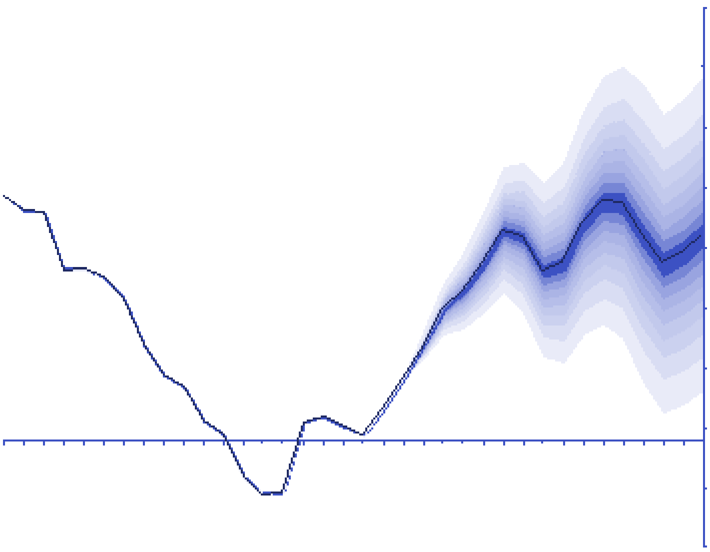
Inflation Report: Recent developments and outlook

JANUARY 2003



BANCO CENTRAL DE RESERVA DEL PERÚ

JANUARY 2003

Inflation Report:

Recent developments and outlook

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INFLATION REPORT:
RECENT DEVELOPMENTS AND OUTLOOK

CONTENT

January 2003

FOREWORD

In 2002, monetary policy was oriented to fight deflationary pressures and sluggish economic activity through lower interbank interest rates (from 8,6 percent in 2001 to 3,2 percent in 2002) and the expansion of liquidity levels. In 2002, the inflation target of 2,5 ± 1 percent margin was met. The end-of-year annual rate of inflation was 1,52 percent, near the lower margin of the announced target, and higher than the inflation rate of the previous year. Economic growth rebounded significantly (4,9 percent).

In the third quarter of 2002, the conduct of monetary policy faced exchange rate pressures derived from the deterioration of investor confidence in the region. The stability of the domestic currency was preserved through monetary tightening and exchange market intervention. These factors, along with a rapidly growing economy and a sustainable public deficit, allowed a prompt restoration of conditions for a reduction in interest rates.

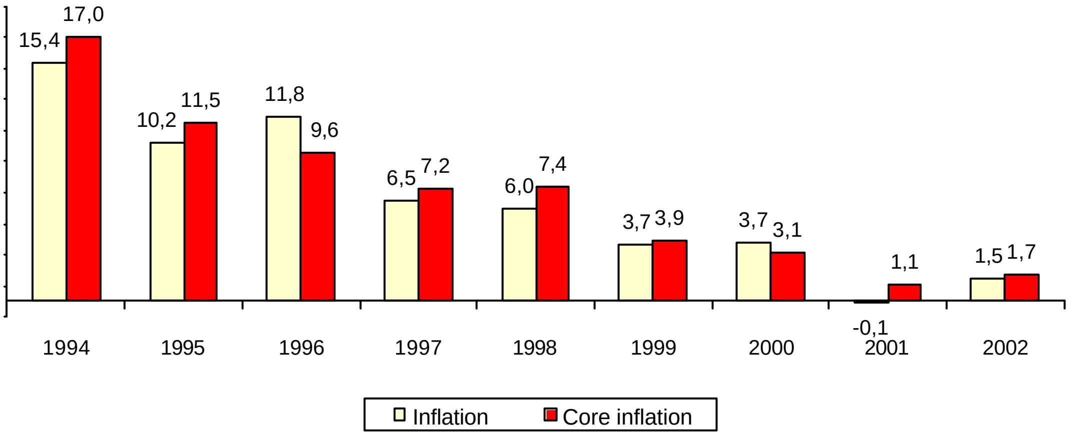
In 2003, estimated inflation would allow a flexible monetary stance in a context of economic growth. Over this period, uncertainties regarding the international oil market will be taken into consideration. However, a more stable scenario for oil international prices and a greater recovery of world economic activity would have a positive effect on external demand and therefore on real output and employment.

The Board of the Central Bank has decided to release its monetary policy decisions, beginning January 2003 Monetary Program, in terms of the Central Bank's interest rates for lending and borrowing operation with banks. These rates establish a reference corridor for interest rates in the interbank market. Additionally, the Central Bank will continue releasing every month the estimated banks' daily average disposable liquidity.

I. INFLATION IN 2002

1. In 2002, annual inflation calculated as the percentage change in the Consumer Price Index of Metropolitan Lima was 1,52 percent, reverting the negative variation recorded in 2001 (-0,13 percent) and meeting the range announced by the Central Bank. On the other hand, core inflation, an indicator that excludes high-volatility prices, reached 1,69 percent in 2002 (vis-à-vis 1,06 percent in 2001).

Graph 1
INFLATION AND CORE INFLATION
(In percentage)



2. **Core inflation** was 1,69 percent in 2002. By components, average prices of goods grew 1,76 percent, whereas those of services increased 1,57 percent. Within goods, the prices of processed foodstuffs increased 2,4 percent, in particular bread (14 percent) and oil (7 percent). This responded to the increase in the international price of wheat (30 percent) and soybean oil (15 percent).

3. Regarding the **non-core** components of inflation, the most important price increase was for fuels, 15,6 percent in 2002. It should be noted that last year, the international price of oil increased 50 percent.

Table 1

INFLATION

(Percentage change)

	Weight	2000	2001	2002
I. CORE INFLATION	**68,3**	**3,11**	**1,06**	**1,69**
Goods	**41,8**	**2,47**	**0,66**	**1,76**
Non-processed foodstuff	1,8	-1,42	-1,13	0,26
Processed foodstuff	16,7	0,96	-0,69	2,43
Beverages	2,3	6,04	0,52	0,82
Textiles	5,5	3,06	2,02	1,24
Footwear	2,0	1,30	1,71	0,58
Electrical appliances	1,0	1,83	-0,19	3,42
Other processed goods	12,5	4,77	2,39	1,54
Services	**26,6**	**4,04**	**1,65**	**1,57**
Restaurants	12,0	3,68	1,29	1,28
Education	5,1	5,60	3,97	2,70
Other personal services	3,5	2,82	1,08	0,28
Rent	2,3	3,43	-0,37	1,00
Health	1,3	4,68	3,02	3,31
Other services	2,4	6,22	3,50	2,11
II. NON-CORE INFLATION	**31,7**	**5,18**	**-2,82**	**1,16**
Foodstuff	14,8	-0,43	-1,16	-2,35
Fuels	3,9	30,33	-13,14	15,60
Transportation	8,4	5,02	-0,02	0,11
Utilities	4,6	5,13	-2,73	1,96
III. INFLATION	**100,0**	**3,73**	**-0,13**	**1,52**

4. The three items with the highest positive price variation explained 0,97 percentage points of the annual inflation rate. In particular, the increase in bread and fuels, due to the effect of the increases in the international price of wheat and oil, explained 0,50 and 0,47 percentage points of the CPI increase, respectively. On the other hand, the three items with the highest negative price variation contributed to -0,63 percentage points of CPI variation, due to the greater supply of agriculture and livestock products.

Table 2

INFLATION: 2002
(Percentage points)

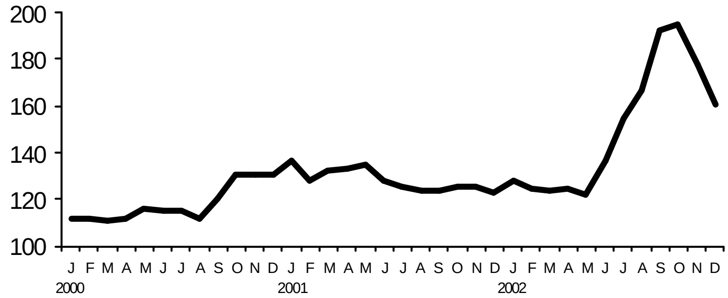
Highest positive variations				Highest negative variations			
Items	Weight	Percentage change	Contribution (percentage points)	Items	Weight	Percentage change	Contribution (percentage points)
Bread	3,7	13,6	0,50	Poultry	4,0	-7,8	-0,31
Kerosene	1,2	20,4	0,24	Potato	1,5	-11,4	-0,18
Gasoline	1,5	15,7	0,23	Rice	2,3	-5,8	-0,14
Total			**0,97**				**-0,63**

Source: National Institute of Statistics and Data Processing (INEI)

- The price of bread increased mainly in September and October (18,9 percent) and decreased in November and December (4,5 percent) due to the fall in the international price of wheat (17,6 percent during these two months). Between January and October 2002, the international price of wheat increased 58 percent, due to droughts in main producer countries such as Australia, Canada, and the United States.

Graph 2

INTERNATIONAL QUOTATIONS FOR WHEAT (HRW)
(US$ /M.T.)



Source: Chicago Board of Trade

- In 2002, oil price grew 15,7 percent, the price of kerosene 20,4 percent, and the price of liquid gas 11,3 percent. In the same year, the international price of oil increased 50 percent, reflecting the decision of the Organization of Petroleum Exporting Countries (OPEC) to limit supply, the uncertainty about a possible conflict between the U.S. and Iraq and export restrictions in Venezuela. In consequence, the price per barrel of West-Texas Intermediate crude oil reached US$ 29 in December 2002, compared with US$ 19 a year ago. In the first half of January 2003, the price of this commodity reached US$ 33 per barrel, reflecting the recrudescence of the above mentioned factors. Another source of the oil price increase was the rise in the excise tax on fuel, which on average increased from S/. 1,79 in December 2001 to S/. 2,20 in December 2002 (a 23 percent increase).

Graph 3

INTERNATIONAL QUOTES FOR WTI OIL
(US$ per barrel)

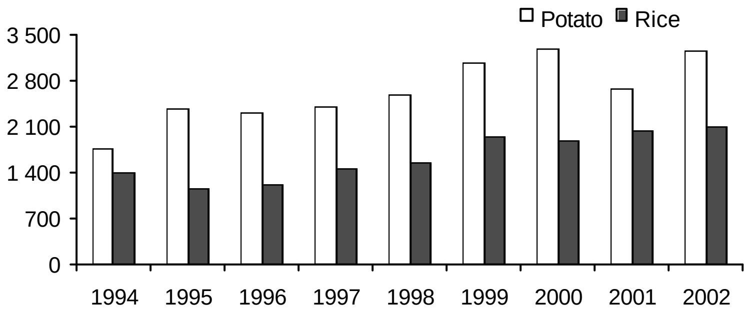
Source: Bloomberg

- Downward pressures on the prices of main agriculture products such as potato and rice are linked to the increase in sown areas and higher yields during the last agricultural season (9,4 and 6,2 percent, respectively), in a context of good weather conditions. For instance, potato yield increased from 12,5 tons per ha in 2001 to 13,3 in 2002.

