



Diversica Financial Group B.V.



THE RISE A LATIN TIGER

INSIGHT INTO THE PERUVIAN ECONOMY



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INSIDE THIS ISSUE:

Introduction	1
Chapter I	
Economic Growth	2
Commerce	3
Inflation	5
Debt / Fiscal deficit	6
Credit Ratings	7
Currency	7
Chapter II	
Banking	8
Capital Market	9
Investments	10
Politics	11
PPP's	12
Economic Policy	13
Taxes	13
Social Factors	14
Risks	15
Conclusion	16

INTRODUCTION

At present the world economy is growing despite the fallout of the US credit crisis. Economic growth in developing countries has shown to be resilient from US financial stresses. There is a recent economic power shift that developing countries are enjoying, outperforming the developed world in GDP growth. Emerging market countries consume over half of the world's energy, account for four fifth of the growth in oil demand in the past five years and possess 75% of global foreign exchange reserves¹. China and India are major players contributing to global economic strength. Many countries benefit from the Chinese thirst for natural resources, in particular Peru. Thanks to the surge in demand, Peruvian mining industry has prompt economic growth in the Andean nation. As a result other sectors of the economy are now benefiting too.

These figures are significant considering the fact that the informal economy in many developing countries out weighs the formal economy. The informal economy is not a synonym to black market, but refers to the part which is not regulated by the government. There are many cases in which the formal and the informal cross boundaries; such is the case as informal employment for formal enterprises. Due to its diversity the informal economy is difficult to define precisely. Its activities range from children mowing the neighbor's lawn to people in developing countries selling food on the street or providing some sort of public transportation. It is estimated that in 2005, the Peruvian informal economy was approximately 48%, of which 38% of GDP or 60% of labor working hours.² Given its complexity we will focus on the formal economy of Peru.

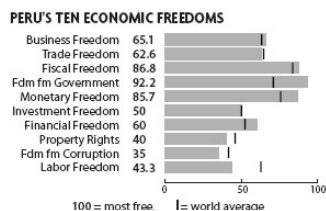
In the last five years the Peruvian economy (we will assume formal economy) has been growing on average by 5.7%. Peru is the fifth most populous and third largest country in Latin America. Their main exports include minerals, hydrocarbons, textiles, and clothing. Peru leads other Latin American countries in economic growth, production of gold, zinc, tin, and lead and is second in copper production, after Chile. Peru is a leading producer of fish meal, fish oil, silver, and exporter of asparagus, dry paprika, and future net hydrocarbon exporter.

According to the Index for Economic Freedom, Peru's economy is "62.1%" free, which makes it the world's 63rd freest economy. Peru is ranked 15th out of 29 countries in the Americas, and its overall score is equal to the regional average. In comparison to the United States which ranks 4 in the world and 1 out of the 29 in the Americas.³

Peru surpasses the global average in business, fiscal, monetary, financial and government freedom and equals to the global average in investment and trade freedom. (See Fig. 1&2) There are certain issues such as labour market freedom, property rights, and corruption that require attention. The current government administration is establishing programs to deal with improving corporate governance, transparency and accountability. For example, an anti-corruption body was recently created to investigate corruption. The World Economic Forum's 'Global Competitive Indices' ranks Peru 74 out of 125 countries and 12 out of the 20 regional countries. The World Bank's 'Doing Business' ranks Peru 58 out of 178 countries and 7 out of 31 regional countries. According to these competitive indices, Peru stands at a relatively stable position, with few aspects for improvements in institutional quality and stability, public infrastructure, secondary education and work training. In this document we highlight the currently improving Peruvian economy in which we believe that domestic growth and an enormous leap in welfare can be made.

Fig.1 Economic Freedom

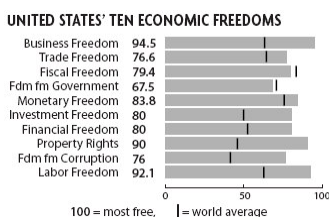
Peru



Source: Index for Economic Freedom, 2007

Fig.2 Economic Freedom

U.S.A.



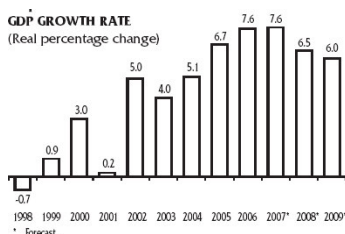
Source: Index for Economic Freedom, 2007

CHAPTER I

ECONOMIC GROWTH

According to Reuters, as of August 2006 to August 2007, the Peruvian economy grew 6.5%. The INEI (National Institute of Statistics and Information of Peru) put GDP growth at 8.4% in the third quarter, compared with 7.6% the previous quarter.⁴ One main economic driver was the construction sector which grew 14.7% just in the month of August. Furthermore, construction grew 15.7% yoy in August and 15.2% since January. Mining and fishing are usual constant growth sectors representing large trade volumes. The fishing industry was hit the hardest from the earthquake in August where growth was -5.6% yoy while in August growth was 1.9%. Mining grew 2.4% in August and 2.5% yoy August. Other industries, such as manufacturing, commerce and electricity have seen yoy strong growth at 9.4%, 9.8%, and 8.7% respectively.⁵ The Central Reserve Bank of Peru raised its economic growth forecast from 7.2% to 7.6% for the year. (See Table 1)

Fig.3 GDP Growth Rate



Source: Central Reserve Bank of Peru, September 2007

Table 1. Peru GDP Growth by Sector (in percentage)

	2004	2006	August	Jan.- Aug.	Yoy August
Agriculture	0.2	7.17	-4.16	1.41	3.3
Fishing	30.7	2.74	-5.60	3.21	1.89
Mining/ hydrocarbons	5.3	0.97	3.45	.67	2.47
Manufacturing	7.7	6.61	6.71	9.60	9.46
Electricity & Water	4.5	6.89	7.66	9.15	8.69
Construction	4.7	14.74	14.74	15.76	15.16
Commerce	5.8	12.11	8.42	8.92	9.86
Other services	4.4	8.25	8.06	8.48	8.21

Source: Central Reserve Bank of Peru and INEI, September 2007

Table 1. illustrates the diversity of the Peruvian economy which suggest that the Peruvian economy is not only reliant to primary sectors. Agriculture and fishing have been influenced by climatic conditions. The mining industry has been affected by several social disputes causing lower production and in certain areas closing of mines.

Today's growth potential is expected to continue in to 2008. In particular, manufacturing will continue to grow, in the company of the US Senate recently approving the Free Trade Agreement with Peru. In addition, construction is expected to continue on a similar growth pattern as seen in the last two years.

