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2004: PRICE SWINGS DOMINATE

Preliminary figures show the Peruvian economy grew 5.1% in 2004, led by growth in exports (15.2%) and private investment (9.4%). Exports were boosted by the sharp increase in prices of commodities such as gold and copper. In addition, agricultural and textile exports benefited from higher US demand. Throughout President Toledo's administration, exports have been the main factor in economic growth, highlighting a large positive impact coming from a healthier world economy. In fact, the value of exports in 2006 could be double the level in 2001, when Mr. Toledo came into office.

Investment has remained sluggish. In spite of a large increase in private investment in 2004, public investment increased by just 2.8%. Moreover, gross domestic investment stood at 18.5% of GDP, slightly lower than the 2003 level of 18.8%. Therefore, potential GDP growth was lower than real GDP growth, thus reducing the GDP gap. This means that in the coming years there will be less space for above-trend growth, meaning that unless investment picks up in the short term Peru will experience lower growth rates.

Inflation remained under control last year, at 3.7%. This was higher than in 2003 (2.3%), but that was largely due to higher oil prices and a domestic drought that led to lower agricultural output. Despite these shocks, the Central Bank's inflation target was met for the third consecutive year. Exchange rate developments played a big role in this situation because the sol rose against the US dollar by 1.9%, which helped reduce inflationary pressures. There were two main reasons for the sol's rise. First, solid external accounts showed a balance of payments surplus of 3.4% of GDP. This was mainly due to a large trade surplus. Second, exchange rate expectations have dramatically changed in the last couple of years. This has led to a higher demand for soles and lower demand for dollars as businesses have been switching their portfolios from dollar-denominated assets to sol-denominated assets. Therefore, broad money denominated in soles grew 24% on average, while broad money denominated in dollars just grew 3% on average. This means that Peru's economy has been trending toward a lower percentage of dollars in the economy.

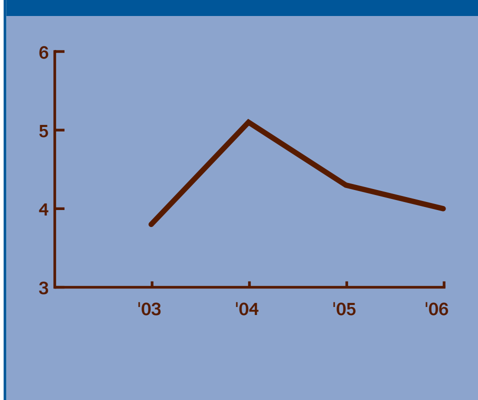
According to Peru's Central Bank, the sol's appreciation has been mostly related to the second factor. Since the appreciation was due mainly to speculation, the Central Bank responded with strong interventions in the currency market aimed at reducing exchange rate volatility. During 2004, the Central Bank bought US$2.3 billion, which amounts to almost 85% of the monetary base. This, in turn, has led to a large increase in international reserves. The Central Bank, however, seems have ignored the first reason for the sol's appreciation – the balance of payments surplus. Recent developments in the Peruvian economy show that the exchange rate needs to fall further in order to attain its long-term equilibrium level. The fact that this has not yet happened has largely been due to the Central Bank's interventions. Moreover, currency interventions have only increased in 2005, as the pressures in the currency market have strengthened.

Peru's monetary policy is guided by an inflation targeting scheme. The Central Bank's goal is to keep inflation in check. This means that the exchange rate ought to float. As long as the Central Bank continues to intervene at its current pace, there is a potential conflict between its explicit goal (controlling inflation) and its implicit goal (maintaining the exchange rate at a reasonable level).

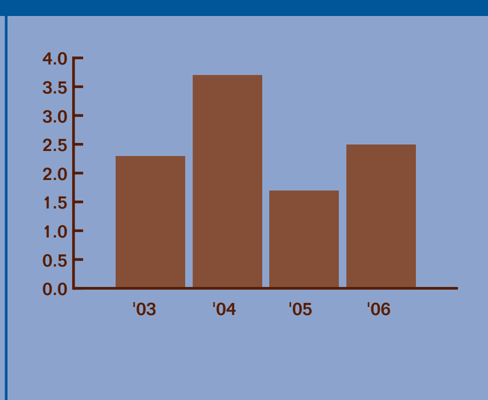
Meanwhile, fiscal policy was austere. The primary balance rose from 0.4% of GDP in 2003 to 1% in 2004, thanks to an increase in public revenues and a fall in non-financial public expenditure. The overall balance closed at –1.1% of GDP, down from –1.8% in 2003.

