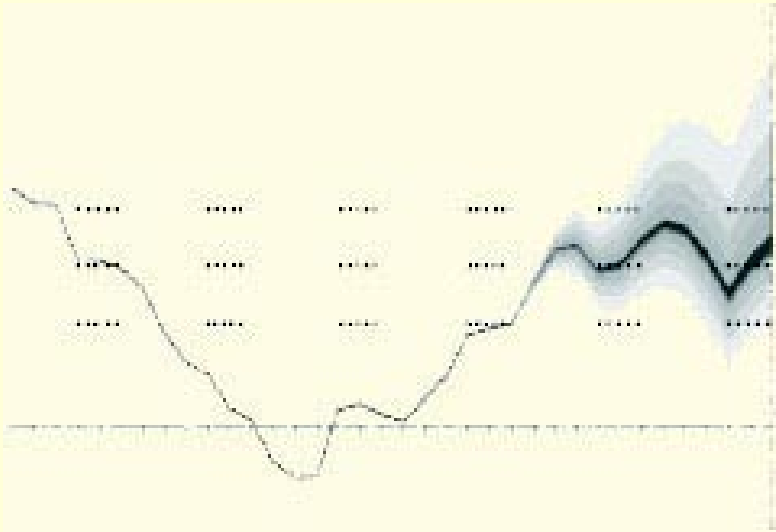
INFLATION REPORT:

Recent developments and prospects

May 2005



CENTRAL RESERVE BANK OF PERU

INFLATION REPORT:

Recent developments and prospects

May 2005

Central Reserve Bank of Peru
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CONTENTS

This inflation report was drawn up using first quarter information on gross domestic product, trade balance and central government operations, and data up to May on monetary accounts, inflation and exchange rate.

FOREWORD

- Since 2002, the monetary policy of the Central Reserve Bank of Peru (BCRP) has been governed by an Inflation Targeting framework. The annual inflation target is 2.5 percent, plus or minus one percentage point. This target is measured by the annual variation in the Consumer Price Index (CPI) for Metropolitan Lima as of end-December.

- One of the fundamental elements of the Inflation Targeting framework is a transparent monetary policy, under which the BCRP shares with economic agents all the relevant information used for monetary policy decisions. As part of this policy of transparency, the Central Bank publishes an Inflation Report three times a year (January, May, and August). This document also represents a form of accountability to the public about the fulfillment of the constitutional mandate to preserve monetary stability.

- This second report of the year contains a description of the factors explaining inflation during the first five months of 2005 and the macroeconomic forecasts for 2005 and 2006.

- Since 2001, the BCRP has been publishing a calendar of monetary policy meetings; held on the first Thursday of each month. The calendar is published at the beginning of each year with the press release for the January monetary program.

- At each monetary policy meeting, the BCRP board establishes reference interest rates for loan (monetary regulation loans and direct repos) and deposit (overnight deposits) operations with banks. These interest rates establish a reference corridor for the interbank interest rate. Daily monetary operations carried out by the BCRP are aimed at keeping the interbank interest rate at the center of the reference corridor.

- The timetable for the following monetary policy meetings is as follows:

July 7	August 4	September 1	October 6
November 3	December 1		

The BCRP will publish its next Inflation Report on September 2.

EXECUTIVE SUMMARY

- This second Inflation Report of the year analyzes the conduct of monetary policy during the first five months of 2005 and the macroeconomic forecasts for 2005 and 2006. In general, forecasts indicate that during the next two years inflation will remain within the target range and that there will be sustained growth in economic activity.

- From January to May 2005 accumulated inflation was 0.76 percent, while accumulated inflation for the last twelve months was 1.8 percent.

- Inflation in these months was mainly a response to a gradual reversal of the external and internal supply shocks during 2004, which is reducing imported inflation and enabling the supply of agricultural produce to recover. It is worth pointing out that the inflation rate between January and May 2005 was slightly lower than the figure forecasted in the January Inflation Report. In this context, the BCRP has maintained a stable monetary policy with an interbank interest rate of 3.0 percent, unchanged since October last year.

- The inflation rate for 2005 is forecast to be 2.2 percent, similar to that estimated in the January Inflation Report. Throughout the year, the inflation rate for the previous twelve months should remain around the lower limit of the target range (1.5 percent). For 2006 inflation forecast should be around 2.5 percent, which assumes that the appreciation trend of the nuevo sol will reverse within a context of rising international interest rates.

- As a consequence of increased economic activity and improved indicators of consumer and business confidence, the real GDP growth forecast for 2005 has been revised upwards from 4.5 to 5.0 percent and it is expected that this rate will be maintained in 2006. The higher production in this scenario has not affected our inflation forecasts because of the improvement in food prices and a downward revision in the forecasted exchange rate. The international environment should continue favorable for Peru's exports, with an economic growth of 3.5 percent on average for our main trading partners, gradual changes in US interest rates and a moderate reduction in our terms of trade.

- The macroeconomic scenario for 2005 and 2006 considers a fiscal deficit of 1.0 percent of GDP caused by temporary earnings associated with high export prices and a solid balance of payments position, with no financing pressures in either case. This macroeconomic environment assumes that financial markets will continue to operate without turbulence. There may be a certain volatility in the financial markets during the election process, but the BCRP has accumulated a high level of international reserves to address this contingency.

I. MACROECONOMIC PERFORMANCE

I.1 Inflation

During the first five months of the year accumulated inflation, measured by changes in the Consumer Prices Index, was 0.76 percent. Accumulated inflation over the last twelve months was 1.8 percent. The lower inflation rate is associated with a recovery in the supply of agricultural produce, a downward trend in world wheat and soybean prices and the appreciation of the nuevo sol, factors that offset the increase in domestic demand in the first months of the year.

1. The increase in the **Consumer Price Index** between January and May was 0.76 percent, lower than the figure for the same period of the previous year (2.44 percent). This result is explained by a recovery in agricultural production associated with better weather and a reduction in world wheat and soybean oil prices, which reduced domestic prices of pasta and edible oils.

   Between January and May 2005 five products contributed to a rise of 0.74 percentage points in inflation, while five more were responsible for -0.41 percentage points.

Figure 1
CONTRIBUTION TO INFLATION: January-May 2005
(Monthly percentage change and percentage points)

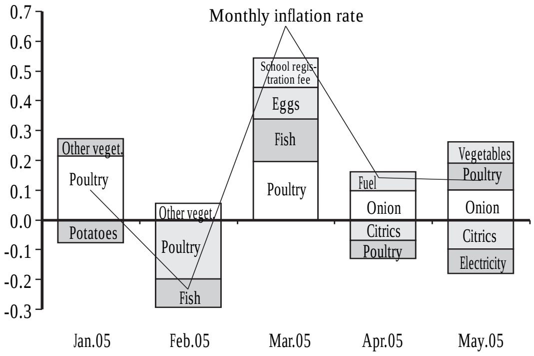
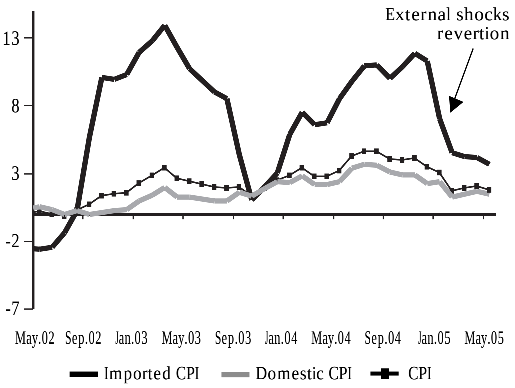


Table 1

WEIGHTED CONTRIBUTION TO INFLATION: January-May 2005
(Percentage points)

Item	Weighting	% change	Positive contribution	Item	Weighting	% change	Negative contribution
Poultry	4,0	6,9	0,24	Citrus fruits	0,7	-23,4	-0,15
Onions	0,4	44,1	0,18	Electricity	2,2	-5,9	-0,14
Vegetables	0,4	28,3	0,12	Rice	2,3	-1,9	-0,05
School registration fees & tuition	5,1	2,0	0,10	National transport	0,3	-11,9	-0,04
Carrots	0,2	54,8	0,10	Potatoes	1,5	-2,3	-0,03
Total			**0,74**				**-0,41**

Figure 2
DOMESTIC AND IMPORTED INFLATION: May 2002-May 2005
(% change over the last 12 months)



2. **Imported inflation**, consisting of goods included in the Consumer Prices Index that are affected either directly or indirectly by international prices (bread, pasta, edible oil and fuels) and/or by the exchange rate, showed an accumulated variation of 0.02 percent in the period January - May 2005 (7.4 percent in the same period of 2004), due mainly to a normalization of international foodstuff prices. The downward trend in grain prices caused by the reduced demand from China and improved prospects for international harvests contributed to the reduction in the domestic price of bread and pasta.

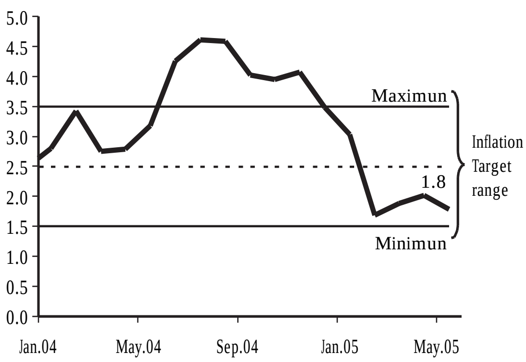
   Domestic inflation however, was 0.88 percent in the first five months of 2005, lower than the rate recorded in the same period of 2004 (1.67 percent).

Table 2

IMPORTED AND DOMESTIC INFLATION: 2004 - 2005
(Accumulated percentage change)

	Weighting	2004		2005
		Jan-May	Jan-Dec	Jan-May
I. IMPORTED CPI	**12.1**	**7.40**	**11.33**	**0.02**
Food	5.4	10.80	10.90	-0.65
Fuels	3.9	7.06	17.77	0.59
Electrical appliances	1.0	-0.52	-2.83	-1.61
Others	1.8	1.68	3.23	1.43
II. DOMESTIC CPI	**87.9**	**1.67**	**2.28**	**0.88**
III. CPI	**100.0**	**2.44**	**3.48**	**0.76**

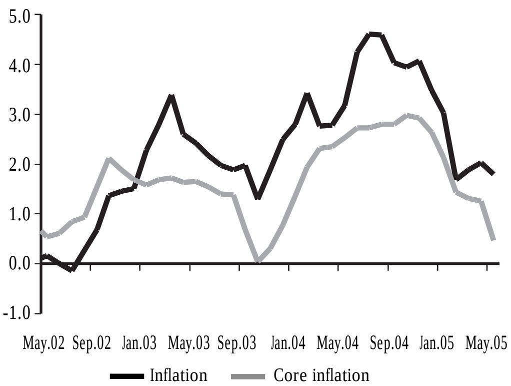
Figure 3
INFLATION AND TARGET INFLATION: January 2004-May 2005
(% change over the last 12 months)



3. The rate of inflation as measured by the increase in the Consumer Prices Index over the last 12 months fell from 3.5 percent at the end of 2004 to 1.8 percent in May, within the annual target range set by the BCRP (1.5 to 3.5 percent).

Core inflation and non-core inflation

Figure 4
INFLATION AND CORE INFLATION: May 2002-May 2005
(% change over the last 12 months)



4. **Core inflation**, which excludes those foodstuffs that have shown the greatest price variations fuel, public services and fares, amounted to an accumulated 0.46 percent in the period January - May this year (1.90 percent in the same period of 2004).

   Breaking down core inflation, the prices of goods increased 0.28 percent between January and May while those of services rose 0.73 percent, mainly caused by seasonal increases in the cost of education (1.99 percent).

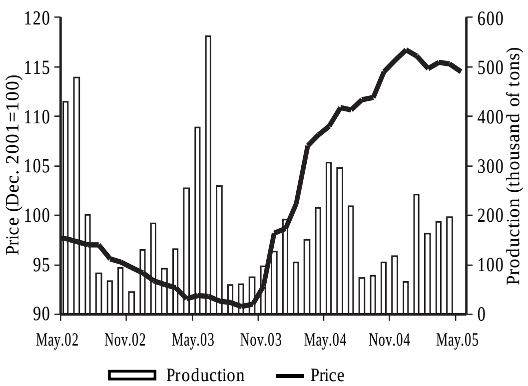
Table 3

INFLATION 2004 - 2005
(Accumulated percentage change)

	Weighting	2004 Jan-May	2004 Jan-Dec	2005 Jan-May
I. CORE INFLATION	**68.3**	**1.90**	**2.63**	**0.46**
Goods	41.8	2.35	3.19	0.28
Food & beverages	20.7	5.04	6.82	0.04
Textile & footwear	7.6	0.77	1.36	0.73
Electrical appliances	1.0	-0.52	-2.83	-1.61
Other industrial products	12.5	-0.92	-1.24	0.59
Services	26.6	1.19	1.75	0.73
Restaurants	12.0	1.01	1.78	0.42
Education	5.1	3.21	4.63	1.99
Health	1.3	0.65	1.18	0.36
Rent	2.3	0.49	-1.57	-0.20
Other services	5.9	0.14	0.48	0.64
II. NON CORE INFLATION	**31.7**	**3.52**	**5.20**	**1.38**
Food	14.8	5.70	1.85	4.24
Fuels	3.9	7.06	17.77	0.59
Transport	8.4	-0.51	3.49	-0.18
Public services	4.6	0.64	6.19	-3.67
III. INFLATION	**100.0**	**2.44**	**3.48**	**0.76**

On average, **food and beverages** showed no change. Within this group, the price of rice fell by 1.9 percent, pasta by 1.3 percent and edible oil by 3.5 percent.

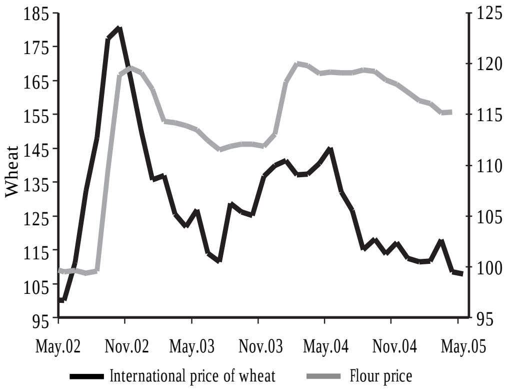
Figure 5
PRODUCTION AND PRICE OF RICE:
May 2002-May 2005



a. **Rice:** The price of rice fell by 1.9 percent during the period January - May 2005 as production of hulled rice increased by 19 percent between January and April 2005, compared to the same period in 2004. This higher production was the result of higher sowing and harvesting in San Martin and Lambayeque.

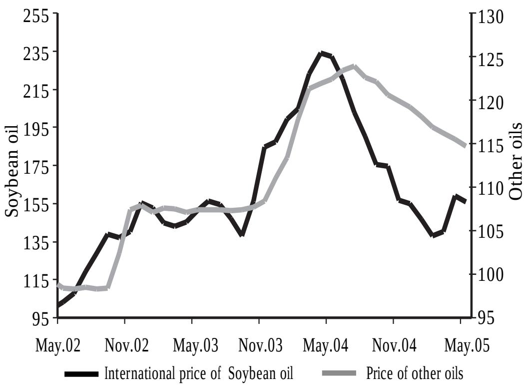
Nevertheless, restrictions on imported rice have prevented prices from falling further. Phytosanitary restrictions imposed by SENASA on rice imports from Asia have been in place since March 2004. This rice is known as “ordinary”, the main variety that competes with Peruvian production. Imports are only allowed from Uruguay and the United States, which are the better quality “extra” and “superior” varieties and are sold mainly in supermarkets.

Figure 6
WHEAT AND FLOUR PRICES:
May 2002-May 2005
(Index December 2001 = 100)



Source: INEI and Bloomberg.

Figure 7
SOYBEAN OIL AND OTHER EDIBLE OILS:
May 2002-May 2005
(Index December 2001 = 100)



Source: INEI and Bloomberg.

Table 4

RICE IMPORTS: 2004 - 2005
(Thousands of tons)

	2004		2005					
	Jan-May	Total	Jan	Feb	Mar	Apr	May	Jan-May
Uruguay	3	52	9	12	7	8	16	52
U.S.A.	2	12	11	3	2	5	2	24
Bolivia	0	4	1	0	0	0	0	1
Other 1/	3	6	0	0	1	1	1	4
Total	**8**	**75**	**21**	**16**	**11**	**14**	**19**	**80**

1/ Includes Australia, Brazil, Guyana, Holland and Italy among others.
Source: Sunat-Aduanas.

On the 28th of last May the government and rice producers associations in Piura, Tumbes and Lambayeque agreed on a warrant mechanism for rice production in order to manage the sale of this product and prevent a further fall in the price to the consumer.

b. **Pasta:** Between January and May 2005 the price of pasta fell 1.1 percent reflecting the lower international price of wheat, the main raw material for the flour used to produce pasta. During this period wheat and wheat flour prices fell by 3 and 1 percent respectively.

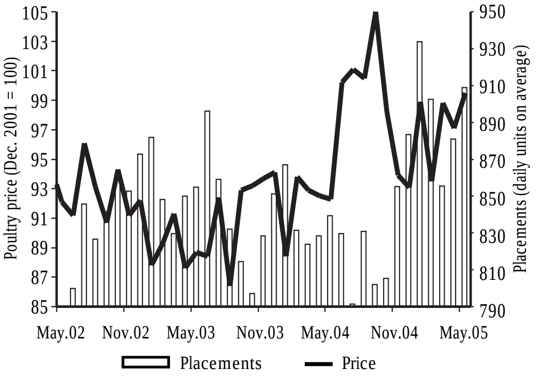
c. **Edible oils:** The price of edible oil fell 3.5 percent between January and May 2005, an average rate of 0.7 percent. The reduction was concentrated in the months of January and February, reflecting a fall in the price of soybean oil. 5 percent in December 2004 and 6 percent in January 2005. A factor that also caused domestic prices to fall was the strong competition, especially from imported oil.

5. **Non-core inflation** recorded an accumulated variation of 1.4 percent between January and May 2005, with a notable increase in food prices (4.2 percent). Fuel prices increased 0.6 percent, while those of public services fell 3.7 percent. It should be pointed out that urban bus fares rose by 0.3 percent.

Food

6. Among foodstuffs classified as non-core, chicken increased 6.9 percent and onions 44.1 percent, which was partially offset by a fall in the prices of citrus fruit (23.4 percent) and potatoes (2.3 percent).

Figure 8
POULTRY PRICE AND CHICKS PLACEMENTS: May 2002-May 2005



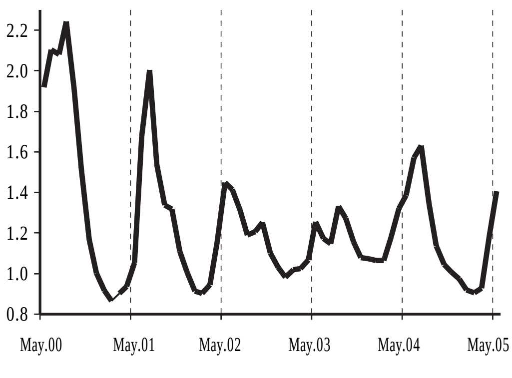
Chicken: As in previous years the price of chicken varied with the availability of substitute products and the number of chicks hatched. Steep rises in January and March were neutralized in part by reductions in February and April, resulting in a net price rise of 6.9 percent.

