INFLATION REPORT:

Recent trends and macroeconomic forecast

May 2007

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CENTRAL RESERVE BANK OF PERU

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Boxes

The ***Inflation Report*** was drawn up using data on gross domestic product, trade balance, operations of the non-financial public sector and monetary accounts as of March 2007, and data on inflation and exchange as of May 2007.

Foreword

- According to the Peruvian Constitution, the Central Reserve Bank of Peru (BCRP) is a public autonomous entity whose role is to preserve monetary stability. By doing so, the Central Bank contributes to establish the necessary stable macroeconomic conditions required for the economic development of the country.

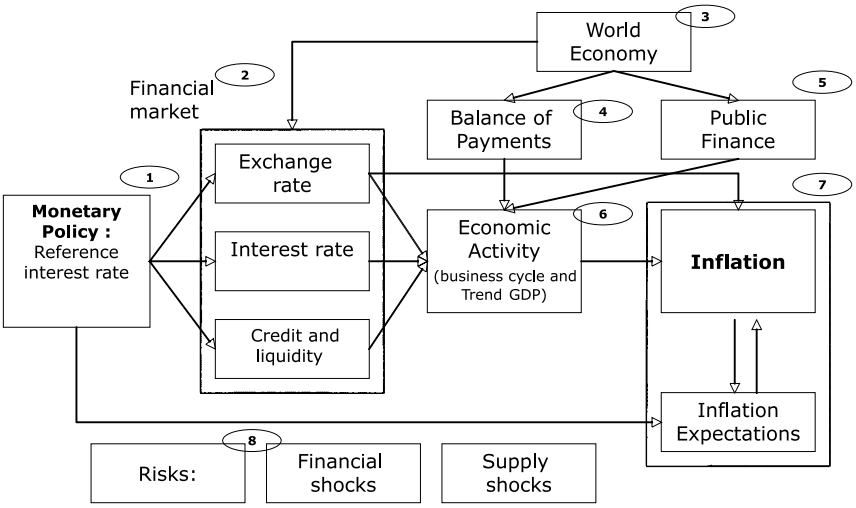
- In order to consolidate this goal, since 2002 the Bank has implemented its monetary policy based on an inflation targeting scheme. As of this year, the inflation target has been reduced from 2.5 to 2.0 percent, plus or minus one percentage point (between 1.0 percent and 3.0 percent).

- At the beginning of each month, and according to the schedule announced in January, the Board of the BCRP approves a reference rate for the interbank lending market. This interest rate affects the entire array of domestic economic variables and inflation through several channels in different timeframes and, therefore, this rate has to be determined on the basis of forecast studies and macroeconomic simulations.

- The economic studies on which monetary policy decisions are made are disseminated to generate the public's understanding of the consistency of the decisions adopted and to ensure that economic agents' expectations take these forecasts and simulations into account. With this aim, the Central Bank publishes its Inflation Report every four months. The previous Inflation Report was released on February 9 this year and the next Inflation Report will be published on October 5.

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

TRANSMITION CHANNELS OF THE MONETARY POLICY



Summary

i. During the first four months of 2007, last 12-month inflation has continued to show a downward trend, in line with the forecasts of our January Inflation Report. Last 12-month inflation in this period was transitorily below the lower band of the inflation target, mainly due to the reversal of the price increases observed in food products in the first months of last year. The central forecast scenario used in this Report considers that inflation will be within the target range in the 2007-2009 forecast horizon, in a context marked by high economic growth and some price increases in food products and fuel associated with higher international prices for *commodities*.

ii. So far this year, the evolution of core inflation shows particularly stable last 12-month rates, which reached 1.5 percent in May. This evolution took place in a context of high dynamism of economic activity, increased productive capacity due to higher investment and productivity, appreciation of the Nuevo Sol, greater competition, and inflation expectations anchored to the Central Bank's inflation target.

iii. The Board of the Central Bank maintained the monetary policy reference rate at 4.5 percent -the same level since May 2006- during the first months of the year. The BCRP communiqués on the monetary program highlighted the transitory nature of lower inflation rates than the Bank's inflation target and emphasized that the evolution of domestic demand is closely followed in terms of the dynamic of the productivity of production factors.

iv. The Peruvian economy continued to show high rates of GDP growth (7.5 percent in the first quarter) and indicators of economic activity, consistent with magnitudes observed

in an expansionary stage of the economic cycle. Domestic production has been responding in an increasingly strong manner to the growth of domestic demand (10.2 percent in the first quarter). Domestic demand has been driven mainly by more consumption and increased private investment in a context of consumers and business' optimistic expectations regarding the improvement of the economic situation. This dynamism of economic activity has been favored by an extraordinarily positive international environment and by surpluses in both the balance of payments and fiscal accounts.

v. The forecasts on economic growth for 2007 and 2008 have been revised upwards from 6.8 to 7.2 percent and from 5.8 to 6.0 percent respectively. This revision considers the high dynamism of private consumption and investment in the first quarter -with rates of 7.4 and 19.5 percent respectively-, the high levels of confidence of economic agents, and better terms of trade than the ones forecast in our January Inflation Report. An annual growth rate of 6.0 percent -similar to the growth rate estimated for the potential GDP for 2007-2009- is forecast for 2009.

vi. Following the remarkable 27 percent growth of terms of trade observed in 2006, the **international environment** has continued to be extraordinarily favorable for the Peruvian economy. On average, terms of trade would increase by 2 percent in 2007, maintaining the trend observed over the past six years. China should continue to grow at high rates, boosting the demand for raw materials in a context in which several products still maintain levels of inventories below their historical levels. Together with a scenario marked by the weakness of the dollar against other currencies and by uncertainty in terms of possible supply constraints in the production of some commodities in the forthcoming months, these factors would contribute to maintain the prices of metals above the levels forecast in our previous Report, as a result of which price corrections would gradually occur only as of the second half of this year.

The economy of the United States continues to show signs of a gradual slowdown, but with a high degree of uncertainty in terms of the evolution of the real estate market and its possible impacts on consumption and investment in that country. In contrast, the Eurozone shows signs of a faster than expected recovery, and Japan is expected to grow at a slow but continuous pace in the following two years.

vii. The forecast on the **current account of the balance of payments** for 2007 has been revised upwards from the 0.7 percent surplus estimated in our previous Report to 1.3 percent of GDP. This revision is based essentially on the results recorded in the first months of the year both in terms of the prices of commodities and in the robust growth shown by some of our trading partners. In 2008 and 2009 the current account of the balance of payments would record a deficit of 0.1 and 0.4 percentage points of GDP respectively, maintaining the growth trend observed in the volumes of external trade and the gradual correction of terms of trade.

viii. A **fiscal surplus** of 1.2 percent of GDP is forecast for 2007. This projection, higher than the one estimated in our January Report, is based on the high prices that our commodities have in international markets and on the slower pace of public sector spending so far this year. A surplus of 0.5 percent of GDP and a nil economic result is forecast for 2008 and 2009 respectively, as a result of both a less favorable international environment -leading to a gradual decline in terms of trade- and a domestic demand that would show a more moderate pace of expansion in the following periods.

ix. The evolution of nominal **exchange rate** so far this year is explained by the continuous favorable development of external accounts and by the process of financial dedollarization observed in the country in a context of a better country risk rating. The Central Bank continued to intervene in the exchange market in order to offset volatility in this market and to preventively accumulate international reserves. Between January and May, the BCRP intervened in the exchange market purchasing US$ 4,531 million, of which US$ 919 million were used to prepay the external debt. As a result of this, the international reserves increased by US$ 3,996 million to US$ 21,271 million.

x. The main risks that could lead forecasts away from the central scenario include the following:

- **Pressures for the appreciation of the Nuevo Sol**: In a scenario of appreciation of the Nuevo Sol, imported inflation would pressure inflation downwards. In this case, the BCRP would maintain its current reference rate for a longer period of time or would reduce said rate.

- **Expansionary demand shock**: The high growth of domestic demand has slowed down in the first quarter:

domestic demand declined from 12.6 percent in the fourth quarter of 2006 to 10.2 percent in the first quarter of 2007. Should the expansion of domestic spending exceed the growth of productivity and create inflationary pressures, the BCRP would raise its reference interest rate.

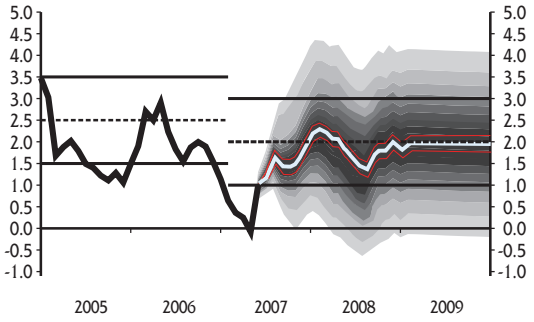
- **Negative external shock due to the international price of oil**: The geopolitical risk that generated an increase in the price of oil in the first months of 2007 has not disappeared. A scenario with greater upward volatility in the oil market would lead the price of oil above the levels considered in the forecast scenario.

  In the event of such a shock, the BCRP would only react if a generalized and sustained price rise should occur, and if agents' expectations regarding inflation would change towards levels considered to be inconsistent with the inflation target. This has not been the case in the last episodes of rises in the international price of fuels since inflation expectations have continued to be within the target range.

- **Negative external shock**: The international environment remains favorable in the forecast horizon, with a gradual reversal of the increase in terms of trade and a transitory slowdown in the economy of the United States, while high rates of growth are observed in the rest of the world and particularly in Asia. This scenario considers a moderate correction in the imbalances of the global fiscal balance and balance of payments. A scenario with a severe correction of the prices of export commodities and/or a situation of recession in the United States (should the lower dynamism of the construction sector extend to the rest of the economy and should imports decline) would imply -depending on the movement of external capitals in emerging economies- a depreciation of the Nuevo Sol and then a downward trend in the dynamism of our economy, a situation that could be stressed if the Free Trade Agreement between Peru and the United States is not approved.

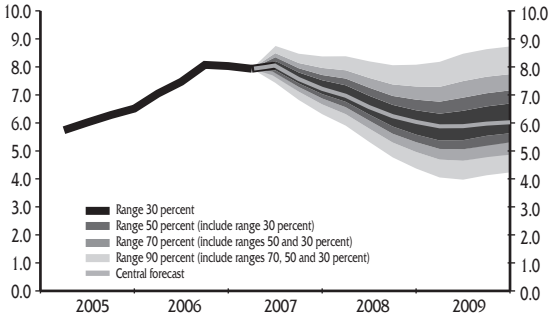
  This lower international demand could imply a lower dynamism in our domestic economic actitivity and therefore the BCRP could maintain the reference interest rate for a longer period of time, provided that the exchange and financial markets continue to show their normal conditions.

INFLATION FORECAST
(Annual percentage change)



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

GDP GROWTH FORECAST
(Annual percentage change in every quarter)



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

- **Negative supply shock due to adverse climatic conditions**: The baseline forecast scenario considers stable climatic conditions for the 2008-2009 period. There is little probability that there will be a "severe" El Niño event in 2008 or that a La Niña event might occur. The latter would imply temperatures below normal that could affect agriculture, thereby causing temporary effects on the prices of food products.

Should any of these events occur, the BCRP would only react if the rise in the price of agricultural products affected inflation expectations and extended to other prices in the economy.

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

STATISTICAL ANNEX
INFLATION REPORT FORECAST

	2006	2007 1/		2008 1/		2009 1/
		IR Jan. 07	IR May. 07	IR Jan. 07	IR May. 07	IR May. 07
				Var.% real		
1. GDP	8.0	6.8	7.2	5.8	6.0	6.0
2. Domestic demand	10.6	8.1	9.0	6.4	6.6	6.6
a. Private consumption	*6.5*	*5.7*	*6.3*	*5.4*	*5.3*	*5.3*
b. Public consumption	*8.7*	*8.8*	*5.4*	*4.9*	*4.1*	*3.8*
c. Private fixed investment	*20.2*	*16.3*	*19.7*	*12.2*	*14.1*	*12.1*
d. Public investment	*12.7*	*34.7*	*29.1*	*8.6*	*25.3*	*13.0*
3. Export (Goods & services)	0.3	6.8	5.3	7.2	8.2	6.1
4. Imports (Goods & services)	12.3	13.3	14.3	9.9	10.9	8.7
5. Main trade partner's economic growth	4.6	3.9	4.1	4.0	4.0	3.8
				Real % change		
6. Inflation	1.1	1.5-2.0	2.0-2.5	1.5-2.0	1.5-2.0	1.5-2.5
7. Core inflation	1.4	1.5-2.0	1.5-2.0	1.5-2.0	1.5-2.0	1.5-2.5
8. Nominal exchange rate 2/	-6.4	-0.2	-0.8	1.6	0.6	0.9
9. Multilateral exchange rate 2/	-2.3	0.6	0.1	2.1	1.2	2.2
10. Terms of trade	27.4	-3.7	1.9	-6.3	-7.7	-4.9
a. Export price index	*36.9*	*-1.6*	*6.5*	*-3.7*	*-4.6*	*-2.6*
b. Import price index	*7.4*	*2.2*	*4.5*	*2.8*	*3.4*	*2.4*
				% change		
11. Current account of the balance of payments	2.8	0.7	1.3	-0.6	-0.1	-0.4
12. Trade balance	9.6	7.1	8.0	5.0	5.6	3.6
13. Gross external finance of the private sector 3/	4.4	3.6	4.3	4.2	3.9	3.6
14. Current income of the general government	19.6	19.2	19.9	18.8	19.9	19.6
15. Non-financial expenditure of the general government	16.1	17.3	17.0	17.4	17.8	18.1
16. Non-financial public sector economics result	2.0	0.0	1.2	-0.5	0.5	0.0
17. Total public debt balance	32.6	29.7	29.1	27.5	27.2	25.4
18. External public debt balance	23.5	21.2	20.6	19.3	18.6	16.8
				Nominal % change		
19. Monetary base (annual average)	17.2	13.0	17.0	11.0	11.0	10.0
20. Loan to the private sector	8.1	9.5	13.8	8.7	11.6	10.7

IR: Inflation Report.
1/ Forecast.
2/ Expectations regarding the exchange rate according to the survey on macroeconomic expectations.
3/ Includes foreign direct investments and private sector's long run dibursements.

I. Monetary policy

Due to the absence of inflationary pressures, the Central Bank has maintained the monetary policy reference interest rate at 4.5 percent since May 2006. This evolution of prices has taken place in a context characterized by a high dynamism of economic activity-due to an increase of productive capacity associated with the growth of investment and productivity-, an appreciation of the Nuevo Sol and low expectations of inflation.

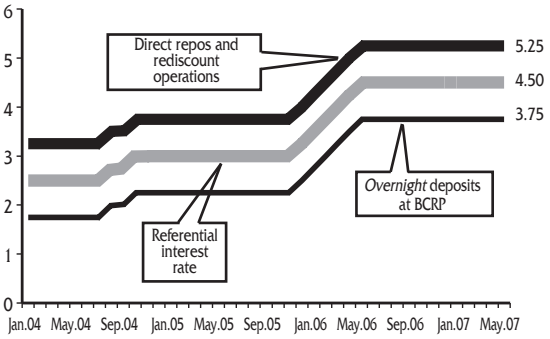
1. At the beginning of each month, the Board of the BCRP evaluates macroeconomic forecasts to approve a reference interest rate that will allow inflation to converge to the inflation target of 2.0 percent, plus or minus one percentage point.

2. After the Inflation Report of January, the monetary programs implemented between February and May 2007 have maintained the reference interest rate at 4.5 percent due to the absence of inflationary pressures. Thus, the last 12-month inflation rate on May 2007 was 0.94 percent, below the 1.0 - 3.0 percent target range. This result is mainly explained by the reversal of the price rises observed in food products in the first four months of 2006, in line with the forecasts of our Inflation Reports of September 2006 and January 2007. These factors have a one time impact on inflation and therefore this deviation from the target range was considered to be transitory. In fact, inflation started to converge to the 2.0 percent inflation target since May and should be within the 1.0 - 3.0 target range as of June.

   Moreover, core inflation -component indicating the trend of inflation- has remained at an annual rate of 1.3-1.5 percent, within the lower band of the target range.

This evolution of prices has taken place in a context characterized by a high dynamism of economic activity-due to an increase of productive capacity associated with the growth of investment and productivity-, an appreciation of the Nuevo Sol and low expectations of inflation.

Graph 1
CENTRAL BANK REFERENCE INTEREST RATE
(In percentage)



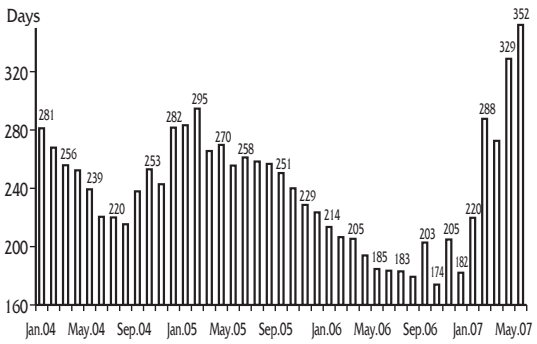
3. All the BCRP communiqués on the monetary program for each month following the Inflation Report of January coincided in that last 12-month inflation would be below the lower band of the inflation target (1.0 percent) during the first half of 2007, that it would be within the target range in the second half of the year, and that it would thereafter converge to the 2.0 percent inflation target, in line with the forecasts of our last Report.

Particularly, the monetary programs for the months of February and March emphasized that no inflationary pressures were expected in the short term and that the Bank would oversee that increased domestic spending would not translate into inflationary pressures.

In the Monetary Program for the month of April, the Board of the BCRP expressed concerns about the possible impact of a very high growth of domestic demand in a 12-18 month horizon, given that domestic demand would have grown more in the first two months of 2007 than in the fourth quarter of 2006. Therefore, the Board informed that it would be inclined to opportunely withdraw monetary stimulus should this trend remain.

However, the Monetary Program for the month of May reported that the growth of domestic demand in the first quarter of 2007 had been estimated to be lower than in the previous quarter and in the first months of the year.

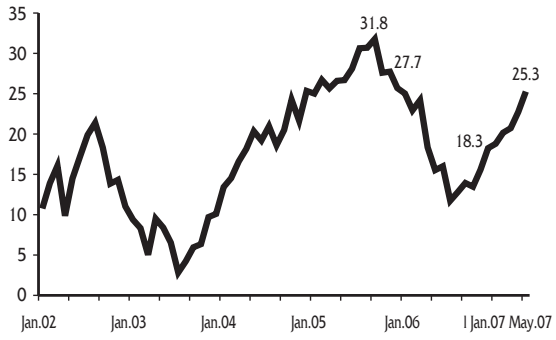
Graph 2
AVERAGE MATURITY OF CDBCRP



4. The BCRP carries out monetary operations in order that the interest rate for the interbank market reaches the level announced as the reference interest rate in its Monetary Program for each month. In order to do so, excess liquidity is sterilized through the placement of Certificates of Deposits (CDBCRP), while requirements of liquidity are covered through temporary repurchases of CDBCRP or Treasury bonds, an operation called REPO. The Central Bank intervenes in the exchange market to accumulate international reserves and to deal with situations of excessive volatility in the exchange rate performance. International reserves allow to buffer the impacts of possible adverse macroeconomic shocks and provide a dollarized economy with a better stance to face liquidity risks.

These monetary and exchange operations allowed the Bank to recirculate liquidity in Nuevos Soles in the financial system and to maintain the interbank interest rate at the reference rate (4.5 percent) during the period of regularization of income tax which takes place between end March and early April. Furthermore, during March the Bank reduced the maturity terms for placements of CDBCRPs and concentrated maturities in the first days of April, thus preventing the financial system from undergoing a period of temporary illiquidity. Once the period of regularization of the income tax was over, the maturity term for CDBCRPs was again extended. The average residual maturity for CDBCRPs was raised from 220 days in January to 352 days in May.

Graph 3
MONETARY BASE
(Percentage change last 12 months)



5. The issuance of bills and coins increased 25.3 percent between May 2006 and May 2007, a rate higher than the one recorded in the same period last year, in a context of increased economic activity and gradual dedollarization of the economy.

Table 1

MONETARY BASE
(Millions of Nuevos Soles)

	2002	2003	2004	2005	2006	2007* January-May
1. Flow of the monetary base	**672**	**682**	**1,886**	**2,397**	**2,140**	**-253**
(% annual change)	11.0	10.1	25.3	25.7	18.3	25.3
2. Foreign exchange operations	**436**	**3,465**	**6,239**	**2,360**	**9,140**	**11,515**
(Millions of US$)	128	998	1,854	767	2,861	3,625
3. Monetary operations	**236**	**-2,783**	**-4,353**	**37**	**-7,000**	**-11,768**
a. BCRP certificates of deposits (CDBCRP)	205	-2,462	-4,158	578	-389	-7,956
b. REPOS	170	-170	0	2,850	-2,850	0
c. Public sector deposits	-81	-921	-721	-2,821	-5,434	-5,099
d. Indexed certificates of deposits (CDRBCRP)	-319	319	0	-1,202	1,202	0
e. Other	261	451	526	631	471	1,286
Note: Balance at the end-of-period						
- Monetary base	6,759	7,441	9,327	11,724	13,864	13,610
- BCRP certificate deposits	1,635	4,097	8,255	7,676	8,066	16,021
- Public sector deposits	275	1,196	1,918	4,738	10,172	15,271

* On this period monetary base reduces due to seasonal factors.

BOX 1

THE COMMUNICATION OF MONETARY POLICY

Low levels of inflation have been achieved worldwide with societies' implementation of an institutional framework aimed at guaranteeing a serious commitment with price stability. The high costs of inflation observed all over the world in the seventies and eighties led to this institutional reform that was initiated in the eighties by central banks committed to preserving monetary stability. The role of central banks in fostering a monetary policy that would contribute to low levels of inflation required central banks to be able to act in a long-term horizon and independently from the short-term political cycle. Jones (2004) states that the concept of central banks' independence became almost universally accepted over the past two decades due to the fact that independent central banks satisfactorily carried out their mission of preserving monetary stability. This principle, which was first discussed in the times of David Ricardo, became then a necessary condition to ensure a responsible management of monetary policy.

As pointed out by Ricardo in volume IV of 'The Works and Correspondence of David Ricardo'[1], "It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it (...) But I propose to place this trust in the hands of Commissioners, not removable from their official situation but by a vote of one or both Houses of Parliament. I propose also to prevent all intercourse between these Commissioners and ministers, by forbidding every species of money transaction between them. The Commissioners should never, on any pretence, lend money to Government, nor be in the slightest degree under its control or influence. (...) If Government wanted money, it should be obliged to raise it in the legitimate way; by taxing the people; by the issue and sale of exchequer bills, by funded loans, or by borrowing from any of the numerous banks which might exist in the country; but in no case should it be allowed to borrow from those who have the power of creating money."

Central banks gradually began to enjoy greater not only formal but also effective independence, thus allowing those responsible for the design and implementation of monetary policy to have the technical and administrative capacities needed for the accomplishment of monetary objectives. However, this greater freedom of central banks also required them to become accountable to society.

The global trend towards independence in the conduction of monetary policy finally translated into growing concern regarding transparency, understood as an important factor in the practice of informing the public in general and specialized media in particular about monetary management. In fact, Geraats (2006) holds that transparency in monetary policy management has increased extraordinarily over the past fifteen years as a result of the great interest that central banks have demonstrated recently. .

Thus, communication, which is the means used by central banks for transparency purposes, is currently the practice by which central banks inform, clarify and quantify their objectives, announce and explain their monetary policy decisions, their assessments of current economic situations and their outlook for the future (ECB, 2007).

In practice, central banks can influence on very short-term rates through their monetary operations, while expenditure decisions in the economy depend rather on interest rates with longer maturities. The latter depend on the expectations of economic agents regarding the futures decisions adopted by the monetary authority and, therefore, communication is understood as a mechanism to orient said expectations. Woodford (2005) says that the public's understanding of what the central bank is expected to do in the future is crucial for the effectiveness of monetary policy. In fact, the strategy used by the central bank will depend on the capacity of financial markets to anticipate monetary policy decisions and thus facilitate a more immediate transmission of these decision to the real sector of the economy.

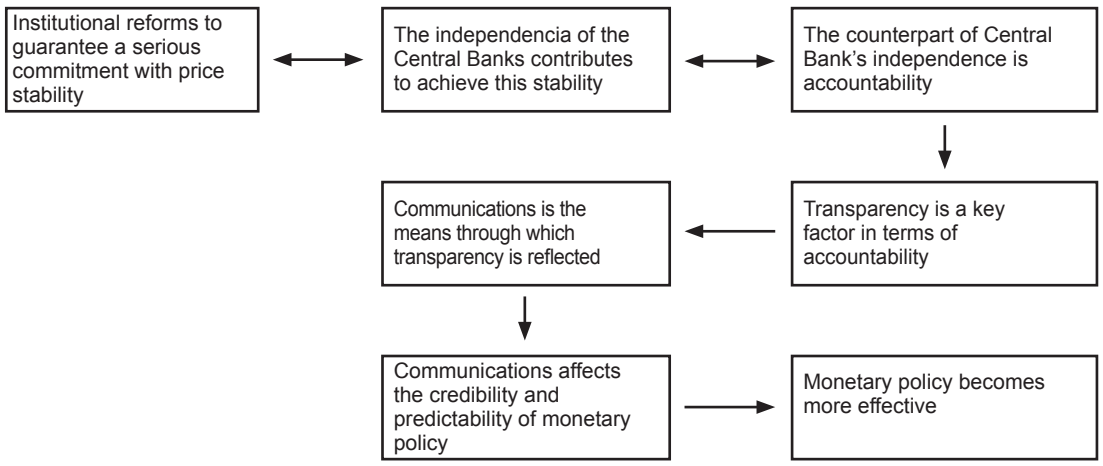
1 Ricardo (1824): "Plan for the Establishment of a National Bank", in 'The Works and Correspondence of David Ricardo', 11 volumes, edited by Piero Sraffa and M.H. Dobb, (Cambridge, Cambridge University Press, 1951-1973).

Blinder et. al. (2001) point out that monetary decisions are taken in pre-announced dates in central banks with inflation targets and operational independence in order to evaluate changes in the interest rate. Thus, standard communications consists of announcing every policy decision by means of a brief minute that informs which reference rate has been established, as well as by a communiqué explaining the reasons for such a decision. In this way, central banks disseminate information about the analyses made, the actions taken and the underlying considerations in order that observers may understand monetary policy decisions as a logical chain of actions aimed at guaranteeing price stability.

The credibility generated a central bank's responsible monetary management allow that medium-term inflation expectations remain anchored at the central bank's inflation target, thus making it unnecessary for central banks to intervene when shocks with a transitory impact on consumer prices occur. In other words, effective communication also contributes to reduce the sensitivity of expectations face shocks with a one-time impact or transitory shocks, given that they are neither sustained nor expand to rest of the economy. Therefore, agents should not expect the central bank to tackle temporary price fluctuations since these interventions are not only costly, but also inefficient given the lags of the actions adopted by monetary policy.

This lack of sensitivity vis-à-vis short-term shocks is associated with the capacity of financial markets to properly anticipate the following monetary policy decision. In the case of the European Central Bank, the degree of the decisions adopted by its Board in terms of the short-term range of the yield curve has decreased over time; in other words, monetary policy decisions have gradually decreased the factors that could surprise the markets (ECB, 2007).

THE COMMUNICATION OF MONETARY POLICY



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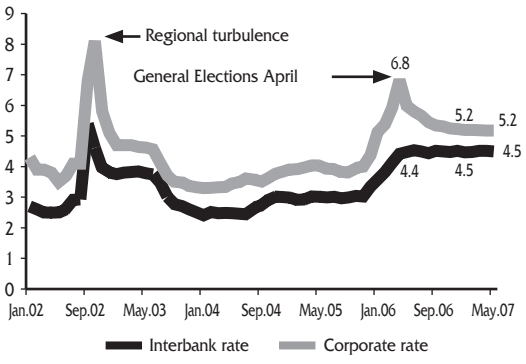
II. Financial markets

Interest rates in soles remain stable since January 2007, particularly rates involving lower risks and lower maturity-terms. On the other hand, longer-term rates in the capital market continued to decline, reflecting better economic prospects and lower expectations of inflation in the country.

