# CENTRAL RESERVE BANK OF PERU

# INFLATION REPORT:
# RECENT DEVELOPMENTS AND OUTLOOK
# May 2003

## CONTENTS

# CENTRAL RESERVE BANK OF PERU

## I. INTRODUCTION

1. In this Inflation Report, the Central Reserve Bank of Peru publishes its macroeconomic projections for the period 2003-2004, with special emphasis on projected inflation.

2. Monetary Policy seeks to achieve the explicit goal of reaching an annual inflation rate of 2.5 percent, with a tolerance margin of 1.0 percent, either up or down. Decisions made by the Board of the Central Bank are aimed at facing eventual inflationary or deflationary pressures.

3. January's Inflation Report mentioned that the inflation target was challenged mainly by two risks. On the one hand, the "El Niño" weather oscillation at the beginning of this year may have increased food and transportation prices because of eventual damages to infrastructure. On the other hand, the contingency of a probable and significant sustained increase in fuel prices resulting from the Middle East conflict was also taken into consideration. However, these two inflation risk factors have vanished. As a consequence, in this Report the inflation forecast is within the lower band of the target range (from 1.5 to 2.5 percent), compared to projections in January's Inflation Report in which it was within the upper band of the range (2.5 to 3.5 percent).

4. This Report maintains the GDP growth forecast of 4 percent for 2003, and estimates a 4.5 percent growth in 2004. GDP grew 5.1 percent in IQ2003, in particular through more dynamic exports and growth in private consumption and investment.

5. From January to April 2003, the Consumer Price Index for Metropolitan Lima increased 1.8 percent. To a large extent, this figure reflects the impact of inflation rates, mostly in February and March, caused by rising international oil prices. During those two months, the 12-month inflation rate rose from 1.5 percent in December 2002 to 2.8 percent in February and to 3.4 percent in March. Given the transient nature of this rise in inflation, linked to the oil price increases mentioned above, the Central Bank did not change its monetary policy stance. By the end of the conflict, the price of oil fell precipitously and in April the annual inflation rate went down to 2.6 percent.

6. As noted in the January 2003 Inflation Report, policy decisions are announced every month, including benchmark interest rates for lending (rediscounts and direct repos) and deposit (overnight deposits) monetary transactions between the Central Bank and commercial banks. These announcements aimed at underscoring the desired course of interbank interest rates. From January to May, the interbank interest rate was 3.8 percent, as in December 2002.

# CENTRAL RESERVE BANK OF PERU

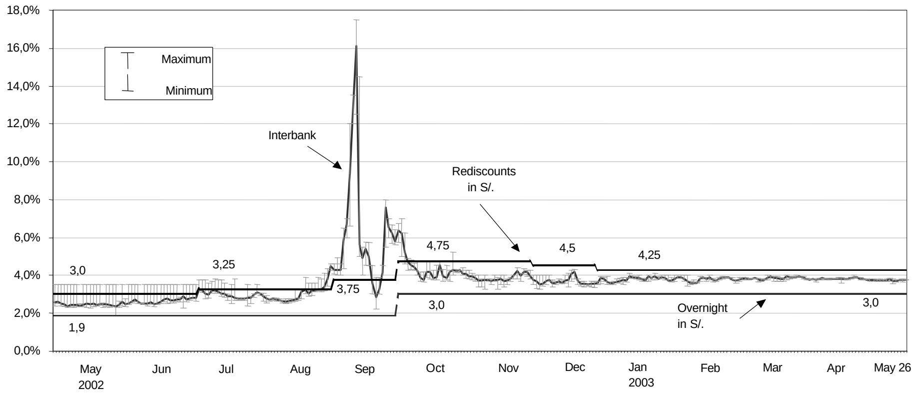
## II. MONETARY POLICY

### Interbank interest rates

7. During the first five months this year, the monetary policy has remained stable, including benchmark interest rates of 3 percent for overnight deposits at the BCR, and 4.25 percent for rediscounts. Monetary policy decisions and stability in the domestic and external markets kept interbank interest rate around 3.8 percent since December 2002, with the added result of a reduced fluctuation.

**Graph 1**

**Domestic Currency Interest Rates**
**May 2002 - May 2003**




**Domestic Currency Interest Rates**
**January - May 2003**

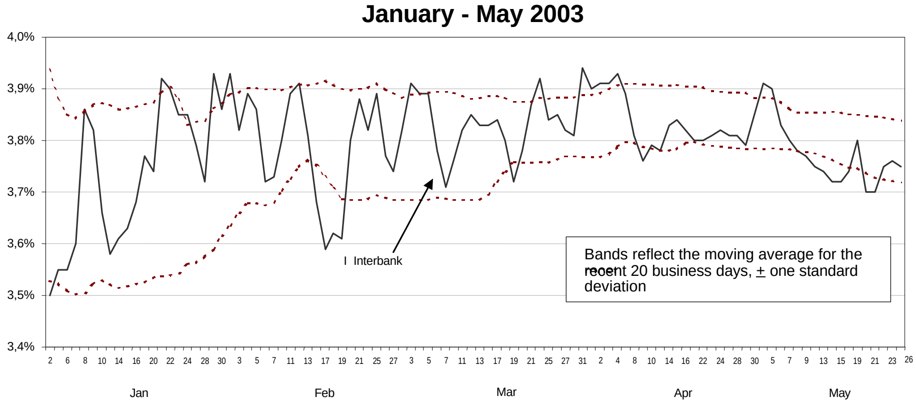



**Table 1**

**Interbank interest rates**

| | 2002 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Jan.** | **Feb.** | **Mar.** | **Apr.** | **May.** | **Jun.** | **Jul.** | **Aug.** | **Sep.** | **Oct.** | **Nov.** | **Dec.** |
| Average | 2,69 | 2,59 | 2,51 | 2,52 | 2,47 | 2,65 | 2,94 | 2,93 | 5,35 | 4,62 | 3,93 | 3,78 |
| Standard Deviation | 0,24 | 0,29 | 0,13 | 0,07 | 0,07 | 0,12 | 0,18 | 0,24 | 2,10 | 0,73 | 0,21 | 0,20 |
| Variability Coefficient (%) | 9,1 | 11,2 | 5,3 | 2,9 | 2,9 | 4,5 | 6,0 | 8,2 | 39,3 | 15,8 | 5,3 | 5,3 |

| | 2003 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Jan.** | **Feb.** | **Mar.** | **Apr.** | **May.** [1/] | **Jun.** | **Jul.** | **Aug.** | **Sep.** | **Oct.** | **Nov.** | **Dec.** |
| Average | 3,75 | 3,80 | 3,82 | 3,84 | 3,77 | | | | | | | |
| Standard Deviation | 0,13 | 0,10 | 0,06 | 0,05 | 0,06 | | | | | | | |
| Variability Coefficient (%) | 3,6 | 2,6 | 1,6 | 1,3 | 1,7 | | | | | | | |

[1/] As of May 26.

8. Smaller fluctuations of interbank interest rate allow for a more predictable overnight rate that increases the effectiveness of this monetary policy channel. Consequently, monetary policy announcements aimed at guiding the evolution of the interbank interest rate may have a greater impact on longer-term interest rates. Evidence of this impact is the clear link between the interbank interest rate and the interest rate attached to loans for low-risk customers. However, there is a weaker linking risk with the interest rates for higher credit-risk transactions

