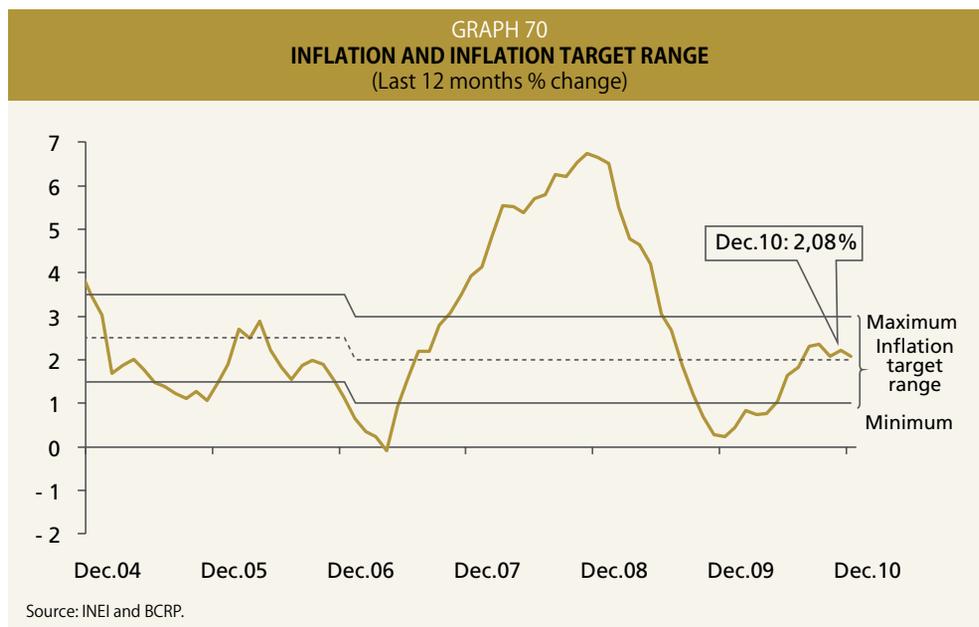


IV.

Inflation

After showing a rate of 0.25 percent at end 2009, inflation recorded a rate of 2.08 percent in 2010. The higher pace of growth of domestic prices was mainly associated with the rise in the international prices of some food products and fuels, as well as with adverse climate conditions that affected the prices of some foodstuffs.

Since 2002 the BCRP's monetary policy is based on an inflation targeting regime, with an inflation target of 2.0 percent, plus or minus one percentage point (between 1.0 percent and 3.0 percent). Reflecting the Central Bank's permanent commitment with monetary stability, compliance with the inflation target is continuously evaluated. Monetary policy actions have a preventive nature and are aimed at maintaining the rate of inflation within the announced target range. Inflation may transitorily divert from the target as a result of domestic supply shocks or changes in the prices of imported products.