6. The Central Bank carries out monetary operations to control the amount of liquidity in the banking market. These operations are aimed at influencing the interbank rate and leading it towards the BCRP reference rate. The BCRP's reference rate for operations in the interbank market acts as a benchmark for the formation of the other interest rates in Nuevos Soles, influencing particularly lower-risk and shorter-term operations because these operations depend less on other components of the interest rate, such as credit risks or long-term inflation expectations.

Graph 4
INTERBANK AND CORPORATE INTEREST RATE IN DOMESTIC CURRENCY
(In percentage)

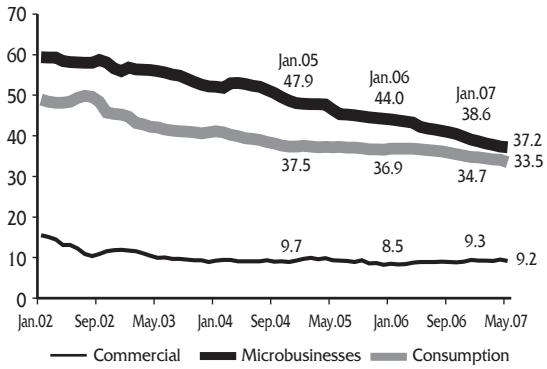


7. The 90-day corporate prime rate remained stable at the levels of January 2007 and reached an annual level of 5.2 percent. As a result of this, the differential between the interbank rate and the corporate prime rate in Nuevos Soles was 68 basis points, a lower level than the one recorded in January 2007 (down 73 basis points). This reduction in the differential between both rates reflects a higher connection between the reference rate and short-term rates in soles in the money market.

8. The interest rates for commercial loans (low risk components) also had a stable performance. Thus, the average rate on these operations in May was 9.2 percent, a similar rate to that of January (9.3 percent).

   The other interest rates for banks active operations continued to show a downward trend. This decrease was due to a reduction in the rates in Nuevos Soles for loans to microenterprises

Graph 5
INTEREST RATE ON COMMERCIAL, MICROBUSINESS AND CONSUMPTION LOANS IN DOMESTIC CURRENCY
(In percentage)



(which fell from 38.6 to 37.2 percent), consumer loans (which fell from 34.7 to 33.5 percent) and mortgage loans (which fell from 10.3 to 10.1 percent), favored by a better financial situation of borrowers and by a context with a better perception of risks in a scenario of increased competition for these segments among financial entities. As a result, the average rate on banks' lending operations (TAMN[2]) carried out in this period -which included operations with different risk levels- fell from 23.8 percent in January 2007 to 22.1 percent in May 2007.

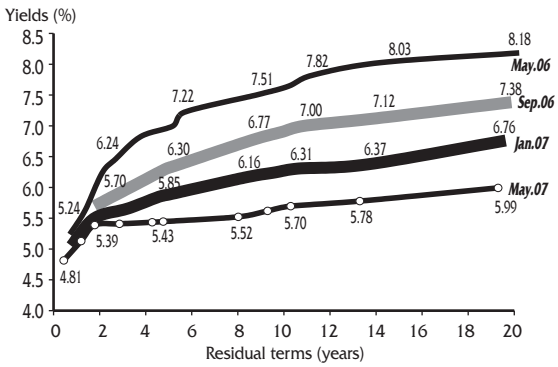
9. During the last months, the interest rates for deposits in dollars for most maturity terms increased slightly relative to January, while some of the active rates in dollars decreased. An upward pressure on interbank rates in dollars was observed in May, originated by the use of foreign currency to finance clients' forward operations in dollars. As a result of this, the differential between the interest rate in soles and the interest rate in dollars decreased for all terms, except for the 90-day corporate prime rate.

Table 2

INTEREST RATES IN DOMESTIC AND FOREIGN CURRENCIES
(In percentage)

	(A) Nuevos Soles					(B) Dollars					Diferential (A) - (B)				
	Apr. 2006	Sep. 2006	Dec. 2006	Jan. 2007	May. 2007	Apr. 2006	Sep. 2006	Dec. 2006	Jan. 2007	May. 2007	Apr. 2006	Sep. 2006	Dec. 2006	Jan. 2007	May. 2007
1. Reference rate and and FED funds rate	4.3	4.5	4.5	4.5	4.5	4.8	5.3	5.3	5.3	5.3	-0.5	-0.8	-0.8	-0.8	-0.8
2. Deposits up to 30 days	5.5	4.6	4.6	4.5	4.6	4.0	4.2	4.3	4.4	4.6	1.5	0.5	0.3	0.2	0.0
3. Term deposits between 31 to 180 days	5.0	4.9	4.8	4.8	4.8	3.1	3.5	3.4	3.4	3.6	1.9	1.5	1.3	1.3	1.1
4. Term deposits between 181 to 360 days	5.2	5.8	5.7	5.7	5.5	3.2	3.5	3.6	3.7	3.7	2.0	2.3	2.1	2.1	1.8
5. Average lending up to 360 days	6.8	5.3	5.2	5.2	5.2	6.1	6.1	6.1	6.1	6.1	0.8	-0.8	-0.9	-0.9	-0.9
6. Average lending up to 360 days	14.5	14.7	13.8	14.0	13.4	9.7	9.9	10.1	10.0	9.9	4.9	4.7	3.7	4.0	3.5
7. Average lending constant structure	17.3	17.1	17.1	16.9	16.5	10.4	10.5	10.6	10.5	10.4	7.0	6.6	6.5	6.4	6.1

Graph 6
SECONDARY MARKET FOR PUBLIC TREASURY SOVEREIGN BONDS 1/
(In percentage)



1/ Average yield observed in the secondary market during the period.

Bond market

10. Since the 20-year Public Treasury Bond (PTB) was first issued in May 2006, the yield on this bond has decreased from 8.18 percent to 6.76 percent in January 2007 and to 5.99 percent in May. Likewise, the average yield on the 15-year bond fell from 6.37 percent in January to 5.78 percent in May. This reduction in the yield on longer-maturity bonds would be

2 Average weighted active rate on operations in domestic currency, expressed in actual annual terms.

associated with better economic prospects in the country reflected, for instance, in a lower country risk premium or expectations of lower rates of inflation.

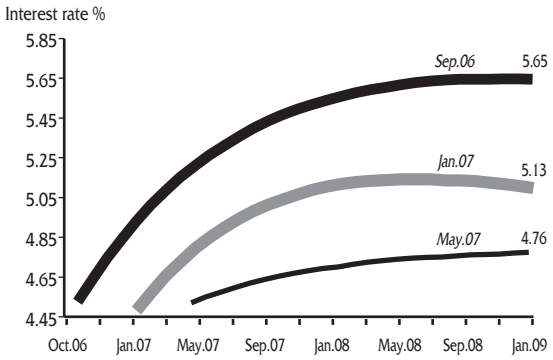
11. The rate of expected annual depreciation -estimated on the basis of data on the yield on sovereign bonds in soles and in dollars maturing in 2015- has declined from 0.55 to 0.02 percent between May 2006 and May 2007.

Table 3

YIELDS OF THE PUBLIC TREASURY BONDS BY CURRENCIES
(Monthly average data in percentage)

	Nominal bonds BTP in Nuevos Soles May 2015 (a)	Global bonds in dollars February 2015 (b)	Yields differential (a) - (b)
December 2005	7.88	6.66	1.22
May 2006	7.51	6.96	0.55
December 2006	6.09	5.64	0.45
May 2007	5.52	5.50	0.02

Graph 7
EXPECTED *OVERNIGHT* INTEREST RATE 1/



1/ Implicit in the yield curve.

Expected interbank interest rate

12. Based on data on the yield curve for CDBCRPs and Treasury bonds, it is estimated that a path with lower interbank rates than the ones indicated in our previous Inflation report should be expected in the market for the next 2 years (January 2007-January 2009). Thus, while economic agents expected in January up to three increases in the reference interest rate (of 25 bps each) -approximately from 4.5 to 5.25 percent- for that period, in May economic agents would be expecting only one increase of 25 bps in the interest rate for the following 2 years (from 4.5 to 4.75 percent).

BOX 2

THE YIELD CURVE AND ITS USE FOR MONETARY ANALYSIS

The yield curve is a useful tool for monetary policy since both the evolution of the structure of domestic interest rates and the spreads between the short- and long-term rates may be analyzed through this tool. Thus, the impact of changes (influenced by the central bank) in short-term interest rates on the term structure of interest rates, that is, the effectiveness of monetary policy, can be estimated. Likewise, based on the yield curves exhibited before and after the decisions on interest rates are made, the degree in which these decisions are anticipated by the market can also be determined.

Nominal interest rates in soles, implied in the yield curve, contain information regarding the expectations of economic agents about macroeconomic variables, such as the real interest rate, the inflation rate and the risk premium (for liquidity, among others) for different maturities[3]. This information is essential for monetary policy. Lower nominal long-term yield curves are usually associated with lower future expectations of inflation. On the other hand, some authors state that a negative yield curve (long-term rates lower than short-term rates) indicates expectations of a future recession[4], which would generate a reduction in future short-term rates This expectations leads to a fall in current long-term rates -since these become attractive in relation to expected rates in the future- until these rates reach levels below the actual short-term rates.

The development and dynamism of the capital markets contributes to develop domestic yield curves for the assets transacted in an economy. These yield curves -which reflect the term structure of the interest rates- are used as reference rates when diverse financial instruments with different maturities are issued, which contributes to reduce the uncertainty for interest rates determination of participants in the market.

The interest rates on different government instruments, such as the Treasury Bonds, play a key role in constructing the yield curve in an economy because they are considered to be lower risk domestic assets. Adjusted through a risk premium, the yield curve on these public assets serves as a benchmark or reference for the interest rates on private bonds.

The estimated yield curve is an approximation to spot rates that cannot be observed in the market, as well as to spot rates with maturities dates that are not available in the market.

The models most commonly used to estimate the yield curve on the basis of a sample of prices are the parametric models proposed by Nelson and Siegel (1987), Svensson (1994)[5] and the polinomic models[6].

Based on the yield on Treasury Bonds in soles and the Central Bank's Certificates of Deposits, a zero coupon yield curve (spot rates) is derived using both the Nelson & Siegel - NS (1987) and the Svensson - SV (1994) models. The model that best adjusts to the data is then selected. Once the parameters of the models have been estimated using either the NS or the SV models, the spot yield curve and the instantaneous forward curve (1-day maturity) are obtained. A risk premium -independently estimated and proportionately higher as the maturity terms increases- is then subtracted from the forward rates estimated by the model. The result of this operation is the curve of expected interbank rates for different maturities terms.

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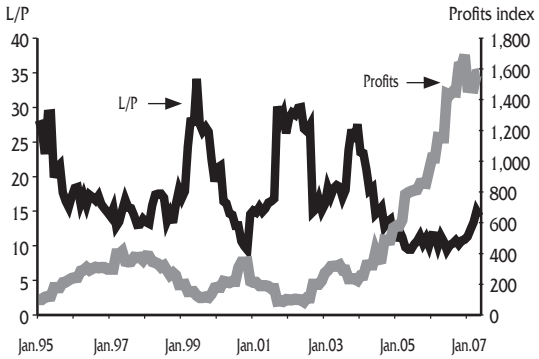
3 For more information on this, see European Central Bank (2004).
4 Estrella, A. and F. Mishkin (1996) "The Yield Curve as a predictor of the United States recessions". Federal Reserve Bank of New York, Current Issues in Economics and Finance.
5 A good summary of the models used by central banks may be found in BIS (2005) "Zero-Coupon Yield Curves: Technical Documentation". BIS Paper 25. October.
6 For example Fisher, M., Nychka, D. y Zervos, D. (1995). See Anderson, N. y Sleath, J. (2001), Jamieson, D. and Gusba, S. (2002) y BIS (2005).

Variable income market

Graph 8
L/P AND PROFITS IN THE GENERAL INDEX OF THE LSE 1/
(In percentage)



1/ Profits stands for the last 12 months.

13. Both the General Index and the Blue Chip Index at the Lima Stock Exchange (LSE) have increased by over sixteen-fold between early 2002 and May 2007, posting the highest growth recorded in the region (followed by Colombia's stock exchange which grew nearly eight-fold). This dynamic performance of the LSE was based on the growth of firms' profits as a result of increased economic activity and an unprecedented rise of commodity prices (gold, silver, zinc, copper, lead and tin).

A way of measuring the magnitude of risks associated with the stock market is through the price of financial assets-corresponding earnings ratio (PER or P/E ratio). This ratio measures the number of years that it will take an investor to recover his investment in stocks, assuming that earnings are distributed among stockholders. In Peru, considering the last 12-month business profits of the firms integrating the General Index, the PER is below 15. A P/E ratio of 15 is consistent with an annual earning of 6.7 percent per stock, which represents a recovery period of 15 years (the yield on a government bond with a similar maturity is below 6 percent).

Approximately 45 percent of the stocks listed at CAVALI (amounting to nearly US$ 15.6 billion in April) are held by non-residents and approximately 35 percent are held by investors, such as mutual funds, investment funds, individuals and non-financial firms. When fixed income holdings are included, the percentage held by non-residents falls to 34 percent, while the percentage held by other investors rises to 38 percent. Therefore, it is important to strengthen information mechanisms and to improve the dissemination of information on the risks that investors face when they invest in the stock market.

Table 4

VALORIZATION OF THE FINANCIAL ASSETS IN CAVALI: FIXED YIELD AND VARIABLE
(Millions of US$)

	Dec-05	%	Dec-06	%
Residents	**14,790**	**66**	**20,654**	**66**
Pension Funds	6,107	27	8,831	28
Mutual Funds	35	0	59	0
Investment Funds	493	2	768	2
Insurance companies	722	3	805	3
Banks and financial companies	1,178	5	950	3
Others	6,255	28	9,242	30
Non-Residents	**7,681**	**34**	**10,461**	**34**
Total CAVALI 1/	**22,471**	**100**	**31,115**	**100**

1/ Financial assets suscript and not in the stock exchange valued at the market price
Source: CAVALI.

BOX 3

EVOLUTION OF THE PERUVIAN STOCK MARKET

A bubble appears when the market price of a financial asset differs significantly and increasingly from its fundamental value, reflected in the current value of the corresponding expected cash flows, mainly as a result of speculative elements (Garber, P.M., 2000). Kindleberger (2000) complements this definition by emphasizing a persistent upward movement in the price of assets that culminates with the burst and dissemination of the bubble. Moreover, Kane y Kindleberger (2004) point out that bubbles appear in the last stages of an economic boom, when expectations become irrationally optimistical and the prospects for certain businesses and projects are overestimated.

Daye et.al. (2002) say that the appearance of a bubble is associated with 3 main factors:

* *Asymmetric information*, caused by weaknesses in the corporate governance[7] of business and by defficient regulation, which allow firms to manipulate the information they provide to the market (i.e. Enron, Parmalat).
* *Forecast errors*, which affect the value of financial instruments, thereby generating both differences in the mechanisms on which expectations are based and difficulties to assess the fundamentals, which turns out to be especially relevant when significant changes occur in the industrial segments of firms (Farrell, 2002)[8].
* *The Ponzi scheme or game*, based on the mechanism known as the pyramid, in which "returns are paid to earlier investors who receive the money of subsequent investors, but the latter cannot be paid in the end since there are no new investors"(Wallace, 2002).

De Long et.al (1990) have identified the growing presence of new and less informed investors whose decisions are based on non-relevant information, thus substantially reducing the influence of well-informed investors in the market.

Historically, the 1929 collapse of the New York Stock Exchange originated in the thriving market of the 1920s. This was an episode where mass psychology exceeded the fundamentals that should have governed the price of stocks. A new generation of unsophisticated investors, eager to make fortunes, entered the market. Allen (1931) states that optimism based on rumors extended to the working class, who also began participating in the market as small investors. Rappoport and White (1994) refer to these new investors who had invested in government papers during World War I and now started investing in private bonds and stocks. Shiller (1999) suggests that the emergence of thesea new investors was basically due to peer pressures. Individuals would have been strongly influenced by the actions of their friends and acquaintances.

Morever, Sornette (2003) mentions psychological factors associated with bubbles:

* Given an increase in the price of an asset, investors consider that another increase is more likely to follow than a price drop.
* Investors prefer to follow the actions of other people already participating in the market rather than to make decisions based on their own information.
* An individual obtains prestige if he acts in the same way as a specific group.
* An investor acts like the rest of investors, after he has seen a great many investors carrying out transactions with the same asset.

The prices of domestic assets, such as stocks, bonds and real estate, influence the main macroeconomic variables, basically through the wealth effect. A higher price of certain assets affects the expenditure of both consumers and the government (through increased taxes), which can lead to inflationary pressures. When the price of assets drops, in addition to affecting domestic spending, this can also generate a negative impact on the financial system (if these were financed through credit).

7 Johnson, Boone, Breach y Friedman (1999).

8 It is worth emphasizing that an asset that is properly valued should reflect the expected evolution -and not the current evolution- in terms of cash flows. Economic agents do not necessarily agree in their cash flow expectations or in the discount rate that should be used.

Although there is no evidence of a bubble in the stock market, its current price level is based on the persistence of the favorable conditions observed today in both the global and the domestic economies. This situation with high prices is reinforced by the little depth of the domestic market of securities and by a high liquidity that is affecting most of the global stock markets in a market in which approximately 60 percent of the General Index at the Lima Stock Market consist of mining stocks. In this sense, a drop in the prices of minerals or a global slowdown are scenarios that have to be considered for the forthcoming years.

Strengthening prudential regulations and disseminating information and knowledge in the financial arena are important actions to take to prevent unsustainable trends in the prices of assets and to reduce the risks associated with bubbles. These reforms should be oriented at improving the corporate governance of firms, at incentive the issue of primary stocks as a mechanism to finance business, and at strengthening the control and supervision of the companies listed in the stock market, among other ends. These measures will contribute to dynamize the stock market as they will allow companies to offer a profitable investment option for potential investors in the market of capitals.

YIELD SPREAD BETWEEN THE STOCK EXCHANGE AND SAVINGS DEPOSIT OVER 360 DAYS
(Annual variation)

	Variable Yield	Saving deposit over 360 days
2000	-34.2	14.6
2001	-2.6	12.0
2002	18.3	7.7
2003	74.9	6.9
2004	52.4	6.9
2005	29.4	7.8
2006	168.3	8.2
Accumulated Dec.99-Dec.06	**601.9**	**265.4**

Source: LSE and SBS.

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Real estate assets

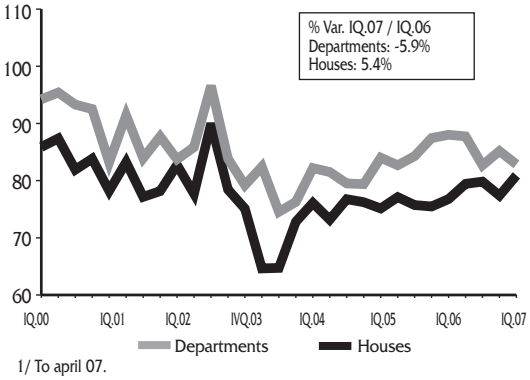
14. Information on the price of real estate has been collected since the second quarter of 1998. On average, information is gathered on the prices of 350 houses and 350 apartments every quarter. The elaboration of the index on the prices of real estate assets comprises 3 stages:

    * Data collection: weekly gathering of information for the database on the real estate supply[9], which includes the districts of Miraflores, La Molina, San Borja, San Isidro and Surco. This information is based on predetermined sizes of samples per district.

    * Data segmentation and depuration: weekly recording of information on houses and apartments, carried out through a random selection of the sample, and corroboration of said information by phone.

    * Index construction: the median of the price of a square meter is calculated for houses and apartments every quarter.

Graph 9
SALE PRICE OF BUILDINGS IN CURRENT DOLLARS 1/
(Index II Quarter 1998 = 100)



1/ To april 07.

15. In the first quarter of 2007, the prices of houses increased by 5.4 percent relative to the same quarter in 2006, while the prices of apartments fell by 5.9 percent. This increase in the price of houses could be explained by the relative shortage of lots demanded to build apartment buildings, commercial facilities and/or offices in certain areas of Lima. As regards mortgage loans, between March 2006 and March 2007, direct loans and MiVivienda loans increased 11 percent and 4 percent respectively.

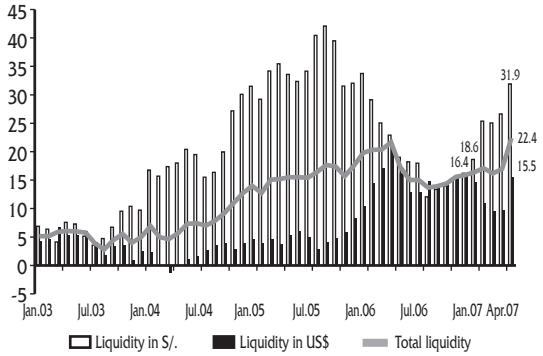
Liquidity and credit

Monetary and credit aggregates continued generating a context with favorable financial conditions. The evolution of credit paralleled the growth of economic activity, while the high dynamism of liquidity provided the funding required. In April, the flow of expansion of credit to the private sector over the last 12 months was S/. 12,818 million (of which 60.7 percent was credit in Nuevos Soles), a sum equivalent to 4.1 percent of GDP.

16. Liquidity in the private sector resumed the pace of growth observed since the second half of 2006 in a context of greater

9 Information sources: El Comercio: http://www.elcomercioperu.com.pe/Clasificados/ and BWS: http://www.ofertainmobiliaria.com/index.asp. The data refer to the above mentioned districts since these districts show a higher real estate supply.

Graph 10
LIQUIDITY IN THE PRIVATE SECTOR
(Change of the last 12 months, at a constant nominal exchange rate[1/])



1/ Considering the monthly average ask price of the exchange rate.

dynamism of economic activity and grew from an annual rate of 16.4 percent in December 2006 to 22.4 percent in April 2007. This evolution is mainly explained by the growth of liquidity in domestic currency (31.9 percent), due to the higher relative preference for soles as assets of deposit of value given their higher relative returns in terms of saving.

This high growth of liquidity has contributed to create favorable financial conditions, which in turn allow the necessary increase of funds to enable an expansion of credit.

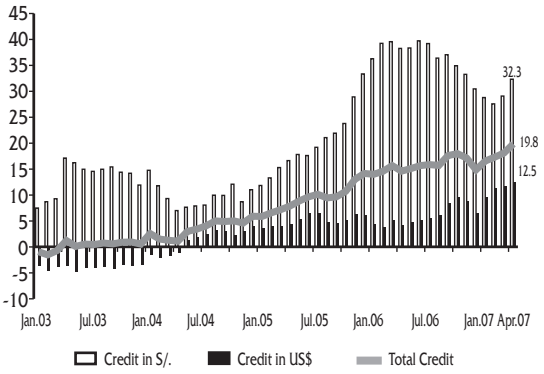
17. Financial dollarization continued to decline in the first months of this year. Thus, the dollarization of liquidity in the private sector decreased from 58.8 percent in April 2006 to 54.4 percent in April 2007. The ratio of dollarization of credit to the private sector fell 4.9 percentage points.

Table 5

FINANCIAL DOLLARIZATION INDICATORS
(As a percentage of total monetary agregates)

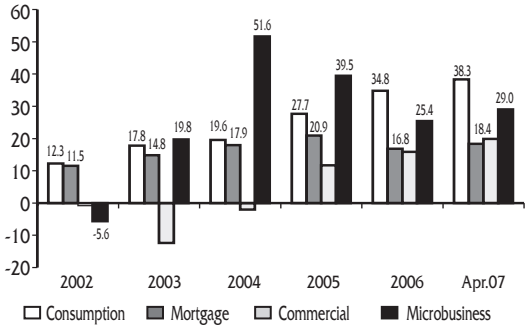
Year	Private sector liquidity	Financial system loans to the private sector
1997	67	75
1998	71	79
1999	72	82
2000	72	81
2001	69	78
2002	69	76
2003	67	73
2004	61	71
2005	57	67
2006		
April	59	64
December	54	61
2007		
April	54	59

Graph 11
FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR
(Change of the last 12 months, at a constant nominal exchange rate[1/])



1/ Considering the monthly average ask price of the exchange rate.

Graph 12
GROWTH OF CREDIT IN COMMERCIAL BANKS
(Change of the last 12 months, at a constant nominal exchange rate[1/])

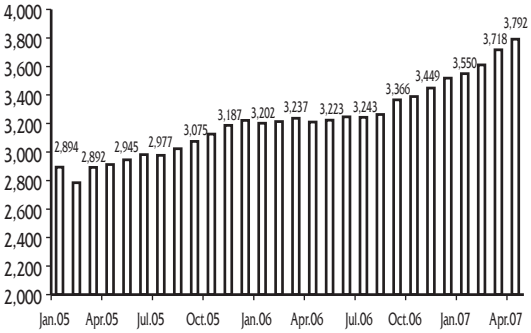


1/ Considering the monthly average ask price of the exchange rate.

18. In the first four months of this year, credit to the private sector grew at a faster annual rate (19.8 percent in April. This is equivalent to a flow of S/. 12,875 million, or to 4.1 percent of GDP).

19. By components, credit for consumption purposes grew 38.3 percent between April 2006 and April 2007. Moreover, mortgage loans have been recovering their dynamism, showing a last 12-month growth of 18.4 percent after the funds of the MiVivienda program were limited in May 2006. Today, banks' own resources account mainly for mortgage loans.

Graph 13
PERCAPITA CONSUMPTION LOANS IN THE OVERALL FINANCIAL SYSTEM
(Nuevos Soles)



The growth of consumer loans was coupled by an increase in the level of indebtedness per average person, the most dynamic component being recorded through credit cards.

20. Mortgage loans still exhibit a high degree of dollarization (86.1 percent in April 2007), and therefore a series of measures should be implemented to reduce this, as well as exposure to credit-exchange related risks. A key element to initiate the dedollarization of mortgage loans has been the issuance of the 20-year Public Treasury bonds in nominal soles, as this has promoted that home loans in soles be established with the same maturity terms as those for loans in dollars.

21. In April 2007, credit in domestic currency maintained a higher relative dynamism with a last 12-month growth rate of 32.3 percent (S/. 7,778 million), while credit in dollars increased by 12.5 percent (equivalent to a flow of US$ 1,590 million). The most dynamic components of credit in domestic currency were the placements of banks (36.9 percent), of microfinance institutions (26.8 percent), of mutual funds (95.6 percent) and the Banco de la Nación (31.5 percent).

Table 6

FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR IN DOMESTIC CURRENCY

	Balance in millions of Nuevos Soles			% Variation	
	Apr.06	Mar.07	Apr.07	Apr.07/ Apr.06	Apr.07/ Mar.07
Banks	**14,385**	**18,890**	**19,689**	**36.9**	**4.2**
Banco de la Nación	**1,384**	**1,617**	**1,820**	**31.5**	**12.6**
Microfinance institutions	**4,586**	**5,794**	**5,814**	**26.8**	**0.3**
Municipal saving banks	1,986	2,490	2,490	25.4	- -
Rural saving banks	385	493	493	28.1	- -
Cooperatives	646	758	758	17.3	- -
Edpymes	383	637	637	66.2	- -
Financial companies	1,186	1,416	1,436	21.1	1.4
Institutional investors 1/	**3 268**	**4,109**	**4,206**	**28.7**	**2.3**
Private pension funds (AFPs)	2,197	2,831	2,911	32.5	2.8
Insurance companies	748	664	664	-11.2	- -
Mutual funds	322	613	631	95.6	2.8
Leasing companies and others	**442**	**348**	**315**	**-28.7**	**-9.3**
Total Financial System	**24,065**	**30,758**	**31,844**	**32.3**	**3.5**

1/ Corresponde principalmente a títulos valores emitidos por el sector privado.

