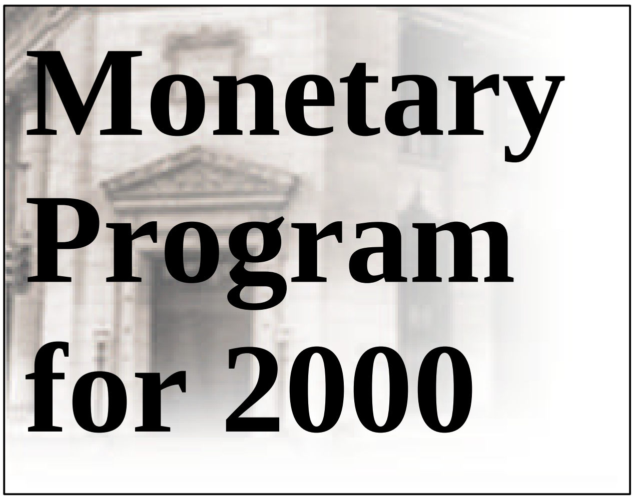


Monetary Program for 2000

27 January 2000

Summary

- In compliance with the constitutional mandate to preserve monetary stability, the Board of Directors of the Central Reserve Bank of Peru, as in previous years, has approved the Monetary Program for 2000, with the objective of lowering inflation to an annual rate in the range between 3.5 and 4.0 percent.

- Given the continuous reduction of inflation since 1991, the aim is to achieve a rate similar to that of industrial countries. Monetary stability provides a favorable environment for the development of investment and production, and prevents the deterioration of the real income of private households.

- In order to fulfill its anti-inflation objective, this year the Central Bank will expand the average balance of the monetary base at a rate in the range between 8 and 10 percent. Such increase reflects the expected growth of GDP, which is forecasted at a rate between 4 and 5 percent in real terms and between 8.5 and 9.5 percent in nominal terms. Forecasts for the increase in monetization and bank intermediation have also been taken into consideration.

- Daily control of bank liquidity will continue to be consistent with the monetary base growth target and with the floating exchange rate and free interest rate regimes. Foreign exchange market intervention by the Central Bank will occur only when smoothing-out of temporary fluctuations is necessary.

- In a way consistent with production recovery, the annual growth rates of banking system credit in domestic and foreign currency are forecasted at 9 and 6 percent, respectively.

- Foreign accounts will preserve their feasibility, as reflected by a current account deficit of 3.9 percent of GDP, with a trade deficit of US$ 500 million. Long-term private capitals will cover 75 percent of the current account deficit.

- Thanks to the recovery of domestic demand, tax collections will increase and the fiscal deficit is expected to decrease from 2.5 percent of GDP in 1999 to 1.9 percent in 2000. Additionally, considering that revenue from privatization is forecasted at US$ 650 million in 2000, a US$ 300 million increase in net international reserves is expected.

MONETARY PROGRAM FOR 2000

The mission of the Central Reserve Bank of Peru is to defend the purchasing power of the domestic currency, which is being achieved thanks to a continuing reduction of the rate of inflation. In order to fulfill this objective, the Bank keeps a strict control of the monetary base, in line with the annual Monetary Program. This document provides information on the Monetary Program for 2000 approved by the Board of Directors.

Objective of the monetary policy

The objective of the monetary policy for 2000 is to lower inflation to a rate between 3.5 and 4.0 percent. Last year, the target range was 5.0 to 6.0 percent and the inflation rate was 3.7 percent, the lowest in the last 40 years and the second lowest in the last 60 years. The fact that inflation was below the announced range is explained by events that resulted in an exceptionally good harvest and thus in lower prices of food products. It is important to stress that the agricultural campaign for 1999-2000 has been developing normally, which implies that neither a price fall nor a reversal to higher prices will take place.