The January rise (6.2 percent) was explained by the lower availability of fish and beef, the later being a consequence of a strike by beef producers during the first fortnight of January. From the second fortnight onwards, when the supply of beef and mackerel returned to normal (rising from a daily average of 168 M.T. in the first fortnight to 247 M.T. in the final fortnight), the price of chicken began to fall, in February it fell 5.5 percent. This was largely the result of the large number of chicks available (934,000 a day in January and 902,000 in February compared to 883,000 a day in December).

The price rise in March (5.7 percent) was caused by lower availability of chicks (5 percent compared to February). In addition to this the price of mackerel rose (31.0 percent) as supply fell to 93 M.T. a day between the fourth week of February and the first week of March, compared to an average of 195 M.T. in February The reduction in the price of chicken in April (1.7 percent) can be explained by the high level of supply: 881,000 chicks were available each day compared to 855,000 a day in March.

May's increase (2.5 percent) mainly reflected an increase in the first week of the month caused by an increase in demand for the Mother's Day celebrations.

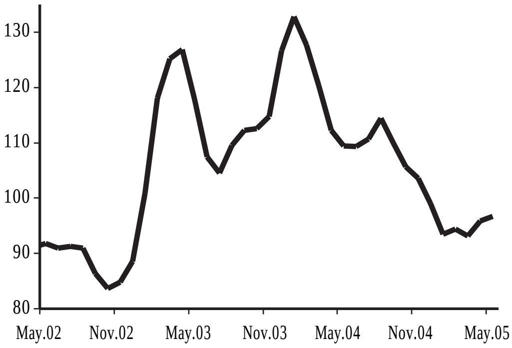
Figure 9
ONION PRICE: May 2000-May 2005
(Nuevos soles)



Onions: The price of this product rose 44.1 percent between January and May 2005. This result reflects the strong rises in April and May (25.6 and 21.2 percent respectively), due mainly to seasonal factors, as can be seen in the illustration: the price of onions increased between March and July before falling between August and February. Furthermore, the amount of sowed land in Arequipa, the main supplying area, fell 7 percent in the August - April sowing season compared to that of the previous year.

Citrus fruit: This product suffered a 23.4 percent fall on average. This is explained by an increase in lemon production (5.3 percent compared o the first quarter of the previous year), which was reflected in an increase of approximately 4 percent in supplies to Lima. As for other citrus fruits, from April onwards supply recovered strongly, largely as a result of seasonal factors.

Figure 10
POTATO PRICE: May 2002-May 2005
(Index December 2001 = 100)



Potatoes: Between January and May there was a 4 percent increase in the supply to Lima compared with the same period in the previous year. This result is explained by increased production in the areas that supply the capital (approximately 6 percent compared to the previous year). After a period of low prices recorded in the first quarter of the year, this situation was reverted in April and May (2.9 percent and 0.8 percent respectively) because the weather in the Central Highlands delayed harvesting. This was exacerbated by the government's commitment to purchase potatoes in Andahuaylas, which could have boosted the prices of native varieties (yellow and huayro potatoes).

Fuels

The international price of WTI rose from US$ 43.3 per barrel in December 2004 to US$ 49.9 per barrel in May 2005 (15 percent), after rising 35 percent in the previous year (26 percent in the period January - May 2004).

Changes in the oil price during this period were a response to low levels of supply in a context of increasing world demand, security problems in the Middle East (terrorist attacks on production installations in Saudi Arabia and Iraq) and speculation on the international market.

Domestic fuel prices increased, on average, 0.6 percent between January and May 2005 (See box 1).

Table 5

FUEL PRICES: MAY 2004 - MAY 2005
(Monthly percentage change)

	2004									2005					
	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.-Dec.	Jan.	Feb.	Mar.	Apr.	May	Jan.-May
Fuels	**1.0**	**1.5**	**1.8**	**0.6**	**0.7**	**2.6**	**2.8**	**-0.3**	**17.8**	**-0.9**	**-0.6**	**0.8**	**1.2**	**0.2**	**0.6**
Gasoline	1.7	2.0	-0.2	0.7	0.9	3.3	3.3	-0.2	17.7	-0.3	-0.6	0.6	1.4	0.3	1.5
Gas	0.2	0.7	5.5	0.0	-0.4	1.7	0.9	-1.1	15.3	-2.6	-1.8	1.1	0.6	-0.2	-2.9
Kerosene	0.9	1.6	0.6	0.9	1.4	2.7	4.2	0.2	20.3	0.0	0.5	0.7	1.4	0.2	2.9
WTI Price 1/															
US$ / barrel	40.3	38.3	40.7	44.9	45.9	53.2	48.5	43.3		47.1	48.1	54.3	53.0	49.9	
% Var.		-4.9	6.3	10.2	2.3	15.9	-8.9	-10.8	34.9	9.0	2.0	12.9	-2.4	-5.7	15.4

Source: INEI, Bloomberg.

Public services

Public service charges fell 3.7 percent in the period January - May 2005, driven by cheaper electricity and telephone charges (5.9 and 2.4 percent respectively).

Electricity tariffs fell as a result of lower fuel prices: residual 6 and natural gas fell by 13.9 and 1.3 percent respectively between November 2004 and January 2005; and bus bar tariffs fell in May because of increased use of natural gas. The fall in telephone charges occurred between February and March and is explained mainly by the quarterly productivity factor applied in March. The application of his factor (2.6 and 2.0 percent for local fixed-line and long distance calls, respectively) was reflected in reductions in the 19 tariff plans offered by Telefónica del Perú.

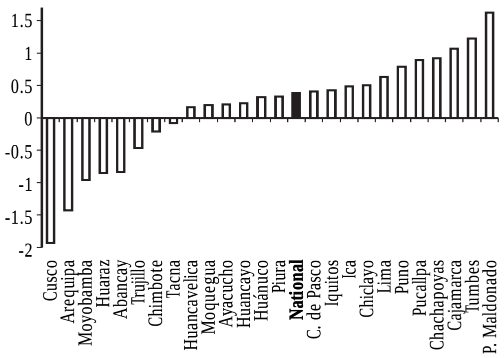
Table 6

PUBLIC UTILITIES RATES: MAY 2004 - MAY 2005
(Monthly percentage change)

	2004									2005					
	May	Jun.	Jul.	Aug.	Sep .	Oct.	Nov.	Dec.	Jan.-Dec.	Jan.	Feb.	Mar.	Apr.	May	Jan.-May
Public services	**-0.2**	**0.3**	**0.3**	**0.8**	**0.6**	**0.1**	**3.7**	**-0.3**	**6.2**	**-1.1**	**-0.2**	**-0.5**	**0.0**	**-1.9**	**-3.7**
Electricity	-0.5	0.6	0.5	0.4	1.3	0.1	7.4	0.3	12.0	-2.1	-0.3	0.0	0.0	-3.6	-5.9
Telephone	0.0	0.0	0.0	-0.1	0.0	0.1	0.0	-2.0	-2.0	0.0	-0.2	-2.1	0.0	-0.1	-2.4
Water	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: INEI.

Figure 11
NATIONAL INFLATION: January-April 2005
(% accumulated change)



Domestic inflation

7. Since January 2003, the INEI has produced an aggregate national consumer prices index based on prices recorded in 25 cities. The increase in accumulated prices between January and April 2005 was 0.38 percent, lower than the figure for Lima (0.63 percent). The last 12 months inflation rate of the aggregate national index was 1.9 percent in April (compared to 2.0 percent for the Lima CPI). In 14 cities the CPI was lower than the national average while in the remaining 11 cities this index of inflation was higher than the national average.

BOX 1

FUEL PRICE STABILIZATION MECHANISMS

Faced with an increase in world oil prices, the government implemented two mechanisms for stabilizing domestic fuel prices.

The first, applied during May - August 2004, consisted of a reduction in excise tax in order to offset the rise in fuel producers' prices, with a fiscal cost of S/. 112 million.

This mechanism was evaluated using two scenarios:

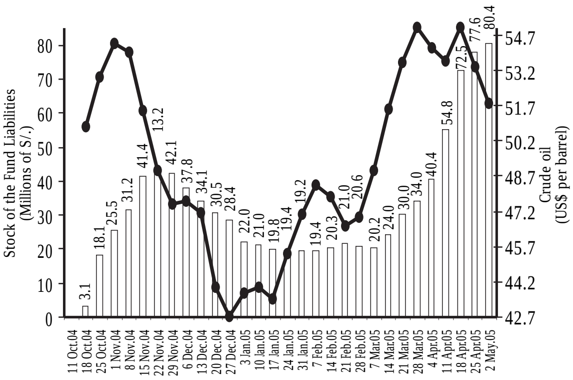
1. If the ISC stabilization mechanism had not been applied: there would have been no cost to the treasury but annual inflation would have been 0.15 percentage points higher in 2004 (3.63 percent compared to 3.48 percent).

2. If the ISC stabilization mechanism had remained in force between May and December 2004: prices would not have varied during this period, which would have implied a reduction of 0.36 percentage points in inflation in 2004 (3.12 percent versus 3.48 percent) but at a fiscal cost between May and December of S/. 421 millions (0.2 percent of GDP in 2004).

STABILIZATION MECHANISM THROUGH EXCISE TAX REDUCTION

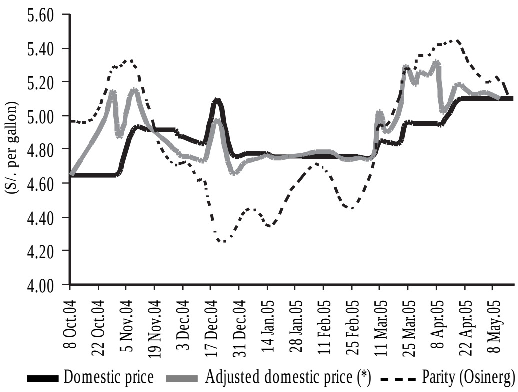
	Fiscal Cost (Millions of S/.)	Marginal Contribution (percentage points)	Inflation 2004 (% Var)
With the excise tax mechanism (May-Aug. 2004)	112	0.00	3.48
Without the excise tax mechanism	0	0.15	3.63
With the excise tax mechanism (May-Dec. 2004)	421	-0.36	3.12

CRUDE OIL PRICE AND THE STOCK OF THE STABILIZATION FUND LIABILITIES: October 2004-May 2005



The second mechanism was a Stabilization Fund, which came into force in October 2004 and will operate until September 2005. It establishes a price band for products, used for compensation and contributions of producers and importers depending on the international parity prices published by Osinerg. When the fund was created the balance of obligations amounted to S/. 3 million, while as at the 2nd of May 2005 this balance had reached its limit value of S/. 80 million.

DOMESTIC PRICES AND INTERNATIONAL PARITY: October 8, 2004-May 9, 2005
(Weighted average)



(*) Domestic price plus compensating factor minus contribution factor.

This mechanism dampened the increase in domestic prices in a context of highly volatile international fuel prices. This reduction in the variability of domestic prices (without tax) was restricted to the availability of resources assigned to the Fund and was more a response to increases in international prices than reductions. Thus the average volatility of international parity (13 percent) was higher than that of domestic fuel prices (4 percent).

Faced with an upward trend in international prices, the correction of the price bands enabled the reduction in the cost to the treasury. Nevertheless, because of the manner in which the mechanism is applied, the generation of obligations does not commit government funds immediately, in fact the effect on the budget will be felt in subsequent years.

I.2 Exchange rate

In the first five months of the year the exchange rate was relatively stable, in contrast to the downward trend experienced during the second half of the previous year. In nominal terms, it appreciated by 0.8 percent and in real terms by 0.4 percent.

8. The nominal exchange rate fell from S/. 3.28 in December 2004 to S/. 3.26 in May this year, implying a bilateral appreciation of Peru's currency of 0.8 percent with respect to the United States dollar and 1.5 percent with respect to the average of our main trading partners. In real terms, the sol depreciated 0.8 percent with respect to the dollar because accumulated inflation in the USA in the first five months (2.4 percent) may have been more than that of Peru (0.76 percent). As a multilateral average, the sol appreciated slightly in real terms (0.4 percent).

Figure 12
REAL AND NOMINAL EXCHANGE RATE: January 1999-May 2005

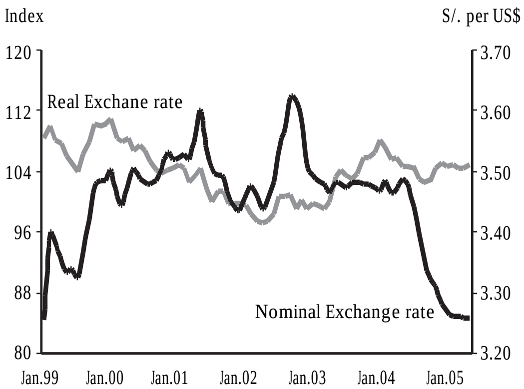


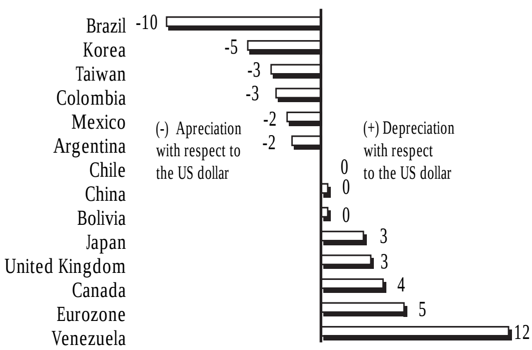
Table 7

BILATERAL EXCHANGE RATES AS OF MAY 2005

	% change in nominal exchange rates		% change in real exchange rates	
	May. 2005/ May. 2004	May. 2005/ Dec. 2004	May. 2005/ May. 2004	May. 2005/ Dec. 2004
USA	-6.7	-0.8	-5.5	0.8
Euro zone	-1.2	-5.8	-1.0	-5.3
Japan	-1.5	-3.4	-3.3	-4.2
Brazil	18.1	10.1	25.4	12.7
UK	-3.0	-4.6	-1.9	-4.3
Chile	2.6	-1.2	3.5	-0.6
China	-6.7	-0.8	-3.1	0.2
Colombia	8.5	2.5	11.8	5.2
Mexico	-2.0	1.4	0.8	1.7
Argentina	-6.5	1.1	-0.1	5.7
Korea	9.6	4.1	11.2	5.5
Taiwan	-0.4	2.2	-0.3	2.6
Venezuela	-16.6	-11.4	-4.9	-6.6
Canada	2.6	-3.8	2.5	-3.2
Bolivia	-8.6	-1.2	-4.2	1.0
Basket *	**-1.6**	**-1.5**	**0.1**	**-0.4**

* Weighted with respect to trade in 1994.

Figure 13
DEPRECIATION AND APPRECIATION OF NUEVO SOL WITH RESPECT TO THE CURRENCIES OF OUR MAIN COMMERCIAL PARTNERS
(% change May. 05/Dec. 04)



Between December 2004 and May 2005, the dollar appreciated with respect to other hard currencies (the euro, Canadian dollar, sterling and yen) because of lower growth prospects for the economies of those countries and a greater interest rate differential in favor of the dollar. Nevertheless, the dollar depreciated with respect to the region's currencies, except for the Venezuelan Bolivar.

9. Changes in the nominal exchange rate were influenced by the continued favorable situation of external accounts; lower country risk and depreciation of the dollar with respect to the currencies of the region, lower expectations of depreciation and the dedollarization of financial transactions:

a. **External accounts.** The balance of payments current account was in surplus for the third quarter in a row, reaching the equivalent of 1.8 percent of GDP during the first quarter of this year, above the forecasts included in the January Inflation Report. This performance of the balance of payments is influenced by the trade balance, which by March had been in surplus for 23 consecutive months and in that month reached US$ 395 million.

b. **Improved perception of country risk:** The sovereign bonds of several of the region's economies had their credit ratings revised upwards by ratings agencies. This favorable perception on the part of the agencies occurred in a context of low levels of country risk measured by the difference between emerging market bond yields and those of US treasury bonds.

Figure 14
FOREIGN EXCHANGE AND TRADE BALANCE: January 1999-May 2005

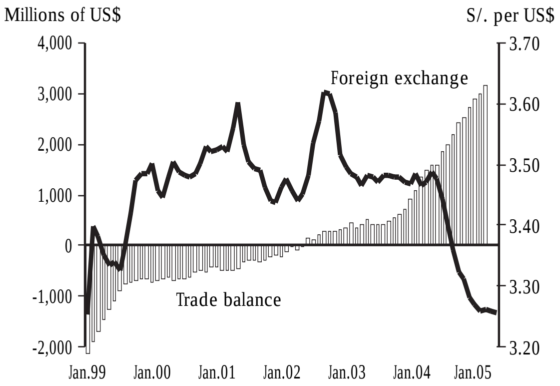
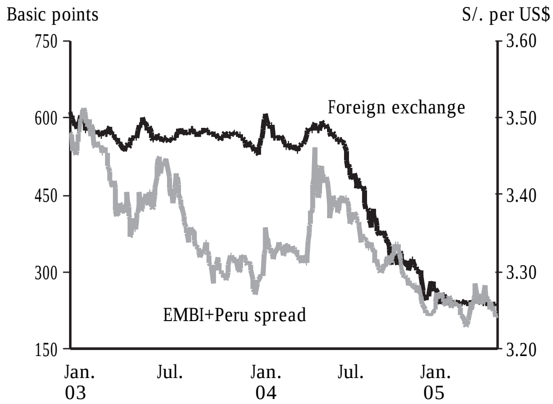


Table 8

EMERGING MARKETS' BONDS SPREADS
(In basic points)

	Dec. 03 (1)	Dec. 04 (2)	May.25 (3)	Change (3)-(2)
Emergent economies	418	356	372	16
Latin America	521	466	455	-11
Brazil	463	382	420	38
Colombia	431	396	354	-42
Mexico	199	180	164	-16
Argentina	5,632	4,703	6,498	1,795
Peru	312	220	206	-14

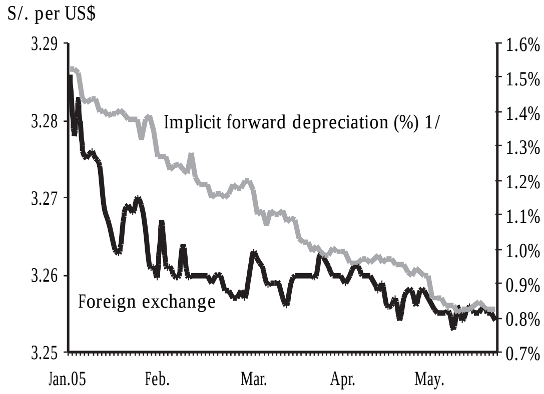
Figure 15
FOREIGN EXCHANGE AND COUNTRY RISK: January 2003-May 2005



It should be pointed out that the low spreads for emerging economies is even more significant as they occurred after the 5th of May when Standard & Poor's (S&P) reduced the credit rating of the third and first largest car makers Ford (from BBB- to BB+) and General Motors (from BBB- to BB) in both cases from "investment" to "speculative". The lower rating implies that their bonds (estimated at US$ 85 billion) are now in the same speculative/high yield category as the majority of emerging market sovereign bonds.

The region's currencies appreciated: the real by 10 percent, the Colombian peso by 3 percent, the Mexican peso by 2 percent and the Argentinean peso by 2 percent; while the Chilean peso and Bolivian peso did not move. In contrast, the Bolivar devaluated by 12 percent when the Central Bank of Venezuela adjusted its exchange rate bands in March. This result could also have been influenced by monetary policy changes towards less flexible or restrictive positions by some central banks (such as Chile, Mexico and Brazil) in order to eliminate inflationary pressures. The Central Bank of Colombia did not alter its reference rates as inflation developed favorably.

Figure 16
NOMINAL DAILY FOREIGN EXCHANGE AND IMPLICIT FORWARD DEPRECIATION (3 MONTHS): January-May 2005



1/ Measured by the difference in Peruvian currency and foreign currency interest rates to determine the future price of the dollar.