**Graph 2**

**Average monthly interest rates in domestic currency**
**May 2002 – May 2003**

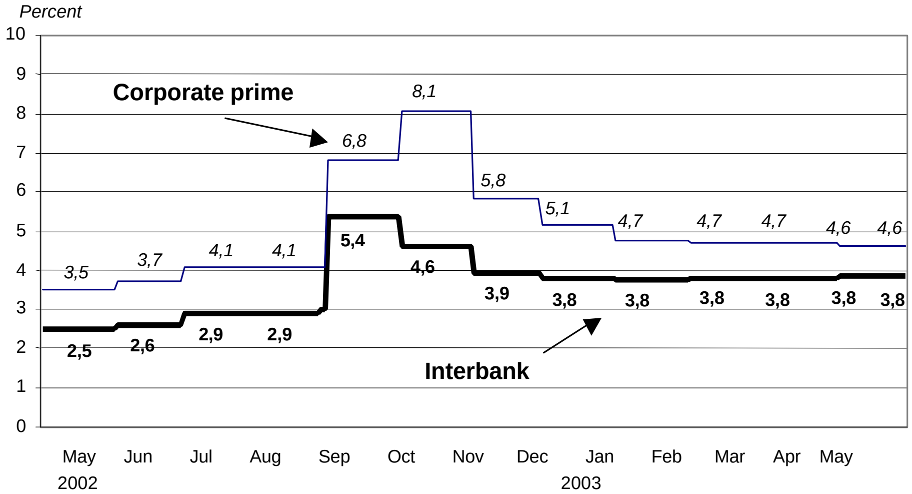



**Table 2**

**INTEREST RATES FOR LOCAL CURRENCY TRANSACTIONS**
(Percent)

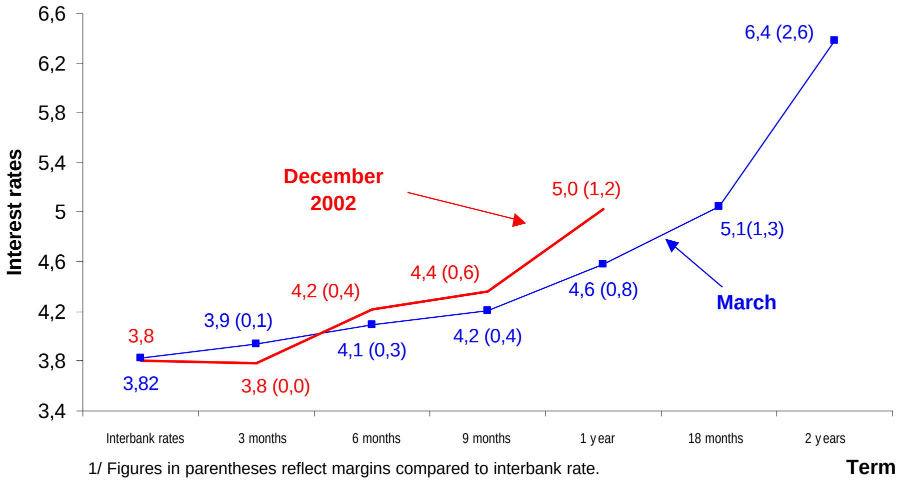
| | 2001 | | | | 2002 | | | | 2003 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar | Jun | Sep | Dec | Mar | Jun | Sep | Dec | Mar | Apr |
| 1. Interbank | 10.3 | 16.0 | 5.9 | 3.1 | 2.5 | 2.6 | 5.4 | 3.8 | 3.8 | 3.8 |
| 2. Saving Deposits | 6.8 | 6.3 | 5.2 | 3.0 | 1.8 | 1.7 | 1.7 | 1.7 | 1.7 | 1.6 |
| 3. Lending (prime) | 12.4 | 13.2 | 9.4 | 5.0 | 3.9 | 3.7 | 6.8 | 5.1 | 4.7 | 4.6 |
| 4. Lending (average) up to 360 days | 21.3 | 21.2 | 19.4 | 17.2 | 15.5 | 14.1 | 14.0 | 14.8 | 14.3 | 13.9 |

9. Longer placement terms for 18-month and 2-year BCR Deposit Certificates (CDBCRP) also favored the link between various interest rates in domestic currency. These placements are a point of reference for private sector security issues at fixed nominal interest rates in domestic currency. In March, private sector bond placement for a 2-year term at an effective 6.5 percent interest rate totaled S/. 160 million.

10. Extended 2-year CDBCRP rates, launched in February this year, also helped to reference interest rates for Public Treasury Bonds (BTP) with a similar maturity.

**Graph 3**

**CDBCRP YIELDS**




1/ Figures in parentheses reflect margins compared to interbank rate.

The BTP placement program was launched again in April for its impact on developing the local market for domestic currency capitals. This program includes bond issues through market-makers to increase liquidity of public securities and thus provide markets with a reference for longer-term debt issues. Since March, 15- and 18-month bonds, amounting to S/.150 million each, were issued. Additionally, a Government Treasury Securities program now underway aims at improving treasury management capacity. Total worth of the 6-month securities reached S/.150 million in April.

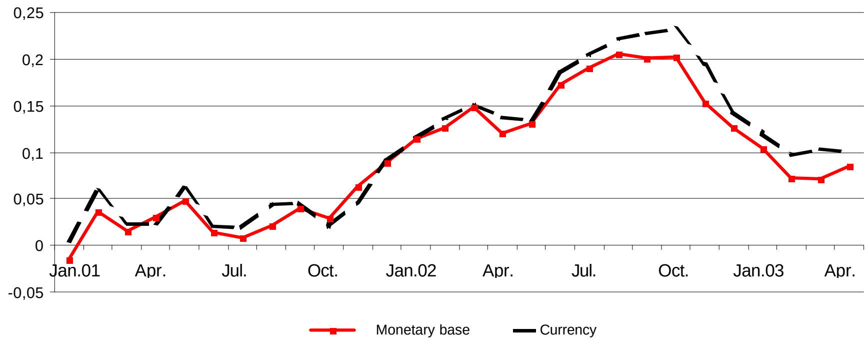
## Broad money and credit

11. Lower deposit interest rates in 2002 increased public demand for currency. However, this impact has gradually diminished resulting in a slowdown of the growth rate of this type of money aggregates. The currency annual growth rate dropped from 14 percent in December 2002 to 10 percent in April while the monetary base fell from 12.6 percent to 8.6 percent.

**Graph 4**

**Currency and monetary base growth**

**(Y o Y month of the year change rate)**



12. Estimated liquidity growth indicators are comparable to the January report. To December 2003, domestic currency liquidity balance is expected to grow by 13 percent, a higher figure than the projected 2.1 percent increase for liquidity in foreign currency. For 2004, 14 percent and 2 percent growth figures are estimated for liquidity in nuevos soles and US dollars, respectively. The trend to a smaller rate of dollarization in liquidity and bank loans may be linked to stable local financial markets.

**Table 3**

**(Percent YoY change for end-period balances)**

| | Dec 2001 | Dec 2002 | Dec 2003 January Report | Dec 2003 May Report | Dec 2004 |
|---|---|---|---|---|---|
| 1. Currency | 9.0 | 13.5 | 9.2 | 9.0 | 6.5 |
| 2. Liquidity in soles | 13.5 | 9.9 | 12.0 | 13.0 | 13.5 |
| 3. Credit in soles | | | | | |
| Banking system | 2.7 | 7.2 | 11.3 | 14.0 | 17.5 |
| Financial system | 9.3 | 10.3 | 13.5 | 14.0 | 18.0 |
| 4. Credit in US$ | | | | | |
| Banking system | -3.8 | -3.5 | 5.1 | 1.9 | 1.9 |
| Financial system | -4.1 | -1.9 | 5.0 | 2.0 | 2.0 |

13. The monetary base dropped S/.523 million between January and April due to seasonal factors. The main transactions explaining this change were as follows:

a. Net dollar purchases totaling US$431 million (S/.1496 million), resulting in an expanded monetary base.

b. Monetary sterilization through net CDBCRP placements worth S/.1335 million, increasing the CDBCRP balance in April to S/.2970 million (48 percent of the monetary base)

c. Increased government deposits at BCR totaling S/.1095 million, reflecting the seasonality of government finances (mainly after income tax regularization payments between March and April) and government securities placements.

d. Total redemption of the S/.319 million balance of Readjustable Deposit Certificates from the Central Bank (CDR). These certificates were issued in IIIQ2002 to reduce pressures on the foreign exchange market during the Brazilian elections.

14. In 2003, the average monetary base is expected to grow by 8 percent. This estimate is based on the following factors:

    a. Nominal GDP growth of 7 percent (4 percent in real terms).

    b. A 3 percent increase in the bank multiplier, stemming from reduced currency preference.

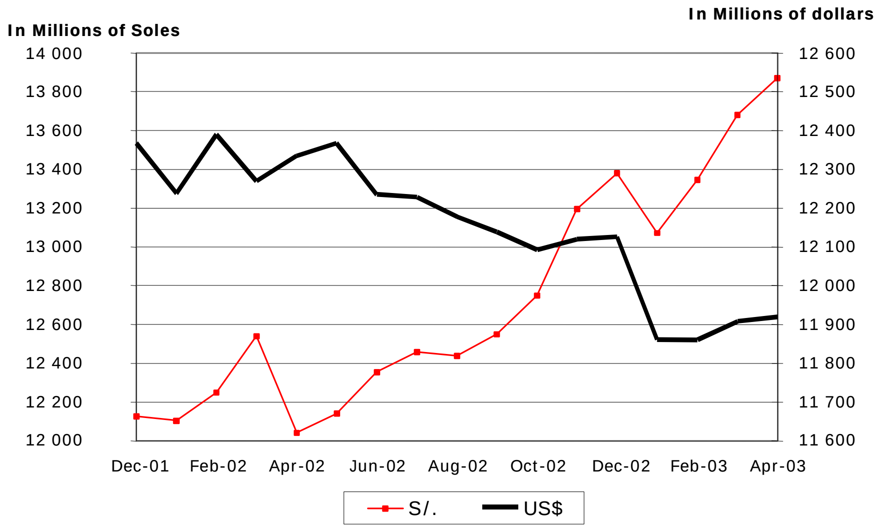
    c. Slower "Nuevo Sol" velocity, reflecting increased demand for local currency against a background of stable local financial markets.

    In 2004, monetary base is expected to grow by 7 percent, in connection with similar nominal GDP growth.

15. Financial system credit to the private sector followed a trend already evident in 2002, which expanded sol-denominated loans (5.4 percent growth between January and April), while the dollar-denominated loans fell by 1.2 percent. Expanded credit in soles (S/.727 million) came principally from banking companies (S/.463 million) and micro-credit organizations (S/.175 million). Dollar-denominated loans dropped US$141 million, due to reduced dollar loans by banking companies (down US$263 million), partially offset by financing provided by institutional investors (worth US$182 million).

