

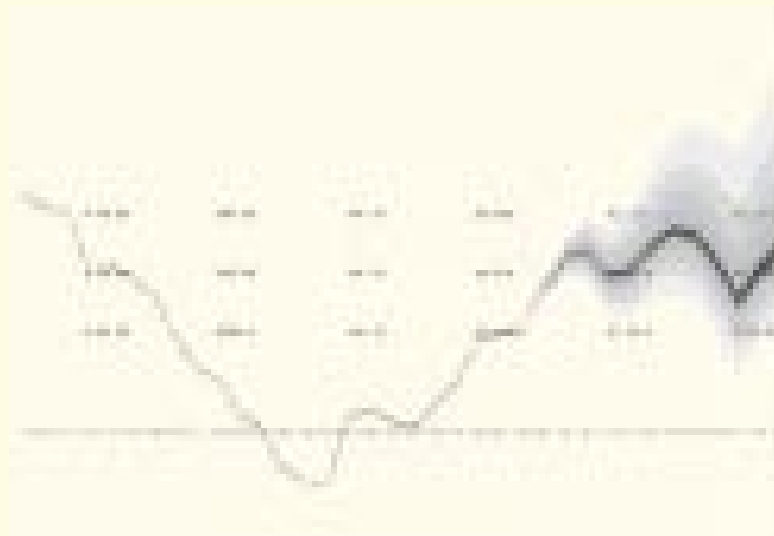


# **INFLATION REPORT:**

## **Recent trends and macroeconomic forecast**

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*May 2006*



**CENTRAL RESERVE BANK OF PERU**

# **INFLATION REPORT:**

## **Recent trends and macroeconomic forecast**

*May 2006*

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



## FOREWORD

- The monetary policy of the Central Reserve Bank of Peru (BCRP) has been based on an Inflation Targeting framework since 2002. The annual inflation target is 2.5 percent, plus or minus one percentage point. Starting in 2006, this target is measured continuously against the last twelve months' growth of the Consumer Price Index (CPI) for Metropolitan Lima. Inflation may temporarily fall outside the target range during a specific period, in which case the Central Bank will determine the necessary action to return inflation to that range, taking into account the lags in monetary policy operation.
- Transparency is a key element of the Inflation Targeting framework, and for that reason the Bank share the relevant information used in monetary policy formulation with economic agents. In line with this policy, the Bank publishes an Inflation Report three times a year, informing the public about compliance with its constitutional mandate to maintain monetary stability.
- This second Inflation Report for the year describes the factors responsible for inflation in the first five months of 2006 and contains the macroeconomic forecasts for 2006 and 2007.
- Decisions on the monetary policy position taken by the Central Bank Board include the announcement of a reference interest rate for the interbank lending market. BCRP monetary operations are aimed at maintaining this short-term interest rate at the announced reference target level and, as a result, affect the entire array of economic variables that determine the inflation rate.
- Since 2001, the BCRP has been publishing a schedule of the meetings of its Board of Directors, held on the first Thursday

of every month to approve monetary policy decisions. The schedule is published at the beginning of each year, together with a Press Release about the January Monetary Program. The publication schedule for the rest of the year (Spanish versions) is detailed below:

July 6	August 3	September 7
October 5	November 2	December 7

- The BCRP will publish the following Inflation Report in Spanish on October 6.

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## EXECUTIVE SUMMARY

- This second Report for the year contains an analysis of monetary policy execution in the first five months of 2006, macroeconomic forecasts for 2006 and 2007, and an assessment of the risks that might affect these forecasts. The baseline scenario considers that inflation will remain within the target range during the period and that economic activity will continue to show sustained growth.
- The inflation rate accelerated from 1.5 percent in December 2005 to 2.2 percent in May 2006. This outcome resulted from supply-side recent trends factors associated in this case with three specific products: sugar, chicken, and potato. Variations in the prices of these products account for 70 percent of the inflation recorded in the January-May period (1.5 percent). The rise in the international price of oil (19 percent) in this period was not significantly transferred to domestic prices due to the implementation of compensatory fiscal measures.

On the other hand, the rate of core inflation increased from 1.2 percent in December 2005 to 1.3 percent in May.

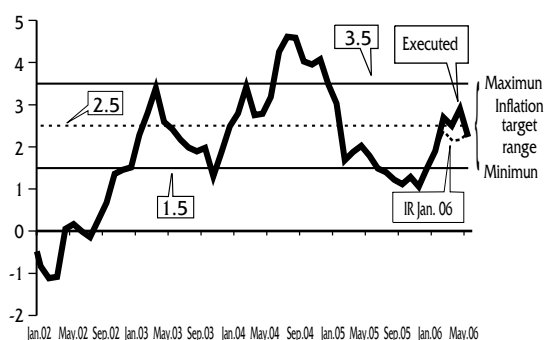
- The greater economic activity recorded over the last 6 months of 2005 (with an average of 6.8 percent) continued in the first quarter of 2006 (6.8 percent). This evolution was due to the accelerated growth of domestic demand (9.9 percent in the first quarter), which was based particularly on the increase of private consumption (5.3 percent) and private investment (25.4 percent).
- The international environment has been highly favorable to the Peruvian economy over the last two years, especially in terms of conditions that contributed to increase the volume and prices of our export products. The international context in this period was also characterized by low interest rates -in comparison with historic records-, which contributed to the financial soundness of both the balance of payments and the fiscal balance. This international context and macroeconomic stability have favored the acceleration of economic growth since 2004.

- The expansion of economic activity is expected to continue throughout 2006, boosted by a growth of private investment, estimated at 13.5 percent, and by a favorable international context, which is reflected in the 16.5 percent increase in our terms of trade. Therefore, the forecast on GDP growth for 2006 has been revised upwards from 5.0 percent in January's Inflation Report to 5.5 percent in this Inflation Report. Likewise, GDP is expected to grow 5.3 percent in 2007.
- In terms of world economic growth, international interest rates, and the prices of our main export products, prospects appear to be less favorable in 2007. However, the ongoing macroeconomic stability, the greater access of our export products to international markets, and the implementation of policies aimed at improving the economy's growth potential will allow to continue showing rates of sustained growth of over 5 percent, that is, without experiencing inflationary or balance of payment-related pressures.
- Since December 2005, the Central Bank has been gradually reducing monetary stimulation, raising its reference interest rate by a total of 150 basis points (4.5 percent). The BCRP will continue evaluating any relevant macroeconomic information to take the necessary measures that guarantee that inflation remains within the target range.
- In the first five months of 2006, the exchange rate exhibited greater volatility (fluctuations ranging from S/. 3.26 and S/. 3.45 per dollar), as well as a recent bias towards an appreciatory trend. Therefore, the Central Bank intervened in the foreign exchange market to offset this volatility. It should be said here that the greater exchange volatility touched off by election uncertainties was among the risk scenarios forecast in previous Central Bank reports.
- The scenario forecast discussed herein is considered to be the most likely scenario for 2006 and 2007. The analysis of monetary policy is complemented with a risk evaluation, which will allow to establish how the inflation forecast will be affected by the possible development of the main factors determining inflation. Given the current domestic and external conditions, risk factors include the possibility of a greater appreciation of the nuevo sol, a higher rise in the international price of fuels, and an increase in the country risk indicator.



## I. EVOLUTION OF INFLATION

**Graph 1**  
**INFLATION AND TARGET INFLATION**  
(% change over the last 12 months)



As of May 2006, the 12-month inflation rate was 2.2 percent, within the target range. Inflation showed a transitory upward trend until April due to the evolution of the prices of some food products (chicken, sugar, and potato).

1. Fluctuations in the level of inflation in recent years were due to supply shocks, particularly in the area of food products (33.2 percent of the consumer basket) and fuels (3.9 percent of the consumer basket). Inflation rose from 1.5 percent in December 2005 to 2.2 percent in May 2006 as a result of price increases in three products (chicken, sugar, and potato). Average annual inflation between the introduction of Inflation Targeting (January 2002) and May 2006 is 2.4 percent.

### I.1 Weighed Contribution to Inflation

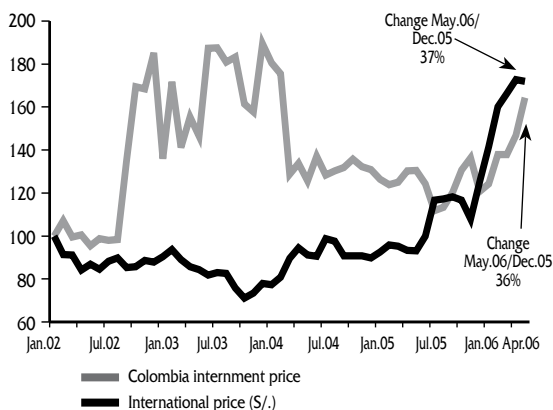
2. The products that contributed most heavily to increase inflation between January and May 2006 (1.5 percent) were sugar (31.2 percent), chicken (11.6 percent), and potato (14.0 percent).

**Table 1**

#### WEIGHTED CONTRIBUTION TO THE INFLATION (%)

Item	Weighting	Var. %	Positive contribution	Item	Weighting	Var. %	Negative contribution
Sugar	1.4	31.2	0.45	Electricity	2.2	-6.9	-0.16
Chicken	4.0	11.6	0.37	Onion	0.4	-22.9	-0.15
Potato	1.5	14.0	0.22	Papaya	0.2	-22.2	-0.10
<b>Total</b>			<b>1.04</b>				<b>-0.41</b>

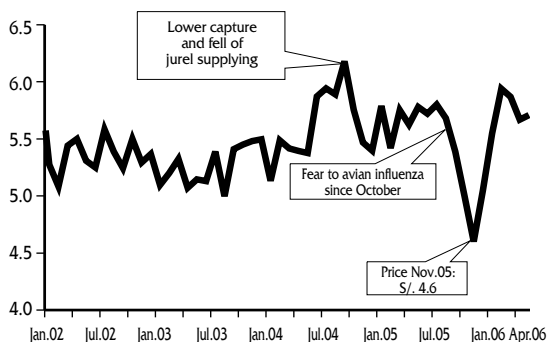
**Graph 2**  
**SUGAR: INTERNATIONAL AND INTERNMENT PRICES**  
(Index: January 2002=100)



In January-May, the price of sugar recorded an accumulated variation of 31.2 percent. This variation took place mainly in the month of April (29.0 percent) due to maintenance technical stoppages produced in several sugar-producing companies. In May, the normalization of sugar supply caused the price of this product to fall 6.5 percent; -8.7 percent in the case of brown sugar and 6.2 percent in the case of white sugar.

3. Sugar international prices (in nuevos soles) have risen continuously over the past months. A 37.3 percent price increase with respect to December 2005 was recorded in May (after accumulating a 39.4 percent increase in 2005). Most of Peru's imports of sugar come mainly from Colombia; as of May 2006, these internment prices are estimated to have increased 36.2 percent with respect to December 2005.

**Graph 3**  
**CHICKEN MEAT PRICE**  
(Nuevos soles per Kg.)

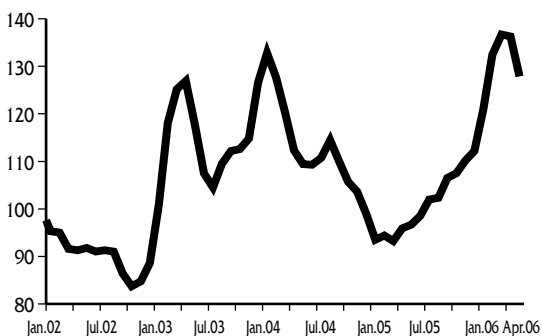


4. In the case of chicken, the rise (11.6 percent) is explained by a price recovery following the strong drop this product logged in October and November 2005 (-15 percent), as a result of a demand contraction originated by bird flu fears.

Since 2002, the price of chicken fluctuated between a minimum of S/. 5.0/kg. (average price minus one standard deviation) and a maximum of S/. 5.9/kg. (average price plus one standard deviation). The current price of chicken is S/. 5.7/kg., that is to say, it is still within the price range.

In May, the price of chicken recorded a slight increase (0.7 percent) due mainly to a demand increase associated with Mother's Day. Over the past weeks, it continued to rise as a result of a decrease in the supply of chicken meat caused by lower temperatures which affected the productivity of this bird.

**Graph 4**  
**POTATO PRICE**  
(Index: Dec. 2001 = 100)



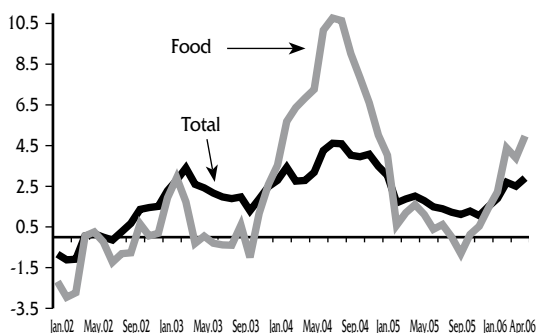
5. The potato price rise (14.0 percent) reflects the increase produced until March, which was caused by a supply drop due to fewer sown areas in the central highlands, particularly in Huánuco and Pasco. In April and May, the price of potato fell 0.2 and 0.6 percent respectively as a result of higher sowing in the areas supplying Lima with this product: thus, the price of potato increased 1 percent after having dropped by 10 percent in the January-March period. The price of white potato in Lima's Wholesale Market recorded a 21 percent decrease with respect to April.

## BOX 1 PRICE FLUCTUATIONS IN FOOD PRODUCTS AND INFLATION

Between November 2005 and April 2006, total annual inflation rose from 1.1 to 2.9 percent. This marked inflation increase resulted from a series of both supply- and demand-related factors that affected prices performance. The evolution of the prices of food products is briefly analyzed below.

The variation in the Consumer Price Index (CPI) comprises various items. The item weighing the most in the CPI basket is that of food products, which represents 33 percent of the same. The following graph shows the evolution of total inflation, together with the evolution of inflation in terms of food products. As shown below, food inflation's ups and downs induce a similar pattern onto total inflation.

**% CHANGE 12 MONTHS**



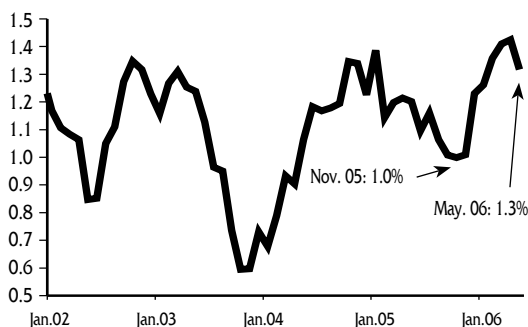
**PRICE FLUCTUATION OF FOOD 1999-2006**

Period	Date	Duration (months)	Magnitude (percentage points)
Rise	Sep. 99 - Oct. 00	14	7.4
Fall	Nov. 00 - Feb. 02	16	-4.9
Rise	Mar. 02 - Feb.03	12	5.9
Fall	Mar. 03 - Oct. 03	8	-3.9
Rise	Nov. 03 - Jul. 04	9	11.8
Fall	Aug. 04 - Sep. 05	14	-11.6
Rise	Oct. 05 - Apr. 06	7	5.8

Four more or less prolonged periods of price rises and three periods of price falls alternating over time may be identified. The relatively short period of shock affecting food products, which took place between November 2003 and July 2004, is noteworthy as food inflation during this period increased from -1 percent in October 2003 to 10.8 percent in July 2004. In the same period, total inflation rose 3.3 percentage points.

A more recent period of inflation ups began in November 2005. Over the past 7 months, this rise has represented an impact of 5.8 percentage points (total inflation increasing by 1.8 percent).

**Graph 5  
CORE INFLATION**  
(% change over the last 12 months)



### 1.2 Core inflation

- The 12-month core inflation rate -the indicator that represents the growth tendency of prices by isolating the most volatile items of the general index- was 1.3 percent in May. This indicator continues to show an upward trend, as it rose from 0.7 percent in December 2003 to 1.2 percent in December 2005, and reached the current rate of 1.3 percent in 2006.

**Table 2**

**INFLATION 2003-2006**  
(Cumulative percentage change)

	Weighting	2003	2004	2005			2006		Annual average 2002-2006
				Jan.-May.	Jun.-Dec.	Year	Jan.-May.	May.06/	
<b>I. Core</b>	<b>60.6</b>	<b>0.73</b>	<b>1.23</b>	<b>0.68</b>	<b>0.55</b>	<b>1.23</b>	<b>0.76</b>	<b>1.32</b>	<b>1.17</b>
1. Food	10.7	0.14	3.24	0.52	0.45	0.98	0.41	0.87	1.08
2. Non-Food	49.9	0.85	0.80	0.71	0.57	1.28	0.84	1.41	1.19
a. Goods	23.3	0.08	-0.29	0.68	0.03	0.71	0.75	0.78	0.60
b. Services	26.6	1.53	1.75	0.73	1.03	1.77	0.91	1.94	1.71
<b>II. Non-core</b>	<b>39.4</b>	<b>5.16</b>	<b>6.75</b>	<b>0.88</b>	<b>0.98</b>	<b>1.87</b>	<b>2.51</b>	<b>3.52</b>	<b>4.12</b>
1. Food	22.5	3.73	5.82	2.26	-0.62	1.62	5.02	4.36	3.71
2. Non-Food	16.9	7.00	7.90	-0.80	3.00	2.17	-0.52	2.46	4.66
a. Fuel	3.9	8.94	17.77	0.59	6.26	6.89	1.15	7.47	11.28
b. Transportation	8.4	10.99	3.49	-0.18	1.47	1.29	0.06	1.52	3.52
c. Public Services	4.6	-1.98	6.19	-3.67	2.03	-1.72	-3.85	-1.90	0.07
<b>III. Total</b>	<b>100.0</b>	<b>2.48</b>	<b>3.48</b>	<b>0.76</b>	<b>0.73</b>	<b>1.49</b>	<b>1.49</b>	<b>2.23</b>	<b>2.37</b>

**BOX 2**

**ALTERNATIVE INDICATORS OF CORE INFLATION**

The Consumer Price Index (CPI) is commonly used to measure inflation, a variable comprising both permanent and transitory components. For monetary policy purposes, an indicator considering only the permanent component of inflation is required: core inflation.

A good indicator of core inflation must be easy to calculate, and must be subject to few, if any, significant revisions. It must neither under- nor overestimate inflation in the long-term. Furthermore, it must have a variability lower than inflation and allow to predict future inflation.

**The current indicator**

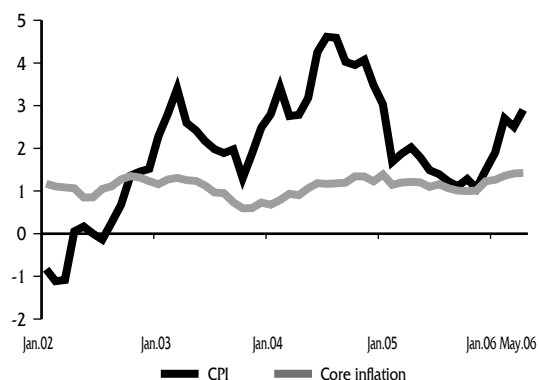
The indicator of core inflation currently used excludes from IPC calculation those items that exhibit the highest variability in terms of monthly price percentage variation in the period January 1995 - December 2005, in addition to bread, rice, noodles, oils, fuels, public utilities, and transport fares. The core inflation basket of products accounts for 61 percent of total products.

Products such as bread, rice, noodles and oil are excluded because their prices depend on the international quotations of wheat and soy oil, as well as on domestic supply shocks, as in the case of rice.

The prices of fuels are excluded since they are determined independently of the monetary policy, given that they depend on the evolution of the international price of oil and on tax policy. Likewise, as the price of public utilities is subject to price control, it was deemed convenient to exclude them. Transport fares are also excluded given that they are rarely, but significantly readjusted, thus generating distortions in inflation's measure.

It is worth pointing out that the selection of the products included in the basket of core inflation has allowed to verify that in long terms this basket does not under- or overestimate the result exhibited by the general index. Between January 1995 and May 2006, core inflation recorded an accumulated variation of 62 percent (versus 66 percent in the case of the CPI). The differential with respect to the accumulated variation of the CPI is due mainly to the heavy increase recorded in the price of fuels (177 percent). The core inflation measure shows a variability 30 percent lower than that of the CPI measure. The indicator meets the requirement of being easily understood by the public.

**INFLATION AND CORE INFLATION  
(Change last 12 months)**



It is worth noting that the indicator of core inflation, is widely used worldwide to have a better comprehension of inflationary trends.

**INFLATION AND CORE INFLATION  
IN MAIN COUNTRIES: APRIL 2006**  
(% change, last 12 months)

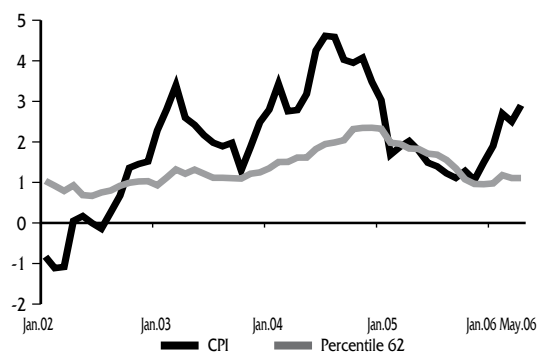
	Total	Core inflation
United States	3.5	2.3
Japan	0.4	0.5
United Kingdom	2.0	1.3
Euro zone	2.4	1.5
Germany	2.3	0.8
France	2.0	1.3
Peru	2.9	1.4

Source: Bloomberg.

**Other methods**

In addition to this, a follow-up is made on different price indicators, some of which are discussed below. It is worth noting this is not done with the purpose of replacing the currently used measure, but rather to complement it.

**ALTERNATIVE MEASURES OF INFLATION  
(Change last 12 months)**

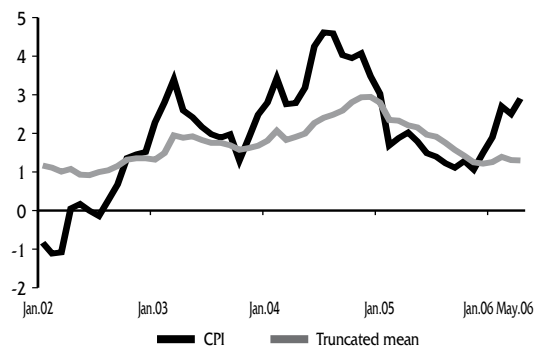


**i. Roger's method<sup>1/</sup> (modified)**

The median, or percentile 50, is an unskewed estimator of the central tendency in the case a symmetric distribution (Bryan and Cecchetti)<sup>2/</sup>. However, due to the right skewness exhibited by the distribution, another percentile above 50 will provide an unskewed estimation. Rogers chose the percentile that, on average, contained the arithmetic media. In the Peruvian case, this method was modified since it tended to underestimate inflation. Therefore, a percentile recording an accumulated variation equal to inflation was chosen.

In the period under analysis, the percentile selected is percentile 62. The indicator calculated on the basis of this percentile shows an accumulated variation of 64 percent and a variability 30 percent lower than that of inflation in the period January 1995 - May 2006.

**ALTERNATIVE MEASURES OF INFLATION  
(Change last 12 months)**



**ii. The trimmed-media method**

This method consists on calculating the arithmetic media, excluding part of the tails of the distribution.

This method was tested excluding 50 percent of the basket. In order to guarantee that inflation was neither over- nor underestimated, the cut was made on percentile 58. The resulting series shows an accumulated variation of 65 percent and a variability 34 percent lower than that of inflation.

1/ Roger Scott. Discussion Paper G95/5. September 1995. Reserve Bank of New Zealand.

2/ Bryan M. and S. Cecchetti. The consumer price index as a measure of inflation. NBER WP 4505. 1993.

**ALTERNATIVE MEASURES OF INFLATION**

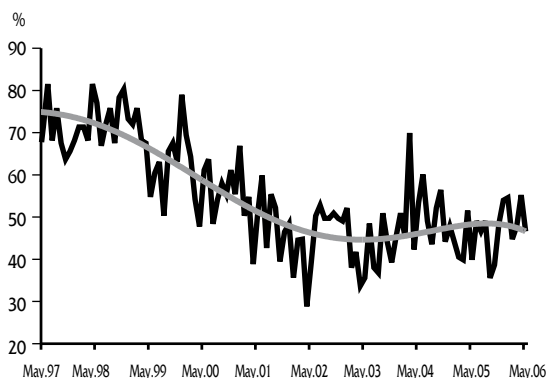
(% change last 12 months)

	CPI	Actual	Percentile 62	Truncated mean
% included	100.0%	60.6%		50.0%
Jan. 2004	2.80	0.68	1.35	1.81
Feb.	3.43	0.79	1.50	2.07
Mar.	2.76	0.93	1.51	1.83
Apr.	2.78	0.90	1.61	1.91
May.	3.18	1.06	1.61	1.99
Jun.	4.26	1.18	1.82	2.27
Jul.	4.61	1.17	1.95	2.40
Aug.	4.59	1.18	1.98	2.48
Set.	4.03	1.19	2.04	2.59
Oct.	3.95	1.35	2.32	2.81
Nov.	4.07	1.34	2.34	2.94
Dec.	3.48	1.23	2.35	2.94
Jan. 2005	3.03	1.39	2.32	2.80
Feb.	1.68	1.14	1.98	2.35
Mar.	1.88	1.20	1.95	2.33
Apr.	2.02	1.21	1.84	2.21
May.	1.79	1.20	1.83	2.16
Jun.	1.49	1.10	1.71	1.97
Jul.	1.40	1.16	1.69	1.92
Aug.	1.22	1.06	1.55	1.75
Set.	1.11	1.01	1.35	1.57
Oct.	1.28	1.00	1.08	1.42
Nov.	1.06	1.01	0.96	1.25
Dec.	1.49	1.23	0.95	1.22
Jan. 2006	1.90	1.26	0.98	1.25
Feb.	2.70	1.36	1.18	1.39
Mar.	2.50	1.41	1.11	1.31
Apr.	2.90	1.42	1.11	1.30

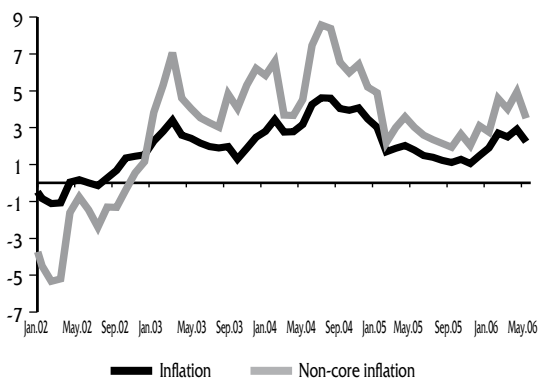
% change acum.				
Jan.95-Apr.06	66.7	62.0	64.1	64.5
Standard deviation 1995-2006	0,44	0,32	0,31	0,29

An indicator providing information on whether the tendency of inflation is due to a generalized variation of prices or to the evolution recorded in a single group of prices is the percentage of items that exhibit a positive monthly percentage variation. As shown in the graph below, this indicator has remained relatively stable since mid-2002.

**PERCENTAGE OF ITEMS WITH POSITIVE CHANGES ON MONTHLY PRICES**



**Graph 6**  
**INFLATION AND NON-CORE INFLATION**  
(% change over the last 12 months)



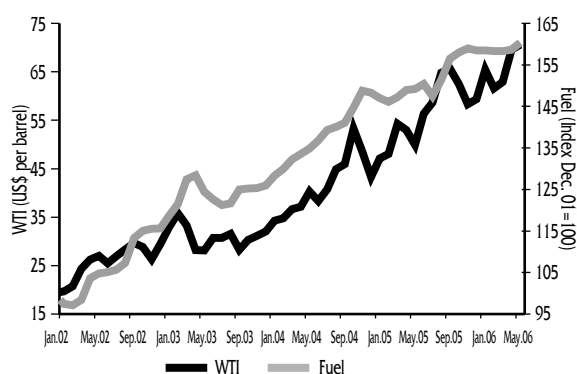
**1.3 Non-core inflation**

- Twelve-month non-core inflation was 3.5 percent. This measure represents the group of goods and services subject to supply shocks or with regulated prices. The evolution of this indicator was mostly due to increases in the prices of food products (4.4 percent) and fuels (7.5 percent).

**Fuels**

- The international price of West Texas Intermediate (WTI) crude rose from US\$ 59.4 to US\$ 70.6 a barrel between December 2005 and May 2006 (19 percent) due to security problems in the Middle East, to increased world demand for fuels (particularly in China), and to speculative movements. However, this rise in international oil prices impacted only partially on domestic prices due to the implementation of a series of fiscal measures and to the appreciation of the nuevo sol.

**Graph 7**  
**PETROLEUM WTI AND FUEL PRICES**



9. The fiscal compensation measures adopted by the government included the application of the Fuel Price Stabilization Fund, as well as the reduction of the excise tax (ISC) on gasoline and kerosene. The appreciation of domestic currency between January and April 2006 contributed also to lessen the impact of the oil's international price rise on domestic prices.