Figure 17
BANKING SYSTEM COEFFICIENT OF DOLLARIZATION: January 1999-April 2005

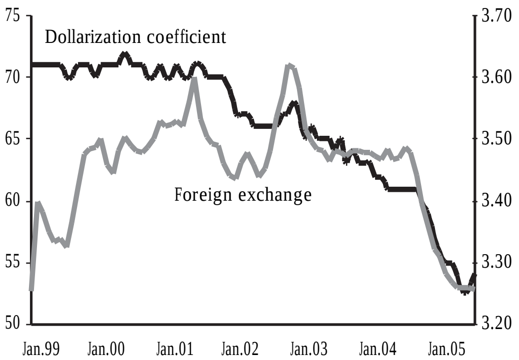


Figure 18
PENSION FUND'S PORTFOLIO IN US$ AND FOREIGN EXCHANGE: January 2002-April 2005

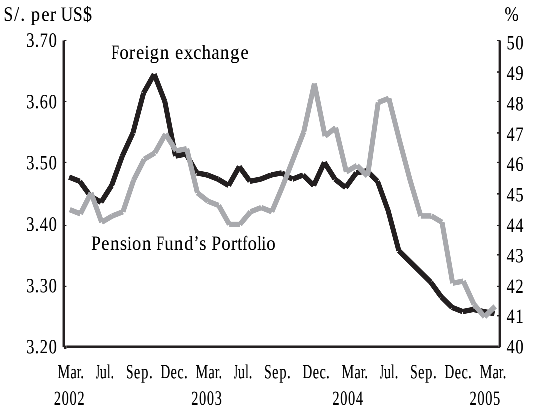


Table 9

MONETARY POLICY DECISIONS OF CENTRAL BANKS IN THE REGION: 2005

		Jan	Feb	Mar	Apr	May	Level up to May
Brazil	SELIC O/N rate	+ 50 bps	+ 50 bps	+ 50 bps	+ 25 bps	+ 25 bps	19.8%
Chile	reference rate	+ 25 bps	+ 25 bps	--	+ 25 bps	+ 25 bps	3.25%
Colombia	repo rate	--	--	--	--	--	6.50%
	reverse repo rate	--	--	--	--	--	5.50%
Mexico	corto (daily average) interbank	+6 billion	+2 billion	+2 billion	--	--	79 billion
Peru	reference rate	--	--	--	--	--	3.0%

* An increase in the "corto" implies less liquidity.

c. **Lower expectations of depreciation:** The favorable external account position and reduced country risk indicator produced lower expectations that the nuevo sol would depreciate. Between January and May expectations of depreciation (implicit in 3-month forward operations) fell from 1.5 to 0.8 percent.

d. **Financial dedollarization.** The factors mentioned above meant that economic agents continued to replace foreign-currency-denominated assets with Peruvian-currency-denominated ones in their portfolios, as we saw last year. In particular, investments of pension funds in foreign-currency-denominated assets fell from 44 to 41 percent. The coefficient of dollarization of the banking system fell from 55 to 54 percent between December

Figure 19
FOREIGN EXCHANGE AND INTEREST RATES IN THE FED AND PERU: January 2003-May 2005

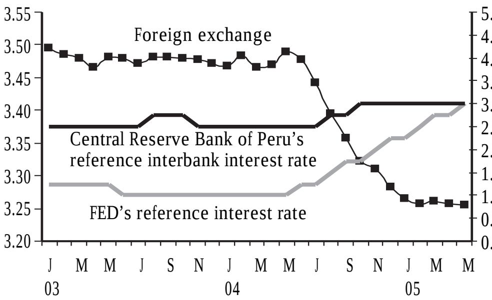


Figure 20
NET BALANCE OF EXCHANGE COVERAGE OPERATIONS, FOREIGN EXCHANGE POSITION AND FOREIGN EXCHANGE January 2003-May 2005

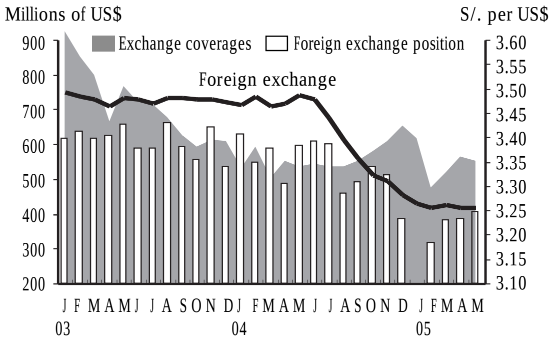


Figure 21
FOREIGN EXCHANGE AND BCRP INTERVENTIONS: January 2002-May 2005

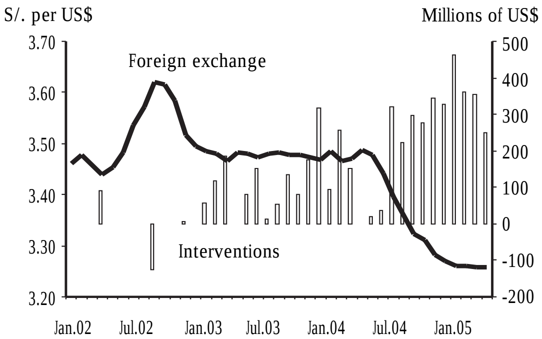
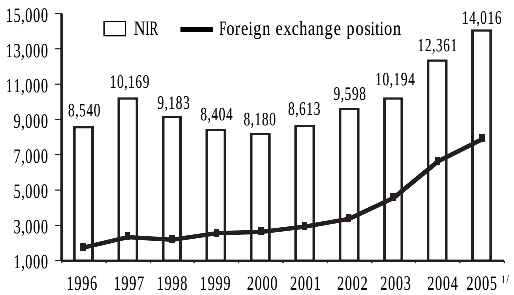


Figure 22
NET INTERNATIONAL RESERVES AND FOREIGN EXCHANGE POSITION: 1996-2005
(Millions of US$)



1/ As of May 2005.

2004 and April 2005. This last indicator was 70 percent in 2000, a demonstration of the process of financial dedollarization.

It should be pointed out that the lower differential between internal and external interest rates, resulting from a cycle of rising rates started by the FED in June last year, has attenuated the appreciation of the nuevo sol seen during the first few months of the year.

Lower expectations of depreciation also led to lower demand by the public for exchange rate coverage operations, which fell from a net balance of US$ 699 million in December to US$ 538 million in May. Bank slightly increased their exchange rate position from US$ 340 million in December to US$ 358 million in May.

10. In this context, dollar purchases by the Central Bank (US$ 1,754 million between January and May) in the foreign exchange market, enabled it to continue building up its international reserve position, in a context of strong external accounts and portfolio adjustments by economic agents. Part of its over-the-counter purchases enabled it to meet the demand for dollars from the public sector (US$ 418 million), so that net dollar purchases by the BCRP amounted to US$ 1,336 million.

This level of net dollar purchases explain the US$ 1,385 million increase in international reserves to US$ 14,016 million at end-May. Net dollar purchases, in addition to interest earned on deposits and investments abroad, increased the BCRP's exchange position by US$ 1,220 million to US$ 7,858 million at end-May.

I.3 Domestic demand and GDP

11. During the first quarter gross domestic product increased 5.4 percent, driven by a 19.9 percent increase in exports and a 7.7 percent increase in private investment. This took place when the prices of most of Peru's main export, particularly minerals, continued to rise and with stable macroeconomic conditions that favored investor confidence. Also, increased consumer confidence in a context of rising incomes and employment together with lower interest rates; favored increased consumption by the private sector, which explains the 54 percent growth in GDP in the first quarter.

Table 10

GLOBAL SUPPLY AND DEMAND
(Real percentage values compared to same period in previous year)

	2004		2005
	I Quarter	Year	I Quarter
I. GLOBAL DEMAND (1 + 2)	**4.5**	**5.6**	**6.9**
1. Domestic demand 1/	2.7	3.8	4.4
a. Private consumption	3.1	3.4	4.0
b. Public consumption	-0.2	3.8	10.6
c. Fixed private investment	8.0	9.3	7.7
d. Public investment	-12.7	5.5	7.0
2. Exports 2/	14.7	15.0	19.9
II. GLOBAL SUPPLY (3 + 4)	**4.5**	**5.6**	**6.9**
3. GDP	**4.8**	**4.8**	**5.4**
4. Imports 2/	2.7	10.1	16.3
Memo:			
Consumption plus public investment	-2.9	4.2	9.9

1/ Includes inventory changes.
2/ Goods and services.
Source: INEI and BCRP.

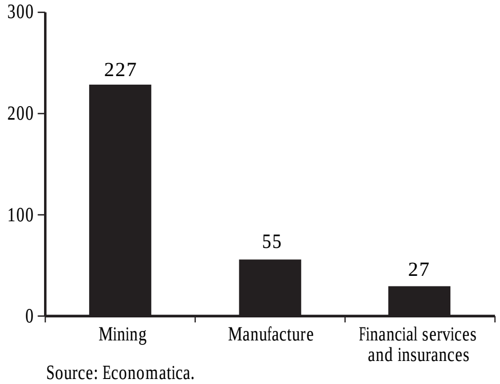
12. **Exports** continued to grow with increases recorded for both traditional and non-traditional products. Among the first, exports of zinc, copper, molybdenum, fishmeal and coffee rose, offsetting reduced exports of gold. Non-traditional exports grew 25 percent with textiles to the fore - especially knitted garments for the United States market - chemicals, agriculture and livestock, and fish products.

13. **Private investment** maintained the upward trend that started in the third quarter of 2002. The gain in terms of trade, increased sales and profits and improved business expectations encouraged companies to renew and extend plant and installations to meet higher demand.

    In the first quarter of 2005 significant disbursements were made for the Alto Chicama project, which is scheduled for completion towards the end of the second quarter and will start production in the final quarter of the year.

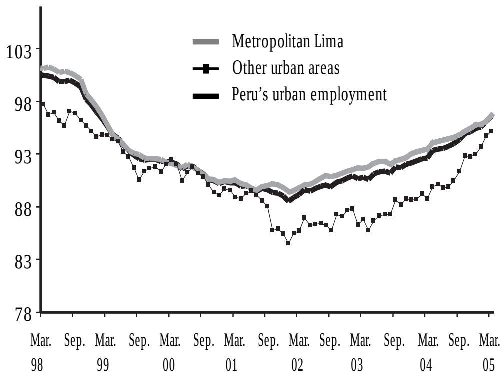
    Southern Peru also continued with its expansion and modernization program at Toquepala. This project, which consists of the construction of leaching beds, a crushing plant and conveyor belts at the Toquepala mine, is intended to increase metal recovery and generate annual savings of

Figure 23
COMPANIES PROFITS IN 2004
(% annual changes)



Source: Economatica.

Figure 24
EMPLOYMENT IN COMPANIES WITH 10 OR MORE EMPLOYEES: March 1998-March 2005
(Seasonally adjusted indices. October 1997 = 100)



Source: ENVME, MTPE.

US$ 25 million in operating costs. Other mining and hydrocarbons companies pressing ahead with investment were Antamina, Minera Yanacocha and Pluspetrol with the Camisea project.

Similarly, private sector companies in the manufacturing, electricity, commercial, hotel and services sectors invested both in non-residential building (extensions and new branch offices) and in acquisitions of new machinery. This latter was reflected in a 21.4 percent increase in machinery and equipment imports.

Private consumption increased 4.0 percent because of increases in disposable income, sustained growth in urban employment among companies with 10 or more employees, the increase in consumption credits of financial companies and the improved consumer confidence.

According to the Ministry of Labor, employment in companies with 10 workers increased 3.9 percent in the first quarter of the year, mainly because of expansion in the provinces (6.4 percent), which exceeded the growth recorded in metropolitan Lima (3.1 percent). The cities with the highest growth in employment were Ica, Iquitos and Piura, associated with the dynamism of farm exports and fishing (Ica and Piura) and forestry exports in the case of Iquitos.

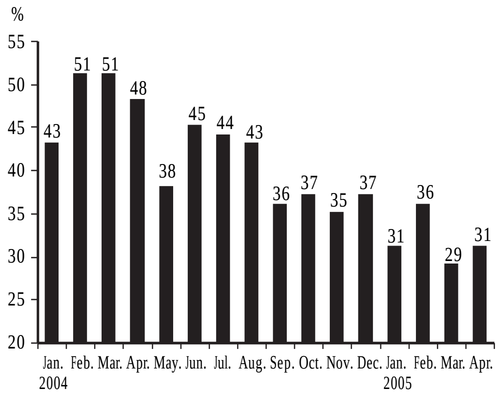
Table 11

URBAN EMPLOYMENT IN MAIN CITIES COMPANIES WITH MORE THAN 10 EMPLOYEES
(Annual percentage change)

	March 2005/ March 2004	Jan.-Mar. 2005/ Jan.-Mar. 2004
Urban Peru	**4.3**	**3.9**
Metropolitan Lima	3.4	3.1
Other urban	7.2	6.4
Ica	29.9	23.7
Chincha	14.1	8.8
Iquitos	14.1	13.9
Pisco	10.4	8.5
Piura	10.3	13.0
Pucallpa	6.1	2.7
Trujillo	6.1	6.3
Cusco	5.5	5.2
Arequipa	3.1	1.8
Chiclayo	2.4	1.2
Cajamarca	1.9	3.1
Huancayo	1.8	3.7
Tarapoto	1.7	0.7
Tacna	0.6	-1.6
Chimbote	0.2	0.8
Puno	-3.2	-1.2
Paita	-7.2	-10.9

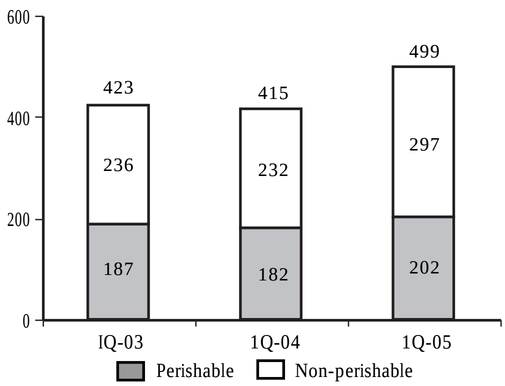
Source: MTPE, Monthly Statistical Report. Survey of monthly variation in employment.

Figure 25
PERCENTAGE OF PEOPLE WHO BELIEF ITS ECONOMIC SITUATION WILL BE WORSE IN 12 MONTHS: January 2004-April 2005



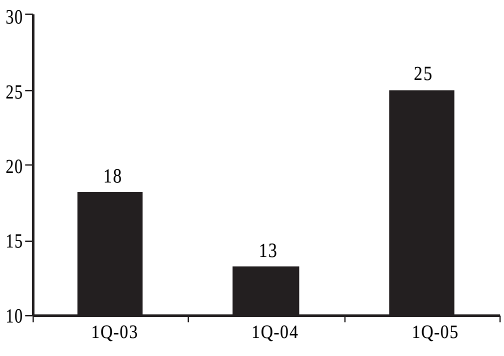
Source: Apoyo Opinión y Mercado.

Figure 26
CONSUMPTION GOODS IMPORTS
I quarter 2003-2005
(Millions of US$)



Source: SUNAT.

Figure 27
SALES OF NEW CARS
I quarter 2003 - 2005
(% changes)



Source: Asociación de Representantes Automotrices del Perú (ARAPER).

A survey by Apoyo Opinión y Mercado showed that consumers were more confident about their future economic situation. The percentage of people who said that the economic situation in the next 12 months would worsen has fallen significantly throughout the year.

The increase in spending is reflected in a number of indicators such as growth in consumer goods imports, increased sales of new vehicles (25 percent) and higher production in some parts of the non-primary manufacturing sector associated with large-scale consumption such as dairy products (10.4 percent) and beauty and hygiene products (13.3 percent).

14. **Public consumption** increased 10.6 percent because of increased payroll costs (18.3 percent in the case of the central government). Public investment increased 7.0 percent, driven by higher local government spending and, to a lesser extent, projects carried out by certain public enterprises such as Sedapal, Electroperú and Enapu.

BOX 2

UNIT LABOR COST AND LABOR PRODUCTIVITY

One of the indicators used to identify inflationary pressures is the concept of unit labor cost (ULC). This indicator identifies whether wage increases will generate inflationary pressures, discounting the effect of increases in labor productivity.

ULC is defined as nominal remuneration per unit produced (real production per employee).

$$ULC = \frac{W}{Y / L}$$

Where:

	ULC	represents unit labor cost
	W	represents nominal wages
	L	represents the number of workers
	Y	represents the product level (in real terms)
	Y/ L	represents labor productivity

In terms of variation this ratio implies:

$$\Delta ULC = \Delta W - \Delta(Y / L)$$

In other words, wage increases would imply increases in the ULC, while improvements in labor productivity would imply a drop in this indicator.

In Peru, ULC has been calculated using non-primary GDP excluding government services as an indicator of activity, and wages and salaries in Metropolitan Lima in companies with 10 or more employees according to the Ministry of Labor (MTPE) as the indicator of remuneration. The indicator of employee was urban employment in companies with 10 or more employees according o the MTPE.

As incomplete information on remunerations was available from the MTPE for 2004, from that year onwards the changes in remuneration were estimated using the pension funds records.

Inflationary pressures in the first quarter of 2005 should be weak as in this period the ULC fell by 1.1 percent because of a 1.8 percent increase in nominal wages and a 2.9 percent increase in productivity.

UNIT LABOR COST
(% change)

	ULC	Wages	Productivity
1999	2.5	7.4	4.8
2000	2.1	7.1	5.0
2001	-3.8	-2.2	1.6
2002	-2.3	2.0	4.5
2003 1/	2.8	4.8	2.0
2004 2/	0.1	3.0	2.9
2005 3/	-1.1	1.8	2.9

1/ Percentage change of wages June and December 2003/June and December 2002 (MTPE).
2/ Percentage change of wages June and December 2004/June and December 2003 (SBS).
3/ Percentage change of wages I quarter 2005/I quarter 2004 (SBS).
Source: INEI, MTPE y SBS.

GDP by sector

15. An analysis of sector growth shows that in the first quarter of 2005 the non-primary sectors grew 6.2 percent, while primary sectors grew 1.1 percent. The **non-primary sector** was driven by growth in non-primary manufacturing, which increased 6.7 percent, explained by increased domestic and external demand, while growth in the construction sector (2.8 percent) arose from the development of housing programs.

Mixed results were observed in the **primary sector**. On the one hand the agricultural & livestock sector grew 3.0 percent due to increased production of rice, potatoes, coffee and farm products for export; on the other hand primary manufacturing contracted by 3.3 percent because of reduced sugar, fishmeal and fish oil production.

16. In the first quarter **the agricultural & livestock sector** grew 3.0 percent because of increased production of rice, coffee and other farming products for export (mangoes, grapes, white onions and olives) that benefited from larger sowed areas, better weather and higher international prices. These results offset reduced sugar cane and yellow maize production, which were affected by the drought in 2004 and delays in sowing, respectively.

17. The **fishing sector** expanded 1.3 percent in the first quarter, driven by an increase in landings for human consumption, which was offset by a contraction in industrial consumption. Within the first category there were higher landings of hake, whelks and langostino for freezing and of silverside, dolphinfish and other species for fresh consumption. Landings destined for canning declined, however, because of a relative scarcity of jack mackerel. Furthermore, landings of Peruvian anchovy for industrial use fell because, in contrast to the previous year, fishing for this species off the north central coast was prohibited, where that species is most abundant.