**Graph 5**

**Financial System Credit to the Private Sector**



# CENTRAL RESERVE BANK OF PERU

## Table 4

| Evolution of Financial System Credits to Private Sector. Local Currency | Balances in millions of Nuevos Soles | | | | |
|---|---|---|---|---|---|
| | Dec-01 | Dec-02 | Apr-03 | Apr.03/ Dec.02 | Apr.03/ Apr.02 |
| Banks 1/ | 7 638 | 7 793 | 8 256 | 5,9 | 13,4 |
| Banco de la Nación | 222 | 434 | 458 | 5,5 | 29,4 |
| **Microfinance Organizations** | **2 332** | **3 108** | **3 283** | **5,6** | **34,1** |
| Banks (Trabajo y MiBanco) | 548 | 774 | 842 | 8,8 | 43,0 |
| Municipal S&Ls | 600 | 848 | 915 | 7,9 | 43,6 |
| Rural S&Ls | 83 | 135 | 145 | 7,4 | 54,3 |
| Savings and Loans Cooperatives | 329 | 381 | 381 | -.- | 13,1 |
| Edpymes | 105 | 130 | 137 | 5,4 | 28,0 |
| Financial Companies | 667 | 840 | 863 | 2,7 | 26,2 |
| **Institutional Investors 2/** | **1 688** | **1 653** | **1 712** | **3,6** | **-0,8** |
| AFPs | 1 157 | 1 102 | 1 150 | 4,4 | -7,3 |
| Insurance companies | 497 | 493 | 498 | 1,0 | 15,0 |
| Mutual funds | 34 | 58 | 64 | 10,3 | 25,5 |
| **Leasing and other companies** | **247** | **393** | **400** | **1,8** | **70,9** |
| **Total Financial System** | **12 127** | **13 381** | **14 108** | **5,4** | **17,2** |

1/ Excluding Trabajo and MiBanco banks

2/ Mainly private sector-issued securities

## Table 5

| Evolution of Financial System Credits to Private Sector. Foreign Currency | Balances in millions of US$ | | | | |
|---|---|---|---|---|---|
| | Dec-01 | Dec-02 | Apr-03 | Apr 03/ Dec 02 | Apr 03/ Apr 02 |
| Banks 1/ | 10 459 | 10 065 | 9 802 | -2,6 | -5,6 |
| Banco de la Nación | 36 | 36 | 36 | -.- | -.- |
| **Microfinance Organizations** | **305** | **367** | **382** | **4,1** | **26,1** |
| Banks (Trabajo and MiBanco) | 23 | 35 | 42 | 20,0 | 82,6 |
| Municipal S&LS | 74 | 111 | 122 | 9,9 | 62,7 |
| Rural S&Ls | 46 | 44 | 43 | -2,3 | -.- |
| Savings and Loans Cooperatives | 85 | 101 | 101 | -.- | 18,8 |
| Edpymes | 21 | 31 | 34 | 9,7 | 41,7 |
| Financial Companies | 56 | 45 | 40 | -11,1 | -24,5 |
| **Institutional Investors 2/** | **653** | **800** | **982** | **22,8** | **38,5** |
| AFPs | 330 | 445 | 518 | 16,4 | 57,0 |
| Insurance Companies | 33 | 37 | 34 | -8,1 | -49,3 |
| Mutual funds | 290 | 318 | 430 | 35,2 | 37,8 |
| **Leasing and other companies** | **916** | **858** | **785** | **-8,5** | **-13,0** |
| **Total Financial System** | **12 368** | **12 127** | **11 986** | **-1,2** | **-2,8** |

1/ Excluding Trabajo and MiBanco banks

2/ Mainly private sector-issued securities

## Exchange rate

16. From January to April 2003, the exchange rate remained on its downward trend already on the way since October 2002. April's average exchange rate reached S/.3.47 per US dollar, or a 1.4 percent drop since December 2002. However, in real terms, the Nuevo Sol's value fell 1.1 percent between December 2002 and April this year as Latin American currencies, including the Brazilian Real and Argentina's Peso, as well as the Euro and the Japanese Yen, became stronger.

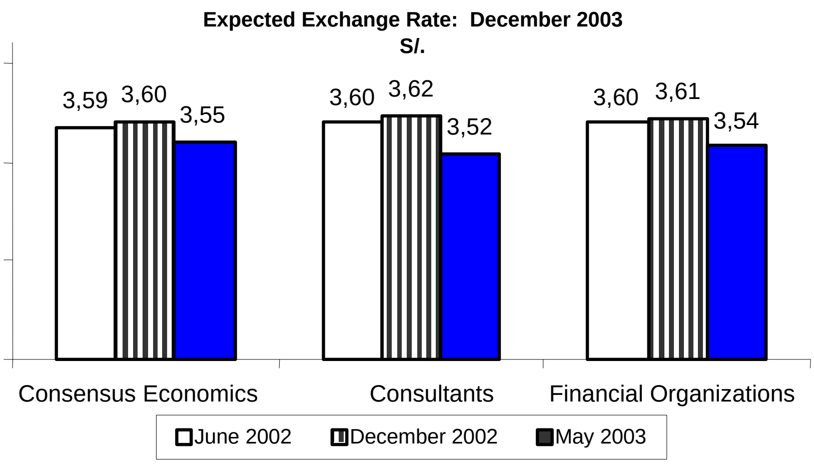
**Table 6**

**Currency basket of main trade partners**

| | | Nominal Exchange Rate (% change) | | | Real Exchange Rate (% change) | | |
|---|---|---|---|---|---|---|---|
| | Weighting | Apr02 / Dec97 | Apr03 / Apr02 | Apr03 / Dec02 | Apr02 / Dec97 | Apr03 / Apr02 | Apr03 / Dec02 |
| **United States** | 25,1% | 27,4 | 0,7 | -1,4 | 23,7 | 0,6 | -1,3 |
| **Japan** | 10,3% | 37,6 | 10,2 | 0,6 | 13,3 | 6,4 | -2,0 |
| **Brazil** | 6,4% | -54,3 | -24,8 | 15,0 | -42,3 | -14,3 | 20,1 |
| **Euro zone** | 20,1% | 15,7 | 23,7 | 5,3 | 20,0 | 22,6 | 4,4 |
| **United Kingdom** | 5,8% | 20,8 | 10,0 | -2,1 | 15,8 | 10,1 | -2,8 |
| **Chile** | 4,8% | -22,1 | -8,5 | -3,4 | -20,2 | -7,3 | -3,2 |
| **China** | 4,3% | 27,5 | 0,7 | -1,4 | 3,8 | 0,2 | -2,0 |
| **Colombia** | 4,0% | -43,4 | -21,9 | -5,0 | -14,1 | -17,9 | -2,4 |
| **Mexico** | 3,4% | -2,6 | -13,0 | -4,9 | 34,7 | -10,8 | -5,2 |
| **Argentina** | 3,4% | -56,0 | -1,2 | 17,0 | -47,7 | 15,0 | 18,0 |
| **Korea** | 3,3% | 53,7 | 7,9 | -3,2 | 55,3 | 9,1 | -2,8 |
| **Taiwan** | 2,5% | 18,5 | 1,0 | -1,5 | 20,4 | -1,7 | -3,1 |
| **Venezuela** | 2,5% | -59,9 | -44,7 | -18,5 | -1,6 | -28,1 | -10,9 |
| **Canada** | 2,4% | 25,1 | 9,4 | 5,6 | 21,5 | 10,6 | 5,9 |
| **Bolivia** | 1,8% | -10,3 | -6,6 | -3,2 | -11,2 | -5,9 | -4,1 |
| **Currency Basket** | | 11,5 | 8,0 | 1,7 | 7,0 | 3,1 | 1,1 |

17. The rising value of the Nuevo Sol is also reflected in the economic agents' reduced depreciation expectations. A *Consensus Economics*' survey and those conducted by BCR among financial organizations and consultants resulted in adjusted exchange rate expectations (from S/.3.61 to S/.3.54) at 2003-end.

**Graph 6**



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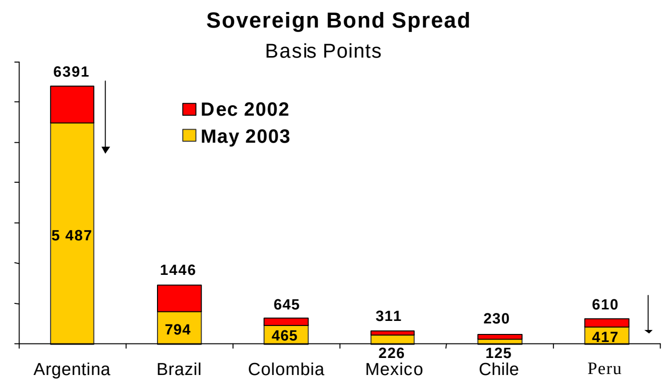
18. The implicit depreciation rate in 3-month *forward* transactions dropped from 3.3 percent to 3.0 percent from December 2002 to May this year, against a rather stable regional backdrop in particular stemming from positive market perceptions about the Brazilian economic program and improved prospects in Argentina, which resulted in those countries' currency appreciations by 19 percent in that period.

19. Country-risk ratings in the period under review also pointed to significant improvements in regional countries. In Peru, evolutions are linked to strong macroeconomic fundamentals, recovering economic activity, large foreign currency reserves and the absence of perceived risks in the balance of payments and government expense financing. Bonds' overall sovereign *spread* dropped from 8.2 percent points in August 2002 to 6.1 percent points in December and 4.2 percent points in May 2003.

**Graph 7**



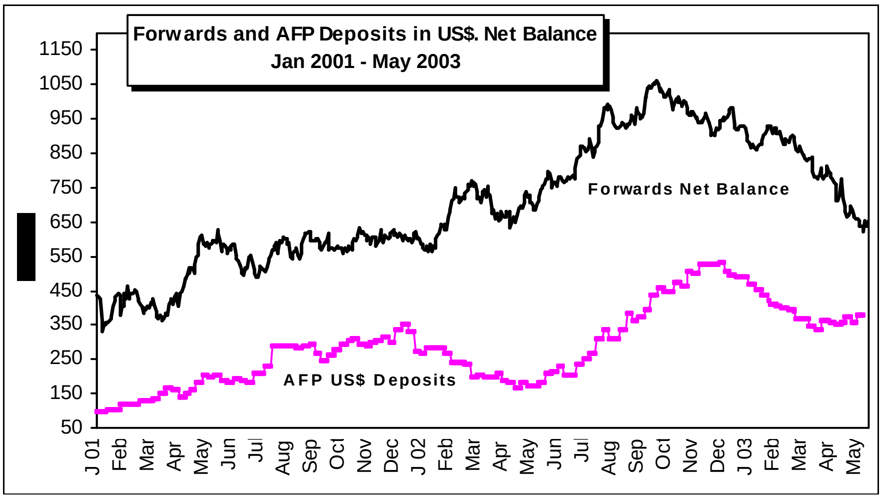

Source: Reuters

20. Reduced expected depreciation may have led to a shift in the currency mix of the financial system's deposits, with a dollar share that fell from 78 percent in December 2002 to 77 percent in April 2003. Likewise, the dollar share in AFP pension fund managers' portfolios dropped from 47 percent in December 2002 to 44 percent in April 2003.

