

Sovereigns
Peru
Credit Analysis

Republic of Peru

Ratings

Security Class	Current Ratings
Foreign Currency	
Long-Term IDR	BBB-
Short-Term IDR	F3
Local Currency	
Long-Term Local Currency	BBB
Country Ceiling	BBB

Outlook

Sovereign Foreign Long-Term IDR	Stable
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Financial Data

Issuer	2007e	2008f
GDP (USDbn)	109	124
GDP per head (USD)	3,908	4,410
Real GDP, % change	6.5	7.1
Consumer prices, % change	1.8	3.6
Government debt, % GDP	27.8	23.1
Net external debt, % CXR	-1.0	-16.6
International liquidity ratio	158.9	306.5

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Rating Rationale

- Fitch recently upgraded Peru's ratings to recognize the strong improvement in the country's fiscal and external solvency ratios. The strength of these ratios relative to peer credits now demonstrate a sufficient counterbalance to the country's key credit weaknesses, including a concentrated export base as well as political and social risks.
- Peru's public finance and external account performance once again exceeded expectations, as robust domestic demand and historically high prices for the country's commodity exports underpinned growth in all economic sectors. As a result, most of Peru's financial indicators are equivalent to or stronger than the median for low investment grade credits.
- Positive trends in public finances, underpinned by high commodity prices and the strength of the economy, have led to an improvement in Peru's government debt burden relative to peers, a key rating constraint in the past. Peru's government debt/GDP ratio of 28% of GDP was in line with the 'BBB' median by the end of 2007. Given recent and planned debt prepayments as well as growth expectations for this year, the ratio will be lower than the 'BBB' median by the end of 2008.
- The nominal reduction of public debt positively affected Peru's external solvency and liquidity ratios as well, as the public sector owes the majority of the country's external debt. Accumulation of international reserves combined with liability management operations and debt prepayments resulted in Peru becoming an overall net external creditor as well as a net public external creditor for the first time in 2007. Additionally, these debt re-profiling operations have reduced the public sector's external amortizations to less than 1% of GDP per year over the medium-term, which further mitigates the government's external debt burden. Other external solvency ratios such as liquidity and external financing needs as a proportion of foreign exchange reserves also compare favorably to the median of low investment grade sovereigns.

Key Rating Drivers

- Peru's key credit weaknesses relative to low investment grade sovereigns continue to include its concentrated export base as well as poor governance and social indicators. While these weaknesses will remain a source of risk over Fitch's rating horizon, the continuation of high, broad-based economic growth and a solid fiscal position will sustain the declining trend in both public and external debt burdens, as well as provide the flexibility necessary to target social expenditures toward addressing human development shortcomings. Maintenance of these positive trends should alleviate Peru's vulnerability to a commodity price shock and entrench the growing consensus for Peru's macroeconomic framework.
- Over the medium- to long-term, substantive progress on structural reforms related to enhancing productivity and competitiveness, would be supportive of an improvement in Peru's creditworthiness. Similarly, sustained high growth momentum that allows Peru's per capita income at market exchange rates to converge toward the 'BBB' median would also bode well for the sovereign's ratings.

Key Indicators for Peru

Population (2007^e): 27.9m
 GDP (2007^e): USD109.1bn
 GNI Per Head at Purchasing Power Parity (2006): USD6,070 (= 14% of USA level)
 Modern Sovereign Rescheduling History: Commercial banks 1980, 1983; moratorium 1985; Brady deal effective 1997

Population Growth Rate (2002-2007^e): 1.2% p.a.
 GDP per Head at Market Exchange Rates (2007^e): USD3,908

	2003	2004	2005	2006	2007 ^e	2008 ^f	2009 ^f
Domestic Economy and Finance							
Real GDP Growth (%)	3.9	5.2	6.5	7.8	8.9	7.0	6.3
Unemployment (% of Labour Force)	10.3	10.5	9.0	8.2	7.9	7.4	7.0
Consumer Prices (Annual Average % Change)	2.3	3.7	1.6	2.0	1.8	3.6	3.1
Gross Domestic Savings (% of GDP)	18.8	21.7	24.0	29.2	30.2	30.2	30.1
Gross Domestic Investment (% of GDP)	18.8	18.9	18.6	21.0	23.0	25.7	27.5
Short-Term Interest Rate (%) ⁽¹⁾	3.3	3.8	4.0	5.3	5.8	6.3	5.8
Broad Money (% Change Dec to Dec)	-2.4	3.1	16.8	11.8	15.8	12.0	12.0
PEN per USD (Annual Average)	3.48	3.41	3.30	3.27	3.13	2.98	3.00
REER (CPI, 2000=100)	99.1	98.2	104.0	105.9	106.1	104.1	102.1
REER: % Change (+ = Appreciation)	-3.2	-0.8	5.9	1.8	0.2	-1.9	-1.9
Public Finances							
General Government Balance (% of GDP)	-1.4	-0.9	-0.5	1.8	3.0	2.0	1.0
General Government Debt (% of GDP)	47.3	42.6	39.3	31.9	27.8	23.1	20.8
General Government Debt Maturities (% of GDP) ⁽²⁾	2.5	3.0	4.6	2.8	5.9	1.1	0.9
General Government Debt/Revenue (%)	261.7	238.5	213.3	161.3	136.0	119.8	109.1
Interest Payments/Revenue (%)	11.8	11.3	10.3	9.3	8.5	8.3	7.9
Balance of Payments							
Current Account Balance (USDbn)	-0.9	0.0	1.1	2.6	1.5	0.1	-1.1
Current Account Balance (% of GDP)	-1.6	0.0	1.4	2.8	1.4	0.1	-0.8
Current Account Balance plus Net FDI (USDbn)	0.3	1.6	3.7	6.1	6.8	4.6	3.4
Current Account Balance plus Net FDI (% of GDP)	0.5	2.3	4.7	6.5	6.2	3.7	2.5
Gross Financing Requirement (% of Official Reserves) ⁽³⁾	29.4	21.6	20.3	-4.2	26.6	5.8	8.2
Current External Receipts CXR (USDbn)	12.3	16.6	22.1	29.5	35.0	38.2	40.9
Current External Receipts CXR (Annual % Change)	16.8	34.3	33.1	33.6	18.7	9.1	7.1
Current External Payments CXP (USDbn)	13.3	16.6	20.9	26.9	33.5	38.0	42.0
Current External Payments CXP (Annual % Change)	13.8	24.5	26.4	28.6	24.5	13.6	10.5
External Assets and Liabilities							
Gross External Debt (USDbn)	29.6	31.2	29.4	29.3	32.0	33.6	35.4
Gross External Debt (% of GDP)	48.7	44.8	37.1	31.4	29.3	27.0	26.6
Gross External Debt (% of CXR)	239.7	188.4	133.4	99.4	91.4	88.1	86.5
Net External Debt (USDbn)	16.3	15.2	11.1	7.2	-0.3	-6.3	-10.0
Net External Debt (% of GDP)	26.8	21.9	14.0	7.7	-0.3	-5.1	-7.5
Net External Debt (% of CXR)	131.8	92.0	50.2	24.4	-1.0	-16.6	-24.4
Public External Debt (USDbn)	22.8	24.4	23.0	23.0	21.8	20.8	20.9
Public External Debt (% of GDP)	37.4	35.1	29.0	24.6	20.0	16.7	15.7
Net Public External Debt (% of CXR)	102.0	71.3	40.6	18.9	-17.1	-37.4	-46.9
Public FC Denominated & FC Indexed Debt (USDbn)	24.6	26.1	24.2	23.9	22.3	21.3	21.4
Short-Term External Debt (% of Gross External Debt)	8.5	8.9	10.9	10.3	13.0	12.6	12.3
External Debt Service (% of CXR)	26.4	22.1	24.4	12.6	23.2	10.1	9.7
External Interest Service (% of CXR)	11.0	8.7	7.6	5.8	5.7	5.5	5.4
Liquidity Ratio (%) ⁽⁴⁾	186.6	185.3	168.5	201.0	158.9	306.5	371.2
Official International Reserves Including Gold (USDbn)	10.2	12.6	14.1	17.4	27.8	35.1	40.1
Official International Reserves in Months of CXP Cover	9.2	9.2	8.1	7.8	10.0	11.1	11.5
Official International Reserves (% of Broad Money)	56.2	64.1	64.0	65.9	84.7	95.5	99.0

