Rabobank

Country report **PERU**

Summary

Peru's 2011 presidential elections were won by former left-wing radical Ollanta Humala. However, in spite of his former orientation, both the policies and the most key economic decision makers of the new government have a very moderate and pragmatic character. Furthermore, Humala did not obtain a majority in congress, and thus relies on support from his more centrist coalition partner. Nevertheless, Humala has been able to deliver on important campaign pledges, such as increasing the taxation of mining activities, which has boosted his popularity. Meanwhile, economic growth is likely to slow slightly, but should nevertheless remain decent, unless global economic sentiment deteriorates sharply. The current account deficit is likely to grow somewhat, but these deficits are likely to be more than covered by large FDI inflows. Peru has a large stock of foreign reserves.

Things to watch:

- Prices of Peru's major export products copper and gold.
- The policies of the new government: will Humala continue to rule through the centre?

Author: **Herwin Loman**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31105
H.Loman@rn.rabobank.nl

Peru

National facts	
Type of government	constitutional republic
Capital	Lima
Surface area (thousand sq km)	1,285
Population (millions)	29.6
Main religions	Roman Catholic (81.3%)
	Evangelical (12.5%)
Main ethnic groups	Amerindian (45%)
	Mestizo (37%)
	White (15%)
Head of State (president)	Ollanta Humala Tasso
Head of Government	Ollnata Humala Tasso
Monetary unit	nuevo sol (PEN)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	154	0.25
Nominal GDP at PPP	277	0.37
Export value of goods and services	40	0.21
IMF quotum (in mln SDR)	638	0.29
Economic structure	*2010*	*5-year av.*
Real GDP growth	8.8	6.8
Agriculture (% of GDP)	7	7
Industry (% of GDP)	32	33
Services (% of GDP)	54	52
Standards of living	*USD*	*% world av.*
Nominal GDP per head	5135	52
Nominal GDP per head at PPP	9229	78
Real GDP per head	3745	47

Social and governance indicators	rank / total
Human Development Index (rank)	63 / 169
Ease of doing business (rank)	36 / 183
Economic freedom index (rank)	41 / 179
Corruption perceptions index (rank)	78 / 178
Press freedom index (rank)	109 / 178
Gini index (income distribution)	47.96
Population below $1.25 per day (PPP)	7.7%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	16	US	26
China	14	China	14
Canada	10	Canada	8
Japan	6	Japan	6
Main export products (%)			
Copper			25
Gold			22
Fishmeal			5
Zinc			5
Main import products (%)			
Intermediate goods			49
Capital goods			31
Consumer goods			19
Openness of the economy			
Export value of G&S (% of GDP)			26
Import value of G&S (% of GDP)			23
Inward FDI (% of GDP)			4.8

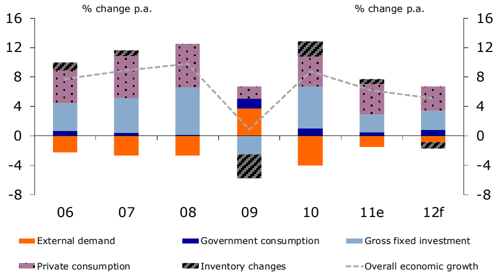
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

With an annual average economic growth of 6.9% between 2007 and 2011, Peru's economy has been booming in recent years. As a result, Peru's GDP per capita is set to almost double from USD 2,840 in 2005 to roughly USD 5,600 in 2011. Growth is likely to slow slightly in the coming years, but will nevertheless remain decent, unless global economic sentiment deteriorates sharply. We expect growth of roughly 5% in the coming years. Investment, in particular investment in the mining and energy sectors, has been an important driver of growth. However, private consumption has also become an increasingly important source of growth in recent years. Consumption has been supported by the increase in employment and income levels, which in turn were driven by strong economic growth.

