V.

Money and Credit

In 2003, inflation reached its target level of 2.5 percent, amid a series of monetary policy measures to ease monetary policy and reduce the interbank funds rate. In the year there was a reduction of dollarization in the financial system and the credit markets were influenced by a greater dynamism of primary placements issued in nominal local currency and an increase in the value of the pension and mutual funds.

1. Monetary policy measures

During the first half of 2003, the Central Bank maintained its stance on monetary policy, with an interbank interest rate at 3.8 percent. The growth rate of prices increased temporarily due to the higher oil prices associated with the war in Iraq. Given the transitory nature of these shocks, the Central Bank did not change its stance on monetary policy.

In the second half of the year, the Central Bank gradually eased its policy stance, by lowering four times its reference interest rates, leading to a reduction in the interbank interest rate from 3.7 percent in June to 2.5 percent in December. This looser monetary policy was based on inflation forecasts approaching the lower band of the target in 2003 and 2004 (Inflation Reports of May and August 2003).

The inflation rate in 2003 was 2.48 percent, very close to the 2.5 percent annual target set by the Bank.

BOX 7

MONETARY POLICY DESIGN UNDER AN INFLATION TARGETING FRAMEWORK

The Board of the Banco Central de Reserva del Perú (BCRP) decided as of June to execute monetary policy through an Inflation Targeting (IT) regime. Under this regime, Central Bank operations are targeted to reach a specific target of annual inflation, making an explicit commitment to monetary stability.

The BCRP is the first Central Bank adopting IT in a financial dollarization context. Monetary policy has shown to be effective in reverting deflationary pressures and meeting the inflation target. Particularly, the inflationary pressures between the end of 2001 and the beginning of 2002 were overcome. The annual inflation rate rose from -0.1 percent in

December 2001 to 1.5 percent in 2002, and 2.5 percent in December 2003. Moreover, since December 2002 the 12-month inflation rate has been inside the announced range, except in October 2003 (1.3 percent).

Under IT, the BCRP announces the target with the aim of anchoring economic agent expectations. The one-percentage point tolerance up and down the central target induces a more flexible monetary policy, allowing it to overlook temporary shocks in prices.

The BCRP aims at anticipating inflationary or deflationary pressures that could deviate the actual inflation rate from the announced target, given the lags in monetary policy outcomes. The decision-making process uses an inflation forecasting system that considers inflation expectations, domestic conditions of aggregate demand and supply, local financial markets and the expected world economy evolution. The inflation forecasting system and its results are discussed and analyzed in the Macroeconomic Models Committee by members of the Board and Central Bank's staff.

Transparency is a necessary condition to strengthen the Central Bank's credibility and, consequently, improve the effectiveness of monetary policy. With this end in view, the BCRP publishes an Inflation Report every four months, to inform about the main determinants of the inflation evolution as well as the forecasts on inflationary pressures. Likewise, a Press Release containing the Board´s decisions on monetary policy is published the first Thursday of every month.

2. Interest rates

The Central Bank changes its monetary policy stance by adjusting the reference interest rate for its operations with commercial banks: for overnight deposits as well as for direct repos and monetary regulation credits. The open market daily auctions inject or withdraw liquidity in order to lead the interbank interest rate around the center of the range set by the reference interest rates.

The greater emphasis of monetary operations on maintaining interbank interest rate stability has led to a reduction of its standard deviation, from 0.5 percent in 2002 to 0.1 percent in 2003.

This greater stability contributes to a better understanding of the monetary policy stance and facilitates the market setting process of the other interest rates in domestic currency (for loans, overdrafts, rediscounts, deposits, securities, etc).

TABLE 32

INTERBANK INTEREST RATE

(In percentage points)

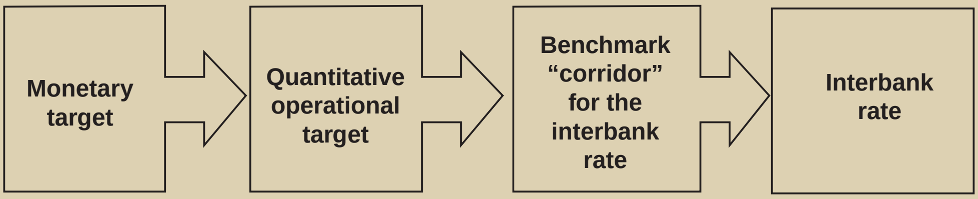
Year	Average	Standard deviation
1998	19.0	6.6
1999	14.9	4.8
2000	12.7	2.5
2001	8.6	0.9
2002	3.2	0.5
2003	3.4	0.1

Source: BCRP.

BOX 8

THE TRANSITION FROM MONETARY TARGET TO AN INTEREST RATE OPERATIONAL TARGET

During the last years, the Central Bank has changed its monetary policy from a monetary base growth control scheme, gradually through such stages as an operational target of broad money and a corridor range for the interbank interest rate, to an interbank interest rate target.



Monetary base growth	Banking reserves at the Central Bank	**Upper limit** rediscount rate **Lower limit** deposit facilities rate	OMOs tend to lead the interbank rate around the center of the “corridor”
(until 2001)	(2001 - 2002)	(2002 - 2003)	(since 2003)

Under this process, the volatility of the interbank interest rate has diminished continuously. During the years 2001 – 2002, the announcement of the operational target (in terms of the current account deposits of the banking system at the Central Bank), was accompanied by the release of the reference interest rates range, within which the interbank interest rate should lie. Thus, open market operations (through auctions) continued being aimed at the target for broad money, although the interbank interest rate was driven through this corridor.

The upper limit of this range is the interest rate for direct repos and the rediscount rate while the lower limit corresponds to the interest rate for overnight deposits of commercial banks at the Central Bank.

Since 2003, the current account deposits of the banking system at the Central Bank are no longer the operational target but a forecast, while it is announced that monetary operations will be aimed at setting the interbank interest rate in the center of the reference range. The reduction in the interbank interest rate volatility has significantly reinforced the influence of this rate over the rest of the banks' interest rates.

The Central Bank contemplates the possibility of temporary deviations from the interbank interest rate target when facing significant increments in the nominal exchange rate (as in September 2002). This "escape clause" of the monetary management is adopted to prevent adverse balance sheet effects on businesses and families in an economy with financial dollarization.