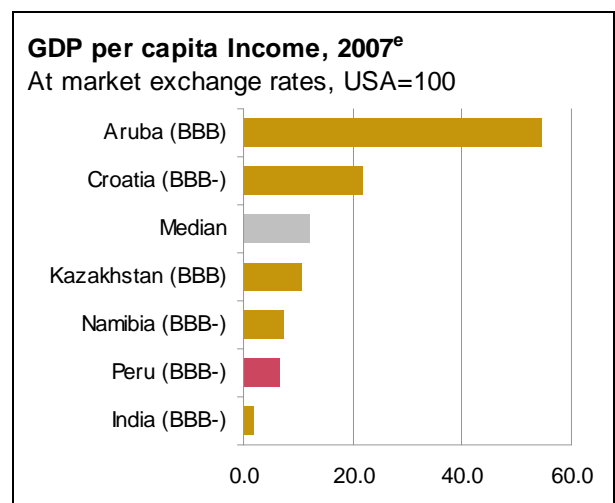
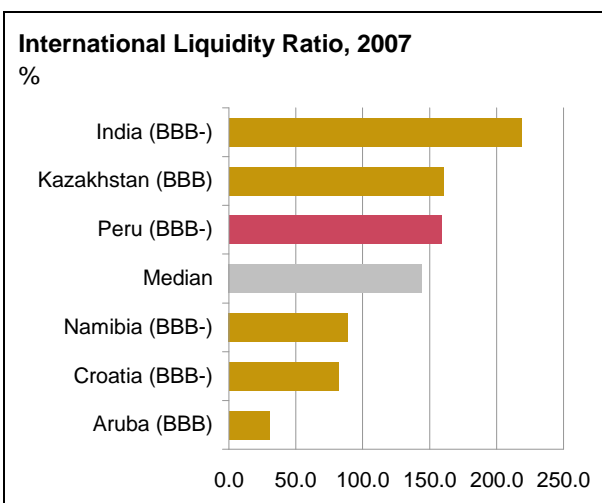
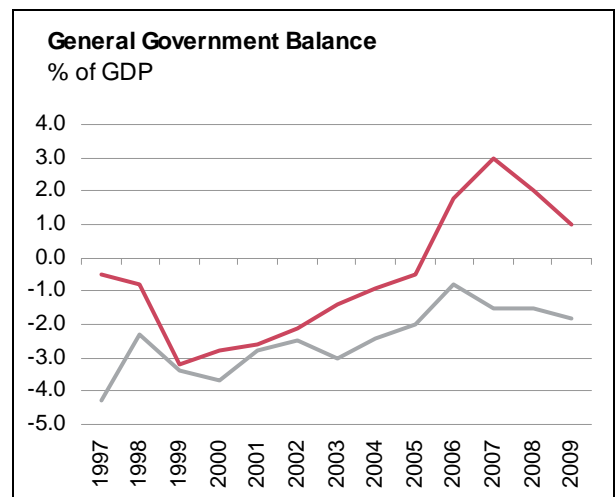
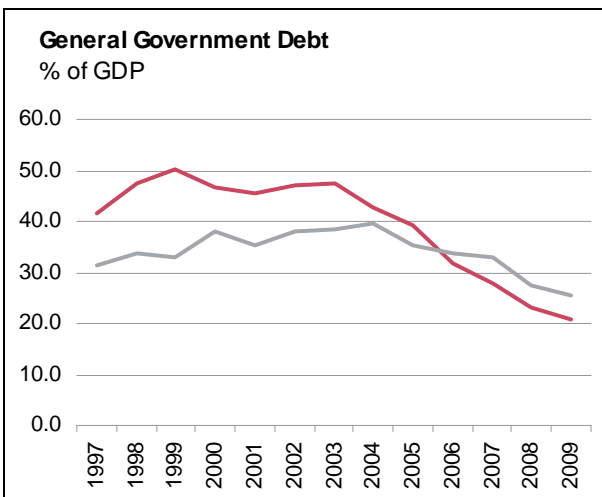
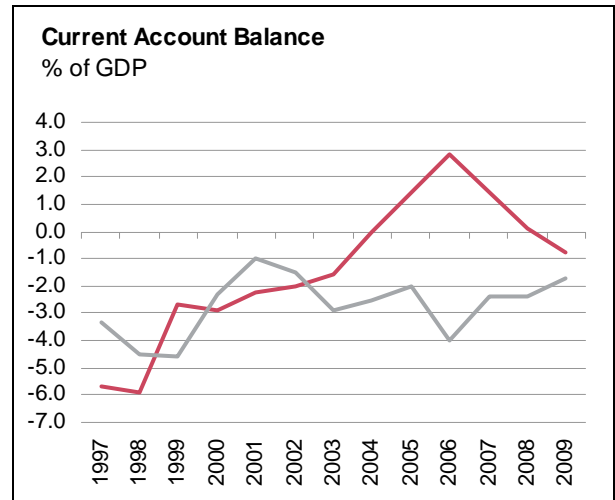
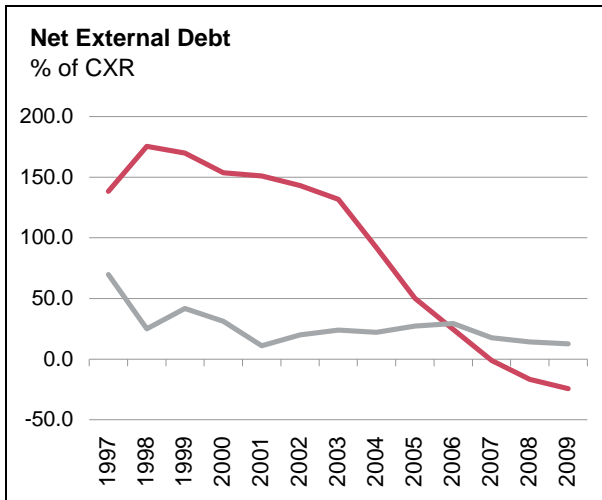
⁽¹⁾ Interbank discount rate (annual average).