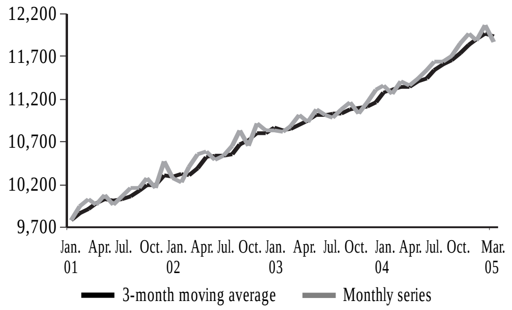
Table 12

GROSS DOMESTIC PRODUCT: 2004 - 2005
(Real percentage values compared to same period in previous year)

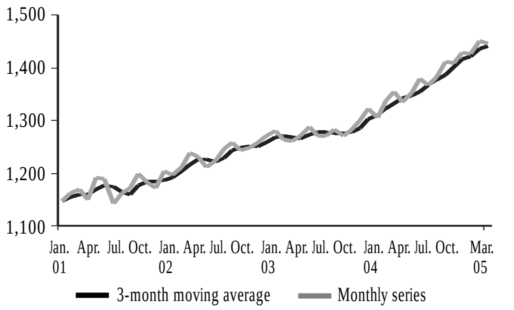
	2004		2005
	I Quarter	Year	I Quarter
Agriculture & livestock	**2.0**	**-1.1**	**3.0**
Fishing	**18.9**	**30.5**	**1.3**
Mining & fuel	**12.9**	**5.4**	**0.8**
Metal mining	14.2	5.2	-1.6
Fuel	-5.4	7.1	34.1
Manufacturing	**5.2**	**6.7**	**4.9**
Based on raw materials	1.8	4.6	-3.3
Non-primary industries	5.4	7.2	6.7
Electricity & water	**4.9**	**4.6**	**3.5**
Construction	**7.0**	**4.7**	**2.8**
Commerce	**3.4**	**4.8**	**5.6**
Other services	**4.5**	**4.7**	**6.8**
GROSS ADDED VALUE (GAV)	**5.0**	**4.6**	**5.2**
Taxes on products and import	3.0	6.4	7.2
GLOBAL GDP	**4.8**	**4.8**	**5.4**
Primary GAV	**6.3**	**2.8**	**1.1**
Non-primary GAV	**4.7**	**5.1**	**6.2**

Source: INEI.

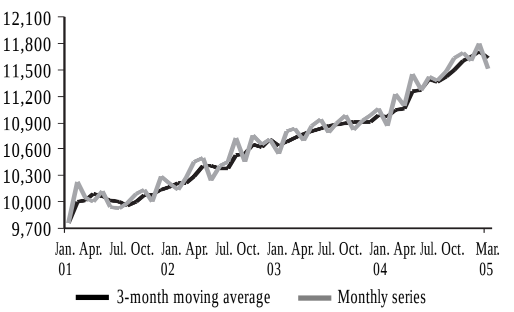
Figure 28
SEASONALLY ADJUSTED GROSS DOMESTIC PRODUCT
(Millions of nuevos soles of 1994)



SEASONALLY ADJUSTED NON-PRIMARY MANUFACTURE
(Millions of nuevos soles of 1994)



SEASONALLY ADJUSTED DOMESTIC DEMAND INDICATOR
(Millions of nuevos soles of 1994)



18. The **mining and hydrocarbons sector** recorded growth of 0.8 percent based on increased hydrocarbon production (34.1 percent) while metal mining fell by 1.6 percent. Crude oil production rose 28.5 percent and that of natural gas by 131.7 percent. The latter figure is explained by the Camisea project coming on stream. In contrast, gold production fell as reserves at the Pierina mine were worked out, therefore the availability of deposits with a high gold content has fallen significantly and fine gold production could not be maintained.

19. **Manufacturing** production increased 4.9 percent. The primary processing industry recorded a contraction of 3.3 percent, while non-primary manufacturing grew 6.7 percent.

    Reduced primary processing activity is explained by lower production of refined petroleum, sugar, canned and frozen fish and refined non-ferrous metals.

    In the non-primary manufacturing sector there was notable growth in the paper and printing, chemical products, rubber and plastics industries; food, beverages and tobacco and, to a lesser extent nonmetallic minerals.

    This result reflects an increase in non-traditional exports (25 percent), the development of certain mining projects, a dynamic construction sector and an increase in domestic demand driven by new products and more economic presentations.

20. During the first quarter of the year, the 3-month moving average of seasonally adjusted GDP continued the upward trend observed since the beginning of 2001; this was accompanied by growth in indicators of domestic demand and seasonally adjusted non-primary manufacturing.

21. **National disposable income** increased 6.8 percent in the first quarter, a higher rate than that of GDP as a result of dynamic domestic demand and improved terms of trade associated with higher prices for Peru's exports.

Table 13

NATIONAL DISPOSABLE INCOME
(Real percentage values compared to same period in previous year)

	2004		2005
	I Quarter	Year	I Quarter
I. Gross domestic product (GDP)	4.8	4.8	5.4
II. Gross national product (GNP) 1/	3.2	3.2	5.7
III. Gross national income (NI) 2/	5.5	5.3	7.0
V. National disposable income (NDI) 3/	**5.8**	**5.5**	**6.8**

1/ Excludes from GDP the net income paid to non-resident productive factors.
2/ GDP and GNP are isolated from changes in foreign terms of trade.
3/ Net transfers from non-residents is added to NI.
Source: INEI and BCRP.

I.4 External accounts

The favorable external account position continued during the first quarter of this year. The prices of the country's exports rose by 5.5 percent and volumes shipped increased by 27 percent, producing a trade surplus for the eighth consecutive quarter and a current account surplus for the third quarter in a row.

In the first quarter international reserves also increased by US$ 924 million, thus strengthening the international liquidity position and sustainability of the external accounts.

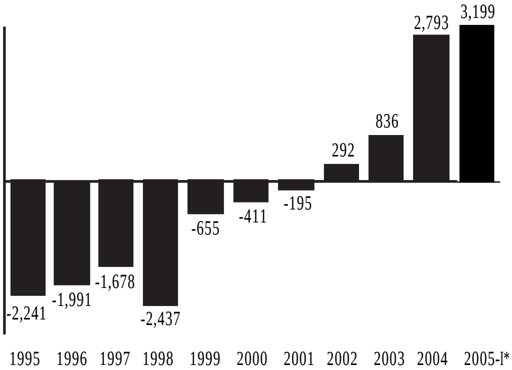
Table 14

BALANCE OF PAYMENTS
(Millions of US$)

	2004		2005
	I Quarter	Year	I Quarter
I. CURRENT ACCOUNT BALANCE	**- 43**	**- 10**	**326**
(% of GDP)	*- 0.3*	*- 0.0*	*1.8*
1. Trade balance	643	2,793	1,049
a. Exports	2,767	12,617	3,707
b. Imports	- 2,124	- 9,824	- 2,658
2. Services	- 207	- 843	- 212
3. Investment income	- 805	- 3,421	- 860
4. Current transfers	326	1,461	349
II. CAPITAL ACCOUNT	**249**	**2,336**	**656**
1. Private sector 1/	298	1,348	489
2. Public sector	- 49	988	167
III. EXCEPTIONAL FINANCING	**2**	**26**	**3**
IV. NET FLOW OF CRBP RESERVES (1-2)	**- 209**	**- 2,352**	**- 984**
(Increment carries negative sign)			
1. Variation in NIR balance	- 217	- 2,437	- 924
2. Effect of valuation and monetarization of gold	- 8	- 85	61

1/ Includes short term capitals and net errors and omissions.
Source: BCRP, MEF, SUNAT and companies.

Figure 29
TRADE BALANCE: 1995-2005
(Millions of US$)



* Last four quarters.

Trade balance

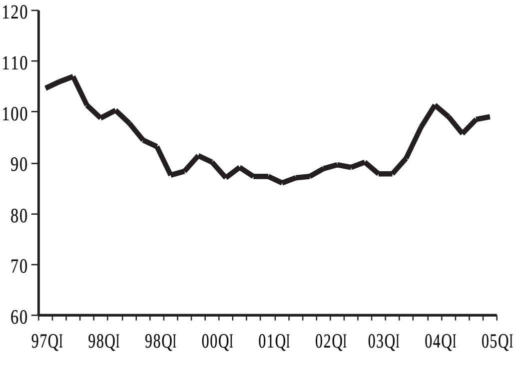
22. In the first quarter of 2005, in a context of higher international prices the **trade balance** surplus was US$ 1,049 million, the highest quarterly figure ever recorded. This result is explained by the 34 percent increase in exports, while imports increased by 25 percent. The trade surplus reached US$ 3,199 millions in the last four quarters to March, exceeding the figure for the previous year.

23. First quarter **exports** amounted to US$ 3,707 million, US$ 940 million higher than in the same period of 2004. This improvement is explained by increases of 27.1 percent in volumes and 5.5 percent in prices. Foreign sales of traditional products rose by US$ 738 million (38 percent), while those of non-traditional products rose US$ 197 millions (25 percent). The improvement in traditional exports is explained by higher mineral prices. It should also be mentioned that lower gold shipments were caused mainly because Pierina mine exhausted its reserves.

Non-traditional exports continued to be dynamic, particularly the agricultural and livestock sector (20 percent) as a result of maturing investments in the sector and increases in productivity, and the textile sector which still benefited from the Andean Trade Promotion and Drug Eradication Act (ATPDEA) which enabled the sector to grow by 16 percent despite the start of a process of eliminating textile quotas in the North American market and the impact of China on the world market. There was also a notable increase in chemical products (38 percent) driven by sales of inorganic products, and steel products and jewelry (25 percent) taking advantage of better international prices.

24. **Imports** amounted to US$ 2,658 million, US$ 533 million or 25 percent higher than in the same period of the previous year. This dynamism is explained mainly by increased raw materials acquisitions (27 percent), because of increased fuel imports as the oil price rose and of industrial raw materials in a context of greater economic activity. It is also worth highlighting the significant growth in capital goods purchases (25 percent), particularly by manufacturing industry, associated with increased private investment. Consumer goods imports rose 22 percent in the quarter, covering both durable and non-durable consumer goods, with a notable increase in rice imports (54,000 MT compared to 2,000 MT in the first quarter of 2004).

Figure 30
TERMS OF TRADE: I quarter 1997-2005
(Index 1994 = 100)



Terms of trade

25. In the first quarter, export prices rose 5.5 percent, mainly copper (25 percent), coffee (39 percent), zinc (20 percent) and gold (5 percent) offset by lower prices for fishmeal (5 percent); while import prices rose 7.8 percent, principally oil (36 percent), which was offset by lower prices for wheat (16 percent) and soybean (31 percent). Thus the terms of trade fell by 2.1 percent.

This development was associated with sustained demand from China for the principal metals, despite measures taken by the Chinese government to cool the economy; low inventory levels for commodities and a lack of flexibility in the balance between supply and demand in the copper and oil markets; and, in the case of gold, inflationary pressures in the United States.

Coffee prices recovered because of reduced growth in world supply in the 2004 - 2005 season, while wheat and soybean prices continued on the downward trend that started in the second quarter of 2004 in a context of expected improvements in the harvest.

Current account balance and capital flows

26. In the first quarter of 2005 the **balance of payments current account** was in surplus for the third consecutive quarter at US$ 326 million (1.8 percent of GDP), contrasting with the US$ 43 million deficit recorded in the same period of the previous year. This improvement was generated mainly by a trade surplus of US$ 1,049 million, which was partly offset by an increased deficit in investment income and services.

    Within the investment income segment, outflows resulting from increased profits of foreign investors stood out in a context of improved world prices and higher export volumes. The higher deficit in services is explained mainly by increased spending on freight for imports.

27. In this quarter the **capital account** achieved a flow of US$ 656 million, higher in US$ 407 million than in the first quarter of 2004 due to better results by the private and public sectors. In the first case there was an increase in disbursements of long-term private loans to the mining sector, less foreign investment by the financial sector as investors adjusted their portfolios in favor of Peruvian currency and an increase in short term liabilities in the banking system caused by increased foreign trade. In the public sector, higher spending resulted mainly from placements of global bonds abroad having a market value of US$ 427 million (US$ 400 million nominal value), which offset higher amortizations and assets abroad, mainly deposits of US$ 100 million made by the Pension Control Office (ONP). It should be mentioned that the flow of foreign funds under the heading errors and omissions was negative in US$ 82 million.

    With this, the BCRP's flow of net international reserves rose US$ 924 million to US$ 13,555 million.

I.5 Public finances

The fiscal accounts performed positively during the first quarter of 2005, showing a primary surplus greater than that recorded in the same period of the previous year. In contrast to that period, this was the result not of reduced public spending, but of increased tax revenue, particularly due to the higher income tax clearing in March.

Table 15

NON-FINANCIAL PUBLIC SECTOR: 2004-2005
(Millions of nuevos soles)

	2004		2005
	I Quarter	Year	I Quarter
1. Current revenue	**8,204**	**35,381**	**9,333**
(% of GDP)	15.1	15.1	15.8
Real % var.	6.6	8.1	11.3
2. Non-financial expenditure	**-6,781**	**-34,165**	**-7,621**
(% of GDP)	-12.4	-14.6	-12.9
Real % var.	-2.8	4.8	10.0
Current	-6,303	-29,870	-7,128
(% of GDP)	-11.6	-12.8	-12.1
Real % var.	1.0	5.3	10.7
Capital	-478	-4,295	-493
(% of GDP)	-0.9	-1.8	-0.8
Real % var.	-35.3	1.5	1.0
3. Others	**473**	**1,184**	**731**
(% of GDP)	0.9	0.5	1.2
4. Primary balance	**1,896**	**2,400**	**2,444**
(% of GDP)	3.5	1.0	4.1
5. Interest	**-1,406**	**-4,865**	**-1,234**
(% of GDP)	-2.6	-2.1	-2.1
Of which:			
Pension reform bonds	-204	-333	49
External debt (Millions of US$)	-$310	-$1,159	-$308
6. Overall balance	**491**	**-2,465**	**1,209**
(% of GDP)	0.9	-1.1	2.0
Millions of US$	$141	-$754	$371

28. During the first quarter of 2005 the **overall balance** of the non-financial public sector recorded a surplus equivalent to 2.0 percent of GDP, higher by 1.1 percent of GDP than the figure for the first quarter of 2004. This was the result of an improvement in the primary balance amounting to 0.6 percent of GDP and to lower interest payments on Peru's debt amounting to 0.5 percent of GDP. The improved primary balance was caused by an increase of 11 percent in central

government income while non-financial expenditure increased 10 percent.

29. Central government **current revenue** rose by 15.8 percent of GDP, 0.7 percent of GDP higher than in he same period of the previous year. This was the result mainly of improved tax revenue (0.6 percent of GDP), of which income tax made a higher contribution (growth of 18 percent in real terms).

This increase in income tax was generated by higher economic activity, improved mineral prices and an increase in the corporate tax rate from 27 percent to 30 percent. These last two factors would have had a significant effect on annual clearing of income tax.

Value added tax (IGV) showed a real increase of 9 percent, mainly due to higher imports and certain new administrative measures such as the inclusion of new goods and services into the system of detractions in August 2004 and the application of a tax system for local sales of several products in January 2005.

30. **Non-financial expenditure** by central government rose to 12.9 percent of GDP, a level 0.4 percent of GDP higher than in the same period of the previous year. This increase was basically in current expenditure, caused by public sector wage increases in 2004 and advance payments of the school fee bonus in February (in the previous year this bonus was paid in April). This implied an increase in wage costs of 0.4 percent of GDP.

Table 16

NON-FINANCIAL PUBLIC SECTOR FINANCING: 2004 - 2005

	2004		2005
	I Quarter	Year	I Quarter
1. Overall balance (Millions of nuevos soles)	**491**	**-2,465**	**1,209**
(% of GDP)	0.9	-1.1	2.0
Millions of US$	141	-754	371
2. Amortization (Millions of US$)	**-421**	**-2,068**	**-388**
Redemption of pension reform bonds	-51	-215	-34
Internal repayments	-72	-505	-32
External repayments	-298	-1,348	-322
3. Borrowing requirements (Millions of US$)	**280**	**2,822**	**17**
External disbursements	260	2,474	633
Freely available	201	2,158	577
Investment projects	59	315	56
Domestic bonds	173	766	205
Privatization	70	114	7
Others 1/	-223	-532	-827

1/ The negative sign implies mainly an increase in deposits.

31. Public debt **interest payments** amounted to 2.1 percent of GDP, a figure 0.5 percentage points lower than in the previous year. This was due both to lower interest accruing on bonds (the result of lower inflation) and lower expenditure on external interest because of the lower exchange rate.

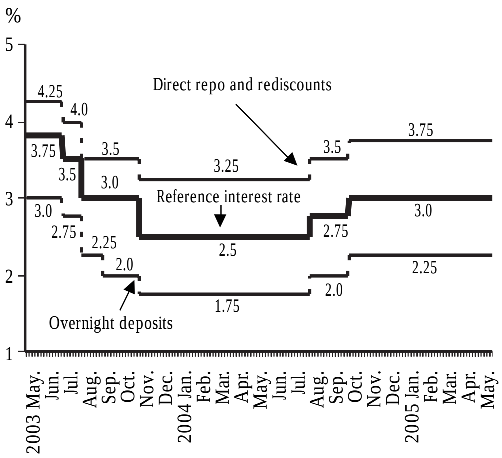
32. The **borrowing requirement** amounted to US$ 17 million, US$ 263 million less than the requirement in the same period of the previous year, which reflects the higher fiscal surplus.

During the quarter US$ 633 million was received from abroad, of which US$ 577 million were freely available (US$ 427 million arising from bond placements) and US$ 56 million were for investment projects. Sovereign bonds valued at S/. 669 million (equivalent to US$ 205 million) were also issued.

I.6 Interest rates and monetary aggregates

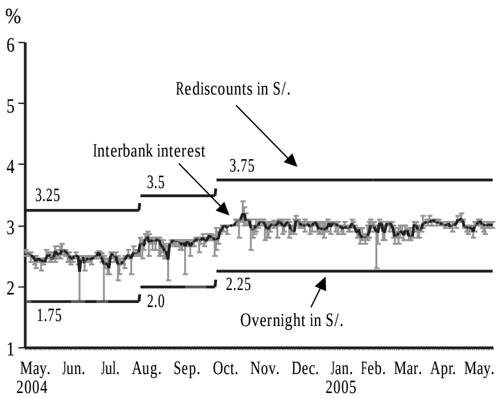
During the first months of the year, the Central Bank maintained its reference interest rate at 3.0 percent as the supply shocks that caused an increase in inflation in 2004 subsided and because forecast inflation for 2005 is around the center of the inflation target range (2.5 percent).

Figure 31
REFERENCE INTEREST RATE: May 2003-May 2005



33. The Central Reserve Bank establishes its monetary policy position through a reference interest rate for the interbank market. Since the Inflation Targeting scheme was adopted (in January 2002) the policy position has been monetary stimulus and this has led to historically low real interbank interest rates. This has been consistent with compliance with the inflation target and has contributed to the recovery in economic activity after the recession, which affected the Peruvian economy between 1998 and 2001.

Figure 32
INTEREST RATES IN DOMESTIC CURRENCY: May 2004-May 2005



34. During the first months of 2005 the Central Bank's monetary policy position remained unchanged. Thus the reference interest rate for operations in the interbank market remains at 3.0 percent. This stable monetary position is consistent with the disappearance of inflationary supply shocks that affected the economy last year, forecast inflation for 2005 slightly below the center of the target range (2.5 percent) and public expectations of inflation at around this level.