As a result, the average increase in fuel prices between January and May was only 0.1 percent. A breakdown of fuel prices shows rises of 1.4 and 1.3 percent in gasoline and kerosene respectively. On the other hand, the price of gas increased 0.5 percent.

**Table 3**

**FUEL PRICES**  
(Monthly percentage change)

	2004	2005			2006	
		Jan.-May	Jun.-Dec.	Year	Jan. - May	12-month
<b>Fuels</b>	<b>17.8</b>	<b>0.6</b>	<b>6.3</b>	<b>6.9</b>	<b>1.1</b>	<b>7.5</b>
Gasoline	17.7	1.5	7.6	9.2	1.4	9.1
Gas	15.3	-2.9	-8.2	-10.9	0.5	-7.8
Kerosene	20.3	2.9	17.6	21.0	1.3	19.1
WTI Price						
US\$ per barrel % change	34.9	22.5	12.1	37.2	18.9	41.5

Source: INEI and Bloomberg.

In the May 2005 - April 2006 period, the government allocated S/. 510 million to mitigate the impact of the international rise of oil prices on domestic prices. This sum included S/. 350 million on account of reducing the excise tax (ISC) and nearly S/. 160 million on account of compensations generated by the Fuel Price Stabilization Fund. These sums were covered by the higher tax collection resulting from the higher prices of fuels, especially Royalties, Income Tax, and General Sales Tax (IGV).

**Public utilities**

10. Public utility rates dropped 3.9 percent on average from January to May 2006. Electricity rates decreased 6.9 percent due to Osinerg's regulation No. 111-2006-OS/CD that set tariffs for the period May 2006 - April 2007. On the other hand, telephone rates fell 1.2 percent due to Osiptel's

implementation of productivity-increasing factors, which were corrected for inflation.

**Table 4**

**PUBLIC UTILITIES RATES**  
(Monthly percentage change)

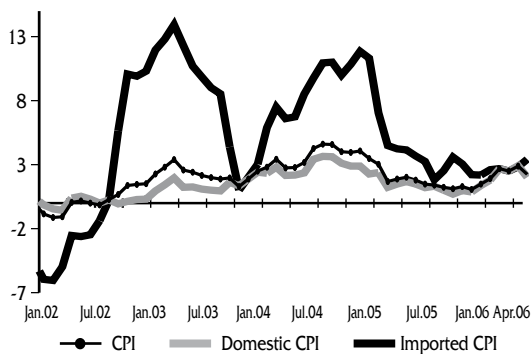
	2004	2005			2006	
		Jan.-May	Jun.-Dec.	Year	Jan. - May	12-month
<b>Public services</b>	<b>6.2</b>	<b>-3.7</b>	<b>2.1</b>	<b>-1.7</b>	<b>-3.9</b>	<b>-1.9</b>
Electricity	12.0	-5.9	3.6	-2.5	-6.9	-3.5
Telephone	-2.0	-2.4	-4.7	-7.0	-1.2	-5.8
Water	3.0	0.0	5.2	5.2	0.0	5.2

Source: INEI.

**I.4 Imported inflation and other inflation indicators**

1. Imported inflation, applicable to goods in the family shopping basket that are directly or indirectly affected by international prices and the exchange rate, showed an accumulated change of 3.4 percent, variation explained mainly by the higher prices of fuels (7.5 percent)

**Graph 8**  
**DOMESTIC AND IMPORTED INFLATION**  
(Annual cumulative % change)



**Table 5**

**IMPORTED & DOMESTIC INFLATION: 2003 - 2006**  
(Cumulative percentage change)

	Weighting	2003	2004	2005			2006	
				Jan.-May	Jun.-Dec.	Year	Jan.-May	12-month
<b>I. IMPORTED CPI</b>	<b>12.1</b>	<b>3.0</b>	<b>11.3</b>	<b>0.0</b>	<b>2.2</b>	<b>2.2</b>	<b>1.2</b>	<b>3.4</b>
Food	5.4	-0.1	10.9	-0.7	-0.8	-1.5	1.8	1.0
Fuel	3.9	8.9	17.8	0.6	6.3	6.9	1.1	7.5
Electrical appliances	1.0	-1.9	-2.8	-1.6	0.4	-1.2	0.0	0.4
Others	1.8	1.4	3.2	1.4	0.8	2.3	0.3	1.1
<b>II. DOMESTIC CPI</b>	<b>87.9</b>	<b>2.4</b>	<b>2.3</b>	<b>0.9</b>	<b>0.5</b>	<b>1.4</b>	<b>1.5</b>	<b>2.0</b>
<b>III. CPI</b>	<b>100.0</b>	<b>2.5</b>	<b>3.5</b>	<b>0.8</b>	<b>0.7</b>	<b>1.5</b>	<b>1.5</b>	<b>2.2</b>
Exchange rate		-1.2	-5.5	-0.7	5.1	4.4	-4.2	0.7



## Wholesale price index (WPI)

12. The Wholesale Price Index (WPI), which covers both domestic and imported consumer, intermediate and capital goods, showed a 12-month variation of 3.8 percent.

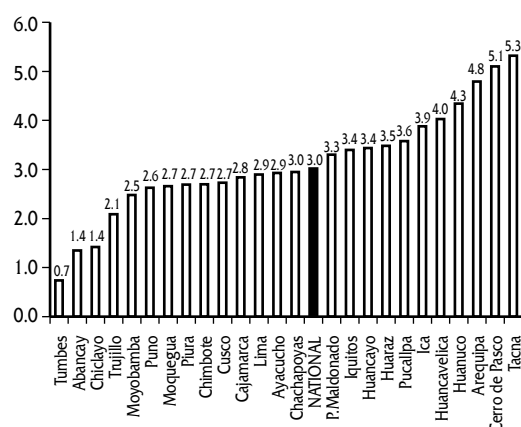
Between January and May, the domestic agriculture and livestock sector, as well as the domestic manufacturing sector contributed most heavily to the variation in the WPI (1.8 percent and 1.0 percent respectively).

**Table 6**

### WEIGHTED CONTRIBUTION TO WHOLESAL PRICE (Percentage points)

Item	% change	Weighted contribution
WPI		1.1
of which:		
Refined petroleum products	3.0	0.4
Other domestic foods products	6.0	0.3
Farming domestic product	1.8	0.2

**Graph 9**  
**INFLATION NACIONAL APRIL 2005 - APRIL 2006**  
(% accumulated change)



## Domestic inflation

13. The INEI has been preparing the national aggregated consumer price index since 2003, based on the price indexes for 25 cities. The accumulated price increase between May 2005 and April 2006 was 3.0 percent, with 16 cities showing a smaller-than-average increase and the remaining 9 a higher-than-average inflation.

The strongest price growth was to be found in the cities of Tacna (5.3 percent), Cerro de Pasco (5.1 percent), and Arequipa (4.8 percent). On the other hand, the cities with the lowest price growth included Tumbes (0.7 percent), Abancay and Chiclayo (each with 1.4 percent).

## II. MONETARY POLICY

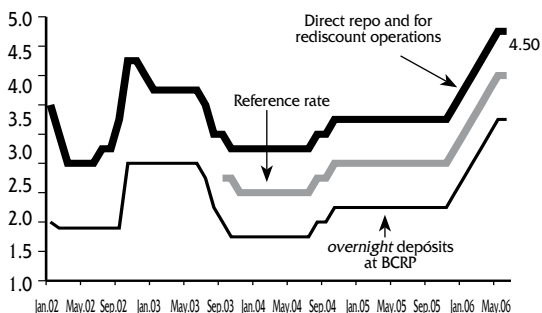
Since December 2005, the BCRP has increased its reference interest rate by 150 basis points (25 basis points each month), as a result of which it rose from 3.0 percent in November 2005 to 4.50 percent in May 2006. This reduction of monetary stimulation is consistent with the continuous dynamism of economic activity and in line with inflation target compliance. Moreover, increasing the reference interest rate has contributed to prevent situations of excess upward volatility in the exchange market, which could generate undesired effects on inflation and on economic activity in general.

14. The BCRP establishes its monetary position through a reference interest rate for the interbank market. Ever since the Inflation Targeting framework was introduced in January 2002, the Central Bank has maintained a position of monetary stimulation, consistent with inflation target compliance and economic recovery following the recession that preceded the framework's implementation.

The interbank reference rate was raised to 3.0 percent in October 2004, remaining at this level until November 2005. In May 2006, the interbank reference rate was 4.5 percent, after having gradually been increased since December 2005.

The 150 basis point-increase produced in the interbank reference rate between November 2005 and May 2006 (25 basis points each month) reflects a lesser need for maintaining monetary stimulation, given the greater dynamism of economic activity, particularly of domestic demand, since the fourth quarter of 2005.

**Graph 10**  
CENTRAL BANK REFERENCE INTEREST RATE <sup>1/</sup>  
(%)

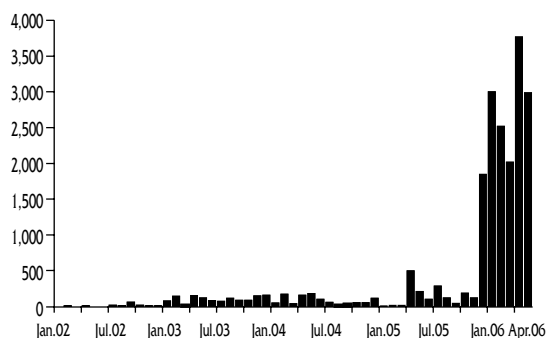


<sup>1/</sup> Before september 2003, direct repo and for rediscount operations rate and overnight deposits rate, were indicated.

Raising the interbank reference rate also contributed to prevent situations of excess upward volatility in the exchange market, which could generate undesired effects on inflation and economic activity given the economy's level of financial dollarization.

Decisions concerning the interbank reference rate take into account all relevant macroeconomic and financial information available to date. Thus, the effects generated in the exchange and financial markets as a result of electoral uncertainty, as well as the duration of the latter, made it necessary to continuously evaluate what the adequate level of the reference interest rate should be in each period in order to reduce the risks in the economy, without establishing ex-ante a sequence of rises in the interbank reference rate.

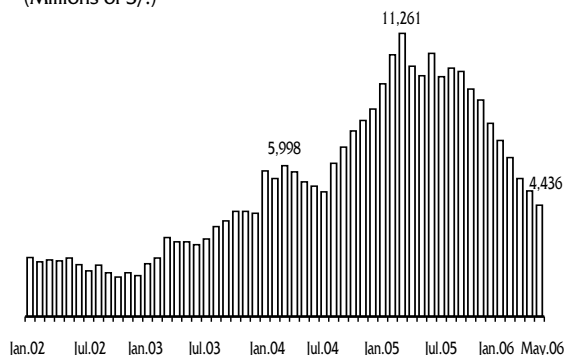
**Graph 11**  
**MONTHLY AVERAGE REPOS**  
(Millions of S/.)



15. With respect to monetary management, in order to set the interbank interest rate at the reference level, the Central Bank continued carrying out significant repo operations in April. For example, in this month, repo operations ranged between S/. 3,236 million and S/. 4,527 million. Through these operations, the Central Bank temporarily purchases BCRP Certificates of Deposits (CDBCRP), BCRP Certificates of Deposits Readjustable to the exchange rate (CDRBCRP), or Public Treasury financial securities from the financial entities.

In this way, repo operations increased considerably between November 2005 and April 2006: average daily repo operations increased from S/. 121 million in November to S/. 1,848 million in December 2005, and to S/. 2,989 million in May 2006.

**Graph 12**  
**END OF PERIOD CDBCRP BALANCE**  
(Millions of S/.)



**Table 7**

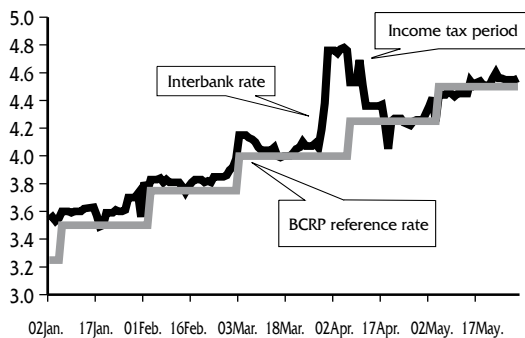
**REPO OPERATIONS**

(Millions of nuevos soles)

	Oct.05	Nov.05	Dec.05	Jan.06	Feb.06	Mar.06	Apr.06	May.06
Monthly average repos	149	102	1,828	2,166	1,069	809	535	282
Average daily balance	185	121	1,848	3,002	2,517	2,018	3,766	2,989

Additionally, in order to cover the banks' demand for liquidity, the BCRP allowed its certificates of deposits (CDBCRP) to mature, as a result of which these operations decreased from S/. 7,676 million in December 2005 to S/. 4,436 million in May 2006.

**Graph 13**  
**REFERENCE AND INTERBANK RATES IN DOMESTIC CURRENCY**



16. Banks' requirements of liquidity are explained by the sums of dollars that financial institutions purchased from the Central Bank during the period of greatest exchange volatility (from October 2005 to January 2006), which reduced the banks' availability of domestic currency. The regularization of income tax payments in April 2006 posted the unprecedented sum of S/. 2.2 billion (72 percent higher than that of the previous year), which intensified banks' demand for liquidity.

17. In this context of upward pressures on the interbank interest rate (and on the other short-term interest rates in the market), the BCRP sought to reduce them also by means of repo operations with longer maturity terms, including 1-week, 2-week, 1-month, and 3-month maturity terms. In doing so, the BCRP contributed to reduce the uncertainty of banks over the availability of liquid funds.

In addition, the BCRP increased banks' access to repo operations (liquid funds) by permitting that the Certificates of Deposits of the Central Bank (CDBCRP) be used in the auctions of these funds. Moreover, the BCRP coordinated with the Banco de la Nación in order that the latter give interbank loans to banks. This was carried out through auctions, which mainly involved one-week maturity terms. In this way, the Banco de la Nación reinjected into the financial system part of the funds (an average of S/. 900 million in April and May) that had been withdrawn from the system as a result of the regularization of income tax payments.

These measures contributed to reduce the upward pressures on the interbank interest rate, as a result of which it returned to its reference level (4.5 percent by the end of May).

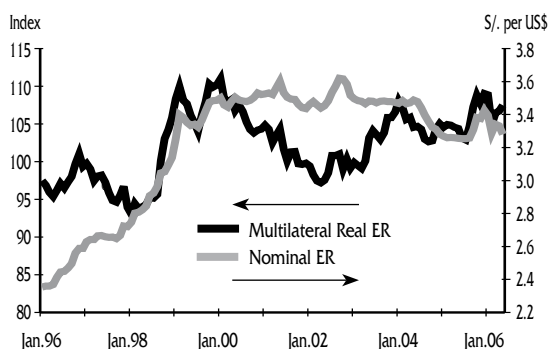
### III. EVOLUTION OF EXCHANGE RATE

Since the fourth quarter of 2005, the evolution of the exchange rate has been associated with elections-related uncertainties. In this period, the exchange rate showed a higher volatility, with fluctuations ranging between S/. 3.27 and S/. 3.45 per dollar, although showing a bias toward resuming the downward trend exhibited between 2003 and mid-2005. The BCRP intervened in the exchange market to moderate fluctuations in the exchange rate.

18. So far this year, the nuevo sol has appreciated 4.2 percent against the dollar in nominal terms. In real terms, the nuevo sol has appreciated 1.4 percent, given that the inflation differential (4.5 percent in the case of our commercial partners vs. 1.5 percent in the case of local inflation) was added to the aforementioned nominal appreciation.

The level of inflation recorded by our commercial partners was associated with the depreciation of the dollar in international markets. Year-to-date, the dollar has depreciated 7 percent against the euro and 6 percent against the yen, due to the likelihood of an interest rate increase in these countries.

**Graph 14**  
**NOMINAL AND REAL EXCHANGE RATE**



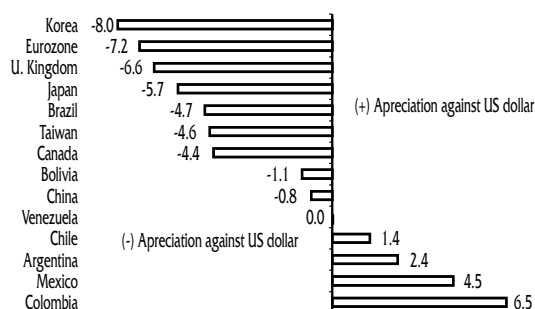
**Table 8**

**MAY 2006: BILATERAL EXCHANGE RATE (S/. per M.U.)**

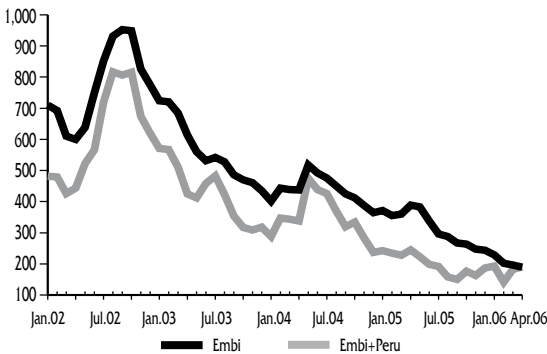
	Weighting*	Nominal Exchange Rate (% change)			Real Exchange Rate (% change)		
		May.06 Dec.04	May.06 May.05	May.06 Dec.05	May.06 Dec.04	May.06 May.05	May.06 Dec.05
USA	25.1%	-0.1	0.7	-4.2	2.9	2.3	-3.2
Eurozone	20.1%	-4.6	1.4	3.2	-4.3	1.2	2.7
Japon	10.3%	-7.2	-3.7	1.6	-9.8	-5.8	0.3
Brazil	6.4%	24.8	13.5	0.5	30.6	16.1	1.0
U. Kingdom	5.8%	-3.2	1.4	2.6	-2.5	1.7	2.5
Chile	4.8%	10.4	11.7	-5.6	12.8	13.3	-5.6
China	4.3%	3.2	4.1	-3.5	0.7	4.2	-6.0
Colombia	4.0%	-0.4	-2.9	-10.1	4.0	-1.2	-9.1
Mexico	3.4%	0.9	-0.2	-8.4	2.0	0.7	-9.1
Argentina	3.4%	-3.9	-5.8	-6.5	9.8	3.1	-3.5
Korea	3.3%	11.6	7.3	4.1	13.2	7.6	4.5
Taiwan	2.5%	1.3	-0.8	0.3	1.3	-1.7	-0.4
Venezuela	2.5%	-10.7	0.7	-4.3	2.2	8.2	-2.8
Canada	2.4%	9.6	14.0	0.2	10.4	14.2	0.2
Bolivia	1.8%	1.1	2.5	-3.2	4.9	5.3	-2.7
<b>Basket</b>	<b>100.0%</b>	<b>0.3</b>	<b>1.9</b>	<b>-1.5</b>	<b>2.3</b>	<b>2.9</b>	<b>-1.4</b>

\* 1994 trade weighting.

**Graph 15**  
**CURRENCY DEPRECIATION AND APPRECIATION OF PERU'S MAIN TRADE PARTNERS AGAINST US DOLLAR:**  
(May.06/Dec.05)

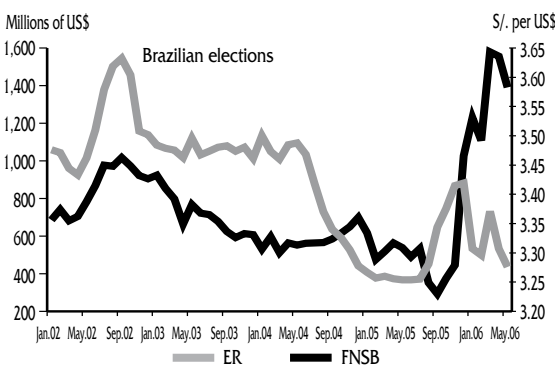


**Graph 16**  
**COUNTRY RISK INDICATORS**  
(Basis points)



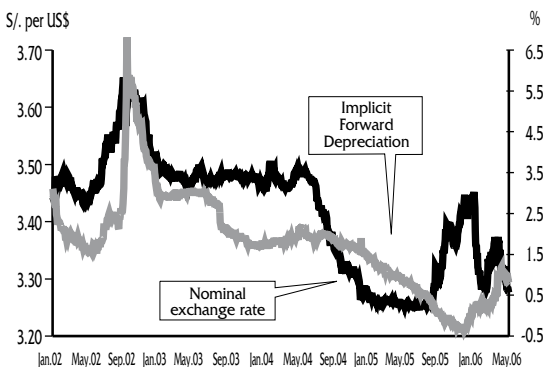
19. As a result of greater electoral uncertainty, between the end of September and December 2005, the nuevo sol depreciated 2.2 percent against the US dollar in nominal terms, rising from S/. 3.34 to S/. 3.42. This greater uncertainty was also observed in some periods over the first months of 2006, particularly during the first two weeks of January and from the end of March to the day of the first electoral round (April 9), and pressed the exchange rate upwards. During the rest of the time this year, the exchange rate has exhibited a downward trend, which reverted the previous increases. The uncertainty over electoral results was also reflected in the evolution of the country risk, which temporarily did not follow the same trend of other countries in the region, particularly in moments of high uncertainty such as the first two weeks of January and the weeks preceding the first electoral round. On February 27, during a period with one of the lowest levels of uncertainty, the country risk logged its minimum historic level: 128 bps.

**Graph 17**  
**FORWARD NET SALES BALANCES (FNSB) AND END OF PERIOD INTERBANK EXCHANGE RATE (ER)**



20. In line with the evolution of the country risk indicator, uncertainty over electoral results raised expectations of the depreciation of the nuevo sol in some periods during the first months of 2006. These stronger expectations of depreciation boosted public's demand for protection instruments face exchange risks (banks' forward selling operations). As a result, the balance of forward net sales to the public rose from US\$ 1,027 million in December 2005 to US\$ 1,391 million on May 30, 2006 (increasing by US\$ 400 million), having posted a maximum historic level of US\$ 1,650 million on April 17.

**Graph 18**  
**DAILY NOMINAL EXCHANGE RATE AND IMPLICIT FORWARD DEPRECIATION (3 MONTHS)**



21. The evolution of the forward depreciation implicit in the interest rate differential between nuevos soles and dollars increased in the January-April period. This not only reflected the greater demand for these hedging instruments and for funding these operations with soles (maturities ranging between 1 and 6 months) but also created an upward pressure on the interest rates in soles in the exchange market. In the case of 90-day maturities, this differential between nuevos soles and dollars rose from 6 bps in December 2005 to 118 bps as of April 19, 2006. Since then, this differential has dropped approximately 20 bps (on May 25, the differential was 88 bps), coinciding with a reduction of demand for forward selling operations and with the enhancement of maturity terms for BCRP repo operations.

Table 9

**EXCHANGE MARKET**  
 (Millions of US\$)

Month	Bank operations 1/		Banks International Position (Flows)	BCRP Operations 1/		End of exchange rate
	Forward Market	Spot Market		Spot Market	CDR Placement	
<b>2005</b>						
Average Jan.-Jun.	58	297	3	-353	0	3.25
Jul.	361	452	49	-765	0	3.25
Aug.	211	-43	-46	-214	0	3.28
Sep.	37	-35	-31	-33	0	3.34
Oct.	-105	67	45	34	50	3.38
Nov.	-107	122	68	53	-1	3.42
Dec.	-525	-78	40	345	300	3.42
<b>2006</b>						
Jan.	-310	-118	-69	355	4	3.31
Feb.	-130	262	74	-59	0	3.30
Mar.	-352	458	96	0	-10	3.37
Apr.	-59	103	44	0	0	3.31
May. 2/	-150	86	-64	1	0	3.30

1/ Negative sign for demand / positive sign for supply.

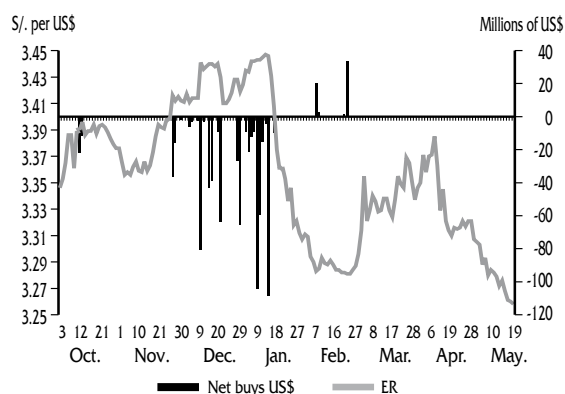
2/ Up to May. 29.

22. Conversely, when uncertainty grew lower, as in February and after the first electoral round, the demand for dollars in the foreign currency forward market decreased significantly, thereby dissipating the upward pressures on the exchange rate. The significant dollar supply in the spot market, explained by the requirements of liquidity to regularize Income Tax payments, generated downward pressures on the exchange rate.

23. In this context of exchange volatility, the Central Bank intervened by buying or selling dollars and by placing CDRBCRPs. When the upward volatility of the exchange market was significant, as in October 2005 and January 2006, the BCRP sought to moderate it with direct sales of US\$ 786 million to the banks and with the placement of US\$ 409 million worth of CDRBCRPs.

Conversely, when the downward volatility in the exchange market was higher, as in February 2006, the Central Bank moderated this by purchasing dollars from the banks. In this period, the BCRP bought US\$ 59 million, in response to treasury's demands for a similar sum. So far this year, a total of US\$ 705 million has been bought by the Banco de la Nación to meet its foreign currency requirements. These operations took place particularly in April and May.

**Graph 19**  
**INTERBANK EXCHANGE RATE AND BCRP INTERVENTION:**  
 October 2005 - May 2006



24. The exchange operations carried out by the Central Bank have been aimed at preventing that an excessive volatility of the exchange rate in a context of high financial dollarization have a negative impact on economic activity. The BCRP has not sought to eliminate exchange variability completely, given that the economic agents' perception of a BCRP's exchange insurance in a context of currency mismatch inhibits them from internalizing exchange-related risks and generates greater dollarization.

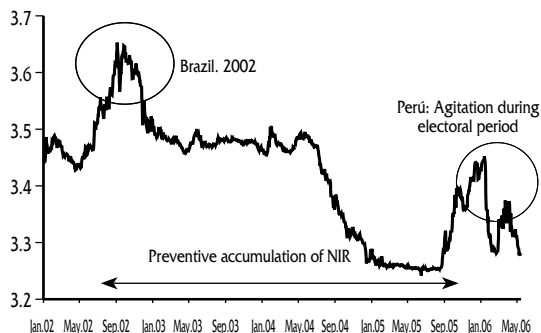
In relative terms, the variability of the exchange rate has currently increased with respect to other episodes of turbulence in terms of the interbank rate. This will favor financial dedollarization, because the real revenues of assests in nuevos soles are relatively more stable than those in dollars.

Table 10

**EXCHANGE RATE AND INTERBANK RATE VARIABILITY COEFFICIENTS**

Year	Interbank rate (a)	Exchange rate (b)	Ratio (%) (b) / (a)
1999	0.31	0.005	1.6
2000	0.21	0.003	1.7
2001	0.11	0.003	2.8
2002	0.15	0.004	2.8
2003	0.03	0.001	4.9
2004	0.03	0.003	12.2
2005	0.02	0.002	12.7
Abr.06	0.03	0.008	26.8

**Graph 20**  
**EVOLUTION OF EXCHANGE RATE**

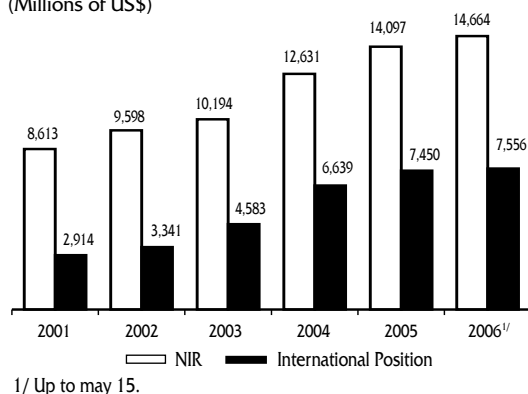


25. The likelihood that an upward-trend episode would take place during the electoral process had already been forecast in previous Inflation Reports<sup>1/</sup>. For this reason, and also for the risks that electoral processes in the rest of Latin America involved, for the rise produced in terms of international interest

1/ "In the event of any future volatility in financial markets, caused by elections in Peru and in the region, the Central Bank has accumulated a high level of international reserves." (Inflation Report, August 2005).  
"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."  
(Inflation Report, May 2005).



**Graph 21**  
**NET INTERNATIONAL RESERVES**  
**AND INTERNATIONAL POSITION**  
(Millions of US\$)



rates, and for the likelihood that an increase in terms of trade had a transitory component, the Central Bank preventively accumulated international reserves by purchasing foreign currency from the financial system between February 2003 and September 2005.