⁽²⁾ Maturities of medium and long-term debt during year plus short-term debt outstanding at the beginning of the year.

⁽³⁾ Current account balance plus amortization of medium and long-term debt, over official international reserves.

⁽⁴⁾ Official reserves incl. gold plus banks' foreign assets/ Debt service plus liquid external liabilities.

Peer Comparison



— Peru

— BBB Median

Peer Group

Rating	Country
BBB	Aruba
	Bulgaria
	Kazakhstan
	Romania
	Tunisia
BBB-	Peru
	Croatia
	India
	Morocco
	Namibia
BB+	Azerbaijan
	Brazil
	Colombia
	Egypt
	El Salvador
	Guatemala
	Macedonia
	Panama

Rating Analysis

The maintenance of Peru's macroeconomic policy framework that has served it well in recent years and the prudent management of the commodity windfall to invest in infrastructure, pay down public debt and increase assets has improved the sovereign's capacity and willingness to honor its future obligations in full and on time, underpinning Fitch's decision to upgrade Peru's ratings.

Since Fitch revised the Outlooks on Peru's ratings to Positive from Stable in March 2007, the country's public finance and external account performance continued to exceed expectations, contributing to a better than anticipated improvement in key financial ratios. As a result, most of Peru's financial indicators are in line with or stronger than the median for low investment grade credits. Fitch believes that the marked improvement in Peru's external liquidity and solvency ratios in particular, now demonstrate a sufficient counterbalance to the country's key credit weaknesses, including its still high dependence on commodity exports as well as political and social risks.

Peru's real GDP growth accelerated for a third consecutive year, reaching an estimated 9.0% in 2007 compared with 7.8% in 2006. Robust domestic demand and historically high prices for Peru's commodity exports underpinned growth as all economic sectors expanded. It is important to highlight an incipient structural shift in the drivers of Peru's economic growth, as the non-primary sectors are now experiencing the most dynamic growth (+10.8% in real terms last year). Though weaker external demand and a softening of commodity prices will result in a deceleration of growth in 2008, domestic demand remains healthy and prices for Peru's mineral exports are expected to remain favorable relative to historical averages. This should underpin real GDP growth between 7.0% and 7.5% this year as well.

As was the case with other countries, inflationary pressures, from food and energy prices in particular, drove Peru's inflation rate to 3.9% by year-end 2007. Though this rate exceeded the inflation target of 1% to 3%, Peru's inflation rate was the second lowest in Latin America. While it will remain challenging to stay within the inflation target in the near-term, medium-term inflation expectations remain anchored within the targeted range and Fitch expects inflationary pressures to begin easing in the second half of this year.

For a second year in a row, the general government balance reached a surplus, which increased to an estimated 3% of GDP in 2007 from 1.8% of GDP in 2006. Peru's improved fiscal performance, nominal reductions in government debt, as well as solid economic growth led to a decline in the general government debt to 27.8% of GDP in 2007, similar to the 'BBB' median of 26.9%. Given recent debt repayments and growth expectations, Peru's debt/GDP ratio will be lower than the 'BBB' median by the end of this year. Yet, this measure continues to underestimate Peru's debt burden relative to low investment grade credits as the public sector's debt remains predominantly external and its tax base is limited. As additional liability management operations that reduce the proportion of foreign currency debt are expected in the coming months, the former constraint will ease over our rating horizon.

Peru's balance of payments performance supported international reserve accumulation of US\$10.4 billion in 2007. As a result of the prepayment of Paris Club debt, Peru's external financing needs increased to about 27% of reserves last year, though this remained significantly below the median for 'BBB' category credits. In 2008, among 'BBB' rated sovereigns, only Russia and Thailand have lower external financing needs than Peru. Similarly, reserve accumulation, combined with the reduction of debt service achieved through the government's debt re-profiling operations and prepayments, boosted Peru's liquidity ratio to 306% this year. While this compares favorably to a median of 161% for 'BBB' rated sovereigns, when adjusting the liquidity ratio to include resident foreign currency

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
02 Apr 2008	BBB-	BBB
31 Aug 2006	BB+	BBB-
18 Nov 2004	BB	BB+
18 Apr 2001	BB-	BB+
14 Oct 1999	BB	BBB-

Economic performance and outlook

	2007e	2008f	2007f
Real GDP (%)	9.0	7.0	6.3
CPI inflation (% annual avg.)	1.8	3.6	3.1
Budget balance (% GDP)	3.0	2.0	1.0
Current account (% GDP)	1.4	0.1	-0.8

Source: Fitch Ratings.

bank deposits in the denominator, the liquidity ratio falls to around 118%, highlighting the risks associated with high, albeit declining, dollarization. Unlike previous years, a disproportionate amount of the build up in reserves can now be attributed to capital inflows rather than to a positive terms-of-trade shock.

