II.

Inflation and exchange rate

In 2003, the inflation rate, measured as the cumulative percentage change of the consumer price index (CPI) for Metropolitan Lima was in line with the target set in the monetary policy approved by the Board of Directors of the Central Bank.

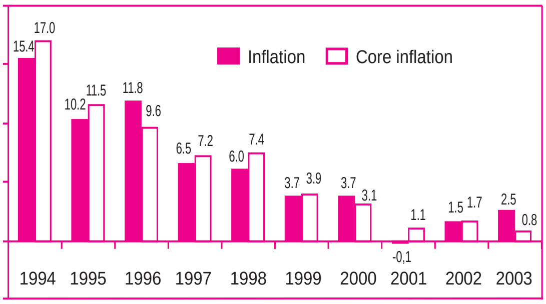
Annual inflation at 2.5 percent

During 2003, the second year in which an Explicit Inflation Targeting scheme was implemented, the change in the CPI was 2.48%. This rate was mainly explained by the effect of higher international oil prices on domestic fuel and transport prices, and a decline in the domestic supply of some agricultural products. These items accounted for 1.80 percentage points of total inflation.

The Central Bank also measures the **core inflation,** that excludes price fluctuations associated with exogenous shocks, such as in international prices or sudden changes in domestic agriculture and livestock supply. This core inflation, which excludes volatile food items, fuels, utilities and urban transport, went up by 0.77%, as against 1.69% in 2002. Between January and October, core inflation averaged 0.02% monthly. Over November-December, core inflation grew by 0.52%, because of increases in the prices of processed foods (mainly rice and oil, which rose 7.9% and 4.6%, respectively during those months and 4.3% and 5.9% annually).

GRAPH 5

INFLATION AND CORE INFLATION
(Annual percent change)



Non-core inflation increased by 6.21% compared to 1.16% in 2002, because of price rises in transport, food and fuel, which

TABLE 5

CUMMULATIVE ANNUAL INFLATION
(Annual percent change)

	Weighting	2001	2002	2003
I. CORE INFLATION	**68.3**	**1.06**	**1.69**	**0.77**
Goods	**41.8**	**0.66**	**1.76**	**0.29**
Foodstuffs and beverages	20.7	-0.59	2.07	-0.08
Textiles and footwear	7.6	1.94	1.06	0.91
Electric domestic appliances	1.0	-0.19	3.42	-1.91
Other manufactured products	12.5	2.39	1.54	0.70
Services	**26.6**	**1.65**	**1.57**	**1.53**
Restaurants	12.0	1.29	1.28	1.25
Education	5.1	3.97	2.70	3.02
Health	1.3	3.02	3.31	2.19
Rent	2.3	-0.37	1.00	0.99
Other services	5.9	2.14	1.02	0.85
II. NON-CORE INFLATION	**31.7**	**-2.82**	**1.16**	**6.21**
Foodstuffs	14.8	-1.16	-2.35	5.24
Fuels	3.9	-13.14	15.60	8.94
Transportation	8.4	-0.02	0.11	10.99
Utilities	4.6	-2.73	1.96	-1.98
III. INFLATION	**100.0**	**-0.13**	**1.52**	**2.48**

explained 2.9, 2.4 and 1.3 percentage points, respectively partially offset by lower cost of utilities, especially electricity, with a -0.3 percentage points effect.

Foodstuff prices increased by 5.2%, including a 43% rise in potato prices, bouncing back after a 17% fall in 2001 and 2002. The negative influence this price reduction had on farmers' decisions plus adverse weather conditions at the beginning of the 2002-2003 and 2003-2004 agricultural years delayed the planting seasons and caused smaller productivity. The effect of potato price increase in inflation was 0.58 percentage points.

Fuel prices rose by 8.9% in line with the evolution in the international market. Domestic prices went up 11.1% between January and April, dropped by 5.6% from May to July and went up again by 3.9% till December. Throughout the year domestic prices for kerosene, gasoline and gas went up 13%; 9.7% and 4.2%, respectively.

Among **transport services**, urban fares went up by 11.1% over the first quarter, after remaining constant since September 2000.

Utilities as a whole dropped by 2% because of the 4.6% decline in electric tariffs counterbalanced by increases in telephone and water prices by 0.3% and 0.9%. The decrease in electricity rates was explained by lower tariffs offered by the electricity generating firms to the distributors for the periods of May-October 2003 and November 2003-April 2004 and by the recalculation of potential demand and supply energy estimates during the revisions of June and July.