Table 7

FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR IN FOREIGN CURRENCY

	Balance in millions of dollars			% Variation	
	Apr.06	Mar.07	Apr.07	Apr. 07/ Apr. 06	Apr.07/ Mar. 07
Banks	**9,850**	**10,572**	**10,751**	**9.2**	**1.7**
Banco de la Nación	**22**	**14**	**14**	**-38.1**	**-0.0**
Microfinance institutions	**637**	**752**	**751**	**18.0**	**-0.1**
Municipal savings banks	300	357	357	18.9	- -
Rural savings banks	56	56	56	-0.4	- -
Cooperatives	182	224	224	23.2	- -
Edpymes	54	72	72	32.7	- -
Financial companies	45	43	43	-4.3	-1.3
Institutional investors 1/	**1,599**	**2,079**	**2,144**	**34.1**	**3.1**
Private pension funds (AFPs)	808	1,120	1,179	46.1	5.3
Insurance companies	154	185	185	20.0	-0.0
Mutual funds	637	774	780	22.4	0.8
Leasing companies and others	**622**	**657**	**658**	**5.9**	**0.2**
Total Financial System	**12,729**	**14,073**	**14,319**	**12.5**	**1.7**

1/ Mainly securities issued by private sector.

22. This expansion of credit in domestic currency also characterized most of the economies in the region, where the growth of credit was higher in most cased than the nominal growth of the product. The highest rates of expansion of credit were observed in Venezuela, Colombia and Mexico.

Table 8

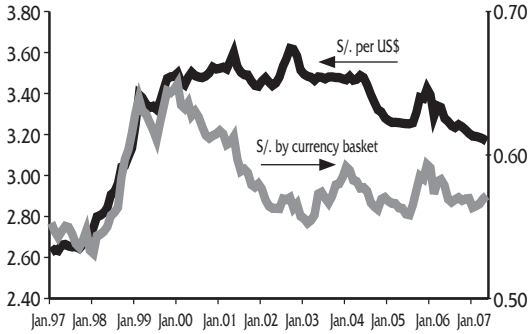
CREDIT ANNUAL GROWTH RATE

	% annual change (Apr.07/ Apr.06)
Brazil 1/	20.9
Chile	17.5
Colombia	31.7
Mexico	29.5
Peru	19.8
Uruguay	10.7
Venezuela	89.2

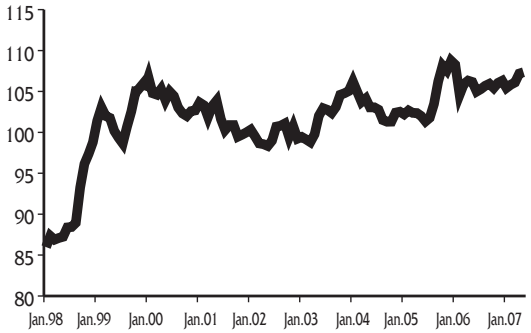
1/ To march.

Source: Bloomberg and central banks.

Graph 14
NOMINAL EXCHANGE RATE
(S/. per US$)



Graph 15
MULTILATERAL REAL EXCHANGE RATE
(Index Dec. 2001=100)

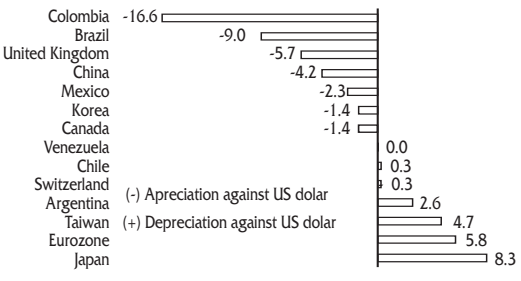


The real effective exchange rate index (REER) is an indicator of the relative price of external goods relative to domestic goods and shows the value of an external good in terms of national goods. A stronger currency (lower REER) expresses a lower relative value of external goods, while a weaker currency (higher REER) expresses that external goods have a higher value in terms of local goods:

$$REER = \frac{NERI * CPI_{external}}{CPI_{Peru}}$$

NERI= Nominal exchange rate index. Defined as the average exchange rate of the nuevo sol against the currencies of our trading partners.
$CPI_{external}$=Average price index of our trading partners.
CPI_{Peru}=Peru's consumer price index.

Graph 16
TRADING PARTNERS CURRENCIES PERCENT VARIATION AGAINST US DOLLARS
(May.07/May.06)



Exchange rate

23. So far this year, the Nuevo Sol has appreciated 1.2 percent in nominal terms against the dollar: the exchange rate fell from S/. 3.205 per dollar at the close of 2006 to S/ 3.168 per dollar in May. This greater strength of the Nuevo Sol against the dollar reflects the increase in terms of trade, the stability of prices achieved, and better prospects for domestic macroeconomic fundamentals, in a context marked by the weakness of the dollar in the international financial market.

    As regards the currency basket of our 20 main trading partners, the exchange of the Nuevo Sol evolved from S/. 0.5696 at the end of 2006 to S/. 0.5717 at the end of May. This result reflects a faster devaluation of the dollar relative to the currencies of our trading partners, as in the case of the pound sterling (1.0 percent), the euro (2.3 percent), the Colombian peso (11.4 percent) and the Brazilian real (7.8 percent).

24. In real terms, the index of the multilateral exchange rate depreciated 1.0 percent, due to the nominal depreciation of the Nuevo Sol relative to the basket (0.4 percent) and to external inflation (1.9 percent) which was higher than domestic inflation (1.3 percent).

25. It is worth mentioning here that the pound recorded historical maximum quotations and that significant appreciatory pressures were observed in Colombia and Brazil in the period of analysis.

Table 9

DESAGREGATION BY COMPONENTS OF THE REAL MULTILATERAL EXCHANGE RATE
(Percentage change)

	Real multilateral exchange rate	Nominal exchange rate by current basket	Inflation of trading partners	Domestic inflation
1996	1.6	6.7	7.2	11.8
1997	-4.1	-3.0	5.2	6.5
1998	14.1	15.4	4.9	6.0
1999	6.4	4.9	5.3	3.7
2000	-2.3	-4.8	6.4	3.7
2001	-2.6	-5.7	3.1	-0.1
2002	-0.8	-3.9	4.8	1.5
2003	5.9	4.9	3.4	2.5
2004	-2.4	-2.4	3.5	3.5
2005	6.1	4.0	3.5	1.5
2006	-2.3	-4.0	3.0	1.1
2007 1/	1.0	0.4	1.9	1.3

1/ Cumulate variation to May..

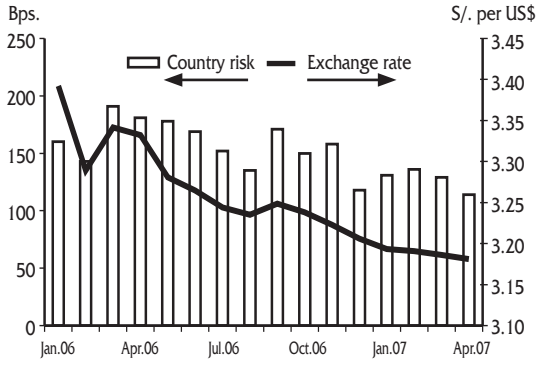
Table 10

BILATERAL EXCHANGE RATE (S/. per monetary unit): MAY 2007
(Percent variation)

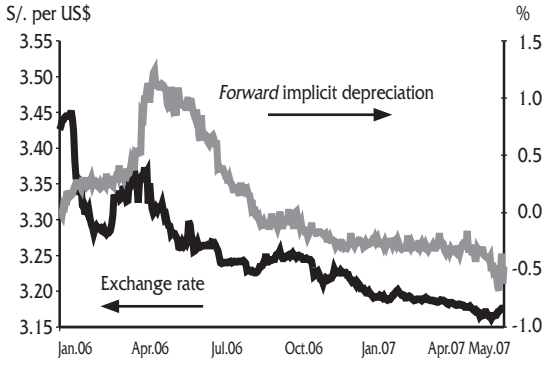
	Weight *	Nominal relative to:		Real relative to:	
	(%)	Dec.06	May.06	Dec.06	May.06
United States	29.2	-1.2	-3.4	0.1	-2.1
Eurozone	12.3	1.0	2.2	1.1	3.1
Japan	4.0	-4.2	-10.8	-5.3	-11.7
Brazil	5.5	7.3	6.3	7.6	8.4
United Kingdom	1.3	-0.2	2.5	-0.8	4.0
Chile	6.7	-0.1	-3.6	-0.1	-2.2
China	11.4	0.8	0.9	0.4	6.0
Colombia	4.2	12.2	16.2	15.1	21.7
Mexico	2.9	-0.7	-1.1	-1.1	2.3
Argentina	2.6	-3.5	-5.8	-1.3	1.7
Korea	2.2	-1.4	-2.0	-0.6	-0.5
Taiwan	1.9	-3.4	-7.7	-4.0	-8.3
Venezuela	3.1	-1.2	-3.4	3.0	14.0
Canada	4.8	4.1	-2.0	4.8	-1.3
Ecuador	4.6	-1.2	-3.4	-1.7	-2.5
Switzerland	3.4	-2.3	-3.7	-2.8	-4.3
Basket	**100.0**	**0.4**	**-1.2**	**1.0**	**1.1**

* Weight relative to the commercial year 2006.

Graph 17
EXCHANGE RATE AND COUNTRY RISK



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

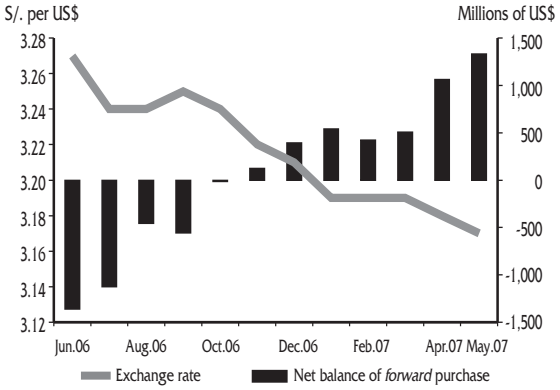


26. A more favorable perception of the Peruvian economy determined a lower level of the country risk indicator, which dropped from 118 at end 2006 to 100 -its lowest historical level- at end May this year. This also implied an increase in non-deliverable forward (NDF) sales of foreign currency, which were mainly carried out by operators abroad and which have a speculative nature. The net balance of NDFs between the public and the banking system increased from US$ 394 million in December 2006 to US$ 1,330 million at end May. These forward operations are carried out with local banks, which execute an effective operation of purchase of sale of foreign currency in the spot market to counterbalance the exchange risk involved in forward operations. Thus, between April and May, the strong inflow of non-deliverable forward operations led banks to sell foreign currency, thus reducing the availability of this currency. Therefore, the interbank interest rate in dollars was raised from 5.5 percent in May to 6.75 percent on May 21, an adjustment that discourages forward operations[10]. However, the interbank rate was lowered to 5.25 percent at end May.

10 An increase in the interest rates in foreign currency (i*) and a reduction in local interest rates (i) increases the difference between the forward exchange rate (ef) and the current exchange rate: $\frac{e_f}{e_o} = \frac{1+i}{1+i^*}$

This is reflected in the hedge operations against the risk of appreciation. Thus, the net balance of banks' forward purchases of foreign currency from the public increased from US$ 9 million in December 2006 to US$ 1,075 million in May 2007. A forward purchase transaction implies an operation between an agent and banks in which the latter agrees to purchase dollars in the future at a previously fixed exchange rate. If the exchange rate by the end of the contract is lower than the rate agreed upon, the agent obtains a benefit. On the other hand, in order to cover themselves against exchange risks, banks usually make the inverse operation in the spot exchange market, selling dollars in said market.

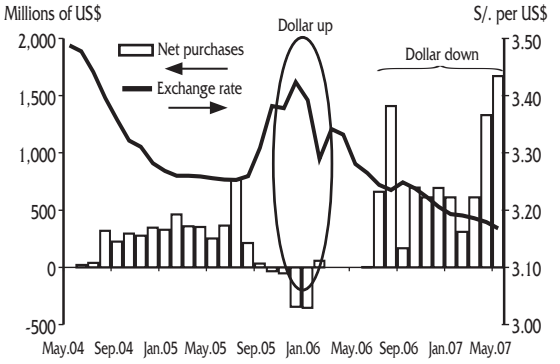
Graph 19
NET BALANCE OF DOLLAR PURCHASES AND EXCHANGE RATE



The increase observed in forward purchases has been coupled by a higher presence of non-resident investors.

27. Non-deliverable net forward purchases (involving a higher speculative component and a higher participation of non-residents) amount to US$ 1,330 million. This higher supply of forward operations increased even further since April, when the period of uncertainty associated with February results at the Shanghai Stock Exchange dissipated in international markets.

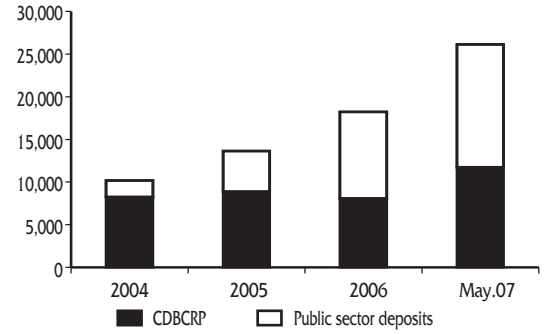
Graph 20
NET BALANCE OF DOLLAR PURCHASES AND EXCHANGE RATE



Moreover, downward pressures associated with sales of dollars for the payment of income tax were also observed in the exchange market.

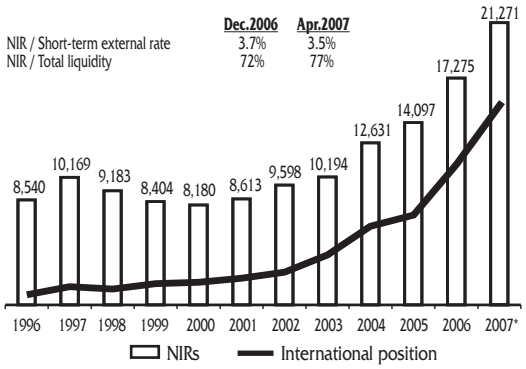
28. In this context, between January and May 2007 the BCRP intervened in the exchange market purchasing dollars for a total of US$ 4,531 million, of which US$ 930 million were used to repay the external debt. The purchase of dollars allows a precautionary hoarding of international reserves to face eventual negative external shocks in the future. The monetary impact of these purchases of dollars was sterilized through the placement of CDBCRPs and through higher public sectors deposits resulting from the improvement seen in public finances during this period.

Graph 21
PUBLIC SECTOR DEPOSITS
(S/. per US$)



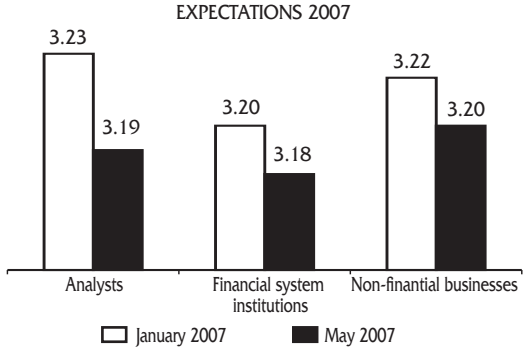
29. Net international reserves (NIRs) at the BCRP have increased by US$ 3,996 million so far this year, amounting to US$ 21,271 million in May 2007. This result is mainly explained by an increase of US$ 3,981 million in the international position of the BCRP and by an increase of US$ 126 million in public sector deposits. This result was offset by lower deposits from the financial system (down US$ 29 million).

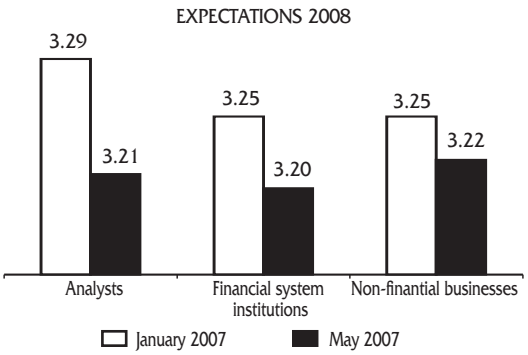
Graph 22
NET INTERNATIONAL RESERVES AND INTERNATIONAL POSITION
(Millions of US$)



* To May.

Graph 23
EXPECTATIONS REGARDING THE EXCHANGE RATE
(Nuevos Soles per US$)





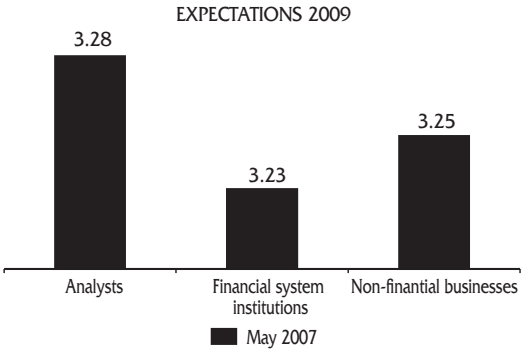


Table 11

NET INTERNATIONAL RESERVES FLOWS
(Millions of US$)

	2004	2005	2006	2007 Jan. - May.
I. FOREIGN EXCHANGE OPERATIONS	**1,854**	**767**	**2,861**	**3,625**
1. Over the counter	2,340	2,699	3,944	4,531
a. Purchases	2,340	3,130	4,299	4,531
b. Sales	0	-431	-355	0
2. Operations with the public sector	-487	-1,935	-1,084	-919
3. Other net purchases	2	3	1	14
II. FINANCIAL SYSTEM DEPOSITS	**23**	**1,251**	**-684**	**-29**
III. PUBLIC SECTOR DEPOSITS	**359**	**-587**	**245**	**126**
IV. OTHERS	**201**	**35**	**756**	**274**
V. TOTAL	**2,437**	**1,466**	**3,178**	**3,996**

With this evolution, the percentage of private sector liquidity covered by international reserves continued to increase and grew from 72 percent in 2006 to 77 percent in April 2007. Furthermore, external obligations with short-term maturities continued to be covered in a higher proportion by international reserves.

Expectations regarding the exchange rate

30. Economic agents corrected their exchange expectations for 2007 downwards: the expectations on the exchange rate declined from a range of S/. 3.20 - S/. 3.23 per dollar in January this year to a range of S/. 3.18 - S/. 3.20 per dollar in May 2007. Economic agents have also corrected their exchange expectations for 2008 downwards: from S/. 3.25 - S/. 3.29 per dollar to a range of S/. 3.20 - S/. 3.22 per dollar. Moreover, the exchange rate is expected to range between S/. 3.23 and S/. 3.28 per dollar in 2009.

III. International environment

Indicators on global economic activity in the first months of the year show a dynamism in line with the forecasts of our Inflation Report of January.11 The increased demand generated by some economies growing at a fast pace, the low levels of inventories, supply problems in the case of some commodities, and expectations of a weak dollar given the likelihood that the FED will reduce its interest rate would indicate that our terms of trade should increase by 1.9 percent this year (a higher rate than the one forecast in our previous Inflation Report).

United States continues to show evidence of a gradual slowdown, although uncertainty regarding the evolution of the real estate market and its impact on the dynamic of the global economy remains. On the other hand, the Eurozone would continue to show signs of a rapid recovery, boosted by growth in Germany and the United Kingdom, and would moderately slow down by 2009. Moreover, Japan would exhibit a slow but continuous growth in the forthcoming two years.

Table 12

FORECASTS ON GDP GROWTH OUR MAIN TRADING PARTNERS [1/]
(In percentage)

	Weighted trade 2006	2005	2006	2007		2008		2009
				RI Jan.07	RI May.07	RI Jan.07	RI May.07	RI May.07
Trade partners [2/]	**100**	**4.3**	**4.6**	**3.9**	**4.1**	**4.0**	**4.0**	**3.8**
North America	***29%***	***3.2***	***3.2***	***2.4***	***2.1***	***3.0***	***2.8***	***3.0***
USA	24%	3.2	3.3	2.4	2.1	3.0	2.8	3.0
Canada	5%	2.9	2.7	2.3	2.4	2.9	2.8	3.0
Europe	***20%***	***1.6***	***2.9***	***2.2***	***2.6***	***2.2***	***2.3***	***2.0***
Germany	4%	0.9	2.7	1.5	2.4	2.0	2.3	1.9
United Kingdom	1%	1.9	2.8	2.5	2.7	2.4	2.3	2.3
Asia	***21%***	***7.3***	***7.7***	***6.9***	***7.2***	***7.0***	***7.2***	***6.8***
China	11%	10.4	10.7	9.6	10.0	9.4	9.8	9.5
Japan	5%	1.9	2.2	1.8	2.2	2.3	2.2	1.2
Latin America	***30%***	***5.5***	***5.5***	***4.8***	***5.1***	***4.2***	***4.4***	***3.9***
Argentina	2%	9.2	8.5	7.2	7.6	4.7	5.8	4.9
Brazil	7%	2.9	3.7	3.4	4.2	3.6	4.2	4.3
Chile	7%	5.7	4.0	5.2	5.7	5.0	5.2	4.9
Mexico	3%	2.8	4.8	3.4	3.1	3.7	3.6	3.8
Venezuela	3%	10.3	10.3	6.9	7.0	5.0	3.8	1.4
Note:								
India		9.2	9.2	8.4	8.1	7.8	7.8	7.0
Russia		6.4	6.7	6.2	6.3	6.0	6.0	5.8
World economy: a) [3/]		**3.3**	**3.9**	**3.2**	**3.3**	**3.3**	**3.4**	**3.3**
b) [4/]		**4.9**	**5.4**	**4.9**	**4.9**	**4.9**	**4.9**	**4.9**

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

Global economic situation

31. After having shown a sound economic expansion in 2006 (4.6 percent), a moderate slowdown is expected to occur between 2007 and 2009 in the growth of our main trading partners, particularly in the growth of the United States due to ongoing corrections in the real estate market in this country.

    This evolution would not have significant effects on Europe and Japan due to the improvement in the domestic fundamentals and to the favorable prospects seen in these economies. Emerging economies also show favorable prospects in terms of growth, as a result of which our forecasts have been revised slightly upwards.

32. In the first quarter **United States** reported a higher economic slowdown than expected. GDP grew at an annual rate of 1.3 percent, after having reached an annual growth of 2.5 percent in the fourth quarter of 2006. The corrections seen in the real estate market continued to have a negative impact on private investment, whose contribution to GDP growth was negative in the first quarter (-0.8 percent). However, the soundness of consumption has continued to offset corrections in the real estate market. On the other hand, net exports contributed negatively to GDP growth (-0.5 percent), mainly due to a higher contribution of imports (-0.4 percent), reflecting the sound dynamism of consumption. This has favored the external demand of trading partners.

Table 13

MAIN INDICATORS ON THE USA AND CANADA [1/]

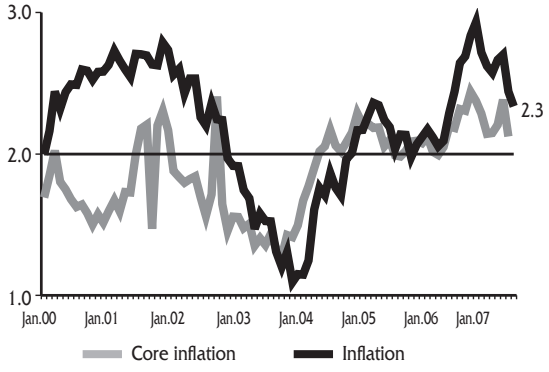
	2005	2006	2007*		2008*		2009*
			IR Jan.07	IR May.07	IR Jan.07	IR May.07	IRMay.07
GDP (% change)							
USA	3.2	3.3	2.4	2.1	3.0	2.8	3.0
Canada	2.9	2.7	2.3	2.4	2.9	2.8	3.0
Inflation							
USA	3.4	2.5	2.3	2.8	2.3	2.2	2.1
Canada	2.2	1.6	2.2	2.1	2.0	2.1	2.1
Current account (in percentage)							
USA	-6.4	-6.5	-6.0	-6.1	-5.6	-6.0	-6.0
Canada	2.3	1.7	1.2	0.7	1.0	0.6	0.6
Fiscal deficit of the government (in percentage)							
USA	-3.7	-2.6	-3.2	-2.5	-2.9	-2.5	-2.5
Canada	1.4	0.9	1.0	0.6	0.9	0.7	0.7

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

The weakness of the real estate market should continue to affect investment in the rest of 2007, particularly in the first half of the year, while consumption should gradually slow down. Therefore, an annual growth of 2.1 percent, 2.8 percent and 3.0 percent is expected for 2007, 2008 and 2009 respectively.

On the other hand, inflation -measured on the basis of the Consumer Price Index and the personal consumption expenditure deflator (PCE)- showed signs of acceleration in the first months of the year, evolution explained by the rise of the oil price and by higher labor costs in a labor market that showed demand pressures and lower productivity.

Graph 24
USA: INFLATION AND CORE INFLATION
(Percent change in the last 12 months)



The core component of these price indices -excluding food products and energy- also showed some inflationary pressures. In April, core inflation in terms of CPI was 2.3 percent, while the PCE deflator was 2.1 percent -slightly above the 2 percent level considered as benchmark by the Federal Reserve (FED). The FED has continued to maintain its bias for inflationary risks, although it has also pointed out that inflation should gradually decline in response to the impact of an expected more moderate growth.

In this context of economic slowdown and inflationary pressures, the FED has maintained its interest rate -in line with our forecasts- for its past seven sessions (after having raised its interest rates on 17 occasions between June 2004 and June 2006). On the other hand, given the fact that the European Central Bank (ECB) raised its interest rates, the rate spread favoring the euro has decreased from 175 bps to 150 bps so far this year.

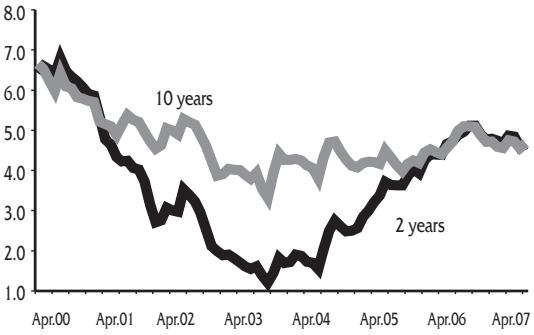
Table 14

SCHEDULE OF THE NEXT MONETARY POLICY MEETING 2007

	Federal Reserve	European Central Bank	Bank of England
Reference rate	**5.25%**	**3.75%**	**5.50%**
	Jun.28	Jun.06	Jun.07
	-	Jul.05	Jul.05
Next	Aug.07	-	Aug.02
meeting	Sep.18	Sep.06	Sep.06
2007	Oct.31	Oct.04	Oct.04
	-	Nov.08	Nov.08
	Dec.11	Dec.06	Dec.06

The possible repercussions of the real estate market and the increase of non-performing loans in the sub-prime segment of the mortgage market would support the likelihood of a reduction in the interest rate. However, the favorable prospects for employment, the pressures on salaries and the persistence of inflationary pressures would point to an increase of interest rates. In this context, our forecast is that the rate would fall by 25 bps by the end of 2007 and that it would remain at this level for the following two years.

Graph 25
USA: TREASURY YIELDS



Long-term rates have had a volatile performance in the first months of the year, influenced by changes in the expectations of investors regarding the future evolution of growth in the United States. This can also be observed in the four variations shown in the gradient of the yield curve during the January-May period. Although investors were concerned about the prospects of a lower growth in the first quarter, expectations that the economic slowdown will be moderate have increased over the past two years.

33. In **Europe**, after the growth of 2.9 percent recorded in 2006 (the highest rate in the decade), the economy should grow at rates of 2.6 percent in 2007 and 2.3 percent in 2008 - higher levels than the ones forecast in our Inflation Report of January- and at around 2.0 percent in 2009.

The **Eurozone** stands out in this upward revision, with an annual growth rate of 3.1 percent in the first quarter. Business sound earnings and the high degree of installed capacity used should contribute to a continuous growth of private investment. Furthermore, the growth of employment -unemployment declined to 7.2 percent, the lowest rate observed since the eighties- has generated an increase in consumption demand.