Fiscal restraint, liability management operations and sizable reserve accumulation in recent years have allowed net repayments of public external debt. As a result, the public sector became a net external creditor in 2007, sooner than initially anticipated. Peru's net public external debt (NPXD) to current account receipts (CXR) ratio, a key rating weakness in the past, reached an estimated -17% by the end 2007 approaching the 'BBB' median of -22%. Given current trends, Peru's net public external creditor position will not only exceed the 'BBB' median by the end of this year, but will exceed the creditor position of Kazakhstan (BBB), a sovereign with similar commodity dependence. The government's external debt burden is further mitigated by its astute debt re-profiling operations and prepayments, which have reduced the public sector's external amortizations to less than 1% of GDP per year over the medium term.¹

Peru's governance indicators, which evaluate government effectiveness, control of corruption, political stability and rule of law, are comparatively weak relative to the 'BBB' category median. It is important to note, however, that other commodity exporters in the coveted investment grade category, such as Kazakhstan ('BBB') or Russia ('BBB+') also exhibit poor governance indicators relative to peers. Broader human development, as measured by the United Nation's index, ranks Peru above the 'BB' median, though it could take time to approach the median rank of low investment grade credits. Peru also ranks 58 out of 178 countries in the World Bank's 'Doing Business' survey. Peru's ranking is more in line with credits in the 'BBB' category, suggesting that the country's economy is well positioned to continue attracting strong investment growth.

The continuation of high, broad-based economic growth and a solid fiscal position will sustain the declining trend in both public and external debt burdens over Fitch's rating horizon, as well as provide the flexibility necessary to target social expenditures toward addressing human development shortcomings. Maintenance of these positive trends could further mitigate Peru's vulnerability to a commodity price shock and entrench the growing consensus for Peru's macroeconomic framework. Implementation of the trade promotion agreement with the US and the development of the Camisea gas fields will also be important factors for maintaining the ongoing diversification of sources of export and economic growth. In addition, mounting evidence that political shocks or a less favorable external environment will not derail current economic policies and prudent fiscal policy in particular also supports Peru's sovereign creditworthiness. Future rating actions would likely depend on progress with improving social and governance indicators, perhaps best demonstrated by the implementation of substantive structural reforms.

Credit Fundamentals

Peru's key credit weaknesses relative to low investment grade sovereigns continue to include its poor governance and social indicators. Nevertheless, sustained growth and job creation as well as the government's expenditure focus on targeted social programs and infrastructure projects with a high social rate of return should result in increased opportunities for Peruvians and relieve pressures on this front over the medium- to long-term. The benefits of the unprecedented economic expansion have begun to trickle down to urban areas outside of Lima, as illustrated by the dynamic employment growth underway and a sustained reduction of poverty. The urban areas that have reported the highest levels of employment growth since 2004 have been the coastal cities of Sullana (+90%), Chincha (+72%) and Talara (+61%). Even more impressively, urban areas in the interior of the country, such as Puno

¹ Refer to amortization schedule on medium- and long-term external debt at end of report for more detail.

(+59%), Tarapoto (+40%) and Cuzco (+32%) have also reported high levels of employment creation during this period.² Furthermore, a gradual reduction in poverty is in progress, with the proportion of the population below the national poverty line declining from 49.0% in 1997 to an estimated 41.2% in 2007. The government's goal is to reduce poverty to less than 30% by the end of its mandate in 2011. Given recent rates of poverty reduction and Peru's growth trajectory, this appears to be a reasonable target.

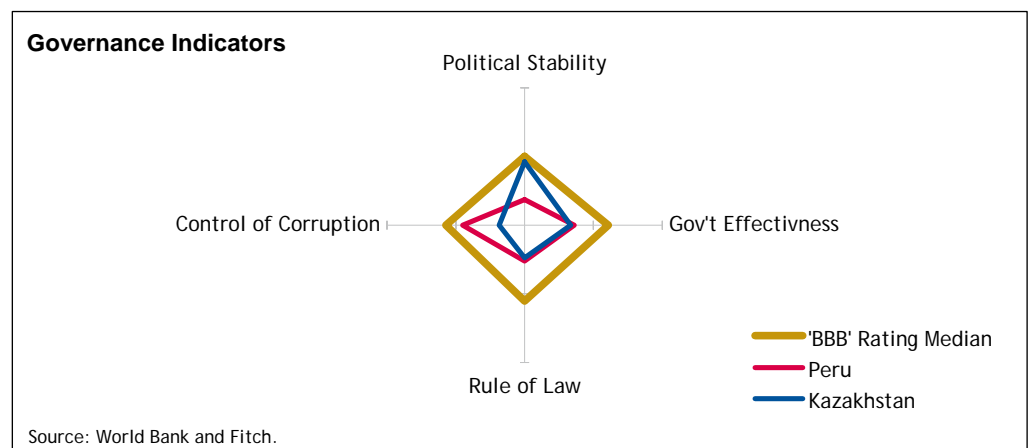
Credit Fundamentals

	Peru (BBB-)	Brazil (BB+)	Panama (BB+)	Egypt (BB+)	BB median	BBB median
GNI per capita, USD (PPP, 2006)	6,070	8,800	7,680	4,680	5,920	9,980
GDP per Capita, USD (market rates)	3,908	6,771	5,576	1,819	3,369	6,373
Real per Capita GDP growth, 5-year average (%)	5.3	2.3	5.4	3.2	4.7	4.8
UN Human Development Index (rank of 177, 2003)	79.0	63.0	56.0	119.0	94.0	64.0
Inflation, annual average (%)	1.8	3.6	3.9	9.3	7.0	5.4
Gross domestic savings (% GDP)	30.2	19.9	26.0	21.2	20.3	24.7
Gross domestic investment (% GDP)	23.0	17.9	21.9	17.0	224.3	29.6
CXR (% GDP)	32.1	15.5	84.1	36.5	44.6	50.9
Commodity dependence (% exports)	83	46	91	69	47	41
Private sector credit (% GDP)	19.8	47.6	92.1	44.1	30.2	61.7
Ease of Doing Business (rank of 178, 2008)	58	122	65	126	100	47

Data for 2007 unless noted otherwise.

Source: Fitch Sovereign Data Comparator - December 2007; Sovereign Peer Analysis Tool; CBI; IMF; World Bank.

As a presidential republic with a unicameral congress, power remains highly centralized in the executive branch. The legacy of a presidential system has contributed to a tendency toward authoritarianism in the past, which has resulted in reduced accountability among the various branches of government and weak political institutions more generally. This is illustrated by Peru's governance indicators as compiled by the World Bank, which are similar to 'BB' category credits, but remain significantly below the median for 'BBB' category credits. All governance indicators included in the chart below have remained relatively stable from 1996 to 2006 (the latest data available), with the exception of the indicator for 'political stability', which has improved since 1996. It is important to note, however, that other commodity exporters in the coveted investment grade category, such as Kazakhstan ('BBB') or Russia ('BBB+') also exhibit significant institutional weaknesses.

