

Economic

Credit Agencies:

Moody's: Ba2
S&P: BB+
Fitch: BB+

Nominal GDP (2006):

USD 93.4bn

Population (2006):

28.4mn

Total Trade / GDP (2006):

41.4%

Currency:

Nuevo Sol

Exchange regime:

Managed Float

Merchandise Imports from Canada (2006):

CAD 267mn

Main sources of Foreign Exchange (excl. FDI):

Mineral exports

Largest Merchandise Trading Partner:

United States
Eurozone

Main imports:

Intermediate Goods
Capital Goods

Risks to the Outlook:



Investment-grade status



A sustained fall in mineral prices

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Market Spotlight: On October 1, the public sector became a net external creditor, after agreeing on a US\$2.6bn pre-payment with the Paris Club. ■ After signing a FTA with the US, Peru awaits Congressional approval, likely some time in Q4. ■ Canada officially launched FTA negotiations with Peru and Colombia in June.

Real Sector: Economic activity jumped 7.6% y/y in Q2, bringing growth in the first half to almost 7.7%. The expansion continues to be driven by strong investment, as a result of a number of projects in the mining and hydrocarbons sectors, as well as strong housing construction and public infrastructure spending. Meanwhile, healthy consumer confidence, increasing employment, and positive credit growth is boosting consumption. In fact, consumption credit expanded 51.5% y/y in July, up from 34.1% in January. Domestic demand, up 7.6% in H1, is expected to maintain its momentum through the remainder of 2007 and into 2008. EDC Economics expects strong growth to continue, albeit at a slower rate – due to slowing external conditions and a tighter monetary environment.

Monetary: The BCRP increased its benchmark interest rate by 25bps in September, to 5% – its second hike this year, and the highest level since 2002. The move came after inflation of 0.14% m/m in August – a result of high international energy and food prices, and strong domestic absorption. Annual price growth has gone from -0.08% in April, to 2.2% in August – the highest since May 2006, and slightly above the central bank's 2% target. The trend is stoking concerns over mounting price pressures. We believe that the Bank will keep an eye on robust economic activity, and that another 25bps hike is likely, given a policy rate well-below the neutral level.

External Sector: Despite an increase in imports, the trade surplus jumped to US\$2.2bn in Q2, from US\$1.5bn in Q1. Capital goods imports continue to show solid gains, a sign that the industrial sector is expanding its capacity. The current account moved into a surplus of US\$466mn on the year, after a slight deficit in Q1. The cumulative surplus for the past four quarters amounts to US\$2.9bn. We expect the current account balance to contract moderately going forward, as metals prices converge toward historical averages. Remittances will continue to grow, and FDI should remain solid.

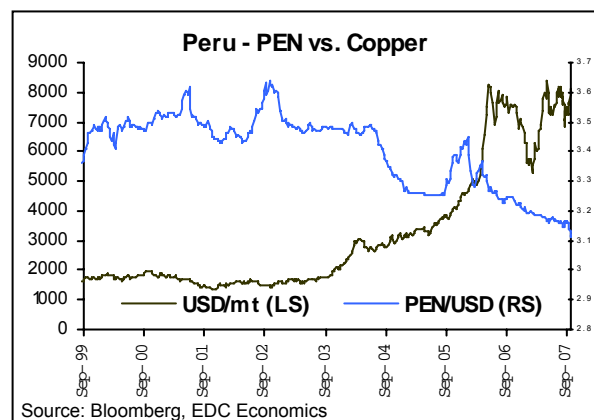
Fiscal: With government revenue fueled by strong economic growth, and public consumption relatively modest, the overall surplus of the non-financial public sector jumped to a record 8.2% of GDP in Q2. Public infrastructure was severely hit by the earthquake, with losses occurring in water and sanitation, roads, bridges, and ports. According to the Ministry of Finance, reconstruction efforts could reach US\$285mn, and may require private sector participation. Construction prices are already signaling the impending surge in demand for materials. This additional spending will be added to previously ambitious infrastructure plans.

Debt: Skillful debt management has reduced the government's foreign currency exposure and rollover risks via placements in local currency at lengthened maturities. If growth remains strong and the public sector deficit is kept in line with the Fiscal Responsibility and Transparency Law ceiling, Peru's public debt stock will continue to decline below 30% of GDP. Given that 80% of external debt is owed by the government, Peru's external debt would likewise fall toward 25% of GDP, from 50.1% just 10 years ago.

Outlook: Over the medium-term, GDP is projected to grow by an average of 4.5%, inflation is expected to settle at around 2.5%, and the President will likely pursue sound macroeconomic management. The main risks continue to stem from Peru's vulnerability to a fall in mineral prices, still-high dollarization ratios, the large share of foreign currency denominated public debt (79%), and policy slippage associated with a challenging social environment. While some progress has been made with respect to structural reform, efforts need to be stepped up in other areas.