Table 15

MAIN INDICATORS ON EUROPE 1/

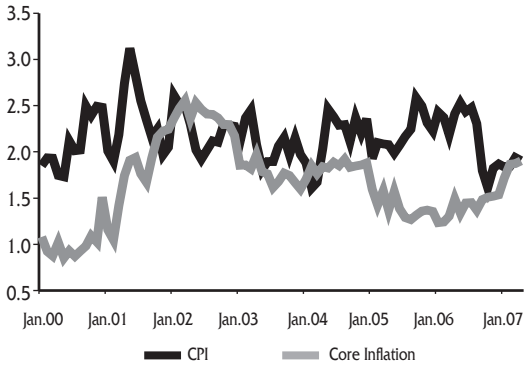
	2005	2006	2007*		2008*		2009*
			IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
GDP (% change)							
Germany	0.9	2.7	1.5	2.4	2.0	2.3	1.9
Spain	3.5	3.9	3.2	3.6	2.9	3.0	2.5
United Kingdom	1.9	2.8	2.5	2.7	2.4	2.3	2.3
Inflation							
Germany	2.1	1.4	2.4	1.6	1.0	1.6	1.6
Spain	3.7	2.7	3.1	2.6	2.2	2.7	2.7
United Kingdom	1.9	3.0	1.5	1.9	2.0	1.9	1.9

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

In terms of Eurozone countries, **Germany's** recent higher growth -favored by a dynamic corporate investment and industrial activity, as well as by a continuous growth of exports- has led to revise expected growth upwards to 2.4 and 2.3 percent in 2007 and 2008 respectively (after which it would slow down to 1.9 percent in 2009).

Inflation has been recovering and reached 1.9 percent, while core inflation increased from 1.4 percent in August to 1.9 percent in March. Both rates are close to the 2 percent target.

Graph 26
EUROZONE: INFLATION
(Percentage change last 12 months)



In this context, the **European Central Bank (ECB)** raised its reference interest rate by 25 basis points to 3.75 percent in March, the highest rate since 2003. New adjustments should occur in 2007, which would contribute to moderate the growth of the economy and to contain inflationary pressures, as a result of which inflation should be around 1.6 percent in the following years.

The growth of the **United Kingdom** (2.8 percent in the first quarter of 2007) is noteworthy outside the Eurozone. Economic activity should continue to grow in response to domestic demand, due both to investment and to private consumption, as well as due to the wealth effect given the continuous boom in the real estate sector. This growth has been coupled by a progressive increase of inflation since September 2006, which reached an annual rate of 3.1 percent last March. In this context, the **Central Bank of England (BoE)** has raised its interest rate by 50 bps so far this year and new adjustments should be considered if inflationary pressures are not contained.

34. **Japan** is expected to continue growing, although at a slower pace than in 2006. This more moderate growth would be associated with the lower dynamism of exports as a result of the expected slowdown in the U.S. economy and of China's actions to prevent the overheating of its economy, but would be offset by a possible increase in consumption given the currently favorable conditions of employment and investment.

With this economic expansion, the deflationary process that began in the past decade is expected to end. Core inflation in March posted a negative annual rate of 0.3 percent, which has led the **Bank of Japan (BoJ)** to revise its inflation forecasts for 2007 downwards and to report that inflation would grow

at a faster pace in 2008 to 0.6 percent. This could lead the BoJ to postpone the rate adjustment expected for this year (the BoJ raised the policy rate by 25 bps to 0.5 percent in February).

Table 16

MAIN INDICATORS ON ASIA [1/]

	2005	2006	2007*		2008*		2009*
			IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
GDP (% change)							
China	10.4	10.7	9.6	10.0	9.4	9.8	9.5
South Korea	4.2	5.0	4.4	4.5	4.9	5.0	4.7
Japan	1.9	2.2	1.8	2.2	2.3	2.2	1.2
Inflation							
China	1.6	2.8	2.4	2.5	2.0	2.5	2.2
South Korea	2.6	2.1	2.5	2.6	2.4	2.6	2.5
Japan	-0.4	0.3	0.3	0.4	1.0	0.6	1.6

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

35. In terms of **emerging economies**, it is worth highlighting the significant growth exhibited by **China**. After growing at a rate of 10.7 percent in 2006 -the highest growth rate since the mid-nineties-,GDP increased 11.1 percent in the first quarter, while industrial production grew 18.3 percent in March. This significant dynamic performance of the Chinese economy was based on the strength of investments and exports.

    This increased economic activity led annual inflation to grow to 3.3 percent in March, a higher level than the 2.8 percent rate recorded in December 2006. According to these indicators, it is estimated that the economy could be growing at a very fast pace, although this accelerated growth would only be concentrated on some sectors (steel, aluminum and real estate).

    This has China's monetary authority to increase reserve requirements five times this year -from 9.0 percent in December 2006 to 11.5 in May 2007- and to increase its interest rate on 1-year loans twice in 2007 and four times since April 2006. This rate increased from 6.12 percent in December 2006 to 6.57 percent in May this year. Likewise,

the Central Bank raised -for the first time this year- the interest rate on 1-year passive operations by 27 bps from 2.79 to 3.06 percent. As regards its currency, the Central Bank of China enhanced the flotation band to allow a higher appreciation of the yuan against the dollar.

36. **Latin America** continued to show a dynamic economic activity during the first months of 2007. The indicators for the first quarter show a favorable evolution that continues the trend observed in 2006, which was the fourth consecutive year with a continuous demand based on the robust growth of domestic demand.

Moreover, the region continued to be favored by an external context with high prices for commodities and abundant international liquidity.

The 5.5 percent growth recorded in 2006 and the evolution of activity indicators so far this year have led to revise growth forecasts upwards from 4.8 to 5.1 percent in 2007 and from 4.2 to 4.4 percent in 2008. Furthermore, a growth of 3.9 percent is expected in 2009.

It should be pointed out that this increased economic dynamism has been coupled, in most cases, by a substantial increase in the rest of relevant macroeconomic variables, such as inflation, public finances, and the balance of payments.

Table 17

MAIN INDICATORS ON LATIN AMERICA 1/

	2005	2006	2007*		2008*		2009*
			RI Jan.07	RI May.07	RI Jan.07	RI May.07	RI May.07
GDP (% change)							
Argentina	9.2	8.5	7.2	7.6	4.7	5.6	4.7
Brazil	2.9	3.7	3.4	4.2	3.6	4.1	4.2
Chile	5.7	4.0	5.2	5.2	5.0	5.1	4.8
Colombia	5.3	6.8	5.0	5.6	4.2	4.8	4.4
Mexico	2.8	4.8	3.4	3.3	3.7	3.7	3.9
Inflation							
Argentina	12.3	9.8	10.3	9.2	10.2	10.3	10.2
Brazil	5.7	3.1	4.0	3.6	4.1	4.0	3.9
Chile	3.7	2.6	2.9	2.9	2.9	2.9	2.9
Colombia	4.9	4.5	4.1	4.9	3.9	4.1	3.8
Mexico	3.3	4.1	3.5	3.7	3.5	3.6	3.5

1/ Source: Consensus Forecast .

* Forecast.

Table 18

ECONOMIC INDICATORS OF THE MAIN TRADE PARTNERS IN LATIN AMERICA

	2003	2004	2005	2006	2007*	2008*
Current account (% of GDP)						
Argentina	6.2	2.3	3.1	3.9	2.8	1.9
Brazil	0.8	1.8	1.6	1.3	0.8	0.2
Chile	-1.1	2.2	1.1	4.0	2.3	0.5
Colombia	-1.2	-0.9	-1.5	-2.1	-2.2	-2.4
Mexico	-1.4	-1.0	-0.6	-0.2	-1.2	-1.4
Venezuela	14.1	13.8	17.6	15.1	7.4	4.7
Ovellar balance of the public sector (% of GDP)						
Argentina	0.5	2.6	1.8	1.8	1.3	1.2
Brazil	-3.6	-2.5	-3.1	-3.2	-2.2	-1.8
Chile	-0.4	2.2	4.8	7.8	5.9	3.4
Mexico	-0.6	-0.2	-0.1	0.1	0.0	-0.1
Venezuela	-4.4	-1.9	1.7	-0.9	-4.1	-4.8
International reserves (thousand of millions of US$) non gold and SDRs, at the end of period						
Argentina	13.1	18.0	22.7	30.4	42.5	49.3
Brazil	49.1	52.7	53.5	85.6	127.3	145.7
Chile	15.2	15.5	16.7	19.2	18.8	19.0
Colombia	10.2	12.8	14.2	14.7	17.2	17.6
Mexico	57.7	62.8	73.0	75.4	73.7	75.9
Venezuela	15.5	17.9	23.5	28.9	30.6	28.7
Long-term external debt (% of GDP)						
Argentina	98.4	83.4	64.6	57.0	45.4	36.1
Brazil	33.2	25.9	16.8	13.9	10.6	8.3
Chile	48.4	37.9	25.9	23.0	19.0	15.0
Colombia	42.1	33.0	23.6	21.5	16.2	13.3
Mexico	20.7	19.0	14.6	13.4	10.6	8.9
Venezuela	36.5	27.8	20.7	16.5	12.6	9.8
Annual service of long-term debt (% of reserves)						
Argentina	56.8	33.7	81.2	60.8	41.6	36.8
Brazil	89.8	87.6	82.0	51.3	27.8	22.0
Chile	51.7	60.7	45.4	39.5	29.3	29.8
Colombia	83.4	58.8	42.5	41.2	35.7	32.3
Mexico	72.4	81.0	40.8	39.5	36.8	25.2
Venezuela	56.3	36.5	25.1	20.3	15.7	16.9

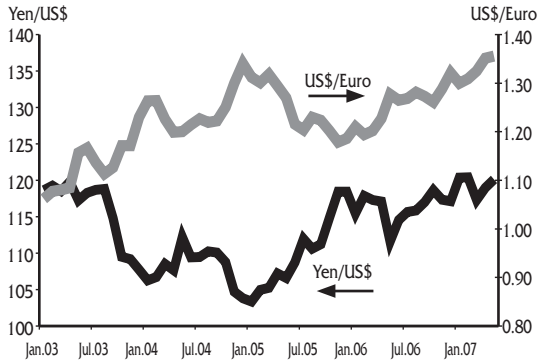
Source: Latin American Consensus Forecast, April 16, 2007.

* Forecast.

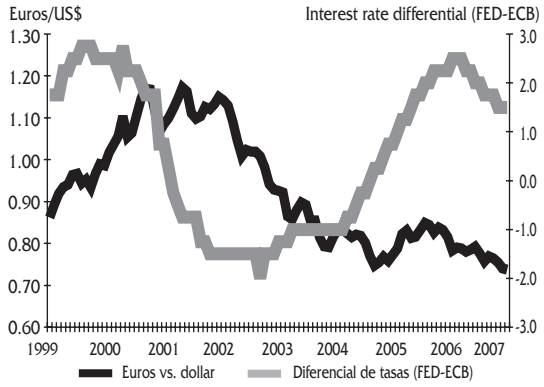
Evolution of the dollar in international markets

The dollar continued with its depreciatory trend during the first months of 2007, affected by an expected reduction in the differential of rates given expectations that the European Central Bank and the Bank of England will raise their rates in the course of 2007. Together with the external imbalances of the United States, this lower differential would contribute to generate a depreciation of the dollar against the main other currencies, although no abrupt correction of these imbalances is expected in the short-term.

Graph 27
US DOLLAR AGAINST EURO AND YEN



Graph 28
QUOTATION OF US DOLLAR (EURO/US$)
AND INTEREST RATE DIFFERENTIAL



37. During the first months of 2007, the **dollar** continued to show a depreciatory trend. The reduction in the differential of rates between the economies of the United States and the rest of the world, and expectations of a further reduction -given the possibility that the FED might lower its rate and given expected rises in the Eurozone and the United Kingdom- influenced a depreciation of the dollar against the euro and other strong currencies, such as the pound. The dollar reached a historical minimum against the euro on April 27 (US$ 1.3653 per euro) and a historical minimum against the pound on April 18 (US$ 2.0082 per pound). This would have been reinforced by a restructuring of central banks' portfolios, which would have favored the euro.

    On the other hand, the dollar has registered a high volatility against the yen, despite the adjustment made by the Bank of Japan in its interest rate (which was raised to 0.5 percent in February). The evolution of the yen over the past few months has been significantly influenced by speculative currency operations.

38. A moderate depreciation of the dollar against the euro is forecast for 2007, while an appreciation of the dollar against the euro is expected for 2008. On the other hand, the dollar is expected to weaken against the yen and the yuan due to a gradual reversal of speculative operations (carry trade) in the case of the former and to China's high current account surplus in the case of the latter.

    These events would reflect an orderly adjustment of external imbalances. It should be pointed out that despite the evolution of the dollar, the U.S. economy continues to show external imbalances and that the U.S. high current account deficit (6.5 percent of GDP in 2006) is still being financed by purchases of assets in dollars by foreigners, particularly by the central banks of China and oil exporting countries in order to accumulate reserves.

Debt of emerging economies

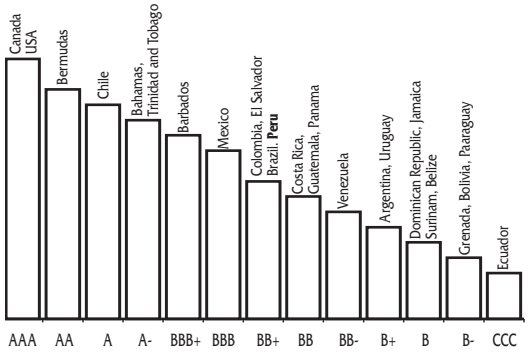
The spreads of emerging countries continued to show a downward trend and even reached new historical minimum records in May. This evolution would be explained by the continuous high prices of commodities, by improvements in the macroeconomic fundamentals of emerging economies, by the still abundant international liquidity, and by expectations that the FED's rate will remain relatively stable.

39. On the overall, the spreads on emerging countries' debts showed a marked downward tendency, which was briefly

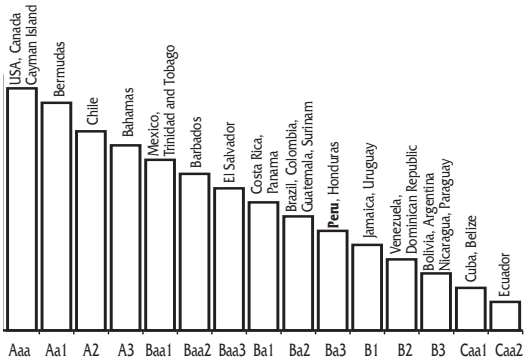
interrupted by the turbulence observed between late February and early March 2007 that temporarily affected some spreads. However, these spreads resumed their downward trend thereafter.

The EMBI+ spread recorded its minimum level on April 23 (149 bps), while the minimum levels of the EMBI+ Peru spread was 100 bps on May 23, the EMBI+ Brazil spread was 139 bps on May 22, and the EMBI+ Colombia was 117 bps on May 31.

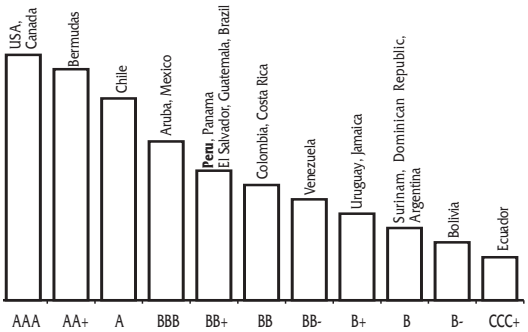
Graph 29
STANDARD & POOR'S



MOODY'S



FITCH



Note: Standard & Poor's increased the qualitation of Peru from BB to BB+ in november 2006. Fitch increased from BB to BB+ in august 2006.

Table 19

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

	2002	2003	2004	2005	2006	2007**	Var. in pbs 2007 - 2006
Emerging economies	**765**	**418**	**356**	**245**	**169**	**153**	**-16**
Latin America	**1,007**	**521**	**420**	**283**	**186**	**168**	**-18**
Brazil	1,446	463	382	311	192	142	-50
Colombia	645	431	332	238	161	117	-44
Mexico	331	199	166	126	98	75	-23
Argentina	6,391	5,632	4,703	504	216	277	61
Peru 1/	610	312	220	206	118	103	-15

* End-of-period data.

** Data as of May. 31, 2007.

1/ Since September 29, J.P. Morgan included the 2025 and 2033 global bonds in the calculation of the EMBI, resulting in an increase of approximately 40 pbs.

40. The improvement of fundamentals in most of these economies (increase in international reserves, debt restructuring and reduction, among other factors) influenced a favorable evolution of *spreads* which, in turn, was reflected in the fact that the main rating agencies assigned better risk ratings to these economies.

Standard & Poor's upgraded the rating assigned to nine emerging economies, including Brazil and Colombia (which were rated one level below investment grade), and India. So far this year, **Moody's** has upgraded the risk rating of the Dominican Republic and Belize. **Fitch** raised the rating assigned to Poland and Brazil.

BOX 4

CARRY TRADE AND VOLATILITY IN INTERNATIONAL MARKETS

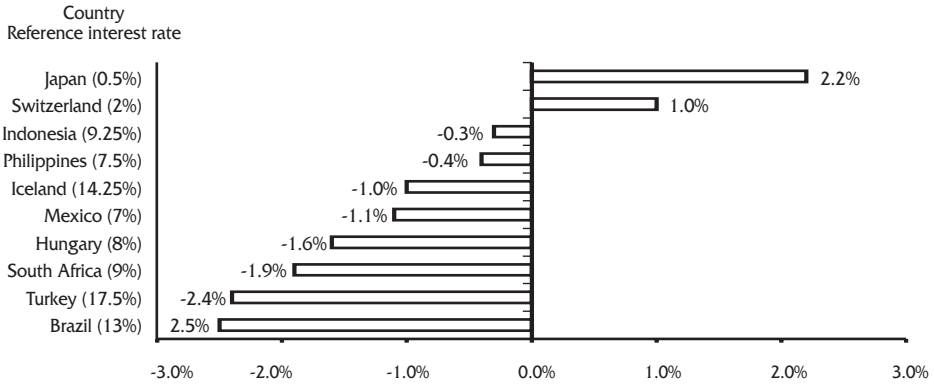
Carry trade operations or speculative operations between currencies are defined as a financial strategy in which a borrower obtains a loan in a currency with a low interest rate, changes those funds into a loan with a high interest rate and gives credit in said currency. *Carry trade* operations have considerably increased in 2006, as a result of a reduction in risk aversion and of a high level of international liquidity, in a context of high spreads between the interest rates of several countries.

Due to their low interest rates, the main funding currencies have been the Japanese yen and the Swiss franc, while the target currencies (high yield currencies) are those of both developed countries (the United States, the Eurozone, and the United Kingdom, among other countries) and those of emerging countries (Iceland, Brazil, Thailand, Indonesia, South Africa, among others). These operations would explain the depreciation of the yen and the appreciation of the currencies of emerging countries, some of which show high current account deficits.

A new episode of sudden increase in investors' risk aversion was observed In February 2007. Although this episode was briefer, of a lower magnitude, and involved different currencies than the one seen in May-June 2006 -during which the countries exhibiting a higher weakness in their external accounts were subject to greater pressures-, it reflected the volatility of the financial markets.

This volatility event took place after China's Stock Exchange plunged 8.8 percent as a result of expectations that illegal operations would be controlled through regulations and also as a result of concerns regarding the *sub-prime* sector in the U.S. mortgage market and the slowdown of the U.S. economy. On this occasion, the reversal of *carry trade* operations strengthened the yen and the franc and weakened the currencies of those economies with the highest interest rates (Indonesia, the Philippines, Iceland, Mexico, Hungary, South Africa, Turkey and Brazil).

EXCHANGE RATE VARIATION (February 26-28)



There is no consensus on the amount of money associated with these speculative operations between currencies. Conservative estimates include that of John Dizard *(Financial Times)* who holds that the yen's *carry trade* would amount to between US$ 20 and US$ 40 billion, while Japan's Minister of Finance, Hiroshi Watanabe, estimates this amount between US$ 85 and US$ 170 billion. On the other hand, estimates that consider that these speculative operations have been more important include Jesper Koll's *(Merril Lynch)* who, based on the amount of credit provided to foreign banks in Japan, estimates that these operations would amount to US$ 1 trillion (of which US$ 300 billion would have been generated in 2006).

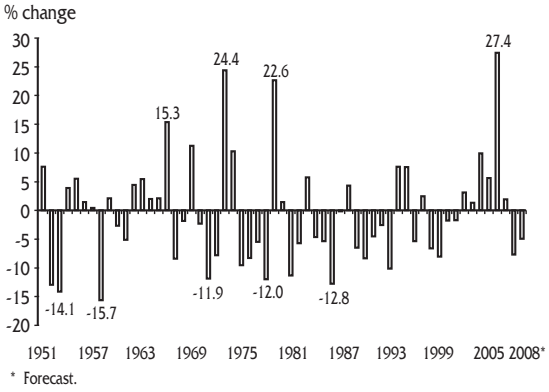
Terms of trade

After having increased 27 percent in 2006 (historical maximum), terms of trade would grow at a slower pace in 2007, showing corrections in 2008 y 2009. Terms of trade should increase by 1.9 percent, since metals have reached better quotations than expected early this year due to the low levels of inventories of copper, lead and tin.

Terms of trade would decline by 8 percent and 5 percent in 2008 and 2009 respectively due to lower prices of minerals. High volatility is expected to continue in the prices of commodities, with an upward bias in the case of oil.

41. After reaching a historical record of 27 percent on average in 2006, terms of trade would improve for the sixth consecutive year growing at an average rate of 1.9 percent in 2007. This forecast could be affected by factors such as the geopolitical uncertainty observed in the middle east and/or the possibility that the global economic slowdown be stronger than expected.

Graph 30
TERMS OF TRADE
(Percentage change)



* Forecast.

42. Terms of trade increased 5.1 percent between December 2006 and May 2007 mainly due to a 7.6 percent increase in the price of mining exports. This increase contrasts with the price fall of 10.4 percent that was forecast for this same period in our January Report.

43. The quotations of the main minerals exported by Peru (gold, copper, tin, lead and oil) increased after being significantly corrected at end 2006 and early 2007. Consequently, the prices of most minerals have considerably exceeded our initial forecasts. The price of zinc, on the other hand, was the only one that fell significantly during the first quarter of the year, after having posted historical record levels in November and December 2006. However, a partial reversal in the prices of some of these products is expected in the rest of the year, particularly in the case of copper.

44. In 2008, terms of trade should decrease by 7.7 percent basically due to a fall of 9.0 percent in the price of minerals and to a lower rise in the price of food products (5.3 percent). This trend should continue in 2009 when the decline in terms of trade would reach 4.9 percent.

Table 20

TERMS OF TRADE
(Annual percentage change)

	2005	2006	2007*		2008*		2009*
			IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
Terms of trade	**5.6**	**27.4**	**-3.7**	**1.9**	**-6.3**	**-7.7**	**-4.9**
1. Exports price index	**16.8**	**36.9**	**-1.6**	**6.5**	**-3.7**	**-4.6**	**-2.6**
of which:							
- Gold (US$ / Ounce.Tr.)	445	605	637	666	661	680	697
- Copper (US$ / Pound)	1.67	3.05	2.57	2.98	2.32	2.65	2.48
- Zinc (US$ / Pound)	0.63	1.49	1.65	1.61	1.31	1.32	1.10
- Fish meal (US$ / MT)	686	1,080	1,074	1,157	1,062	1,052	1,036
2. Imports price index	**10.6**	**7.4**	**2.2**	**4.5**	**2.8**	**3.4**	**2.4**
of which:							
- Petroleum (US$ / barrel)	57	66	62	63	65	67	67
- Wheat (US$ / MT)	130	169	183	179	175	185	182

IR: Inflation Report.
* Forecast.

Gold

45. The quotation of gold increased 6.9 percent between December 2006 and May 2007, reaching US$ 673 per troy ounce. This result was consistent with market expectations for 2007 in the sense that, in general terms, the price of gold would recover during the year. Factors that positively affected the price of gold included:

    a. *The use of gold as a hedge against the weakening of the dollar*. The depreciation of the dollar -in a context of high current account deficit in the U.S. and lower spreads between interest rates- encouraged the demand for gold as a reserve asset.

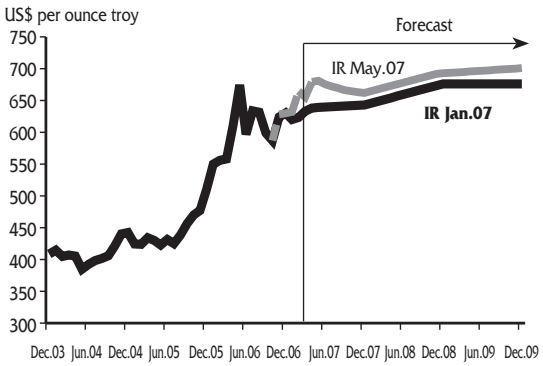
    b. *The use of gold as a hedge given oil price rises*. Inflationary concerns are generated by increases in the price of oil and, therefore, the quotation of gold has historically fluctuated according to changes in the price of oil. In the first months of the year, the price of petroleum increased 3.1 percent, while the price of gold increased 7.9 percent.

    c. *Global geopolitical uncertainty*: Geopolitical tensions were observed in the Middle East, particularly after the United Nations imposed new sanctions on Iran due to its nuclear program.

d. *Lower global production*. A survey carried out by Gold Field Mineral Service (GMS), a metals consultancy, estimates that gold supply will drop in 2007, although at a lower level than in 2006.

e. *Investors' interest in the commodity market*. The fact that gold is considered an asset underlying several financial instruments has generated a higher interest from investors seeking greater earnings for their funds. Bloomberg reported that net long positions[11] in speculative contracts increased to a peak of 142 thousand on February 27 this year -the highest level observed since January 24, 2006-, slightly declining thereafter as a result of the financial turbulence generated by the plunge of the Shanghai Stock Exchange. These positions have been showing a recovery since April.

Graph 31
GOLD PRICES: FORECAST



IR: Inflation Report.

46. The prospects for the price of gold are favorable in 2007. Despite volatility, an average price of US$ 665 per troy ounce is expected for 2007, which is a higher price level than the one forecast in our Inflation Report of January (US$ 637 per troy ounce). Moreover, the price of gold is expected to increase to US$ 680 and to US$ 697 per troy ounce in 2008 and 2009 respectively.

However, this forecast could be affected by factors such as sales of gold by the European central banks, which would imply a reduction in the price of this metal. Recent reports confirm that central banks in Europe have increased their sales of gold since the week ended March 16. Two European central banks reduced their gold assets by 195 million euros (US$ 265 million), which would represent sales of nearly 12.3 tons in the week ended April 27.

Copper

47. The price of copper increased 17.4 percent between December 2006 and May 2007, but showing differentiated conducts. Between January and the first week of February, the price of copper showed a downward trend and reached a minimum level (US$ 2.37 per pound) on February 8. Although a price correction was expected, the reduction was higher than the one initially estimated.

The quotation of copper then resumed an upward trend, reaching a level of US$ 3.73 per pound on May 4, the highest level posted since July 12, 2006.

11 An investor adopts a long position when he purchases forwards contracts.

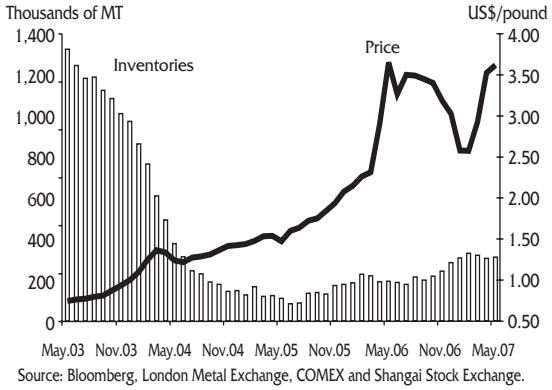
48. A higher than expected growth of demand is among the reasons explaining the upward trend observed in the *spot* price of copper. Today, there is some consensus on the fact that the demand for copper should remain high this year. This consensus is based on some recent developments, including the following:

a. *China's increased demand during the first quarter*: China's imports of uncut copper and copper products amounted to 777 thousand MT in the first quarter of this year, increasing by 58 percent relative to the same period in 2006.

Refined copper showed a similar trend. China imported a net amount of 478.4 thousand MT in the first quarter of the year, twice as much as net imports of copper (129.5 thousand MT) in the same period last year.

b. *Supply problems*. Several supply shocks affected the price of copper in the first four months of this year: (i) a strike at the Grasberg mine in Indonesia (the second largest copper mine in the world), (ii) reprogramming of copper production at the Xstrata company (the world's fourth largest supplier of copper), (iii) the mining strike in Peru that took place between April 30 and May 4, which was aggravated by the strike of Doe Run workers, (iv) concerns of a lower supply after Zambia -the largest producer of copper in Africa- reported that its annual production had decreased by 14.3 percent in January due to a partial interruption of operations (strikes at the mines of Luanshya and Mopani), and (v) concerns that workers would go on strike at the Chilean mine of Chuquicamata, which represented 38 percent of Codelco's total production in 2006.