35. During the first months of the year, the interbank rate was close to the reference interest rate (3.0 percent). During February and March, there was a slight increase in the variability of the interbank interest rate, which then fell to an average range of 3 to 5 basis points in April and May, respectively. This higher variability was caused by liquidity adjustments caused by

clearing payments of income tax, which fell due on the 8th of April and meant an unprecedented payment of S/. 1,864 million

Table 17

INTERBANK INTEREST RATE IN SOLES

	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
2004												
Average (%)	2.41	2.52	2.48	2.49	2.48	2.46	2.44	2.67	2.73	2.93	3.02	3.00
Standard desviation (pp)	0.10	0.04	0.04	0.06	0.05	0.07	0.08	0.10	0.04	0.12	0.07	0.04
Variability coefficient (%)	4.2	1.7	1.5	2.6	1.9	2.7	3.1	3.8	1.4	4.2	2.3	1.4
2005												
Average (%)	2.98	2.90	2.93	3.03	3.01							
Standard desviation (pp)	0.04	0.08	0.08	0.03	0.05							
Variability coefficient (%)	1.2	2.8	2.7	0.9	1.8							

Source: BCRP.

Interest rates on loans and deposits

36. The corporate prime lending rate in domestic currency rose slightly during the first months of 2005, from 3.8 percent in December 2004 to 4.0 percent in May 2005. Thus the difference usually seen with respect to the interbank interest rate (around 90 base points) was maintained. There were also slight increases in lending and deposit interest rates.

TABLE 18

INTEREST RATES FOR SOL-DENOMINATED OPERATIONS
(In percentages)

	2002				2003				2004				2005	
	Mar.	Jun.	Sep.	Dec.	Ma.r	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Apr.
1. Interbank	2.5	2.6	5.4	3.8	3.8	3.7	2.8	2.5	2.5	2.5	2.7	3.0	2.9	3.0
2. Term deposits between 31 to 180 days	3.9	3.2	4.0	5.3	4.1	4.1	3.5	3.0	2.8	3.0	2.9	3.2	3.2	3.3
3. Term deposits between 181 to 360 days	7.1	4.9	4.7	5.1	5.0	4.8	4.4	4.2	3.9	3.8	3.9	4.4	4.6	4.6
4. Preferential corporate lending	3.9	3.7	6.8	5.1	4.7	4.6	3.5	3.3	3.3	3.5	3.5	3.8	4.0	4.1
5. Average lending up to 360 days	15.5	14.1	14.0	14.8	14.3	14.0	14.3	14.0	14.8	14.7	14.3	14.7	15.5	14.9
6. Average lending constant structure	25.0	23.6	22.5	22.3	21.1	20.1	19.6	19.0	19.3	18.7	18.3	18.2	18.3	18.5
7. CDBCRP														
Balance	5.4	4.8	4.1	4.7	4.7	4.8	4.3	3.9	3.7	3.8	4.1	4.5	4.5	4.6
Average term of the CDBCRP balance (in days)	115	99	81	162	206	213	251	260	256	220	238	282	265	269

Source: BCRP.

BOX 3

IMPACT OF THE INTERBANK INTEREST RATE ON OTHER INTEREST RATES IN SOLES

The interbank interest rate level serves as a reference for other interest rates in soles and has a greater effect on those rates involving a lower credit risk and shorter terms. A greater response by interest rates over a shorter period to changes in the interbank rate strengthens the influence of monetary policy.

In order to estimate these effects, information was used from the period between 1995 and 2004, which was divided into two sub-samples to identify whether the greater predictability of the interbank rate after the recent reduction in its volatility has strengthened the monetary policy transmission mechanism. The results show that, after adoption of Inflation Target, the long term impact (pass-through coefficient) of interbank interest rates on domestic currency rates has increased and the time required for the effect to be transmitted has fallen.

In addition, the effect of a one percentage point change in the interbank interest rate is greater for interest rates on longer term loans, while for deposit rates the effect is less for longer terms.

INTERBANK INTEREST RATE IMPACT OVER OTHER INTEREST RATES IN SOLES: SHORT RUN AND LONG RUN ANALYSIS
(April 1995- December 2004)

	Loans		Term deposits				
	Up to 360 days	More than 360 days	Savings	Up to 30 days	31-179 days	180-359 days	360 days and more
Long run impact							
Apr.95-Dec.01	0.36	0.59	0.12	0.31	0.20	0.10	0.07
Apr.95-Dec.04	0.88	1.45	0.49	0.70	0.67	0.61	0.55
Speed of adjustment 1/							
(In months)							
Apr.95-Jan.01	6	25	12	3	7	4	15
Feb.01-Dec.04	3	8	2	1	3	4	5

1/ It considers the long run impact for the whole sample (April 1995-December 2004).

Figure 33
DOMESTIC CURRENCY INTEREST RATES FOR COMMERCIAL AND MICROBUSINESSES LOANS AND LOANS FOR CONSUMPTION: January 2003-May 2005

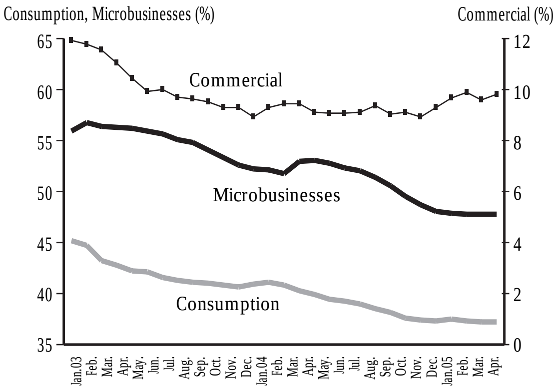


Figure 34
CORPORATE PRIME INTEREST RATE: January 2003-May 2005
(Up to 90 days)

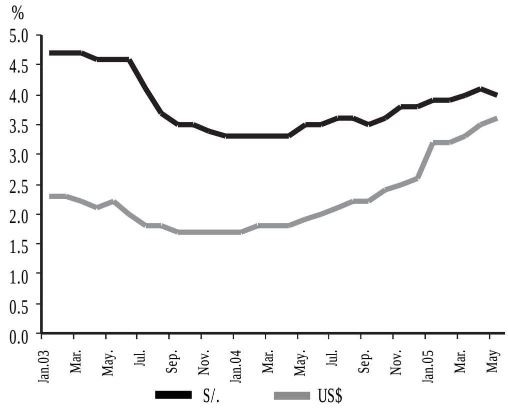
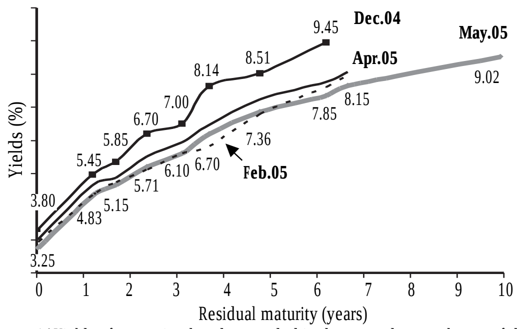


Figure 35
PUBLIC TREASURY SOVEREIGN BONDS IN THE SECONDARY MARKET 1/



1/ Yields of sovereign bonds recorded in the secondary market as of the closest date to the end of period.

37. Observing the behavior of interest rates by segment in the loan market, we can see that average interest rates for consumer loans and loans to microbusinesses in Peruvian currency are falling significantly. It should be mentioned that the interest rates applied to these last two segments incorporate an increased premium for credit risk.

38. Although in recent years the impact of the interbank rate on other interest rates in soles has increased; the latter have also been influenced by dollar interest rates and by the level of country risk, as was the case in the middle of 2004.

In recent months there has been a reduction in the differential between interest rates in dollars and soles. In particular, the differential in the 90-day corporate interest rate had fallen from 120 base points in December 2004 to 30 base points in May 2005 (5 base points at the close of May).

Yield curve

39. The reduction in interest rates on CDBCRPs and Peruvian Treasury Bonds (BTP) at the beginning of 2005 continued the downward trend that started at the end of the previous year after public expectations of inflation came into line with the inflation target, this being more pronounced for long-term treasury bonds.

40. Thereafter interest rates on these securities increased between February and April. This period coincided with an increase in country risk in the second half of March (it would later fall) and the anticipation by the private sector of higher liquidity requirements for the period of income tax clearing payments (end of March and beginning of April). In May interest rates on these securities fell and there was an extension of the maturity structure of the yield curve of sovereign bonds of up to 10 years.

41. The balance of CDBCRPs increased from S/. 8,255 million in December 2004 to S/. 11,261 million in March 2005 as a result of monetary sterilization of exchange rate interventions by the BCRP. Later, in April, the balance of these certificates was reduced to provide banks with liquidity during the period of income tax clearing payments for 2004. Similarly, in May treasury revenues deposited in the BCRP meant a lower sterilization requirement using CDBCRPs, enabling a reduction in the balance of these securities to S/. 9,573 million.

Figure 36
PUBLIC STOCKS AVERAGE INTEREST RATES IN NUEVOS SOLES: January 2003-May 2005

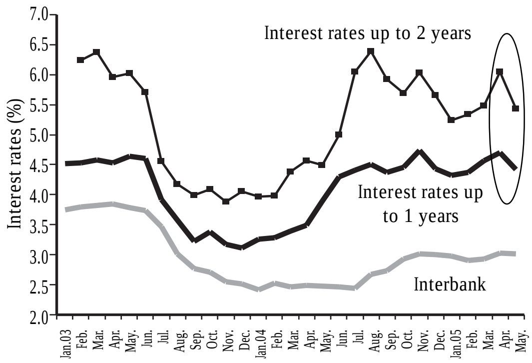
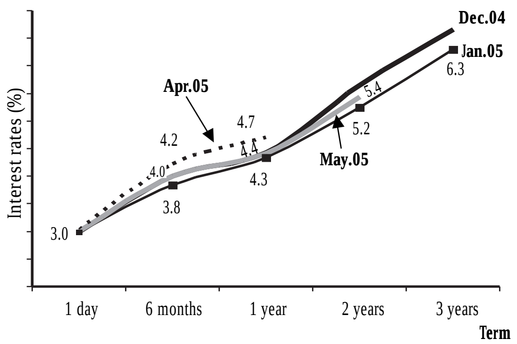


Figure 37
CDBCRP YIELDS BY MATURITY



In general, placements of CDBCRP followed a criterion of diversified maturities and to provide references for the yield curve in soles.

42. The average maturity of the CDBCRP balance increased between December 2004 and February 2005 (from 282 days to 295 days), the period in which the placement of CDBCRP returned to 3 years in a context of lower interest rates, which favored the increase in the average maturity of these securities.

With the subsequent reversal of the downward trend in interest rates for these bonds, the average maturity of the balance of CDBCRPs fell to 265 days in March. This reduction in maturity was also the result of demand for CDBCRPs by financial institutions being concentrated temporarily in short run maturities because of the anticipation for liquidity needs for the income tax clearing payments between the end of March and the beginning of April. At the close of May, the average maturity of the balance of CDBCRPs was 256 days.

43. CDBCRPs with maturities equal to or greater than one year as a share of the total balance rose from 69 percent in December 2004 to 77 percent in May 2005.

TABLE 19

CDBCRP BALANCE BY MATURITY: 2004 - 2005
(Millions of nuevos soles)

	2004					2005	
	Mar.	Jun.	Sep.	Dec.		May	
				Amount	%	Amount	%
Up to 18 weeks	305	130	245	155	1.9	160	1.7
4 to 6 months	955	615	405	495	6.0	614	6.4
7 to 10 months	523	393	1,605	1,870	22.7	1,415	14.8
1 year to 18 months	3,031	2,816	3,116	3,985	48.3	5,441	56.8
2 & 3 years	1,185	1,235	1,360	1,750	21.2	1,943	20.3
Total	**5,998**	**5,188**	**6,730**	**8,255**	**100.0**	**9,573**	**100.0**
Memo:							
Treasury bills balance	3,040	2,855	3,250	3,751		4,530	
Average CDBCRP balance interest rate	3.7%	3.8%	4.1%	4.5%		4.6%	

Source: BCRP.

44. In the first five months of the year, the public Treasury continued to combine placements of sol-denominated and inflation-linked securities, extending the maturity of the latter up to 30 years. Between December and May, the government placed BTPs

valued at a total of S/. 1,831 million, bringing the balance of sol-denominated sovereign bonds in circulation as at May to S/. 5,561 million, 48 percent higher than the figure for December 2004 (S/. 3,751 million). Interest rates on BTPs behaved in a similar way to those of CDBCRPs (rising between February and May), but in May they were lower than in December 2004.

Table 20

INTEREST RATE OF SOVEREIGN BONDS IN THE SECONDARY MARKET BY MATURITY
(Percentages)

	12-Aug-06	9-Oct-07	9-Jul-08	11-Feb-09	10-Mar-10	10-Aug-11	31-Jan-12
2004							
Jan	4.56	5.69	6.45	-	-	-	-
Feb	4.88	5.55	6.43	7.25	-	-	-
Mar	4.68	5.53	6.27	7.44	8.66	-	-
Apr	4.74	5.74	6.41	7.37	8.59	-	-
May	5.82	7.71	8.00	-	-	-	-
Jun	6.11	8.23	9.07	10.06	11.26	-	-
Jul	6.47	8.43	9.20	10.00	11.05	-	-
Aug	6.39	7.79	8.56	9.12	10.48	12.43	-
Sep	5.80	6.75	7.60	8.25	9.35	11.31	-
Oct	5.51	6.50	7.23	7.90	8.70	9.94	-
Nov	5.52	6.59	7.17	8.10	8.57	9.72	-
Dec	5.70	6.76	7.11	8.14	8.51	9.60	-
2005							
Jan	4.89	5.87	6.40	6.97	-	8.70	-
Feb	4.83	5.63	6.10	6.35	7.30	8.26	8.68
Mar	5.03	5.69	6.36	6.79	7.68	7.79	8.59
Apr	5.15	6.03	6.44	6.95	7.80	8.25	8.63
May	4.94	5.83	6.28	6.73	7.56	8.06	8.31

45. At the beginning of May the government carried out its third restructuring of domestic public debt since the beginning of the Market Makers Program. This time dollar denominated bonds worth US$ 262 million were exchanged for sol denominated bonds worth S/. 851 million, mostly maturing in 10 years. As a result of this operation, the dollarization of the balance of domestic public debt fell from 37 percent to 25 percent. The yield curve in nominal soles was also extended from 7 to 10 years, which will be a new reference for private sector bond issues.

In this operation the following series of sol denominated sovereign bonds were issued: a new issue of the 05MAY2015 bond (S/. 787 million), maturing in 10 years, at a coupon rate of 9.91 percent (effective annual rate of 10.16 percent) and the reopening of the 10MAR2010 bond (S/. 64 million), having a residual maturity of 5 years.

46. Between December and May, the balance of fixed income instruments issued by the private sector fell S/. 87 million, mainly because of early maturity of Southern Peru bonds (US$ 199 million between January and April). In soles, placements net of redemptions were S/. 182 million, Telefónica del Perú issues (bonds valued at S/. 238 million and short-term instruments valued at S/. 180 million) and Corporación Financiera Internacional (IFC) issues (bonds valued at S/. 100 million) were particularly noteworthy. Net placements in dollars amounted to minus US$ 79 million, with significant issues by Minera Barrick Misquichilca valued at US$ 50 million and Transportadora de Gas del Perú valued at US$ 71 million. The balance of private instruments at the end of May was S/. 12,325 million (US$ 3,781 million).

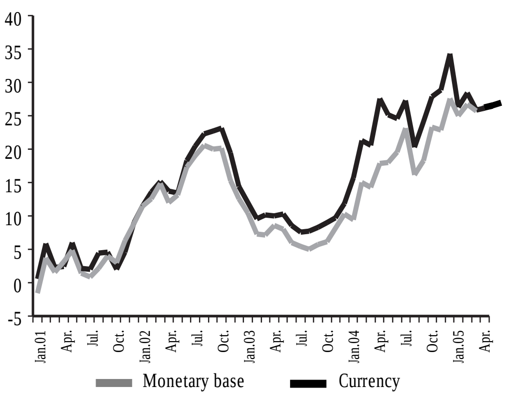
Table 21

NET PLACEMENT OF FIXED INCOME INSTRUMENTS: 2004-2005 1/

	January-May 2004			January-May 2005		
	S/.	US$	Total	S/.	US$	Total
Private sector	33	144	534	182	-79	-87
Placement	664	263	1,578	986	257	1,824
Amortization	631	119	1,043	804	336	1,910
Public Treasury	319	-.-	399	1,810	-.-	779
Placement	809	-.-	809	1,831	-.-	799
Amortization	490	-.-	410	21	-.-	21
CDBCRP	1,251	-.-	1,251	1,318	-.-	1,318
Placement	4,100	-.-	4,100	8,175	-.-	8,175
Amortization	2,849	-.-	2,849	6,857	-.-	6,857
TOTAL	1,603	144	2,184	3,310	-79	2,010
Placement	5,573	263	6,487	10,992	257	10,798
Amortization	3,970	119	4,302	7,682	336	8,788

1/ Includes bonds, commercial papers, tradable certificates and public treasury papers.

Figure 38
GROWTH OF THE MONETARY BASE AND CURRENCY BALANCES: January 2001-May 2005
(% change with respect to the same month of the previous year)



Monetary aggregates

47. During the first five months of 2005 there was a significant increase in the monetary base and cash in circulation. The percentage growth rate of these two monetary aggregates was higher than 26 percent in May 2005 and has remained at a similar level since the beginning of the year. The greater demand for monetary base and cash in circulation reflects the continued dynamism of economic activity and a higher preference for domestic currency over foreign currency.

48. Between January and May, the monetary base increased S/. 75 million. During this period US$ 1,336 million dollars were bought (over-the-counter mechanism purchases of US$ 1,753 offset by sales to the public sector of US$ 418 million). The monetary expansion associated with these purchases was offset by higher public sector deposits (S/. 3,173 million) and by net placements of CDBCRPs (S/. 1,319 million).

Table 22

SOURCES OF CHANGE IN THE MONETARY BASE
(Millions of nuevos soles)

	2002	2003	2004	2005 Jan-May
I. FOREIGN EXCHANGE OPERATIONS	**436**	**3,465**	**6,239**	**4,353**
(Millions of US$)	*128*	*998*	*1,854*	*1,336*
1. Over-the-counter net purchases	- 32	1,050	2,340	1,753
2. Public sector	157	- 51	- 487	- 418
3. Other	3	- 1	2	1
II. MONETARY OPERATIONS	**236**	**-2,783**	**-4,353**	**-4,278**
1. Public sector	- 81	- 921	- 721	-3,173
2. Repos	170	-170	0	0
3. CDBCRP	- 114	-2,143	-4,158	-1,319
4. Other	261	450	526	214
III. TOTAL	**672**	**682**	**1,886**	**75**
End of period percentage change	11.0	10.1	25.3	0.8
Average percentage change	15.8	7.4	18.8	26.2
Note:				
END OF YEAR BALANCES				
CDBCRP	1,944	4,097	8,255	9,573
Deposits of public sector	275	1,196	1,918	5,091
Monetary base	6,759	7,441	9,327	9,402

49. The downward trend of the indicators of financial dollarization observed in recent years has continued in 2005 so far, within a context of price stability resulting from the Inflation Targeting regime and a more predictable interbank interest rate, which serves as a reference for sol-denominated financial instruments.