    In addition, lower expected depreciation may also have slowed exchange-risk hedging transactions (*forward* transactions). Consequently, from December 2002 to May this year, the net balance of *forward* transactions fell by US$253 million, from US$905 million to US$652 million.

21. Against a background of appreciation pressures, mainly linked to changes in the private sector's portfolio, the Central Bank made net dollar purchases totaling US$431 million, of which US$360 million were in the trading desk while US$71 million were transactions with the public sector.

**Graph 8**




## III. AGGREGATE DEMAND AND SUPPLY

### Aggregate demand

22. During IQ2003, GDP grew 5.1 percent, driven by larger exports (7.7 percent) and domestic demand (4.9 percent). Domestic demand recorded rising rates across all components. Private investment grew for the fourth quarter in a row, reaching 6.8 percent in IQ2003. A highlight in this area was the Camisea project (with capital goods inputs rising from US$34 million in IQ2002 to US$62 million in IQ2003); plant and equipment purchases by manufacturing companies, in particular in the textile industry, and rising home starts as well as new supermarket and department store projects.

**Table 7**

**AGGREGATE DEMAND AND SUPPLY**
(YoY real percent changes)

| | 2002 | | 2003 | | 2004* |
|---|---|---|---|---|---|
| | IQ | Year | IQ | Year* | |
| **I. Aggregate Demand (1+2)** | **1,6** | **4,9** | **5,3** | **4,1** | **4,9** |
| 1. Domestic Demand | 1,0 | 4,8 | 4,9 | 4,0 | 4,4 |
| a. Private consumption | 2,8 | 4,4 | 4,5 | 4,3 | 4,0 |
| b. Public consumption | 3,5 | 1,6 | 5,8 | 2,3 | 1,1 |
| c. Private investment | -5,8 | 0,7 | 6,8 | 5,4 | 7,4 |
| d. Public investment | -3,6 | -5,9 | 11,2 | 4,7 | 5,2 |
| 2. Exports | 5,2 | 5,7 | 7,7 | 5,0 | 7,3 |
| **II. Aggregate Supply (3+4)** | **1,6** | **4,9** | **5,3** | **4,1** | **4,9** |
| **3. GDP** | **2,7** | **5,3** | **5,1** | **4,0** | **4,5** |
| 4. Imports | -4,9 | 2,4 | 6,8 | 4,9 | 6,8 |

* Projected

23. Private consumption grew 4.5 percent, linked to a 5.7 percent increase in national disposable income, a 5.5 percent increase in employment in Metropolitan Lima and rising consumer credits (16 percent to March). Expanding consumer demand was also reflected in greater imports of consumer goods (at 11 percent), in particular durables (household appliances and cars). New car sales reported by the Peruvian Association of Motorcar Dealers (Araper) grew 18 percent.

**Table 8**

**NATIONAL DISPOSABLE INCOME**

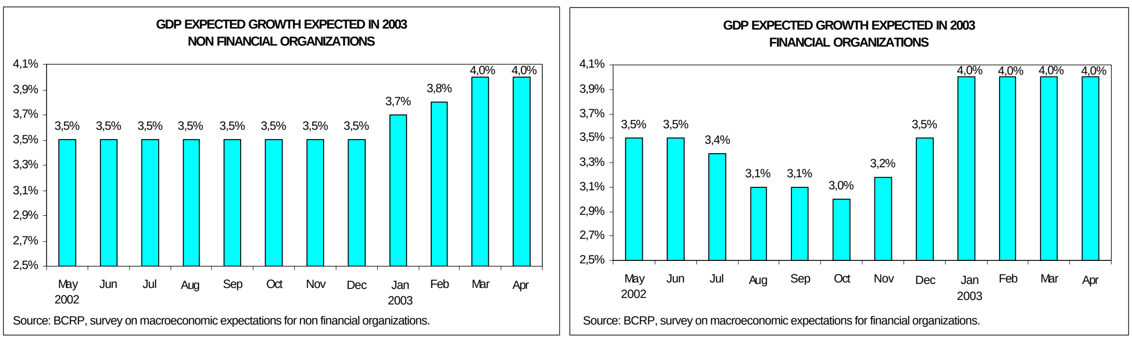
(YoY real percent changes)

| | | 2002 | | 2003 * | | 2004 * |
|---|---|---|---|---|---|---|
| | | IQ | Year | IQ | Year | |
| **I.** | **Gross Domestic Product (GDP)** | **2,7** | **5,3** | **5,1** | **4,0** | **4,5** |
| II. | Gross national product (GNP) 1/ | 2,9 | 4,9 | 4,7 | 3,5 | 4,4 |
| III. | Gross national income (IN) 2/ | 1,4 | 5,1 | 5,8 | 4,0 | 4,3 |
| **IV.** | **National disposable income (NDI) 3/** | **1,1** | **4,8** | **5,7** | **4,0** | **4,4** |

* Projected
1/ GDP, excluding net rent to non-resident production factors
2/ Gross National and Domestic Products exclude changes in terms of trade
3/ Includes net transfers from non-residents in Gross National Income

24. The survey carried out by BCR on growth expectations points to a 4 percent increase in output in 2003 and 4.5 percent in 2004. A *Consensus Economics* surveys points to expected growth of 4 percent in 2003 and 2004.

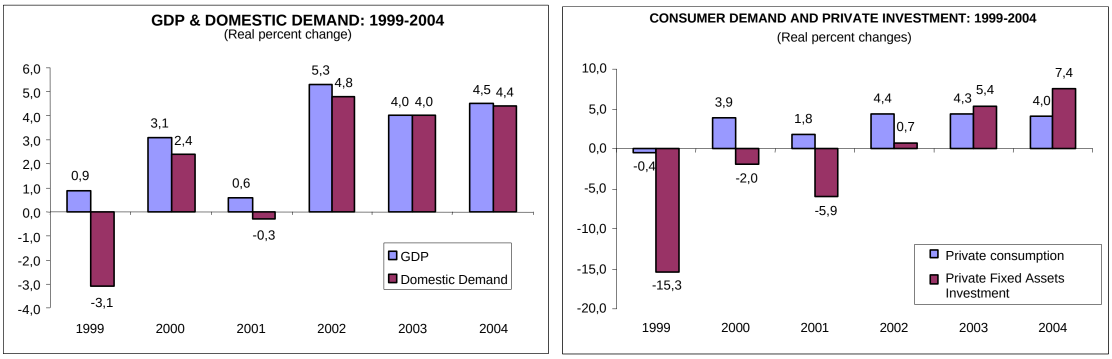
**Graph 9**



25. This report maintains a real GDP growth projection of 4 percent in 2003, based on a real growth of exports of 5 percent, and of 4 percent in domestic demand. GDP is expected to grow 4.5 percent in 2004.

Exports may grow at 5 and 7 percent real-term in 2003 and 2004, as the volume of mineral exports increases, in particular gold and copper. Another contributing factor comes from expected higher sales of textile products thanks to the positive impact of the Andean Trade Preference and Drug Eradication Act (ATPDEA). On the domestic side, the drive for increased private consumption is expected to come from larger national income, expected to grow about 4 percent in the next two years, as well as more jobs and cheaper credits. In addition, private investment may rise by 5.4 percent in 2003 and 7.4 percent in 2004. Highlights include the Camisea gas field project, the Alto Chicama gold project, expansion at Southern Peru Copper Corporation, the Minas Conga project, expansion at the Antamina mine, expanded Tim Peru telecommunications operations and improvements at the Lima airport by LAP, the airport operator, coupled with new shopping centers, both in Lima and the interior.

**Graph 10**




## Gross Domestic Product (GDP)

26. Our analysis of individual sector growth shows non-primary industries driving growth in the first quarter at a rate of 5.4 percent, while primary industries grew 0.9 percent, a slower rate compared to previous quarters, mainly due to reduced fisheries landings. Highlights in the non-primary sectors were in manufacturing and trade. The textile, food, non-metallic mineral and construction-related products stood out among non-primary manufacturing industries. The government-sponsored low income housing Mivivienda program drove construction's growth.

27. Economic growth forecasts for 2003 point to a more dynamic growth of non-primary industries, at 4.3 percent, compared to 2.5 percent in the primary GDP. A drop is expected in the fisheries industry (4.7 percent down), while agricultural output is expected to grow less than a year ago (2.5 percent compared to 5.8 percent). The projected slide in fisheries may result from reduced Peruvian pilchard landings, while smaller rice and potato planting may account for lower growth in the agricultural sector. In addition, the mining industry is expected to grow by 4.1 percent through expanded gold output at the Yanacocha and Barrick mining operations, renewed operations at the Tintaya copper mine, and larger output from Southern Peru Corporation as the expanded Toquepala facility comes on line.

In 2004, growth may continue to be driven by non-primary industries (4.4 percent), with faster growth in primary sectors (5.2 percent) after growth in fisheries and agriculture.