Graph 32
COPPER PRICE AND INVENTORIES



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

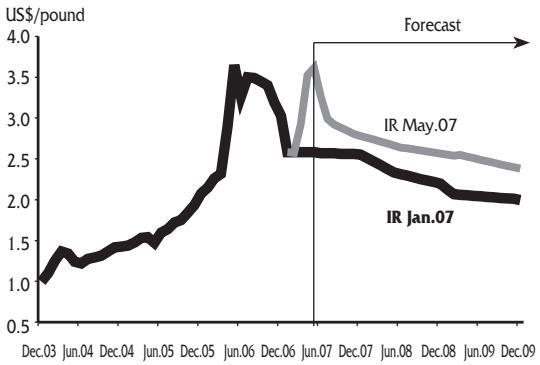
c. *Low levels of inventories*: Although global inventories at the main metal exchange markets have been recovering, the current level of these inventories only guarantees 5 days of global consumption, a level quite far away from the 41 days of global consumption that could be covered by inventories in early 2003.

d. *Increased participation of investors:* the net short positions of investors speculating with the price of copper have decreased since February 6, which implies lower expectations that the price of copper will be corrected in the short-term. This also implies that the rise in the price of copper would be reflecting fundamental factors.

49. The price of copper is expected to show a gradual and moderate reduction this year. The average quotation - US$ 3.05 per pound in 2006- would decline to US$ 2.98 per pound in 2007. This forecast was corrected upwards relative to the US$ 2.57 per pound estimated in our previous Inflation on the basis of already executed prices, but is still conservative in terms of market forecasts.

The copper quotation should continue to decline, reaching an average price of US$ 2.65 and US$ 2.48 per pound in 2008 and 2009 respectively.

Graph 33
COPPER PRICE FORECAST



IR: Inflation Report.

50. This expected downward correction is based on the assumption that the recent rise observed in copper prices could be reflecting some level of market over-reaction despite prospects of increased demand in China. This would be associated with the slowdown of the U.S. economy (accounting for 13 percent of global demand), the recovery of global production and the probable moderation of demand in China.

However, the current balance between supply and demand is still quite tight and therefore any interruption in production would have a direct impact on the price given the still low levels of copper inventories.

Zinc

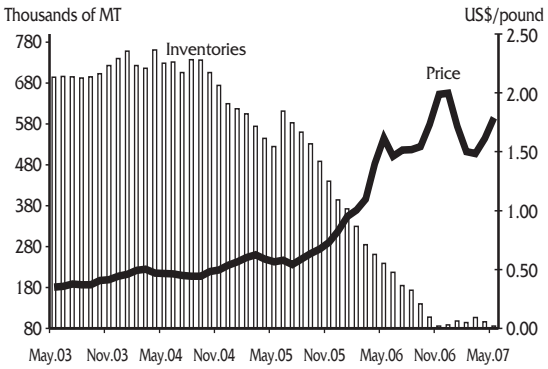
51. The quotation of zinc fell from US$ 2.00 per pound in December 2006 to US$ 1.77 per pound in May 2007 (11.3 percent). After having reached a maximum high on November 24 (US$ 2.10 per pound), the quotation of zinc plunged to a minimum of US$ 1.38 per pound on February 8, to start a recovery path thereafter. This evolution contradicted the market outlook that considered a quite tight balance between supply and demand, and that the price of zinc would continue to rise.

52. The main causes explaining this unexpected decline in the *spot* price of zinc would include the following:

a. *China's increased production of refined zinc*: China's production of refined zinc increased by 22 percent in the first two months of 2007 (versus 15 percent in the same period in 2006). This higher production would be partly due to the inclusion of mineral residues in the productive process, which would have increased China's zinc production by nearly 100 thousand MT in 2006.

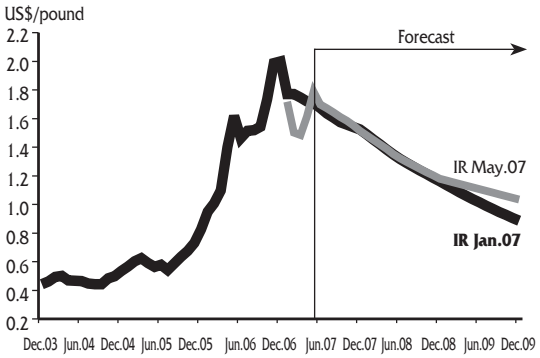
b. *China's exports of refined zinc*. Despite being a net importer of zinc in the past, China has become a net exporter of this metal over the past four months.

Graph 34
ZINC PRICE AND INVENTORIES



Source: Bloomberg, London Metal Exchange.

Graph 35
ZINC PRICE: FORECAST



IR: Inflation Report.

Therefore, although this was initially considered to be a temporary event, it is being speculated that fundamental factors would be underlying this conduct.

c. A slight recovery of inventories: After having dropped for three consecutive years, zinc inventories at the London Metal Exchange (LME) increased 24 percent as of March 26. However, they fell thereafter to the levels they showed at the beginning of the year, and thus they now represent 3 days of global consumption (a figure contrasting with the 18 days of global consumption they represented in early 2002.

53. Despite the drop observed in the price of zinc in the first months of the year, the price outlook would indicate that the global market would close 2007 posting -for the fourth consecutive year- a supply deficit, given that zinc consumption is expected to remain strong in the medium- and long-term due to increased demand in developing countries (China should revert its zinc exports in the second half of the year).

The price of zinc should rise in the long-term. This quotation is quite sensitive to concerns of possible supply interruptions due to the lack of investment in this sector. The average price of zinc is expected to increase from US$ 1.49 per pound in 2006 to US$ 1.61 per pound in 2007. The average forecast for the price of zinc for 2007 has been revised downwards from the US$ 1.65 per pound estimated in our January Report, due to the unexpected fall of spot prices observed in the first quarter of this year.

Table 21

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

	2005	2006	2007*
Gold			
- Supply	4,024	3,529	808
- Demand	3,729	3,380	827
Gap (Supply - Demand)	296	149	-19
Copper			
- Supply	11,698	12,480	12,573
- Demand	11,736	12,140	12,462
Gap (Supply - Demand)	-38	340	111
Inventories	451	791	902
Consumption weeks	2.0	3.4	3.8
Zinc			
- Supply	7,015	7,239	7,626
- Demand	7,316	7,523	7,745
Gap (Supply - Demand)	-301	-284	-119
Inventories	811	527	408
Consumption weeks	6.0	3.7	2.8

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

Petroleum

54. The quotation of WTI oil increased 2.0 percent between December 2006 and January 2007, but showed a differentiated evolution. After declining to US$ 50.5 per barrel on January 18, the price of oil rose to its maximum level in the year (US$ 66.5 per barrel on April 27). The main causes associated with this price rise included:

    a. *Geopolitical tensions*: economic sanctions were imposed on Iran for not suspending its nuclear program.

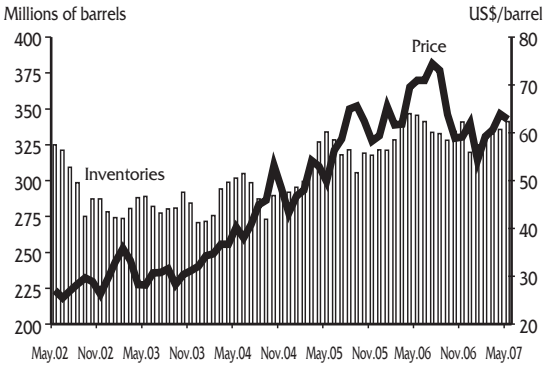
    b. *Supply constraints*: The International Energy Agency reported that the Organization of the Petroleum Exporting Countries (OPEC) had reduced its supply of oil to 30 million b/d in March, the lowest level observed since January 2005.

    In addition, concerns about possible cuts in Africa's supply of oil also increased due to terrorist attacks and oil spills in different countries.

    c. *Inventories of gasoline in the United States*: in a context of constraints in the supply of crude, the proximity of the "driving season" (when demand typically increases in the U.S.) generated concerns regarding the low levels of inventories. Between February 2 and April 27, inventories fell 15 percent during 12 consecutive weeks (from 227 to 193 million barrels).

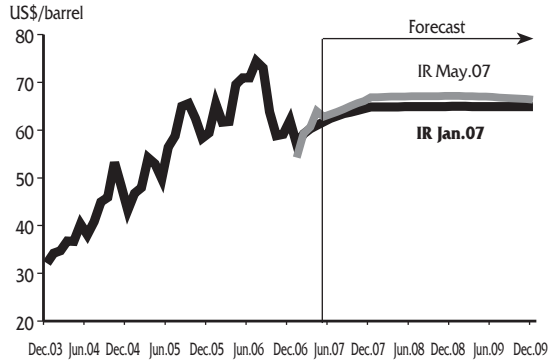
    d. *Increased participation of investors in the energy market*: investors continued to increase their participation in the oil market. The forwards market showed that speculative funds moved from net short positions during the first 6 weeks of 2007 to increasingly net longer positions as of the week ended February 20.

Graph 36
PETROLEUM PRICE AND INVENTORIES IN THE USA



Source: Bloomberg, Department of Energy of USA.

Graph 37
PETROLEUM PRICE: FORECAST



IR: Inflation Report.

55. The outlook on the oil quotation for this year remains unchanged despite the volatility seen over the first four months of 2007. The forecast on the average price of oil for this year was raised to US$ 63 per barrel (US$ 62 per barrel in our previous Report), whereas the average quotation of oil in 2008 would increase to US$ 67 per barrel (US$ 65 per barrel in our previous Report).

    These forecasts are based on the fact that the markets's fundamentals have not changed drastically. The price of oil

is based on the supply deficit expected for the next two years, which makes the price vulnerable to geopolitical risks that would sustain the high prices forecast. Another factor contributing to this would be uncertainty regarding the possible impact of the hurricane season.

Fish meal

56. After posting a 58 percent increase in its 2006 average quotation, the price of fish meal rose from US$ 1,100 per MT in December 2006 to US$ 1,255 per MT in April 2007 (14 percent increase).

This evolution is explained by a lower supply and a higher demand. On the side of supply, Perú -one of the main producers and exporters of fish meal- reduced its production due mainly to the lower availability of fish. Factors affecting demand, on the other hand, include the higher consumption of China (main importer), Japan and Germany.

Price rises in this product should slow down in 2007 to an average of 7 percent in a context in which supply conditions would tend to a gradual normalization. Demand conditions would remain, as in the case of soy flour, which is one of the main substitutes. The prices of fish meal would decrease as of 2008: a drop of 9 percent is estimated in 2008.

Maize

57. Year-to-date, the quotation of maize has fallen 4 percent, from US$ 138 to US$ 133 MT between December 2006 and April 2007.

This evolution is basically explained by the U.S. market (the main producer, consumer and exporter). Favorable prospects for this year's agricultural campaign in the U.S. (2006/07 cycle) have affected the international quotation; however, the price of maize began to increase since May due to the prospects for the rest of the year.

Although the higher demand for ethanol has entailed that a larger area be sown with maize in the United States, the U.S. Department of Agriculture has estimated that the impact of this would only be reflected in the following cycle (2007/08). Thus, in terms of the balance between global supply and demand, this agency estimates that global

production of maize would have increased in 2006/07 due the higher production of Argentina, Brazil, Mexico and China. Moreover, global production should increase significantly in 2007/2008, basically due to a higher output in the U.S., and would be coupled by a strong increase in global demand in order to produce ethanol.

According to the forwards market -which reflect the persistence of demand pressures-, the prices of maize should show an upward trend. Thus, the average quotation of maize is expected to rise by 55 percent this year and by 6 percent next year relative to the average quotation in 2006.

Wheat

58. The average quotation of wheat has remained almost unchanged so far this year after having increased in 2006 (US$ 180 MT in December 2006 and US$ 179 MT in April 2007).

This persistence of high prices is due to the low levels of inventories, associated with a lower output and increased consumption. According to the balance of global supply and demand, global production of wheat in the 2006/07 cycle would have been the lowest production since 1994 (affected by weather conditions). Moreover, production's recovery in the 2007/08 cycle, particularly in Australia, Brazil, India and the United States, would still be below the levels of the 2004/05 cycle.

Furthermore, the higher production in the 2007/08 cycle would be offset by increased global consumption. Incentives provided to ethanol production in the U.S. and the increased use of maize for this production would be generating a wider space for wheat as a source to feed animals. Thus, it is estimated that inventories by the end of the 2007/08 farming campaign would drop to their lowest level (not observed since 1981/82).

According to the market of forwards, the price of wheat should show an upward trend, increasing by 6 percent in 2007 and by 3 percent in 2008.

Soy flour

59. After decreasing by 6 percent in 2006, the average quotation of soy flour has increased 5 percent year to date (from US$ 201 MT in December 2006 to US$ 212 MT in April 2007).

In general, the high increase in the price of maize has boosted a rise in the quotation of other grains, since the larger production of maize in the U.S. has been achieved at the expense of the cultivation of soy bean, the grain used to elaborate soy flour. However, increased production in South America (particularly in Brazil and Argentina) would be influencing a higher output in the 2006/07 cycle. On the other hand, main consumers of this product (China, Latin America, Northern Africa, the Middle East, and South and South East Asia) would continue generating pressures on the prices of soy flour.

Global production of this product would have been consistent with increased demand although inventories would should a slight increase in this cycle (2006/07). A reduction of production is expected for the 2007/08 cycle mainly as a result of lower sown areas in the U.S.

As regards prospects, the price of soy flour should increase by 9 percent in 2007 and by 4 percent in 2008, according to information on the forwards market.

Table 22

BALANCE OF WORLD'S SUPPLY AND DEMAND OF FOODSTUFF
(Millions of MT)

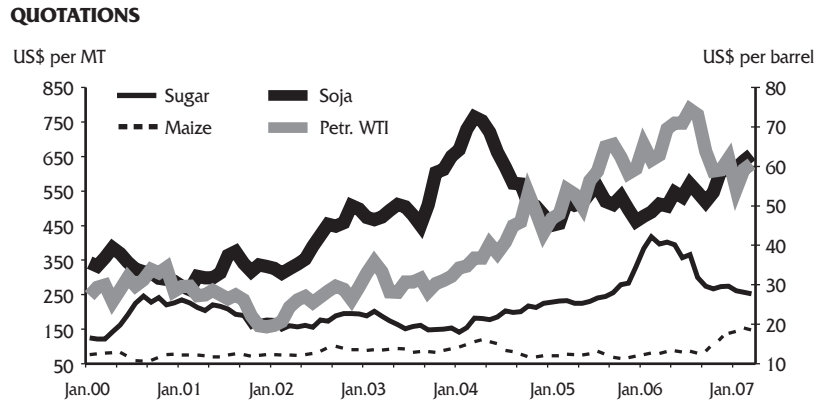
	2004/05	2005/06	2006/07*	2007/08*
MAIZE				
World production	713	696	698	767
Initial inventories	104	131	122	93
Total supply	**894**	**905**	**903**	**942**
World consumption	685	704	727	769
World demand	**763**	**785**	**814**	**853**
Final inventories	**131**	**122**	**93**	**90**
WHEAT				
World production	629	622	594	617
Initial inventories	133	151	149	120
Total supply	**871**	**883**	**850**	**845**
World consumption	610	624	622	624
World demand	**721**	**740**	**730**	**734**
Final inventories	**151**	**149**	**120**	**113**

* Forecast.
Source: Department of Agriculture of USA.

BOX 5

BIOFUELS: RECENT DEVELOPMENTS

The significant increase in the price of oil in recent years and greater concern for environmental issues have gone hand in hand with a renewed and growing interest in the use of biofuels (fuels derived from any renewable biological resource or biomass). This has also led to a significant increase in the price of raw materials used to produce biofuels (mainly maize, sugar and soy bean).



The production of biofuels is concentrated mainly in the United States, Europe, Southeast Asia, China and Brazil. The most common biofuels include maize ethanol (United States) and sugar cane ethanol (Brazil), and soy bean biodiesel (United States) and canola biodiesel (Europe). The global production of ethanol has increased from 4 billion gallons in 1990 to 10 billion gallons in 2006 (up over 250 percent), mainly due to the higher production of the U.S. and Brazil (both of which account for 70 percent of global production). On the other hand, the global production of biodiesel increased from an almost nil production in 1990 to over 1,000 million gallons in 2006, with Europe accounting for 90 percent of this production.

Consumption of biofuels in the United States is expected to increase from 5 to 35 billion gallons between 2007 and 2017, while in the European Union the percentage of energy produced from renewable sources will increase from 2 to 5.75 percent in 2010 and to 20 percent in 2020. Given these different governmental initiatives and as long as the price of petroleum is high, the demand for biofuels will continue to increase. Nevertheless, the net impact of the use of biofuels on energy consumption and agriculture, as well as their impact of food security in poor countries are still controversial issues.

PETROLEUM PRICE FOR BIOFUELS VIABILITY (WITHOUT SUBSIDY)

US$ 110/bb	Ethanol EU
US$ 80/bb	Biodiesel EU
US$ 60/bb	Ethanol USA
US$ 30-35/bb	Ethanol Brazil

Impact on Peru

Peru is a net importer of basic food products. In 2006, 4.4 thousand MT of basic food products were imported (US$ 860 millions). Because of this, a rise in the price of basic food products would have a negative impact on the trade balance and on terms of trade.

The price rise observed in 2006 was significant, particularly in the case of sugar and maize, which increased on average 54 and 23 percent respectively. This implied a negative price effect of US$ 87 million in 2006 (maize accounted for US$ 32 million and sugar for US$ 35 million); in other words, the trade balance was negatively affected by US$ 87 million.

IMPORTS PRICE EFFECT OF THE MAIN FOOD STUFF
(Millions of US$)

	Hipotetical value 1/	Observed value	Price effect 2/
Main food stuff	**793**	**880**	**87**
Wheat	211	224	13
Maize and/or sorghum	140	172	32
Rice	15	14	- 1
Sugar	65	100	35
Soja	295	300	5
Milk	48	46	- 2
Meat	19	24	5

1/ Import volumes in 2006 valued at average price.
2/ Difference between observed valve and hipotetical value.

This 10 percent increase in the price of foodstuffs implied a 0.6 percent reduction in terms of trade. Maize, wheat and soy bean accounted for 50 percent of this impact.

As regards inflation, the important rise observed in the price of grains last year was not completely reflected in inflation due to the substitution of these products by other raw materials and to domestic competition, among other factors. However, should the demand for biodiesel continue to grow, a greater impact could be seen in consumer prices. Thus, an increase of 10 percent is estimated in the international prices of maize, wheat, soy bean, and sugar, which would have a direct impact on inflation of 0.7 percent if this impact is fully reflected in the cost structure of bread, chicken, noodles and sugar.

These estimates do not include the indirect effects on the productive chain associated with the raw materials used for biofuels (livestock, meat, leather, etc.), nor those derived from an increased demand for fertilizers and their impacts on the production costs of other food products (including agroexport products).

IV. Balance of payments

Terms of trade and global growth in 2007 have been revised upwards for 2007 and therefore a higher surplus is expected in the current account of the balance of payments than the one forecast in our previous Inflation Report.

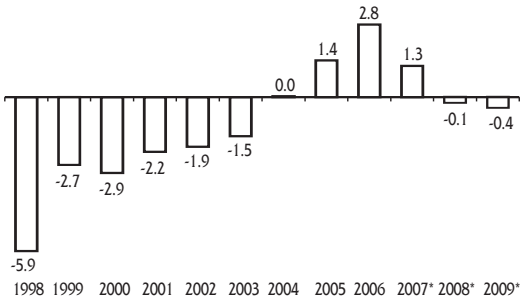
A less favorable international environment than in 2006 and 2007 is expected for 2008 and 2009 due to the gradual reversal of terms of trade in a context where global economic activity would still show signs of strong growth. Therefore, the current account would show a deficit of 0.1 and 0.4 percent of GDP in 2008 and 2009 respectively.

Current account

60. The **first quarter of 2007** showed a current account deficit of 0.3 percent of GDP, as a result of transitory factors affecting the dynamic of production of goods. Exports of goods grew by US$ 1,007 million (22 percent) due to a 20 percent increase in prices and to a 1 percent increase in the volume of exports, while imports of goods -amounting to US$ 4,225 million- increased by US$ 842 million (25 percent). Moreover, increased current transfers (US$ 77 million) were also recorded, as a result of which current transfers amounted to US$ 549 million, of which US$ 470 million were remittances of Peruvian residents abroad (remittances increased by 21 percent relative to those observed in the first quarter of 2006).

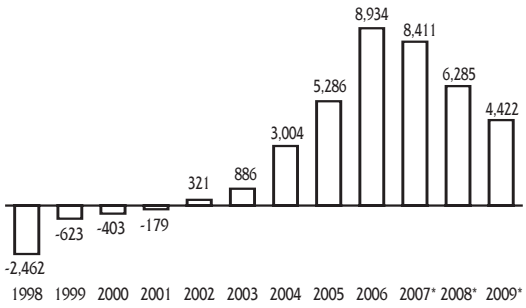
61. A surplus of 1.3 percent of GDP in the current account of the balance of payments is expected for **2007**. This surplus, 0.6 points higher than the one estimated in our Inflation Report of January, is explained by better forecasts regarding terms of trade and global growth. Therefore, a surplus of US$ 8.4 billion is expected in the trade balance, a result higher than the one forecast in our January Inflation Report (US$ 7.3 billion).

Graph 38
CURRENT ACCOUNT
(Percentage of GDP)



* Forecast.

Graph 39
TRADE BALANCE
(Millions of US$)



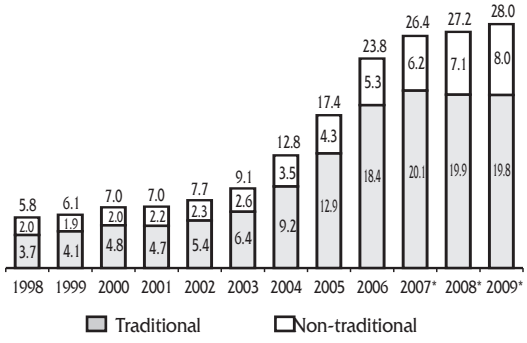
* Forecast.

The result in the trade balance would be lower than in 2006 (US$ 8.9 billion) in a context of a lower pace of growth in the volume of traditional exports, mainly mining and fishing exports, while imports should maintain an evolution in line with the growth of the economy.

62. A less favorable international environment and a fall in terms of trade are expected for **2008 and 2009**. Thus, a current account deficit equivalent to 0.1 and 0.4 percent of GDP respectively would be expected, while the trade balance is expected to be positive by US$ 6.3 and US$ 4.4 billion in these years.

Exports

Graph 40
GOODS EXPORTS
(Billions of US$)



Note: Total exports include other exports.
* Forecast.

63. In the **first quarter of 2007** exports grew 22 percent, continuing with the trend seen in the previous quarters. By countries of destination, exports to the U.S. showed similar levels than in the same period in 2006, while exports to the rest of the world grew 30 percent, particularly in the case of exports to Colombia (33 percent), Venezuela (47 percent), Spain (29 percent), Chile (24 percent) and Ecuador (26 percent).

Traditional exports in this quarter amounted to US$ 4,267 million, up 23 percent (US$ 786 million) relative to the same period in 2006. The average price of traditional exports increased 25 percent, while the volumes shipped dropped 2 percent, a result explained by lower shipments of gold (16 percent), fish meal (18 percent), molybdenum (42 percent) and tin (34 percent).

On the other hand, non-traditional exports amounted to US$ 1,346 million, up US$ 227 million (20 percent) relative to the same period last year, a result explained both by the prices (12 percent) and the volume of non-traditional exports (8 percent).

Exports in **2007** should amount to US$ 26.4 billion, posting a growth rate of 11 percent -a rate 7 percentage points higher than the once forecast in our previous Report. This upward revision is based on the data observed in the first quarter -which were higher than forecast- and on higher prices expected for metals throughout this year. By components, traditional exports should grow at a faster pace than expected (10 percent instead of the 1 percent

indicated in our previous Report), while non-traditional exports should grow 17 percent, in line with previous forecasts. This increase in traditional exports would be associated with the onset of operations at several mining projects, such as primary sulfides at Cerro Verde (copper) and Cerro Lindo (zinc).

The 11 percent increase in exports forecast for 2007 may be broken down into a 5 percent increase in terms of volume and a 6 percent percent increase in the prices of goods.

Exports would grow 3 percent points in **2008 and 2009** respectively as a result of higher sales of non-traditional products (15 and 13 percent in 2008 and 2009 respectively), particularly textiles and agricultural products, while exports of traditional products would drop 1 percent each year in this period due to the lower prices of exports of metals.

It is worth pointing out that between **2007 and 2009** the production of copper would increase at an average rate of 12 percent, while the production of gold would drop in 2007 to recover thereafter and grow at rates of around 4 percent in 2008 and 2009.

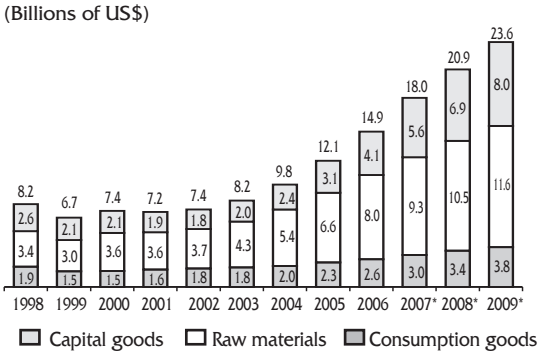
Table 23

TRADE BALANCE
(Millions of US$)

	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
EXPORTS	**4,640**	**23,800**	**5,647**	**24,771**	**26,435**	**25,481**	**27,231**	**27,994**
Of which:								
Traditional products	3,481	18,374	4,267	18,497	20,121	18,216	19,949	19,782
Non-traditional products	1,120	5,271	1,346	6,101	6,153	7,078	7,100	8,016
IMPORTS	**3,383**	**14,866**	**4,225**	**17,507**	**18,024**	**20,026**	**20,946**	**23,572**
Of which:								
Consumption goods	564	2,611	684	2,926	3,009	3,405	3,448	3,811
Raw materials	1,839	7,987	2,217	8,945	9,291	9,936	10,526	11,617
Capital goods	936	4,145	1,306	5,479	5,631	6,520	6,875	8,044
TRADE BALANCE	**1,257**	**8,934**	**1,421**	**7,264**	**8,411**	**5,456**	**6,285**	**4,422**
Note: % change								
Exports	23.8	37.0	21.7	4.3	11.1	2.9	3.0	2.8
Imports	27.2	23.0	24.9	17.5	21.2	14.4	16.2	12.5

IR: Inflation Report.
* Forecast.

Graph 41
GOODS IMPORTS
(Billions of US$)



Note: Total imports include other imports.
* Forecast.

Imports

64. Imports in the f**irst quarter of 2007** grew 25 percent relative to the same period last year, in a context in which the dynamic performance of private investment and economic activity boosted a 34 percent increase in imports of inputs for industry and a 40 percent increase in imports of capital goods.

By economic sectors, increases in imports of capital goods for manufacturing (48 percent), of machinery for the construction sector (54 percent) and for the transport sector (14 percent) were noteworthy. It is also worth pointing out the higher purchases of IT equipment, which increased 40 percent relative to the first quarter of 2006.

Table 24

CAPITAL GOODS IMPORTS FOR INDUSTRY BY ECONOMIC SECTORS
(Millions of US$)

	I Quarter		
	2006	2007	% change
Agriculture	7	12	58.6
Fishing	1	3	368.3
Mining and fuel	179	179	0.3
Manufacturing	65	90	39.1
- Textil machineries	4	5	28.9
Construction	14	22	54.4
Electricity, gas and water	12	13	8.2
Transports	182	276	51.5
Telecomunications	109	189	73.4
Commerce and services	159	254	59.6
- IT equipment	48	71	50.0
- Other machineries and equipment	21	41	94.2
- Medical and surgery instruments	8	11	44.7
- Office equipment	3	5	41.7
- Financial services	34	64	87.9
- Others	45	62	36.0
Sub Total	**729**	**1,039**	**42.6**
Construction materials and others	208	268	29.0
Total	**936**	**1,306**	**39.5**

In **2007** imports of goods should amount to US$ 18,0 billion -a sum in line with the dynamism exhibited by economic activity and involving purchases of raw materials and capital goods. Thus, capital goods and raw materials for industry would account for the main increases observed in imports (36 percent and 27 percent respectively).

