# INFLATION REPORT
# RECENT DEVELOPMENTS AND PROSPECTS
# May 2004

# CENTRAL RESERVE BANK OF PERU

**OVERVIEW**

- This second 2004 Inflation Report presents an analysis of the monetary policy during the first months of the year and the macroeconomic projections for the 2004-2005 period. So far this year, the registered inflation rate is in line with the January Inflation Report, which forecasted a temporary rise in inflation during the first months of the year due to the expected increase in international oil prices and the rise in prices of some food items as a result of slack conditions in local agricultural supply.

- The January inflation forecast showed a transitory acceleration on the year-on-year inflation rate until mid 2004 basically due to the low inflation rates observed last year (inflation rate in June 2003 was –0.5 percent). For December 2004, the January Inflation Report projected an inflation rate close to the target rate of 2.5 percent, assuming a stable monetary policy stance (interbank interest rate of 2.5 percent).

- In this Report, the central scenario for 2004 has been revised upwards. The end-of-year inflation is now estimated to approach the upper bound of the inflation target range (2.5 – 3.5 percent). This higher outcome reflects stronger supply shocks (specially higher international prices) relative to those anticipated at the time in which the January Report was issued. During the following months of 2004, the year-on-year inflation rate is projected to be above the upper bound of the inflation target range as a result of both, the aforementioned supply shocks and the statistical effect that results from comparing higher projected CPI indices with the ones observed between April and July 2003 (the average inflation rate in those months was negative). This tendency would disappear as of September and the annual inflation forecast for 2004 would stay within the target range. Hence, the recent increase in the short-term interest rates in domestic currency, nuevos soles, would not be consistent with those inflation forecasts.

- Given the lagged response of inflation to monetary policy actions (estimated to be around one year), this Report also presents the inflation projections for 2005. The current monetary policy stance is consistent with a 2005 inflation rate still projected to be within the target range. One factor that will drive total inflation within the range during 2005 is the expected fall in oil prices.

- The central projection scenario maintains the prospect of favorable external conditions due to expected improvements in our traditional export prices and to the recovery of the world economy combined with moderate increases in foreign interest rates, which would remain at relatively low historical levels. For 2005, the favorable external conditions will be weaker relative to those of 2004; however, the prospect would be better than those of previous years. Regarding the public finance, the central scenario assumes a falling path of fiscal deficit consistent with the projections included in the 2005-2007 Multiannual Macroeconomic Framework.

- The GDP growth rate projection is maintained at 4.0 percent for 2004 and will go up to 4.5 percent for 2005. These rates are consistent with the growth in exports (7.9 and 6.0 percent in 2004 and 2005 respectively) and with the recovery in private investment (7.2 and 6.0 percent in those years). This GDP outlook is considered to be sustainable in so far as it will neither generate inflationary pressures nor jeopardize the balance of payments viability.

- The factors that could affect the inflation projections presented in this Report are essentially related to the international context. On the one hand, a higher-than-expected rise in international oil prices may produce a one-time boost in domestic fuel prices, which due to their transitory feature, should not induce economy-wide rises on other prices and hence no monetary policy response. On the other hand, higher than expected adjustments of interest rates in main economies due to output and inflation stabilization reasons, could generate upward pressures on country risk premia and exchange rates throughout emerging economies. Hence, the strength of Peruvian macroeconomic fundamentals, its high level of international liquidity and its floating exchange rate regime allow the monetary policy of the BCRP to keep being focused on attaining the inflation target and offsetting any excessive variability in domestic foreign exchange and money markets.

# CENTRAL RESERVE BANK OF PERU

## INTRODUCTION

1. Since January 2002, the monetary policy of the Central Bank of Peru follows an inflation-targeting regime. The target for the annual inflation rate at the end of every year is 2.5 percent, with an upward and downward tolerance range of one percentage point. This inflation target is the annual variation of the Consumer Price Index (CPI) in Metropolitan Lima, measured by the Instituto Nacional de Estadística e Informática –INEI (National Statistics Bureau). The Central Bank calculates a referential measure of core inflation in order to identify the inflation trend. In this regard, the monetary policy decisions of the Board of the BCRP look to offset inflationary or deflationary pressures.

2. The decisions taken by the Board of Directors are based on inflation projections given the lagged effects of monetary policy actions on inflation. These projections are explained in the Inflation Reports published three times a year by the Central Bank, such that the relevant information used by the Bank in order to take its decisions are shared with economic agents.

   This second Inflation Report of the year includes the monetary policy performance during the first months of 2004 and the macroeconomic projections for 2004 and 2005.

3. Monetary policy transparency is one of the key elements of the Inflation Targeting framework given the fact that it allows Central Bank accountability regarding its constitutional mandate of preserving monetary stability. Likewise, transparency improves the efficiency of monetary policy since the rationale of the operations carried out by the Central Bank is revealed to economic agents, so that their decisions are consistent with the information provided.

4. The monetary policy decisions about its stance are released to the public through the announcement of the referential interest rates for Central Bank lending facilities in the money market (rediscounts and direct repos) as well as overnight deposit facilities at the Central Bank. These interest rates - set by the Central Bank - establish a referential corridor for the interbank interest rate. The daily monetary operations carried out by the Central Bank are aimed at maintaining the interbank interest rate in the center of this referential corridor.

5. The stability of the soles-denominated interbank interest rate and the communication of inflation projections enhance the predictability of monetary policy and therefore, guide the formation of domestic currency interest rates at longer terms.

6. Furthermore, the flexible exchange rate regime allows the Central Bank to follow an independent monetary policy. The adjustments of the referential interest rates are solely made in order to fulfill the inflation target and not necessarily to follow the movements of international interest rates. In periods of high volatility in the foreign exchange market, the Central Bank can intervene as a buyer or seller with the only purpose of reducing excessive exchange rate fluctuations, without implying a specific objective for the level of the nominal exchange rate.

7. Since 2001, the BCRP publishes a calendar of Board meetings where monetary policy decisions are taken. These meetings take place every first Thursday of each month. The timing of these sessions is published at the beginning of every year as part of the Informative Note of the Monetary Program released each January.

## I. CURRENT MACROECONOMIC SITUATION

### I.1 Inflation

*During the first five months of the year inflation (measured by CPI) was 2.4 percent, while the year-on-year change on May was 3.2 percent. The higher inflation rate registered since November 2003 was due mainly to supply shocks resulting from higher imported oil and food inflation (flour and fat) and a lower agricultural domestic supply.*

*Because of the transitory nature of these shocks, the Central Bank did not react to them, as explained in the January Inflation Report. A similar experience was registered during the first quarter of 2003 when the increase of the international price of crude oil caused a temporary increase in inflation that was reverted later, so that by the end of the year 2003 the inflation target was met.*

8. The consumer price index grew 2.4 percent between **January and May 2004**, higher than the 1.7 percent increase over the same period of 2003. Three products (bread, sugar and rice), which account for 7.4 percent of the consumer basket for CPI, explained one percentage point of the January–May 2004 cumulative inflation rate, while the increase of domestic fuel prices also contributed to inflation (0.3 percentage points).

   On the one hand, wheat, soybean oil and oil prices increased in the international markets, generating higher bread, noodles, oil seeds and fuel domestic prices. On the other hand, water shortage affected domestic rice and sugar production.

**Table 1**
**WEIGHTED CONTRIBUTION TO INFLATION: JANUARY - MAY 2004**
(Percentage points)

| Item | Weight | % change | Positive contribution | Item | Weight | % change | Negative contribution |
|---|---|---|---|---|---|---|---|
| Bread | 3.7 | 12.2 | 0.49 | Potato | 1.5 | -13.6 | -0.25 |
| Fuel | 3.9 | 7.1 | 0.34 | Personal care items | 4.5 | -2.2 | -0.09 |
| Sugar | 1.4 | 24.7 | 0.31 | Citric fruits | 0.7 | -12.2 | -0.08 |
| Eggs | 0.7 | 38.5 | 0.29 | Poultry | 4.0 | -1.9 | -0.07 |
| Rice | 2.3 | 11.0 | 0.24 | Grape | 0.1 | -26.9 | -0.06 |
| **Total** | | | **1.67** | | | | **-0.55** |

Source: INEI (National Statistics Bureau)

9. **Imported inflation**, which includes those items of the consumer price index which are determined, directly or indirectly, by international prices (bread, noodles, oil seeds, fuels), grew 7.4 percent between January and May 2004 (2.0 percent over the same period of 2003), due mainly to the increase of food prices and, to a lesser extend, of fuel prices. Domestic component of inflation grew 1.7 percent during the first five months of 2004, a similar rate to the one registered over the same period of 2003.

# CENTRAL RESERVE BANK OF PERU

**Figure 1**
**INFLATION, DOMESTIC INFLATION AND IMPORTED INFLATION**
**(Year-on-year percentage change)**

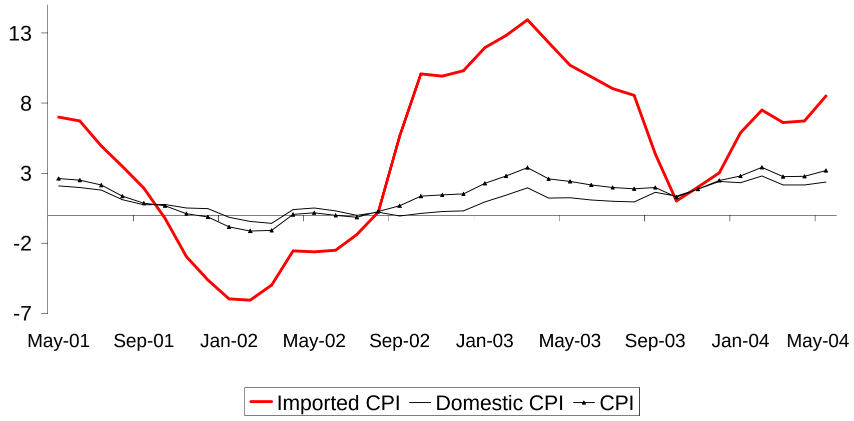



**Table 2**

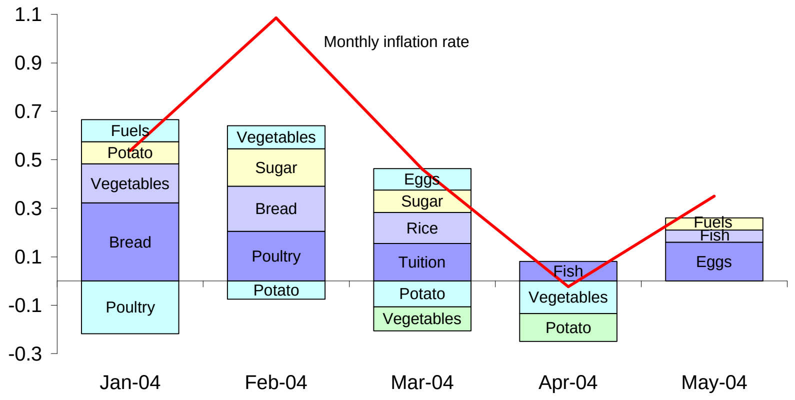
**DOMESTIC AND IMPORTED INFLATION**
(Cumulative percentage change)

| | Weight | 2003 | | 2004 |
|---|---|---|---|---|
| | | Jan-May | Jan-Dec | Jan-May |
| **I. IMPORTED CPI** | **12.1** | **1.98** | **3.03** | **7.40** |
| Food | 5.4 | -1.16 | -0.10 | 10.80 |
| Fuel | 3.9 | 7.60 | 8.94 | 7.06 |
| Electric appliances | 1.0 | -1.34 | -1.91 | -0.52 |
| Others | 1.8 | 0.19 | 1.40 | 1.68 |
| **II. DOMESTIC CPI** | **87.9** | **1.70** | **2.40** | **1.67** |
| **III. CPI** | **100.0** | **1.74** | **2.48** | **2.44** |

Source: INEI (National Statistics Bureau)

10. Bad weather conditions affecting agricultural supply of products coming from the central highland during the first months of the year (potatoes and fresh vegetables) have tended to improve. Fresh vegetables and potatoes, two of the products with the highest contribution to the January and February inflation rates, registered significant price reductions since March.

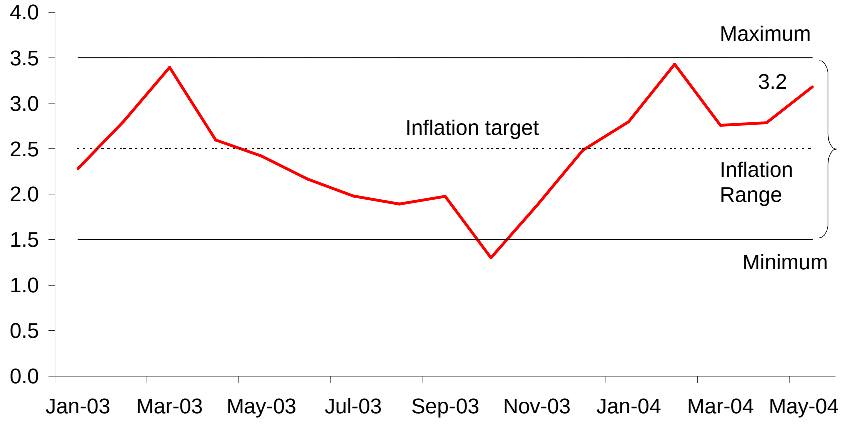
**Figure 2**
**CONTRIBUTION TO INFLATION**
**BY MAIN PRODUCTS**
**(Monthly percentage change and percentage points)**




Water shortage in the north coast, mainly in Lambayeque, had a negative impact on both the level and prospects of rice and sugar production, which in turn had an impact on prices during the first quarter. Since April, these prices have stabilized, due to sugar imports and activities resumption by sugar enterprises, as well as the anticipated partial recovery of rice production due to the larger planted areas in San Martín.

11. The CPI measured year-on-year inflation rate, went from 2.5 percent at the end of 2003 to 3.2 percent in May, within the annual target range set by the Central Bank. The latter is 2.5 percent, with a tolerance of one percentage point upwards and downwards and applies to the annual inflation rate of December.

**Figure 3**
**INFLATION AND INFLATION TARGET**
**(Year-on-year percentage change)**

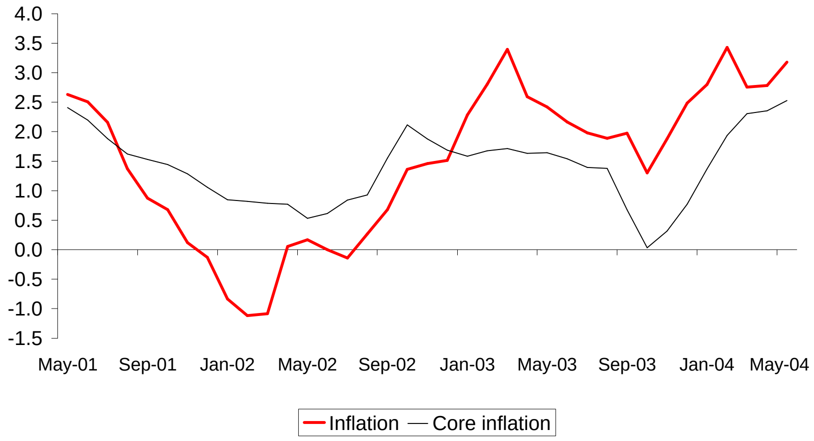



### Core inflation and non-core inflation

12. **Core inflation**, a trend inflation indicator which excludes more erratic food prices, fuel and utility prices, and transport tariffs, was 1.9 percent between January and May 2004, a lower rate than the one registered by the general consumer price index, due to the transitory effect on the latter of the increase in food and oil prices.

This increase of 1.9 percent in core inflation was due mainly to a rise in bread and rice prices. If both bread and rice were excluded, the cumulative change of the resulting index would be 0.9 percent (0.3 percent over the same period of 2003).

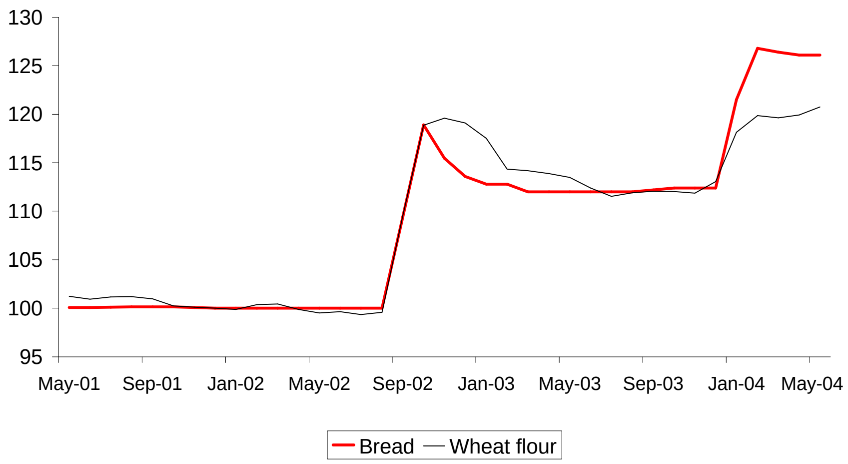
**Figure 4**
**INFLATION AND CORE INFLATION**
**(Year-on-year percentage change)**




Within the food and beverages group, the main increases were in bread (12.2 percent), rice (11 percent), noodles (6.7 percent) and oil seed prices (8.8 percent). Together they explain 67 percent of core inflation.

a. Bread: In January and February, the price of bread rose 8 and 4 percent, respectively, the latter being the statistical lag of the January increase. This increase is related to the rise of the international wheat price (from US$ 118 per M.T. in June 2003 to US$ 147 per M.T. in January 2004), partially offset by a reduction in duties from 20 to 12 percent in December 2003, competition of the informal market and a seasonal decline in demand. The average price of bread fell slightly in March and April (-0.6 percent) and remained stable in May.

**Figure 5**
**BREAD AND WHEAT FLOUR PRICES**
**(Index December 2001 = 100)**




b. Rice: The price of rice rose as of October 2003, due to the smaller executed and projected sown land resulting from a water shortage in the north coast, specially in the department of Lambayeque. Between January and March 2004 the price of rice rose 9 percent and since April it has tended to stabilize due to the larger sown lands in the department of San Martín, which will partially compensate the lower annual projected crops. Between August 2003 and April 2004 of the present farming season, the sown area fell from 275 to 227 thousand Has, while in the same period, the sown area in San Martín rose from 34 to 48 thousand Has.

c. Oil seeds: The price of oil seeds rose since September 2003, accumulating an increase of 7 percent between January and February 2004 and a modest increase of 2 percent between March and May. The price increase reflects the soybean oil international price trend, which rose from an average of US$ 481 per M.T. in the first half of 2003 to US$ 600 per M.T. in October 2003 and US$ 754 per M.T. in March 2004. Strong competition has limited the rise of the domestic oil seeds price, especially after the removal of the antidumping rights to imported oil seeds from Bolivia.

**Table 3**
**INFLATION**
(Cumulative percentage change)

| | Weight | 2003 | | 2004 |
|---|---|---|---|---|
| | | Jan-May | Jan-Dec | Jan-May |
| **I. Core Inflation** | **68.3** | **0.15** | **0.77** | **1.90** |
| **Goods** | **41.8** | **-0.30** | **0.29** | **2.35** |
| Food and Beverages | 20.7 | -0.95 | -0.08 | 5.04 |
| Textiles and Footware | 7.6 | 0.42 | 0.91 | 0.77 |
| Electrical Appliances | 1.0 | -1.34 | -1.91 | -0.52 |
| Other Industrial Goods | 12.5 | 0.43 | 0.70 | -0.92 |
| **Services** | **26.6** | **0.85** | **1.53** | **1.19** |
| Restaurants | 12.0 | 0.38 | 1.25 | 1.01 |
| Education | 5.1 | 2.73 | 3.02 | 3.21 |
| Health | 1.3 | 1.41 | 2.19 | 0.65 |
| Rent | 2.3 | 0.99 | 0.99 | 0.49 |
| Other Services | 5.9 | -0.02 | 0.85 | 0.14 |
| **II. Non Core Inflation** | **31.7** | **5.18** | **6.21** | **3.52** |
| Food | 14.8 | 3.43 | 5.24 | 5.70 |
| Fuel | 3.9 | 7.60 | 8.94 | 7.06 |
| Transportation | 8.4 | 10.28 | 10.99 | -0.51 |
| Utilities | 4.6 | -0.88 | -1.98 | 0.64 |
| **III. Inflation** | **100.0** | **1.74** | **2.48** | **2.44** |

Source: INEI (National Statistics Bureau)

13. Non-core inflation rose 3.5 percent between January and May 2004, due to higher food and fuel prices, which explain 2.5 and 1.0 percentage points of this inflation component, respectively.

