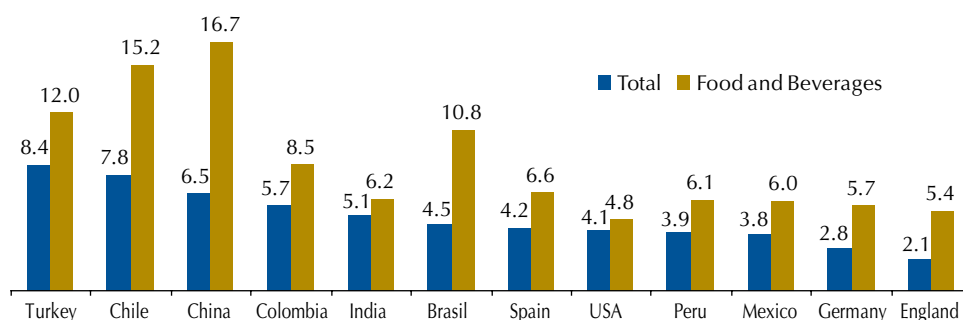


Macroeconomic Environment

In 2007 economic activity in Peru continued to show a robust growth mainly due to the dynamic performance of domestic demand, particularly private consumption and private investment, in a context of positive business and consumer expectations and surpluses in both the fiscal accounts and in the current account of the balance of payments.

In contrast, the external scenario was characterized by increased uncertainty in international financial markets as a result of the mortgage crisis in the United States and the price rises in foodstuffs and petroleum which, together with a greater weakening of the dollar, generated strong inflationary pressures worldwide.

GRAPH 1
Overall inflation and food and beverage inflation in December 2007
 (Las 12-month percentage change)



Data on inflation in China and Germany refers only to food.
 Source: Bloomberg.

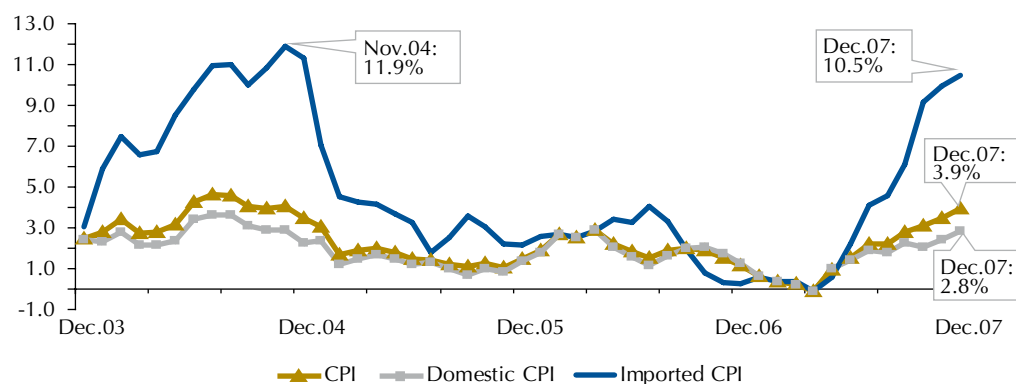
These external factors had a strong impact on domestic inflation –measured by the Consumer Price Index (CPI) of Lima Metropolitana– which reached 3.9 percent in 2007, the highest inflation rate observed in the country since 1998.

It is worth pointing out that Peru recorded the third lowest inflation rate in Latin America after Ecuador (2.7 percent) and Mexico (3.8 percent), and that Chile, China, Taiwan, United States, Singapore and Japan showed in 2007 the highest inflation rates of the last ten years, while inflation in the Eurozone (3.1 percent) reached the highest level since this region was created.

This higher inflation rate in Peru was mainly due to the effect of the higher prices of foodstuffs and imported inputs (wheat, maize, soybean oil, and petroleum), as reflected in the rate of imported inflation which reached 10.5 percent in 2007. Excluding food and beverages, inflation was 2.0 percent in 2007.

The higher prices of food in international markets are explained by both supply factors –reduction of sown areas and droughts in main producing countries– and demand factors –increased consumption in Asian countries. In Peru, this affected both the prices of some final goods included in the consumer basket (bread, food outside the household, evaporated milk) and firms’ production costs (fuels and related inputs, such as plastics and fertilizers, and inputs for the production of foodstuffs).

GRAPH 2
DOMESTIC AND IMPORTED COMPONENTS OF INFLATION
 (Last 12-month percentage change)



As mentioned above, the dynamism shown by domestic demand (11.6 percent), –particularly as a result of the evolution of private expenditure– reflected the growth of non-primary sectors, especially construction and non-primary manufacturing, which led the Peruvian economy to grow 9.0 percent in 2007 (the highest growth rate seen over the past 13 years).