Furthermore, imports are expected to grow by 16 percent in **2008** and by 13 percent in **2009**, based on higher purchases of capital goods and raw materials for industrial purposes. These forecasts include the imports associated with the onset of the pre-operational stage of mining projects such as Cerro Corona, Toromocho, Minas Conga and Río Blanco.

Table 25

BALANCE OF PAYMENTS
(Millions of US$)

	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
I. Current account balance	**-219**	**2,589**	**-83**	**752**	**1,352**	**-617**	**-86**	**-490**
As percenage of GDP	*-1.1*	*2.8*	*-0.3*	*0.7*	*1.3*	*-0.6*	*-0.1*	*-0.4*
1. Trade balance	1,257	8,934	1,421	7,264	8,411	5,456	6,285	4,422
a. Exports	4,640	23,800	5,647	24,771	26,435	25,481	27,231	27,994
b. Imports	-3,383	-14,866	-4,225	- 17,507	-18,024	-20,026	-20,946	-23,572
2. Services	-221	-949	-266	-1,248	-1,220	-1,400	-1,419	-1,462
3. Investment income	-1,726	-7,581	-1,787	-7,628	-8,441	-7,320	-7,863	-6,656
4. Current transfers	472	2,185	549	2,364	2,602	2,648	2,911	3,205
II. FINANCIAL ACCOUNT	**595**	**589**	**1,235**	**1,048**	**3,648**	**1,117**	**1,086**	**1,490**
III. NIRs FLOWS	**375**	**3,178**	**1,152**	**1,800**	**5,000**	**500**	**1,000**	**1,000**
Memo:								
International reserves balance (Millions of US$)	14,472	17,275	18,427	19,075	22,275	19,575	23,275	24,275
NIR/Short-term external liabilities	3.1	3.7	3.6	3.3	4.3	3.6	4.8	4.7
NIR/Total liquidity (%)	58%	72%	74%	73%	78%	68%	73%	69%
NIR/GDP (%)	18%	19%	19%	19%	21%	18%	21%	20%

IR: Inflation Report.
* Forecast.

65. In 2007 the **financial account** of the private sector should record a positive flow of US$ 3.9 billion, explained by a flow of Direct Foreign Investment (DFI) amounting to US$ 3.8 billion, and should post similar levels in the next two years, fueled by favorable expectations on the evolution of economic activity. This higher investment flow would be geared not only towards the mining and fuel sector -which should develop various important projects in the following years-, but also towards sectors such as the telecommunications sector, where investments are expected to be around US$ 1.5 billion in the forthcoming years. Moreover, investments are also forecast in the electricity sector, in road infrastructure, in agro industry and in petrochemicals, among other sectors.

The balance of the first quarter also shows a higher preference of institutional investors for maintaining a lower percentage of their portfolios in financial assets abroad.

V. Public finance

A surplus of 4.8 percent of GDP was achieved in the first quarter of 2007 as a result of high prices for exports of minerals, the dynamism of economic activity and the lower pace of public spending.

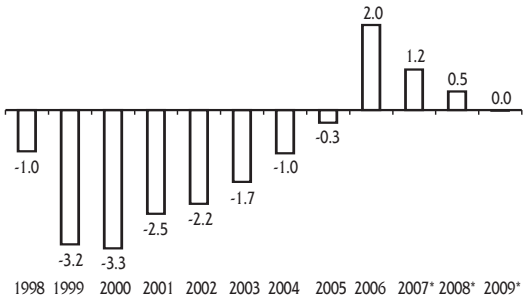
The forecast on the public sector's economic result for 2007 has been revised upwards to a surplus of 1.2 percent (in contrast with the nil result forecast in our previous Inflation Report). As long as terms of trade continue to be above their trend level, this fiscal position scenario would imply an additional boost on domestic demand in a context of an expansionary economic cycle, although the forecast on the magnitude of this boost has been adjusted downwards in terms of our previous Report forecast.

A surplus of 0.5 percent is forecast for 2008 and a nil economic result is forecast for 2009. These results would be associated with a less favorable international environment, with terms of trade gradually decreasing and with domestic demand showing a more moderate pace of growth in the following years.

Economic result

66. During the **first quarter of 2007**, the economic result posted by the Non-Financial Public Sector was a surplus equivalent to 4.8 percent of GDP, a level higher than the one achieved in the first quarter of 2006 (3.9 percent of GDP). This surplus in the first quarter is broken down into a 2.9 percent surplus in the case of central government operations (versus 3.1 percent of GDP in the first quarter of 2006) and a 1.8 percent surplus in the case of operations of the rest of the general government (versus 0.6 percent of GDP in the first quarter of 2006), while state enterprises showed a nil result.

Graph 42
OVERALL BALANCE OF THE NON FINANCIAL PUBLIC SECTOR
(Percentage of GDP)



* Forecast.

67. The forecast on the economic result for **2007** has been revised upwards from a nil result to a surplus of 1.2 percent of GDP. This adjustment is based mainly on improved terms of trade, a higher growth of domestic demand, increased imports in this year and transfers of remaining business profits to regional governments. Considering the execution of fiscal accounts, the forecast on the growth of public investment for this year has been revised downwards from 35 to 29 percent in real terms.

Moreover, the forecasts for **2008** and **2009** have been improved from 0.0 and -0.5 percent of GDP, as stated in our January Report, to 0.5 and 0.0 percent of GDP, given the better forecasts on economic activity for these years and the evolution of terms of trade.

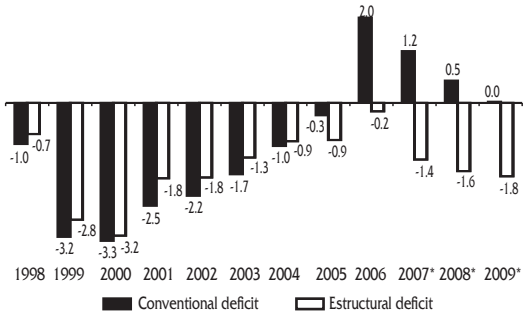
Table 26

NON-FINANCIAL PUBLIC SECTOR
(Millions of Nuevos Soles)

	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May. 07	IR May.07
1. General government current revenue	**13,997**	**60,056**	**15,348**	**61,963**	**65,949**	**63,990**	**69,536**	**72,889**
(% of GDP)	*20.5*	*19.6*	*20.2*	*19.2*	*19.9*	*18.8*	*19.9*	*19.6*
Real percentage change	*23.3*	*23.1*	*9.2*	*2.7*	*8.5*	*1.3*	*3.5*	*2.8*
2. General government non-finantial expenditure	**9,867**	**49,318**	**10,221**	**55,701**	**56,103**	**59,258**	**62,213**	**67,261**
(% of GDP)	*14.4*	*16.1*	*13.5*	*17.3*	*17.0*	*17.4*	*17.8*	*18.1*
Real percentage change	*8.4*	*8.7*	*3.2*	*12.1*	*12.4*	*4.4*	*8.8*	*6.0*
Of which:								
a. Current	8,719	40,833	9,123	43,491	45,239	46,758	48,323	51,213
(% of GDP)	*12.7*	*13.4*	*12.0*	*13.5*	*13.7*	*13.7*	*13.8*	*13.8*
Real percentage change	*7.7*	*7.3*	*4.2*	*5.8*	*9.5*	*5.5*	*4.8*	*4.0*
b. Capital	1,101	7,880	1,050	10,709	10,346	11,843	13,388	15,510
(% of GDP)	*1.6*	*2.6*	*1.4*	*3.3*	*3.1*	*3.5*	*3.8*	*4.2*
Real percentage change	*14.0*	*14.2*	*-5.1*	*34.6*	*29.7*	*8.5*	*27.0*	*13.6*
3. Others	**322**	**1,219**	**131**	**163**	**420**	**36**	**457**	**456**
(% of GDP)	*0.5*	*0.4*	*0.2*	*0.1*	*0.1*	*0.0*	*0.1*	*0.1*
4. Primary balance (1-2+3)	**4,451**	**11,956**	**5,258**	**6,425**	**10,265**	**4,769**	**7,781**	**6,083**
(% of GDP)	*6.5*	*3.9*	*6.9*	*2.0*	*3.1*	*1.4*	*2.2*	*1.6*
5. Interests	**1,757**	**5,693**	**1,621**	**6,304**	**6,158**	**6,430**	**6,063**	**6,066**
(% of GDP)	*2.6*	*1.9*	*2.1*	*2.0*	*1.9*	*1.9*	*1.7*	*1.6*
6. Overall balance	**2,694**	**6,263**	**3,637**	**121**	**4,107**	**-1,662**	**1,718**	**16**
(% of GDP)	*3.9*	*2.0*	*4.8*	*0.0*	*1.2*	*-0.5*	*0.5*	*0.0*
Central government current revenue	17.7	17.2	17.3	16.7	17.4	16.2	17.3	16.9
Central government non-finantial expenditure	12.5	14.1	12.5	14.9	15.3	14.9	15.6	15.6

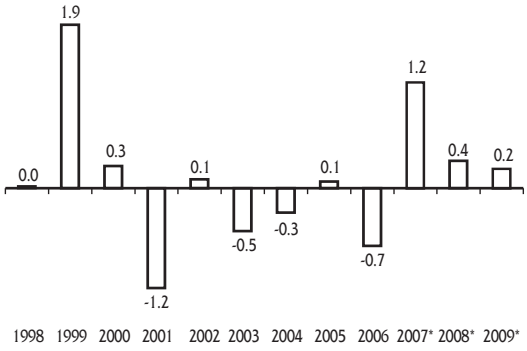
* Forecast.

Graph 43
CONVENTIONAL AND STRUCTURAL DEFICIT OF THE NFPS
(Percentage of GDP)



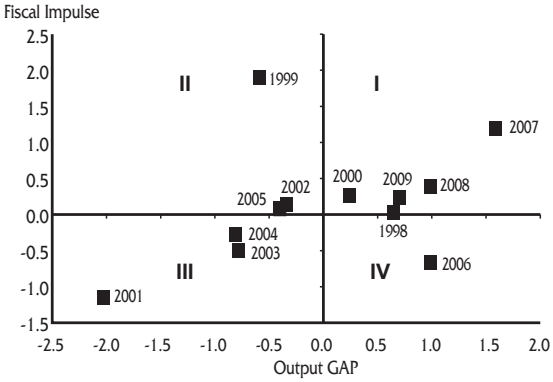
* Forecast.

Graph 44
FISCAL IMPULSE
(Percentage of GDP)

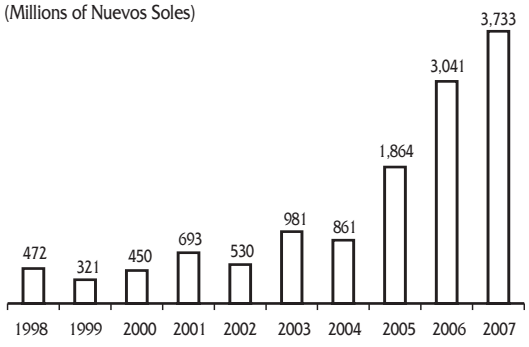


* Forecast.

Graph 45
FISCAL IMPULSE AND OUTPUT GAP



Graph 46
INCOME TAX REGULARIZATION[1/]
(Millions of Nuevos Soles)



1/ Stands for the regularization of the previous year.

A nil result is forecast for the Non-Financial Public Sector for **2009**, which would represent a lower result in terms of the previous year. This result would be associated with lower terms of trade, with a moderate change in domestic demand, and with a reduction in the rates of ITF -from 0.07 percent to 0.06 percent- and the Temporary Tax on Net Assets (ITAN) -from 0.5 percent to 0.4 percent.

Structural economic result

68. The structural economic result isolates the effect of the economic cycle on the revenues of the general government as well as the impact of higher prices of minerals and hydrocarbons on fiscal accounts. This indicator points to a growing deficit in the 2007-2009 period, thus indicating an expansionary fiscal position. Therefore, the fiscal impulse -indicator measuring the expansionary or contractionary fiscal policy stance and defined as the change in the primary structural result (difference between the structural result and expenditure on account of interests)- would indicate that the fiscal policy would boost domestic demand in 2007-2009.

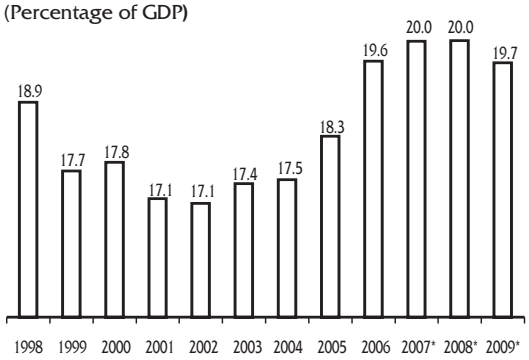
The four-quadrant figure shows the relationship between fiscal impulse and the output gap and allows the analysis of the connection between the fiscal policy and the economic cycle in said years. Quadrants I and III show a positive relationship, which means that the fiscal policy in those years was procyclical. On the other hand, quadrants II and IV show a negative relationship, in other words, that the fiscal policy was countercyclical in those years. Considering the positive relationship between fiscal impulse and the output gap forecast for the 2007-2009 period, the fiscal policy would show a procyclical stance.

69. Given that increased fiscal revenues respond significantly to cyclical factors associated with the behavior of economic activity, it is essential to maintain a prudential fiscal policy that will allow that most of the fiscal resources of a transitory nature be saved. This saving could be channeled to accumulating resources in the Fiscal Stabilization Fund or to operations aimed at reducing the public debt.

Evolution of fiscal revenues

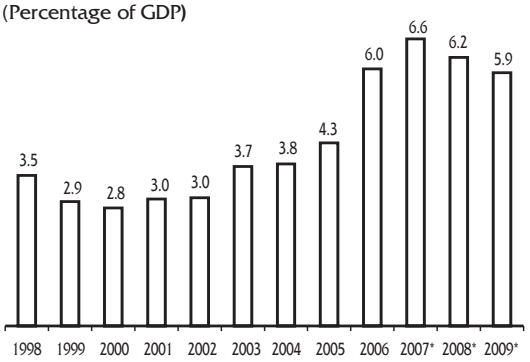
70. In the **first quarter of 2007**, the general revenues of the general government amounted to 20.2 percent of GDP, thus showing an increase of 9.2 percent in real terms based on

Graph 47
GENERAL GOVERNMENT CURRENT ACCOUNT
(Percentage of GDP)



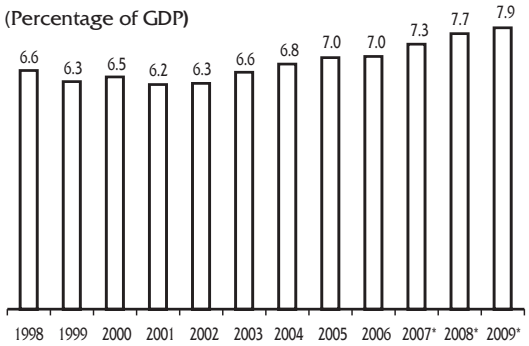
* Forecast.

Graph 48
INCOME TAX
(Percentage of GDP)



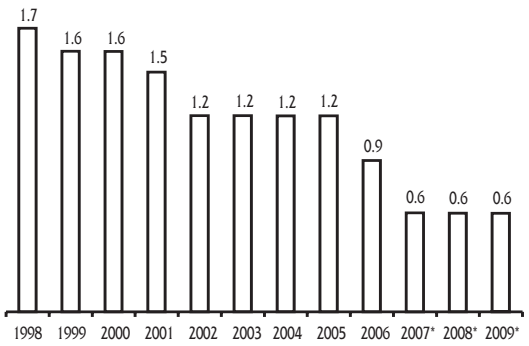
* Forecast.

Graph 49
VALUE ADDED TAX
(Percentage of GDP)



* Forecast.

Graph 50
IMPORT TAX REVENUE
(Percentage of GDP)



* Forecast.

the performance of the income tax and the value-added tax. These higher revenues on account of the income tax (29 percent in real terms) was associated with higher ratios of advanced payments, in force since April 2006, as a result of improved economic activity and the profits generated by mining.

As a result of the 2006 income tax regularization campaign, that is, the total revenues collected through the regularization of income tax payment between January and April 2007, revenues grew 23 percent in real terms relative to last year' campaign. The amount collected (S/. 3,733 million) was the highest recorded in terms of regularization of income tax payment in the past 10 years.

71. Revenues from the Value-Added Tax (VAT) grew 14 percent as a result of the dynamism of economic activity and of control mechanisms (tax withholding, detraction, etc) introduced by the Peruvian tax agency, which have positively contributed to the growth of revenues collected from domestic VAT.

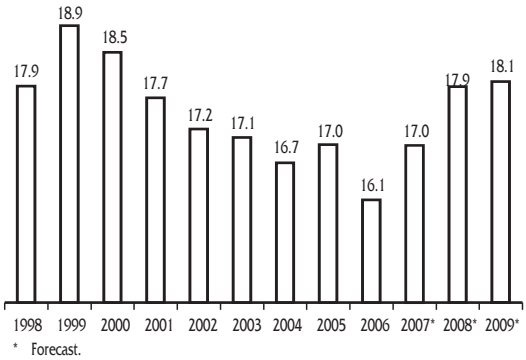
72. The current revenues of the General Government for **2007** have been revised upwards by 0.7 additional percentage points to 19.9 percent of GDP. The VAT has also been revised upwards given the greater dynamism of domestic demand that is expected. As regards the income tax, the upward revision was based on the fact that the prices of commodities have been higher than expected this year and that the ratios of advanced payments of income tax have also been higher.

In 2008-2009, fiscal revenues should parallel the evolution of terms of trade in a scenario showing a gradual reduction in the prices of raw materials and a lower global economic activity. The forecast scenario also considers a gradual reduction of the rate of the Tax on Financial Transaction (ITF) and the Temporary Tax on Net Assets (ITAN) according to a schedule announced by the government.

Evolution of fiscal expenditure

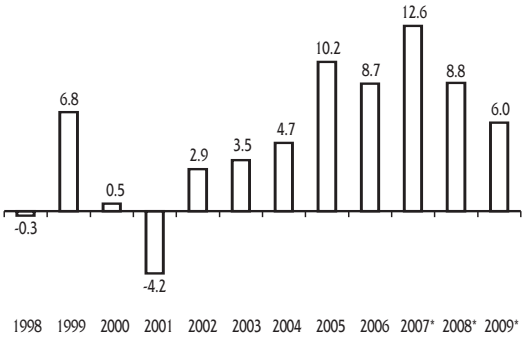
73. During the **first quarter of 2007**, the general government's non-financial expenditure reflected a lower spending by sub-national governments, which led to a 5 percent reduction in gross capital formation. Thus, the non-financial expenditure of the general government was 13.5 percent of GDP, 0.9 percentage points of GDP lower than in the first quarter of 2006.

Graph 51
GENERAL GOVERNMENT NON-FINANTIAL EXPENDITUR
(Percentage of GDP)



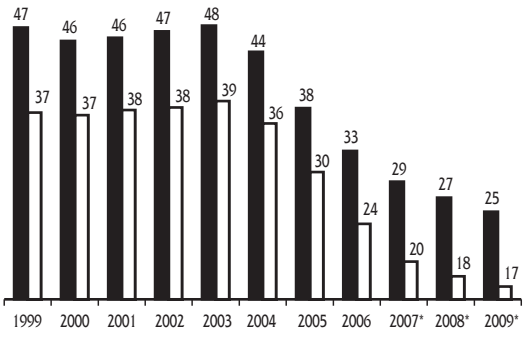
* Forecast.

Graph 52
GENERAL GOVERNMENT NON-FINANCIAL EXPENDITURE
(Real percentage change)



* Forecast.

Graph 53
PUBLIC DEBT
(Percentage of GDP)



* Forecast.

74. The forecast for the 2007-2009 period considers the changes introduced in the Multiannual Macroeconomic Framework regarding Fiscal Accountability and Transparency (Ley de Responsabilidad y Transparencia Fiscal - LRTF) for the central government's spending. Given the evolution observed in the first quarter of 2007, the general government's non-financial expenditure is expected to be 0.3 percent of GDP lower than forecast in our January Report, and would include 30 percent of capital spending this year.

In 2008 and 2009, non-financial expenditure by the general government should grow 9 and 6 percent in real terms respectively, with public investment accounting for the main impulse to public spending. The general government's investment is expected to increase by 27 and 14 percent in real terms in these years.

Financial requirements

75. Given that the public sector has both assets and liabilities, public finance may be analyzed from a global perspective using the concept of **net public debt**. If assets grow at a faster pace than the public debt, the public treasury's financial situation will improve in terms of solvency. In the first quarter of 2007, the balance of the net public debt decreased from 28 percent of GDP in the first quarter of 2006 to 22 percent.

In terms of external financing, the **first quarter of 2007** saw the approval of managing public debt operations by exchanging and/or totally or partially repurchasing Global Bonds 2012 and Brady Bonds through bonds maturing in 2016, 2033 and 2037 in order to smoothen the profile of amortizations in the following years. This is the second time that Peru carries out an exchange operation of this kind (the first took place in February 2002). Because of its magnitude, this operation could be considered the most important one carried out so far as it reduces the weight of Brady bonds in terms of the total debt.

Together with the dynamism of economic activity and the positive terms of trade, the fiscal scenario described above would allow reducing public debt as a percentage of GDP from 33 percent in 2006 to 25 percent by 2009, and reducing net public debt from 24 percent in 2006 to 17 percent in 2009.

In line with its borrowing policy, the government decided to continue implementing its strategy for the restructuring

of the debt service and in May negotiated with the Paris Club a repurchase of the debt for the 2007-2015 period that included all the categories considered in the repurchase operation carried out in July 2005. This transaction will allow restructuring the public debt portfolio into a domestic currency-denominated debt, thereby reducing exchange risks. In addition, this will allow an extension in the debt's maturity that will contribute to reduce the level of country risk.

Table 27

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

	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
I. Uses	**-462**	**-234**	**143**	**1,493**	**1,086**	**2,728**	**1,525**	**1,358**
1. Amortization	345	1,649	1,283	1,531	2,339	2,197	2,082	1,363
a. External	281	1,193	355	1,174	1,179	1,673	1,594	1,110
b. Internal	64	456	928	357	1,160	523	488	252
Of which:								
Pension Bonds	30	148	32	81	155	94	170	183
2. Overall balance (negative sign indicate surplus)	-807	-1,883	-1,140	-38	-1,253	531	-557	-5
II. Sources	**-462**	**-234**	**143**	**1,493**	**1,086**	**2,728**	**1,525**	**1,358**
1. External	10	534	2,400	1,034	3,264	1,046	1,042	611
2. Internal 1/	-575	-1,620	-3,307	-240	-3,815	782	-623	-177
3. Bonds 2/	103	852	1,050	700	1,637	900	1,106	923
Memo:								
Gross debt balance								
In millions of US$	29,482	30,484	29,819	30,294	30,484	29,940	30,716	30,995
In percentage of GDP	36.1	32.6	30.8	29.7	29.1	27.5	27.2	25.4
Net debt balance 3/								
In millions of US$	23,086	22,396	21,146	21,887	20,553	22,220	20,064	20,109
In percentage of GDP	28.3	24.0	21.8	21.4	19.6	20.4	17.7	16.5

IR: Inflation Report.
* Forecast.
1/ Positive sign indicates overdraft and negative sign indicates greater deposits.
2/ Includes internal and external bonds. The effect of change of public treasury debt for longer maturities, in the second quarter 2006 and first quarter 2007, has been isolated.
3/ Define as the difference between public debt and NFPS deposits.
Source: BCRP and MEF.

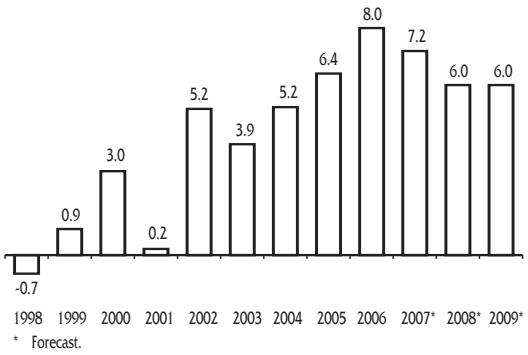
VI. Economic activity

Economic activity in the first quarter of 2007 grew 7.5 percent, boosted by domestic demand, particularly by private investment and private consumption. During this quarter, the indicators on consumer and business confidence and the sustained growth of employment in the main cities of the country continued to show a regular pace of expansion of economic activity.

Given this increased economic dynamism and the levels of investment foreseen, the forecast on the growth of the economy for this year has been revised upwards from 6.8 to 7.2 percent. This dynamic performance of economic activity would continue to be supported by a favorable international environment, with higher terms of trade and higher global growth in 200. Moreover, this dynamism would also continue to be consistent with inflation rates in line with the inflation target as productivity is expected to continue improving in diverse sectors.

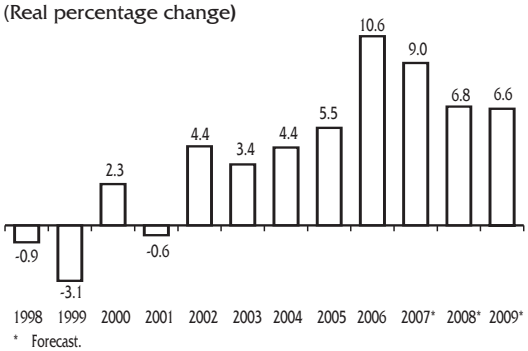
The economy should grow at around 6.0 percent in 2008 and 2009, thus reaching a growth rate that is closer to the increase forecast for potential GDP in this period.

Graph 54
GDP GROWTH RATE
(Real percentage change)



* Forecast.

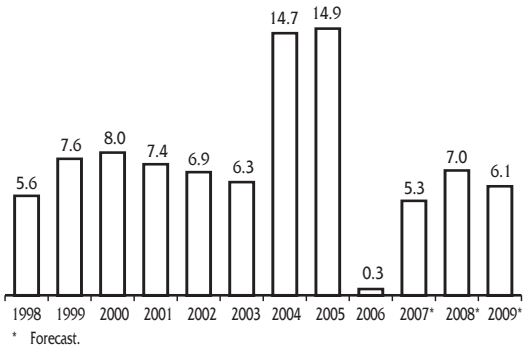
Graph 55
DOMESTIC DEMAND GROWTH RATE
(Real percentage change)



* Forecast.

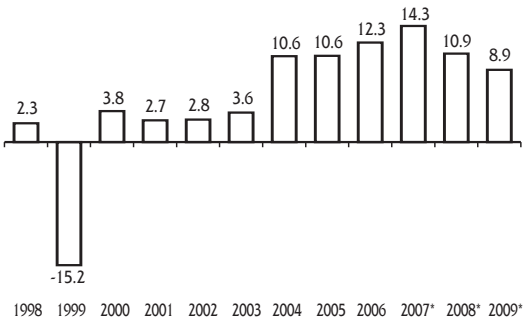
76. Growth rates in 2006 and in the first quarter of 2007 were associated with a significant expansion of domestic spending. The high rates of growth of private consumption and private investment indicate an expansionary stage in the economy, with growth rates that are above the growth trend. The upward revision of the forecast on GDP growth in 2007 (from 6.8 to 7.2 percent) responds to a higher growth of domestic demand (9.0 percent instead of 8.1 percent), consistent with higher rates of expansion of private spending.

Graph 56
GOODS AND SERVICES EXPORTS GROWTH RATE
(Real percentage change)



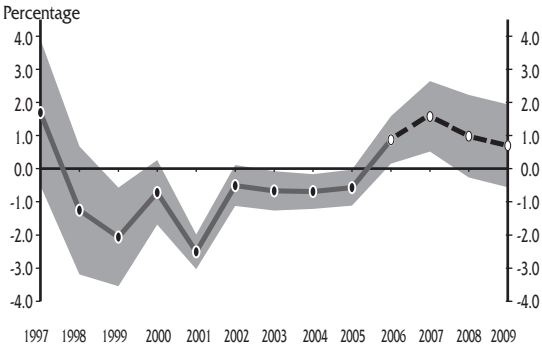
* Forecast.