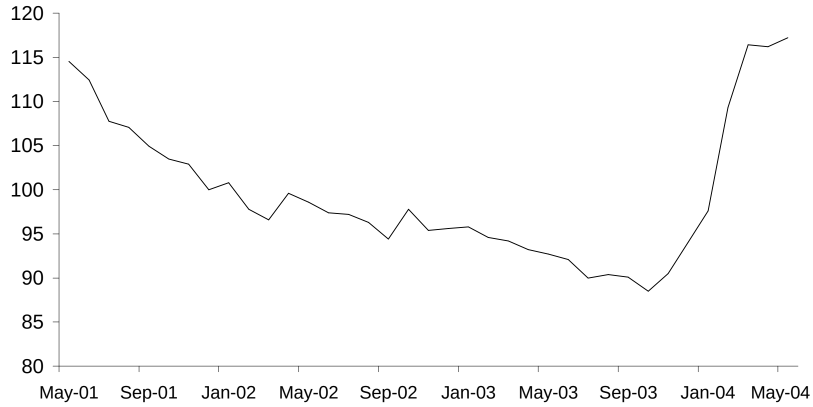
**Food**

Noteworthy within the food items classified as ”non core” are the price rises of sugar (25 percent), eggs (38 percent) and fish (18 percent), which were partially offset by the drop in the prices of potato (-14 percent), citric fruits (-12 percent) and poultry (-2 percent).

a. Sugar: The price of sugar showed a rising trend since November 2003, due to a fall of production of approximately 16 percent in the January - April 2004 period compared to the same period of the previous year. This was mainly the result of the following factors: weather disturbances that affected sugar cane yields, unripe harvest motivated by financial problems of the sugar firms, and a technical halt of production, which did not take place in 2003.

Between January and March, the price of sugar rose 24 percent and has remained relatively stable since April, thanks to 48 thousand M.T. of imports coming mainly from Ecuador (30 thousand M.T.), Colombia (10 thousand M.T.) and Bolivia (6 thousand M.T.).

**Figure 6**
**PRICE OF SUGAR**
**(Index December 2001 = 100)**




b. Potato: The price of potato rose between August 2003 and January 2004, particularly in December 2003 (10 percent) and January 2004 (5 percent). However, between February and May 2004 it fell 18 percent, in spite of the lack of rain that affected the sown lands which supply Lima (in the August – November 2003 period of the current farming season the sowed area in these lands fell 8 percent compared to the previous season).

A factor that has contributed to a higher supply to Lima is the fact that, motivated by higher prices, a larger proportion of total production was chanelled to the market. The amount of potatoes entering the Lima wholesale market rose 3.5 percent in the January – May 2004 period compared to the same period of 2003, with a higher supply coming from Huanuco and more distant zones such as Cajamarca.

**Fuel**

The international price of WTI oil rose from US$ 32.1 per barrel in December 2003 to US$ 40.3 per barrel in May 2004 (26 percent) as a result of security problems in the Middle East (terrorist attacks in the producing areas of Saudi Arabia and Iraq), low oil stocks and the greater demand from China.

Domestic fuel prices grew at a monthly average rate of 7.1 percent in January - May 2004.

**Table 4**
**FUEL PRICES**
(Monthly percentage change)

| | 2003 | | | | | | | | 2004 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jun. | Jul. | Aug. | Sep. | Oct. | Nov. | Dec. | Jan.-Dec. | Jan. | Feb. | Mar. | Apr. | May. | Jan.-May. |
| **Fuels** | **-1.4** | **-1.1** | **0.3** | **2.8** | **0.2** | **0.1** | **0.5** | **8.9** | **1.9** | **1.3** | **1.8** | **1.0** | **1.0** | **7.1** |
| Gasoline | -1.7 | -2.4 | 0.2 | 5.4 | -0.5 | -0.2 | 0.2 | 9.7 | 0.8 | 0.8 | 2.4 | 1.1 | 1.6 | 6.9 |
| Gas | -2.0 | -0.3 | 0.6 | 0.1 | 0.1 | 0.2 | 0.1 | 4.2 | 2.7 | 2.2 | 1.2 | 0.7 | 0.2 | 7.2 |
| Kerosene | -0.5 | -0.4 | 0.2 | 2.4 | 1.2 | 0.4 | 1.2 | 13.0 | 2.5 | 0.9 | 1.6 | 1.0 | 0.9 | 7.1 |
| WTI oil quotation | | | | | | | | | | | | | | |
| US$ per barrel | 30.7 | 30.8 | 31.6 | 28.3 | 30.3 | 31.1 | 32.1 | | 34.2 | 34.8 | 36.7 | 37.1 | 40.3 | |
| % change | 9.2 | 0.1 | 2.7 | -10.4 | 7.1 | 2.7 | 3.0 | 8.9 | 6.8 | 1.5 | 5.5 | 1.1 | 8.5 | 25.7 |

**Utilities**

Between January and May of 2004 utility prices grew 0.6 percent, as a result of increased electric tariffs (1.2 percent). In January, electric tariffs rose 0.7 percent due to the updating of generating tariffs affected by the increase of fuel prices. In April electric tariffs rose 0.9 percent due to higher distributional electric costs. The drop in May (-0.5 percent) was due to the application of the generation tariffs regulatory scheme corresponding to the period May – October 2004.

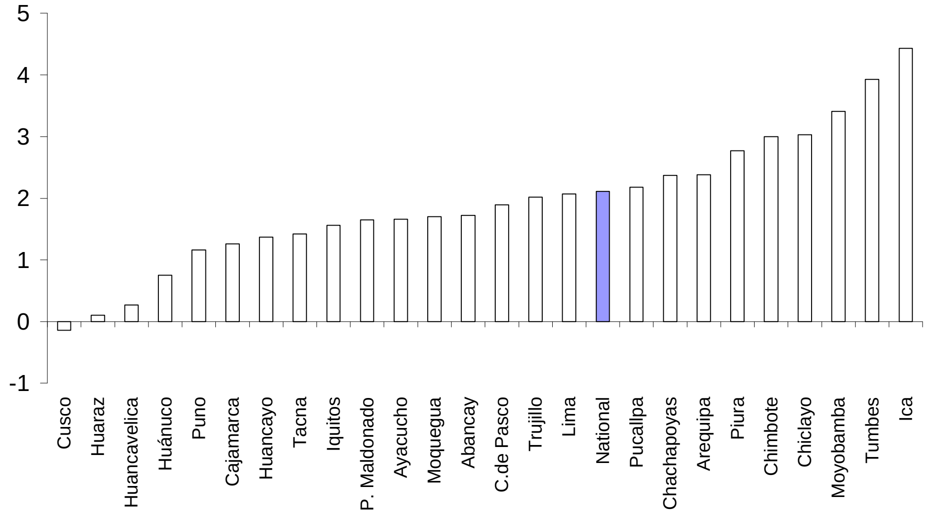
**Table 5**
**UTILITY RATES**
(Monthly percentage change)

| | 2003 | | | | | | | | 2004 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jun. | Jul. | Aug. | Sep. | Oct. | Nov. | Dec. | Jan.-Dec. | Jan. | Feb. | Mar. | Apr. | May. | Jan.-May. |
| **Utilities** | **-0.2** | **-0.5** | **0.7** | **0.0** | **0.0** | **-1.1** | **0.0** | **-2.0** | **0.3** | **0.1** | **0.0** | **0.5** | **-0.2** | **0.6** |
| Electricity | -0.7 | -1.0 | 0.5 | 0.0 | 0.1 | -2.3 | 0.0 | -4.6 | 0.7 | 0.1 | 0.0 | 0.9 | -0.5 | 1.2 |
| Telephone | 0.4 | 0.0 | 0.9 | -0.1 | 0.0 | 0.0 | 0.0 | 0.3 | -0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Water | 0.0 | 0.0 | 0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

### National Inflation

14. Since January 2003, the National Statistics Bureau reports an aggregate national consumer price index based on the price indexes of 25 cities. Between January and April 2004 this index presented an increase of 2.1 percent, similar to the index of Lima. 16 cities registered an inflation rate lower than the national average, while the 9 remaining cities registered a higher rate.

**Figure 7**
**NATIONAL INFLATION: JANUARY - APRIL 2004**
**(Cumulative percentage change)**




## I.2 Exchange rate

*The exchange rate appreciated between January and March 2004 in a context of a favorable trade balance and a drop in the spreads of emerging economies debt. The exchange rate reversed its appreciation trend since April 2004, mainly due to external factors such as the anticipated increase in international interest rates and the rise of oil prices.*

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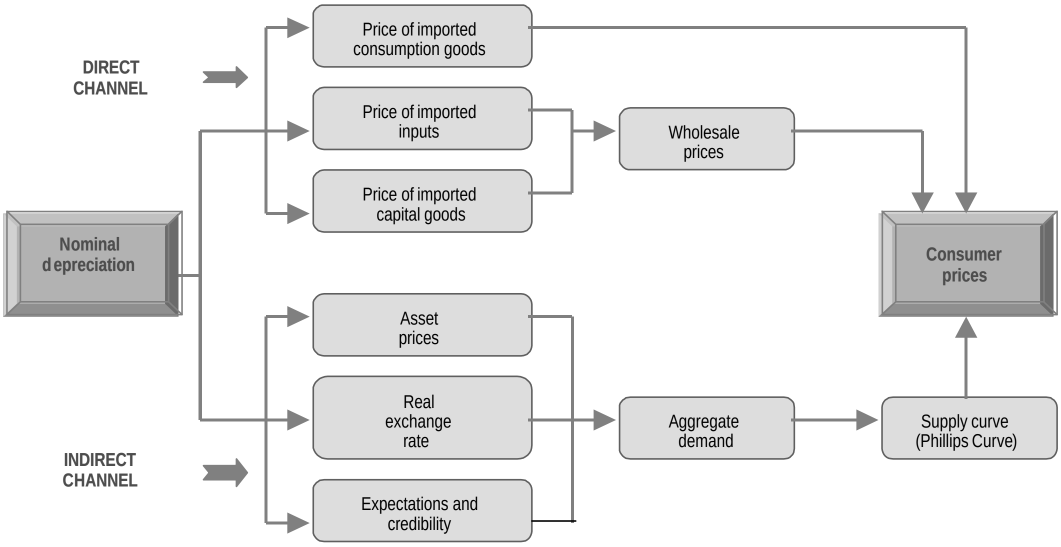
**BOX 1**

**NOMINAL DEPRECIATION EFFECTS ON INFLATION**

A nominal depreciation increases directly the price of imports (first-level pass-through). Higher prices of imported consumption goods lead in turn to an increase in the general consumer price level, according to the share of imports in the Consumer Price Index. Likewise, higher prices of imported capital and intermediate goods raise the domestic production costs, which in its turn could be transferred to consumer prices (second-level pass-through) if firms do not adjust their earning margins.




The exchange rate also affects indirectly the inflation through its effects on the aggregate demand in so far as the enhanced economic activity exerts pressures for a rise or fall in the growth of prices. On the one hand, there is a positive effect on net exports due to improved competitiveness, while on the other hand there is a negative impact on the balance sheets of firms with debts in dollars and soles earnings.

The size of the pass-through depends on the inflationary environment, exchange rate volatility, uncertainty about aggregate demand fluctuations, degree of openness of the economy, among other factors.

Evidence on the pass-trough in Peru suggests that its magnitude is low and depends on the cyclical position of the economy. Thus, in economic recessions a one percent nominal depreciation will raise inflation in 0.15 percent whereas in booms the pass-through is about 0.30 percent.

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15. In the period January-May 2004, the nominal exchange rate rose 0.5 percent with respect to Decembre 2003, which in real terms represents an appreciation of 2.0 percent. The real appreciation results from the differential between the 2.4 percent domestic inflation and the null external inflation, both of which overcompensated the nominal depreciation mentioned above.

**Figure 8**
**MULTILATERAL REAL EXCHANGE RATE INDEX**
**(1994=100)**


The change in the external prices index also incorporates changes in the currencies exchange rates of our main trade partners with respect to the dollar. Between January and May 2004 the Dollar appreciated relative to the Canadian Dollar (4.9 percent), the Euro (2.3 percent) and the Japanese Yen (3.8 percent). However, the Dollar depreciated relative to the Sterling Pound (2.2 percent) and the Asian currencies (Korea and Taiwan, in 1.3 and 1.8 percent, respectively). In Latin America the Dollar depreciated against the Argentinean Peso (0.1 percent), and the Colombian Peso (2.9 percent) while appreciating against the Chilean Peso (5.6 percent); the Brazilian Real (6.2 percent); the Mexican Peso (2.2 percent), the Venezuelan Bolivar (20 percent) and the Bolivian Peso (1.3 percent).

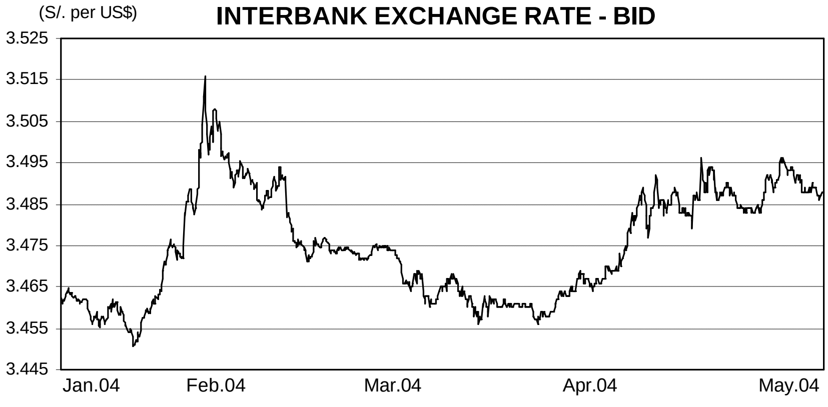
**Table 6**
**MAY 2004: BILATERAL EXCHANGE RATES**
(S/. per currency)

| | | Nominal Exchange Rate (Percentage change) | | | Real Exchange Rate (Percentage change) | | |
|---|---|---|---|---|---|---|---|
| | Weight* | May04/ Dec96 | May04/ May03 | May04/ Dec03 | May04/ Dec96 | May04/ May03 | May04/ Dec03 |
| **USA** | 25.1% | 28.3 | 0.2 | 0.5 | 23.3 | -0.4 | 0.2 |
| **Euro zone** | 20.1% | 38.9 | 3.5 | -2.3 | 29.0 | 2.2 | -3.6 |
| **Japan** | 10.3% | 48.0 | 4.8 | -3.3 | 18.6 | 1.0 | -5.5 |
| **Brazil** | 6.4% | -53.3 | -3.2 | -4.0 | -38.6 | -1.4 | -3.7 |
| **United Kingdom** | 5.8% | 37.2 | 9.7 | 2.0 | 31.4 | 9.0 | 0.9 |
| **Chile** | 4.8% | -11.5 | 10.9 | -4.6 | -12.0 | 8.2 | -5.8 |
| **China** | 4.3% | 28.3 | 0.2 | 0.5 | 8.2 | 4.3 | -0.5 |
| **Colombia** | 4.0% | -38.6 | 5.8 | 4.2 | -10.6 | 7.9 | 5.7 |
| **Mexico** | 3.4% | -9.5 | -10.9 | -1.9 | 26.4 | -9.7 | -2.5 |
| **Argentina** | 3.4% | -55.7 | -3.5 | 1.6 | -47.2 | -2.6 | 1.7 |
| **Korea** | 3.3% | 61.5 | 2.0 | 1.6 | 62.6 | 2.2 | 1.2 |
| **Taiwan** | 2.5% | 24.3 | 4.0 | 2.4 | 6.3 | 1.6 | 0.8 |
| **Venezuela** | 2.5% | -66.4 | -16.5 | -16.3 | 0.0 | -1.5 | -10.9 |
| **Canada** | 2.4% | 32.3 | 0.2 | -4.7 | 25.6 | -1.2 | -6.0 |
| **Bolivia** | 1.8% | -13.2 | -3.6 | -0.9 | -13.4 | -2.3 | -2.0 |
| **Basket** | | **9.5** | **1.4** | **-1.3** | **11.1** | **1.3** | **-2.0** |

* Weight according to 1994 trade structure
Source: IMF, SBS and REUTERS

16. During January- May 2004 the nominal exchange rate fluctuated between S/. 3.45 to S/. 3.52 per dollar. The exchange rate maintained its appreciatory trend until March in response to favorable external sector events, in particular a positive trade balance and the fall of debt spreads that reached historical minimums in the first quarter of 2004. After showing a deficit of US$ 18 million in the first quarter of 2003 the trade balance climbed to a surplus of US$ 559 million in the first quarter of 2004. Besides, the low depreciatory expectations were reflected in the implicit rates of the 3-month forward operations, which have remained at around 1.8 percent.

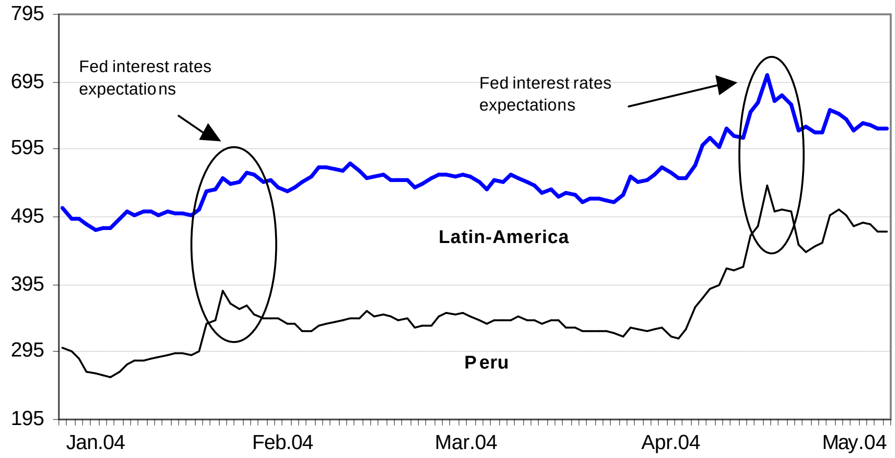
**Figure 9**
**INTERBANK EXCHANGE RATE - BID**




17. The appreciatory trend reversed since April due to external and internal events. Expectations of a rise in the United States interest rates stand out among the external

factors. In January the FED statement eliminated the reference about holding the interest rates low for a "prolonged" period while in May the FED communication envisaged a gradual rise in the interest rates. These events exerted depreciatory pressures on Latin American currencies and contributed to the rise of the yields of emerging countries debt securities.

**Figure 10**
**COUNTRY RISK INDICATORS**
**MARGIN RESPECT TO USA BOND**
**(Basis points)**



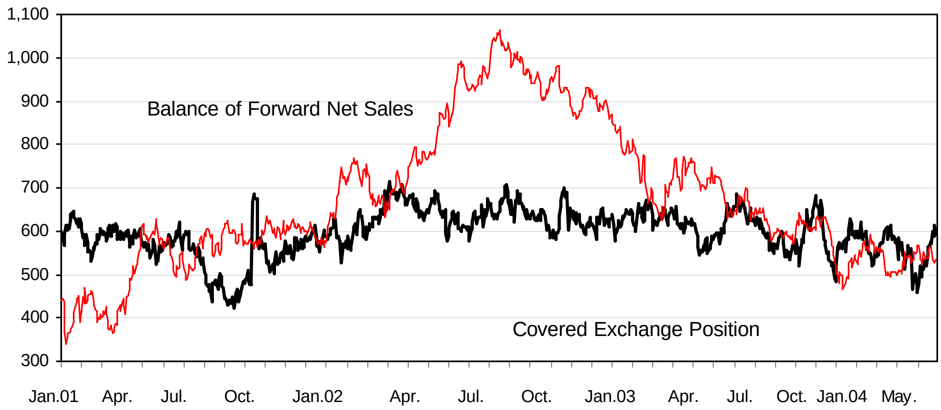

Those interest rise expectations of the Fed fund rate are based on the publication of economic indicators for the USA economy, which confirm the improved scenarios for growth and employment demand as well as the existence of signs of inflationary pressures. The market expected an increase of around 50 bps in the interest rate for the second semester 2004, but it now expects a higher increase of 100 bps and to take place sooner (probably as of June).

