

III.

Exchange rate

In real terms, the multilateral exchange rate grew 1.8 percent on average in 2006 due to the lower inflation seen in Peru relative to inflation in the rest of the world and to the weakness of the dollar against the other main currencies. In nominal terms, the Nuevo Sol appreciated 0.7 percent, although it showed a fluctuating evolution throughout the year. Upward pressures on the exchange rate associated with the elections were observed in the first half of the year, as well as in May and June when they were associated with the higher volatility of capital flows. Once the electoral uncertainty was over, the improvement observed in terms of confidence was one of the key factors that contributed to the appreciatory trend of the Nuevo Sol.

The increase in the inflows of dollars associated with increased incomes due to exports and current transfers, together with the weakness of the US dollar in international markets, determined a downward pressure on exchange. Thus, the price of the dollar fell from S/. 3.43 in December 2005 to S/. 3.20 in December 2006.

This drop in the quotation of the US currency did not necessarily translate into a loss of competitiveness vis-à-vis other countries given that inflation in Peru was lower than in the United States and that the currencies of our main trading partners also appreciated against the US dollar (this was the case of the euro, the yen, the Canadian dollar and the pound sterling). Thus, in real terms the exchange rate grew 1.8 percent on average during 2006, following the temporary increase of 1.0 percent seen in 2005 due to electoral uncertainty.

TABLE 21
VARIATION OF THE NUEVO SOL DURING 2006
Against commercial partners currencies

	Nominal	Real
USA	-0,7%	0,5%
Eurozone	0,1%	0,3%
Japan	-1,4%	-7,6%
Brasil	-5,9%	12,9%
United Kingdom	10,6%	0,9%
Chile	0,5%	6,0%
China	4,7%	1,5%
Colombia	2,1%	-0,1%
Mexico	-2,2%	0,9%
Argentina	-0,7%	2,6%
Korea	-5,6%	6,9%
Taiwan	6,5%	-3,1%
Venezuela	-1,7%	7,5%
Canada	-3,5%	6,0%
Switzerland	6,0%	-2,4%
Ecuador	-0,7%	0,3%
Basket	0,6%	1,8%



BOX 3

UPDATING THE WEIGHT OF REAL MULTILATERAL EXCHANGE

In order to calculate the real multilateral exchange rate (RMER), an external price index is elaborated based on the price indices in dollars of our main trading partners. This new series of RMER includes an update of the weight of exchange.

The 1994 share of our 20 main trading partners in Peru's trade was used as weight; in other words, this reflected Peru's trade structure in 1994. The new weights used include Peru's main trading partners in 2005, and include the following countries: Germany, Argentina, Belgium, Brazil, Canada, Chile, China, Colombia, South Korea, Ecuador, Spain, the United States, Switzerland, Italy, Japan, Mexico, the Netherlands, the United Kingdom, Taiwan and Venezuela.

Independently of these weights, December 2001 was established as the base period so that data may be compatible with the consumer price index published by the National Statistics and Information Institute (INEI).

The real exchange rate (RER) is defined as:

$$RER = NER * CPI_{external} / CPI_{domestic}$$

- Where :
- NER = nominal exchange rate
 - $CPI_{external}$ = external price index
 - $CPI_{domestic}$ = domestic price index

In the case of the real bilateral exchange rate, the nominal as-buy exchange rate of the Nuevo Sol against the dollar and the US CPI are used:

$$RER = E_{US\$}^{Sl.} * CPI_{USA} / CPI_{Peru}$$

- $E_{US\$}^{Sl.}$ = Nominal exchange rate of the Nuevo Sol against the US dollar.
- CPI_{USA} = US Consumer price index.
- CPI_{Peru} = Peru's consumer price index.

Until recently, the real multilateral exchange rate was calculated in the following way:

$$RMER = E_{US\$}^{Sl.} * CPI_{External} / CPI_{Peru}$$

$$CPI_{External} = \prod_{i=1}^T \left(\frac{CPI_i}{E_{US\$}^{U.M.i.}} \right)^{W_i}$$

- $E_{US\$}^{Sl.}$ = Nominal exchange rate of the Nuevo Sol against the US dollar.
- CPI_i = Price index of country "i"
- $E_{US\$}^{U.M.i.}$ = Nominal exchange rate of country "i" against the US dollar.
- W_i = Participation of country "i" in Peru's trade.
- CPI_{Peru} = Peru's consumer price index.