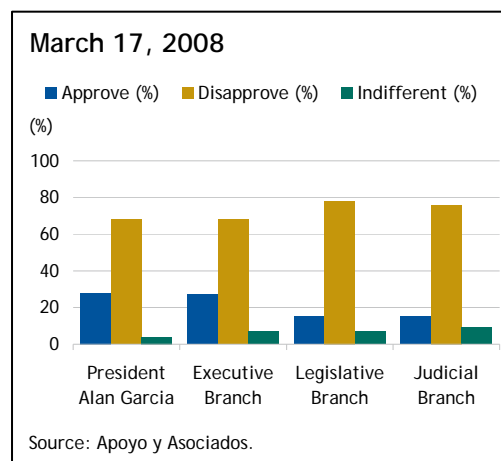


The weakness of political institutions remains an ongoing concern in Peru as it could undermine the credibility of effective governance. Currently, the main challenges created by institutional weakness are the slow implementation of the decentralization process and substantive structural reforms, as well as the reduced

² Preliminary data from the Ministry of Work and Employment Promotion based on monthly employment data from private sector companies with 10 or more employees.

execution of infrastructure investment projects. Popular actions led by miners, nurses, dock workers, and other public sector employees, as well as periodic social turmoil, attest to the additional failure of conventional political institutions to channel dissent. While social and economic disparities continue to result in periodic strife, episodic strikes and bouts of social unrest remain regionalized and have not derailed the overall orientation of macroeconomic policy, and prudent fiscal policy in particular, which bodes well for policy credibility. Furthermore, there appears to be a growing consensus on the key pillars of macroeconomic policy, which includes maintaining macroeconomic stability underpinned by responsible fiscal policy, attracting private investment and strengthening the country's export capacity, as evidenced by voters' preferences for potential presidential candidates. The mayor of Lima, Luis Castañeda Lossio, from the centrist Solidaridad Nacional party, has the highest voter appeal for a potential presidential candidacy in 2011, while leftist candidates which may not support the current macroeconomic framework are lagging in the polls.

The lack of popular trust in political figures and institutions in general, is best illustrated by the results of monthly public opinion polls administered by local pollster Apoyo Opinion y Mercado (see chart below). If perceptions of the state do not eventually improve, even with the recent track record of economic stability and



growth, the potential for 'outsider' candidates who may not be supportive of the current macroeconomic framework to gain power will likely remain a risk, albeit a declining one, to Peru's credit story. However, in the event that a radical candidate was to assume the presidency, his ability to change the macroeconomic policy orientation of the country would probably be limited by a divided Congress. Furthermore, given Peru's recent past, the use of extra-constitutional means to ignore the will of the legislature is not likely to be tolerated by society.

The Trade Promotion Agreement (TPA) has been approved by both the US and Peruvian Congresses and is expected to be implemented in early 2009. Progress has already been made with implementing legislation related to labor, environmental protection and intellectual property rights. Fitch expects implementation of the TPA to reinforce positive trends already supported by ATPDEA, such as growth in lower-priced imports, more diversified exports, and employment generation. More importantly, sustaining the ongoing diversification trend of Peru's export base will help reduce the country's vulnerability to a fall in commodity prices. Peru's total exports of goods increased 17.5% in 2007, and represented about 26% of GDP. Preferential access to the U.S. market boosted Peru's non-traditional exports in particular, which grew by 19.3% in 2007. Additionally, job growth under ATPDEA has been noteworthy in agro-industry. Guaranteed permanent market access and further competition could drive innovation, technology transfer, and economic growth. Moreover, the TPA would fortify the rule of law in Peru, encouraging improved transparency and decreased corruption, as well as creating a more attractive climate for foreign investment.

Fitch has assigned Peru a Banking Systemic Indicator (BSI) of 'D', which is on par with most emerging market banking systems.³ The main risks to the Peruvian

³ Fitch's Banking Systemic Indicator (BSI) measures intrinsic bank system risk on a scale from A (very high quality) to E (very low quality).

Key Facts: Banking system

2007

M2 (% GDP)	28.6
NPL ratio	1.3
Capital adequacy ratio	11.7
Public Ownership, % of Assets	12.7
Foreign Ownership, % of Assets	48.5

Source: Fitch Ratings.

banking system continue to be high levels of dollarization as well as its concentrated nature. However, based on a systematic analysis of macro-prudential indicators, Fitch views the country's vulnerability to banking system stress as low. In addition, financial intermediation remains low, with deposits accounting for about 23% of GDP and M2 accounting for 29% of GDP, limiting the potential contingent liability to the sovereign.

The Peruvian banking system has strengthened significantly in recent years, reflecting better asset quality, liquidity and profitability. Strict credit and write-off policies have reduced the non-performing loan/total loans ratio (as defined by international standards under Basel II) to 1.3% at year-end 2007, the lowest reported level in 23 years. If restructured and refinanced loans are included, total impaired loans declined to 2.7% of total loans in 2007 from 4.0% in 2006, although much of this improvement is explained by accelerated loan growth, which reached 33% in nominal terms last year. Loan loss reserve coverage reached 278% of past-due loans and 132% of total impaired loans. Although asset growth has pressured prudential ratios, these remain sound, with system equity/assets of 8.8% and risk-adjusted capital ratio of 11.7%. Similarly, liquidity ratios remained well above Peruvian regulatory standards.

Monetary and Exchange Rate Policy

The Banco Central de Reserva del Perú (BCRP) has maintained an inflation-targeting framework since 2002. Using the monetary regulation interest rate as an upper bound and the overnight interest rate as a lower limit, the BCRP sets a range for the interbank interest rate to achieve its inflation target of 2.0% ± 1%.⁴ The authorities missed their target for the first time since implementing an inflation-targeting regime, with year-end inflation reaching 3.9% in 2007. Nevertheless, Peru's inflation rate was the second lowest in Latin America and thus far medium-term inflation expectations remain anchored within the targeted range. Although the main cause of the spike in inflation has been imported through higher food and fuel prices (which accounts for a combined 50% of Peru's CPI basket), both monetary and fiscal measures have been taken to ease inflationary pressures and to prevent the contamination of future inflation expectations. The reference interest rate has been increased to 5.5% since July 2007, while both the legal and marginal reserve requirements have been increased on foreign and local currency deposits. Fiscal measures include tax cuts on fuels and import tariff decreases on food products. In light of the policy measures implemented in recent months, Fitch expects inflationary pressures to begin easing in the second half of this year, with the inflation rate falling to 3.3% by the end of 2008.

