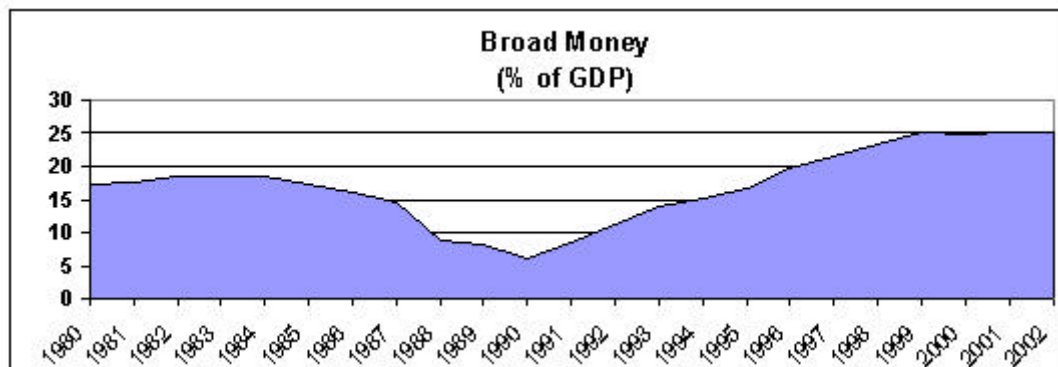


BANCO CENTRAL DE RESERVA DEL PERÚ

DISSEMINATION NOTE

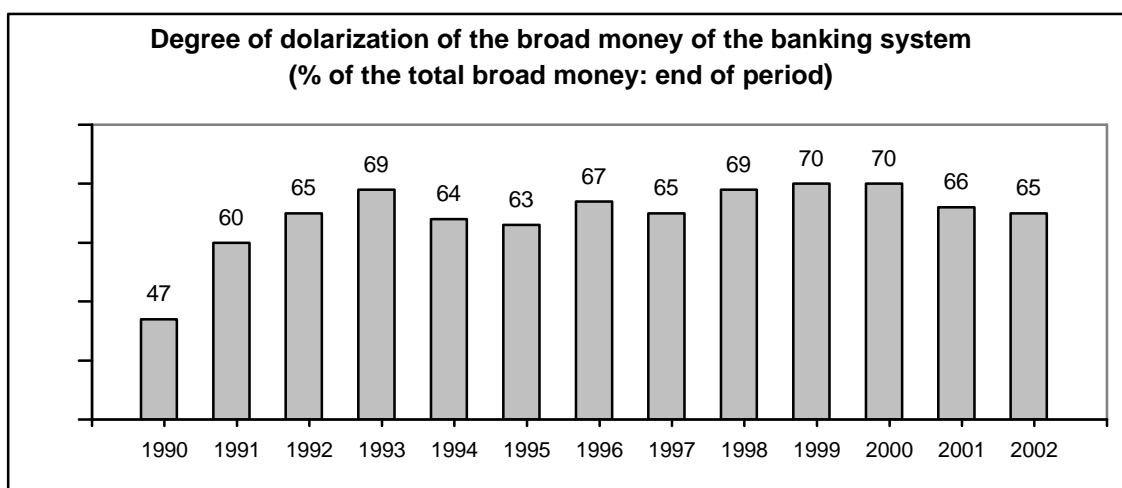
PROTECTING THE ECONOMY AGAINST VULNERABILITIES CREATED BY PARTIAL DOLLARIZATION

1. After the hyper-inflation event (1988–1990), the Peruvian financial system managed to recover its capability of intermediation. Thus, while in the second quarter of 1990 broad money was only 6 percent of GDP, in year 2002 it reached its highest historical level (25 percent). However, this indicator of financial intermediation is still lower than those of Chile (55 percent) and Colombia (35 percent).