The nominal buy-sell exchange rate of the Nuevo Sol against the currency basket of our main trading partners and external inflation –that is, the average inflation of our trading partners– are used for the new series of the RMER.

$$RMER = E_{Canasta}^{Sl.} * CPI_{External} / CPI_{Peru}$$

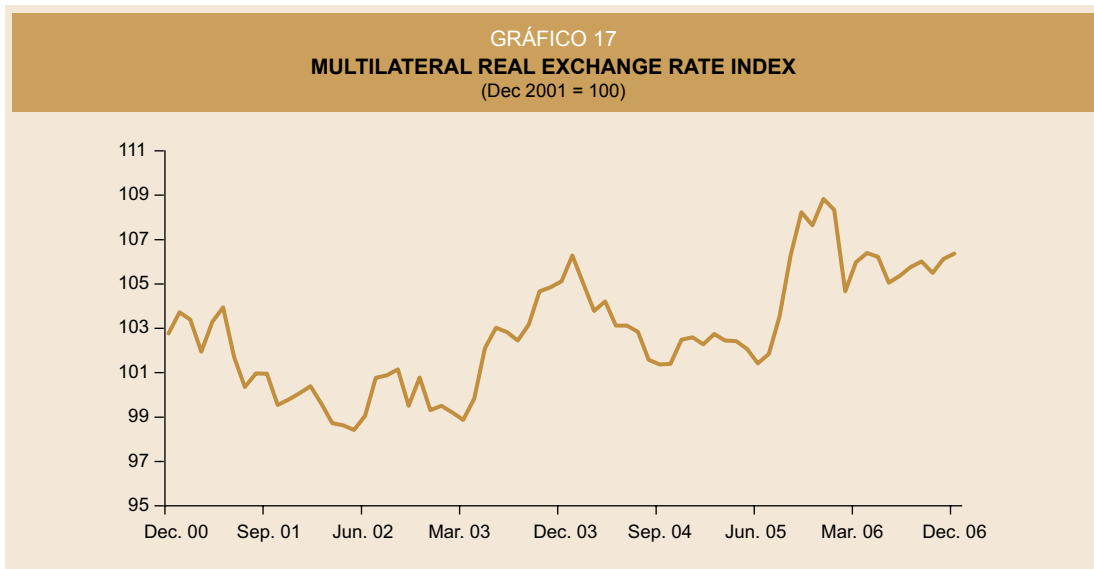
$$E_{Basket}^{Sl.} = \prod_{i=1}^T \left(\frac{E_{US\$}^{Sl.}}{E_{US\$}^{U.M.i.}} \right)^{W_i}$$

$$CPI_{External} = \prod_{i=1}^T (CPI_i)^{W_i}$$

- $E_{US\$}^{Sl.}$ = Nominal exchange rate of the Nuevo Sol against the US dollar.
- CPI = Consumer price index of country "i"
- $E_{US\$}^{U.M.i.}$ = Nominal exchange rate of country "i" against the US dollar.
- W_i = Participation of country "i" in Peru's trade.
- $E_{Basket}^{Sl.}$ = Nominal exchange rate of the Nuevo Sol against the currency basket of our main trading partners.
- CPI_{Peru} = Peru's consumer price index.

Although both methods are equivalent, the new method emphasizes the evolution of the Nuevo Sol against the currency basket of our trading partners and not only against a single currency.

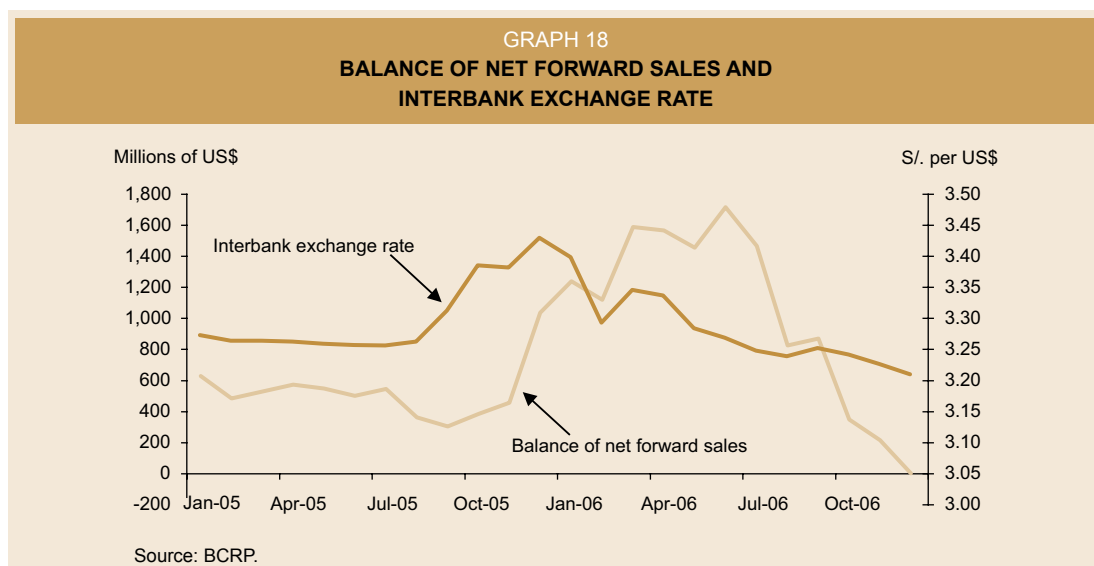
The differences between the new series and the former series are exclusively due to the change of weights.