BOX 9

IMPACT OF THE INTERBANK INTEREST RATE OVER THE REST OF INTEREST RATES IN DOMESTIC CURRENCY

The Central Bank influences the interbank interest rate through its monetary operations. The market for interbank loans is made of very short-term domestic currency supply and demand. A bank can be in a supply or demand position depending on its individual level of liquidity. The Central Bank regulates the aggregate level of banks' liquidity, and consequently influences the setting of the interbank interest rate.

The level of the interbank interest rate is a reference for the other interest rates in nuevos soles and, in general, has a greater influence on the interest rates with shorter terms and lower risks. A higher response of the rest of interest rates in nuevos soles to changes in the interbank interest rate strengthens the effectiveness of monetary policy through the interest rate transmission channel.

Data for the period 1995-2003 was analyzed to estimate these effects. This period was divided in two sub-periods, to detect if the higher predictability of the interbank rate (due to its reduced volatility) has strengthen this transmission channel. The results show that in the case of the second sub-period, the effect of the interbank interest rate is indeed markedly stronger on loans and deposits rates with terms less than a year. For instance, the estimated effect of a one percentage point change in the interbank interest rate over the interest rates of loans up to 360 days is 0.46 percentage points in a 5-month period.

IMPACT OF INTERBANK INTEREST RATE

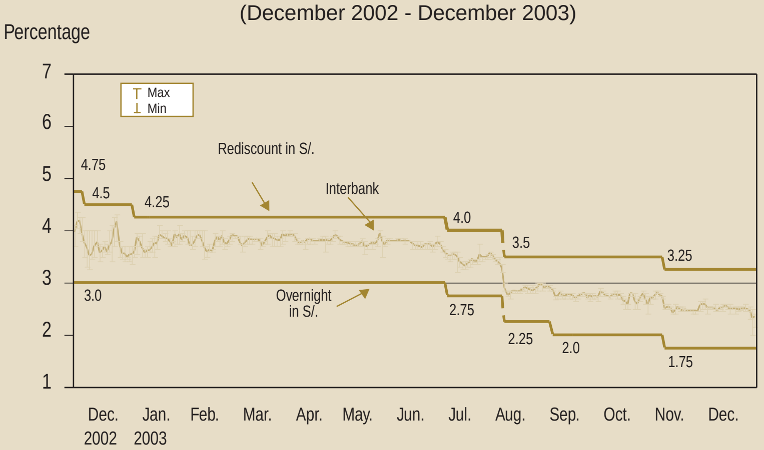
	Effect (In percentage points)	
	Apr.95-Jan.01	**Feb.01-Mar.03**
Interest rates		
Loans		
Up to 360 days	0.11	0.46
More than 360 days	0.61	0.61
Deposits		
Savings	0.04	0.25
Up to 30 days	0.18	0.61
Between 31-179 days	0.06	0.44
Between 180-360 days	0.21	0.21
More than 360 days	0.13	0.13

Source: BCRP.

The interbank interest rate reductions over the second half of 2003 continued inducing falls in the other interest rates in nuevos soles (for credits, deposits, and securities markets).

GRAPH 16

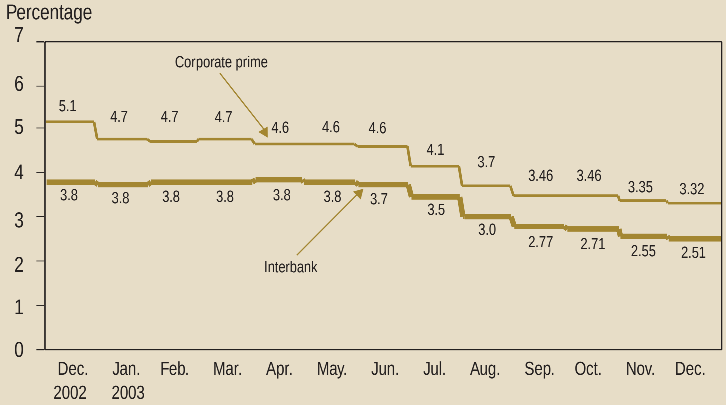
INTEREST RATES IN DOMESTIC CURRENCY
(December 2002 - December 2003)



Source: BCRP.

GRAPH 17

MONTHLY AVERAGE INTEREST RATES IN DOMESTIC CURRENCY
(December 2002 - December 2003)



Source: BCRP.

TABLE 33

INTEREST RATES IN DOMESTIC CURRENCY
(In percentages)

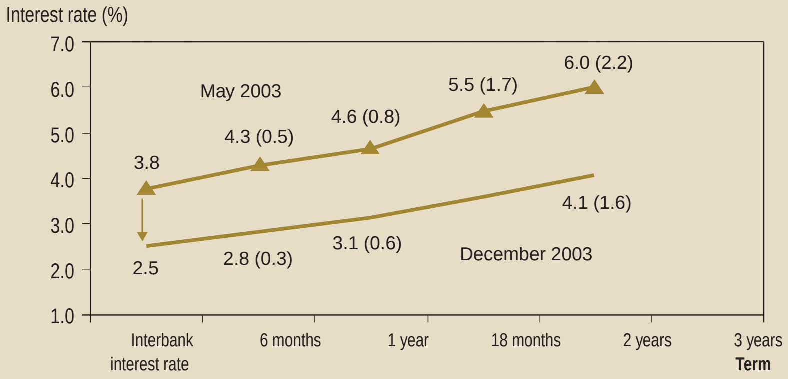
	2001				2002				2003			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
1. Interbank	10.3	16.0	5.9	3.1	2.5	2.6	5.4	3.8	3.8	3.7	2.8	2.5
2. Savings deposits	6.8	6.6	5.2	3.0	1.8	1.7	1.7	1.7	1.7	1.5	1.3	1.3
3. Corporate prime lending	12.4	13.2	9.4	5.0	3.9	3.7	6.8	5.1	4.7	4.6	3.5	3.3
4. Average lending rate up to 360 days	21.3	21.2	19.4	17.2	15.5	14.1	14.0	14.8	14.3	14.0	14.3	14.0
5. CDBCRP												
Of the balance	12.6	12.4	10.8	7.5	5.4	4.8	4.1	4.7	4.7	4.8	4.3	3.9
Average term of the placement of the month (in months) 1/	6	7	6	6	6	6	-	8	12	7	15	11

1/ Excludes one-week CDBCRP deposits.
Source: SBS and BCRP.