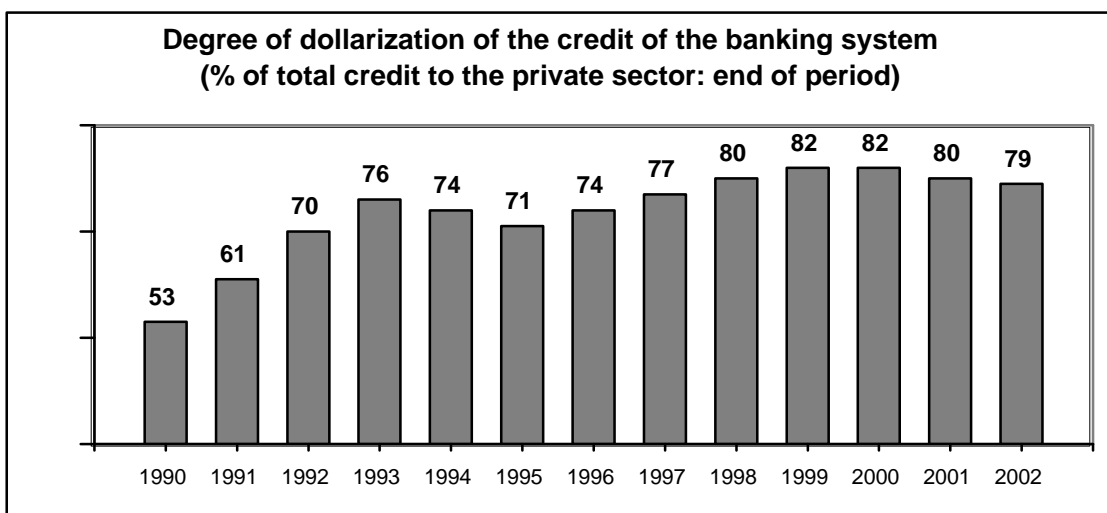


2. One of the main features of financial intermediation deepening has been the growth of dollar-denominated deposits. Therefore, the banking system maintains a condition of partial dollarization, which has been reverting at a slow but sustained pace. The ratio of dollarization decreased from 70 percent in December 2000 to 65 percent in March 2003. In terms of credit, dedollarization has been also important: from 82 to 78 percent.

Dedollarization is a voluntary and gradual process that will occur along with the recovery of confidence on savings in domestic currency.



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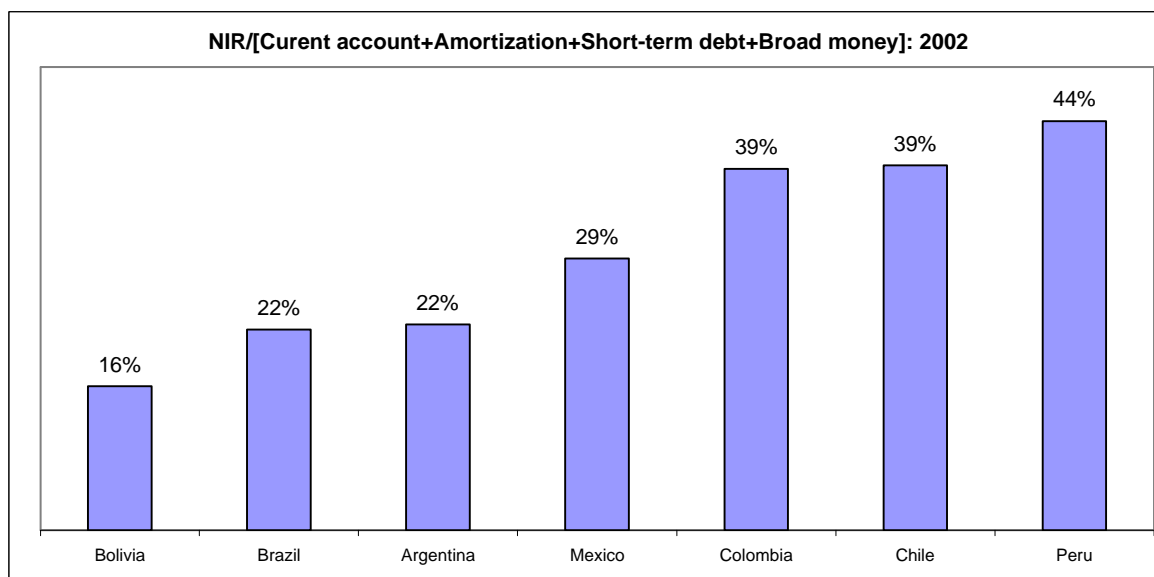


3. A dollarized financial system has two risks to be faced with prudential measures:
- Regarding the possibility of a bank-run in dollar deposits, the Central Bank must provide conditions for financial entities to have funds available in foreign currency, thus providing confidence to depositors. This is possible with high reserve requirements on dollar-denominated deposits.
 - Concerning currency mismatch risk, the Central Bank must have the ability to reduce exchange rate volatility through its monetary and exchange rate operations.

These precautionary measures that allow the Central Bank to face these risks are related to a sound level of **net international reserves**. In this way, it is possible to have resources for supporting the financial system whenever a bank run in dollar-denominated deposits occurs and for intervening in the exchange rate market, if necessary.