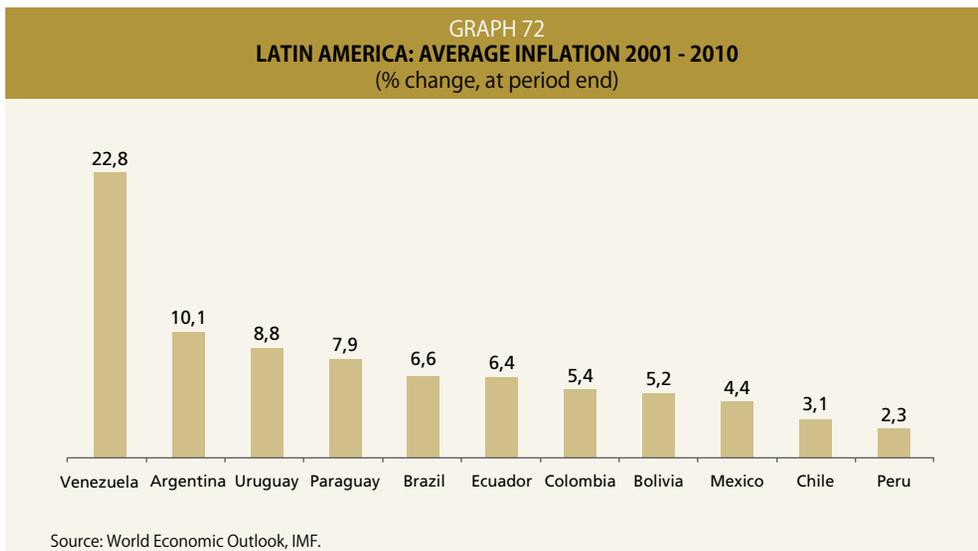
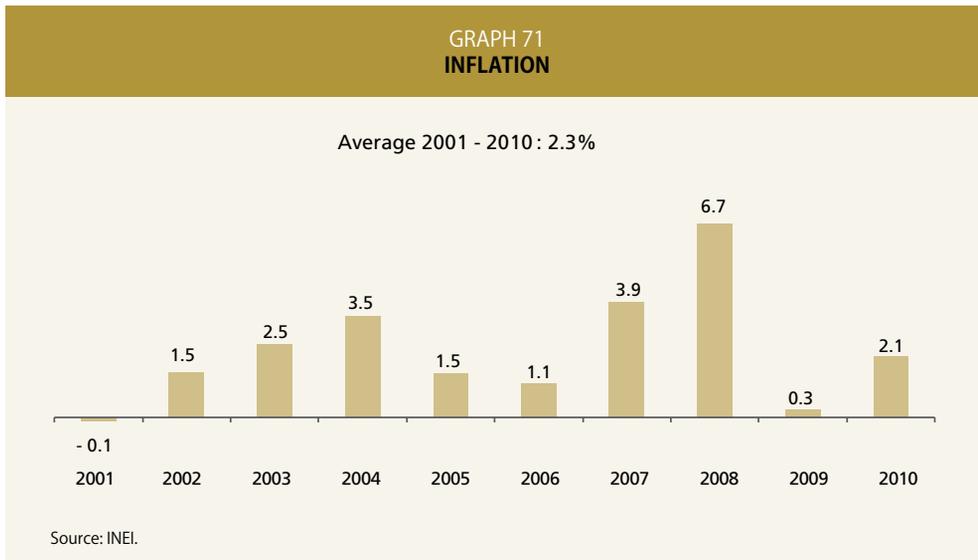




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In spite of the strong dynamism recorded in several indicators of Peru's economic activity, inflation remained very close to the inflation target reflecting that inflation expectations continued to be anchored around the Central Bank's target.

In 2001-2010 the average inflation rate was 2.3 percent, which reflects monetary policy's commitment to maintaining price stability within the target range levels in the long term. Core inflation showed an average rate of 2.0 percent in the same period. It should be pointed out that Peru recorded the lowest inflation rate in the region between 2001 and 2010.



Core inflation

After the economic slowdown observed during 2009 due to the impact of the international financial crisis, the Peruvian economy recovered its dynamism driven by economic agents' favorable expectations, which reflected in the evolution of both consumption and private investment. As a result of this, the output gap started gradually closing up in 2010 after having shown negative values during 2009.

In this context, and with inflation expectations anchored around the target, **core inflation** –component reflecting the trend of inflation associated with demand factors in the domestic economy– recorded 2.1 percent, a rate slightly higher than the inflation target.

The appreciation of the nuevo sol against the dollar and strong competition in the market of industrial products with high imported components were other factors that also contributed to maintain relatively low core inflation levels. The lower pace of growth in the prices of products such as personal grooming items (whose growth rate declined from 3.0 percent in 2009 to 0.6 percent) and cleaning items (whose growth rate fell from 7.3 to -2.8 percent) offset the increase observed in other items like meals outside the home (up from 3.3 to 3.9 percent).