**Table 9**

**GROSS DOMESTIC PRODUCT**

(YoY Real percent change)

| | 2002 | | 2003 | | 2004 * |
|---|---|---|---|---|---|
| | I Q. | Year | I Q. | Year * | |
| Agriculture | 6,2 | 5,8 | 1,9 | 2,5 | 4,0 |
| Fisheries | -21,5 | 3,1 | -19,2 | -4,7 | 5,3 |
| Mining and Oil | 25,9 | 11,3 | 4,3 | 4,1 | 6,6 |
| Manufacturing | -0,8 | 4,2 | 4,6 | 4,5 | 5,0 |
| Construction | 10,4 | 8,3 | 3,5 | 5,0 | 6,0 |
| Trade | 0,3 | 3,8 | 5,8 | 4,7 | 4,7 |
| Services | 1,5 | 4,5 | 4,8 | 3,7 | 4,0 |
| **GROSS ADDED VALUE (GAV)** | 3,2 | 5,1 | 4,4 | 3,9 | 4,6 |
| Taxes on goods and import duties | -1,6 | 7,5 | 11,7 | 4,4 | 4,0 |
| **GDP** | **2,7** | **5,3** | **5,1** | **4,0** | **4,5** |
| GAV Primary sectors | 9,4 | 6,4 | 0,9 | 2,5 | 5,2 |
| GAV Non primary sectors | 1,6 | 4,8 | 5,4 | 4,3 | 4,4 |

* Projected

## External factors

28. So far this year, the international economy has grown only slightly mainly because of the Iraq conflict, a weakening European economy, in particular Germany's, and the impact of SARS in Asia. In addition, markets focus on the fundamentals of the US economy, in particular the likelihood of a deflationary scenario. Consequently, world growth estimates for 2003 were revised from 3.7 percent in January to 3.3 percent. Likewise, estimated economic growth among our main trading partners was corrected downwards.

**Table 10**

**PROJECTED ECONOMIC GROWTH AMONG TRADING PARTNERS**

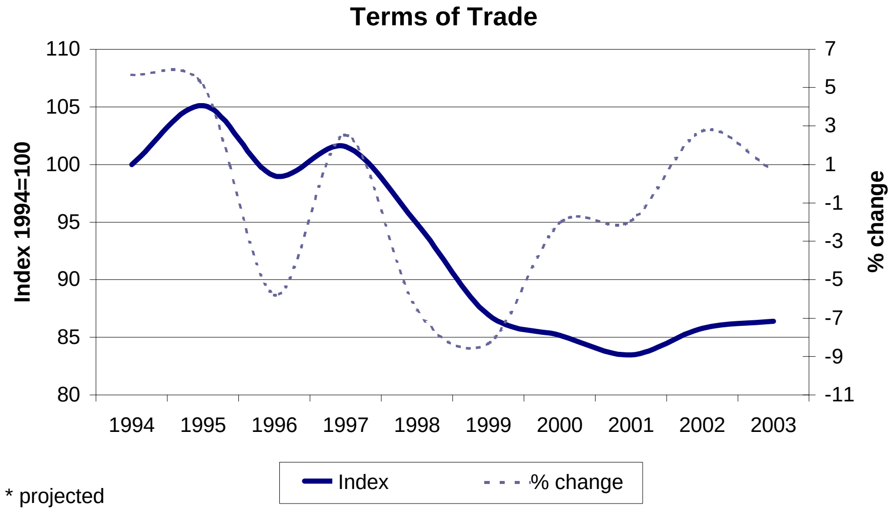
(In percent)

| | Actual | | Projection | | | |
|---|---|---|---|---|---|---|
| | | | Jan | | May | |
| | 2001 | 2002 1/ | 2003 | 2004 | 2003 | 2004 |
| **World *** | **2,3** | **3,0** | **3,7** | **4,5** | **3,3** | **4,2** |
| **Main trading partners **** | **1,2** | **1,6** | **2,6** | **3,5** | **1,9** | **3,4** |
| North America | 0,3 | 2,4 | 2,8 | 3,7 | 2,3 | 3,6 |
| Europe | 1,7 | 1,1 | 1,8 | 2,5 | 1,5 | 2,2 |
| Asia | 2,6 | 3,8 | 3,8 | 4,1 | 3,7 | 4,1 |
| Latin America | 1,4 | -1,0 | 2,1 | 3,7 | 0,4 | 3,9 |

* World Economic Outlook (September 2002 and April 2003).
** Consensus Forecasts (May and Jan 2003).
1/ Preliminar

29. Peru's terms of trade are expected to increase by 0.7 percent in 2003, slightly below the 0.8 percent projection included in the January report. This increase is accounted for by 4.6 percent higher export product prices, partially offset by 3.9 percent increase in import prices. Terms of trade are also expected to improve by 1.3 percent in 2004, based on 0.9 percent higher estimated export prices, including better quotations for coffee, copper, tin and iron, parallel to 0.4 percent lower import prices, mainly for cheaper crude.

**Graph 11**




30. Taking into account adjusted terms of trade and the forecasts of a slower world economy growth, Peru's trade balance surplus in 2003 is estimated at US$492 million, or US$93 million lower than the January report projections.

**Table 11**

**Trade Balance**
**(In millions of US dollars)**

| | 2002 | | 2003 | | 2004 * |
|---|---|---|---|---|---|
| | IQ | Year | IQ | Year* | |
| **1. EXPORTS** | **1578** | **7688** | **2028** | **8564** | **9320** |
| Traditional exports | 1045 | 5309 | 1424 | 5965 | 6260 |
| Non-traditional exports | 512 | 2265 | 587 | 2520 | 2983 |
| Other | 21 | 114 | 17 | 79 | 77 |
| **2. IMPORTS** | **1643** | **7426** | **2036** | **8072** | **8755** |
| Consumer goods | 379 | 1745 | 420 | 1876 | 2119 |
| Raw material | 806 | 3761 | 1092 | 4167 | 4405 |
| Capital goods | 437 | 1843 | 507 | 1942 | 2134 |
| Other | 22 | 77 | 17 | 87 | 97 |
| **3. Trade Balance** | **-65** | **261** | **-8** | **492** | **565** |

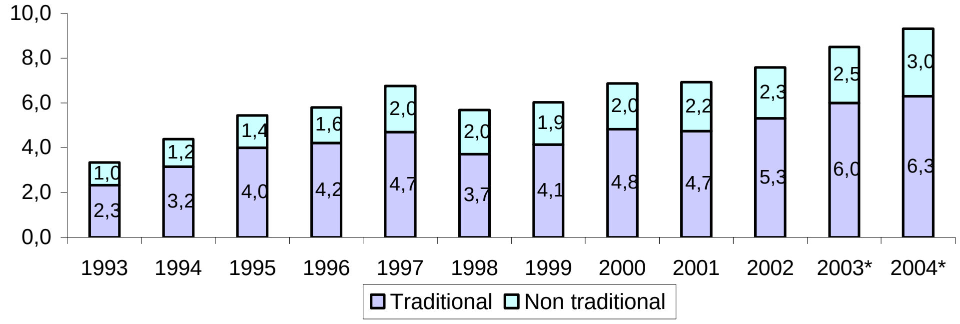
* Projected

31. Exports are expected to reach US$ 8564 million this year. Traditional exports are expected to increase through higher oil and oil by-product sales which may rise by US$194 million. Traditional mining exports were reviewed downwards, in particular zinc, lead and copper, as expectations of recovering world prices were dampened, together with reduced output from Volcan, Southern and Antamina mine operations. Higher gold prices worldwide and expanded shipments from Yanacocha may result in improved gold exports. However, on the aggregate, projected mining exports may remain as in the January report.

32. In 1994, exports are expected to reach US$9320 million, or a nominal 9 percent growth. Traditional product exports may rise 5 percent, while non-traditional exports would increase 18 percent.

**Graph 12**

**GOODS EXPORTS**
**(In billions of US dollars)**

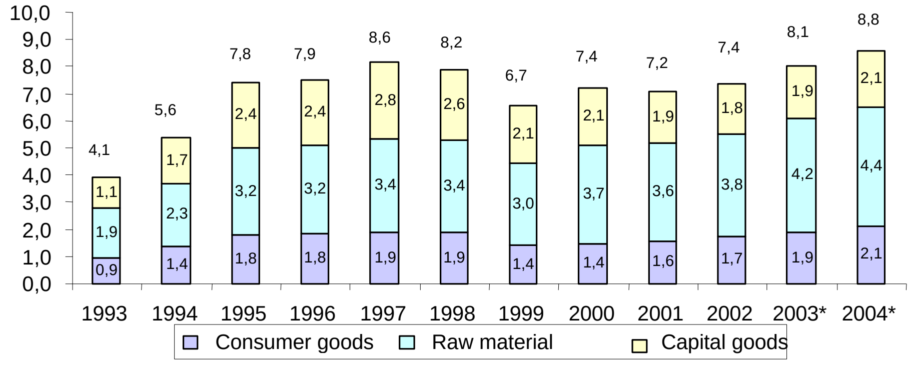



***** Projected

33. Imports are projected to grow a nominal 9 percent in 2003, higher than the January 7 percent estimate. This revised figure results from higher oil prices that rose 60 percent in IQ2003 year-over-year. This revised projection also includes larger capital goods imports during the first quarter mainly for the Camisea project. In 2004, an increase of consumer and capital goods purchases abroad may result in an estimated 8 percent growth of imports.