Graph 4

PRODUCTION VOLUMES

(Thousand of metric tons.)



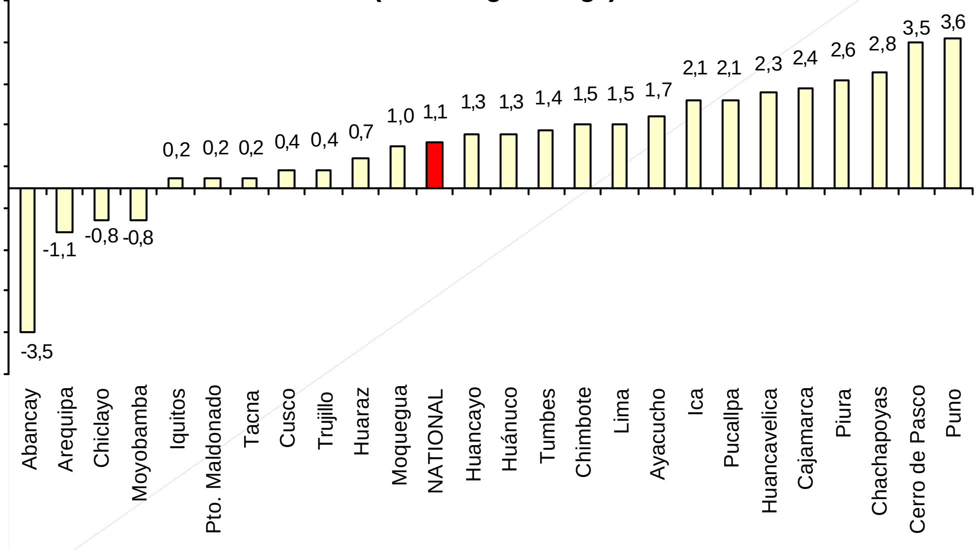
Source: Ministry of Agriculture

5. Since January 2003, the National Institute of Statistics and Data Processing (INEI) has begun to release a Consumer Price Index on a national basis, considering the price indexes of 25 major cities. According to this indicator, the overall price increase in 2002 was 1,1 percent. Eleven cities, accounting for 19 percent of national urban expenditure, were below the national urban average, whereas 14 cities explaining the remaining 81 percent were above. It should be noted that the weight of Metropolitan Lima is 70 percent of overall expenditure.

Graph 5

INFLATION BY CITIES: 2002

(Percentage change)



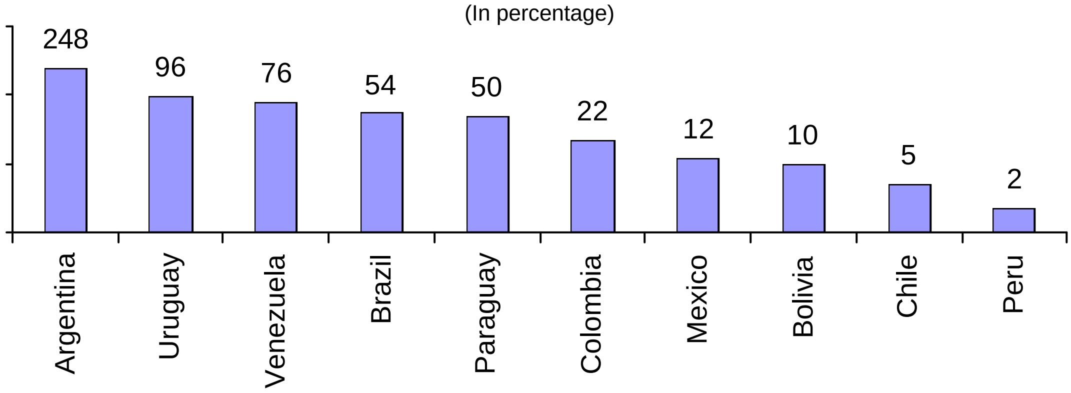
Source : National Institute of Statistics and Data Processing

6. The nominal exchange rate recorded an increase of 2,3 percent in the year, closing at S/. 3,52. However, domestic currency depreciation did not exert pressure on consumer prices. The items of the consumer price index related to the exchange rate, such as tradable goods, recorded a joint increase of 1,9 percent. The Peruvian sol was the currency that recorded the lowest rate of depreciation in Latin American in 2002.

Graph 6

DEPRECIATION OF LATIN AMERICAN CURRENCIES: 2002

(In percentage)



Source: IMF, Reuters, Bloomberg

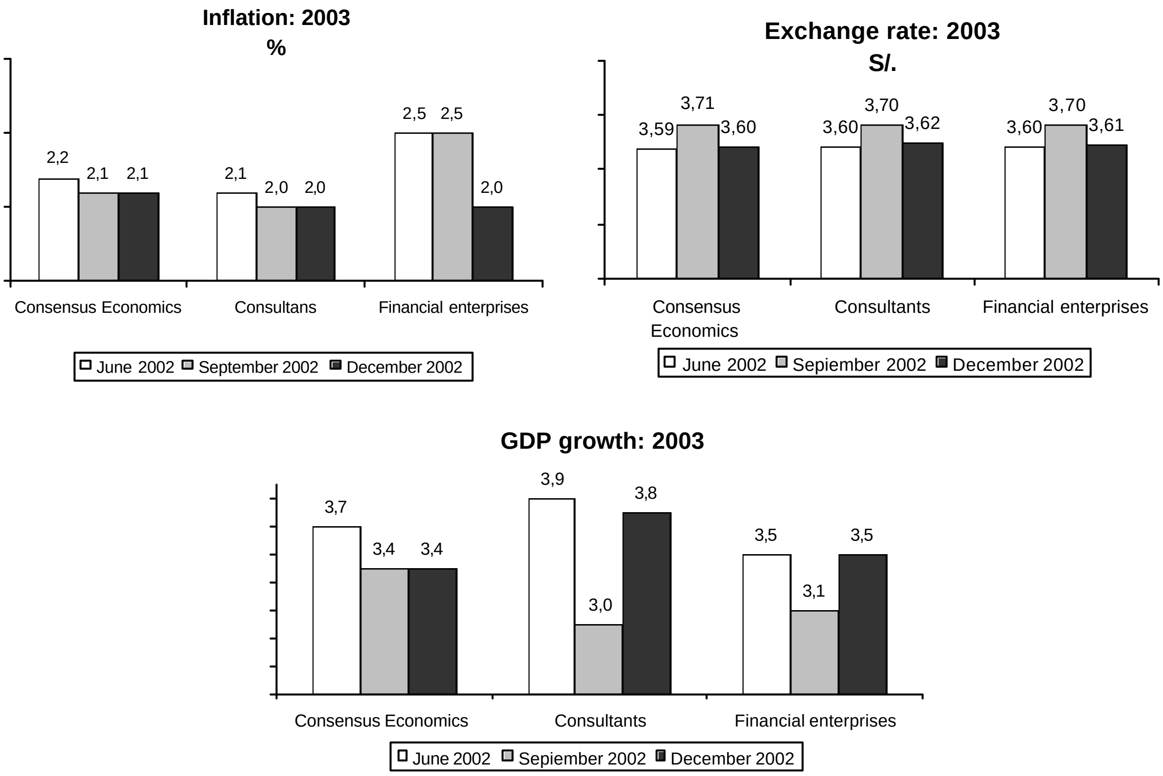
7. The factors contributing to the strength of the domestic currency in 2002 were the increase in export prices and volumes, which grew 3,8 percent in each case, and the substantial inflow of private capitals. Terms of trade increased 2,6 percent in 2002, reverting the fall of 2 percent in 2002 and 16 percent in the period 1997-2000. The short- and long-term inflow of private capitals increased from US$ 2 006 million in 2001 to US$ 2 267 million in 2002. Other important factors were the level of net international reserves of the Central Bank, as well as the more dynamic management of public debt in international markets.

8. Domestic inflation was favored by a lower external inflation, measured in terms of the U.S. dollar, due to the depreciation of the currencies of our main trade partners currencies against the U.S. currency. Thus, the external inflation indicator of our 20 trade partners was negative in 1,2 percent (-2,1 percent in 2001). However, at the end of 2002 the yen and euro recorded a sharp increase against the U.S. dollar (13 and 4 percent in 2002) due to the negative outlook of the U.S. economy and uncertainties about a military conflict in Iraq.

II. FORESEEN INFLATION SCENARIOS

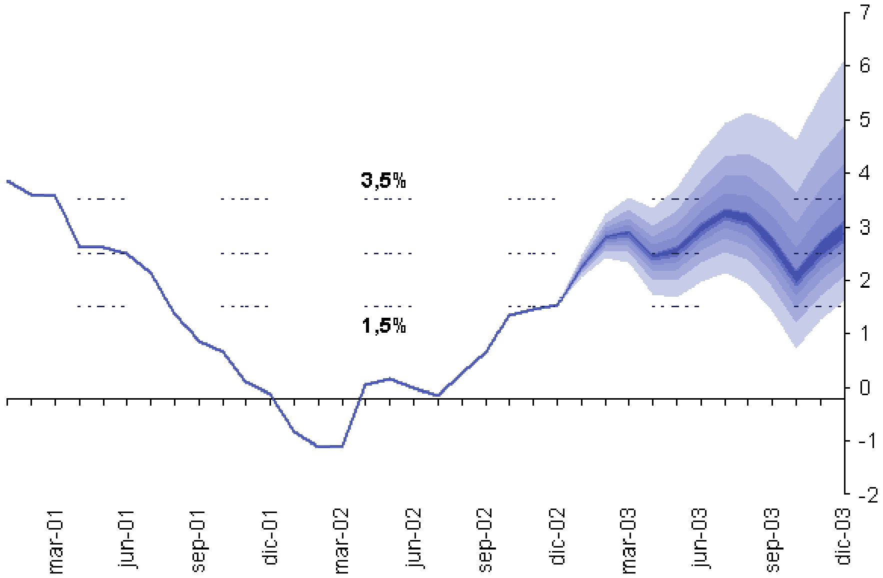
9. Market expectations for 2003 are gathered from the **Consensus Economics** and the surveys carried out by the Central Bank among financial enterprises and economic consultants. Compared with the inflation report of September 2002, inflation expectations remained at 2,0 percent, in line with the Central Bank´s target. There is also a decrease in end-2003 exchange rate expectations from S/. 3,70 to S/. 3,61, following the appreciation of the domestic currency in late 2002. The upward revision of 2002 GDP growth expectations from 3,2 to 3,6 percent should be noted.

