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Monetary Program for 2002

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Summary

As of this year, the Central Reserve Bank of Peru (BCR) has adopted an **Explicit Inflation Targeting** system. The Board of Directors have approved a target of 2,5 percent, for cumulative inflation as of December 2002 (with a range of 1 percentage point above or below)

To this end, the BCR will monthly approve and release a range for the liquidity of the current accounts Banks held at the Central Bank, as well as BCR operations´ interest rates, thus leading interbank interest rate development. These decisions will respond to the assessment of a set of indicators of future inflation such as surveys of expectations, real output level, demand for the different components of monetary liquidity and the exchange rate. In this way the Central Bank will calibrate the banks' liquidity to avoid inflationary or deflationary pressures and to promote an adequate level of economic activity.

An integral element of this framework will be the practice of higher transparency in monetary policy. Therefore, an inflation report with the last developments and outlooks on monetary policy will be released every four months (in January, May and September).

MONETARY POLICY FOR 2002

As recently approved by the Board of the Central Reserve Bank of Peru, an annual rate of inflation of 2,5 percent, plus or minus 1 percentage point, will guide monetary policy during 2002.

1. Foreword

Up to 2001, monetary policy was conducted by approving an **operating target** for the disposable volume of banks' liquidity, aimed at achieving a predetermined **base money** growth. This growth was consistent with the inflation target as established in the annual Monetary Program, after considering the determinants of the demand for money. In consequence, the base money growth rate was considered an **intermediate target**, between the operating target of banks' liquidity and the inflation target, as such, it was considered relevant in anchoring the inflation expectations of economic agents.

2. Features of an Explicit Inflation Targeting System

Since the early 90s, some central banks have adopted **Explicit Inflation Targeting**, aimed at directly relating monetary policy decisions, based on an operative target, with the inflation outcome. In order to anchor expectations on inflation these central banks announce an inflation target and employ a strategy of communication to transmit the policy actions to be adopted to achieve the target.

The main features of an **Explicit Inflation Targeting** System are:

i. Announcement of an inflation target.

ii. Autonomy to manage an operative target, which is discretionally modified by the Central Bank in accordance with an integral analysis of the factors that affect price levels. The instrument adopted could be banks' current account held at the BCR or the short-term interest rates.

iii. Management of an operative target, according solely to the achievement of the inflation target and not of any other nominal variable, such as a monetary aggregate or the exchange rate. Hence, this scheme is consistent with a flotation regime.

iv. Transparency on the objectives and monetary decisions of the Central Bank.

3. Adoption of Explicit Inflation Targets

The Board of Directors of the Central Reserve Bank of Peru has approved that monetary policy will follow a scheme of **Explicit Inflation Targeting**, by which decisions on the monetary policy operative target will be based on the assessment of inflation determinants, such as surveys on inflation expectations, the growth rate of monetary aggregates, the development of real GDP and the exchange rate. For instance, if a weak domestic demand pushes inflation below its target monetary policy will be expansive; however, if an excessive aggregate expenditure growth compromises the inflation target monetary policy will be tightened.

The **target** approved for annual inflation is 2.5 percent with a margin of 1 percentage point above and below.

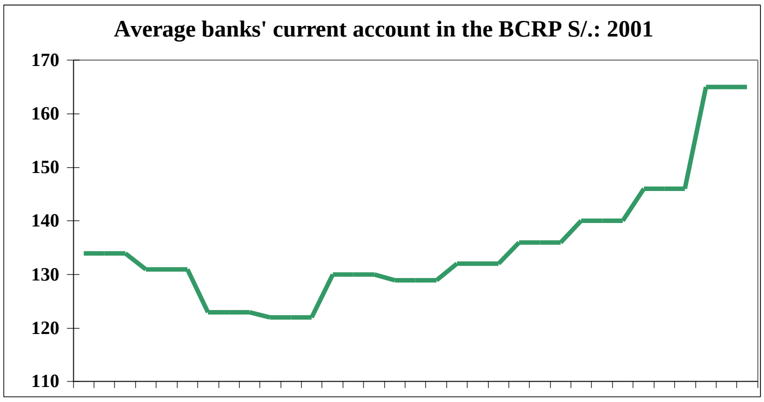
The monetary policy decisions oriented to achieve the inflation target will be taken and released monthly every first Thursday. They will be still related to the **operative target** for the range, i.e. the average monthly balance of the current accounts Banks hold at the Central Bank. They will also include the interest rates, active and passive, the BCR applies on its operations with banks. Through this monetary action the Bank influences the interbank interest rate. In case the market interest rate for domestic operations, the interbank rate, is higher than the rate used for liquidity lending by the Bank, then the higher one will be applied, as is done today. Thus, the provision of liquidity by the Bank will not validate abrupt changes in short - term expectations.