The BCRP net purchases of dollars in this period amounted to US\$ 3,674 million (net value relative to the sales of foreign currency carried out to meet the public sector's requirement of dollars). This operation took place in a context in which the economic agents were restructuring their currency portfolio, given the ongoing development of a dedollarization process. As a result of this, the downward pressure on the exchange rate was offset. This pressure was associated with the increased dollar inflow produced by foreign trade outcomes (the trade balance grew from US\$ 292 million in 2002 to US\$ 5,163 million in 2005) and with the remittance of funds by Peruvian citizens living abroad (which rise up from US\$ 705 to US\$ 1,440 million between 2002 and 2005).

Purchases of dollars in the exchange market were sterilized in order that the interbank interest rate would not deviate the reference level that was consistent with the inflation target.

### BOX 3

#### EVOLUTION OF INTERNATIONAL RESERVES

In the last 3 years, the BCRP has accumulated international reserves for approximately US\$ 4 billion, reaching a total of US\$ 14.2 billion at the close of May. The level of this coverage against adverse macroeconomic contingencies is one of the highest levels in the region and reduces the risks that might affect our economy.

Moreover, volatility episodes in the international markets, such as the one recently observed (see Box 4), highlight one more time the importance of having a sound international position - a position being consolidated by emerging economies.

#### NET INTERNATIONAL RESERVES OF EMERGING MARKETS

(Billions of US dollars)

	Balances		Flow
	1999	2005	2005
China	155	819	664
Malasya	31	71	40
Philippines	15	18	3
Thailand	34	52	18
Russia	13	174	161
Czech Republic	13	30	17
Argentina	26	23	-3
Brazil	35	54	19
Chile	14	17	3
Colombia	7	14	7
Mexico	31	73	42
Peru	9	14	5
Venezuela	12	23	11

Source: Bloomberg and FMI.

The risks taken into account to implement this preventive accumulation of international reserves in the Peruvian case included (i) the likelihood that the price rise that our exports currently show would be importantly reverted, (ii) the cycle of interest rate rises in the United States which have negatively affected the Latin American region, and (iii) the uncertainty associated with the electoral processes in the region, which is affecting the exchange and financial markets.

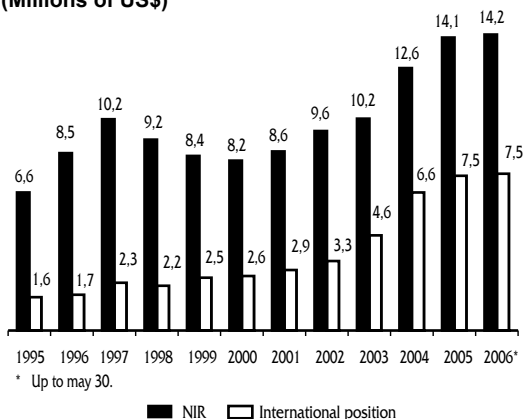
The vulnerability of an emerging economy vis-à-vis adverse shocks depends on a series of macroeconomic conditions, including high levels of : (i) current account deficit in the balance of payments; (ii) fiscal deficit; (iii) public debt; and (iv) dollarization in the economy (both in the public and private sectors).

Dollarization generates risks and, therefore, the Central Bank is trying to reduce it by implementing several measures, among which the following may be mentioned:

- maintaining a low and stable rate of inflation,
- favoring the development of a local debt market in soles,
- promoting awareness on the risks caused by financial dollarization through a high requirement of legal reserves in dollars, and
- promoting the full reestablishment of the nuevo sol as medium of payment for all economic transactions.

However, it will take time to dedollarize the economy. Therefore, measures are being implemented additionally in order to guarantee that the Central Bank will be able to provide dollar liquidity to the financial system transitorily during adverse situations, as well as to offset the evolution of the exchange rate in order to avoid that a significant depreciation of the nuevo sol might accelerate the balances of economic agents.

**NIR AND INTERNATIONAL POSITION: 1995-2006**  
(Millions of US\$)



For these reasons, it is important for the Central Bank to maintain a high level of international reserves. This will allow the BCRP to act as the dollar lender of last resort in situations of banks' illiquidity of this currency, thereby reducing this risk.

Maintaining a high level of international reserves allows to reduce the probability that higher risks of insolvency or illiquidity associated with a partially dollarized economy might materialize. This favors the economy's better credit rating in the international markets, which in turn promotes investment and contributes to develop a local debt market in nuevos soles.

Conversely, a reduced level of International Reserves not only increases the probability of occurrence of economic crises, but also reduces the economy's capacity to respond to these events. The evidence in our country, as well as in other emerging economies, is that the costs of economic crises caused by adverse macroeconomic shocks are significantly important in terms of both production and employment losses.

Today, our net international reserves (NIRs) cover twice the amount to be paid in the following twelve months on account of debt with non-residents. Additionally, NIRs cover over 70 percent of the total liquidity in the bank system. Moreover, empirical evidence shows that there are higher probabilities of financial crises in countries with low levels of international reserves in terms of their short-term external obligations.

**EXTERNAL VULNERABILITY INDICATORS\***

	2002	2003	2004	2005
1. NIR / debt due within a year (number of times) <sup>1/</sup>	2.1	2.1	2.2	2.6
2. NIR / broad money (%)	65	67	73	72

1/ Short-term debt plus amortization of medium and long term debt due in the next year.  
Ratio in 2004 excludes prepayment for 2005.

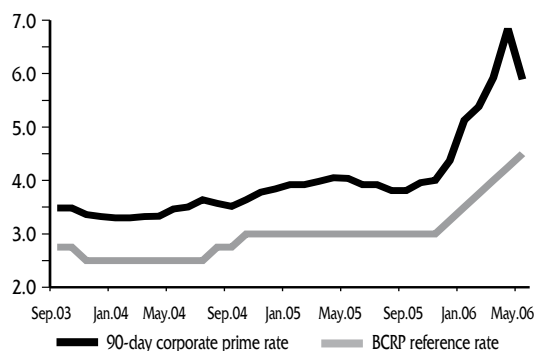
\* D. Rodrick and A. Velasco (1999) "Short-Term Capital Flows". NBER.

## IV. EVOLUTION OF FINANCIAL MARKETS

### IV.1 Interbank interest rates

Interest rates in soles, both on active and passive operations and with different maturity terms, showed increases during the first months of 2006. Interest rates in dollars, on the other hand, also increased, but in lesser magnitudes.

**Graph 22**  
**INTEREST RATES IN DOMESTIC CURRENCY**  
(Percentages)



26. The active corporate 90-day prime rate in soles showed a rising evolution in recent months, increasing from 4.37 percent in December 2005 to 6.84 percent in April 2006. This increase exceeded that of the BCRP reference rate during this period, as a result of which the differential between both rates was on average 1.4 percentage points in April (approximately 2.2 percentage points at the close of the month), although this differential has usually been one percentage point.

In this context, the BCRP implemented measures to offset the banks' sensation of illiquidity, thereby reducing the differential between the active corporate 90-day prime rate and the reference interest rate to nearly 1.5 percentage points as of May 15. This differential now exhibits a decreasing trend.

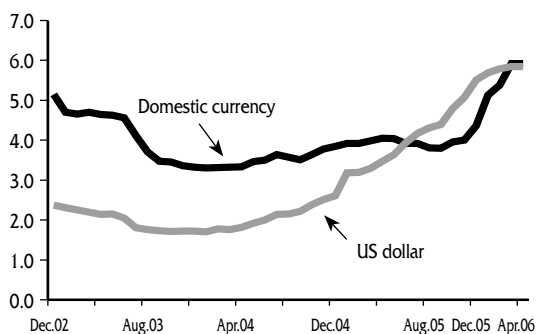
27. The differential between the overnight interest rate in nuevos soles and dollars has increased in the first months of 2006. This evolution is associated with the fact that the US Federal Reserve has risen its reference interest rate by 50 basis points since December 2005, whereas the BCRP increased its reference interest rate by 100 basis points in the same period.

**Table 11**

**INTEREST RATES IN DOMESTIC AND FOREIGN CURRENCY: 2005 - 2006**  
(Percentages)

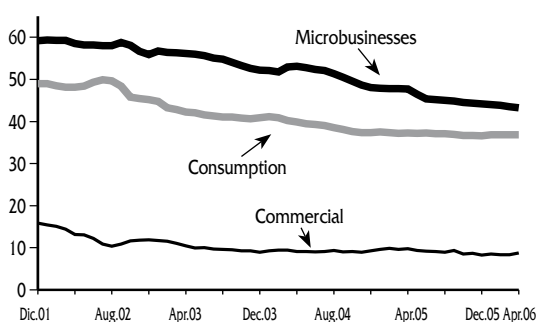
	(A) Domestic currency					(B) Foreign currency					Differential (A) - (B)				
	Dec.	May.	Aug.	Dec.	Apr.	Dec.	May.	Aug.	Dec.	Apr.	Dec.	May.	Aug.	Dec.	Apr.
	2004	2005	2005	2005	2006	2004	2005	2005	2005	2006	2004	2005	2005	2005	2006
1. Interbank and FED funds rate	3.00	3.00	3.00	3.25	4.25	2.25	3.00	3.50	4.25	4.75	0.8	0.0	-0.5	-1.0	-0.5
2. Deposits up to 30 days	3.1	3.3	3.2	3.6	5.5	2.1	2.8	2.9	3.6	4.0	1.0	0.5	0.2	-0.1	1.5
3. Term deposits between 31 to 180 days	3.3	3.4	3.6	3.6	5.0	1.7	1.9	2.6	2.9	3.1	1.6	1.5	1.0	0.7	1.9
4. Term deposits between 181 to 360 days	4.4	4.6	4.7	4.6	5.2	1.8	2.1	2.3	2.9	3.2	2.6	2.6	2.4	1.7	2.0
5. Corporate prime	3.8	4.0	3.8	4.4	6.8	2.6	3.6	4.3	5.5	6.1	1.2	0.4	-0.5	-1.1	0.8
6. Average lending up to 360 days	14.7	15.1	15.2	13.9	14.5	7.7	8.3	8.7	9.4	9.7	7.0	6.9	6.4	4.6	4.9
7. Average lending constant structure	18.2	18.1	17.7	17.0	17.3	9.4	9.7	9.8	10.3	10.4	8.8	8.4	7.8	6.8	7.0

**Graph 23**  
**3-MONTHS CORPORATE PRIME RATE**  
(Percentages)



This increased differential between the overnight interest rate in nuevos soles and in dollars has also been reflected in the market's other interest rates with different terms, especially on the short-term interest rates. This evolution was enhanced due to the lesser liquidity experienced by banks as a result of income tax payments from the end of March to mid-April.

**Graph 24**  
**DOMESTIC CURRENCY INTEREST RATES FOR COMMERCIAL, MICROBUSINESSES AND CONSUMPTION LOANS**  
(Percentages)



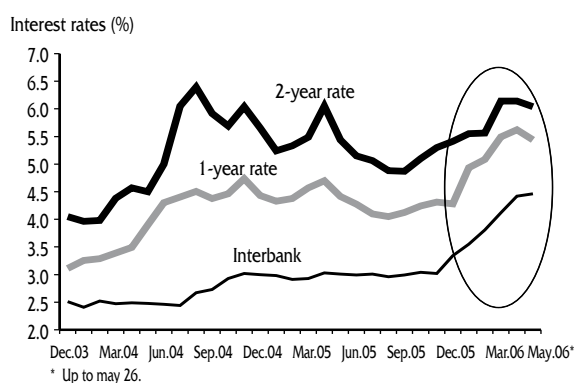
Thus, the interest rates in nuevos soles showing the stronger increase are the active corporate 90-day prime rate, which rose from 4.4 to 6.8 percent, and the interest rate on deposits up to 30 days, which rose from 3.6 to 5.5 percent.

28. The greater competition of banks in terms of lending to the consumption and microenterprise segments was reflected in the decline of their interest rates. The average interest rate on loans in soles to microenterprises fell from 44.2 percent in December 2005 to 43.3 percent in April 2006.

## IV.2 Bond Market

In May 2006, the first local currency denominated (nominal nuevos soles) bond with a 20-year maturity was issued. This bond issuance is aimed at consolidating the yield curve of bonds in nominal soles in the local market, and serves as reference for the issuance of private sector securities with increasingly longer maturities. This bond will be particularly relevant to the mortgage sector.

**Graph 25**  
**INTERBANK AND GOVERNMENT SECURITIES**  
**INTEREST RATES**



29. Between December 2005 and May 2006, yield rates of CDBCRPs and sovereign Treasury bonds (BTP) with a residual maturity up to two years showed, on average, an upward course. This development followed the upward trend of the interbank reference rate established by the Central Bank and the upward pressures in the monetary market resulting from banks' greater demand for nuevos soles for operations with short maturities. A decline of these rates was observed in May, together with a correction of short maturity rates.

30. Yield rates in the case of securities with longer maturities (over ten years) have followed a downward course, due to better macroeconomic prospects.

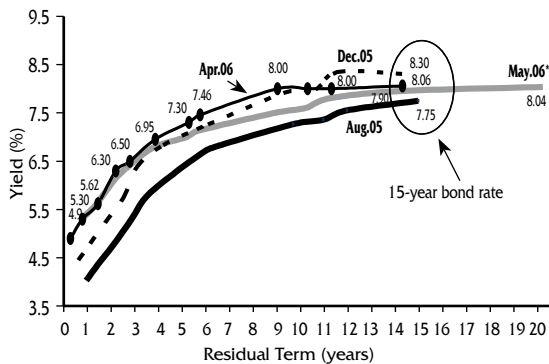
**Table 12**

**INTEREST RATES OF SOVEREIGN BONDS**  
**IN THE SECONDARY MARKET <sup>1/</sup>**  
(Percentages)

	12Aug.06	09Oct.07	09Jul.08	11Feb.09	10Mar.10	10Aug.11	31Jan.12	05May.15	12Aug.16	12Aug.17	12Aug.20	12Aug.26
<b>2005</b>												
January	4.89	5.87	6.40	6.97	-	8.70	-	-	-	-	-	-
February	4.83	5.63	6.10	6.35	7.30	8.26	8.68	-	-	-	-	-
March	5.03	5.69	6.36	6.79	7.68	7.79	8.59	-	-	-	-	-
April	5.15	6.07	6.44	6.95	7.80	8.25	8.63	-	-	-	-	-
May	4.94	5.83	6.28	6.73	7.56	7.95	8.31	9.30	-	-	-	-
June	4.47	5.40	6.03	6.52	7.06	7.65	7.83	8.72	-	-	-	-
July	4.19	5.04	5.51	6.08	6.51	7.10	7.21	7.86	-	8.45	7.87	-
August	4.00	4.80	5.36	5.69	6.31	6.76	6.96	7.34	7.36	7.65	7.86	-
September	4.01	4.79	5.24	5.53	6.11	6.44	6.47	7.15	6.92	7.28	7.45	-
October	4.14	4.91	5.39	5.57	6.44	6.65	6.83	6.70	7.75	7.79	7.79	-
November	3.99	5.09	5.52	5.85	6.30	6.60	6.67	7.24	7.48	7.69	7.80	-
December	4.45	-	5.62	6.32	6.77	7.11	7.06	7.88	7.99	8.21	8.15	-
<b>2006</b>												
January	4.56	5.35	5.87	6.38	6.90	7.04	7.29	7.72	7.75	8.05	8.17	-
February	4.67	5.38	5.75	6.03	6.63	6.79	6.89	7.33	7.27	7.59	7.67	-
March	4.81	5.72	6.28	6.50	6.73	6.79	7.02	7.71	7.52	7.59	7.92	-
April	4.90	5.70	6.36	6.66	7.41	7.51	7.76	8.00	-	8.05	8.17	-
May (2-26)	-	5.62	6.24	6.46	6.82	7.00	7.22	7.51	7.64	7.76	7.97	8.18

<sup>1/</sup> Average interest rate for each period.

**Graph 26**  
**SECONDARY MARKET OF PUBLIC TREASURY**  
**SOVEREIGN BONDS**<sup>1/</sup>  
 (Percentages)



\* Up to may 26.

1/ Sovereign bonds' yield registered in the transaction most close to the end-of-period of the secondary market.

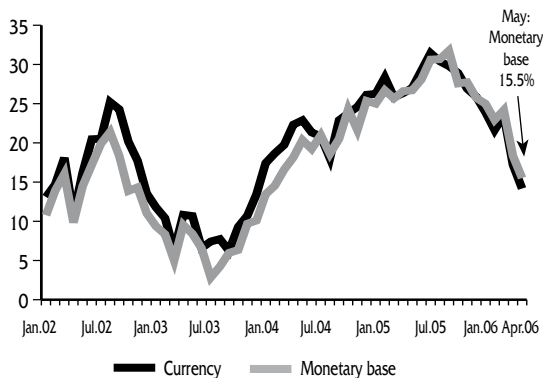
31. The first sovereign bonds with a 20-year maturity was issued on May 2. The issuance of these bonds seeks to continue consolidating a yield curve for bonds in nominal soles that may serve as reference for private sector securities with increasingly longer maturities. Likewise, this yield curve will also serve as reference for mortgage loans in nominal soles with longer maturities, thereby allowing to reduce mortgage installments given their longer maturities. Hence, not only will this contribute to a greater dynamism of this type of loans, but also to financial dedollarization, since the loans are denominated in nominal nuevos soles.

The quotations of said sovereign bonds during May confirm the upward yield trend that these securities with longer maturities showed in previous months. The 8.04 percent yield of these securities was below the yield rate recorded by the 15-year bond in the last transaction made in April (8.06 percent).

Thus, together with Mexico, Peru has the local currency (nominal) denominated bond with the longest maturity in the region.

### IV.3 Liquidity and credit

**Graph 27**  
**CURRENCY AND MONETARY BASE BALANCE**  
**GROWTH IN NUEVOS SOLES: January 2002 - May 2006**  
 (% change compared to same period in previous year)



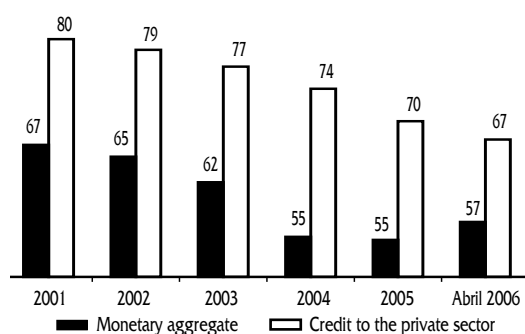
**Table 13**

**MONETARY AND CREDIT AGGREGATES**  
**OF THE FINANCIAL SYSTEM**  
 (Annual % change, end-of-period)

	2003	2004	2005	2006 Apr.06
Currency	13.4	26.3	25.8	17.1
Monetary base	10.1	25.3	25.7	18.3
Deposits in domestic currency	7.6	34.6	26.8	21.0
Total liquidity (banking system)	1.0	8.2	18.4	12.9
Credit to the private sector in S/.	11.9	11.0	33.6	38.5
Total credit to private sector	-0.8	1.9	17.5	15.7

32. The widest monetary aggregates continued to perform dynamically during the first four months of 2006. The growth rates of total liquidity in the bank system and of total credit to the private sector in the financial system were 12.9 and 15.7 percent respectively. Deposits in nuevos soles showed a slight desacceleration (21.0 percent). The annual growth of the narrowest monetary aggregates, such as currency and monetary base, also declined to 17.1 and 18.3 percent respectively.

**Graph 28**  
**BANKING SYSTEM DOLLARIZATION RATIO**  
(Percentages)



33. Although the monetization of the economy relected the continuous dynamism of economic activity in this period, uncertainty in the exchange market influenced the public's preference for foreign currency assets. The dollarization coefficient of bank obligations showed a slight increase, rising from 55 to 57 percent between December 2005 and April 2006, and temporarily changing the dedollarization trend that had been observed since 2000. However, the level of dedollarization in terms of credit to the private sector, both in the financial and the bank system, decreased 3 percentage points in the same period. Credits in local currency increased as a result of the lower cost of short term lending in soles with respect to lending in foreign currency.

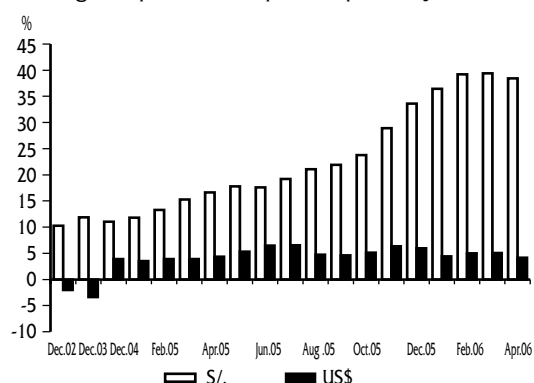
**Table 14**

**FINANCIAL DOLLARIZATION INDICATORS**  
(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	55	70	67
2006 1/	57	67	64

1/ Up to April 2006.

**Graph 29**  
**CREDIT TO THE PRIVATE SECTOR**  
(% change compared to same period in previous year)



34. Credit to the private sector in the financial system - including loans to enterprises and families from non-bank financial entities - recorded an annual growth rate of 15.7 percent. This evolution was mainly due to banks and microfinance institutions, as well as to the greater participation of institutional investors.

35. As in previous years, financial system loans in soles to the private sector outpaced the growth of loans in dollars. Due to the increased growth of this component, sol lending showed an annual growth of 38.5 percent as of the close of April, while dollar lending increased by 4.2 percent in the same period.

36. Banks were responsible for the lion's share (S/. 3,981 million) of the growth in sol lending in the last 12 months (S/. 6,695 million) because of the increase recorded in their segments of commercial and consumer loans. The largest commercial bank loans went to the manufacturing and commerce sectors. With this, banks' annual growth of loans in soles increased from 37.1 percent in December 2005 to 45.5 percent in April 2006.

Likewise, an expansion was also observed in the case of loans in soles made by microfinance institutions (S/. 1,597 million) and by institutional investors (S/. 773 million), as a result of the proceeds of fixed-income securities in soles.

**Table 15**

**FINANCIAL SYSTEM LOANS IN SOLES TO THE PRIVATE SECTOR**

	Balance in millions of soles			Rates of growth	
	Apr.05	Dec.05	Apr.06	Apr.06/ Apr.05	Apr.06/ Dec.05
Banks 1/	8,747	11,606	12,728	45.5	9.7
Banco de la Nacion	1,162	1,277	1,384	19.1	8.3
<b>Microfinance institutions</b>	<b>4,624</b>	<b>5,882</b>	<b>6,221</b>	<b>34.5</b>	<b>5.8</b>
Banks (microfinance loans)	1,206	1,545	1,657	37.4	7.3
Municipal savings and loans	1,496	1,848	1,981	32.5	7.2
Rural savings and loans	274	348	383	39.9	10.2
Cooperatives	526	634	634	20.4	--
Edpymes	245	351	380	54.8	8.2
Finance companies	878	1,156	1,186	35.1	2.5
<b>Institutional investors 2/</b>	<b>2,552</b>	<b>2,900</b>	<b>3,325</b>	<b>30.3</b>	<b>14.7</b>
Pension funds	1,529	1,821	2,197	43.7	20.7
Insurance companies	821	751	806	-1.9	7.2
Mutual funds	202	328	322	59.5	-1.6
<b>Leasing companies and others</b>	<b>321</b>	<b>323</b>	<b>443</b>	<b>38.1</b>	<b>37.2</b>
<b>Total of Financial System</b>	<b>17,406</b>	<b>21,988</b>	<b>24,101</b>	<b>38.5</b>	<b>9.6</b>

1/ Excludes microfinance loans.

2/ Mainly securities issued by the private sector.

37. **Credit to the private sector in dollars** grew at an annual rate of 4.2 percent as of the close of April, which represented a flow of US\$ 510 million with respect to April 2005. Institutional investors contributed the most to this outcome, as they supplied an annual flow of US\$ 460 million, which includes pension funds' (AFPs) and mutual funds' investments in fixed-income instruments in this currency.



Table 16

**FINANCIAL SYSTEM LOANS IN DOLLARS  
TO THE PRIVATE SECTOR**

	Balance in millions of US dollars			Rates of Growth	
	Apr.05	Dec.05	Apr.06	Apr.06/ Apr.05	Apr.06/ Dec.05
Banks 1/	9,741	9,856	9,682	-0.6	-1.8
Banco de la Nacion	22	22	22	-0.9	-0.1
<b>Microfinance institutions</b>	<b>680</b>	<b>804</b>	<b>813</b>	<b>19.5</b>	<b>1.0</b>
Banks (microfinance loans)	134	177	170	27.4	-3.6
Municipal saving and loans	258	292	300	16.1	2.7
Rural saving and loans	55	56	56	2.8	1.2
Cooperatives	152	188	188	24.0	0.0
Edpymes	50	55	53	6.9	-2.1
Finance companies	32	37	45	41.3	19.8
<b>Institutional investors 2/</b>	<b>1,140</b>	<b>1,497</b>	<b>1,600</b>	<b>40.4</b>	<b>6.9</b>
Pension funds	593	733	808	36.2	10.2
Insurance companies	97	151	155	60.6	2.8
Mutual funds	450	613	637	41.5	3.9
<b>Leasing companies and others</b>	<b>643</b>	<b>669</b>	<b>619</b>	<b>-3.6</b>	<b>-7.4</b>
<b>Total for Financial System</b>	<b>12,226</b>	<b>12,848</b>	<b>12,736</b>	<b>4.2</b>	<b>-0.9</b>

1/ Excludes microfinance loans.

2/ Mainly securities issued by the private sector.

## V. INTERNATIONAL ENVIRONMENT

The world economy continues to show favorable prospects in terms of growth, with important improvements taking place in some developed economies (such as Japan and Europe) and in the main emerging economies (Russia, China, and India). This scenario has favored that commodity prices remain at high levels, and that expectations arise in terms of a significant adjustment of interest rates. However, risks associated with global imbalances, with the high prices of oil, and with a disacceleration of the real estate market in the US also remain.

### V.1 Economic situation of trading partners

38. The current forecast scenario considers correcting the forecasts on the overall growth of our trading partners in Europe, Asia, and Latin America upwards, as a result of which the forecast for 2006 has increased from 3.8 to 4.0 percent.

Table 17

#### FORECAST FOR THE MAIN TRADE PARTNERS' GDP GROWTH 1/ (Percentage)

	Trade 2004	2004	2005	Forecast		
				2006		2007
				IR Jan.06	IR May.06	IR May.06
<b>Trade partners 2/</b>		<b>4.8</b>	<b>4.0</b>	<b>3.8</b>	<b>4.0</b>	<b>3.6</b>
<b>North America</b>	<b>35%</b>	<b>4.1</b>	<b>3.5</b>	<b>3.4</b>	<b>3.4</b>	<b>2.9</b>
USA	33%	4.2	3.5	3.4	3.4	2.9
Canada	2%	2.9	2.9	3.0	3.0	2.8
<b>Europe</b>	<b>26%</b>	<b>2.5</b>	<b>1.9</b>	<b>2.2</b>	<b>2.4</b>	<b>2.2</b>
Germany	3%	1.6	0.9	1.6	1.8	1.1
United Kingdom	6%	3.1	1.8	2.1	2.3	2.5
<b>Asia</b>	<b>15%</b>	<b>7.1</b>	<b>6.8</b>	<b>6.1</b>	<b>6.8</b>	<b>6.2</b>
China	8%	10.1	9.9	8.7	9.6	8.8
Japan	4%	2.3	2.7	2.2	3.0	2.3
<b>Latin America</b>	<b>23%</b>	<b>6.8</b>	<b>5.3</b>	<b>4.6</b>	<b>4.9</b>	<b>4.4</b>
Argentina	2%	9.0	9.2	6.2	7.7	5.2
Brazil	5%	4.9	2.3	3.4	3.5	3.7
Chile	7%	6.1	6.3	5.5	5.6	5.3

1/ Consensus Forecast data as of the corresponding month.

2/ Weighted according to the 2004 trade.

39. The major developed economies show a positive evolution simultaneously. In the **United States of America**, despite the mixed results of economic activity indicators, these indicators seem to confirm that the desacceleration of growth produced in the fourth quarter of 2005 was temporary. The United States is estimated to grow at a rate of 3.4 percent this year and of 2.9 percent in 2007, estimates that are slightly lower than those forecast in January 2006.