Fig.4. Macroeconomic Framework, 2006-2008

	Country Report 07/04	Prel.	Prog.	Staff Projection	
	2006	2007	2007	2007	2008
(Annual percentage change)					
Real GDP growth	6.5	8.0	5.5	7.0	6.0
Inflation (end-year)	1.6	1.1	2.5	2.0	2.0
(In percent of GDP)					
External current account balance	1.3	2.6	0.2	0.9	0.5
Public sector balance (excluding CRPAOs)	1.0	2.2	-0.8	0.0	-0.5
Public sector balance (including CRPAOs)	0.9	2.1	-1.2	-0.3	-0.9
Total public debt (including CRPAOs)	32.0	32.8	31.2	30.0	28.8
Gross official reserve coverage of:					
Short-term debt (residual maturity)	350	357	337	413	458

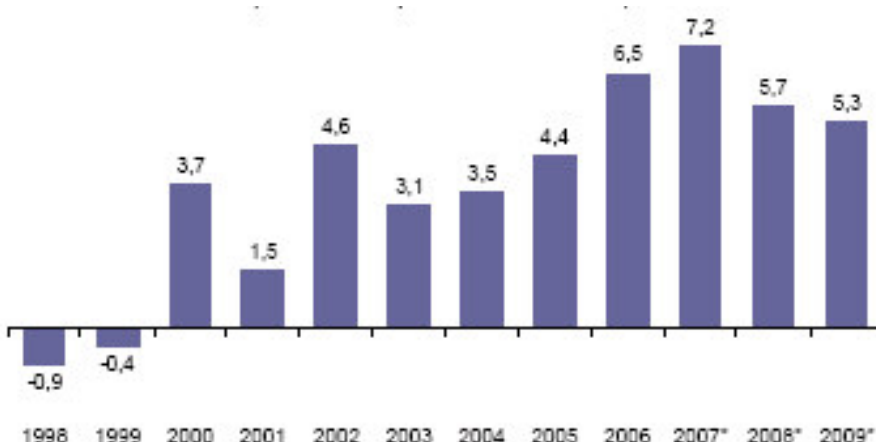
Source: IMF Staff and Peruvian Authorities, 2007



According to the IMF, the Peruvian economy is expected to continue to grow, outpacing inflation. Furthermore, the current account balance remains positive.⁶

The growing economy has had a positive effect on the working man. Recently, the employment rate in companies with more than 10 employees, rose dramatically (8.4% in August). This is significant compared to figures from 2004, 2005 and 2006 where employment growth was 2.7%, 4.5% and 7.3% respectively.⁷ (See Fig. 4)

Fig.5. Growth rate of private consumption (% change)



Source: Central Reserve Bank of Peru, September 2007

Likewise, economic growth is strong as domestic demand rose and is expected to increase by 7.2% in 2008. For example, household consumption, i.e. private consumption grew by 7.6% in the first half of 2007.⁸ (see Fig. 5) Typically, cars sales rose twofold in the first half of 2007 relative to 2005.(see Fig. 7)

Also, consumer credit has grown on average 35% where the lower middle class is the main contributor. Moreover, there has been an increase in credit card use by 37% from September 2006 to September 2007. The main use of credit cards was for personal consumption (\$1,694 million), followed by micro businesses (\$295 million), and the commercial sector (\$344 million) at the end of September compared to 2006, \$408 million, \$130 million and \$3 million respectively.⁹ These indicators show that the internal economy is growing rapidly and is not solely dependent on foreign demand.

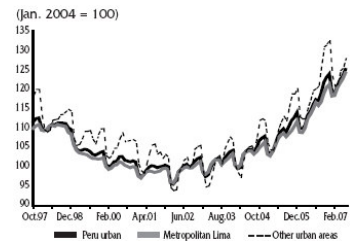
COMMERCE

The Peruvian economy has become a productive exporting country, especially with the recent boom in metal and mineral prices. The main exports include gold, copper, fishmeal, petroleum, zinc, textiles, apparel, asparagus and coffee. Imports include machinery, vehicles, processed food, petroleum and steel.

In 2006, Peru registered a trade surplus of \$8.8 billion and the Central Bank forecasts a \$8.5 billion surplus for 2007. Exports reached \$23.7 billion, partially as a result of high mineral prices which surged due to Chinese demand. According to Credit Suisse estimates, the Peruvian current account surplus is to reach 2.1% of GDP in 2007.¹⁰ The Central Bank of Peru estimates that exports will continue to surpass imports, creating a trade surplus. (see Fig. 8)

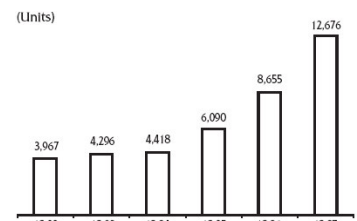
However, the Central Bank also projects that the current account in terms of percentage to GDP will be less favourable in 2008 and 2009 and forecasts a decreasing trade balance in the next two years. (See Fig. 8)

Fig.6 Urban Employment in Companies with over 10 workers



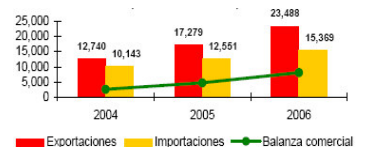
Source: Central Reserve Bank of Peru, September 2007

Fig.7 Family Vehicles Sales in the First Semester



Source: Central Reserve Bank of Peru, September 2007

Fig.8 Evolution of Peruvian Commercial Balance (in \$ millions)



Source: SUNAT and COMEXPERU, 2007

Table 2. Peruvian Export by Sector (in \$ millions)

Sector	Amount	% 06/05
Primary	18,215	40%
Mining	14,501	28%
Fishing	1,334	2%
Oil and Derivatives	1,812	14%
Agriculture	569	74%
Manufacturing	5,572	23%
Farming	1,214	20%
Textile	1,471	15%
Fishing	400	33%
Chemicals	595	12%
Metallurgical	163	-15%
Iron and steel	714	86%
Non metallic mining	135	14%
Crafts	1	12%
Wood and Paper	332	27%
Furs and Leather	38	30%
Various (jewellery)	170	10%
Total	23,488	36%

Source: Central Bank of Peru, 2007

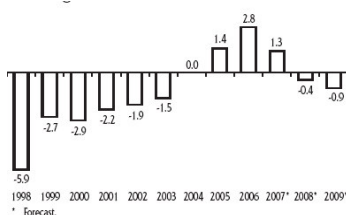
Exports have been growing at an annual rate of approximately 28% in the last five years, increasing from \$7 billion in 2001 to \$24 billion in 2006. Exports benefit from the rise in certain metal prices, in which the mining sector in 2006 represented about 60% of exports similar to 56% or about \$10 billion in 2005. In other traditional export sectors, agricultural exports increased in 2006 substantially by 74% with coffee increasing 68%, representing 90% and sugar increasing 238%. Traditional export sector, fishing, alone grew 2%; however it contributes substantially, like the mining sector, in US dollars terms.¹¹ Table 2 presents primary export sectors (mining, fishing, oil/derivatives and agriculture) and the secondary exports, such as manufacturing sectors.