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	4.2	8.0	7.4	6.0
Inflation (%chg, pa avg.)	1.9	2.0	2.0	2.2
Fiscal Balance (% of GDP)	-1.6	2.0	1.0	0.2
Exports (% comp. annual growth)	20.0	37.0	10.0	5.0
Imports (% comp. annual growth)	10.4	23.4	20.0	10.0
Current Account (% of GDP)	-0.9	2.6	1.9	2.1
Reserves (months of curr. debits)	8.8	7.5	8.6	9.3
External Debt (% of GDP)	45.9	30.3	26.1	23.8
Debt Service Ratio (due)	18.8	10.8	15.8	10.6
Exchange Rate (to USD; eoy)	3.4	3.2	3.2	3.2



General Political Environment:

On July 28, Alan Garcia took office for a second time in Peru's history replacing former President Alejandro Toledo who led a weak and ineffective government.

Garcia was first President from 1985 to 1990 during times of economic and social turmoil. Garcia is largely remembered for his disastrous first term in office in which he advanced a heterodox policy agenda which included the nationalization of the banking sector, spiraling inflation and selective debt defaulting which led to IMF abandonment and significant capital flight. Furthermore, his government was corrupt and blamed for human rights abuses in dealing with a rising insurgency. Despite his tarnished reputation, Garcia was elected by a small margin in the June 2006 presidential run-off mostly as the lesser evil of the two contenders and as such benefited from the so-called fear vote.

Since his last tenure in the Presidency, Garcia has evolved his ideas towards a model resembling the European modern social democracy. He has vowed to pursue market-friendly economic policies and extend the IMF stand-by facility. In contrast to his first tenure in the presidency, Garcia does not enjoy a majority in Congress. Many observers believe that Garcia has learned from his past mistakes and that he will strive to be a moderate and pragmatic politician.

Radical leftist presidential candidate Ollanta Humala put up a tough fight in the recent elections which demonstrates the extent of Peru's divisiveness and the need to address the country's social inequalities. He will remain an influential force in Peruvian politics, although his clout has diminished since his defeat.

Garcia needs to build political support within a divided legislature early in his tenure to enable policy progress. In an attempt to do so, he has created a diversified cabinet comprised of moderate and pro-market individuals. The government will seek to strike a difficult balance between the social and pro-market interests of the various members of the legislature. Indeed, legislative negotiations will be required for policy progress which will serve to moderate policy direction but could also impede policy development.

The regional implications of Garcia's victory are a blow to Venezuela's Bolivarian Revolution ambitions. Garcia is serving to strengthen regional alignments between pragmatic leftist politicians.

Investment Environment:

Peru's Foreign Investment Law offers automatic investment authorization and national treatment to foreign investors. Privatisation is a hot-button political issue.

Rising political violence threats and legal uncertainty serve as disincentives for new investments in Peru's mining sector, the country's key economic driver.

Foreign currency may be used to acquire goods abroad or cover financial obligations so long as the operator is in compliance with the relevant tax legislation. There are no barriers to profit remittances and capital repatriation.

The judiciary is plagued by corruption, bureaucracy and political interference. Canada and Peru are engaged in advanced negotiations towards a Foreign Investment Protection Agreement (FIPA).

Political Violence:

Groups involved in violence for political ends, including the Maoist Shining Path and the left-wing Movimiento Revolucionario Tupac Amaru, were weakened by the counter-insurgency campaigns of the 1990s. However, as a result of military cutbacks implemented by Toledo, it appears that they are regrouping and gaining strength through increased revenue generated from the drug trade.

Protests involving occupations of foreign investment installations and roadblocks are increasingly common and, at times, turn violent. Mining projects across the country are the most affected.

Political

Political Structure

Presidential Republic

President

Alan Garcia

Vice-President

Luis Giampietri

Legislative Bodies

- National: Congress (120 seats)
- Local: 24 departments – further divided into provinces and municipalities

Major Parties (seats in Congress)

- *Union por el Peru (UP)* – 43 seats* (minus recent defections)
- *Partido Aprista Peruano (APRA)* - 35 seats
- *Unidad Nacional (UN)* - 19 seats

Last Elections

- Presidential: June 2006
- Legislative: April 2006

Next Elections

- General elections: April 2011

Press Freedom Survey:

- 2006 Score: 39 Partly Free (0: Free; 100: Not Free)

freedomhouse.org

Control of Corruption Index:

- 2006 Score: -0.35 (-2.5: Worst; +2.5: Best)

worldbank.org

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Political Outlook

Peru's fractured legislature will be Garcia's greatest challenge. Alliance building will be key to policy progress. Failing to forge a strong coalition will protract slow policy progress on all fronts including the much-needed attention to the societal fragmentation along socioeconomic and regional lines. This could serve to broaden the already high level of popular disillusionment with the political class. As such, the opportunity for a populist character from outside the political mainstream to rise to power, such as Ollanta Humala, remains an on-going risk to political stability in Peru, although such power shift would likely occur through a democratic process. Therefore, unless Garcia's government can manage the difficult feat of tackling poverty within its 5 year term, a radical leftist could re-emerge as a very strong candidate in the 2011 elections.