BANCO CENTRAL DE RESERVA DEL PERÚ

Inflation Report: Recent Developments and Outlook

September 2002

CONTENT

INFLATION REPORT: RECENT DEVELOPMENTS AND OUTLOOK

FOREWORD

1. In January 2002, the Central Reserve Bank of Peru adopted an Inflation Target regime, by which the monetary authority announced an end-of-December inflation target of 2,5 percent with margin of ± 1 percent. That is to say, the lower limit of annual inflation is 1,5 percent and the upper limit 3,5 percent.

   The attainment of this goal is based on monthly Monetary Program announced by the Board of the Bank at the beginning of every month. Monetary programming includes the setting of reference interest rates of BCR operations as well as average disposable banks' liquidity.

   BCR decisions are taken considering forecasts from different sources such as surveys, models, leading indicators, rational expectations of economic agents and other algorithms. An inflation report, published every four months, describes recent inflation related developments and gives an explanation of the forecast.

I Inflation as of September 2002

2. In the period January-September inflation reached 1,23 percent, in line with the annual target.

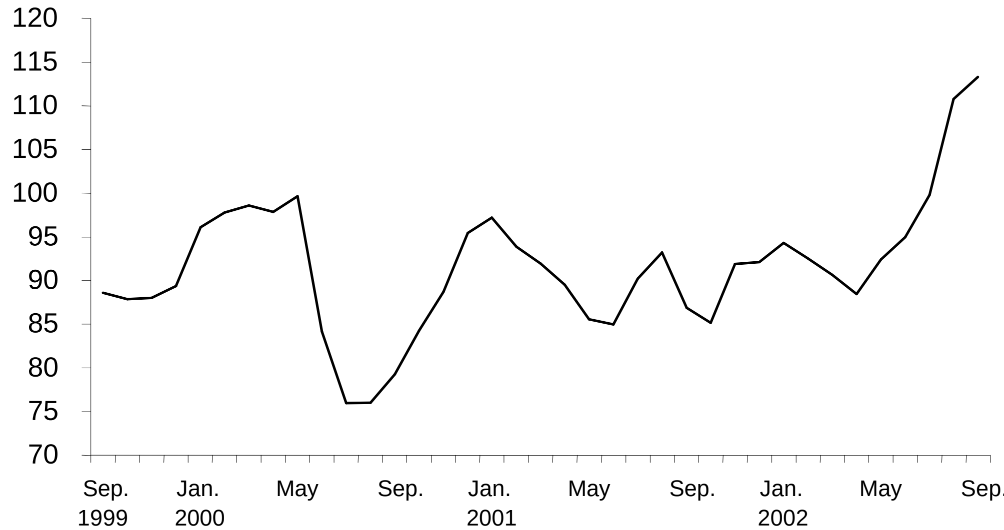
Table 1
Inflation: January-September 2002
(Percentage change)

Highest positive variations			**Highest negative variations**		
Items	Percentage change	Contribution (Percentage points)	Items	Percentage change	Contribution (Percentage points)
Bread	9,4	0,35	Poultry	-9,3	-0,37
Oil and derivatives	15,2	0,22	Potato	-13,6	-0,21
Kerosene	18,5	0,21	Rice	-4,4	-0,10
Education	2,7	0,14	Telephone fees	-7,0	-0,09
Vegetables (other)	20,3	0,13	Sugar	-5,6	-0,08
Electricity	5,6	0,13	National transportation	-16,8	-0,05
Fresh vegetables	23,0	0,10	Tomatoes	-16,1	-0,05
Restaurants	0,9	0,09	Meat	-1,5	-0,04
Total		**1,36**	**Total**		**-0,99**

The prices of poultry, potato and rice decreased whereas the prices of bread, fuel and kerosene recorded an increase.

- The decrease in the price of poultry had a –0,37 percentage points impact on January-September inflation, and reflected the higher supply of BB chicken. The declining trend in the price of poultry happens despite that the price of yellow corn, the most important input in poultry feeding, increased 23 percent.

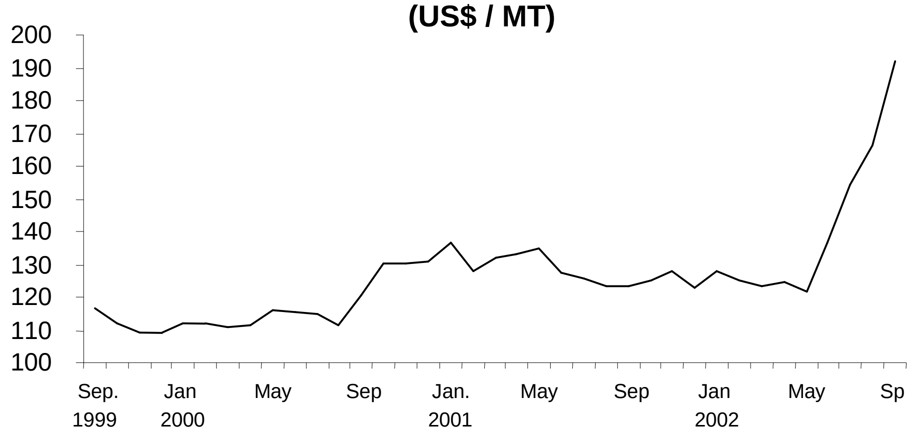
Graph 1
International corn quotations
(US$/MT)



- The lower consumer prices of potatoes and rice contributed 0,31 negative percentage points to the January-September rate of inflation. The sowing of potatoes and rice grew 9 and 6 percent respectively during the 2001-2002 season, increasing the supply of these products and thus lowering their prices.

- The higher price of bread explained 0,35 percentage point of January-September inflation. The price of bread is correlated to the international price of wheat, its most important input, which increased 56 percent during this period, reflecting unfavourable weather conditions in Australia, Canada and the United States, the most important suppliers.

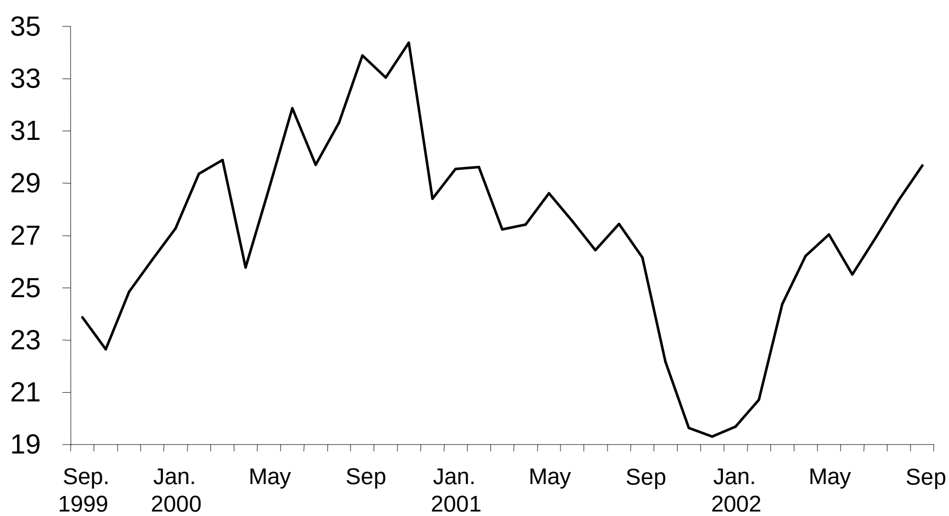
Graph 2
International wheat quotations
(US$ / MT)



- The increase in the international price of crude oil (54 percent) was reflected in higher domestic prices for fuel and kerosene, having a 0,43 percentage points impact in January-September inflation.

The excise tax on fuels increased in the domestic market from 12 to 15 percent in the case of fuels, 19 percent in the case of gas and 103 percent for kerosene. The latter was intended to correct the distortion because of its low price relative to other derivative substitutes.

Graph 3
International quotes for WTI oil
(US$ per barrel)



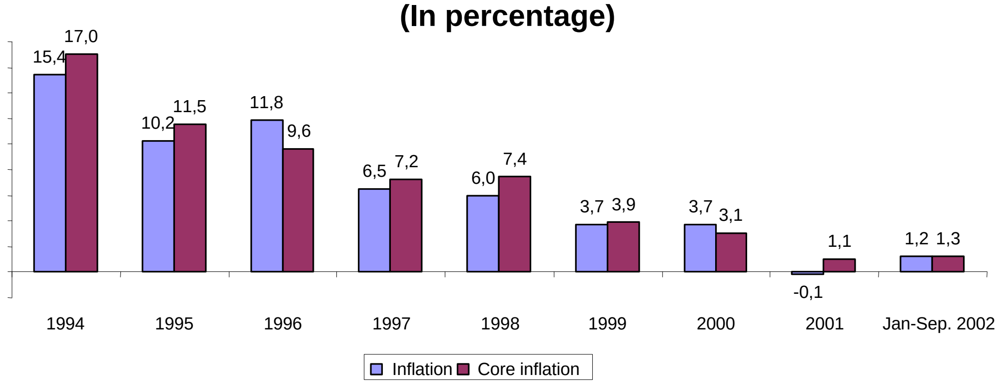
3. A nominal index which includes all the items of a reference basket is used in the measurement of inflation, whereas another index, named core inflation, is used to measure price trends by excluding high variability items, resulting from external or domestic shocks.

Over the period January-September core inflation increased 1,26 percent, whereas non-core inflation reached 1,16 percent. The small breach indicates the convergence of both indicators to the average consumer price increase (1,23 percent).