Peruvian companies have benefited heavily from the increase in demand for export goods. During 2001-2007 the number of companies exporting non-traditional goods increased by 53%, while the number of companies that exported goods worth over \$5 million increased from 90 in 2001 to 208 companies in 2007.

Peru's major trading partners are the U.S., China, EU, Chile and Japan. In 2006, 23% of exports were delivered to the U.S. with value of \$5.9 billion (while 16% of imports came from the U.S. \$2.9 billion).¹² As of September 2007, US, China, Switzerland Japan and Chile are the main destination for Peruvian exports. The slow down of the US economy has impacted Peruvian exports to the US; however the recent free trade agreement passed by the US Senate, exports to the US are estimated to increase. In addition, exports to Asian countries are rising and are expected in the following years, especially to China, to surpass the US as the main export destination. (See Table 3)

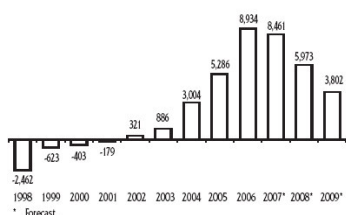
Total exports are estimated to reach \$28 billion for 2007. The Central Bank's export forecasts indicate a growth by 3.7% in 2008 and 2.0% in 2009. This growth is mainly

Fig.9 Current Account (% of GDP)



Source: Central Reserve Bank of Peru, September 2007

Fig.10 Trade Balance (million of \$)



Source: Central Reserve Bank of Peru, September 2007

due to the non-traditional sectors, which are expected to increase by 15% to 13% in 2008 and 2009 respectively.¹³ Further estimates of exports show that traditional export sectors will have no significant variation in 2008 and 2009, mainly as a result in the possible decreasing prices in zinc, copper and fishmeal in the years to come.

Table 3. Principal 10 Destination for Peruvian Exports (in \$ millions)

Country	Jan.- Sept. 2006	Jan.-Sept. 2007	% change Jan.-Sept. '07-06	% change Jan.-Sept. '07
United States	4,206	3,673.7	-12.7%	18.5%
China	1,591	2,373.4	49.2%	12.0%
Switzerland	1,238	1,692.9	36.7%	8.5%
Japan	824	1,575.8	91.2%	7.9%
Chile	1,048	1,209.2	15.3%	6.1%
Canada	1,215	1,197.3	-1.5%	6.0%
Spain	507	727.8	43.5%	3.7%
South Korea	423	723.9	71.0%	3.7%
Brazil	670	704.3	23.5%	3.6%
Italy	507	629.3	24.1%	3.2%
Subtotal	12,131	14,507.5	19.6%	73.2%
Other s	4,823	5,317.6	10.3%	26.8%
Total countries	16,954	19,825.1	16.9%	100%

Source: Gestion, October, 2007

Imports into Peru rose, showing a healthy demand and a vibrant economy. At the first half of the year imports increased by 22% and are estimated to increase to 27% by the end of the year. Imports of goods grew at an annual average of 22% between 2003 and 2006. A positive sign for the development for the local economy is the fact that the purchase of capital goods increased by 40% in the first half of 2007. The import figures show how private businesses are rising their capital stock and look for improvements in production.

INFLATION

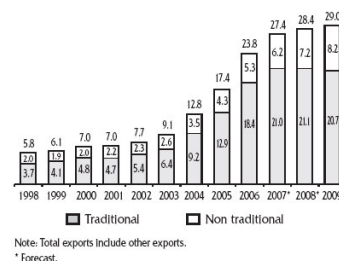
History has shown that in developing countries the federal government easily interferes with the central bank's policy. Often this had led to spiralling inflation and a collapse of the domestic economy.

The Peruvian Constitution states that the Central Reserve Bank of Peru is a public autonomous entity whose role is to preserve monetary stability and with respect to that the Central Bank has built a decent track record over the last 15 years. Politicians have refrained from interfering in the Central Bank's policies allowing it to have full autonomy.

To illustrate Peru's low inflation rate, yoy in August it stood at a mere 2.2%¹⁴. Julio Velarde, Peru's Central Reserve Bank President, stated that inflation was mainly caused by the increase in food prices, in particular grains, and oil prices which can be seen as a global phenomenon.

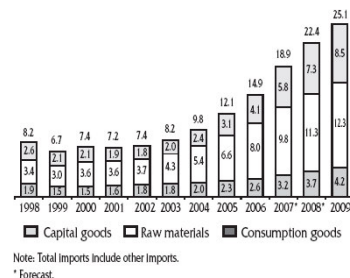
The Central Banker also stated, that excluding food from the consumer price index, inflation in the last 12 months is estimated to be a mere 1.36%. The Central Bank thus, targets inflation 2% for 2007, which the IMF has agreed to use in their forecast. (See Fig. 13)

Fig. 11 Export Goods (\$ billion)



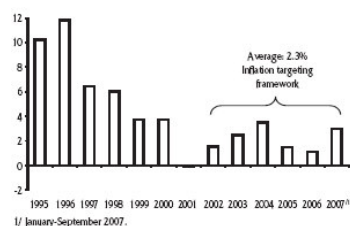
Note: Total exports include other exports.
* Forecast.
Source: Central Reserve Bank of Peru, September 2007

Fig. 12 Imports Goods (\$ billions)



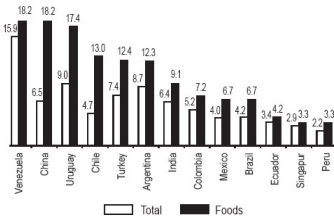
Note: Total imports include other imports.
* Forecast.
Source: Central Reserve Bank of Peru, September 2007

Fig. 14 Inflation (% change)



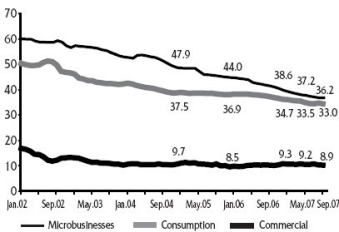
Source: Central Reserve Bank of Peru, September 2007

Fig. 15 Total Inflation and Food & Beverage (Aug. 12month % change)



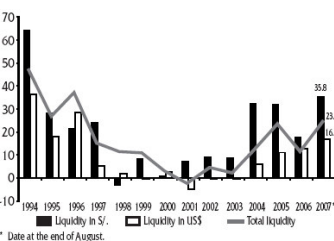
Source: Central Reserve Bank of Peru, September 2007

Fig. 16 Interest Rate on Commercial Micro businesses and Consumer Loans in Peru Nuevo Sol (in %)