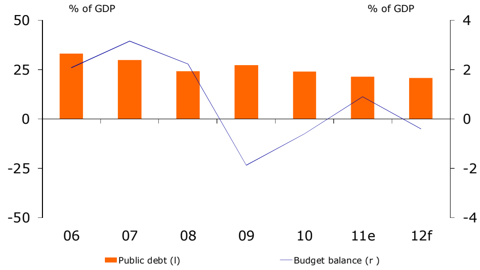
High investment is also welcome from a structural point of view. Like many other Latin American countries, Peru suffered from a low investment rate until recently. However, in recent years the investment rate has gone up from 19% of GDP in the 2004-2007 period to 25% of GDP in the 2008-2011 period. We expect the investment rate to stay at this higher level in the coming years, which will help to improve Peru's structural growth rate. Investments have become broader based in the past years, which is a welcome development, as it will result in some diversification of Peru's commodity export based economy. Nevertheless, most investments will continue to go the mining and energy sectors, with the government expecting some USD 30bn of investments in mining in the coming years. Mining is already Peru's most important export sector, with copper being the most important export product, as it accounted for USD 8.9bn in export revenues in 2010, while gold is another major export commodity, accounting for USD 6.3bn. Other sizeable export products are oil and zinc, while exports of fruits and vegetables have also grown strongly in recent years. According to most business indicators Peru's business environment is relatively good. However, social conflicts do sometimes have a clear negative impact on the business sector. In particular mining and energy projects have been hit by protests from local communities against development on their land. Indeed, the way the country will deal with its political and social challenges will to a large extend determine the future economic development of Peru.

Chart 1: Growth performance



Source: EIU

Chart 2: Public finances



Source: EIU

Political and social situation

On 28 July 2011, a new government led by President Ollanta Humala took power. In the past Humala campaigned on a left-wing nationalist platform. He narrowly lost the 2006 presidential elections, with his alliance with Venezuelan president Hugo Chavez provoking resistance among large parts of Peru's society. Since then, Humala has moved to the center. In particular after his victory in the first round of the 2011 elections he chose to moderate his stance on several policy issues. This, together with voter dislike of his contender Keiko Fujimori, due to her close relationship with the corrupt entourage of her father, a former president who has been convicted for human right abuses, allowed Humala to win the second round of the presidential elections.

So far, Ollanta Humala has indeed followed a moderate and centrist course. He is likely to continue to do so, as his own Gana Perú alliance lacks a majority in congress and therefore rules together with the centrist Perú Posible. The two parties only have a two seat majority, which limits the government's ability to implement reforms to the constitution or the macroeconomic policy framework. Humala's prime minister, Salomon Lerner, has been able to implement pragmatic policies, even as his cabinet team not only consists of orthodox economists, but also of left-wing radicals and people with a military background. So far, Humala has fared well. He has been able to deliver on a number of promises, such as increasing the government income from the mining sector (see also next chapter) and giving local communities a say in decisions on (mining and energy) developments within their region. The government's measures in both areas had a pragmatic nature. For example, although local communities will now have the right to be consulted before developments take place, they will not enjoy veto power. Humala's centrist policies imply that changes will only be implemented gradually, which may make his radical support basis disenchanted. Humala may therefore feel pressure to take a more radical course in the near future, although, as already mentioned, his political room to do so is fairly constrained due to the fact that his party does not have a majority in parliament. Furthermore, corruption remains an issue, as corruption scandals hit the popularity of the former government and have tainted the image of the political class.

Peru's social issues remain. Although the number of poor has decreased in recent years, about 30% of the population still live in poverty. What is more, inequality is also high within Peru and has strong geographical and ethnic characteristics. The ability of the government to improve the welfare of the population is thereby constrained by the low quality of Peru's institutions. Especially at the local level, the capacity of the government to realize social projects is often low. At the same time, thanks to high economic growth and the good fiscal position, Peru's government now has a chance to further improve the welfare of the population with well-targeted interventions. If it succeeds, it could help to diminish the social tensions within Peru's society, which would help to make Peru's growth model more sustainable.

Economic policy

Before his election, many observers feared that a Humala presidency could pose big risks to Peru's investment climate. However, so far, the centrism and pragmatism of the new government has quickly taken away those fears. The mining policy of the new government is an important example of the moderate nature the new government has so far shown. Before his election, Humala's insistence that he would raise the government's income from the mining sector raised concerns about the investment climate. In August, the new government concluded an agreement with the mining industry. The mining industry agreed to pay higher royalties and to base these royalties on the operating profits of the companies, instead of on their sales. The mining companies have already indicated that Peru will remain a competitive investment destination for them. The new agreement will help to raise the traditionally low income Peru's government receives from the mining sector with approximately USD 1bn a year.