Table 1
Target ranges and accumulated inflation
(Percent change)

	Target	**Inflation**
1994	15.0 – 20.0	15.4
1995	9.0 – 11.0	10.2
1996	9.5 – 11.5	11.8
1997	8.0 – 10.0	6.5
1998	7.5 – 9.0	6.0
1999	5.0 – 6.0	3.7

As can be seen in **table 1**, since the beginning of the announcements of the objectives of inflation in 1994, the results have been significantly close to the target. Inflation reduction is unquestionably an important factor in the achievement of sustained growth. **Table 2** shows that in the last 60 years, high rates of growth have been coupled with lower inflation rates. This should not lead us to ignore the fact that sustained growth also depends on greater capital accumulation, training of the working force and structural reforms that favor an efficient allocation of productive assets.

Table 2
Inflation and real GDP growth
(Percent change)

	Inflation	GDP
1941-1950	14.6	3.7
1951-1960	7.4	5.7
1961-1970	9.5	5.3
1971-1980	32.6	3.8
1981-1990	369.5	-0.8
1991-1999	27.2	4.5

Intermediate target

In order to achieve its objective, the Board of Directors of the Central Reserve Bank of Peru approves annually a range for the rate of growth of the daily average balance of the monetary base. This becomes an intermediate target between the objective of reducing inflation and the monetary instruments controlled by the Bank. The monetary base, which is made up of currency in circulation and reserves in domestic currency, is used in most of the economic transactions considered in the consumer price index. Strict control of the monetary base has resulted in a successful control of inflation.

Fixing the growth target for the monetary base involves taking into consideration the percentage growth of economic transactions, measured by nominal GDP growth, as well as growth in the demand for money resulting from a lower velocity of circulation. Additionally, it is also taken into consideration that the demand for liquidity in domestic currency can be satisfied not only through the issuance of notes and coins by the Central Bank, but also through a greater intermediation of financial resources by the banking system. These determinants of the primary base are shown in **table 3**.

Since there are elements that introduce a degree of uncertainty in point forecasts, **the Board of Directors of the Central Bank has approved a range of 8 to 10 percent for the yearly average growth of the monetary base**. The average balance of the monetary base was S/. 4 772 million in 1999, so in 2000 it would be in the range between S/. 5150 million and S/. 5 250 million. In certain months the monetary base could be out of this range due to seasonality, and so the target range must be understood as an indicator of the average daily balance during 2000.

The monetary base average growth target will be revised quarterly by the Board of Directors of the Central Bank, taking into consideration the inflation forecasts.

Table 3
Determinants of monetary base growth

	Factors	Variation		Comments
		1999	2000	
A	Nominal GDP	5.0	9.0	▪ GDP growth runs parallel with economic recovery.
B	Velocity of circulation of money	3.7	-1.5	▪ Lower velocity is associated with lower expected rates of inflation and depreciation.
C	Money multiplier	-5.1	1.5	▪ Multiplier growth is associated with greater bank intermediation, originated in a declining preference for currency in circulation and lower reserve requirements.
D	Monetary base 1/	6.7	9.0	▪ Daily average growth of the monetary base is forecasted by taking into consideration the determinants of the demand for money.

1/ $$D = \frac{\left(1+\frac{A}{100}\right)}{\left(1+\frac{B}{100}\right)\cdot\left(1+\frac{C}{100}\right)} - 1$$

Operative target

Daily control of bank liquidity will continue to be in line with the monetary base growth target and with the floating exchange rate and free interest rate regimes. Foreign exchange market intervention by the Central Bank will take place only to smooth out temporary fluctuations.

The operative target of the monetary policy will continue to be the daily control of the current accounts held by commercial banks at the Central Reserve Bank of Peru, which is part of their reserves.

Credit to the private sector

In 1999 there was a contraction in the banking system credit to the private sector, as a result of a reduction in credit demand. As a consequence, there was a US$ 1 090 million reduction in short-term foreign liabilities of commercial banks.

In 2000, the economic recovery would result in a growth rate of GDP between 4 and 5 percent in real terms, which would bring about a greater demand for credit. For that reason, the accumulated rates of growth of credit in domestic and foreign currency are forecasted at 9 and 6 percent, respectively. The interest on additional reserves associated with foreign exchange liabilities will continue to be the same as the interest earned by the Central Bank on its foreign deposits. Marginal and average reserve rates will be managed taking into account the need to keep a balance between adequate funding of the banking system and the flow of net international reserves.