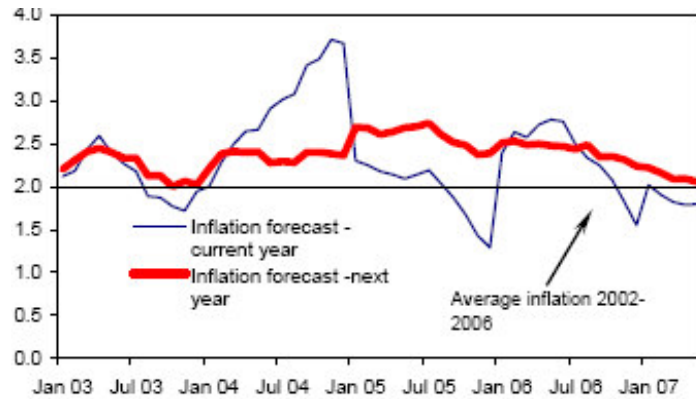
Source: Central Reserve Bank of Peru, September 2007

Fig. 17 Liquidity in the Private Sector (%change in last 12 months)



Source: Central Reserve Bank of Peru, September 2007

Fig. 13. Market Consensus Forecast—current and next year inflation rates



Source: IMF, July, 2007

Importantly, rigid monetary policy will continue to maintain inflation expectations targeted at 2.0%. Currently, the interbank interest rate is at 5.0% and it is expected to rise by 50 basis points to 5.5% in early 2009, which keeps inflationary pressures in check.¹⁵

Given a stable monetary situation interests rates to commercial micro businesses and consumer loans, dominated in local currency, have been steadily decreasing whereas spreads have tightened. (see Fig. 16) This suggests that Peruvian businesses may now benefit from lower cost of capital which spurs overall investments.

DEBT & FISCAL DEFICIT

Table 4 shows how Peru’s external debt position has improved dramatically over the past three years. Figure 19 shows the debt burden in percentage terms relative to GDP.

Approximately 80% of total external debt is public and thus at government responsibility. The government of Peru intends to continue to pursue an active debt management in order to deepen the domestic capital market. It will continue to increase the share and duration of local currency instruments, to reduce exchange rate risks and to extend the yield curve.¹⁶ In July 2007 for the first time the Peruvian Government issued a 30 –year bond at a fixed rate, with a yield of 6.90%.¹⁷

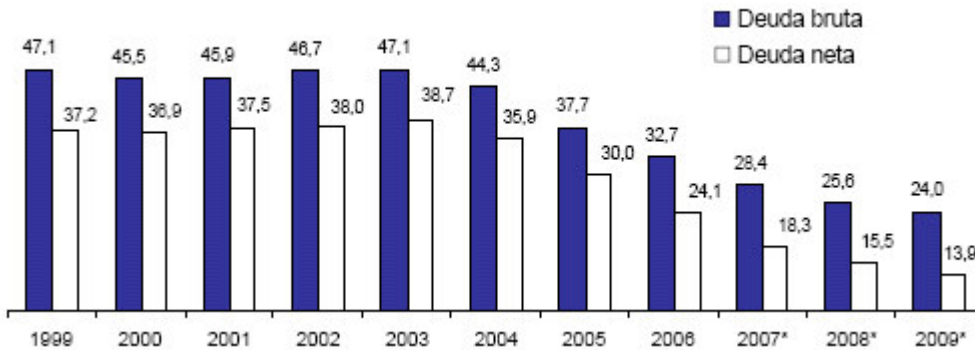
Table 4. External Debt

	2004	2005	2006	1Q2007	2Q2007
Public & Private	44.8	36.1	30.4	29.0	29.7
Public medium & long term	35.1	28.0	23.6	22.3	21.3

Source: Central Reserve Bank of Peru, September 2007

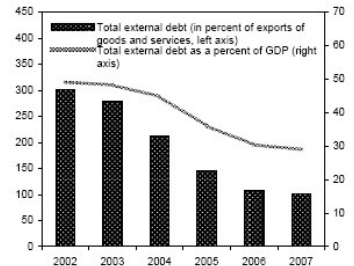
Figure 18 (next page) shows how public debt, net and gross, are decreasing since 1999. This is a clear indication on the effectiveness of government policies managing debt and the sources of government revenues. In all, prudent government finance creates an environment where the private sector has access to a more “stable” credit market where ad hoc government interference is minimal¹⁸. As a positive side effect this stability is shown in a yield curve that has slight changed since 2006. (See Fig. 20)

Fig.18. Public Debt



Source: Central Reserve Bank Of Peru, September, 2007

Fig. 19 External Debt



Source: IMF, 2007

CREDIT RATING

We expect that sovereign debt in Peru will be upgraded in the coming years. This is due to effective fiscal policies where the government prudently manages its debt burden as well as a continuing strong economic growth ensuring sufficient tax revenues. At the moment, Standard & Poor's or Fitch grade Peru one notch below investment grade compared to Moody's two notch below investment grade.

Table 5. Credit Classification in Long-term Sovereign Debt

	S&P	Fitch	Moody's
Chile	A	A	A
Mexico	BBB	BBB	BaaT
Brazil	BB+	BB+	Ba2
Peru	BB+	BB+	Ba2

Source: Ministry of Economics and Finance (MEF), 2007

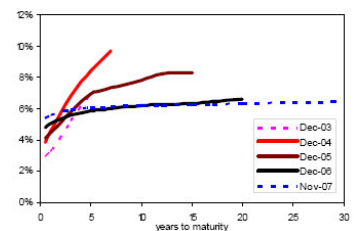
CURRENCY—PERUVIAN NUEVO SOL

The Peruvian Nuevo Sol has been appreciating to the US dollar in the last three years. This year, the Nuevo Sol has appreciated an additional 2.9% to the dollar in October, making it 6.2% stronger year to date.¹⁹

The currency has been strengthening to the dollar for two reasons. Firstly, the US dollar has been weak due to a collapsing US credit market and secondly, Central Bank policies of de-dollarization, a result of strong economic growth and rising interest rates. The macroeconomic performance entailing a trade surplus and low inflation, has enabled Peru to attract foreign investments which further supports the value of the Nuevo Sol. We expect that this trend will likely to continue.

Finally, the Central Bank will limit its intervention in the foreign exchange market to avoid excessive volatility and to build international reserves, thus helping economic agents to better diversify foreign exchange risks.

Fig. 20 Yield Curve of Local Currency Sovereign Bonds

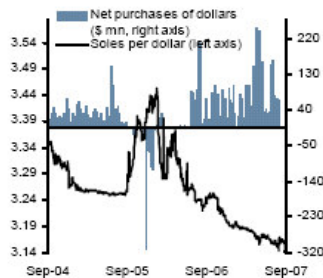


Source: IMF, 2007

CHAPTER II

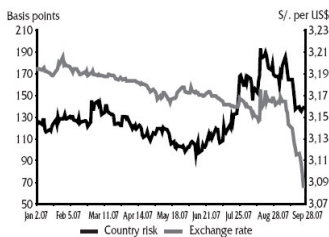
Peru is awakened as an industrialized economy and has the potential to become a rising Tiger. However, there are certain conditions that still need to be improved in particular in the banking sector and the capital market system. Furthermore, investments, economic policies and a range of social factors also need to be reassessed. The potential is eminent, although some risks could hinder the rise. This chapter will describe these elements.

