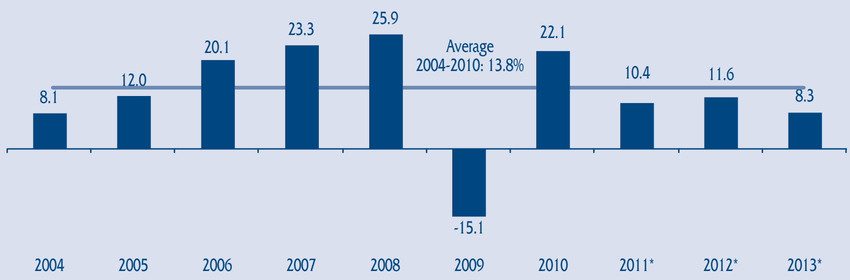
Graph 33
PRIVATE CONSUMPTION
(Real % change)



* Forecast.

24. The forecast on the growth of **private investment** in 2011 has been revised from 15.0 to 10.4 percent due mainly to a transitory change in business expectations, although private investment is estimated to record rates above the growth rate of GDP (11.6 percent in 2012 and 8.3 percent in 2013), in line with the pace of implementation of programmed investment projects.

Graph 34
PRIVATE INVESTMENT
(Real % change)



* Forecast.

Table 13
ANNOUNCED INVESTMENT PROJECTS
(Millions of US$)

	2011	2012	2013	2011 - 2013
Mining	5,390	8,297	8,523	22,210
Hydrocarbons	2,098	1,618	2,718	6,433
Electricity	1,895	2,425	2,160	6,480
Industry	1,819	1,460	1,028	4,307
Infrastructure	1,537	1,153	933	3,623
Other Sectors	2,185	1,173	1,064	4,422
Total	**14,924**	**16,126**	**16,426**	**47,475**

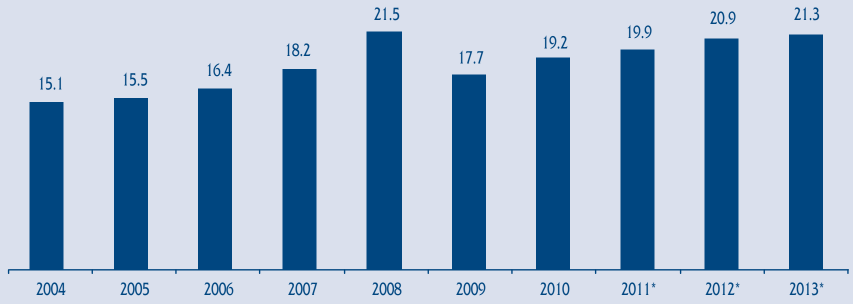
Source: Media and information of companies.

25. Investment projects amounting to a total of US$ 47.5 billion have been announced for 2011 – 2013.

Significant investment projects in the sector of **mining and hydrocarbons** with approved environmental impact studies include projects such as Las Bambas, Galeno, Quellaveco, and the expansions of Antamina and Cerro Verde. Projects worth pointing out in the sector of hydrocarbons include crude and gas exploration and production activities in lots 58, Z-2b, Z46, as well as the expansion of plants Malvinas and Pisco, aimed at increasing Camisea's production.

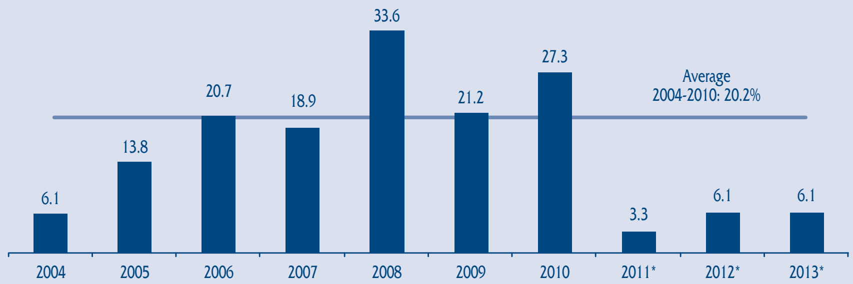
Projects in the area of infrastructure worth mentioning are projects aimed at improving the road network and infrastructure directly associated with foreign trade (piers, ports, and airports), such as the modernization of Muelle Norte and the expansion of the Matarani port.

Graph 35
PRIVATE GROSS FIXED INVESTMENT
(% of GDP)



* Forecast.

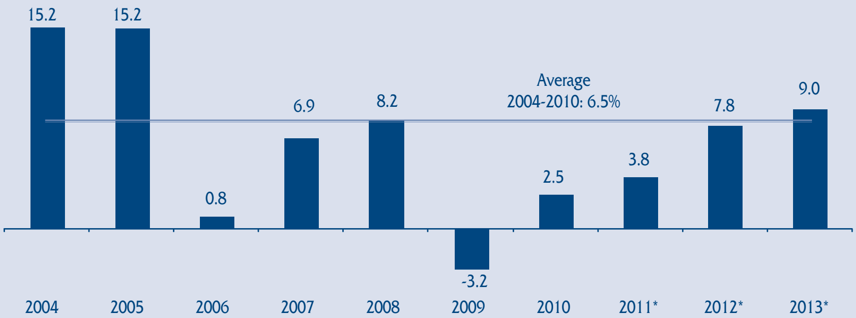
Graph 36
PUBLIC INVESTMENT
(Real % change)



* Forecast.

26. Considering the onset of operations of some investment projects towards the end of the forecast horizon as well as the expected evolution of global demand, a growing trend is forecast in exports, whose growth rate would increase from 3.8 percent in 2011 to 9.0 percent in 2013.

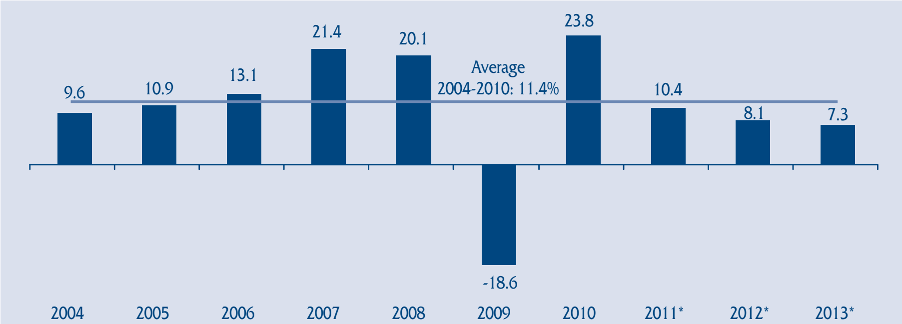
Graph 37
EXPORTS OF GOODS AND SERVICES
(Real % change)



* Forecast.

This trend would be reinforced as a result of the country's increased access to foreign markets through the trade agreements established, which would continue to boost non traditional exports. The evolution of imports, on the other hand, would be associated not only with the evolution of economic activity, which would grow 6.5 percent on average between 2011 and 2013, but also by the capital goods required for the development of investment projects.

Graph 38
IMPORTS OF GOODS AND SERVICES
(Real % change)



* Forecast.

27. As regards the saving-investment gaps, the rate of domestic investment would reach a level of 27.9 percent of GDP by the end of the forecast horizon. It is worth pointing out the rise in the public gap that would result from the higher surplus that would be recorded in the non financial public, which is consistent with a recovery in terms of fiscal space.

Table 14
SAVING-INVESTMENT GAP
(% of GDP)

	2010	2011*	2012*	2013*
Saving - Investment gap	**-1.5**	**-3.0**	**-3.3**	**-3.0**
Domestic saving	23.5	23.7	24.3	24.9
Gross domestic investment	25.0	26.7	27.5	27.9
Gross fixed investment	25.1	25.6	26.6	27.0
Inventories change	-0.1	1.1	0.9	0.9
Public gap	**-0.5**	**0.2**	**0.4**	**0.8**
Public saving	5.4	6.0	6.1	6.5
Public investment	5.9	5.7	5.7	5.7
Private gap	**-1.0**	**-3.2**	**-3.7**	**-3.8**
Private saving	18.1	17.8	18.2	18.4
Private investment	19.1	21.0	21.8	22.2

*Forecast.

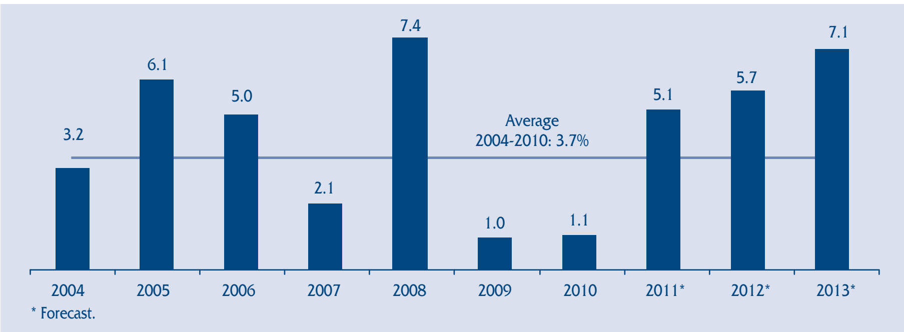
GDP by sectors

28. In Q1, **non primary sectors** grew 9.6 percent, showing a slight slowdown compared to previous quarters, especially in non primary industry and construction, while primary sectors increased their growth rate to 3.6 percent in Q1, driven by the sectors of fishing and hydrocarbons.

    The growth forecast of **primary sectors** in 2011 has been revised from 5.4 to 5.1 percent due mainly to the lower production estimated in metallic mining, particularly gold. Likewise, the growth forecast of non primary sectors has been revised from 7.2 (March Inflation Report) to 6.7 percent, which is consistent with the slowdown of private investment and government expenditure.

29. In **2012** and **2013** GDP would grow 6.5 percent, in line with the potential growth of the economy. It is worth pointing out that the growth forecast for 2012 remains unchanged at 6.5 percent based also on the onset of new mining projects and the expansions of Antamina and Southern, as well as on the continuity of public and private infrastructure projects.

Graph 39
PRIMARY SECTORS GROWTH RATE
(Real % change)



Graph 40
NON-PRIMARY SECTORS GROWTH RATE
(Real % change)

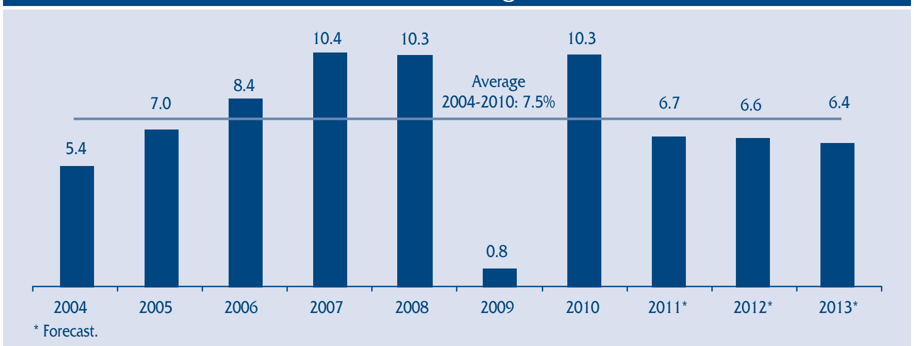
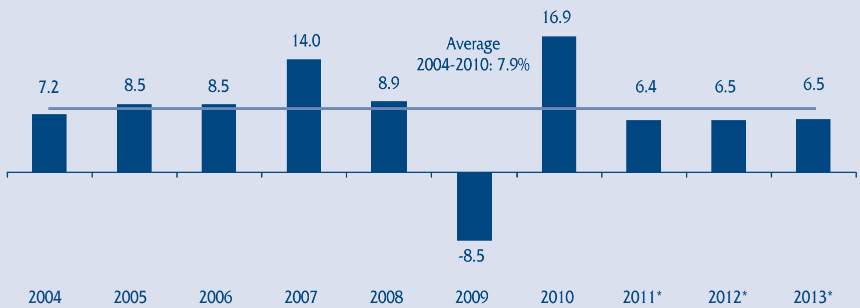


Table 15
GROSS DOMESTIC PRODUCT BY ECONOMIC SECTORS
(% change relative to the same period of the previous year)

	2010		2011*			2012*		2013*
	I Trim.	Año	I Trim.	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
Agriculture and livestock	3.8	4.3	2.9	3.0	3.5	4.8	5.2	4.3
Agriculture	3.9	4.2	-0.7	1.9	2.1	4.8	5.8	3.7
Livestock	3.7	4.4	7.5	4.9	5.2	4.9	4.8	4.8
Fishing	-8.2	-16.4	16.0	21.8	26.0	2.6	1.4	2.8
Mining and hydrocarbons	1.1	-0.1	-0.3	4.7	1.4	8.5	7.5	11.8
Metallic mining	-1.0	-4.9	-5.6	1.5	-1.6	8.3	7.7	11.8
Hydrocarbons	11.0	29.5	34.6	22.5	17.6	8.6	6.6	11.9
Manufacturing	7.5	13.6	12.0	7.7	7.6	6.3	6.2	6.5
Raw materials	-5.6	-2.3	12.1	11.3	14.6	5.2	4.3	6.3
Non-primary industries	10.1	16.9	12.0	7.1	6.4	6.5	6.5	6.5
Electricity and water	6.5	7.7	7.2	6.8	6.5	5.6	5.6	5.6
Construction	16.8	17.4	8.1	11.3	6.6	10.6	10.5	7.6
Commerce	8.1	9.7	10.0	7.1	6.8	6.3	6.0	5.6
Other services	4.9	8.0	9.1	6.8	6.8	6.2	6.4	6.5
GDP	**6.2**	**8.8**	**8.7**	**7.0**	**6.5**	**6.5**	**6.5**	**6.5**
Memo:								
Primary GDP	0.9	1.1	3.6	5.4	5.1	6.0	5.7	7.1
Non-Primary GDP	7.2	10.3	9.6	7.2	6.7	6.6	6.6	6.4

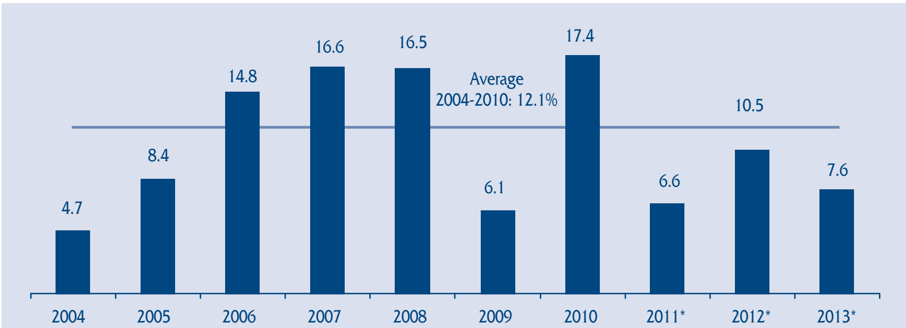
*Forecast.

Graph 41
NON-PRIMARY MANUFACTURING GROWTH RATE
(Real % change)



* Forecast.

Graph 42
CONSTRUCTION SECTOR GROWTH RATE
(Real % change)



* Forecast.

BOX 2
ELECTRICITY GENERATION SUPPLY – DEMAND BALANCE
(2011 – 2013)

Appropriate capacity and supply conditions in the National Interconnected Electricity System – Sistema Eléctrico Interconectado Nacional (SEIN)– are required to ensure sustained growth without inflationary pressures.

In this sense, the existence of excess supply or a generation reserve allows electrical systems to ensure an unrestricted supply of electricity even in conditions of climate contingencies (e.g. low rainfall seasons, dry season), technological contingencies (e.g. unavailability of fuel due to transportation restrictions), or technical contingencies (e.g. power or transmission failures). Under this premise, the estimated reserve margin of SEIN for different contingent supply-demand scenarios is discussed below.

The available reserve margin is calculated as the percentage of excess supply of electrical power output relative to maximum electricity demand. The available electrical power supply is the effective power capacity (maximum electric power supply in a given period under conditions of optimal generation and transmission) minus unusable installed capacity due to: i) hydrological conditions, ii) restrictions on the transportation of natural gas, and iii) maintenance. On the other hand, the maximum demand of electricity is the maximum total power required by users during a specific period.

The projections depend on the estimates of demand growth and increases in available installed capacity. The supply projected in this exercise is based on OSINERGMIN Work Plan for 2011-2013 and on projects that will start operating in the period analyzed according to information provided by MINEM and PROINVERSION.

According to this information, the power generated by the national electricity generation facilities would increase by over 2,400 MW between 2011 and 2013. The baseline scenario shows a growth of about 40 percent in terms of installed generating capacity: 1,870 MW in thermal plants and 557 MW in hydro electrical and other generation plants based on renewable sources (e.g. wind and solar energy).

It should be pointed out that the generation projects included in this analysis do not fully translate into new available power due mainly to variable hydrological conditions in the case of hydro electrical plants and to constraints in the transportation system of natural gas in the case of thermal plants.

As regards the latter, the main pipeline network used to transport natural gas from Camisea to the Central Coast has a capacity of 530 MDCF. The assumption here is that this capacity remains in the forecast horizon and that the pipeline capacity will be extended to 920 MDCF in 2014. For this reason, although the thermal supply based on natural gas would have a capacity of around 3,900 MW by 2013, the available supply would be approximately 2,200 MW. Therefore, natural gas plants would operate at 60 percent of their capacity on average in the period analyzed here given that the capacity of the natural gas transportation would not grow in this period.

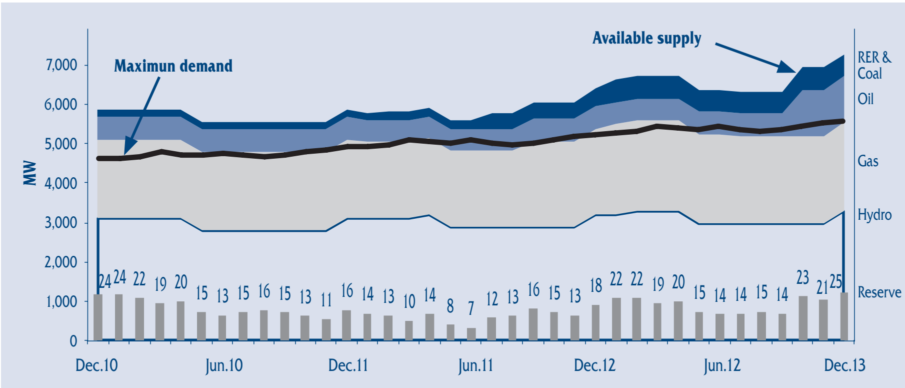
GENERATION PROJECTS 2011 - 2013 (MW)
BASELINE SCENARIO [1/]

GENERATION PLANT	Source	Zone	2011	2012	2013	2011-13
Hydroelectric plant			**0**	**100**	**90**	**190**
HP Machupicchu II (Apr.2012)	Water	South		100		
HP Huanza (Feb. 2013)	Water	Center			90	
Thermoelectric plant			**30**	**293**	**1,547**	**1,870**
TP Tablazo (Sep. 2011)	NG CS	North	30			
TP Kallpa CC (Sep. 2012)	NG (from CS to CC)	Center		293		
TP Fenix (Jan. 2013) 2/	NG (CS and CC)	Center			521	
TP Olleros (Dec. 2012) 2/	NG CS	Center			196	
TP Chilca I CC (Sep. 2013)	NG (from CS to CC)	Center			230	
TP Reserva Fría - Ilo (Oct. 2013)	Dual (Diesel and NG SC)	South			400	
TP Reserva Fría - Talara (Oct. 2013)	Dual (Diesel and NG SC)	North			200	
Renewable energy			**6**	**228**	**133**	**367**
CHs < 20 MW			2	38	101	
Biomass			4			
Windpower				110	32	
Solar				80		
Total SEIN 2011 - 2013 (MW)			**36**	**621**	**1,770**	**2,427**

HP: Hydroelectric plant / TP: Thermoelectric plant/ NG: Natural Gas/ SC: Simple Cycle / CC: Combined Cycle.
Memo: Work plan for 2011-2013 which shows the power generation capacity of each project (plant factor of 100 percent: the information included does not consider supply restrictions caused by hydrological conditions, restrictions on the transportation of natural gas or maintenance).
1/ The baseline scenario is the one considered in OSINERGMIN Work Plan for 2011-2013 and includes the cold reserve plants given in concession that will start operating after the forecast horizon analyzed by the regulator.
2/ Thermal power plants scheduled to start operating within the period analyzed, but whose supply of natural gas is not guaranteed so as to ensure their operation at full capacity due to transportation restrictions.

The baseline scenario, which considers that maximum demand would grow by an average annual rate of 7 percent and average hydrological conditions (a 10 percent reduction in the water supply), among other assumptions, does not consider significant risks of electricity supply interruptions in the period. The growth of maximum demand in this scenario is consistent with an annual GDP growth rate of 6.5 percent and also with the onset of new mining projects.

RESERVE (%), MAXIMUM DEMAND AND EFFECTIVE NET POWER (MW)



In this scenario, the minimum reserve margin is around 7 percent (June 2012), which is equivalent to approximately 350 MW. This means that the system in Q2-2012 would supply energy with transitory and partial constraints only if there is a simultaneous failure in plants with a combined power of over 350 MW (e.g. in two Kallpa or two Edegel turbines).

Considering a stress scenario, in which the annual growth of demand is around 9 percent and a severe drought implies a reduction of 20 percent in the hydro electrical supply, the probability of electrical supply restrictions would increase significantly during the dry seasons of the period analyzed. In this unlikely scenario of simultaneous high growth of demand and severe drought, maximum demand could exceed available supply by even 250 MW, which could imply temporary and partial situations of energy rationing.