Table 2
Inflation
(Percentage change)

	Weight	2001	January-September
I. CORE INFLATION	**68,3**	**1,06**	**1,26**
Goods	**41,8**	**0,7**	**1,2**
Foodstuffs and beverages	20,7	-0,6	0,9
Textile and footwear	7,6	1,9	1,0
Other processed goods	13,5	2,2	1,8
Services	**26,5**	**1,7**	**1,3**
Restaurants	12,0	1,3	0,8
Education and health	6,4	3,8	2,5
Other services	8,1	1,4	1,2
II. NON-CORE INFLATION	**31,7**	**-2,82**	**1,16**
Foodstuffs	14,8	-1,2	-1,1
Fuels	3,9	-13,1	13,3
Transportation	8,4	0,0	-0,6
Public services	4,6	-2,7	1,2
III. CPI	**100,0**	**-0,13**	**1,23**

Graph 4
Inflation and core inflation
(In percentage)

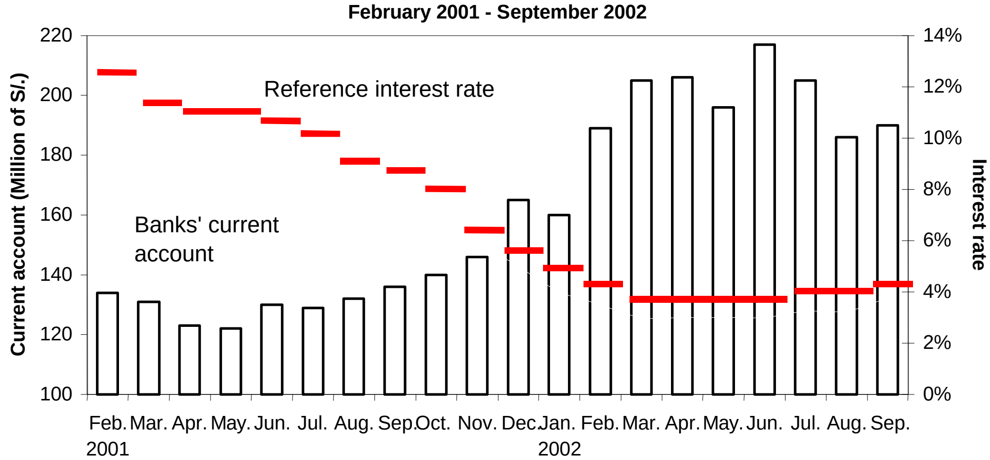


II Monetary Policy

4. The Central Bank has adopted a stance which is watchful, flexible and consistent with a monetary policy management oriented to avoid inflationary or deflationary risks and to accomplish inflation goal set beforehand.

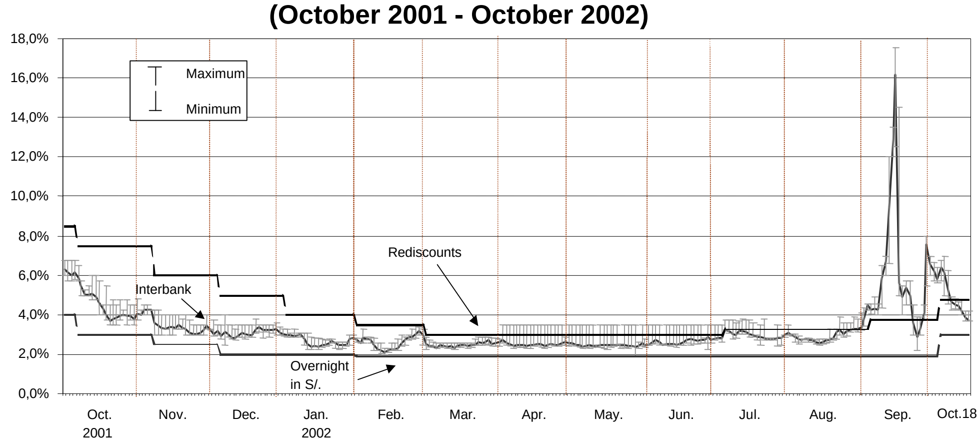
5. In 2002, the announcements of reference interest rates on Central Bank monetary operations as well as of the balance of current account deposits of banks at the Central Bank (namely the operating target), helped in the formation and evolution of interbank interest rates.

Graph 5
Current account and reference interest rates of Central Bank monetary operations
February 2001 - September 2002



6. As of August 2002, the daily average interbank interest rate remained inside a band set by the reference interest rates of Central Bank monetary operations. The amounts of transactions at interest rates out of this band were negligible.

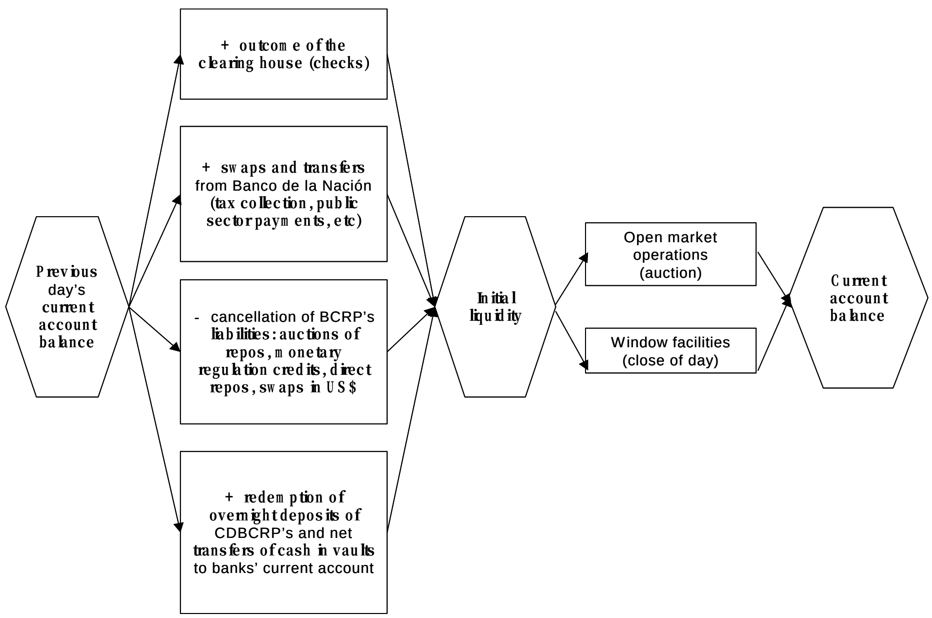
Graph 6
Interest rates on domestic currency
(October 2001 - October 2002)



Box 1
Daily management of Central Bank monetary operations

The BCR announces at the beginning of each month the daily average balance of banks' current account deposits held at the Central Bank (operating target) in order to guide the interbank interest rates, which in turn have direct influence on the rest of interest rates in domestic currency. In order to set a reference corridor for the interbank rate, the Central Bank announces its monetary operation reference interest rates.

On a daily basis, the Central Bank's monetary operations (injections and withdrawals in the money market) are oriented to provide a level of liquidity consistent with the expected monthly average balance. These decisions take into account the difference between the current account target and the initial balance of the current day.



Initial liquidity is announced around 11:30 am. Open market operations amounts are announced in order to attain the daily target. To do so, the Central Bank injects or withdraws liquidity in domestic currency. The former through auctions of repos with Certificates of Deposit of the Central Bank (CDBCRP) or Public Treasury bonds and the latter through auctions of CDBCRP's.

Also, there are window facilities as direct repos, monetary regulation credits and swaps of foreign currency, designed to provide liquidity to financial institutions that could not meet reserve requirements via open market operations or in the interbank market. The resulting interest rate of these facilities is the higher between the reference interest rate announced at the beginning of the month and the daily average interbank interest rate. Moreover, there is an overnight deposits window, by which banks make deposits of surplus funds at the Central Bank, being paid at an interest rate announced at the beginning of the month. This window is used to sterilize surplus liquidity in the interbank market.

In order to smooth out exchange rate volatility, the daily use of direct repos and monetary regulation credits is subject to global limits, which are proportional to the amount of deposits of each bank.

On a daily basis, the Central Bank's website (www.bcrp.gob.pe) publishes the initial liquidity and the announcement of operations (11:30), the results of these operations (13:00) and a daily report of Central Bank's operations (18:30). This information is also available via Reuters, Bloomberg and DATATEC.

7. During the execution of the monetary program, some deviations, up or down, from the range announced at the beginning of the month of the operating target are reported. This is allowed in order to maintain the dispersion in interbank interest rates in domestic currency at a minimum.

   As of September 2002, the cash lag effect has been incorporated; this takes into account the average balance of funds in vaults of the previous month, in order to calculate the reserves of banks in the current month. By doing so, the prevision of the current account balance is made with greater precision and the variability of the interbank interest rate is reduced.

Table 3
Operating target of the banks' current account at the BCRP and reference interest rates approved by the Board of the Central Bank

	2001	2002									Program
	December	January	February	March	April	May	June	July	August	September	October 2002
1. Operational target: current account (In million of S/.)											
Range	150-160	160-170	160-170	185-195	205-215	205-215	195-205	205-215	190-210	175-195	180-200
Actual	165	160	189	205	206	196	217	205	186	190	
2. Reference interest rates (In percentages)											
a. Liquidity facilities in nuevos soles	5,0	4,0	3,5	3,0	3,0	3,0	3,0	3,25	3,25	3,75	4,75
b. Overnight deposits in nuevos soles	2,0	2,0	1,9	1,9	1,9	1,9	1,9	1,9	1,9	1,9	3,0
Note:											
Interbank interest rate in domestic currency	3,1	2,7	2,6	2,5	2,5	2,5	2,6	2,9	2,9	5,6	

8. Given the greater uncertainty during late August and most of September, interbank interest rate remained transitorily above the band established by the reference interest rates of Central Bank monetary operations. On September 17, the interbank interest rate reached **16,1** percent due to unusual market volatility and expectations of domestic currency devaluation. Over the next days, the interbank rate returned to the corridor as a result of Central Bank intervention, reduction of devaluation expectations, and the re-establishment of banking liquidity.

9. Once this contingency was over, monetary policy returned to normal conditions. Volatility of interbank interest rate between January and August ranged from 2,7 to 2,9 percent and its standard deviation from 0,3 to 0,2 percentage points. In September, the interbank interest rate went up to 5,6 percent with a standard deviation of 3,3 percentage points. Notwithstanding, in late September, these started to decline. Despite nervousness and greater uncertainty in financial markets, standard deviation came down from 2,0 percentage points in 2001 to 0,5 percentage points as of September 2002.