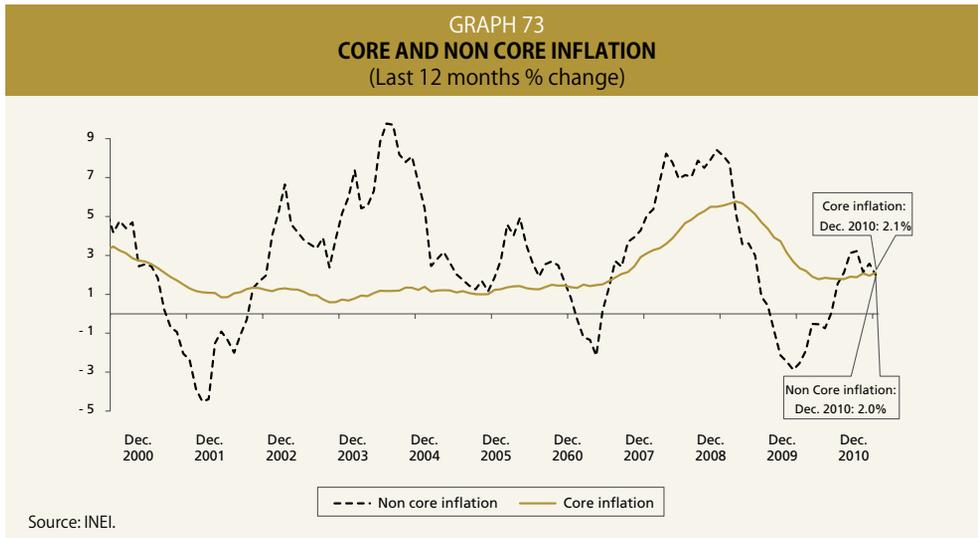
Non-core inflation

The rate of **non-core inflation** rose from -2.5 percent in December 2009 to 2.0 percent in December 2010, mainly as a result of higher fuel prices (up from -12.7 to 12.2 percent) and food prices (up from -1.4 to 1.2 percent). The rise in the case of the former was associated with the rise in the international price of crude, while the rise in the case of the latter in the domestic market was associated with the higher prices of imported inputs and with supply shocks.

TABLE 60
INFLATION
(Annual % change)

	Weight 2009 = 100	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average 2001-2010
I. Core inflation	65.2	1.30	1.23	0.73	1.23	1.23	1.37	3.11	5.56	2.35	2.12	2.01
1. Food	23.0	0.45	0.70	0.19	2.29	0.80	1.42	4.90	8.35	2.58	3.20	2.46
2. Non food	42.2	2.14	1.59	1.07	0.50	1.63	1.28	1.89	3.51	2.16	1.53	1.73
a. Goods	21.7	2.16	1.46	0.65	-0.38	0.87	0.64	1.72	3.29	2.32	1.07	1.37
b. Services	20.5	2.12	1.81	1.76	1.72	2.47	2.28	2.03	3.91	1.96	2.01	2.21
II. Non core	34.8	-2.36	1.96	5.16	6.75	1.87	0.83	5.07	8.11	-2.54	2.00	2.63
1. Food	14.8	-0.99	0.28	3.73	5.82	1.62	2.06	7.25	10.97	-1.41	1.18	2.98
2. Non food	20.0	-4.27	4.22	7.00	7.90	2.17	-0.67	2.37	4.39	-4.10	2.60	2.08
a. Fuels	2.8	-13.14	15.60	8.94	17.77	6.89	-1.50	6.45	-0.04	-12.66	12.21	3.53
b. Transportation	8.9	-0.02	0.11	10.99	3.49	1.29	1.12	0.82	5.86	0.37	1.94	2.55
c. Public Services	8.4	-2.73	1.96	-1.98	6.19	-1.72	-3.22	0.24	7.48	-2.31	0.01	0.33
III. Total	100.0	-0.13	1.52	2.48	3.48	1.49	1.14	3.93	6.65	0.25	2.08	2.27
Memo:												
Food	37.8	-0.21	0.50	1.89	4.00	1.13	1.76	6.02	9.70	0.57	2.41	2.74
CPI without food	62.2	-0.09	2.44	3.04	3.03	1.75	0.61	2.02	3.86	-0.07	1.87	1.84
CPI without food and energy	56.4	1.65	1.06	2.86	1.09	1.36	1.28	1.49	4.25	1.71	1.38	1.81

Source: INEI and BCRP.



