

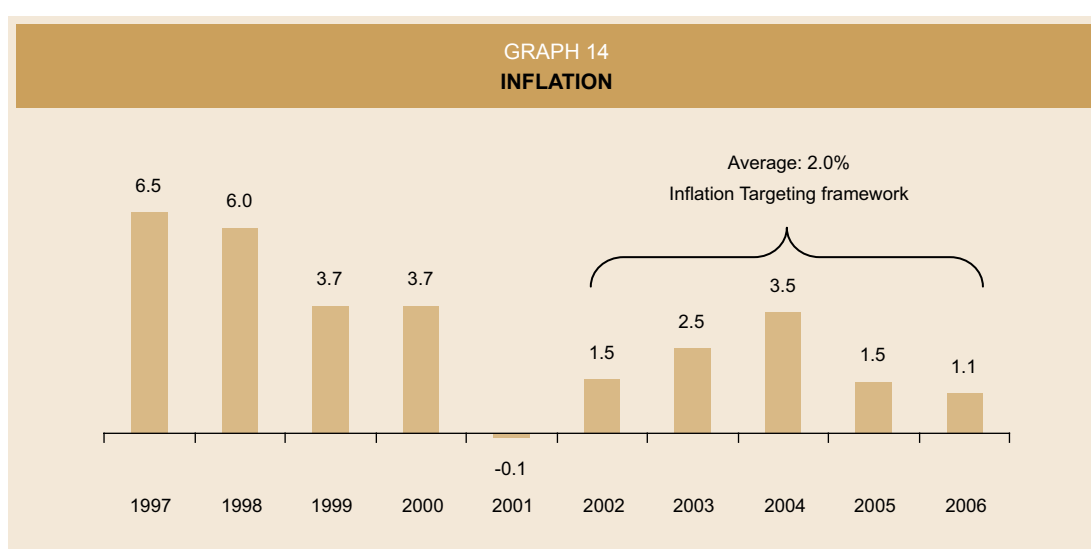
## II. Inflation

*The rate of accumulated inflation by December 2006 was 1.1 percent, a lower rate than the one recorded in the previous year (1.5 percent). This result was associated with the reversal of the supply shocks that affected the prices of food products in 2005 and with the drop of the prices of fuel and electricity rates. Core inflation –indicator of the price trend– posted a rate of 1.4 percent, a higher level than the one observed in 2005 (1.2 percent).*

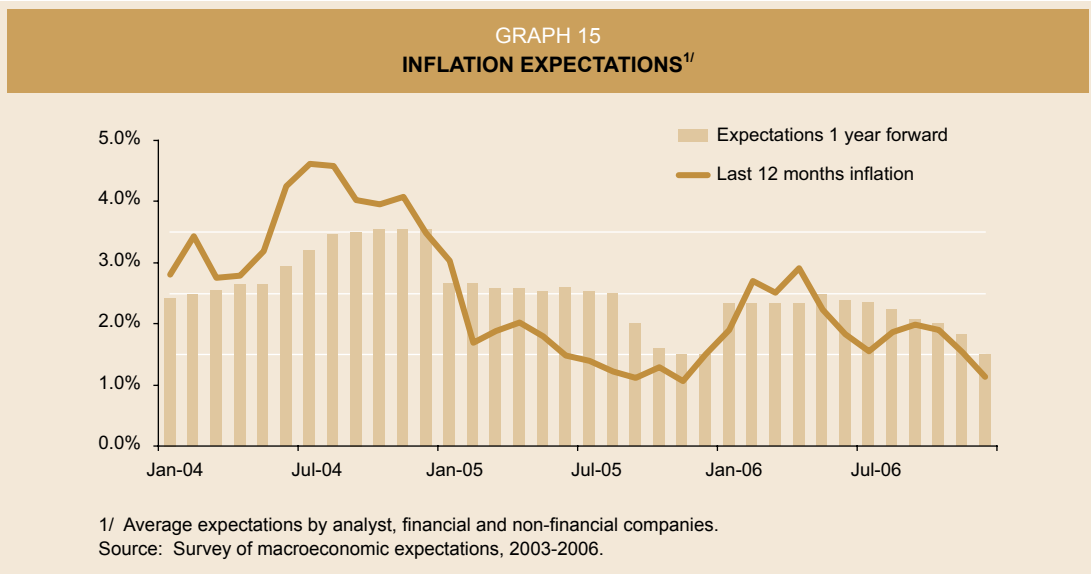
Since 2002, the monetary policy implemented by the Central Reserve Bank of Peru (BCRP) has been based on an Inflation Targeting scheme. Until 2006 the annual inflation target was 2.5 percent, plus or minus one percentage point<sup>1</sup>. Between 2002 and 2006, average inflation was 2.0 percent.

