

ELMER CUBA

Macroconsult S.A.

PERU

2003: EXTERNAL DEMAND AND INVESTMENT DRIVE GROWTH

In 2003, the Peruvian economy was driven by external demand, with exports growing 5%. Peru's GDP grew 4.1%, less than in 2002 (4.9%) but still one of the most solid performances in Latin America.

Peru's economy has maintained solid fundamentals, although only a small part of its population has been able to enjoy the benefits of economic stability. Except in the unlikely case of an outbreak of political turmoil, Peru's fiscal account is sustainable. The external account is also sustainable and financed. Moreover, inflation rose just 2.3% in 2003.

Private investment grew 5.2%, reaching 15.2% of GDP, an increase from just 14.9% of GDP in 2002, the lowest level since 1993. The government is now expected to auction investment projects worth US\$1.6 billion to the private sector long-term concessions, boosting private investment.

Public investment is still in a downward trend, reaching an historical low of 2.8% of GDP in 2003.

Exports were boosted by a real depreciation of 7.5% in the multilateral exchange rate. The metal and textile sectors led exports to the Andean region. Metal exports rose 2.5% in 2003, mainly due to an increase in gold and copper prices. Meanwhile, non-primary exports, such as textiles and chemicals, rose as they received benefits from the Andean Trade

Promotion and Drug Eradication Agreement, which gave some Peruvian products free access to the US market. Peru's exports to the United States grew 18.6% in 2003.

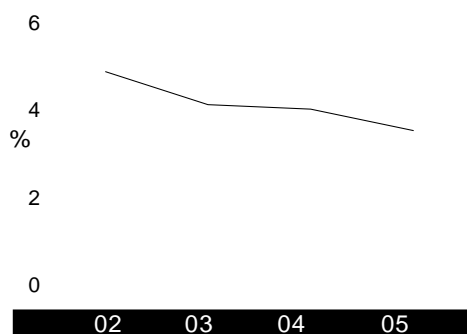
The Central Reserve Bank of Peru faced low inflationary pressures in 2003. Inflation to below the 2.5% target for most of the year.

Monetary policy was stable in 2003 and the sol posted a slight appreciation. The central bank intervened in the currency market several times to avert further appreciation. The central bank's purchases of dollars were sterilised by its sales of certificates of deposits. The currency appreciation was due to an increasing trade surplus balance. The sol should be stable this year and the central bank will continue buying dollars to avoid volatility in the foreign exchange market. Peruvian inflation will reach about 2.9% in 2004.

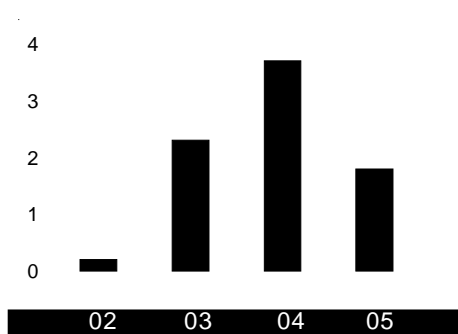
The government managed to achieve its fiscal target of 1.9% of GDP for 2003, compared with 2.3% of GDP in 2002. Some improvements in the tax system led to an 8.2% rise in government current revenues. These resources were enough to offset non-financial and financial public expenditure increases.

Despite further tax reform in 2004, it is very likely that the government will not be able to achieve its fiscal target of 1.5% of GDP. Macroconsult expects that fiscal deficit will be 1.7% of GDP in 2004.

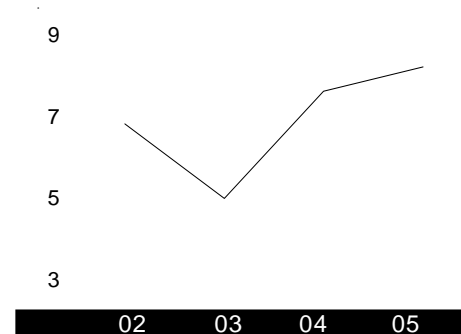
GDP growth



CPI inflation



Export growth



Peru's public debt stands at around 47% of GDP, and the government will have liquidity problems this year. The government will require about US\$3 billion in 2005 to cover a higher public debt service. Privatisations were halted in 2002 and are unlikely to resume, given the current social mood. Peru must therefore rely completely on the international capital market next year. However, this might be difficult if the internal political situation worsens, although that is the least likely scenario.