The items that contributed most to increase the rate of inflation were meals outside the home, education (tuition and fees), and gasoline, while the items that contributed most to the decline in the inflation rate were poultry, eggs, and telephone rates, all of which are non-core inflation components.

TABLE 61
INFLATION 2010

	Weight 2009 = 100	% Change	Weighted contribution
I. CORE INFLATION	65.2	2.1	1.38
Goods	32.9	1.5	0.50
Food and beverages	11.3	2.4	0.27
Textiles and footwear	5.5	2.6	0.14
Domestic appliances	1.3	-0.6	-0.01
Other industrial products	14.9	0.7	0.10
Services	32.2	2.7	0.88
Meals outside the home	11.7	3.9	0.47
Education	9.1	3.4	0.31
Health	2.4	-0.2	-0.01
Rent	1.1	2.8	0.03
Other services	7.9	1.0	0.08
II. NON-CORE INFLATION	34.8	2.0	0.69
Food	14.8	1.2	0.17
Chicken meat	3.0	-14.2	-0.44
Bread	1.9	1.1	0.02
Rice	1.9	1.7	0.03
Potato	0.9	11.2	0.09
Sugar	0.5	25.1	0.16
Noodles	0.5	1.6	0.01
Oils	0.5	-1.6	-0.01
Other foodstuff	5.6	5.7	0.31
Fuels	2.8	12.2	0.34
Oil and lubricants	1.3	16.4	0.22
Gas	1.4	8.8	0.12
Transportation	8.9	1.9	0.17
Urban Fares	8.5	1.8	0.15
National Transportation	0.3	6.0	0.02
Public services	8.4	0.0	0.00
Electricity	2.9	1.4	0.04
Telephone	2.9	-3.8	-0.11
Water consumption	1.6	4.5	0.07
III. CPI	100.0	2.1	2.08
<u>Memo:</u>			
Food	37.8	2.4	0.91
CPI excluding food	62.2	1.9	1.16

Source: INEI and BCRP.

Food products with a positive contribution to inflation

- **Sugar:** The price of sugar rose 25.1 percent in 2010. This rise reflected the evolution in the international price of this product, which increased from an average level of US\$ 557/ton for contract 11 sugar in December 2009 to US\$ 779/ton in December 2010 (40 percent), influenced by the drop of global supply and by India's higher demand. In the domestic market, the production of sugar fell 2.8 percent affected by adverse climate conditions and by some strikes and technical stoppages.
- **Fresh and frozen fish:** Fishing declined due to low sea temperatures caused by a La Niña episode and anomalous waves that hindered this activity. As a result of this, the catch of fish for human consumption contracted 8.2 percent in the year, while the price of fresh and frozen fish increased 15.7 percent,
- **Potato:** The price of this crop registered several episodes of rises during the year due to supply problems that affected normal supply. The price of potatoes rose early in the year due to the effect of rains, while the rise observed in mid-2010 was associated with the temporary time gap that arose between the close of the crop year in the Sierra and the beginning of the crop year in the Coast. The price of potatoes increased 11.2 percent in 2010.

Food products with a negative contribution to inflation

- **Chicken meat and eggs:** The price of chicken dropped 14.2 percent on average as a result of higher supply. The placements of baby chicken increased 7 percent compared to 2009, while sales in distribution centers in Metropolitan Lima increased from 500 thousand units per day in 2009 to 539 thousand units per day in 2010 (8 percent).

The domestic production of eggs grew 6.1 percent in the year, leading the price of eggs to drop 6.4 percent.

