

## Introduction

In 2007 economic activity in Peru continued to show a robust growth mainly due to the dynamic performance exhibited by the domestic market. Economic agents' positive expectations about the future evolution of the economy, as well as the growth of employment and disposable income favored both investment and private consumption. The growth of the product was coupled by a favorable domestic macroeconomic context, with surpluses in both the current account of the balance of payments and the fiscal balance.

The international environment, on the other hand, was characterized by uncertainty in international financial markets due to the mortgage crises in the United States and to the higher international prices of fuels and some food products, which rose at magnitudes unseen since the seventies.

In this scenario of supply imbalances –originated by external factors– and high growth of domestic demand, inflation showed a faster pace since mid-year causing last 12-month inflation to increase above the target range (between 1 and 3 percent) since October. The rises seen in external prices affected the local prices of food as well as firms' production costs and the costs of inputs. As a result of this, imported inflation increased from 0.3 percent in 2006 to 10.5 percent in 2007, thus becoming the main factor that explains the acceleration of inflation from 1.1 to 3.9 percent during this period.

After having grown at a rate of 7.6 percent in 2006, economic activity grew 9.0 percent in 2007 –the highest growth rate observed in the last 13 years. Domestic demand grew 11.6 percent, showing a generalized increase in all its components, particularly in public investment (19.7 percent) and private investment (23.2 percent), while private consumption grew 8.3 percent –the highest growth rate seen in the last 12 years. The high growth of investment was coupled by productivity improvements, which have also increased the potential of growth of the Peruvian economy. This increased dynamism was also reflected in indicators such as employment, which grew 8.3 percent in firms with 10 and more workers, and consumer credit, which increased 37 percent compared to the previous year.

Considering monetary policy lags, preventive measures were implemented in 2007. The Board of the Central Bank decided to raise the reference rate for the interbank market on two occasions –July and September–, as a result of which this rate increased from 4.5 percent in December 2006 to 5.0 percent in December 2007. In this way, the inflation expectations of economic agents remained anchored and inflationary pressures resulting from the high growth of domestic demand were prevented.

The current account of the balance of payments continued to show a surplus (1.4 percent of GDP), reflecting both a surplus of US\$ 8,356 million in the trade balance result and higher remittances from abroad, which increased 16 percent relative to 2006.

Exports, which grew 17.5 percent, continued to be favored by the high prices of minerals in the international market and by the demand of our main trade partners –especially in Asia and Latin America–, which showed growth rates of over 5 percent on average. Thus, while the prices of exports increased 14 percent, the volume of exports increased 3.3 percent. It is worth pointing out here the increasing importance of non-traditional exports whose volume grew by 8 percent during the year. On the other hand, imports

grew 31.8 percent in nominal terms, particularly due to higher imports of capital goods and inputs.

The evolution of the nominal exchange of the nuevo sol against the dollar during the year continued reflecting the robustness of external accounts and the weakening of the dollar in international markets. In nominal terms, the Nuevo Sol appreciated 7.0 percent against the dollar. However, in real terms, the average multilateral exchange remained stable during 2007 given that the nominal appreciation of the sol against the dollar was compensated by higher inflation in the rest of the world and by the depreciation of the nuevo sol against the currency basket of our main trading partners.

The strengthening of nuevo sol was associated with better macroeconomic fundamentals in the Peruvian economy, with the positive evolution of its external accounts and with portfolio movements showing a preference for the domestic currency, as well as with the weakening of the dollar in the international financial market. Among other factors, this is mainly explained by the high deficit in current account seen in the United States (6.2 percent of GDP in 2006), by fears of a recession in the US economy, and by the Federal Reserve's consecutive reductions of its interest rate. The nominal exchange declined from S/. 3.21 per dollar in December 2006 to S/. 2.98 in December 2007.

The Central Bank continued to intervene in the exchange market in order to offset volatility in this market, to preventively accumulate international reserves, and to compensate the sales of foreign currency to the treasury. Net purchases of foreign currency during the year amounted to US\$ 10,306 million, while sales of dollars to the public sector amounted to US\$ 3,275 million. Thus, the international position of the BCRP was US\$ 19,622 million, as a result of which international reserves amounted to US\$ 27,689 million. This accumulation of reserves has improved Peru's position to face adverse shocks, as reflected in the country's sound stance in terms of vulnerability indicators: the level of international reserves accumulated is equivalent to 4.1 times the short-term external debt, to 17 months of imports of goods, and to 92 percent of total liquidity in the private sector.

This higher growth of economic activity and the favorable international context for our main exports had a positive impact on fiscal revenues, which increased by a real 14 during 2007. The income tax paid by the mining sector increased 48 percent in real terms and the value added tax increased 15 percent. The expenditure of the general government showed a real growth of around 7 percent. As a result of this, an economic surplus equivalent to 3.1 percent of GDP was observed in the year (a surplus nearly one percentage point higher than the one recorded in 2006).

In 2007 the government continued carrying out debt management operations and placing Public Treasury Bonds in domestic currency as a strategy to improve the debt profile and reduce exchange risks. Bond exchange operations were carried out –Brady bonds were exchanged by global bonds– and debt prepayments were made –to the Paris Club and the Andean Development Corporation (CAF)– throughout the year, as a result of which the external debt has been reduced by US\$ 1,890 million compared to last year and the percentage of the total debt in domestic currency relative to the total public debt has been increased from 24.5 percent to 36.5 percent in this period.



The expansion of monetary aggregates such as liquidity and credit to the private sector was associated with increased economic activity and with the process of “bankarization” seen in the economy. Liquidity in domestic currency increased 34 percent, while liquidity in foreign currency increased 18 percent, with higher long-term deposits accounting mainly for both evolutions.

The ratios of dollarization of liquidity and credit decreased by 5 and 3 percentage points to 47 and 57 percent respectively. During the year, the BCRP gradually raised the limit for investments abroad by Private Administrators of Pension Funds (AFPs) from 12 to 15 percent, thus allowing them greater flexibility to manage their portfolios.

Banks’ financial indicators showed improvements mainly due to the reduction of the non-performing portfolio –non-performing loans decreased from 1.6 percent in 2006 to 1.3 percent in 2007– and to increased provisioning –the allowance to non-performing loans increased from 100.3 percent in 2006 to 124.4 percent in 2007. Moreover, return on equity (ROE) increased from 23.9 percent in 2006 to 27.9 percent in 2007.