TABLE 1
OVERALL DEMAND AND SUPPLY^{1/}
 (Real percentage changes)

	2005	2006	2007
I. Overall Demand (1+2)	7.4	8.3	10.6
1. Domestic Demand ^{2/}	5.7	10.0	11.6
a. Private consumption	4.6	6.2	8.3
b. Public consumption	9.1	8.7	4.8
c. Gross domestic investment	8.4	24.7	25.5
Gross fixed investment	12.0	18.9	22.7
i. Private	12.0	20.1	23.2
ii. Public	12.2	12.7	19.7
2. Exports ^{3/}	15.2	1.2	5.4
II. Overall Supply (3+4)	7.4	8.3	10.6
3. GDP	6.7	7.6	9.0
4. Imports ^{3/}	10.9	12.6	18.8

1/ Preliminary data.

2/ Includes change in inventories.

3/ Includes goods and non-financial services.

Source: INEI and BCRP.

This high growth of domestic demand is explained by consumers and business optimistic expectations given the country's macroeconomic robustness, favorable credit conditions, and the growth of formal employment seen in all the economic sectors and in most regions, as well as by increased announcements of investments in all production sectors.

In the external front, the surplus in the current account of the balance of payments was equivalent to 1.4 percent of GDP in 2007, lower than the 3.0 percent observed in 2006. This lower outcome is associated with a higher pace of imports (32 percent) due to increased domestic demand. Together with the current account result, a strong inflow of both short-term and long-term external capitals during this period caused the appreciation of the local currency.

TABLE 2
BALANCE OF PAYMENTS
(Millions of US\$)

	Millions of US\$		
	2005	2006	2007
I. BALANCE IN CURRENT ACCOUNT	1,148	2,755	1,505
<i>(Percentage of GDP)</i>	<i>1.4</i>	<i>3.0</i>	<i>1.4</i>
1. Trade Balance	5,286	8,934	8,356
a. Exports	17,368	23,800	27,956
b. Imports	-12,082	-14,866	-19,599
2. Services	-834	-781	-928
a. Exports	2,289	2,647	3,343
b. Imports	-3,123	-3,428	-4,270
3. Investment income	-5,076	-7,583	-8,418
a. Private	-4,211	-6,903	-7,985
b. Public	-865	-679	-433
4. Current transfers	1,772	2,185	2,495
of which: remittances	1,440	1,837	2,131
II. FINANCIAL ACCOUNT	141	639	8,558
1. Private sector	1,818	1,941	9,002
2. Public sector	-1,441	-738	-2,473
3. Short-term capital	-236	-563	2,030
III. EXCEPTIONAL FINANCING (I+II+III-IV)	100	27	67
IV. NET ERRORS AND OMISSIONS	239	-668	-476
V. BCRP NET RESERVES FLOWS (1-2)	1,628	2,753	9,654
(V= I + II + III + IV)			
1. Change in the NIRs balance	1,466	3,178	10,414
2. Valuation changes and monetization of gold	-162	425	760

Source: BCRP, MEF, SBS, SUNAT, Ministry of Trade Affairs, Cofide, ONP, FCR, Zofratatna, Banco de la Nación, Cavali ICLV S.A., Proinversión, BIS and companies.

On the fiscal side, the economic result of the Non-Financial Public Sector was equivalent to 3.1 percent of GDP (1.0 percentage point higher than in 2006). The Central Government accounted mainly for this surplus (1.8 percentage points), while entities in the rest of the General Government –particularly local governments– and state enterprises accounted for 1.2 percentage points and 0.1 percent of GDP respectively.

TABLE 3
NON-FINANCIAL PUBLIC SECTOR OVERALL BALANCE

	Percentage of GDP		
	2005	2006	2007
I. PRIMARY BALANCE	1.6	3.9	4.8
1. Central government primary balance	1.4	3.6	4.7
a. Current revenues	18.3	19.7	20.4
i. Tax revenue	13.9	15.1	15.6
ii. Non-tax revenue	4.4	4.5	4.7
b. Non-financial expenditure	17.0	16.2	15.7
i. Current	14.2	13.4	12.7
ii. Capital	2.7	2.8	3.0
c. Capital revenues	0.1	0.1	0.1
2. Primary balance of other entities	0.2	0.3	0.1
II. INTERESTS	1.9	1.9	1.8
1. External debt	1.6	1.4	1.3
2. Internal debt	0.3	0.4	0.5
III. OVERALL BALANCE (I-II)	-0.3	2.1	3.1
1. Net financing abroad	-1.5	-0.7	-1.9
<i>(Millions of US\$) (a-b+c)</i>	<i>-1,167</i>	<i>-658</i>	<i>-2,147</i>
a. Disbursements	3.3	0.6	3.1
b. Amortization	4.6	1.3	5.2
c. Other	-0.1	-0.1	0.1
2. Net domestic financing	1.7	-1.4	-1.3
3. Privatization	0.1	0.1	0.1

Source: MEF, Banco de la Nación, BCRP, SUNAT, EsSalud, local governments, state-owned companies and public institutions.