Graph 7
EXPECTATION SURVEYS



10. The **baseline scenario** of the Central Bank's 2003 forecasts indicates that the rate of inflation would meet the target of the monetary policy, and that it would be similar to that reported in September 2002. In the new forecast, the increase in the oil price is netted out with a lower exchange rate. However, the upward bias of this forecast, shown in the shaded areas around the most lkely scenario for 2003, reflects the uncertainty about the oil price. The darkest area indicates the most likely scenario if the monetary stance set by the Board of the Central Bank in January remains along the year.

Graph 8
Inflation forecasts
(% variation over last 12 months)



11. The main elements behind this forecast are:

- The components of the **non-core consumer price index** would increase 3,7 percent in 2003, higher than in the previous forecast (2,6 percent), mainly due to the upward revision of the estimated oil international price from US$24 to US$26 as of end-2003. On the other hand, the increase in foodstuff prices would be 3,5 percent (versus 2,4 percent in the September report) due to the impact of unfavorable weather conditions on agriculture.

- The **multilateral index of external prices** in U.S. dollars might increase 3,4 percent (the September forecast was 2,8 percent). External inflation in 2003 would reflect the depreciation of the U.S. dollar against the euro (estimated at 3,0 percent).

- The 3-month **LIBOR** would remain low thanks to the expansionary monetary policy carried out in developed countries to avoid deflationary pressures. In the fourth quarter of 2003, the LIBOR would be 2,0 percent (versus 3,3 percent of September report).

- The **gap between potential and actual output** would decrease further in 2003, in line with the recovery in incomes and employment in response to a favorable macroeconomic framework of low interest rates and to the absence of fiscal pressure for financing. This trend would be reinforced by the increase in potential GDP growth due to the recovery in the stock of capital and to higher increments in productivity.

Table 3
EXTERNAL SECTOR ASSUMPTIONS: 2003
(In percentage)

	2001	2002	2003
1. External inflation index	-2,1	-1,2	3,4
Excluding Argentina	*-2,1*	*2,0*	*3,2*
2. Rate of inflation 1/			
United States	2,8	1,6	2,2
Euro zone	2,5	2,2	1,7
Japan	-0,7	-0,9	-0,8
3. Exchange rate (end of period)			
Euro / US$	1,12	0,98	0,95
Yen / US$	127,4	121,8	122,5
4. GDP growth			
World economy	1,1	1,7	2,3
Main trade partners 2/	1,6	1,6	2,6
United States	0,3	2,4	2,7
Euro zone	1,4	0,8	1,4
5. Terms of trade	-1,95	2,64	0,81
6. Interest rates			
3 month LIBOR (end of period)	1,9	1,5	2,0
US Treasury bonds (10 years)	5,1	3,8	5,9

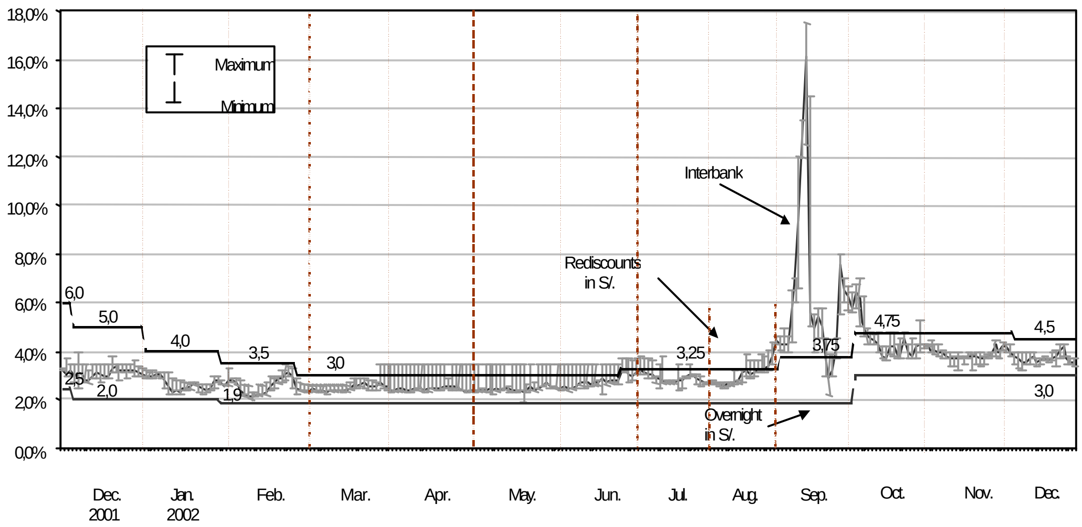
1/ Average of the year.
2/ Average of Peru's main trade partners.
Source: Consensus Forecast and World Economic Outlook (IMF)

III. MONETARY POLICY

12. The monetary policy set by the Board of Directors of the Central Bank since August 2001 has aimed at avoiding deflationary pressures. In this context, the adoption of explicit inflation targeting has increased the transparency of monetary policy by relating it to the achievement of the target and by taking into consideration the balance of risks for macroeconomic variables.

13. These decisions have induced a reduction in the interbank interest rate from 8,4 percent in July 2001 to 3,1 percent in December 2001, and furthermore to 2,6 percent in June 2002. However, since July 2002, financial instability increased in Latin America. In order to prevent an inflation rise because of this, measures were taken to increase the interbank interest rate, which reached 2,9 percent in July and 5,4 percent in September. Once financial instability decreased in October, a more accommodative stance of monetary policy allowed the interbank interest rate to reach a level of 3,8 percent at the end of year.

Graph 9
INTEREST RATES IN DOMESTIC CURRENCY



14. In 2002, monetary policy decisions were communicated by means of a range for commercial banks' demand deposit balances held at the Central Bank. Until December, this variable was the operational target of monetary policy, used as a guide for monetary injection or stabilization, and thus, for the interbank interest rate. However, there were six times when current account balances fell outside the announced range. This was because of shifts in banks' demand for liquidity to meet domestic currency reserve requirements, and because of changes in the composition of reserves between cash in vault and demand deposits at the Central Bank. Therefore, in order to reduce uncertainty when estimating banks' reserves, the Central Bank decided to consider banks' cash in vault of the previous month to calculate reserves for the current month.

15. In order to improve the communication with the public, since January 2003 the stance of monetary policy is set in terms of the lending and borrowing interest rates for Central Bank monetary operations with commercial banks (direct repos, rediscounts and overnight deposits). The estimated demand deposit balances are still announced, not as a target but as a reference for banks of the level of monetary operations for each month. This emphasis aims at increasing the Central Bank's ability to affect the interbank interest rate level and to reduce its variability. However, the lending interest rate will be the same as the interbank interest rate should the latter rise above the reference lending interest rate announced by the Central Bank. In this way, the Central Bank aims at avoiding significant transitory depreciation pressures on the forward and spot foreign exchange markets.

Box 1

PRESS RELEASE: JANUARY MONETARY PROGRAM

Press release

MONETARY PROGRAM APPROVED BY THE BOARD OF THE CENTRAL BANK FOR JANUARY 2003

1. **The Board of the Central Bank approved a reduction of the effective interest rate for monetary regulation credits and temporary direct purchases of securities from 4,50 to 4,25 percent, remaining the effective interest rate for overnight deposits in domestic currency held by banks at the Central Bank at 3,0 percent**. In this month, the projected range for banks' current account balances held at the Central Bank is S/. 170 - S/. 190 million on a daily average basis, considering the lower liquidity requirements registered seasonally in January. The interest rate for monetary regulation credits and temporary direct purchases of securities will be equal to the interest rate of the interbank market when the latter surpasses 4,25 percent.

2. The decisions of monetary policy are oriented to obtain an annual accumulated inflation rate of 2,5 percent, with a range of tolerance of plus/minus one percentage point. In 2002 the rate of inflation was 1,52 percent, in the lower margin of the Central Bank´s target. For 2003, economic surveys suggest expectations for inflation and exchange rate depreciation at 2 percent and 3 percent, respectively.

3. Until October 2002, the annual growth of GDP and domestic demand reached 4,7 and 3,9 percent, respectively. For 2003, favorable prospects continue regarding the evolution of economic activity in a low-inflation environment. Economic surveys point to an expected GDP growth rate of 3,5 percent.

4. In the short term, the main source of inflationary risk is a possible rise in the international price of oil, which already increased 15 percent in December, in a volatile external context. Nevertheless, since this does not affect the other domestic prices, it would not prompt any offsetting monetary policy action.

5. The interest rates for the Central Bank's operations in U.S. dollars are:
   a. Monetary regulation credits: one-month Libor interest rate plus one percentage point.
   b. Overnight deposits: the average rate that the Central Bank obtains abroad for same type of deposits.

6. The calendar of Board meetings for the approval of Monthly Monetary Programs is the following:

February 6 th	March 6 th	April 3 rd	May 8 th	June 5 th	July 3 rd
August 7 th	September 4 th	October 2 nd	November 6 th	December 4 th	

7. The Central Bank will issue its Inflation Report in the following dates:

January 31 st	May 30 th	August 29 th

January 6, 2003

Table 4
MONETARY POLICY DECISIONS

	Interest rates (%)			Banking liquidity (million of S/. daily)		
	Overnight deposits	Rediscounts	Interbank interest rate	Lower limit	Upper limit	Actual average balances
Dec. 2001	2,0	5,0	3,1	150	160	165
Jan. 2002	2,0	4,0	2,7	160	170	160
Feb.	1,9	3,5	2,6	160	170	189
Mar.	1,9	3,0	2,5	185	195	205
Apr.	1,9	3,0	2,5	205	215	206
May.	1,9	3,0	2,5	205	215	196
Jun.	1,9	3,0	2,6	195	205	217
Jul.	1,9	3,25	2,9	205	215	205
Aug.	1,9	3,25	2,9	190	210	186
Sep.	1,9	3,25	5,4	175	195	190
Oct.	3,0	4,75	4,6	180	200	188
Nov.	3,0	4,75	3,9	170	190	165
Dec. 2002	3,0	4,50	3,8	180	200	191
Jan. 2003	3,0	4,25		170	190	

16. In 2002, the trend shown by the interbank interest rate was mainly a consequence of the amount of liquidity created by the Central Bank's monetary operations with commercial banks. The variability of the interbank interest rate continued decreasing, from 0,9 percentage points in 2001 to 0,5 percentage points in 2002. The latter allows a more predictable interbank interest rate for market participants, increasing its value as a benchmark for other market interest rates. In this way, changes in the interbank interest rate, induced by monetary policy stance changes, will be transmitted more easily to other market interest rates, thereby increasing monetary policy effectiveness.