Education: tuition and fees

education costs (tuition and fees), which increased 3.4 percent, contributed with nearly 0.3 percentage points to this year's inflation rate. This result is explained by the adjustments in school education costs that are usually made at the beginning of the school year and by the adjustments in university and higher education tuition rates made over the year.

Fuels

The price of fuels increased 12.2 percent in 2010 due to the rise in the international price of crude and to the lower resources allocated to the Fuel Price Stabilization Fund during the year. It is worth pointing out that S.D. No. 027.2010 established that the price bands of all types of fuels would be updated on a bi-monthly basis, provided that the international parity price was above the upper limit or below the lower limit of the band. These fuel price adjustments could not be higher than 5 percent, except in the case of LPG whose maximum variation was established at 1.5 percent.

Thus, the price of gasoline and lubricants increased 16.4 percent, while the price of gas increased 8.8 percent. However, the highest price increase was recorded in July (2.1 percent), when the supply of imported GDP gas was affected by abnormal waves that hampered its landing in the port of Callao.

The contract price of WTI crude rose from an average value of US\$ 74.5/barrel in December 2009 to US\$ 89.2/barrel at end December 2010.



TABLE 62
FUEL PRICES
(Annual % change)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average 2001-2010
Fuels	- 13.1	15.6	8.9	17.8	6.9	- 1.5	6.4	0.0	- 12.7	12.2	3.5
Gasoline	- 11.4	15.7	9.7	17.7	9.2	- 6.2	10.7	- 6.1	- 15.8	16.4	3.3
Gas	- 12.3	11.3	4.2	15.3	- 10.9	0.3	1.3	2.7	- 4.6	8.8	1.2
Price of WTI 1/ oil (end of period)											
US Dollar	19.3	29.4	32.1	43.2	59.4	62.0	91.4	41.4	74.3	89.2	
Nuevos soles	66.4	103.5	111.6	141.9	203.5	198.8	272.4	129.1	213.8	251.2	

1/ West Texas Intermediate.
Source: INEI and Bloomberg.

Utilities

Electricity rates: Electricity rates increased 1.4 percent due to the adjustments established by the sector’s regulating entity, OSINERGMIN, in the months of February and November. The purpose of these adjustments was to update the generation, transmission and distribution rates in accordance with the higher costs resulting from the rises in the prices of fuels and metals like aluminum and copper. These increases were offset by a rate reduction in May (-2.8 percent) as a result of the elimination of the generation charge levied for the transportation of natural gas.

Water rates: Water rates increased 4.5 percent. This increase was associated with the implementation of SEDAPAL’s new rate structure in May, in the frame of the process established by SUNASS, the regulating entity, to set the water rates for the period 2010-2015.

Telephone rates: These rates declined 3.8 percent as a result of the implementation of the quarterly Productivity Factor adjustment decreed by OSIPTEL for fixed telephony rates. Rate reductions included residential telephone services (7.2 percent), international long distance calls (1.8 percent), and telephone cards for calls to fixed telephones (5.0 percent).

The Productivity Factor is one of the main components applied in the regulation scheme. In September, OSIPTEL established a new factor that will be effective until August 2013.

TABLE 63
PUBLIC UTILITIES RATES
(% change)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average 2001-2010
Public utilities	- 2.7	2.0	- 2.0	6.2	- 1.7	- 3.2	0.2	7.5	- 2.3	0.0	0.3
Electricity	- 6.3	7.9	- 4.6	12.0	- 2.5	- 7.3	1.9	6.3	- 4.6	1.4	0.2
Telephone	1.1	- 8.3	0.3	- 2.0	- 7.0	- 6.2	- 7.2	- 4.2	- 1.4	- 3.8	- 3.9
Water	0.0	2.3	0.9	3.0	5.2	8.5	3.2	18.9	0.0	4.5	4.5

Source: INEI.

Imported inflation

The imported component of the CPI increased mainly due to the 12.2 percent rise recorded in the prices of fuels and due to the rise registered in food prices (the latter increased from -3.1 percent to 0.8 percent). This was offset by the appreciation of the exchange rate.