Core inflation gradually rose from an annual rate of 0.7 percent at end-2003 to 1.4 percent at end-2006, in a context marked by a faster pace of economic growth (which rose from

4.0 percent in 2003 to 8.0 percent in 2006). In this period, the Peruvian economy went from a recessive cycle to an expansionary stage and the potential output grew from an estimated rate of 3 percent four years ago to around 6 percent today. This increased growth rate of potential GDP is associated with the recent dynamism shown by investment and with productivity improvements which, together with a reduction in firms margins due to greater competition, inflation expectations anchored at the inflation target and the appreciation of the Nuevo Sol,



<sup>1/</sup> Since 2007 the aim of monetary policy will be the convergence of last 12-month inflation to an inflation target of 2.0 percent, plus or minus one percentage point (between 3.0 percent and 1.0 percent).



would account for the slight increase seen in core inflation despite the faster pace of economic growth.

Since 2006, the inflation target is continuously measured using the last 12-month Consumer Price Index (CPI) for Metropolitan Lima as reference. Inflation may transitorily be outside the inflation target in a specific month, in which case the BCRP evaluates the necessary actions to be taken to return to said range considering the lags with which monetary policy operates.

The evolution of inflation during 2006 was associated with the reversal of shocks that affected the prices of the non-core component of the CPI basket. Thus, while accumulated inflation between January and April was 2.0 percent, between May and December it was – 0.9 percent. This evolution showed a downward trend of inflation since May, and inflation posted a rate below the target range in December.

The reference interest rate was raised by 150 basis points between December 2005 and May 2006 (25 points each month), reflecting mainly

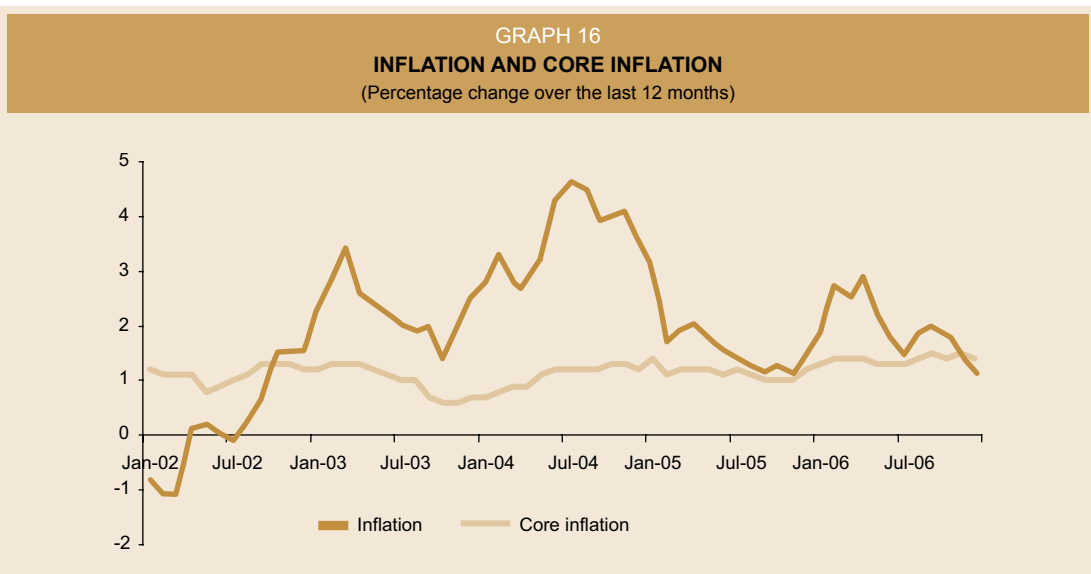


TABLE 19  
CORE AND NON-CORE INFLATION  
(Percentage change)

|                               | Weighted     | 2002        | 2003        | 2004        | 2005        | 2006        | Average     |
|-------------------------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>I. Core inflation</b>      | <b>60.6</b>  | <b>1.23</b> | <b>0.73</b> | <b>1.23</b> | <b>1.23</b> | <b>1.37</b> | <b>1.16</b> |
| 1. Food                       | 10.7         | 0.02        | 0.14        | 3.24        | 0.98        | 0.98        | 1.07        |
| 2. Non-food                   | 49.9         | 1.49        | 0.85        | 0.80        | 1.28        | 1.45        | 1.17        |
| a. Goods                      | 23.3         | 1.39        | 0.08        | -0.29       | 0.71        | 0.97        | 0.57        |
| b. Services                   | 26.6         | 1.57        | 1.53        | 1.75        | 1.77        | 1.85        | 1.69        |
| <b>II. Non-core inflation</b> | <b>39.4</b>  | <b>1.96</b> | <b>5.16</b> | <b>6.75</b> | <b>1.87</b> | <b>0.83</b> | <b>3.31</b> |
| 1. Food                       | 22.5         | 0.28        | 3.73        | 5.82        | 1.62        | 2.06        | 2.70        |
| 2. Non-food                   | 16.9         | 4.22        | 7.00        | 7.90        | 2.17        | -0.67       | 4.12        |
| a. Fuels                      | 3.9          | 15.60       | 8.94        | 17.77       | 6.89        | -1.50       | 9.54        |
| b. Transportation             | 8.4          | 0.11        | 10.99       | 3.49        | 1.29        | 1.12        | 3.40        |
| c. Public services            | 4.6          | 1.96        | -1.98       | 6.19        | -1.72       | -3.22       | 0.25        |
| <b>III. Total</b>             | <b>100.0</b> | <b>1.52</b> | <b>2.48</b> | <b>3.48</b> | <b>1.49</b> | <b>1.14</b> | <b>2.02</b> |