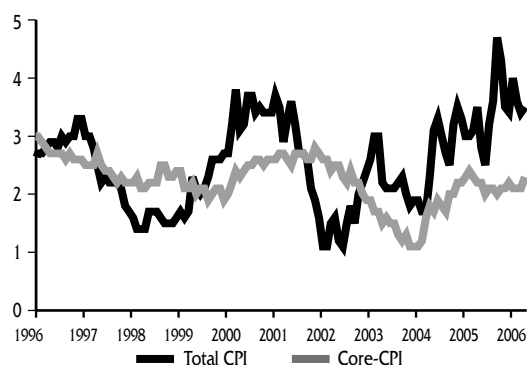
**Table 18**

**MAIN USA INDICATORS 1/**

	2002	2003	2004	2005	2006	2007
GDP growth (%)	1.6	2.7	4.2	3.5	3.4	2.9
Personal consumption (annual % change)	2.7	2.9	3.9	3.5	3.3	2.8
Investment in businesses (annual % change)	-9.2	1.3	9.4	8.6	9.1	6.7
<b>Gaps</b>						
Curren Account (billions of US\$)	-475	-520	-668	-805	-898	-892
Fiscal Balance (billions of US\$)	-158	-378	-413	-318	-351	-351
<b>Inflation Indicators</b>						
Consumer prices (average)	1.6	2.3	2.7	3.4	3.2	2.4
Producer prices (average)	-1.3	3.2	3.6	4.9	3.2	1.7
Laboral costs (annual % change)	3.6	3.8	3.7	3.3	3.3	3.5
<b>Interests rates</b>						
3-month treasury bonds (annual % change)	1.2	0.9	2.2	4.0	5.0	4.9
10-year treasury bonds (annual % change)	3.8	4.4	4.2	4.4	5.1	5.2
Spread between short and long term rates (bps.)	260	350	200	40	10	30

1/ Source: Consensus Forecast of May 2006.

**Graph 30**  
**USA: TOTAL CPI AND CORE-CPI**



**Graph 31**  
**USA: USED INSTALLED CAPACITY**  
(As percentage of total)



Source: Bloomberg.

**Prices**, on the other hand, remain stable, but still show high levels. The annual inflation of the CPI at April is 3.5 percent (after reaching 4.3 in October 2005 and 4.0 percent in May 2006); while the **core inflation** of the CPI is considerably lower, exhibiting a rate of 2.3 percent in April. However, as pointed out by the FED, the possibility that inflationary pressures will intensify in the forthcoming months may not be eliminated, due to recent trends in oil prices and to the high use of installed capacity which has recorded its maximum level since July 2000.

Growth in the trading partners of **Europe** is estimated at 2.4 percent, which assumes a recovery boosted by investment in the first quarter of 2006. This result is produced in the context of inflationary pressures which have driven inflation to a level above the limit of 2.0 percent.

**Table 19**

**MAIN EUROZONE INDICATORS 1/**

	2002	2003	2004	2005	2006	2007
<b>Activity indicators</b>						
GDP growth (%)	1.0	0.7	1.8	1.4	2.1	1.8
Private consumption (annual % change)	0.9	1.1	1.4	1.4	1.6	1.5
Gross fixed investment (annual % change)	-1.4	0.8	1.9	2.5	3.4	3.3
<b>Gaps</b>						
Current Account (billions of US\$)	37.5	31.2	75.2	2.5	-23.8	-1.4
Fiscal Balance (billions of euros)	-183.0	-227.0	-213.0	-189.0	-204.0	-189.0
<b>Inflation Indicators</b>						
Consumer prices (average)	2.3	2.1	2.1	2.2	2.1	2.1
Producer prices (average)	-0.1	1.4	2.3	4.1	3.5	1.8
Laboral costs per hour (annual % change)	3.7	3.3	3.5	2.6	2.4	2.4

1/ Source: Consensus Forecast de mayo de 2006.

All Euro zone countries included.

In the particular case of **Germany and France**, the most dynamic component continues to be exports, which are expected to grow at much higher rates than the GDP in 2006 and 2007 (between 5.0 and 6.0 percent). In 2007, Europe's partner economies are expected to grow 2.2 percent on average.

**Table 20**

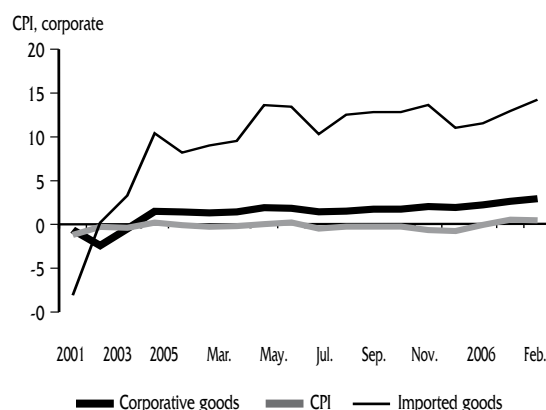
**MAIN GERMANY INDICATORS 1/**

	2002	2003	2004	2005	2006	2007
<b>Activity indicators</b>						
GDP growth (%)	0.1	-0.2	1.6	0.9	1.8	1.1
Private consumption (annual % change)	-0.5	0.1	0.6	0.0	0.6	0.2
Gross investment (annual % change)	-7.5	-0.2	2.6	4.0	5.6	3.9
<b>Gaps</b>						
Current Account (billions of US\$)	40.8	45.5	101.7	114.8	98.3	122.7
Fiscal Balance (billions of US\$ euros)	-65.2	-74.1	-64.9	-72.0	-67.0	-54.9
<b>Inflation Indicators</b>						
Consumer prices (average)	1.4	1.1	1.7	2.0	1.7	2.3
Producer prices (average)	-0.6	1.7	1.6	4.6	4.3	2.1
Laboral costs per hour (annual % change)	3.2	2.5	1.8	1.5	1.8	1.8
<b>Interest rates</b>						
3-month euros (annual % change / end of period)	2.9	2.1	2.2	2.5	3.0	3.3
10-year government bonds (annual % change / end of period)	4.2	4.3	3.7	3.3	4.0	4.0
Spread between short and long term rate (bps).	130	220	150	80	100	70

1/ Source: Consensus Forecast of May 2006.

The end of the deflationary process in **Japan** is expected to intensify the favorable prospects for the domestic market. The consumer price index has shown positive annual variations in the months of May and March (between 0.4 and 0.5 percent),

**Graph 32**  
**JAPAN: DIFFERENT INFLATION INDICATORS**



due to the price evolution of imported goods. However, the GDP deflator is still negative. Should this trend materialize, Japan could get into a virtuous circle where real interest rates incentivate consumption and investment, as a result of which the recent economic recovery might consolidate. In this context, the growth forecast for this country was raised from 2.2 to 3.0 percent for 2006, and from 2.1 to 2.3 percent for 2007.

**Table 21**

**MAIN JAPAN INDICATORS 1/**

	2002	2003	2004	2005	2006	2007
<b>Activity indicators</b>						
GDP growth (%)	0.1	1.8	2.3	2.7	3.0	2.3
Private consumption (annual % change)	1.1	0.6	1.9	2.2	2.3	2.0
Investment in businesses (annual % change)	-5.2	6.2	4.6	7.9	6.5	5.6
<b>Gaps</b>						
Current Account (billions of US\$)	112.6	136.2	172.1	163.9	140.2	133.6
Fiscal Balance (trillions of yenes)	-29.2	-35.3	-32.9	-29.4	-24.7	n.d.
<b>Inflation Indicators</b>						
Inflation (average)	-1.0	-0.3	0.0	-0.3	0.4	0.6
Corporate goods prices (annual % change)	-2.1	-0.8	1.2	1.7	1.9	0.5
<b>Interest rates</b>						
3-month Deposit Certificates (annual % change)	0.1	0.1	0.1	0.1	0.3	0.8
10-year government bonds (annual % change / end of period)	0.8	1.4	1.4	1.5	2.0	2.2
Spread between short and long term rates (bps).	70	130	130	140	170	140

1/ Source: Consensus Forecast of May 2006.

40. Growth forecasts for 2006 in the case of **China** and other economies not included among the 20 main trading partners, such as **India** and **Russia**, have been revised upwards. These developments, together with those of developed economies, impact on Latin America's terms of trade and demand for export products, which show positive prospects for growth. The evolution has also been positive in the case of emerging economies.
41. **China** continues to grow at significant rates, as a result of which the GDP growth rates for 2006 and 2007 have also been revised (from 8.7 to 9.6 percent for 2006 and from 8.3 to 8.8 percent for 2007). In the first quarter, the GDP grew by 10.2 percent, due to various factors including higher investment, high levels of domestic consumption, and dynamism in the domestic market (trade surplus reached US\$ 11.2 billion in March - the second historic record-, and US\$ 10.5 billion in April).

Inflation, which reached a maximum level of 5.3 percent in August 2004, has been declining gradually, posting 1.2 percent in April 2006. Likewise, prices to producers decreased from a maximum of 8.4 percent in October 2005 to 1.9 percent in April 2006. Despite this positive price evolution, fears remain with respect to a possible overheating in some sectors. In this context, and after 18 months, the Central Bank of China increased its reference interest rate for loans by 27 pbs., to 5.85 percent.

**Table 22**

**MAIN CHINA INDICATORS 1/**

	2002	2003	2004	2005	2006	2007
<b>Activity indicators</b>						
GDP growth (%)	9.1	10.0	10.1	9.9	9.6	8.8
<b>Gaps</b>						
Current Account (billions of US\$)	35.4	45.9	68.7	140.8	136.5	126.8
<b>Inflation Indicators</b>						
Inflation (average)	-0.8	1.2	3.9	1.8	2.2	2.3
<b>Interest rates</b>						
For 1-year labor capital	5.3	5.3	5.6	5.6	5.9	6.0

1/ Source: Consensus Forecast of May 2006.

42. **Latin America** also shows significant growth, favored by world growth and by the high international prices of commodities. In terms of countries, there is a generalized growth, although the cases of Chile and Colombia should be highlighted, as the growth of exports has been coupled by the expansion of domestic demand.

**Chile** is estimated to grow at a rate of 5.6 percent in 2006, after having grown at 6.3 percent in 2005. The reduction of unemployment to unprecedented levels, as well as February's trade surplus are noteworthy. In the first quarter of this year, domestic demand appears to have moderated its growth in a context where the Central Bank has been gradually increasing its interest rate to set it at 5.0 percent. Furthermore, inflation has been increasing, and has reached 3.8 percent, a level which is close to upper limit of the 4.0 percent inflation target.

**Argentina** and **Venezuela** also recorded important expansion, although showing higher inflation rates. Considering its economic evolution in the first quarter, Argentina is expected

to grow 7.7 percent in 2006 and 5.2 percent in 2007. Venezuela, on the other hand, grew 7.9 percent during the first quarter of 2006, mainly due to the evolution of the non-oil sector, particularly construction. This country is expected to grow 7.4 percent in 2006 and 5.0 percent in 2007.

**Mexico** and **Brazil**, on the other hand, show lower growth rates. Both countries have been flexibilizing their monetary policies in a context of moderate growth, high trade surpluses, and moderate inflationary pressures. Thus, for the ninth time the Central Bank of Mexico reduced its overnight interest rate, which fell from a maximum of 9.75 percent in August 2005 to 7.0 percent (a 25 bps. reduction) on April 21. Likewise, and for the seventh consecutive time since September 2005, in April the Central Bank of Brazil reduced the reference rate by 75 bps., reaching a level of 15.75 percent in line with market expectations.

Table 23

## MAIN LATIN AMERICAN INDICATORS 1/

	2002	2003	2004	2005	2006	2007
<b>GDP growth (%)</b>						
Argentina	-10.9	8.8	9.0	9.2	7.7	5.2
Brazil	1.9	0.5	4.9	2.3	3.5	3.7
Chile	2.2	3.9	6.2	6.3	5.6	5.3
Mexico	0.8	1.4	4.2	3.0	4.0	3.4
<b>Private consumption (annual % change)</b>						
Argentina	-12.8	7.0	8.3	8.5	7.0	4.8
Brazil	-0.4	-1.5	4.1	3.1	3.9	3.9
Chile	2.4	4.2	6.1	8.2	6.4	5.5
Mexico	1.6	2.2	4.1	5.4	5.0	4.3
<b>Gross fixed capital formation (annual % change)</b>						
Argentina	-36.4	38.2	34.4	22.7	16.6	9.9
Brazil	-4.2	-5.1	10.9	1.8	5.6	6.6
Chile	1.5	5.7	11.7	24.7	11.2	8.4
Mexico	-0.6	0.4	7.5	7.6	7.7	5.9
<b>Current Account (billions of US\$)</b>						
Argentina	8.6	7.7	3.3	5.4	4.4	3.0
Brazil	-7.6	4.2	11.7	14.2	9.1	4.0
Chile	-0.6	-1.0	1.6	0.7	2.0	0.2
Mexico	-13.5	-8.6	-7.2	-5.7	-6.7	-10.9
<b>Overall balance of the Public Sector (% of GDP) 2/</b>						
Argentina	-1.5	0.5	2.6	1.8	1.7	1.6
Chile	-1.3	-0.4	2.2	4.8	5.7	3.2
Mexico	-1.2	-0.6	-0.2	-0.1	0.0	-0.1
<b>Inflation (acumulated)</b>						
Argentina	41.0	3.7	6.1	12.3	12.3	11.6
Brazil	12.5	9.3	7.6	5.7	4.4	4.5
Chile	2.8	1.1	2.4	3.7	3.2	2.9
Mexico	5.7	4.0	5.2	3.3	3.4	3.5

1/ Source: Latin American Consensus Forecast of May 2006.

2/ For Argentina is the overall balance of the non-financial Public Sector. For Chile is the overall balance of the General Government. For Mexico is the overall balance of the Public Sector including privatization.

43. In line with the best economic fundamentals, the region's spreads decreased with respect to the previous Inflation Report. This drop was also associated with the restructuring of the external debt in order that it include longer maturities and be oriented mainly to domestic currency. It is worth noting that a better debt management has been observed over the past year through debt repurchase, debt swap, and extension of the yield curve in local currency.

**Table 24**

**EMERGING MARKET BOND SPREAD INDEX (EMBI+)**

	Dec. 03 (1)	Dec. 04 (2)	Dec. 05 (3)	May. 06* (4)	Pbs changes (4) - (2)
Emerging economies	418	356	245	215	-30
Latin America	521	466	283	239	-44
Brazil	463	382	311	273	-38
Colombia	431	396	238	207	-31
Mexico	199	180	126	146	20
Argentina	5,632	4,703	504	369	-135
Peru	312	220	206	178	-28

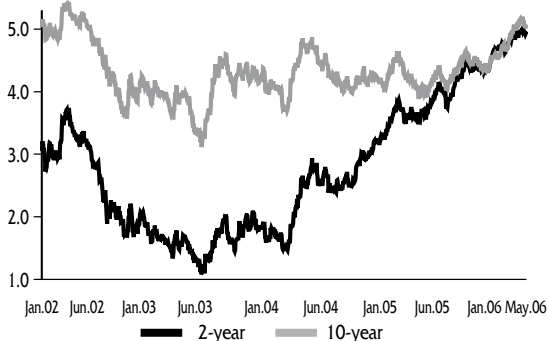
\* Up to May 26, 2006.  
Source: Reuters.

**Evolution of international interest rates**

44. In line with the macroeconomic evolution in the United States if America, the **FED** increased its interest rates to continue gradually withdrawing monetary stimulation. Between December 2005 and May 2006, the rate was raised at a 25 bps. pace in three different months (January, March, and May), thus increasing from 4.25 to 5.00 percent.

The FED has stated that additional increases may be produced should inflationary pressures arise as a result of the high prices of oil and the high use of installed capacity. Therefore, it is estimated that the FED is likely to raise its interest rate up to 5.25 in 2006. Forecasts assume that this rate would remain throughout 2007, although this does not eliminate the possibility of an additional increase.

**Graph 33**  
**US TREASURY YIELD**  
(Percentages)



Source: Bloomberg.

45. Long-term interest rates have shown a higher increase than short-term interest rates so far this year. Thus, US 10-year Treasuries rose from 4.40 percent at the end of 2005 to 5.10 percent at the close of May 2006, thus reversing the trend observed at the end of last year when the yield of these securities was even lower than the short-term rates. This upward trend appears to be influenced by fears that the high oil prices will impact on inflation and therefore affect the real return of these securities.



46. In Europe, the **European Central Bank (ECB)** has raised its interest rate twice since December, in a context marked by some economic recovery and inflationary pressures. Although the ECB has not modified its rate in its last meetings, it has suggested that the interest rate might be raised in June. The market assumes that this increase would take place in June and in the second six-month period of this year, as a result of which the rate would range between 3.0 and 3.5 percent, depending on how the signs of greater inflationary pressures and of acceleration of the economy evolve.

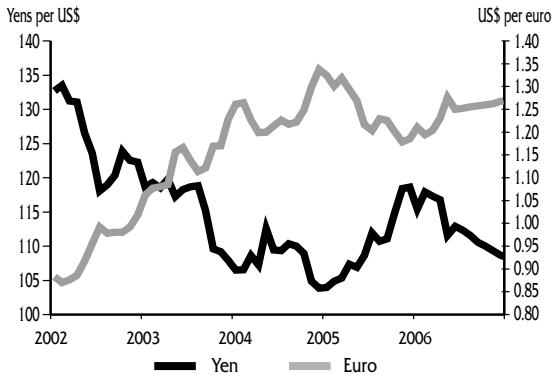
Table 25

**LAST DECISIONS OF THE CENTRAL BANKS (Up to May 30, 2006)**

Country	Interest rates	Last meeting		
		Date	Direction	Rate
<b>AMERICA</b>				
United States	Federal Funds	10-May-06	+	5.00
Canada	Overnight (Loans)	24-May-06	+	4.25
Peru	Reference rate	4-May-06	+	4.50
Chile	Monetary policy	11-May-06	=	5.00
Mexico	Overnight rate	26-May-06	=	7.00
Colombia	Repo (reverse)	26-May-06	=	6.25
Brazil	Selic	19-Apr-06	-	15.75
<b>EUROPE</b>				
ECB	Minimum auction	4-May-06	=	2.50
United Kingdom	Repo	4-May-06	=	4.50
Rumania	Base rate	11-May-06	=	8.50
Iceland	Repo	18-May-06	+	12.25
Hungary	Repo (2 sem)	22-May-06	=	6.00
Czech Republic	Repo (2 sem)	25-May-06	=	2.00
Turkey	Overnight (Deposits)	25-May-06	=	13.25
Slovaquia	Repo (2 sem)	25-Apr-06	=	3.50
Poland	Intervention (28d)	26-Apr-06	=	4.00
Norway	Deposits rate	26-Apr-06	=	2.50
Sweden	Repo rate	28-Apr-06	=	2.00
<b>ASIA</b>				
Japan	Liquidity target (trills. of yens)	19-May-06	+	14.30
China	Loans rate (12 m)	27-Apr-06	+	5.85
Australia	Cash Overnight	3-May-06	+	5.75
Philippines	Repo rate reverse	4-May-06	=	7.50
Indonesia	SB(1m)	9-May-06	-	12.5
South Korea	Overnight Call Rate	11-May-06	=	4.00
Sri Lanka	Overnight (Deposits)	15-May-06	=	8.75
Malasya	Overnight	22-May-06	=	3.50
Israel	Short term credit	29-May-06	=	5.25
Thailand	Repo (14d)	10-Apr-06	+	4.75
India	Repo (Reverse)	18-Apr-06	=	5.50
New Zeland	Official Cash	27-Apr-06	=	7.25
<b>AFRICA</b>				
Sout Africa	Repo	13-Apr-06	=	7.00

Source: Bloomberg.

**Graph 34**  
**EURO AND YEN PRICES**



Source: Bloomberg.

47. Moreover, in line with the best economic conditions and with the reversal of the deflationary process, the Bank of Japan (BOJ) announced the reduction of cash in banks' current accounts from a range of 30 thousand to 35 thousand trillion yen to 6,0 thousand trillions yen. This reduction would be gradual and would culminate in June 2006. Likewise, the BOJ is expected to raise its rate during the last six months of this year.

**Evolution of the US dollar in international markets**

48. Year-to-date, the dollar has depreciated 3.6 percent against the euro and 1.6 percent against the yen. Prospects of a lower rate differential favoring the dollar and better macroeconomic prospects in the case of Japan and the Eurozone would have influenced this evolution. The depreciatory trend of the dollar against the main currencies is expected to continue during the rest of the year.

**V.2 Terms of trade**

*So far this year, our terms of trade have shown a significant growth due to the favorable evolution of most commodities, which exceeded initial forecasts. Prospects in the rest of 2006 are even more favorable, but must be corrected downward with respect to current levels, basically due to a desacceleration of industrial demand which is associated with lower growth rates, particularly in the cases of the United States and China. This price correction is expected to continue in 2007, but with average levels that would still be over those recorded in 2005.*

49. In the first quarter of this year, our terms of trade increased 17 percent with respect to the same period last year, reflecting a generalized price rise of the main commodities, which in some cases posted unprecedented price levels. This was the case of oil, copper, zinc, and gold (which recorded its highest record ever in the last 26 years).

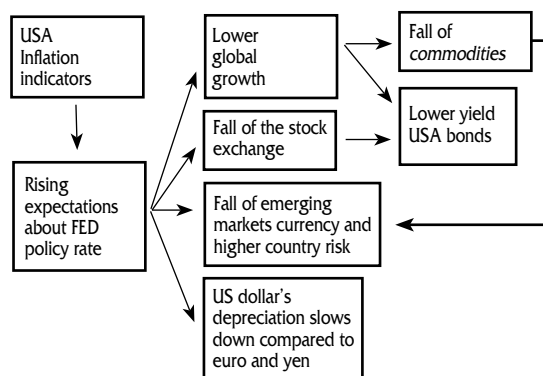
This generalized price rise may be explained by short-term supply restriction-related problems in the basic metal market of copper and zinc, and in the oil market, as well as by increased global demand-related problems, which are being intensified by the low levels of inventories of these products.

**BOX 4**  
**RECENT DEVELOPMENTS IN INTERNATIONAL MARKETS**

In the last weeks of May, financial markets recorded high volatility, partly generated by the possibility that the FED will increase its interest rates. The probability of an additional adjustment in the FED's meeting of June has increased from 32 percent at the beginning of May to 54 percent at the close of the month.

Among other possible effects, this has reduced expectations of growth and has also affected commodity prices (copper logged drops to even 14 percent). This has also implied some reversion of financial flows, with the subsequent fall of stock exchange markets, as well as the rise of security spreads in emerging markets, the depreciation of most currencies, and the drop of Treasuries' yield.

Although this volatility declined over the past week, the possibility that this might happen again in the future cannot be eliminated, considering that global prospects point to a reduction of monetary stimulation in most of the developed economies (particularly the Eurozone and Japan). In addition, there are other factors, such as the possible slow down of China, persistent high prices of oil, or an increased risk aversion that might heighten a scenario such as the one described herein.



Hence, the relevance that this scenario may have on emerging economies. In the case of trade, an adjustment -higher than the one foreseen by the market- is likely to be made in the price of commodities, particularly in those products (such as copper and zinc) whose prices are strongly linked with the evolution of global economic activity. In Peru, a drop in the price of these products could be partially offset by a better price of gold, which is usually pressured upwards in scenarios of higher inflation and increased risk aversion.

In the financial arena, a lower global liquidity and a higher risk aversion might bring about additional pressures on the spreads and currencies of emerging economies. Pressures on the currencies of some economies showing high current account deficits (Iceland, New Zealand, Turkey, and Hungary) allow to predict that the economies showing

greater external imbalances would be in a less advantageous position, which could additionally be aggravated by a weak fiscal position or by the long-term local currency position that non-residents hold in some of these countries.

**CURRENT ACCOUNT BALANCE AS PERCENTAGE OF GDP\***  
(Ratio)

Country	1999	2000	2001	2002	2003	2004	2005	2006	2007
Iceland	-6.9	-10.3	-4.4	1.5	-5.0	-9.4	-16.6	-13.8	-8.6
New Zealand	-6.2	-5.2	-2.8	-4.0	-4.3	-6.6	-8.8	-8.9	-7.6
Thailand	10.2	7.6	5.4	5.5	5.6	4.2	-2.3	-2.0	-2.1
Turkey	-0.7	-5.0	2.4	-0.8	-3.3	-5.2	-6.3	-6.5	-6.1
Hungary	-7.9	-8.5	-3.2	-4.6	-7.2	-8.8	-8.7	-9.1	-8.9

\* Source: World Economic Outlook, April 2006.

In this sense, it is worth highlighting that the Peruvian economy has been more robust in terms of its external and fiscal accounts over the past years, and that these factors have played a role not only in the lower exchange volatility observed, but also in the moderate fall of its stock exchange market vis-à-vis other emerging economies during recent periods of market turbulence.

It is also worth noting that these factors have been encourage speculators' net purchasing positions in the forward markets of commodities, even in the case of products such as oil where the net purchasing position had practically been reversed since the close of 2005. According to some estimates, investment funds have increased their participation in commodities from US\$ 45 billion in 2004 to US\$ 70 billion in 2005.

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## **BOX 5**

### **FUNDAMENTALS OR SPECULATIVE BUBBLE IN THE COMMODITY MARKET?**

So far this year, commodities have recorded a generalized price rise that has been coupled by a significant increase of volatility. Over the past two months, most commodity prices have struck record levels, including copper, oil, and gold (which reached its highest peak in 26 years), although prices decreased considerably in the last weeks. Whether this rapid growth, and its subsequent correction, reflects supply-and demand-related factors or rather responds to a speculative bubble is now being debated.

Some analysts say that the price rise is not in line with the evolution of economic fundamentals. For example, Roach (2006) <sup>1/</sup> argues that a global growth of 4 percent is not significantly different from other growth episodes that have taken place over the past three decades. However, the index of industrial commodities has increased 53 percent in the last four years - 42 percent in real terms-, almost twice as much as in the seventies' boom. Also, China would not be able to sustain the current demand for commodities as it intends to reorient its growth towards the domestic market and to develop technology that will reduce the use of commodities. This evolution is consistent with projections that involved gradual price corrections *ex ante*.

Other analysts (Roubini <sup>2/</sup> and others) say that current prices respond not only to the sustained growth of global economy, to the demand of China and India, and to supply restrictions (with scarce possibilities of increases in the short run), but also to other factors. These factors include the global favorable conditions of liquidity and low interest rates, which have generated lower risk aversion. In addition to this, the greater participation of non-trade positions in the commodity market would also play a role, as there is evidence of a high correlation between the increase produced in terms of contracts -which, for example, representing 25 percent of total forward copper operations in 2002, increased to 47 percent in 2005- and the evolution of commodity prices. Non-trade positions are estimated to have increased from US\$ 45,000 million to US\$ 75,000 million in 2005, and would reach US\$ 110,000 million in 2006.

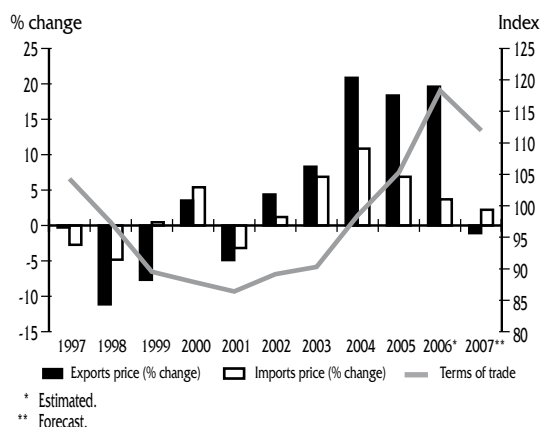
The debate is basically focused in determining which part of the demand, including these non-trade positions, has gone beyond the fundamentals associated with liquidity and low interest rate, thereby creating a bubble; and which part of the demand responds to a reversal in the cycle of abundant liquidity and to the withdrawal of monetary stimulation.

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1/ Stephen S. Roach, "Commodity Bubble", Morgan Stanley, May 15, 2006.

2/ Roubini, Nouriel, "Commodity Prices Sharp Rise. and Recent Sharp Fall: Bubbles of Fundamentals?" (RGE monitor page).

**Graph 35**  
**TERMS OF TRADE: 1994 = 100**



50. So far this year, this evolution, along with supply-side problems in the commodity markets, has generated an upward correction in price expectations for this year which contrast with the expectations observed by the end of 2005.

The main commodities are expected to maintain prices above the levels they had last year, but with a gradual correction in the rest of the year and in 2007, which is consistent with the forecast of a lower global growth. It should be noted that in the context of the debate on prices' evolution beyond fundamentals (see Box), a significant price correction is not totally eliminated in terms of the market.