Water supply and telephone rates rose because of the 1% increase in the value added tax. In the case of telephone rates, prices went up despite the quarterly application of the productivity factor, established in the tariff adjustment for a period running to mid-2004

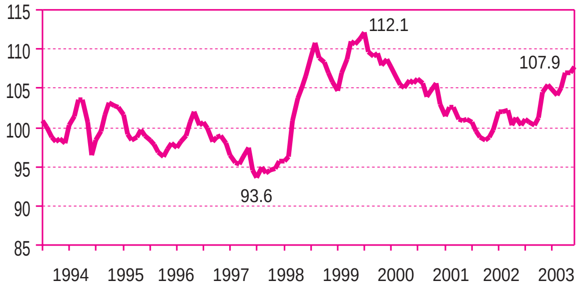
Real exchange rate up by 7.5 percent

As of December 2003, the exchange rate was S/. 3.472 per U.S. dollar, a nominal appreciation of 1.2% over December 2002. With the exception of May, the exchange rate appreciated during the first half of the year while during the second half, with the exception of December, it recorded a relative stability reaching 3.47 to 3.48 nuevos soles per dollar.

In real terms, the nuevo sol depreciated by 7.5% in 2003, as nominal exchange rate went down by 1.2% and domestic inflation and external price index increased by 2.5% and 11.6%, respectively.

GRAPH 7

MULTILATERAL REAL EXCHANGE RATE INDEX
(1994 = 100)



Changes in the external price index include the appreciation of the currencies of our main trading partners vis-à-vis the U.S. dollar. Over the year, the dollar depreciated 12% against the yen and 17% against the euro. As for Latin America, it depreciated 19% against the Brazilian real, and 14% each to the Argentine and the Chilean peso.

Within the region, all economies were favored by positive developments in Brazil, basically because of advances in their reform plans, which in turn meant larger capital inflows into the region and a higher demand for debt titles of emerging economies.

Capital inflows may have caused upward pressure on regional currencies and reduced spreads. In the Peruvian case, the EMBI+ spread was below the 300 basis points in the last quarter of 2003.

TABLE 6

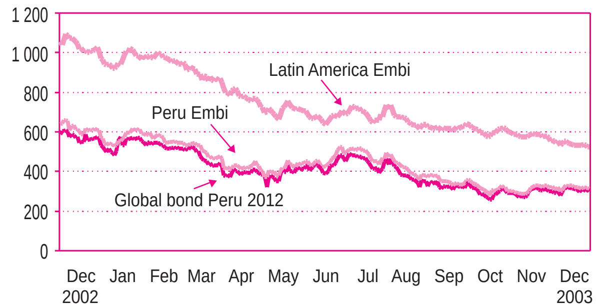
NOMINAL AND REAL DEPRECIATION OF THE NUEVO SOL VIS-A-VIS THE CURRENCIES OF OUR MAIN TRADING PARTNERS
(Variation rates as of December 2003)

		Nominal		Real	
	Weighting *	From 1998	From 2002	From 1998	From 2002
USA	25.1	28	-1	23	-2
Euro zone	20.1	43	19	35	18
Japan	10.3	53	12	26	9
Brazil	6.4	-51	23	-37	31
United Kingdom	5.8	35	9	30	10
Chile	4.8	-7	15	-6	14
China	4.3	28	-1	5	-1
Colombia	4.0	-41	-1	-9	3
Mexico	3.4	-8	-10	29	-9
Argentine	3.4	-57	15	-49	16
Currency basket		**13**	**7**	**15**	**8**

* For trade in the year 1994.

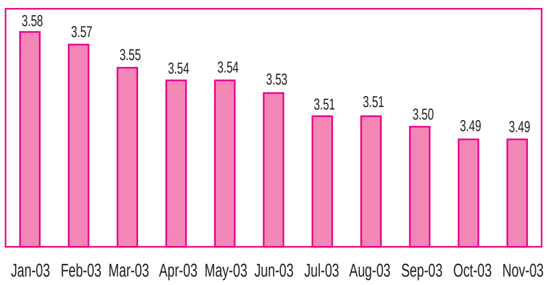
GRAPH 8

COUNTRY RISK INDICATORS
(December 2002 - December 2003)



GRAPH 9

EVOLUTION OF THE EXCHANGE RATE EXPECTATIONS IN THE FINANCIAL SYSTEM FOR DECEMBER 2003



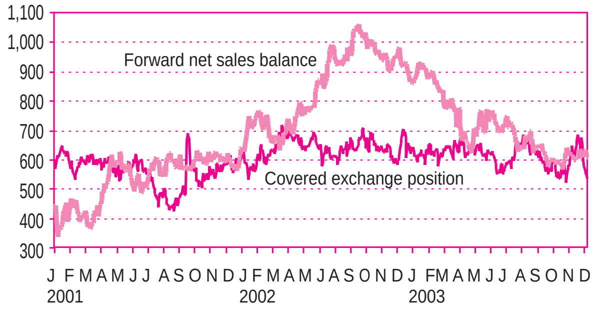
In that same quarter, Fitch changed Peru's outlook from «negative» to «stable», Standard & Poor's kept its country risk at «BB-» while the Government placed a US$ 500 million 30 year-matured global bond in the market.