The central bank's secondary objectives after inflation targeting are increasing foreign exchange reserves to bolster Peru's commodity-dependent, dollarized economy against shocks and to stabilize the managed floating exchange rate with respect to the USD. Peru's exchange rate has been under pressure to appreciate given still high export prices and volumes, as well as private capital inflows. The BCRP has been conducting sterilized interventions to smooth volatility and prevent the currency from appreciating even more rapidly. Net purchases of dollars reached US\$10.3 billion in 2007 and already reached US\$6.5 billion by the end of March this year. Fitch anticipates further interventions of this nature in 2008 as the PEN continues to appreciate under pressure from capital inflows.

Peru's financial system continues to be highly dollarized. The proportion of total deposits in foreign currency has declined from 74% in 2000 to 60% in 2007. Liability side risks from dollarization are counterbalanced by foreign currency reserve levels, foreign currency deposits held by the banking system, and credibility of the monetary and exchange rate management. BCRP authorities assert that maintaining low inflation contributes to de-dollarization as people gain further

⁴ The target was decreased from 2.5% ± 1% during the years 2002-2006 starting in 2007.

confidence in the PEN. Deepening the domestic capital market and more freely floating the PEN could also accelerate de-dollarization of the economy.

Public Finances

Public Finances

	Peru (BBB-)	Brazil (BB+)	Panama (BB+)	Egypt (BB+)	BB median	BBB median
Budget balance, (% GDP)	3.0	-2.4	0.0	-7.7	-1.3	-1.3
Interest (% revenue)	8.5	15.5	2.9	28.6	7.6	7.0
GG debt (% revenue)	136.0	176.8	200.6	290.4	142.7	105.8
GG debt (% GDP)	27.8	67.2	53.8	81.7	34.7	27.6
Domestic debt (% total debt)	37.0	92.2	29.4	81.4	42.4	61.0
GG debt maturities (% GDP)	5.9	23.1	2.9	17.9	3.4	5.9

Data for 2007 unless noted otherwise.

Source: Fitch Ratings Sovereign Peer Analysis Tool.

Positive trends in public finances, underpinned by high commodity prices and the strength of the economy, have led to an improvement in Peru's government debt burden relative to peers, a key rating constraint in the past. Peru's government debt/GDP ratio is now more in line with 'BBB' credits as the country's fiscal performance and average GDP growth over the past five years has been better than most peers in this rating category. The Garcia Administration has contained current spending pressures and has used the commodity windfall to invest in infrastructure, pay down public debt and increase assets. Liability management operations and debt repayments have reduced Peru's public financing requirement to less than 2% of GDP per year over the medium term, which combined with increased flexibility in domestic financing options, further supports the country's creditworthiness.

Peru's fiscal performance continued to outperform expectations in 2007, in part reflecting still buoyant revenue growth, but more importantly, an under-execution of expenditures. The non-financial public sector reported a surplus of 3% of GDP in 2007 compared with an initially budgeted deficit of 0.8% of GDP. In spite of the expiration of certain taxes such as the financial transactions tax and company asset tax, higher than anticipated economic growth combined with an increase in income tax, canon and royalty revenues from mining companies in particular, drove a nominal increase of 15.9% in total current revenues. On the expenditure side, both current and capital expenditures increased less than budgeted. The government's 2007 surplus position will fund a transfer of US\$1 billion to the fiscal stabilization fund (FEF), bringing total funds to about 1.4% of GDP. According to the Fiscal Responsibility and Transparency Law, once funds in the FEF reach 2% of GDP, any resources above this target can be used for prepayments of debt. Initially, the non-financial public sector (NFPS) was expected to report a balanced budget this year; however, in light of revenue trends and expectations for an under-execution of capital expenditure once again, the NFPS is likely to report a surplus of close to 2% of GDP in 2008. As was the case in 2007, Fitch expects real GDP growth and inflation to be higher than the original budget assumptions, while the exchange rate will likely be stronger. Unlike peers, Peru's expected surplus will more than cover general government maturities this year.

Although Fitch expects favorable fiscal trends to continue over our rating horizon, Peru could face future policy challenges. As economic growth decelerates, the government may have limited room for maneuver given tax revenues are fundamentally constrained by low per capita incomes and a sizable informal economy. Tax buoyancy may also come under pressure due to regional and sector tax exemptions that have proven politically difficult to eliminate, though some progress has occurred on this front with the introduction of a program to eliminate certain exemptions and replace these with revenue transfers for public works projects for several regional governments. Furthermore, a gradual decline in mineral prices will also put downward pressures on Peru's revenue base. However, commodities only contribute to about 14% of total revenues, which is low relative

to other commodity exporters. On the expenditure side, the government may be challenged to resist pressures to raise salaries to compensate for rising inflation in the short-term, though thus far there have been no salary adjustments. There are risks beyond our rating horizon with respect to the fiscal decentralization process as well. Although performance to date appears satisfactory, an accelerated transfer of programs and revenues to regions could occur ahead of management capacity. Nevertheless, the level of resource transfer to the regions should remain modest over our forecast horizon, and legislation was passed that would limit transfers to those municipalities that meet certain limits on debt and spending growth.

Fitch does not expect the fiscal position to approach the 1% of GDP deficit target until 2010 at the earliest. Even if the government chooses to run a deficit of 1% of GDP, under current macroeconomic conditions this would still support the downward trajectory of Peru's debt dynamics. Fitch estimates that the government's debt/GDP ratio fell to 28% by the end of 2007, significantly below the 'BB' median of 35% and similar to the 'BBB' median. Nevertheless, Fitch maintains that GDP measures of public debt in Peru continue to understate the sovereign's debt burden, given the still high proportion of external debt and the limited tax base. Although this proportion is expected to decline to around half of total debt by 2011 due to the government's liability management strategy, external public debt still accounts for about two-thirds of total public debt compared to around 40% of total public debt for low investment grade peers. Similarly, windfall income tax revenues underpinned much of the improvement in Peru's debt/revenues ratio, which declined to 136% by year-end 2007. While Peru is now better than the 'BB' median for this ratio, it still lags the 'BBB' median of 106%. The government will eventually need additional measures to compensate for a gradual decline in income tax revenues, from mining companies in particular, and stem a deterioration of this ratio over the long-term.