Graph 57
GOODS AND SERVICES IMPORTS GROWTH RATE
(Real percentage change)



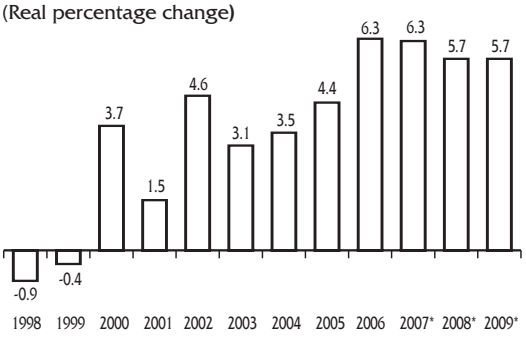
* Forecast.

Graph 58
OUTPUT GAP



Note: The shaded area indicates the uncertainty in the calculation and forecast of the output gap.

Graph 59
PRIVATE CONSUMPTION GROWTH RATE
(Real percentage change)



* Forecast.

The growth forecast for 2008 has been revised upwards from 5.8 to 6.0 percent because a more favorable international environment is expected. In 2009, the economy should grow 6.0 percent, in line with the trend observed in terms of the potential output.

Table 28

GLOBAL DEMAND AND SUPPLY
(Real percentage change)

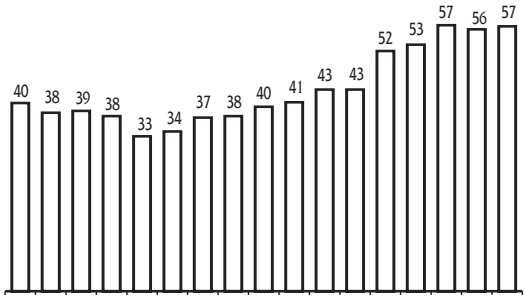
	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
1. Domestic demand	**11.3**	**10.6**	**10.2**	**8.1**	**9.0**	**6.4**	**6.6**	**6.6**
a. Private consumption	5.6	6.5	7.4	5.7	6.3	5.4	5.3	5.3
b. Public consumption	8.6	8.7	2.5	8.8	5.4	4.9	4.1	3.8
c. Private investment	24.3	20.2	19.5	16.3	19.7	12.2	14.1	12.1
d. Public investment	8.4	12.7	-4.3	34.7	29.1	8.6	25.3	13.0
2. Exports	0.6	0.3	1.0	6.8	5.3	7.2	8.2	6.1
3. GDP	**8.0**	**8.0**	**7.5**	**6.8**	**7.2**	**5.8**	**6.0**	**6.0**
4. Imports	16.4	12.3	14.9	13.3	14.3	9.9	10.9	8.7

IR: Inflation Report.
* Forecast.

77. The dynamism of economic activity would be one of the main factors driving inflation back towards the target range. The output gap shows positive but decreasing levels throughout the forecast horizon, so the demand impulse should narrow down along the forecast horizon. Thus, GDP growth should gradually converge to the growth of potential GDP.

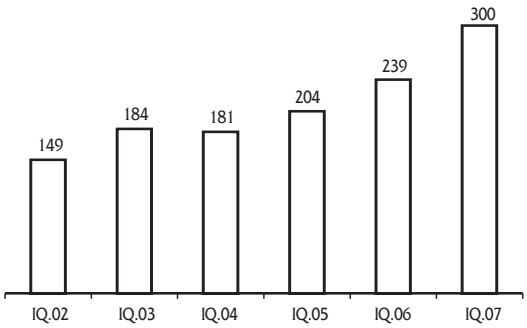
78. **Private consumption** grew 7.4 percent in the first quarter of 2007, boosted by a higher disposable national income (in a context of better terms of trade), the growth of employment, increased consumer loans and higher consumer confidence. Based on these results, and particularly on the increase expected in disposable national income, private consumption should grow by 6.3 percent in 2007, at a higher rate than forecast in our previous Report (5.7 percent).

Graph 60
CONSUMER CONFIDENCE INDEX: INDICCA

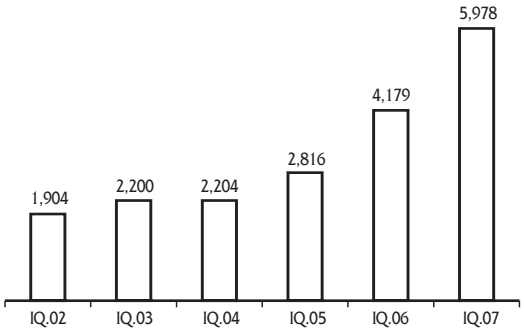


Source: Apoyo.

Graph 61
DURABLE GOODS IMPORTS IN THE FIRST QUARTER
(Millions of US$)

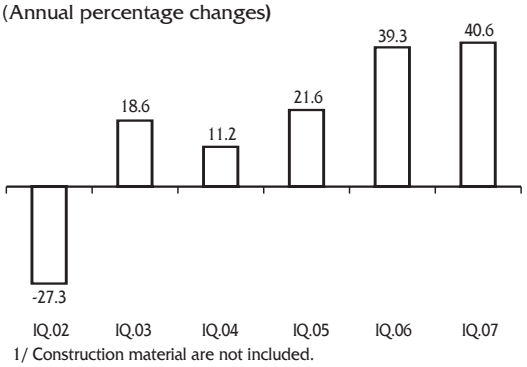


Graph 62
FAMILY VEHICULES SALES IN THE FIRST QUARTER
(Units)



Source: Araper.

Graph 63
CAPITAL GOODS IMPORTS IN THE FIRST QUARTER[1/]
(Annual percentage changes)



1/ Construction material are not included.

79. Disposable national income, which grew 11.3 percent in the first quarter of 2007 due to improved terms of trade, should show a more moderate pace of growth in the following years. Considering this slowdown and a reversal in the trend of terms of trade, private consumption should increase 5.3 percent in 2008 and in 2009.

Table 29

NATIONAL DISPOSABLE INCOME
(Real percentage change)

	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May.07	IR May.07
Gross domestic product	8.0	8.0	7.5	6.8	7.2	5.8	6.0	6.0
Gross national product	5.1	5.5	8.4	8.3	7.4	6.9	7.6	7.9
Gross national income	8.9	11.7	11.3	6.3	7.5	5.4	5.7	6.7
National disposable income[1/]	9.1	11.9	11.3	6.9	7.6	5.5	5.7	6.7

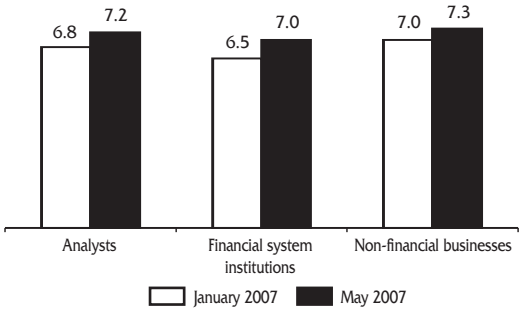
IR: Inflation Report.

80. **Private investment** grew 19.5 percent during the first quarter, as reflected in a 40.6 percent increase in imports of capital goods, particularly equipment for industry.

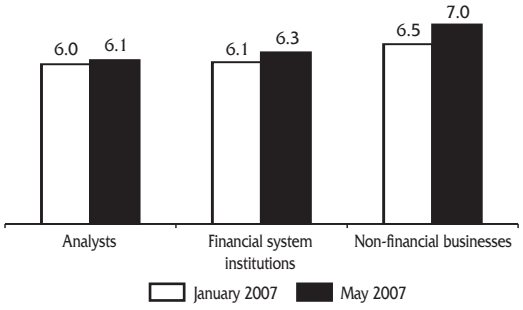
Taking into account both the dynamism observed in the economy and the improvement of terms of trade relative to the forecasts made in our previous report, private investment should increase by 19.7 percent in 2007 (instead of 16.3 percent).

Investments in the private sector would be associated with higher levels of demand resulting from increased sales and profits due to the dynamic performance of economic activity and to the improvement of business expectations. Main investments would include the enhancement of operational capacity in manufacturing firms and projects developed in the sectors of infrastructure, energy and telecommunications. Moreover, investment would also include mining projects, such as Yanacocha (where a sulfide treatment plant is being built), Southern Copper Corporation (Ilo smelter), and the second stage of Camisea (export of natural gas). The latter

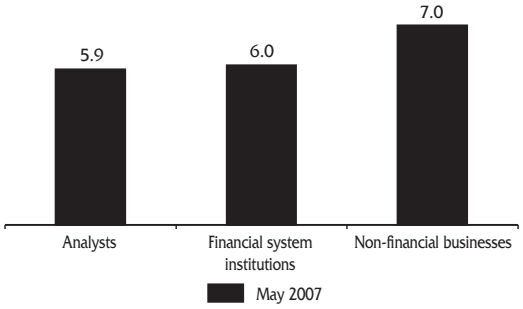
Graph 64
GDP GROWTH EXPECTATIONS 2007



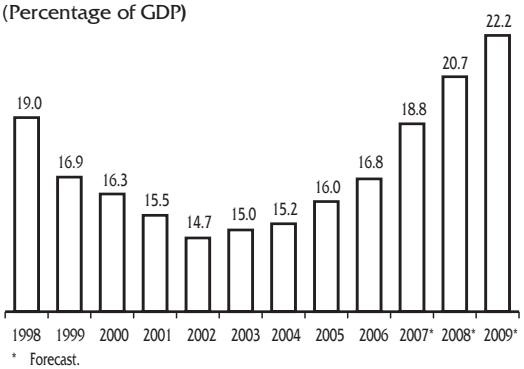
GDP GROWTH EXPECTATIONS 2008



GDP GROWTH EXPECTATIONS 2009



Graph 65
PRIVATE FIXED INVESTMENT
(Percentage of GDP)



* Forecast.

project, which involves investments for over US$ 2,500 million in the next years, should initiate export operations in 2010.

Private investment should maintain a high dynamism in 2008 and 2009 and grow at rates of 14.1 and 12.1 percent respectively. Investments are expected in all the economic sectors and include the implementation of the second stage of Camisea and the construction of installations for the extraction of crude in Lot 67.

81. According to the Monthly Survey on Macroeconomic Expectations conducted by the Central Bank, 45 percent of non-financial entities forecast a better economic situation in the country, while no firms anticipated that the economic situation would worsen.

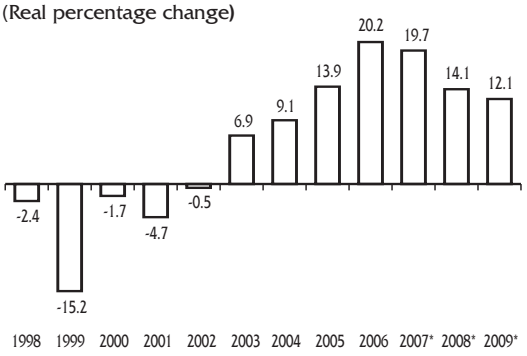
82. Like capital, which has been showing a positive evolution, **labor** continued with the growing trend initiated in 2002. Thus, in March 2007, employment in firms with 10 or more workers in urban areas increased 9.2 percent relative to the same month last year. Employment in Metropolitan Lima grew at a higher rate (9.4 percent) than employment in the rest of urban areas (7.9 percent). This result was associated with the dynamism observed in the sectors of manufacturing, services and commerce.

In terms of the 21 largest cities in the country, Trujillo posted the highest rate of growth of employment due to increased activity in the branches of processing and packing of artichoke, asparagus and red pepper. Talara ranked second, as a result of petroleum extraction-related activities.

83. Based on the execution of public spending in the first quarter, the forecast on public spending considers a surplus of 1.2 percent in 2007, a surplus of 0.5 percent in 2008, and a nil result in 2009. However, public spending would show greater dynamism along the rest of the year due to non-performed expenditure in 2006, which would increase spending by 29.1 percent. Public investment would grow 25.3 percent in 2008 and 13.0 percent in 2009, in line with a rate of GDP growth of around 4.4 percent.

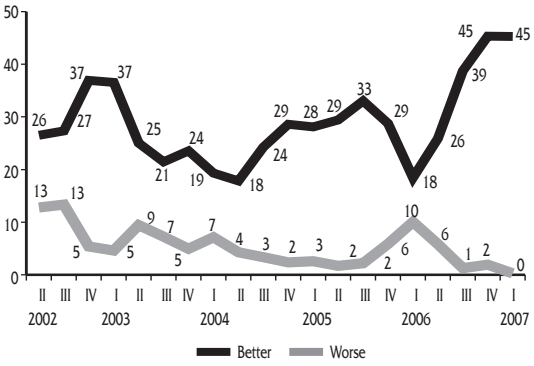
On the other hand, public consumption, which grew 2.5 percent in the first quarter of 2007, would increase 5.4 percent in 2007, falling thereafter to 4.1 and 3.8 percent in 2008 and 2009 respectively.

Graph 66
PRIVATED FIXED INVESTMENT
(Real percentage change)

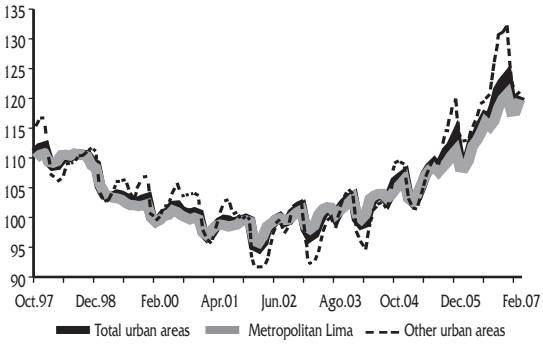


* Forecast.

Graph 67
ECONOMIC SITUATION IN THE NEXT 3 MONTHS
Quarter average (In percentage)

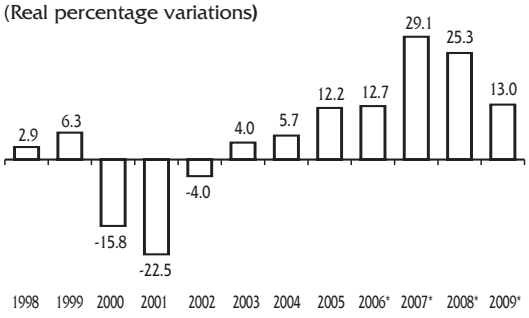


Graph 68
URBAN EMPLOYMENT IN COMPANIES WITH 10 OR MORE WORKERS
(Index January 2000 = 100)



Source: Ministerio de Trabajo y Promoción del Empleo.

Graph 69
PUBLIC INVESTMENT
(Real percentage variations)



* Forecast.

Sector production

84. Dynamism in non-primary sectors accounted for the 7.5 percent growth of GDP in the **first quarter of 2007**, particularly due to the contribution to growth of non-primary manufacturing (11.1 percent), commerce (10.2 percent), and construction (9.0 percent).

Growth in the case of non-primary manufacturing was associated with private consumption and the production of inputs. Construction was fueled by the dynamic performance of mortgage loans, by self-construction projects and the construction of offices, and by civil works implemented by local governments.

On the other hand, primary sectors grew 0.6 percent given that growth in the agricultural sector (4.5 percent) was offset by a drop in the sectors of primary manufacturing (-4.5 percent), mining (-1.6 percent) and fishing (-1.2 percent).

Table 30

GROSS DOMESTIC PRODUCT
(Percentage change)

	2006		2007*			2008*		2009*
	IQ	Year	IQ	IR Jan.07	IR May.07	IR Jan.07	IR May.07	IRMay.07
Agricultural and livestock	**4.7**	**7.2**	**4.5**	**4.0**	**4.0**	**3.5**	**3.9**	**3.8**
Agriculture	2.4	7.7	5.1	3.7	3.7	3.2	4.0	4.0
Livestock	7.4	6.6	3.9	4.6	4.4	3.9	3.9	3.6
Fishing	**31.9**	**2.7**	**-1.2**	**4.3**	**3.5**	**3.8**	**3.5**	**4.0**
Mining and fuel	**6.1**	**1.0**	**-1.6**	**3.3**	**2.9**	**5.1**	**5.2**	**4.2**
Metallic mining	6.4	0.5	-2.7	3.1	2.6	5.0	5.1	4.0
Natural gas and oil	0.4	5.7	10.6	5.6	6.5	6.1	6.3	5.5
Manufacturing	**7.3**	**6.6**	**8.4**	**6.5**	**7.8**	**6.2**	**6.5**	**6.5**
Based on raw materials	9.0	2.1	-4.5	2.6	2.2	3.9	4.4	4.4
Non-primary industries	6.9	7.7	11.1	7.6	9.1	6.8	7.0	7.0
Electricity and water	**7.2**	**6.9**	**8.3**	**6.8**	**8.8**	**5.5**	**6.0**	**5.5**
Construction	**16.3**	**14.7**	**9.0**	**11.5**	**11.5**	**10.2**	**11.0**	**11.0**
Commerce	**11.7**	**12.1**	**10.2**	**7.9**	**8.1**	**6.2**	**6.2**	**6.4**
Other services	**7.2**	**8.2**	**8.4**	**7.4**	**7.7**	**5.8**	**5.8**	**6.0**
GLOBAL GDP	**8.0**	**8.0**	**7.5**	**6.8**	**7.2**	**5.8**	**6.0**	**6.0**
Primary	**6.6**	**4.0**	**0.6**	**3.5**	**3.3**	**4.1**	**4.4**	**4.1**
Non-primary	**8.7**	**9.3**	**9.4**	**7.8**	**8.4**	**6.4**	**6.5**	**6.6**

IR: Inflation Report.
* Forecast.

The increase observed in the agricultural sector was associated with good weather conditions that allowed larger sown areas with crops such as potato, grapes, and hard yellow maize. On the other hand, growth in the hydrocarbon sector is explained by a higher production of natural gas.

Production fell in metal mining due to a lower output of gold, while lower activity in the fishing sector was due to a lower catch of anchovy, a result offset by a higher catch of fish for human consumption.

85. Growth in **2007** would continue to be led by **non-primary sectors**, but would grow at a lower rate than in 2006, in line with an expected slow down in domestic demand. However, they would continue to show a dynamic performance (8.4 percent).

An expansion of 9.1 percent is foreseen in non-primary manufacturing, higher than the forecast made in our previous Report (7.6 percent), given the evolution observed in the branches oriented to the production of consumer goods and to better prospects for the access of our products to external markets.

Furthermore, an increase of 11.5 percent is expected in the construction sector considering the development of self-construction and housing projects, as well as the implementation of road infrastructure and mining works. The evolution of construction is also based on the dynamism observed in the mortgage market.

The forecast in terms of **primary sectors** considers a growth of 4.0 percent in agriculture and livestock and a growth of 3.5 percent in fisheries.

The mining and hydrocarbon sector should grow 2.9 percent, mainly as the result of the onset of the Cerro Lindo project, which is expected to start in mid-2007, and the expansion of the Cerro Verde project. The onset of these two projects would offset the drop in gold production expected in the case of Yanacocha.

86. Primary sectors should show a recovery in **2008**, with a growth of 5.2 percent in mining and hydrocarbons due to the onset of operations at Cerro Corona (gold), to Yanacocha's sulfide treatment plant, to full capacity production at Cerro Verde (copper) and Milpo's Cerro Lindo (zinc), and to the new molybdenum plant at Cerro Verde. Normal weather

conditions are considered for the forecast on the evolution of agriculture and fisheries for both 2008 and 2009.

Non-primary sectors would show a more moderate growth in 2008 (6.5 percent, slightly higher than the 6.4 percent previously forecast). Construction should grow 11.0 percent considering the development of programs of road infrastructure and the implementation of several mining and hydrocarbon projects, while non-primary manufacturing should grow 7.0 percent.

In **2009**, non-primary sectors should grow 6.6 percent. Non-primary manufacturing is expected to grow 7.0 percent, while construction would maintain a high rate of growth (11.0 percent) considering the evolution expected in private investment.

The growth of mining and hydrocarbons (4.2 percent) would be noteworthy in terms of the primary sectors. This forecast considers the onset of operations at Magistral (copper) and production at full capacity at Yanacocha's sulfide treatment plant.

BOX 6

DIVERSIFIED GROWTH OF EMPLOYMENT

According to the survey carried out Ministry of Labor, in 2004 employment grew in 17 cities of the 22 cities that integrate the sample, while in 2006 employment grew in all these cities. In the first quarter of 2007, Paita was the only city that posted a negative variation, associated with a 1.2 percent decline of fisheries that was mainly due to lower catch.

The following table shows the distribution of the cities included in the sample according to the rates of growth of employment in each of these cities over the past three years. Between

EMPLOYMENT GROWTH IN BUSINESSES WITH MORE THAN 10 OR MORE EMPLOYEES BY CITIES
(Porcentual change)

	2004	2005	2006	2007 IQ.
Total urban areas	**2.7**	**4.5**	**7.3**	**8.9**
Metropolitan Lima	2.4	3.8	7.1	8.9
Other urban areas-Lima	3.6	6.4	8.3	8.2
Arequipa	**2.6**	**4.2**	**7.5**	**12.6**
Cajamarca	1.4	3.6	4.1	2.2
Chiclayo	-1.3	3.5	7.5	6.8
Chimbote	2.6	0.4	0.8	1.4
Chincha	4.7	15.5	14.2	1.4
Cusco	0.6	6.4	5.7	13.0
Huancayo	2.6	3.8	6.1	6.4
Huaraz	9.7	-7.4	3.0	5.0
Ica	8.8	16.5	10.4	4.5
Iquitos	6.6	9.1	3.2	0.3
Paita	6.8	-4.6	9.4	-4.6
Pisco	1.3	6.1	6.6	0.9
Piura	8.9	8.5	8.3	10.2
Pucallpa	0.4	2.9	2.1	2.9
Puno	-4.4	5.5	3.1	4.0
Sullana	-2.7	23.3	14.1	9.7
Tacna	-3.7	2.4	2.0	3.4
Talara	9.4	18.7	10.7	18.3
Tarapoto	-0.9	7.3	8.7	5.7
Trujillo	5.8	5.6	17.0	22.2

Source: Ministerio de Trabajo y Promoción del empleo (MTPE).

2004 and 2006, the number of cities where employment grew at rates of over 5 and 8 percent increased from 7 to 15 and from 4 to 12 respectively in that period.

NUMBER OF THE MAIN CITIES WHICH RECORDED EMPLOYMENT GROWTH

	2004	2005	2006
% change > 0	17	20	22
% change > 5	7	12	15
% change > 8	4	7	12
Dispersión 1/	6	8	2
Total cities	22	22	22

Source: TMPE.
1/ The cuantity of dispersion was built from the variability of growth in the cities adjusted by the growth average.

During these 2 years, employment not only expanded in a larger number of cities, but also showed more homogeneous growth rates, that is, the gap between cities with high and lower rates of expansion of employment decreased. This was reflected in the reduction of the dispersion ratio, which dropped from 6 to 2 between 2004 and 2006.

The table below shows that the cities where employment grew also increased their contribution to a higher pace of growth of GDP.

PERCENTAGE OF THE MAIN CITIES WHICH RECORDED EMPLOYMENT GROWTH RATES HIGHER THAN :

	2004	2005	2006
% change > 5	41	60	68
% change > 8	24	35	55

Source: TMPE.

VII. Inflation

In line with the forecasts made in previous reports, last 12-month inflation continued showing a downward trend in the first four months of the year due to transitory supply-related factors and increased in May. Core inflation -trend measurement- ranged between 1.3 and 1.5 percent in this period.

Inflation evolution

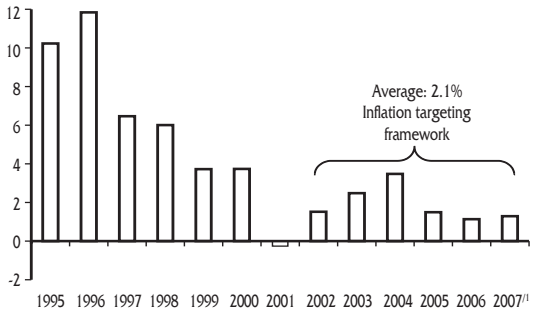
87. Since the inflation targeting scheme was formally adopted in 2002, average inflation has been 2.1 percent and average core inflation has been 1.2 percent. In May, total inflation and last 12-month inflation were 0.9 and 1.5 percent respectively.

Between January and May 2007, accumulated inflation was 1.3 percent, lower than in the same period in 2006 (1.5 percent), mainly due to the lower variations observed in the prices of chicken, sugar and potato as a result of increased production of these products. Core inflation posted 0.9 percent in this period, a rate slightly higher than the one recorded between January and May 2006 (0.8 percent).

Items contributing most heavily to inflation between January and May 2007 included onion, eggs, school tuition, and chicken, while the items that contributed negatively to inflation included telephone rates, electricity rates, national transport, and tomato.

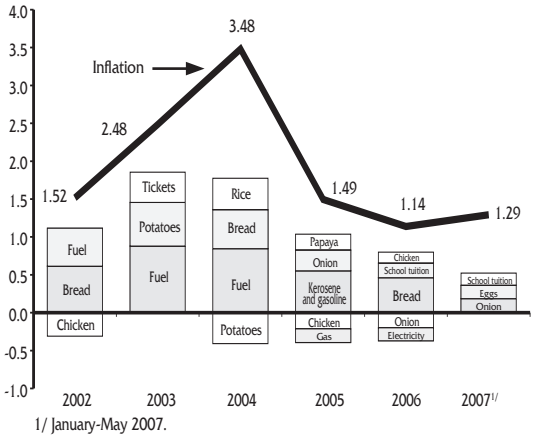
As of May, core inflation accumulated a rate of 0.9 percent (1.5 over the last twelve months), while non-core inflation accumulated a rate of 1.8 percent (0.2 percent over the last twelve months).

Graph 70
INFLATION



1/ January-May 2007.

Graph 71
WEIGHTED CONTRIBUTION TO THE DIFFERENCE INFLATION
(Percentage points)



1/ January-May 2007.