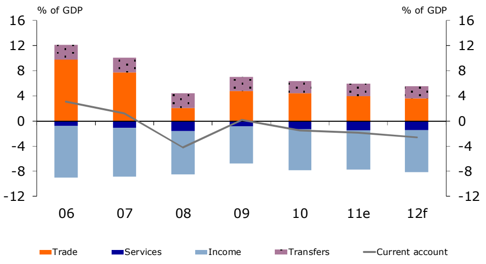
This additional government revenue will help to raise the revenue base of the government. This is welcome, as the income base of the government is small, which limits the ability of the government to increase investment and spending to meet the large infrastructure and social needs. However, from a fiscal point of view Peru also has a number of important strengths. Firstly, public debt is low and expected to decline from further from 24% of GDP in 2010 to 21% of GDP in 2011. Secondly, the fiscal position of the government is also good, with the government expected to have a 0.9% of GDP fiscal surplus in 2011. The government intends to increase public sector wages and increase spending on infrastructure and social policies. However, the government has stressed that it wants to do this while maintaining Peru's prudent fiscal policy stance by matching increased spending with more government revenue. A positive development in this respect is that even Humala's own Nationalist party has approved a bill which strengthens the existing Fiscal Responsibility Law. In response to the weakening of global economic sentiment, the government has announced a 0.5% of GDP stimulus program. In light of the good fiscal position this should not pose great risks.

The new government also has continued Peru's successful monetary policy framework and has reappointed the well-respected central bank president Julio Velarde. Slightly more than two decades ago Peru suffered from hyperinflation, but afterwards the country managed to build an impressive track record in keeping inflation low. The high dollarization rate, which makes large exchange rate fluctuations potentially harmful to the financial sector and its clients, limits the flexibility of both monetary and exchange rate policy. Nevertheless, the central bank has implemented an inflation targeting regime and has formally liberalized the exchange rate. In practice, tough, the central bank intervenes to limit exchange rate volatility. In September year-on-year inflation increased to 3.7%, which means that inflation is now above the 1-3% inflation target. However, it is expected that inflation will fall back within the inflation target range in the medium-term. The central bank has indicated that it intends to leave the policy rate at the existing, mildly accommodative rate of 4.25%. In light of the weakening of global economic sentiment and the expected fall of inflation in the medium term this stance seems understandable.

Balance of Payments

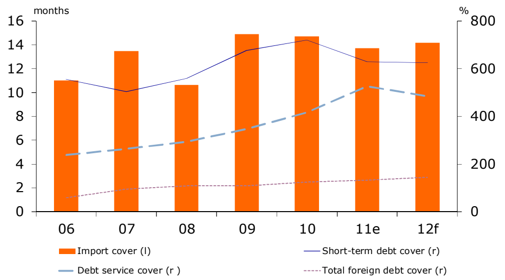
Traditionally Peru has a large surplus on its trade balance, and a large deficit on the income balance of the current account. This pattern is largely the result of the high exports of mining products and the related repatriation of profits by foreign mining companies. Furthermore, remittances from the US and Europe create a surplus on the transfers account. In 2010 Peru had a current account deficit of 1.5% of GDP and this deficit is likely to increase somewhat in the coming years, partially due to a strong growth of imports. However, this should not be a cause for alarm, as the country is also expected to continue to attract large FDI inflows. With inward FDI expected to remain above 4% of GDP in the coming years, the current account deficit should be easily covered. Moreover, in the past years Peru has also attracted significant non-FDI capital inflows. As a result, the country has been able to increase its foreign reserves, with the total stock of reserves increasing from USD 32bn to an expected USD50bn in 2011. The most important risk to Peru's balance of payment position is a long period of low commodity prices. Furthermore, a sudden shock to the (mining and energy sector) investment climate might hit the FDI inflows. However, as mentioned, we believe that such a shock is unlikely to happen, as the Humala's party does not have a parliamentary majority and thus has to rely on its centrist coalition partner. Furthermore, the high level of reserves is a strong mitigant of balance of payments risk.

Chart 3: Current account



Source: EIU

Chart 4: External liquidity



Source: EIU

External position

With foreign reserves expected to be equal to 14 months of imports and 525% of the 2011 debt service, Peru's external liquidity is good. The declining but still high level of dollarization of the financial sector, with about 45% of deposits denominated in foreign currency, does result in some risk. However, this risk is mitigated by the relatively small size of the financial sector, with private sector credit accounting for just 25%of GDP. The USD 111bn in external liabilities Peru had in 2010 exceeded the USD 73bn in external assets the country had at that time, which means that Peru had a negative net investment position. However, we think that this should not be a big cause for concern, as about 40% of the external liabilities consist of FDI stock. The government has a positive net creditor position, as its ample foreign reserves (equal to 27% of GDP in 2010) are much larger than its foreign debt stock (equal to roughly 13% of GDP in 2010). This is partially the result of the increase of the share of public debt issued in local currency. Almost half of Peru's public debt has now been issued in domestic currency, up from only 18% in 2006.