Depreciatory trends on the exchange rate were also influenced by some internal factors such as a greater demand of dollars from the private pension system (AFPs), companies and banks as well as exchange rate hedging operations by banks (forward sales) in April.

18. In the period December 2003 - May 2004 banks net forward sales fell by US$ 72 million (from US$ 607 to US$ 536 million) and the foreign exchange position rose by US$ 62 million (from US$ 536 to US$ 598 million).

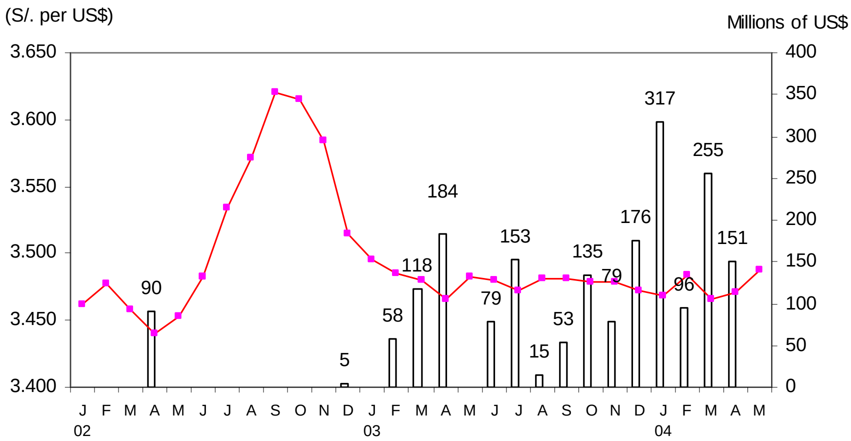
**Figure 11**

**COVERED EXCHANGE POSITION AND FORWARD SALES BALANCE**
**(Millions of US$)**



19. Between January – May 2004, the Central Bank bought US$ 818 million in the foreign exchange market and sold US$ 250 million to the Treasury so that net purchases amounted to US$ 568 million. Since the third week of April the Central Bank has not intervened in the exchange market. The dollar purchases reinforced the international reserves position in a context of a downtrend volatility of the exchange rate which took place until April.

**Figure 12**
**EXCHANGE RATE AND CENTRAL BANK MONTHLY INTERVENTIONS: Dec 2002 - May 2004**




This level of net purchases of dollars and the greater dollar deposits by the public sector in the Central Bank (US$ 135 million) have brought about an increase of US$ 629 million in the international reserves, attaining a balance of US$ 10,824 million at the end of May. On the other hand, dollar deposits by financial intermediaries in the Central Bank decreased by US$ 88 million.

**Figure 13**

**NET INTERNATIONAL RESERVES**
**(Millions of US$)**

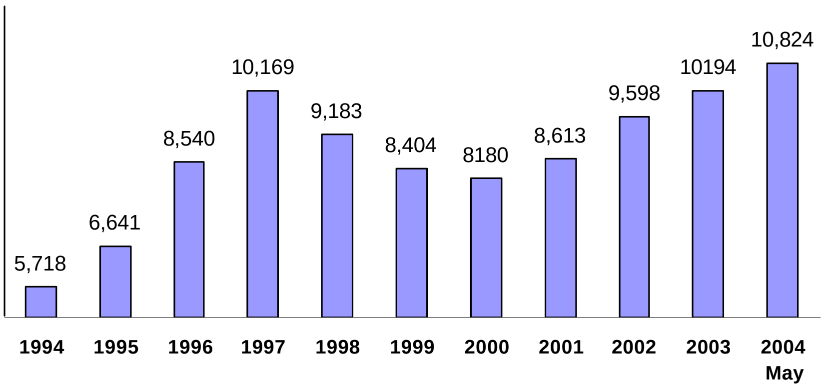
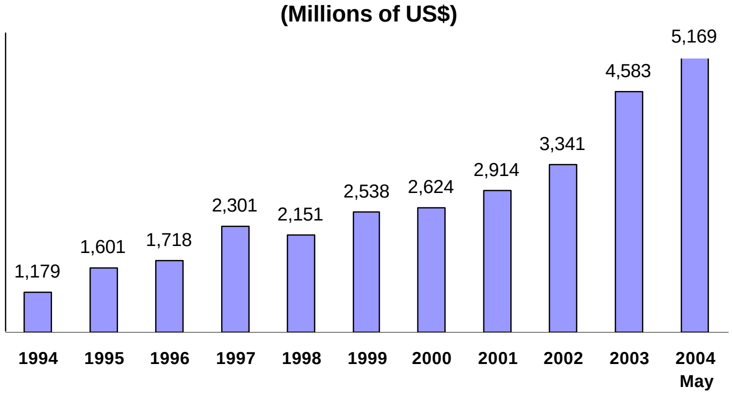


**Figure 14**

**CENTRAL RESERVE BANK EXCHANGE POSITION**
**(Millions of US$)**




## I.3 Domestic demand and GDP

*The growth of exports, boosted mainly by the greater traded volumes of mining and non traditional products, as well as the greater activity of private investment and the increase in private consumption, are the main explaining factors of the gross domestic product development in the first quarter.*

20. During the first quarter, **gross domestic product** grew by 4.6 percent, showing positive rates for 11 consecutive quarters. In the first three months of the year, the growth of the economy was boosted by the exports activity, which increased 11.9 percent in a context of world economy growth and recovery in the price of our exports and private investment. The latter grew by 8.0 percent, the highest rate since the fourth quarter of 1997, influenced by the execution of mining and energy projects such as Camisea.

**Table 7**

**GROSS DOMESTIC PRODUCT**
(Real annual percentage change)

| | 2003 | | 2004 |
|---|---|---|---|
| | Q1 | Year | Q1 |
| **I. GLOBAL DEMAND (1 + 2)** | **6.4** | **3.9** | **4.2** |
| 1. Domestic Demand [1/] | 6.2 | 3.6 | 2.8 |
| a. Private Consumption | 4.5 | 3.2 | 3.1 |
| b. Public Consumption | 6.4 | 4.5 | 0.3 |
| c. Private Fixed Investment | 7.0 | 5.3 | 8.0 |
| d. Public Investment | 5.0 | 5.0 | -12.9 |
| 2. Exports | 7.6 | 5.8 | 11.9 |
| **II. GLOBAL SUPPLY (3 + 4)** | **6.4** | **3.9** | **4.2** |
| **3. Gross Domestic Product** | **6.3** | **4.1** | **4.6** |
| 4. Imports | 6.9 | 3.2 | 1.9 |

1/ Includes inventories changes.
Source: INEI.

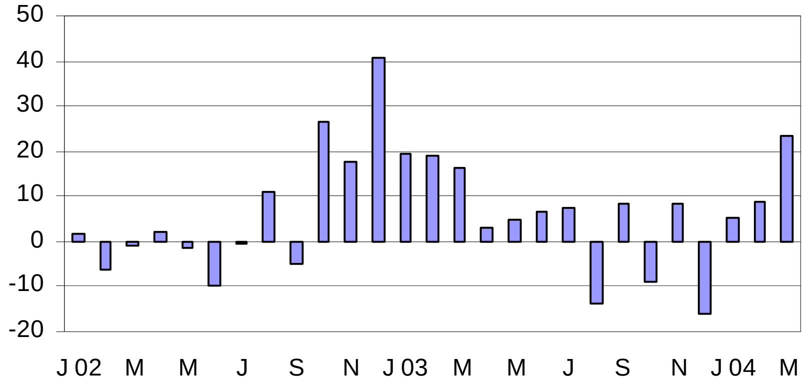
21. **Exports** grew due to the increased activity of traditional mining products such as gold (16 percent), copper (13.9 percent), lead (33.5 percent) and silver (2.4 percent); and non-traditional products, standing out the textile sector (31.3 percent), agriculture and livestock (31.6 percent) and basic metal industries and jewelry (56.1 percent). **Imports** increased by 1.9 percent mainly in raw materials and capital goods for industry (10.7 and 7.7 percent, respectively) and transportation equipment (24.1 percent).

22. **Private investment** is growing mainly due to the development of the mining and fuel sector projects such as Camisea, which, together with the acquisition and renovation of equipment in the industrial sector, contributed to the greater dynamism of the construction sector. In this regard, construction sector grew by 8.3 percent. Also, capital goods imports, excluding building materials grew by 11.5 percent in nominal terms, mainly in goods for industry and transportation equipment, which was reflected in greater purchases by Ferreyros (a machinery distribution firm), the mining firm Southern and the refinery La Pampilla.

23. The 3.1 percent increase in **private consumption** was associated to the 6.2 percent rise in the national disposable income and to the 1.9 percent increase in urban employment in the firms with 10 or more workers, mainly in the manufacturing sector. This development was reflected in the 22.0 percent increase in the consumer credits of the financial enterprises and in the 10 percent growth in the sales of vehicles.

**Figure 15**

**NEW VEHICLES SALES**
(12-month percentage changes)

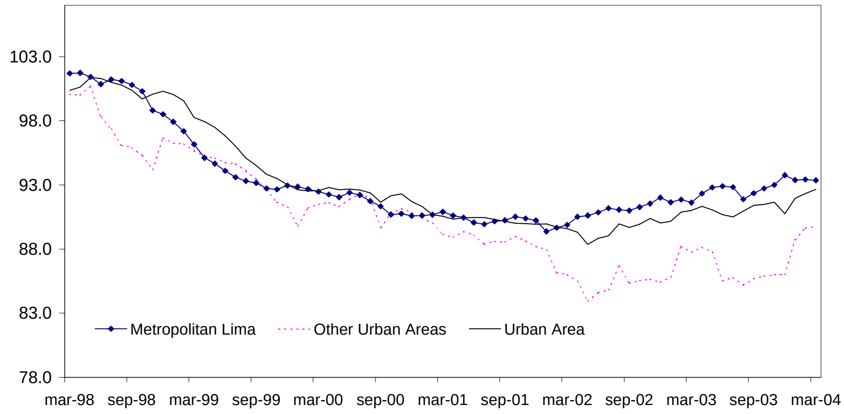



Source: Asociación de Representantes Automotrices del Perú (ARAPER)

The growth of production has been accompanied by an increase in employment in the last months. In March 2004, employment in firms with 10 or more workers increased by 1.9 percent in the urban area, compared with March of the previous year, according to the National Survey of Monthly Variation in Employment, undertaken by the Ministry of Labor and Employment Promotion (MTPE). The most important rises occurred in the manufacturing sector (2.4 percent), services (2.6 percent) and transportation (2.2 percent). It should be mentioned that this survey reports indicators for the urban area of Metropolitan Lima and other 21 cities of the country.

**Figure 16**

**EMPLOYMENT IN BUSINESSES OF 10 OR MORE WORKERS**
(Seasonally adjusted indices October 1997 =100)




Source: National Survey of Monthly Variation in Employment, Ministry of Labor and Employment Promotion

In the rest of urban areas, employment grew by 2.3 percent, standing out Paita (26.9 percent), which was accompanied by a greater industrial activity and in Ica (15.3 percent), driven by a greater agricultural and commercial activity. In Trujillo employment grew by 5 percent due to the greater agroindustrial activity for exports, while in Piura it grew mainly in the transportation sector (due to maintenance operations) and education services.

**Table 8**
**URBAN EMPLOYMENT IN MAIN CITIES**
**BUSINESSES OF 10 OR MORE WORKERS**
(Annual percentage change)

| | March 2004/ March 2003 | Jan. - Mar 2004/ Jan. - Mar. 2003 |
|---|---|---|
| **Urban Peru** | **1.9** | **1.9** |
| Metropolitan Lima | 1.9 | 1.8 |
| Other Urban | 2.3 | 2.5 |
| | | |
| Arequipa | 1.9 | 1.8 |
| Cajamarca | 2.7 | -0.1 |
| Chiclayo | -0.3 | -0.7 |
| Chimbote | -2.2 | 3.0 |
| Chincha | 1.7 | 3.5 |
| Cusco | -1.1 | -3.1 |
| Huancayo | 4.1 | -0.2 |
| Ica | 15.3 | 10.9 |
| Iquitos | 0.7 | 1.4 |
| Paita | 26.9 | 9.5 |
| Pisco | -2.7 | -2.3 |
| Piura | 6.8 | 5.1 |
| Pucallpa | -4.1 | -1.6 |
| Puno | -4.0 | -6.4 |
| Tacna | -2.1 | -5.9 |
| Tarapoto | 0.7 | -1.6 |
| Trujillo | 5.0 | 8.2 |

Source: Ministry of Labor and Employment Promotion, Monthly Statistical Report

24. **Public consumption** increased slightly (0.3 percent) compared to the first quarter of 2003, as a consequence of greater expenditures in goods and services of the central government, regulating institutions, registry offices and local governments. The 12.9 percent reduction in **public investment** is explained by the delay in the implementation of the programs transferred to local and regional governments.

25. During the first quarter of 2004, primary sectors grew by 5.5 percent, while non-primary sectors increased 4.6 percent. In that period all sectors grew, a situation not observed since the fourth quarter of 2002. Primary sector was boosted by the metallic mining (14 percent) due to the higher production of gold, copper and iron; and the fishing (6.5 percent), led by the greater unloading of anchovy. Within the non primary sector, the sectors that stood out were: construction (7.1 percent) prompted by the state promoted housing programs; and non primary manufacturing (6 percent), reflecting the increase of non traditional exports, the development of mining projects and a higher production of final consumption goods for the domestic market (food and beverages) and construction related goods (cement, glass and tiles).

**Table 9**
**GROSS DOMESTIC PRODUCT**
(Annual percentage change)

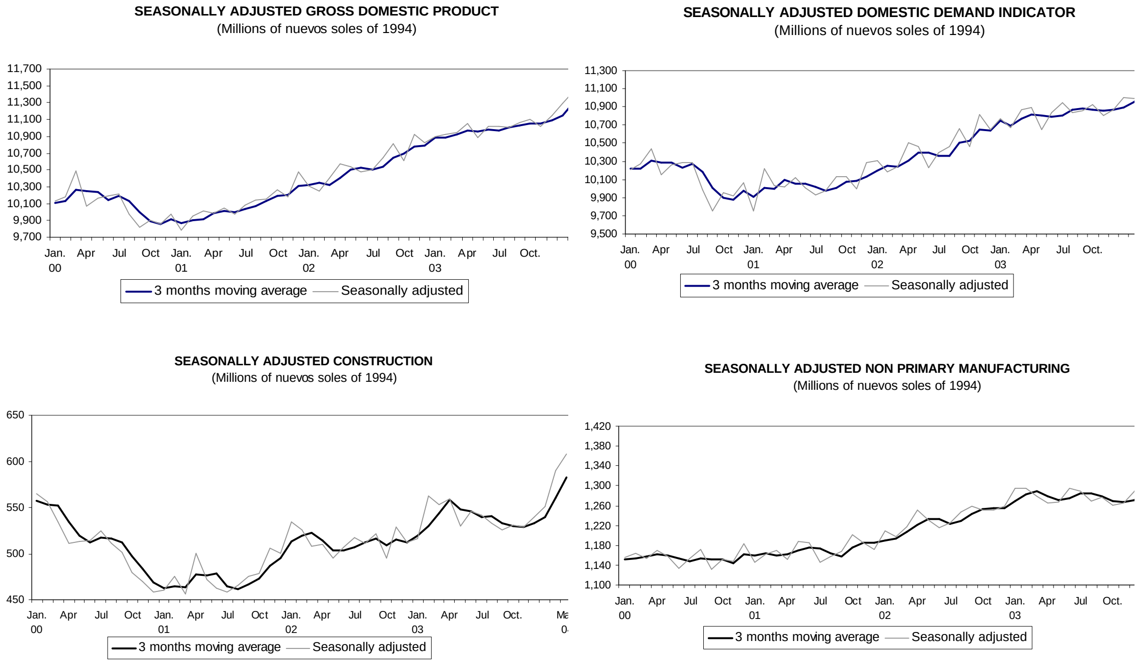
| | 2003 | | 2004 |
|---|---|---|---|
| | Q1 | Year | Q1 |
| **Agriculture and livestock** | **2.1** | **2.2** | **1.7** |
| **Fishing** | **-15.0** | **-13.4** | **6.5** |
| **Mining and fuel** | **4.5** | **6.7** | **12.4** |
| Metallic mining | 5.6 | 7.8 | 14.0 |
| Natural gas and oil | -6.2 | -4.5 | -5.4 |
| **Manufacturing** | **6.4** | **2.2** | **5.0** |
| Based on raw materials | -2.2 | -2.8 | 0.5 |
| Non-primary industries | 8.5 | 3.6 | 6.0 |
| **Construction** | **5.2** | **4.8** | **7.1** |
| **Commerce** | **8.0** | **3.6** | **2.2** |
| **Services** | **6.0** | **4.5** | **4.8** |
| Electricity and water | 4.7 | 4.2 | 4.7 |
| Other services | 6.1 | 4.5 | 4.8 |
| **GROSS AGGREGATED VALUE (GAV)** | **5.7** | **3.8** | **4.8** |
| Taxes on products and import duties | 11.9 | 6.3 | 2.6 |
| **TOTAL GDP** | **6.3** | **4.1** | **4.6** |
| **Primary GAV** | **1.8** | **2.5** | **5.5** |
| **Non-primary GAV** | **6.8** | **4.2** | **4.6** |

Source: INEI

26. The seasonally adjusted GDP has grown continuously since December 2003, keeping the rising tendency that began in 2001. The development in the last months has been associated to the greater activity of non-primary sectors such as manufacturing and construction, as well as the dynamism of non-metallic mining. In recent months, this

increment has been accompanied by a seasonal adjusted increase of the domestic demand indicator.

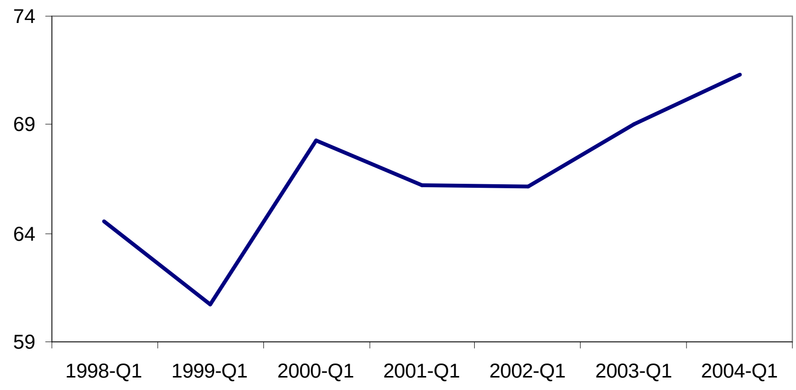
**Figure 17**




27. This growth has meant a higher rate of capital use. The information of the manufacturing sector as a whole shows a progressive increase in the last three years.

**Figure 18**

**INDIRECT INDICATOR OF THE RATE OF CAPITAL USE OF THE MANUFACTURING SECTOR**
(Percentage)




Source: INEI and Ministry of Production

28. In most of the manufacturing industries, the rate of capital use during the first quarter of 2004 was higher relative to the same periods in the previous years (2002 and 2003). The sectors which stood out were paper and paper products, non-metallic mineral products, chemical products, rubber and plastics, and food, beverages and tobacco.

29. **National disposable income** rose 6.2 percent in the first quarter of 2004, a higher rate than the one of the GDP (4.6 percent). This greater increase is explained by the improvement of the terms of trade, as a consequence of both a 19.4 percent increase in the export prices and greater transfers (which grew 18.8 percent), in a context of a

growing world economy and, particularly, of the American economy, from which most of these transfers originate.