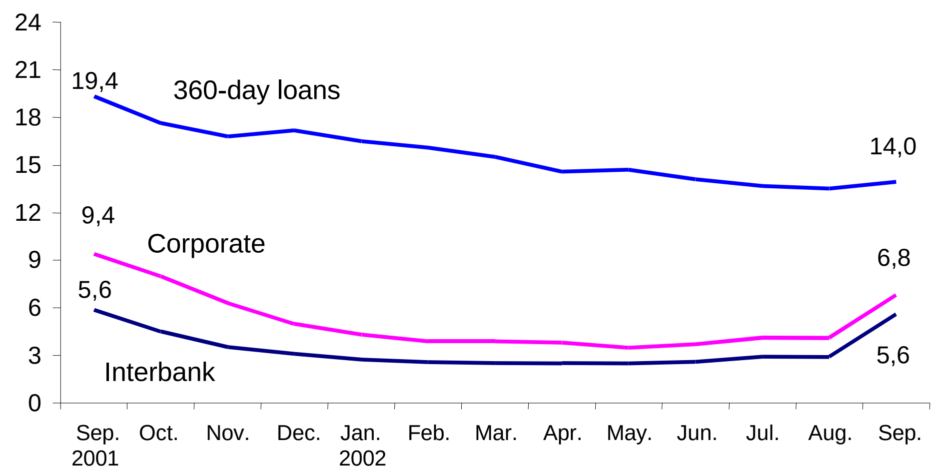
Table 4
Interbank interest rate volatility
(In percentage)

	Average interest rate	Standard deviation
2001 1/	8,6	2,0
Jan. 2002	2,7	0,3
Feb.	2,6	0,3
Mar.	2,5	0,1
Apr.	2,5	0,1
May.	2,5	0,1
Jun.	2,6	0,1
Jul.	2,9	0,2
Ago.	2,9	0,2
Sep.	5,6	3,3
Jan-Sep. 2002 1/	3,0	0,5

1/ Year standard deviation is computed as the average of monthly deviations

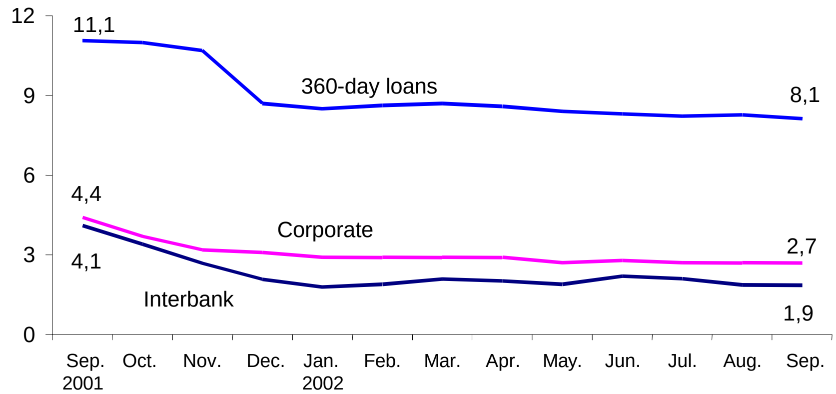
10. The monetary policy stance transmitted via monetary and credit channels was reflected in the decrease of interest rates until July. In September, the corporate prime interest rate for 90-day loans started to increase, from 4,1 percent in July to a peak of 6,8 percent in the third week of September. Similarly, 360-day loans interest rates, which had diminished from 17,2 to 13,7 percent between December 2001 and July 2002, increased to 14,0 percent in September, before returning to previous levels.

Graph 7
Nominal interest rates in domestic currency
(September 2001 - September 2002)



11. The corporate prime interest rate in foreign currency decreased from 3,1 percent in December 2001 to 2,7 percent in September 2002, whereas the 360-day loan interest rate dropped to 8,1 percent from 8,7 percent over the same period. The behaviour of these rates reflected the evolution of international interest rates (3-month Libor remained at 1,8 percent).

Graph 8
Nominal interest rates in foreign currency
(September 2001 - September 2002)



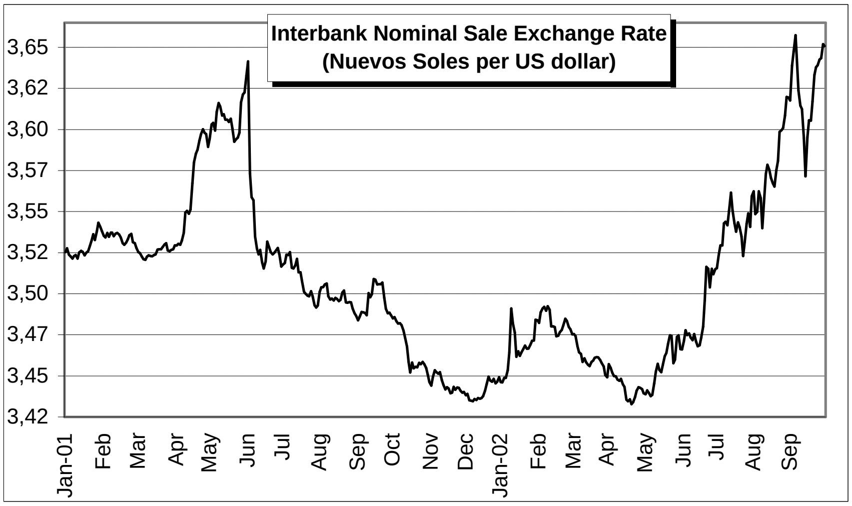
Exchange rate

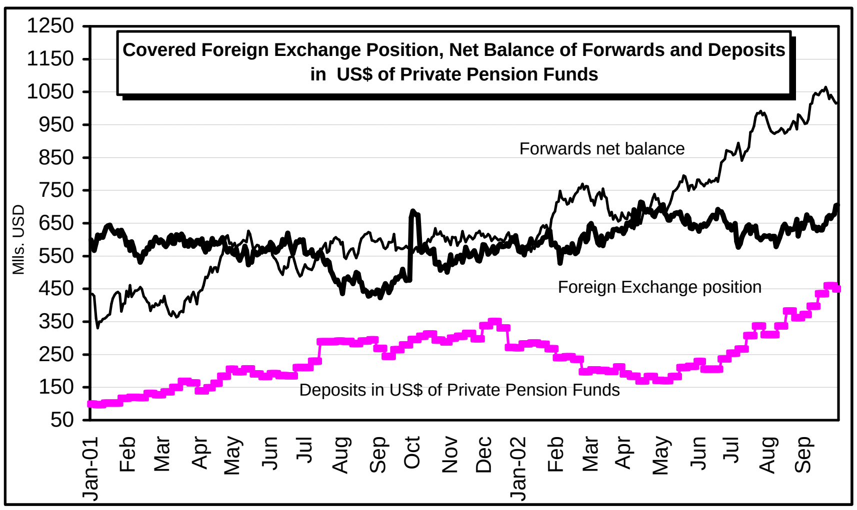
12. Between January and May 2002, the exchange rate recovered from the domestic currency appreciation in the fourth quarter of 2001. In May, the exchange rate rose and had a greater variability reaching the parity levels of the May-June 2001 period.

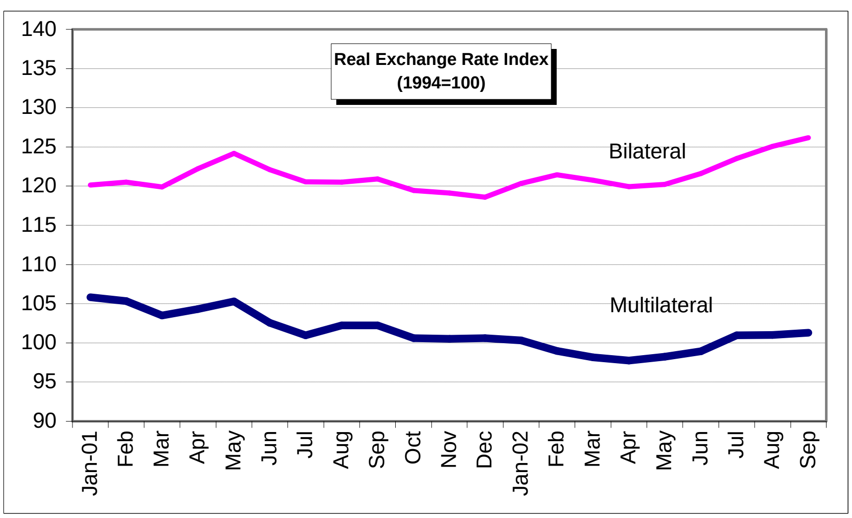
This behaviour accentuated between July and September, given the higher demand for foreign currency, in particular the portfolio recomposition of Pension Administration Funds to deposits in foreign currency, which increased by US$ 237 million, from US$ 212 million in March 2002 to US$ 449 million in September.

Likewise, regional factors linked to the world economic outlook, as well as political changes had influence in portfolio assessments, specially those related to global treasury decisions made at headquarters. The latter would give greater coverage of financial assets in the domestic market, as well as greater demand for foreign currency, also reflected in the increase of net sale balances of forwards (Graph 9), which passed from US$ 869 million as of end-June to US$ 1 017 million as of end-September. Over the same period, the net international position of the banks increased by US$ 60 million (from US$ 645 million to US$ 706 million).

Graph 9
EXCHANGE RATE INDICATORS
January 2001 - September 2002







Box 2
Foreign exchange intervention and Central Bank monetary management

- In order to meet the inflation target, the Central Bank sets a range for the average balance of banks' current account deposits at the Central Bank as well as the reference interest rates of Central Bank monetary operations, whereas the exchange rate is market determined (free floating). Monetary policy is designed to avoid inflationary or deflationary pressures.

- In exceptional situations, even in the absence of inflationary pressures, the Bank may modify banking liquidity and reference interest rates and intervene in the exchange market in order to smooth out sharp fluctuations in the exchange rate or avoid speculative bubbles that might compromise the normal development of financial markets or the real economy. In these circumstances the interest rate may temporarily abandon the reference interest rate corridor.

- The Central Bank determines the direction and magnitude of its operations (injection or withdrawal) in order to regulate the banks' liquidity level at the close of daily operations. This level can be affected through purchases or sales of foreign currency to the banks. Therefore, the Central Bank makes monetary operations in order to offset the effect on liquidity of foreign exchange operations.

- So far, the Central Bank has made only a few interventions in the foreign exchange market. In April, the Central Bank purchased foreign currency amounting to US$ 90 million, whereas in September, the Bank sold foreign currency totalling US$ 127 million. In both cases, Central Bank intervention was oriented to smooth out the volatility of the exchange rate.