Following the reduction of the monetary policy reference interest rates, the BCRP Certificates of Deposit's (CDBCRP) yield curve showed a downward shift in the second half of the year. Short-term yields (for one year or less) fell 150 bps. between May and December, similar to the reduction in the interbank interest rate (130 bps.). Meanwhile, long-term yields fell 200 bps. over the same period. This downward shift in the CDBCRP yield curve reflects the expectations for lower interest rates in the future, as a result of the higher credibility of the Central Bank's monetary policy.

GRAPH 18

CDBCRP yield curve 1/



1/ Numbers between parentheses indicate spreads with respect to the interbank rate.
Source: SBS and BCRP.

The CDBCRP's balances increased from S/. 1,635 million (24 percent of the monetary base) in December 2002, to S/. 4,097 million (55 percent of the monetary base) in December 2003. The term structure of the CDBCRPs has been lengthened up to three years in order to diversify the maturity of the securities. In addition, maturity dates have been standardized in order to increase the liquidity of these securities. In spite of the increasing average maturity, the average interest rate for CDBCRPs fell from 4.7 percent to 3.9 percent, following the reduction of the interbank interest rate.

TABLE 34

CDBCRP OUTSTANDING BALANCE
(Millions of nuevos soles)

	Dec. 2002	Dec. 2003
Up to 3 months	130	32
Between 4 and 6 months	565	790
Between 7 and 9 months	560	180
Between 1 year and 18 months	380	2,280
Between 2 and 3 years	0	815
Total	**1,635**	**4,097**
Average interest rate of the CDBCRP	4.7%	3.9%

Source: BCRP.

Interest rates for foreign currency loans maintained the downward trend observed since 2001, following the evolution of international interest rates. For example, the 3-month Libor fell from 1.4 percent in December 2002 to 1.2 percent a year later.

TABLE 35

INTEREST RATES IN FOREIGN CURRENCY

(In percentages)

	2001				2002				2003			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
1. Interbank	8.6	5.0	4.1	2.1	2.1	2.2	1.9	2.2	2.4	1.5	1.1	1.1
2. Savings deposits	3.0	2.6	2.2	1.2	0.8	0.8	0.7	0.7	0.7	0.7	0.6	0.6
3. Corporate prime lending	6.4	5.5	4.4	3.1	2.9	2.8	2.7	2.4	2.2	2.0	1.7	1.7
4. Average lending rate up to 360 days	12.3	11.6	11.1	8.7	8.7	8.3	8.1	8.1	8.8	7.9	6.9	7.2
5. Libor (3 months)	5.0	3.8	3.0	1.9	2.0	1.9	1.8	1.4	1.3	1.1	1.1	1.2

Source: SBS and BCRP.

3. Monetary aggregates

Monetary base and currency

In 2003, the annual growth rate of the average monetary base and currency reached 10 percent and 12 percent, respectively, less than in the previous year.

Nonetheless, these rates showed different patterns during the year. Between January and July, the growth rates of the monetary base and currency decelerated, following the downward trend recorded since October 2002. The annual growth rate of currency fell from 23 percent in October 2002 to 14 percent in December of the same year, and 8 percent in July 2003. The average balance of monetary base recorded annual growth rates of 20 percent, 13 percent, and 5 percent on these dates. This fall was mainly due to rising interest rates in the second half of 2002 and to the statistical effect of the higher balances in the previous year.

Since August, the annual growth rates of monetary base and currency started to show an upward trend again. In December, the average monetary base grew at an annual rate of 10 percent, and currency at a rate of 12 percent.

The forecast released in the January 2003 Inflation Report projected an 8 percent annual growth for the monetary base, assuming a nominal GDP growth rate of 6.8 percent (4.0 percent in real terms), a reduction in the velocity of money of 3.5 percent, and a money multiplier increase of 2.5 percent. The actual monetary base annual growth rate was slightly under the forecast (7.4 percent), explained by a higher money multiplier (3.1 percent) and a smaller drop in the velocity of money (-3.4 percent).

TABLE 36

AVERAGE BROAD MONEY IN SOLES (BANKING SYSTEM)

(Average annual percentage change)

	GDP Deflator	GDP growth		Local currency broad money	Velocity of money	Money supply components	
		Real	Nominal			Monetary base	Multiplier
2001	1.3	0.3	1.6	6.9	-5.0	3.2	3.6
2002	0.6	4.9	5.5	17.0	-9.9	15.8	1.1
2003	2.7	4.1	6.9	10.7	-3.4	7.4	3.1

Source: BCRP.

In December 2003, the monetary base balance totaled S/. 7,441 million, S/. 682 million higher than the balance of the previous year (S/. 6,752 million). The main source of growth were the exchange operations (S/. 3,465 million or US$ 998 million).

Central Bank interventions in the exchange market, through

TABLE 37

SOURCES OF CHANGE IN THE MONETARY BASE

(Millions of nuevos soles)

	2001	2002	2003
I. FOREIGN EXCHANGE OPERATIONS	**450**	**436**	**3,465**
(Millions of US$)	*135*	*128*	*998*
1. Over- the- counter net purchases	487	- 133	3,645
2. Public sector	- 35	558	- 177
– External public debt	- 107	0	0
3. Other net purchases	- 2	11	- 3
II. MONETARY OPERATIONS	**- 5**	**236**	**-2,783**
1. Non-financial public sector and Banco de la Nación	125	- 81	- 921
2. Financial system	0	170	-170
3. Central Bank Certificates (CDBCRP)	- 480	- 114	-2,143
4. Other monetary operations	350	261	450
III. TOTAL	**445**	**672**	**682**
End of period percentage change	7.9	11.0	10.1
Average percentage change	3.2	15.8	7.4
Note:			
END-OF-YEAR BALANCES			
Central Bank Certificates	1,840	1,944	4,097
Credits of monetary regulations (rediscounts)	0	0	0
Deposits of the public sector and Banco de la Nación	194	275	1,196
Monetary base	6,087	6,759	7,441

Source: BCRP.

over-the-counter purchases, aimed at moderating abrupt fluctuations of the exchange rate, without imposing specific targets.

Concerning monetary operations, the Central Bank placed certificates (CDBCRP) for a net amount of S/. 2,143 million in order to sterilize the effect of interventions in the exchange market. These operations were complemented with higher deposits of the public sector (S/. 921 million) and repo redemptions (S/. 170 million). The later was partially offset by the expiration of overnight deposits at the Central Bank (S/. 65 million).