**Table 10**
**NATIONAL DISPOSABLE INCOME**
(Real annual percentage change)

| | 2003 | | 2004 |
|---|---|---|---|
| | Q1 | Year | Q1 |
| I. Gross Domestic Product (GDP) | 6.3 | 4.1 | 4.6 |
| II. Gross National Product (GNP) 1/ | 4.8 | 3.2 | 3.6 |
| III. Gross National Income (GNI) 2/ | 5.4 | 3.7 | 5.9 |
| IV. National Disposable Income (NDI) 3/ | 5.5 | 3.9 | 6.2 |

1/ Excludes from the GDP the net investment income paid to non-resident producers.
2/ The GDP and GNP are isolated from changes in the terms of trade in foreign trade.
3/ Adds to the GNI the received net transfers from non-residents

Source: INEI, BCRP

## I.4 External accounts

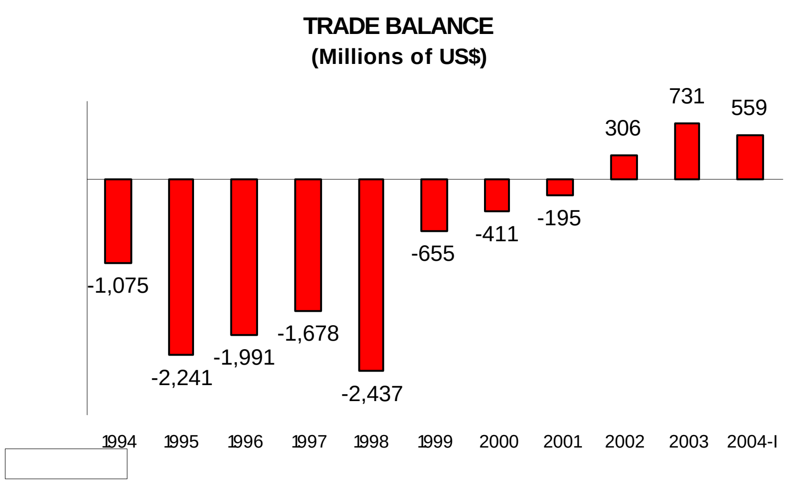
*Over the first quarter of 2004, the trade balance recorded a US$ 559 million surplus, within a favourable international context, which reflected an improvement in the terms of trade (14.7 percent the greatest increase since 1994)) and an increase in export volumes of 11 percent (mainly copper and gold).*

*The reduction of the current account deficit made possible by the larger trade surplus, keeps improving the external sector sustainability, which has meant lowering capital inflow requirements and increasing international reserves by US$ 216 million, all of which strengthens the country's international liquidity position.*

### *Trade balance*

30. As the favorable external conditions held along the first quarter of 2004, the trade balance recorded a surplus of US$ 559 million, with a 33 percent increase in exports and a 4 percent growth in imports.

**Figure 19**



31. **Exports** totaled US$ 2,687 million during the first quarter of 2004, up US$ 664 million from the same period of 2003. Exports of traditional products grew by 34 percent or US$ 483 million, whereas exports of non-traditional products expanded by 31 percent or US$ 181 million. Within the former, the more dynamic items were gold (due to Yanacocha's higher output) and copper (due to both Antamina's and Tintaya's higher outputs), which grew by 16.0 and 13.9 percent, respectively, whereas their international prices rose by 16.0 and 58.6 percent, respectively. Exports of non-traditional products were favored mainly by the Andean Trade Promotion and Drug Eradication Act (ATPDEA) that propelled the growth of textile exports in 31.3 percent; the dynamism of agriculture and livestock products (31.6 percent) and higher international prices in the basic-metal and jewelry sectors (56.1 percent).

**Imports** amounted to US$ 2,128 million in the first quarter of 2004, up 4 percent (US$ 86 million) from a year ago. Acquisitions of intermediate goods rose 7 percent (US$ 72 million), in particular those oriented to industry (11 percent). Likewise, capital good imports grew by 5 percent (US$ 23 million), mainly machinery for industry; however, durable and non durable consumer goods acquisitions recorded a fall.

***Terms of trade***

32. The remarkable trade surplus has been due also to the 14.7 percent increase in terms of trade, mainly since the second half of 2003 thanks to higher international prices associated to world economic growth prospects. Thus, the increase in the terms of trade over the first quarter of 2004 is mainly a result of the 19.4 percent growth in export prices. The highest increase was recorded in copper (58.6 percent). On the other hand, the increase in import prices (4 percent) was mainly a result of the rise in wheat and soybean prices (18.6 and 31.7 percent, respectively).

***Current account balance and capital flows***

33. Over the first quarter of 2004, the **current account deficit** of the balance of payments was US$ 68 million (-0.4 percent of GDP), US$ 446 million lower than the one of the same period in 2003 (3.6 percent of GDP). This improvement is a result of higher trade surplus (US$ 559 million) and current transfers (which grew by US$ 60 million, mainly remittances from Peruvians living abroad), that offset the greater deficits in services and investment income (US$ 180 million). The higher deficit in investment income is due to higher private profits and lower yield on assets as well as higher interest rate on bonds in the public sector.

**Table 11**

**BALANCE OF PAYMENTS**
**(Millions of US$)**

| | 2003 | | 2004 |
|---|---|---|---|
| | Q1 | Year | Q1 |
| **I. CURRENT ACCOUNT BALANCE** | **-514** | **-1,061** | **-68** |
| *Percentage of GDP* | *-3.6* | *-1.7* | *-0.4* |
| 1. Trade balance | -18 | 731 | 559 |
| a. Exports | 2,024 | 8,986 | 2,687 |
| b. Imports | -2,041 | -8,255 | -2,128 |
| 2. Services | -250 | -931 | -262 |
| 3. Investment income | -509 | -2,082 | -689 |
| 4. Current transfers | 263 | 1,221 | 323 |
| **II. CAPITAL ACCOUNT** | **1,364** | **1,476** | **275** |
| 1. Private sector 1/ | 768 | 791 | 309 |
| 2. Public sector | 597 | 685 | -34 |
| **III. EXCEPTIONAL FINANCING** | **1** | **64** | **2** |
| **IV. BCR NET INTERNATIONAL RESERVES FLOW (1 - 2)** | **-851** | **-479** | **-208** |
| **(Increase with negative sign)** | | | |
| 1. Change in Central Bank reserves | -845 | -596 | -216 |
| 2. Valuation changes and monetization of gold | 6 | -118 | -8 |
| Note: | | | |
| Gross external financing of private sector | 668 | 1,940 | 429 |

1/ Includes short-term capital and net errors and omissions
Source: BCRP, MEF, SUNAT and firms

34. In this quarter the capital account reached a US$ 275 million surplus, lower than the one of the same quarter of 2003 by US$ 1,089 million. The decrease was a consequence of lower financial private capital inflows in US$ 459 million (loans and direct investment) partially offset by a lower investment of domestic pension funds (AFPs) abroad. Gross long term private capitals amounted to US$ 429 million, mainly for the Camisea project (US$ 42 million) and the industry (US$ 25 million), there being as well a sizable investment volume as a counterpart of non-distributed profits. Conversely, public capital flows were negative in US$ 34 million, against the US$ 597 million surplus of a year ago, mainly due to the revenue of US$ 750 million from the issuance of sovereign bonds in the first quarter of 2003.

Overall, the BCRP’s net international reserves registered a positive flow of US$ 216 million during the first quarter of 2004.

## I.5 Government expenditure and fiscal accounts

*In the first quarter of the year, fiscal accounts showed a positive performance resulting in a primary surplus due to growing fiscal revenues and the reduction of non-financial expenditures. In particular, capital expenditures were low as a result of execution delays in some decentralized investment projects that were recently transferred from central government to regional governments, and adverse weather conditions that delayed the implementation of certain investment projects, among other factors.*

35. During the first quarter of 2004, the non-financial public sector (NFPS) **overall balance** run a surplus of 0.7 percent of GDP. This figure is in sharp contrast with the 0.7 percent of GDP deficit obtained in the same quarter of 2003. This improvement was due to a strong increase in the NFPS primary balance of about 1.6 percent of GDP, brought about mainly

by higher tax revenues, lower non-financial expenditures and a surplus in the accounts of the state owned enterprises.

NFPS **interest** expenditures amounted to 2.6 percent of GDP, and were higher by 0.2 percent of GDP compared to those recorded in the same quarter of 2003. This increase was due to higher external public debt maturities.

**Table 12**
**NON-FINANCIAL PUBLIC SECTOR**
(Millions of nuevos soles)

| | 2003 | | 2004 |
|---|---|---|---|
| | Q1 | Year | Q1 |
| **1. Current revenue** | **7,458** | **31,551** | **8,135** |
| *(% of GDP)* | *15.0* | *14.9* | *14.8* |
| *Real % change* | *17.0* | *8.0* | *5.9* |
| **2. Non-financial expenditure** | **-6,766** | **-31,460** | **-6,775** |
| *(% of GDP)* | *-13.6* | *-14.8* | *-12.4* |
| *Real % change* | *7.8* | *5.2* | *-2.8* |
| **3. Other** | **175** | **814** | **454** |
| *(% of GDP)* | *0.4* | *0.4* | *0.8* |
| **4. Primary balance** | **866** | **905** | **1,815** |
| ***(% of GDP)*** | ***1.7*** | ***0.4*** | ***3.3*** |
| **5. Interests** | **-1,215** | **-4,633** | **-1,421** |
| ***(% of GDP)*** | ***-2.4*** | ***-2.2*** | ***-2.6*** |
| Of which: | | | |
| *Pension Reform Bonds* | *-174* | *-235* | *-204* |
| *External debt (Millions of US$)* | *-252* | *-1,082* | *-310* |
| **6. Overall balance** | **-349** | **-3,728** | **393** |
| ***(% of GDP)*** | ***-0.7*** | ***-1.8*** | ***0.7*** |
| ***Millions of US$*** | ***-100*** | ***-1,072*** | ***113*** |

Source: MEF, SUNAT, ESSALUD, societies of public beneficence, local governments, state enterprises and public institutions

36. Central government **current revenues** rose 6 percent in real terms relative to the first quarter of 2003 due to the increase in tax revenues (9 percent in real terms). This development was explained by higher income tax collections associated to an increase in taxable income and the improvement in the factors used to compute income tax advance payments and the depletion of fiscal credits; the one percentage point increase (from 16 to 17 percent) in the value added tax rate established in August 2003; inclusion of a new group of goods and services in the VAT detraction payment system in the second semester of 2003; the implementation of the perception regime for VAT on imported goods since mid November 2003; and the proceeds from the Financial Transactions Tax.

37. The reduction in non-financial expenditures of the central government during the first quarter (from 13.6 percent of GDP in 2003 to 12.4 percent of GDP in 2004) was explained mainly by a lower current (from 12.1 to 11.5 percent of GDP) and capital (from 1.4 to 0.9 percent of GDP) spending relative to the authorized amounts. There were different factors that caused this result.

On the one hand, some social and capital expenditure programs were transferred from central government to the newly elected regional governments. This transfer produced delays in the execution of public expenditure because of the need to implement new operative processes at the regional level and because of managerial problems in some of the transferred programs. As a result, even though expenditure was reduced at the central government level in social programs developed by Pronaa, Foncodes, Pro Vias Rural, ex-Ordesur and A Trabajar Urbano Project (Ministry of Labor), no equivalent increase in expenditure at the regional and local governments levels was observed.

On the other hand, bad weather conditions affected negatively the development of some transportation investment projects. In particular, the improvement and maintenance of Chalhuanca-Abancay and Aguaytía-Pucallpa highways were postponed.

Finally, the expenditure level observed in the first quarter of 2003 included some operations that were not executed in 2004. For example, capital expenditure was higher in the first quarter of 2003 due to the acquisition of machinery for the Municipal Basic Equipment Program financed with a loan from the JBIC (S/. 93 millions). In the same token, current transfers were higher in the first quarter of 2003 due to the fact that the Previsional Normalization Office had to pay pensions accrued in previous periods.

38. The increase in the **non-financial state-owned enterprises** balance (S/. 364 millions relative to the first quarter of 2003) was explained mainly by the surplus obtained by Petroperu, Sedapal and the regional electricity companies.

39. The NFPS **gross borrowing requirements** were lower than those registered in the same period of 2003. The gross financial requirements amounted to US$ 308 million and were mainly covered by US$ 259 million in external debt disbursements, of which US$ 200 million correspond to free disposal funds and US$ 59 million to investment projects loans. In addition, the government placed an equivalent of US$ 173 million in local currency bonds in the domestic market and collected US$ 71 million in privatization proceeds.

**Table 13**
**NON-FINANCIAL PUBLIC SECTOR FINANCING**

| | 2003 | | 2004 |
|---|---|---|---|
| | Q1 | Year | Q1 |
| **1. Overall balance (millions of nuevos soles)** | **-349** | **-3,728** | **393** |
| ***(% of GDP)*** | ***-0.7*** | ***-1.8*** | ***0.7*** |
| ***Millions of US$*** | ***-100*** | ***-1,072*** | ***113*** |
| | | | |
| **2. Amortization (millions of US$)** | **-378** | **-1,741** | **-422** |
| Redemption of Pension Reform Bonds | -51 | -170 | -51 |
| Other domestic | -72 | -385 | -72 |
| External | -254 | -1,187 | -299 |
| | | | |
| **3. Gross financial requirements (millions of US$)** | **478** | **2,813** | **308** |
| External financing | 838 | 2,101 | 259 |
| *Free disposal funds* | *750* | *1,765* | *200* |
| *- Multilaterals* | *0* | *519* | *200* |
| *- Bonds* | *750* | *1,246* | *0* |
| *Investment projects* | *88* | *336* | *59* |
| Domestic bonds | 48 | 508 | 173 |
| Privatization | 6 | 52 | 71 |
| Others | -415 | 152 | -194 |

Source: MEF, Banco de la Nación and BCRP

## I.6 Interest rates and monetary aggregates

***Interbank interest rate***

*Monetary policy management is executed through the announcement of benchmark interest rates for the Central Bank's monetary operations, for both credit and deposit facilities, with the banking sector. Open market operations have enabled the interbank interest rate to remain at 2.5 percent. Since November 2003, the Central Bank has kept stable its monetary policy stance with an interbank interest rate of 2.5 percent.*

40. The benchmark interest rates for Central Bank's monetary operations with the banking system, both the loan rate for repo agreements and rediscounts and the rate for deposit facilities at the Central Bank, determine a reference corridor for the interest rate of the interbank market in domestic currency. Daily monetary operations to inject or withdraw liquidity from the market have allowed the interbank interest rate to remain around the center of this corridor during the period December 2003 - May 2004. Thus, the average standard deviation of the interbank interest rate during the year so far has been maintained at 0.1 percentage points, similar to the level observed last year.

The stability achieved by the interbank rate makes more predictable the formation process of the other interest rates in soles.

**Table 14**

**LEVEL AND VOLATILITY OF INTERBANK INTEREST RATE**
(In percentage points)

| Year | Average Level | Standard deviation |
|---|---|---|
| 1998 | 19.0 | 6.6 |
| 1999 | 14.9 | 4.8 |
| 2000 | 12.7 | 2.5 |
| 2001 | 8.6 | 0.9 |
| 2002 | 3.2 | 0.5 |
| 2003 | 3.4 | 0.1 |
| 2004 [1/] | 2.5 | 0.1 |

1/ Jan-May.

Source: BCRP

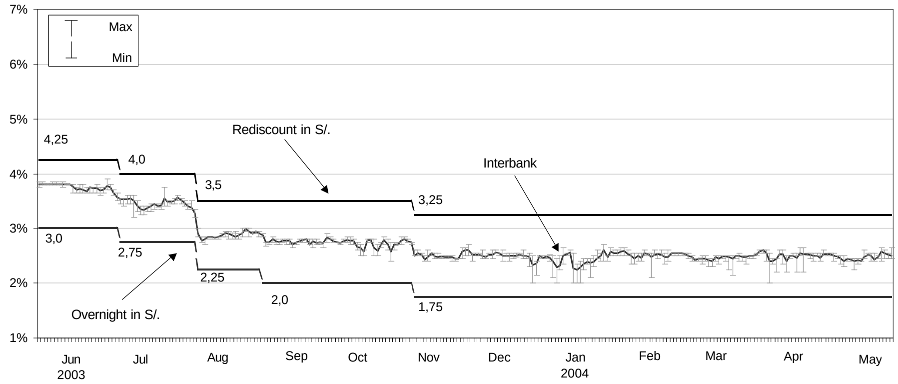
**Table 15**
**INTERBANK INTERES RATES IN SOLES**
(In percentages)

| | Jan. | Feb. | Mar. | Apr. | May. | Jun. | Jul. | Aug. | Sep. | Oct. | Nov. | Dec. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2003** | | | | | | | | | | | | |
| Average | 3.75 | 3.80 | 3.82 | 3.84 | 3.78 | 3.74 | 3.47 | 3.01 | 2.77 | 2.71 | 2.55 | 2.51 |
| Standard deviation | 0.1 | 0.1 | 0.1 | 0.0 | 0.1 | 0.0 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.0 |
| Variability coefficient (%) | 3.6 | 2.6 | 1.6 | 1.3 | 1.8 | 1.3 | 2.5 | 8.2 | 2.2 | 2.9 | 4.3 | 2.0 |
| **2004** | | | | | | | | | | | | |
| Average | 2.41 | 2.52 | 2.48 | 2.49 | 2.48 | | | | | | | |
| Standard deviation | 0.1 | 0.0 | 0.0 | 0.1 | 0.0 | | | | | | | |
| Variability coefficient (%) | 4.2 | 1.7 | 1.5 | 2.6 | 1.9 | | | | | | | |

Source: BCRP

**Figure 20**

**INTEREST RATES IN DOMESTIC CURRENCY**
**(May 2003 - May 2004)**




41. As observed in previous months, the evolution of the interbank interest rate continued to influence the term structure of interest rates in soles (deposits, loans and securities). The 90-day corporate prime lending interest rate remained stable at levels of around 3.3 percent between December 2003 and April 2004, with a slight increase in May (3.5 percent).