BOX 3
SOURCES OF ECONOMIC GROWTH AND COMPETITIVENESS IN PERU

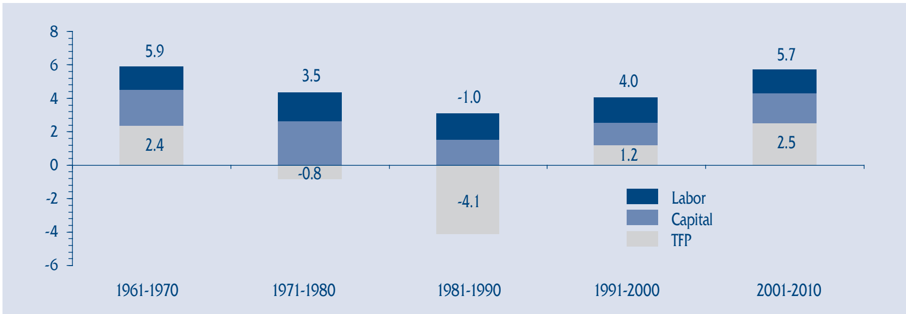
Following the methodology proposed by R. Solow (1957),[5] a country's economic growth may be broken down into the three classical main components of the production function: capital, labor, and total factor productivity (TFP). TFP measures efficiency in the use of the production factors

5 Solow, Robert. "Technical Change and the Aggregate Production Function"; Review of Economics and Statistics 39: 312-20. 1957.

of capital and labor. Given a constant level of capital and labor, a higher TFP means a higher production level and, in this sense, higher efficiency in the use of factors.

Based on standard growth accounting, an exercise has been made for Peru. The results by decades are illustrated in the graph below.

GDP GROWTH ACCOUNTING
(% points)



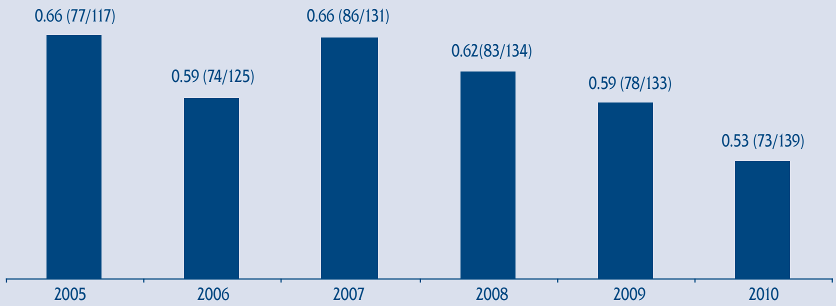
A fact that stands out is that differences in average growth rates between decades can be explained mostly by differences in the growth rates of productivity. Thus, the high volatility of the growth rate between decades would be associated with the volatility of TFP.

This is important because even when economic growth is sustained by the growth of capital and labor, the growth of wages and of GDP per capita will be based mainly on the possibility of generating added value or productivity. Furthermore, empirical evidence suggests that long periods of growth are based on a sustained growth of productivity.

Moreover, the positive evolution of productivity in the last two decades would be consistent with the structural reforms implemented in the country during this period. For example, the latest edition of World Economic Forum's competitiveness ranking points out the position recorded by Peru in such areas as protection of private investment (position 20 out of 139 countries), the impact of foreign direct investment rules on business (position 17), the fiscal surplus (position 31), the public debt (position 41), banks' soundness (position 18), and available financial services (position 31), all of which is the result of policies initiated two decades ago and maintained until today.

Despite these positive aspects, Peru ranks 73rd in the 2010-2011 Global Competitiveness Report ranking. Even though this implies that the country has climbed 5 positions in the Global Competitiveness Index (IGC) compared to the previous year, Peru is currently in the third quintile at the global level, with 53 percent of countries showing a higher Global Competitiveness Index (ICG) than ours.

PERU: GLOBAL COMPETITIVENESS INDEX
(Percentile, Relative position)



Memo: The percentile summarizes the country's relative position and corrects the effect of variation in the number of countries considered in the GCI of each year.
Source: Global Competitiveness Report (several years).

The deficits of the Peruvian economy that would account for this position and negatively offset the positive aspects mentioned above are associated with institutional aspects, infrastructure, health and primary education, and innovation. For example, Peru stands in position 120 in the indicator of confidence in the political class and in position 119 in terms of both independence of the judiciary system and the burden of government regulation and the cost of crime and violence on business. Furthermore, Peru is ranked 133 in both the indicator that measures the quality of primary education and the one that measures the quality of education in math and science. Nonetheless, it is worth highlighting that Peru is ranked 92 both in terms of the quality of general infrastructure and the quality of roads in the country.

PERU: GLOBAL COMPETITIVENESS INDEX

	2009-2010	2010-2011
Global Competitiveness Index (Global position)	**78**	**73**
A. Basic Requirements	**88**	**87**
1. Institutions	90	96
2. Infrastructure	97	88
3. Macroeconomic stability	63	75
4. Health and primary education	91	92
B. Efficiency Reinforcement	**59**	**56**
5. Higher education and training	81	76
6. Efficiency of the goods market	66	69
7. Efficiency of the labor market	77	56
8. Financial market's sophistication	39	42
9. Technological readiness	77	74
10. Size of market	46	48
C. Innovation and sophistication factors	**85**	**89**
11. Business sophistication	68	71
12. Innovation	109	110

Memo: Relative positions among 133 countries (2009-2010) and among 139 countries (2010-2011).
Source: World Economic Forum.

A complementary diagnosis of Peru's conditions and constraints that can help us to continue generating substantial growth rates can be obtained from the methodology proposed by Hausmann, Rodrik and Velasco (2005)[6] called Growth Diagnostics (GD). This methodology is based on the idea that incentives for investment and growth are determined, on the one hand, by the possibility of generating high returns (Social Return on Investment) and security in terms of their ownership (appropriation) and, on the other hand, by an appropriate cost of financing.

The application of this methodology suggests that growth constraints in the country are associated with a low return on private investment and not so much with the cost of financing.

The low return on private investment is explained by both the low social return on investment and by low appropriation. Among other factors, low social return on investment is mainly explained by deficiencies in infrastructure, especially transport infrastructure, and by constraints in the accumulation of human capital due to the low quality of education.

On the other hand, low ownership is mainly explained by two types of failures classified as government failures and market failures. The former are associated with problems with property rights, public safety, poor business regulations, inefficient public administration, while the latter include problems associated with competition, good business practices, technology adaptation, business sophistication, and innovation.

6 Hausmann, R., Rodrik, D. and Velasco, A. "Growth Diagnostics"; Cambridge, MA: John F. Kennedy School of Government, Harvard University. 2005.

III. Balance of Payments

30. Because the central forecast scenario considers a higher level of prices for several commodity exports –particularly gold– and higher volumes of exports of non traditional products, the forecast of the current account deficit in the year has been revised from 3.3 percent of GDP (March Report) to 3.0 percent of GDP.

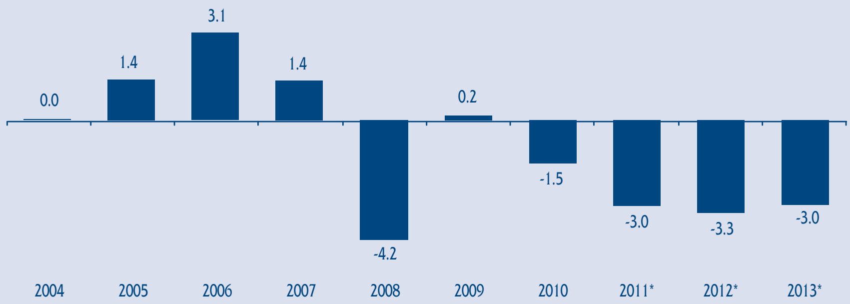
The deficit in the current account in 2012 would decline from 3.5 (March Inflation Report) to 3.3 percent of GDP due to a lower growth in the volume of imports of goods and a lower factor income due to lower export prices.

Table 16
BALANCE OF PAYMENTS
(Millions of US$)

	2010		2011*			2012*		2013*
	Q1	Year	Q1	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
I. CURRENT ACCOUNT BALANCE	**-553**	**-2,315**	**-672**	**-5,746**	**-5,173**	**-6,757**	**-6,217**	**-6,135**
% of GDP	-1.6	-1.5	-1.6	-3.3	-3.0	-3.5	-3.3	-3.0
1. Trade Balance	1,589	6,750	1,831	6,287	6,751	5,723	6,056	7,349
a. Exports	7,924	35,565	10,017	41,700	42,924	45,192	45,525	49,859
b. Imports	-6,336	-28,815	-8,186	-35,413	-36,173	-39,469	-39,469	-42,510
2. Services	877	-2,037	1,055	-2,610	-2,563	-2,742	-2,624	-2,712
3. Investment Income	-2,414	-10,053	-2,783	-12,601	-12,539	-13,184	-13,097	-14,338
4. Current transfers	-36	3,026	-44	3,178	3,178	3,447	3,447	3,567
of which: Remittances	711	2,534	756	2,731	2,731	3,001	3,001	3,120
II. FINANCIAL ACCOUNT	**3,075**	**13,285**	**2,716**	**8,246**	**8,473**	**7,757**	**7,717**	**8,135**
of which:								
1. Private Sector (long and short term)	2,971	13,587	2,587	8,220	8,439	7,930	8,103	8,263
2. Public Sector	104	-1,108	129	83	27	-187	-485	-167
III. BALANCE OF PAYMENT (=I+II)	**2,134**	**10,970**	**2,022**	**2,500**	**3,300**	**1,000**	**1,500**	**2,000**
Memo:								
Gross long-term external private financing								
Millions US$	2,104	12,053	2,798	11,169	11,757	11,000	11,850	12,471
% of GDP	6.0	7.8	6.8	6.5	6.8	5.7	6.2	6.0
NIR balance								
Millions US$	35,269	44,105	46,127	46,605	47,405	47,605	48,905	50,905
% of GDP	26.2	28.6	28.9	27.1	27.5	24.8	25.6	24.5

RI: Inflation report.
* Forecast.

Graph 43
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS
(% of GDP)



* Forecast.

31. In Q1-2011, the **trade balance** recorded a surplus of US$ 1.8 billion (versus a surplus of US$ 1.6 billion in the same period in 2010). Exports in Q1-2011 grew 26.4 percent, mainly as a result of the rise observed in prices (24.5 percent) associated with the higher prices of copper, gold, and oil. The volume of exports grew 1.4 percent due to increased shipments of non traditional products (up 23.,2 percent), while exports of traditional products declined 4.1 percent due to lower shipments of fishmeal, gold, and oil.

    On the other hand, imports grew 29.2 percent relative to Q1-2010. The volume of imports rose 14.7 percent due to higher imports of capital goods, durable consumer goods, and industrial inputs, while the average price of imports grew 12.8 percent due to the higher prices of food, crude, and industrial inputs.

Table 17
TRADE BALANCE
(Millions of US$)

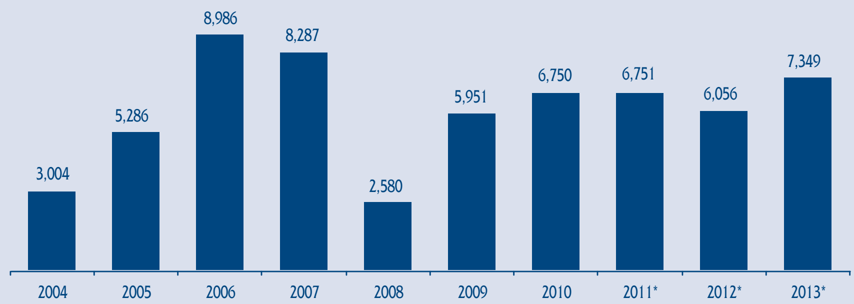
	2010		2011*			2012*		2013*
	Q1	Year	Q1	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
Exports	**7,924**	**35,565**	**10,017**	**41,700**	**42,924**	**45,192**	**45,525**	**49,859**
Of which:								
Traditional products	6,255	27,669	7,726	32,675	33,335	35,145	34,766	37,921
Non-traditional products	1,606	7,641	2,211	8,711	9,271	9,725	10,382	11,550
Imports	**6,336**	**28,815**	**8,186**	**35,413**	**36,173**	**39,469**	**39,469**	**42,510**
Of which:								
Consumer goods	1,126	5,489	1,425	6,849	6,473	8,156	7,348	7,922
Inputs	3,171	14,023	4,019	17,488	18,005	18,431	18,492	19,407
Capital goods	1,970	9,074	2,654	10,901	11,524	12,699	13,426	14,970
TRADE BALANCE	**1,589**	**6,750**	**1,831**	**6,287**	**6,751**	**5,723**	**6,056**	**7,349**

RI: Inflation report.
* Forecast.

32. The forecast on the surplus in the **trade balance** in 2011 has been revised considering a higher growth in the terms of trade estimated in our previous report, which would more than offset the increase in imports associated with higher domestic demand. Thus, the trade surplus in 2011 is now estimated at US$ 6.8 billion (US$ 6.3 billion in the March Inflation Report).

The trade balance in 2012 and 2013 would continue showing surpluses (US$ 6.1 billion and US$ 7.3 billion respectively) due to an improvement in terms of trade and a higher volume of exports, especially mining exports, as a result of the onset on operations in some investment projects in the mining sector.

Graph 44
TRADE BALANCE
(Millions of US$)



* Forecast.

Table 18
TRADE BALANCE
(% change)

	2010	2011*		2012*		2013*
		IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
1. Value:						
Exports	31.9	17.3	20.7	8.4	6.1	9.5
Traditional products	34.2	18.1	20.5	7.6	4.3	9.1
Non-traditional products	23.5	14.0	21.3	11.6	12.0	11.2
Imports	37.1	22.9	25.5	11.5	9.1	7.7
2. Volume:						
Exports	1.6	4.3	4.0	9.1	8.3	9.8
Traditional products	-2.7	3.4	1.8	9.1	8.2	9.9
Non-traditional products	15.3	7.3	11.6	9.0	9.0	9.3
Imports	24.1	11.3	11.6	9.5	8.2	8.2
3. Price:						
Exports	29.9	12.5	16.1	-0.7	-2.1	-0.3
Traditional products	37.8	14.2	18.3	-1.5	-3.6	-0.8
Non-traditional products	7.1	6.2	8.7	2.4	2.8	1.7
Imports	10.1	10.4	12.5	1.8	1.2	-0.5

RI: Inflation report.
* Forecast.

33. **Exports** in 2011 have been revised on the upside to US$ 43 billion, mainly due to a price effect resulting from commodity prices, which would rise more than foreseen in our previous report.

Exports in 2012 are estimated to amount to US$ 45.5 billion. The volume of traditional exports would be lower than the one considered in our previous report due to the expected decline of copper production associated with the fact that operations at mine Toromocho will start in 2013 instead of staring in 2012.

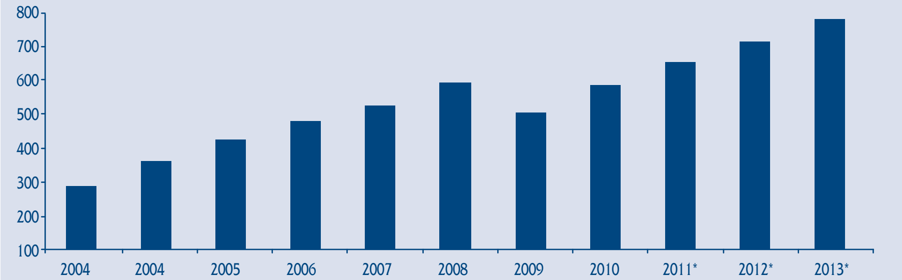
Exports in 2013 would amount to nearly US$ 50 billion due to increased mining exports, especially copper and zinc, as a result of the onset of operations at mines Toromocho, Los Chancas, and Hilarión, as well as due to the expansion of Southern operations.

Graph 45
EXPORTS OF GOODS
(Billions of US$)

Memo: Total exports also includes other exports.
* Forecast.

34. The volume of **non traditional exports** has increased two-fold between 2003 and 2010, the United States being the main destination of these exports. The volume of non traditional exports is expected to grow at an average rate of 10 percent in the forecast horizon as a result of the country's increased access to international markets associated with new trade agreements and as a result of global economic recovery.

Graph 46
NON TRADITIONAL EXPORTS
(Volume index 1994 = 100)

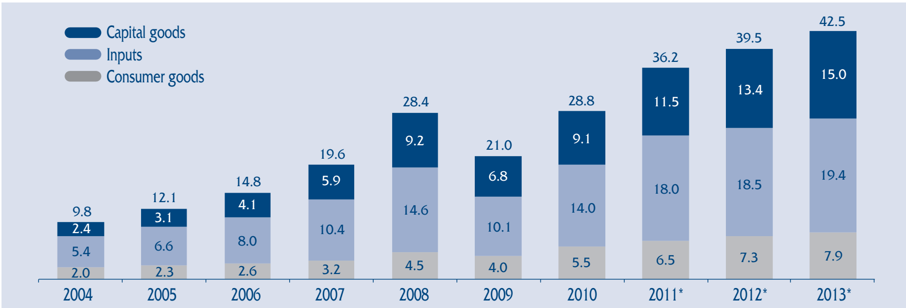


* Forecast.

35. The value of **imports** would grow 26 percent in 2011, reaching US$ 36.2 billion. This higher result than the one expected in our previous report would be associated both with higher prices and higher volumes of imports. The average price of WTI oil in 2011 has been revised from US$ 97 to US$ 99 per barrel in this report.

    The volume of imports in the forecast horizon is expected to maintain high growth rates (8.2 percent in 2012 and 2013) in line with the evolution of domestic demand.

Graph 47
EXPORTS OF GOODS
(Billions of US$)



Memo: Total imports also includes other imports.
* Forecast.

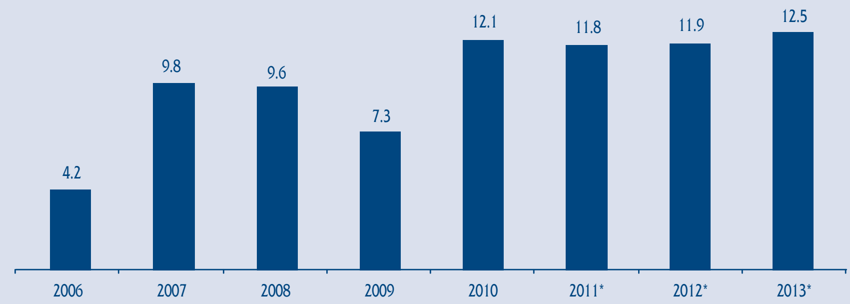
Financial account

36. In Q1-2011, the long term **financial account of the private sector** amounted to US$ 2.88 billion. On the side of liabilities, it is worth pointing out loan disbursements for a total of US$ 1.05 billion, a flow of foreign direct investment for a total of US$ 1.71 billion, and non residents' acquisition of securities issued in the local market for a total of US$ 48 million. On the side of assets, it is worth pointing out the reduction recorded in institutional investors' holding of foreign securities (US$ 179 million).

37. The private sector financial account would register positive capital flows in 2011 and 2012 (US$ 8.77 billion and US$ 8.10 billion, respectively). Like in our March Report, lower flows than the ones recorded in 2010 are considered in the financial account of the private sector for 2011 and 2012. In this scenario, a lower acquisition of securities issued in the local market by non residents and lower long term disbursements to finance investment projects are foreseen since part of these projects would be financed by institutional investors.

38. Long term external financing (net foreign direct investment plus disbursements) would be higher than foreseen in our March Report and would amount to US$ 11.8 billion and US$ 11.9 billion in 2011 and 2012, respectively.

Graph 48
PRIVATE SECTOR FINANCING
(Billions of US$)



* Forecast.

Table 19
PRIVATE SECTOR FINANCIAL ACCOUNT
(Millions of US$)

	2010		2011*			2012*		2013*
	Q1	Year	Q1	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
1. ASSETS	**619**	**-1,041**	**151**	**-1,541**	**-1,640**	**-1,402**	**-2,064**	**-2,695**
Direct investment abroad	-63	-215	34	0	34	0	0	0
Portfolio investment abroad 1/	682	-826	118	-1,541	-1,673	-1,402	-2,064	-2,695
2. LIABILITIES	**1,827**	**14,365**	**2,732**	**9,761**	**10,408**	**9,332**	**10,167**	**10,958**
Foreign direct investment in the country	1,944	7,328	1,712	8,169	8,512	8,500	8,950	9,512
Foreign portfolio investment in the country	97	3,284	48	30	48	183	124	300
Long-term loans	-213	3,752	973	1,562	1,849	649	1,093	1,146
Disbursements	222	4,940	1,052	3,000	3,211	2,500	2,900	2,959
Amortization	-436	-1,187	-79	-1,438	-1,362	-1,851	-1,807	-1,813
3. TOTAL	**2,446**	**13,324**	**2,884**	**8,220**	**8,769**	**7,930**	**8,103**	**8,263**

* Forecast.
1/ Includes mainly the portfolio investments of the financial and non financial sectors in shares and other foreign assets. A negative sign indicates an increase in assets.

39. The net flow of **short term capitals** in Q1-2011 was negative by US$ 297 million. This was associated with the increase observed in the assets of non financial firms abroad (US$ 425 million), particularly mining companies' deposits overseas. It is worth mentioning that banks increased both their assets and liabilities abroad (by US$ 652 million and US$ 669 million, respectively). No major net capital flows are foreseen in the rest of 2011 and in 2012 and 2013.

