Introduction

The international scenario in 2010 was marked by economic recovery in most countries, as well as by the beginning of a significant rise in commodity prices and increased international liquidity. This recovery was not homogeneous worldwide. In emerging economies, it was mainly based on the dynamic growth of domestic demand. On the other hand, economic recovery in developed countries was slower and depended on their possibility of sustaining fiscal and monetary stimulus policies. The uncertainty generated by the fiscal problems of some Eurozone countries and the rise in the international prices of food and energy were risk factors that limited a more favorable evolution of global economic activity.

Positive growth rates were again observed in the domestic economy since Q4-2009 as a result of the simultaneous implementation of monetary and fiscal stimulus in response to the international economic crisis. In 2010, with a more favorable international environment and a domestic market driven by private agents' optimistic expectations, high growth rates were observed, leading GDP to record a growth rate of 8.8 percent with an output gap that continued closing over the year.

GDP growth was driven by domestic demand, which grew 12.8 percent. Factors accounting for this result included the recovery of private consumption and the expansion of private investment at similar rates as the ones observed prior to the international financial crisis. Non primary sectors' contribution to growth –particularly labor-intensive sectors, such as construction and non primary manufacturing – was extremely important due to the positive effects they generate on the levels of employment and income.

Inflation returned to the target range in May, after the effect of lower imported inflation in 2009 disappeared and rises in the international prices of food and fuels were then observed. The latter was coupled by rises in agricultural and domestic prices due to lower supply as a result of adverse climatic conditions during the first months of the year. In this context, inflation reached 2.4 percent in September, declining thereafter to 2.1 percent in December. Core inflation –trend indicator of inflation– fell around the 2 percent target over the year, with rates ranging between 1.8 and 2.2 percent, and recording a rate of 2.1 percent at the end of the year.

In a context of strong growth of domestic demand and reversal of the economic cycle, the Central Bank preventively started gradually withdrawing monetary stimulus by raising the reference interest rate and the rate of reserve requirements. Between May and September, the reference rate was raised from a historical minimum level of 1.25 to 3.0 percent. A pause was made in this cycle of adjustments in Q4 considering the evolution of inflation and inflation expectations in a context of increased uncertainty about global growth, given the fiscal problems observed in some Eurozone countries.

Moreover, the reserve requirements measures were also aimed at offsetting the dynamism of credit and liquidity in the domestic market in a context characterized by increased capital inflows and appreciatory expectations due to the presence of higher liquidity in global markets and investors' lower risk aversion.

Interest rates, especially shorter term rates, increased in line with the rises in the reference rate and the adjustments implemented in reserve requirements during the year. Despite this, the rates on loans for micro businesses, consumer loans and mortgages declined due to increased competition in these market segments, as well as due to the greater availability of funds in dollars.

Monetary aggregates grew in line with the greater dynamism of economic activity in a context of a less flexible monetary policy. Credit to the private sector increased by 21 percent and the dollarization ratio of credit to the private sector fell from 47 to 46 percent between 2009 and 2010.

As regards the Central Bank interventions in the foreign exchange market, the BCRP purchased foreign currency for a total of US$ 2,655 million in the first four months of the year with the aim of mitigating the volatility caused by the sales of dollars associated with the period of regularization of the income tax and a higher supply position in the forward market. Between June and October, due to the acceleration of capital inflows, the BCRP intervened in the foreign exchange market purchasing US$ 6,309 million through front desk operations. In this way, the Central Bank accumulated international reserves for a total of US$ 10,970 million, as a result of which international reserves amounted to US$ 44,105 million at December, level equivalent to 29 percent of GDP.

Between 2009 and 2010 the fiscal deficit declined from 1.6 to 0.5 percent of GDP, mainly as a result of tax collection improvements. This implied a lower fiscal impulse than the one observed in 2009, in line with the announcement of the withdrawal of fiscal stimulus. The increase in the revenues of the general government from 18.7 to 19.8 percent of GDP represented an increase of nearly 19 percent in real terms, and is explained by both higher domestic economic activity and by the rise in the prices of our main export commodities. The general government expenditures grew 11 percent in real terms, with capital expenditure growing 20 percent, which represented 6 percent of GDP.

The current account of the balance of payments declined from a surplus of 0.2 percent of GDP in 2009 to a deficit of 1.5 percent of GDP in 2010. This result is mostly explained by the higher *prices of imports, particularly fuels, as well as by the higher volume of imports generated by the strong dynamism of domestic demand during they year. The inflow of long term private capitals observed during the year, which amounted to nearly US$ 14.4 billion, was associated with the increased amount of funds oriented to finance investment projects, with banks' higher debt contracted abroad, and with non residents' demand for government securities.*