**Figure 21**

**MONTHLY AVERAGE INTEREST RATE IN DOMESTIC CURRENCY**
**(May 2003 - May 2004)**

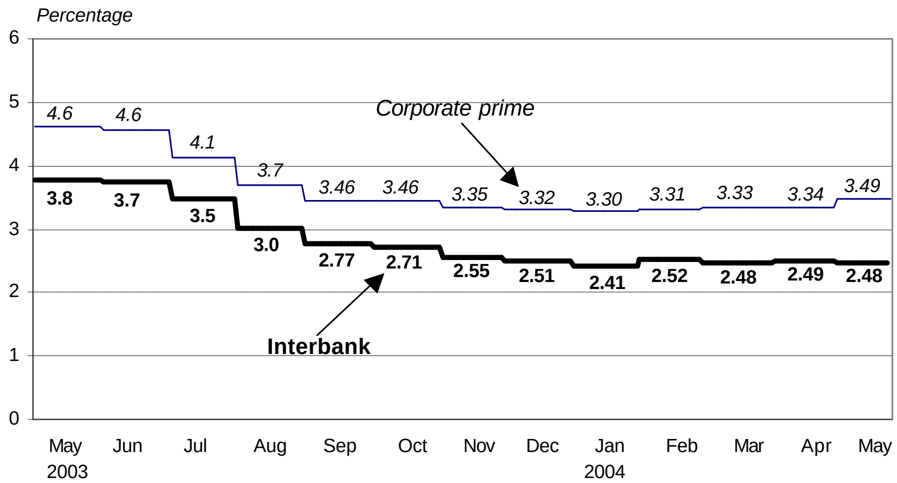



**Table 16**
**INTEREST RATES FOR OPERATIONS IN SOLES**
(In percentage points)

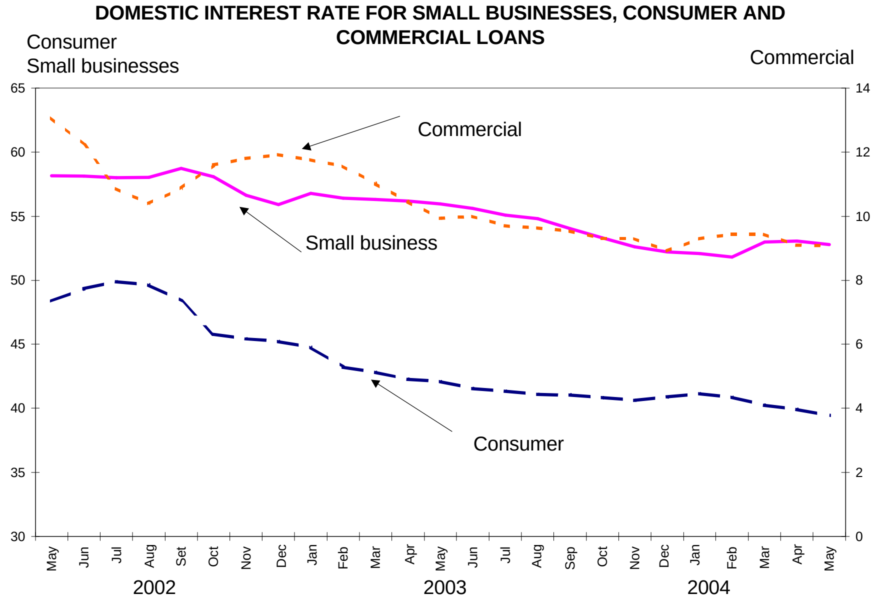
| | 2002 | | | | 2003 | | | | 2004 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | mar | jun | sep | dec | mar | jun | sep | dec | mar | apr | may |
| 1 Interbank | 2.5 | 2.6 | 5.4 | 3.8 | 3.8 | 3.7 | 2.8 | 2.5 | 2.5 | 2.5 | 2.5 |
| 2 Saving deposits | 1.8 | 1.7 | 1.7 | 1.7 | 1.7 | 1.5 | 1.3 | 1.3 | 1.4 | 1.3 | 1.3 |
| 3 Prime lending rate | 3.9 | 3.7 | 6.8 | 5.1 | 4.7 | 4.6 | 3.5 | 3.3 | 3.3 | 3.3 | 3.5 |
| 4 Average lending rate up to 360 days | 15.5 | 14.1 | 14.0 | 14.8 | 14.3 | 14 | 14.3 | 14.0 | 14.8 | 14.2 | 14.5 |
| 5 CD | | | | | | | | | | | |
| On the balance | 5.4 | 4.8 | 4.1 | 4.7 | 4.7 | 4.8 | 4.3 | 3.9 | 3.7 | 3.7 | 3.7 |
| Average term of monthly placements (in months) 1/ | 6 | 6 | - | 8 | 12 | 7 | 15 | 11 | 11 | 12 | - |

1/ Excludes one-week CD deposits

Source: BCRP

42. The average interest rate for lending operations of the banking system in domestic currency (see Box 2) dropped from 19.0 percent in December 2003 to 18.8 percent in May 2004, following the decreasing trend of the last years. By components, the average rate for consumer loans fell from 40.9 to 39.4 percent in the same period, while the lending rate for small businesses grew from 52.2 to 52.8 percent. Similarly, the interest rate for commercial loans rose from 8.9 to 9.1 percent in this period.

**Figure 22**

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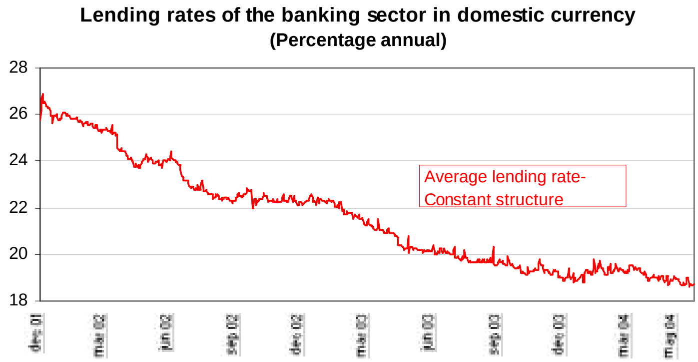
**BOX 2**

**<u>New indicators of average interest rates of the banking sector</u>**

The Central Bank has started to publish indicators of the average lending and deposit interest rates of the banking sector, which have been calculated using constant weights. These new indicators show clearly the general trend of market interest rates, independently of variations in the relative weight of different types of lending or deposit operations. The use of these new indicators has been necessary due to the fact that the steady fall in interest rates of several types of credit has not been reflected in the current indicators of average lending rates of the banking sector (TAMN). This is due because the latter incorporate the effect of the higher growth of those loans carrying higher interest rates, such as consumer loans and loans to small businesses.

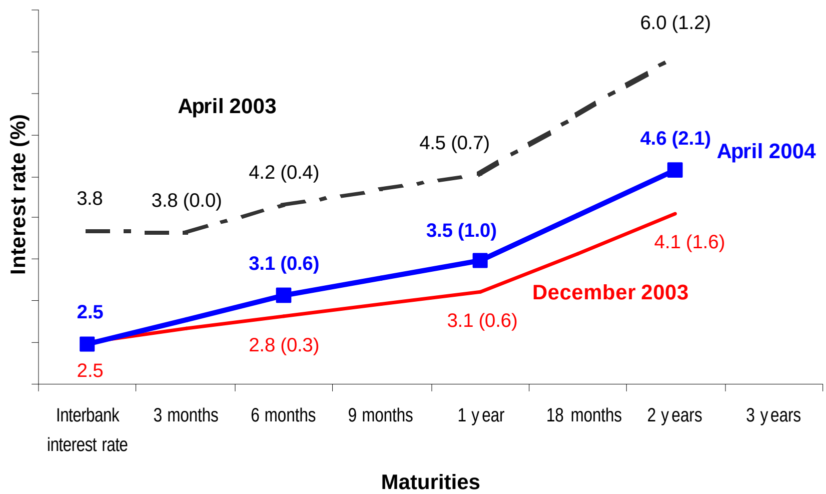
The new indicator of average interest rate in domestic currency has been calculated using the share structure of the four main types of commercial bank loans (commercial, small businesses, consumer and mortgage loans) as of December 2001, allowing a better assessment of the general trend of the market interest rates.




43. In the first four months of the year, the yield curve of Central Bank's securities (CDBCRP) shifted upwards, showing a steeper pattern for longer-term interest rates. This evolution could be explained by expectations of an increase in interest rates in the future due to the expected rise of international interest rates. Thus, the average interest rate of 6-month CDBCRP and 1-year CDBCRP rose 0.3 and 0.4 percentage points between December 2003 and April 2004, respectively, while the 2-year CDBCRP rate increased 0.5 percentage points in the same period.

**Figure 23**

**CDBCRP RETURNS BY TERM [1/]**




1/ Numbers between parentheses indicate spreads with respect to the interbank rate.

44. The outstanding balance of CDBCRP increased from S/. 4,097 million as of December 2003 to S/. 5,998 million as of March 2004, mainly due to the sterilisation of Central Bank's foreign exchange operations. The improvement of the public finances in April and May allowed to sterilise these operations through dollar sales to the public sector and higher deposits of Banco de la Nación. Therefore, the outstanding balance of CDBCRP decreased to S/. 5,348 million in May.

Simultaneously, the average interest rate of the CDBCRP balance lowered from 3.9 to 3.7 percent during the year, explained by the shortening of the terms of placements of CDBCRP (the last placement of 3-year CDBCRP occurred in the first half of January), in a context of upward pressures in the interest rates of these securities.

**Table 17**
**CDBCRP BALANCE PER TERM**
(Millions of nuevos soles)

| | 2003 | 2004 | | |
|---|---|---|---|---|
| | Dec. | Mar. | Apr. | May. |
| 1 and 3 month | 32 | 305 | 130 | 40 |
| 5 and 6 month | 790 | 955 | 915 | 865 |
| 7 and 9 month | 180 | 523 | 523 | 393 |
| 1 year and 18 month | 2,280 | 3,031 | 2,941 | 2,816 |
| 2 and 3 year | 815 | 1,185 | 1,235 | 1,235 |
| **Total** | **4,097** | **5,998** | **5,743** | **5,348** |
| Average interest rate of CDBCRP balance | 3.9% | 3.7% | 3.7% | 3.7% |

Source: BCRP

45. Between January and May 2004, the amount of Treasury Bonds placed through the Market Maker Program initiated last year reached S/. 809 million. At the end of May, the balance of Sovereign Bonds in soles was S/. 3,179 million, up from S/. 2,660 million in December 2003.

**Table 18**
**INTEREST RATES OF TREASURY BONDS**
**IN THE SECONDARY MARKET**
**(In percent)**

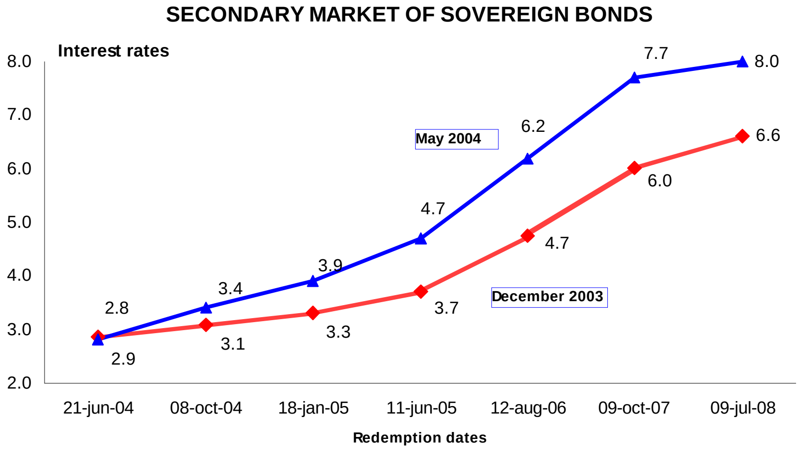
| | Jan.05 | Jun.05 | Aug.06 | Oct.07 | Jul.08 |
|---|---|---|---|---|---|
| **2003** | | | | | |
| January | - | - | - | - | - |
| February | 7.50 | - | - | - | - |
| March | 6.80 | - | - | - | - |
| April | 5.90 | - | - | - | - |
| May | 6.00 | - | - | - | - |
| June | 4.70 | 4.95 | - | - | - |
| July | 4.13 | 4.35 | - | - | 9.00 |
| August | 3.67 | 3.95 | 4.62 | - | 7.70 |
| September | 3.65 | 3.95 | 4.27 | - | 6.77 |
| October | 3.65 | 4.01 | 4.71 | 5.98 | 6.80 |
| November | 3.30 | 3.65 | 4.81 | 6.10 | 6.61 |
| December | 3.27 | 3.66 | 4.67 | 5.96 | 6.55 |
| **2004** | | | | | |
| January | 3.45 | 3.75 | 4.75 | 5.79 | 6.45 |
| February | 3.29 | 3.56 | 4.67 | 5.55 | 6.35 |
| March | 3.28 | 3.54 | 4.61 | 5.50 | 6.26 |
| April | 3.40 | 3.95 | 5.07 | 5.75 | 6.55 |
| May | 3.90 | 4.70 | 6.15 | 7.73 | 8.00 |

Source: BCRP

46. Interest rates of the Treasury Bonds fell during the first quarter but started to rise in April, and particularly in May. The yield of the June 2005 Sovereign Bond rose 1.0 percentage point between December 2003 and May 2004; the yield of the October 2007 Sovereign Bond increased 1.7 percentage points, while the yield of the July 2008 Sovereign Bond rose 1.4 percentage points.

The increase of longer-term bond yields in local currency came as a result of higher interest rates of the US Treasury Bond and higher spreads of sovereign risk in the region. To avoid overreaction in the market and prevent interest rate volatility, the government cancelled the Sovereign Bond auctions scheduled for May.

**Figure 24**




47. Between January and May 2004 the total amount of securities placed by private companies (net from redemptions) was positive, in soles and in dollars. The amount placed in soles (net from redemptions) was S/. 33 million, higher than the previous year (S/. 25 million), while the amount placed in dollars (net from redemptions) was US$ 144 million, higher than the previous year (US$ 111 million). There was a higher issuing of dollar-denominated securities during the first quarter in a context of sol appreciation. In April, there was a temporary reverse to domestic currency securities as investors expected a future rise in international interest rates. In May, after the rise in long term interest rate in soles, placements of sol-denominated securities dropped again.

**Table 19**

**NET PLACEMENT OF FIXED INCOME SECURITIES 1/**
(In millions)

| | Jan - May2003 | | | Jan - May2004 | | |
|---|---|---|---|---|---|---|
| | S/. | US$ | Total | S/. | US$ | Total |
| **Private Sector** | **25** | **111** | **402** | **33** | **144** | **533** |
| Placement | 560 | 387 | 1,904 | 664 | 263 | 1,577 |
| Redemption | 535 | 275 | 1,502 | 631 | 119 | 1,045 |
| **Sovereign** | **395** | **-** | **395** | **319** | **-** | **319** |
| Placement | 675 | - | 675 | 809 | - | 809 |
| Redemption | 280 | - | 280 | 490 | - | 490 |
| **CDBCRP** | **1,340** | **-** | **1,340** | **1,251** | **-** | **1,251** |
| Placement | 2,798 | - | 2,798 | 4,185 | - | 4,185 |
| Redemption | 1,458 | - | 1,458 | 2,934 | - | 2,934 |
| **TOTAL** | **1,760** | **111** | **2,137** | **1,603** | **144** | **2,103** |
| Placement | 4,033 | 387 | 5,377 | 5,658 | 263 | 6,571 |
| Redemption | 2,273 | 275 | 3,240 | 4,055 | 119 | 4,469 |

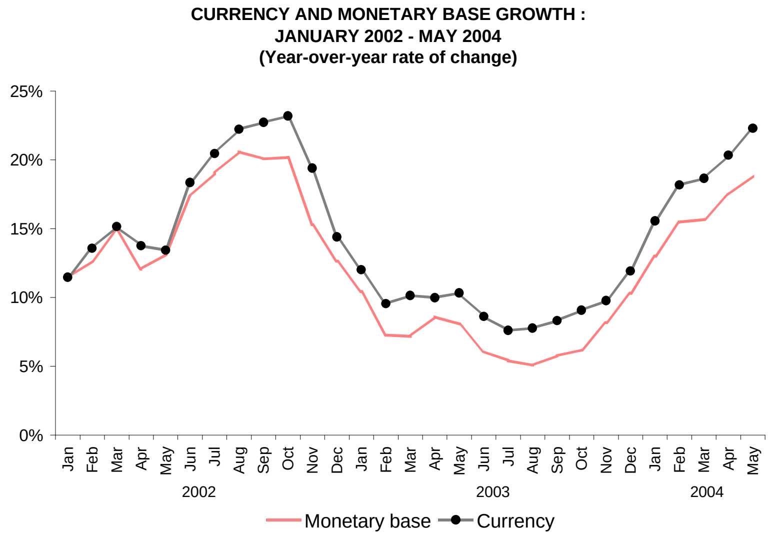
1/ Includes bonds, commercial paper, negociable certificates and Treasury Bills

Among the companies that placed sol-denominated bonds were Luz del Sur (S/. 139 million), Gloria (S/. 35 million), Edegel (S/. 30 million), Edelnor (S/. 50 million) and Telefónica del Perú (S/. 30 million). Interest rates for triple A corporate issues were higher as compared to December 2003. For example, the two-year nominal bond carried an interest rate of 4.55 percent in April as compared to 4.05 percent in December, while the three-year nominal bond had an interest rate of 5.56 percent in April as compared to 4.77 percent in December.

### *Monetary Aggregates*

48. Between January and May 2004, the annual growth rates of both monetary base and currency in circulation continued the upward trend observed since the second half of 2003, following the reduction in the benchmark interest rates of Central Bank's monetary operations in the second semester of 2003. While the year-on-year rate of growth of currency in circulation increased from 12 percent in December 2003 to 22 percent in May 2004, the annual growth rate of the average monetary base stock rose from 10 to 19 percent in the same period.

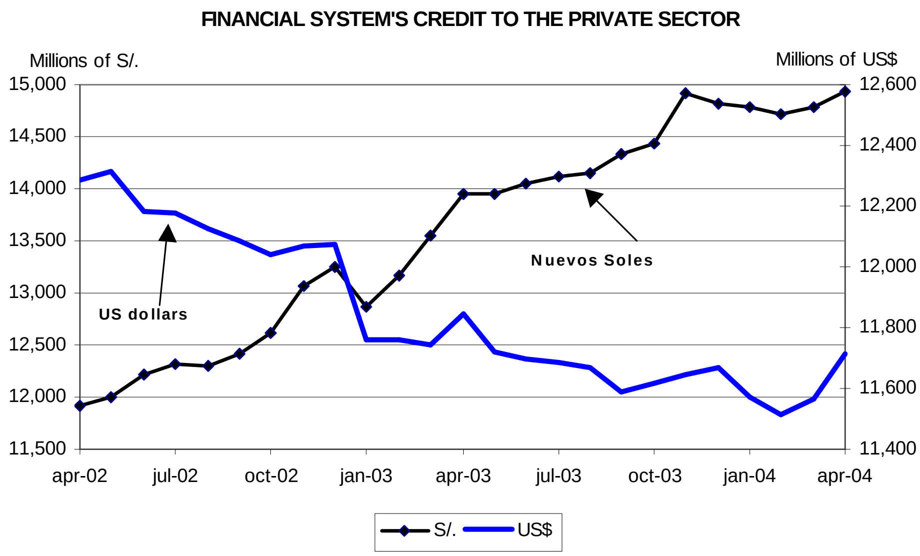
**Figure 25**




49. The credit of financial system to the private sector expanded in soles (0.7 percent) as well as in dollars (0.4 percent), between January and April 2004. In both cases, the credit diminished in January and February and has recovered since March. The annual growth rate for credit in nuevos soles has slowed down from 11.9 percent in December 2003 to 7 percent in April 2004, while the annual growth rate for credit in dollars continues to be negative (-1.1 percent).

The annual growth rate of the credit granted by micro finance institutions and institutional investors to the private sector fell, although the growth rates remain high.

**Figure 26**



50. The credit expansion in soles during the first 4 months of 2004 was due to the Banco de la Nación (S/. 180 million), owing to greater credit awarded to public sector workers, and to institutional investors (S/. 19 million), which was offset in part by less credit from banking firms (S/. 120 millions) and micro finance institutions (S/. 9 million). With these results, the annual growth rate of credit to the private sector by micro finance institutions, which was growing at 25.3 percent in December 2003 fell to 17.1 percent in April 2004. A similar trend was observed in credit to the private sector by institutional investors which went down from 31.9 percent to 27.9 percent in the same period.

**Table 20**

**FINANCIAL SYSTEM'S CREDIT TO THE PRIVATE SECTOR IN DOMESTIC CURRENCY**

| | Millions of nuevos soles | | | Percentage change | |
|---|---|---|---|---|---|
| | Apr.03 | Mar04 | Apr04 | Apr.04/ Apr.03 | Apr.04/ Mar.04 |
| Commercial banks 1/ | 8,257 | 8,130 | 8,101 | -1.9 | -0.3 |
| Banco de la Nación | 457 | 631 | 691 | 51.3 | 9.5 |
| **Micro finance institutions** | **3,122** | **3,625** | **3,657** | **17.1** | **0.9** |
| Banks (micro finance credits) | 634 | 940 | 941 | 48.4 | 0.2 |
| Local government S&Ls | 926 | 1,121 | 1,157 | 24.9 | 3.2 |
| Rural S&Ls | 146 | 189 | 188 | 28.9 | -0.4 |
| Saving and credit cooperatives | 410 | 466 | 466 | 13.7 | -.- |
| Edpymes | 143 | 171 | 170 | 19.0 | -0.5 |
| Financial companies | 863 | 738 | 734 | -14.9 | -0.6 |
| **Institutional investors 2/** | **1,720** | **2,142** | **2,199** | **27.9** | **2.7** |
| AFPs | 1,150 | 1,417 | 1,431 | 24.4 | 1.0 |
| Insurance companies | 506 | 575 | 580 | 14.8 | 0.9 |
| Mutual funds | 64 | 149 | 187 | 194.5 | 25.5 |
| **Leasing companies and others** | **392** | **257** | **277** | **-29.3** | **7.8** |
| **Total financial system** | **13,948** | **14,785** | **14,926** | **7.0** | **1.0** |

1/ Excludes micro finance credits.
2/ Mainly securities issued by the private sector
Source: BCRP

51. The increase in dollar financing during the period January-April 2004 is explained by the greater credit granted by institutional investors (US$ 117 million) through the purchases of bonds in the capital market. In the same period, there was a reduction in the dollar credit given by banks to the private sector (US$ 60 million).