40. **NIRs** at May 31, 2011 amounted to US$ 46.13 billion. This level of reserves guarantees the soundness of the Peruvian economy face possible real and financial

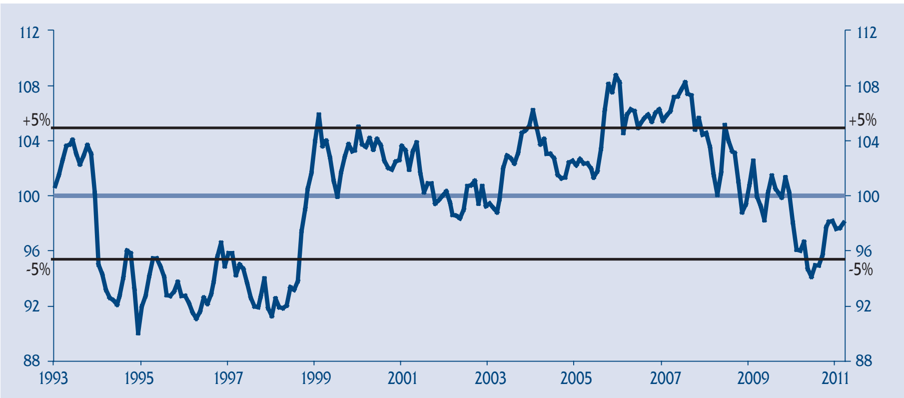
shocks. Moreover, this level of reserves, which represents 28.5 percent of GDP, backs up 91.1 percent of total liquidity in depository institutions and is equivalent to 4.6 times government and private short term liabilities.

BOX 4
THE REAL MULTILATERAL EXCHANGE RATE AND ITS FUNDAMENTALS

The real exchange rate (RER) indicates the number of domestic goods that can be exchanged for foreign goods (expressed in a common currency). In other words, the RER is a relative price. The multilateral RER is the cost of a consumer basket of our trading partners' goods expressed in soles compared to the cost of a basket of similar goods in Peru[7]. Based on this definition, increases in the RER would be indicating that the domestic economy is trading cheaper products than its trading partners, which implies a real depreciation of the nuevo sol. Therefore, it is important to study the dynamics of the RER because significant deviations of the RER from its historical levels could compromise the sustainability of the balance of payments.

Figure 1 shows that the multilateral RER has been around +/- 5 percent relative to its average level in 18 years (March 1993 - March 2011). Thus, the variability ratio for this period is 4.7 percent, while this ratio declines to 3.3 percent in a more recent period (March 2001 - March 2011). Given the country's low levels of inflation (2.3 percent in the last decade) and low volatility of the multilateral RER index, a relatively stable nominal exchange rate should be expected.

Figure 1
MULTILATERAL RER (INDEX 2001 = 100)



7 The methodology used by the BCRP to construct the multilateral RER is discussed in the BCRP Annual Report of 2006. The data and fundamentals of the RER are elaborated on the basis of the data published in the BCRP Weekly Economic Report.

In order to identify the main determinants of the RER (see Figure 2), we analyze how the RER was affected by its fundamentals in two recent stress episodes in international markets: first, the period following the Russian crisis (Q2-1998 – Q1-2001), when the RER depreciated 10.8 percent in accumulated terms, and second, the period after the subprime crisis (Q4-2007 – Q1-2011), when the RER appreciated 9.6 percent. Both the contribution of real determinants and the response of the multilateral RER in these two episodes are notoriously opposite[8].

The following fundamentals are discussed in economic literature:

- **Net External Liabilities:** a higher volume of net external liabilities typically reflects the result of capital inflows seeking to invest in the domestic economy, which will imply higher payments to other countries in the future. Thus, in order that the sustainability of the balance of payments is not compromised, countries with high flows of external liabilities have to generate a trade surplus, which requires a real depreciation.

- **Terms of trade:** in a primary export economy, an increase in the terms of trade results in higher private and public income, which tends to increase the demand for all goods. This pushes up the price of domestic goods and, given the prices of foreign goods, there is a real appreciation.

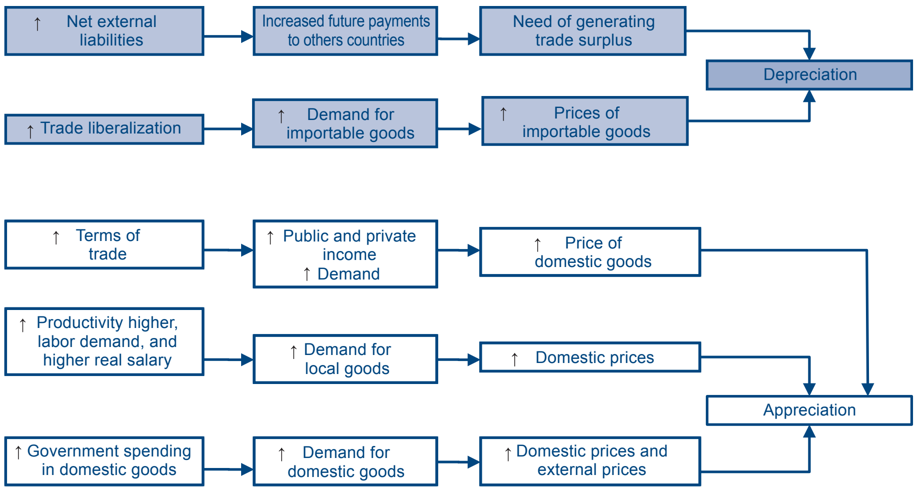
- **Trade liberalization:** an increase in trade liberalization, for example due to a tariff reduction, leads to an increase in the demand for imported goods and therefore to upward pressures on their prices. Since the prices of these goods are determined in foreign markets, there would be a real depreciation

- **Productivity:** an increase in domestic productivity relative to productivity in trading partner countries would lead to an increased demand for labor and hence to higher real salaries paid for local production. The latter would lead to a higher demand for local goods which, subject to higher labor costs, would increase domestic prices and result in a real appreciation.

- **Government expenditure:** public sector purchases are typically oriented to goods produced in the country. A fiscal expansion would generate demand pressures on these goods, increasing their price, as a result of which the local currency would tend to appreciate.

8 For more information on the methodology used, see Rodriguez and Winkelried (2011): ¿Qué explica la evolución del tipo de cambio real de equilibrio en el Perú?, Revista Moneda, No 147, pp. 9-14.

Figure 2
TRANSMISSION OF THE EFFECT OF FUNDAMENTALS TO THE MULTILATERAL RER

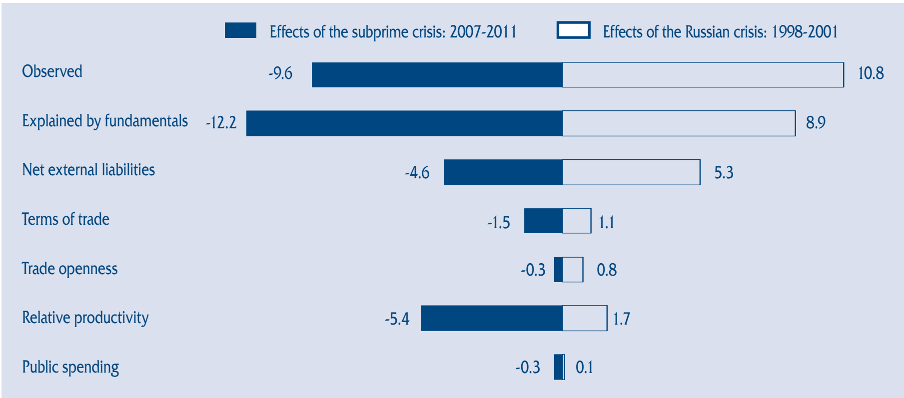


The contribution of fundamentals to the 10.8 percent real accumulated depreciation of the RER after the 1998 Russian crisis is shown on the right side of Figure 3. As we can see, 8.9 percent of this depreciation is due to changes in the fundamentals, especially the increase of net external liabilities and, to a lesser extent, the evolution of productivity in Peru compared to that of productivity in trading partners, and the growth of terms of trade. The increase of net external liabilities in this period is due to the significant outflow of external capitals associated with panic in international markets at that time. The slowdown in the global economy contributed also to reduce the terms of trade, generating in this way a negative income effect and pushing the RER upwards.

Finally, the domestic economy goes into a deeper recession than the one experienced by our trading partners, which brings about a decline in terms of productivity that entails an even higher real depreciation.

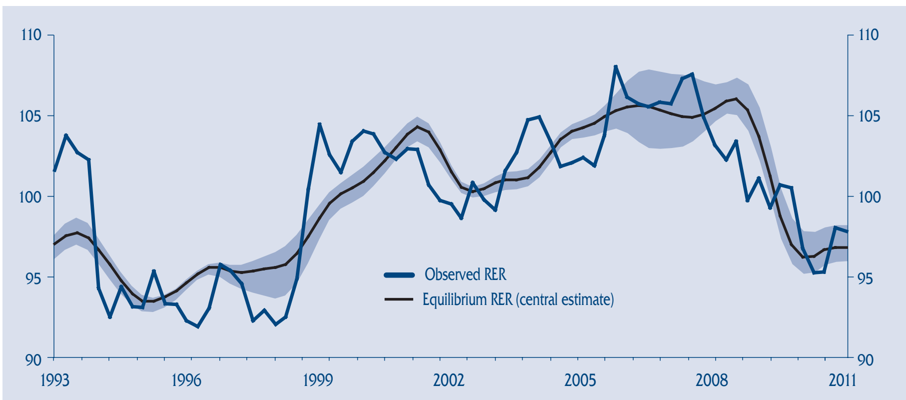
On the other hand, the left side of Figure 3 shows the contribution of fundamentals to the 9.6 percent accumulated real appreciation of the RER after the 2007 subprime crisis. Similarly, a high percentage of this evolution (12.2 percent) can be explained by the dynamics of fundamentals. The appreciatory effects of productivity gains recorded in Peru recently stand out, but the contribution of the reductions in net external liabilities and of trade liberalization are also significant.

Figure 3
EVOLUTION OF THE MULTILATERAL RER AFTER THE RUSSIAN CRISIS (10.8% DEPRECIATION) AND AFTER SUBPRIME CRISIS (9.6% APPRECIATION)



Thus, both episodes illustrate the greater importance of net foreign liabilities, productivity, terms of trade and trade openness in determining the RER. Furthermore, no major differences are observed between the variation of the RER and the one explained by fundamentals. Therefore, this is consistent with foreign exchange interventions aimed at reducing the extreme volatility in the nominal exchange rate to prevent balance sheet effects and negative impacts on productivity and trade flows.

Figure 4
MULTITALERAL RER AND EQUILIBRIUM LEVEL



IV. Public Finances

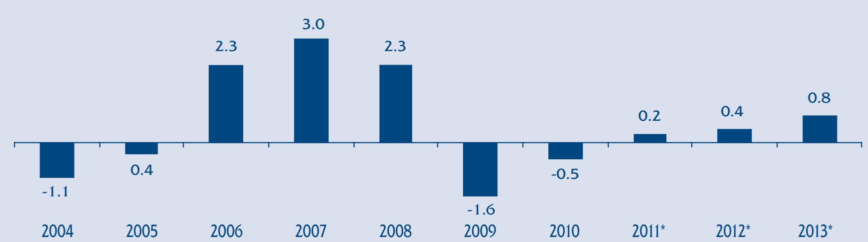
41. With the purpose of generating the fiscal space required to face eventual adverse macroeconomic contingencies, the aim of the Ministry of Economy and Finances (MEF) is to record a fiscal surplus in 2011 which we estimate could reach 0.2 percent of GDP (a deficit of 0.3 percent was estimated in our March Inflation Report). This improvement is associated with the revision of the projection of the general government current revenues which, despite the tax changes approved in the first semester that implied a reduction in the VAT, ITF, and the excise tax, have been showing a significant growth trend, especially in the case of revenues from the income tax. On the side of the general government non financial spending, the level of expenditure considered in this report is the one established in the Multiannual Macroeconomic Framework (MMF) of May 2011, which is higher than the one established in the revised MMF of August 2010.

42. A counter-cyclical prudent fiscal position aimed at reducing the treasury's vulnerability vis-à-vis adverse shocks by generating savings that should be used prudentially without affecting fiscal sustainability is considered for the next years. On the side of non financial expenditure, a growth of 4 percent is considered in current expenditure and a growth of 6 percent is considered for gross capital formation in the next years. Moreover, the projection also considers the tax structure established in the MMF of May 2011 for years 2012 and 2013.

    The projection of the economic balance in 2012 and 2013 shows a surplus of 0.4 and 0.8 percent of GDP in these years. These surpluses are lower than the ones considered in the MMF (1.0 and 1.6 percent of GDP, respectively) given that a closer evolution of non financial expenditure to that of real GDP has been considered.

43. In Q1-2011 the non financial public sector (NFPS) recorded an **economic surplus** of 5.6 percent of GDP, a balance 2.6 percentage points higher than the one recorded in the same period in 2010 associated with the increase of the general government current revenues (14.0 percent), as well as with the evolution of non financial expenditure, which dropped by a real 0.2 percent, especially in the case of capital expenditure, which declined 17.7 percent.

Graph 49
OVERALL BALANCE OF THE NON FINANCIAL PUBLIC SECTOR
(% of GDP)



* Forecast.

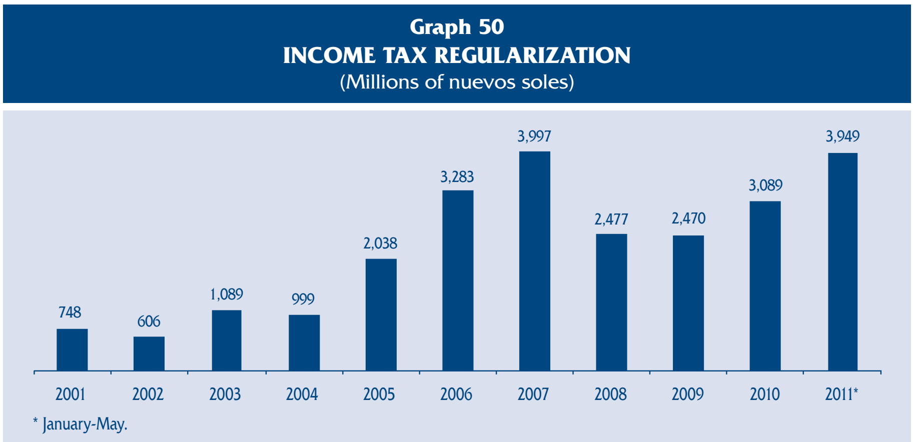
Table 20
NON FINANCIAL PUBLIC SECTOR
(% of GDP)

	2010		2011*			2012*		2013*
	1Q.	Year	1Q.	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
1. General government current revenue 1/	**20.9**	**19.8**	**21.6**	**19.5**	**20.3**	**19.3**	**20.2**	**20.2**
Real % change	*18.0*	*18.4*	*14.0*	*5.5*	*9.4*	*4.8*	*5.4*	*6.8*
2. General government non-financial expenditure 2/	**16.1**	**19.2**	**14.5**	**18.6**	**18.9**	**18.2**	**18.7**	**18.4**
Real % change	*9.2*	*10.7*	*-0.2*	*3.5*	*5.5*	*2.9*	*4.6*	*4.7*
Of which:								
a. Current	12.7	13.2	12.1	12.4	13.3	12.2	13.1	12.8
Real % change	*5.4*	*6.9*	*5.8*	*0.7*	*8.3*	*3.6*	*4.0*	*4.0*
b. Gross capital formation 3/	2.9	5.5	2.2	5.9	5.3	5.7	5.3	5.3
Real % change	*16.4*	*20.8*	*-17.7*	*13.0*	*2.3*	*2.0*	*6.0*	*6.0*
3. Other	**-0.1**	**0.1**	**0.2**	**0.1**	**0.1**	**0.0**	**0.1**	**0.1**
4. Primary balance (1-2+3)	**4.7**	**0.7**	**7.2**	**0.9**	**1.5**	**1.2**	**1.5**	**1.9**
5. Interests	**1.7**	**1.2**	**1.6**	**1.2**	**1.2**	**1.2**	**1.1**	**1.1**
6. Overall Balance	**3.0**	**-0.5**	**5.6**	**-0.3**	**0.2**	**0.0**	**0.4**	**0.8**
Memo:								
1. Central government current revenues (billions of S/.)	21.0	86.1	24.5	93.2	97.1	100.0	105.4	114.8
2. Central government non-financial expenditure (billions of S/.)	16.2	83.5	16.5	89.0	90.8	93.9	97.9	104.5

1/ The central government includes the ministries, national universities, public agencies and regional governments. The general government has a wider coverage that includes the central government, social security, regulators and supervisors, government charity organizations and local governments.
2/ Includes the compensation payment to the Fuel Price Stabilization Fund (FPSF).
3/ Government investment comprises gross capital formation plus the investment of state enterprises.
IR: Inflation report.
* Forecast.

Evolution of fiscal revenues

44. In Q1-2011 the **current revenues of the general government** amounted to 21.6 percent of GDP. This result, which represents an increase of 14 percent in real terms, is mostly explained by the growth observed in the regularization of income tax (74 percent in real terms) and also by a significant increase in the revenues from income tax in the mining sector, which represents approximately one third of revenues from corporate income taxes and recorded an increase of 44 percent in January-April. On the side of non tax revenues, it is worth pointing out revenues from oil royalties (canon) and oil and mining royalties grew by a real 38 percent, a result explained by the high international prices of crude and main mineral exports.



45. The **general government current revenues** in 2011 (20.3 percent of GDP) would be higher than those projected in the March Inflation Report (19.5 percent of GDP), basically due to the growth of revenues from the income tax which would offset the lower revenues associated with the tax measures approved in the last months that established the reduction of the rates of VAT, ITF, and tariffs. These higher tax revenues would also be coupled by a 10 percent increase in non tax revenues due to the higher revenues from oil canon and oil royalties. Therefore, the revenues of the general government in 2011 are estimated to record a growth rate of 9.4 percent, a higher rate than the one considered in our March Report (5.5 percent).

Table 21
GENERAL GOVERNMENT CURRENT REVENUES
(% of GDP)

	2010		2011*			2012*		2013*
	Q1	Year	Q1	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
TAX REVENUES	**15.9**	**15.2**	**16.7**	**14.8**	**15.4**	**14.6**	**15.3**	**15.3**
Income tax	6.8	5.9	7.6	6.0	6.6	6.0	6.6	6.6
Value added tax	8.4	8.2	8.5	8.0	8.2	8.1	8.2	8.2
Excise tax	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Import duties	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Other tax revenues	1.2	1.4	1.1	1.2	1.3	1.2	1.2	1.2
Tax returns	-1.9	-1.8	-1.9	-1.8	-1.9	-1.9	-2.0	-2.0
NON TAX REVENUES	**3.3**	**3.0**	**3.1**	**3.1**	**3.1**	**3.0**	**3.1**	**3.2**
CONTRIBUTIONS	**1.7**	**1.7**	**1.7**	**1.7**	**1.7**	**1.7**	**1.8**	**1.8**
TOTAL	**20.9**	**19.8**	**21.6**	**19.5**	**20.3**	**19.3**	**20.2**	**20.2**

* Forecast.

Graph 51
GENERAL GOVERNMENT CURRENT REVENUES
(% of GDP)

* Forecast.

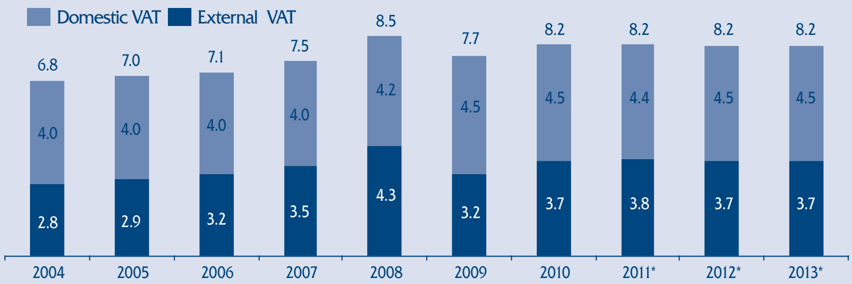
46. Revenues from the **income tax** would amount to 6.6 percentage points of GDP in 2011, showing a significant growth compared to 2010 as a result of the dynamism of economic activity and the continuous high levels of the prices of mineral exports. It is worth pointing out that, in accordance with regulations in force, the ratios used to determine payments on account of income tax –obtained by dividing the tax to be paid for fiscal year 2010 by total net income in the same period– have been raised since April.

Graph 52
INCOME TAX AND EXPORT PRICE INDEX

* Forecast.

47. Revenues from the **value added tax** (VAT), the main tax revenue, would amount to 8.2 percent of GDP, showing a similar level to the one registered in 2010. A series of administrative measures were implemented since the beginning of the year to continue reducing tax evasion and to broaden the tax base. For example, goods such as gold, paprika, and asparagus, as well as construction contracts, have been included in the tax withholding on sales system, which has had a positive effect on tax collection in these months.

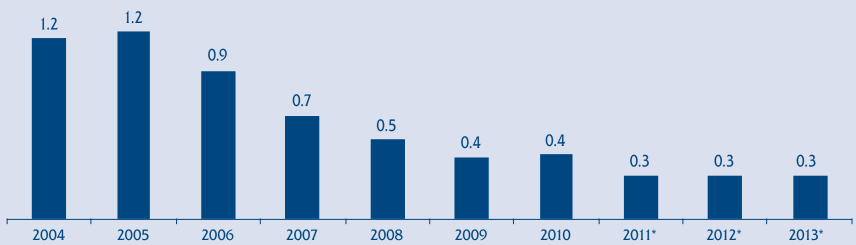
Graph 53
VALUE ADDED TAX
(% of GDP)



Memo: The addition of components may not fit due to roundup.
* Forecast.