**Graph 13**

**GOODS IMPORTS**
**(In billions of US dollars)**




***** Projected

34. The current account of the balance of payments may run a US$1170 million deficit in 2003 or 1.9 percent of GDP, similar to the January report's estimate. Projections in the financial accounts were reviewed to include larger capital flows of US$1796 million, or US$591 million more than in January. Government capital funds may increase by US$203 million, largely due to greater freely-available disbursements from multilateral

organizations, while private long and short term capital flows may increase by US$201 million and US$224 million, respectively. This greater estimated private capital inflow may be accounted for by larger foreign financing for the Camisea gas field project that rose from US$500 million to US$735 million.

35. As a result of increased capital flows, Peru's net foreign currency reserves position will rise in 2003, with an estimated cumulative increase of US$625 million.

**Table 12**

**BALANCE OF PAYMENTS**
(In millions of US dollars)

| | 2002 | | 2003 | | 2004 * |
|---|---|---|---|---|---|
| | IQ | Year | IQ | Year* | |
| **I. CURRENT ACCOUNT BALANCE** | **- 380** | **- 1 128** | **- 382** | **- 1 170** | **- 1 353** |
| ***(as a percentage of GDP)*** | *-2,9* | *-2,0* | *-2,7* | *-1,9* | *-2,1* |
| **II. FINANCIAL ACCOUNT** | **552** | **2 114** | **1 228** | **1 796** | **1 503** |
| 1. Private sector | 63 | 1 012 | 631 | 890 | 815 |
| 2. Public sector | 489 | 1 102 | 596 | 906 | 688 |
| **III. NET INTERNATIONAL RESERVES (FLOW)** **(Increases shown in negative)** | **- 173** | **- 985** | **- 845** | **- 625** | **- 150** |

* Projected

36. The current account deficit for 2004 is estimated at US$1353 million, or 2.1 percent of GDP. Financial accounts flows may reach US$1503 million, with US$815 million in the private sector, principally from financing for mining and gas projects, such as Alto Chicama and Camisea, and US$688 million from government. Consequently, the estimated flow of net international reserves (NIR) this year would total US$150 million.

37. Estimates included in this inflation report point to a sustainable evolution of Peru's balance of payments, free of financial restrictions, thus contributing to an improved country risk.

## Fiscal factors

38. The projections' fiscal scene is based on a non-financial fiscal deficit dropping from 2.3 percent of GDP in 2002, to 2.0 percent in 2003 and 1.5 percent in 2004. The resulting lower need for additional financing therefore may reduce the foreign government debt to GDP ratio from 36 percent in 2002, to 35 percent in 2004.

**Table 13**

**NON-FINANCIAL GOVERNMENT OVERALL BALANCE**

**(As a percentage of GDP)**

| | 2002 | | 2003 | | 2004 * |
|---|---|---|---|---|---|
| | IQ | Year | IQ | Year* | |
| I. Central government current revenues | 13,4 | 14,1 | 14,7 | 14,2 | 14,3 |
| *of which: Tax revenues 1/* | *11,6* | *11,8* | *13,0* | *12,4* | *12,6* |
| II. Central government non-financial expenses | -13,1 | -14,5 | -13,4 | -14,2 | -13,8 |
| III. Other Government agencies | 0,7 | 0,1 | -0,3 | 0,1 | 0,2 |
| IV. Interest | -2,0 | -2,1 | -2,1 | -2,1 | -2,2 |
| **OVERALL BALANCE (I+II+III+IV)** | **-1,1** | **-2,3** | **-1,0** | **-2,0** | **-1,5** |

* Projected

1/ Excluding the Extraordinary Tax on State Assets.

**Table 14**

**GOVERNMENT DEFICIT FINANCING**

(In millions of US dollars)

| | 2002 | | 2003 * | | 2004* |
|---|---|---|---|---|---|
| | IQ | Year | IQ | Year* | |
| **I. OVERALL BALANCE** | **- 143** | **- 1 320** | **- 137** | **- 1 208** | **- 974** |
| *(Percentage of GDP)* | *-1,1* | *-2,3* | *-1,0* | *-2,0* | *-1,5* |
| **II. AMORTIZATION** | **- 192** | **- 1 074** | **- 329** | **- 1 507** | **- 1 600** |
| 1. Internal | - 18 | - 138 | - 73 | - 374 | - 354 |
| 2. External | - 174 | - 936 | - 256 | - 1 132 | - 1 246 |
| **III. FINANCING REQUIREMENT** | **335** | **2 394** | **466** | **2 715** | **2 574** |
| 1. External | 643 | 2 012 | 838 | 2 085 | 1 975 |
| 2. Internal | - 308 | 381 | - 372 | 630 | 599 |

* Projected

39. Government may require financing worth US$2715 million in 2003 and a lower US$2574 million total in 2004 as the fiscal deficit narrows from 2.0 to 1.5 percent of GDP. Also expected is an increase in local currency denominated internal debt, that is reducing the government's foreign exchange risk.

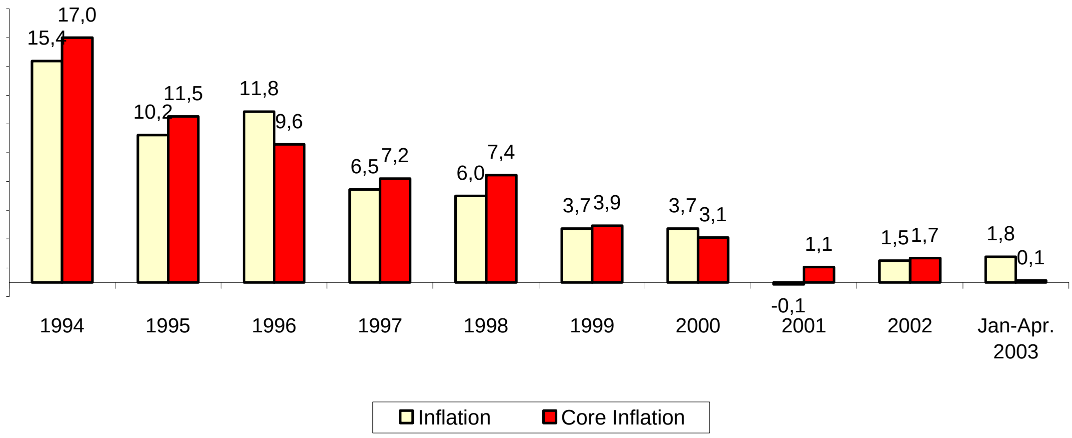
40. To meet financial needs, freely-available foreign disbursements in 2003 may reach about US$1600 million, while project disbursements may reach US$450 million. In 2004, freely-available disbursements worth US$1450 million and project disbursements for US$500 million may be needed. Also required may be domestic bond issues for about US$450 million yearly.

## IV. INFLATION

41. The Consumer Price Index for Metropolitan Lima increased 1.8 percent during the first four months of 2003, mainly due to higher fuel and transportation prices. The corresponding cumulative rate for the same period one year ago was 0.7 percent.

**Graph 14**

**INFLATION AND CORE INFLATION**
**(Cumulative change)**




42. The underlying component of the Consumer Price Index, which excludes items showing greater price fluctuations, grew 0.1 percent. While goods dropped 0.3 percent, services rose 0.7 percent. Foodstuffs and beverages dropped 0.8 percent, after falls in the price of rice (2.8 percent down) and bread (1.4 percent down).

43. The non-underlying component of the Consumer Price Index includes goods and services with highly volatile prices that reflect fluctuations in supplies and world quotations. The cumulative non-underlying inflation for January to April reached 5.3 percent. Items in this group with the steeper rises include fuels and transportation services with 11 percent increases each, which together account for 77 percent of the 1.8 percent inflation rate.

**Table 15**

**INFLATION**

(Annual cumulative change)

| | Weight | April 2001/ Dec 2000 | 2001 | April 2002/ Dec 2001 | 2002 | April 2003/ Dec 2002 |
|---|---|---|---|---|---|---|
| **I. CORE INFLATION** | **68,3** | **0,47** | **1,06** | **0,18** | **1,69** | **0,13** |
| **Goods** | **41,8** | **0,06** | **0,66** | **-0,10** | **1,76** | **-0,26** |
| Foodstuffs and beverages | 20,7 | -0,76 | -1,13 | -0,92 | 0,26 | -0,76 |
| Textiles and footwear | 7,6 | 0,90 | 2,02 | 0,40 | 1,24 | 0,00 |
| Electric appliances | 1,0 | 1,00 | -0,19 | 0,68 | 3,42 | -1,43 |
| Other industrial goods | 12,5 | 1,15 | 2,39 | 0,89 | 1,54 | 0,50 |
| **Services** | **26,6** | **1,06** | **1,65** | **0,62** | **1,57** | **0,74** |
| Restaurant meals | 12,0 | 0,54 | 1,29 | 0,33 | 1,28 | 0,29 |
| Education | 5,1 | 3,23 | 3,97 | 2,30 | 2,70 | 2,63 |
| Health | 1,3 | 2,02 | -0,37 | 0,62 | 1,00 | 1,33 |
| Rents | 2,3 | 0,90 | 3,02 | 0,10 | 3,31 | 0,69 |
| Other services | 5,9 | 0,84 | 3,50 | -0,04 | 2,11 | -0,14 |
| **II. NON-CORE INFLATION** | **31,7** | **0,62** | **-2,82** | **1,87** | **1,16** | **5,34** |
| Foodstuffs | 14,8 | 1,45 | -1,16 | 3,52 | -2,35 | 2,45 |
| Fuels | 3,9 | -1,83 | -13,14 | 3,64 | 15,60 | 11,10 |
| Transportation | 8,4 | -0,06 | -0,02 | -0,62 | 0,11 | 10,52 |
| Utilities | 4,6 | 1,24 | -2,73 | -0,40 | 1,96 | -0,61 |
| **III. CPI (Consumer price index)** | **100,0** | **0,52** | **-0,13** | **0,71** | **1,52** | **1,78** |

44. The three largest price increases account for 1.7 percent points of the inflation rate, in particular price increases in urban transportation, potatoes and gasoline. In addition, the three sharpest price declines contributed –0.3 percent points to changes in the CPI, in particular lower prices for chicken meat, citrus fruits and grapes.