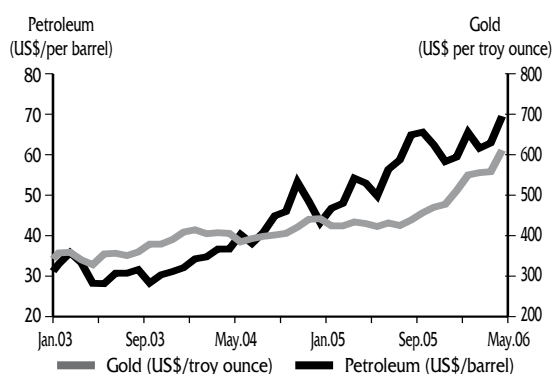
**Table 26**

**TERMS OF TRADE**  
(Annual change)

	Actual		Forecast			
	2005	2006	2006		2007	
	I Q	Year	I Q	IR Jan.06	IR May 06	
<b>Terms of trade</b>	<b>1.5</b>	<b>7.0</b>	<b>16.6</b>	<b>0.5</b>	<b>16.5</b>	<b>-4.9</b>
Exports price index	11.8	18.4	23.6	4.6	25.4	-0.6
of which international prices:						
- Gold (US\$ / troy ounce)	428	445	555	521	608	649
- Copper (cUS\$ / pound)	148	167	224	181	271	256
- Zinc (cUS\$ / pound)	60	63	100	80	124	114
Imports price index	10.2	10.6	5.9	4.1	7.7	4.6
of which international prices:						
- Petroleum (US\$ / barrel)	50	57	63	61	70	73
- Wheat (US\$ / TM)	125	130	153	142	165	173

Source: BCRP.

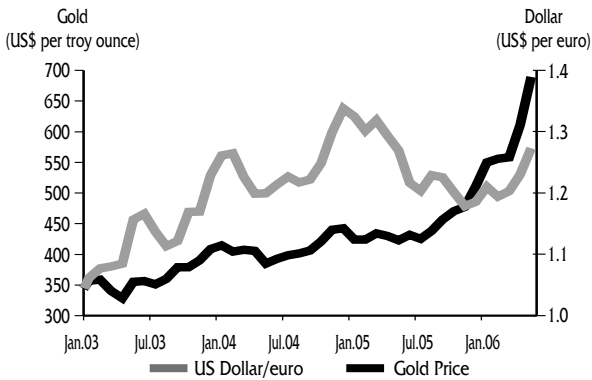
**Graph 36**  
**GOLD AND PETROLEUM PRICES**



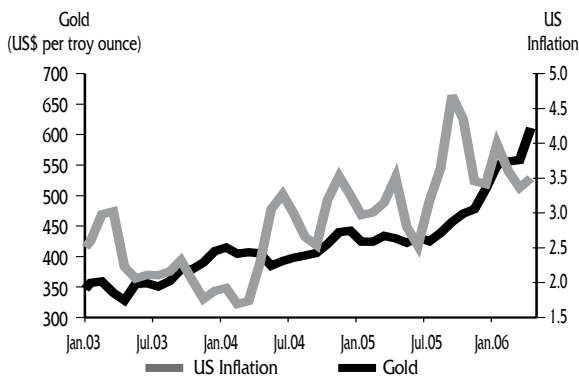
**Gold**

51. Year-to-date, gold quotation has increased significantly, showing unprecedented levels in the last 26 years, and reaching a maximum of US\$ 721 per ounce on May 11. This increase is associated with the characteristics of gold as a store of value, and therefore would have been influenced by factors such as increased inflationary fears due to new rises in oil prices, geopolitical uncertainties, and the weakness of the dollar against the euro.

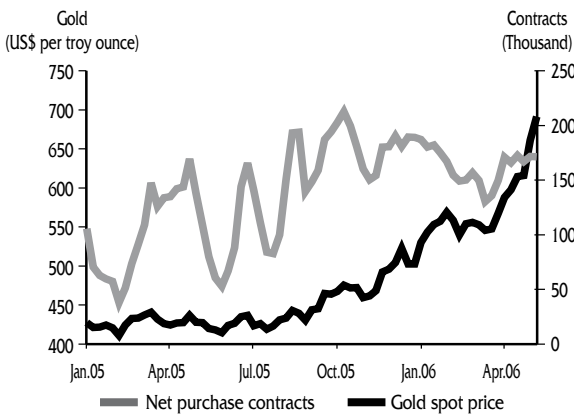
**GRAPH 37**  
**GOLD AND US DOLLAR AVERAGE PRICES**



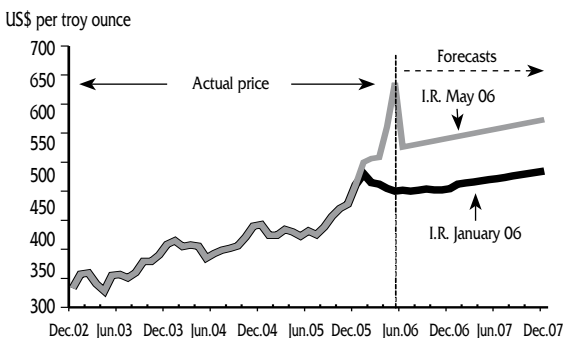
**GRAPH 38**  
**GOLD PRICE AND US INFLATION**



**Graph 39**  
**GOLD: SPECULATIVE CONTRACTS (NON COMMERCIALS)**



**Graph 40**  
**GOLD PRICE**



Similarly, these factors would be also stimulating the demand of investment funds and other commodity-specialized funds. It should be highlighted that the latter recovered their net purchase positions in the forward market since March, in contrast with what happened in other markets, such as the copper market.

52. Price prospects in the rest of 2006 and in 2007 are favorable. Although prices are expected to be downward corrected with respect to their current high levels, the average quotation in 2006 would rise from US\$ 521 to US\$ 608 per troy ounce, and to US\$ 649 per ounce in 2007.

The balance of world supply and demand mentioned in the "Inflation Report - January 2006" (which showed similar levels to those of 2005) would not record significant changes, although the volatility factor attributed to demand based on investment has played an important role in the evolution of gold quotation so far this year. As long as inflationary fears persist (in connection with the evolution of oil), this demand will continue to support the levels of gold, as will also the depreciation of the dollar (explained by the forecast reduction of rate differentials with the Eurozone).

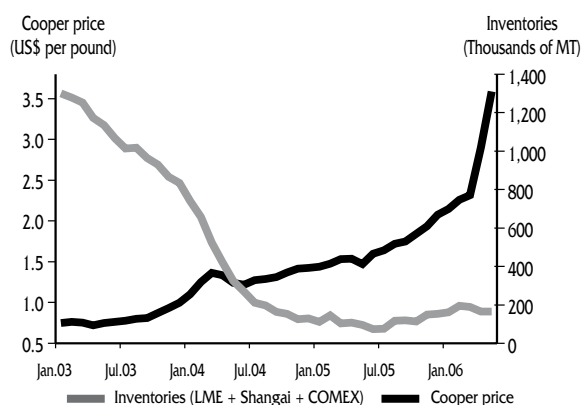
**Table 27**

**BALANCE OF GOLD SUPPLY AND DEMAND**  
(MT)

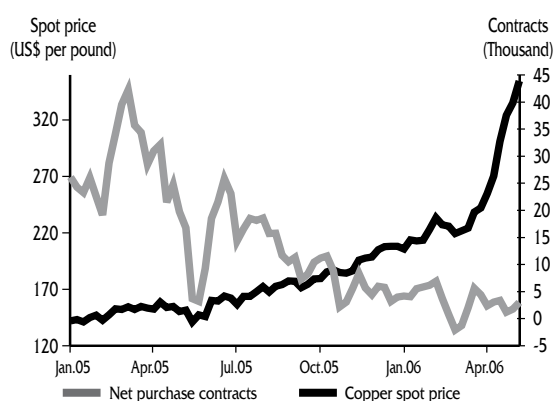
	2003	2004	2005
Mining supply	2,322	2,037	2,355
Official sector sales	617	471	663
Scrap	939	834	841
<b>Total supply</b>	<b>3,878</b>	<b>3,342</b>	<b>3,859</b>
Manufacture (industrial and jewelry)	2,858	3,028	3,155
Investment (coins and bars)	310	391	425
Other retail investments	- 18	- 48	- 29
Specialized funds	39	133	203
<b>Total demand</b>	<b>3,189</b>	<b>3,504</b>	<b>3,754</b>
<b>Balance</b>	<b>690</b>	<b>-162</b>	<b>105</b>

Source: World Gold Council.

**Graph 41**  
**COPPER AVERAGE PRICE AND TOTAL INVENTORIES**  
(Up to May 15, 2006)



**Graph 42**  
**COPPER: SPECULATIVE CONTRACTS (NON COMMERCIALS)**



## Copper

53. So far this year, the price of copper has showed a significant increase, reaching record levels in May (with a peak of US\$ 3.99 on May 12).

This rise may be explained mainly by the persistence of short-term supply-related problems, which have been reflected in the low levels of global inventories. Also, by the greater growth of most developed and emerging economies, which boosted the demand for this metal. Additionally, the recent depreciation of the dollar against the euro and the yen would have also motivated consumption in Europe and Asia.

54. One of the main sources of the supply-side restrictions was social problems -strikes- in countries like Indonesia (the Grasberg mine of Freeport-MCMoran Cooper & Gold) and México (La Caridad and Cananea mines, of Grupo Mexico). Moreover, Codelco (Chile) announced a lower production for this year and for 2007, relative to 2005. All these events have negatively impacted on this and next year's production.

These higher quotation levels may be explained by the increased seasonal commercial (non speculative) demand that characterizes the evolution of the basic product markets in this second quarter, given that net speculative demand in the forward market has maintained low levels (as in end-2005), in contrast with gold and oil.

55. Prospects in the rest of 2006 are still favorable, despite the fact that the market maintains the forecast that supply will exceed demand this year and the next, thus reversing a three-year trend of continuous deficits.

**Table 28**

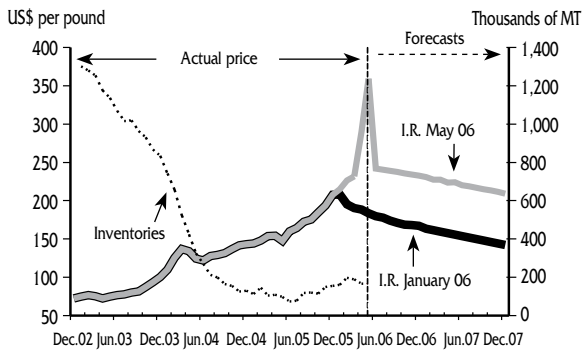
**BALANCE OF COPPER SUPPLY AND DEMAND**  
(Thousands of MT)

	2003	2004	2005	2006*
Mining supply	11,076	11,933	12,133	12,903
Total production of refined (1)	11,506	11,689	11,891	13,003
Total consumption of refined (2)	11,840	12,537	11,929	12,948
<b>Market balance (1) - (2)</b>	<b>- 334</b>	<b>- 848</b>	<b>- 38</b>	<b>55</b>
Total registered inventories	1,336	488	451	506
As consumption days	6.0	2.1	2.0	2.1

\* Forecast.

Source: Metal Bulletin Research (Base Metals Monthly, May 2006).

**Graph 43  
COPPER PRICE**



These estimates are consistent with the latest forecasts made by the International Copper Study Group (ICSG) according to which the demand for refined copper in 2006 and 2007 would grow in approximately 5 percent, whereas the supply would increase in almost 7 percent this year and almost 4 percent next year. As a result, the market's surplus would be 244 thousand MT in 2006 and 55 thousand MT in 2007.

With these tight balances, and in a context of short-term supply restrictions and high volatility due to the participation of speculative funds, the expected average prices for this year have been corrected upward. Average quotation in 2006 is forecast to rise from US\$ 1.81 to US\$ 2.71 per pound, and to fall to US\$ 2.56 per pound in 2007.

### Zinc

56. Zinc quotation has increased significantly so far this year, reaching record levels that struck US\$ 1.81 per pound on May 11.

As in the case of copper, this rise is explained by supply restrictions of concentrates, which brought on more closings of zinc smelters, and therefore scarcity of refined zinc. Several refineries have closed, particularly in China, Mexico, and Korea, thus generating a higher pressure on prices. This decreased supply has been reflected in the low levels of inventories in the London Metal Exchange (LME), which at May 15 have dropped 36 percent with respect to the close of 2005 (and to their lowest levels in the last 4 years).

Additionally, the main consumer's (China) demand increase in the first quarter and the recent depreciation of the dollar against the yen would have propelled the demand for this metal. In the case of zinc, the perception is that global demand for refined zinc will not be negatively impacted by China's raising its interest rate, as more important measures are deemed to be implemented in order to impact on the consumption of automobiles and on construction, the most important industries consuming zinc.

The expectation that commodity markets will show greater profits this year would be also impacting on this evolution, as speculative funds would be led to increase their participation in this market.



Table 29

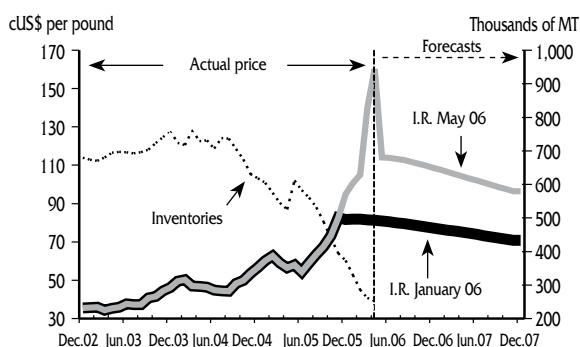
**WORLD BALANCE OF ZINC SUPPLY AND DEMAND**  
(Thousands of MT)

	2003	2004	2005	2006*
Mining production	6,706	6,545	6,646	7,026
Total production of refined	6,651	6,677	6,566	6,759
Total supply of refined (1)	7,429	7,304	7,102	7,315
Total consumption of refined (2)	7,202	7,579	7,501	7,812
<b>Market balance (1) - (2)</b>	<b>227</b>	<b>- 275</b>	<b>- 399</b>	<b>- 497</b>
Total registered inventories	1,322	1,047	648	151
As consumption days	9,7	7,3	4,6	1,0

\* Forecast.

Source: Metal Bulletin Research (Base Metals Monthly, May 2006).

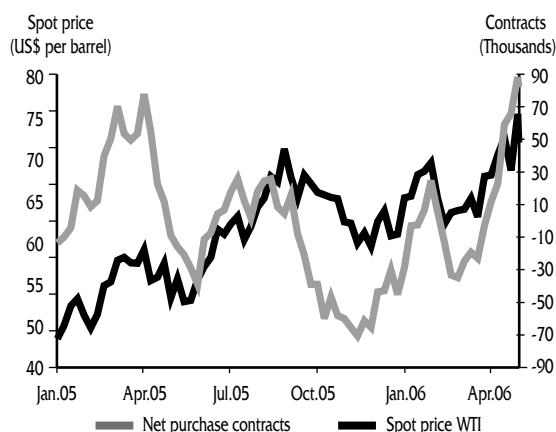
**Graph 44**  
**ZINC PRICE AND LME INVENTORIES**



57. Prospects for the rest of 2006 are very favorable. As stated in the Inflation Report -January 2006, the difference with other basic metals is that, for the third consecutive year, the zinc market would maintain a supply deficit this year.

This prospect is corroborated by the International *Lead and Zinc Study Group* (ILZSG), which in its latest report estimates that the demand for refined zinc would increase 4.8 percent, basically due to the highest growth of China, India, Korea, and Japan; whereas the supply of refined zinc would increase in 4.3 percent. As a result of this, the deficit in the market would be of 437 thousand MT this year. Therefore, the average quotation of zinc is forecast to increase from US\$ 0.80 to US\$ 1.24 per pound this year, and to fall to US\$ 1.14 per pound in 2007.

**Graph 45**  
**PETROLEUM: SPECULATIVE CONTRACTS (NON COMERCIALS)**



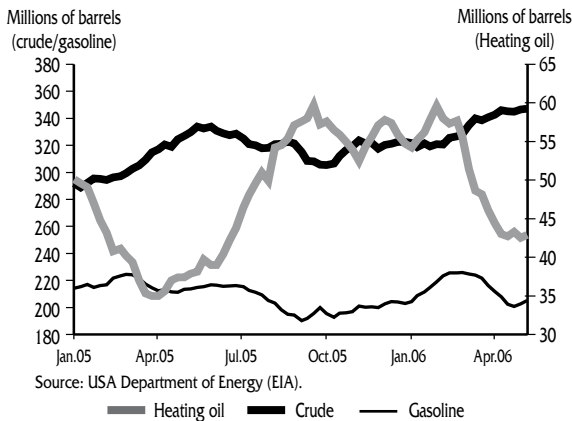
Source: Bloomberg.

**Oil**

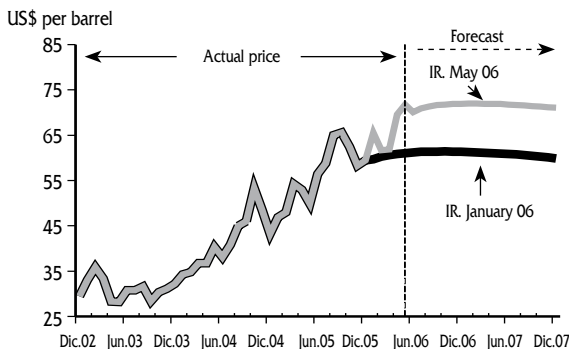
58. Oil quotation has significantly increased year-to-date, reaching unprecedented levels in May (a peak of US\$ 74.6 was recorded at the close of May 2).

This evolution is explained by fears of supply interruptions in the Middle East due to the geopolitical tensions in Iran (the fourth world producer), Irak and Nigeria (the eighth world producer). This evolution was also influenced by new US military operations in Irak in March and by tensions in Nigeria, which dropped production in this country by 9 percent, due to strikes and sabotage. Likewise, terrorist attacks extended to Saudi Arabia in March, affecting the production of important companies such as the *Royal Dutch Shell*.

**Graph 46  
USA FUEL: INVENTORIES**



**Graph 47  
PETROLEUM PRICE**



59. However, these supply-side factors have been partially offset by a positive evolution of the inventories of oil crude and oil derivatives in the United States. According to the US Department of Energy, by May 10, the inventories of crude would have increased by 24.4 million barrels (8 percent), with respect to the close of 2005.

OPEC's agreement to maintain their production in 28 million barrels per day (nearly its maximum capacity) also contributed to slow down the rise in the price of oil. A similar impact was produced by the International Energy Agency's estimate that cut down global demand for this year by 200 thousand barrels per day (to 84.83 million barrels per day).

All these factors have favored a slight downward correction of oil prices. However, geopolitical fears still persist, basically with respect to Iran, and therefore any increase in the tensions between the United States and Iran will boost oil quotation above the levels observed so far.

60. Forecasts this year include an upward correction for 2006 and 2007. The oil quotation would increase from US\$ 61.0 to US\$ 70 per barrel in 2006, and to US\$ 73 per barrel in 2007.

These price increases seem to reflect the larger world demand (a growth of around 1.5 percent), as well as increased uncertainty over supply forecasts in the case of OPEC member countries (associated with the Middle East geopolitical crisis). According to market specialists, this year would record a supply deficit that would not be corrected in the next year.

**Table 30**

**WORLD BALANCE OF PETROLEUM SUPPLY AND DEMAND**  
(Millions of barrels per day)

	2003	2004	2005
OECD demand	48,6	49,5	49,6
China	5,6	6,4	6,6
<b>Total demand</b>	<b>79,4</b>	<b>82,5</b>	<b>83,6</b>
OECD supply	21,6	21,3	20,3
Russian Federation	10,3	11,2	11,6
Total OPEC	30,7	33,0	34,0
<b>Total supply</b>	<b>79,7</b>	<b>83,1</b>	<b>84,1</b>
Changes on inventories	0,4	0,5	0,5

Source: OECD / International Energy Agency.

Table 31

## SUMMARY CHART OF MAIN FACTORS (January-May 2006)

Metal	Demand factors	Supply factors
<b>Gold</b> Maximum in May after 26 years (US\$/troy ounce 720.7)	<b>rising by:</b> inflation fear (petroleum price)  dollar depreciation (compared to euro)  speculative demand by specialized funds	<b>rising by:</b> possible reduction in production of main South Africa mine.
<b>Copper</b> Maximum in May (US\$/pound 3.9862)	<b>rising by:</b> non-speculative demand by global economic growth (China) and preventing the seasonally in second quarter	<b>rising by:</b> cut in production (Indonesia, Chile and Mexico). reduction of total inventories
<b>Zinc</b> Maximum in May (US\$/pound 1.8098)	<b>rising by:</b> higher non-speculative demand by global economic growth (China) and preventing the seasonally in second quarter	<b>rising by:</b> concentrated and refined products constraint (more foundries were closed) reduction of total inventories
<b>Petroleum</b> Maximum in May (US\$/barrel 74.61)	<b>fall by:</b> reduction of the global demand forecast by International Energy Agency.  inventories incement in United States of North America  <b>rising by:</b> speculative demand by specialized funds	<b>rising by:</b> cut in supply of the Middle East (Iran, Irak and Nigeria)

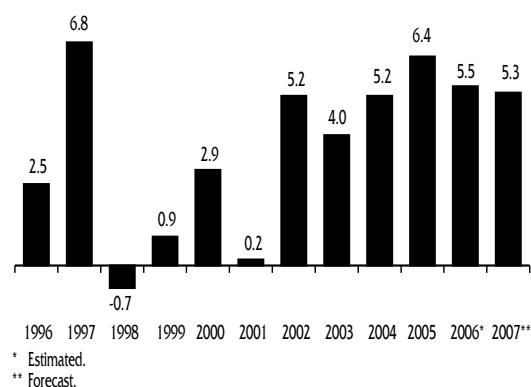
## Foods

61. Food products are expected to increase their prices by 13 percent in 2006 and by 8 percent in 2007. This would take place in a context where global supply is expected to decline 0.5 percent with respect to last year, after the US Department of Agriculture (USDA) announced that the world production of basic grains for the period 2005/2006 (wheat, fodder grains, and polished rice) would be 1,983 million MT which, together with last year's final inventories, would represent a total world supply of 2,384 million MT. Furthermore, for the 2006/2007 campaign, the USDA forecasts that adjustments would be produced in the world output of wheat and maize mainly, but that other increases would be produced in the consumption of soy, maize, and sugar, basically in the Asian countries.

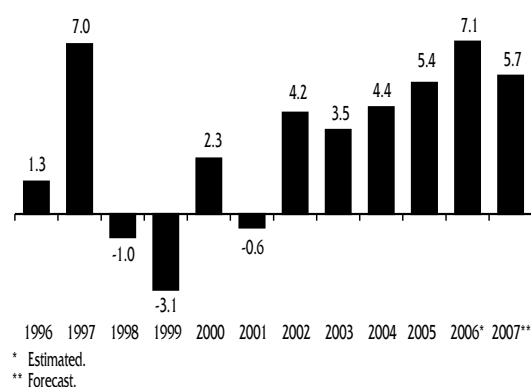
## VI. DETERMINANTS OF ECONOMIC ACTIVITY

62. One of the determinants explaining inflation's evolution is the balance between the demand and the supply of goods and services. In the first quarter of 2006, economic activity expanded 6.8 percent due to an importantly dynamic performance of domestic demand (9.9 percent), especially of private investment (25.4 percent) and private consumption (5.3 percent). Demand indicators in this quarter, particularly of consumers confidence, showed that economic activity had grown continuously and at a faster pace than expected in the previous Inflation Report (January), despite the uncertainty that typically arises in times of elections.
63. Although real exports slowed down in the first quarter (especially in the case of mining products), the trade surplus has been consolidating its upward trend propelled by a favorable international context, with terms of trade growing at an annual rate of 17 percent. Thus, national available income has increased, this being one of the factors that explains the evolution of domestic demand.
64. Economic activity is expected to continue growing in the rest of 2006 and to reach a rate of 5.5 percent, driven by increased private investment (13.5 percent) and by a favorable international context, which will represent terms of trade 16.5 percent higher to those of 2005, as well as high rates of global growth.
65. Forecasts for 2007-on assume private investment will continue to grow dynamically, productivity will increase, and our products will have increased access to international markets. All of which will contribute to our sustained growth in a context without inflationary pressures or restrictions to finance our balance of payments.

**Graph 48**  
**GDP GROWTH**  
(Real % changes)



**Graph 49**  
**DOMESTIC DEMAND GROWTH**  
(Real % changes)



However, a less favorable international environment is expected for 2007 as a moderate reversal in the trend of our terms of trade may be foreseen, along with a lower global growth due to higher international rates. Given this context, economic activity is expected to decelerate slightly (5.3 percent), but will still maintain this rate of growth that exceeds the level achieved over the past years.

## VI.1 Supply and demand

66. Economic activity is expected to expand at a rate of 5.5 and 5.3 percent in 2006 and 2007 respectively. On the expense side, domestic demand is expected to perform dynamically, with consumption and private investment growing at rates of over 4 and 12 percent respectively. On sectors, primary sectors are expected to perform at a slower pace in 2006 and to recover in 2007; whereas non-primary sectors would show a more stable dynamism, in line with the evolution of domestic demand.

### Aggregate demand

67. The **gross domestic product (GDP)** grew 6.8 percent during the **first quarter**, boosted by a 25.4 percent increase in private investment and a 5.3 percent increase in private consumption. The prices of most of our main export products, particularly mining products, continued to grow in a context with stable macroeconomic conditions and continuous growth that contributed to generate trust among investors.

**Table 32**

### GLOBAL DEMAND AND SUPPLY

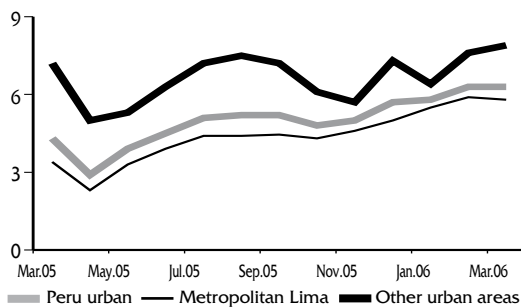
(Annual real % changes)

	2004	2005	2006		2007	
			IR January I Q	IR May 2006		
I. Global demand (1+2)	6.0	6.9	8.3	5.3	6.4	6.0
<b>1. Domestic demand 1/</b>	<b>4.4</b>	<b>5.4</b>	<b>9.9</b>	<b>5.4</b>	<b>7.1</b>	<b>5.7</b>
a. Private consumption	3.5	4.4	5.3	4.2	4.8	4.3
b. Public consumption	4.0	9.8	8.4	3.5	6.2	4.2
c. Private investment	9.1	13.9	25.4	10.6	13.5	12.0
d. Public investment	5.7	12.3	7.8	10.3	20.5	9.9
2. Exports	14.7	14.2	0.0	5.1	2.9	7.6
II. Global supply (3+4)	6.0	6.9	8.3	5.3	6.4	6.0
<b>3. GDP</b>	<b>5.2</b>	<b>6.4</b>	<b>6.8</b>	<b>5.0</b>	<b>5.5</b>	<b>5.3</b>
4. Imports	10.6	9.9	16.6	7.5	11.3	10.0

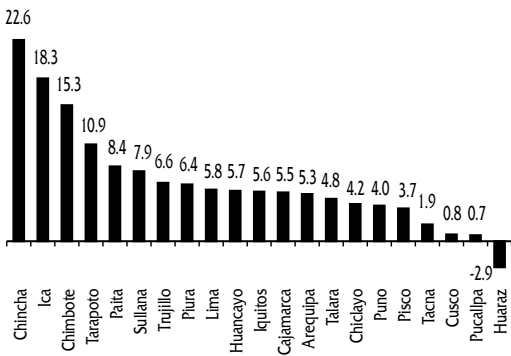
1/ Includes inventory changes.

Source: INEI.

**Graph 50**  
**URBAN EMPLOYMENT IN COMPANIES WITH 10 OR MORE WORKERS**  
(Annual % changes)

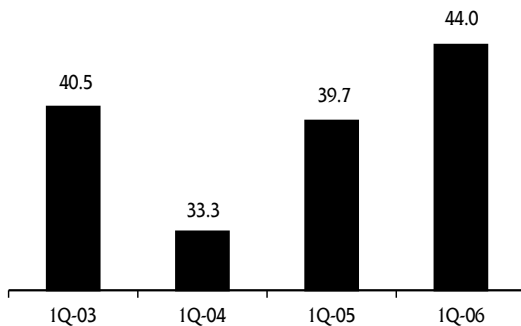


**Graph 51**  
**URBAN EMPLOYMENT IN COMPANIES WITH 10 OR MORE EMPLOYEES: March 2006**  
(Annual % change)



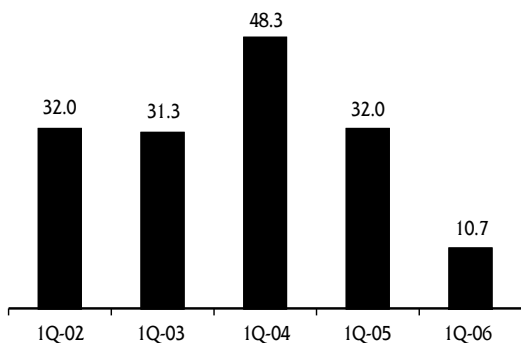
Source: MTPS.

**Graph 52**  
**CONSUMER CONFIDENCE INDEX: INDICCA**



Source: Apoyo.

**¿WILL YOUR ECONOMIC SITUATION BE WORSE THE NEXT 12 MONTHS?**



Source: Apoyo.