Figure 39
RESERVE REQUIREMENT INTEREST RATES AND LENDING AND DEPOSIT INTEREST RATES IN FOREIGN CURRENCY: January 2004-May 2005
(In percentages)

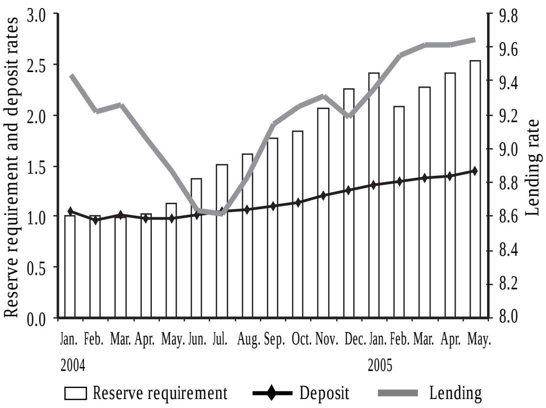


Table 23

FINANCIAL DOLLARIZATION INDICATORS
(In percentages of the total monetary aggregate)

Year	Total liquidity of the Banking System	Credit of the Banking System to the private sector	Credit of the Financial System to the private sector
1993	69	76	77
1994	64	74	74
1995	63	71	72
1996	67	74	72
1997	65	77	75
1998	69	80	79
1999	70	82	82
2000	70	82	81
2001	67	80	78
2002	65	79	76
2003	62	77	73
2004	55	74	71
2005 1/	54	73	70

1/ Up to April 2005.

In addition, market measures are needed to internalize the risk that dollarization creates in the economies of families and businesses. Therefore the Central Bank has modified the remuneration for reserves requirement in foreign currency, which since June has stood at 2.25 percent. These modifications in the interest rate for reserves requirements in dollars approved by the Central Bank since October last year have reduced the rise in deposit rates, as can be seen from the illustration.

BOX 4

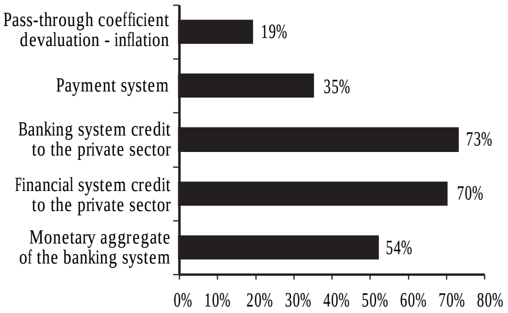
THE DOLLARIZATION PHENOMENON

The process of dollarization implies a partial and gradual replacement of the three functions of money: as a store of value, a unit of account and a means of payment, in that order. The origin of this process is usually a loss of confidence in domestic currency as a result of high and persistent inflation, which in Peru's case began in the mid 1970s and culminated with hyperinflation at the end of the 1980s.

Given that inflation punishes holders of domestic currency and makes it difficult for the economy to set prices correctly, and financial intermediaries offer credit mainly in dollars (a response to their own funding), the dollar becomes the currency of choice as a means of payment and unit of account. Payment systems are created for both currencies (ATMs, checks, etc.) and durable goods contracts are denominated in dollars. A change occurs in the payment and price setting behavior of economic agents and this is institutionalized by legislation that enables the domestic currency to be ignored. These habits are not reversed automatically when inflation is reduced and brought under control.

Currently, the degree of financial dollarization in Peru's economy is less when it comes to price setting (the majority of prices in the CPI basket of products are set in soles) and transactions (around 35 percent are denominated in dollars).

INDICADORES DE DOLARIZACIÓN



In order to reduce the vulnerability associated with dollarization (exchange rate risk and liquidity risk), measures and policies are being implemented aimed at recovering confidence and the habit of using the sol for all its monetary functions.

The adoption of the Inflation Targeting regime in 2002 and the development of a market for sol-denominated public debt has contributed in recent years to reducing the dollarization of the Peruvian economy. In the first case, the BCRP has made an explicit commitment to keep annual inflation at 2.5 percent plus or minus one percentage point, and this is being strictly accomplished. This is being complemented by a legal framework at constitutional level, consistent with this important commitment: to preserve monetary stability, prohibit financing of the public treasury and ensure the autonomy of the central bank.

With the Inflation Targeting regime, the Central Bank is using the interbank interest rate in soles as an operative target to guide its monetary policy, which facilitates setting interest rates in soles. The development of a public debt market in soles has for the first time enabled issues of nominal sol-denominated securities with different maturities (up to 10 years) and securities indexed to inflation (up to 30 years) which serve as a reference for issues of sol-denominated securities with ever longer maturities by the private sector.

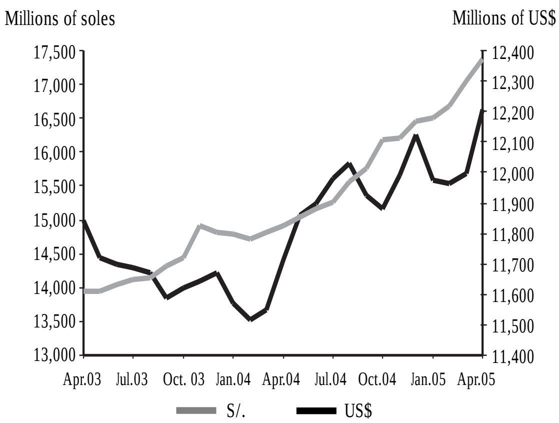
Although use of Peruvian currency for all monetary functions is increasing, the habit of using dollars in certain circumstances persists and in some cases this is reinforced by legislation.

For this reason, the Central Bank has proposed changes to legislation that would avoid discrimination against the nuevo sol in order to extend its use further. These regulations were produced under circumstances very different to the present (high rates of inflation). At present, our currency can fulfill all monetary functions as it retains its purchasing power over time with inflation at international levels (Peru has the lowest inflation target in the region) and with reference interest rates to continue deepening the financial markets in nuevos soles.

Thus, for example, article 7A of the Consumer Protection Act has been modified to establish an obligation by suppliers of goods and services who label their prices in foreign currency, to do so also in Peruvian currency and this has contributed to the pricing of durable goods in soles.

As far as its function as a means of payment is concerned, it is an international practice that the domestic currency must be accepted within the country, in other words it cannot be rejected as a means of payment. Therefore, the Central Bank proposed a modification to article 1237 of the Civil Code in order to completely restore the use of the Peruvian sol as a means of payment.

Figure 40
FINANCIAL SYSTEM CREDITS TO THE PRIVATE SECTOR: April 2003-April 2005



50. Between January and April, financial system loans to the private sector in soles expanded 5.6 percent as a result of which the growth rate in the last 12 months rose from 11.0 to 16.4 percent. This growth is well in excess of the rate achieved in the same period of the previous year (0.7 percent). Foreign-currency-denominated loans fell in the first 2 months, basically because of redemptions of corporate bonds held by institutional investors, they then recovered and achieved a growth of 0.7 percent (4.2 percent over the last 12 months).

51. The expansion of sol-denominated credit (S/. 918 million) was granted by the banks (S/. 277 million), specialist microfinance institutions (S/. 274 million), institutional investors (S/. 240 million) and the Banco de la Nación (S/. 111 million). With these results the annual rate of growth of bank lending to the private sector accelerated from 5.7 percent in December 2004 to 8.4 percent in April 2005 and lending by microfinance institutions rose from 15.2 percent to 25.2 percent respectively.

Table 24

EVOLUTION OF DOMESTIC CURRENCY FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR

	Balances in millions of soles			Rates of growth	
	Apr.04	Dec.04	Apr.05	Apr.05/ Apr.04	Apr.05/ Dec.04
Banks 1/	8,061	8,464	8,741	8.4	3.3
Banco de la Nación	690	1,051	1,162	68.4	10.5
Microfinance institutions	**3,677**	**4,329**	**4,603**	**25.2**	**6.3**
Banks (microfinance loans)	941	1,120	1,206	28.1	7.7
Municipal savings and loans	1,167	1,376	1,492	27.8	8.4
Rural savings and loans	203	253	272	33.9	7.7
Cooperatives	456	511	511	12.0	-.-
Edpymes	175	229	245	39.8	6.7
Finance companies	734	840	878	19.6	4.5
Institutional investors 2/	**2,220**	**2,307**	**2,547**	**14.7**	**10.4**
Pension funds	1,431	1,337	1,529	6.8	14.4
Insurance companies	601	812	816	35.7	0.5
Mutual funds	187	158	202	8.1	27.8
Leasing companies and others	**277**	**306**	**322**	**16.3**	**5.3**
Total for Financial System	**14,925**	**16,457**	**17,375**	**16.4**	**5.6**

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

52. Foreign-currency-denominated loans increased by US$ 82 million, caused by increased bank lending (US$ 263 million) offset by a reduction in loans by the pension and mutual funds due to a US$ 199 million redemption of Southern Peru corporate bonds. Nevertheless, it should be indicated that, as happened with loans in soles, growth rates annualized to April 2005 for banks and microfinance institutions (4.3 percent and 28.3 percent respectively) were higher than those recorded in December 2004 (1.1 percent and 25.6 percent respectively).

Table 25

EVOLUTION OF FOREIGN CURRENCY FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR

	Balances in millions of US dollars			Rates of growth	
	Apr.04	Dec.04	Apr.05	Apr.05/ Apr.04	Apr.05/ Dec.04
Banks 1/	9,331	9,465	9,728	4.3	2.8
Banco de la Nación	22	22	22	-0.6	-0.1
Microfinance institutions	**532**	**665**	**682**	**28.3**	**2.5**
Banks (microfinance loans)	91	126	134	47.0	6.0
Municipal savings and loans	202	250	258	27.5	3.2
Rural savings and loans	47	55	55	18.6	-0.1
Cooperatives	122	154	154	26.3	-0.0
Edpymes	40	49	50	23.6	2.9
Finance companies	30	32	32	5.9	-1.6
Institutional investors 2/	**1,207**	**1,333**	**1,135**	**-5.9**	**-14.8**
Pension funds	586	729	593	1.2	-18.7
Insurance companies	60	89	92	54.4	3.2
Mutual funds	561	515	450	-19.8	-12.5
Leasing companies and others	**624**	**639**	**639**	**2.3**	**0.1**
Total for Financial System	**11,716**	**12,125**	**12,207**	**4.2**	**0.7**

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

II. FORECASTS 2005-2006

II.1 International context and external accounts

The international scenario considers a deceleration of the growth of the world economy compared to 2004 in a context of higher interest rates.

World growth

53. In 2004 the world economy grew at an exceptionally high rate (the highest for three decades), due in part to the maintenance of expansive fiscal and monetary policy by the United States. In 2005 the world growth rate is expected to be lower but sustainable, consistent with a gradual lifting of international interest rates.

54. During the first quarter of 2005, growth in the world economy was sustained by the North American and Chinese economies. In that period United States GDP grew 3.5 percent, although indicators for certain sectors of the economy were mixed and there were signs of inflationary pressure, explained in part by a continuing high oil price. These increased inflationary pressures, however, could be compatible with a gradual increase in interest rates by the United States Federal Reserve.

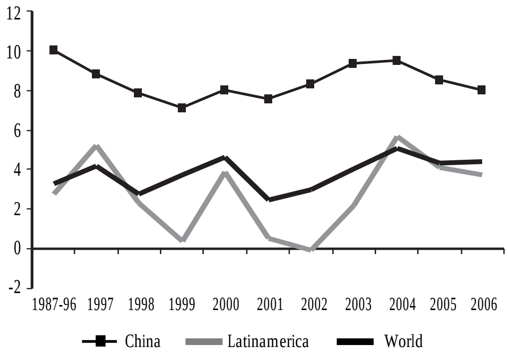
55. In the euro zone, economic activity showed little dynamism during the first quarter of the year. Among emerging economies, China stands out with higher than expected growth in the first months of the year, despite the application of measures aimed at preventing the economy from overheating. (See box 5).

BOX 5

CHINA: ECONOMIC GROWTH PROSPECTS

Over the last 20 years, the Chinese economy has grown much faster than the world average. Its share of world production

GDP GROWTH: 1987-2006
(%)



measured by purchasing power parity has risen from 5.7 percent in 1990 to 13.2 percent in 2004. Because of this, China is an important consumer of products and commodities. According to the IMF[1/], China is responsible for 20 percent of world copper consumption, 25 percent of iron ore and 33 percent of cotton consumption, among other products.

In the particular case of Peru, during 2004 China replaced the United Kingdom as the country's second largest trading partner. Exports to China consist mainly of traditional products (95 percent). Our main export product is copper (which makes up 40 percent of Peru's sales to China), for use in industry (mainly cable production). Fishmeal exports are also important (35 percent), for use in fish farming (China is the world's largest farmed fish producer) as are exports of mineral products such as lead (8 percent) and iron ore (7 percent). Non-traditional exports represent 5 percent of Peru's sales, with fish products being prominent (2 percent).

EXPORTS TO CHINA
(Millions of US$)

	2003	2004	2004 Participation
TRADITIONAL	**648.2**	**1,173.5**	**95.0**
COPPER	232.2	501.0	40.5
FISHMEAL	276.0	425.7	34.5
LEAD	55.3	104.0	8.4
IRON	56.8	90.9	7.4
MOLYBDENUM	2.2	40.4	3.3
ZINC	24.1	8.2	0.7
OTHER AGRICULTURE & LIVESTOCK	0.3	2.3	0.2
FISH OIL	1.1	0.8	0.1
PETROLEUM	0.0	0.1	0.0
MINOR METALS	0.2	0.1	0.0
NON-TRADITIONAL	**28.7**	**62.2**	**5.0**
FISHING	9.7	28.9	2.3
TEXTILE	9.9	12.5	1.0
TIMBERS AND PAPERS	2.5	8.1	0.7
OTHER	6.7	12.8	1.0
TOTAL	**677.0**	**1,235.7**	**100.0**

One risk factor is that China's growth rate could fall abruptly, particularly if restrictive policies are added to a sudden appreciation of the yuan, which would have a direct effect on Chinese exports and the country's demand from imports from the rest of the world. In Peru's case, minerals and especially

1/ World Economic Outlook, September 2004 copper, would be affected by a reduction in demand from China (it is the world's main importer of copper) and this could provoke a fall in the price, although given supply characteristics a significant reduction in volumes sold is unlikely.

A stronger yuan would be one of the ways to correct, at least partially, United States trade imbalance with China. Another possibility mentioned by the North American authorities is the application of trade measures.

The appreciation of the yuan would also have repercussions in the financial markets. China's trade surplus and growing direct foreign investment mean an inflow of foreign currency for China which, under a fixed exchange rate regime, leads to a significant increase in international reserves.

These reserves, in turn, enable the purchase of assets abroad, including American Treasury Bonds. It is estimated that the central banks of Asia (including Japan) have increased their reserves between 2001 and 2003 by US$ 700 billion. This form of financing the United States current account deficit, associated with a large-scale intervention by central banks that maintain inflexible exchange rate regimes has been described as the "new Bretton Woods"[2/]. An appreciation of the yuan in this context would reduce demand for United States Treasury Bonds affecting their interest rates and reducing the demand for dollars.

Although measures have been applied to restrain downward pressures on the currency, such as a short-term indebtedness quota for banks, there is something of a consensus in the market that a fall is likely.

56. Considering this scenario, it is thought that the growth of our main trading partners in 2005 will be approximately 3.5 percent. For the United States growth is forecast to be approximately 3.4 percent, less than the estimate contained in the Inflation Report for January this year (3.6 percent) insofar as consumption reduces its growth rate slightly (as a result of a gradual adjustment of interest rates).

As far as our trading partners in the region are concerned, growth in 2005 should be 4.9 percent, less than that for 2004 but higher than the January forecast (4.7 percent). It should be pointed out that during this year a smaller dispersion in the

2/ Michael Dooley, David Folkerts-Landau & Peter Garber. An essay on the revived Bretton Woods System. 2003.

growth rates of the different countries is forecast. This favorable situation assumes that the region will continue to benefit from high prices for its exports.

Table 26

GROWTH AMONG PERU'S MAIN TRADING PARTNERS: 2004 - 2006 1/
(In percentages)

		Forecasts		
		January 2005	May 2005	
	2004	2005	2005	2006
Trading partners*	**4.6**	**3.5**	**3.5**	**3.4**
North America	*4.3*	*3.6*	*3.4*	*3.3*
USA	4.4	3.6	3.4	3.3
Canada	2.7	2.8	2.6	3.0
Europe	*2.4*	*2.0*	*1.9*	*2.1*
United Kingdom	3.2	2.5	2.5	2.3
Germany	1.7	1.2	0.8	1.4
Asia	*5.6*	*4.2*	*4.4*	*4.6*
Japan	2.9	1.1	1.0	1.7
China	9.4	8.2	8.8	8.0
Latin America	*6.9*	*4.7*	*4.9*	*4.2*
Chile	5.8	5.5	5.8	5.0
Brazil	5.1	3.8	3.7	3.7

* Weighted acording to 2001 trade (excluding petroleum).
1/ Data of Consensus Forecast in the month.

It is also expected that favorable conditions for financing will be maintained with moderate changes in international interest rates. In contrast to past occasions, this adjustment should be gradual and anticipated by the market, so it is not expected to have a significant effect on the region's economies, especially when it is considered that the countries in the region enjoy better economic fundamentals.

The dollar in international markets

57. The United States' current account imbalances have generated an upward pressure on the dollar, which weakened between 2002 and 2004. Nevertheless, between December 2004 and May 2005, the dollar appreciated 5.2 percent with respect to the euro and 2.8 percent with respect to the yen due to an increase in interest by the FED, higher demand for variable income securities, given favorable expectations about corporate profits, and better growth prospects for the United States compared to other developed economies.

By the end of 2005 the market envisages, on average, variations of little significance during the rest of the year, but

Figure 41
LIBOR AND FED INTEREST RATES: January 2004-May 2005
(%)

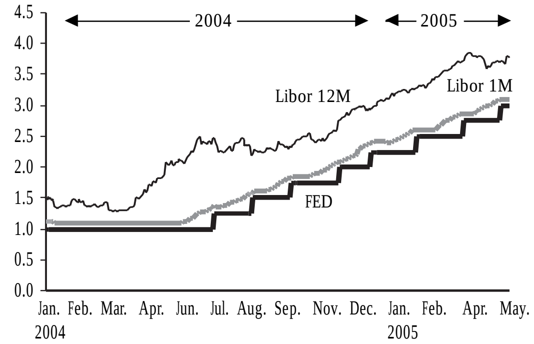


Figure 42
FINANCIAL STOCKS' YIELD CURVE IN THE UNITED STATES
(%)

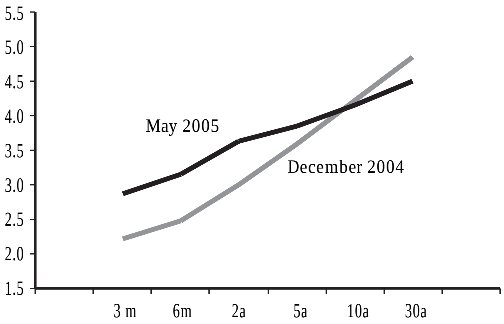
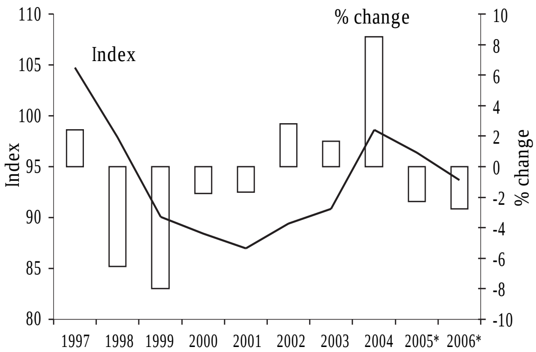
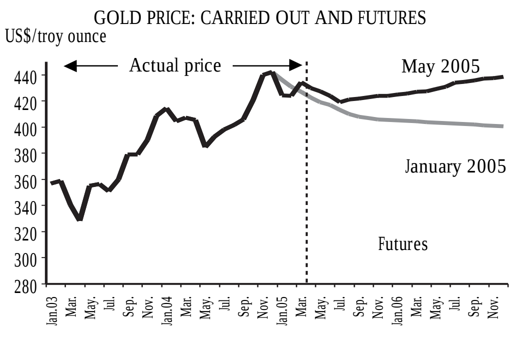


Figure 43
TERMS OF TRADE: 1997-2006



* Forecast.