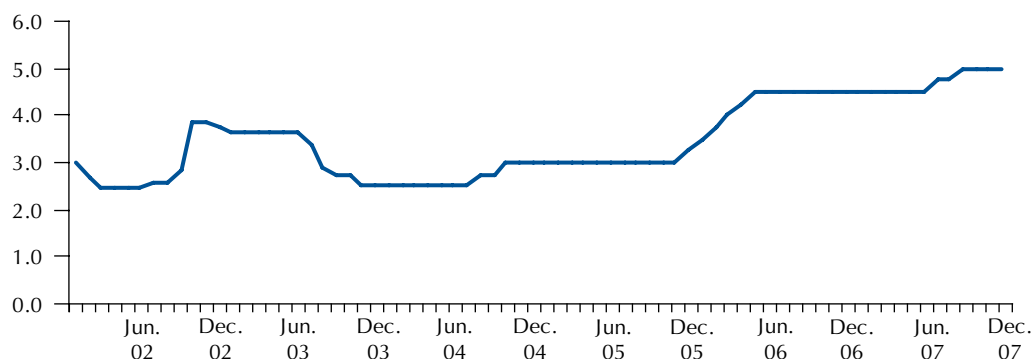
In 2007 the current revenues of the General Government grew by a real 13.6 percent due to increased domestic economic activity and to the favorable international prices of minerals, our main export products. These favorable conditions were reflected in the higher return of firms operating in the country, especially in the mining sector. In this way, the level of Central Government revenues recorded in 2007 (17.9 percent of GDP) is the highest observed since 1980.

The taxes that showed a more significant improvement were the income tax, which grew by a real 22 percent, and the internal value added tax (VAT), which increased 12 percent in real terms. The taxes associated with imports showed mixed conducts: while the external VAT increased by a real 20 percent due to the growth of imports during the year, tariffs declined by a real 24 percent mainly due to the reduction of tariff rates established at end 2006.

On the other hand, the Non-Financial Expenditure of the General Government was equivalent to 15.7 percent of GDP, increasing by a real 7 percent compared to 2006 mainly as a result of public investment which grew 20 percent in real terms.

In the financial sphere, short-term and long-term interest rates in soles in the money and capital markets have been increasing since September 2007. The changes in the short-term rates resulted from preventive adjustments implemented by the Central Bank in the reference rate in July and September 2007 (25 basis points in each case). On the other hand, long-term interest rates increased as a result of greater uncertainty in international markets and of investors' demand for higher yields –spreads– in emerging economies.

GRAPH 3
REFERENCE INTEREST RATE
(Percentage)



In 2007, in line with the robustness of the economy, financial entities showed a good performance, as reflected in their indicators of solvency, quality of portfolio, operational efficiency, and profitability.

The capital market showed a positive evolution both in terms of fixed and variable income instruments, as reflected in increased public and private long-term bond issues in nuevos soles and in the participation of new issuers. The indices of the Lima Stock Exchange (LSE) showed an important growth in 2007 (36.0 percent), as a result of which the LSE was one of the most profitable bourses in Latin America, surpassed only by the Sao Paulo Stock Exchange. The growing resources of institutional investors, particularly mutual funds, private administrators of pension funds (AFPs), and insurance companies, account for this evolution.

The growth of the monetary base in 2007 (S/. 3,916 million) was mainly associated with the BCRP exchange operations (amounting to S/. 21,914 million or US\$ 7,070 million), which included purchases of foreign currency (S/. 32,057 million or US\$ 10,306 million) that were partially compensated by net sales of dollars to the public sector (S/. 10,263 million and US\$ 3,275 million). Conversely, the monetary base shrank due to net placements of BCRP Certificates of Deposit (S/. 13,393 million) and higher deposits from the public sector at the central bank (S/. 6,751 million).