International reserves

Net International Reserves (NIR) amounted to US$ 10,194 million in December 2003, up US$ 596 million compared to the previous year. This was the third consecutive year of increase. This balance is equivalent to 15 months of imports, 5 times the balance of the monetary base and 67 percent of the banking system's broad money.

The NIR increment was due mainly to exchange operations totaling US$ 998 million and US$ 1,050 million of foreign currency over-the-counter

TABLE 38

SOURCE OF CHANGE IN NET INTERNATIONAL RESERVES

(Millions of US dollars)

	2001	2002	2003
I. Foreign exchange operations	**135**	**128**	**998**
1. Over-the-counter net purchases	145	- 32	1,050
– Purchases	203	95	1,050
– Sales	-59	-127	0
2. Public sector	- 9	157	- 51
– Purchases	21	157	235
– Sales	- 30		- 286
3. Other foreign exchange operations	- 1	3	- 1
II. Financial system and private sector deposits	**245**	**185**	**- 488**
1. Commercial banks	183	103	- 361
2. Banco de la Nación	50	73	- 137
3. Other financial institutions	11	10	9
III. Public sector	**- 158**	**364**	**- 139**
IV. Net interest	**216**	**195**	**174**
V. Other NIR sources of variation	**- 3**	**113**	**52**
VI. TOTAL NIR CHANGE	**433**	**985**	**596**

Source: BCRP.

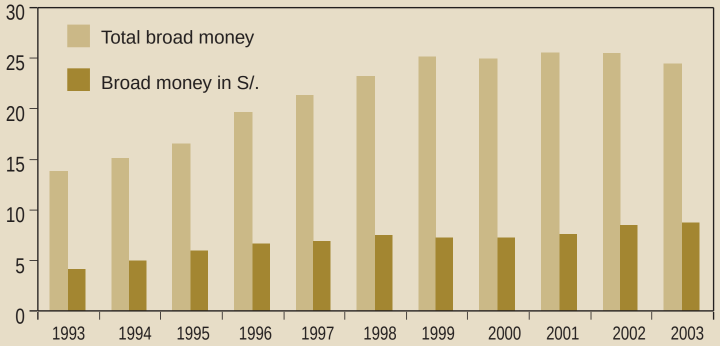
purchases, partly attenuated by US$ 51 million of foreign currency net sales to the public sector. These operations were partially offset by the deposit withdrawals of financial institutions (US$ 448 million) and the public sector (US$ 139 million).

Broad money

The average balance of broad money was 24.5 percent of GDP in 2003, one percentage point less than the previous year and around the 25 percent of GDP obtained in the last 5 years. Broad money in nuevos soles increased from 8.5 percent to 8.8 percent of GDP between 2002 and 2003.

GRAPH 19

BROAD MONEY
(As percentage of GDP)



Source: SBS and BCRP.

BOX 10

THE DEDOLLARIZATION PROCESS

In the last years, a process of financial dedollarization has taken place in Peru. The dollarization ratio of the banking sector's liabilities dropped from 70 percent in 2000 to 62 percent in 2003. A similar trend was observed in the dollarization of the credit to the private sector.

DOLLARIZATION RATIOS
(In percentage)

Year	Banking system broad money	Banking system credit to the private sector	Credit of the financial system to the private sector
2000	70	82	81
2001	67	80	78
2002	65	79	76
2003	62	77	73

The dedollarization process has been positively influenced by the IT adoption in two ways. First, a low and stable inflation rate increases the demand for domestic currency as store of value. Second, the stability and predictability of the interbank interest rate has made easier the setting of the other interest rates in domestic currency, encouraging financial intermediation in domestic currency.

In the period, credits in nuevos soles by the financial system have shown greater dynamism, with annual growth rates between 10 and 12 percent in the last three years. This growth, by financial institutions, has been in the case of micro-finance, 26 percent and 33 percent in 2002 and 2003 respectively, and concerning institutional investors, 32 percent in 2003, among others. On the other hand, credit in dollars has diminished at annual rates between 2 and 3 percent during this period.

INTEREST RATES FOR LOANS IN DOMESTIC AND FOREIGN CURRENCY 1/
(In percentage)

Year	Loans up to 360 days: nuevos soles	Loans up to 360 days: dollars	Spread
2000	26.5	11.9	14.6
2001	17.5	8.7	8.5
2002	14.8	8.1	6.7
2003	14.0	7.2	6.8

1/ End of year interest rates, effective annual rates.

Another key factor, which has incentivated the dedollarization process in Peru has been the emergence of a yield curve in government debt in nuevos soles of up to 6 years, which is being used as a benchmark for private issues with longer terms. Currently, there are nominal Treasury bonds in nuevos soles with maturities up to 6 years. The IT framework, by guaranteeing a low and stable inflation in the long run, has also contributed to the development of this market.

In this way, securities denominated in domestic currency amounted to 34 percent of the private sector's portfolio of fixed-income securities in 2003 (22 percent in 2000). It is worth mentioning that the share of bonds indexed to inflation (VAC), with respect to the total outstanding balance of bonds in nuevos soles, has diminished in the last years, which implies a disindexation process.

FIXED-INCOME PRIVATE SECURITIES BY TYPE AND CURRENCY 1/
(In percentage)

	Domestic currrency			Foreign
Year	Nominal	VAC	Total	currency
1999	1	22	23	77
2000	2	20	22	78
2001	11	18	28	72
2002	13	17	30	70
2003	16	18	34	66

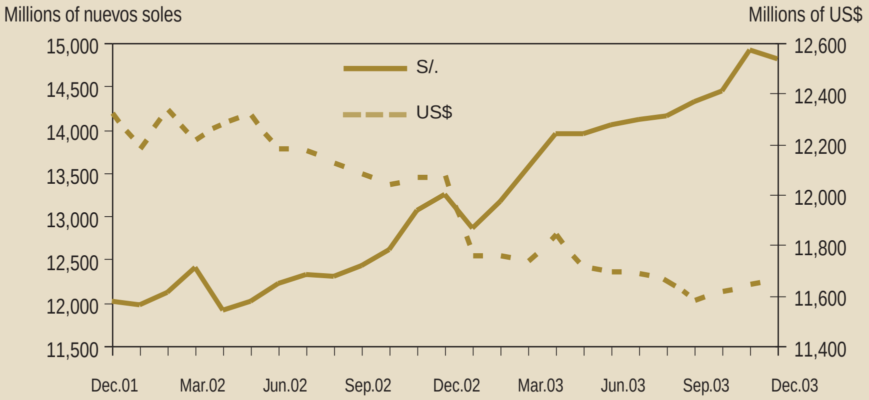
1/ Include bonds and short-term paper issued by private financial institutions.