Table 4
Credit to the private sector

	Flow		Percentage change	
	1999	**2000**	**1999**	**2000**
In domestic currency (in millions of S/.)	-260	815	-3%	9%
In foreign currency (in millions of US$)	-115	652	-1%	6%

External sector

Foreign account perspectives are favorable. International prices and the exported volume are expected to increase by 8 and 7 percent in 2000, respectively. Such developments will compensate the increase in imports resulting from the recovery of domestic demand. As a consequence, the current account deficit will grow from 3.5 percent of GDP in 1999 to 3.9 percent in 2000.

Table 5
Foreign sector indicators
(millions of US$)

	1999	2000
A. Trade Balance	-600	-500
Exports	6 100	7 080
Imports	-6 700	-7 580
B. Current account	-2 000	-2 250
C. NIR flow	-780	300
D. NIR/(short-term debt+ annual amortization)	120%	130%
E.Terms of trade percent change	-5%	5%

Macroeconomic coordination

The macroeconomic forecasts underlying the Monetary Program are consistent with a decrease in the fiscal deficit from 2.5 to 1.9 percent of GDP. The fiscal deficit for 1999 was originated basically by a 7 percent fall in real terms in central government current revenue. The financing requirements resulting from this situation were transitorily covered with a reduction in foreign exchange deposits of the Treasury at the Central Reserve Bank, which allowed avoiding a crowding-out effect to the private sector financing. Resorting to internal and foreign financing, which would have limited private sector access to financial resources, was thus avoided.

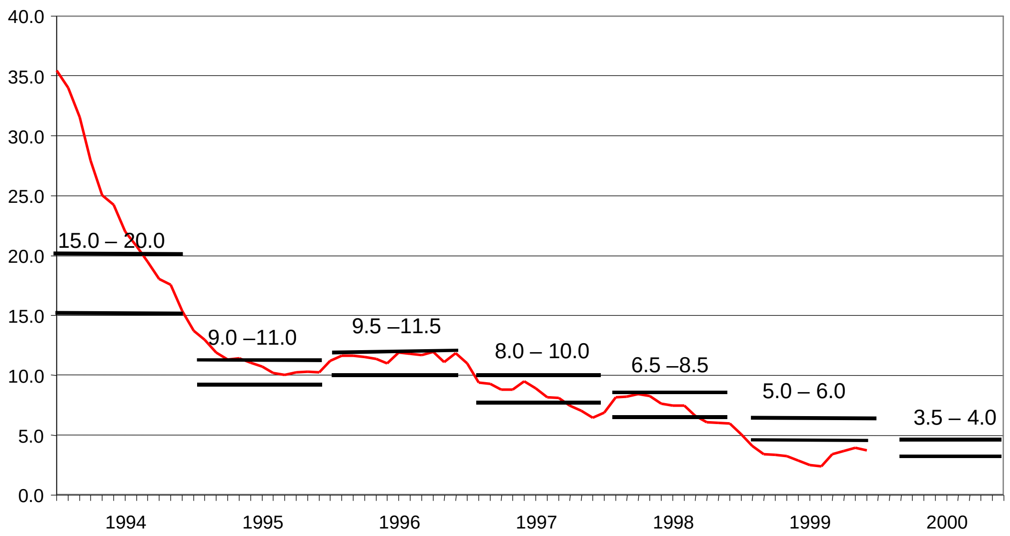
The forecasted net international reserve accumulation of US$ 300 million in 2000 will be possible thanks to the recovery of the financial position of the Treasury, together with an expected revenue from privatization amounting to US$ 650 million.

Medium term

The new Law of Prudential Fiscal Policy and Transparency, in force since the current year, establishes that the Ministry of Economy and Finance will submit to the Central Bank, before end-April, a Multiannual Macroeconomic Framework for the next three years. The Bank will issue a technical report, which will be made public, containing an evaluation of its consistency with the forecasts for the balance of payments, the net international reserves and the monetary policy.

The medium-term objective of the monetary policy is to pursue a further reduction of inflation, to a level similar to those of industrial countries (between 1.5 and 2.5 percent).

ANNUAL INFLATION TARGETS AND 12-MONTH INFLATION RATES 1994 - 2000



Lima, 27 January 2000