Graph 10
CURRENT ACCOUNT AND LENDING INTEREST RATES OF BCR MONETARY OPERATIONS

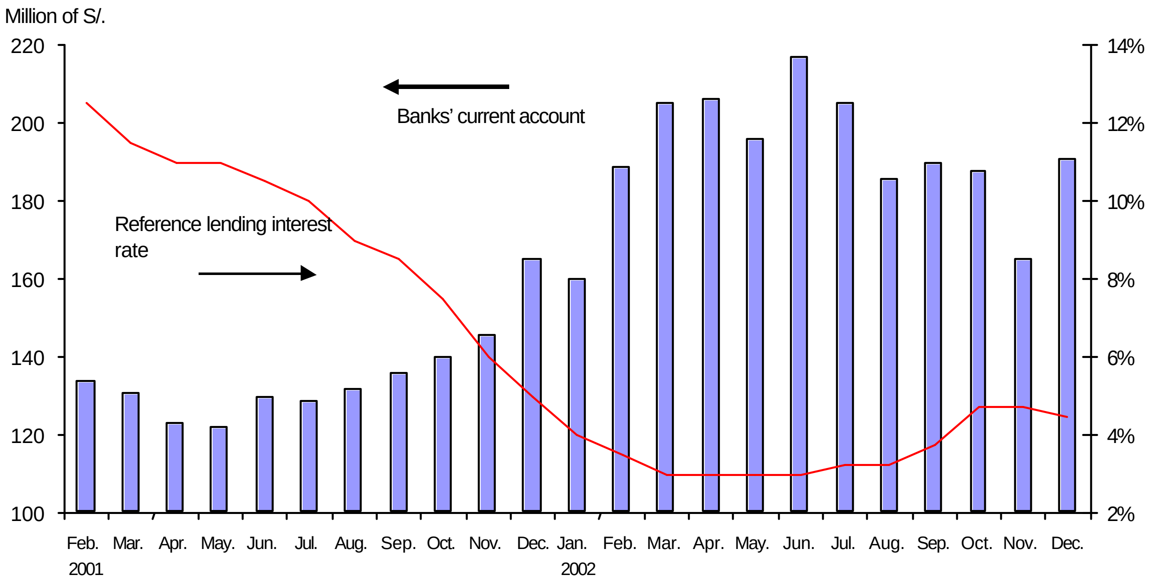


Table 5

LEVEL AND VARIABILITY OF THE INTERBANK INTEREST RATE[1/]

(percentage points)

Year	*Average interest rate*	*Standard deviation*
1998	19,0	6,6
1999	14,9	4,8
2000	12,7	2,5
2001	8,6	0,9
2002	3,2	0,5

1/ Year standard deviation is computed as the average of monthly deviations.

17. The interbank interest rate had the expected influence over other market interest rates in domestic currency. Graph 11 shows a clear relationship between the interbank interest rate and the corporate prime interest rate for low-risk clients.

Graph 11

MONTHLY AVERAGE INTEREST RATES IN DOMESTIC CURRENCY

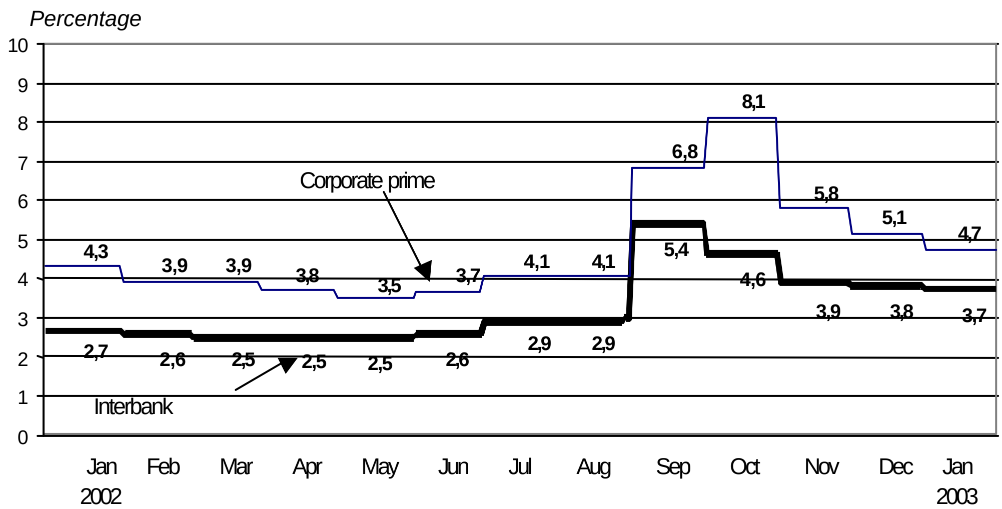


Table 6

INTEREST RATES IN DOMESTIC CURRENCY

(In percentage)

	2001				2002			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
1. Interbank	10,3	16,0	5,9	3,1	2,5	2,6	5,4	3,8
2. Saving deposits	6,8	6,3	5,2	3,0	1,8	1,7	1,7	1,7
3. Lending (prime)	12,4	13,2	9,4	5,0	3,9	3,7	6,8	5,1
4. Lending (average) up to 360 days	21,3	21,2	19,4	17,2	15,5	14,1	14,0	14,8
5. Balance of CDBCRP	12,6	12,4	10,8	7,5	5,4	4,8	4,1	4,7

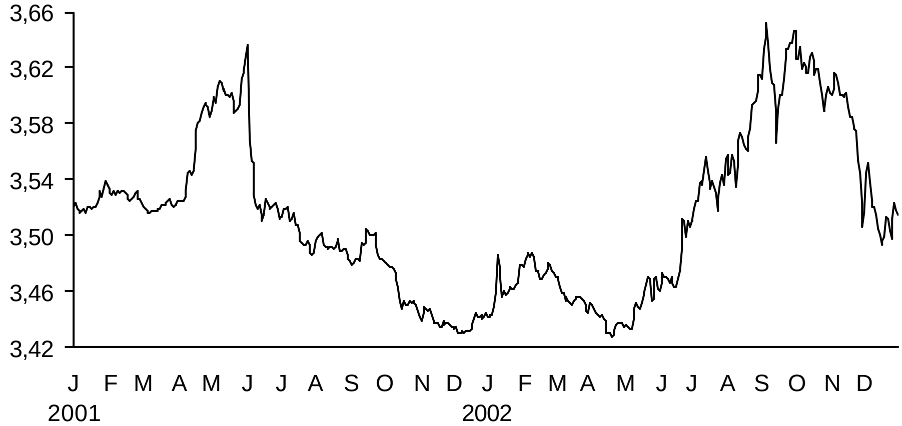
18. In 2002, the Central Bank intervened in the exchange market through purchases and sales of foreign currency in the spot market. The aim was to avoid transitory and significant fluctuations in the exchange rate, since these movements can have a permanent negative impact on financial stability. Thus, in the second quarter, the Central Bank purchased US$ 90 million, whereas in the fourth quarter it sold US$ 127 million. Additionally, in July the Board of the Central Bank authorized the creation of a depreciation-linked certificate of deposit (CDR). CDRs contribute to reducing pressures over the forward exchange market when there is an unexpected and significant demand increase. Between August and December, the Central Bank issued CDRs by S/. 319 million, of which S/. 83 million were redeemed in January 2003 and were not renewed.

19. In January and February, the nuevo sol started to depreciate as a consequence of the Argentine crisis. A greater number of sale forward operations were carried out (the net balance increased from US$ 586 million in December 2001 to US$ 740 million in February 2002). In this context, domestic currency depreciation reached 0,7 percent in the first two months of the year. Conversely, in March and April, the nuevo sol appreciated, reflecting a lower demand for forwards (the net balance decreased to US$ 705 million as of April).

Graph 12

ASK INTERBANK EXCHANGE RATE

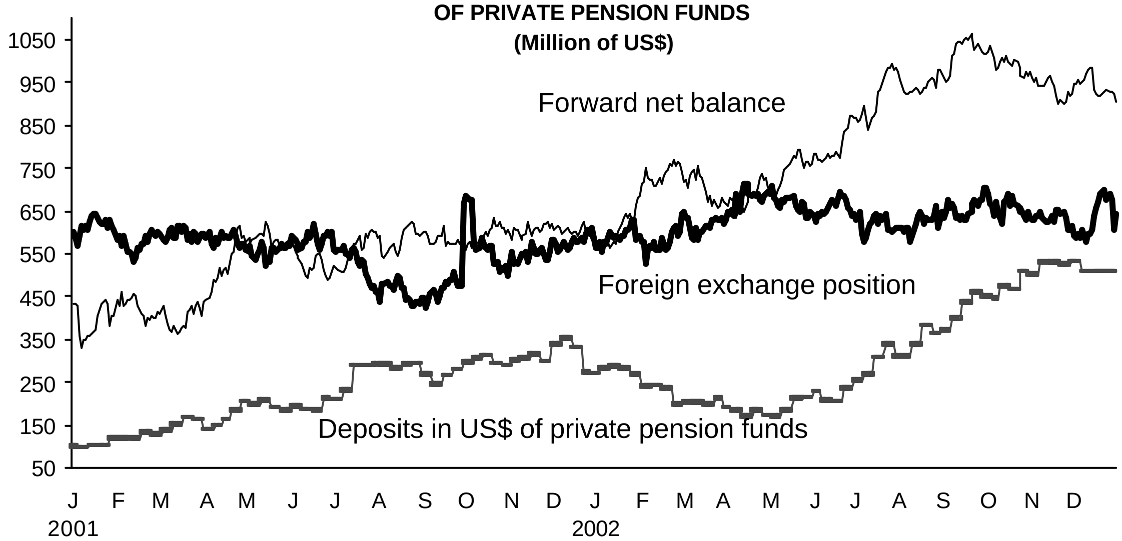
(Nuevos Soles per US dollar)



20. Since May, regional market uncertainty related to the electoral process in Brazil pushed the demand for sale forwards in foreign currency up to a net balance of US$1 017 million in September. Also, demand for foreign currency deposits of local pension funds increased from a US$167 million balance in April to US$449 million in September. Over this period, exchange rate movements were closely related to the behavior of the Brazilian real. Between May and September, domestic currency depreciation was 6 percent. On September 5 the exchange rate recorded its highest level in the year (S/. 3,65 per dollar).