Credit

For the fourth consecutive year, in 2003 the credit in nuevos soles expanded while the credit in dollars showed a reduction. The credit in nuevos soles to the private sector, defined as loans to households and private businesses plus the purchase of bonds and commercial paper issued by private companies, grew by 11.9 percent while the credit in dollars decreased by 3.4 percent.

GRAPH 20

CREDIT OF THE FINANCIAL SYSTEM TO THE PRIVATE SECTOR



Source: SBS and BCRP.

The increase in sol credits (S/. 1,576 million) was mainly explained by the credits to micro-finance institutions (S/. 740 million), institutional investors (S/. 527 million) and banks (S/. 380 million).

The reduction of the credit in dollars (US$ 407 million) was due to lower dollar-denominated loans to banks (US$ 562 million) and leasing companies and others (US$ 221 million), offsetting the growth of credits to

TABLE 39

FINANCIAL SYSTEM'S CREDIT TO THE PRIVATE SECTOR IN DOMESTIC CURRENCY

	Millions of nuevos soles			Percentage change	
	Dec.01	Dec.02	Dec.03	2002	2003
Commercial banks 1/	7,642	7,841	8,221	2.6	4.9
Banco de la Nación	222	434	511	95.6	17.6
Micro finance institutions	**2,214**	**2,926**	**3,666**	**32.2**	**25.3**
Banks (micro finance credits)	431	593	730	37.8	23.0
Local government S&Ls	600	848	1,083	41.2	27.7
Rural S&Ls	83	135	181	62.6	33.9
Saving and credit cooperatives	329	381	459	15.7	20.7
EDPYMES	105	130	172	24.1	31.8
Financial companies	667	840	1,042	25.9	24.1
Institutional investors 2/	**1,688**	**1,653**	**2,180**	**-2.1**	**31.9**
AFPS	1,157	1,102	1,449	-4.7	31.5
Insurance companies	497	493	568	-0.7	15.1
Mutual funds	34	58	163	68.4	182.5
Leasing companies and others	**247**	**393**	**247**	**59.1**	**-37.2**
Total financial system	**12,014**	**13,248**	**14,824**	**10.3**	**11.9**

1/ Excludes micro finance credits.
2/ Mainly securities issued by the private sector.
Source: SBS and BCRP.

TABLE 40

FINANCIAL SYSTEM'S CREDIT TO THE PRIVATE SECTOR IN FOREIGN CURRENCY

	Million of US dollars			Percentage change	
	Dec.01	Dec.02	Dec.03	2002	2003
Commercial banks 1/	10,294	9,971	9,409	-3.1	-5.6
Banco de la Nación	36	36	22	-0.4	-38.1
Micro finance institutions	**428**	**410**	**511**	**-4.1**	**24.5**
Banks (micro finance credits)	145	78	87	-46.5	11.4
Local government S&Ls	74	111	186	50.1	66.9
Rural S&Ls	46	44	48	-5.5	8.8
Saving and credit cooperatives	85	101	116	19.0	15.4
EDPYMES	21	31	40	49.2	28.0
Financial companies	56	45	34	-19.3	-24.2
Institutional investors 2/	**653**	**800**	**1,091**	**22.7**	**36.2**
AFPS	330	445	517	34.9	16.2
Insurance companies	33	37	60	12.0	59.7
Mutual funds	290	318	514	10.0	61.4
Leasing companies and others	**915**	**858**	**637**	**-6.2**	**-25.8**
Total financial system	**12,326**	**12,077**	**11,670**	**-2.0**	**-3.4**

1/ Excludes micro finance credits.
2/ Mainly securities issued by the private sector.
Source: SBS and BCRP.

micro-finance institutions (US$ 101 million) and institutional investors (US$ 291 million).

Credit of the banking system to the private sector maintained its downward trend observed in recent years, which would reflect the substitution effect of direct funding from the capital market and the process of portfolio sales or write-offs of irrecoverable loans from past years. It is worth pointing out the increasing competition of other non-bank financial intermediaries such as local governments, savings and loans and financial corporations specialized in lending to micro-finance institutions and consumers.

During 2003, total credit of the banking system to the private sector decreased 4.5 percent. Loans in domestic currency grew by 5.1 percent, while those in foreign currency decreased by 5.8 percent, a reduction for the fifth year in a row. Consequently, the total credit of the banking system to nominal GDP ratio diminished from 23.3 percent in 2002 to 21.0 percent in 2003, a similar financial intermediation level to that observed in 1997.

Bank credit to the private sector in domestic currency went up from S/. 693 in 2002 to S/. 493 million in 2003. This increase was due to the rise in credit by the commercial banks and Banco de la Nación to the private sector (S/. 384 million and S/. 76 million, respectively). Meanwhile, the US$ 384 million decrease in banking foreign currency credit in 2002 dropped further to a US$ 593 million decrease in 2003. This was the result of the drop in foreign currency credits given by commercial banks and Banco de la Nación (US$ 581 million and US$ 14 million, respectively).

This dedollarization of commercial banks' credit to the private sector reflected, on the one hand, the dedollarization of the deposits of the private sector and, on the other hand, the decrease in the banks' net forward sales balances (exchange rate risk hedging contracts). To compensate the increase in the commercial banks spot foreign exchange position (difference between assets and liabilities in foreign currency) due to the private sector portfolio change, the banks sold dollars in the exchange market, some of which were acquired by the BCRP. The corresponding increase in the banks' financial assets denominated in nuevos soles took place in larger liquid assets (larger holdings of CDBCRP by S/. 1,398 million and of sovereign bonds by S/. 290 million), and credit to the private sector in nuevos soles (S/. 384 million). Consequently, dollar denominated assets decreased.

Commercial banks

In line with the trend started in 2001, the year 2003 was characterized by an improvement in commercial banks' main financial indicators, specially in the banking profitability (return on equity rose from 8.4 percent on December 2002 to 10.9 percent on December 2003) and asset quality (the non-performing loans to gross loans ratio dropped to 5.8 percent at the end of 2003, the lowest in 6 years).

4. Financial savings and capital market

In 2003, financial savings, including total financial system's liabilities with the private sector, excluding money, increased as percentage of GDP, from 27.6 to 28.5 percent.