Fig. 21 Exchange Rate \$ Central Bank FX Intervention



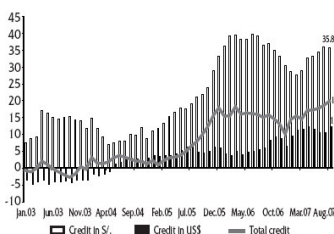
Source: Central Reserve Bank of Peru and Credit Suisse, 2007

Fig. 22 Share of Credit and Deposits in Foreign Currency



Source: Central Reserve Bank of Peru, 2007

Fig. 23 Financial System Loans to the Private Sector (% change last 12 month – Aug.)



Source: Central Reserve Bank of Peru, September 2007

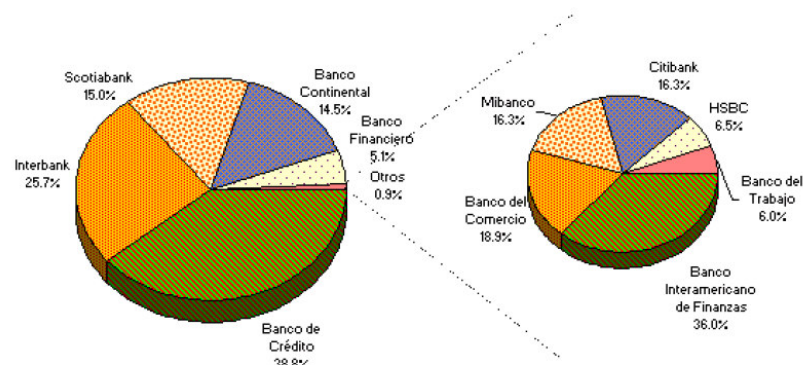
BANKING

There are five major private banks operating in Peru, in which the largest being locally owned Banco de Credito del Peru (BCP). (see Fig. 24) Other banks include: BBVA Banco Continental, Banco Interamericano (Interbank), Scotia Bank, Citibank, HSBC and Banco Financiero. The holding company for the BCP, CrediCorp, has 7.7% share in the Lima Stock Exchange followed by the BBVA Banco with 3.25% share and Scotia Bank with 3.01% share.²⁰ The HSBC claims that the private sector borrowing in the country represents just 19% of GDP, compared with 163 % in the UK.²¹

In order to facilitate business needs for credit a broad based banking system is needed. Today in Peru, it is clear that modern banks have entered the market. These banks take an important place in the development of the capital market of Peru by structuring financial market products fitting the needs of Peruvian business and savers. As in any industrializing nation endogenous growth can only be the result of efficient risk transfer between savers and investors. This improvement is taking hold in Peru today at a rapid pace and also perhaps more important local banks with local information benefit from their experiences demonstrating how local banks still dominate the banking system in Peru.

Last year, confidence in the national currency was positive continuing the de-dollarization for the economy; however the mortgage system has to be more involved in the de-dollarization process for this operation to continue. The government through its housing programs intend to have mortgage loans to be dominated in Nuevo Soles. These programs include MiVivienda, Mi Hogar and Techo Propio, that assist low income families to purchase homes at low rates. At the moment 83% of mortgages are dominated in US dollars, this is less that last year's 96% and thus banks are less vulnerable to dollars declines.

Fig.24 Participation in % of Interbank Operations



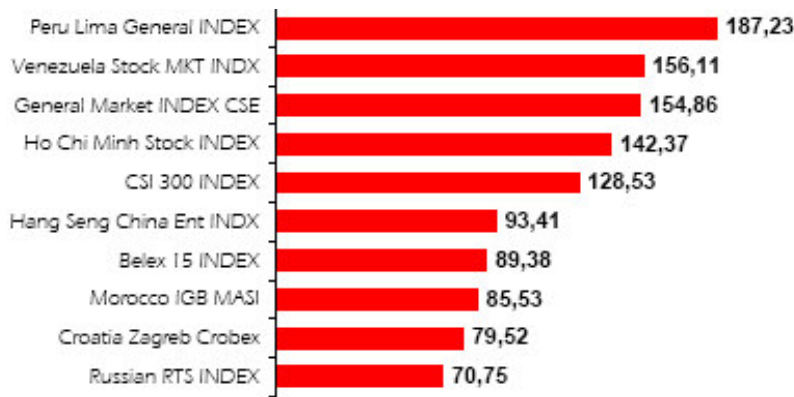
Source: IMF, 2007

CAPITAL MARKET

The Lima stock exchange has been the most profitable in all Latin America last year. Figure 25 shows the some top developing world indices in relation to the Lima General stock index.

The Lima Stock Exchange (IGBVL) comprises 33 companies, whereby one company, Southern Copper (PCU/C PE), dominates the entire index by 45%. The following three companies that participate in the index are Sociedad Minera Cerro Verde S.A (SMCV PE) with 12.4%, Cia. Minería Buenaventura SA. (BVN PE) with 8.3%, and Credicorp (BAP PE) with 7.7%.²³ Figure 26 shows how the Lima Stock Index has substantially increased in value in the last year .

Fig.25 Selected Global Indexes in 2006



Source: Proinversion, 2007

The Lima Index is still young, however with room for further growth. IPO's are not very common in Peru, especially not for local companies, which are mostly family owned businesses. To accept non family members in boards or adapt to corporate governance schemes takes time. These company cultural trends are beginning to change. Many companies are witnessing the benefits of a capital market, in attracting capital.

Fig.26 Lima Stock Index

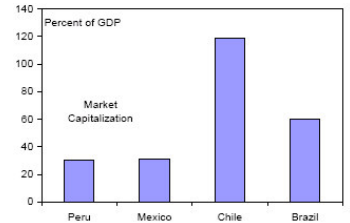


Source: Bloomberg, 2007

The performance of the index is appealing, but represents a very small percentage of GDP. In retrospect profits from the firms listed on the stock exchange alone grew by S/.698 million (\$323.6million), a 19.3% increase between the second quarter of 2006 and 2007.²⁴ Figure 27 shows how the Peruvian Index compares to neighbouring countries. Figure 28, clearly demonstrates how the stock market index and P/E Ratios have, in the last three years, grown.

