

CENTRAL RESERVE BANK OF PERU

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Introduction

A positive macroeconomic performance characterized the Peruvian economy in 2005: GDP grew 6.4 percent and inflation posted 1.5 percent amid a favorable international context that saw the growth of our trading partners and the improvement of our terms of trade. All of these factors contributed to increase the country's fiscal revenues and to reduce the fiscal deficit to 0.3 percent of GDP.

*Having adopted an Inflation Targeting Scheme since 2002, the Central Reserve Bank of Peru (BCRP) met its inflation target in 2005 for the fourth consecutive year. **Annual inflation was 1.5 percent** –at the lower band of the target range of 2.5, plus or minus one percentage point–, a level lower than in the previous year. Factors explaining this result include the reversal of the supply shocks –caused by adverse climatic conditions– which increased inflation during 2004 and the lower impact of international price rises of oil on domestic prices due to compensatory fiscal measures implemented during this year.*

***Economic activity grew at a rate of 6.4 percent** –the highest rate recorded since 1997–, fueled by the dynamic expansion of domestic demand (5.5 percent), particularly consumption and investment, which grew 4.4 percent and 13.9 percent respectively. External demand, driven by a strong demand for minerals and non-traditional textile and agricultural products, also contributed importantly to this evolution.*

This dynamism was also observed in various productive sectors, as evidenced in the 6.4 percent growth of non-primary sectors –especially non-primary manufacturing and construction– and in the 5.5 percent growth of primary sectors –especially oil and fuels due to Camisea's increased production throughout the year.



Furthermore, this greater economic dynamism was also reflected in the expansion of **employment**, which grew **4.5 percent**. It should be pointed out that employment outside Lima increased 6.4 percent while in Metropolitan Lima it did so by 3.8 percent.

The international context continued to be favorable during 2005, with our main trading partners growing at a rate of 4.0 percent and our **terms of trade at 5.2 percent**. It is worth highlighting that the price of our exports rose 16.3 percent, with molybdenum, zinc, copper, and gold contributing most heavily to this result.

In this context, **exports grew 35.3 percent** and reached US\$ 17,336 million in 2005, a level US\$ 4,527 million higher than that of 2004, as a result of both higher prices and larger volumes of exports. This increase is also explained by the growth of both traditional exports (40.4 percent) and non-traditional exports (22.9 percent). The expansion of the former was led by mining exports, particularly copper, gold, and molybdenum, while the expansion of the latter was driven by agricultural and textile products, favored by world demand and by the effect of the investments made over the past few years.

On the other hand, **imports increased 23.2 percent**, an evolution explained mainly by the faster pace of growth of imports of capital goods (29.6 percent) and, to a lesser extent, by raw materials and consumer goods growing at a rate of 23.1 and 16.2 percent respectively. As a result of this, the **trade balance** increased from US\$ 3,004 million in 2004 to **US\$ 5,260 million** in 2005.

Although offset by higher outlays arising from the profits of companies with foreign shareholding, this improvement in the trade balance and the higher remittances of Peruvians living abroad accounted for the surplus recorded in the **current account of the balance of payments** which, for the first time since 1979, logged a positive result, reaching a level equivalent to 1.4 percent of GDP.

The favorable evolution of external accounts and financial de-dollarization continued to explain the downward trend of exchange observed between January and August 2005. However, this evolution was reversed along the rest of the year due to a greater demand for forward contracts in dollars and portfolio movements towards this currency by private administrators of pension funds. In 2005, the **nuevo sol depreciated 4.4 percent** against the U.S. dollar (6.3 percent in real terms) and 1.9 percent in terms of the currency basket of our main trading partners (3.8 percent in real terms).

In order to avoid abrupt exchange fluctuations, the Central Bank purchased foreign currency for a total of US\$ 3,130 million between January-August. Given the high volatility observed in the exchange market in the last quarter of 2005, the BCRP

intervened in this market selling US\$ 431 million and placing Readjustable Certificates of Deposits (CDRBCRP) for US\$ 350 million.

*Net purchases of foreign currency, discounting sales of dollars to the public sector and the higher deposits made by financial entities in the Central Bank, generated an accumulation of **net international reserves** amounting to **US\$ 14,097 million** by the close of 2005, a level of reserves equivalent to 14 months of imports of goods and to 70 percent of total liquidity in the banking system. In this way, the Peruvian economy maintained a sound international position and capacity to face adverse external shocks.*

*Economic growth and better results obtained by export companies are the main factors accounting for the increase in fiscal revenues, which allowed to reduce the fiscal deficit to **0.3 percent of GDP** in 2005 (versus 1.0 percent of GDP in 2004).*

*The **banking system's liquidity and credit to the private sector** also went hand in hand with increased economic activity, exhibiting a trend of greater dynamism in the case of domestic currency (with rates of 28.8 percent and 18.0 percent) than in the case of foreign currency (rates of 1.5 percent and 0.9 percent). In 2005, the ratios of financial dollarization of liquidity and credit decreased from 42 to 40 percent and from 71 to 67 percent respectively with respect to 2004.*

Finally, continuing with the tendency that started in 2001, banks' indicators of return showed higher values than in the previous year. Thus, for example, return over equity improved from 11.5 percent in December 2004 to 22.1 percent in December 2005, and arrears in the financial system decreased from 3.8 percent to 2.2 percent this year.