Like in previous years, this growth was led by the financial savings in nuevos soles, which grew by 24.6 percent annually, while the financial savings in dollars fell 1.4 percent. As percentage of the GDP, financial savings in nuevos soles increased its share from 10.6 to 12.2 percent. The most dynamic was the private pension funds system, growing by 34.8 percent in real terms, reaching the equivalent of 10.4 percent of the GDP. As of year-end, these funds accounted 34

TABLE 41

FINANCIAL SAVINGS

(Percentage of GDP)

	Domestic Currency	TOTAL
1994	2.5	12.7
1995	3.3	13.9
1996	4.4	17.5
1997	5.2	19.8
1998	6.3	22.2
1999	7.1	24.7
2000	7.9	25.4
2001	9.1	26.7
2002	10.6	27.6
2003	12.2	28.5

Source: BCRP.

TABLE 42
FINANCIAL SAVINGS BY INSTITUTIONS

	Year end balances in December 2003 Millions of nuevos soles			Percentage change	
	2001	2002	2003	2002	2003
I. DOMESTIC CURRENCY	20,005	23,694	29,516	18.4	24.6
1. Banking system	5,563	5,932	5,652	6.6	-4.7
2. Non-banking system	14,441	17,762	23,864	23.0	34.3
Local government S&L's associations	320	415	646	29.9	55.5
Rural S&L's associations	73	101	146	39.0	44.9
S&L's cooperatives	315	378	439	20.0	16.0
Financial leasing associations	0	6	13	n.a.	125.2
Financial companies	145	93	28	-35.9	-70.3
Private pension funds	12,894	16,202	21,844	25.7	34.8
Mutual funds	509	365	533	-28.3	45.9
Insurance companies	181	199	214	9.9	7.3
Other	3	2	3	-33.3	50.0
II. FOREIGN CURRENCY 1/	33,939	35,168	34,672	3.6	-1.4
1. Banking system	29,209	28,998	27,438	-0.7	-5.4
2. Non-banking system	4,730	6,170	7,234	30.4	17.3
Local government S&L's associations	435	595	697	36.8	17.1
Rural S&L's associations	91	127	140	40.4	10.5
S&L's cooperatives	453	483	521	6.6	7.8
Financial leasing associations	89	222	269	150.6	20.8
Financial companies	4	3	3	-13.4	-3.3
Mutual funds	3,334	4,379	5,219	31.4	19.2
Insurance companies	325	357	384	9.9	7.4
III. TOTAL	53,944	58,862	64,188	9.1	9.0

1/ Valued at the average buying and selling exchange rate for the end of the period.
Source: BCRP.

percent of total financial savings and 74 percent of the financial savings in nuevos soles.

By contrast, financial savings in dollars diminished by 1.4 percent in real terms as a result of the drop in bank deposits (5.4 percent in real terms), partially offset by the growth in mutual funds (19.2 percent in real terms).

Primary market

In 2004, the average balance of bonds issued by public offering grew by 18.5 percent in real terms to reach the equivalent of 5.4 percent of GDP. This growth was largely explained by corporate issues and sovereign bonds. Thus, the balance of corporate bonds increased by 41.9 percent in real terms as compared to the previous year, while the balance of public sector bonds (including COFIDE bonds) grew by 26.6 percent. By contrast, there was a reduction in bonds issued by financial corporations, particularly concerning leasing bonds (27.8 percent in real terms), because of loan reductions.

TABLE 43

BOND MARKET 1/

	Year end balances in December 2003 Millions of nuevos soles			Percentage change	
	2001	2002	2003	2002	2003
By Type	**10,247**	**10,876**	**12,892**	**6.1**	**18.5**
Public sector 2/	1,671	2,338	2,961	39.9	26.6
Financial leasing	2,883	2,368	1,709	-17.9	-27.8
Subordinated	996	907	1,034	-8.9	14.1
Mortgage-backed	90	108	104	20.6	-4.2
Securitization	897	889	1,029	-0.9	15.8
Corporate	3,711	4,266	6,055	15.0	41.9
By Term	**10,247**	**10,876**	**12,892**	**6.1**	**18.5**
Up to 3 years	2,976	3,509	3,779	17.9	7.7
More than 3, up to 5 years	3,536	3,157	3,391	-10.7	7.4
More than 5 years	3,736	4,210	5,722	12.7	35.9
Percentage share by currency	**100.0**	**100.0**	**100.0**		
In foreign currency	63.3	58.0	53.4		
In domestic currency	36.7	42.0	46.6		
- Nominal	17.4	24.0	27.7		
- Indexed	19.3	18.1	18.9		
Note:					
Total of bonds as percentage of GDP	4.7	5.3	5.4		

1/ Includes only public auctions
2/ Sovereign bonds placed through public auctions and COFIDE bonds.
Source: CONASEV and BCRP.

According to issue term, the balance of bonds issued with a 5-year term or more grew by 35.9 percent in real terms, while the balance of bonds issued with a 3 to 5 year term grew by 7.4 percent and the balance of issues up to 3 years grew by 7.7 percent.

By type of currency, bonds in nuevos soles increased their share of the total from 42 to 47 percent, and within this group, nominal bonds increased their share from 24 to 28 percent.

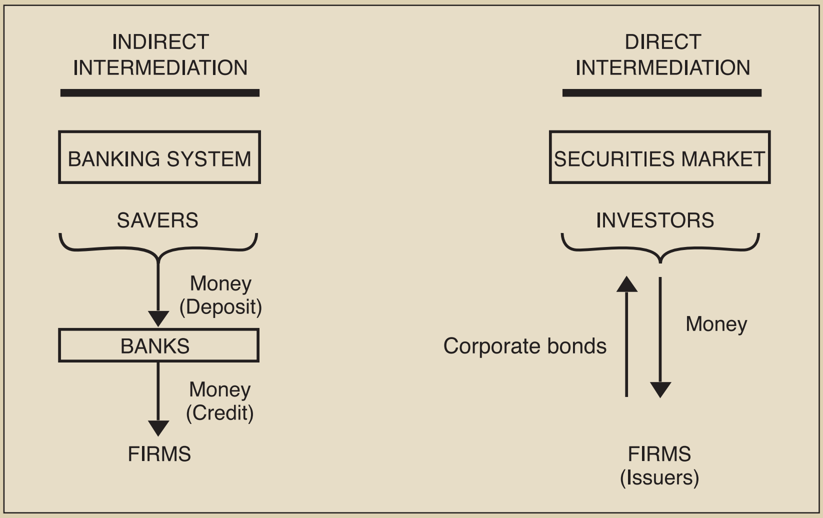
Macroeconomic stability, lower interest rates abroad and an excess demand by institutional investors drove nuevos soles and dollar interest rates down along the yield curve. The average interest rate in nuevos soles for issues up to 3 years dropped from 7.2 percent in 2002 to 5.5 percent in 2003. Likewise, the average interest rate in dollars fell by around 1.5 percentage points.

