

PERU

2002: DOMESTIC SOURCES DRIVE GROWTH

Domestic demand started to drive growth in 2002 after 4 years of stagnation. As a consequence, Peru's annual GDP growth was the strongest in Latin America. Unemployment, one of the most important problems affecting the Peruvian population, fell. Private investment began to recover in the second half of the year after 7 quarters of successive contractions, even though signals from the political side were not those expected.

In 2003, Peru's economic growth will continue at the current rates. But the political situation may remain the main source of uncertainty due to the poor performance of the official party (Peru Posible) in the regional elections.

On the economic side, concerns about financing of the fiscal deficit and the high public debt burden will remain, highlighting the need for tax and public sector reform.

In 2002, GDP grew 5.3 per cent, the highest rate in 4 years, led not only by the good performance of primary sectors (6.4 per cent) but by the dynamism of the non-primary sectors (4.8 per cent), mainly during the second half of the year. Domestic demand was boosted by expansionary fiscal and monetary policies.

Construction was the most dynamic sector in 2002, propelled by the government Mivivienda program (a housing program) and especially by the Camisea natural gas project, a project which will transport natural gas from the interior of the country to the main

centres of Lima and Callao. It is expected that this solid performance will continue through 2003. Mining grew at almost the same pace as in 2001, reflecting increases in export volumes and notwithstanding the sharp reduction of some export prices, excepting gold.

The fiscal deficit target of 2.3 per cent of GDP, established in the economic agreement signed with the IMF, was achieved in 2002. During that period, expenditures of the non-financial public sector increased slightly (1.9 per cent) but were fortunately fully offset by improvements in tax collecting capacity (current revenues of the non-financial public sector grew 5.1 per cent in 2002).

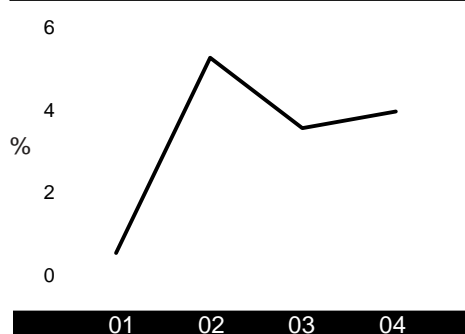
The fiscal deficit is expected to narrow in 2003–04 in accordance with the IMF agreement and targets set in the Multi-annual Economic Framework published by the Ministry of Economy and Finance. Financing needs for 2003 will total US\$2.7 billion. Given that restriction, unless the postponed tax and expenditure rationalisation is carried out, the delay of the privatisation program will most probably force the country to depend on capital markets (both external and internal) to finance its gap. This poses a risk to the country as long as global economic recovery is still uncertain and sentiment in international markets remains volatile.

Inflation reached 1.5 per cent in 2002. Expansionary monetary management by the Central Reserve Bank of Peru (BCRP) induced a sharp reduction in the overnight rate for inter-bank deposits. Furthermore, the recovery of the Nuevo Sol facilitated a decrease in local interest rates.

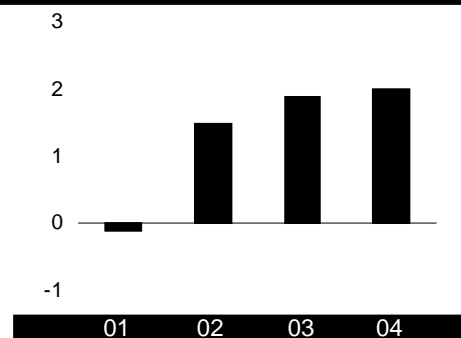
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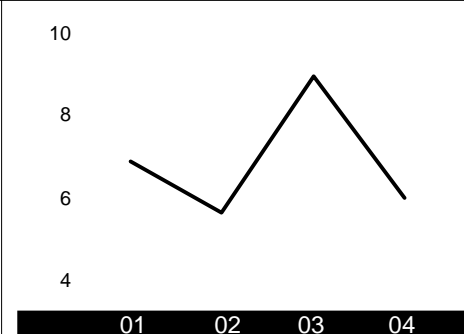
GDP growth



CPI inflation



Export growth



The Nuevo Sol has probably been the most stable Latin American currency during the last year. The end of period nominal devaluation was 2 per cent in 2002. The abundant liquidity in dollars, explained by the growth of net international reserves, played a central role in this result. This behaviour is likely to continue and the end of period nominal appreciation expected for 2003 is 0.1 per cent.