48. Revenues from **import duties** would amount to 0.3 percent of GDP at end 2011. This projection considers the reduction of tariffs for a group of 797 tariff items established in April (S.D. 055-2011-EF of April 10, 2011) as a result of which the average nominal tariff rate was lowered from 3.4 to 3.2 percent. This reduction adds onto the one established at end 2010 for another group of 340 tariff items, which resulted in a reduction of the nominal tariff rate from 5.0 to 3.4 percent.

Graph 54
IMPORT FARES
(% of GDP)



* Forecast.

Graph 55
AVERAGE NOMINAL IMPORT FARE RATE
(%)

49. In addition to this, revenues in 2011 would be favored by the growth of non tax revenues associated with higher oil and mining royalties, as well as with the additional revenues from the remnant of firms' profits that go to regional governments. It should be pointed out that workers participate in the profits of companies in a percentage of annual income before taxes. When there is a remnant between the percentage and the limit of participation in earnings per worker, the resulting amount up to a limit of 2,200 tax units goes to the National Job Training and Employment Promotion Fund (FONDOEMPLEO). If there is any additional remnant, it is transferred to the regional governments to finance exclusively road infrastructure projects.

50. In **2012** the current revenues of the general government would grow 5.4 percent, as a result of which the ratio of these revenues to GDP would be 20.2 percent, slightly lower than in 2011 (20.3 percent). This is mainly explained by the fact that impact of the recently established measures on tax revenues would only be fully reflected in revenues in 2012, in contrast with 2011 when revenues were affected only in certain months. Revenues in **2013** would remain in the ratio of 20.2 percent of GDP. It is worth pointing out that several of the tax stability contracts signed in the nineties with mining companies will expire in the next years, which implies that some mining companies will start paying royalties. These resources will be allocated to local governments (80 percent), regional governments (15 percent), and public universities (5 percent).

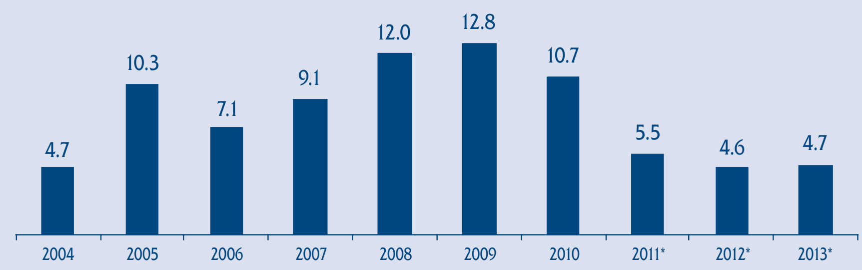
Evolution of government expenditure

51. In Q1-2011 the **non financial expenditure of the general government** represented 14.5 percent of GDP. Current non financial expenditure grew 5.8 percent. About 50 percent of this growth of expenditure is explained by payments for obligations to the Fuel Price Stabilization Fund (S/. 600 million). As regards capital expenditure (down 17.7 percent), sub national governments reduced their investments significantly: 60 percent in the case of local governments and 7 percent in the case of regional governments. This evolution is associated with the elections cycle because the recently elected municipal and regional authorities have to familiarize themselves with the processes involved in the management of public expenditure.

52. This dynamic of government expenditure would continue in Q2, which is explained by the approval of Emergency Decree 012-2011 (dated March 31, 2011), enacted with the purpose of ensuring compliance with the fiscal rule set forth especially for this year in the Fiscal Balance Law which establishes that an annual surplus of 2 percent of GDP should be generated in the first semester of this year. With this aim, a series of expenditure limits have been established for programmed annual

commitments and the approval of new supplementary credits financed through ordinary resources has been suspended, among other measures. Emergency Decree 012-2011 was repealed on June 10. The expenditure of the general government in 2011 is projected to be the one considered in the MMF of May 2011.

Graph 56
NON FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT
(Real % change)



* Forecast.

53. The non financial expenditure of the general government should grow by a real 5.5 percent in 2011 to be consistent with the previously mentioned level of expenditure. The projection of expenditure in this year includes the recently approved extraordinary bonus for active personnel of the Armed Forced and Police in effect since May, which is equivalent to 20 percent of pensionable remunerations. Furthermore, a total of S/. 1.26 billion has been paid so far this year to the Fuel Price Stabilization Fund (S/. 600 million in March and S/. 664 million in May) through Treasury transfers.

    It should be pointed out that specific fiscal rules apply in 2011 since this is a year when general elections take place. Thus, the non financial expenditure of the general government in the first seven months of the year should not exceed 60 percent of the non financial spending budgeted for this year and the fiscal deficit in the first semester should not exceed 50 percent of the annual deficit.

54. Placements of sovereign bonds to finance regional governments' investment projects have been suspended (E.D. 021-2011 dated May 14, 2011) as long as market conditions are compatible with the guidelines of the Annual Indebtedness and Debt Management Program. However, the Treasury has been authorized to transitorily support regional governments' projects with up to S/. 888 million in order that the continuity of project implementation is not affected. These resources will be repaid through future issuances of sovereign bonds for regional governments.

55. Some extraordinary measures have also been approved to strengthen the Fiscal Stabilization Fund (FSF), including an extraordinary contribution of S/. 2 billion from the Treasury, the transfer of 50 percent of the balances in the funding source of Directly Collected Resources from agencies attached to the Executive in the 2010 fiscal year balance, and the resources of public funds to become extinct as a result of the rationalization established in the Financial Balance Act of 2011. With these contributions, plus the usual transfer of regular resources, the balance of the FSF in late June would amount to US$ 5.6 billion, which is roughly equivalent to 3.3 percent of GDP.

    Considering that the impact of the recent international financial crisis was 4 percent of GDP, higher deposits in the FSF are still required to be able to implement a countercyclical fiscal policy in order to face a new negative shock.

56. In **2012** and **2013** non financial spending would increase 4.6 and 4.7 percent, respectively. An aspect to take into account is that expenditure in maintenance of infrastructure should be ensured in the next years to guarantee the continuity over time of the significant government investment executed in the last years, which has nearly reached 6 percent of GDP in 2011.

    The projections of government expenditure are consistent with the annual fiscal rules on the deficit and the growth of expenditure contained in the Fiscal Responsibility and Transparency Law, which have been fully restored since 2011 after the exceptions established for years 2009 and 2010. Thus, the deficit can not be higher than 1 percent of GDP and the increase in the central government's consumption spending can not be higher than 4 percent in real terms, including expenditure in salaries, pensions, and goods and services.

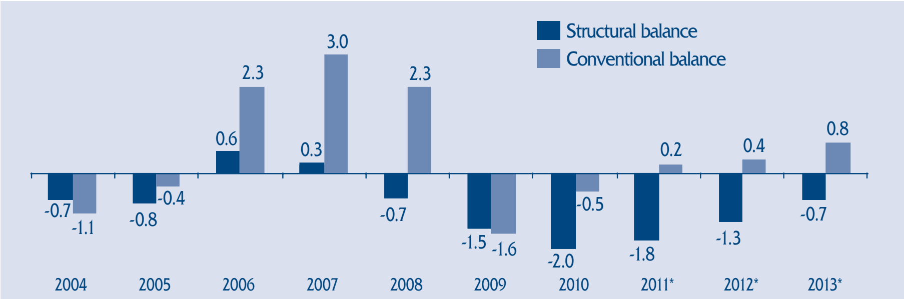
Structural economic balance and fiscal impulse

57. The **structural economic balance**, indicator that shows the evolution of fiscal policy decisions since the effects of the economic cycle and of the prices of the main mineral exports are deducted from the conventional economic balance, was negative by 2.0 percent of GDP in 2010

    A structural deficit of 1.8 percent of GDP is estimated for 2011. This balance would improve to 1.3 percent of GDP in 2012, which would be consistent with the moderation of the growth of government expenditure foreseen in our last Report

58. The **Fiscal impulse**, which shows the net expansionary effect of fiscal policy on domestic demand, was equivalent to 0.7 percent of GDP in 2010, which indicates that fiscal policy was expansionary during this year. In 2011 and 2012 the fiscal impulse would be contractive by 0.2 and 0.4 percent of GDP, respectively.

Graph 57
CONVENTIONAL AND STRUCTURAL BALANCE OF THE NON FINANCIAL PUBLIC SECTOR
(% of GDP)



* Forecast.
Memo: The structural result includes adjustments in the output gap and the terms of trade considering a period of 10 years for the reference price, as in Nota de Estudios No. 51 (2008). Moreover, the structural economic result discounts the payments made to the Fuel Price Stabilization Fund and includes the accrued expense (net compensation) for this expenditive.

Graph 58
FISCAL IMPULSE
(% of GDP)

* Forecast.
Memo: The fiscal impulse is the difference in the structural result, which is an indicator of how the fiscal position affects the economic cycle.

Financial requirements

59. In 2011, the **public sector's financial requirements** would amount to US$ 1.01 billion, amount consistent with the economic balance estimated for the year (surplus of 0.2 percent of GDP) and with the amortization of the debt projected. Financial requirements in 2012 are estimated at US$ 1.09 billion, while a negative financial requirement of US$ 308 million is estimated for 2013, basically due to the fiscal positive results foreseen for the next years.

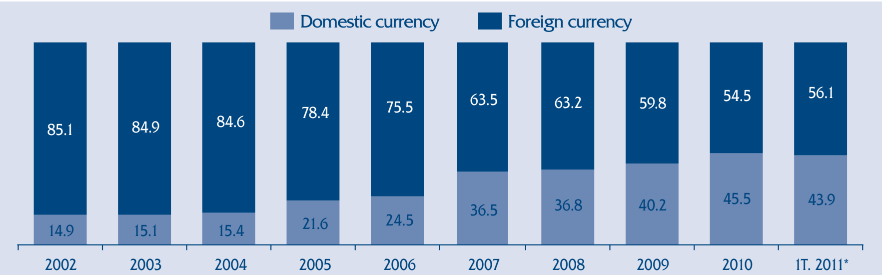
Table 22
FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR 1/
(Millions of US$)

	2010		2011*			2012*		2013*
	1Q.	Year	1Q.	IR Mar.11	IR Jun.11	IR Mar.11	IR Jun.11	IR Jun.11
I. Uses	**-681**	**2,310**	**-2,036**	**1,873**	**1,014**	**1,667**	**1,086**	**-308**
1. Amortization	390	1,496	253	1,329	1,422	1,762	1,742	1,382
a. External debt	157	952	141	788	880	1,191	1,182	956
b. Domestic debt	234	543	112	541	543	571	560	426
Of which: Recognition bonds	23	263	40	253	234	287	292	170
2. Overall balance (negative sign indicates surplus)	-1,071	814	-2,289	545	-408	-96	-656	-1,690
II. Sources	**-681**	**2,310**	**-2,036**	**1,873**	**1,014**	**1,667**	**1,086**	**-308**
1. External	243	1,532	301	1,119	1,168	1,065	747	860
2. Bonds 2/	221	835	43	739	404	815	0	0
3. Internal 3/	-1,146	-56	-2,380	15	-558	-214	339	-1,168
Memo:								
Balance of gross public debt								
Billion US$	33.9	36.2	36.0	36.7	37.2	37.5	36.9	36.6
% of GDP	25.2	23.5	22.5	21.3	21.5	19.6	19.3	17.6
Balance of gross public debt 4/								
Billion US$	17.0	17.9	15.8	17.7	17.7	17.2	17.1	15.2
% of GDP	12.6	11.7	9.9	10.3	10.2	9.0	9.0	7.3

RI: Inflation report.
* Forecast.
1/ The effect of exchanging treasury bonds for longer-maturity bonds, as well as the effect of placements made for the prepayment of both internal and external operations has been isolated in the case of amortization and disbursements.
2/ Includes domestic and external bonds.
3/ A positive sign indicates a withdrawal or overdraft and a negative sign indicates higher deposits.
4/ Defined as the difference between gross public debt and NFPS deposits.
Source: BCRP. MEF.

60. The total public sector debt at March 2011 amounted to US$ 35.97 billion (22.5 percent of GDP), of which 56 percent corresponds to external debt and 44 percent to domestic debt. Debt management operations amounting to US$ 128 million were carried out in Q1. These operations were mainly aimed at modifying the government debt portfolio in terms of currencies and interest rates.

Graph 59
BALANCE OF THE PUBLIC DEBT BY CURRENCY
(%)



* Forecast.

61. A significant reduction is projected in the gross and net debt towards the end of 2013 as a result of both the improvement foreseen in fiscal accounts –which will allow an increase in their level of assets– and the expected growth of economic activity. The gross debt would decline from 23.5 percent of GDP in 2010 to 17.6 percent in 2013 and the net debt would reach 7.3 percent of GDP in the same year.

Graph 60
PUBLIC DEBT
(% of GDP)

* Forecast.

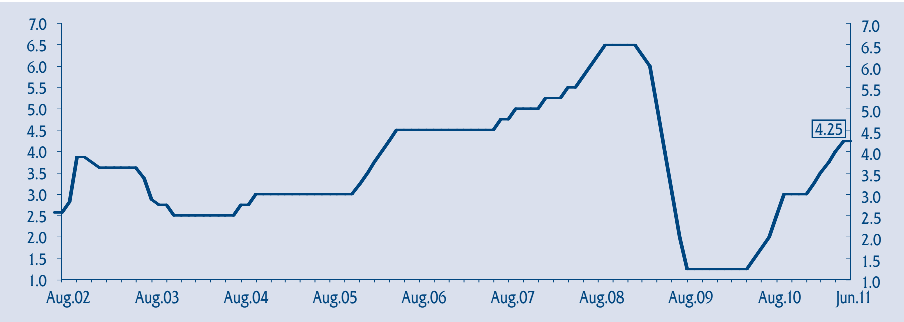
V. Monetary Policy

62. The Board of the Central Bank continued raising the reference interest rate by 25 basis points each month in the first five months of the year, as a result of which this rate rose from 3.0 percent in December 2010 to 4.25 percent in May 2011. The reference rate was raised in a context of growing international food and fuel prices and high dynamism of domestic demand with the aim of preventing that the price rises would translate into economic agents' expectations of inflation and in this way into the formation of the rest of prices in the consumer basket.

    The reference rate was maintained at 4.25 percent in June in a context in which a moderation was observed in the rise of consumer prices and some indicators of activity.

    The Central Bank considers that some external risk factors that could reverse the growth of prices and economic activity still persist, including the fiscal weakness of some European economies, the slow economic recovery of the United States, and the effect of Asian countries' actions to moderate their growth.

Graph 61
BCRP REFERENCE INTEREST RATE
(%)



RECENT POLICY RATE MEASURES:
March – June 2011

March: The Board of the Central Reserve Bank of Peru approved to raise the monetary policy reference from 3.50 percent to 3.75 percent.

The nature of this rise in the reference rate is mainly preventive in a context of rising international food and energy prices. This measure is aimed at offsetting the potential impact of these supply factors on inflation expectations in a context of growth of domestic demand. Future adjustments in the reference rate will depend on new information on the evolution of inflation and its determinants.

April: The Board of the Central Reserve Bank of Peru approved to raise the monetary policy reference from 3.75 percent to 4.0 percent.

This measure is aimed at offsetting the impact of the rise in the international prices of food and fuels on inflation expectations, in a context of high growth of domestic demand. Future adjustments in the reference rate will depend on new information on the evolution of inflation and its determinants.

May: The Board of the Central Reserve Bank of Peru approved to raise the monetary policy reference from 4.0 percent to 4.25 percent.

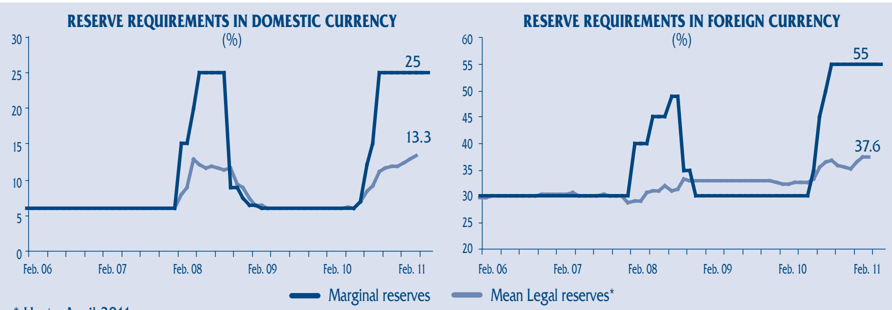
This measure is aimed at offsetting the impact of the rise in the international prices of food and fuels on inflation expectations. Future adjustments in the reference rate will depend on new information on the evolution of inflation and its determinants.

June: The Board of the Central Reserve Bank of Peru approved to maintain the monetary policy reference at 4.25 percent.

This measure takes into account the moderation of increases in consumer prices and in some indicators of activity. Future adjustments in the reference rate will depend on new information on the evolution of inflation and its determinants.

63. The rises in the reference rate were coupled by rises of 0.5 percentage points in the rates of mean reserve requirements in domestic currency and in foreign currency in April, as a result of which the rates of legal reserves increased from 12.9 and 37.4 percent to 13.3 and 37.6 percent, respectively, between March and April 2011.

Graph 62



* Up to April 2011.

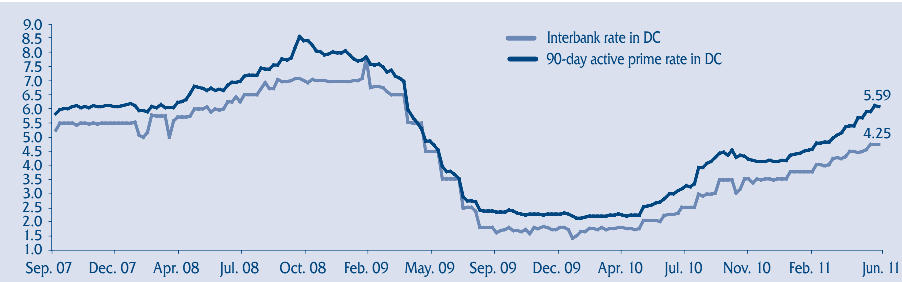
Table 23
RECENT RESERVE REQUIREMENTS POLICIES
(%)

	Domestic Currency				Foreign currency				
					General regime		Foreign liabilities		
	Legal minimun reserve requirements	Marginal reserve requirements for deposits	Increase in the average reserve requirements	Non residents reserve requirements	Marginal reserve requirements for deposits	Increase in the average reserve requirements	Short term	Long term	Reference interest rate
Mar-09	6.0			35	30		0	0	6.00
Feb-10	6.0			35	30		35	0	1.25
Jul-10	7.0			40	35		40	0	2.00
Aug-10	8.0	12		50	45	0.10	50	0	2.50
Sep-10	8.5	15		120	50	0.20	65	0	3.00
Oct-10	9.0	25		120	55	0.20	75	0	3.00
Nov-10	9.0	25		120	55		75	0	3.00
Dec-10	9.0	25		120	55		75	0	3.00
Jan-11, 1/	9.0	25		120	55		60	0	3.25
Feb-11	9.0	25	0.25	120	55	0.25	60	0	3.50
Mar-11	9.0	25	0.25	120	55	0.25	60	0	3.75
Apr-11	9.0	25	0.50	120	55	0.50	60	0	4.00
May-11	9.0	25		120	55		60	0	4.25

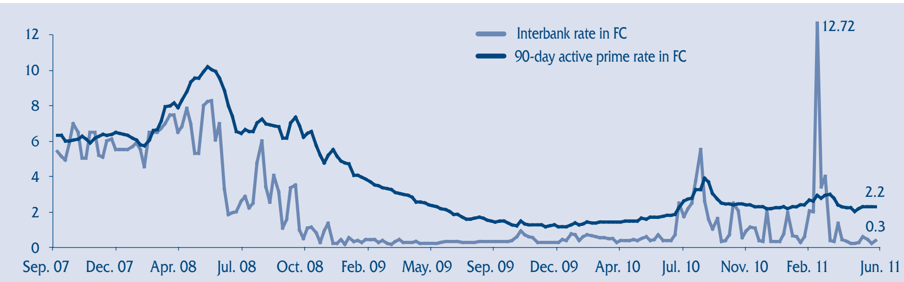
1/ The operations of local bank's branches abroad are subject to reserve requirements since January 2011.

64. These rises in the reference rate translated into rises in the financial system and capital market interest rates. The 90-day lending rates rose from 5.18 to 5.59 percent between April and May and the prime rates in foreign currency rose from 1.96 to 2.21 percent in the same period due to the increase of the rate of reserve requirements.

Graph 63
INTERBANK AND CORPORATE PRIME INTEREST RATES IN DOMESTIC CURRENCY
(%)



Graph 64
INTERBANK AND CORPORATE PRIME INTEREST RATES IN FOREIGN CURRENCY
(%)



65. By type of placements, interest rates in domestic currency on corporate loans showed a mixed conduct. The rates on loans for micro enterprises declined from 32.5 percent in March to 31.5 percent in May, the rates on loans for small businesses fell from 24.6 to 23.8 percent and the rates on loans for medium-size firms fell from 11.1 to 11.0 percent, while the rates on loans for large enterprises and corporate firms rose from 7.5 to 8.0 percent and from 5.4 to 6.1 percent, respectively. Moreover, the rates on consumer loans rose from 38.4 to 39.3 percent and mortgage rates rose from 9.4 to 9.6 percent in the same period.