Nevertheless, there are still some risks. Fiscal revenues displayed very solid growth in 2004. In part, this was due to important efforts by the government to increase revenues. However, the extraordinarily high revenues may not be sustainable. First, as noted, real GDP has been growing much faster that potential GDP. This means that some of the increase in revenues comes from favourable cyclical developments, and may not be sustainable. Second, the government has also introduced a number of transitory taxes, which are due to expire in late 2006. Therefore, we can expect a significant fall in public revenues in 2007. On the other hand, public expenditure management has been very prudent. Non-financial public expenditure amounted to 15.7% of GDP in

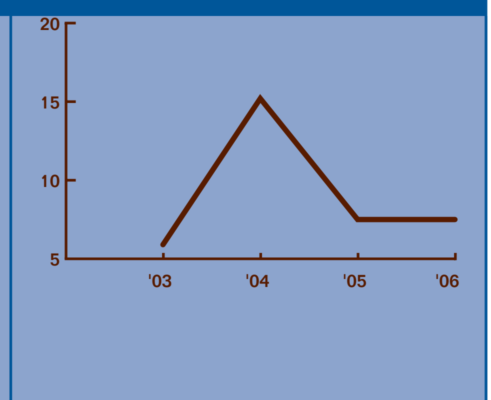
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



2004, down from 16.1% in 2003. Better results in the fiscal accounts have softened the impact of public debt, so Peru's bonds are on the path to achieving investment grade. Therefore, fiscal accounts show lower risks than they did a few years ago.

ECONOMIC POLICY ISSUES

Exchange rate appreciation during 2004 was related to the depreciation of the US dollar. The US currency has been losing value against most other currencies, especially those that float freely. As long as this trend is mostly related to the deep imbalance in the US economy, it is possible that this situation could persist despite further rises in interest rates by the US Federal Reserve. For the Peruvian economy, both factors which drove up the sol in 2004 are likely to continue in 2005. The balance of payments surplus will shrink, but it will still be largely positive. Moreover, domestic portfolio changes are likely to continue, as exchange rate expectations trigger a further reduction in the volume of dollars in the economy.

However, there is a strong likelihood that inflation will fall below the Central Bank's target. Thus, it is likely that the Central Bank will attempt to keep interest rates stable throughout the year, leading to lower capital inflows. Such a policy would open negative spreads between domestic interest rates and ever-rising international interest rates, softening appreciation pressures. Therefore, there is a rather strong likelihood that the sol will start to lose strength against the dollar, although at a very slow pace.

On the other hand, the risk of further appreciation should not be dismissed. As stated, an exchange rate equilibrium is still probably below current levels. Moreover, we have to count the possibility that Central Bank currency interventions could attract international speculative capital. As market pressures point toward an appreciation of the exchange rate, speculative capital might start flowing in with the expectation that the Central Bank could eventually give up its defence of the exchange rate. It is possible that this is already happening, as the Central Bank has strengthened its interventions.

Massive interventions are causing financial losses for the Central Bank. International reserves denominated in US dollars earn interest rates close to 1.5%, while Certificates of Deposit (instruments used by the Central Bank to reduce liquidity in soles after its currency interventions) pay interest rates close to 4.5%. These losses might well trigger a move from dollar-denominated international reserves toward euro-denominated assets.

In any case, it is very likely the sol will gain further strength against the dollar. In this scenario, those whose assets are denominated in dollars would incur significant financial losses. In spite of the current trend toward so-called "de-dollarization," some 64% of deposits in banks are still denominated in the US currency. The appreciation would mainly affect households, which seem to have been slow to move their assets away from dollars. Nevertheless, the impact should not be too strong since most households receive sol-denominated income. On the other hand, most firms and banks seem insured against financial losses, as they have already diversified their portfolios away from dollars. In addition, exports could slow down a little, but the negative impact would probably be matched by a boost in domestic demand.

OUTLOOK FOR 2005-06:

The economic outlook will be dominated by presidential elections in April 2006. It is still too soon to predict who will run in the elections, since most political groups are still in the process of forging alliances that allow them to participate. Discussions regarding negotiations for a Free Trade Agreement (FTA) with the US are also going to be at the political forefront. Talks should conclude this year, and most politicians are likely to focus their political agendas on this issue. Meanwhile, there seems to be quiet support among politicians for the FTA, but that could change as political pressures from interest groups gain strength. Should the FTA be signed, there would be a significant boost to investment and exports, leading to higher growth in the following years.

On the other hand, the government has already showed signs of its intention to increase public spending in coming months. The target for the fiscal deficit stands at 1% of GDP, just below last year's result, so it should not be to hard to attain. But, as noted, the government apparently does not intend to achieve that target and President Toledo seems to be calling for a change in the fiscal target. The first sign of this is a program announced to give direct subsides to poor families. In principle, it is not a bad idea but there are serious issues in designing such a program, not the least of which has to do with conducting a census to properly identify the poor.

In any case, Peru's economy will remain solid in the period. We estimate that Peru's GDP will rise 4.3% this year, boosted by external demand. Exports will grow 7.5%, a slower pace than last year, but still a significant increase. Regrettably, household incomes will keep growing rather slowly, so political pressures will remain.