In 2003, we do not expect unusual inflation pressures. We foresee annual inflation of 1.9 per cent in 2003.

External accounts were the main source of economic imbalances in Peru during the late 1990s. Times have changed. In 2002, the current account deficit was equivalent to only 2.0 per cent of GDP, due to the combined effect of a modest growth in imports and an increase in export earnings associated with large mining projects. The level of external financing available has long exceeded the requirements, leading to an important increase in net international reserves. At the end of 2002, net international reserves were US\$9,598 million, equivalent to 1.3 times annual imports and five times the monetary base in Soles.

In 2003, the current account deficit will shorten gently. Imports will be more than double the 2002 growth rate (up from 3.2 per cent to 10.5 per cent) while exports will grow 12.4 per cent, up from the 8.2 per cent registered in 2002. The impact of the US–Andean Trade Promotion and Drug Eradication Act (ATPDEA) on non-traditional exports could be an additional source of expansion, as could the gradual rise projected for commodity prices and the continued investment in mining projects.

But, this behaviour is likely to be moderated by a slowdown in economic growth in the United States.

ECONOMIC POLICY ISSUES

Peru is moving to a higher degree of regionalisation in government, but there are still many problems to be addressed. Probably the most important is the lack of definition regarding the ownership of state enterprises.

Tax reform is another topic of intensive debate in Peru. Although the fiscal deficit financing highlights the necessity of eliminating tax exemptions, both population and politicians seem to be unconvinced. Since there is uncertainty regarding the availability of capital market financing for the fiscal gap, advances in tax reform and avoidance of initiatives with high fiscal costs are important.

The combination of the current fiscal deficit and high public debt payments alongside important social problems in the country have posed dilemmas for the government. If debt is increased to cover the gap, more financial costs are generated, lessening the medium-term fiscal capacity to meet the social problems. This trap, which affects many emerging economies, requires gradual corrective measures in order to avoid episodes of spiralling debt, and these are currently being evaluated.

There is a debate going on among Congress and the private sector about some recently approved amendments to the Constitution with respect to labour rights. Special attention must be given to avoiding negative effects on competitiveness and incentives for investment. Coordination between the Congress and the Executive needs to be

improved to sustain a healthy environment for private sector investment.

The increase in year-on-year inflation (from 1.5 per cent in December 2002 to 3.4 per cent in March 2003) should be treated as temporary and linked primarily to the change in oil prices. The impact on economic growth will also be negligible but will hit the various sectors of the economy differently. Transport will be the sector most affected, mainly because of the supply surplus that prevents the oil increases being passed through to consumer prices.

The negative effects will most probably be reflected in the external accounts, mainly through a decline in the demand for local exports and a slower recovery in the terms of trade. Nonetheless, these negative effects will not be enough to offset the large increase in exports boosted by the trading privileges received from the United States under ATPDEA.

Finally, international relations may also be affected slightly through a change in the bilateral agenda with the United States, which may freeze certain negotiations in which Peru had important interests.

OUTLOOK FOR 2003–04: ONGOING MACRO STABILITY

The Peruvian economy will present a framework of strong macro stability in 2003. Prices will increase 1.9 per cent—inside the Central Bank's inflation targeting band of an annual rate of 2.5 +/- 1 per cent. The current account deficit will remain low and over-financed at 1.9 per cent of GDP. We expect GDP to grow at 3.6 per cent, possibly one of the highest rates in Latin America.

In 2004, economic growth will be 4 per cent, inflation will remain under control at 2.0 per cent, and the fiscal deficit will be reduced further to 1.5 per cent of GDP. Private consumption growth will remain solid at 3.9 per cent and gross private fixed investment will exhibit a 10 per cent increase, driven in particular by the increase in demand associated with export companies.

Composition of GDP growth (per cent)

Growth in Peru continues to be dominated by personal consumption, though the turnaround in the private investment in 2002 has also been important.