- The Central Bank can make auctions of Readjustable Certificates of Deposit (CDR) in order to provide a domestic currency substitute of foreign currency liquidity, in particular when forward operations demand might alter the exchange market.

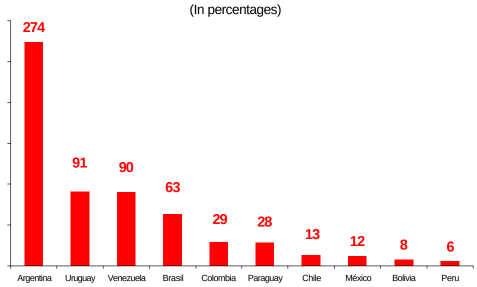
- In September, exchange rate intervention through the issuance of CDR (amounting to S/. 148 million), the direct sale of foreign currency and other monetary regulation tools offset the transitory imbalances in the forward market, smoothing the sharp fluctuations in the exchange rate. The imbalances resulted from the greater demand for foreign currency in the spot and forward markets. In that month, the current account balance was within the range announced by the Central Bank (S/. 175 million – S/. 195 million).

Box 3
Exchange rate evolution in Latin America

From January to September, the currencies of the region have been subject to devaluatory pressures at the same time that regional economies' sovereign risk increased. The Argentine crisis had a direct impact only on its main trade partners, between May and September, the whole region is exposed to political uncertainty and the high external debt burden of Brazil.

Paraguay, Bolivia and Uruguay, countries more integrated to the Argentine and Brazilian economies, were liable to bank runs and pressures on their currencies. Uruguay abandoned the exchange rate band system and set a schedule for deposit withdrawals in state-owned banks. In Bolivia, banking deposits stabilized once the new administration took office. Chile has been affected also by the fall in the price of copper and the increase in oil prices. The delay in the US economy recovery has also affected Mexico, which has strong trade ties with the US. Colombia and Venezuela are being impaired by domestic political or social factors.

Devaluation January – September: Latin America*
(In percentages)



* In end of period terms.

Spread of sovereign bonds: Latin America
Basis points

13. In a context of exchange rate variability recorded since end-August, on September 5, the US dollar reached a maximum of S/. 3,652. On August 28 and September 4, 5, 11 and 30, the Central Bank issued Readjustable Certificates of Deposits (CDR) amounting to S/. 218 million, with a 6-month maturity. On the other hand, the Central Bank sold foreign currency in the spot market by US$ 127 million. Other regulatory measures were taken on window facilities in order to manage liquidity requirements and a Protocol of surveillance and execution was activated (see Box 2).

As of end-September, last 12 month devaluation amounted to 6 percent, the lowest in the region (see Box 3).

14. Banking deposits increased 1,6 percent in domestic currency and 4,2 percent in foreign currency in the third quarter of 2002, despite the volatility in foreign exchange and monetary markets as of end-August and September.

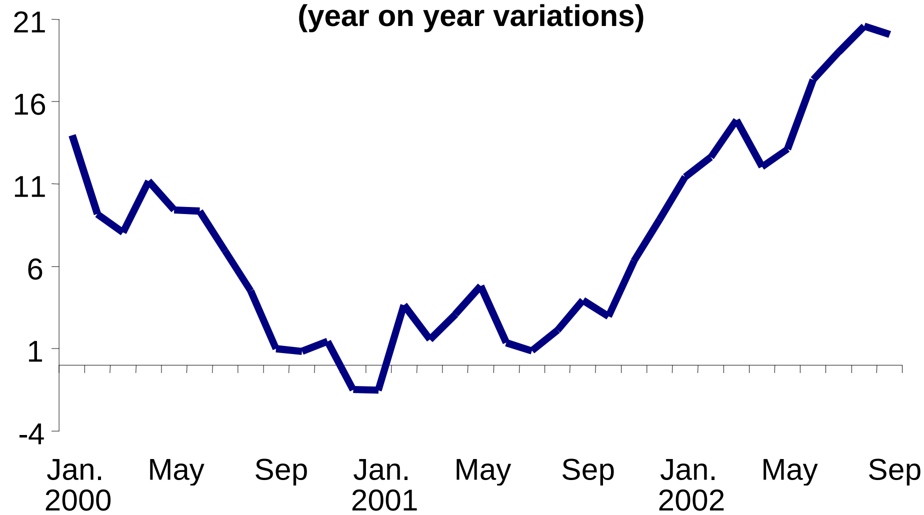
15. In the year, the bilateral real exchange rate increased 6,5 percent, due to a nominal depreciation of 5 percent and the difference between domestic and US inflation (1,2 and 2,4 percent, respectively).

    The multilateral exchange rate increased 0,7 percent, reflecting the nominal depreciation of our main trade partners' currencies against the US dollar.

Monetary aggregates

16. The rate of growth of the average balance of the monetary base increased from 6 percent in November 2001 to 20 percent in September 2002. This increment obeys to the reduction in interest rates as well as the recovery in economic activity. The opportunity cost of cash holdings decreased since savings deposit interest rates contracted from 3,0 percent in December 2001 to 1,7 percent in September 2002.

Graph 10
Monetary base
(year on year variations)



17. Taking into account monetary base levels between January and September, this year monetary base would increase 15 percent, above the projection made in the June Inflation Report (12,5 percent). The new forecast considers a nominal GDP growth of 3,9 percent (real increase of 3,7 percent), a velocity of circulation lower by 11 percent and a greater banking multiplier, by 1,7 percent.

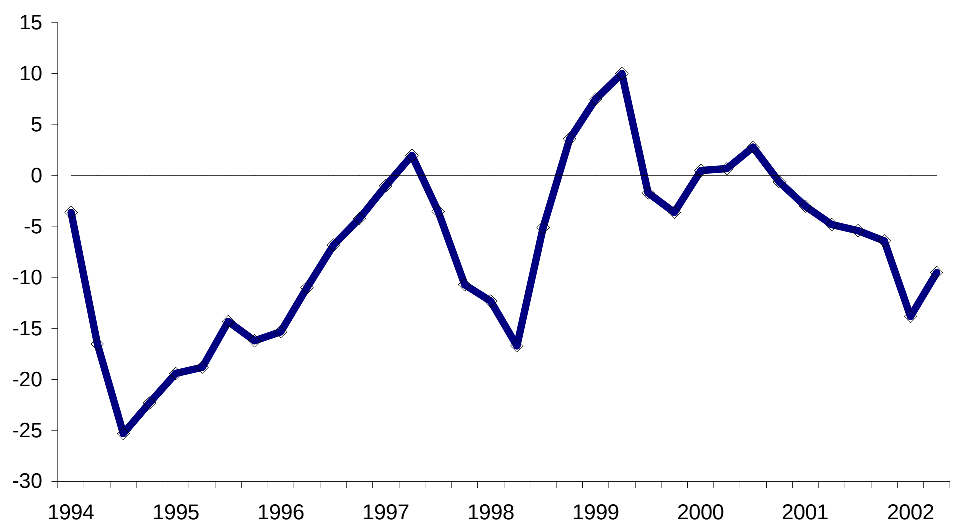
Table 5
Determinants of the monetary base average growth in 2002 1/

	Factors	Forecast variation		Comments
		June revision	October revision	
A	Nominal GDP	4,5	3,9	The assumption of economic activity holds, but the forecast concerning the average percentage change of prices is reduced.
B	Velocity of circulation	-9,6	-11,2	Higher demand for soles in a context of greater stability in foreign exchange and financial markets.
C	Banking multiplier	2,7	1,7	The lesser growth of the banking multiplier is due to higher cash preferences, reflecting the reduction of interest rates.
D	Monetary base	12,5	15,0	Higher growth because of the difference in the evolution of determinants of the monetary base compared with initial assumptions.

1/ $$D = 100 \cdot \left(\frac{\left(1 + \frac{A}{100}\right)}{\left(1 + \frac{B}{100}\right) \cdot \left(1 + \frac{C}{100}\right)} - 1 \right)$$

18. The velocity of circulation of domestic currency fell 12 percent in the first half of 2002, compared with the same period a year ago. This pattern has not been recorded since the first semester of 1998. This year, velocity of circulation would decreased 11 percent.

Graph 11
Velocity of circulation of liquidity in domestic currency
(Annualized quarterly variation)



1/ The negative sign indicates that growth of demand for domestic currency exceeds that of the nominal GDP.

Possible scenarios

19. The range announced by the Central Bank, within the Inflation targeting scheme has properties that contribute to monetary policy transparency and to lower uncertainty.

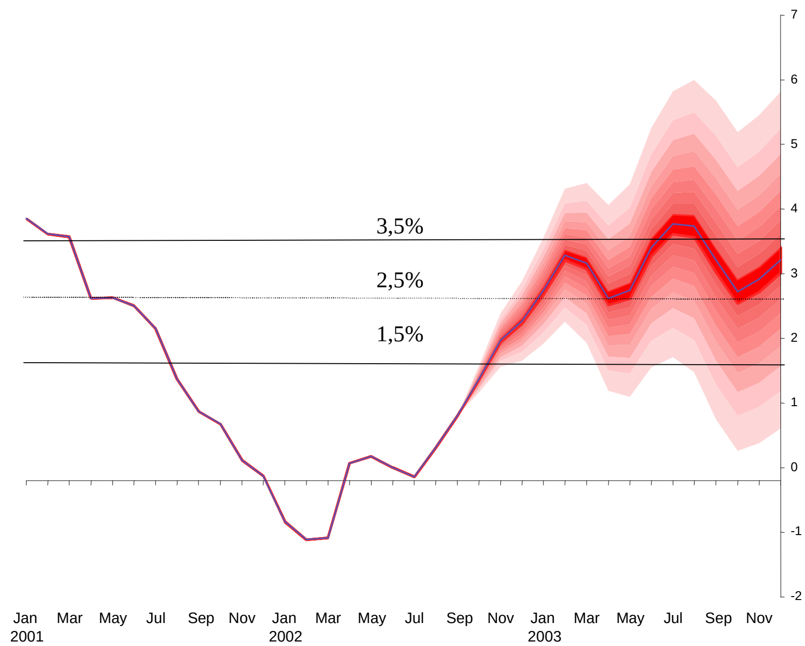
    - Presents Central Bank's outlook, considering the current monetary policy stance.
    - Suggests how monetary policy will be applied, by considering forecasts, scenarios and inflation target ranges.
    - Presents the risks implicit in the forecast and probability scenarios.
    - Makes an inflation forecast based on models used by the monetary authority.
    - The forecast assumes current monetary policy stance. Thus, short-term interest rates are constant in the projection.
    - Takes into account the lagged effects of monetary policy actions on inflation.
    - It shows the relevant period considering the lags of monetary policy.