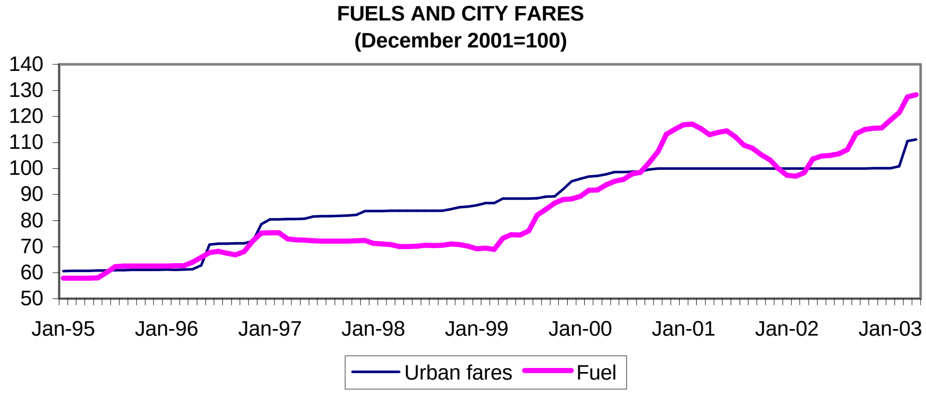
**Table 16**

**WEIGHTED CONTRIBUTIONS TO INFLATION: 2002**
**(Percent points)**

| Items | Weight | % Changes | Positive Contribution | Items | Weight | % Changes | Negative Contribution |
|---|---|---|---|---|---|---|---|
| Transportation fares | 8.0 | 11.1 | 0.88 | Chicken meat | 4.0 | -5.0 | -0.18 |
| Potatoes | 1.5 | 43.2 | 0.58 | Citrus fruits | 0.7 | -12.7 | -0.08 |
| Gasoline & lubricants | 1.5 | 15.0 | 0.25 | Grapes | 0.1 | -37.4 | -0.07 |
| **Total** | | | **1.71** | | | | **-0.33** |

- Higher fuel prices led to an 11 percent increase in transportation rates, in particular urban fares which rose by the same percentage. It is worth noticing that city transport prices have not changed since November 2000.

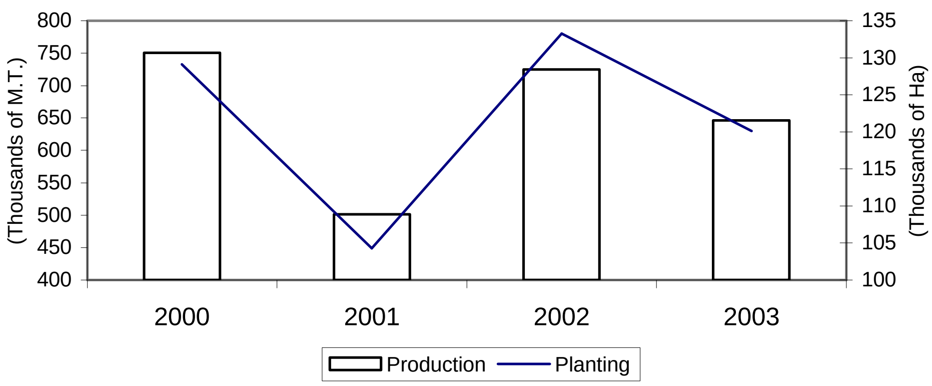
**Graph 15**




- Potatoes' price rose due to shrinking supply after 10 percent smaller cultivation area. Cumulative national output through March reveals an 11 percent fall compared to a year ago, principally in the typical potato growing areas in Huánuco, Pasco and Junín, Lima's main suppliers.

**Graph 16**

**Potato planting and output nationwide** 1/




1/ Production runs from January to March and planting goes from the preceeding year August-October season.

- Between January and April 2003, gasoline rose 15 percent, and gas and kerosene increased 9 percent. New prices are linked to evolving international oil quotations that rose from US$29 per barrel of oil in December, to US$43 in March (45 percent up), to fall back again to US$28 in April after the end of the Iraq conflict.

**Table 17**

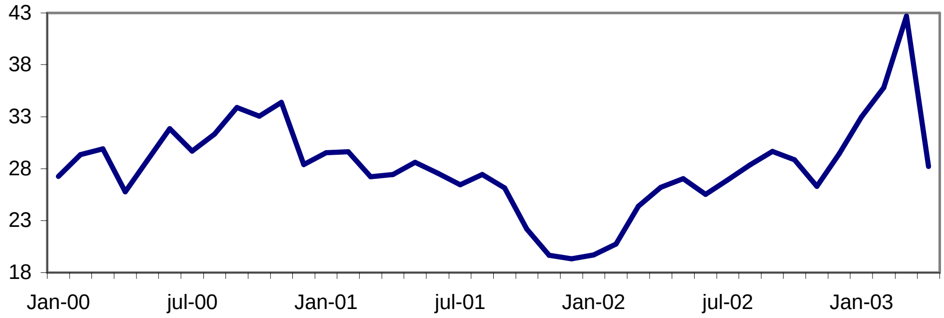
**FUEL PRICES: 2003**

**(Monthly percent change)**

| | Weight | Jan-03 | Feb-03 | Mar-03 | Apr-03 | Cumulative |
|---|---|---|---|---|---|---|
| **Fuels** | **3.9** | **2.7** | **2.4** | **4.9** | **0.8** | **11.1** |
| Gasoline & lubricants | 1.5 | 1.0 | 3.3 | 8.7 | 1.5 | 15.0 |
| Gas | 1.3 | 6.9 | 1.8 | 1.0 | -0.8 | 9.1 |
| Kerosene | 1.2 | 0.3 | 1.8 | 4.5 | 1.6 | 8.5 |
| WTI quotation | | 11.9 | 8.6 | 19.2 | -33.9 | -4.1 |

**Graph 17**

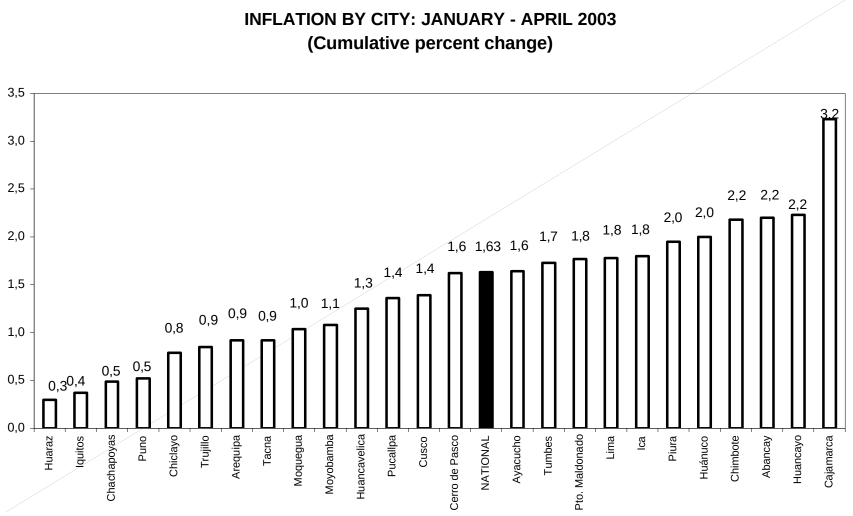
**WTI OIL INTERNATIONAL QUOTATION**
**January 2000-April 2003**
**(US$ per barrel)**




- Chicken meat's price fell 5 percent after mass baby chicken production. Average monthly sales from November 2002 to February 2003 were 4 percent higher than a year before. Citrus fruit prices fell 13 percent after larger seasonal tangerine output north of Lima, and new orange planting areas in Junín. Grape prices fell 37 percent partly for seasonal factors and also after a 7 percent output increase compared to a year ago.

45. Since January 2003, the National Statistics Institute (INEI) publishes a national consumer price aggregate index based on price indicators for 25 cities. This index shows a cumulative price increase of 1.6 percent for the January-April 2003 period. In 14 cities accounting for 25 percent of national urban expenditure, increases were below average. In another 11 cities that account for 75 percent of national expenses, average inflation was above the national average.

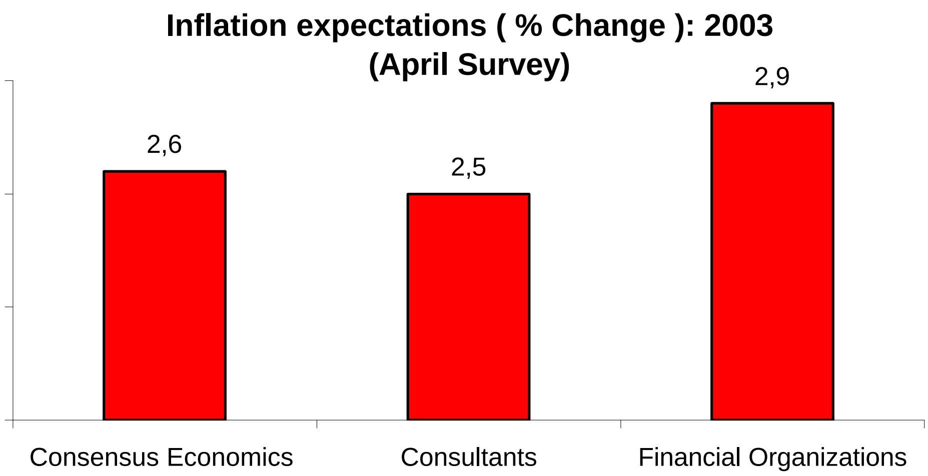
**Graph 18**




## Inflation forecast

46. To reflect the market's inflation expectations for 2003, both *Consensus Economics* and BCR surveys among financial entities and consultants were collected. Compared to the December survey, inflation expectations have moved closer to the Central Bank's target.