Table 24
INTEREST RATES BY TYPE OF CREDIT IN DOMESTIC AND FOREIGN CURRENCY [1/]
(%)

	Domestic Currency [2/]						
	Corporate	Large enterprises	Medium-size firms	Small business	Microbusiness	Consumption	Mortgages
Sep-10	5.5	6.4	8.7	23.6	30.9	39.5	9.6
Oct-10	5.6	6.3	9.5	23.2	31.3	38.4	9.5
Nov-10	5.1	6.1	10.1	23.7	31.5	37.8	9.5
Dec-10	4.6	5.9	10.3	23.3	27.2	40.7	9.3
Jan-11	4.8	6.2	10.5	23.1	24.5	39.6	9.3
Feb-11	5.4	6.9	10.7	24.6	31.5	38.2	9.3
Mar-11	5.4	7.5	11.1	24.6	32.5	38.4	9.4
Apr-11	5.6	7.6	10.5	24.3	31.7	38.4	9.4
May-11	6.1	8.0	11.0	23.8	31.5	39.3	9.6
	Foreign Currency [2/]						
	Corporate	Large enterprises	Medium-size firms	Small business	Microbusiness	Consumption	Mortgages
Sep-10	4.3	5.5	9.5	15.0	15.5	21.3	8.4
Oct-10	3.8	5.5	9.3	14.7	15.5	22.0	8.3
Nov-10	3.2	5.3	9.1	14.3	15.8	20.9	8.2
Dec-10	3.3	5.5	8.6	14.2	14.8	19.4	8.1
Jan-11	3.5	5.5	8.6	14.2	14.1	21.0	8.1
Feb-11	3.5	5.3	8.8	15.6	17.0	21.4	8.2
Mar-11	3.6	5.6	9.3	16.3	16.7	20.9	8.3
Apr-11	3.1	5.5	9.0	15.8	16.3	20.5	8.4
May-11	2.7	5.3	9.4	16.1	16.1	21.2	8.5

1/ Annual active interest rates on the operations carried out in the last 30 working days.
2/ Firms' reports to the SBS include more segmented information about the average interest rates on corporate loans, credits to large, medium-size, small and micro businesses, according to the definitions included in SBS Resolution 11356-2008 and complementary regulations. The information of corporate credits to large, medium-size, and small businesses is reported since September 2010.
Source: SBS.

66. The interest rates on corporate loans in foreign currency declined between 0.4 and 0.2 percentage points, except in the case of the rates on loans for medium-size firms, consumer loans, and mortgage loans which increased from 9.3 to 9.4, from 20.9 to 21.2, and from 8.3 to 8.5 percent respectively between March and May 2011.

67. The deposit interest rates on 30-day deposits in domestic currency increased from 3.1 to 4.0 percent between March and May, while these rates on deposits in

foreign currency fell from 1.4 to 0.5 percent as a result of increased liquidity in dollars in the financial system.

Table 25
INTEREST RATES IN NUEVOS SOLES AND US DOLLARS
(%)

	Nuevos soles		US Dollars		Difference (bps) (May.11-Mar.11)	
	Mar.11	May.11	Mar.11	May.11	Nuevos soles	US Dollars
1. Deposits up to 30 days	3.1	4.0	1.4	0.5	86	-90
2. Rate on 31 to 180-day term deposits	3.0	3.4	1.1	1.0	33	-1
3. Rate on 181 to 360-day term deposits	4.0	4.2	1.7	1.7	23	-3
4. Corporate prime rate	4.4	5.4	2.8	2.1	98	-69
5. TAMN / TAMEX	18.7	18.5	7.8	8.0	-20	17

68. The Central Bank has been placing 6-month and 12-month Certificates of Deposit (CDBCRP) for a total of S/. 50 and S/. 30 million, respectively, on a weekly basis since January of this year with the aim of completing all the short term reference yields.

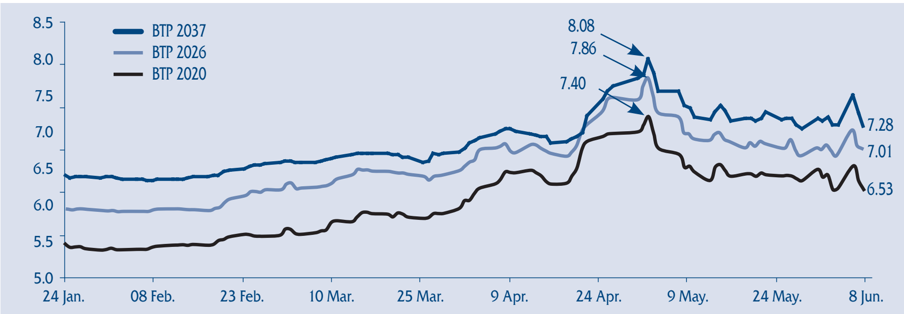
Graph 65
WEEKLY AUCTIONS OF CDBCRP
(Annual % rates)

The yields on CDBCRP should serve as reference to build a short term yield curve that will allow to dynamize the market of interest rate swaps, which contribute to mitigate the risk of having liabilities at floating interest rates. The development of this instrument requires the approval of the bill on Repo Operations, which has been submitted to the Congress in order to provide this instrument with the legal framework required and to define in this way the technological infrastructure for these transactions.

The yields on CDBCRP also serve as a basis to value fixed-income assets in the short tranche of the yield curve, which contributes in turn to strengthen the transmission channel of the monetary interest rate.

69. Between March and April 2011, the yield curve on sovereign bonds was adjusted upwards in the long term tranche of the curve due to local and foreign investors' lower demand for longer term bonds –associated probably with the elections period–, while a downward correction was observed in this tranche in May. After the elections results, the yields on longer term bonds increased in June, although showing lower levels than the ones recorded at end of April, declining thereafter to similar levels than those observed at the end of May.

Graph 66
YIELD TO MATURITY OF BTP: 2011
(%)



Non-residents' holdings of sovereign bonds declined by S/. 277 million between February and May 2011, which implied that non-residents' share of total holdings of sovereign bonds fell from 38 to 37 percent.

Table 26
NON RESIDENTS' HOLDINGS OF SOVEREIGN BONDS
(Millions of nuevos soles)

Date	BTP*	Change	% Balance of BTP
Dec.07	5,042		27
Dec.08	5,189	147	27
Dec.09	4,053	-1,136	19
Mar.10	3,594	-111	17
Jun.10	4,643	644	20
Jul.10	5,653	1,010	24
Aug.10	6,650	997	28
Sep.10	7,535	885	32
Oct.10	8,015	87	33
Nov.10	10,640	2,625	38
Dec.10	10,663	23	38
Jan.11	10,944	281	39
Feb.11	10,809	-135	38
Mar.11	10,690	-119	38
Apr.11	10,694	4	38
May.11	10,532	-162	37

* Sovereign bonds (Global Depositary Notes) for a total of S/. 4,196 Millions (US$ 1.5 billion) were issued on November 18, 2010.

Monetary operations

70. The operations of the Central Bank were mainly aimed at maintaining appropriate liquidity levels and at ensuring the flow of operations in the money market, in a context of banks' higher preference for short term instruments due to expectations of rises in the policy interest rate.

As part of its liquidity injection strategy, between March and May 2011 the Central Bank allowed a net maturity of its sterilization instruments for a total of S/. 8.86 billion, consisting mainly of term deposits (S/. 10.65 billion), which was relatively offset by the placement of S/. 1.60 billion of BCRP Certificates of Deposit and by public sector deposits in the BCRP for a total of S/. 6.79 billion. In the same period, the government withdrew a net total of S/. 1.53 billion from the Central Bank, which included S/. 8.32 billion of deposits withdrawn from the Central Bank to buy foreign currency from the BCRP (US$ 3.01 billion) to increase the balance of the Fiscal Stabilization Fund.

In this way, as shown in the table below, public sector deposits increased from representing 34.8 percent of net international reserves (NIRs) in March to 37.8 percent in May, while the share of BCRP instruments declined from 19.1 to 14.2 percent, and the share of deposits of reserve requirements increased from 24.4 to 25.9 percent in the same period.

Table 27
BCRP SIMPLIFIED BALANCE SHEET
(As % of Net International Reserves)

Net Assets	31.Mar.11	31.May.11
I. Net International Reserves	**100** (US$ 46,127 mills.)	**100** (US$ 46,307 mills.)
Net Liabilities		
II. Total public sector deposits	**34.8**	**37.8**
In domestic currency	25.4	22.6
In foreign currency	9.4	5.5
III. Total reserve requirements	**24.4**	**25.9**
In domestic currency	5.8	6.2
In foreign currency 1/	18.5	7.1
IV. BCRP Instruments	**19.1**	**14.2**
CD BCRP	0.8	1.3
CDV BCRP	8.4	7.7
CDR BCRP	0.2	1.4
CDLD BCRP	0.1	0.0
Term deposits	9.6	3.8
V. Currency	**17.5**	**18.1**
VI. Other	**4.2**	**4.4**

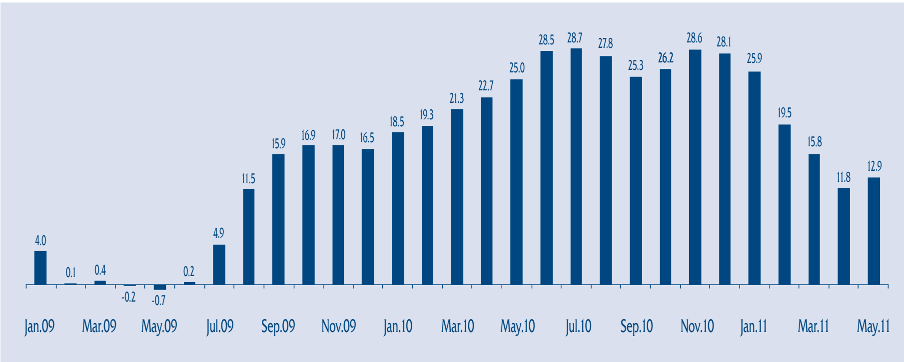
1/ Includes banks' overnight deposits at the central bank.

It should be pointed out that in the second week of May the Central Bank made 1-day repo operations for a daily average of S/. 1.65 billion to provide liquidity in nuevos soles to the financial entities that required higher funding for reserve requirements.

In addition to this, the Central Bank continued periodically placing 6-month and 12-month CD BCRP through auctions of S/. 50 and S/. 30 million of these certificates of deposit each time to continue promoting the development of the capital market through the formation of the yield curve. These operations reached a balance of S/. 1.65 billion in May.

71. Average deseasonalized currency in circulation would have grown by a monthly rate of 2.0 percent in May, thus accumulating a growth rate of 21.0 percent in the last 12 months. In April, currency in circulation recorded a monthly growth rate of 1.3 percent and an annual growth rate of 22.2 percent. Moreover, the quarterly growth rate of average moving quarterly deseasonalized currency in May was 12.9 percent, higher than in April (11.8 percent).

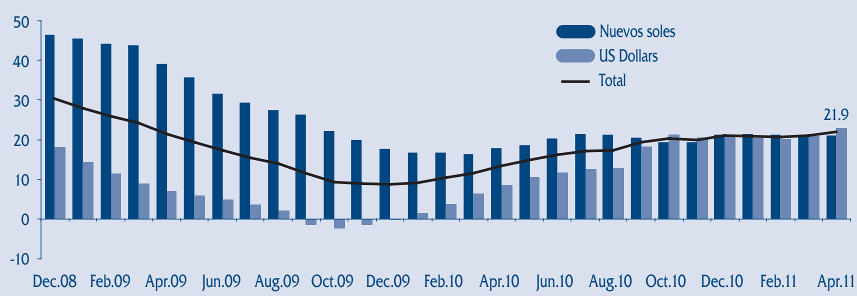
Graph 67
MOVING QUARTERLY SEASONALLY ADJUSTED AVERAGE CURRENCY
(Annualized quarterly % change)



Credit

72. **Credit to the private sector** in April paralleled the high dynamism of economic activity in the period recording a growth rate of 21.9 percent in the last 12 months. By **type of currencies**, credit to the private sector in nuevos soles grew at an annual rate of 21.0 percent in April and credit to the private sector in foreign currency grew 23.0 percent.

Graph 68
CREDIT TO THE PRIVATE SECTOR
(12-month growth rate)



Credit		Dec.07	Dec.08	Dec.09	Jun.10	Sep.10	Jan.11	Feb.11	Mar.11	Apr.11
Nuevos soles	Monthly flow	928	1,250	422	1,265	426	598	978	1,077	1,584
	Annual % change	37.9	46.4	17.6	20.3	20.4	21.4	21.3	21.1	21.0
	Monthly % change	2.9	2.6	0.7	2.0	0.7	0.9	1.4	1.5	2.2
US$	Monthly flow	373	34	304	234	629	8	189	372	711
	Annual % change	26.8	18.1	0.0	11.7	18.2	20.2	20.1	21.0	23.0
	Monthly % change	2.5	0.2	1.7	1.2	3.2	0.0	0.9	1.7	3.2
Total	Monthly flow	1,977	1,346	1,275	1,921	2,193	620	1,508	2,122	3,581
	Annual % change	31.4	30.5	8.6	16.1	19.4	20.8	20.7	21.0	21.9
	Monthly % change	2.7	1.4	1.2	1.7	1.8	0.5	1.1	1.6	2.6

73. By type of financial entity, the growth of credit in April was led by commercial banks and financial firms (3.0 and 2.1 percent, respectively).

Table 28
TOTAL CREDIT TO THE PRIVATE SECTOR, BY TYPE OF FINANCIAL INSTITUTION

	Balance in millions of nuevos soles			Growth rates (%)			Flows in millions of nuevos soles		
	Apr.10	Mar.11	Apr.11	Mar.11/ Mar.10	Apr.11/ Apr.10	Apr.11/ Mar.11	Mar.11/ Mar.10	Mar.11/ Feb.11	Apr.11/ Mar.11
Banks*	95,503	112,507	115,845	20.1	21.3	3.0	20,342	1,785	3,338
State banks	3,229	3,588	3,611	13.0	11.8	0.6	381	42	23
Microfinance Institutions	15,074	19,055	19,275	29.0	27.9	1.2	4,201	294	220
Municipal banks	7,250	8,790	8,882	23.4	22.5	1.0	1,632	134	92
Financial firms	3,811	5,414	5,529	48.2	45.1	2.1	1,719	128	115
Other	4,014	4,851	4,864	21.5	21.2	0.3	850	32	13
TOTAL	**113,807**	**135,151**	**138,731**	**21.0**	**21.9**	**2.6**	**24,924**	**2,122**	**3,581**

* Includes loans made by banks branches abroad.

74. By sectors, the dynamism of credit to businesses and individuals was noteworthy, with growth rates of 22.0 and 21.7 percent, respectively. The growth of credit oriented to foreign trade activities also stands out in terms of corporate loans in the period with an annual growth rate of 60.3 percent, while mortgage loans and consumer loans maintained their dynamism recording annual growth rates of 27.0 and 18.6 percent, respectively.

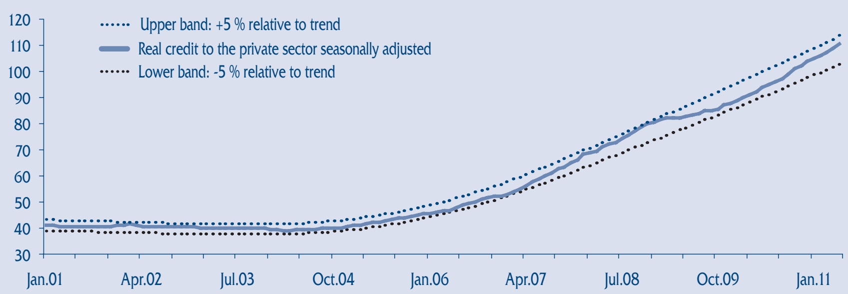
Table 29
TOTAL CREDIT TO THE PRIVATE SECTOR, BY TYPE OF PLACEMENTS 1/

	Balance in millions of nuevos soles			Growth rates (%)			Flows in millions of nuevos soles		
	Apr.10	Mar.11	Apr.11	Mar.11/ Mar.10	Apr.11/ Apr.10	Apr.11/ Mar.11	Mar.11/ Mar.10	Mar.11/ Feb.11	Apr.11/ Mar.11
Business loans 1/	76,414	90,372	93,209	20.6	22.0	3.1	16,795	1,267	2,836
Of which:									
Foreign trade	5,620	7,977	9,009	43.7	60.3	12.9	3,389	1,127	1,032
Loans to individuals	37,393	44,778	45,523	21.9	21.7	1.7	8,129	855	744
Consumer loans	23,505	27,510	27,880	19.0	18.6	1.3	4,375	371	370
Mortgages	13,889	17,268	17,643	26.7	27.0	2.2	3,754	483	375
TOTAL	**113,807**	**135,151**	**138,731**	**21.0**	**21.9**	**2.6**	**24,924**	**2,122**	**3,581**

1/ Comprises business loans plus holdings of corporate bonds, including the loans made by banks' branches abroad.

75. The current evolution observed in credit to the private sector has been consistent with the sustainable growth pattern recorded in the last years, which has been in line with the growth of the Peruvian economy. Credit to the private sector has not shown deviations of +/- 5 percent from its long term trend even during the periods of the recent financial crisis.

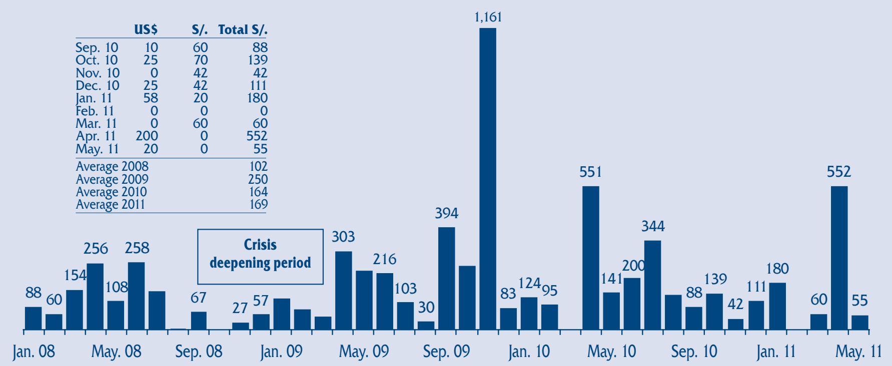
Graph 69
CREDIT TO THE PRIVATE SECTOR FROM DEPOSIT SOCIETIES 1/
(Billions of nuevos soles)



1/. Seasonally adjusted serie, by the constant exchange rate and in real terms. Trend is calculed using the Hodrick Prescott filter.

76. Credit outside the financial sector continued to be associated with large energy and infrastructure enterprises. The average issuance of bonds by non financial firms increased significantly in Q2 compared to Q1, basically due to Hunt Oil Company's issuance of bonds for a total of US$ 200 million in April to finance its operations in Peru.

Graph 70
BOND ISSUED BY NON-FINANCIAL FIRMS*
(Millions of nuevos soles)



* Bonds issued in US dollars are valued at the exchange rate of the last month. Includes securitization bonds.

Exchange rate

77. Uncertainty in the period of April and May led to volatility in the exchange rate. The demand for dollars that came from non resident investors and AFPs in this period (US$ 1.27 billion and US$ 544 million, respectively) was offset by private investors' supply of dollars (US$ 828 million). Excess demand was covered by the BCRP exchange rate operations (US$ 1.02 billion). With this, a differentiated evolution was observed in the exchange rate, which showed depreciation pressures in April and appreciatory pressures in May and reflected in differentiated exchange rate flows.

Table 30
BANKS' OPERATIONS IN FOREIGN CURRENCY[1]
(Millions of US$)

	1Q.11			Apr.11 - May.11		
	Spot	Forward	Total	Spot	Forward	Total
1. AFP	459	581	1,041	127	417	544
2. Non residents	77	301	378	153	1,121	1,274
3. Local mutual funds	-2,534	2,534	0	-118	118	0
4. Nación and financial institutions	176	26	202	52	23	75
5. Other	-2,756	550	-2,206	-912	84	-828
6. Total	**-4,577**	**3,992**	**-585**	**-700**	**1,763**	**1,063**
7. Change in international position			**303**			**-44**
Net purchases of BCRP			**497**			**-435**
CDLD BCRP operations			**-108**			**-53**
Issuance of CDR BCRP			**-107**			**-531**
Total BCRP			**282**			**-1,019**

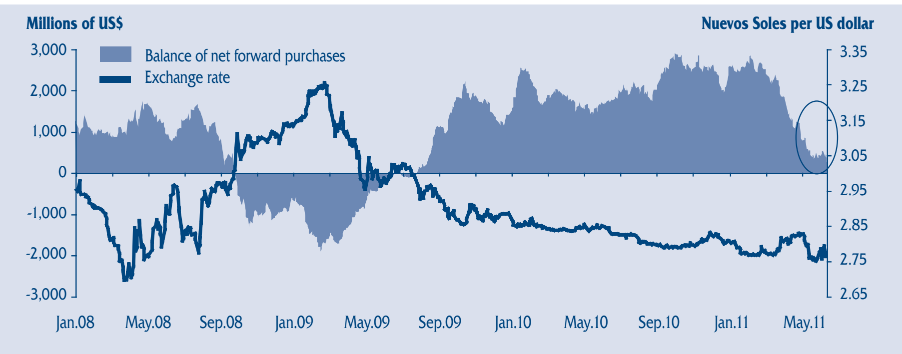
1/ A positive sign indicates demand and a negative sign indicates supply.