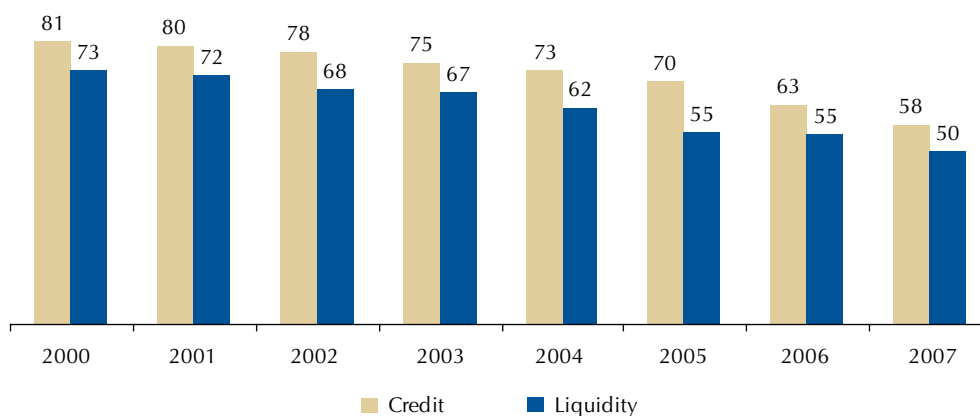
TABLE 4
BCRP OPERATIONS
(Millions of nuevos soles)

	2003	2004	2005	2006	2007
I. NET INTERNATIONAL POSITION	4,315	6,917	2,518	11,696	26,464
<i>(Millions of US\$)</i>	1,242	2,056	811	3,636	8,536
1. Foreign Exchange Operations	998	1,854	767	2,861	7,070
A. Over the Counter Operations	1,050	2,340	2,699	3,944	10,306
B. Public Sector	-51	-487	-1,935	-1,084	-3,275
C. Other	-1	2	3	1	39
2. Rest of Operations	244	202	44	775	1,466
II. NET INTERNAL ASSETS	-3,560	-5,252	-438	-10,016	-23,275
1. Deposits of the Public Sector	-921	-721	-2,821	-5,434	-6,751
2. Purchase of securities	-170	0	2,850	-2,850	0
3. BCRP Certificates of Deposit (CDBCRP)	-2,462	-4,158	578	-389	-13,393
4. Readjustable CDBCRP	319	0	-1,202	1,202	0
5. Overnight Deposits	65	-52	-8	-188	227
6. Reserve Requirements in domestic currency	7	-148	4	63	-157
7. Other	-398	-173	160	-2,420	-3,201
III. CURRENCY	755	1,665	2,080	1,680	3,189
Note: Balance at end period					
- CDBCRP	4,097	8,255	7,676	8,066	21,458
- Public Sector Deposits	1,196	1,918	4,738	10,172	16,924

Source: BCRP.

The levels of dollarization continued to decrease during 2007. The ratio of dollarization of liquidity in the private sector declined from 55 percent in 2006 to 50 percent in 2007 on average. Moreover, the ratio of dollarization of credit to the private sector decreased 5 percentage points in the same period, reaching a level of 58 percent in average terms in 2007.

GRAPH 4
DOLLARIZATION OF LIQUIDITY AND CREDIT TO THE PRIVATE SECTOR
(Average percentage in the period)



Monetary Policy Decisions

During the first half of 2007, the Board of Directors of the Central Bank maintained the monetary policy reference interest rate at 4.5 percent –the same rate since May 2006–, given that last 12-month inflation remained below the inflation target range (1% - 3%) during the first four months of the year, mainly as a result of the reversal in the price rises of food observed in the first months of 2006.

Since May 2007, inflation showed an upward trend, influenced mainly by rises in the international prices of food and petroleum. On the other hand, core inflation –indicator excluding the most volatile components of the consumer basket– also showed an upward tendency since mid-2007.

Therefore, the reference interest rate was raised by 25 basis points in both July and September, as a result of which this rate increased from 4.5 percent in June to 5.0 percent in December.

This gradual increase of the reference interest rate was a preventive action adopted to maintain inflation expectations anchored in a context marked by a robust growth of domestic demand (domestic demand grew 10.9 percent between January and July 2007).

In the second half of 2007 the BCRP communiqués on the monetary program emphasized that the Central Bank would continue to keep a close watch on inflation and on the factors affecting it, distinguishing between those factors with temporary effects and those with a permanent impact.

In the last quarter of the year, the Board of the BCRP decided to maintain the policy rate at 5.0 percent. This pause allowed the Central Bank to analyze the reaction of the economy and evaluate the impact of the turbulence seen in international markets as a result of the crisis of the subprime mortgage market in the United States.

TABLE 5
MONTHLY MONETARY PROGRAM: 2007
Interest rates (%)

	Operations in domestic currency		
	Reference Rate	Overnight Deposits	Direct repos and rediscounts
January	4.50	3.75	5.25
February	4.50	3.75	5.25
March	4.50	3.75	5.25
April	4.50	3.75	5.25
May	4.50	3.75	5.25
June	4.50	3.75	5.25
July	4.75	4.00	5.50
August	4.75	4.00	5.50
September	5.00	4.25	5.75
October	5.00	4.25	5.75
November	5.00	4.25	5.75
December	5.00	4.25	5.75