68. The 5.3 percent increase in **private consumption** in the first quarter was associated with families' higher incomes, growth of employment, increased credit for consumption, and stronger consumer confidence.

69. **National disposable income** rose 8.1 percent during the first quarter, reflecting better terms of trade.

**Table 33**

**NATIONAL DISPOSABLE INCOME**

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

	2004	2005	2006		2007	
			IR January IQ 2006	IR May 2006		
Gross domestic product (GDP)	5.2	6.4	6.8	5.0	5.5	5.3
Gross national product (GNP) 1/	3.6	4.6	4.4	4.3	2.5	6.4
Gross national income (NI) 2/	5.8	6.2	7.8	4.4	7.0	5.0
National disposable income (NDI) 3/	5.9	6.5	8.1	4.6	7.1	5.0

\* Forecast.

1/ Excludes from GDP the net income paid to non-resident productive factors.

2/ Includes profits and losses from changes in foreign terms of trade.

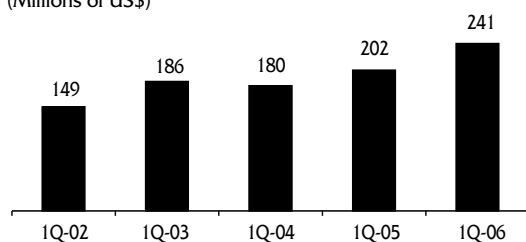
3/ Net transfers from non-residents is added to NI.

Source: INEI and BCRP.

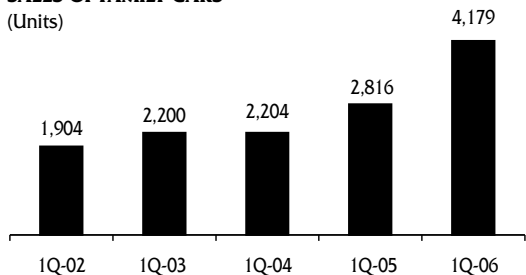
70. In March 2006, **urban employment in private companies with 10 or more workers** grew 6.3 percent with respect to March last year, according to the Labor Ministry. Employment rose higher in the rest of the country -urban areas- (7.9 percent) than in Metropolitan Lima (5.8 percent). This result is related to the dynamic performance observed in extractive activities, such as agriculture and mining, in export-oriented agribusiness, and in services.

In terms of the 21 largest cities, employment grew outstandingly in Chincha (22.6 percent), due to higher crops of asparagus and artichoke, and to increased production of chicken; whereas in the case of Ica, employment growth (18.3 percent) was mainly driven by higher processing of asparagus and artichoke for exports.

**Graph 53**  
**IMPORTS OF DURABLE GOODS**  
(Millions of US\$)

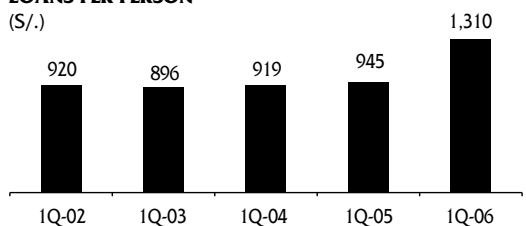


**SALES OF FAMILY CARS**  
(Units)



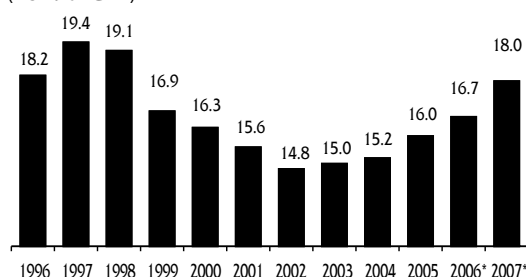
Source: ARAPER.

**FINANCIAL INSTITUTIONS' CONSUMPTION**  
**LOANS PER PERSON**  
(S./.)



Source: SBS.

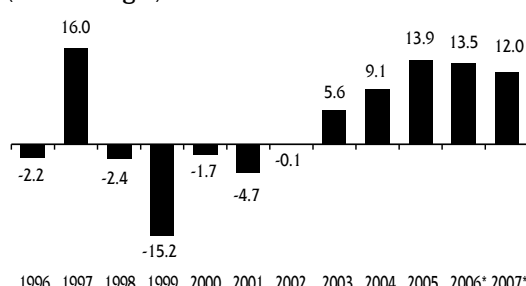
**Graph 54**  
**PRIVATE FIXED INVESTMENT**  
(As % of GDP)



\* Estimated.

\*\* Forecast.

**Graph 55**  
**PRIVATE FIXED INVESTMENT**  
(Real % changes)



\* Estimated.

\*\* Forecast.

71. The results of consumer confidence index improved notably during the first quarter of the year. According to the index prepared by Apoyo, consumers' confidence on their future economic situation recorded its highest level with respect to the last three years. Furthermore, families' perception that their economic situation might worsen in the following years continued to decline. Consumers confidence even reached again the historic minimum level of the past five years.

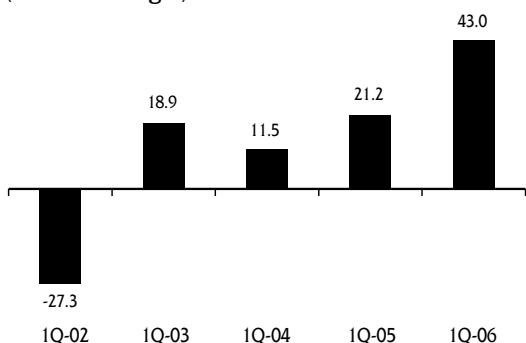
The growth of consumption was also reflected in several indicators, such as increased imports of consumption goods, both durable and non-durable, which showed two-digit rates in both cases. In addition to the participation of new car dealers in the market, the 45 percent increase in sales of new cars clearly reflects higher consumption in a context with better conditions and increased access to credit.

Dynamism in private consumption was also reflected in the higher production of some non-manufacturing branches associated with products massively consumed such as beer and malt (24.7 percent), juices and beverages (78.4 percent), margarine (13.0 percent), and floor wax (6.8 percent).

72. Private investment grew 25.4 percent during the first quarter, a rate that had not been achieved since the second quarter of 1995. Greater sales and profits in a context of continuous growth (almost 5 consecutive years) and better business expectations encouraged companies to implement technological renovation projects and to expand their plants in order to respond to increased demand.

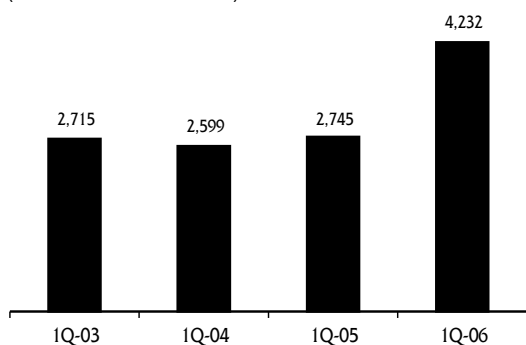
Companies in the sectors of manufacturing, energy, commerce, hotels, and services invested both in non-residential construction projects (plant expansion and construction of new facilities) and in buying new machinery. The latter was reflected in the 43 percent increase in imports of capital goods, especially equipment for telecommunications, other industrial machinery and special equipment, and automatic data-processing machines, among other capital goods.

**Graph 56**  
**IMPORTS OF CAPITAL GOODS** <sup>1/</sup>  
(Annual % changes)



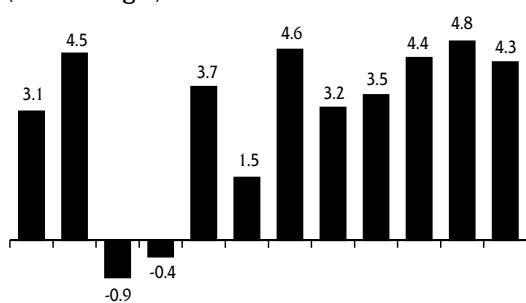
<sup>1/</sup> Excludes construction materials.  
Source: BCRP.

**Graph 57**  
**TOTAL FINANCIAL RENTING**  
(Millions of nuevos soles)



Source: SBS.

**Graph 58**  
**PRIVATE CONSUMPTION GROWTH**  
(Real % changes)



\* Estimated.  
\*\* Forecast.

According to information provided by the Superintendence of Banking and Insurance, financial leasing or lease contracts<sup>2/</sup> continued to grow since the end of 2004. The mining, manufacturing, electricity, gas, and water sectors also showed expansion in the first quarter of 2006.

73. In the first quarter, **public consumption** increased 8.4 percent due to higher spending in government payroll. These disbursements were also coupled by higher purchases of goods and services by the central government. **Public investment**, on the other hand, grew 7.8 percent in the first quarter due to increased disbursements by the central government, higher investments by local governments and EsSalud, as well as projects developed by Petroperu.

74. **Exports** did not show variations with respect to the first quarter of 2005. Fewer available volumes of some mining products, such as zinc, copper, molybdenum, and lead, and of other products like fish meal and coffee were compensated by larger exports of gold. In this quarter, non-traditional exports grew 14 percent, due mainly to chemical, agricultural, and non-metallic mining products.

75. In the first quarter, **imports** increased 16.6 percent with respect to the same period last year, due to an increase in nominal prices in purchases of consumer goods (14.7 percent) and to imports of raw materials and capital goods (23.8 and 45.7 percent respectively). Raw materials for agriculture grew 50.5 percent, whereas capital goods for industry and transport increased by 43.0 and 46.7 percent respectively.

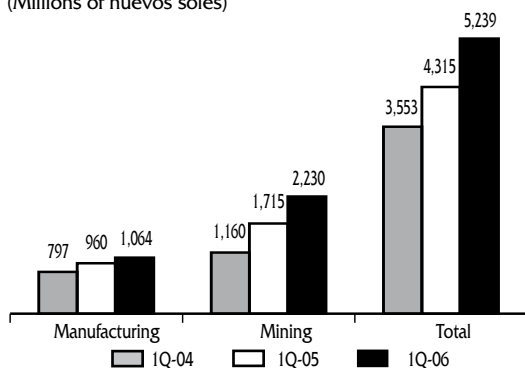
76. In 2006, **private consumption** is expected to grow 4.8 percent, given the increase forecast in terms of national disposable income (7.1 percent) and greater consumers trust.

On the other hand, private investment is expected to increase 13.5 percent in 2006 given the results achieved in the first quarter, as a result of macroeconomic stability and business' higher profits, as well as increased expectations of economic growth.

<sup>2/</sup> A lease or tenancy is an interest in personal property or real property given by a lessor to another person (usually called the lessee) for a fixed period of time, and the lessee obtains exclusive possession of the property in return for paying the lessor a fixed or determinable consideration, plus any financial and additional costs, according to contract provisions.

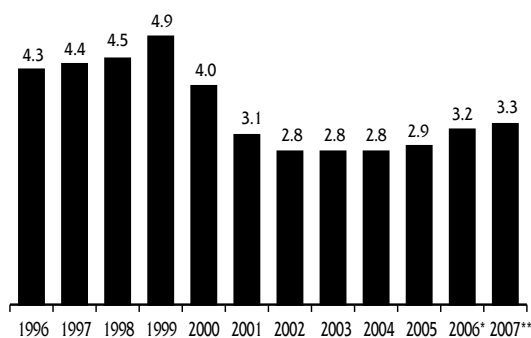


**Graph 59**  
**GROSS PROFITS**  
(Millions of nuevos soles)



Source: Economática.

**Graph 60**  
**PUBLIC INVESTMENT**  
(As % of GDP)



\* Estimated.  
\*\* Forecast.

77. In the case of **public consumption**, the forecast of a 6.2 percent increase considers the availability of fiscal incomes as well as higher incomes in the central government, on the one hand, and increased spending by regional and local governments, on the other hand. Likewise, in the case of **public investment**, the forecast of 20.5 percent is associated with the higher spending of the central government and of sub-national governments.

78. In 2006, **exports** would increase by 2.9 percent (mainly due to increased non-traditional exports, including agricultural and textile, steel and metallurgical products, and jewelry), while **imports** would increase by 11.3 percent, considering the growth pace of raw materials and capital goods oriented mainly to industry.

79. A less favorable international scenario is expected for **2007**: the trend of international quotations is expected to reverse, thus causing terms of trade to decline and world economy to grow at a slower pace. **GDP** would grow at a rate of 5.3 percent as a result of the recovery of the primary sectors and of dynamism in private investment.

80. Given the reversal in the trend of terms of trade, **private consumption** is expected to slow down (4.3 percent) since national disposable income would decline (5.0 percent).

81. **Private investment**, on the other hand, would continue to show a dynamic growth and would increase by 12.0 percent, as a result of increased access of our products to international markets. Likewise, public consumption and public investment are expected to grow by 4.2 percent and 9.9 percent respectively.

82. In 2007, **exports'** increase would post a real variation of 7.6 percent, as a result of increased export volumes of copper and zinc - favored by start of operations in Cerro Verde and Cerro Lindo -, and the continuous dynamism exhibited by non-traditional exports. **Imports** are expected to increase around 10.0 percent - less than in 2006 - due to the above-mentioned deceleration of national disposable income.

**BOX 6**  
**SOME HIGHLIGHTS ON THE FREE TRADE AGREEMENT**  
**BETWEEN PERU AND THE UNITED STATES**

After holding 13 negotiation rounds in a period of 19 months, negotiations over a Peruvian-US Free Trade Agreement (FTA) concluded on December 7, 2005, although preliminary agreements signed will still have to be ratified by the countries' respective congresses. The negotiated text consists of 21 chapters involving not only trade-related matters, but also others associated with labor, environment, transparency, and intellectual property, among others.

**FTA BETWEEN THE US AND PERU: CHAPTERS INCLUDED IN THE FTA TEXT**

Trade of goods and services		
Goods	Services	Other matters
<ul style="list-style-type: none"> <li>• Customs procedures</li> <li>• Agricultural</li> <li>• Technical barriers to trade</li> <li>• Government procurement</li> <li>• Textile and apparels</li> <li>• Rules of origin</li> <li>• Sanitary and phytosanitary measures</li> <li>• Access to the market</li> </ul>	<ul style="list-style-type: none"> <li>• Electronic commerce</li> <li>• Cross-border trade in services</li> <li>• Telecommunications</li> <li>• Financial services</li> </ul>	<ul style="list-style-type: none"> <li>• Institutional issues</li> <li>• Investment</li> <li>• Environment</li> <li>• Labor</li> <li>• Intellectual property rights</li> <li>• Competition policies</li> <li>• Dispute settlements</li> <li>• Safeguards and trade</li> </ul>
<p>of industrial goods</p>		<ul style="list-style-type: none"> <li>defense</li> <li>• Strengthening trade capacities</li> </ul>

In the commercial arena, the agreement consolidates the elimination of tariffs achieved through the Andean Trade Promotion and Drug Eradication Act (ATPDEA), extending it to other products. In agriculture, it guarantees tariff-free access to the North American market for 1629 items representing 90 percent of the universe and 99 percent of the total value of our agricultural exports to the US. In terms of textiles, it ratifies the terms of the ATPDEA and extends it to other items, while also incorporating some of the other activities of the productive chain to this liberalization. The consolidation of an access to the North American market offers a wider and more stable horizon for the development of export projects, which will be able to grow if greater access to more external markets is promoted.

Tariffs for products from countries with no trade agreement with the USA are, for example 21 percent for the asparagus; 20 percent for T-shirts; 17 percent for sweaters and pullovers; and 6 percent for other non-traditional products.

In contrast with the ATPDEA, the Free Trade Agreement with the USA also implies opening our market: 81 percent of imported manufactured goods will be automatically subject to tariff exemptions. This implies access to goods at a lower cost and greater facilities to import raw materials and capital goods, which will favor productivity and technological transference.

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**TARIFF-EXEMPTIONS SCHEDULE FOR US NON-TEXTILE MANUFACTURED GOODS**

Basket	Free trade*	Items	%	US Imports (2001 - 2001)	
				US\$ (thousands)	%
A	Inmediately	3,934	77,1	1,045,687	80.7
B	in 5 years	583	11,4	76,114	5.9
E	in 7 years	38	0,7	46,550	3.6
C	in 10 years	547	10,7	127,917	9.9
TOTAL		5,103	100.0	1,296,267	100.0

Notes: \* Remanufactured products from basket B and C will have a grace period of 5 years, with tariff exemption beginning in year 6.

Source: MINCETUR.

It is difficult to evaluate ex-ante what the overall effect of this bilateral opening will be, with measure alternatives ranging from using models to simulate impacts to sector analyzes. Models include the standard computable general equilibrium (CGE) models presented by Cuadra et al. (2004) and the Ministry of Commerce and Tourism (2005). This first study estimates that FTA benefits in the long-term would range between 3 and 7 percent of the baseline GDP, due to the accumulation of capital and externalities associated with the growth of trade. The study carried out by the MINCETUR (2005) only includes the effect of capital accumulation and shows a result equivalent to 2.3 percent of GDP.

**ESTIMATES OF IMPACT OF PERU-US FTA ON GDP**

Source	Methodology	Impact (% of GDP)	
		Short term	Long term
Cuadra et al. (2004)	CGE (GTAP v.5)	0.11 - 1.10 <sup>1/</sup>	3.10 - 7.02 <sup>2/</sup>
MINCETUR (2005)	CGE (GTAP v.6) <sup>3/</sup>	-	2.31 <sup>4/</sup>
Moron (2005)	DCSE	1.58 -1.99 <sup>5/</sup>	3.28 - 4.59 <sup>6/</sup>
Luque (2005)	DCSE <sup>7/</sup>	-	4.03 <sup>8/</sup>

Notes:

1/ Results of Model Variations 1 and 2 based on Cuadra et al. (2004).

2/ Results of Model Variations 3 o 5 (trade-related capital accumulation and externalities) Cuadra et al. (2004).

3/ Revised and updated to 2004.

4/ Allows capital accumulation, but does not mock effects in productivity or externalities.

5/ Accumulated result a year after the agreement was signed, assuming capital accumulation and externalities. The alternative scenario includes an increase in the participation of Peruvian exports to the US, as well as effects produced by trade diversion.

6/ Accumulated result in the long-term.

7/ Allows trade among productive sectors.

8/ Results vary according to assumptions on changes produced in total productivity of factors (1 to 3 percent increase).

Source: Studies previously quoted.

Morón (2005) and Luque (2005), on the other hand, use dynamic models on general equilibrium (DCSE) to calculate the aggregate impact of the FTA on the Peruvian economy. According to Morón, the long-term aggregate impact would be equivalent to 3,3 - 4,6 percent, growth explained mainly by an increase in the productivity of factors. Luque (2005), on the other hand, finds that the increase in the product would be around 4,0 percent. This outcome is also sensitive to variations in the total productivity of factors.

However, the short-term effect of tariff reduction -and the subsequent reallocation of resources- is moderate. This is due to the fact that the tariffs on Peruvian exports for the North American market are relatively lower than those on US products for the Peruvian market, which represents a higher drop of tariffs for Peru. Nevertheless, in the long-term, the Trade indirect effects, such as an increase in the productivity of factors and greater capital accumulation, will increase economic activity.

Although most studies estimate that the FTA will have a positive effect on the economy, all sectors will not be equally impacted. The opening of our market will also bring about competition in sensitive sectors. Peru has negotiated tariff exemptions of 10 years or more for 125 tariff items related to sensitive products, including rice, beef, dairy products, and yellow hard corn. In addition, if necessary, the government will apply special agricultural safeguards on 36 sensitive products, including evaporated milk, cheese, quality standard beef, chicken leg quarters, etc.

#### RESULTS OF NEGOTIATION ON AGRICULTURAL PRODUCTS (SELECTED PRODUCTS)

	Rice	Milk	Hard yellow Corn	Wheat	Cotton
Base tariff established for tariff elimination program:	52%	25% (35% for powdered milk)	25%	17%	12%
Tariff elimination timeframe:	17 (4 years grace)	15-17 (10 years grace)	12	Immediate	Immediate
Import quota:	74 000 MT	4 630 MT	500 000 MT	-	-
Growth rate of Quota:	6%	12%	6%	-	-

Source: Ministerio de Agricultura.

The government has announced that compensations will be provided to producers of hard yellow corn, cotton, and wheat. The latter two products would be particularly affected when the agreement is signed because the tariffs on these would be immediately eliminated. In addition, these products are mainly imported by the United States. The compensation program -still being debated- would give national producers a direct subsidy equivalent to the tariff that is currently paid for importing these three products.

The advantage of this system is that it is easily implemented. Producers would be paid their compensations at the processing centers (mills, cotton-picking and balanced food-processing plants, etc.) and would depend on the output produced -a fixed sum paid for quintal or metric ton. People and producers also easily assimilate the scheme, since producers are paid the same price for their products as before the agreement was signed.

However, the scheme has one failure: no incentives are provided in order that farmers shift their production towards more profitable crops. Given that farmers must pay the cost implied in such a reconversion process, they have no incentives to migrate to other crops since the government will pay them the same price they received before the FTA. It is worth pointing out here that in order to promote the effectiveness of this scheme, it is necessary to specify when the benefits will end.

The modern trend in schemes aimed at supporting agriculture is to migrate from the guaranteed price systems to systems based on direct transferences of fixed sums. The advantage of the latter is that by disconnecting support from production, the migration to more profitable crops is incentivated. The European Union, Mexico, and the US constitute interesting examples of reforms geared towards this system.

## FEATURES OF THE DIRECT TRANSFERENCE SCHEME IN THE EUROPEAN UNION, MEXICO, AND THE UNITED STATES

	European Union CAP Reform <sup>1/</sup> 1993	Mexico PROCAMPO <sup>2/</sup> 1994	United States FAIR Act <sup>3/</sup> 1996
<b>Aim</b>	Compensate producers for drop in guarantee prices	Compensate producers for elimination of guarantee prices for protected products	Compensate producers for the elimination of compensatory payments
<b>Bases for payment</b>	Average surface included in support system in 1989-1991	Average surface used for protected crops included in the support system in 1991-1993	Surface included in compensatory benefits in 1990-1995
<b>Products Included</b>	Maize, wheat, barley, rye, oat, sunflower, seed, soy bean, seeds of dry legumes, beans, tobacco, beef and lamb	Maize, wheat, millet, barley, rice, beans, soy, bean, and carthamus (safflower)	Maize, wheat, millet, barley, rice, cotton and oat
<b>Plan's timeframe</b>	Indefinite. Amounts are set in nominal values, and the program is subject to CAP reforms	For a total of 15 years. During the first 10 years, benefits include fixed sums in real terms; in the next 5 years, benefits decline	The program culminated after 7 years and was extended for another 7 years
<b>Payment ceilings</b>	No ceilings	US\$ 6,700 per farm	US\$ 40,000 per farm
<b>Restrictions on land use</b>	Must be used for protected crops; large farmers must leave a predetermined area of land fallow. Since 2003, environmental, animal, well-being, hygiene, and field conservation measures are being reinforced	Had to be used for protected crops, but since 1996 may be used for other agricultural purposes	For farming use only (excluding vegetables and fruits); must comply with existing conservation plans

Source: Baffes et al. (2003)

1/ Common Agricultural Policy.

2/ Programa Nacional de Modernización del Campo.

3/ Federal Agricultural Improvement and Reform Act.

With this system, annual payments are established on the basis of the area that was sown with the crops considered for program benefits. However, differentiated payments may also be established on the basis of the extension of land reported by each farmer, so that farmers with less land - who usually have less income and less access to markets - may benefit the most in relative terms. In this way, support is given to small farmers with a more equitable system. Moreover, farmers may use the payments they receive from the government as guarantees for loans, thereby accelerating the reconversion process. Another option is to implement a mixed system combining compensation payments with productive reconversion-oriented loans for farmers at preferential rates.

Although this mechanism is attractive to promote efficiency and equity, international experiences have showed that it is not easily implemented. First, a system is required to identify adequate beneficiaries and

to determine the extension of land sown with each crop. This also implies dealing with issues such as land lots with legal problems, with informal contracts, without defined borders, or lots temporarily affected by floods or landslides. Communication is another important factor in order that benefits reach the farmers of more remote areas. Finally, the Mexican experience suggests that a reconversion program cannot rely exclusively on this mechanism; it has to be complemented with technical support to small farmers in order to be effective.

Another alternative is to make a single payment to those farmers affected by some policy, instead of making periodical transferences to them. International experience provides numerous examples of single payment schemes which have been more successful than the ones based on periodical transferences of fixed sums, such as the cases of Canada and New Zealand. Even though this scheme concentrates fiscal spending in one period, the advantage is that it reduces the risk of not being able to terminate the program in the future due to beneficiaries' pressures. Although this system does not need to implement an institutional apparatus to make periodical payments to farmers, it shares several of the problems associated with the implementation of the direct transference of fixed-sums scheme, particularly the identification of remote farmers (due to land registration-related problems) and communication.

The FTA allows for establishing a protection regime for test data on medications. In a few words, the agreement provides for protecting the originator (lab innovating medicine) exclusive rights over their test data used to demonstrate the effectiveness of a product, and prevents other labs from using these data to produce copies of said product (the so-called generic brand medicines). Under the test data protection regime, this information would not be available for at least five years, and would therefore delay the entry of medicine copies or similar products to the market, which represent a strong competition for new or original medication. This regime would be suspended in cases of public health emergencies.

The FTA would therefore imply a reduced number of copies (brand generic medicines) of new medicines, which are protected by patents and test data. The impact of this regime on prices will depend on the elasticity of demand in the case of each of these groups of products, as well as on the effect of tariff reduction.

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### Sector Production

83. During the **first quarter of 2006**, growth in the **gross domestic product** (6.8 percent) was driven by the **non-primary sectors** which logged the highest ever level since the fourth quarter of 1997 (7.6 percent), especially due to the sectors of construction (16.2 percent) and non-primary manufacturing (6.2 percent).

The **primary sectors** increased 3.8 percent due to the contributions of the fishing sector (19.1 percent) -because of larger catches for human consumption, particularly for canning and freezing-, of primary manufacturing (6.6 percent) -due to the higher output in fishing and sugar industries-, and mining (5.1 percent), due to larger extraction of gold.

The **agricultural sector** grew 1.7 percent in the first quarter, mainly due to increased livestock production (4.3 percent),

Table 34

**GROSS DOMESTIC PRODUCT**

(Percentage changes compared to same period in previous year)

	2004	2005	2006			2007
			IR January		IR May	
			I Q	2006		
<b>Agriculture &amp; livestock</b>	<b>1.7</b>	<b>4.8</b>	<b>1.7</b>	<b>3.0</b>	<b>3.1</b>	<b>4.7</b>
Agriculture	-3.2	4.0	0.0	1.3	1.7	5.0
Livestock	2.0	6.6	4.3	5.9	5.4	4.6
<b>Fishing</b>	<b>33.9</b>	<b>1.2</b>	<b>19.1</b>	<b>3.1</b>	<b>-1.2</b>	<b>4.7</b>
<b>Mining &amp; Hydrocarbons</b>	<b>5.3</b>	<b>6.7</b>	<b>5.1</b>	<b>1.6</b>	<b>1.6</b>	<b>6.2</b>
Metallic mining	5.3	7.4	5.4	0.7	0.8	6.2
Hydrocarbon	7.1	23.5	0.4	13.1	10.7	6.6
<b>Manufacturing</b>	<b>7.4</b>	<b>6.5</b>	<b>6.5</b>	<b>5.5</b>	<b>5.7</b>	<b>5.7</b>
Based on raw materials	6.2	4.0	6.6	3.5	1.7	3.0
Non-primary	6.8	7.6	6.2	6.2	6.6	6.4
<b>Electricity &amp; water</b>	<b>4.6</b>	<b>5.3</b>	<b>6.7</b>	<b>5.0</b>	<b>5.5</b>	<b>4.4</b>
<b>Construction</b>	<b>4.7</b>	<b>8.4</b>	<b>16.2</b>	<b>8.0</b>	<b>9.2</b>	<b>7.0</b>
<b>Commerce</b>	<b>5.8</b>	<b>5.2</b>	<b>8.8</b>	<b>5.3</b>	<b>6.3</b>	<b>5.2</b>
<b>Other services</b>	<b>4.4</b>	<b>6.4</b>	<b>6.5</b>	<b>5.2</b>	<b>5.9</b>	<b>5.0</b>
<b><u>GROSS VALUE ADDED (GVA)</u></b>	<b><u>5.1</u></b>	<b><u>6.2</u></b>	<b><u>6.9</u></b>	<b><u>5.0</u></b>	<b><u>5.5</u></b>	<b><u>5.3</u></b>
Taxes on products and import duties	6.4	8.5	5.2	4.9	5.0	4.9
<b><u>GLOBAL GDP</u></b>	<b><u>5.2</u></b>	<b><u>6.4</u></b>	<b><u>6.8</u></b>	<b><u>5.0</u></b>	<b><u>5.5</u></b>	<b><u>5.3</u></b>
<b>Primary GVA</b>	<b>4.1</b>	<b>5.5</b>	<b>3.8</b>	<b>2.6</b>	<b>2.3</b>	<b>5.0</b>
<b>Non-primary GVA</b>	<b>5.3</b>	<b>6.3</b>	<b>7.6</b>	<b>5.6</b>	<b>6.3</b>	<b>5.4</b>

1/ Estimated.

particularly poultry, beef, and eggs. However, this was offset by results in the agricultural subsector, which recorded nil growth in the first quarter.