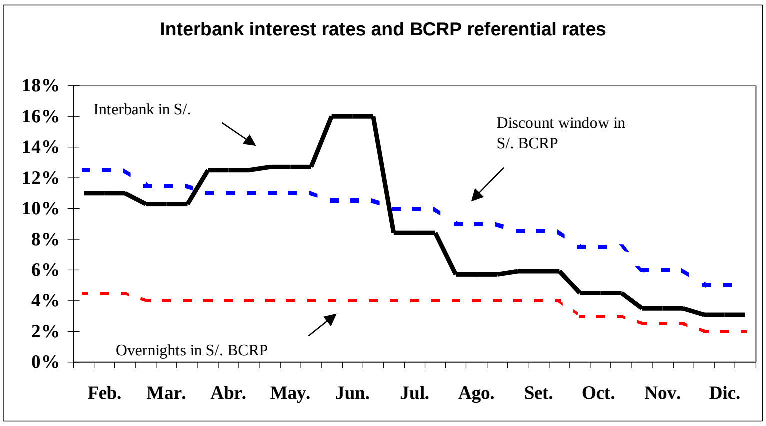
Over the second half of 2001, the operative target grew steadily. Also, reference interest rates for Central Bank operations diminished. Both factors contributed to the decrease of the interbank interest rate, reversing the increases observed during the electoral process. Therefore, the interbank rate as of December 2001 was 3.1 percent. In line with the declining trend in this rate, the interest rates of loans in domestic currency also declined in this period. For instance, the corporative prime interest rate passed from 13.2 percent in June to 5.0 percent as of December.

In order to fulfill the banks' monthly ranges of liquidity, the BCR relies on tools to inject or withdraw liquidity from the market. In order to inject liquidity the Bank temporarily repurchases its own Certificates of Deposit and foreign currency CD's. It also grants monetary regulation credit and purchases foreign currency in the spot market. On the other hand, the Bank withdraws liquidity through the auction of BCR Certificates of Deposits, overnight deposits in the BCR and the sale of foreign currency in the spot market.

The **prompt release** of monetary policy decisions, as well as the data upon which these decisions are based, will allow economic agents to bear in mind this information when estimating their expectations.

Therefore, every four months, in January, May and September, an inflation report with the last developments and outlooks on monetary policy will be released. Furthermore monthly, every first Thursday, the Bank will release an Informative Note that will include its monetary policy decisions.





….Since the last semester of the year 2001, the increase in the operating target of disposable liquidity in the banks' current account deposits held at the BCR and the decrease in interest rates of Central Bank's operations have allowed a continuous reduction of interbank interest rates.

4. Monetary Policy Transmission Mechanisms

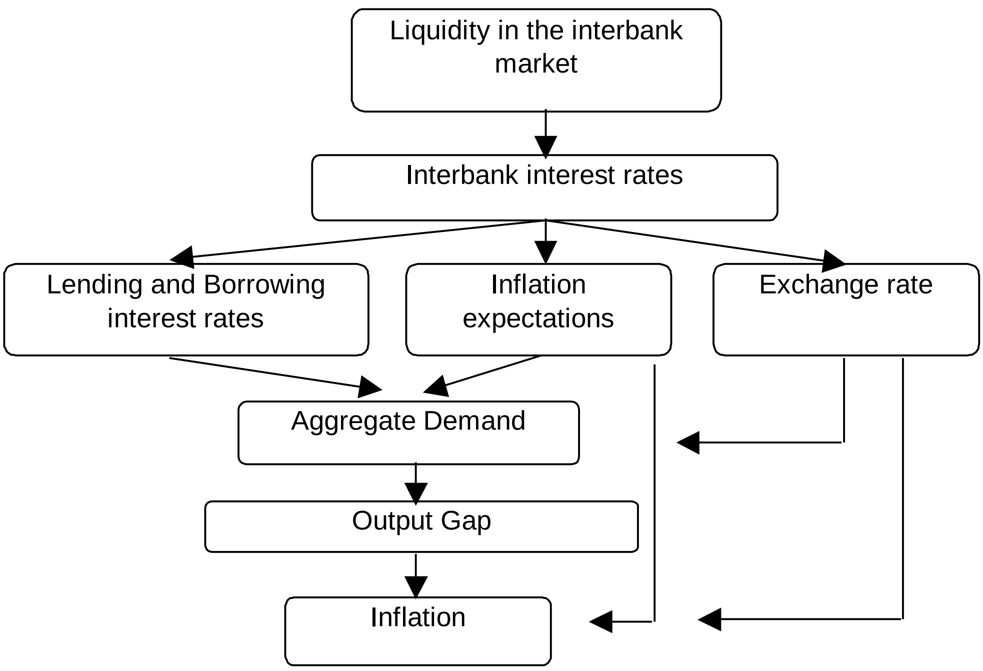
The Central Bank's monetary policy actions affect the banking system's disposable liquidity in the short run and thus the interbank interest rate in domestic currency. How these changes affect output and inflation rates is described below, differentiated by transmission mechanisms.