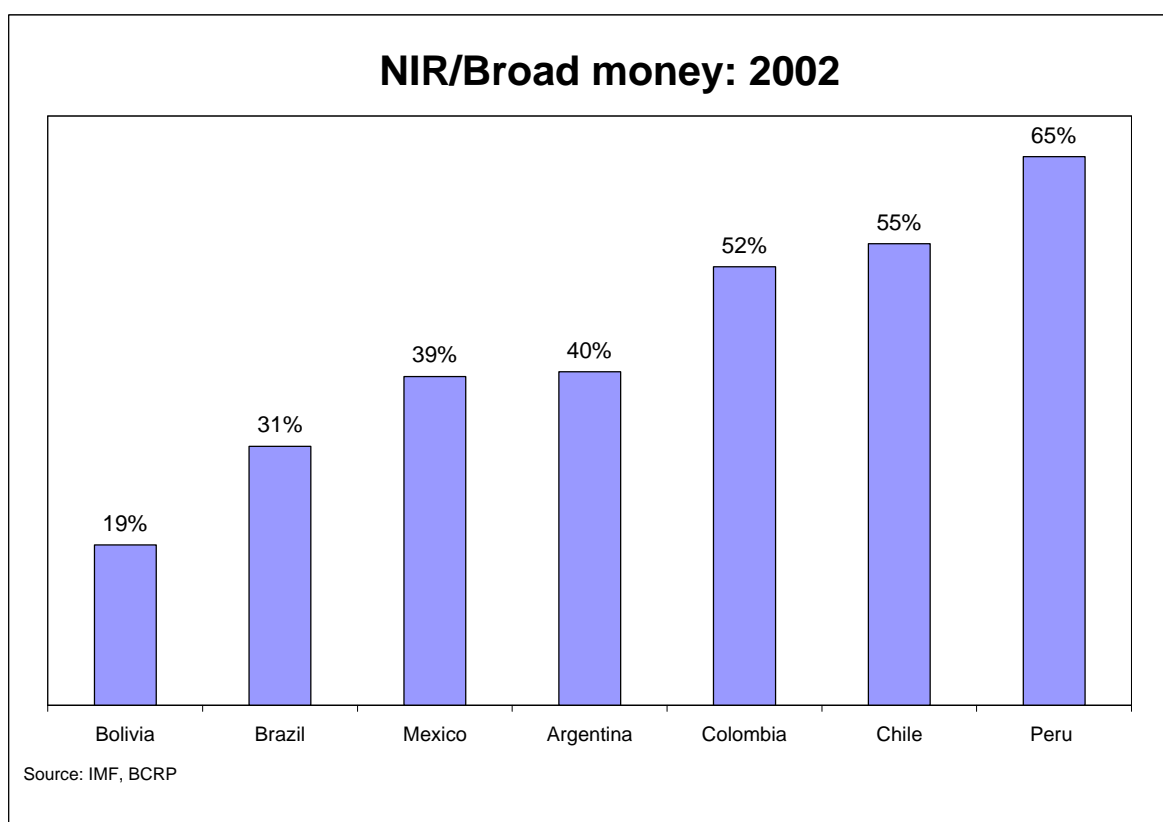
4. To identify an adequate level of international reserves, there have been established comparison criteria between its level and several definitions of domestic and international liabilities. The widest criterion compares the level of net international reserves against the volume of Balance of Payments' liabilities (sum of BOP's current account, short-term external debt and one-year maturities of long-term debt) plus broad money. This criterion reveals that in Latin America, Peru has the highest ratio (44 percent), followed by Chile (39 percent), which confirms the adequate level of international liquidity of Peru to face the risks of dollarization in the financial system.

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Sources: IMF, BIS, ECLAC, BCRP.

- To face the risk of lack of liquidity in dollars, there is a level of international reserves equivalent to 1,1 times the deposits in foreign currency (international reserves exceed US\$ 10 billion while the level of deposits in dollars reaches US\$ 9 billion). It should be mentioned that Peru owes a high ratio of international reserves to broad money (the highest in our sample).