As of March, the government resumed the auctions of Sovereign Bonds under the new scheme of market makers, which prompted other private issuers to follow suit. In July, the government issued for the first time a 5-year bond at an effective interest rate of 9.69 percent. By year-end, the rate had dropped to 6.55 percent.

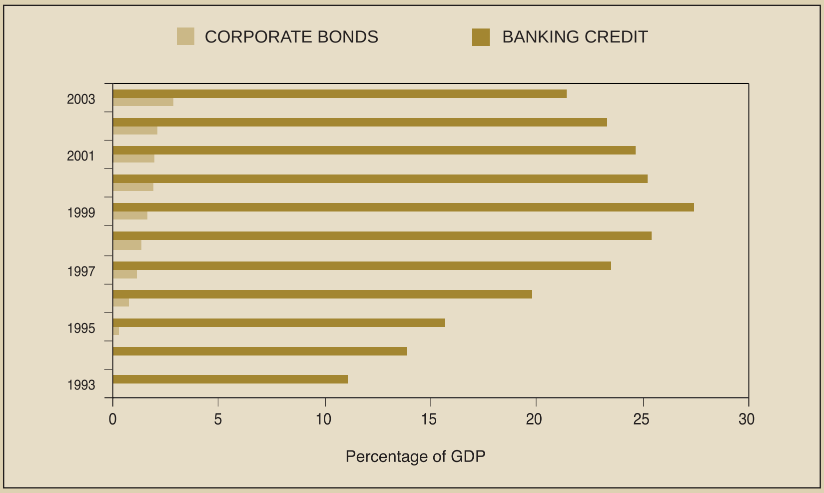
BOX 11

MARKET FOR CORPORATE BONDS

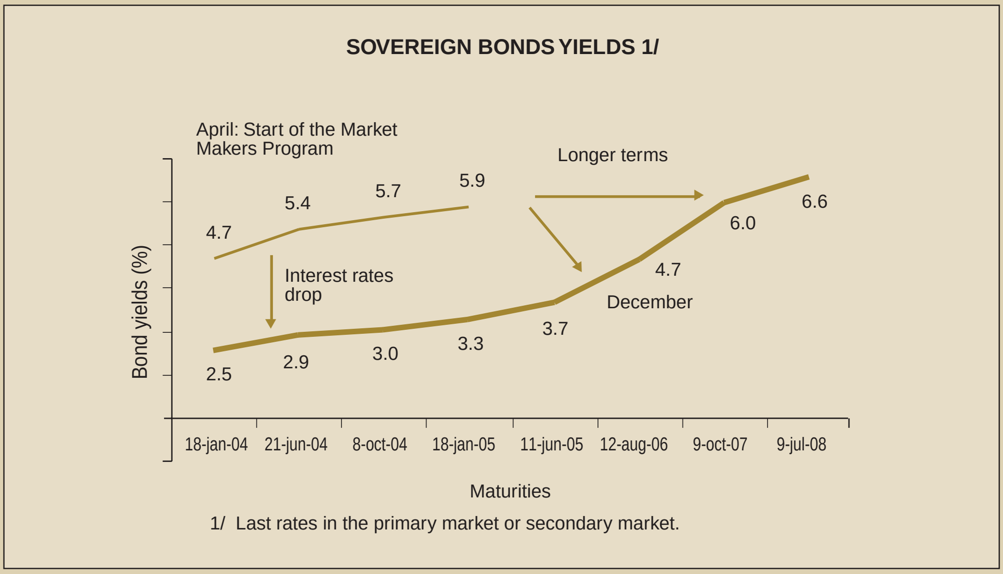
The corporate bond market is a financing alternative, whereby the firms looking for credit can head directly to the savers (investors), enabling them to obtain a lower financial cost, especially when higher amounts of money are involved.



In recent years, the amount of corporate bonds has grown considerably, from US$ 154 million (0.6 percent of GDP) in 1998 to US$ 1,976 million (2.9 percent of GDP) in 2003. Meanwhile, as a percentage of the banking credit, financing through the bonds market went up from 0.13 percent in 1993 to 13.5 percent in 2003.



In Peru there is a very large potential demand for corporate bonds by institutional investors (pension funds, mutual funds and insurance companies), which will be met as long as new issuers come to the market. For this to happen, it will be necessary to improve the corporate governance culture, so as to develop the secondary market for these securities and to ensure the enforcement of the contracts.



Stock exchange

In 2003 the two main stock indices, the General Index and the Selective Index, registered positive returns of 75 percent and 81 percent, respectively, owing to the good performances of foreign stock exchanges and higher commodities prices. By economic sector, yields were higher in the mining sector (178 percent), following a surge in metal prices, such as gold, silver and zinc.

The trading volume dropped 23.5 percent in real terms as compared with the previous year. In the equity market, volume fell by 22 percent, because of the Backus takeover operation by Bavaria, which increased the 2002 figures. In the fixed-income market, the volume reduction (25 percent) was explained largely by Sovereign Bonds being traded in the over-the-counter market (mainly Datatec).

Market capitalization grew by 23 percent in real terms, reaching the equivalent of 23.6 percent of GDP.

Private pension funds

At the end of 2003, the value of the private pension funds managed by the Pension Funds Managers (AFPs) reached S/. 21,844 million (US$ 6,308 million), 38.7 percent higher than the previous year. In terms of GDP, the private pension funds rose from an equivalent of 7.9 percent in 2002 to 10.3 percent in 2003.