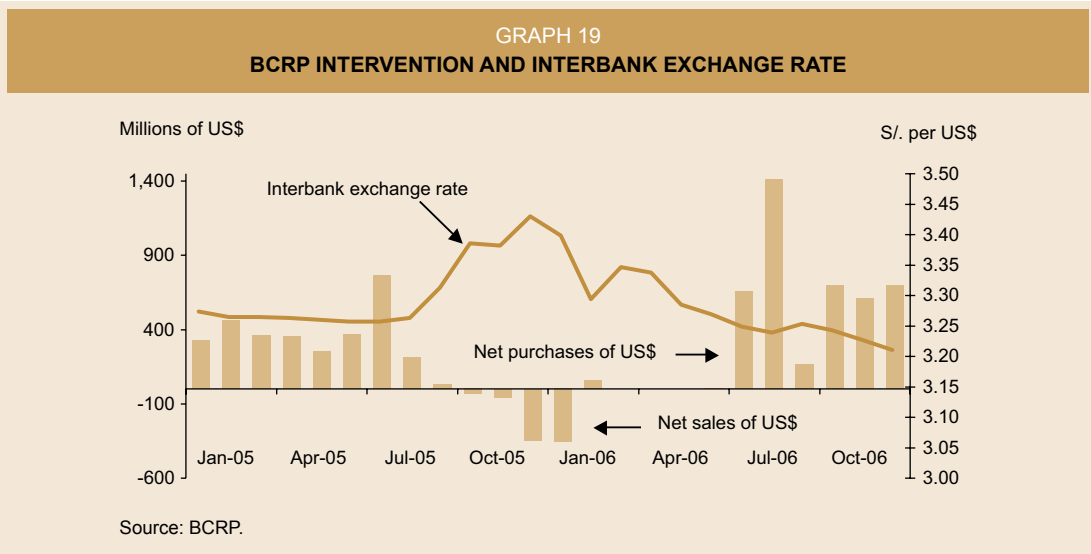


The evolution of nominal exchange fluctuated along the year. In the first months of 2006, upward pressures were observed in connection with the electoral process, while in May and June these pressures were associated with the increased volatility of capital flows in emerging economies (given concerns of higher increases in international interest rates). A process of gradual drops followed, which even led agents to expect an appreciation of the Nuevo Sol, as reflected in the balance of net forwards sales in domestic currency which decreased from a positive balance of US\$ 1,027 million in December 2005 to a negative balance of US\$ -9 million at end-2006.

It should be pointed out that this change occurred mainly in the second half of the year, after the new balance of forward sales reached a maximum of US\$ 1,706 million in June. Furthermore, the traditional asymmetry in this market—characterized by low balances of purchases (contracts against appreciation risks) and high balances of purchases (contracts against depreciation risks)—declined. Since August, the former showed an upward trend, while the latter showed a downward trend.

In this context, the BCRP intervened in the exchange market purchasing dollars for a total of US\$ 4,237 million in the second half of 2006,





while only US\$ 62 million were bought in the first 6 months of this year. These purchases served to cover the requirements of the Public Sector and to repay the external debt. The difference was used to increase the international exchange position of the BCRP which closed 2006 with a total of US\$ 11.1 billion.

Country risk

During 2006, Peru's country risk indicator fell from 206 bps at end 2005 to 118 bps at end-2006, in a context of improved country risk indicators in the region and in emerging economies in general. Only interrupted by the uncertainty generated by the electoral process,

the country risk indicator continued to show a downward evolution, reaching a historical minimum level of 117 basis points on December 28. This evolution was due to the country's good economic prospects, as reflected in the improved rating assigned by Fitch (BB+ in August 2006) and by Standard and Poor's (from BB to BB+ at end November). Moreover, Moody's upgraded Peru from stable to positive in November.

It is worth pointing out that the reduction in the premium for country risk was influenced by both external factors, such as the conditions of liquidity in the international context, and by domestic factors, such as the positive results seen in the trade balance and in the fiscal accounts.