- The **interest rate** channel describes how changes in nominal interest rates affect private consumption and investment decisions, thus affecting aggregate demand.

- The **inflation expectations** channel is the effect of changes in expectations on economic agents' pricing process and on real interest rates, which are relevant for consumption and investment decisions.

- The **exchange rate** channel affects the aggregate demand in two opposite ways. On the one hand, changes in export and domestic prices have an expansionary effect. On the other hand, the wealth effect due to financial dollarization of private debt has a contractive effect. Furthermore, the exchange rate has a direct impact on inflation because of the relative importance of the share of tradable goods in the consumption basket used in the calculation of the Consumer Price Index.

Transmission Mechanisms of Monetary Policy



This Monetary Program contains forecasts based on the said transmission mechanisms. However, some unforeseeable circumstance may put on risk the observance of the announced inflation target. Three types of contingencies are considered: financial, related to aggregate demand, and, related to inflation.

- The first type affects economic agents' expectations, changing the interest and exchange rates, and inflation expectations. Therefore, the maintenance of an operating target for the range of banks' disposable liquidity restrains financial volatility.

- The second type of contingency affects economic activity, i.e. a slowdown in external demand. The corresponding monetary policy reaction must consider its effects on the output gap.

- The third type of contingency directly affects the inflation rate, such as a change in international fuel prices. However, in some cases such contingencies may have only a one-time effect on consumer prices, with no permanent effects on the inflation rate. The latter do not deserve a change in monetary policy.

5. Inflation Forecasts and Indicators

The baseline macroeconomic scenario for 2002 is consistent with a 2,5 percent inflation target within a 1 percent range. In 2001, cumulative inflation was negative in 0.1 percent, explained by the contraction of domestic demand in 1.2 percent, the reduction of the exchange rate in 2.4 percent and the decrease of international fuel prices. The inflation target of the year 2002 is supported by:

- Inflation expectations surveys, for the year 2002, on financial and non-financial institutions show a rate of inflation of 2.2 and 2.5 percent, respectively.

Survey of Macroeconomic Expectations 2002

	Enterprises	
	Financial	Non Financial
Annual growth of GDP	3,0%	3,0%
Exchange rate at december	3,52	3,58
Cumulative depreciation	2,3%	4,1%
Cumulative inflation at december	2,2%	2,5%

- Domestic demand should have a sustained recovery in 2002. Monetary policy is consistent with an improved economic activity (real GDP will grow 3.5 percent whereas domestic demand will expand by 3.4 percent). Fiscal policy actions and low interest rates, recorded particularly since the fourth quarter of 2001, in a context of political stability, will encourage the recovery of consumption and investment levels in the private sector. These facts, together with the development of investment projects such as the extraction, transportation and distribution of natural gas (Camisea project) and the planned infrastructure and services privatizations or concessions, will be determinants for private investment growth.

  The adverse international context, especially since the September 11th events, has decelerated the rate of growth of the volume of exports and impinged their price evolution. However, the start of exports from Antamina project in August 2001 will explain 5.2 points of the 10.5 increase in exports and 1.0 point of annual GDP growth in 2002.

- The nominal exchange rate should increase 2.6 percent in 2002, whereas financial institutions surveys indicate a lower increase expectation (2.3 percent). In 2001, the exchange rate fell 2.4 percent because of the lower net volume of banks' forward operations, reflecting a higher political stability. The balance of these operations dropped from US$ 1 121 millions in July to US$ 834 millions as of end-December.

- Fuel prices should grow 34.8 percent in 2002, reverting the transitory fall in 2001 that contributed to the deviation from the announced inflation target. It should be noted that of 2001 inflation (-0.1 percent) 0.6 percentage points were due to the decrease of domestic fuel prices.