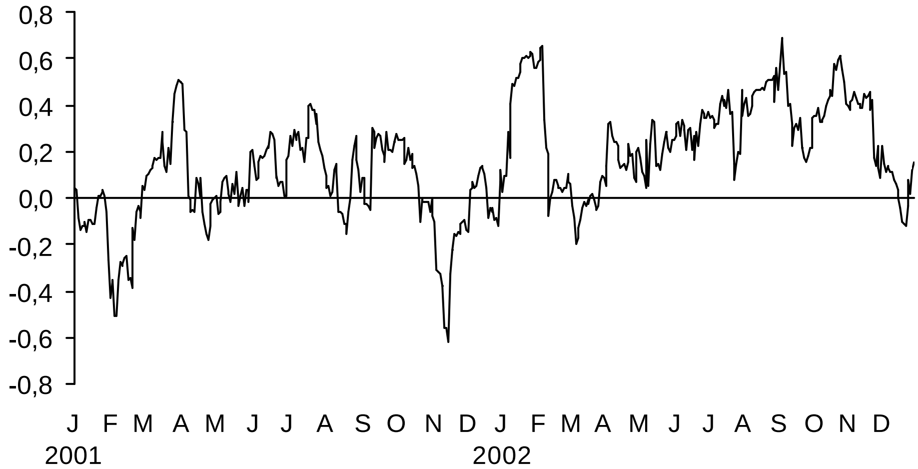
Graph 13

FOREIGN EXCHANGE POSITION, NET BALANCE OF FORWARDS AND DEPOSITS IN US$ OF PRIVATE PENSION FUNDS
(Million of US$)



Graph 14

MOVING CORRELATION COEFFICIENT
Peruvian nuevo sol and Brazilian real

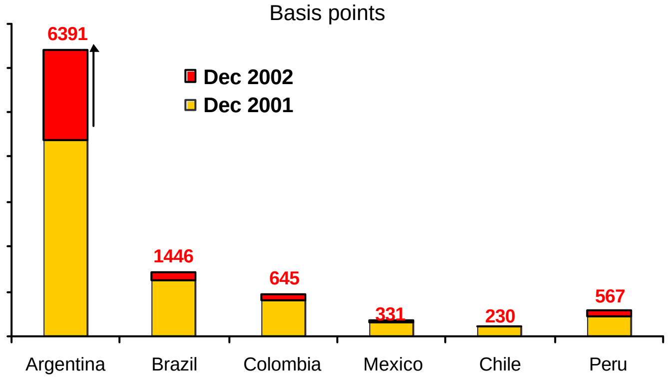


21. In the fourth quarter of the year, the risk perception of the economies in the region turned positive. In particular, the Peruvian economy started to show signals of differentiation thanks to its greater economic activity, price stability, public finances under control and high level of international reserves. As a consequence, the spread of Peruvian sovereign bonds passed from 8,2 percentage points in August to 6,2 percentage points in December. On November 25, the government issued 5-year matured sovereign bonds for US$ 500 million with an effective rate of 9,35 percent. In this context, the Peruvian currency appreciated 3,5 percent in the fourth quarter.

Graph 15

SOVEREIGN BOND SPREADS

Basis points



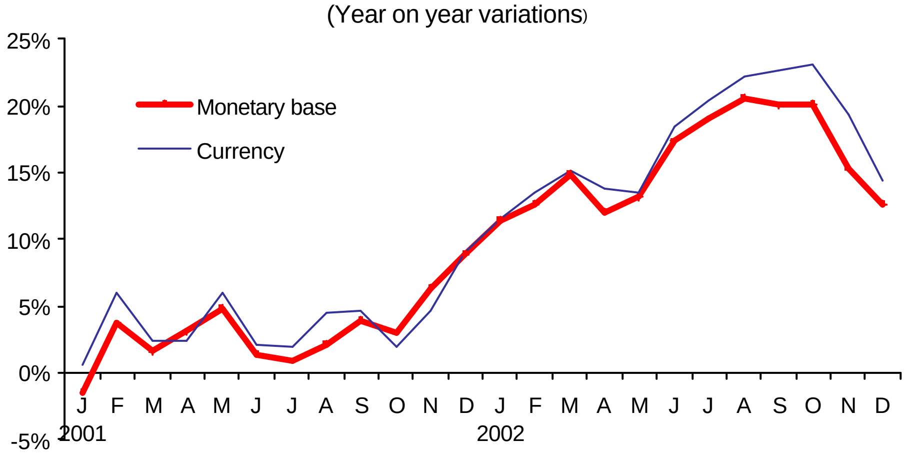
Source: Reuters

22. The low interest rate context induced highly liquid **monetary aggregates growth**, in particular currency, whose annual rate of growth augmented from 9 percent in 2001 to 14 percent in 2002. The higher level of liquidity of private sector assets had a considerable impact on the growth of sales and expenditures. It is worth mentioning that this increase in monetary aggregates slowed in the fourth quarter as a consequence of the transitory rise of interest rates between September and October.

Graph 16

CURRENCY AND MONETARY BASE RATES OF GROWTH

(Year on year variations)



23. In 2002, financial system credit to the private sector in domestic currency grew 10,6 percent, compared with a growth of 9,3 percent in 2001, whereas credit in foreign currency decreased again this year (-4,1 percent in 2001 and –2,9 percent in 2002). Overall, financial system credit to the private sector recorded an increase of 1,7 percent in 2002, against a 3,5 percent contraction in 2001, thus reverting the last three-year fall. This shift in the trend reflected the improvement of banks' portfolios (non-performing loans decreased from 9 percent in December 2001 to 8 percent in November 2002), whereas banks' profits, as a percentage of equity, rose from 4,5 percent in 2001 to 6,7 percent in November 2002.

24. It is expected that liquidity in domestic and foreign currency will grow 12 percent and 2,1 percent in 2003, respectively. The higher demand for domestic currency over that of foreign currency would be associated with the stability of domestic financial markets. Credit in domestic currency of the financial system to the private sector would grow 13,5 percent, whereas the growth of credit in foreign currency would be 5 percent, pointing to a greater dynamism of credit to the private sector in 2003.

Table 7

ANNUAL RATES OF GROWTH OF MONETARY AGGREGATES

(Year on year variations)

	Dec. 2000	Dec. 2001	Dec. 2002	Dec. 2003
1. Currency	-2,0	9,0	13,5	9,2
2. Liquidity in S/.	2,5	13,5	10,1	12,0
3. Credit in S/.				
Banking system	0,9	2,7	7,2	11,3
Financial system [1/]	5,5	9,3	10,6	13,5
4. Credit in US$				
Banking system	-4,5	-3,8	-3,4	5,1
Financial system [1/]	-2,2	-4,1	-2,9	5,0

1/ Bank and non-bank financial entities.

25. For 2003, the monetary base will grow 8 percent on average as a result of:

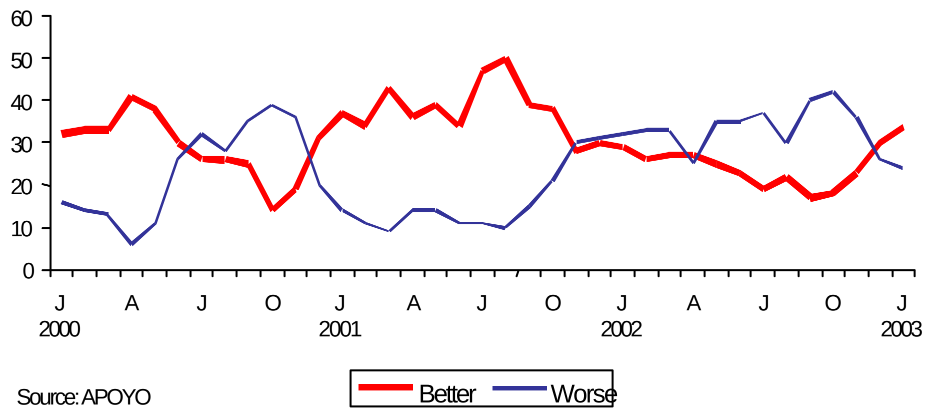
- GDP growth of 6,8 percent in nominal terms (4,0 percent in real terms).
- A 2,5 percent increase in the banking multiplier, reflecting the fall of cash preference in 2003, due in turn to higher interest rates.
- A reduction in the velocity of circulation of domestic currency, reflecting greater confidence in the nuevo sol, as well as lower depreciation expectations.

IV. ECONOMIC ACTIVITY

26. Between January and November, the GDP grew 4,8 percent, and it is expected to grow by 4,9 percent in 2002. **Private consumption** and **exports**, with an estimated growth of 4,1 and 5,7 percent, respectively, provided significant momentum.

27. Private consumption started to recover in the fourth quarter of 2001, due to the improvement in expected revenues (the national disposable income is estimated to grow 4,3 percent in 2002), the higher level of employment, and the greater dynamism of consumer credits. According to APOYO's surveys, the proportion of people that expect their personal income to increase over the next 12 month started to grow, especially since September 2002, exceeding the percentage of people that expected a fall. On the other hand, employment in Metropolitan Lima grew 3,7 percent between December 2001 and December 2002, with a simultaneous increase in the rate of participation of labor force, a characteristic of periods of economic growth. Other indicators of greater private consumption are the sales of new vehicles (which grew 6 percent in 2002) and the increase in imports of consumer goods (13 percent in the fourth quarter).

Graph 17
PERSONAL ECONOMIC SITUATION IN NEXT 12 MONTHS
(In percentages)



Source: APOYO

28. The volume of exports of goods and services grew 5,7 percent in 2002, in particular those of traditional products, thanks to the good performance of copper and gold exports (25,7 and 10,6 percent, respectively).