Source: INEI and BCRP.

the lower need for maintaining monetary stimulus. This decision was adopted considering the greater dynamism of economic activity, particularly of domestic demand (which grew from 6.1 percent in the third quarter of 2005 to 7.5 percent in the second quarter of 2006) and the faster pace of core inflation observed between November 2005 (1.0 percent) and April 2006 (1.4 percent).

In addition, this coincided with a depreciation of exchange rates (2.3 percent between August 2005 and April 2006). On the other hand, core inflation remained between 1.3 and 1.5 percent between May and December, despite the fact that domestic demand continued to accelerate with rates of 10 percent in a context of appreciation of the Nuevo Sol.

The BCRP monetary programs for the months of June to December 2006 maintained the reference interest rate at 4.5 percent due to the absence of inflationary pressures. Accumulated inflation in 2006 was 1.1 percent, a rate lower than the inflation target range (between 1.5 and 3.5 percent), a result explained by the reduction in the prices of fuel, electricity and telephone rates, and by the lower prices of some

food products. These factors have a temporary impact on inflation and therefore do not require monetary policy actions to compensate this impact.

The volatility of the inflation rate stemmed from supply shocks, which were usually transitory and which implied a one time impact on the level of prices. These shocks affected mainly the prices of food products and fuel, representing 33 and 4 percent of the consumer basket respectively. Non-core inflation, which reflects all the goods and services that are affected by these diverse supply shocks or the prices of goods and services subject to price control, accumulated 0.8 percent in 2006, as explained in further detail in the case of each product below:

- **Fuel:** The domestic price of fuel decreased by 1.5 percent due to the fact that the appreciation of the domestic currency and the reduction of the excise tax on gasoline and kerosene compensated by far the rise in the international quotation of oil. On average, the price of West Texas Intermediate (WTI) oil increased from US\$ 56.4 per barrel in 2005 to US\$ 66.0 per barrel in 2006. However,



prices showed some volatility along the year, and even reached US\$ 74 per barrel in the month of July.

Nevertheless, the volatility seen in international prices along the year was not reflected in domestic prices due to the compensation mechanism achieved through the Fuel Stabilization Fund.

- **Rates of public utilities:** Electricity rates declined by 7.3 percent on average throughout the year due to the rate reductions approved by Osinerg, the regulating entity, between May and November. The reduction approved in the month of May (6.8 percent) was based on the conditions of supply and demand in this market, as well as on firms' structure of costs. Moreover, the reduction approved in November (2.4 percent) reflected the adjustment of all the electricity generation rates resulting from the drop in the prices of No. 6 fuel oil and No. 2 diesel between July and October 2006.

The reduction in telephone rates (6.2 percent) was due to the application of productivity increasing factors established by Osiptel, the regulating entity.

On the other hand, the rates of drinking water increased by 8.5 percent mainly due to the increase requested by Sedapal and approved by the Sunass in order to improve and expand investment in water and sanitation infrastructure.

TABLE 20  
PUBLIC SERVICES TARIFFS  
(Monthly percentage change)

|                        | 2003        | 2004       | 2005        | 2006        |
|------------------------|-------------|------------|-------------|-------------|
| <b>Public services</b> | <b>-2.0</b> | <b>6.2</b> | <b>-1.7</b> | <b>-3.2</b> |
| Electricity            | -4.6        | 12.0       | -2.5        | -7.3        |
| Telephones             | 0.3         | -2.0       | -7.0        | -6.2        |
| Water                  | 0.9         | 3.0        | 5.2         | 8.5         |

Source: INEI.

- **Food products:** The reduction in the prices of onion (30.5 percent) and papaya (32.5 percent) due to the recovery of the production of this crops relative to 2005 was noteworthy. These lower prices contributed to reduce inflation in 2006 by 0.5 and 0.4 percentage points respectively.

In 2005, the production of papaya was 12 percent lower than in the previous year. This reduction was aggravated by a lower output in Huánuco (which supplies Lima with 60 percent of this product) due to the ring spot virus.

- **Chicken meat:** The production of this product increased 14.5 percent as a result of the recovery of demand which contracted heavily in October and November 2005 due to concerns associated with the bird flu.
- **Bread:** The price of bread rose 3.4 percent during 2006 due to the increase in the international quotation of wheat flour (16 percent).