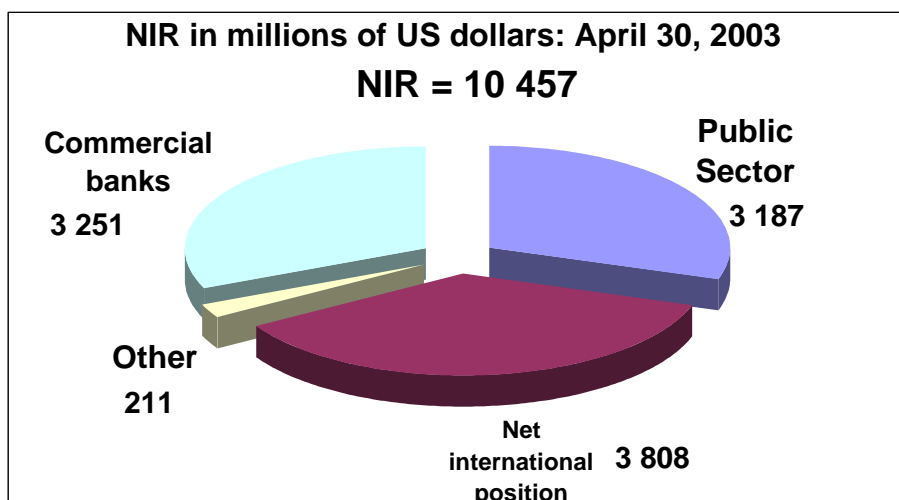


Source: IMF, BCRP

- An important component of international liquidity, as reflected in BCR's international reserves, is the level of dollar-denominated deposits of the commercial banks at the Central Bank (reserve requirements and overnights). These deposits are liquid funds available to

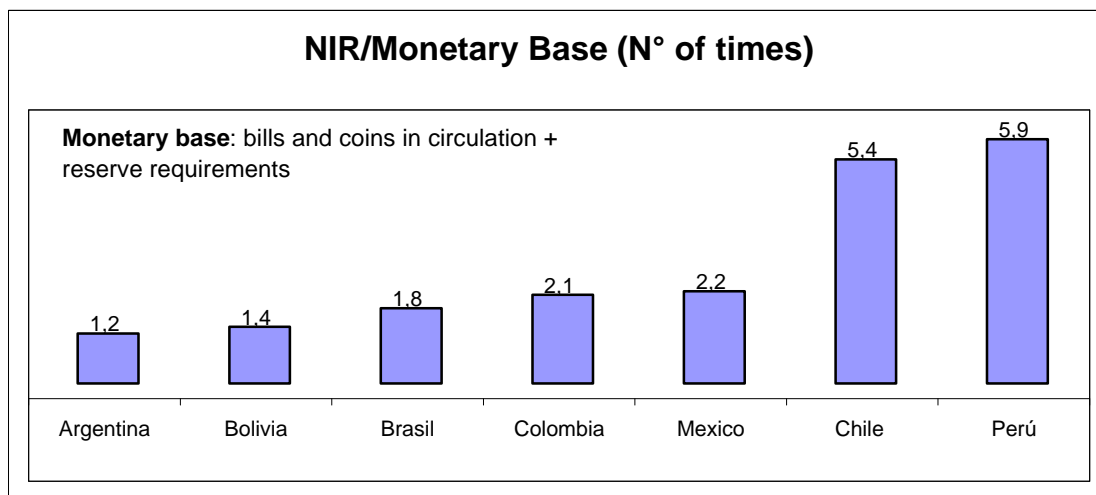
BANCO CENTRAL DE RESERVA DEL PERÚ

face situations of lack of liquidity in foreign currency (due to transfers abroad or withdrawals). Commercial banks' deposits in dollar at the Central Bank amounted US\$ 3,3 billion on April 15.



7. The possibility of a currency crisis is diminished by the following:

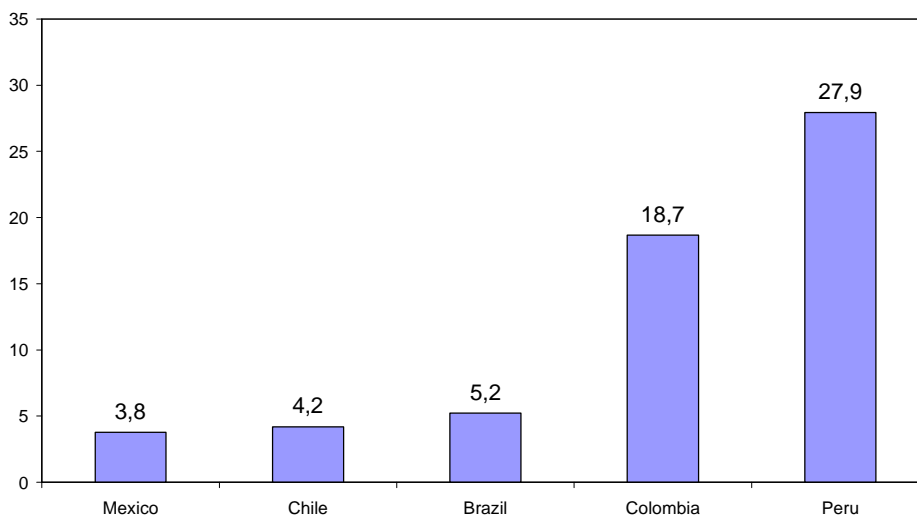
- The reduced size of the volume of soles with respect to the level of foreign reserves: NIR represent six times the monetary base and twice the total money aggregate in soles (including deposits)