The government continues to focus on reducing refinancing risk through market-based operations that increase the average life and duration of the debt portfolio, as well as reduce currency and interest rate exposure. As a result, the structure of Peru's public debt has improved steadily. The most recent liability management operations included a prepayment of Paris Club obligations in October 2007 and of Brady bonds in February 2008. The Paris Club pre-payments totaled US\$1.8 billion and were financed with the domestic issuance of US\$1.5 billion in sol-denominated 30-year bonds and treasury resources, while the prepayment of Brady bonds was financed entirely with treasury resources. The government also recently announced plans to prepay multilateral debt by mid-2008 with treasury resources or domestic debt issuance, depending on market conditions, which will further reduce external indebtedness.

External Finances

Peru's external finances have witnessed a marked improvement in recent years relative to peers and rating medians. The accumulation of international reserves combined with liability management operations and debt prepayments resulted in Peru becoming an overall net external creditor as well as a net public external creditor for the first time in 2007. Given sustained international asset accumulation during the first quarter of this year, Fitch expects further improvements on this front, with almost all of Peru's international liquidity and external debt ratios forecast to outperform 'BBB' rating peers by the end of 2008. This position provides a substantial cushion in the event of external shocks, such as a disruption to international capital markets or a terms-of-trade shock.

Peru's accelerated reserve accumulation since 2004 is correlated with improved terms of trade, strong foreign direct investment (FDI) inflows, and to a lesser extent, increased portfolio inflows relative to historical levels. In spite of persistent high international commodity prices and increased volumes of traditional and non-traditional exports, robust domestic demand and high oil prices have

pushed import growth above that of exports, resulting in a deterioration of the trade balance last year for the first time since 1998. Although Peru is expected to maintain a solid trade surplus over Fitch's rating horizon, it will decline as the country's terms of trade gradually weakens and domestic demand continues to underpin robust import growth. FDI remains and should continue to be the most significant component of Peru's capital account, increasing by 53% to an estimated US\$5.3 billion in 2007. At 4.9% of GDP last year, inward FDI exceeded both the 'BB' and 'BBB' medians. Though the weak global environment may dampen FDI inflows, Fitch expects levels to remain healthy in light of the upcoming implementation of the US-Peru TPA, Camisea's second phase liquefied natural gas (LNG) export project, as well as other mining investment and concession projects in progress or on the horizon.

External Finances

	Peru (BBB-)	Brazil (BB+)	Panama (BB+)	Egypt (BB+)	BB median	BBB median
Current account balance (% GDP)	1.4	0.3	-7.9	0.6	-2.9	-2.1
Current account balance plus net FDI (% GDP)	6.2	2.6	5.4	5.8	2.2	0.9
Inward FDI (% GDP)	4.9	2.5	13.3	5.4	4.5	4.3
External Finance need (% FX reserves)	26.6	30.8	181.4	11.5	42.5	45.6
Gross external debt (% CXR)	91.4	122.4	197.3	80.2	79.8	98.5
Net external debt (% CXR)	-1.0	1.6	2.4	-20.9	-0.7	10.2
Public external debt (% CXR)	62.2	53.4	45.6	62.6	41.1	21.55
Net public external debt (% CXR)	-17.1	-36.2	24.7	0.8	-1.8	-21.7
Public debt (% total external debt)	68.1	42.2	23.3	78.0	56.8	27.8
Debt service ratio (% CXR)	23.2	23.5	14.5	8.5	9.5	12.2
Interest service (% CXR)	5.7	8.5	8.6	1.2	3.6	3.9
Liquidity ratio (2008)	306.5	179.2	142.8	377.3	245.0	161.5

Data for 2007 unless noted otherwise.
Source: Fitch Sovereign Peer Analysis Tool.

The tradeable sector and foreign exchange generating capacity of the economy as a proportion of GDP is comparatively weaker than that of peers. Furthermore, in spite of the dynamic growth of non-traditional exports in recent years, commodities still account for about 83% of merchandise exports, which is around twice the 'BB' and 'BBB' category medians. The country's commodity dependence is similar to that of Kazakhstan ('BBB') and Russia ('BBB+'). Peru's concentrated export base and commodity dependence is a key credit weakness in the face of a severe price shock. However, the diversity of commodities and export markets could help offset some of this risk. Peru has a broad mineral export base, a quarter of which includes gold, a commodity with price movements that are not as closely correlated to those of other minerals. In addition, a new natural gas plant and export terminal is expected to come on line in mid-2010, which will further diversify Peru's commodity base. The implementation of the TPA with the US next year will also support the recent trends of non-traditional export growth.

With the exception of gross public external debt (GPXD) to current account receipts (CXR), all other external debt ratios relative to CXR are now either in line or better than the 'BBB' category median. As mentioned above, Peru became a net public external creditor last year, a characteristic of many low investment grade sovereigns. Although the public sector has reduced its external indebtedness, it still accounts for about 66% of total external debt. About 58% of the public sector's debt is still owed to official creditors while liability management operations have improved the profile of market debt, which has resulted in an overall profile with favorable average maturities. Strong export performance, astute debt reprofiling and debt prepayments will reduce Peru's external debt service ratio to 10.1% in 2008; a level similar to 'BBB' rated peers.

Fiscal accounts summary*

% of GDP	2003	2004	2005f	2006	2007e	2008f	2009f
Revenue & grants (excl. priv'n)	18.1	17.9	18.4	19.8	20.5	19.3	19.1
o/w tax revenues	13.2	13.4	13.9	15.1	15.6	15.5	15.4
Expenditure & net lending	19.4	18.7	18.9	18.0	17.5	17.3	18.1
Primary balance (excl. interest)	0.8	1.2	1.4	3.6	4.7	3.6	2.5
Overall balance	-1.4	-0.9	-0.5	1.8	3.0	2.0	1.0
Financing:							
Domestic, net	0.0	-0.8	1.9	-1.3	-1.1	-0.9	-1.0
Privatisation proceeds	0.1	0.2	0.1	0.1	0.1	0.0	0.0
External, net	1.3	1.5	-1.5	-0.6	-2.0	-1.0	-0.1
Public debt**	47.3	42.6	39.3	31.9	27.8	23.1	20.8
Domestic	10.0	8.9	10.1	8.9	10.3	7.8	6.5
External	37.3	33.7	29.2	23.0	17.5	15.3	14.4
Public debt (% of revenue)	261.7	238.5	213.3	161.3	136.0	119.8	109.1
Net public debt***	43.9	40.1	33.4	28.1	22.6	16.3	13.8
memo:							
interest service (% of revenue)	11.8	11.3	10.3	9.3	8.5	8.3	7.9
commodity dependent (% of revenue)							

* All figures refer to the consolidated general government.