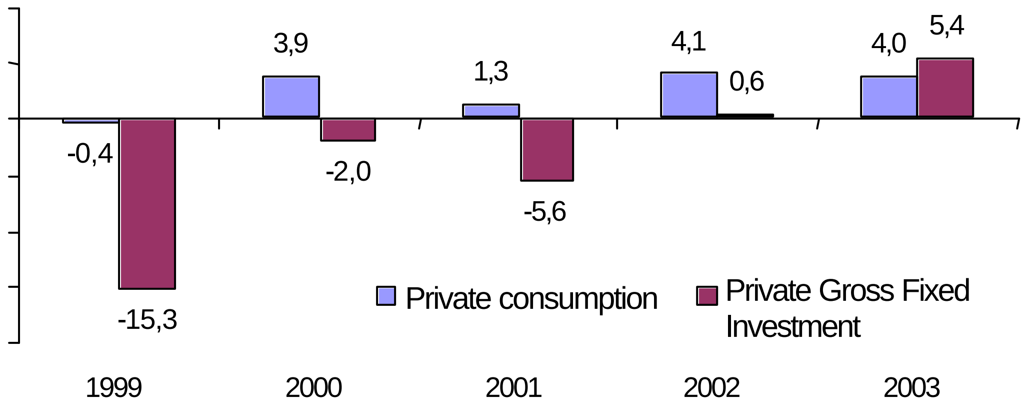
29. The estimated increase in gross domestic investment in 2002 is 6 percent, thus reverting the 8 percent decline registered in 2001. Gross fixed investment of the private sector would expand 1 percent, and the dynamism in sales would result in an inventories increase from 0,1 percent of GDP in 2001 to a 0,9 percent of GDP in 2002. Fixed investment started to grow in the third quarter, after falling for eight consecutives quarters. This improvement was reflected in higher construction activity (8,2 percent) and in the increase in imports of capital goods since the third quarter. It should be noted that in March, the government approved a tariff reduction, from 12 to 7 percent, for 1 248 capital good items, followed by a further

reduction to 4 percent for 178 items in September. The favorable performance of investment was reflected in the 19 percent increase in newly constituted enterprises, as well as in the 18 percent increase in patrimony according to the National Office of Public Records (Sunarp) as of November.

30. In **2003**, GDP would record a 4,0 percent rise, driven by the dynamism of exports and private consumption. **Exports of goods and services** would grow 6 percent, in particular the export volume of fishmeal (11,1 percent), copper (6,5 percent) and gold (3,2 percent), and the real value of non-traditional exports (15,4 percent) in response to the Andean Trade Promotion and Drug Eradication Act (ATPDEA). **Private consumption** will keep a similar pace to that of 2002, led by a 2 percent increase in employment, a 4 percent increase in national disposable income, and the lower cost of borrowing for consumption and housing. Fixed private investment would grow 5,4 percent in 2003, due to a better corporate performance; in particular, of manufacturing companies listed in the Lima Stock Exchange, which had a 100 percent increase as of September; due to greater opportunities related to the external (ATPDEA) and domestic market (higher consumption), as well as the start of gas and mining projects such as Camisea, Southern Peru and Yanacocha.

Graph 18

CONSUMPTION AND PRIVATE INVESTMENT
(Real rates of growth)



31. **Public investment** would grow 5,9 percent in 2003 after a three-year contraction. There would be an expenditure increase in investment projects financed with external resources from US$ 350 million in 2002 to US$ 450 million in 2003. The most remarkable public investment projects are rehabilitation and reconstruction of infrastructure (S/.189 million), rehabilitation and improvement of the Tingo María-Aguaytía (S/.172 million) and Chalhuanca-Abancay highways (S/.140 million), rehabilitation of local roads (S/. 77 million), rehabilitation of southern roads (S/. 55 million), and maintenance of rural roads (S/. 40 million) and of the Chulucanas-Morropón-Huancabamba (S/. 29 million) and Huallanca-Sihuas-Tayabamba transmission lines (S/. 18 million).

Table 8
GLOBAL DEMAND AND SUPPLY
(Real rates of growth)

	2000	2001	2002		2003
			Jan. - Sep.	Year	
I. GLOBAL DEMAND (1 + 2)	**3,2**	**0,4**	**4,2**	**4,5**	**4,0**
1. Domestic demand	2,4	-0,7	3,7	4,3	3,6
a. Private consumption	0,9	1,3	3,8	4,1	4,0
b. Public consumption	5,1	-0,5	3,7	2,7	1,6
c. Gross domestic investment	-3,7	-8,0	3,3	6,1	3,1
- Private	-2,0	-5,6	-0,5	0,6	5,4
- Public	-15,4	-19,0	-6,3	-8,8	5,9
2. Exports	7,9	6,9	6,9	5,7	6,2
II. GLOBALSUPPLY (3 + 4)	**3,2**	**0,4**	**4,2**	**4,5**	**4,0**
3. Gross domestic product	3,1	0,2	4,7	4,9	4,0
4. Imports	3,6	1,6	1,0	2,4	4,3

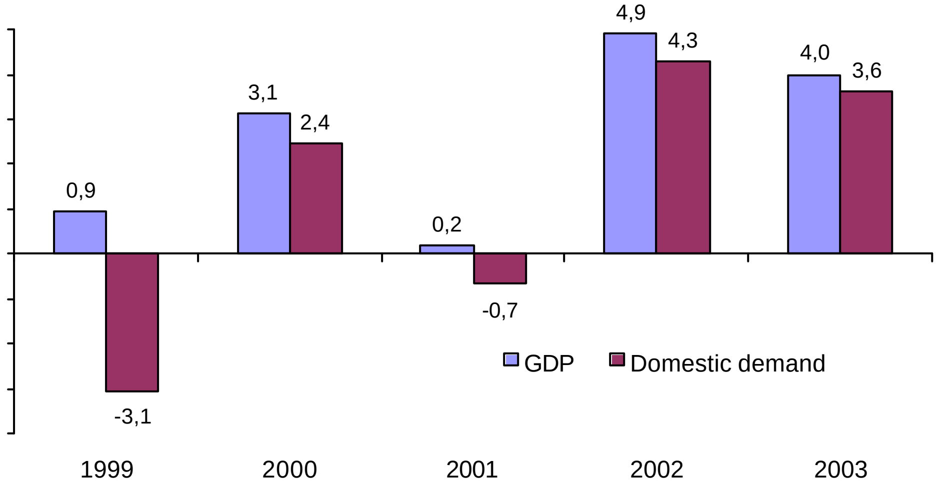
Table 9
NATIONAL DISPOSABLE INCOME
(Real rates of growth)

	2001	2002		2003
		Jan.-Sep.	Year	
I. GROSS DOMESTIC PRODUCT (GDP)	**0,2**	**4,7**	**4,9**	**4,0**
II. GROSS NATIONAL PRODUCT (GNP) 1/	0,9	4,4	4,5	3,5
III. GROSS NATIONAL INCOME (GNI) 2/	-0,2	4,2	4,6	4,0
IV. NATIONAL DISPOSABLE INCOME (NDI) 3/	**-0,2**	**3,9**	**4,3**	**4,0**

1/ Excludes investment income of non-residents' production factors from GDP.
2/ Excludes terms of trade effect from GNP and GDP.
3/ Includes net transfers received from non-residents.

Graph 19

GDP AND DOMESTIC DEMAND: 1999-2003
(Real rates of growth)



32. In 2002, the primary and non-primary sectors grew 6,0 percent and 4,6 percent, respectively. The expansion of primary sector activities was mainly due to the impact of Antamina, which accounted for 0,8 percentage points of annual GDP growth, whereas non-primary sectors' growth reflected the higher activity in construction (8 percent) and non-primary industry (5 percent).

The dynamism in the mining sector was reflected in increase in the export volume (4,8 percent). On the other hand, the greater activity in construction and manufacturing is related to the increase in domestic demand (4,3 percent), in particular of private consumption (4,1 percent).

Table 10
GROSS DOMESTIC PRODUCT
(Rates of growth)

	2000	2001	2002 Jan.-Nov.	2002 Year	2003
Agriculture and livestock	6,2	-0,6	5,1	5,0	3,8
Fishing	9,1	-13,3	0,2	4,1	2,3
Mining and fuel	2,4	11,2	12,6	11,6	4,1
Manufacturing	6,7	-1,1	3,5	3,9	4,5
Construction	-4,3	-6,0	8,3	8,2	5,5
Trade	5,1	0,0	3,2	3,4	5,0
Other services	1,8	0,4	4,4	4,5	3,4
GDP	**3,1**	**0,2**	**4,8**	**4,9**	**4,0**
Primary sectors	5,6	1,9	6,2	6,0	4,0
Non-primary sectors	2,6	-0,2	4,5	4,6	3,9

33. The main features of sectoral GDP growth forecasts for 2003 are:

• **In the agricultural sector**, a weak "El Niño" phenomenon would contribute to creating favorable weather conditions for water-intensive consuming products, such as rice, and for sunlight-demanding and water-resistant products, such as yellow corn and sugarcane. However, cotton output would be lower.

• **In the fishing sector**, "El Niño" events and the subsequent heating of seawater will increase the presence of species such as jurel and mackerel (for human consumption), as well as tuna, bumphead parrotfish, and giant squid. On the other hand, an anchovy catch of 7,5 million of Metric Tons (6 percent lower than in 2002) is estimated.

• **In the mining and oil sector**, the forecasted 4,1 percent growth will be driven by the higher production of copper, due in turn to the greater output of Southern Peru, the extension tasks in Toquepala, and the resumption of BHP Billiton Tintaya operations in the second half of the year; gold, due to greater extraction activity by Yanacocha; and zinc, as a result of the recovery of Volcan, after the strikes in 2002.

• **In the manufacturing sector**, the overall expansion of 4,5 percent would result from a 4,3 percent increase in raw materials-based industries and the 4,5 percent growth in non-primary industry.

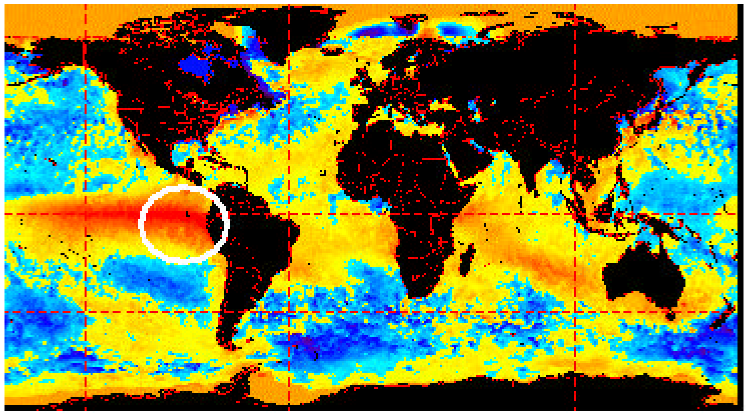
The greater activity in raw materials-based industries would reflect the higher availability of sugarcane and copper (the latter due to the normalization of operations at the Cajamarquilla refinery, after a three-month halt). The fishing industry would register a lower level of activity due to the insufficient supply of anchovy, partially offset by the higher output in canned and frozen fish.

The development of the non-primary industry would respond to higher employment and low interest rates, which will push consumption; the positive effects dynamism in construction; and the benefits derived from the ATPDEA with the United States.