- An additional indicator to measure Central Bank's ability to response is the volume traded in the foreign exchange market with respect to the level of international reserves. NIR represent 28 times the average volume of daily foreign exchange operations, one of the highest in the region. In developed economies this ratio is between 7 percent (United Kingdom) and 19 percent (United States).

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Net international reserves over foreign exchange turnover ^{1/ 2/}
(number of times)



1/ Spot, outright forward, and foreign exchange swap transactions (daily average)
2/ Source: BIS Triennial Central Bank Survey (April) 2001, IMF, BCR

- The level of BCR's foreign reserves and its interventions in the foreign exchange market hinder excessive exchange rate volatility. It is worth mentioning that interventions do not have as objective the defense of a certain level of the exchange rate. Additionally, the interbank interest rate is adjusted in episodes of turbulence as an additional dissuasive factor.
 - The floating exchange rate regime reduces the possibility of a sharp depreciations associated to fixed exchange rate regimes. Our scheme of floating exchange rate regime has been successful in absorbing several adverse shocks in the past (domestic and external).
 - The credibility of monetary policy, which is aimed at preserving monetary stability. Credibility of the Central Bank has led to low inflation expectations from the public, consistent with the inflation target of the Central Bank (2,5 percent).
8. Finally, to support the process of dedollarization, actions are being taken to deepen the financial market in domestic currency:
- Development of the local debt market in soles. To encourage the deepening of the financial market in domestic currency, the Central Bank and the Treasury have been issuing securities at nominal rates in soles with the main goal of generating interest rate benchmarks for private issuers. This has encouraged the flotation of private corporate bonds.

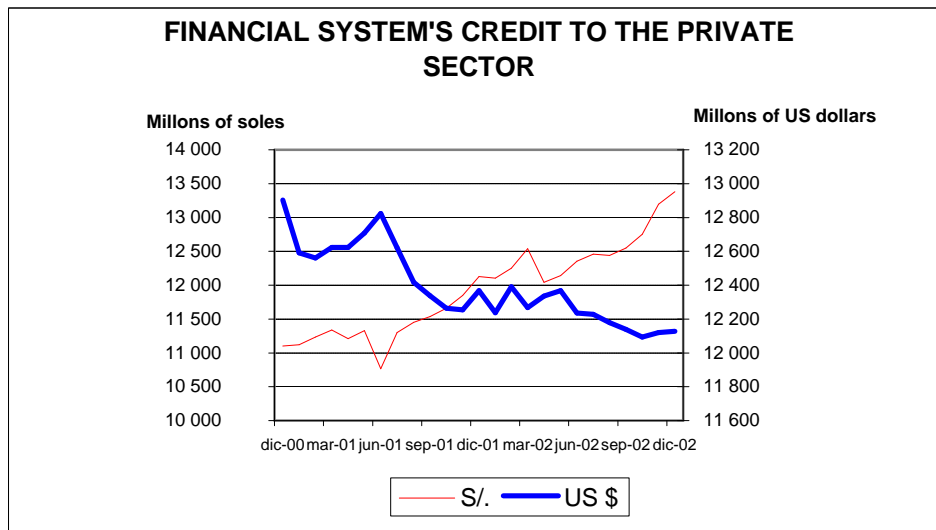
Composition of private securities in % (*)

Year	Soles	Indexed (VAC)	Dollars
2000	1,6	20,5	77,9
2001	10,9	17,9	71,3
2002	13,0	17,2	69,8

(*) Includes public offers of bonds and short-term securities.

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- In the last two years, dollarization of financial system's credit to the private sector has reduced from 80 to 76 percent. In the last year, credit in soles rose 10,3 percent while credit in dollars dropped 1,9 percent.



9. In summary, the Peruvian economy has sound macroeconomic fundamentals and a credible monetary policy focused on preserving monetary and financial stability. These features have reduced the vulnerability stemming from partial financial dollarization.

May, 12th 2003.