Figure 44
FORECAST COMMODITY PRICES:
January 2003-December 2006



with a certain dispersion. The central scenario assumes a dollar/euro exchange rate of 1.31 for the end of both 2005 and 2006. The implicit assumption is that there will be no sharp change in financing of the US current account or significant variations in China's exchange rate regime.

It should be pointed out that the US current account deficit, which in 2004 reached 5.7 percent of GDP, would be around 6 percent. This tendency arises from the evolution of the trade balance, which in February reached a historic high of US$ 61 billion.

International interest rates

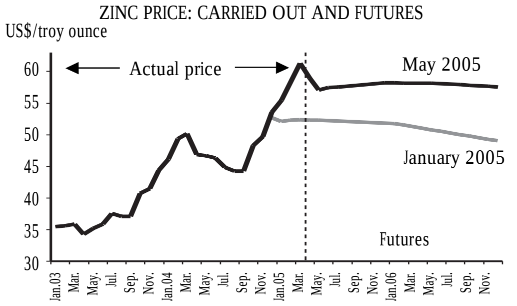
58. International interest rates have been trending upwards since the second half of 2004, associated with a cycle of rising interest rates set by the FED. The FED raised interest rates eight times between June of last year and May this year, from 1.0 percent to 3.0 percent.

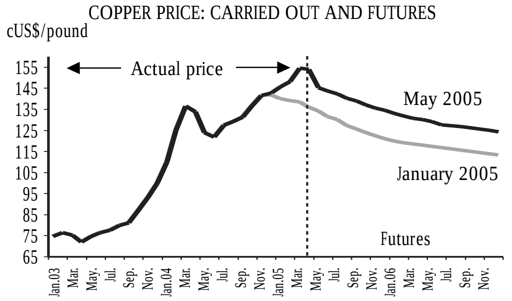
In the long term section of the curve the increase has not shown the same behavior. Between December 2004 and May of this year, there has been practically no variation in 10 year treasury bond yields; while that 30 year bond yields have fallen from 4.9 to 4.5 percent. This behavior could be associated with the expectations that the rate of economic growth will fall off, and demand for USA treasury bonds from Asian central banks.

In 2005 the 3-month Libor rate is expected to be around 4.2 percent. This assumes that the FED continues to raise federal fund rates gradually to 4.0 percent in December 2005. In 2006 it is expected that the FED will decelerate the rate of interest rate adjustments to close the year at 4.5 percent.

Terms of trade

59. A reduction of 2.3 percent in the terms of trade in 2005 (compared to the 2.6 percent fall forecast in January) takes into account persistently high international prices in the first few months of the year, sustained by strong demand from China, restrictions on improving the weak balance of world markets for the principal basic materials and by inflationary pressures in the United States. It should be pointed out that the forecast terms of trade index for 2005 (96.4) would be higher than the average for the last five years (average for 2000 - 2004: 90.9).





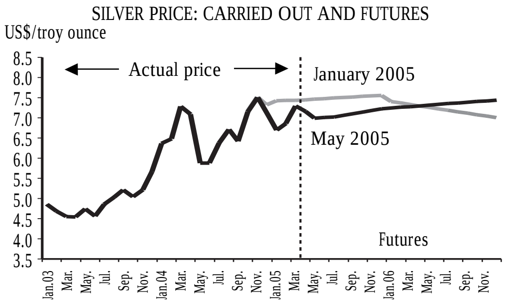


Figure 45
PETROLEUM WTI PRICES: CARRIED OUT AND FUTURES: January 2003-January 2006

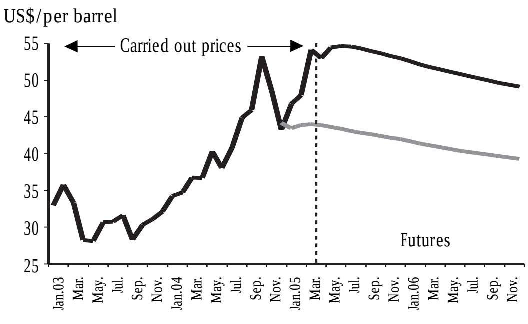


Figure 46
OIL PRICE AND INFLATION IN DEVELOPED ECONOMIES: 1997-2004

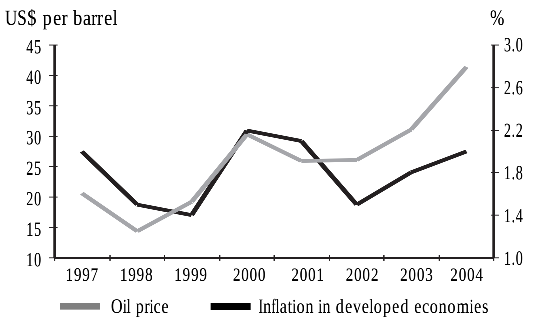


Table 27

TERMS OF TRADE
(Annual change)

		Forecasts		
	2004	January 2005	May 2005	
		2005	2005	2006
Terms of trade	**8.5**	**-2.6**	**-2.3**	**-2.8**
Export prices index	17.6	0.4	4.4	-1.4
Import prices index	8.3	3.1	6.9	1.4

Source: BCRP.

Given future prices in the world's main stock markets, a gradual correction of international prices is expected in a context of more moderate economic world growth, particularly in the second half year, which should continue during 2006. In this scenarios, the level of terms of trade for 2006 would be even less than recent yearly forecasts.

60. It is expected that after price rises for metals such as copper (which reached its historic maximum last April), zinc (price levels not seen since 1997) and gold (since August 2004 the price has been the highest since 1988), these metals will fall gradually to an average for the year of US$ 1.46 per pound, US$ 0.58 per pound and US$ 424.7 per troy ounce respectively.

As far as oil is concerned, the forecast price of WTI for the end of 2005 has been revised upwards from US$ 42 per barrel in the January Inflation Report to US$ 53 per barrel. This is because OPEC has little room for a substantial increase in production.

One factor causing uncertainty in the international environment is the danger of inflation in the world economy, generated by increased oil prices.

Trade balance

61. Considering the favorable international situation, which, though less so than last year is still having a positive effect on export prices and volumes, it is expected that the trade balance will show a surplus for the fourth year running, of US$ 3,112 million in 2005. This forecast is based on exports at higher forecast prices of the principal base metals, as well as higher forecast export volumes of copper, gold, zinc, oil and petroleum products. In 2006 the trade

surplus should have fallen to US$ 2,508 million, considering the forecast fall in the terms of trade in a context of lower world growth.

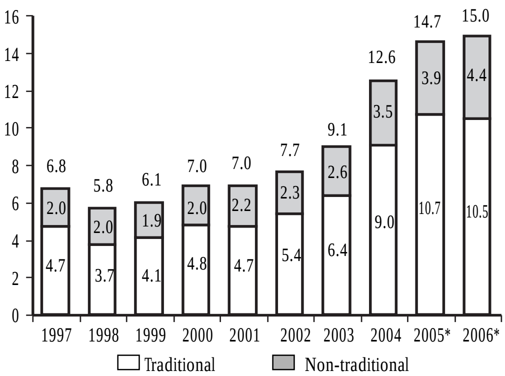
Table 28

TRADE BALANCE: 2004 - 2006
(Millions of US$)

	2004	2005* January IR	2005* May IR	2006*	% change 2005*	% change 2006*
1. EXPORTS	**12,617**	**13,652**	**14,729**	**15,003**	**16.7**	**1.9**
Traditional products	9,028	9,583	10,673	10,473	18.2	- 1.9
Non-traditional products	3,476	3,937	3,921	4,393	12.8	12.0
Others	113	132	135	137	18.9	1.5
2. IMPORTS	**9,824**	**10,633**	**11,617**	**12,495**	**18.2**	**7.6**
Consumer goods	1,973	2,109	2,267	2,458	14.9	8.4
Raw materials	5,356	5,700	6,398	6,642	19.5	3.8
Capital goods	2,365	2,719	2,837	3,289	19.9	15.9
Other goods	130	104	115	106	- 11.3	- 7.7
3. TRADE BALANCE	**2,793**	**3,018**	**3,112**	**2,508**		

* Forecast.

Figure 47
GOOD EXPORTS: 1997-2006
(Billions of US$)



* Forecast.

62. In 2005 it is estimated that exports will increase at a rate of 16.7 percent, higher than the forecast made in January (9.1 percent). On average, export prices should increase 4.4 percent (0.4 percent in the January report) and export volumes should grow by 11.9 percent (8.9 percent in the January report). Traditional exports should grow by 18 percent and non-traditional exports by 13 percent.

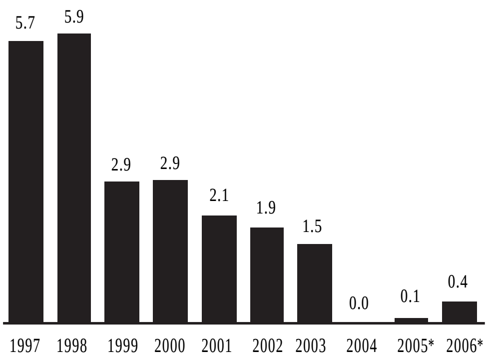
Higher prices for base metals, oil and coffee, increased export volumes from Antamina (copper) and the implementation of the Alto Chicama (gold) project in the second half of 2005 together with the full year impact of the Camisea project (petroleum and derivatives) which started production in the second half of 2004, as well as a moderate effect caused by the elimination of textile quotas and dynamic agricultural & livestock exports, all support our forecasts for exports.

63. Imports in 2005 could reach US$ 11,617 million, with growth of 18.2 percent (8 percent in the January report) consistent with growth of 5 percent in GDP, higher oil prices compared to January's forecast and further recovery in private investment. This growth could be led by raw materials imports (20 percent), mainly fuels and industrial materials and capital goods (20 percent), particularly for industry.

64. In 2006 it is forecast that exports will grow at a more moderate rate (1.9 percent) reaching US$ 15,003 million, in a context of lower export prices. Imports, on the other hand, could grow at a rate of 7.6 percent (US$ 12,495 million) a lower rate than that of 2005, partly associated with lower oil prices. This could mean that the trade balance would continue to be positive at US$ 2,508 million, though less than the estimate for 2005.

Balance of payments current account and capital flows

Figure 48
BALANCE OF PAYMENT'S
CURRENT ACCOUNT DEFICIT: 1997-2006
(As a percentage of the GDP)



* Forecast.

65. In 2005 a slight current account deficit is projected, of US$ 71 million (less than the US$ 340 million surplus forecast in the January report). This is because, although a higher positive trade balance is forecast, higher export prices, particularly for minerals, are also reflected in higher profits for companies with foreign shareholders. In 2006, considering a gradual reduction in the prices of the principal commodities, a balance of payments current account deficit of 0.4 percent of GDP is forecast.

66. It is estimated that the capital account will be US$ 636 million, US$ 1,700 million less than in 2004. The private sector balance could be US$ 652 million, US$ 696 million less than in the previous year, in a context of higher international interest rates, which could cause lower net capital inflows and create incentives for investing abroad. Public capital could reach a negative level of US$ 17 million, US$ 1,005 million less than in 2004, explained mainly by fewer placements of global bonds given that part of the borrowing requirement for this year was financed in advance in 2004. NIR should be positive at US$ 610 million.

67. For 2006 a slightly higher current account deficit is forecast (US$ 343 million or 0.4 percent of GDP) in a context of lower terms of trade. In a scenario in which international interest rates are higher, the private sector capital account should favor a lower net inflow while the public sector should show a positive net flow slightly higher than in 2005, consistent with increased global bond placements. This will result in a flow of international reserves equal to zero.

II.2 Economic activity

68. For **2005** forecast growth in GDP has been revised upwards from the 4.5 percent included in the January Inflation Report to 5.0 percent, bearing in mind that the increase in the first quarter was higher than initially forecast as well as greater confidence among consumers and companies and continued high exports. Domestic demand could increase 5.3 percent

and private investment 9.6 percent, maintaining the dynamism observed in the first quarter of the year. Goods exports should grow at a rate of 6.6 percent in real terms.

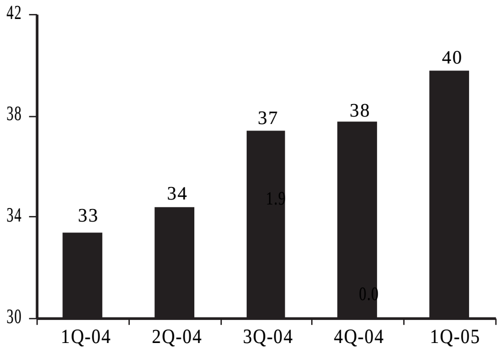
Table 29

GLOBAL SUPPLY AND DEMAND
(Real percentage values compared to same period in previous year)

	2004	2005*		2006*
		January IR	May IR	
I. Global demand (1+2)	**5.6**	**4.7**	**5.5**	**5.2**
1. Domestic demand 1/	3.8	4.5	5.3	5.2
a. Private consumption	3.4	3.8	4.4	4.5
b. Public consumption	3.8	3.8	6.1	2.1
c. Fixed private investment	9.3	8.0	9.6	10.2
d. Public investment	5.5	9.0	12.1	3.2
2. Exports	15.0	5.5	6.6	5.2
II. Global supply (3+4)	**5.6**	**4.7**	**5.5**	**5.2**
3. GDP	**4.8**	**4.5**	**5.0**	**5.0**
4. Imports	10.1	5.5	8.0	6.6

1/ Includes inventory changes.
* Forecast.
Source: INEI and BCRP.

Figure 49
CONSUMER CONFIDENCE INDEX
INDICCA: I quarter 2004-2005



Source: Apoyo S.A.

69. The growth in **private spending** could reach 4.4 percent for the year, a figure that is consistent with the 5 percent growth in national disposable income and the recovery in consumer confidence in Metropolitan Lima which, according to Apoyo, has been increasing since the first quarter of 2004 and which reached 40 points in the first quarter of 2005. Loans availability and interest rates for consumer credit is also predicted to remain favorable.

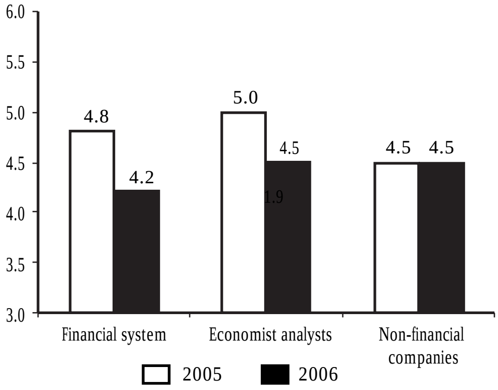
Table 30

NATIONAL DISPOSABLE INCOME
(Real percentage values compared to same period in previous year)

	2004	2005*	2006*
I. Gross domestic product (GDP)	4.8	5.0	5.0
II. Gross national product (GNP) 1/	3.2	4.9	5.7
III. Gross national income (NI) 2/	5.3	5.1	4.9
IV. National disposable income (NDI) 3/	**5.5**	**5.0**	**4.9**

1/ Excludes net income paid to non-resident productive factors.
2/ GDP and GNP are isolated from changes in foreign trade terms.
3/ Net transfers from non-residents added to NI.
* Forecast.
Source: BCRP.

Figure 50
2005 AND 2006 GDP GROWTH FORECASTS
(Real % change)



According to a survey of expectations carried out by the BCRP, financial institutions expect GDP to grow 4.8 percent in 2005, economic analysts expect 5.0 percent and non-financial entities expect growth of 4.5 percent. In 2006 financial institutions expect growth of 4.2 percent, while economic analysts and non-financial companies expect growth of 4.5 percent.

70. In 2005 **exports** could increase 6.6 percent in real terms as a consequence of higher export volumes of traditional products such as gold, copper and zinc and non-traditional products, the nominal value of which could rise by 13 percent, particularly textiles, agricultural & livestock products and chemicals.

    It is expected that in 2005 **public consumption** will grow 6.1 percent, mainly through higher spending on wages, goods and services by central government, while **public investment** could grow at a rate of 12.1 percent. On aggregate, public consumption and investment could rise by 7.5 percent

71. During **2006**, economic activity could grow at the same rate as in 2005, driven by the growth of our trading partners (3.4 percent) and positive expectations about the economic environment on the part of companies and consumers. In this context, domestic demand could rise by 5.2 percent. Growth in exports could reach 5.2 percent, driven by traditional exports (mainly gold, zinc and coffee) while exports of non-traditional products continue to expand at a rate of 12 percent, principally textiles and agricultural & livestock products.

72. Imports could grow 6.6 percent, particularly for industry, both consumer goods (15.7 percent) and capital goods (16.5 percent).

Sector performance

73. In **2005** the non-primary sectors could grow by 5.3 percent while primary sectors do so by 4.3 percent.

74. The **agricultural & livestock sector** could grow by 3.7 percent favored by the improvement of the weather conditions with respect to the previous year. The principal products contributing to the growth of the agricultural & livestock should be rice, potatoes, export crops, beef and poultry.

    In the **fishing sector** growth is forecast to be 1.9 percent based on increased production of canned fish and higher landings of fish for freezing and fresh consumption. Peruvian anchovy landings could decline from 8.6 to 8.5 million M.T. compared to 2004.

Table 31

GROSS DOMESTIC PRODUCT
(Real % changes)

	2004	2005*		2006*
		January IR	May IR	
Agriculture & livestock	**-1.1**	**3.4**	**3.7**	**4.2**
Fishing	**30.5**	**1.8**	**1.9**	**2.6**
Mining & fuel	**5.4**	**7.0**	**6.7**	**4.4**
Metals	5.2	5.7	5.0	3.6
Fuel	7.1	26.2	21.3	14.7
Manufacturing	**6.7**	**5.0**	**5.2**	**5.2**
Based on raw materials	4.6	3.4	1.1	3.1
Non-primary	7.2	5.5	6.0	6.0
Electricity & water	**4.6**	**4.0**	**4.1**	**4.4**
Construction	**4.7**	**6.0**	**6.5**	**8.3**
Commerce	**4.8**	**4.6**	**4.5**	**4.9**
Other services	**4.7**	**4.1**	**5.1**	**4.9**
GROSS VALUE ADDED (GVA)	**4.6**	**4.6**	**5.0**	**5.0**
Taxes on products and import duties	6.4	4.5	5.0	5.0
GLOBAL GDP	**4.8**	**4.5**	**5.0**	**5.0**
Primary GVA	**2.8**	**4.7**	**4.3**	**4.0**
Non-primary GVA	**5.1**	**4.5**	**5.3**	**5.2**

* Forecast.
Source: INEI & BCRP.

The **mining and fuel sector** could see growth of 6.7 percent through increased metal production, mainly gold, as well as fuel production as Block 88 (Camisea) will be operational throughout the year. As far as gold is concerned, it is expected that the Alto Chicama gold project in La Libertad (Barrick) will come on stream by the middle of the year and that the Yanacocha's Cerro Negro mine will be operational throughout the year. Zinc, silver and lead production could see moderate growth as Volcan and other companies recover.