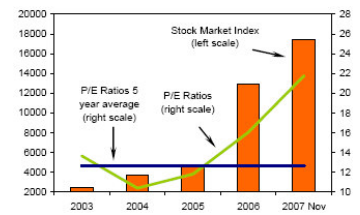
However the situation is changing, IPOs are not anymore dominated by AFP (pension funds administrators – see Figure 29), but a mix of Mutual Funds, (36.9%), AFP (35.2%), public funds (13%) and insurance companies (6.5%) are participating more. The amount

Fig.27 Capital Markets



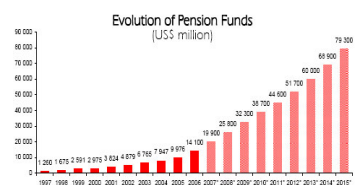
Source: IMF, 2007

Fig.28 Equity Prices



Source: IMF, 2007

Fig.29 Pension Fund



(*) Referential projection: Proinversion

Source: Proinversion & Bank and Insurance Superintendence (SBS), 2007

of participants has increased by 60% in the last year. As of 2006, AFP invested \$14 billion increasing 40% per year. It is estimated that will grow at an annual rate of 15%.²⁵

INVESTMENTS



In the 1990's the Fujimori administration (1990-2001) privatized many state owned industries, initiating a flow of foreign investments along with exports, the Peruvian economy began to grow. During Toledo's administration (2001-2006) government expenditure decreased due to a policy to lower public spending. Confidence rose after the insecurities of Toledo's presidency subsided, and public and private investment began to flow in his last years of office. In the last three years, private investments increased dramatically continuing economic growth in many sectors of the economy. Figure 30 demonstrates how important private investments are in Peru in the last three years, compared to other sources of investments.

Private investments, since 2006, have grown at the rate around 20% annually topping at 22% in the first half of 2007. It is worth highlighting that private investments increased 24.3% in the 3Q alone.²⁶ Many large projects in Peru have been carried out by private investment. In the coming three years investments will be implemented in mining, energy and hydrocarbons, telecommunications and service sectors. Three main mining projects will include an investment of \$3.8 billion and three main hydrocarbon projects will require investments of \$4.6 billion. In addition many other sectors receive large amounts of private investment.²⁷ Dubai Ports World will extend the port facilities in Callao for an estimated \$617 million and Grupo Romero (owners of the largest bank in Peru), is to invest \$200 million in building a port in Ancon, north of Lima.²⁸

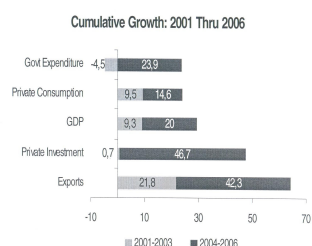
Public investments are estimated to increase by 25% in 2007. The central government has increased investment spending by 5.7% in September. As of January until September public investments grew in real terms 9.5%, passing the accumulative amount of S/.2,488 million (\$827million) from September 2006 to S/.2,758 (\$916 million) in the same month in 2007. The sectors that received the most investments were transport and communications, agriculture, and education.

Table 6. Public Investment from the Central Government by Sector

Sector	2006	2007	Acum. To sept. 2006	Acum. To sept. 2007	% '07/'06 month	% '07/'06 year
Transport & communication	70	95	529	576	32.5%	7.6%
Agriculture	51	32	246	260	-39.7%	4.5%
Education	24	28	233	237	13.8%	.05%
Women & Social dev.	31	6	176	153	-79.8%	-14.1%
Housing const. & Sanitation	27	10	144	125	-65.7%	-14.4%
Employment & its promotion	14	19	121	103	37.4%	15.7%
Energy & Mining	3	11	41	94	304.7%	124.2%
Presidential ministry advice	6	19	54	74	195.8%	35.0%
Health	12	11	74	68	-11.0%	8.9%
Other services	143	183	869	1067	24.2%	21.3%
Total	380	413	2,488	2,758	5.7	9.5

Source: Gestion and SIAF-MEF, 2007

Fig.30 Investment Growth



Source: INEI, 2007

Until recently government expenditures were mainly focused in Lima Metropolitan, now regional government expenditures are increasing accentuating regional economic growth. Regional government expenditures has grown three times as much as to the central government. Regional government investments were S/.921 million (\$306million) 29.9% higher than September 2006.²⁹

Foreign investment is over \$15.4 billion, with the U.S., Spain and the United Kingdom being the principal investors with 64% of the total.³⁰ However, these investments are made from subsidiaries of companies with their headquarters in another country. (For example Spain’s Telefonica invests via its Dutch subsidiary Atento N.V.) Calculating the sources of these investments puts Spain, the US Switzerland and Chile as principal sources of foreign investments, in which Spain and the US representing almost 50%. Foreign direct investment (FDI) is concentrated in telecommunications, mining, manufacturing, finance and electricity.

The main destination for foreign investment is the communications sector followed by mining and industry. Table 7 shows the percentage of foreign investment per sector in 2006.

There is no screening process for foreign investors, and only investments in banking and defense-related industries require prior approval. The recent ethanol hype in the US, has attracted many farmers and investors to transform Peru’s north into a sugar cane production area specifically for ethanol export.

Table 7. Destination of Foreign Investment by Sector

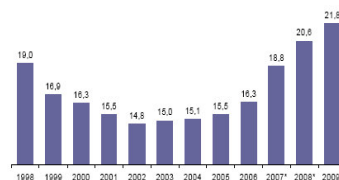
Sector	2006 (\$mil)	% change
Agriculture	45,0	0,29%
Communications	4 863,3	31,64%
Construction	123,9	0,81%
Energy	1 645,3	10,70%
Finance	1 924,7	12,52%
Fishing	150,1	0,98%
Housing	16,7	0,11%
Industry	2 313,5	15,05%
Mining	2 889,0	18,79%
Oil	207,9	1,35%
Services	276,9	1,80%
Transport	248,4	1,62%
Tourism	62,1	0,40%
Trade	604,5	3,93%
Total accumulated	15 372,6	100%

Source: IMF, 2007

POLITICS

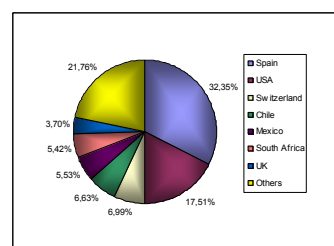
Peru has come along way to reach its current economic status. Its political system has undergone many changes providing economic policies that have fuelled the economy and moreover have created a more politically stable country.