** Public debt refers to NFPS plus loans to BCRP for balance of payment support.

***Public debt less general government deposits at the central bank and other monetary institutions.

Source: Ministry of Finance, Fitch Ratings estimates and forecasts.

Amortisation schedule on medium- and long-term debt

USDmn	2008	2009	2010	2011	2012	2013
Public sector	950.1	964.3	1108.1	1121.8	1573.0	1141.1
International organizations	665.1	694.8	719.4	717.6	754.8	718.3
Paris Club	274.9	259.4	380.4	399.2	411.6	417.7
Other bilateral creditors	6.4	6.3	4.7	1.4	1.4	1.4
Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0
Bonds	0.0	0.0	0.0	0.0	401.6	0.0
Other	3.7	3.7	3.7	3.7	3.7	3.7

Source: MEF.

Balance of payments

USDmn	2003	2004	2005	2006	2007e	2008f	2009f
Current account balance	-949	19	1148	2589	1513	147	-1130
% of GDP	-1.6	0.0	1.4	2.8	1.4	0.1	-0.8
% of CXR	-7.7	0.1	5.2	8.8	4.3	0.4	-2.8
Trade balance	886	3004	5286	8934	8356	6628	5066
Exports, fob	9091	12809	17368	23800	27956	30325	32360
(annual % change)	17.8	40.9	35.6	37.0	17.5	8.5	6.7
Imports, fob	8205	9805	12082	14866	19599	23697	27293
(annual % change)	11.0	19.5	23.2	23.0	31.8	20.9	15.2
Services, net	-900	-732	-834	-949	-928	-382	-150
Services, credit	1716	1993	2289	2451	3343	3777	4155
Services, debit	2616	2725	3123	3400	4270	4159	4305
Income, net	-2144	-3686	-5076	-7581	-8419	-8854	-9008
Income, credit	322	332	625	1033	1189	1307	1386
Income, debit	2466	4017	5701	8614	9607	10161	10394
o/w: interest payments	1357	1450	1672	1717	1978	2090	2221
Current transfers, net	1209	1433	1772	2185	2503	2754	2961
Non-debt creating flows, net	-11	1126	2530	1818	6300	5500	5500
Equity Direct investment, net	1275	1599	2579	3467	5300	4500	4500
Portfolio equity investment, net	-1286	-473	-49	-1648	1000	1000	1000
External borrowing, net	594	1105	-1463	-663	849	1467	1415
General government	916	1161	-882	-571	-1891	-1033	-85
Monetary authorities	-118	-33	-35	-7	0	0	0
Commercial banks	-84	53	327	-234	1040	1000	500
Other private sector	-119	-75	-872	149	1700	1500	1000
Net lending abroad	127	15	-1083	9	800	-500	-1230
Capital nes, net	-48	-59	-22	-100	1000	500	500
Net errors and omissions	801	236	362	-445	-203	0	0
Overall balance = chg in reserves (--=increase)	515	2442	1472	3209	10258	7114	5055
memo:							
Gross borrowing (incl. short-term)	2490	3323	2245	1330	6986	3217	3179
Gross external financing requirement	2845	2199	2560	-596	4624	1603	2894
Stock of International reserves, excl. gold	9777	12176	13599	16733	26992	34105	39160

Source: IMF IFS, BCRP, Fitch Ratings estimates and forecasts.

External debt & liquidity

USDmn	2003	2004	2005	2006	2007e	2008f	2009f
Gross external debt	29587	31224	29424	29306	31984	33648	35357
% of GDP	48.7	44.8	37.1	31.4	29.3	27.0	26.6
% of CXR	239.7	188.4	133.4	99.4	91.4	88.1	86.5
By maturity:							
Medium- and long-term	27062	28455	26216	26295	27830	29394	31003
Short -term	2525	2769	3208	3011	4154	4254	4354
% total debt	8.5	8.9	10.9	10.3	13.0	12.6	12.3
By debtor:							
Public sector	22768	24446	23046	22977	21772	20836	20945
Non-bank private sector	4087	3781	2967	3018	4718	6218	7218
Banks	207	228	203	300	1340	2340	2840
Unidentified sector (short-term)	2525	2769	3208	3011	4154	4254	4354
By creditor:							
Multilateral	7358	7875	7983	7843	7851		
Bilateral	8740	8573	5745	5663	3908		
Commercial banks	212	232	203	301	1341		
Debt securities	5630	6944	8393	8392	8262		
Other	7647	7599	7100	7107	10622		
Gross external assets*	13319	15985	18339	22121	32325	39989	45337
International reserves, incl. gold	10182	12633	14095	17407	27768	35109	40107
Deposit money banks' foreign assets	1291	1095	1351	1867	1918	2109	2320
PV of Brady bond collateral							
Other foreign assets	1846	2257	2893	2847	2639	2771	2909
Net external debt	16268	15239	11085	7185	-341	-6341	-9980
% of GDP	26.8	21.9	14.0	7.7	-0.3	-5.1	-7.5
% of CXR	131.8	92.0	50.2	24.4	-1.0	-16.6	-24.4
Sovereign Net Foreign Assets**	-12586	-11813	-8951	-5570	5996	14272	19162
% of GDP	-20.7	-17.0	-11.3	-6.0	5.5	11.5	14.4
% of CXR	-102.0	-71.3	-40.6	-18.9	17.1	37.4	46.9
Debt service (principal & interest)	3253	3668	5380	3710	8115	3840	3985
Debt service (% of CXR)	26.4	22.1	24.4	12.6	23.2	10.1	9.7
Interest service (% of CXR)	11.0	8.7	7.6	5.8	5.7	5.5	5.4
Liquidity ratio (%)	186.6	185.3	168.5	201.0	158.9	306.5	371.2
excl. banks' foreign assets	165.8	164.4	155.0	183.4	143.5	286.7	350.1
incl. banks' resident FCDs	68.8	73.0	76.4	81.3	78.2	118.2	139.4
memo:							
Public Foreign Currency & FC indexed debt	24,572	26,103	24,247	23,890	22,272	21,336	21,445
Non-resident holdings of domestic debt	0	0	767	1,005	1,691	1,788	1,982

* wide definition

**Sovereign financial assets less gross external debt of the general government and monetary authorities.

Source: MEF, BCRP, IMF, World Bank, Fitch Ratings estimates and forecasts.

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