The exchange rate depreciated 0.7 percent in April, which reflected in an increased demand for dollars from AFPs and non resident agents (US$ 668 million and US$ 647 million, respectively) and in an increase in banks' exchange rate position (US$ 419 million). The latter was partially offset by private investors' increased supply of dollars (US$ 635 million) associated with the period of regularization of the income tax. The excess of demand for foreign currency in April was offset by the BCRP through sales of dollars (US$ 583 million) and net placements of indexed instruments (CDR) for a total of US$ 584 million.

In May the exchange rate appreciated 2.0 percent due to the higher supply of dollars from AFPs (US$ 124 million) and private companies (US$ 194 million), especially mining companies, as well as due to the reduction of banks' exchange rate position (US$ 464 million). These movements were offset by non resident investors' increased demand (US$ 627 million), which would have shown a cautious conduct due to the pre-elections context. In this period, the BCRP bought US$ 148 million in the spot market, offsetting in this way the excess of supply in the foreign exchange market.

78. Greater expectations that the exchange rate would rise reflected in a decline in the balance of banks' purchases of forwards associated with the maturities of purchase contracts and higher sales of contracts established. Thus, between the end of February and May 2011, the balance of net purchases of forwards dropped from US$ 2.52 billion to US$ 478 million.

Graph 71
BALANCE OF NET FORWARD PURCHASES AND EXCHANGE RATE
(Balance in millions of US$ and exchange rate in soles / US dollar)

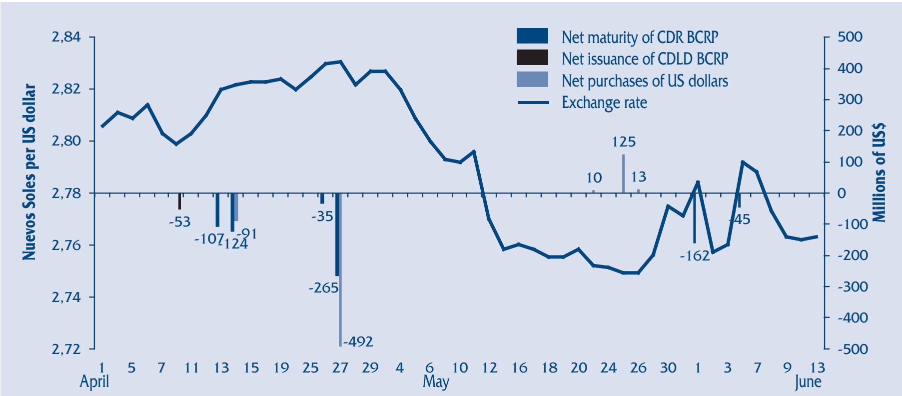


79. The BCRP intervened in the foreign exchange market with the aim of reducing the volatility of the exchange rate either through purchase and sale operations or through the issuance and maturity of instruments indexed to the exchange rate, such as the CDR BCRP and the CDLD BCRP (the last placement of this instrument was carried out on February 7, 2011). Since CDR are instruments used to meet financial entities' higher demand for dollars in the forward market, placements

of these certificates are a way of reducing depreciatory pressures. CDLD are new instruments in nuevos soles, payable in dollars at the exchange rate recorded at the time of the placement (financial agents pay dollars to buy the CDL) and at the time of their maturity (financial agents receive the equivalent value in dollars). The maturity of these certificates also constitutes a higher supply of dollars from the BCRP.

80. Excessive upward volatility was observed in the exchange rate after the first elections round (April 10), which reflected in an increased demand for dollars in the foreign exchange market. This volatility was offset through the sale of US$ 583 million in the spot market (on April 14 and 27) and through the placement of US$ 531 million of CDR BCRP (on April 13, 14, 26, and 27), as well as through CDLD maturities amounting to US$ 53 million.

Graph 72
INTERVENTION AND EXCHANGE RATE: APRIL-JUNE 2011



* Negative (positive) sign indicates supply (demand) by the Central Bank in the foreign exchange market.

The nuevo sol continued appreciating against the US dollar thereafter, resuming the trend observed prior to the beginning of the elections period. Little volatility was observed in the foreign exchange market and in the exchange rate in the rest of May, except in the last week of the month when the BCRP bought US$ 148 million (on May 23, 25, and 26). So far in June, the Central Bank has issued CDR BCRP for a total of US$ 207 million to reduce the excessive volatility in the exchange rate associated with the elections result.

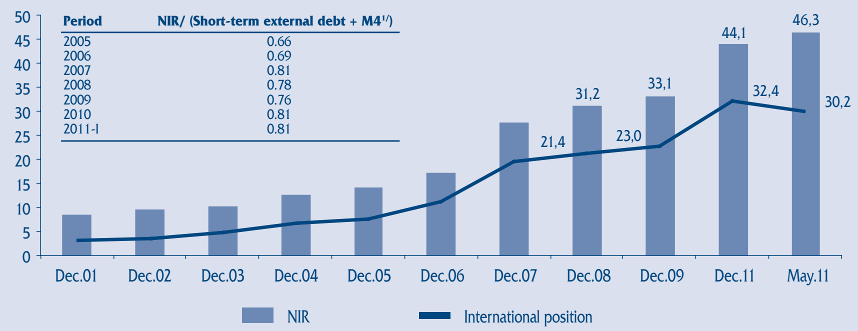
81. The BCRP survey on expectations about the exchange rate in the period of 2011-2012 shows higher expected levels in the exchange rate on average, reflecting increased uncertainty about this variable among financial entities, non financial firms, and economic analysts.

Table 31
SURVEY ON MACROECONOMIC EXPECTATIONS: EXCHANGE RATE
(Nuevo Soles per US$)

	Sep.10	Dec. 10	Jan. 11	Feb. 11	Mar. 11	Apr. 11
Financial entities						
2011	2.79	2.75	2.75	2.75	2.75	2.80
2012	2.80	2.75	2.70	2.70	2.75	2.78
Economic analysts						
2011	2.78	2.75	2.75	2.75	2.74	2.80
2012	2.72	2.70	2.75	2.69	2.70	2.79
Non-financial firms						
2011	2.82	2.81	2.80	2.80	2.80	2.82
2012	2.90	2.87	2.82	2.80	2.80	2.85
Average						
2011	2.80	2.77	2.77	2.77	2.76	2.81
2012	2.81	2.77	2.76	2.73	2.75	2.81

82. Despite financial entities' increased need for foreign currency –which led the BCRP to intervene in the foreign exchange market through direct sales of dollars and net maturities of CDLD–, international reserves increased by US$ 39 million between February and May 31, 2011, reaching a balance of US$ 46.31 billion at May 31. This level of NIRs represents 81 percent of total short term external liabilities plus total liquidity.

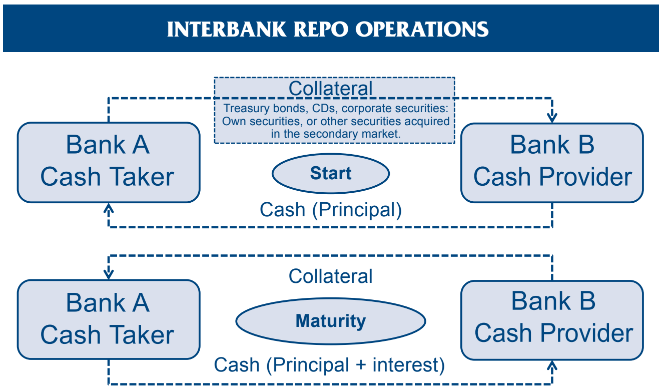
Graph 73
NET INTERNATIONAL RESERVES
(Billions of US$)



1/ Corresponds to total liquidity in deposit societies.

BOX 5
BILL ON REPO OPERATIONS, SIMULTANEOUS SALE AND PURCHASE AND TRANSFER OF SECURITIES

One of the reasons why the development of the market of repos has been limited in Peru is the lack of a law specifying the nature of such operations, recognizing the transfer of ownership of the securities involved, and specifying the accounting system required for this type of financial transactions. Since repos are neither explicitly recognized nor adequately protected in the legal framework in force by regulations ranked as laws, there is the risk that these operations may be re-characterized and interpreted as a loan against collaterals and that the regular procedure is applied to these "collaterals" in case of default by the seller. This risk makes this type of operations less attractive for financial institutions.



The bill on repo operations submitted by the Central Bank to Congress seeks to correct precisely these shortcomings in the current regulatory framework and therefore constitutes a fundamental element to promote the development of this market.

The development of the market of repo operations offers a number of benefits for the companies involved in this market, as well as for the stability of the financial system. On the one hand, it reduces the counterparty risk in lending operations in the money market, thus lowering the cost of short-term financing for companies involved in this market. In addition, because there is a lower counterparty risk, the demand for these operations is encouraged, leading to higher trading volumes which contributes to increase liquidity in the money market as well as the depth of this market.

In turn, more liquid and deeper money markets contribute to increase the effectiveness of monetary policy since this allows a greater pass-through of changes in short-term interest rates to longer-term interest rates. Moreover, in periods of financial stress, collateralized money markets reduce the probability of market segmentation, a situation which is more frequently observed in non-collateralized interbank lending markets.

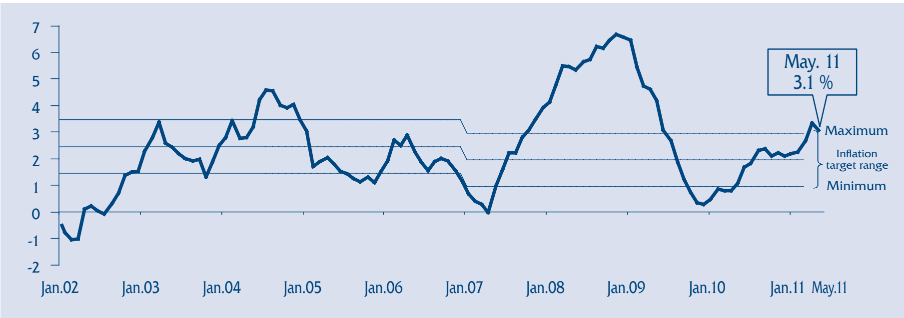
As the development of the repo market extends to longer terms, this process also contributes to develop a short term yield curve, which favors in turn the appreciation of financial assets and the development of other markets, such as interest rates swaps, which are essential to facilitate the management of financial risks.

The bill also includes the operations of temporary transfers of securities. These operations are known in other markets as security lending transactions or Security Lending. As in the case of Repos, the development of security lending generates a higher demand for fixed-income, low risk securities and therefore contributes to the development of capital markets. Moreover, in so far as a market for security lending is generated, the development of this type of operations contributes to a more efficient management of participants' liquidity in the money market.

VI. Inflation

83. So far this year inflation in the last 12 months –measured by the consumer price index (CPI)– has increased from 2.08 percent in December to 3.07 percent in May. This increase is basically explained by the impact of the rise in the international prices of products such as wheat, maize, and soybean on the domestic prices of food products. Thus, core inflation in May recorded a lower rate (2.80 percent) and the CPI excluding food and energy showed a rate of 1.80 percent.

Graph 74
INFLATION AND INFLATION TARGET
(12-month % change)



84. Like food prices, the price of crude has been rising since May 2010 from an average price of US$ 73.6 per barrel to US$ 109.6 per barrel in April 2011, showing a decline in May when in fell to US$ 100.7 per barrel. Part of this increase translated into adjustments in the price of fuels, particularly last year, and part has been absorbed by the Fuel Price Stabilization Fund.

85. Because of this, **non core inflation**, which reflects short term variations that are beyond the control of monetary policy, recorded an accelerated growth since the beginning of the year, rising from a rate of 2.0 percent in December 2010 to a rate of 3.6 percent in May 2011, driven mainly by the effect of the rise in food prices (from 1.2 to 5.8 percent) such as chicken, bread, and oil. As previously pointed out, the rise in the price of these goods was associated with the higher costs of imported inputs, such as maize, wheat, and soybean oil.

86. On the other hand, **core inflation**, which reflects the inflationary pressures associated with demand factors in the domestic economy, rose from an annual rate of 2.1 percent in December to 2.8 percent in May.

87. Accumulated inflation between January and May recorded a rate of 2.15 percent, with the rise in the prices of non core food products (7.0 percent) and fuels (2.4 percent) accounting mainly for this increase. Accumulated core inflation between January and May showed a rate of 1.7 percent, associated mainly with the rise in the prices of education (2.6 percent) and meals outside the home (3.0 percent).

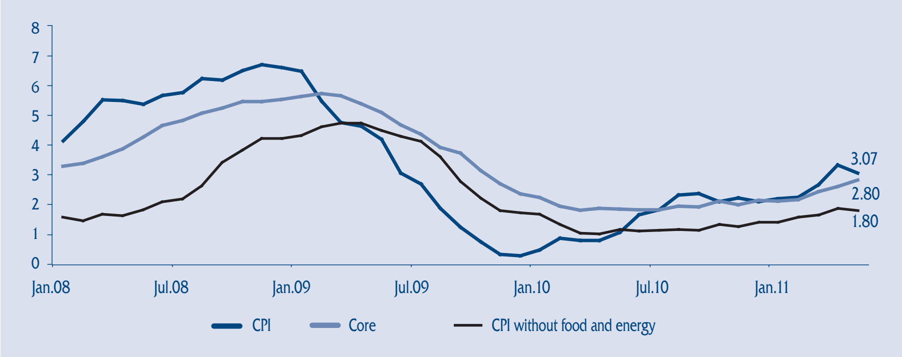
Table 32
INFLATION: 2006-2001
(% change)

	Weight 2009=100	2006	2007	2008	2009	2010	2011 Jan.-May.	2011 12 month
I. INFLATION	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**2.15**	**3.07**
II. CORE INFLATION	**65.2**	**1.37**	**3.11**	**5.56**	**2.35**	**2.12**	**1.75**	**2.80**
Goods	32.9	0.97	3.30	5.32	2.17	1.53	1.39	2.14
Services	32.2	1.85	2.88	5.86	2.56	2.72	2.11	3.47
III.NON CORE INFLATION	**34.8**	**0.83**	**5.07**	**8.11**	**-2.54**	**2.00**	**2.90**	**3.57**
Foods	14.8	2.06	7.25	10.97	-1.41	1.18	6.95	5.80
Fuels	2.8	-1.50	6.45	-0.04	-12.66	12.21	2.42	7.64
Transportation	8.9	1.12	0.82	5.86	0.19	1.94	-0.66	1.79
Utilities	8.4	-3.22	0.24	7.48	-4.56	0.01	-0.32	-0.10
Memo:								
CPI without food and energy	56.4	1.28	1.49	4.25	1.71	1.38	0.90	1.80

Table 33
INFLATION: 2006-2001
(Weighted contribution)

	Weight 2009=100	2006	2007	2008	2009	2010	2011 Jan.-May.	2011 12 month
I. CPI	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**2.15**	**3.07**
II. CORE INFLATION	**65.2**	**0.79**	**1.80**	**3.20**	**1.34**	**1.38**	**1.14**	**1.83**
Goods	32.9	0.31	1.05	1.69	0.68	0.50	0.46	0.70
Services	32.2	0.48	0.75	1.52	0.66	0.88	0.69	1.12
III.NON CORE INFLATION	**34.8**	**0.35**	**2.13**	**3.44**	**-1.09**	**0.69**	**1.01**	**1.24**
Foods	14.8	0.48	1.69	2.63	-0.35	0.17	1.02	0.86
Fuels	2.8	-0.09	0.36	0.00	-0.68	0.34	0.08	0.23
Transportation	8.9	0.10	0.07	0.51	0.03	0.17	-0.06	0.16
Utilities	8.4	-0.14	0.01	0.30	-0.09	0.00	-0.03	-0.01

Graph 75
CPI, CORE CPI AND WITHOUT FOOD AND ENERGY CPI
(12-month % change)



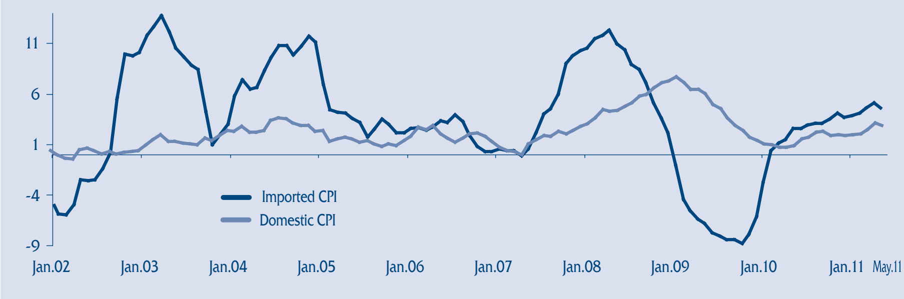
88. Imported inflation at May 2011 recorded an annual growth of 4.7 percent, with the rise in the price of food products being noteworthy (0.8 percent in 2010 and 8.2 percent at May 2011). Reflecting the evolution of food components (7.9 percent) and fuels (2.4 percent), the rate of imported inflation between January and May was 2.9 percent.

The evolution of the exchange rate, which showed a nominal last 12-month appreciation of 2.5 percent in May, contributed to some extent to offset the impact of the rise in the international prices of these products in the domestic market.

Table 34
DOMESTIC AND IMPORTED INFLATION
(Accumulated % change)

	Weight 2009=100	2006	2007	2008	2009	2010	2011 Jan.-May.	2011 12 month
I. IMPORTED CPI	**10.8**	**0.27**	**10.46**	**2.20**	**-6.25**	**3.78**	**2.85**	**4.71**
Food	3.0	2.08	18.83	4.75	-3.07	0.76	7.86	8.20
Fuel	2.8	-1.50	6.45	-0.04	-12.66	12.21	2.42	7.64
Electric appliances	1.3	-1.29	-1.50	-0.06	-2.39	-0.58	-1.11	-1.62
Other	3.7	0.64	0.47	0.46	-0.34	1.20	0.53	1.66
II. DOMESTIC CPI	**89.2**	**1.28**	**2.84**	**7.44**	**1.35**	**1.87**	**2.06**	**2.87**
III. CPI	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**2.15**	**3.07**
Exchange rate		**-6.40**	**-7.00**	**4.47**	**-7.59**	**-2.15**	**-1.45**	**-2.48**

Graph 76
DOMESTIC AND IMPORTED INFLATION
(12-month % change)



89. The items that contributed most to the growth of inflation between January and May were meals outside the home, chicken, education (tuition and fees), rice, bread, and eggs, while the items that contributed most to reduce inflation were citrus fruits, domestic transportation rates, telephone rates, potatoes, avocados, and ollucos.

Table 35
WEIGHTED CONTRIBUTION TO INFLATION: JANUARY- MAY 2011

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Meals outside the home	11.7	3.0	0.36	Citrus fruits	0.5	-13.6	-0.09
Poultry	3.0	13.0	0.34	National transportation	0.3	-15.4	-0.06
Education (fees and tuition)	8.8	2.7	0.24	Telephone rates	2.9	-2.2	-0.06
Onion	0.4	89.1	0.21	Potato	0.9	-5.0	-0.04
Rice	1.9	11.3	0.20	Avocado	0.1	-21.5	-0.03
Bread	1.9	6.6	0.13	Olluco and similar	0.1	-27.3	-0.03
Eggs	0.6	21.0	0.10	Grape	0.1	-19.3	-0.03
Garment for men and kids aged 12 or older	1.5	6.0	0.09	Peach	0.1	-16.0	-0.02
Edible oils	0.5	19.6	0.09	Chilli pepper	0.1	-18.5	-0.02
Gasoline and oil	1.3	4.3	0.06	TV set	0.5	-2.8	-0.01
Total			1.82	Total			-0.39

Table 36
WEIGHTED CONTRIBUTION TO INFLATION: JUNE 2010 - MAY 2011

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Meals outside the home	11.7	5.3	0.62	Telephone rates	2.9	-4.3	-0.12
Education (fees and tuition)	8.8	3.5	0.32	Other fresh vegetables	0.4	-10.5	-0.05
Rice	1.9	12.9	0.22	Fresh vegetables	0.2	-15.1	-0.05
Poultry	3.0	7.2	0.20	Tomato	0.2	-16.7	-0.04
Onion	0.4	64.5	0.17	Carrot	0.1	-16.4	-0.03
Bread	1.9	7.7	0.15	Garlic	0.1	-24.0	-0.03
Garment for men and kids aged 12 or older	1.5	9.3	0.14	Eggs	0.6	-4.3	-0.03
Urban transportation	8.5	1.6	0.14	TV set	0.5	-3.7	-0.02
Gasoline and oil	1.3	9.3	0.13	Soda	1.3	-1.1	-0.02
Gas	1.4	6.2	0.09	Cleaning items	0.9	-1.6	-0.01
Total			2.18	Total			-0.40

Meals outside the home

Like in 2010, this item continued showing a rising trend, driven by increased domestic demand. At May 2011 it recorded a growth rate of 5.3 percent in the last 12 months, a higher rate than the rate recorded by total food and beverages consumed in the home (4.4 percent in the last 12 months) and than the growth rate of the CPI (3.1 percent).

Poultry

The increase registered in the price of chicken in the first four months of the year (18.0 percent) reflected the higher production costs, which led to a supply contraction. The international price of maize rose from US$ 221.4 per ton in December 2010 to US$ 286.8 per ton in April 2011. Because of this, placements of baby chickens reduced their pace of growth between February and April declining 3 percent compared to the previous three months. In May, when the price of maize continued showing high levels (US$ 277.9), the rise in the price of chicken meat registered in the previous months allowed producers to increase placements of baby chicken (up 3 percent relative to April). Together with the reduction in the price of the main substitutes of chicken –mackerel (-3.6 percent) and bonito (-4.9 percent)–, this led the price of chicken to fall 4.5 percent in May.