Fig.31 Fixed Private Investment 1998-2009 (% GDP)



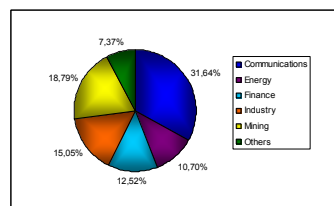
Source: Central Reserve Bank of Peru, September 2007

Fig.32 Foreign Investments



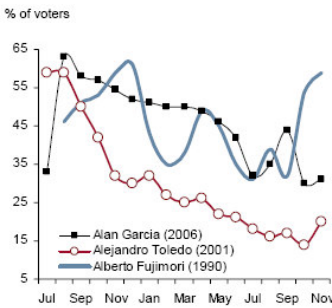
Source: Gestion, October, 2007 (DFG design)

Fig.33 Destination of Foreign Investments by Economic Sector



Source: Gestion, October, 2007 (DFG design)

Fig.34 Presidential Approval



Source: Apoyo & Credit Suisse, 2007

Politics in Peru, like most part of Latin America has a history of democratic instability, dictatorships and corruption. Since the last leftist military dictator Juan Velasco in 1980, Peru has had democratically elected governments. During the leftist dictator two Marxists guerrilla movements were born and terrorized the country for the next 25 years, in which more than 70,000 people died. Under democratically elected presidents, Terry Belaunde (1980-1985) and Alan Garcia (1985-1990), these two groups were not defeated and only grew influence. Not until the latter did the political, economical and social situation deteriorate completely. Garcia left Peru with hyperinflation at 7,640% in 1990, a negative \$900 million reserve.³¹

During Alberto Fujimori's (1990–2001) first term as president the guerrilla movements ended, a new currency was introduced and negotiation with the IMF and World Bank commenced. Fujimori introduced his economic 'shock' policy to kick start the economy, by means of privatizing many state run enterprises. Fujimori's administration has been defined as authoritarian and with some corruption charges, however, his policies helped Peru recover. Fujimori resigned in 2001 from the presidency after his third term election win in 2000 was beset by irregularities. New elections in 2001 brought in Alejandro Toledo (2001-2006) who continued much of Fujimori's economic policies. Toledo's presidency was marked with being very unpopular due to his new party's lack of a tract record and being the first president of Andean Indian descent. However, Toledo's macro economic and political policies finally began to take affect at the end of his term. In the 2006 elections and after the second election rounds, Alan Garcia won the presidency again, but this time with people very wary about his policies, ambitions and values. Garcia has no intention of changing macroeconomic policies, but is committed to continue economic growth and decrease poverty levels.

Alan Garcia recent approval ratings as president stand at 30% compared to 57% last year October, which is however 20% better than the previous president's approval ratings.³² Most of disapproval is related to the increase in food prices, especially bread, chicken, milk and other wheat related foods and oil. In August, as seen in Figure 34, Garcia's popularity is comparable to that of Alberto Fujimori's first year in term. A large portion of the population has not forgotten Garcia's presidency in 1985-1990. Taking this into account, Garcia is very much aware of his past errors and to present has continued his predecessor's economic policies and to expand foreign investments and free trade.

Total government expenditures in Peru, including consumption and transfer payments, are low. In the most recent years, government spending equalled 17% of GDP, and the government received 3.5% of its revenues from state-owned enterprises and government property. Much of the progress made in privatization has been in the infrastructural sector.

According to the Index for Economic Freedom the government of Peru has a 92.2% freedom of government.

PUBLIC– PRIVATE PARTNERSHIP

In order to have broad based economic growth, it is necessary to improve national infrastructure. To overcome existing deficiencies in public infrastructure, the government is promoting the use of Public-Private Partnerships. Private-Public Partnerships are financial constructions that facilitate infrastructural projects at low costs. During 2007, the government plans to initiate PPP operations for a total amount of US\$3 billion, with large projects in the areas of ports, highways, and sanitation.³³



ECONOMIC POLICY

Peru belongs to the economic trade bloc called the Andean Community, as well as the Asia-Pacific Economic Cooperation (APEC) forum, which will host the 2008 meeting, and the World Trade Organization (WTO). Peru has many trade agreements and seeks to expand further trade deals. The Free Trade Agreement (FTA) with the United States was approved by the House of Congress in October 2007 and as recently been approved by the US Senate. Peru has also engaged in other trade agreements recently and is in negotiations regarding:

- An agreement with Singapore which is being finalized with legal revision.
- A negotiation, reinitiated with Mexico which is estimated to end April 2008.
- A negotiation with Canada planned to be completed by December 2007.
- Finalizing agreements with EFTA (Norway, Iceland, Switzerland and Liechtenstein) by February 2008.
- Initiated negotiations with China.
- Initiated studies and negotiations with South Korea and the European Union.



Overall economic policy is geared to strengthening Peru's export position. In order to stimulate trade the Garcia administration also cut import duties on 300 products, including wheat and sugar.

Moreover, in July 2007, for the first time the Peruvian Government issued a 30-year bond at a fixed rate, with a yield of 7%.³⁴ In addition, the difference between the rates of sovereign bonds in Nuevo Soles and sovereign bonds in dollars is traded at a spread of 0.4%. This reflects the country's strengthening position internationally.

TAXES

In order for Peru to enable entrepreneurs and businesses to face a competitive and transparent tax system, several steps will be necessary. Today, Congress is in discussion to draft a law that would rationalize fiscal exemptions for companies. There are steps that will be taken to limit the adverse impact on tax collections from the creation of the tax free zone in Puno, a southern province. With the same objective, tax exemptions will be applied to companies operating in the high altitude regions of the country. The Financial Transactions Tax rate will be gradually reduced beginning first quarter 2008.

Peru has moderate income tax rates. Both the top income tax rate and the top corporate tax rate are 30%. Other taxes include a value-added tax, a real estate tax, and a vehicle tax. In the most recent year, tax revenues as a percentage of GDP was 13.3%.³⁵

There is a recent investigation to lower corporate income tax for the companies to reinvest their earnings. The new proposal would be in effect in 2008 where the tax reduction would lead to a tax of 28%, in 2009 to 24% and finally reaching a 20% corporate tax in 2010.³⁶



SOCIAL FACTORS

Peru has a history of social unrest, highlighted in the politics section, however since the end of the guerrilla wars in the mid 1990's there has been social stability. Most confrontations between authorities and citizens are not military strategies like the guerrilla wars. Most recent armed conflicts result from narco-traffickers and mining or hydrocarbon communities. There are occasional strikes or protests in Peru but never with severe fatal consequences. The last large protest was by the teachers union unwilling to be obliged by the State for teaching proficiency exams.



The main political risk that in the last year was perceivable was the presence of the nationalist presidential candidate Ollanta Humala. His popularity was focused among the rural poor, especially in the southern and mid mountainous regions of the country; because his anti-mining, nationalisation and anti-American sentiments. He portrayed the ills of the nation, in particular the rural poor and urban poor to be capitalism and privatization of national resources. However, IPOS Apoyo Opinion y Mercado SA conducted a recent political survey asking the population for whom they would vote for in the 2011 elections and Mr. Humala relieved a 61% of people who would definitely not vote for him compared to 11% who would. The leading candidate is Luis Castañeda, twice elected mayor of Lima has 18% of voters who definitely would vote for him and 37% of most probably vote for him, followed by ex-president Alberto Fujimori's daughter Keiko Fujimori with 11% and 24% respectively.