**Table 21**

**FINANCIAL SYSTEM'S CREDIT TO THE PRIVATE SECTOR IN FOREIGN CURRENCY**

| | Millions of US dollars | | | Percentage change | |
|---|---|---|---|---|---|
| | Apr.03 | Mar04 | Apr04 | Apr.04/ Apr.03 | Apr.04/ Mar.04 |
| Commercial banks 1/ | 9,711 | 9,248 | 9,349 | -3.7 | 1.1 |
| Banco de la Nación | 36 | 22 | 22 | -38.3 | -0.5 |
| **Micro finance institutions** | **429** | **508** | **515** | **20.1** | **1.4** |
| Banks (micro finance credits) | 82 | 87 | 91 | 10.8 | 4.6 |
| Local government S&Ls | 126 | 190 | 197 | 56.3 | 3.6 |
| Rural S&Ls | 42 | 48 | 46 | 7.7 | -5.8 |
| Saving and credit cooperatives | 104 | 112 | 112 | 7.3 | -.- |
| Edpymes | 34 | 40 | 39 | 15.5 | -1.8 |
| Financial companies | 40 | 30 | 30 | -25.1 | -1.5 |
| **Institutional investors 2/** | **937** | **1,164** | **1,208** | **28.9** | **3.8** |
| AFPs | 468 | 536 | 586 | 25.3 | 9.3 |
| Insurance companies | 40 | 63 | 61 | 54.2 | -2.9 |
| Mutual funds | 430 | 565 | 561 | 30.4 | -0.7 |
| **Leasing companies and others** | **730** | **622** | **623** | **-14.8** | **0.1** |
| **Total financial system** | **11,843** | **11,563** | **11,716** | **-1.1** | **1.3** |

1/ Excludes micro finance credits.
2/ Mainly securities issued by the private sector
Source: BCRP

## II. FORECAST

### II.1 Inflation

52. Inflation projections are based on the assumption that the monetary policy stance remains unchanged during the forecast horizon. This standard methodological assumption allows evaluating the likely inflation scenario if the monetary policy remains passive within the macroeconomic scenario projected for subsequent months until 2005.

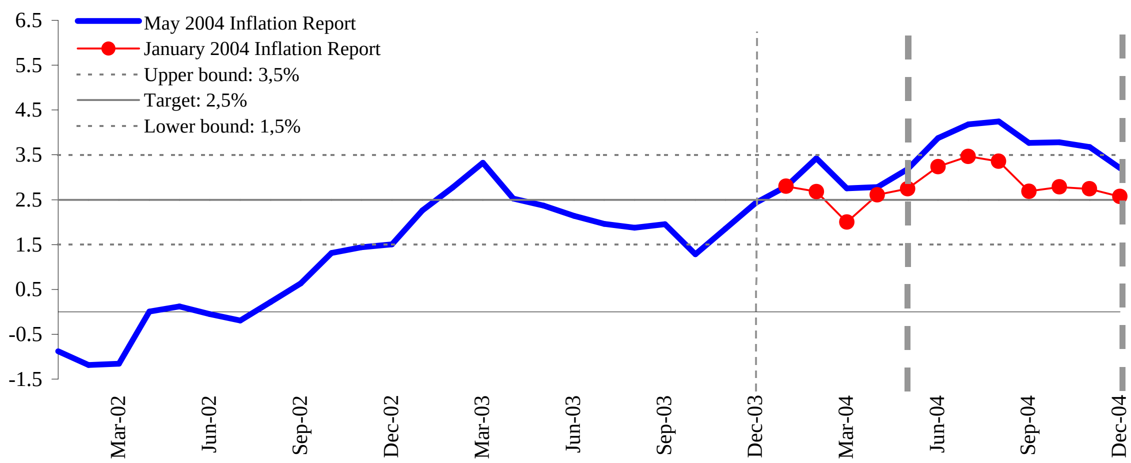
53. The projected macroeconomic scenario for 2004 assumes favorable external conditions for the Peruvian economy, associated to high prices of our main traditional export products and historical lower levels of international interest rates. Nevertheless, it is expected that international interest rates will begin to rise in the second semester of 2004 and will continue this trend during 2005, since economic activity growth and employment rate indicators in the USA suggest the surge of price pressures and the elimination of deflation risks. In this environment, the probability of a rise in the Fed Funds rate within the next months has increased. This hypothesis is considered in the central scenario. In this regard, an increase in the Fed Funds rate from 1.0 to 2.0 percent is expected for this year. For the end of 2005, this interest rate is assumed to reach 3.5 percent.

    The central scenario assumes as well a non-core inflation rate for 2004 of 3.8 percent. This projection includes supply shocks that already affected the trend of food prices during the first quarter of 2004. Regarding the previous Inflation Report, the current projections take into account an increase of fuel prices as a response to the sustained increase in the international oil price. It is expected that supply shocks considered for 2004 will have a transitory effect that would be reversed in 2005. Consequently, the non-core inflation for next year is projected to be 0.3 percent.

54. For 2004, the central inflation forecast is 3.2 percent, higher than the level considered in the January Inflation Report (2.5 percent). For 2005, the central inflation projection is 1.9 percent (within the target range), although the error margin is higher since the forecast horizon is longer. The evolution of the central projection is basically determined by supply shocks, both in core and non-core components, which would cause an increase in prices in 2004, whereas they would cause the opposite effect in the non-core component in 2005.

**Figure 27**

**INFLATION FORECAST**
**(Annual percentage change of CPI)**



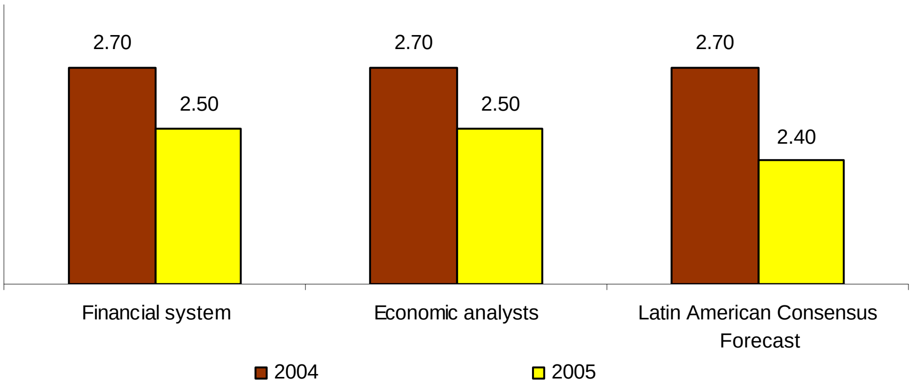

55. In general, it is observed that inflation projections for 2004 and 2005 are within target range (1.5 – 3.5 percent). The trajectory of the year-on-year inflation forecast will be above 3.5 percent between June and November of 2004, because of the supply shocks

already mentioned. There is also a statistical effect resulting from comparing months in which the inflation was negative (between April and July of 2003 the average inflation was –0.2 percent). This acceleration of the year-on-year inflation should have a transitory duration, as long as the effects of supply shocks unwind during the rest of the present year and over the course of 2005. In this way, the year-on-year inflation will reverse its trend from September onwards, noticing that in the year it will be within the target range. Similarly, it is observed that the year-on-year inflation will slow down during the year 2005.

56. According to the expectations survey conducted by the Central Bank among financial firms and economic analysts, as well as the survey results provided by Consensus Forecast, inflation expectations are approximately 2.7 percent for 2004 and between 2.4 and 2.5 percent for 2005.

**Figure 28**

**INFLATION PROSPECTS**
**(Percentage change)**




57. The baseline macroeconomic scenario for 2004 considers the following factors:

- A favorable external condition determined by terms of trade gains of about 9.1 percent, linked to the expected strong world economic recovery coupled by a moderate rise in world interest rates.

- A 4.0 percent real GDP growth and a 3.4 percent domestic demand growth. It is worth highlighting the strong rise in the exports of goods and services (7.9 percent) as well as the increase in gross fixed investment (7.2 percent).

- A public sector deficit to GDP ratio of 1.4 percent in 2004, that reflects the scenario presented in the Multi-annual Macroeconomic Framework.

**Table 22**
**INFLATION REPORT PROJECTIONS: MAY 2004 vs JANUARY 2004**

| | 2002 | 2003 | 2004 [1] | | 2005 [1] |
|---|---|---|---|---|---|
| | | | January Report 2004 | May Report 2004 | May Report 2004 |
| | | | **Real percentage change** | | |
| 1. Gross domestic product | 4.9 | 4.1 | 4.0 | 4.0 | 4.5 |
| 2. Domestic demand | 4.1 | 3.6 | 3.7 | 3.4 | 4.4 |
| *a. Private consumption* | 4.5 | 3.2 | 3.5 | 3.5 | 4.2 |
| *b. Public consumption* | 1.6 | 4.5 | 3.4 | 4.4 | 1.1 |
| *c. Private fixed investment* | 0.1 | 5.3 | 6.1 | 7.2 | 6.0 |
| *d. Public investment* | -4.8 | 5.0 | 6.4 | 8.1 | 4.0 |
| 3. Exports of goods and services | 6.8 | 5.8 | 6.1 | 7.9 | 6.0 |
| 4. Imports of goods and services | 2.4 | 3.2 | 4.5 | 4.4 | 5.7 |
| 5. Growth of our main trade partners | 1.6 | 2.5 | 4.0 | 4.2 | 3.6 |
| | | | **Percentage change** | | |
| 7. Accumulated inflation | 1.5 | 2.5 | 2,5 | 3,2 [2] | 1,9 [2] |
| 8. Accumulated nominal depreciation | 2.3 | -1.2 | 1.2 | 1.1 | 1.1 |
| 9. Accumulated real depreciation (multilateral) | -0.6 | 7.5 | 2.0 | 0.6 | 0.7 |
| 10.Terms of trade | 2.8 | 1.4 | 7.2 | 9.1 | -3.0 |
| | | | **Percentage of GDP** | | |
| 11. Balance of payments current account | -2.0 | -1.7 | -1.0 | -0.4 | -0.7 |
| 12. Trade balance | 0.5 | 1.2 | 2.7 | 3.5 | 3.1 |
| 13. Gross external financing of the private sector [3] | 5.0 | 3.2 | 3.2 | 2.8 | 2.9 |
| 14. Primary balance of non-financial public sector | -0.1 | 0.4 | 0.6 | 0.7 | 1.3 |
| 15. Overall balance of non-financial public sector | -2.3 | -1.8 | -1.5 | -1.4 | -1.0 |
| 16. Tax revenue of central government [4] | 11.9 | 12.9 | 13.4 | 13.3 | 13.4 |
| 17. Outstanding public external debt | 36.7 | 37.3 | 34.8 | 35.2 | 34.6 |
| | | | **Nominal percentage change** | | |
| 18. Non-financial central government expenditures | 3.0 | 7.6 | 5.8 | 6.7 | 4.2 |
| 19. Average monetary base | 15.8 | 7.4 | 8.0 | 14.5 | 8.5 |
| 20. Banking system credit to the private sector | 0.1 | -4.5 | 4.7 | 3.3 | 4.2 |

[1] Projection
[2] The central projection was done under the assumption of a passive stance of monetary policy over the forecast horizon.
[3] Includes direct foreign investment and long-term private sector disbursements.
[4] Excludes tax on state shares
Source: MEF, INEI, SUNAT, SBS, BCRP

58. For 2005, the baseline macroeconomic scenario considers the following elements:

- Favorable external conditions, though weaker relative to those of 2004; however, the prospects would be better than those of previous years. The projected growth of our commercial partners is 3.6 percent compared with the estimate of 4.2 percent for 2004. In 2005, the trade balance would also be positive and above US$ 2 billion.

- A GDP growth rate of 4.5 percent combined with a domestic demand expansion of 4.4 percent. Growth will also be led by the expansion of exports and fixed private investment (6 percent in both cases).

- A reduction in the fiscal deficit to GDP ratio to 1.0 percent, which consolidates the public finance sustainability.

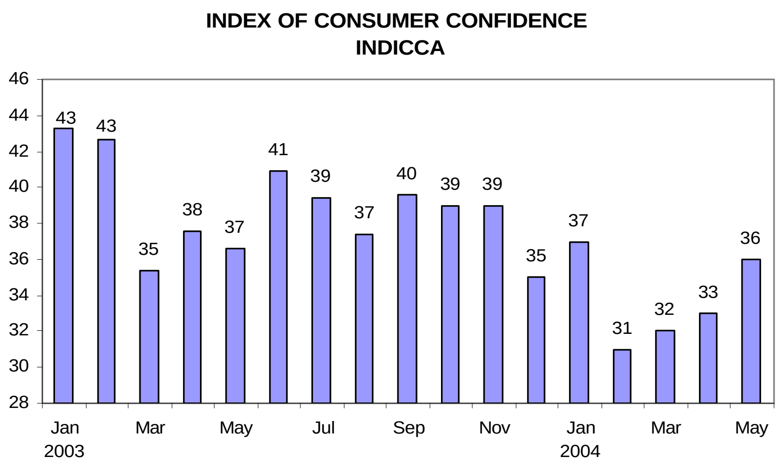
## II.2 Economic activity

59. For 2004, the 4.0 percent forecast of GDP growth is maintained but with an upward bias. The 4.0 percent estimation is based on a 7.9 percent increase in exports, in a context of favorable terms of trade and world economy growth, and on a 3.4 percent increase in domestic demand, particularly of private investment and consumption.

60. The investment dynamism is expected to continue since the conditions and factors explaining this growth would still hold: continuation of mining projects and expansion of production capacity and acquisition of machinery and equipment for the industrial sector.

61. Also, private consumption would grow reaching a 3.5 percent rate during 2004. This growth in private consumption would be based in the recovery of consumer confidence in Metropolitan Lima, which according to the firm Apoyo shows increases in three consecutive months. These figures reflect an improvement in the consumers' perception of their family economic situation for the next 12 months, and takes into account such variables as the decisions regarding durable good purchases, prices evolution, family income, expectations about the general economic performance of the country and the possibilities of finding jobs.

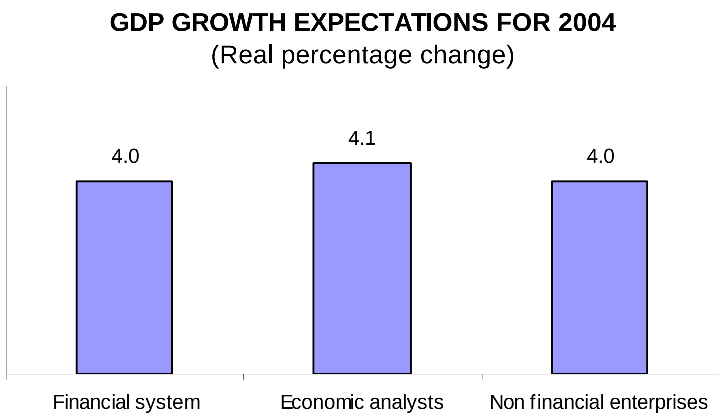
**Figure 29**




Source: APOYO

According to the expectations survey carried out by the BCRP, the expected GDP growth in 2004 will be 4.0 percent for the financial and non financial entities, 4.1 percent for the economic analysts.

**Figure 30**



62. The forecasted GDP growth in 2005 is 4.5 percent, higher than the one of year 2004 due to an anticipated greater dynamism of domestic demand, particularly of private consumption, while the growth in private investment would continue.

**Table 23**
**TOTAL DEMAND AND SUPPLY**
(Real annual percentage change)

| | | 2003 | 2004* | 2005* |
|---|---|---|---|---|
| **I.** | **Total Demand (1+2)** | **3.9** | **4.1** | **4.6** |
| | 1. Domestic Demand [1/] | 3.6 | 3.4 | 4.4 |
| | a. Private Consumption | 3.2 | 3.5 | 4.2 |
| | b. Public Consumption | 4.5 | 4.4 | 1.1 |
| | c. Private Fixed Investment | 5.3 | 7.2 | 6.0 |
| | d. Public Investment | 5.0 | 8.1 | 4.0 |
| | 2. Exports | 5.8 | 7.9 | 6.0 |
| **II.** | **Total Supply (3+4)** | **3.9** | **4.1** | **4.6** |
| | **3. Gross Domestic Product** | **4.1** | **4.0** | **4.5** |
| | 4. Imports | 3.2 | 4.4 | 5.7 |

1/ Includes inventories changes
* Projection
Source: INEI and BCRP estimates

63. At the sectoral level, the agriculture and livestock sector would grow 1.8 percent due to higher production of coffee and cotton (better international prices), export agricultural products (asparagus, grapes and tangerines) and the poultry industry. This increase will compensate the reduction of potato, rice, yellow corn and sugar cane due to scarce rainfalls. Fishing would grow 8.8 percent influenced by the recovery in the extraction of anchovy from 5.2 to 6.7 million tons because of better oceanographic conditions. The mining and fuel sector would grow 7.9 percent, particularly copper (higher grade in Antamina, resumption of operations by Tintaya and expansion of Southern Peru), gold (dynamism of medium-scale mining and the new Cerro Negro unit of Yanacocha), as well as the beginning of Camisea gas production in the third quarter.

64. The non primary manufacturing expected growth is 4.2 percent in 2004, associated to greater non traditional exports, which would grow by almost 16 percent. The sectors outstanding in this evolution are chemicals, rubber and plastics due to the start of operations of Camisea, which would have a multiplying effect over most of the activities of this group, the increased domestic demand of dairy products, greater exports of chocolate and candy products, and non metallic minerals, and the greater dynamism of the construction sector. The latter would grow by 5.6 percent due to the expansion of house building by the housing programs (Mivivienda y Techo Propio), road works, sport premises, mining projects like Alto Chicama and Cerro Negro and the distribution infraestructure of the Camisea gas in Lima.

**Table 24**
**GROSS DOMESTIC PRODUCT**
(Real annual percentage change)

| | 2003 | 2004* | 2005* |
|---|---|---|---|
| **Agriculture and livestock** | **2,2** | **1,8** | **2,6** |
| **Fishing** | **-13,4** | **8,8** | **5,9** |
| **Mining and fuel** | **6,7** | **7,9** | **4,8** |
| Metallic mining | 7,8 | 7,2 | 3,0 |
| Natural gas and oil | -4,5 | 16,6 | 28,0 |
| **Manufacturing** | **2,2** | **4,6** | **4,3** |
| Based on raw materials | -2,8 | 6,3 | 4,8 |
| Non-primary industries | 3,6 | 4,2 | 4,2 |
| **Construction** | **4,8** | **5,6** | **6,5** |
| **Commerce** | **3,6** | **3,4** | **5,7** |
| **Services** | **4,5** | **3,7** | **4,2** |
| Electricity and water | 4,2 | 4,4 | 4,4 |
| Other services | 4,5 | 3,6 | 4,2 |
| **GROSS AGGREGATED VALUE (GAV)** | **3,8** | **4,0** | **4,5** |
| Taxes on products and import duties | 6,3 | 4,1 | 4,5 |
| **TOTAL GDP** | **4,1** | **4,0** | **4,5** |
| **Primary GAV** | **2,5** | **4,8** | **3,8** |
| **Non-primary GAV** | **4,2** | **3,8** | **4,6** |

* Projection

Source: INEI and BCRP estimates

65. The higher GDP rate of growth in **2005** compared with the one that would be observed in 2004 is explained in the sectoral side by a recovery of the agriculture and livestock sector and a greater activity of non primary sectors, linked to domestic demand. In the agriculture and livestock sector crops affected by the scarcity of hydric resources in 2004 (potato, rice, sugar cane and yellow corn) would recover. Also, the dynamism of export agricultural products is expected to continue. In the mining and fuel sector, production of natural gas would grow due to the fact that Camisea will be operating during the entire year, as well as gold production, driven by the Alto Chicama project in the department of La Libertad, La Zanja (Buenaventura) in the department of Cajamarca, and Cerro Negro (Yanacocha) during the entire year.

66. In 2005, non primary manufacturing would grow by 4.2 percent in a context of greater dynamism of the activities related to the domestic demand, as well as higher textile and chemical products exports. The expansion of the construction sector would be associated to the greater private and public investment foreseen for that year, particularly in mining projects and in road works. In this context, there will also be a rise in the construction of housing for owner use within a setting of rising employment.