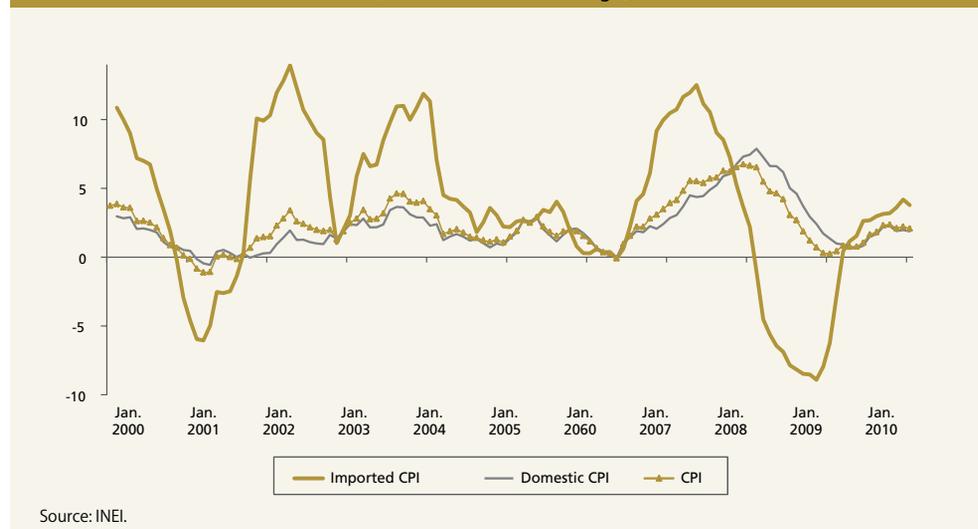
TABLE 64
DOMESTIC AND IMPORTED INFLATION
(Acumulated % change)

	Peso	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average 2001-2010
I. IMPORTED CPI	10.8	-4.61	10.30	3.03	11.33	2.18	0.27	10.46	2.20	-6.25	3.78	3.11
Food	3.0	-1.18	9.98	-0.10	10.90	-1.49	2.08	18.83	4.75	-3.07	0.76	3.94
Fuels	2.8	-13.14	15.60	8.94	17.77	6.89	-1.50	6.45	-0.04	-12.66	12.21	3.53
Domestic appliances	1.3	-0.19	3.42	-1.91	-2.83	-1.23	-1.29	-1.50	-0.06	-2.39	-0.58	-0.87
Other	3.7	4.99	3.39	1.40	3.23	2.27	0.64	0.47	0.46	-0.34	1.20	1.76
II. DOMESTIC CPI	89.2	0.47	0.30	2.40	2.28	1.38	1.28	2.84	7.44	1.35	1.87	2.14
III. CPI	100.0	-0.13	1.52	2.48	3.48	1.49	1.14	3.93	6.65	0.25	2.08	2.27
Exchange rate		-2.40	2.29	-1.23	-5.48	4.36	-6.40	-7.00	4.47	-7.59	-2.15	-2.21

Source: INEI and BCRP.

In 2010, inflation's pace of growth was buffered by the fact that the cost increases associated with the recovery of international prices during the year did not originate increases with the same magnitude in domestic prices given that the drop in international prices in 2009 was not completely reflected in final prices.

GRAPH 74
DOMESTIC AND IMPORTED COMPONENTS OF INFLATION
(Last 12 months % change)





Exchange rate

In addition to this, in 2010 the sol appreciated 2.1 percent against the US dollar, with the sol/US dollar exchange rate declining from S/. 2.88 in December 2009 to S/. 2.82 in December 2010. Moreover, the sol appreciated 3.7 percent against the currency basket of our 20 main trading partners, from S/. 0.537 in December 2009 to S/. 0.518 in December 2010. In real terms, the multilateral exchange rate index appreciated 2.3 percent, from a level of 100 in December 2009 to a level of 98 in December 2010.