Table 8 Potential Presidential Candidates for 2011

	<i>Definitely vote for</i>	<i>Most probably vote for</i>	<i>Definitely not vote for</i>
Luis Castañeda	18%	37%	29%
Keiko Fujimori	11%	24%	52%
Ollanta Humala	11%	16%	61%
Loudres Flores	10%	34%	37%

Source: IPOS Apoyo Opinion y Mercado October, 2007



The sustainability of Peru's economic development critically hinges on a prompt and significant reduction in poverty levels. There are several programs that the government is continuing and implementing to abate poverty. It is estimated less than 50% lives under the poverty line. A recent national census was conducted on with the intention of assessing not only the demographics of the nation, but also the economic and social situation of its population. The government intends to develop social programs based on the information from the census.

The government has established already several new programs and is expanding and reforming existing ones. Here is a list of a few programs,

- Fondo para la Igualdad- water program for those without water,
- Peru Crece- malnutrition of children,
- Agua para todos – potable water,
- Techo propio – housing,
- Cofopris'- property titles, and
- Use of the 'Canon Minero' – direct payment to local people instead of than to the local authorities.

In addition to poverty alleviation, the Humala effect can also be explained by employment rate. Only since 2006 did the macro economic policies of Toledo begin to

reach lower levels of the economy, in particular employment rate. Employment has been on the rise, as previously discussed, which is a positive sign at the political risk level. Recently rural economies are beginning to show growth as well, which was not a phenomenon during the election period.

At the end of the day, the Garcia's administration must ensure foreign investors as well as local ones, that the following administration will continue similar economic policies, transparency and accountability.



RISKS

Several risks surround investing in Peru. As mentioned, half of the population lives in poverty which, as last elections showed, can, if properly motivated, sway the course of the political and economic direction of the country. Peru has been fortunate that the last three presidencies have maintained similar economic policies, creating a stable environment for continuing economic growth. Poverty alleviation is an important factor for the present government to consider, especially in the mountainous rural areas, which is known to be easily swayed and keen to express their discontent not only with the government but with many foreign mining companies operating in their areas.³⁷

Social unrest in mining communities is probably the largest risk for Peru, especially since it is such an important sector of the economy. Mining companies have a terrible historic social and environmental track record. It will be difficult not only for Garcia to appease mining companies but as well mining communities. There are numerous of examples in which mining and oil companies have reduced production as a direct result of deteriorating relationships between them and the communities where they operate.

The Peruvian Central Bank continues to de-dollarize its economy, in order to avoid the negative impact of the depreciation of the US dollar. Local companies need to improve their relationships with financial institutions to continue to grow and to invest in the local currency.

The Sunat, the Peruvian state tax authorities, needs to continue to broaden the tax base and to work with local authorities and the banking system to incorporate a large part of the informal economy into its regulations.

At the political level Peru lacks a developed party system, which means any person can present themselves for the presidency. This creates an environment for populous leaders, like that of Humala, to enter the political sphere without specific credentials.

The continuous rise in imported food prices increase inflationary risks. Other inflation risks include the increase of oil prices, although due to de-dollarizing policies, the impact of oil surge prices may be minimal.

There are external factors that can effect the economic stability of Peru. The credit crisis in the US may continue to exacerbate the fall of the US dollar and economic recession in the US would definitely have some adverse affects yet due to the decoupling of the Peruvian market, these effects are minimized.

Changes in climatic conditions in mainland and maritime Peru can have adverse effects on the fishing and agricultural sectors. This has caused some slowdown in fishing output and agricultural output in the upper Andean highlands. Furthermore, earthquakes and natural disasters can have intermediate slow down in certain industries.



CONCLUSION

Fig.36 Peru Business Sentiments

% of firms surveyed that, over the next six months:



Source: Apoyo & Credit Suisse, 2007

Peru is rich in producing minerals, agricultural products, timber, textiles and tourism services. This provides a plethora of investment opportunities in this developing country.

Recently, Peru has benefited from its exports due to a growing world economy where the demand for natural resources and agricultural products has increased exports and the economic activity in country. As a positive effect, this economic stimulus is now spilling over into other sectors of the economy. Besides the exogenous demand for Peruvian products also a domestic improvement in the political system and the capital market system has led to a positive growth environment for businesses.

In recent years, the government has pursued a more sustainable fiscal policy where its debt burden has been reduced. Next to an improved fiscal situation, the Central Bank has been able to pursue an independent role in targeting inflation and managing inflation expectations. Overall monetary and fiscal policies have given freedom to investors and savers alike to engage into business, helping the Peruvian economy.

Peruvian domestic businesses are expanding production and investing in new activities. Clearly, this development is attracting foreign capital, which is willing to invest along with domestic investors. Foreign capital may be stimulated by an improving of the local currency and a maturing capital market.

We believe that at this stage the growth of Peru will continue to broaden throughout various sectors of its diverse economy. Structural risk issues must be assessed and understood in which may impact capital market, the political system, the maintenance of economic policies, and looming social unrest. We believe that researching and understanding these risk issues allow us to participate in rich opportunities accessible to us.

Table 9 Financial country Comparison

	Peru			Chile			Mexico			Brazil		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Real GDP	6.6	7.6	7.5	5.7	4.0	5.8	2.8	4.8	2.9	2.9	3.7	4.7
GDP per capita	2,919	3,386	3,819	7,337	8,864	9,737	7,210	7,801	8,174	4,785.7	5,737.4	7,019.7
CPI inflation	1.5	1.1	2.5	3.7	2.6	5.1	3.3	4.1	3.7	5.7	3.1	3.8
Gen. gov. fiscal bal. % GDP	-0.5	1.8	1.0	4.5	7.7	7.0	-1.4	-0.8	0.0	-3.0	-3.0	-1.9
Exports % GDP	24.7	28.2	28.1	40.5	45.1	47.3	30	31.7	31.3	15.3	14.8	13.8
Imports % GDP	19.1	19.6	20.9	32.0	30.4	31.2	4.2	4.7	4.1	11.1	11.3	11.6
Cur. Acc. Balance (\$bn)	1.1	2.6	2.2	1.3	5.3	10.4	-4.9	-2.4	-14.3	14.2	13.5	9.8
Cur. Acc. Balance % GDP	1.4	2.8	2.1	1.1	3.6	5.0	-0.6	-0.3	-1.6	1.6	1.2	.7
Net FDI	2.5	3.4	3.0	4.8	5.1	7.5	19.6	18.9	20.0	15.1	18.8	33.0
Foreign Debt	28.7	28.3	26.4	44.9	47.6	39.2	128	117	122	169.5	168.9	185

Source: Credit Suisse, Country Report, 2007

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END NOTES

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