**Table 25**
**NATIONAL DISPOSABLE INCOME**
(Real annual percentage change)

| | 2003 | 2004* | 2005* |
|---|---|---|---|
| I. Gross Domestic Product (GDP) | 4.1 | 4.0 | 4.5 |
| II. Gross National Product (GNP) 1/ | 3.2 | 3.3 | 4.5 |
| III. Gross National Income (GNI) 2/ | 3.7 | 4.9 | 4.5 |
| IV. National Disposable Income (NDI) 3/ | 3.9 | 4.7 | 4.5 |

1/ Excludes from the GDP the net investment income paid to non-resident producers.
2/ The GDP and GNP are isolated from changes in the terms of trade in foreign trade.
3/ Adds to the GNI the received net transfers from non-residents
* Projection

Source: BCRP

## II.3 External accounts

***World Economic Growth***

67. The outlook for economic growth in the main industrilized countries has been revised upwards, particularly regarding the United States, where it is now strongly expected that the Fed will raise its Fed Funds rate in the coming months. The economic indicators in the United States show a favorable evolution in economic activity (a first quarter GDP growth of 4.4 percent in annual terms), a strengthening of the labor markets indicators as well as some inflation pressures

    The European economy as a whole grew 1.3 percent year-on-year in the first quarter of 2004, the highest rate in the last three years. Japan’s GDP rose 5.6 percent in the same period, registering growth for eight consecutive quarters. In China, the economic growth was 9.7 percent year-on-year in the first quarter of 2004. Even though Chinese authorities have announced measures to lessen the economic expansion and, hence, the inflationary pressures, the economy is expected to grow  8 percent.

    Thus, in 2004 the economic growth of our main trade partners will attain 4.2 percent, slightly over the projected rate in January.

68. A more moderated growth is projected for 2005, particularly in the United States and the Asian economies, associated with a gradual increase in the international interest rates along with a stronger Dollar. Our main trade partners would grow 3.6 percent.

**Table 26**

**GROWTH FORECAST: MAIN TRADE PARTNERS**
(In percentages)

| | 2003 | Projections January 2004 | | |
|---|---|---|---|---|
| | | | May 2004 | |
| | | 2004 | 2004 | 2005 |
| **Trade partners average** | **2.5** | **4.0** | **4.2** | **3.6** |
| **North America** | **2.9** | **4.4** | **4.4** | **3.8** |
| *United States* | *3.1* | *4.6* | *4.6* | *3.8* |
| **Europe** | **1.3** | **2.3** | **2.3** | **2.3** |
| *Germany* | *-0.1* | *1.8* | *1.6* | *1.7* |
| *France* | *0.5* | *1.7* | *1.8* | *2.1* |
| **Asia** | **4.9** | **4.9** | **5.5** | **4.6** |
| *China* | *9.1* | *8.3* | *8.6* | *7.7* |
| *Japan* | *2.7* | *2.1* | *3.1* | *1.8* |
| *South Korea* | *3.1* | *5.2* | *5.6* | *5.2* |
| **Latin America** | **1.4** | **4.3** | **4.9** | **4.0** |
| *Argentina* | *8.7* | *5.3* | *7.7* | *4.1* |
| *Chile* | *3.3* | *4.6* | *4.8* | *4.9* |

Source: *Consensus Forecast* (May 2004)

### *Terms of trade*

69. The 9.1 percent increase of the terms of trade for 2004 (superior to the 7.2 percent projected in January) considers the favorable impact of better perspectives for world economy growth. It also assumes that there would no overreaction in response to lower projected growth for China. For 2005 a gradual correction of international prices is assumed in a context of a more moderate growth of the world economy.

70. For **2004** the projection assumes that the consolidation of better prospects in world economy growth will not be significantly affected by the recent measures adopted by China, associated to credit restrictions in economic sectors with overheating conditions, such as construction, steel, aluminum and cement. Hence, price projections for 2004 consider a more favorable context for the world economy and a downward correction that the majority of commodities have experienced last month, as a reaction to the adjustment measures adopted by Chinese authorities in order to avoid inflationary pressures in the economy, as well as recent prospects of interest rates increases that have favored a lower dollar weakness.

**Table 27**
**TERMS OF TRADE FORECASTS**
(Annual percentage change)

| | 2003 | Projections January 2004 | | |
|---|---|---|---|---|
| | | | May 2004 | |
| | | 2004 | 2004 | 2005 |
| **Terms of Trade** | **1.4** | **7.2** | **9.1** | **-3.0** |
| Nominal Price Index of Exports | 7.1 | 9.2 | 16.0 | -3.5 |
| Nominal Price Index of Imports | 5.6 | 1.9 | 6.3 | -0.5 |

Source: BCRP

For 2004, the terms of trade are expected to improve by 9.1 percent, higher than the January projection of 7.2 percent, due to higher export prices of 16 percent (9.2 percent in

January), larger than the rise of import prices, which would grow by 6.3 percent (1.9 percent in January).

Thus, after a rising trend in commodity prices, which peaked in the first quarter of this year, it is expected that copper and gold prices register a slight downward trend, reaching levels of US$ 1.20 per pound and US$ 402.2 per ounce as a year average. In the case of oil, given the context of a high world demand of crude oil, as well as the uncertainty about crude oil supply from Iraq and the decrease of gasoline inventories in USA, prices would reach a level of US$ 34 per barrel at the end of the year. Thus the average projected price of WTI would increase from US$ 31 per barrel in 2003 to US$ 35 per barrel in 2004. The prices are set above the January forecasts, considering terrorist attacks in Middle East, the volatility of gasoline inventories in USA and quote reduction policy of the OPEC.

71. Expected price increases for metals and oil during 2004 will readjust gradually during 2005 in a context of a more moderate growth of the world economy. Average export prices would lower by 3.5 percent, while average import prices would decrease by 0.5 percent, thus bringing about a reduction in the terms of trade of 3.0 percent.

**Figure 31**

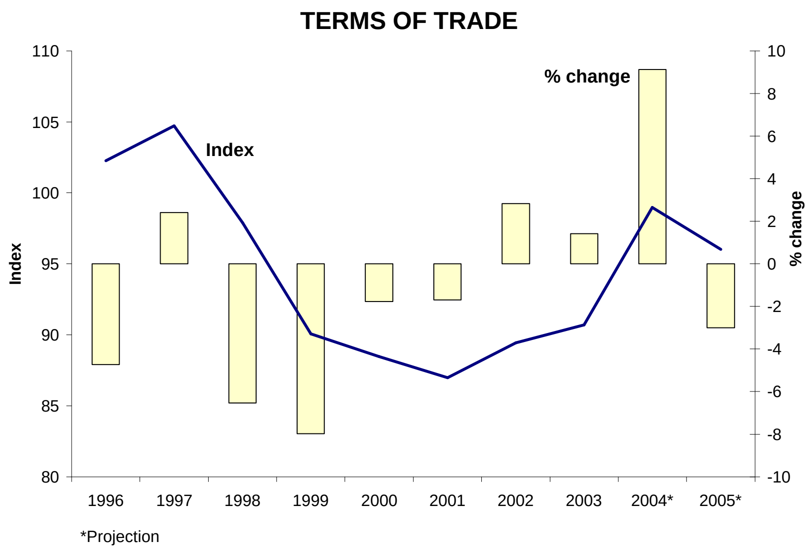



**Figure 32**

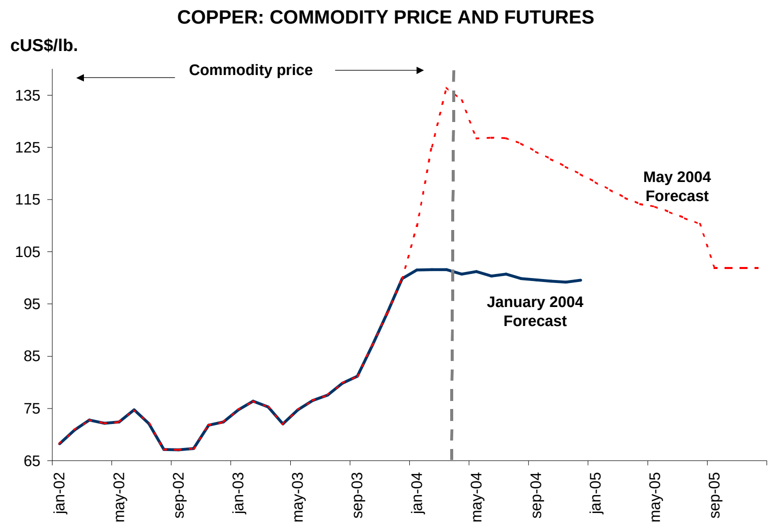
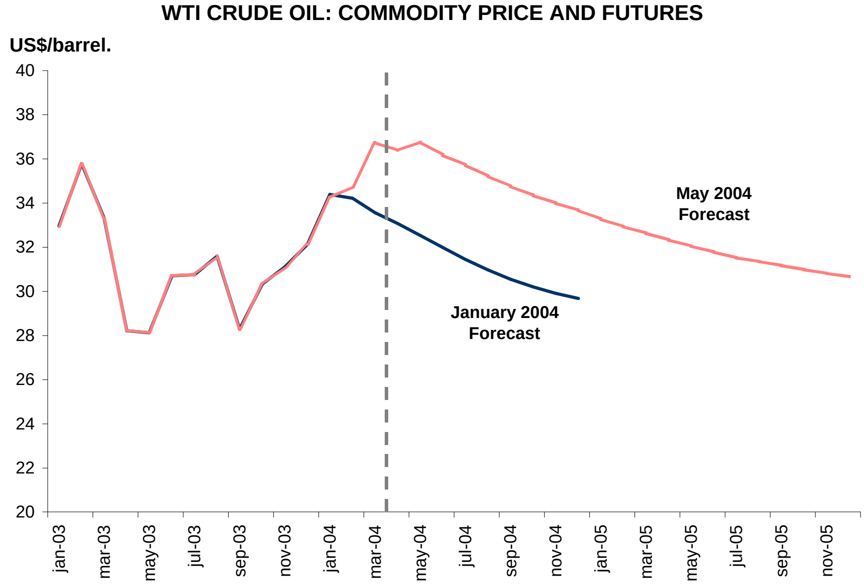


**Figure 33**




***Trade Balance***

72. Taking into account the favorable international context of world economic growth and better terms of trade, it is forecasted that the trade balance will register for the third consecutive year a surplus, estimated now in US$ 2,318 million. In the case of exports, the increase is explained mainly because of higher prices projected for basic metals and the higher export volume of copper projected for Antamina. For 2005 the projected trade surplus is of US$ 2,143 million, considering a 3 percent increase of exports as a result of a gradual correction of international prices within a context of lower world economic growth.

73. For 2004 **exports** are expected to grow by 26 percent, higher than the January forecast of 17 percent. Prices would increase on average by 16 percent (9 percent in the January Report) and volumes by 9 percent (7 percent in January Report). Traditional and non-traditional exports would grow by 32 percent and 16 percent, respectively. Better international prices for minerals, higher export volumes of copper, and the consolidation of textile exports in the context of ATPDEA all back up an increased dynamism in overseas sales.

    Higher increases with respect to 2003 would be observed in copper (US$ 961 million) because of better prices, the reopening of Tintaya mine and the extraction of higher contents of copper programmed by Antamina (which in 2003 favoured zinc exports); gold, zinc and tin due to higher international prices (US$ 242 million, US$ 77 million and US$ 126 million, respectively) and fish meal because of marine resources recovery (US$ 131 million).

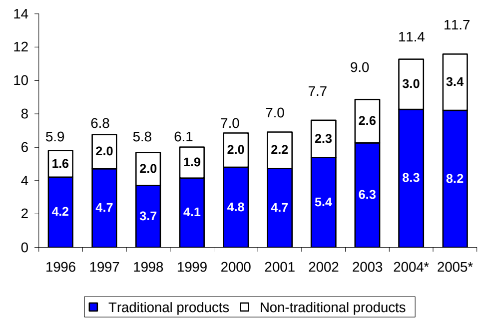
    **Imports** in 2004 would grow 10 percent (6 percent in January Report), consistent with the 4 percent increase in GDP, higher international prices of oil than those forecasted in January and the recovery of private investment. Thus, imports are expected to reach a level of US$ 9,038 million, led by capital goods and intermediate goods imports for industry (9 and 12 percent, respectively). Fuels imports would grow by 3 percent, higher than the 18 percent decrease projected in January. For 2004 the projection of fuel import volumes assumes that the Camisea project will start operations in the second semester of 2004.

**Table 28**
**TRADE BALANCE**
(Millions of US$)

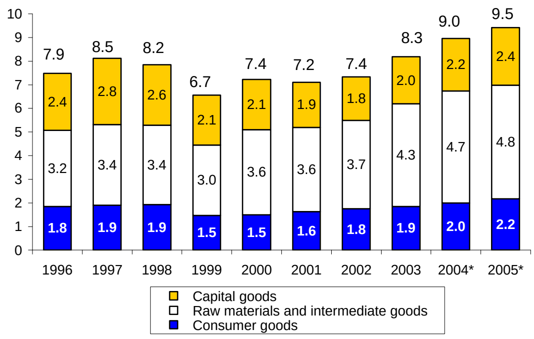
| | 2003 | 2004 * | 2005 * | Percentage change | |
|---|---|---|---|---|---|
| | | | | 2004 * | 2005 * |
| **1. EXPORTS** | **8,986** | **11,356** | **11,676** | **26.4** | **2.8** |
| Traditional products | 6,267 | 8,266 | 8,210 | 31.9 | - 0.7 |
| Non-traditional products | 2,602 | 3,009 | 3,379 | 15.6 | 12.3 |
| Other products | 117 | 81 | 88 | - 30.6 | 8.0 |
| **2. IMPORTS** | **8,255** | **9,038** | **9,533** | **9.5** | **5.5** |
| Consumer goods | 1,851 | 1,999 | 2,170 | 8.0 | 8.6 |
| Raw materials and intermediate goods | 4,344 | 4,734 | 4,813 | 9.0 | 1.7 |
| Capital goods | 1,984 | 2,226 | 2,437 | 12.2 | 9.5 |
| Other goods | 75 | 80 | 113 | 6.6 | 40.5 |
| **3. TRADE BALANCE** | **731** | **2,318** | **2,143** | | |

* Projection.
Source: BCRP and SUNAT .

**Figure 34**




Note: Total exports includes other products.
* Projection.




Note: Total imports includes other imports goods.
* Projection.

74. During **2005** exports growth would slow down because of the effect of export prices correction, attaining a level of US$ 11,676 million. Imports would grow at a 6 percent rate (US$ 9,533 million), because of the impact of the Camisea project during the entire 2005 and lower oil prices. As a result, the trade balance would continue being positive for the fourth consecutive year reaching a level of US$ 2,143 million, slightly lower than that estimated for 2004.

***Current account of the balance of payments and capital flows***

75. For 2004 current account is projected to show a 0.4 percent deficit of GDP explained by the surplus trade balance, and partially offset by higher profits generated by foreign capital enterprises in a context of better terms of trade. Considering commodities prices correction in 2005, the current account deficit is projected to reach 0.7 percent.

76. For 2004 the current account deficit of the balance of payments is estimated to amount to US$ 267 million, US$ 849 million lower to that of 2003, basically because of the projected improvement in the terms of trade. The trade surplus would be partially offset by higher profits generated by foreign capital enterprises.

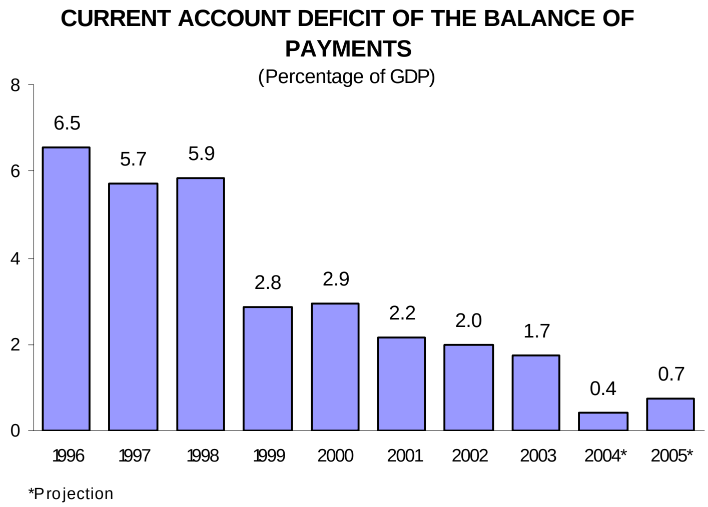
A gross external financing of the private sector of US$ 1,829 million is projected, which would be compensated by considerable financial investment abroad by financial institutions. Among the main projects considered are Alto Chicama and Camisea.

On the other side, the public capital account would register a level of US$ 557 million, lower to that of the previous year by US$ 192 million, mainly because of a lower level of bonds issued abroad. For the year 2004 a US$ 100 million increase in net international reserves is projected.

77. For **2005**, a current account deficit of US$ 521 million is projected (0.7 percent of GDP). This higher deficit is mainly explained by the impact of higher international interest rates.

Capital account would show an external financing to the public sector of US$ 748 million, higher by US$ 191 million to that of 2004 because of higher bond issues, while the private sector would register a level of gross financing of the order of US$ 2,000 million, considering such mining projects as Alto Chicama and the gas export project of Peru LNG. This financing would be partially offset by financial investments abroad by the financing sector. Hence, there would be a US$ 100 million increase in international reserves during the year.

**Figure 35**

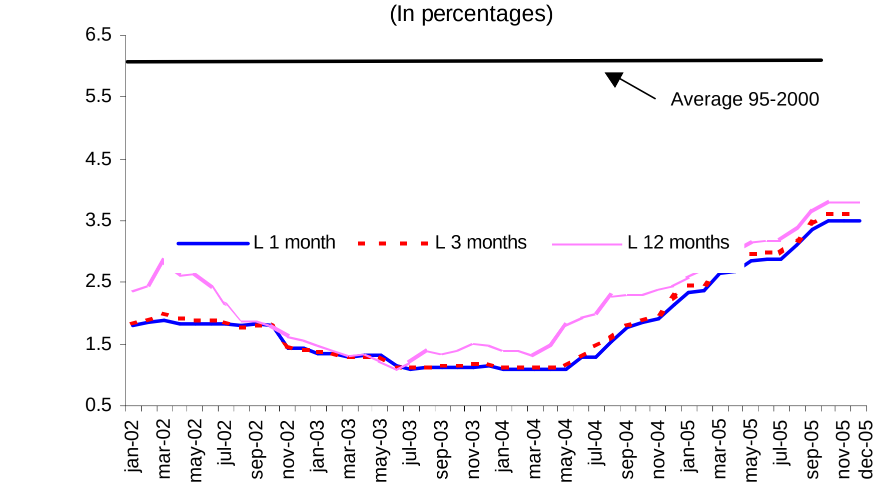



***International interest rates and Dollar prospects***

78. The expectations for a rise in the FED interest rates have strengthened and for some analysts, moreover, the rise could start taking place as of June. So far in this year, these expectations have had an impact on the Libor rates development. The 3-month Libor rose from 1.15 percent at the end of December 2003 to 1.18 percent at the end of April and to 1.32 percent at the end of May 2004. It is expected a further rise of up to 2.25 percent by the end of 2004, which is consistent with a projected rise of about 100 bps in the FED interest rate.