Education costs

The rise of 2.7 percent observed in the education tuition and fees during the period of January - May reflects basically the rise of education costs in March (2.2 percent) associated with the beginning of the school year. Tuition registered rises in both private and public schools (2.7 and 2.3 percent, respectively) and education fees increased in private schools (5.0 percent).

Onion

Although less onion was sown in Arequipa, the main producing area (-21.2 percent in August - January compared to the previous season), the rains that affected this region in Q1 of the year led to earlier harvests that resulted in a higher production (up 19 percent in the period of January-April compared to the same period in 2010), but with a product of lower quality.

Rice

The outlook a lower production in the following months as a result of the drought that affected the north of the country in the first months of the year generated commercialization problems, despite the existence of sufficient stock levels. The information on this crop in the season of August-April shows a decline of national production of 8 percent and a decline of 27 percent in Lambayeque, Lima's main supplier area, compared to the previous crop season.

Bread

The price of bread rose due to the rise in the price of flour elaborated with imported wheat, which increased 8.0 percent between December 2010 and May 2011. The international price of wheat has increased 12.2 percent during this year, showing some deceleration in May due to the liquidation of non commercial positions after the outlook for global production in 2011 was revised on the upside.

Fuels

The rising trend in the price of West Texas Intermediate (WTI oil) that started in February due to political problems in oil producing countries continued until the end of April 2011. The price of WTI oil rose from US$ 89.4 in February to US$ 109.6 per barrel in April 2011. Despite the price corrections observed in May (US$ 100.7 per barrel), the price of oil remains at high levels.

Table 37
PRICE OF FUELS
(Annual % change)

	2008	2009	2010	2011	
				Jan.-May.	12 month
Fuels	**0.0**	**-12.7**	**12.2**	**2.4**	**7.6**
Gasoline and oils	-6.1	-15.8	16.4	4.3	9.3
Gas	2.7	-4.6	8.8	0.5	6.2
WTI (US$ per barrel)	99.6	61.7	79.4	98.4	

Source: INEI.

The rises in WTI oil generated higher international prices and therefore greater differences between the benchmark prices and domestic prices. However, higher increases in the domestic prices of fuels were prevented given that the price updates in the price bands of the products included in the Fuel Price Stabilization Fund (FPSF) that were programmed for February and April were suspended (Emergency Decrees 009-2011 and 017-2011, respectively). These decrees extended the validity of the prices of the bands approved in December 2010 until June 2011.

Because of this, the rise in the price of fuels recorded so far in 2011 (2.4 percent) reflects mainly the price increase registered in January (3.0 percent). Negative price variations close to 0.0 percent were observed thereafter.

Table 38
SITUATION OF THE FUEL PRICE STABILIZATION FUND BETWEEN JUNE 14 AND 20, 2011
(S/. per gallon)

	Current domestic price in Refinery	Osinergmin Parity price	Net weekly Compensation factor	Advanced (+)/ Lag (-) without net compensation 1/
Gasoline 84	7.28	8.02	0.74	-10.2%
Gasoline 90	7.54	8.57	1.03	-13.7%
Gasoline 95	8.16	9.14	0.98	-12.0%
Gasoline 97	8.32	9.32	1.00	-12.0%
Gasohol 84	7.51	8.10	0.82	-7.9%
Gasohol 90	7.75	8.61	1.07	-11.1%
Gasohol 95	8.35	9.14	0.98	-9.5%
Gasohol 97	8.50	9.31	1.00	-9.5%
Diesel B5,2500 ppm	8.15	9.51	1.36	-16.7%
Diesel B5,50 ppm	8.55	9.51	1.36	-11.2%
Residual 6	6.04	7.26	1.22	-20.2%
Residual 500	5.93	7.15	1.22	-20.6%
Diesel B5 GE	8.15	9.51	1.36	-16.7%
Residual 6 GE	6.04	7.26	1.22	-20.2%
Residual 500 GE	5.93	7.15	1.22	-20.6%
Liquified gas	3.69	5.05	1.36	-37.0%
Average / Total	7.04	8.24	1.27	-17.1%

Source: Petroperú, MINEM and Osinergmin.
1/ Expressed as a % of the refinery price. Higher than the lag in final prices given that fixed components of the final price, such as the excise tax, are not considered here.

The excise tax on fuels was lowered on June 8 and the FPSF price bands were increased on June 9. The impact of these measures on the final prices of all the types of fuels is estimated at 5.0 percent, except in the case of LPG which would have increased 1.5 percent.

After these measures, the weekly compensations of the FPSF are estimated to amount to S/. 56.3 million. The delay in refinery prices compared to international parity is estimated at 17.1 percent on average, with LPG showing the highest price delay (37 percent) and 95-octane gasohol showing the lowest delay (9.5 percent).

Electricity

90. Year to date, residential electricity rates have increased 0.1 percent. In Q1, electricity rates accumulated a growth rate of 1.4 percent, associated mainly with the rise established by OSINERGMIN in the month of January due to the price increase recorded in terms of generation costs.

Table 39
ELECTRICITY RATES
(Annual % change)

	2008	2009	2010	2011	
				Jan.-May.	12 month
Electricity rates	6.3	-4.6	1.4	0.1	2.3

Source: INEI.

In Q2, electricity rates were adjusted upwards in April (1.6 percent) due to higher generation and transmission costs and, to a lesser extent, due to higher prices in the added value of distribution. The new generation prices reflected the higher prices of fuels and bituminous coal, while transmission prices reflected the cost of the expansion of the Paragsha - Conococha transmission line, and the rise in distribution prices resulted mainly from the higher prices of copper and aluminum.

The -2.9 percent variation observed in May is explained by the rate adjustment associated with changes in macroeconomic indicators, as well as by several resolutions in force since that month that modified electricity generation, transmission, and distribution costs.

Edible oil

91. The price increase recorded in edible oils is associated with the rise in the price of their main input, soybean oil, whose international price rose from US$ 1,139.4 per ton in December 2010 to US$ 1,238.1 in May 2011.

Expectations

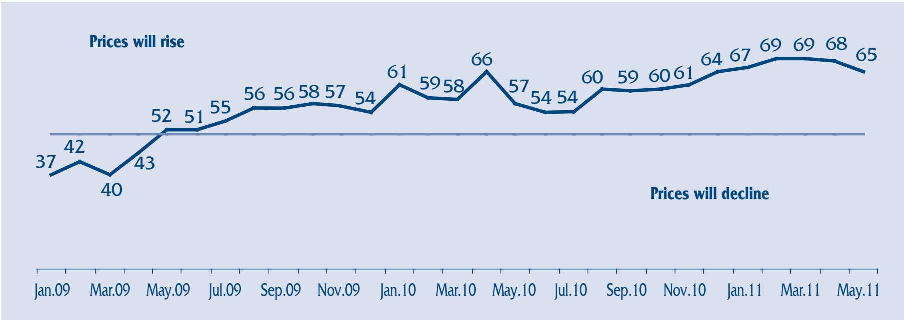
92. **Inflation expectations** reflect that the effect of the rise in food and fuel prices is perceived as transitory and that inflation is expected to converge to the inflation target range in 2012 and 2013. Thus, financial entities and economic analysts expect the rate of inflation to be between 2.6-2.7 percent in 2012.

Table 40
SURVEY ON MACROECONOMIC EXPECTATIONS: INFLATION
(%)

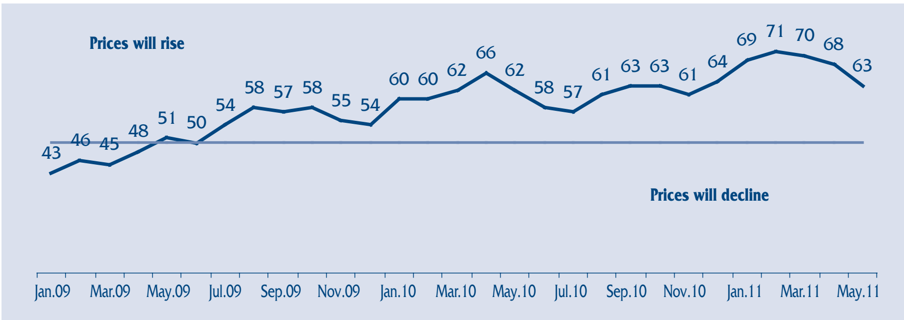
	IR Dec.10	IR Mar.11	IR Jun.11
FINANCIAL ENTITIES			
2011	2.5	3.0	3.5
2012	2.5	2.5	2.6
2013	-	-	2.5
ECONOMIC ANALYSTS			
2011	2.5	3.0	3.8
2012	2.5	2.5	2.7
2013	-	-	2.5
NON-FINANCIAL FIRMS			
2011	2.5	2.5	3.0
2012	2.5	2.5	3.0
2013	-	-	3.0

The prices of inputs expected in the next 3 months have declined and show an index level of 65 points, lower than the one registered in 2008. A similar situation is observed in expectations about end prices, since lower inputs costs would later translate into the price of end goods.

Graph 77
EXPECTED AVERAGE PRICE OF INPUTS IN 3 MONTHS
Manufacturing sector



Graph 78
EXPECTED AVERAGE SALE PRICE IN 3 MONTHS
Manufacturing sector



Inflation forecast

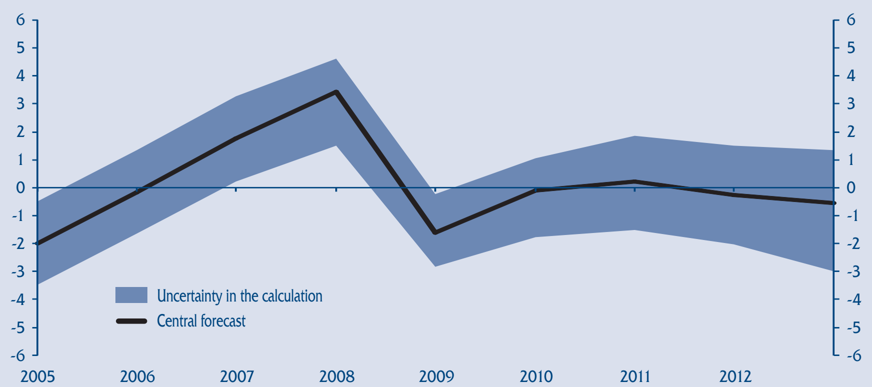
93. The inflation data recorded since the publication of our March 2011 Inflation Report have been in line with the forecasts contained in this report. Particularly, inflation reached a rate of 3.07 percent in May due to the transitory effect of the evolution of the prices of non core inflation components, such as some food products and fuels.

94. The baseline scenario considers that the output gap reflects the moderation of growth in economic activity. Because the output gap is estimated to remain at positive levels close to zero during 2011 and to record slightly negative levels in 2012, it would therefore not generate upward pressures on inflation. This would be the result of the moderation of the impulse associated with terms of trade, as well as the result of the withdrawal of monetary and fiscal stimulus. Moreover, like in 2010, the moderate growth rates registered by our trading partners in the forecast horizon would not contribute to accelerate domestic growth.

95. The output gap, which is the percentage difference between real GDP and its potential (non-inflationary) value, is a very useful indicator to analyze demand pressures on inflation. A nil gap indicates that economic activity is operating at its potential level, which would not generate inflation due to demand pressures. A positive gap is associated with an economy growing at higher levels than the non-inflationary pace and therefore indicates that this activity will translate into inflation.

    The latest data on the evolution of the country's economic activity shows that the output gap would have closed in 2010 after recording a negative value of approximately 2.0 percent during 2009 when the country experienced the effects of the international crisis. Because the gap is projected to show values close to zero between 2011 and 2013, no major demand pressures on inflation are foreseen in the forecast horizon.

Graph 79
OUTPUT GAP
(% of potential GDP)



Memo: Output gap estimated with information as of December 2010. The shadowed area represents existing uncertainty in the calculation and forecast of the output gap plus/minus one standard deviation.

96. The baseline scenario considers the withdrawal of monetary stimulus in response to the balanced evolution of the output gap and future inflation, which indicates that lower monetary stimulus is required. This will also contribute to maintain inflation expectations anchored in a context of persistent significant shocks on the prices of sensitive products of the CPI basket.

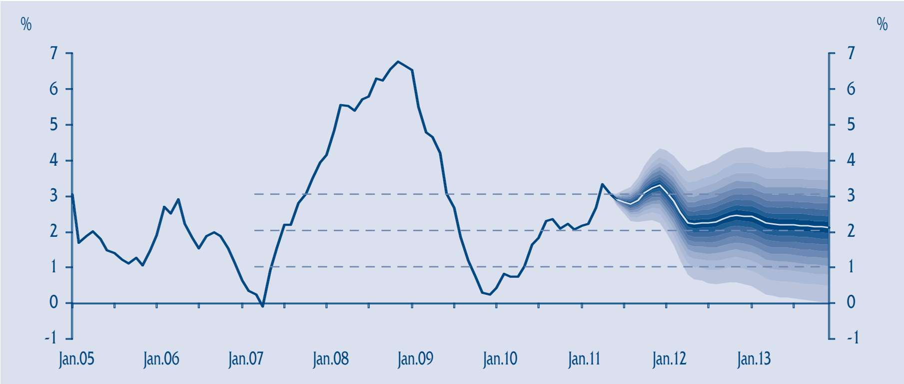
97. Non core inflation would register a rate close to 3.5 percent in 2011 reflecting the effect of the price rises observed in commodities in recent months. The forecast also considers the effects that climate alterations could have on the yields of some farming products, both in Peru and in other countries. Non core inflation would fall

around the inflation target in 2012 as global food supply conditions continue to normalize.

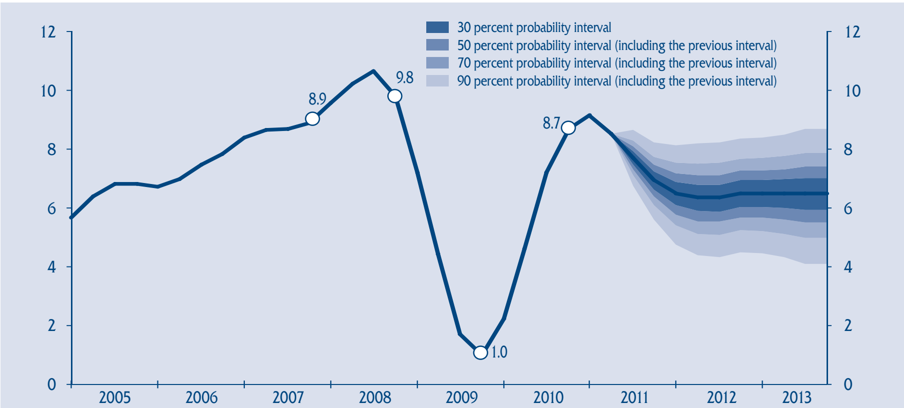
Thus, the update and revision of data on the main factors that would affect the rate of inflation in the next years suggests that inflation would fall around the upper band of the inflation target in the second semester of 2011 and that it would start converging towards the target in 2012, after the effect of the supply shocks disappears.

98. The forecast on GDP growth in 2011-2013 has been revised downward to 6.5 percent, a rate close to the potential growth of the economy. With this growth rate, inflation would fall within the inflation target range in 2012 and 2013.

Graph 80
INFLATION FORECAST
(12-month % change)



Graph 81
FORECAST ON GDP GROWTH: 2011-2013
(Annual % change of GDP in each quarter)



Memo: The graph shows the inflation forecast bands over the forecast horizon. The darkest band shows a 30 percent probability of occurrence, while all the bands together have a 90 percent probability of occurrence.

BOX 6
EXCHANGE RATE TO INFLATION PASS-THROUGH

The pass-through measures the impact that movements in the nominal exchange rate have on CPI inflation. This pass-through takes place both directly and indirectly. The direct pass-through results from the fact that several of the products that comprise the CPI basket are either imported or are close substitutes for imported goods. Thus, an increase in the exchange rate increases the cost price in soles of goods purchased in dollars. The indirect pass-through results from the fact that even though some of the goods in the CPI basket are produced locally, imported inputs whose prices are denominated in dollars are required to produce them. Thus, an increase in the exchange rate would push the cost of production of such goods upwards, which may translate into an increase in the final price of these goods.

The magnitude of the pass-through depends essentially on producers and importers' capability of "transferring" the higher costs to consumers. In a world of homogeneous goods and fully integrated markets, the pass-through would be complete: an increase of one percent in the exchange rate would increase the domestic prices also by one percent. However, in more realistic situations –such as in an economy with imperfect substitute goods, segmented markets, and nominal rigidities–, the pass-through may be less than one. In this case, the importer or producer adjust their profit margins without altering consumer prices.

In a small open economy, monetary policy operates mainly through two channels. The first is the interest rate channel. Movements in the Central Bank's interest rate cause variations in the real interest rate, affecting savings and investment decisions. In turn, this affects economic activity, as well as inflation through aggregate demand. The second is the exchange rate channel, whereby movements in the policy interest rate induce variations in the nominal exchange rate and, through the pass-through effect, in inflation.

Graph 1 shows the evolution of the magnitude of the exchange rate pass-through to the wholesale price index of imported goods (IWPI), the national wholesale price index which includes domestically produced goods (NWPI), and the CPI in percentage terms. The estimates are based on the base model proposed by Miller (2003) and Winkelried (2003) and use moving windows of 72 months (6 years) from 1998 to early 2011. The graph shows that the pass-through varies in time and that it has shown a downward trend. Thus, in a period of 15 years, the pass-through effect goes from about 70 percent to 20 Percent in the IWPI, and from 60-70 percent to about 10 percent in the case of the NWPI and the CPI. This result suggests that after the adoption of inflation targeting in 2002, monetary policy would have increasingly operated through the interest rates channel and increasingly less through the exchange rate channel.

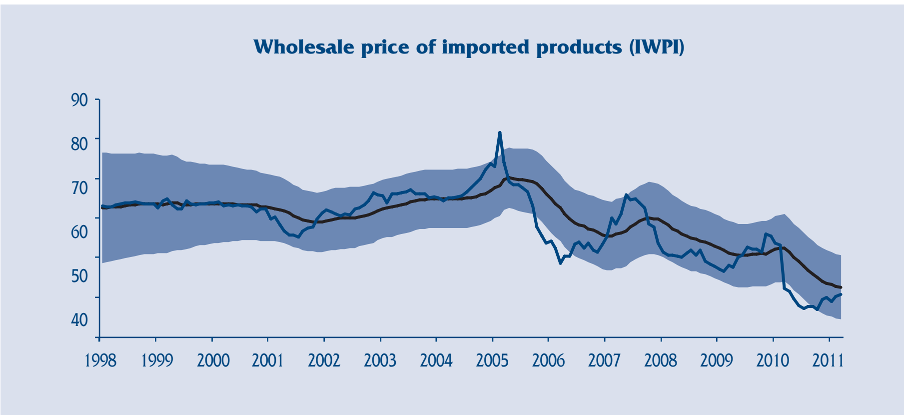
Conceptually, three factors associated with the fact that the pass-through is an asymmetric phenomenon would explain this evolution, since the capability of importers and producers to pass-through costs to consumers depends on the state of the economy. Winkelried (2003) provides evidence of the presence of these asymmetries in Peru:

1. **Inflation:** When there is high inflation, it is more likely that the pass-through will be greater since it is easier to increase prices more frequently in a context of inflation. The strong reduction of the pass-through to the NWPI and the CPI observed in Graph 1 early in the decade of 2000 would be therefore associated with inflation's convergence in Peru to international levels (from an average of 17.1 percent in 1992-2000 to an average of 2.3 percent in 2001-2010) and with the adoption of inflation targeting to consolidate these inflation levels.

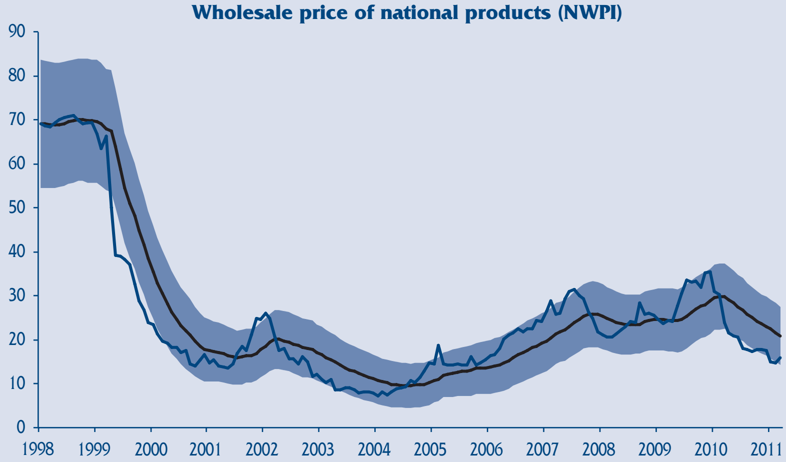
2. **Dollarization:** The pass-through will tend to be higher in a dollarized economy, since exchange rate movements affect a greater number of transactions and a greater number of prices. Thus, the lower levels of pass-through observed in the second half of the sample analyzed are associated with decreasing levels of dollarization (the ratio of dollarization of liquidity declined from 69.5 percent in 2000 to 39 percent in 2010).