**Graph 19**

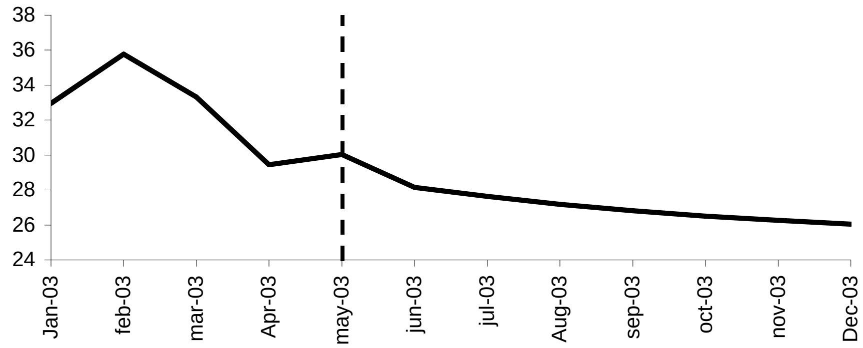


47. Inflation forecasts presented in this report for 2003 and 2004 are mainly based on the following assumptions:

- Monetary policy stance remains constant throughout the period.
- Non-core projected inflation for 2003 may reach 4 percent, mainly due to evolving fuel and foodstuff prices that account for 4 and 15 percent of the consumer goods mix respectively. In 2004, the non-core inflation rate may reach 1.5 percent.

**Graph 20**

**WTI OIL FUTURE PRICE**
**(US$ per barrel)**



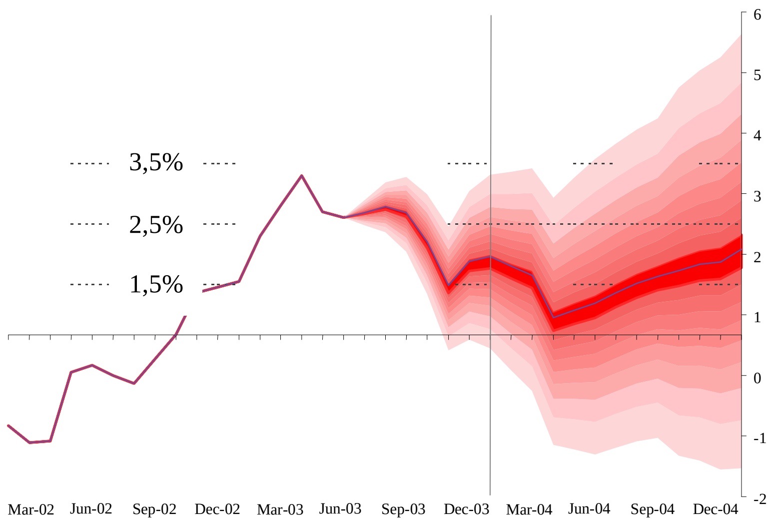

- A public sector deficit reaching 2.0 percent of GDP in 2003 and 1.5 percent in 2004, as described in the Multiannual Macroeconomic Framework.
- Given low prospects of growth and moderate inflation in both the US and Europe, international interest rates are expected to remain stable in 2003 and start climbing gradually next year.
- A smaller gap in 2003 between the economy's potential and actual level of activity.

48. Taking into account the factors mentioned above, the following graph shows the inflation forecast for 2003 and 2004, with a center forecast within the inflation target range for both years. Compared to the January report, inflation pressures are lower. While the January report projected an inflation rate in the upper trench of the target range (2.5-3.5 percent), this report moves the projection down to the lower portion (1.5-2.5 percent) due to lower devaluation expectations for 2003 (falling from 3.1 percent accumulated depreciation forecast in the January 2003 report, to 1.1 percent now) and also to the ongoing reversion of international fuel prices through year-end.

**Graph 21**

**Inflation forecast**

**(12 month CPI cumulative change)**



## V. BALANCE OF RISKS

49. While the January report showed a risk balance tilting towards increased prices caused by uncertainty regarding changes in fuel quotations, this report takes a neutral risk stance where no single factor creates a bias from the center forecast. In Graph 21, the inflation forecast has 20 percent likelihood of falling within the 2.5 percent target range, with 1 percent point above or below tolerance.

50. Sources of risk that may hamper this report’s projections include:

- **Weaker consumer confidence.** The main scenario assumes dynamic private consumer demand throughout the projection. This component of aggregate demand accounted for 3.2 percent points of GDP growth in 2002 (5.3 percent). If consumer confidence falls, the economy may slowdown and, consequently, projected inflation may tilt downwards with more flexible monetary policies required to prevent a deflation risk.

- **Reduced investor confidence.** Private investment is expected to continue improving in 2003 and 2004, resulting in sharper growth of the potential product. i.e., sustained economic growth without inflation pressures. Nevertheless, a stable macroeconomic environment is required. Losing the investors’ confidence would have a negative impact on aggregate expenditure and reduce the potential GDP growth rate. Against this backdrop, coordinated initiatives among economic authorities would be required to restore confidence.

- **Increasing country risk.** Country risk perceptions may be hampered by less favorable expectations regarding evolving fiscal accounts, or from a domino effect born in financial turmoil in other regional countries. If this evolution led to more volatile local exchange and money markets, the Central Bank may adopt a more rigid position to damp volatility in domestic financial markets.

- **World economic recovery below expectations.** In this scenario, a slow world economic recovery would hamper Peru’s terms of trade and reduce exports, requiring the Central Bank to adopt a more flexible monetary stance.

- **Faster drop of oil prices.** The central scenario assumes a decreasing trend in oil quotations. If the world economy fails to recover as expected, international oil demand would fall, pushing prices down. Such a favorable supply shock would not change the Central Bank’s monetary policy position, unless changes in fuel prices hit other prices in the economy.

- **Poor farming season.** When configuring the central scenario, food prices were assumed to fluctuate only moderately. However, a poor agricultural season may increase the cost of the consumer’s goods mix, and thus have an impact on inflation forecasts. Only if these increases affect the behavior of other prices, would the Central Bank modify its monetary policy.

# CENTRAL RESERVE BANK OF PERU

## ANNEX

## FORECASTS IN INFLATION REPORTS

| | 2001 | 2002 | 2003 [1/] January Report | 2003 [1/] May Report | 2004 [1/] |
|---|---|---|---|---|---|
| | | | **Real %Change** | | |
| 1. Gross Domestic Product | 0,6 | 5,3 | 4,0 | 4,0 | 4,5 |
| 2. Domestic Demand | -0,3 | 4,8 | 3,6 | 4,0 | 4,4 |
| 3. Private Consumption | 1,8 | 4,4 | 4,0 | 4,3 | 4,0 |
| 4. Private Fixed Investment | -5,9 | 0,7 | 5,4 | 5,4 | 7,4 |
| 5. Exports of Goods and Services | 6,9 | 5,7 | 6,2 | 5,0 | 7,3 |
| 6. Main Trade Partners' Economic Growth | 1,2 | 1,6 | 2,6 | 1,9 | 3,4 |
| | | | **% Change** | | |
| 7. Annual Inflation | -0,1 | 1,5 | 2,5 [2/] | 2,5 [2/] | 2,5 [2/] |
| 8. Nominal Cumulative Depreciation | -2,4 | 2,3 | 3,1 | 1,1 | 2,5 |
| 9. Real Cumulative Depreciation (multilateral) | -4,3 | -0,6 | 4,0 | 3,3 | 2,3 |
| 10. Terms of Trade | -2,0 | 2,8 | 0,8 | 0,7 | 1,3 |
| | | | **% of GDP** | | |
| 11. Balance of Payments Current Account | -2,0 | -2,0 | -1,9 | -1,9 | -2,1 |
| 12. Trade Balance | -0,2 | 0,5 | 1,0 | 0,8 | 0,9 |
| 13. Gross Private Capital Flow w/o Privatizations | 3,8 | 5,2 | 1,8 | 2,7 | 2,8 |
| 14. Non-financial Public Sector Primary Balance | -0,3 | -0,3 | 0,2 | 0,1 | 0,6 |
| 15. Non-financial Public Sector Overall Balance | -2,5 | -2,3 | -2,0 | -2,0 | -1,5 |
| 16. Central Government's Tax Revenues [3/] | 12,1 | 11,8 | 12,3 | 12,4 | 12,5 |
| 17. External Government Debt Balance | 35,0 | 36,4 | 35,4 | 36,0 | 35,3 |
| | | | **Nominal % change** | | |
| 18. Central Government Non-financial Expenditure | -2,3 | 2,1 | 4,5 | 4,8 | 4,1 |
| 19. Monetary Base | 3,2 | 15,8 | 8,0 | 8,0 | 7,0 |
| 20. Banks' Loans to the Private Sector | -4,6 | 0,2 | 9,0 | 5,5 | 6,5 |

[1/] Projected

[2/] Target.

[3/] Excluding the Extraordinary Tax on State Assets.