**Figure 36**

**LIBOR: ACTUAL AND FORECAST**
(In percentages)

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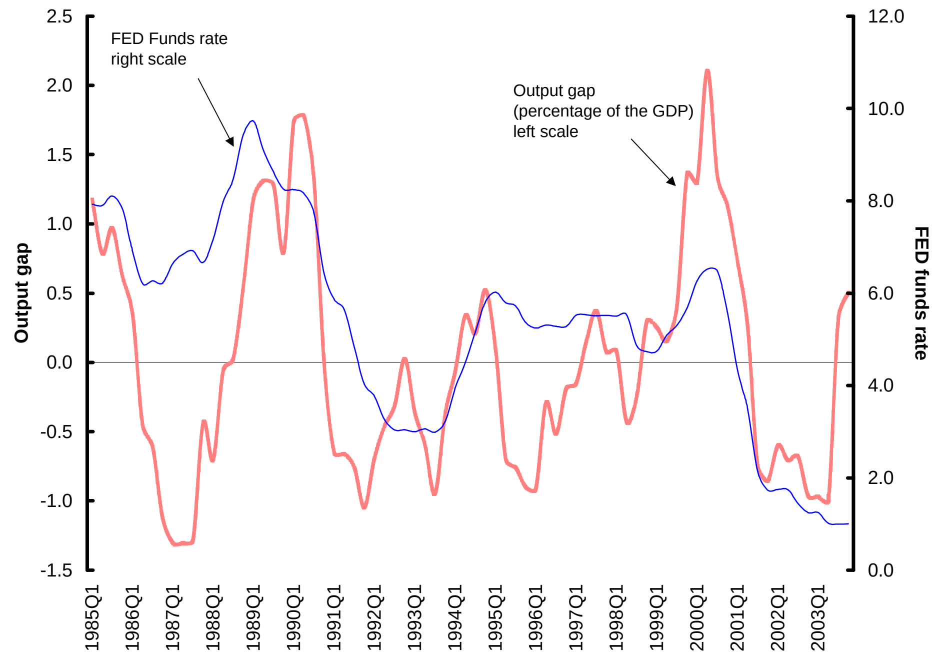
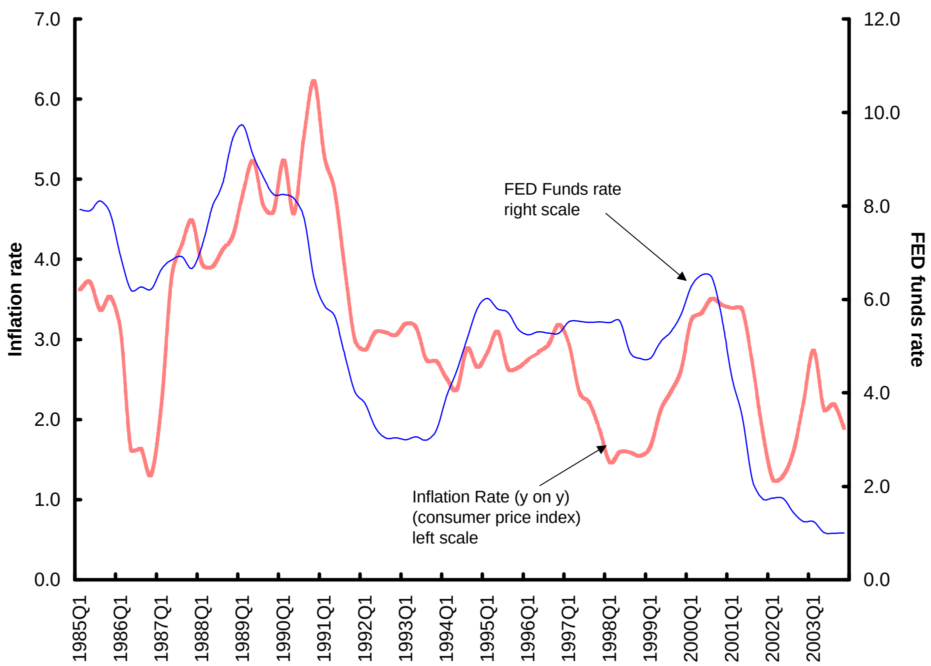
**Box 3**

**What determines the US interbank interest rate?**

As can be seen in the following graphs, the Fed Funds rate has been pushed up in response to the economy´s overheating symptoms, as measured by the gap between the current and potential GDP, and rises in the inflation rate.






Taylor (1993) formalizes this Fed Funds rate behavior approximating it to a policy rule. According to Taylor's Rule, the Fed Funds rate should be adjusted in response to changes in the inflation rate and real output. According to his specification, the US monetary policy would loosen up, reducing the interest rate in response to a lower inflation rate relative to its desired level or a lower output relative to its potential. Contrariwise, the FED would tighten monetary conditions, bringing about a rise in the interest rate whenever the inflation is higher than its desired level or if output is above its potential level. Though the FED does not follow explicitly such a rule, this analysis tries to explain how the FED´s monetary policy has been carried out during the past 10 years. The following equation summarizes this behavior:

$$i = (r^* + p^*) + gy + h(p - p^*)$$

where:

| | |
|---|---|
| $i$ | is the short run nominal interest rate (Fed Funds rate) |
| $r^*$ | is the equilibrium real interest rate |
| $p^*$ | is the inflation target rate |
| $p$ | is the contemporaneous inflation rate |
| $y$ | is the difference between the output and its potential level (output gap) |
| $g$ | is the degree of reaction of the Fed Funds rate to the output gap |
| $h$ | is the degree of reaction of the Fed Funds rate to deviations of the inflation rate from its target level |
| $r^*+p^*$ | is the equilibrium nominal interest rate |

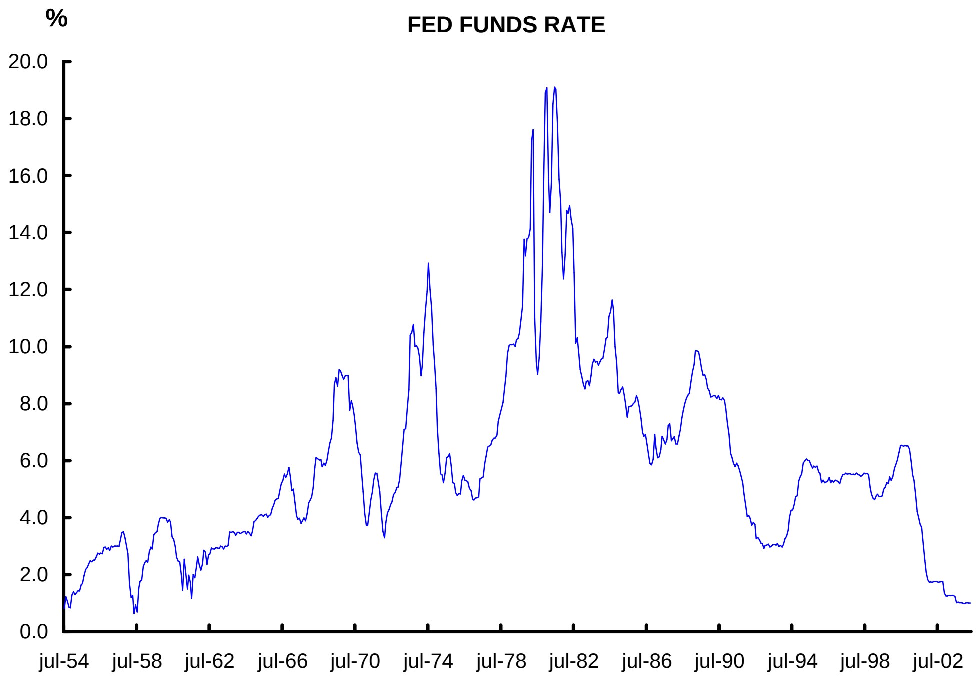
**What is it expected about Fed Funds rate?**

As prospects of economic growth and inflationary pressures in the United States are ever more likely, it is expected that the Fed Funds rate will be increased. The foreseeable rise of international interest rates represents a source of uncertainty concerning the outlook of growth of the world economy as a whole, and specially regarding the developments in emerging economies. In this context, it is worth looking back at similar circumstances in the last decade, specially the events of 1994.

- In 1994, the FED rose its interest rate in 250 basis points, up to 5.5 percent, a higher level than expected by the market. This year, according to FED's statements, the adjustment of the interest rate will be gradual and moderate. Hence, the market expects an approximate rise of 100 basis points by the end of the year, which would raise the Fed Funds rate to 2 percent.

- In the January press release made by the FED, the statement to maintain the interest rate "for a considerable period of time" was dropped, and instead it said it would be "patient", this being interpreted by the markets as a sign of a rise in the short term. Likewise, in the May press release, the FED stated that the increments of the interest rates would be gradual. The overall effect that these statements had on emerging markets securities shows that the market is discounting – at least partially – this rise. Additionally, the current interest rate levels are the lowest since 1958 and they have been maintained as such during a relatively long period.

- The adjustment of the Fed Funds rate for the period 1993–1994 coincided with a slowdown of some important economies such as China, and with a pronounced uncertainty regarding the sustainability of economic policy in some countries that finally ended up facing severe crisis (for example, Mexico). The current economic state is quite different. China has announced policy measures to avoid an overheating of its economy, which it is thought will not affect significantly economic growth (it is estimated that the pace of expansion will be reduced from 9 to 8 percent), contrary to what took place in 1993-1995, when the policy measures which were then adopted aimed at slowing down an economy that had been growing at rates between 12 and 14 percent and with an inflation of 15 percent. Likewise, emerging economies are in a less fragile position than that observed in 1994. This, plus the mild rises expected in interest rates, make it plausible to expect that the impact on exchange rates and spreads in emerging economies will be moderate, considering moreover that part of the adjustment would already have been partially undertaken by the markets since January this year.

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79. The scenario of higher Fed interest rates and better outlook for US economic growth could explain the slight Dollar appreciation against the Euro, partially offsetting the strong depreciation occurred in 2003. Nevertheless, these external events could be reversed by the fiscal and external imbalances in the United States, as well as the geopolitical uncertainties.

The market also expects that the Dollar will hold its depreciation trend against the rest of the strong currencies, which would reverse in 2005, as the interest rates in USA rise.

### II.4 Fiscal accounts

80. Projections for the end of 2004 and 2005 indicate a decreasing trend in the fiscal deficit, consistent with the Fiscal Transparency and Responsibility Law. Thus, fiscal deficit would fall from 1.8 percent of GDP in 2003 to 1.4 percent of GDP in 2004 and to 1.0 percent of GDP in 2005. This gradual reduction in fiscal imbalance is based on both an increase in central government current revenues resulting from favorable economic conditions, and a prudent government expenditure policy.

81. **Central government current revenues** would be equivalent to 15.0 percent of GDP by the end of 2004, which implies an increase of 6.9 percent in real terms. This development would be brought about by the evolution of tax revenues which would grow 8 percent in real terms because of the tax measures taken in the second semester of 2003, and the implementation of new tax administration measures, like the inclusion of more goods and services in the VAT perception regime. Likewise, higher tax collections are expected through the income tax (due to higher payments from the mining sector induced by higher international prices), and the imposition of the Financial Transaction Tax. It's worth mentioning that the projection assumes that the Extraordinary Solidarity Tax would be eliminated in the second semester of 2004.

During 2005 current revenues would amount to 15.2 percent of GDP, growing 5.6 percent in real terms relative to 2004. This would be explained by the expected increase in income tax and value added tax collections, due to the impact of the corporate income tax rate increase from 27 to 30 percent on fiscal revenues and enhancements in tax administration, respectively. In addition, higher non-tax revenues are expected due to mining royalty payments from the Camisea Project.

82. **Central government non-financial expenditure** would grow 4.2 percent in real terms during 2004. This figure takes into account the upward adjustment in the Public Sector Budget expected for the second semester of 2004.

In 2005, central government non-financial expenditure is expected to grow 2.2 percent in real terms.

**Table 29**
**NON-FINANCIAL PUBLIC SECTOR**
(Millions of nuevos soles)

| | 2003 | 2004 * | 2005 * |
|---|---|---|---|
| **1. Current revenue of central government** | **31,551** | **34,798** | **37,465** |
| *(% of GDP)* | *14.9* | *15.0* | *15.2* |
| *Real % change* | *8.0* | *6.9* | *5.6* |
| **2. Non-financial expenditure** | **-31,460** | **-33,815** | **-35,245** |
| *(% of GDP)* | *-14.8* | *-14.6* | *-14.3* |
| *Real % change* | *5.2* | *4.2* | *2.2* |
| **3. Other** | **814** | **709** | **907** |
| *(% of GDP)* | *0.4* | *0.3* | *0.4* |
| **4. Primary balance** | **905** | **1,692** | **3,126** |
| ***(% of GDP)*** | ***0.4*** | ***0.7*** | ***1.3*** |
| **5. Interests** | **-4,633** | **-4,991** | **-5,690** |
| ***(% of GDP)*** | ***-2.2*** | ***-2.2*** | ***-2.3*** |
| Of which: | | | |
| *Pension Reform Bonds* | *-235* | *-255* | *-247* |
| *External debt (Millions of US$)* | *-1,082* | *-1,180* | *-1,329* |
| **6. Overall balance** | **-3,728** | **-3,300** | **-2,564** |
| ***(% of GDP)*** | ***-1.8*** | ***-1.4*** | ***-1.0*** |
| ***Millions of US$*** | ***-1,072*** | ***-943*** | ***-726*** |

*Projection.

83. NFPS **gross borrowing requirements** are expected to amount to US$ 2,908 million by the end of 2004, higher by US$ 95 million relative to the 2003 level, because of the expected increase in external public debt amortization payments (in US$ 184 million) and Pension Reform Bonds redemptions (in US$ 65 million). Gross borrowing requirements would be covered by US$ 1,961 million in external debt disbursements, which include US$ 1,011 million in free disposal funds from multilateral agencies and US$ 500 million from placement of sovereign bonds in the international capital market. Additionally, gross placement of domestic bonds would be equivalent to US$ 559 million while privatization proceeds would reach US$ 100 million.

In 2005, gross borrowing requirements would amount to US$ 2,983 million, which would be covered by US$ 2,184 million in external debt disbursements, including US$ 1,684 million in free disposal loans and US$ 500 million in investment projects loans. It is expected a US$ 600 million placement of domestic bonds.

**Table 30**
**FINANCING OF NON-FINANCIAL PUBLIC SECTOR**
(Millions of US$)

| | 2003 | 2004 * | 2005 * |
|---|---|---|---|
| **1. Overall balance (millions of nuevos soles)** | **-3,728** | **-3,300** | **-2,564** |
| ***(% of GDP)*** | ***-1.8*** | ***-1.4*** | ***-1.0*** |
| ***Millions of US$*** | ***-1,072*** | ***-943*** | ***-726*** |
| **2. Amortization (millions of US$)** | **-1,745** | **-1,965** | **-2,257** |
| Redemption of Pension Reform Bonds | -170 | -235 | -142 |
| Other domestic | -389 | -359 | -681 |
| External | -1,187 | -1,371 | -1,435 |
| **3. Gross financial requirements (millions of US$)** | **2,813** | **2,908** | **2,983** |
| External financing | 2,101 | 1,961 | 2,184 |
| *Free disposal funds* | *1,765* | *1,511* | *1,684* |
| *- Multilaterals* | *519* | *1,011* | *500* |
| *- Bonds* | *1,246* | *500* | *1,184* |
| *Investment projects* | *336* | *450* | *500* |
| Domestic bonds | 508 | 559 | 600 |
| Privatization | 52 | 100 | 43 |
| Others | 152 | 288 | 156 |

*Projection

## III. BALANCE OF RISKS

84. The macroeconomic scenario described in this document is considered as the most likely outcome for the next months. However, the projections of the Inflation Report are subject to different sources of risk, which might deviate the projections from its central scenario. The main risk factors considered in this report are:

- **Higher international oil prices**. The baseline scenario assumes that international oil prices (WTI) will reach US$ 34 and US$ 31 per barrel at the end of 2004 and 2005, respectively. The probability of an increase in the inflation rate is higher if the rise in the oil prices causes adjustments on other prices (specially in public transport fees) or if new unexpected shocks prevent the reduction of projected oil prices during 2005. In both cases, the inflation rate would be pushed upwards transitorily followed by a decline to a level consistent with the inflation target. In this circumstance, the Central Bank would maintain its monetary policy stance according to the projections presented in this Report. However, if the oil price shock induces a rise in inflation expectations, the Central Bank would adopt appropriate actions to avert any undesirable effects. It is worth mentioning that the recent decision made by the Central Government aimed at smoothing the effect of oil prices via the establishment of the “stabilization method of petroleum-derived fuel prices” for the next four months reduces the likelihood of higher inflation pressures.

- **A higher-than-expected rise in foreign interest rates**. The baseline scenario assumes a level for the Fed Funds rate of 2.0 and 3.5 percent at the end of 2004 and 2005, respectively. A higher rise than the one expected in the baseline scenario in turn increases the probability of capital outflows from the region, higher risk premia and higher costs of foreign finance. Also, it would bring about foreign exchange depreciation pressures on the currencies of emerging economies. Therefore, some contagion effects from regional developments to the Peruvian economy are not ruled out. However, the fundamentals of the Peruvian economy are strong enough to face such contingency. One of these fundamentals is the floating exchange rate regime which allows the Central Bank to set referential interest rates only on the grounds of fulfilling the inflation target. The effect of a one percentage point depreciation on the inflation rate is estimated to be between 0.15 and 0.30 percentage points, implying a relatively low pass-through.

The response of the Central Bank in this context could consider a somewhat tighter position as long as the rise in the international interest rates significantly pushes the exchange rate up to the point where the achievement of the inflation target is at risk. Contrariwise, the Central Bank would maintain its current stance according to the projections presented in this Report.

It is worth mentioning that during periods of high volatility in the foreign exchange market, the Central Bank could intervene as a buyer or seller in order to reduce sudden fluctuations in the exchange rate without implying a specific objective for the level of the nominal exchange rate.

- **Lower consumer confidence**. A worsening of consumer expectations would imply insufficient output growth, thus inducing a lower rate of inflation. In this possible scenario, monetary policy could react loosening its stance or keeping it in its current position.

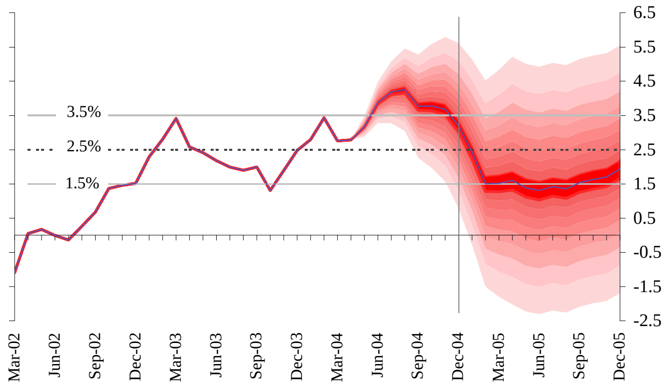
- **A slowdown in the world economy**. Another factor that could affect domestic economic activity is the downturn in the prospects of world economic growth brought about by an overreaction of markets to the slowdown of the Chinese economy for instance. In this case, the Central Bank could also loosen its current stance or maintain it.

85. It is worth stressing that a higher-than-expected increase in private investment could maintain the prospects of a sustainable growth rate of GDP without exerting inflationary pressures.

86. Taking into account all the above-mentioned factors, the following graph plots the central projection of the 12-month inflation rate for 2004 and 2005 assuming that the current monetary policy stance set by the Board of Directors is held firm until the end of next year. The darker band around the inflation forecast indicates that the central scenario described is the more likely one. Additionally, the graph also plots the confidence intervals of the central projection up to a 90 percent confidence (each shaded interval represents a 10 percent probability of occurrence). In the same way, given that the central scenario does not consider any particular upward or downward risk bias in the inflation forecast, the probability of a higher than predicted inflation is the same as the probability of a lower than predicted inflation.

**Figure 37**

**INFLATION FORECAST**
**(Annual percentage change of CPI)**




The figure shows the 12-month inflation forecast for the period 2004-2005, assuming that the current monetary policy stance set by the Board of Directors is held firm until the end of next year. The darker band around the inflation forecast indicates that the central scenario described is the more likely one and each shaded interval represents a 10 percent probability of occurrence. The central scenario does not consider any particular upward or downward risk bias in the inflation forecast and by December 2004 and December 2005 it will be within the target range.

## CONCLUSIONS

87. With the information available at the closing date of this May Report, the projections of the inflation for 2004 and 2005 lie within the target range. These projections were done under the assumption of a passive stance of monetary policy over the forecast horizon. The current interbank interest rate is on its historical lowest observed level (2.5 percent). Therefore, it is expected that in the long run, the interbank interest rate will move towards levels somewhat around historical rates observed in countries with low and stable inflation rates.

88. It is expected that different supply shocks could affect the evolution of inflation during the forecast horizon: higher food and fuel prices in 2004 but lower fuel prices in 2005. These shocks could cause in certain periods of the forecast horizon temporary movements upwards or downwards in the projected trajectory of the 12-month inflation (above 3.5 percent in 2004 and below 1.5 percent in 2005). However, according to the projections presented in this Report, the cumulative inflation rates at the end of 2004 and 2005 should remain within the targeted range.