Peru's current account deficit stood at 1.8% of GDP and was financed with a financial account surplus of 1.5% of GDP, plus net errors and omissions at 1 per cent of GDP. Thus, the inflow of net international reserves was US\$480 million. Reserves reached US\$10.1 billion by the end of 2003, about 3.8 times the amount in the local financial system. Foreign reserves will probably reach US\$11 billion by the end of 2004. This places the central bank in a comfortable position to face any external or monetary shock. Thus, the external sector remains very solid. The current account deficit is expected to decrease this year because of an expected positive trade balance.

ECONOMIC POLICY ISSUES

President Alejandro Toledo has faced sustained political turmoil since he took office in July 2001. A fractured Congress with a strong opposition, high social expectations and the president's own mistakes have produced a very unstable political situation. However, this political instability has not yet affected macroeconomic fundamentals.

Nevertheless, political developments in early 2004 may worsen, as Toledo's popularity has fallen to a record low; the incidence of protests and riots has increased, and people are demanding early presidential elections. This situation may evolve into different scenarios, with diverse political and economic implications.

In the first scenario, the government would remain weak and riots would gain strength. In this case, the economy would face a moderate

outflow of capital and difficulties in financing its budget deficit, while private investment and internal demand would stagnate. This is not a sustainable political situation and would probably evolve into one of the two following scenarios.

In the second scenario, the government would gain support from both Congress and the people, putting a stop to protests. This is our base scenario, and our projections showing solid macroeconomic figures would not be altered. Recent changes of ministers point in this direction, and it is most likely that the economy will follow this path.

The third scenario would be the most difficult but is also the least likely to happen. In this case, President Toledo would be forced to quit and elections would be called for 2005. This would have to be preceded by strong political turmoil and riots. The economy would face large capital outflows, major difficulties in financing the budget deficit and a recession.

The political situation has also affected prospects for further structural reform. At the beginning of the 1990s, Peru implemented a series of reforms aimed at liberalising the economy. Despite the effectiveness of the changes, the reform process came to a halt in 1998 and has not begun again since, even though further reforms are needed.

The Peruvian state remains weak and inefficient, and state reform would represent a very important step towards economic growth. Toledo's government has recognised the importance of state reform but not done much to achieve it. With just two years left in office and an electoral campaign starting next year, the current government is not likely to carry out much reform.

A tax reform is also badly needed: between September 2003 and January 2004, the government decreed a series of new tax laws and measures aimed at raising low central government revenues, which stand at just 13% of GDP. These measures included a tax on banking transactions, which has

been severely criticised. However, the new laws will not be enough, as not much has been done to solve the real problems of the tax system: a low number of taxpayers and a series of tax exemptions.

Peru has been actively seeking a Free Trade Agreement with the United States and the European Union. Prospects for a Free Trade Agreement with the European Union are still unclear, but negotiations with the United States should get under way this year, unless the political situation in Peru worsens. Integration with Latin American countries is also progressing: Peru joined Mercosur as an associate member in 2003. Achieving an FTA with large economies is very important, since external demand will probably be the most important engine for growth next year.

OUTLOOK 2004–05: STRONG FUNDAMENTALS, POLITICAL RISKS

Peru's economy will remain solid, unless the political situation worsens. Another positive important factor will be the world economic recovery. If the recovery proves sustainable, Peruvian exports and capital inflows will grow. Both of these factors should boost Peru's domestic demand and economic growth. We estimate that Peru's GDP will rise 4% in 2004.

External and monetary figures will be the most solid. Even if the political situation gets worse, the central bank will be able to offset any speculative movements against the Peruvian currency or eventual large capital outflows. Although Peru's fiscal deficit will decline in 2003, the expected rise in public debt service payments may pose a risk.