- Monetary Aggregates:

  i. **The average balances of Base money** should increase 7.0 percent in 2002. This because of a 4.5 percent nominal GDP growth (3.5 percent real GDP growth); a 6.3 percent reduction in the velocity of money, which strengthens confidence in the domestic currency (nuevo sol); and, a 4.2 percent increase of the banking multiplier.

  ii. End-of-period total banking **liquidity** should increase 6.7 percent, while liquidity in domestic currency should grow 9.0 percent. This is to say, a higher domestic currency demand growth will reflect greater financial stability.

  iii. **Credit to the private sector** in foreign currency should grow 4.1 percent by the end of 2002. Credit in domestic currency should increase 11.0 percent, an important recovery. It is expected that better economic performance will reverse the contraction in credit to the private sector seen over the last 3 years.

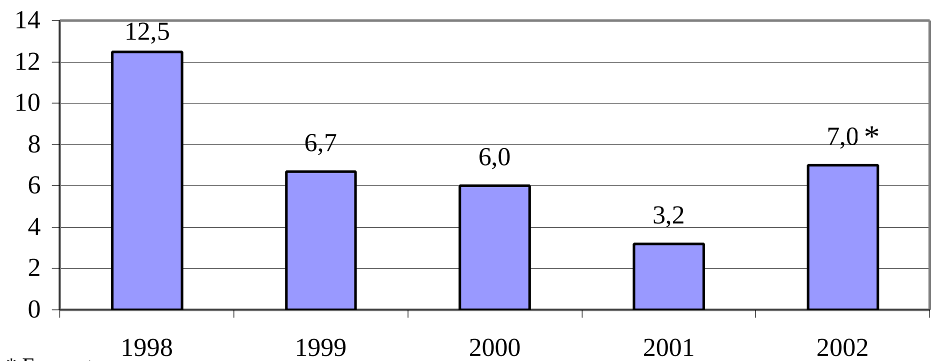
  Any sustained recovery of credit requires changes in institutional aspects that allow an increase in the number of potential borrowers. These aspects refer to the possibility of establishing efficient collateral, allowing equity recovery of firms and developing the capital market.

INFLATION INDICATORS

	2000	2001	2002
1. a. CPI cumulative inflation rate	3,7	-0,1	2,5
b. Underlying cumulative inflation rate	3,2	0,7	2,5
2. Annual variation of aggregate demand	2,4	-1,2	3,4
a. Private consumption	3,9	1,2	2,8
b. Public consumption	5,1	-0,2	3,4
c. Private gross fixed investment	-2,0	-6,1	4,9
d. Public gross fixed investment	-15,4	-19,1	9,6
3. Annual variation of real GDP	3,1	-0,1	3,5
4. Nominal exchange rate			
a. Level	3,52	3,44	3,52
b. Annual variation 12 months	1,0	-2,4	2,5
5. Terms of trade (%Var 12 months)			
a. Terms of trade index	-0,5	-2,9	1,2
b. Export price index	4,9	-7,1	1,8
c. Import price index	5,3	-4,3	0,6
d. Fuel price 1/	57,0	-34,5	34,8
6. Average annual variation of monetary aggregates			
a. Monetary base	6,0	3,2	7,0
b. Liquidity in domestic currency	5,9	6,9	11,5
7. Cumulative variation of credit to the private sector			
a. Domestic currency	0,9	1,9	11,0
b. Foreign currency	-4,5	-2,7	4,1

1/ Corresponds to the price of imported crude oil.

MONETARY BASE
(Annual average growth rate)



* Forecast

6. Risk Balance

The real, financial and monetary conditions mentioned above should allow the Central Bank to meet the inflation target. However, different scenarios that put to risk the observance of this goal may occur, such as:

- A delay in the recovery of private sector expenditure due to a worsening of income expectations implies deflation pressures. This justifies a more flexible monetary stance, considering the output gap evolution.

- The persistence of the US economy slowdown would affect exports volume, tradable goods' prices and private investment flows. In such an eventuality, the current floating exchange rate regime would allow the real exchange rate to adjust. If deflationary pressures persist, monetary policy could be eased.

- The endangerment of the fiscal account sustainability would make lending rates rise in response to credit restriction to the private sector and the negative impact on perceptions on macroeconomic stability.

- The entry of important short-term capital flows would generate demand pressures. Monetary sterilization could be used, but with the limitation of an increase in interest rates. Therefore, macroeconomic coordination is necessary in order to adopt a more austere fiscal stance, permitting higher private expenditure. The latter would also avoid a loss in external competitiveness because of the inflows of capital.