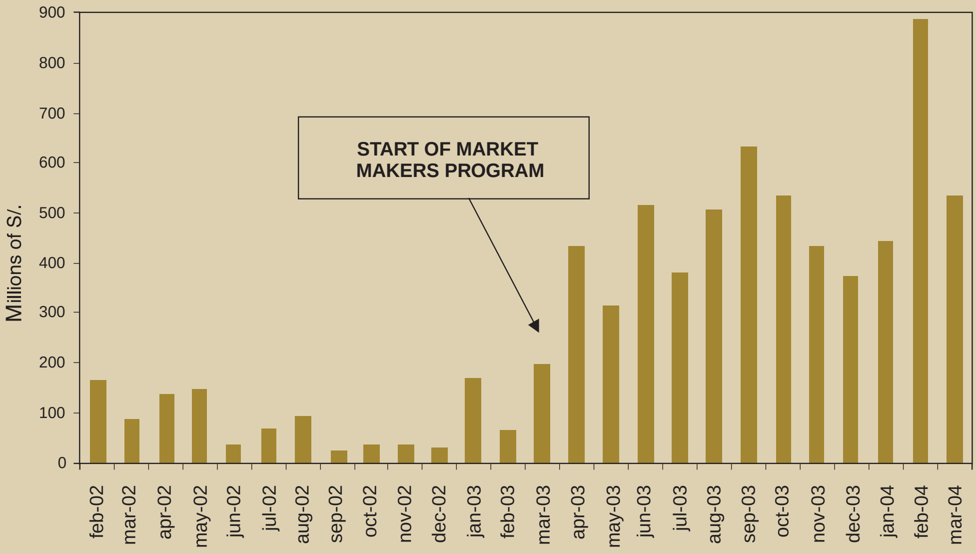
The number of affiliates at year-end was 6.7 percent higher than the previous year and equivalent to 28.2

BOX 12

MARKET MAKERS PROGRAM

To develop a market for local public debt (and in general, a capital market), it is necessary that the securities be liquid. A liquid security has a lower financial cost, because it can be sold easily in the secondary market.

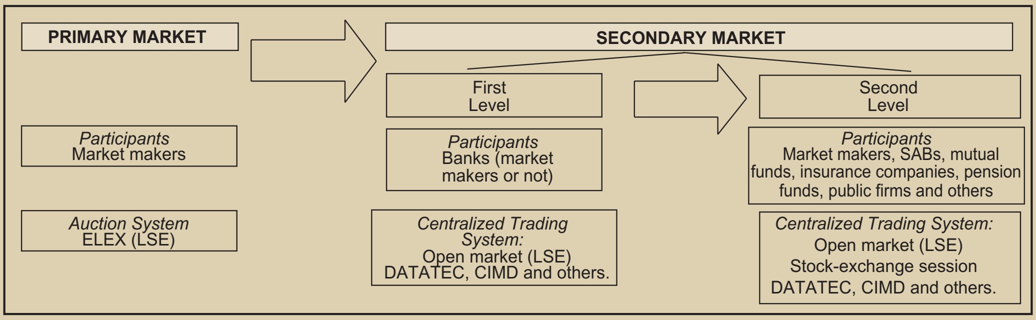
SOVEREIGN BOND TRADING IN THE SECONDARY MARKET



Thus, in order to foster the domestic treasury bond market, the government created in March 2003 The Market Makers Program, having selected a few banks for this purpose. Under the program, the primary placement of domestic treasury bonds is carried out by the banks designated as market makers. These institutions commit themselves to trade these securities in the secondary market on a permanent basis. This kind of program has been used in other countries to deepen the secondary market for domestic public bonds. In Peru, the average monthly traded amount has risen from S/. 57 million in 2002 to S/. 459 million in 2003.

The secondary market has two trading levels. At the first level, only the banks have access, as long as they can satisfy the conditions of the agreement. The second level of trading is open to all the financial institutions and public firms, directly or through brokerage firms.

STRUCTURE OF THE SOVEREIGN BOND MARKET



percent of the Active Labor Force. The number of active contributors (those affiliates whose employers pay their pension fund contributions) was equivalent to 41.1 percent of the total affiliates, higher than the previous year (39.6 percent).

The real return of investment of the funds was exceptionally high in 2003, reaching up to 21 percent, 10 points higher than the previous year. This extraordinary yield was largely explained by the equity portfolio following the returns of the two main stock exchange indices, of 75 percent and 81 percent, respectively. After deducting the management fees charged by the AFPs, the annual net return for an affiliate who has contributed from the beginning of the system (1993) was 4.4 percent on average, higher than 2.6 percent of the previous year.

The dollarization ratio grew from 46.3 percent in December 2002 to 48.8 percent in December 2003, as a result of higher investment in dollar-denominated sovereign bonds (Brady Bonds and Global Bonds). Equally important was the growth of foreign assets, after the raise in the maximum limit placed on this type of investment, from 7.5 percent of the value of the fund to 9.0 percent (Circular No. 016-03-EF/90 of June).

The main changes in the portfolio composition were as follows. Sovereign Bonds increased their share on the total from 8.6 percent to 12.9 percent; shares and other equity increased from 31.3 percent to 35.6 percent; and foreign assets increased from 7.1 percent to 8.7 percent. The latter was mainly due to higher holdings of foreign mutual funds. By contrast, deposits reduced their share from 25.5 percent to 16.7 percent of the fund value.

By economic sector, the public sector assets (government and BCRP) increased their share from 12.9 percent to 19.5 percent in 2003, because of larger holdings of Brady Bonds, Global Bonds, domestic Sovereign Bonds and CDBCRP.

Mutual funds

At the end of 2003, the value of the mutual funds shares held by the non financial private sector amounted to S/. 5,752 million (approximately US$ 1,662 million), 24.7 percent higher than 2002. The number of participants (66,655) increased by 20.8 percent with respect to the previous year. This fact, like in previous years, was explained by the higher returns of mutual funds as compared to bank deposits. Ex post, the nominal return of the fixed-income dollar-denominated mutual funds (87.6 percent of the total), including the currency revaluation, was 0.9 percent on average, while fixed-income mutual funds in nuevos soles attained 3.9 percent.

By type of fund, fixed-income mutual funds accounted for 99.6 percent of the total. By type of currency, nuevos soles-denominated mutual funds accounted for 12 percent. The total number of funds fell from 28 to 23 after the merging of 5 funds. The funds were managed by 6 managing companies: Crédito (6 funds, equivalent to 50.3 percent of the total), Continental (5 funds, equivalent to 23.4 percent of the total), Wiese (4 funds, equivalent to 12.2 of the total), Interfondo (5 funds, equivalent to 14 percent of the total), Promoinvest (2 funds) y Coril (1 fund).

At year-end, mutual fund portfolio investment was comprised of deposits (34.7 percent), private sector bonds (24 percent), government securities (17.5 percent), financial system bonds (13.4 percent), contract operations (4.9 percent), short-term securities (4.1 percent) and other assets (1.4 percent).