20. By the end of 2002, according to the BCRP's forecast, the rate of inflation will be within the range announced, between 1,5 to 3,5 percent; the actual target is 2,5 percent.

21. The darkest band of Graph 12 refers to the most likely outcome in 2003, assuming that the monetary policy stance set by the Board of the Central Bank is the same until the end of 2003. Each successive band covers an additional 10 percent until 90 percent of probability distribution is covered by the shaded area. The bands widen as the forecast horizon lengthens, reflecting the higher uncertainty in predicting inflation over time.

    The fan chart illustrates the likely scenarios under the hypothesis that the current monetary stance holds over the next four to six quarters, over which monetary policy actions are channelled to prices.

Graph 12
Inflation forecasts
(% variation over last 12 months)

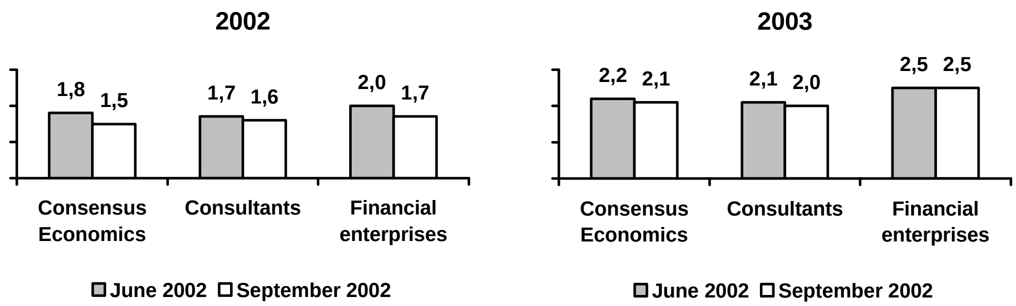


22. The inflation forecast presented above incorporates the greater volatility of the financial and exchange markets recorded in August and September.

    It should be noted that the pass through coefficient (the impact of a 1 percent increase in the exchange rate on prices) is relatively small, 0,12 percent.

23. The result of the monthly survey of macroeconomic expectations applied to consultants foresees a 2002 inflation of 1,6 percent and a 2003 inflation of 2,0 percent. The survey made among financial enterprises points out a 1,7 percent inflation in 2002 and 2,5 percent in 2003. The Consensus Economics, a compilation of private consultants and investment banks forecasts, reveals that inflation would be 1,5 percent in 2002 and 2,2 percent in 2003. It should be noted that all these forecasts fall within the range of target inflation announced by the Central Reserve Bank.

Graph 13
Inflation expectations



III Economic Activity

24. Gross domestic product grew 4,2 percent compared with the first half of the year. Primary sectors grew 8,2 percent whereas non-primary sectors expanded 3,2 percent.

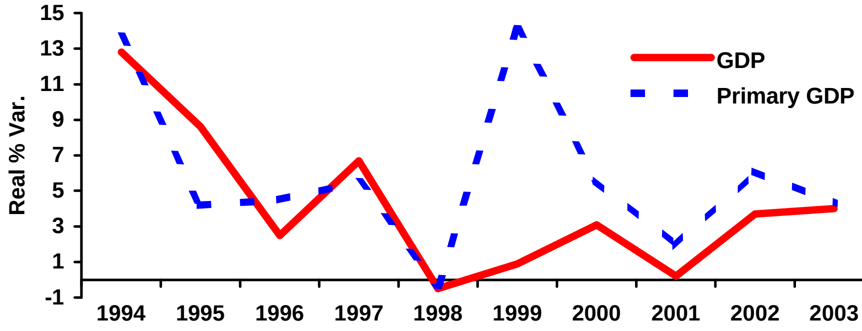
The greater activity in primary sectors was mainly due to good performance in agriculture and mining. The former was explained by the early harvesting of some products as well as better weather conditions; the latter obeyed to the higher production of copper, zinc and silver in Antamina; and gold by Yanacocha, Buenaventura and Barrick Misquichilca.

The performance of the non primary sector was in turn due to the upsurge in construction as well as the growth in processed foodstuffs, beverages and tobacco, chemical products, rubber and plastics and paper products.

Table 6
Gross Domestic Product
(Rates of growth)

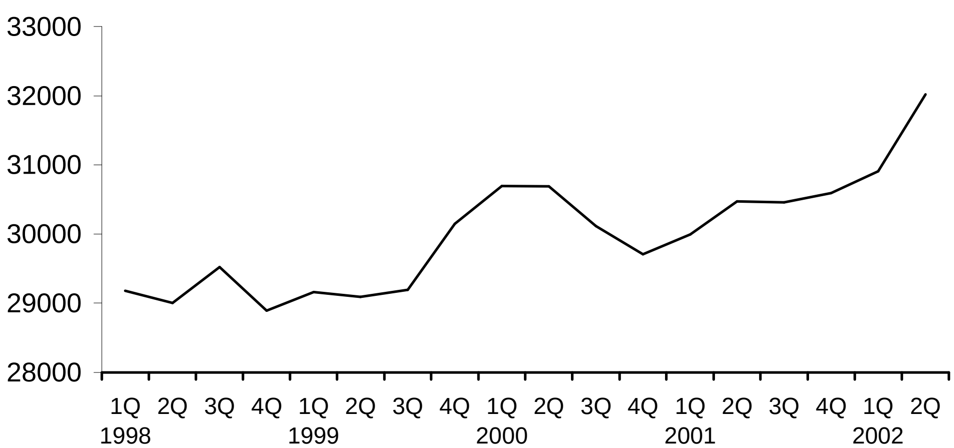
	2001	2002		2003
		I Sem.	Year	
Agriculture and Livestock	-0,6	6,4	4,3	3,4
Fishing	-13,3	-8,3	-0,8	5,5
Mining and Fuels	11,2	20,9	12,9	4,9
Manufacturing	-1,1	1,9	2,8	3,9
Construction	-6,0	8,9	7,1	4,2
Commerce	0,0	2,1	2,4	3,3
Other services	0,4	3,0	2,8	3,1
GDP	**0,2**	**4,2**	**3,7**	**3,5 - 4,0**
Primary GDP	1,9	8,2	6,1	4,3
Non-primary GDP	-0,2	3,2	3,1	3,3

Graph 14
GDP and primary GDP



25. Seasonally adjusted GDP recorded again a growth in the second quarter, because of the economic recovery.

Graph 15
Seasonally adjusted GDP (1998.I-2002.II)
(Millions of nuevos soles at 1994 prices)



26. Domestic demand for goods and services grew 2,6 percent in the first semester of 2002, confirming the up going trend observed since the second semester of 2001. The components that drive the growth of domestic demand are private consumption (3,5 percent) and public consumption (4,2 percent). The former is related to the 2,8 percent increase in disposable income, whereas the latter to wage and pension rises.

It should be noted that public and private investment are recording lower rates of decline than in 2001, but have not yet reached at the levels of the previous year.

27. External demand for goods and services grew 8,6 percent in real terms in the first half of the year, thanks to the mining operations of Antamina (copper and zinc) in the second half of 2001, which increased mining and fuel output 20,9 percent in the first half of 2002. Antamina would account for 1 percentage point of 2002 GDP growth.

Table 7
Global demand and supply
(Rates of growth)

		2002		
	2001	**I Sem.**	**Year**	**2003**
I. GLOBAL DEMAND (1 + 2)	**0,4**	**3,5**	**3,6**	**3,6**
1. Domestic demand	-0,7	2,6	3,3	3,1
a. Private consumption	1,3	3,5	3,6	3,1
b. Public consumption	-0,5	4,2	3,3	0,2
c. Gross domestic investment	-8,0	-1,4	1,7	4,3
- Private	-5,6	-3,0	1,0	4,5
- Public	-19,0	-7,8	-2,3	6,4
2. Exports	6,9	8,6	5,6	6,4
II. GLOBAL SUPPLY (3 + 4)	**0,4**	**3,5**	**3,6**	**3,6**
3. Gross domestic product	**0,2**	**4,2**	**3,7**	**3,5 - 4,0**
4. Imports	1,6	-0,8	3,3	4,2

Table 8
National Disposable Income
(Rates of growth)

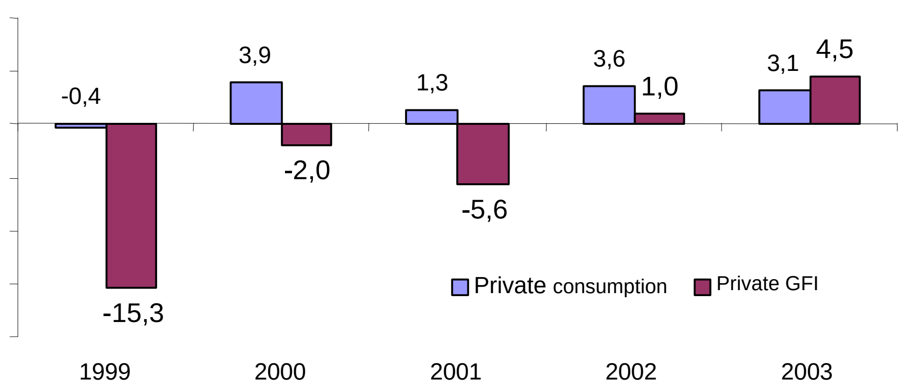
	2001	**2002**		**2003**
		I Sem.	**Year**	
I. Gross domestic product (GDP)	**0,2**	**4,2**	**3,7**	**3,5 - 4,0**
II. Gross national product (GNP) 1/	0,9	3,9	3,1	3,1
III. Gross national income (GNI) 2/	-0,2	3,1	3,5	3,4
IV. Disposable national income (DNI) 3/	**-0,2**	**2,8**	**3,2**	**3,4**

1/ Excludes investment income of residents' production factors from GDP.
2/ Excludes terms of trade effect from GNP.
3/ Includes current transfers received from non-residents.