3. **Nominal appreciation:** Finally, given the rigidities of downward prices, a depreciation (an increase in the exchange rate that causes importers and producers to reduce their profit margins) would generate a greater pass-through to prices than an appreciation (a decline in the exchange rate which translates into higher profit margins). The declining trends observed in the pass-through to the IWPI and the NWPI since 2007 are associated with the fact that the nuevo sol has experienced prolonged episodes of appreciation since then (the nominal exchange rate moved from 3.2 soles per dollar in early 2007 to 2.8 nuevos soles per dollar in late 2010).

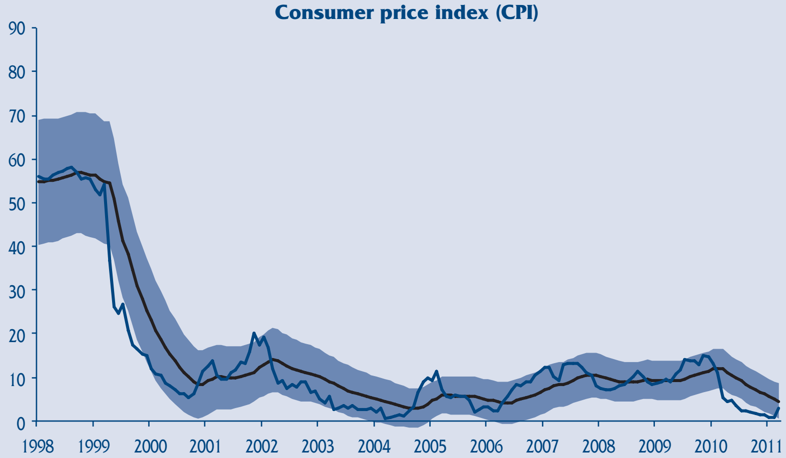
Graph 1
EXCHANGE RATE SHOCK TO INFLATION PASS THROUGH



Wholesale price of national products (NWPI)



Consumer price index (CPI)



Memo: Estimates of pass-through with moving samples of 72 monthly observations. The dates shown on the horizontal axis are the latest observations of the samples used. The black line is a moving average and the shaded area corresponds to the 90 percent confidence interval.

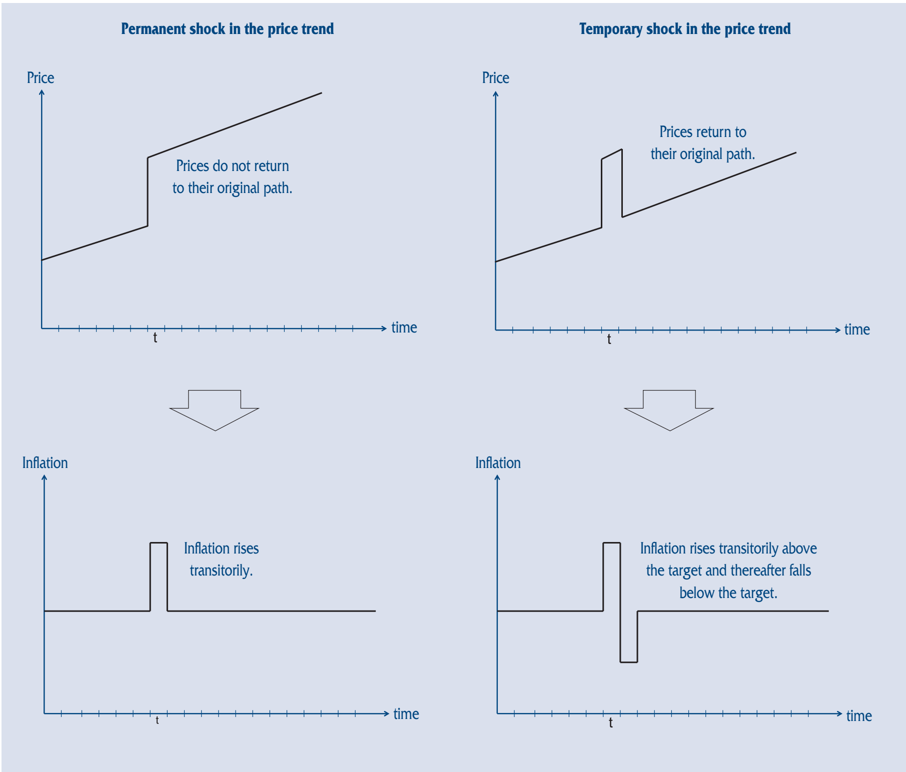
References:

- Miller, S. (2003), “Estimación del pass-through del tipo de cambio a precios: 1995 – 2002”, Banco Central de Reserva del Perú, Revista Estudios Económicos, 10.
- Winkelried, D. (2003), “¿Es asimétrico el Pass-Through en el Perú?: Un análisis agregado”, Banco Central de Reserva del Perú, Revista Estudios Económicos, 10.
- Winkelried, D. (2011), Traspaso de tipo de cambio a precios, Banco Central de Reserva del Perú, Revista Moneda, 148, (forthcoming publication).

BOX 7
FOOD PRICES AND INFLATION VOLATILITY

Inflation is defined as a process of persistent and generalized price changes. Temporary fluctuations are observed some times in the prices of certain goods that will lead inflation to transitorily deviate from its long-term level. Typically, food prices show this conduct, since their dynamics depends on the evolution of international prices and domestic supply conditions in the economy, both of which are factors that usually have high volatility.

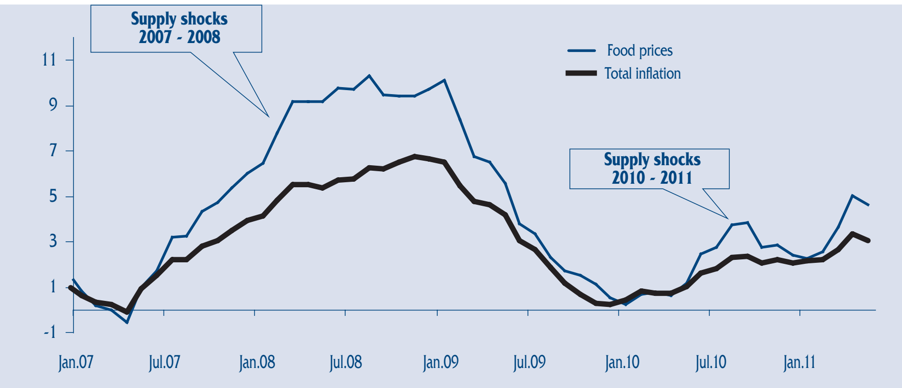
DISTINCTION BETWEEN TEMPORARY AND PERMANENT SHOCKS



Episodes of food price shocks

In recent years the international prices of food have recorded two episodes of sustained rises: the first one, in 2007 – 2008, and the second one, in 2010 - 2011. These rises have been associated with the depreciation of the dollar, supply shocks worldwide, the increase of speculative positions, and higher demand from emerging economies, particularly China (see Graph 14: Evolution of real food prices, FAO). Inflation in Peru was affected significantly during these episodes

FOOD PRICES AND TOTAL INFLATION
(12-month % change)



1. Upward episode: 2007 – 2008

Inflation was initially affected by the rising prices of imported inputs, such as wheat, maize and soybean oil, due to the increase observed in their international prices and later by internal supply shocks associated with climate problems and rising fertilizer prices.

The international prices of the major food staples showed an upward trend since mid-2007 until July 2008, which led products such as bread, noodles, oil, chicken meat and dairy products to show an annual increase of around 10 percent. Given the magnitude of the increases registered in food prices, there was a widespread rise in the prices of other food products as a result of replacement demand.

The rise in the price of fertilizers was associated with the international price of urea, which rose from US$ 304 to US$ 771 per ton between July 2007 and July 2008, affecting purchases of fertilizers early in the 2007-2008 crop year when potatoes are sown in the major producing areas of the Peruvian highlands.

PRICE OF UREA
(US$/ton)

Source: Bloomberg.

The following table offers a summarized break-down of different CPI items in 2008 and 2009. The table shows the effect of the international price fluctuation of fuels and the effect of the international and domestic food (2008) supply shocks, as well as their respective reversal (2009), in these years. It also shows that inflation had increased at May 2011 as a result of recent international food supply shocks. While the rise in the prices of food and energy accounts for 80 percent of the rate of inflation in 2008, so far in 2011 these factors account for 72 percent of accumulated inflation.

INFLATION AND SUPPLY SHOCKS

	Weight		2008		2009		June 2010 - May 2011	
	At Dec-09	Since Jan-10	% Chg.	Wgt. Contr.	% Chg.	Wgt. Cont.	% Chg.	Wgt. Contr.
INFLATION	**100.0**	**100.0**	**6.65**	**6.65**	**0.25**	**0.25**	**3.07**	**3.07**
Food	**47.5**	**37.8**	**9.70**	**4.67**	**0.57**	**0.28**	**4.64**	**1.77**
Effect of international prices	**11.6**	**7.6**	**9.24**	**1.07**	**-1.57**	**-0.18**	**6.34**	**0.48**
Edible oils	0.8	0.5	20.41	0.18	-12.73	-0.13	17.71	0.09
Noodles	1.0	0.5	6.54	0.07	-2.48	-0.02	1.08	0.01
Canned Milk	2.2	1.6	8.75	0.20	-4.07	-0.09	2.47	0.04
Poultry	4.0	3.0	15.64	0.55	3.13	0.12	7.20	0.20
Bread	3.7	1.9	1.57	0.08	-1.13	-0.05	7.73	0.15
Domestic demand shocks	**3.1**	**2.0**	**31.59**	**0.97**	**-12.44**	**-0.38**	**13.22**	**0.26**
Potato	1.5	0.9	50.91	0.78	-22.49	-0.49	2.62	0.02
Fish	1.1	0.7	-2.56	-0.03	16.55	0.17	8.22	0.06
Onion	0.4	0.4	58.43	0.22	-12.07	-0.07	64.53	0.17
Meals outside the home	**12.0**	**11.7**	**8.26**	**0.96**	**3.26**	**0.39**	**5.25**	**0.62**
Other food products	**20.8**	**16.5**	**7.98**	**1.66**	**2.20**	**0.46**	**2.43**	**0.40**
Fuels and urban fares	**12.0**	**11.3**	**4.18**	**0.50**	**-5.51**	**-0.66**	**3.23**	**0.37**
Fuels	3.9	2.8	-0.06	0.00	-17.17	-0.68	8.14	0.23
Urban fares	8.0	8.5	6.11	0.50	0.19	0.02	1.63	0.14
Electricity	**2.2**	**2.9**	**6.31**	**0.13**	**-4.56**	**-0.09**	**2.27**	**0.06**
Others	**38.2**	**47.9**	**3.54**	**1.35**	**1.88**	**0.72**	**1.82**	**0.87**
CPI without food and energy	**46.3**	**56.4**	**4.25**	**1.88**	**1.71**	**0.74**	**1.80**	**1.01**

2. Upward episode: 2010 – 2011

In mid-2010 international prices showed again an upward trend associated with expectations of global economic recovery, unfavorable weather conditions, and the depreciation of the dollar. As in the previous episode, the impact of these rises in international prices reflected mainly in food products such as milk, oil, and bread

Common characteristics

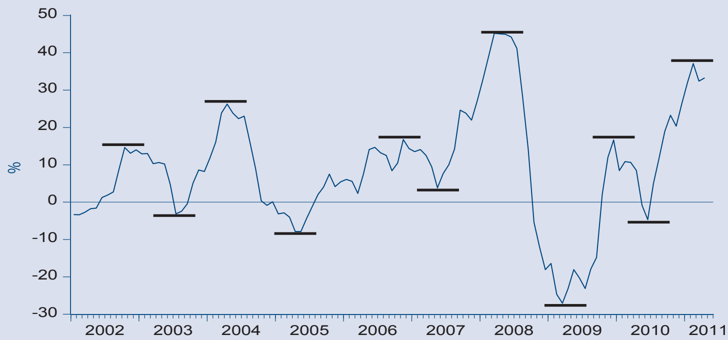
The impact of shocks in international food commodity prices was mostly temporary in both episodes. This would mean that strong positive variations are followed by significant negative variations. Graph 3 describes the effects on prices and inflation, distinguishing permanent from transitory shocks. Additionally, Graph 4 shows how the different price variations are similar to the inflationary effects included in the second column of Graph 3. For example, the 12-month price increase in the food commodity index reached 45 percent in the 2007-2008 price shock episode, whereas a negative variation rate of 30 percent was observed by 2009.

The effects of the shocks on domestic prices can also be observed in Graph 4. The rise-fall pattern is repeated to a greater degree in food price variations in the CPI basket and to a lesser degree in total inflation.

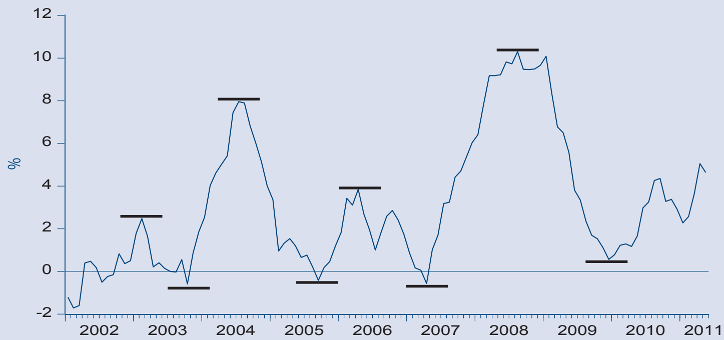
Thus, monetary policy responses will not be adopted if shocks are perceived as transitory, unless the size and duration of these shocks are significant enough so as to affect inflation expectations and therefore a larger number of CPI components.

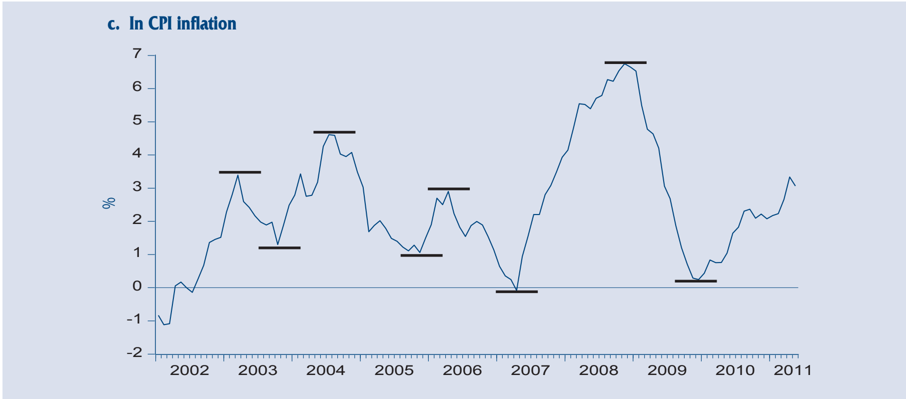
INTER-ANNUAL CHANGE

a. In the price of food commodities:



b. In the food component of the CPI




c. In CPI inflation
%
7
6
5
4
3
2
1
0
-1
-2
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011

INFLATION REPORT FORECAST SUMMARY

	2009	2010	2011 1/		2012 1/		2013
			IR Mar.10	IR Jun.11	IR Mar.10	IR Jun.11	IR Jun.11
Real % change							
1. GDP	0.9	8.8	7.0	6.5	6.5	6.5	6.5
2. Domestic demand	-2.8	12.8	8.1	7.8	6.5	6.6	6.2
a. Private consumption	2.4	6.0	5.6	5.7	5.3	5.7	5.9
b. Public consumption	16.5	10.6	5.0	4.4	2.7	4.1	4.0
c. Fixed private investment	-15.1	22.1	15.0	10.4	12.5	11.6	8.3
d. Public investment	21.2	27.3	8.8	3.3	4.4	6.1	6.1
3. Exports (goods and services)	-3.2	2.5	5.2	3.8	8.4	7.8	9.0
4. Imports (goods and services)	-18.6	23.8	11.2	10.4	8.0	8.1	7.3
5. Economic growth in main trading partners	-1.1	4.4	3.6	3.5	3.4	3.4	3.4
Memo:							
Output gap 2/ (%)	-2.0	0.0	0.0 ; +1.0	-0.5 ; +0.5	-0.5 ; +0.5	-0.5 ; +0.5	-0.5 ; +0.5
% change							
6. Forecast inflation	0.2	2.1	2.5-3.5	3.0-3.5	2.0-3.0	2.0-3.0	1.5-2.5
7. Average price of crude	-38.1	28.7	22.3	25.3	1.7	0.0	0.0
8. Nominal exchange rate 3/	-7.6	-2.1	-1.6	-1.3	-1.4	-0.4	0.7
9. Real multilateral exchange rate 3/	0.9	-2.1	1.4	1.4	-1.2	-0.8	0.7
10. Terms of trade	-2.8	17.9	1.8	3.2	-2.4	-3.3	0.2
a. Export price index	-10.0	29.9	12.5	16.1	-0.7	-2.1	-0.3
b. Import price index	-7.4	10.1	10.4	12.5	1.8	1.2	-0.5
Var.% nominal							
11. Currency in circulation	11.0	25.4	21.0	18.0	18.0	16.0	13.0
12. Credit to the private sector 4/	8.6	21.0	16.0	17.0	15.0	15.0	12.0
% of GDP							
13. Gross fixed investment rate	22.9	25.1	26.8	25.6	27.8	26.6	27.0
14. Current account of the balance of payments	0.2	-1.5	-3.3	-3.0	-3.5	-3.3	-3.0
15. Trade balance	4.7	4.4	3.7	3.9	3.0	3.2	3.6
16. Gross external financing to the private sector 5/	5.7	7.8	6.5	6.8	5.7	6.2	6.0
17. Current revenue of the general government	18.7	19.8	19.5	20.3	19.3	20.2	20.2
18. Non-financial expenditure of the general government	19.4	19.2	18.6	18.9	18.2	18.7	18.4
19. Overall balance of the non-financial public sector	-1.6	-0.5	-0.3	0.2	0.0	0.4	0.8
20. Total public debt	27.2	23.5	21.3	21.5	19.6	19.3	17.6

RI: Inflation report.
1/ Forecast.
2/ Differential between GDP and potential GDP (%).
3/ Survey on exchange rate expectations.
4/ Includes loans made by banks' branches abroad.
5/ Includes foreign direct investment or and private sector's long term disbursement.

VII. Balance of Risks

99. The main risks that could divert the rate of inflation from the baseline scenario in the forecast horizon are associated with the possible pressure of the prices of imported food and fuels and with the financial volatility that international markets could experience. In contrast with our previous Report which considered the possibility of demand inflationary pressures as a risk, it is now estimated that this risk has dissipated.

- **Imported inflation.** The recent evolution of the prices of food commodities and fuels continues indicating a high probability that these goods will continue to show high prices in the future. Even though part of these price increases have already been observed since our last Inflation Report was published in March and although they are reflected in the baseline forecast scenario, the risk of a higher imported inflation persists

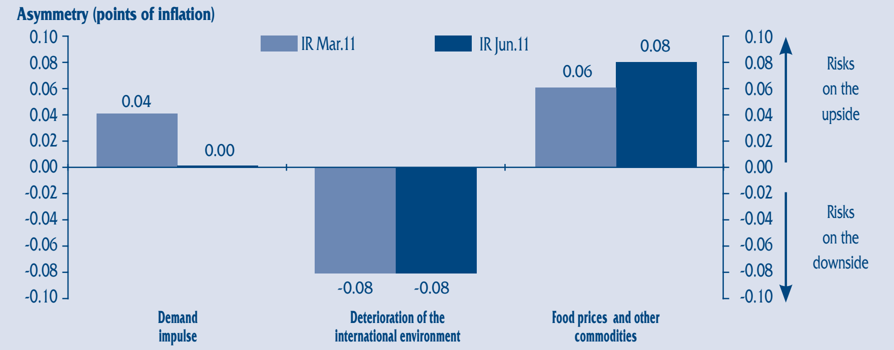
  Persistent shocks in the prices of sensitive goods that are part of the CPI basket could affect economic agents' expectations and contribute to an upward revision of inflation expectations

  Therefore, if signals that imported inflation is being translated into economic agents' expectations were observed, the Central Bank would adjust its monetary position.

- **Uncertainty about the evolution of the world economy**. The baseline scenario considers a global growth rate of 3.9 percent, which would contribute to maintain terms of trade in a favorable position for the Peruvian economy. However, due to uncertainty in international markets as a result of the fiscal situation in some Eurozone countries, among other factors, this recovery may not take place, which would imply a stagnation in our main trading partners' demand. Should this be the case, the resulting scenario would be one of lower prices for a great deal of our primary exports and consequently a deceleration of growth in the domestic economy

  The Central Bank maintains a high level of international reserves and has several liquidity injection mechanisms to face this contingency. Thus, should this risk materialize, the Central Bank would ease monetary conditions

Graph 82
INFLATION FORECAST: BALANCE OF RISKS
(2 year-ahead inflation deviations in % points)



Memo: This graph shows how risk perception has changed relative to the risks perceived in the prior Inflation Report (March 2011). The size and sign of bars show the asymmetry of each risk factor in the distribution of the inflation forecast.

CONCLUSION

100. The recent evolution of the output gap and inflation does not show evidence of significant demand pressures. However, it is estimated that inflation would continue falling around the upper band of the inflation target range until end 2011 due to the recent evolution of the international food and fuel prices and that it would converge thereafter towards the 2 percent target.

Monetary policy oversight of the state of the economy, inflation expectations anchored to the target range in the medium term, and the reversal of supply shocks will allow inflation to converge to the 2 percent target in the 2011-2013 forecast horizon.