Table 31

WEIGHTED CONTRIBUTION TO THE DIFFERENCE IN INFLATION
(Percentage points)

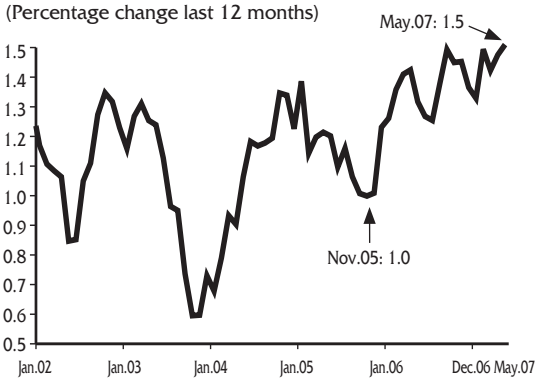
Items	Weight	% change	Positive Contribution	Items	Weight	% change	Negative Contribution
Onion	0.4	40.5	0.19	Telephone	1.3	-7.2	-0.07
Eggs	0.7	25.0	0.18	Electricity	2.2	-2.8	-0.06
School tuition	5.1	3.0	0.16	National transport	0.3	-14.9	-0.06
Chicken meat	4.0	3.3	0.12	Tomato	0.3	-15.6	-0.05
Total			**0.65**				**-0.24**

Table 32

INFLATION
(Percentage change)

	Weighted	2002	2003	2004	2005	2006 Jan.-May.	2006 May.-Dec.	2006 Year	2007 Jan.-May.	Annual average 2002-2007
I. Core inflation	**60.6**	**1.23**	**0.73**	**1.23**	**1.23**	**0.76**	**0.60**	**1.37**	**0.91**	**1.24**
1. Foods	10.7	0.02	0.14	3.24	0.98	0.41	0.57	0.98	0.83	1.14
2. Non-foods	49.9	1.49	0.85	0.80	1.28	0.84	0.61	1.45	0.92	1.26
a. Goods	23.3	1.39	0.08	-0.29	0.71	0.75	0.22	0.97	0.84	0.68
b. Services	26.6	1.57	1.53	1.75	1.77	0.91	0.93	1.85	0.99	1.75
II. Non-core inflation	**39.4**	**1.96**	**5.16**	**6.75**	**1.87**	**2.51**	**-1.65**	**0.83**	**1.83**	**3.38**
1. Foods	22.5	0.28	3.73	5.82	1.62	5.02	-2.81	2.06	3.56	3.14
2. Non-foods	16.9	4.22	7.00	7.90	2.17	-0.52	-0.15	-0.67	-0.33	3.69
a. Fuel	3.9	15.60	8.94	17.77	6.89	1.15	-2.62	-1.50	2.37	9.04
b. Transport	8.4	0.11	10.99	3.49	1.29	0.06	1.06	1.12	-0.74	2.92
c. Public services	4.6	1.96	-1.98	6.19	-1.72	-3.85	0.65	-3.22	-3.01	-0.39
III. Total	**100.0**	**1.52**	**2.48**	**3.48**	**1.49**	**1.49**	**-0.35**	**1.14**	**1.29**	**2.10**

Graph 72
CORE INFLATION
(Percentage change last 12 months)



Core inflation

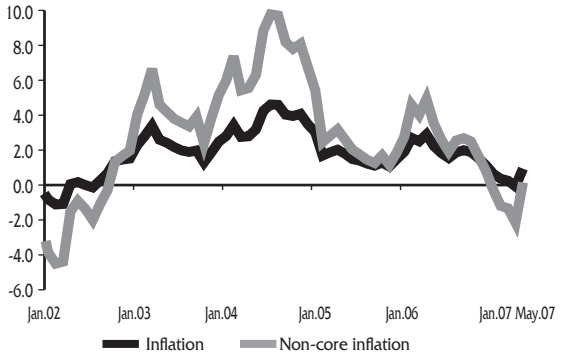
88. Core inflation -indicator representing the trend of price increases as the most volatile components of the general index are isolated- accumulated 1.5 percent over the last twelve months. After growing at a faster pace between November 2005 (1.0 percent) and April 2006 (1.4 percent), which coincided with an expansion of domestic demand (8.7 percent on average between the fourth quarter of 2005 and the first quarter of 2006), this indicator has remained stable between 1.3 and 1.5 percent between May 2006 and May 2007.

In May 2007, the different indicators of trend inflation[12] ranged between 0.8 percent and 1.7 percent. These low levels of inflation -below or at the lower band of the inflation target range- would be reflecting improvements in productivity, increased competition, and absence of pressures on labor costs in the context of an expansionary economic cycle.

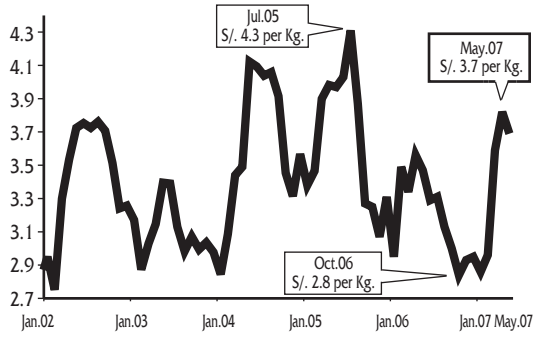
Non-core inflation

89. Non-core inflation -which represents the goods and services affected by supply shocks or whose prices are controlled- accumulated a rate of 1.8 percent between January and May 2007. This rate was mainly due to price increases in the prices of onion, eggs, and chicken meat, but was partially offset by a fall in the prices of tomato, electricity rates, and telephone rates.

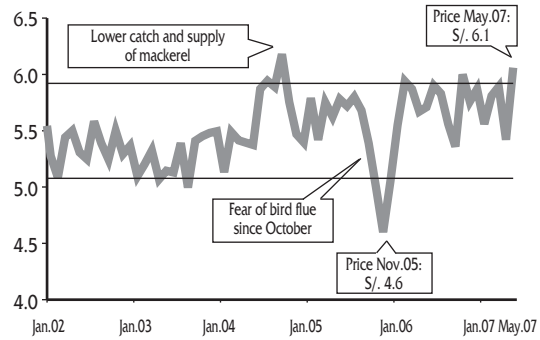
Graph 73
INFLATION AND NON-CORE INFLATION
(Percentage change over the last 12 months)



Graph 74
PRICE OF EGGS
(Nuevos Soles per kg.)



Graph 75
PRICE OF CHICKEN MEAT
(Nuevos Soles per kg.)



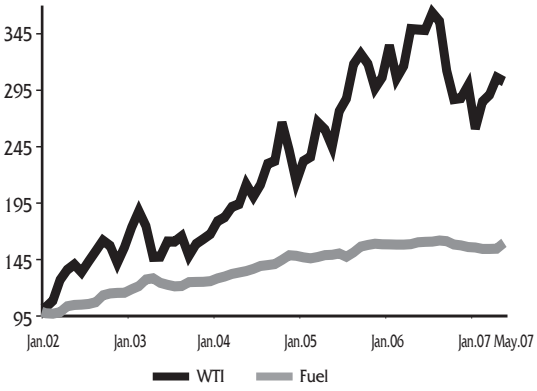
- **Onion:** according to its seasonal evolution, the price of onion rose 40.5 percent. In Arequipa, Lima's main supplier of onions, the price of this product increased from S/. 0.50 per Kg. at end April to S/. 1.20 per Kg. in mid-May. This was associated to a decline in the number of sown areas and to the seasonal evolution of this crop.

- **Eggs:** the increase in the price of eggs was mainly due to a recovery of the relative price resulting from an increased seasonal demand.

- **Chicken meat:** although the average price variation throughout this period was 3.3 percent, the price of this product traditionally fluctuates between January and May. In April, the price dropped by 6.9 percent and increased by 10.6 percent in May. The price drop observed in April was basically due to high level of supply as placements of baby chicken in the January-May period were 9 percent higher than in the same period last year. The price rise in May was due to a higher demand associated with the celebration of Mother's Day and with a lower supply of some fish products that are highly consumed in low-income sectors (tuna and "perico", among others).

12 The methodology used for these indicators is described in Nota de Estudios No. 11, 2006.

Graph 76
CUOTATION OF WTI OIL AND FUEL PRICES
(Index december 2001 = 100)



- **Tomato:** the price of tomato dropped 15.6 percent due to increased production (29 percent between January and April) as a result of larger sown areas in the departments of Lima and Ica.

- **Fuel:** the domestic price of fuels increased 2.4 percent on average between January and May 2007. In the international market, the price of West Texas Intermediate oil (WTI oil) rose from US$ 62 in December 2006 to US$ 63 in May 2007.

Table 33

FUEL PRICES
(Monthly percentage change)

	2002	2003	2004	2005	2006	2007 Jan.-May.
Fuels	**15.6**	**8.9**	**17.8**	**6.9**	**-1.5**	**2.4**
Gasoline	15.7	9.7	17.7	9.2	-6.2	3.1
Gas	11.3	4.2	15.3	-10.9	0.3	1.3
Kerosene	20.4	13.0	20.3	21.0	2.2	2.3
Cuotation WTI						
US Dollars	29.4	32.1	43.3	59.4	61.9	63.4
Nuevos Soles	103.5	111.3	142.0	203.3	198.6	200.9

Source: INEI, Bloomberg.

- **Public utilities rates:** between January and May, electricity and telephone rates fell 2.8 percent and 7.2 percent respectively. The reduction in the price of telephone rates was associated with a reduction in the general rate for residential telephone service and with a series of telephone rate plans resulting from a negotiation between the state and Telefonica.

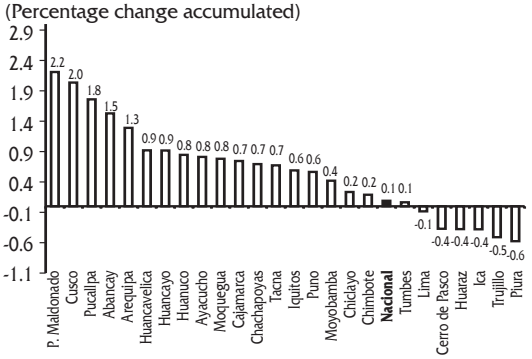
Table 34

PUBLIC SERVICES TARIFFS
(Monthly percentage change)

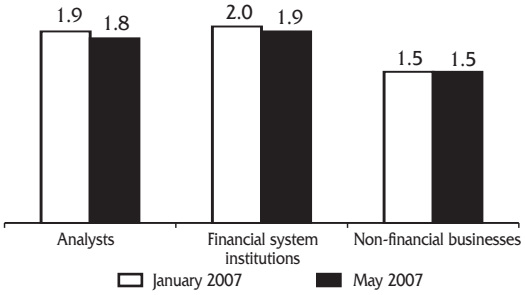
	2002	2003	2004	2005	2006	2007 Jan.-May.
Public services	**2.0**	**-2.0**	**6.2**	**-1.7**	**-3.2**	**-3.0**
Electricity	7.9	-4.6	12.0	-2.5	-7.3	-2.8
Telephones	-8.3	0.3	-2.0	-7.0	-6.2	-7.2
Water	2.3	0.9	3.0	5.2	8.5	0.0

Source: INEI.

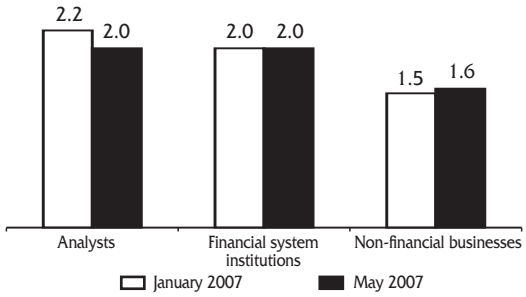
Graph 77
NATIONAL INFLATION RATE APRIL 2007
(Percentage change accumulated)



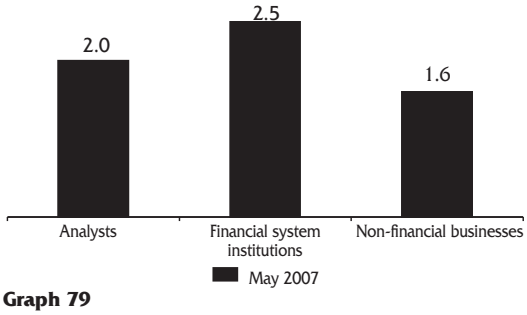
Graph 78
INFLATION RATE EXPECTATIONS 2007



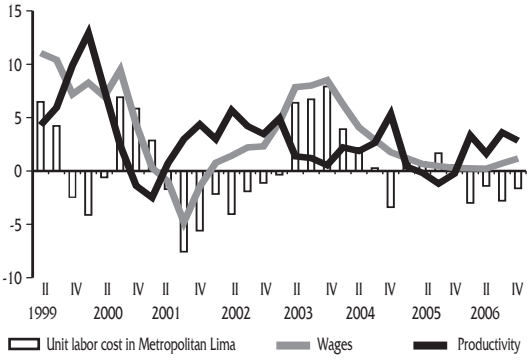
INFLATION RATE EXPECTATIONS 2008



INFLATION RATE EXPECTATIONS 2009



Graph 79
TOTAL UNIT LABOR COST, WAGES AND PRODUCTIVITY
(Percent change over the last 12 months)



Domestic inflation

90. Since 2003, the INEI has produced an aggregate national consumer price index based on prices recorded in 25 cities. The increase in accumulated prices between April 2006 and April 2007 was 0.1 percent. In 18 cities the CPI was higher than average, while in the remaining 7 this index of inflation was lower than the national average. More ever, 6 cities showed negative levels of inflation.

    The cities exhibiting a higher growth of prices were Puerto Maldonado (2.2 percent), Cuzco (2.0 percent) and Pucallpa (1.8 percent). Conversely, the cities showing lower price increases were Piura (-0.6 percent) and Trujillo (-0.5 percent).

Expectations

91. An additional element influencing inflation forecasts is expectations regarding the future evolution of this variable, as expectations have an impact on price formation in the economy. The surveys on macroeconomic expectations carried out by the BCRP show that the credibility of monetary policy has strengthened in the last few years, anchoring inflation expectations at the level of the target throughout the forecast horizon.

Unit Labor Cost

92. The unit labor cost (ULC) is defined as the ratio between salary and average productivity at work. If salaries increase (decrease) more than productivity, the ULC increases (decreases). Based on preliminary data on salary levels for December 2006, the ULC is calculated for Metropolitan Lima (both at the global level and for the manufacturing sector).

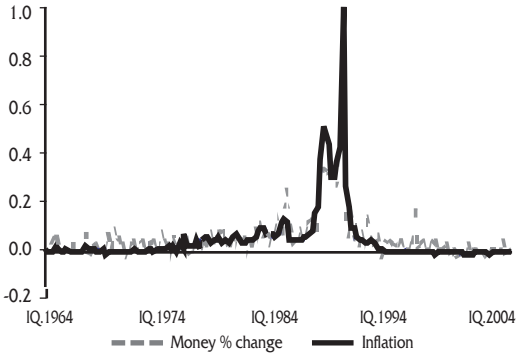
    When the last 12-month ULC percentage variations are analyzed, we can see that productivity is growing at higher rates than salaries in the indicator on Metropolitan Lima, and therefore variations in the ULC are still negative.

BOX 7

IMPACT OF GLOBALIZATION ON INFLATION

The reduction of inflation in Peru, which reached international levels over the past decade, has been coupled by lower uncertainty (volatility) regarding inflation[13]. Both these processes would be associated with changes in the conduction of monetary policy toward less tolerant stances vis-à-vis inflation, with the full adoption of the inflation targeting scheme and, finally, with the fact that the policy instrument of monetary aggregate was replaced by the interest rate.

INFLATION AND MONEY



Evolution of inflation

Period	Monthly inflation rate	
	Average	S.D.
1951 - 1960	0.60	0.99
1961 - 1970	0.78	0.97
1971 - 1980	2.41	2.40
1981 - 1990	16.40	38.28
1991 - 2000	1.88	2.58
2001 - 2006	0.16	0.36

Transitory inflation shocks, associated with core inflation, would have also declined in terms of volatility. This could be due to the beneficial effects of a monetary policy that is adverse for inflation and successful in anchoring agents' expectations around the inflation target.

Additionally, globalization is another factor which may have contributed to maintain low price levels and to reduce uncertainty regarding inflation. Thus, for instance, the higher supply of imported goods (from non-skilled labor intensive countries) at lower prices than those of domestic goods could also have contributed to achieve lower inflation rates. The channels through which globalization could have generated this effect are discussed herein.

The rate of inflation would be determined by demand pressures (the output gap), inflation expectations, the pass-through effect (changes in the prices of imported goods affecting inflation) and by the effect of profit margins on marginal costs[14]. The recent evolution of these factors would be associated with a monetary policy that is adverse to inflation in a favorable context of globalization. The mechanisms explaining each of these factors and their influence on inflation are discussed below.

a) Demand pressures

A pace of growth of aggregate demand above the rate of potential output usually generates inflationary pressures. In recent years, aggregate demand in the Peruvian economy has been growing at rates of over 5 percent. Despite this, total inflation has remained within the target range (showing even a bias toward the lower band of said range). This could be due to the fact that the potential output would have also grown as a result of new productive investments and as a result of an increase in factor productivity.

Moreover, globalization could have increased the levels at which the output gap is consistent with price stability. The presence of cheaper imported goods could have modified labor supply by increasing workers' welfare, thus not requiring that real salary be increased. This factor would have acted as a positive supply shock that offset the

13 Castillo, Humala and Tuesta (2007) analyze the positive relationship existing between the rate of inflation and inflation's volatility and show that the evolution of inflation in Peru has been affected by regime shifts.

14 The conceptual framework here is the Phillips (supply) curve, which represents a hybrid neokeynesian-type equation for inflation. Supply shocks could also be considered, but monetary policy cannot influence them. Vega and Winkelried (2005) point out that, in addition to the pass-through effect, there is a drag effect of international prices that affect domestic prices.

pressure on aggregate demand and maintained inflation under control (thus contributing with monetary policy). However, this result stemming from globalization could be just transitory[15] and, therefore, the monetary decision of countering aggregate demand pressures should be conditional to the permanence of this effect on aggregate demand.

Theoretically, Bean (2007) discusses the possibility of a lower incline in the Phillips curve due to shifts in inflation regimes induced by changes in monetary policy[16]. Inflation targeting would have adequately anchored inflation expectations. In this sense, business would require to change prices less in the short-term if inflation rates are low.

b) Expectations regarding inflation

The adoption of the inflation targeting scheme since 2002 would have contributed to reinforce economic agents' creditability regarding a monetary policy that is adverse to inflation. The central bank's increased independence and the management of monetary instruments oriented to the market would also have contributed to reinforce credibility. Inflation expectations would be therefore anchored around the target range and the volatility of short-term shocks on inflation would also be lower. Thus, this component would be under control and would not imply major deviations in terms of the inflation target.

c) The pass-through effect

Changes in international prices may be directly transmitted to domestic prices, given their weight in the domestic consumer price index (CPI). The prices of imported inputs can also indirectly affect the domestic prices of final goods using this inputs. Moreover, even if international prices (external inflation) are stable, changes in nominal exchange could have a pass-through effect in domestic prices and, therefore, in inflation.

However, the fact that globalization represents a shock on relative prices and not necessarily on absolute prices must be considered. Imported goods are only a part of the CPI consumption basket. The final impact depends on the evolution of the prices of the goods locally produced[17]. Thus, for example, the prices of tradable goods that are close substitutes of imports can also decline. Therefore, the full effect would depend on the evolution of non-tradable goods, which could rapidly increase if consumers reacted to their higher purchasing capacity (cheap imports) spending more on these goods, thereby increasing their prices and countering the above-mentioned effect.

d) Profit margins on marginal costs

Cost increases can also be transferred to prices if the degree of market competition and permanent price changes allow firms to adjust their prices accordingly. This effect would have declines in recent years due to the persistence of low inflation. This low inflation, both in terms of rates and volatility, would also have decreased the persistence of inflation, which in turn would have contributed to increase market competition and, therefore, to maintain business profits.

In general, in the long-term, if the country has a flexible exchange system and monetary policy is conducted independently, Peru could determine its inflation rate. The impacts of globalization on inflation can be just temporary, but more empirical research should be carried out to accurately determine the magnitude of said impacts.

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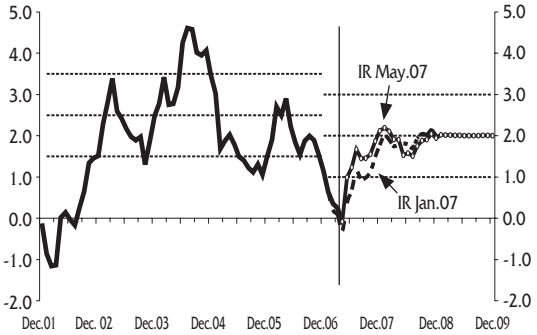
* Castillo, Paul; Alberto Humala and Vicente Tuesta (2007). Monetary policy, regime shifts, and inflation uncertainty in Peru (1949 - 2006). Documento de Trabajo No. 2007-05, Banco Central de Reserva del Peru, March.
* Rogoff, Kenneth (2003). Globalization and global disinflation. Mimeo, Paper presented at the Conference on "Monetary policy and uncertainty : adapting to a changing economy", Federal Reserve of Kansas City, August.
* Vega, Marco and Diego Winkelried (2005). How does a global disinflation drag inflation in small open economies? Documento de Trabajo No. 2005-001, Banco Central de Reserva del Peru, January.

15 Workers can include in their salary demands earnings resulting from terms of trade, thus countering the initial effect (Bean, 2007). The impact of increasing oil prices would have also counterbalanced this downward pressure of imported prices.

16 Castillo, Humala and Tuesta (2007) provide evidence for Peru of regime shifts in terms of inflation and monetary policy. Vega and Winkelried (2005) provide information on the change of incline in the Phillips curve. Rogoff (2003) suggests changes in the inflation process in main developed countries.

17 This difference is emphasized by Bean (2007).

Graph 80
LAST-12-MONTHS FORECAST



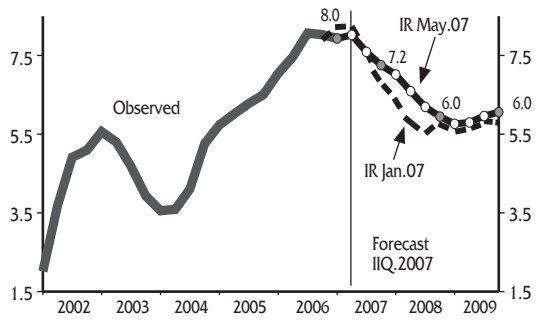
IR: Inflation Report.

Inflation forecasts

93. Inflation should gradually converge to the 2.0 percent inflation target over the next months. Thus, a reversal of the decreasing trend shown by this variable since September 2006 is forecast. The forecast differs from the forecast made in our previous Report (January 2007) in that inflation's convergence towards the 2 percent target will show a faster pace. This difference is due to the fact that the price of fuel has been revised upwards for this year, which implies a high marginal impact on the inflation forecast for the next months. Moreover, inflation could be slightly above the 2 percent target by the end of the year. However, as of mid-2008, inflation's evolution shows no major differences with the scenario described in our January Report. In other words, no major revisions have been made in terms of the expected evolution of inflation's macroeconomic determinants in the medium-term.

94. Although the prices of fuels and public utilities rates have been slightly revised upwards in this Inflation Report, the supply of food products should continue to show stable conditions. Thus, the reversal of supply shocks should not imply significant deviations of non-core inflation from the inflation target. Therefore, it is the factors sensitive to the BCRP's monetary policy that determine the convergence of inflation towards a 2 percent rate in the forecast horizon. These factors, constituting the macroeconomic fundamentals of trend inflation, include agents' expectations regarding the evolution of prices, the expansion of economic activity and, finally, the determinants of imported inflation, such as exchange and the international quotations of fuels and food products.

Graph 81
GDP GROWTH
(Average variation rate to the last 4 quarters)



IR: Inflation Report.

95. Imported inflation should not generate significant pressures in the forecast horizon. This Report considers a moderate revision in our previous forecast on the international price of petroleum for this year: the average international quotation of oil would increase from US$ 62 to US$ 63 per barrel, and from US$ 65 to US$ 67 per barrel in 2008.

96. The expansion of economic activity would be explained by both demand and supply related factors. On the side of the demand, our forecast still considers favorable terms of trade, as well as a positive fiscal impulse and financial conditions in line with the boom of credit, which is supported by high consumers and investors' confidence. On the other hand, growth on the side of supply would be associated with an increase in total factor productivity and with prospects of

sustained investment in sectors such as mining and generation of electricity. This expansion of supply is considered to be consistent with a growth rate of potential GDP of around 6 percent in the forecast horizon.

The forecast on GDP growth at end 2007 and in the following quarters has been increased relative to the forecast made in the Inflation Report of January. This revision is mainly explained by the lower reduction expected in terms of trade.

VIII. Balance of risks

97. The different risk scenarios that could deviate our forecasts from the baseline scenario are evaluated and weighed here, as different shock sources may impact on inflation causing either upward or downward pressures.

98. The main risks that could deviate the forecasts from the central scenario include the following:

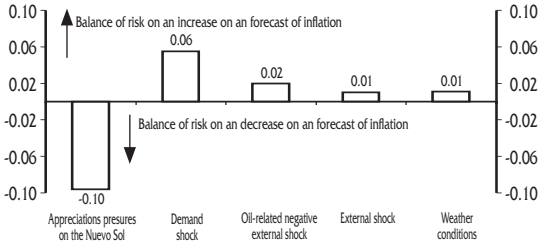
- **Appreciatory pressures on the Nuevo Sol:** In a scenario of appreciation of the Nuevo Sol, imported inflation would pressure inflation downwards. In this case, the BCRP would maintain its current reference rate for a longer period of time or would lower this rate.

- **Expansionary demand shock:** The high growth of domestic demand has slowed down in the first quarter of this year. Thus, domestic demand declined from 12.6 percent in the fourth quarter of 2006 to 10.2 percent in the first quarter of 2007. Should the expansion of domestic spending exceed the growth of productivity and create inflationary pressures, the BCRP would raise its reference interest rate.

- **Negative external shock** due to the international price of oil: The geopolitical risks that generated an increase in the price of petroleum in the first months of 2007 have not disappeared yet. A scenario with greater upward volatility in the oil market would lead the price of fuel to rise above the levels considered in the baseline scenario.

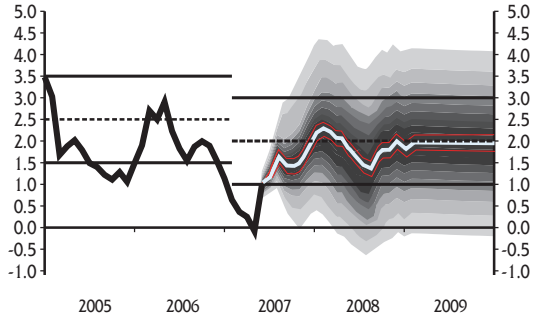
  In such case, the BCRP would only react if the price rises were generalized and sustained and if the expectations of economic agents regarding inflation would change to levels that are inconsistent with the inflation target. This has not been the case in the last episodes observed of rises in the international prices of oil as inflation expectations remained within the target range.

Graph 82
MAIN RISK THAT CAN AFFECT THE INFLATION FORECAST[1/]
(Percent points of deviation from the inflation 2 years forward)



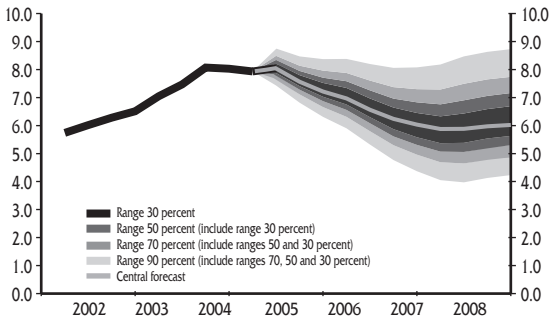
1/ Shows the partial impact of each risk factor on the balance of inflation forecast. One way to measure the asymmetry of predictive density of inflation is through the difference between the average and the trend (central value). For each risk factor the predictive density of inflation is built (obtained from the asymmetric behavior of the factors) and extract the asymmetries.

Graph 83
INFLATION FORECAST
(Annual percentage change)



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

Graph 84
GDP GROWTH FORECAST
(Annual percentage change in every quarter)



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

- **Negative external shock:** The international environment is still favorable in the forecast horizon, although a gradual reversal in terms of trade is expected together with a transitory slowdown in the U.S. economy. On the other hand, high rates of growth are expected in the rest of the world and particularly in Asia. This scenario implies a moderate correction in global fiscal imbalances and in the balance of payments. A scenario involving a severe correction in the prices of export commodities and/or a situation of recession in the United States (in which the lower dynamism of construction would expand to the rest of the U.S. economy and contract imports) would imply -depending on the flow of external capitals to emerging economies-a depreciation of the Nuevo Sol and thereafter a downward impulse on the dynamism of the Peruvian economy. This situation could be aggravated if the Free Trade Agreement between Peru and the United States were not approved.

  Moreover, this lower international demand could imply a decline in our domestic economic activity, in which case the BCRP would maintain its reference interest rate for a longer period of time, provided that conditions in the exchange and financial markets continue to be normal.

- **Negative supply shock due to adverse climatic conditions:** The baseline forecast scenario considers stable climatic conditions for the 2008-2009 period. There is little probability that there will be a severe El Niño event or that a La Niña event might occur. The latter would imply temperatures below normal that could affect agriculture, thereby causing temporary effects on the prices of food products.

  Should any of these events occur, the BCRP would only react if the rise in the price of agricultural products affected inflation expectations and extended to other prices in the economy.

99. Weighing the various risks both upwards and downwards against the baseline scenario shows a neutral balance in the case of the inflation forecast. Risk factors may be estimated by quantifying the probability of their occurrence and of their impact on deviating the inflation forecast should these risks occur. In the case of GDP, weighing the various factors that could affect the forecast shows an upward asymmetry.

CONCLUSION

100. Annual inflation should start to converge towards the 2 percent target in the rest of the year and stabilize thereafter near the inflation target in the rest of the forecast horizon. This context of stable prices should continue to be coupled by a sustained growth of GDP at rates close to those of potential GDP. The different risk factors point to a neutral risk balance in the forecast of inflation.