Some products associated with exports, such as coffee, mango, grapes, olives, and cocoa, showed greater dynamism. This group also includes sugar, which saw a recovery of agribusiness production. However, the output of other products declined, including crops such as potato, hard yellow corn, and rice. These products are mainly oriented to the domestic market and their evolution depends more on climatic conditions and on the volumes of water stored during the sewing season. It is worth mentioning here that yield in these products was affected by temperature changes produced in the first quarter.

The **fishing sector** expanded 19.1 percent, mainly as a result of larger catches for human consumption -particularly for

canning and freezing-, although this expansion was slightly offset by a lower catch of fresh fish. In the first quarter, higher sea temperatures than in same period last year favored the presence of some species, such as mackerel and jack mackerel, and the return of bonito tuna, which had been absent from Peruvian waters since 1999. In the case of industrial fishing, exploratory fishing of anchovy was allowed in Tumbes and Arequipa, excluding some areas to avoid affecting the population of juvenile anchovy.

In the first quarter, the 5.1 percent growth in the **mining and hydrocarbons sector** is explained by an important increase (15.4 percent) in gold extraction due mainly to the entry into operations of Alto Chicama and, to a lesser extent, to the increased production of Yanacocha. A 6.8 percent increase in copper production due to Antamina's greater output (especially in March), and a 14.9 percent increase in iron production contributed also to the positive performance of the sector. Conversely, zinc output declined 13.0 percent due to Antamina's lower production, given the lower concentration of zinc in the mineral extracted.

Hydrocarbon production rose 0.4 percent, spurred by natural gas recovery (21.7 percent), as a result of Camisea's and Petrotech's (lot Z-2B) increased production. One of the reasons explaining the slight growth in this sub sector was pipe breaks in Camisea, which reduced both gas and oil crude extraction recovery in March.

**Table 35**

**HYDROCARBONS SUB-SECTOR GROWTH**  
(Changes compared to same period in previous year)

	Relative weighting (2005)	2006			
		January	February	March	I Q
Crude	90.4%	4.2	0.0	-9.4	-1.8
Natural gas	9.6%	28.8	51.7	-10.3	21.7
<b>HYDROCARBONS</b>	<b>100.0%</b>	<b>6.7</b>	<b>4.4</b>	<b>-9.5</b>	<b>0.4</b>

Source: MINEM.

During the first quarter of 2006, **manufacturing production** expanded 6.5 percent due to the growth of primary resource industries (6.6 percent) and non-primary manufacturing



(6.2 percent). Greater activity in the case of the former is explained by increased output of fish meal and fish-canned products (40 percent) -due to greater availability of anchovy, mackerel, jack, and giant squid- and sugar, due to increased production and higher yield of sugar cane. This outcome was offset by lower levels of refined non-ferrous metals, due mainly to a production decline in Southern Peru caused by technical problems associated with the new smelter. Due to these problems, Southern Peru has stopped producing copper blister and has reoriented production to anodic copper.

Continuing with the positive performance of previous quarters, **non-primary manufacturing** increased 6.2 percent. This evolution was boosted mainly by increased domestic demand, and to a lesser extent, by higher non-traditional exports in a context of greater employment and better incomes.

Intermediate and capital goods showed the greatest expansion due to dynamism in the construction sector and to greater demand associated with the implementation of mining and electrification projects, and with telecommunications expansion. With respect to consumer goods, the increased production of food products and other final products (e.g. school materials and paper-derived products) was offset by the lower production of garments.

**Table 36**

**NON-PRIMARY MANUFACTURING PRODUCTION**

(Annual % changes)

	2004				2005				2006
	IQ	IIQ	IIIQ	IVQ	IQ	IIQ	IIIQ	IVQ	IQ
Consumption goods	11.1	14.0	15.5	15.7	6.6	7.9	4.9	4.4	4.0
Intermediate goods	6.6	7.0	8.6	16.3	11.1	13.2	12.8	7.8	10.3
Capital goods	19.3	-9.9	-2.7	-2.3	-21.7	-16.3	-11.7	26.8	11.3
<b>Total</b>	<b>9.0</b>	<b>10.4</b>	<b>11.8</b>	<b>15.0</b>	<b>7.8</b>	<b>9.6</b>	<b>7.5</b>	<b>5.7</b>	<b>6.2</b>

The branches that showed the strongest growth were cement (due to both domestic consumption and exports to the US); metallic structures (due to mining, construction

and energy projects); printing activities (associated with elections and increased commercial activities); beer (due to higher domestic demand favored also by lower prices); majolica, (due to greater construction); metal containers (due to greater canning); pharmaceutical products (greater sales in local market), and explosives, (due to mining's increased demand, and higher exports to Chile).

**Table 37**

**MAIN BRANCHES WITH HIGHER INCREASES**

CIU	Jan. - Mar. 2006	
	% change	Contrib.% 1/
Cement	19.5	0.8
Metallic products for estructural use	36.3	0.7
Printing activities	12.8	0.7
Beer and malt	27.0	0.5
Ceramic tiles	26.6	0.5
Other metallic products (tins & cans)	18.5	0.5
Pharmaceutical products	37.4	0.5
Explosives, natural and chemical flavorings	16.1	0.4
<b>Subtotal</b>	<b>21.2</b>	<b>4.6</b>
<b>Total</b>	<b>6.2</b>	

1/ Percentage contribution with respect to the non-primary manufacturing.

Source: Ministerio de la Producción.

The **construction sector** grew 16.2 percent during the first quarter in response to an increase in self-building activities; in the mortgage market as a result of the housing program Mivivienda; and in works carried out by local and provincial governments thanks to the revenues of mining royalties. The culmination of projects, such as the improvement of the Ilo Smelter and the expansion of Cerro Verde's Primary Sulphates Plant also contributed to the expansion of this sector.

84. The forecast for the non-primary sector in **2006** is growth of 6,3 percent, due to construction (9,2 percent) which increased mainly because of the favorable performance of the

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mortgage market and house building. Likewise, non-primary manufacturing will grow 6,6 percent, mainly because of the branches oriented to the production of raw materials (e.g. chemicals and non-metallic minerals) and of the branches associated with construction.

Primary sectors are expected to show lower growth (2.3 percent), despite some moderate increases in agriculture (the higher output of coffee and sugar cane would be offset by a drop in the production of potato, rice, and hard yellow corn), mining, and hydrocarbons (due to gold mining operations in Alto Chicama). A fall is forecast for the fishing sector, due to regulations of the Ministry of Production limiting anchovy catch.

85. At the sector level, the forecast for 2007 is a GDP growth of 5.3 percent given the recovery of primary sectors. It is worth highlighting the dynamic performance of mining and hydrocarbons (associated with the new mining project of Cerro Lindo that produces zinc, and with the expansion of the copper Cerro Verde mine). Agriculture is expected to improve due to the normalization of weather conditions. This sector would increase more than in 2006, due to the production recovery of potato, rice, and hard yellow corn.

Non-primary sectors would grow at a lower rate in 2007 due to a slow down of domestic demand. Non-primary manufacturing would increase over percent thanks to better access to international markets. Construction is expected to maintain high growth rates, although lower than in 2006, because of private investment and housing programs.

## **VI.2 Public Finances**

*Greater economic activity and high export prices would increase central government's current revenues from 15.7 percent in 2005 to 16.5 and 16.0 percent in 2006 and 2007 respectively. However, the high volatility of export prices determines greater uncertainty in terms of fiscal income forecasts. Given increased tax collection, a slight fiscal surplus is expected for 2006 and a nil deficit for 2007, as 2006 will see higher spending and increased public investment by regional and municipal governments. In 2007, on the other hand, the increase of spending is expected to be compatible with the legal ceiling of 3 percent (real).*

86. During the first quarter of 2006, the **non-financial public sector** posted a surplus of 3,7 percent of GDP, evolution explained by the increase of central government's current revenues (25,6 percent in real terms).

**Table 38**

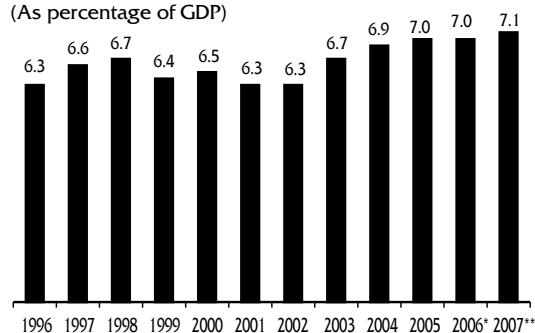
**NON-FINANCIAL PUBLIC SECTOR**

(Millions of nuevos soles)

	2004	2005	2006			2007
			IR January I Q	IR May 2006	IR May 2006	
<b>1. Central government</b>						
<b>current revenue</b>	<b>35,381</b>	<b>40,997</b>	<b>12,023</b>	<b>44,032</b>	<b>48,549</b>	<b>50,054</b>
(% of GDP)	14.9	15.7	17.0	15.8	16.5	16.0
Real % change	8.1	14.0	25.6	4.4	15.3	1.5
<b>2. Central government</b>						
<b>non-financial expenditure</b>	<b>-34,165</b>	<b>-38,477</b>	<b>-8,541</b>	<b>-40,650</b>	<b>-42,629</b>	<b>-44,585</b>
(% of GDP)	-14.4	-14.7	-12.1	-14.6	-14.5	-14.3
Real % change	4.8	10.8	9.5	3.0	7.9	2.5
Current	-29,870	-33,580	-8,006	-35,422	-36,863	-37,852
(% of GDP)	-12.5	-12.8	-11.3	-12.7	-12.6	-12.1
Real % change	5.3	10.6	9.7	2.9	6.9	0.6
Capital	-4,295	-4,896	-534	-5,228	-5,766	-6,733
(% of GDP)	-1.8	-1.9	-0.8	-1.9	-2.0	-2.2
Real % change	1.5	12.2	6.9	3.4	14.7	14.4
<b>3. Others</b>	<b>1,193</b>	<b>1,698</b>	<b>856</b>	<b>726</b>	<b>601</b>	<b>600</b>
(% of GDP)	0.5	0.6	1.2	0.3	0.2	0.2
<b>4. Primary balance</b>	<b>2,409</b>	<b>4,219</b>	<b>4,338</b>	<b>4,108</b>	<b>6,521</b>	<b>6,069</b>
(% of GDP)	1.0	1.6	6.1	1.5	2.2	2.0
<b>5. Interest</b>	<b>-4,867</b>	<b>-5,066</b>	<b>-1,715</b>	<b>-6,103</b>	<b>-5,907</b>	<b>-5,922</b>
(% of GDP)	-2.0	-1.9	-2.4	-2.2	-2.0	-1.9
Of which:						
Pension reform bonds	333	105	102	232	222	231
External debt (Millions of US\$)	-1,159	-1,266	-355	-1,344	-1,334	-1,321
<b>6. Overall balance</b>	<b>-2,458</b>	<b>-847</b>	<b>2,623</b>	<b>-1,995</b>	<b>614</b>	<b>147</b>
(% of GDP)	-1.0	-0.3	3.7	-0.7	0.2	0.0
Millions of US\$	-754	-213	785	-603	161	-45

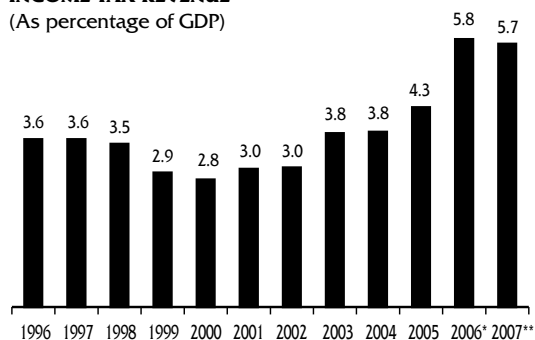
The **current revenues** of the central government rose to 17 percent of GDP. Approximately fifty percent of this increase stemmed from Income Tax payments which increased 39.0

**Graph 61**  
**GENERAL SALES TAX**  
(As percentage of GDP)



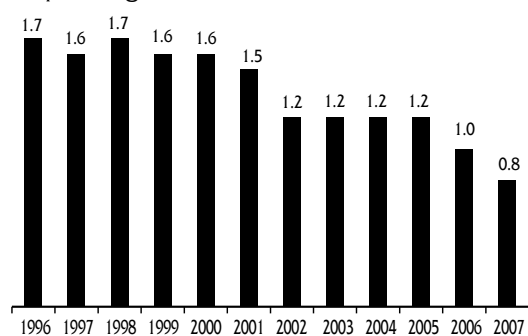
\* Estimated.  
\*\* Forecast.

**Graph 62**  
**INCOME TAX REVENUE**  
(As percentage of GDP)



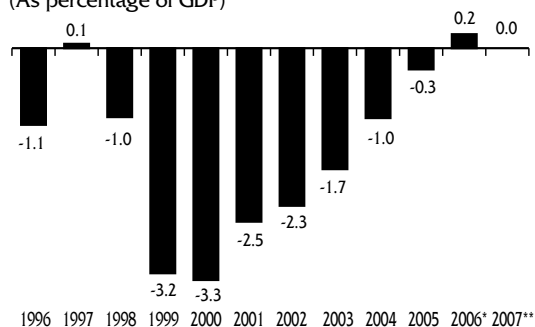
\* Estimated.  
\*\* Forecast.

**Graph 63**  
**IMPORT TAX REVENUE**  
(As percentage of GDP)



\* Estimated.  
\*\* Forecast.

**Graph 64**  
**OVERALL BALANCE OF THE**  
**NON-FINANCIAL PUBLIC SECTOR**  
(As percentage of GDP)



\* Estimated.  
\*\* Forecast.

percent in real terms. This evolution was due particularly to down payments, reflecting on the one hand higher coefficients (due to greater profits in the previous year) and the expansion of economic activity and higher prices for minerals in the international market.

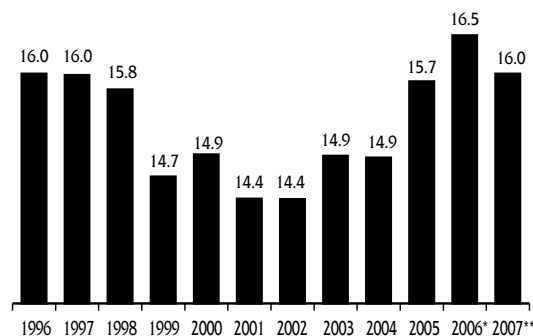
The increased collection of General Sales Tax (18.6 percent in real terms) was brought about by the growth of economic activity, as well as by a significant increase of imports during this period. Greater tax control and the expansion of mechanisms to facilitate tax payments, introduced in August 2004, contributed to this evolution.

Additionally, more revenue collection was possible due to mining and oil & gas royalties, as well as by transferences of profits (Banco de la Nación) and surpluses (Superintendency of National Tax Administration - Sunat), which together represented 0.4 percentage points of GDP. These developments compensated the fiscal loss brought about by the reduction of the excise tax (ISC) on fuels, which had been implemented in order to attenuate the impact of oil's international price on domestic prices.

On the other hand, the **non-financial expenditure** amounted to 12.1 percent of GDP, a 0.7 percent decline with respect to the same period in 2005, but a 9.5 percent in real terms. Increased spending in goods and services is associated with the electoral process, Sunat's higher tax collection, and higher transferences to local governments, the latter due to the Municipal Compensation Fund and mining royalties. Furthermore, spending in this quarter also reflects a rise in salaries over the past months which benefited teachers, education administrative staff, health-care professionals, faculty and staff of private universities, the military and the police.

87. The forecast for **2006** is that the non-financial public sector will total 0.2 percent of the GDP, in a context of extraordinary incomes (given favorable prices for our raw materials), greater committed spending (such as salary increases for the sectors of education, defense, and interior), and increased capital spending by regional and municipal governments.

**Graph 65**  
**CURRENT REVENUES OF THE CENTRAL GOVERNMENT**  
 (As percentage of GDP)



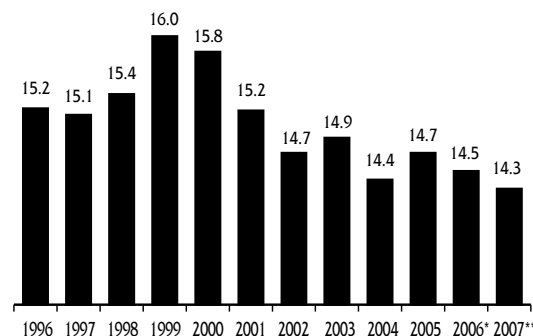
\* Estimated.  
 \*\* Forecast.

Central government **current revenues** are forecast at 16.5 percent of GDP, 0.8 percent more than in 2005, (real increase of 15.3 percent). This result includes a higher collection of income tax -which would rise to 5.8 percent of GDP triggered by increased down payments and regularization of income tax payment corresponding to FY 2005. These revenues, higher than the 4.3 percent of GDP exhibited in 2005, reflect the favorable international context for our raw materials.

However, the volatility of international prices might reverse this trend. A 10 percent decline in the quotation of exportable mining products is estimated to generate a reduction of approximately 0.4 percent of GDP.

Revenues from General Sales Tax (excluding the municipal promotion tax) would remain at similar levels as in 2005 (6.3 percent of GDP), mainly because FY 2005 included extraordinary revenues associated with a transference of shares. The forecast for the excise tax (ISC) considers a decline of 0.3 percent of GDP associated to the reduction of rates in April 2006, on the one hand, to the impact produced by increased use of natural gas, on the other hand.

**Graph 66**  
**NON-FINANCIAL EXPENDITURE OF THE CENTRAL GOVERNMENT**  
 (As percentage of GDP)



\* Estimated.  
 \*\* Forecast.

Non-financial expenditure would reach to 14.5 percent of GDP, decreasing by 0.4 percent with respect to 2005. The forecast considers that capital expenditure will remain around 2.0 percent of GDP, showing an evolution similar to that of 2005. In the case of general government, non-financial expenditure is also expected to remain at similar levels as in 2005: 17 percent of GDP.

Public debt amortization will total US\$ 1,620 million, and will include external as well as external debt maturities amounting to US\$ 1,200 million and US\$ 420 million respectively. This forecast considers that less debt will be payable in 2006 because of Paris Club and Japeco external debt prepayments in 2005. The public sector borrowing requirement in 2006 will be US\$ 1,460 million, which will be covered by external disbursements (US\$ 800 million) and bonds (US\$ 701 million).

## BOX 7 DEVELOPMENT OF SOL-DENOMINATED BONDS MARKET

Treasury's and private business' issuance of bonds in domestic currency is beneficial to the economy. First, because this reduces the exchange risk or the balance sheet effect produced when the government, individuals, or business receive incomes in soles and engage in debts in dollars. Second, because dollarization, which increases the risks of liquidity in dollars in the bank system due to high legal and international reserve requirements, may be reduced. As a result of this, the economy can respond better to external crises, as domestic lending and public debt are not so affected by the exchange rate, and thus the economy becomes less vulnerable. The risks generated by dollarization prevent the economy from reaching higher levels of investment.

In recent years, emerging economies have modified their sovereign debt portfolio, promoting a higher use of domestic currencies due to several factors: (1) improved macroeconomic fundamentals have contributed to reduce vulnerability in these economies, basically due to a better fiscal and balance of payments position and to the accumulation of international reserves; (2) low inflation levels (due to inflation targeting in many emerging economies); (3) a favorable international context including low interest rates and better terms of trade.

In Latin America, the share of the debt (bonds) in domestic currency relative to the overall sovereign debt (external and domestic debt) has increased in 2000-2004, particularly in Brazil and Mexico where it rose to 74 percent and 59 percent respectively. In Peru, this share increased in only five years from 6 to 22 percent in 2005.

Most recently, only Uruguay, Colombia, and Brazil have issued domestic currency-denominated external debt. It is worth highlighting that Colombia and Brazil have issued bonds that are not indexed for inflation.

### SOVEREIGN DEBT IN DOMESTIC CURRENCY AS PERCENTAGE OF TOTAL SOVEREIGN DEBT 1/

	2000	2004 2/	Change
Brazil	61	74	13
Chile	9	16	7
Colombia	47	54	7
Mexico	48	59	11
Peru	6	26	20
Venezuela	29	37	8

### INTERNATIONAL SOVEREIGN DEBT ISSUED IN DOMESTIC CURRENCY

Country	Issue date	Maturity date	Amount Issued (million of US\$)	Coupon rate
Brazil	Sep-05	Jan-16	1,480	12.50
Colombia	Nov-04	Mar-10	588	11.75
Colombia	Feb-05	Oct-15	547	12.00
Uruguay	Oct-03	Oct-06	290	10.50
Uruguay	Aug-04	Feb-06	250	17.75

1/ It only includes bonds.

2/ Peru date correspond to 2005.

Source: BCRP - Standard & Poor's.

Source: Bloomberg, Carlos E. Tovar

Peru has showed an important process of dedollarization of its main monetary and financial aggregates over the past few years, including the market of public and private bonds.

### DOLLARIZATION RATE OF MONETARY AGGREGATES

Year	Banking system liabilities	Banking system credit	Financial system credit	Private bonds 1/	Public bonds 2/
2000	70	82	81	78	
2001	67	80	78	72	
2002	65	79	76	70	64
2003	62	77	73	65	54
2004	55	74	71	66	41
2005	55	70	67	66	12

1/ Includes short-term bonds and instruments.

2/ Public bonds placed in domestic market.

**PRIVATE BONDS IN NOMINAL DOMESTIC CURRENCY 1/**

Year	Domestic currency			Foreign currency
	Nominal	VAC 2/	Total	
2000	2	20	22	78
2001	11	17	28	72
2002	13	17	30	70
2003	17	18	35	65
2004	17	17	34	66
2005	20	14	34	66

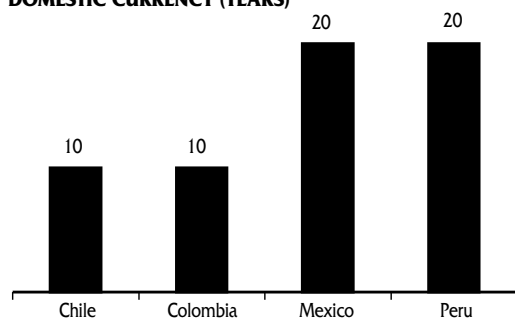
1/ Includes short-term bonds and instruments.  
2/ Balances include the effect of VAC variation.

Inflation Targeting favored this process through two mechanisms. First, a low and stable level of inflation, in line with the inflation target, contributes to generate an increased demand for local currency as a store of value. Second, a higher stability and predictability of the interbank rate contributes to determine the other interest rates in soles, thereby promoting greater financial intermediation in our domestic currency.

Another important factor associated with the private issuance of bonds in soles has been the establishment of a yield curve for Public Treasury bonds, in nominal soles, and with 20-year maturities, which is being used as reference for the issuance of private securities and mortgage loans with increasingly longer maturities. It should be said here that Mexico and Peru have the sovereign (nominal soles) bonds with the longest maturities in Latin America.

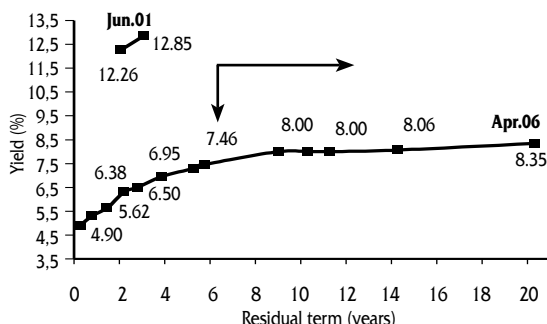
It is also worth mentioning that the yield curve of sovereign bonds denominated in nominal soles, with maturities between 3 and 20 years, has been enhanced in only five years, reducing the yield rate by 50 percent. This evolution is reflected not only in the lower level of country risk, but also in greater trust in terms of macroeconomic stability.

**MAXIMUM TERM OF SOVEREIGN BONDS IN DOMESTIC CURRENCY (YEARS)**



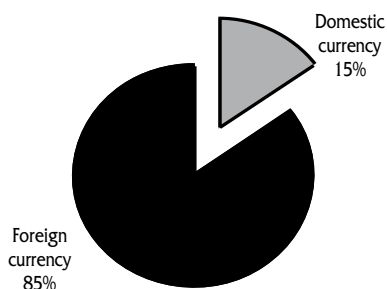
Includes information at 2006.

**SECONDARY MARKET OF PUBLIC TREASURY SOVEREIGN BONDS**

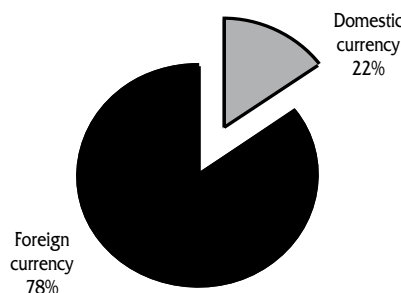


Debt currency swaps (from dollars to soles) carried out in 1995 allowed to reduce the total foreign-currency public debt, both external and domestic, from 85 percent in 2001 to 78 percent in 2005. In the case of the domestic debt, Treasury bonds for the Financial Consolidation Program accounted for a total of S/. 1,244 million (US\$ 381 million), while in the case of the external debt, soles-denominated bonds were issued in the domestic market to finance two extraordinary prepayments of debts with the governments and official agencies of the Paris Club (US\$ 805 million) and JAPECO (US\$ 237 million).

**PUBLIC DEBT PER CURRENCY - 2001**



**PUBLIC DEBT PER CURRENCY - 2005**





## BOX 8 DOMESTIC DEBT CONVERSION

The Ministry of Economics and Finance (MEF) approved the conversion of Peruvian sovereign bonds for a total of S/. 3.9 billion (Supreme Decree N° 072-2006-EF) on May 25, 2006. This operation aimed at restructuring domestic debt in order to establish maturities that would contribute to consolidate a yield curve for securities denominated in soles. As a result, the domestic market will have more liquidity, the risks of debt financing will be reduced, and current maturities will be replaced by amortizations with longer maturity terms.

This debt conversion operation includes the anticipated withdrawal of the bonds included in the table below and their conversion into new bonds to be issued.

### SOVEREIGN BONDS EXCHANGE

(Millions of nuevos soles)

Fecha Venc.	Tipo	Monto	Tasa-Cupon	Precio
12-aug-06	Fixed rate	422	4.98%	100.0%
11-feb-07	Fixed rate	225	7.20%	101.3%
9-oct-07	Fixed rate	341	5.94%	100.4%
11-feb-09	Fixed rate	401	7.25%	102.2%
10-mar-10	Fixed rate	666	8.61%	106.2%
31-jan-12	Fixed rate	525	9.00%	108.7%
12-aug-16	Fixed rate	425	7.34%	98.4%
<b>Subtotal</b>		<b>3,005</b>		
20-feb-11	VAC	192	6.70%+VAC	111.9%
9-aug-09	VAC	49	7.97%+VAC	114.7%
10-jun-10	VAC	75	6.70%+VAC	111.9%
11-dec-13	VAC	75	5.79%+VAC	111.1%
30-jan-14	VAC	209	5.80%+VAC	110.6%
14-apr-16	VAC	150	5.90%+VAC	112.2%
8-jun-16	VAC	80	6.84%+VAC	119.0%
13-jul-19	VAC	69	7.40%+VAC	125.0%
<b>Subtotal *</b>		<b>900</b>		
<b>Total Sovereign Bonds</b>		<b>3,905</b>		

\* VAC bonds at nominal values.

Source: MEF.

Bonds to be converted include the following:

### SOVEREIGN BONDS ISSUES

Maturity	Sort	Bond numbers before exchange (Thousands)	Bond numbers after exchange (Thousands)	Rate-Coupon	Price
9-jul-08	Fixed rate	511	773	9.47%	106.7%
10-aug-11	Fixed rate	641	1,362	12.25%	122.7%
5-may-15	Fixed rate	787	1,242	9.91%	115.7%
12-aug-17	Fixed rate	1,545	1,840	8.60%	105.8%
<b>Subtotal</b>		<b>3,484</b>	<b>5,217</b>		
13-oct-24	VAC	723	795	6.84%+VAC	119.8%
31-jan-35	VAC	394	796	7.39%+VAC	128.7%
<b>Subtotal</b>		<b>1,117</b>	<b>1,591</b>		
<b>Total Sovereign Bonds</b>		<b>4,601</b>	<b>6,808</b>		

Source: MEF.

