Introduction

The year 2008 –and particularly the month of September, after the collapse of the U.S. investment bank Lehman Brothers– will be remembered as the beginning of the deepening of the most serious international financial crisis ever recorded since the Great Depression of 1929. Since that month, the slump of international financial markets has affected the real economy of most countries in the world and also generated a profound economic slowdown in both emerging and developed countries.

Despite this international scenario, economic activity in Peru showed a growth rate of 9.8 percent –the highest rate in the last 14 years and the highest in Latin America–, completing ten consecutive years of expansion. Such a long cycle of growth had not been observed since the seventies. In quarterly terms, economic activity recorded growth rates of over 10 percent during the first three quarters of 2008, slowing down thereafter to an average of 6.7 percent towards the fourth quarter. Domestic demand grew 12.3 percent in 2008 (accumulating three years with two-digit growth rates), favored by the expansion of private investment and consumption due to the confidence that macroeconomic stability generated among businesses and consumers.

Inflation, measured by the variation of the Consumer Price Index (CPI) of Metropolitan Lima, recorded 6.65 percent in 2008, reflecting mainly the impact of supply shocks of domestic and imported food products whose prices increased 9.7 percent during the year. The upward pressures on the prices associated with foodstuffs started subsiding in the last months of the year given the rapid correction of the international prices of commodities in a context of deterioration of the global economy.

The current account of the balance of payments went from a surplus of 1.1 percent of GDP to a deficit of 3.3 percent of GDP between 2007 and 2008, reflecting the high growth of domestic demand and the decline of terms of trade (-13 percent). As from September, the trade balance turned negative due to the deepening of the international financial crisis. However, the current account deficit was more than compensated by long-term private capital flows associated with direct foreign investment and long-term loans.

An increasingly significant inflow of foreign short-term capitals, coupled by a higher preference for the nuevo sol, was observed during the first months of the year. These two factors translated into an important expansion of banks' liquidity and in pressures that contributed to appreciate the domestic currency. In this context, the Central Bank purchased foreign currency and raised reserve requirements in soles and in dollars, seeking to moderate the volatility of exchange and prevent an excessive expansion of credit.

With the deepening of the international financial crisis, the Central Bank intervened in the foreign exchange market since September, selling dollars to reduce the volatility of the exchange rate and to provide liquidity in foreign currency to the market. This decision, aimed at restraining the risks of equity losses associated with the high levels of dollarization of the Peruvian economy, was possible due to the preventive accumulation of international reserves carried out in the last four years, which provided the economy with a high capacity of response to face this type of adverse macroeconomic contingencies.

Net international reserves, which increased by US$ 3,507 million in 2008, amounted to US$ 31.2 billion, a sum equivalent to four times total short-term liabilities and to 24 percent of GDP. International reserves are 81 percent higher than at end 2006.

Amid inflationary pressures, the Central Bank actions during the first nine months of the year were aimed at containing the growth of domestic demand: reserve requirement and the reference interest rate were raised.

When the crisis unfolded, the Central Bank actions were oriented to maintaining liquidity in soles and in dollars in the financial system. The purpose of this was to allow the flow of credit to keep up with the pace of expansion of economic activity so that economic growth would not be affected by drastic changes in the international financial context. Moreover, lower inflationary risks were also observed.

Liquidity for a total of S/. 26,363 million, equivalent to 61 percent of total liabilities subject to reserve requirements, was injected to the economy between September and December alone. This was carried out through a wide range of instruments, including a drastic reduction of reserve requirements, repos of securities with maturities of up to 1-year, swaps in foreign currency, and the maturities of the BCRP Certificates of Deposit.

Interest rates in nuevos soles in the money and capital markets increased along the year in response to the higher costs of banks' funds and to increased perception of credit risks given the external crisis. As a result of this, monetary and credit aggregates moderated their pace of growth. The rate of growth of broad money in the last 12 months went from 22 percent in December 2007 to 34 percent in October 2008, declining thereafter to 25 percent at end 2008. On the other hand, the rate of growth of credit to the private sector increased from 28 to 37 percent between December 2007 and October 2008, and later fell to 33 percent in December 2008.

The ratios of dollarization of liquidity and credit dropped in 2008. The former declined slightly from 47 to 46 percent, while the latter fell five percentage points, from 57 to 52 percent.

Moreover, the cap for AFP's investments abroad was raised from 15 to 20 percent during the year. However, the share of these investments in the structure of the private pension fund system declined from 13.3 to 12.4 percent between 2007 and 2008.

Despite the international financial crisis, banks' financial indicators improved in 2008. Thus, the level of coverage of non-performing loans reached levels of 151.4 percent (versus 124.4 percent in 2007), while the return on equity ratio (ROE) increased from 27.9 to 31.1 percent, despite the reduction of banks' operational margin. In 2008, the ratio of non-performing loans was 1.3 percent, a historical minimum level.

As regards fiscal accounts, the non-financial public sector showed a surplus of 2.1 percent of GDP in 2008, a result one percentage point lower than in the earlier year. This lower result stemmed mainly from the strong expansion of public investment, which grew by a real 42 percent, especially in the case of local governments, although it moderated in the last quarter of the year. The public debt, which amounted to US$ 30.6 billion, is equivalent to 24 percent of GDP, a rate nine percentage points lower than in 2006.