

Economic

Credit Agencies:

Moody's: Baa3
S&P: BBB-
Fitch: BBB-

Nominal GDP at PPP (2009e):

USD 128.8 bn

Population (2009e):

29.6 mn

Total Trade / GDP (2009e):

35%

Currency:

Nuevo Sol

Exchange regime:

Managed Float

Merchandise Imports from Canada (2009e):

CAD 390 mn

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:

Upside risks: Tax reform-income redistribution

Downside risks: A sustained fall in metal prices

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Market Spotlight: Peru is considered to be investment grade by the major rating agencies. ■ The government has announced 16 priority infrastructure projects that will start this year. ■ Inflation is close to zero. ■ Economic activity indicators have started to show some improvement.

Real Sector: Weak external demand, lower metal prices and tighter international credit conditions drove GDP growth down dramatically last year. Nevertheless, Peru is expected to grow at a rate that will be well above the Latin American average over the next two years. We estimate GDP expanded 0.8% last year and will grow 4.8% in 2010.

Monetary: Faced with decreasing inflation (0.25% y/y in December 2009) the CB has cut rates to a record low last year (1.25%); the strong currency, has forced the Bank to intervene in the foreign exchange market to control the currency's appreciation. We do not rule out further interventions if the *Sol* continues strengthening this year. In the absence of a sustained increase in fuel and food prices, inflation should remain within the Central Bank target band (1%-3%) over the forecast horizon.

External Sector: Driven by import demand and a strong currency, the CA deficit is expected to widen moderately. FDI and portfolio inflows are expected to increase significantly this year contributing to the strengthening of the *Sol*. Liquidity remains high and the country's international reserves stand at USD 34bn (equivalent to around 10 months of imports). Skillful debt management has reduced the government's foreign currency exposure and rollover risks via bond placements denominated in local currency and at lengthened maturities. This has resulted in the public sector becoming a net external creditor and the major rating agencies upgrading the country to investment grade last year.

Fiscal: The government has also been able to use counter-cyclical fiscal policy (USD3.3bn fiscal package) to counteract the effects of the global financial crisis last year. Public spending is expected to accelerate further in response to an increasing number of social demonstrations. In fact, the government has come up with a list of 16 priority infrastructure projects for this year and has eliminated taxes for some of the poorest families in the country. Mining-related revenues account for about a quarter of total central government revenues, which makes the government's accounts very dependent on such inflows. Over the MLT, the government is faced with the need to reform the tax regime and to expand its revenue base.

Financial: Although half of the banks in Peru are foreign-owned, systemic risks are low given that banks mostly rely on domestic funding. In general terms, the banking sector is well capitalized, liquid, well provisioned, not reliant on external funding and has no exposure to sub-prime mortgages. Downside risks remain given the existence of currency mismatches between bank loans and deposits (credit dollarization is currently around 60%), as well as the private sector tendency to sharply increase its demand for USD when faced with confidence shocks.

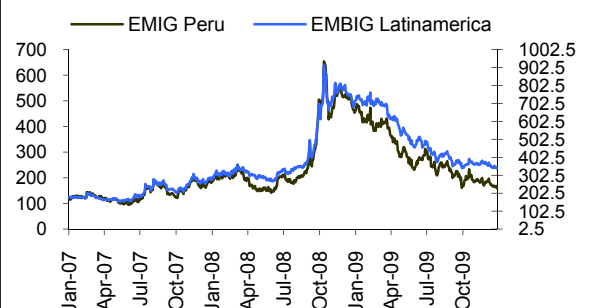
Outlook: Over the short-term, in the absence of radical changes in economic policy, we expect Peru to retain its investment grade status and to continue promoting a foreign investor friendly economic framework. Our medium-long term outlook for the economy is also positive. The government is also expected to boost infrastructure investment in face of the 2011 elections. The main risks for the country continue to stem from Peru's vulnerability to a fall in metal prices and a challenging social environment.

Economic Indicators

	04-08 avg.	2008	2009	2010
GDP (% growth, real)	6.5	9.8	0.8	4.8
Inflation (%chg, pa avg.)	2.3	5.8	3.0	3.0
Fiscal Balance (% of GDP)	0.4	2.2	-3.5	-1.5
Exports (% comp. annual growth)	29.3	13.1	-20.5	12.0
Imports (% comp. annual growth)	21.4	45.1	-25.8	10.0
Current Account (% of GDP)	0.8	-3.3	-0.2	-2.0
Reserves (months of curr. debits)	8.5	8.3	11.8	10.8
External Debt (% of GDP)	38.0	27.4	26.0	23.5
Debt Service Ratio (due)	16.2	13.6	15.1	13.2
Exchange Rate (to USD; eoy)	3.3	3.1	3.0	2.8

Source: EIU, EDC Economics

Peru vs. Latam bond spreads



Source: Bloomberg, EDC Economics

General Political Environment: In June 2006, former president Alan García was re-elected after garnering approximately 53% of votes in a presidential run-off against radical leftist candidate Ollanta Humala. García was first president from 1985-1990, at a time of social and economic turmoil within Peru. Nearly four years into his current term, the landscape is markedly different with the government pursuing prudent macroeconomic policy and investor-friendly market policies.