88. Forecasts for **2007** consider a nil fiscal deficit for the Public Sector.

With respect to **fiscal revenues**, tax pressure is expected to fall by 0.5 percentage points relative to 2006, due to the elimination of the Tax on Financial Transactions (ITF); to lower import duties, as a result of tariff relief stemming from the Free Trade Agreement with the United States; as well as to lower incomes from the regularization of income tax payments, given the gradual reversal of terms of trade. The forecast for 2007 considers that the Temporary Tax on Net Assets (ITAN) will remain. Otherwise, fiscal revenues would decrease in this context of declining terms of trade.

Central government **non-financial expenditure** is forecast to increase in about 3 percent in real terms, a figure consistent with Peru's Fiscal Responsibility and Transparency Act (LRTF).

The public sector **borrowing requirement** for 2007, estimated at US\$ 2,013 million, will be covered by external disbursements for a total of US\$ 770 million, by global bonds for a total of US\$ 1,040 million, and by domestic bond placements. This takes into account debt conversion operations to contribute to dedollarization, and extending the maturity of the public debt.

**Table 39**

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

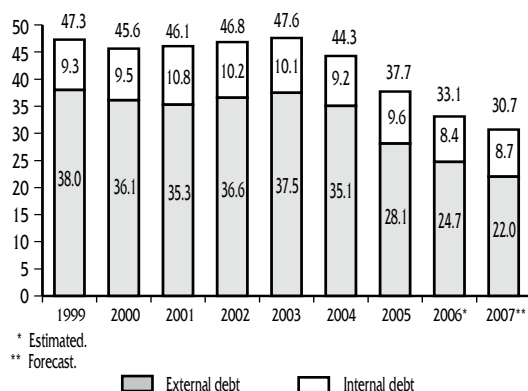
	2004	2005	2006*			2007**
			IR January		IR May	
			IQ	2006		
<b>I. USES</b>	<b>2,822</b>	<b>4,673</b>	<b>-439</b>	<b>2,129</b>	<b>1,460</b>	<b>2,013</b>
<b>1. Amortization</b>	<b>2,068</b>	<b>4,460</b>	<b>346</b>	<b>1,526</b>	<b>1,621</b>	<b>2,058</b>
a. External	1,348	3,678	282	1,132	1,200	1,647
b. Internal	720	783	64	394	421	411
Of which: Pension reform bonds	215	192	30	95	105	79
<b>2. Fiscal Deficit</b>	<b>754</b>	<b>213</b>	<b>-785</b>	<b>603</b>	<b>-161</b>	<b>-45</b>
<b>II. SOURCES</b>	<b>2,822</b>	<b>4,673</b>	<b>-439</b>	<b>2,129</b>	<b>1,460</b>	<b>2,013</b>
<b>1. External</b>	<b>1,205</b>	<b>1,046</b>	<b>79</b>	<b>1,055</b>	<b>855</b>	<b>778</b>
a. Free disposal	863	595	0	499	299	270
b. Investment projects	315	350	53	500	500	500
c. Others	26	100	26	56	56	8
<b>2. Internal</b>	<b>-444</b>	<b>-151</b>	<b>-621</b>	<b>400</b>	<b>-95</b>	<b>195</b>
a. Promotion Process of the Private Investment (PPPI)	114	57	3	24	24	24
b. Deposits uses and others	-558	-208	-624	376	-119	171
<b>3. Bonds</b>	<b>2,061</b>	<b>3,778</b>	<b>103</b>	<b>674</b>	<b>701</b>	<b>1,040</b>

\* Preliminary.

\*\* Forecast.

Source: BCRP, MEF, ONP.

**Graph 67**  
**PUBLIC DEBT**  
(As percentage of GDP)



89. The public debt-to-GDP ratio would decline from 37.7 percent 2005 to 33.1 percent in 2006, and then to 30.7 percent by December 2007.

### VI.3 Balance of payments

90. Increased domestic spending (basically private investment) during the first quarter injected greater dynamism to imports (particularly capital goods), thereby generating a slight deficit on the current account (US\$ 167 million or 0.8 percent of GDP). The trade balance recorded a surplus of US\$ 1,176 million, US\$ 86 million larger than that of 2005. The investment income balance, on the other hand, was negative in US\$ 1,592 million.

**Table 40**

### BALANCE OF PAYMENTS

(Millions of US\$)

	2004	2005	2006*		2007**	
			I Q	IR January	IR May	
<b>I. CURRENT ACCOUNT BALANCE</b>	<b>- 10</b>	<b>1,030</b>	<b>-167</b>	<b>707</b>	<b>596</b>	<b>185</b>
<i>Percentage of GDP</i>	<i>- 0.0</i>	<i>1.3</i>	<i>-0.8</i>	<i>0.9</i>	<i>0.7</i>	<i>0.2</i>
1. Trade balance	2,793	5,163	1,176	5,247	7,189	6,437
a. Exports	12,617	17,247	4,566	18,839	21,842	23,427
b. Imports	-9,824	-12,084	-3,390	-13,591	-14,653	-16,990
2. Services	- 843	-913	-216	-950	-931	-1,091
3. Investment income	-3,421	-5,011	-1,592	-5,563	-7,655	-7,329
4. Current transfers	1,461	1,791	465	1,973	1,994	2,168
<b>II. FINANCIAL ACCOUNT</b>	<b>2,336</b>	<b>498</b>	<b>391</b>	<b>228</b>	<b>723</b>	<b>987</b>
1. Private sector	1,348	1,939	632	506	1,271	2,020
2. Public sector	988	-1,441	-240	-278	-547	-1,033
<b>III. EXCEPTIONAL FINANCING</b>	<b>26</b>	<b>100</b>	<b>26</b>	<b>65</b>	<b>56</b>	<b>28</b>
<b>IV. BCRP NET INTERNATIONAL RESERVES FLOW (1-2)</b>	<b>-2,352</b>	<b>-1,628</b>	<b>-251</b>	<b>-1,000</b>	<b>-1,376</b>	<b>-1,200</b>
<i>(Increase with negative sign)</i>						
1. Change in Central Bank reserves	-2,437	-1,466	-375	-1,000	-1,500	-1,200
2. Valuation changes and monetization of gold	- 85	162	-125	0	-125	0

\* Preliminary.

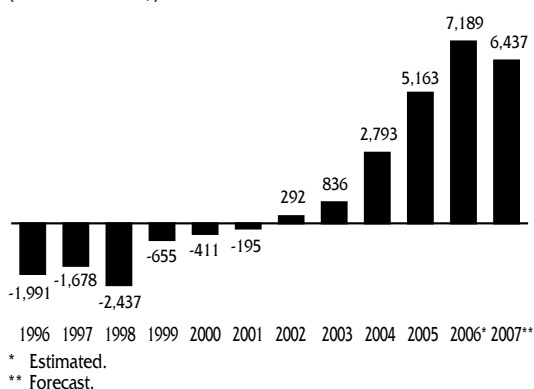
\*\* Forecast.

1/ Includes US\$ 853 millions corresponding to sovereign bonds acquisitions for non-resident.

Source: BCRP, MEF, SBS, SUNAT, Ministerio de Relaciones Exteriores, Cofide, ONP, FCR, Zofratatna, Banco de la Nación, Cavalí ICLV S.A., Proinversión, BIS and enterprises.

**Exports** in this period (US\$ 4,566 million) grew 22 percent (US\$ 818 million) (22 percent) with respect to the first quarter last year, due to larger traditional (25 percent) and non traditional (14 percent) exports.

**Graph 68**  
**TRADE BALANCE**  
(Millions of US\$)



This growth was mainly associated with a rise in average prices (24 percent), given that the volume of exports decreased 2 percent due basically to fewer shipments of fish meal, zinc, and copper. However, this reduction was lessened by larger shipments of non-traditional exports.

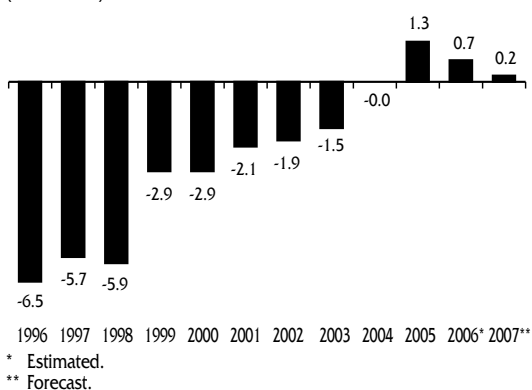
Higher international prices had a positive impact on traditional exports, particularly mining products and oil. The average price increase (32 percent) more than compensated for the reduction in the volumes sold abroad (6 percent) which, in the case of copper, resulted mainly from shipment delays and, in the case of zinc, from less mineral extraction in Antamina.

The growth in non-traditional exports was produced by a larger volume of agricultural and fishing products, which compensated the reduction in the volumes of textiles and chemicals. On the other hand, steel & metallurgical products and jewelry were also favored by higher international prices as the sales of copper, zinc, iron, and common metals increased.

Imports increased by US\$ 732 million (28 percent) spurred by larger purchases of all sorts of products, particularly capital goods for industry.

In the first quarter, the balance of US\$ 391 million balance in financial account reflected a positive flow of US\$ 632 million to the private sector and a negative flow of US\$ 240 to the public sector. This inflow to the private sector was mainly due to direct investment (US\$ 1,122 million), mostly by the reinvestment of companies with foreign shareholding, as well as by capital participation (US\$ 163 million) in Lima Stock Exchange.

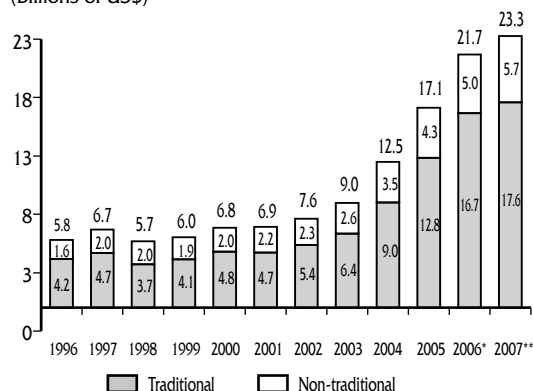
**Graph 69**  
**CURRENT ACCOUNT**  
(% of GDP)



91. The forecast for 2006 is a current account surplus equivalent to 0.7 percent of GDP, consistent with a positive trade balance (US\$ 7,189 million) and with a decrease in the remittances of Peruvian citizens living abroad given the expected deceleration in the world economy.

Exports are expected to grow 26.6 percent, reaching US\$ 21,842 million, although this growth will mainly reflect higher international prices. Larger mining exports, favored by the higher prices, will be partly offset by fewer fishery exports, given weather conditions affecting the availability of fish and inventory sales in the previous year. The growth of non-traditional exports is estimated at 17.2 percent.

**Graph 70**  
**GOOD EXPORTS**  
(Billions of US\$)



Note: Total exports includes other exports.

\* Estimated.

\*\* Forecast.

Imports, on the other hand, are expected to grow 21.3 percent in the context of a dynamic performance of economic activity and of development of investment projects. By components, capital goods and raw materials for industry are expected to grow at rates of 29.3 and 17.4 percent respectively.

The financial account for 2006 is US\$ 723 million. The private sector is expected to have a positive flow of US\$ 1,271 million, due in part to the financing of mining investment projects (e.g. Cerro Verde, Southern, the second stage of Camisea) and to the purchase of shares by SAB Miller.

92. With a less favorable international context in 2007, the trade surplus would decline to US\$ 6,437 million, while the current account surplus in the balance of payments would decrease to 0.2 percent of the GDP. Despite this, both levels would still be higher than in previous years.

In 2007, exports would grow at 7.3 percent. Traditional exports would significantly slow down (growing at 5.4 percent), but the growth rate would remain positive due to the onset of various mining projects, such as the primary sulphure projects in Cerro Verde (copper) and Cerro Lindo (zinc). Imports are estimated to grow 16.0 percent, led by capital goods which would rise 24.4 percent in line with the dynamism of private investment.

The financial account is forecast at US\$ 987 million, with the private sector showing a positive flow of US\$ 2,020 million. The forecast for the balance of payments considers that international reserves will have a growth of US\$ 1,500 million in 2006 and US\$ 1,200 million in 2007, given the surpluses expected in both balance of payments and of capitals.

## VII. ECONOMIC OUTLOOK AND INFLATION FORECASTS

### VII.1 Market expectations

93. In May, inflation expectation for 2006 ranged between 2.6 and 2.8 percent; while these expectations in the case of 2007 are estimated within the inflation target of 2.5 percent.

Economic analysts raised their GDP forecast from 5.0 to 5.3 percent for 2006, while financial institutions raised it to 5.6 percent. Both groups maintain their growth forecast for 2007 at 5.0 percent.

Between January and May, both the economic analysts and the financial institutions revised their expectation on the exchange rate downwards, lowering them from S/. 3.40 to S/. 3.32 and to S/. 3.30 per dollar respectively. For 2007, both groups expect the exchange rate to rise to S/. 3.35 and to S/. 3.34 per dollar respectively.

Table 41

#### MACROECONOMIC EXPECTATIONS SURVEY: 2006 AND 2007

	2006			2007
	Month of the survey			Month of the survey
	Aug.05	Jan.06	May.06	May.06
<b>Inflation (%)</b>				
Economic analysts	2.5	2.5	2.6	2.5
Financial system institutions	2.5	2.5	2.8	2.5
<b>GDP growth (%)</b>				
Economic analysts	4.6	5.0	5.3	5.0
Financial system institutions	4.9	5.0	5.6	5.0
<b>Exchange rate (S/. per US\$)</b>				
Economic analysts	3.30	3.40	3.32	3.35
Financial system institutions	3.30	3.40	3.30	3.40
<b>Interbank interest rate (%)</b>				
Economic analysts	3.5	4.0	4.50	4.5
Financial system institutions	3.8	4.0	4.86	5.0

## VII.2 Inflation

*The twelve-month inflation rate is expected to continue fluctuating within the target range and to move towards the target, in a context of about 5 percent economic growth.*

94. The inflation forecasts presented in this report correspond to 2006 and 2007 and, therefore, take into account the normal lags that occur between monetary policy decisions and their impact on inflation. As in previous reports, the methodological assumption is that monetary stimulation will be gradually reduced to keep it in line with the inflation target. As the BCRP collects new information about the state of the economy, the monetary policy position will be adjusted accordingly, in a manner consistent with the Bank's inflation target.

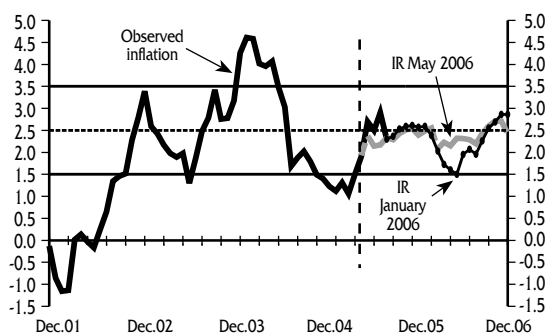
95. The inflation outlook for the next few months is not substantially different from that foreseen in the January Report. Total inflation is in line with the target. Although the prices of some food products increased in the last months above the levels forecast in the last report, the 12-month inflation rate finally settled at 2.2 percent in May, and is expected to remain in the vicinity of the target level during the rest of the year (2.5 percent).

In the first half of 2007, inflation is expected to fall, mainly due to the normalization of supply conditions as of the second half of 2006. No pressures are foreseen in the central scenario that would take inflation beyond the permissible limits of 1.5 to 3.5 percent. Inflation is expected to converge to the target level towards the end of the forecast horizon.

96. Another determinant factor of inflation is the balance between supply and demand for goods and services. In this regard, it is worth mentioning that an important factor considered in these forecasts is that demand has fueled the growth pace of economic activity. The evolution in the first 5 months of 2006 is explained by a sustained growth of terms of trade, given a favorable international context for the quotations of our main non-traditional exports. This evolution has also been coupled by economic agents' high levels of trust, and by positive prospects in terms of investment and consumption, as well as by a favorable trend in the volume and financing costs of financial capital markets. Therefore, economic growth and dynamism are expected to remain in line with the target over the forecast horizon.

97. The second factor has to do with production costs of final goods and services, particularly with imported inflation.

**Graph 71**  
**INFLATION FORECAST**



Projected fuels costs are higher than those predicted in the last Inflation Report (the forecast for the international price of WTI oil has risen from US\$ 61 to US\$ 69), as a result of which the pressures inherent to this inflationary component are expected to increase. However, the 2.7 percent appreciation of the Nuevo sol in April -with respect to the close of 2005- will tend to reduce inflation and has become instrumental to its decline, particularly during the first half of the forecast horizon.

The last important factor in determining inflation is the economic price-setting mechanisms, which are influenced by past inflation and expectations of future inflation. The Bank's successful compliance with the inflation target ever since the Inflation Targeting framework was adopted has reinforced the credibility over BCRP policies. The monetary policy described in this report, by remaining in line with the inflation target and maintaining the Bank's cautious position, guarantees that inflation expectations will continue to be anchored to the target over the forecast horizon.



## VIII. BALANCE OF RISKS AND CONCLUSION

98. The main risks that could affect the baseline scenario inflation forecasts are:

- **Appreciation of the Nuevo Sol:** the recent evolution of the exchange rate has been characterized by its re-connection to existing macroeconomic fundamentals. The baseline scenario takes into consideration the appreciation of the nuevo sol this year. Once the electoral process is over, however, it is quite possible that the nuevo sol will resume the strong growth that was interrupted several months ago, particularly given the prospects for continued macroeconomic stability, high prices of our exports, and more access to foreign markets, as well as a reversal in the trend for forward operations in dollars.

In that situation, the Central Bank could maintain its monetary position for a longer period of time and intervene in the exchange market to reduce excessive volatilities in the exchange rate.

- **Higher international fuel prices:** the baseline scenario for this report considers the price of oil at an average level of US\$ 70 and US\$ 73 per barrel for 2006 and 2007 respectively. However, there is a risk that fuel prices may be subject to several rises due to factors affecting the balance of the oil market.

The Central Bank would not react to a temporary rise in inflation, but would do so in the case of a generalized rise in prices that could threaten to spread within the forecast horizon and affect inflation expectations.

- **An increase in the country risk:** Strong depreciatory pressures have been observed in some countries with high current account deficits (Iceland, New Zealand, and Turkey), which could generate not only risk aversion among investors but also affect risk perceptions regarding emerging economies. In a context of growing international rates and of ongoing electoral processes, this might be reflected in an increase in the country risk of the economies in the Latin American region.

**BOX 9**

**IMPACT OF THE INTERNATIONAL PRICE OF FUELS**

Given the increasing volatility in the international price of oil (US\$ 32 per barrel in December 2003, US\$ 59 in December 2005, and US\$ 72 by the end of May 2006), a combination of price stabilization and reduction of Excise Tax schemes has been developed in order to reduce its impact on domestic prices and on the economy.

*Price stabilization mechanism, May - September 2004.* Implemented in May 2004 for a period of 120 days, this mechanism compensated the rise in international prices by reducing the Excise Tax (ISC) on fuels through a price band scheme. This scheme was in force from May to August 2004. During this period, the Excise Tax on the price of diesel was reduced by S/. 0.19 per gallon; S/. 0.07 per gallon in the case of kerosene; and S/. 0.26 per gallon in the case of liquified gas.

*Fuel Price Stabilization Fund, October 2004 - June 2006.* Initiating operations on October 13, 2004, this Fund was initially established for a period of 180 days, but was subsequently modified and extended to June 2006. The Fund operates on the basis of the following scheme: when Osinerg's reference price is above the upper band of target prices, fuel producers and importers receive a weekly compensation; and conversely, when Osinerg's reference price is below the lower band of target prices, producers and importers contribute specified sums of money to the Fund.

The initial government allocation of S/. 60 million was increased to a total of S/. 250 million. Fund obligations to date have accumulated a total S/. 245 million, S/. 180 million of which were executed in December 2005 against that year's budget, while S/. 65 million have been programmed for the 2007 budget. Therefore, the Fund's available balance by May is S/. 5 million.

*Reduction of Excise Tax on fuels.* In addition to reducing the excise tax as part of the initial price stabilization scheme (May-September 2004), the government has been reducing the excise tax to complement the Fuel Stabilization Fund. The greatest excise tax reduction was produced in the case of diesel, which dropped from S/. 2.29 per gallon in December 2003 to S/. 1.40 per gallon in December 2005. The excise tax on liquified gas was eliminated in July 2005, while the price of kerosene also fell from S/. 2.14 per gallon in December 2003 to S/. 1.77 per gallon in December 2005 due to this tax reduction.

**MODIFICATIONS OF FUEL EXCISE TAX: 2004 -2006**  
(S/. per gallon)

	2003	2004					2005			2006		
	Dec	7 Jul	4 Aug	17 Aug	12 Oct	6 Nov	2 Jul	2 Aug	10 Sep	1 Jan	13 Apr	25 Apr
Gasoline 84	2.90	2.90	2.90	2.90	2.90	2.90	2.90	2.60	2.60	2.35	2.25	
Gasoline 90	3.71	3.71	3.71	3.71	3.71	3.71	3.71	3.61	3.31	3.31	3.06	2.96
Gasoline 95	4.02	4.02	4.02	4.02	4.02	4.02	4.02	3.92	3.62	3.62	3.32	3.22
Gasoline 97	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.15	3.85	3.85	3.55	3.45
Kerosene	2.14	2.14	2.14	2.07	2.07	2.07	2.07	2.07	1.77	2.21	2.21	2.11
Diesel 2	2.29	2.24	2.16	2.10	1.85	1.70	1.70	1.60	1.40	1.84	1.84	1.74
Propane gas	0.54	0.54	0.34	0.28	0.28	0.28	--	--	--	--	--	--
<b>Mean</b>	<b>1.73</b>	<b>1.71</b>	<b>1.64</b>	<b>1.60</b>	<b>1.49</b>	<b>1.42</b>	<b>1.37</b>	<b>1.32</b>	<b>1.17</b>	<b>1.38</b>	<b>1.34</b>	<b>1.28</b>

Note: Includes non-affected by excise tax residuals.

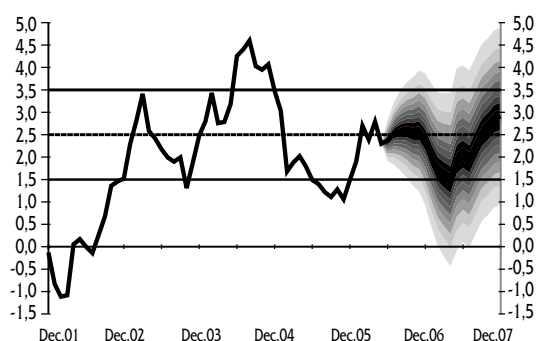
In January 2006, after eliminating the tariffs on the imports of oil and derived products representing fiscal costs for a total of S/. 561 million, the government increased the excise tax on kerosene and diesel by S/. 0.44 per gallon, thereby partially recovering annual revenues for S/. 425 million. This measure had no impact on prices as refineries reduced their prices in the same proportion. Likewise, in response to the rise in the international price of oil, and in order to complement the Stabilization Fund, in April the excise tax on gasolines was reduced between S/. 0.35 and S/. 0.40 per gallon, and by S/. 0.10 in the case of kerosene and diesel.

*Impact on prices.* This set of measures has contributed to partially cushion the rise of domestic prices in a context of high volatility of oil international prices. Thus, although oil increased 27 percent in 2004 and 43 percent in 2005, the final price of fuels (excluding the profits of resellers) increased an average of 17 and 14 percent respectively. In terms of the basket of fuels included in the CPI (gasolines, kerosene, and liquified gas), the average rise was 16 and 6 percent respectively. In January - May 2006, the quotation of oil rose 16 percent, whereas the final prices of fuels increased only 2 percent on average (1 percent in terms of the CPI).

*Fiscal impact.* The fiscal cost of these measures is estimated in S/. 176 million in 2004 and S/. 965 million in 2005, amounts which were covered by higher revenues from the GST, income tax, tariffs, and oil royalties. In the period January-May 2006, the fiscal cost of these measures amounts to S/. 65 million, on account of Fund obligations, and S/. 140 million, on account of lower revenues during the rest of the year due to the reduction of the excise tax on fuels. Moreover, the Public Treasury's revenues are expected to rise to S/. 355 million due to both increased income tax resulting from higher prices and oil royalties, thereby allowing to expand the Fund resources or to reduce the excise tax for up to S/. 150 million.

Given the risk that the international prices of fuels will continue to increase, a more selective stabilization scheme by products should be designed in the future, which would contribute both to save fiscal compensation costs and to focus on measures benefiting particularly the most vulnerable social groups. Furthermore, the current energy matrix should be transformed in order that oil be replaced in the sectors of electricity, industry, massive transport, as well as in vehicles and households by other economically efficient and less contaminating fuels, such as natural gas. Replacing oil-derived fuels by natural gas would represent a potential saving of up to 80 percent in the case of industrial consumers and motorists, which would allow consumers to recover the investment made in the conversion of equipment and vehicles in less than a year.

**Graph 72**  
**INFLATION DENSITY FORECAST**



Note:  
The illustration shows the central inflation bands over the forecast horizon. The darkest band around the central forecast represents a 10 percent probability of occurrence, while all the colored bands represent a 90 percent probability of occurrence. If the bands made dark upwards or downwards, there would be a bias on the risk distribution to up or down, respectively. If it showed a symmetrical distribution around the central inflation forecast, it would reveal a neutral risk balance in the forecast inflation.

Should this generate higher volatility in the exchange market, the BCRP would once again intervene with a less flexible monetary position to avoid an undesired future impact on inflation. The high level of net international reserves would also contribute to this.

- 99. The weighting of the risks considered results in a neutral balance. Therefore, taking into account all information available to date, it may be said that there will be no upward or downward effects on the inflation forecast.

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

If the bands were (overweighted upwards or downwards), the distribution of risks would be biased upward or downward accordingly. If a symmetrical distribution is observed around the central forecast, then the inflation forecast shows a neutral balance for risks.

**CONCLUSION**

- 100. The inflation forecast described in this Report fluctuates around the 2,5 percent target. This evolution is consistent with a growth in economic activity of around 5.0 or 5.5 percent a year in a context characterized by more uncertainty.

**STATISTICAL ANNEX**  
**INFLATION REPORT FORECASTS**

	2004	2005	2006		2007 <sup>1/</sup>
			RI	RI	RI
			Jan. 06	May. 06	May. 06
<b>Real % change</b>					
1. Gross Domestic Product	5.2	6.4	5.0	5.5	5.3
2. Domestic demand	4.4	5.4	5.4	7.1	5.7
a. Private Consumption	3.5	4.4	4.2	4.8	4.3
b. Public Consumption	4.0	9.8	3.5	6.2	4.2
c. Fixed Private Investment	9.1	13.9	10.6	13.5	12.0
d. Public investment	5.7	12.3	10.3	20.5	9.9
3. Exports of goods and services	14.7	14.2	5.1	2.9	7.6
4. Imports of goods and services	10.6	9.9	7.5	11.3	10.0
5. Main trade partners' growth	4.7	4.0	3.8	3.9	3.5
<b>% change</b>					
6. Consumer price index	3.5	1.5	2.5	2.5	2.5
7. Nominal exchange rate <sup>2/</sup>	-5.2	4.4	-0.7	-2.4	1.5
8. Real exchange rate (multilateral) <sup>2/</sup>	-1.5	3.8	0.7	1.7	1.6
9. Terms of trade	9.0	7.0	0.5	16.5	-4.9
a. Exports price index <sup>3/</sup>	20.8	18.4	4.6	25.4	-0.6
b. Imports price index	10.8	10.6	4.1	7.7	4.6
<b>% of GDP</b>					
10. Balance of Payments' current account	0.0	1.3	0.9	0.7	0.2
11. Trade balance	4.1	6.6	6.5	8.1	6.7
12. Gross external finance of the private sector <sup>4/</sup>	3.2	4.0	3.4	4.0	3.6
13. Non-financial public sector primary balance	1.0	1.6	1.5	2.2	2.0
14. Non-financial public sector overall balance	-1.0	-0.3	-0.7	0.2	0.0
15. Tax revenues of the central government	13.3	13.6	13.7	14.5	14.2
16. Outstanding public debt	44.3	37.7	36.8	33.1	30.7
17. Outstanding external public debt	35.1	28.1	27.5	24.7	22.0
<b>Nominal % change</b>					
18. Central government non-financial expenditures	8.6	12.6	5.5	10.8	4.6
19. Monetary base (annual average)	18.8	28.3	17.5	18.5	10.0
20. Banking system credit to the private sector	-0.5	16.0	8.0	8.5	8.5

1/ Forecast.

2/ Exchange Rate Expectations Survey to Economic Analyst.

3/ August Inflation report includes molybdenum price index as part of export prices index, before molybdenum was included in minor metals group.

4/ Includes foreign direct investment and long-run disbursements of private sector.

IR: Inflation Report.

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