28. The rate of growth of GDP forecast for 2002 is 3,7 percent and 3,5-4,0 percent in 2003. Domestic demand would increase 3,3 and 3,1 percent in these years. On the other hand, private investment growth would be 1,0 and 4,5 percent in 2002 and 2003, respectively, so that total investment as a percentage of GDP would pass from 17,8 percent in 2002 to 18,1 percent in 2003.

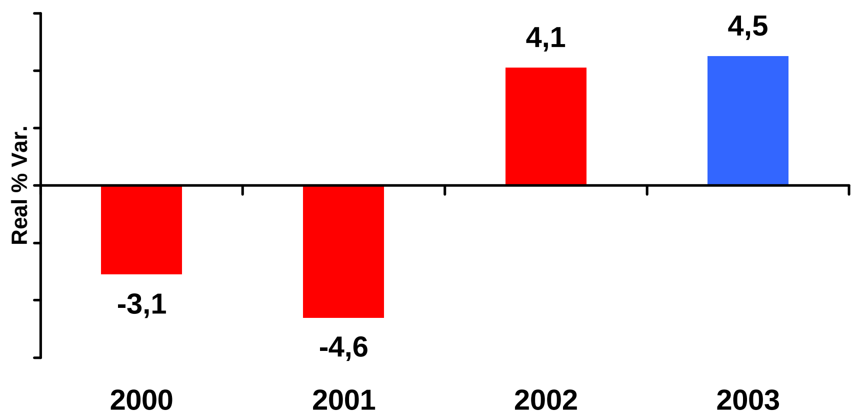
Graph 16
GDP and domestic demand
(Rates of growth)

Graph 17
Private investment and consumption
(Rates of growth)

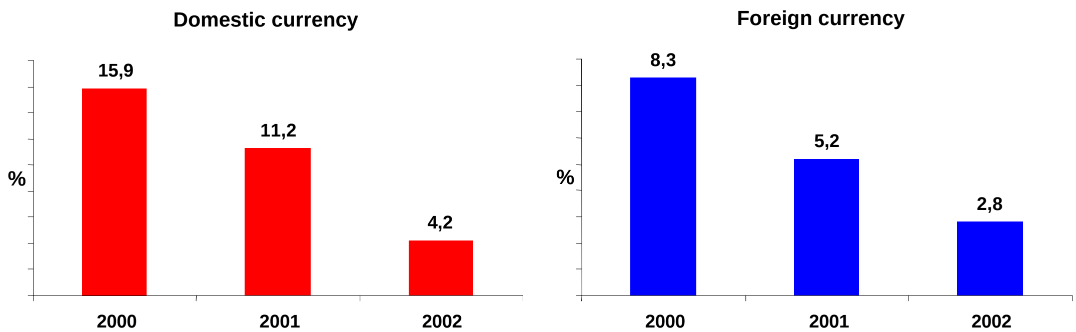


29. Domestic demand will be backed by the expansion of credit to the private sector. Interest rates will be lower than in the previous two years, in particular corporate prime interest rates in domestic currency, which have declined from 12 percent in 2001 to 4 percent as of September 2002. Credit to the private sector started to grow and an increase of 4,5 percent in 2003 is forecasted.

Graph 18
Credit to the private sector



Graph 19
Corporate prime interest rate



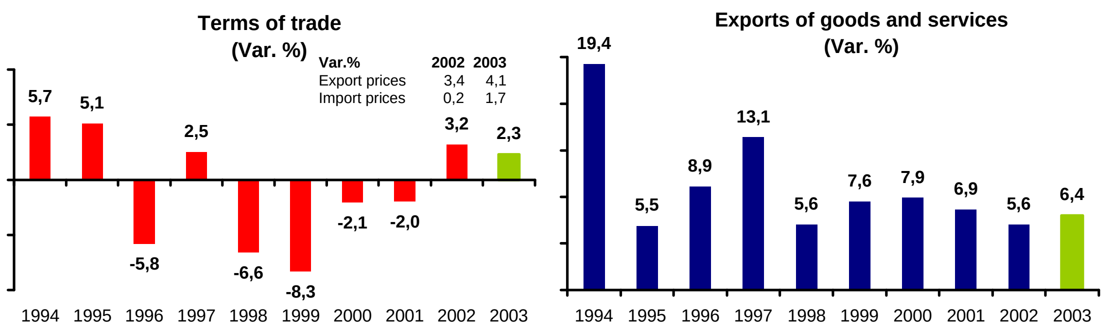
30. Exports would record a real increase of 6,4 percent in 2003, considering higher volumes of copper (12 percent) and zinc (7 percent) and higher values of non-traditional exports (15 percent).

The foreseen growth of copper shipments in 2003 is due to the start of operations of the new oxidation plant belonging BHP Billiton Tintaya, as well as the restarting of its mine operations, halted in early 2002. The increase in the export volume of zinc reflects the restarting of some mining units stopped in 2002.

31. The improvement in exports would be also due to the recovery of terms of trade; 3,2 percent in 2002 and 2,3 percent in 2003, after four consecutive years of decline. The most dynamic products would be fishmeal and fish oil, given the lower supply of these commodities, as well as gold and silver, because of their reserve assets attributes in a more hazardous world (potential terrorist attacks and wars) and a discouraging world economic activity.

In 2003, it is expected that world demand will have a positive impact on the international prices of metals such as copper, which is currently affected by the high stocks in world markets, and zinc, where cutbacks in production have not fully compensated the contraction of world demand. Also, raises in gold and silver prices are expected because of greater demand for precious metals.

Graph 20
Export prices and volumes



32. The recent extension of the ATPDEA until 2006 widens the items subject to trade preference such as garments, which were formerly affected by tariffs up to 20 percent and now will be duty free. Exports of textiles could pass from US$ 300 million in 2001 to US$ 900 million in 2006, a 200 percent increase over this period. In 2003, 15 percent of the forecast growth will come from non-traditional exports, of which 6 percentage points (US$ 140 million) correspond to the effect of the ATPDEA.

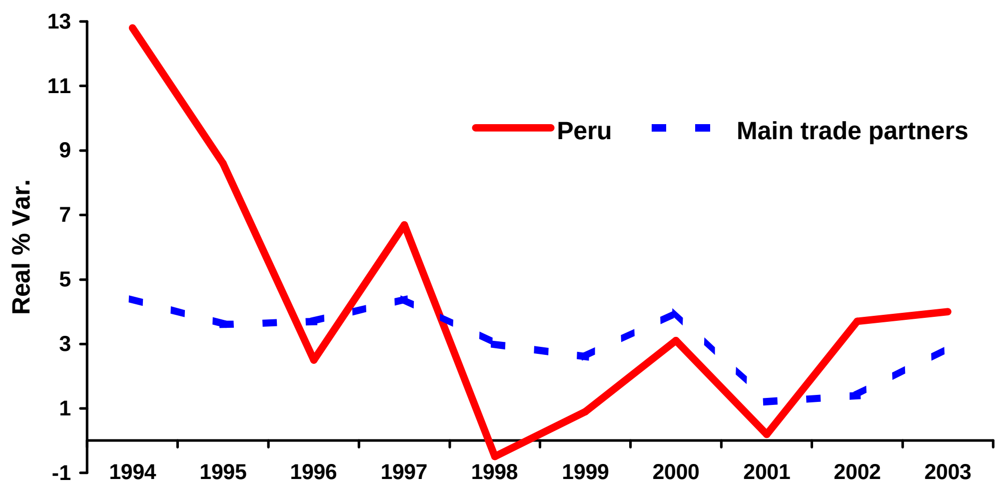
33. World economic expansion will favor also our economic recovery. According to the latest IMF forecasts, published in September, our main trade partners' average economic growth will go from 1,4 percent in 2002 to 2,9 percent in 2003.

Table 9
Forecast of Peru's main trade partners' economic growth [1/]
(In percentages)

	Share in Peruvian foreign trade *	2001	September forecast 2002	September forecast 2003
Main trade partners average	**100**	**1,2**	**1,4**	**2,9**
North America	39	0,3	2,2	2,7
of which United States	*34*	*0,3*	*2,2*	*2,6*
Europe	24	1,6	1,3	2,3
Asia	16	2,6	3,0	4,3
Latin America	22	1,4	-1,3	2,8
Note:				
World growth		2,2	2,8	3,7

* Weight calculated according to 2001 figures (excluding oil).
1/ Source: World Economic Outlook IMF (September)

Graph 21
GDP growth: Peru and main trade partners



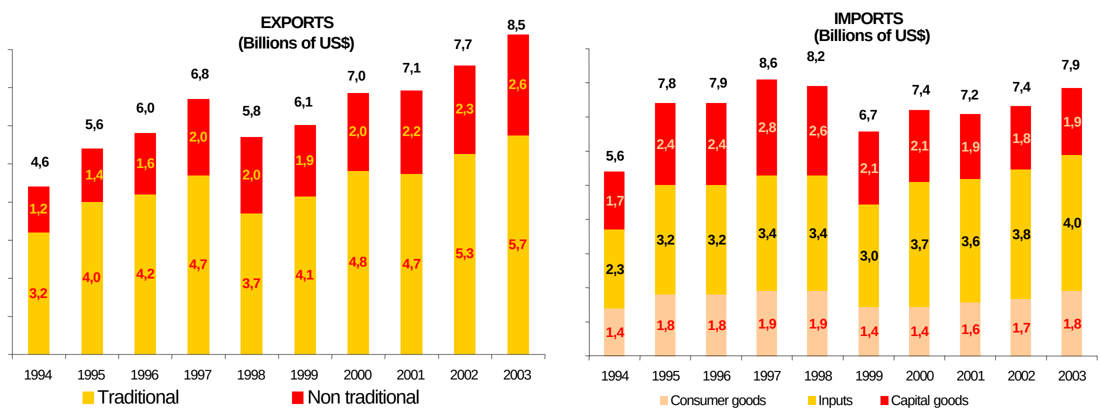
IV Balance of Payments

34. In the first semester, the trade balance recorded a US$ 58 million surplus. In 2002, the surplus would reach US$ 290 million, thanks to a 9 percent increase in exports, and only a 3 percent increase in imports.