Manufacturing is expected to grow 5.2 percent, mainly the result of a 6.0 increase in non-primary manufacturing. In the primary resources processing industry, growth is explained by increased production of meat and non-ferrous metal refining, which should offset the forecast reduction in production of canned and frozen fish and sugar. Non-primary manufacturing should expand 6.0 percent, as in 2004 this would be the result of an increase in domestic demand and in non-traditional exports. The groups seeing the highest growth could be the paper and printing industry; chemical products, rubber and plastics industries; non-metallic minerals and the iron and steel industry.

The **construction sector** should grow 6.5 percent, continuing to be driven by the MiVivienda and Techo Propio house building programs and road construction.

75. In **2006** the non-primary sectors should maintain their dynamism with growth of 5.2 percent, with 4.0 growth in the primary sectors forecast.

The **agricultural & livestock sector** could grow 4.2 if rainfall is good and Peruvian products continue to find favor in foreign markets. The fishing sector could expand by 2.6 percent based on diversification of species for canning and an increase in frozen fish production. There will probably be no significant variation in anchovy landings compared to those in 2005, which were high.

The **mining and fuel sector** should grow 4.4 as the Alto Chicama project will be in operation all year and because of improved performances by polymetalic mines as a result of higher prices for base metals. In the fuel sub sector Petro Tech Peruana and Petrobras are expected to increase production because of their investment in exploration and development wells.

Manufacturing is expected to grow by 5.2 percent. Primary resources processing should expand by 3.1 percent and non-primary manufacturing by 6.0 percent. The increase in the primary resources processing industry should reflect increased production of canned and frozen fish, sugar and refined oil products.

Among non-primary manufacturing there should be greater production of non-metallic minerals; chemical products, rubber and plastics industries; paper and printing and the iron and steel industry.

The **construction** could grow 8.3 percent due to continued private investment, particularly in housing, mining projects and the construction of the inter-ocean highway.

II.3 Overall balance of the public sector

Forecasts for the non-financial public sector assume that the deficit will remain at 1.0 percent for the period 2005 - 2006, complying with the limit set by the Fiscal Responsibility *and Transparency Act and in accordance with the Multi Annual Macroeconomic Framework 2006 - 2008.*

Table 32

NON-FINANCIAL PUBLIC SECTOR
(Millions of nuevos soles)

	2004	2005 *		2006 *
		January IR	May IR	
1. Current revenue	**35,381**	**38,112**	**39,121**	**41,390**
(% of GDP)	15.1	15.3	15.5	15.4
Real % var.	8.1	5.5	8.2	3.2
2. Non-financial expenditure	**-34,165**	**-36,055**	**-37,301**	**-39,200**
(% of GDP)	-14.6	-14.5	-14.8	-14.5
Real % var.	4.8	3.3	6.8	2.5
Current	-29,870	-31,493	-32,685	-34,265
(% of GDP)	-12.7	-12.7	-13.0	-12.7
Real % var.	5.3	3.3	7.1	2.3
Capital	-4,295	-4,562	-4,616	-4,935
(% of GDP)	-1.8	-1.8	-1.8	-1.8
Real % var.	1.5	3.6	5.2	4.3
3. Others	**1,184**	**898**	**1,245**	**1,475**
(% of GDP)	0.5	0.4	0.5	0.5
4. Primary balance	**2,400**	**2,955**	**3,066**	**3,665**
(% of GDP)	1.0	1.2	1.2	1.4
5. Interest	**-4,865**	**-5,405**	**-5,486**	**-6,229**
(% of GDP)	-2.1	-2.2	-2.2	-2.3
Of which:				
Pension reform bonds	-333	-236	-236	-234
External (Millions of US$)	-$1,159	-$1,346	-$1,336	-$1,450
6. Overal ballance	**-2,465**	**-2,450**	**-2,420**	**-2,564**
(% of GDP)	-1.1	-1.0	-1.0	-1.0
Millions of US$	-$754	-$732	-$735	-$772

* Forecast.

76. The **fiscal deficit** for 2005 could reach 1.0 percent of GDP, a figure 0.1 percentage point lower than that of the previous year. This would be caused by a central government primary result of 0.2 percent of GDP, explained by higher current income of 8.4 percent in real terms, while non-financial expenditure could increase by 7.0 percent.

77. The increase in central government **current income** of 0.4 percent of GDP is mainly the result of improved tax revenue, which increased by 7 percent in real terms, and by better income tax and value added tax collection. The improvement in the first item stems from higher international mineral prices, increased economic activity and an increase in the corporate

tax rate from 27 to 30 percent, reflected in increased clearing payments. In the case of the second item, the improvement arises from an extension of the value added tax withholding system applied in the second half of 2004.

Non-tax income should increase by 19 percent in real terms, due mainly to an increase in the mining levy and royalties for oil, gas and mineral production arising from the increase in world prices, the Camisea operation and new legislation, respectively.

78. Increased central government **non-financial expenditure** - 0.2 percent of GDP - would imply a real increase over and above the limit set by the Fiscal Responsibility and Transparency Act on the part of the central government (3 percent) increased expenditure could be seen in the current component (7.3 percent in real terms) and in the capital component (5.4 percent in real terms).

The growth in the current component would be a response mainly to increased transfers to local governments and higher wage costs. As far as transfers are concerned, the increase corresponds mainly to those originated by the mining and petroleum levies, because of the rise in international prices. Increased expenditure on wages and salaries arises from the increases granted during the previous year and those envisaged for this year. The recent wage increases for health and education sector employees imply a cost this year of S/. 60 million and S/. 210 million, respectively (S/. 110 million and S/. 370 million next year).

79. **Interest** costs are estimated at 2.2 percent of GDP, a figure which implies an 11 percent increase in real terms compared to the previous year because of increased foreign debt interest of US$ 177 million, which will be partially offset by lower bond interest accrued of S/. 97 million because of lower inflation in the period.

80. The **borrowing requirement** would be US$ 3,003 million in 2005, US$ 181 million higher than the figure for fiscal year 2004, because of increased amortizations valued at US$ 199 million. This increase is mainly because of foreign debt repayments of US$ 149 million and domestic debt repayments of US$ 69 million falling due.

The requirements could be covered by external disbursements of US$ 1,673 million, of which US$ 1,173 million are freely available (US$ 427 million in bonds) and US$ 500 million is destined for investment projects. Sovereign bond issues could amount to the equivalent of US$ 1,030 million, which includes the refinancing already mentioned.

Table 33

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

	2004	2005 *		2006 *
		January IR	May IR	
1. Overall balance (Millions of nuevos soles)	**-2,465**	**-2,450**	**-2,420**	**-2,564**
(% of GDP)	-1.1	-1.0	-1.0	-1.0
Millions of US$	-754	-732	-735	-772
2. Amortization (Millions of US$)	**-2,068**	**-2,295**	**-2,267**	**-1,910**
Redention of pension reform bonds	-215	-194	-196	-69
Internal	-505	-571	-573	-314
External	-1,348	-1,529	-1,497	-1,527
3. Borrowing requirement (Millions of US$)	**2,822**	**3,026**	**3,003**	**2,682**
External financing	2,474	1,523	1,673	1,799
Free disposal funds	2,158	1,023	1,173	1,299
Investment projects	315	500	500	500
Domestic bonds	766	1,027	1,030	600
Privatization	114	87	97	24
Others	-532	389	203	259

* Forecast.

81. The **deficit in the non-financial public sector** in **2006** could amount to 1.0 percent of GDP, similar to the forecast for 2005 and in line with the Multi Annual Macroeconomic Framework 2006 - 2008. This forecast considered that higher interest payments on public debt (0.1 percent of GDP) will be offset by an improvement in the primary result, which implies that prudent management of public spending will be necessary as income is reduced.

82. Central government **current income** could fall by 0.1 percent of GDP, equivalent to an increase of 3.3 percent in real terms. This reduction in the rhythm of growth would be caused mainly by reduced revenue from income tax, which may fall by 26 percent in real terms (from 0.8 percent to 0.5 percent of GDP), because of the extraordinary nature of the clearing payments in the previous year. Less income is also expected from a reduction in the rate of the financial transaction tax and possible reduced revenue from customs duties resulting from trade treaties.

83. Central government **non-financial expenditure** should increase 2.6 percent in real terms. The forecast considers an increase of 2.4 percent and 4.4 percent in real terms in current expenditure and capital expenditure, respectively. The increase in current spending takes into account transfers to local governments as well as the annual effect of increases granted in 2005.

84. Interest could rise to 2.3 percent of GDP, 11 percent in real terms higher, because of increased payable on foreign debt amounting to US$ 114 millions.

85. The **borrowing requirement** could amount to US$ 2,682 million, a sum US$ 321 million lower than in 2005. This would be due to repayments being US$ 357 million lower, of which, US$ 259 million correspond to domestic debt and US$ 127 million to bonds.

The requirement could be covered mainly from foreign loans of US$ 1,799 million, of which US$ 1,299 million would be freely available and US$ 500 million for investment projects. Sovereign bond issues could amount to S/. 1,992 (equivalent to US$ 600 million).

II.4 Macroeconomic expectations

86. The macroeconomic expectations survey carried out by the Central Bank in January and May of this year among Peruvian financial institutions and a group of economic analysts gave the following results:

Between January and May expectations of GDP growth rose from 4.5 to a range between 4.8 and 5.0 percent for 2005 with a different tendency observed for 2006 (an increase from 4.1 to 4.5 percent among economic analysts and a reduction from 4.5 to 4.2 in the financial system).

As far as inflation is concerned, both the economic analysts and financial institutions expect an inflation rate of around 2.5 percent for 2005 and 2006.

Table 34

MACROECONOMIC EXPECTATIONS SURVEY
Economic Analysts

	January	May
GDP growth (%)		
2005	4.5	5.0
2006	4.1	4.5
Inflation (%)		
2005	2.5	2.5
2006	2.5	2.5
Exchange rate (Nuevos soles per US$)		
2005	3.34	3.29
2006	3.45	3.34
Interbank interest rate (%)		
2005	3.8	3.3
2006	4.0	4.2

Table 35

MACROECONOMIC EXPECTATIONS SURVEY
Financial System

		January	May
GDP growth (%)			
	2005	4.5	4.8
	2006	4.5	4.2
Inflation (%)			
	2005	2.5	2.5
	2006	2.5	2.6
Exchange rate (Nuevos soles per US$)			
	2005	3.30	3.27
	2006	3.35	3.32
Interbank interest rate (%)			
	2005	3.9	3.5
	2006	4.5	4.5

II.5 Inflation

87. The inflation forecast considers the aggregate macroeconomic conditions described above, which could have an influence on the most likely behavior of prices in what remains of 2005 and throughout 2006.

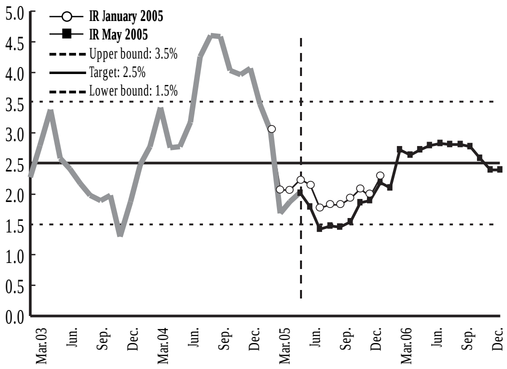
88. In particular, inflation will be determined by the behavior of inflationary expectations over the forecast horizon, the inertia inherent in inflation, imported inflation and other supply factors, as well as inflationary or deflationary pressures arising from the evolution of aggregate demand.

89. The expectations of inflation for 2005 and 2006 obtained from the BCRP's monthly macroeconomic expectations survey remain consistent with the inflation target of 2.5 percent. It is envisaged that these expectations will remain in line with the inflation target over the forecast horizon.

90. Forecast inflation for 2005 in the central scenario is 2.2 percent (near to the inflation target of 2.5 percent), similar to the inflation rate included in the January Inflation Report. The behavior of inflation during 2005 has been marked by increased economic activity and higher world oil prices, which were more than offset by the recovery in agricultural output and, to a lesser extent by the appreciating pressures on the nuevo sol. A recovery in margins is also expected in the rest of the year after they partly absorbed cost pressures caused by higher fuel prices in 2004. These factors lead to an inflation rate close to

the lower limit of the target range (1.5 percent) for the coming months and in the lower half of the range (1.5 - 2.5 percent) for the rest of 2005.

Figure 51
INFLATION FORECAST: March 2003-December 2006
(CPI 12-month accumulated change)



91. In 2006, the central inflation forecast is around 2.5 percent for the close of the year. This forecast results under the premise of an initial slowdown followed by a reversal of the appreciatory trend (which implies a moderate imported inflation), an economic growth without inflationary pressures and an eventual gradual reduction in monetary stimulus.

92. The inflation forecasts for 2005 and 2006 are consistent with the public's expectations and suggest that current monetary policy should be maintained in the following months. As new information on inflationary or deflationary pressures is obtained, the monetary policy stance will be adjusted, consistent with the inflation target of the BCRP.

III. BALANCE OF RISKS

93. The forecast scenarios are considered the most likely for the following months. Nevertheless, the results of these forecasts are sensitive to changes in the external variables considered, which could alter the central scenario. The Central Bank's balance of risks enables to carry out a probability analysis of the direction of divergence of external variables from the central scenario. As a result, the inflation forecast distribution is obtained.

94. For this report, the main downside risks to the inflation forecast are:

- **A higher agricultural output:** The central scenario assumes that agricultural production will recovery over the forecast horizon, which partly explains the current downward trend in annual inflation. Nevertheless, if agricultural output increases more than expected, this could produce a 12-month inflation rate below the lower limit of the target range in certain months. Monetary policy position would not change insofar as such a shock does not affect expected inflation and the setting of prices in the rest of the economy.

- **A stronger Nuevo sol:** The base scenario considers growth of the US economy of around 3.4 percent, which includes a gradual increase in that country's interest rates. Slower growth in the United States could lead the FED to increase interest rates more gradually than is considered in the central forecast. In that case the interest rate differential between the dollar and the nuevo sol would not widen at the rate envisaged, which would generate additional downward pressure on the exchange rate. If this occurs, the Central Bank could prolong the period of monetary stimulus and increase its interventions in the foreign exchange market.

- **A lower world economic growth**, particularly in the US. An additional risk associated with reduced growth in the United States is a reduction in the growth of Peru's exports and, therefore, of domestic economic activity, which would increase the downward pressure on prices. The Central Bank will evaluate these developments and their possible effects on our economy in order to extend the period of monetary stimulus should this become necessary.

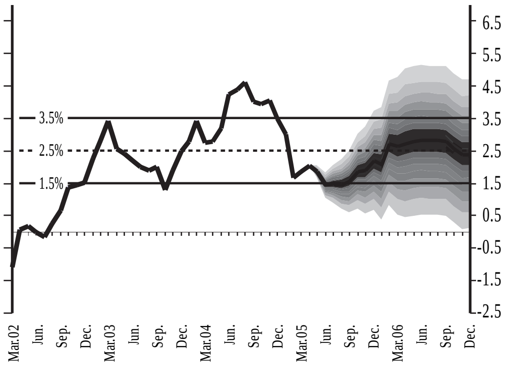
95. On the other hand, the upside risk to the inflation forecast are considered to be driven by:

- **A higher increase in the price of oil** than is considered in the baseline scenario: In this report, the central forecast for WTI is around US$ 53 a barrel in December 2005 and US$ 49 a barrel at the close of 2006. In this context, an even higher increase in crude oil prices than that included in the central scenario would imply a heavier pressure on the Stabilization Fund and this could increase the probability of higher inflation. The Central Bank would not react to a temporary increase in inflation and would only act if there were a general rise in prices.

- **Higher country risk that increases the exchange rate**: The central scenario does not consider this eventuality. Nevertheless, this risk could arise from higher than expected increases in international interest rates (which would reduce our sources of finance and make them more expensive), as well as financial turbulence in a context of elections in the region, that could eventually cause capital flight and have a depreciatory effect on the nuevo sol, which would have an impact on imported inflation. This scenario would become more acute if it coincided with a sudden movement of funds abroad by pension funds. Faced with such a possibility, the Bank maintains a high level of international reserves.

- **An acceleration of growth in domestic demand** significantly higher than contemplated in the central

Figure 52
INFLATION FORECAST: March 2002-December 2006
(CPI 12-month accumulated change)



N.B. The illustration shows the central inflation bands over the forecast horizon. The darkest band around the central forecast has a 10 percent probability of occurrence while all the colored bands represent a 90 percent probability. The concentration of the probability bands below the central forecast reflects the downward bias, in other words there is a higher probability of the inflation rate being below the central scenario than above it.

scenario, would put pressure on costs and on inflation expectations. This risk is greater if the fiscal deficit rises above the level envisaged in the Multi Annual Macroeconomic Framework. In this case, the monetary policy response would imply reduced monetary stimulus in order to keep inflation within the target range.

96. Weighting the various risks of the situation diverging from the central scenario either upwards or downwards produces on aggregate a downward bias, particularly for 2005 taking into account that the agricultural supply shocks are being reversed more quickly than expected.

CONCLUSION

97. The inflation forecasts for 2005 and 2006 provided in this report are near the 2.5 percent inflation target. In the following months, the annual inflation rate should be close to the lower limits of the range (1.5 percent) and for the rest of 2005 it is expected to be in the lower half of the target range (1.5 - 2.5 percent).

STATISTICAL ANNEX

INFLATION REPORT FORECASTS: MAY 2005 COMPARED TO JANUARY 2005

	2003	2004	2005 1/		2006 1/
			Inflation Report January 2005	Inflation Report May 2005	Inflation Report May 2005
			% real change		
1. Gross Domestic Product	4.0	4.8	4.5	5.0	5.0
2. Domestic demand	3.8	3.8	4.5	5.3	5.2
a. *Private Consumption*	3.1	3.4	3.8	4.4	4.5
b. *Public Consumption*	2.9	3.8	3.8	6.1	2.1
c. *Fixed Private Investment*	5.8	9.3	8.0	9.6	10.2
d. *Public Investment*	3.2	5.5	9.0	12.1	3.2
3. Exports of goods and services	5.9	15.0	5.5	6.6	5.2
4. Imports of goods and services	3.3	10.1	5.5	8.0	6.6
5. Our main trade partners growth	2.5	4.6	3.5	3.5	3.4
			% change		
6. Inflation	2.5	3.5	2.3	2.2	2.4
7. Nominal depreciation	-1.2	-5.5	1.8	-0.1	1.5
8. Multilateral real depreciation	7.5	-1.5	0.5	0.3	1.3
9. Terms of trade	1.7	8.5	-2.6	-2.3	-2.8
			% of GDP		
10. Balance of Payments' current account	-1.5	0.0	0.5	-0.1	-0.4
11. Trade balance	1.4	4.1	4.0	4.1	3.1
12. Gross external finance of the private sector 2/	3.0	3.2	0.9	1.4	2.3
13. Non-financial public sector primary balance	0.4	1.0	1.2	1.2	1.4
14. Non-financial public sector overall balance	-1.7	-1.1	-1.0	-1.0	-1.0
15. Tax revenues of the central government 3/	13.0	13.3	13.2	13.4	13.4
16. External debt public balance	37.6	35.7	31.5	31.9	30.6
			% nominal change		
17. Central government non-financial expenditure	7.6	8.6	5.5	9.2	5.1
18. Monetary base (annual average)	7.4	18.8	11.0	22.0	12.0
19. Banking system credit to the private sector	-4.5	-0.3	4.7	4.7	5.0

1/ Forecast.
2/ Includes foreign direct investment and long-run disbursements of private sector.
3/ Excludes government shares taxes.

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