García's Aprista Party for Peru (APRA) holds only a minority position in the 120-seat Congress. This requires that the president build political alliances within the legislature to ensure policy progress. In an attempt to do so, President García has sought to have diversified cabinets comprised of moderate and pro-market individuals.

Despite Peru's 10-year economic boom, Peru still lacks basic infrastructure in most parts of its territory and it continues to experience high poverty rates. As a result, there is growing public discontent over the government's perceived inability to ensure a wider distribution of wealth at a time of rapid economic growth, and Peru is witnessing an increase in protest and strike activity. This, added to the negative effects that the global economic downturn is having on the country's economic stability, may be paving the way for the resurgence of radical populist and former presidential candidate Ollanta Humala for the 2010 regional and 2011 presidential elections. The government has attempted to address the issue through an increase in public investment in infrastructure across the country.

In July 2009, President Garcia undertook the third reshuffle of his cabinet since he came to power, following the recent political crisis in the Peruvian Amazon where 23 policemen and 9 civilians were killed. Speaker of Congress Javier Velásquez Quesquén was named Chief Minister following Yehude Simon's resignation. Simon announced that he intends to contest the 2011 presidential election.

Investment Environment: The government remains committed to pursuing an investor-friendly business climate. Peru's Foreign Investment Law offers automatic investment authorization and national treatment to foreign investors.

Foreign currency may be used to acquire goods abroad or cover financial obligations so long as the operator is in compliance with the relevant Peruvian tax legislation. There are no barriers to profit remittances and capital repatriation. Although the government has recognized the problem of allegations of judicial corruption and is taking steps to reform the judiciary, progress on this front is expected to take some time.

Under Garcia, Peru has maintained an aggressive trade policy that has allowed it to sign Free Trade Agreements (FTA) with the US, Chile, Singapore, Thailand, China and Canada, which has already been ratified by Canadian Parliament and came into effect on 1 August 2009. Peru is currently negotiating similar agreements with the EU and South Korea.

Building on the procedural protections included in the Canada-Peru Foreign Investment Promotion and Protection Agreement (FIPA), the Canada-Peru FTA is expected to influence the development of national laws through the promotion of good governance (e.g. respect for rule of law, transparency), which generally leads to a better investment climate.

Political Violence: Groups involved in violence for political ends, including the Shining Path (Sendero Luminoso, SL), were weakened by the counter-insurgency campaigns of the 1990s. Although there is evidence of their involvement in drug trafficking and kidnapping, insurgent activity poses little risk to foreign firms operating in the country, unless they are operating in remote rural areas where some groups remain active, specifically in the VRAE region.

In June 2009, a clash between Peruvian police and indigenous protesters in Peru's northeastern Amazon region over a series of decrees issued by President Garcia seeking to boost the government's ability to grant concessions for private projects in the extractive, forestry and hydroelectric sectors in the Amazon region, resulted in fatalities on both sides, as 25 policemen and 9 indigenous were killed.

Political

Political Structure

Presidential Republic

President

Alan García (APRA)

Prime Minister

Javier Velásquez-Quesquén (APRA)

Legislative Bodies

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

Major Parties (seats in Congress)

- Union for Peru (UP): 45
- Aprista Party for Peru (APRA): 36
- National Union (UN): 17
- Alliance for the Future (AF): 13
- Other parties: 9

Last Elections

- Presidential (second round): 4 June 2006
- Legislative: 9 April 2006

Next Elections

- Regional elections: October 2010
- General elections: April 2011

Press Freedom Survey:

- 2008 Score: 44 Partly Free (0: Free; 100: Not Free)
- freedomhouse.org

Control of Corruption Index:

- 2008 Score: -0.26 (-2.5: Worst; +2.5: Best)
- worldbank.org

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Political Outlook

Following the June 2009 Amazon crisis, President Garcia undertook a third Cabinet reshuffle since he came to power in 2006. The crisis proved that the Garcia administration's ability to deal with indigenous demands is questionable, and this is therefore expected to have important implications for the country's political and investment environment in the short to medium term, as private investors interested in the extractive sector in Peru are likely to face significant legal, reputational and operational risks. Garcia's declining popularity, added to the slow progress shown by the dialogue process with the country's Amazonian natives will continue to dominate domestic politics for most 2010.