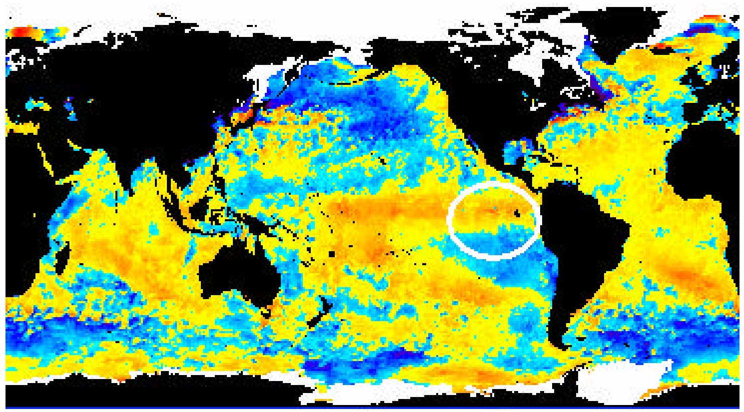
• **In the construction sector**, the 5,5 percent rate of growth estimated for 2003 would be propelled by housing programs and the greater dynamism of private investment. The banking sector is projecting an increase in housing credits similar to that in 2002 (12 percent), whereas the Mivivienda fund will grant 8 thousand credits in 2003, thus enhancing the interest of financial enterprises in this segment. Regarding the Techo Propio program, the target is to deliver 25 thousand bonds (with a similar number of homes) in 2003.

Graph 20
Sea temperature

January 1998



January 2003



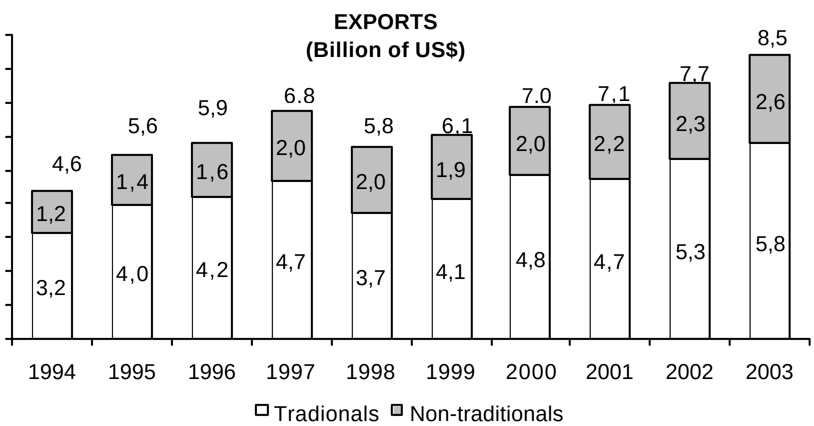
Source: National Oceanic and Atmospheric Administration (NOAA)

V. BALANCE OF PAYMENTS

34. In 2002, the **trade balance** would record a US$ 246 million surplus, up US$ 336 million from the deficit in 2001. This increase reflects the growth in traditional exports (12 percent) and the decline in imports of capital goods (4 percent). In **2003**, the trade balance would reach a US$ 585 million surplus, up US$ 339 million from 2002.

35. Total **exports** in 2002 would record an 8 percent increase (US$ 7 679 million), mainly due to the increase in traditional products. The expansion of mining exports (17 percent) is associated with the onset of Antamina's operations in the second half of 2001, whereas higher exports of oil and derivatives (12 percent) would be explained by higher prices. In **2003**, exports would grow 11 percent (US$ 8 530 million), thanks to higher fishing and mining exports (12 percent) and the increase in non-traditional products (15 percent), reflecting the implementation of the ATPDEA.

Graph 21



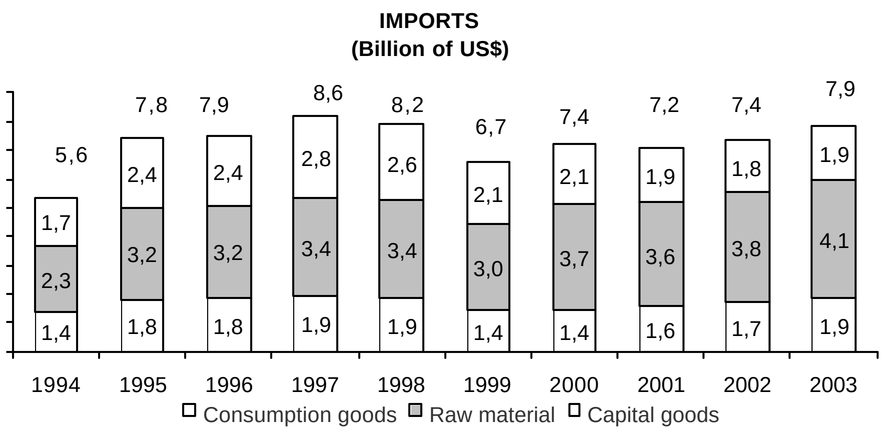


Table 11
TRADE BALANCE
(Million of US)

	2000	2001	2002 Jan-Nov.	2002 Year	2003	Var.% 2002	Var.% 2003
1. EXPORTS	**7 034**	**7 108**	**6 939**	**7 679**	**8 530**	**8,0**	**11,1**
Traditional products	4 821	4 743	4 810	5 313	5 776	12,0	8,7
Non-traditional products	2 044	2 181	2 025	2 254	2 602	3,4	15,4
Others	169	184	104	112	153	-39,0	36,1
2. IMPORTS	**7 351**	**7 198**	**6 754**	**7 433**	**7 945**	**3,3**	**6,9**
Consumption goods	1 446	1 567	1 581	1 743	1 870	11,2	7,3
Raw material	3 655	3 607	3 460	3 770	4 058	4,5	7,6
Capital goods	2 109	1 911	1 645	1 845	1 921	-3,5	4,1
Others	142	113	69	75	96	-33,2	27,3
3. TRADE BALANCE	**- 317**	**- 90**	**185**	**246**	**585**	**372,7**	**138,1**

36. In 2002, **imports** would grow 3 percent due to a lower domestic demand in the first quarter of the year. In particular, the lower acquisition of capital goods (4 percent) should be noted. In 2003, imports would grow 7 percent, driven by higher acquisitions of consumption goods (7 percent) and raw materials (8 percent), in line with the increase in economic activity. Imports of capital goods would grow by 4 percent (those oriented to the industry would grow 5 percent, in a flourishing business context).

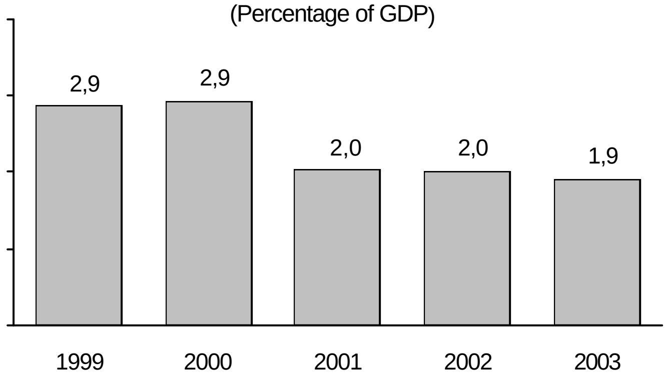
37. The **terms of trade** would increase 0,8 percent due to the rise in export prices (3,4 percent), partially offset by the increase in import prices (2,5 percent).

38. The **current account** deficit of the balance of payments totaled US$ 1 137 million in 2002 (2,0 percent of GDP). By adding public and private debt amortization to this deficit (US$ 935 million and US$ 1 171 million, respectively), the gross financing requirement amounted to US$ 3 243 million, funded by private sector (US$ 2 267 million) and non-financial public sector sources (US$ 1 961 million).

39. The most important private sector transactions, which amounted altogether to US$ 1 300 million, were the purchase of 29 percent of Backus' shares (US$ 657 million), the capitalization of credit lines granted to Banco Wiese-Sudameris by its headquarter (US$ 483 million), and the capital provided to the communication company TIM (US$ 199 million).

40. In the public sector, US$ 352 million were disbursements related to investments, US$ 984 million originated in net issuance of bonds (US$ 500 million in February and US$ 484 million in November), and US$ 625 million were free disposal disbursements from multilateral organizations. In the year, NIR increased US$ 985 million.

Graph 22
CURRENT ACCOUNT DEFICIT
(Percentage of GDP)



41. In 2003, the current account deficit would be US$ 1 134 million (equivalent to 1,9 percent of GDP), and the financing requirement would be US$ 3 126 million, considering amortization payments.

Table 12
BALANCE OF PAYMENT FINANCING REQUIREMENT
(Million of US$)

	2001	2002		2003
		Jan.-Sep.	Year	
1. CURRENT ACCOUNT BALANCE	**- 1 094**	**- 798**	**- 1 137**	**- 1 134**
% of GDP	*- 2,0*	*- 1,9*	*- 2,0*	*- 1,9*
2.AMORTIZATION	**- 1 797**	**- 1 533**	**- 2 106**	**- 1 992**
a. Non-financial public sector	- 769	- 656	- 935 1/	- 1 111
b. Private sector	- 1 028	- 878	- 1 171	- 881
3.GROSS FINANCING (=-1-2)	**2 891**	**2 332**	**3 243**	**3 126**
A. BCR NET INTERNATIONAL RESERVE FLOW (-:Increase)	**- 433**	**- 1 244**	**- 985**	**- 40**
B. PUBLIC SECTOR FINANCING	**1 318**	**1 293**	**1 961**	**1 800**
C. PRIVATE SECTOR FINANCING 2/	**2 006**	**2 283**	**2 267**	**1 366**

1/ Excludes US$ 902 million from swap of Brady bonds
2/ Short and long term.

The gross private financing would be US$ 1 366 million, explained mainly by: Camisea (US$ 500 million), Alto Chicama (US$ 150 million), TIM Perú (US$ 120 million), Lima Airports Partners (US$ 100 million), Cerro Lindo (US$ 30 million), Transmantaro (US $60 million), Quellaveco (US$ 50 million), San Gregorio (US$ 50 million), Nextel (US$ 45 million), Conga (US$ 30 million) and Electric Supply Companies (US$ 30 million).

In the public sector, external disbursements would total US$ 1 800 million, including US$ 450 million for projects. NIR increase would be US$ 40 million.

42. The strength of the external sector has been reflected in the level and flow of net international reserves, which amounted to US$ 9 598 million as of end-2002, up US$ 985 million from 2001. Other indicators of external vulnerability have shown an improvement in 2002, such as the coverage of amortization payments and short term debt, and lower ratios of debt and service. In 2003, these indicators would remain the same or show a small improvement.