Table 10
Trade balance
(Million of US$)

	2001	2002		2003
		I Sem.	Year	
1. EXPORTS	**7 108**	**3 558**	**7 713**	**8 545**
Traditional products	4 743	2 447	5 270	5 746
Non-traditional products	2 181	1 057	2 310	2 648
Other	184	54	134	151
2. IMPORTS	**7 198**	**3 500**	**7 423**	**7 871**
Consumer goods	1 567	809	1 688	1 814
Intermediate goods	3 607	1 777	3 796	3 992
Capital goods	1 911	873	1 845	1 928
Other	113	41	94	138
3. TRADE BALANCE	**-90**	**58**	**290**	**674**

Graph 22 [1/]



1/ Excludes other exports and other imports from the total.

35. In 2002, a current account deficit is estimated at US$ 1 239 million (equivalent to 2,2 percent of GDP). The cumulative deficit of the current account in the first semester was US$ 641 million (2,2 percent of GDP), down US$ 135 million from the same period a year ago.

Net international reserves would record a US$ 1 250 million increase in 2002 to a end-of-year balance of US$ 9 863 million.

The financial requirement of the balance of payments in 2002 would amount to US$ 4 382 million: US$ 2 336 million from the private sector and US$ 2 046 million from the non-financial public sector; which will be funded with private sector capital flows (US$ 2 336 million) and external debt disbursements (US$ 2 046 million). In 2002, external financing will be oriented mainly to the mining sector and Camisea (totalling US$ 665 million), Backus (US$ 657 million), Tim Perú (US$ 190 million) and a bank, Wiese-Sudameris (US$ 150 million).

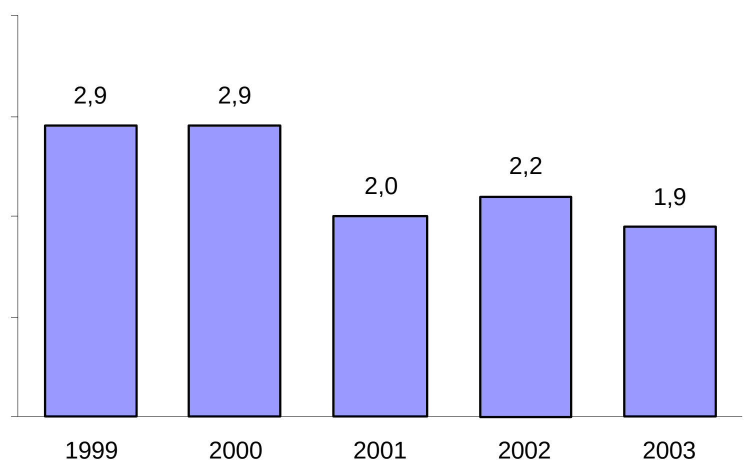
36. In 2003, the current account will record a US$ 1 119 million deficit (1,9 percent of GDP), down US$ 120 million from 2002. The trade balance would record a US$ 674 million surplus, US$ 384 million higher than the previous year due to a 11 percent increase in exports (4,1 percent thanks to higher export prices) that exceed the increase in imports (6 percent). Similarly, in 2003 financial resources to the private sector will be oriented mainly to the mining sector and Camisea gas project (US$ 872 million).

Table 11
Balance of payments
(Million of US$)

	2001	**2002**		**2003**
		I Sem	**Year**	
1. Current account	-1 094	-641	-1 239	-1 119
(% of GDP)	*-2,0*	*-2,2*	*-2,2*	*-1,9*
2. Amortization	1 797	979	1 893	1 933
a. Non-financial public sector[1/]	*768*	*432*	*937*	*1 074*
b. Private sector	*1 029*	*547*	*956*	*859*
3. NIR accumulation	433	513	1 250	70
4. Financing requirements (=-1+2+3)	**3 324**	**2 133**	**4 382**	**3 122**
a. Non-financial public sector[1/]	*1 351*	*910*	*2 046*	*1 827*
b. Private sector	*1 973*	*1 223*	*2 336*	*1 295*

1/ Excludes the debt swap of February 2002.

Graph 23
Current account deficit
(Percentage of GDP)



37. External accounts are supported by an adequate level of net international reserves, which are 1,9 times the volume of short-term liabilities. The debt-to-GDP ratio remains at 51 percent; outstanding external debt service, relative to exports of goods and services is also stable at 35 percent.

Table 12
External vulnerability indicators

	2001	2002	2003
Balance of Central Bank net international reserves (NIR) (Millions of US$)	8 613	9 863	9 933
NIR / debt due within a year (number of times) 1/	1,5	1,9	1,9
NIR (months of imports of goods)	14	16	15
Total external debt as a % of GDP	51	51	51
Total external debt / exports of goods and services (number of times)	3,2	3,1	2,9
Public external debt as a % of GDP	35	37	37
Public external debt / exports of goods and services (number of times)	2,2	2,2	2,1
Total external debt service (% of exports of goods and services) 2/	39	35	35
Public external debt service (% of exports of goods and services) 2/	24	22	23

1/ Short-term debt plus amortization of medium and long term debt due in the next 12 months.

2/ In 2002 excludes the debt swap operation.

V Public Finances

38. During the second quarter of 2002, the overall deficit of the Non-Financial Public Sector amounted to 1,7 percent of GDP and 1,5 percent in the first semester of the year, levels consistent with the targets of the Economic Program. Financing requirements of the public sector amounted to US$ 920 million, covered by the domestic issuance of bonds (US$ 185 million), external disbursements (US$ 910 million) and privatisation receipts (US$ 118 million), increasing the deposits of the public sector in US$ 293 million.

Table 13
Non Financial Public Sector

		2001	2002		2003
			I Sem.	Year	
	Percentage of GDP				
I.	Current revenues	14,1	13,5	14,4	14,7
	of which: Tax revenues[1/]	*12*	*11,6*	*11,9*	*12,6*
II	Non-financial expenditure	-14,9	-13,5	-14,8	-14,5
III.	Other public entities	0,5	0,5	0,2	0,3
IV.	Interest	-2,2	-2,0	-2,1	-2,4
OVERALL BALANCE (I+II+III+IV)		**-2,5**	**-1,5**	**-2,3**	**-1,9**
	Million of US$				
I.	**Overall balance**	-1 276	-418	-1 283	-1 118
II.	**Amortization** [2/]	-896	-502	-1 060	-1 432
III.	**Financing requirement**	**2 172**	**920**	**2 343**	**2 550**
	- External financing	1 318	910	2 011	1 800
	- Domestic financing [3/]	854	10	333	750

[1/] Excludes the Extraordinary Tax on State Asset
[2/] Includes domestic and external amortization.
[3/] Includes private sector share.

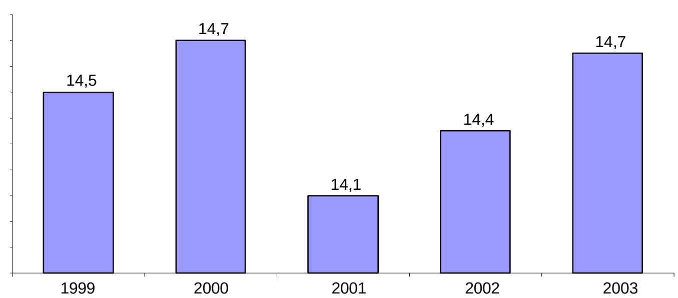
39. In the second quarter, the Central Government's current revenue recovered to 13,7 percent of GDP, similar to the same period in 2001, despite the average tariff reduction and a lower Extraordinary Solidarity Tax rate. In the first semester, central government revenues amounted to 13,5 percent of GDP, down 2 percentage points from the same period a year ago.

40. Non-financial expenditure was equivalent to 13,6 percent of GDP, down 1 percent in real terms from the second quarter in 2001. In the first semester, non-financial expenditure amounted to 13,5 percent of GDP reflecting the increase in wages and pensions granted to public sector workers in September 2001, partially offset by the cutback in capital expenditure (9 percent).

41. In the second semester of 2002, revenues will revive as a consequence of the implementation of tax measures oriented to improve VAT collection as well as the readjustment in the excise tax on fuel and beer, and one-time only revenues from the Antamina forfeit and the capital earning tax from the Backus transaction. Therefore, current revenues should amount to 14,4 percent of GDP.

In 2003, Central Government's revenue would be equivalent to 14,7 percent of GDP, due to tax measures implemented in August 2002, such as the system of retention and detraction of VAT, a new collection system on fuel VAT, oriented to fight inefficient regulation in this market, and retention and collection of VAT on public sector purchases. Besides, a third income tax collection system, regarding the cash in advance payment of income tax calculated as 1 percent of the value of enterprise's net assets, which is expected to have an important effect on tax collection and the decrease of tax evasion.

Graph 24
Central Government current revenues
(Percentage of GDP)

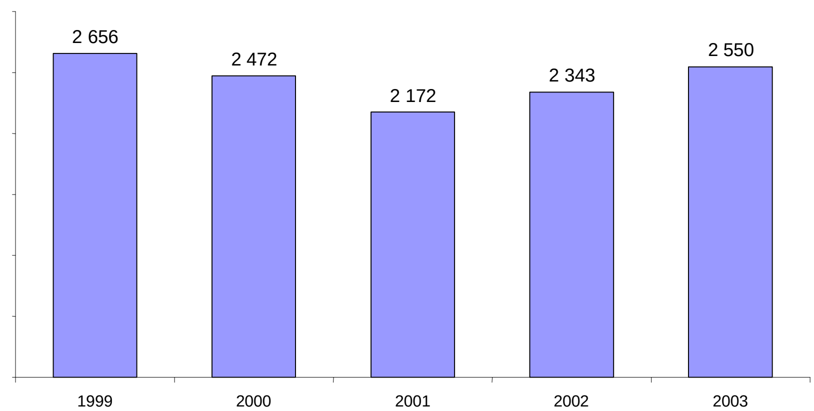


42. Non-financial expenditure will amount to S/. 29,1 billion in 2002 (a real increase of 2 percent), of which S/. 24,8 billion will be current expenditure (real increase of 2 percent) and S/. 4,3 billion to capital expenditure (a real contraction of 4 percent). In 2003, Central Government Non-Financial Public Sector will grow 1,7 percent in real terms, according to budget projections.