Peru

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	7.7	8.9	9.8	0.9	8.8	6.2	5.1
Consumer prices (average % change pa)	2.0	1.8	5.8	2.9	1.5	3.3	3.2
Current account balance (% of GDP)	3.1	1.1	-4.2	0.2	-1.5	-1.9	-2.6
Total foreign exchange reserves (mln USD)	16733	26857	30272	32013	42648	49690	55950
Economic growth							
GDP (% real change pa)	7.7	8.9	9.8	0.9	8.8	6.2	5.1
Gross fixed investment (% real change pa)	20.2	22.6	27.1	-9.2	23.2	8.7	9.2
Private consumption (real % change pa)	6.4	8.3	8.7	2.4	6.0	6.2	5.0
Government consumption (% real change pa)	7.6	4.5	2.1	16.5	10.6	5.1	8.4
Exports of G&S (% real change pa)	0.8	6.9	8.2	-3.2	2.5	6.0	4.2
Imports of G&S (% real change pa)	13.1	21.4	20.1	-18.6	23.8	12.1	7.2
Economic policy							
Budget balance (% of GDP)	2.1	3.2	2.2	-1.9	-0.6	0.9	-0.4
Public debt (% of GDP)	33	30	24	27	24	21	21
Money market interest rate (%)	5.3	5.8	7.3	2.1	3.8	5.0	5.2
M2 growth (% change pa)	12	23	23	3	21	12	11
Consumer prices (average % change pa)	2.0	1.8	5.8	2.9	1.5	3.3	3.2
Exchange rate LCU to USD (average)	3.3	3.1	2.9	3.0	2.8	2.8	2.7
Recorded unemployment (%)	7.5	7.0	8.1	8.9	6.6	7.1	7.7
Balance of payments (mln USD)							
Current account balance	2854	1220	-5318	211	-2315	-3190	-4850
Trade balance	8986	8287	2569	5951	6750	6700	6610
Export value of goods	23830	27882	31018	26962	35565	43200	46590
Import value of goods	14844	19595	28449	21011	28815	36500	39970
Services balance	-737	-1187	-2056	-1144	-2037	-2620	-2660
Income balance	-7580	-8374	-8774	-7484	-10053	-10640	-12440
Transfer balance	2185	2494	2943	2887	3026	3370	3650
Net direct investment flows	3467	5424	6188	5178	7113	6990	7350
Net portfolio investment flows	-1521	2637	1947	-5165	4688	3090	1360
Net debt flows	-569	3494	-1573	2603	5085	2920	1270
Other capital flows (negative is flight)	-967	-2430	2226	-850	-3589	-2650	1040
Change in international reserves	3264	10345	3470	1976	10983	7150	6180
External position (mln USD)							
Total foreign debt	28499	28422	27881	29593	34254	37670	38890
Short-term debt	3011	5333	5419	4730	5928	7910	8950
Total debt service due, incl. short-term debt	7024	10212	10299	9232	10219	9460	11550
Total foreign exchange reserves	16733	26857	30272	32013	42648	49690	55950
International investment position	-25678	-31164	-30245	-32826	-38087	n.a.	n.a.
Total assets	32747	47615	48253	57851	73032	n.a.	n.a.
Total liabilities	58425	78779	78498	90677	111119	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	9.7	7.7	2.0	4.7	4.4	3.9	3.6
Current account balance (% of GDP)	3.1	1.1	-4.2	0.2	-1.5	-1.9	-2.6
Inward FDI (% of GDP)	3.8	5.1	5.5	4.4	4.8	4.2	4.1
Foreign debt (% of GDP)	31	26	22	23	22	22	21
Foreign debt (% of XGSIT)	96	81	71	85	78	71	69
International investment position (% of GDP)	-27.8	-29.1	-23.8	-25.9	-24.8	n.a.	n.a.
Debt service ratio (% of XGSIT)	24	29	26	26	23	18	21
Interest service ratio incl. arrears (% of XGSIT)	6	6	4	4	2	2	2
FX-reserves import cover (months)	11.0	13.5	10.6	14.9	14.7	13.7	14.2
FX-reserves debt service cover (%)	238	263	294	347	417	525	484
Liquidity ratio	150	153	136	165	161	163	161

Source: EIU