Table 13

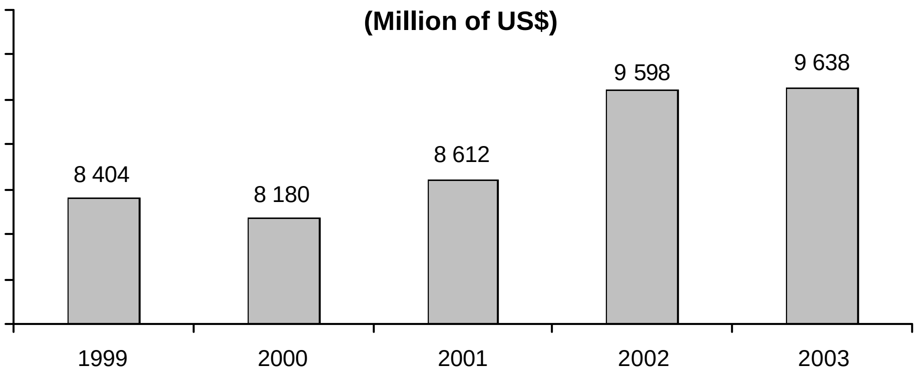
INDICATORS OF EXTERNAL VULNERABILITY

	2001	2002	2003
NIR /Debt due within a year (number of times) 1/	1,6	2,1	2,1
NIR (months of imports of goods)	14	15	15
Total external debt as a % of GDP	51	49	48
Public external debt as a % of GDP	35	36	35
Total external debt service (% of exports of goods and services) 2/	39	37	34
Public external debt service (% of exports of goods and services) 2/	23	22	22

1/ Short-term debt plus amortization of medium and long term debt due in the next 12 months
2/ In 2002 excludes the debt swap operation

Graph 23

NET INTERNATIONAL RESERVES
(Million of US$)



VI. PUBLIC FINANCE

43. In 2002, fiscal policy was oriented to provide a moderate impulse for domestic demand in order to fight the recession of previous years. This strategy was temporary, in order to ensure the reduction of the public deficit. In 2002, the fiscal impulse was equivalent to 0,4 percent of GDP, and would be reverted to –0,2 percent of GDP in 2003.

44. In **2002** the overall public sector deficit would reach 2,3 percent of GDP, implying a financing requirement of US$ 2 345 million, partially covered by external disbursements (US$ 1 961 million).

Table 14

CONSOLIDATED PUBLIC SECTOR

	2001	2002 Jan-Sep.	2002 Year	2003
Percentage of GDP				
I. Current revenues	14,1	14,1	14,2	14,2
of which : tax revenues 1/	*12,0*	*11,6*	*11,8*	*12,3*
II. Non-financial expenditure	-14,9	-14,2	-14,6	-14,3
III. Other public entities	0,7	0,4	0,2	0,3
IV. Interests	-2,2	-2,0	-2,1	-2,1
OVERALL BALANCE (I+II+III+IV)	**-2,3**	**-1,8**	**-2,3**	**-1,9**
Million of US$				
I. Overall balance	-1 276	- 757	-1 271	-1 155
II. Total amortization	- 899	- 761	-1 074	-1 473
III. Financing requirement	**2 175**	**1 518**	**2 345**	**2 627**
- External requirement	1 318	1 293	1 961	1 800
- Domestic requirement 2/	857	225	384	827

1/ Excludes the Extraordinary Tax on State Assets
2/ Privatizations, domestic bonds and banking system accounts flows.

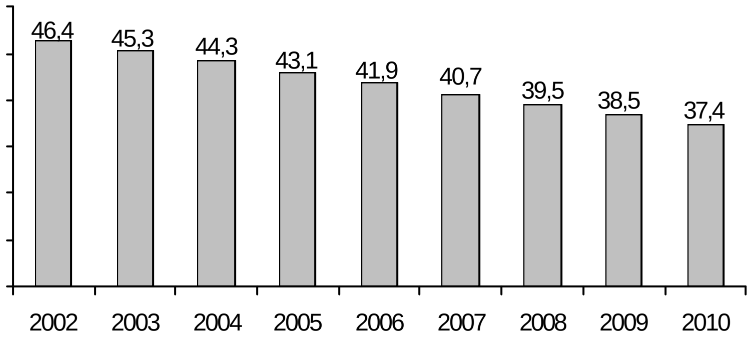
45. The overall public sector deficit in **2003** would be reduced to 1,9 percent of GDP, as a consequence of tax measures that would allow a 6,7 percent increment in central government revenue, whereas non-financial expenditure would increase 4,5 percent in nominal terms due to responsible management. Central government current revenue would amount to 14,2 percent of GDP, whereas non-financial expenditure would reach to 14,3 percent. Revenue forecasts take into account the tax measures applied in the second semester of 2002, the payment in advance of the income tax, the increase in the marginal rate to natural persons, and the extension of the Extraordinary Solidarity Tax, measures that altogether are equivalent to 0,5 percent of GDP. The elimination of the Extraordinary Tax on State Assets was also considered.

46. The financing requirement in 2003 would be US$ 2 627 million, up US$ 282 million from 2002, as a result of higher external (US$ 176 million) and domestic amortizations (US$ 224 million). Financing would come from free disposal disbursements (including the issuance of bonds in the external markets) by US$ 1 350 million and issuances of bonds in the domestic markets by US$ 420 million. It is worth mentioning that the Ministry of Economy and Finance is

developing a domestic debt market that allows the diversification of the several sources of fiscal financing and the formation of a yield curve in domestic currency.

47. The level of outstanding public debt (domestic and external) is expected to be 46 percent of GDP in 2002 and 45 percent in 2003. The external debt to GDP ratio would decrease from 36,1 to 35,4 percent in the same period. A fiscal sustainability analysis reveals that in order to avoid an increase in the external debt service in the next years, considering a GDP growth of 5 percent and an external debt interest rate of 9 percent, the general government's primary balance should increase gradually from 0,2 percent of GDP in 2003 to 1 percent. This would allow to reduce the stock of public debt to 37 percent of GDP in 2010.

Graph 24
PUBLIC DEBT STOCK: 2002 - 2010
(Percentage of GDP)



48. This type of analysis is sensitive to the assumptions of GDP growth and the interest rate of new disbursements. For that reason, the following possibility matrix shows the primary balance levels consistent with fiscal sustainability. The higher the rates of GDP growth and the lower the interest rates, the lower the primary balance needed to attain fiscal sustainability. All these scenarios demonstrate that, under all scenarios, the level of public debt would remain manageable.

Table 15
SENSITIVITY ANALYSIS OF THE SUSTAINABLE PRIMARY BALANCE
(Percentage of GDP)

% var	Interest rate of new disbursements				
GDP	6,5%	7,5%	8,5%	9,5%	10,5%
3,5%	0,8	1,1	1,4	1,6	1,9
4,0%	0,6	0,9	1,2	1,5	1,7
4,5%	0,4	0,7	1,0	1,3	1,5
5,0%	0,2	0,5	0,9	1,1	1,4

VII. BALANCE OF RISKS AND OPPORTUNITIES

49. Some of the factors that could change the benchmark scenario for the central inflation forecast for 2003 are:

    - A more severe than expected "El Niño" phenomenon. The effect would be a lower supply of food and a consequent transitory increase in prices and distribution costs. The Central Bank would not ease the monetary policy stance unless those rises affect other prices in the economy.

    - The possibility of a military conflict in the Middle East. This situation could affect world oil reserves, leading to a price increase. The impact would depend on the length of the conflict. In the short term, oil price would increase above the forecasted level, pushing up the general level of prices. However, this rise could be transitory. In that case, the Central Bank would not change the monetary stance.

    - A lower than expected world economic recovery. This takes into account the fact that indicators of U.S. future economic development are not conclusive about a prompt economic recovery. The possible oil price increase is also playing against the recovery of the most important world markets. A slower world economic activity would have a negative impact on external demand. The Central Bank would ease its monetary policy stance if there are downward pressures on the inflation rate.

    - Instability of regional financial markets. There is a continued uncertainty on the future evolution of the Brazilian and Argentine economies, and on the impact this could have on financial markets. In case these economies evolve as in 2002, the Central Bank might transitorily tighten monetary policy in order to smooth out the volatility of domestic financial markets.

50. On the other hand, a synchronized action of macroeconomic policies in developed countries could enhance world economic growth above the level considered in this report. In that scenario, the Peruvian economy would benefit from higher export volumes and prices. On the domestic front, there would be a higher level of investment, including infrastructure, speeding up potential and actual economic growth in a way consistent with the goal of monetary policy.

ANNEX:
FORECASTS IN INFLATION REPORTS

	2001	2002				2003
		Monetary Program	June Report	September Report	January Report	January Report
		Real % var.				
1. Gross domestic product	0,2	3,5	3,7	3,7	4,9	4,0
2. Domestic demand	-0,7	3,4	3,4	3,3	4,3	3,6
3. Private consumption	1,3	2,8	3,3	3,6	4,1	4,0
4. Gross fixed investment (private)	-5,6	4,9	4,2	1,0	0,6	5,4
5. Exports of goods and services	6,9	6,0	5,6	5,6	5,7	6,2
6. Main trade partners' economic growth	1,6	1,6	2,0	1,4	1,6	2,6
		% var.				
7. Annual inflation	-0,1	2,5	2,0	2,0	1,5	2,5
8. Nominal cumulative devaluation	-2,4	2,5	2,6	4,5	2,3	3,1
9. Real cumulative devaluation (multilateral)	-4,3	2,6	-0,4	1,8	-0,5	4,0
10.Terms of trade	-2,0	1,2	4,6	3,2	2,6	0,8
		% of GDP				
11. Current account of the balance of payments	-2,0	-2,4	-2,0	-2,2	-2,0	-1,9
12. Trade balance	-0,2	0,2	0,7	0,5	0,4	1,0
13. Private capital flow excluding privatization	3,2	2,9	2,6	3,6	4,2	1,8
14. Public sector primary balance	-0,1	-0,2	-0,2	-0,2	-0,2	0,2
15. Public sector overall balance	-2,3	-2,2	-2,2	-2,3	-2,3	-1,9
16. Central government tax collection [1/]	12,0	11,9	12,0	11,9	11,8	12,3
17. Public external debt	35,1	34,8	33,8	36,6	36,1	35,4
		Nominal % var.				
18. Central government non-financial expenditure	-2,3	5,8	2,7	2,8	2,5	4,5
19. Monetary base	3,2	7,0	12,5	15,0	15,8	8,0
20. Banking credit to the private sector	-4,6	7,5	6,0	4,1	0,3	9,0

[1/] Excludes the Extraordinary Tax on State Assets.