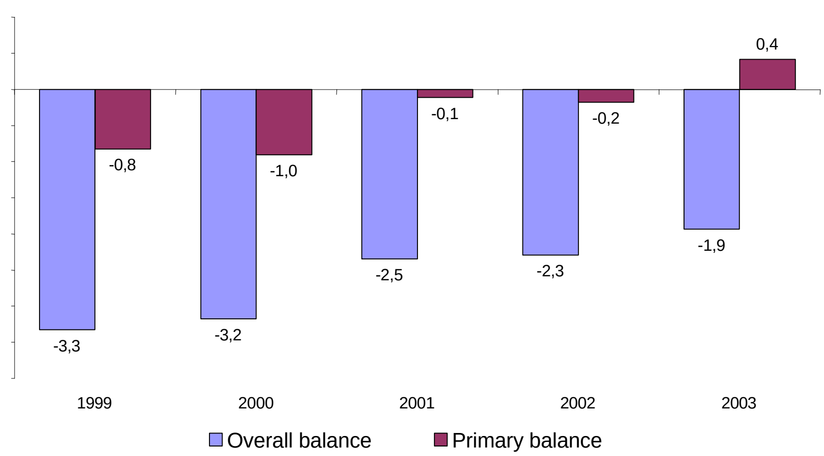
43. The overall deficit in 2002 would come to 2,3 percent of GDP. The public sector borrowing requirement will amount to US$ 2 343 million, of which US$ 1 990 million will come from external disbursements, including the issuance of bonds by US$ 500 million in external markets in the fourth quarter; an amount equivalent to US$ 268 million of domestic bonds and privatisation receipts, among other sources of financing.

In 2003, the public deficit will be equivalent to 1,9 percent of GDP. The public sector borrowing requirement will increase to US$ 2 550 million, reflecting the higher external debt amortization. Financing might come from external debt disbursements (US$ 1 800 million), domestic bonds and receipts from the investment promotion process. It should be noted that external disbursements include resources oriented to project financing, free disposal loans and issuances of sovereign bonds.

Graph 25
Public sector gross borrowing requirements
(Million of US$)



Graph 26
Non financial public sector operations
(Percentage of GDP)



VI Balance of Risks and Opportunities

44. The revision of economic indicators as of the first half of the year and the assessment of macroeconomic perspectives allow us to foresee that in 2002 inflation will fall within the target range. However, some risks must be taken into account in the design of monetary policy in order to avoid deviations from the target.

- US economic recovery is still dubious, considering the uncertainty of the effects of financial asset prices on private expenditure. Thus, a sluggish world economic activity would have a negative impact on export volumes and prices, whereas foreign investment and capital inflows would decline.
- The decline of capital inflows to the region could be greater, which may induce some regional currencies to devalue. Therefore, an adequate level of international reserves as well as a solid fiscal stance are key in reducing contagion risks.
- A military conflict in the Middle East would jeopardize the supply and the international price of oil, affecting not only world economic activity (lowering our exports), but also exerting pressure on domestic prices.
- In the domestic front, the impact of the "El Niño" phenomenon could be greater than expected, affecting the domestic supply of goods and services and exerting transitory pressures on prices. Moreover, the government would need additional financing to cope with this emergency.
- A greater uncertainty on economic legislation and the financing of fiscal accounts would create a negative environment for investment, compromising the current favourable trend in economic activity.
- Finally, delay in the development of fixed income markets would magnify the impact of transitory fiscal requirements and halt the efforts to reduce the degree of financial dollarization.

45. The gradual recovery in economic activity in the second semester as well as financial and monetary stability have differentiated the Peruvian economy from other volatile economies in the region. Differentiation is a key element that reflects not only our solid level of international reserves, but also promising aspects of our economic future, which in turn could improve the forecasts presented here. Some of these aspects are:

- New investments in those sectors favoured by the ATPDEA, in particular textiles and agriculture.
- A faster execution of mining projects, anticipating an increase in international prices.
- An upturn in tourism projects, reflecting the increasing risks in other destinations.

- The development of a sound environment in the newly created regions that promote investment.
- Definition and development of new investment projects as well as concession of infrastructure and utilities.
- In the external front, a new age of synchronized economic growth in world economies.

VII Final Remarks

46. The monetary policy management embedded in an Inflation Targeting Scheme has contributed to revert the deflationary pressures in our economy, without compromising future monetary stability.

47. In 2002, exogenous factors have had different impacts on domestic inflation. On one hand, favorable weather conditions and greater production were domestic determinants in the fall of foodstuffs prices. On the other hand, external factors such as the increase in the international price of oil and some agriculture products, such as wheat, exerted pressures on domestic prices. Finally, the regional uncertainty and devaluation of Latin American currencies had a limited impact on our inflation, since the pass through coefficient is relatively small.

48. This inflation report contains Central Bank's forecasts which show that 2003 inflation will be within the target range (2,5 percent ± 1 point margin). Economic activity and domestic demand indicators show a sustained economic recovery, albeit moderate in 2002 and 2003, which is consistent with a current account deficit of 2 percent of GDP. Further, the good performance in exports should be noted, supporting production and a trade surplus for the second year in a row.

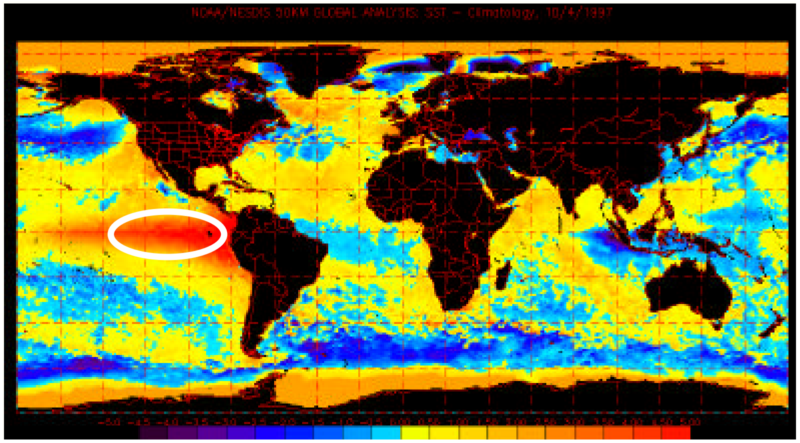
49. The "El Niño" phenomenon could severely affect economic activity. However, current projections point out that this phenomenon would be weak or moderate, and not as strong as that in 1997.

50. Recent regional experiences of monetary and exchange market turmoil, in particular in the electoral period in Brazil ratifies the strong financial soundness of the Peruvian economy. Central Bank actions were oriented to smoothen exchange rate volatility, so that the interbank interest rate moved near the corridor defined by monetary policy reference interest rates.

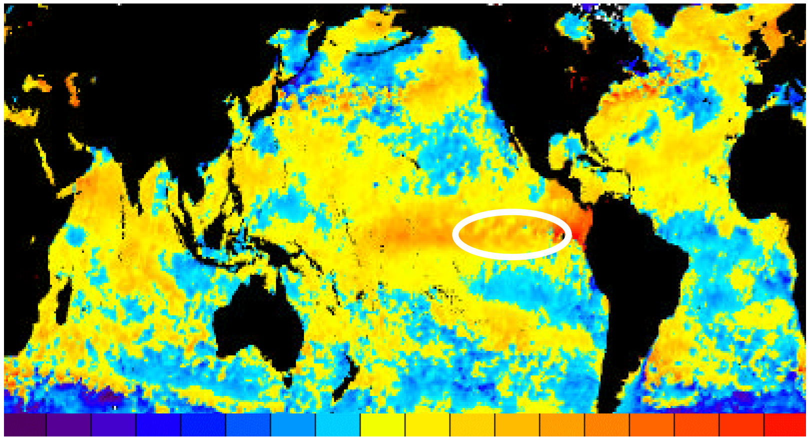
    Considering the current levels: 3 percent for overnight deposits and 4,75 percent for window liquidity contingency facilities at the Central Bank, it is expected that the range target for domestic inflation will be met. If inflation should deviate from its target, the Central Bank would take actions already foreseen.

Graph 27
Sea temperature

October 1997



October 2002



Weak to moderate El Niño

Source: National Oceanographic and Atmospheric Agency (NOAA)

Annex

Main differences among January Monetary Program and June and September Report forecasts

	2001	2002			2003	
		Monetary Program (January)	**June Report**	**September Report**	**June Report**	**September Report**
				Real % Var.		
1. Gross domestic product	0,2	3,5	3,7	3,7	4,0	3,5
2. Domestic demand	-0,7	3,4	3,4	3,3	4,4	3,1
3. Private consumption	1,3	2,8	3,3	3,6	4,0	3,1
4. Gross fixed investment (private)	-5,6	4,9	4,2	1,0	8,5	4,0
5. Exports of goods and services	6,9	6,0	5,6	5,6	4,0	6,4
6. Main trade partners' economic growth	1,6	1,6	2,0	1,4	3,4	2,9
				% Var.		
7. Annual inflation	-0,1	2,5	2,0	2,0	2,5	2,5
8. Nominal cumulative devaluation	-2,4	2,5	2,6	4,5	2,0	2,0
9. Real cumulative devaluation (multilateral)	-4,3	2,6	-0,4	1,8	0,5	0,5
10. Terms of trade	-2,0	1,2	4,6	3,2	2,4	2,3
				% of GDP		
11. Current account of the balance of payments	-2,0	-2,4	-2,0	-2,2	-2,2	-1,9
12. Private capital flow, excluding privatization	3,2	2,9	2,6	3,6	2,2	1,6
13. Public sector primary balance	-0,3	-0,2	-0,2	-0,2	0,4	0,4
14. Public sector overall balance	-2,5	-2,2	-2,2	-2,3	-1,7	-1,9
15. Central government tax collections [1/]	12,0	11,9	12,0	11,9	12,5	12,5
				Nominal % Var.		
16. Central Government non financial expenditure	-2,3	5,8	2,7	2,8	4,6	3,9
17. Monetary base	3,2	7,0	12,5	15,0	7,0	8,0
18. Credit to the private sector	-4,6	7,5	6,0	4,1	9,0	4,5

[1/] Exclude the Extraordinary Tax on State Asset