During 2003 depreciation expectations had a downward trend, as shown in the monthly survey conducted by the Central Bank among financial institutions and economic analysts every month. Further, the implicit depreciation rate for three-month forward operations fell from 3.2% in December 2002 to 1.8% in December 2003.

Falling depreciation expectations are mainly associated with the favorable outlook for external accounts, the positive environment within the region and the dollar weakness against the euro, yen and other strong currencies. These expectations might have caused the small number of forward operations, especially sales. The

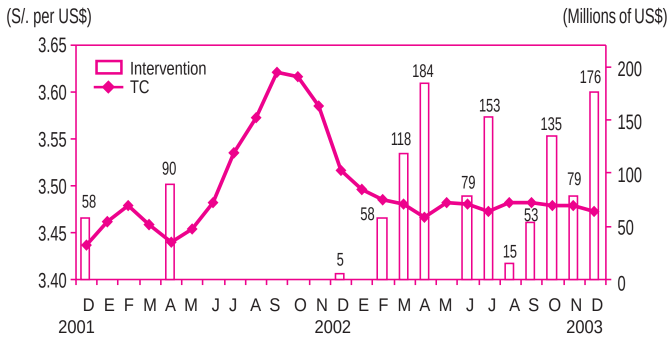
GRAPH 10

COVERED EXCHANGE POSITION AND NET FORWARD SALES BALANCE
(Millions of US$)



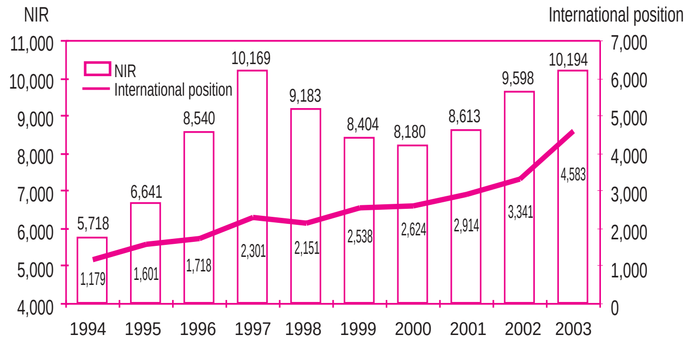
GRAPH 11

EXCHANGE RATE AND BCRP'S INTERVENTION
December 2001 - December 2003



GRAPH 12

BCR'S NET INTERNATIONAL RESERVES AND INTERNATIONAL POSITION 1994 - 2003
(Millions of US$)



stock of banks' net forward sales came down, from US$ 905 million in December 2002 to US$ 607 million in December 2003, reflecting lowered public demand for exchange coverage.

Over the same period, the banks' exchange position fell by US$ 106 million, from US$ 643 to US$ 536 million.

The Central Bank purchased US$ 1,050 million in the exchange market. Net purchases amounted to US$ 998 million including net sales to the Treasury. The purchases done during the year strengthened the international reserves position allowing portfolio changes in a context of financial dedollarization, reversing the deflationary pressure registered over the second and third quarters. Through these operations, the policy of a floating exchange rate is kept, with occasional interventions to avoid significant fluctuations, without aiming at defending any given parity level.

These interventions in the exchange market, plus other operations (mainly net interest earned) allowed an increase of US$ 1,242 million in the Central Bank's exchange position. Net international reserves rose by US$ 596 million despite smaller deposits of the public sector (US$ 139 million) and financial entities (US$ 488 million) which reduced their excess liquidity in dollars. Net international reserves amounted to US$ 10,194 million, the highest level since 1997, before the Russian crisis.

Net international reserves currently cover 15 months of imports and represent 2.3 times the external debt due in one year, which protects the country against

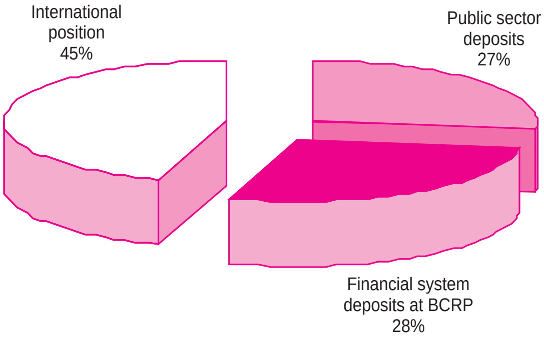
TABLE 7

NET INTERNATIONAL RESERVES'S INDICATORS

	2001	2002	2003
NIR / Monetary base (times)	4.9	5.0	4.7
NIR as % of broad money (M4)	60	65	67
NIR (number of months of imports of goods)	14	15	15
NIR / Debt due in one year (times)	1.4	2.1	2.3

GRAPH 13

NIR COMPOSITION AS OF DECEMBER 31, 2003



possible restrictions in the international capital market. Given that the ratio of NIR to monetary base is almost 5 the country is comfortably placed in the event of extraordinary demand for foreign exchange.