

CENTRAL RESERVE BANK OF PERU

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CENTRAL RESERVE BANK OF PERU

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Jorge Patrón Worm Deputy Manager for Foreign International Investments
Teresa San Bartolomé Gelicich Deputy Manager for International Agreements

Administration Management

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Javier Gutiérrez Gonzáles Deputy Manager for Administrative Services (i)

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Luis Valdivia Acevedo Deputy Manager for Supervision

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Héctor Herrera Soares Deputy Manager of the Legal Office (i)
Helena Uzátegui Tellería Deputy Manager for the Technical Affairs

Institucional Relations Office

José Rocca Espinoza Chief

Internal Auditory

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Raúl Castro Alegría

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Introduction

2004 saw a significant improvement in the principal macroeconomic indicators, continuing the favorable trend that began in 2002. The Peruvian economy was noticeably more dynamic and by December 2004 had experienced 42 consecutive months of growth, which was also reflected in higher employment, especially in the interior. This increase in growth is explained by internal macroeconomic stability, improved domestic financing and lower interest rates within a particularly favorable international context, which in addition to increased production and incomes, also improved the country's external accounts and public finances. Despite the inflationary pressure caused by internal and external supply shocks throughout the year, the Central Reserve Bank of Peru (BCRP) met its inflation target for the third consecutive year.

Gross domestic product grew 4.8 percent in 2004 (4.0 percent in 2003) due to a 14.7 percent increase in external demand and a 3.9 percent increase in domestic demand. Increased world economic activity, particularly among our main trading partners, was reflected in an improvement in our terms of trade and in greater demand abroad for our products. Furthermore, the increase in domestic demand was explained by higher consumption (3.4 percent) and private investment (9.0 percent).

All sectors of the economy expanded, with the exception of agriculture, which contracted as a result of a drought. Non-primary activities grew 5.1 percent, principally non-primary manufacturing, while primary activities recorded growth of 3.1 percent, with the Camisea project coming on stream in the hydrocarbons sector and the fishing sector experiencing significant growth.

Annual inflation was 3.48 percent in 2004, near to the upper limit of the BCRP's target range (3.5 percent). The year, and particularly the first six months, saw a series of supply shocks including a rise in the price of oil and imported raw food products, as well as a drought that affected local agricultural production and forced up food prices, particularly those of rice and sugar. This temporarily raised inflation, which reached its highest annualized rate in July (4.6 percent). Given the transitory nature of these shocks the BCRP made no changes to its monetary policy stance in the first half of the year. Nevertheless, given the magnitude and persistence of the deviation of



inflation with respect to the target, the BCRP twice increased its reference interest rate to prevent the supply shocks affecting the remaining components of the consumer basket and increasing inflationary expectations. This decision was also compatible with a gradual reduction in monetary stimulus.

The balance of payments current account deficit fell for the fourth consecutive year almost to zero (the lowest level for 26 years) after the 2003 deficit of 1.5 percent of GDP. This was the result of a significant trade surplus for the third consecutive year, as well as of an increase in remittances from Peruvians living abroad. It offset a higher factor income deficit, associated principally with an increase in profits made by companies with foreign shareholders.

The significant increase in world mineral prices made a sizeable contribution to the improved trade balance. As far as base metals were concerned, this situation was a response to low inventories due to an increase in world demand and an inflexible supply in international markets; while for precious metals the weak dollar favored the holding of gold as store of value.

The improved balance of payments position and low depreciation expectations led economic agents to adjust their portfolios, stimulating demand for domestic currency and the appreciation of the nuevo sol. The fall in the exchange rate was greater in the second half of the year, and in the whole of 2004 it fell 5.5 percent. Under these circumstances and in order to dampen the downward trend in the exchange rate, as well as to strengthen the country's international reserves, the BCRP purchased US\$ 2,340 million in the foreign exchange market. Peru's international reserves reached US\$ 12,631 million by the close of the year, equivalent to 15 months' imports and 2.5 times the amount of debt falling due in one year. At the same time, the BCRP issued Deposit Certificates (CDBCRP) to sterilize excess liquidity in the banking system and to push interbank interest rates towards the reference level.

Higher economic growth and portfolio adjustments out of foreign currency and into domestic currency increased monetary aggregates in soles. Thus liquidity in domestic currency increased by 28.1 percent, the monetary base by 25.3 percent, and money in circulation by 26.1 percent. In this context, the different indicators of financial dollarization fell for the fourth consecutive year. The banking system's dollarization coefficient fell from 62 percent in 2003 to 55 percent in 2004, while the percentage of credits to the private sector denominated in dollars fell from 77 to 74 percent in the same period.

Several measures were introduced in 2005 aimed at reducing the risks to the economy associated with dollarization: from April onwards, increases in foreign borrowing were included among obligations covered by the reserve requirement; in October the Central Reserve Bank of Peru modified the interest payable on the foreign-currency-denominated reserve requirement from LIBOR-1/8 to LIBOR-1/4 as an incentive to the use of domestic currency in financial mediation; and in November the rate on the foreign currency marginal reserve requirement was increased

from 20 to 30 percent to strengthen the ability of the financial system to respond to temporary shortages in liquidity in foreign currency. Furthermore, in July 23, 2004 Law N° 28300 was promulgated, establishing that goods and services priced in foreign currency should also be priced in domestic currency to facilitate price comparisons and encourage pricing of goods and services in soles.

In the field of public finance, in line with the downward trend observed since 2001, there was a significant reduction in the fiscal deficit from 1.7 percent of GDP in 2003 to 1.1 percent in 2004. This was principally due to an 8.1 percent increase in central government current revenues in real terms, compared to a real increase of 4.7 percent in non-financial spending. The improvement in income is explained by increased Value Added Tax (IGV) and Income Tax revenue, as well as by the introduction of the Financial Transaction Tax (ITF). Value Added Tax revenue increased because of improvements in administration, a rise in the rate from 18 to 19 percent, and increased domestic demand; while higher Income Tax revenue was explained by a rise in withholding payments deriving from the use of higher coefficients (due to companies posting better results in 2003), increased economic activity and higher world mineral prices. These revenue increases were partly offset by a reduction in the Excise Tax (ISC) on fuel aimed at compensating for the effect of higher international oil prices on domestic fuel costs. Law N° 28449, which established new rules for the Law Decree 20530 pensions regime, should be underscored because of its significant impact on the medium-term viability of Peru's fiscal accounts. In addition, the sol-denominated public debt market continued to develop, the maturity of these securities being extended to 7 years nominally and 20 years VAC (inflation indexed).

Finally, the favorable economic context was also reflected in an improvement in the banks' main financial indicators. Arrears in the system (the non-performing portfolio divided by gross loans) fell from 5.8 to 3.7 percent between 2003 and 2004 to reach its lowest level for 20 years; while the return on equity indicator rose from 10.9 percent in December 2003 to 11.3 percent in December 2004. There was a significant increase in primary bond issues (16 percent in real terms), with long term issues (5 years or more) continuing buoyant; and the Lima Stock Exchange general and blue chip indices rose 52 and 54 percent respectively, which made it the second most profitable in Latin America in 2004.