IV. External Sector

The dynamism of the world economy continued to determine positive results in our external accounts during 2007. Despite fears of a recession in the United States in the third quarter of the year, the growth of South East Asian and Latin American countries translated into both higher prices for our raw materials and larger volumes of exports, particularly non-traditional exports. Accumulating 6 years of consecutive growth, our terms of trade increased 3.6 percent and the volume of exports grew 3.3 percent this year, mainly due to the 8.0 percent increase observed in the volumes of non-traditional exports. With these results, the current account of the balance of payments showed a surplus of US$ 1,505 million, equivalent to 1.4 percent of GDP. By components, this was the result of a trade surplus of US$ 8,356 million and current transfers amounting to US$ 2,495 million. This result was partially offset by the deficits observed in services and factor income.

Moreover, the Peruvian economy became an attractive market for external capitals, allowing a significant increase in international reserves which represented 25 percent of GDP at end 2007.

1. International context

In 2007, the world economy grew 4.9 percent, a similar rate to the one observed in 2006. The slowdown in the US economy, associated with lower activity in the real estate sector and by the developments seen in the subprime mortgage market, was compensated by the dynamism of emerging countries (particularly China and India, and the rest of countries in the region). The problems in the US subprime market negatively affected the international financial markets, deteriorating credit conditions and increasing investors' risk aversion.

In most economies, growth was coupled by inflationary pressures associated with the higher international prices of main food products (particularly wheat, soybean, and maize) and fuels, which had already increased significantly during 2006. Increased global demand (particularly from China), the substitution of oil by biofuels, and supply problems in certain products account for this trend.

2. Terms of trade

Continuing with the consecutive growth observed over the last six years, in 2007 our terms of trade grew 3.6 percent given that the increase in the average prices of exports (14 percent) was higher than the increase in the average prices of imports (10 percent). It is worth pointing out that although this increase in 2007 was lower than in recent years, the current level of this indicator is 60 percent higher than the one observed in 2001.

The higher prices of exports in the year reflected both increased global demand and the tight balance between supply and demand, as well as low inventories of some metals. In this sense, it is estimated that global inventories of **copper** would cover only a week and a half of consumption, in line with China's strong demand and cuts in the main producing countries (Chile, Peru, Mexico, Indonesia, and Canada). In this context, the international price of copper increased 6 percent during 2007. Moreover, the price of **gold** rose 15 percent reflecting the increased physical demand of India, China, and the Middle East, as well as the higher demand of investors who sought hedge in this metal after the Federal Reserve reduced its interest rates.

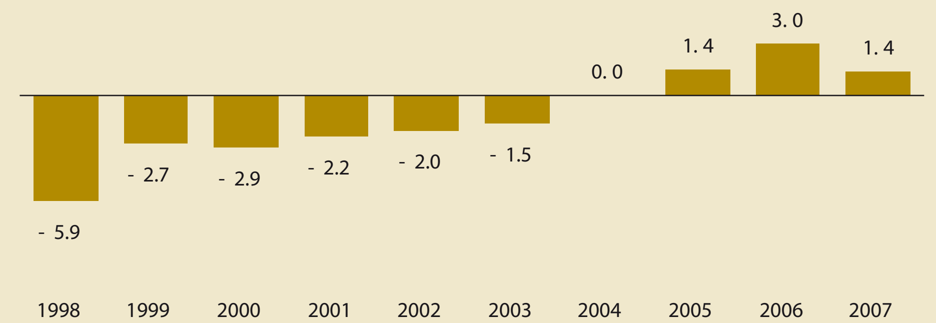
The prices of imports showed an upward trend, particularly in the case of food and fuels. The prices of the main grains rose significantly due to continued supply constraints as a result of adverse weather conditions and lower cultivated areas of wheat and soybean, as well as of increased demand for biofuels in a context of high oil prices, and increased demand for soybean, maize, and sugar to feed animals. These factors were reflected in the drop of global inventories which, in some cases, reached levels that had not been observed for over 20 years.

A speculative component added onto this, generating higher price volatility given the higher participation of investment funds in the grain market. Additionally, supply problems in some grain producing countries have generated the establishment of tariff and para-tariff measures that are constraining trade and accentuating concerns that the shortages could be greater.

3. Balance of payments

In 2007, the **current account** of the balance of payments showed a positive result for the fourth consecutive year with a surplus of US$ 1,505 million, equivalent to 1.4 percent of GDP. This favorable result is explained by the trade surplus and by higher remittances from Peruvians living abroad, which offset the deficits in factor income and services.

GRAPH 14
BALANCE OF THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS
(Percentage of GDP)



Source: BCRP.

It should be pointed out that the positive result in the balance of payments reflects the development strategy aimed at connecting Peru to international markets through the negotiation of free trade agreements and the reduction of administrative costs for exporters[3]. In this sense, it is worth highlighting that the Peru-US Trade Agreement was ratified in December 2007 by the US Senate by 77 votes for and 14 votes against said agreement, which consolidates and expands the access to this market that Peru had achieved through the ATPDEA.

TABLE 25
BALANCE OF PAYMENTS

	Millions of US$			Percentage of GDP		
	2005	**2006**	**2007**	**2005**	**2006**	**2007**
I. CURRENT ACCOUNT BALANCE	**1,148**	**2,755**	**1,505**	**1.4**	**3.0**	**1.4**
1. Trade balance	5,286	8,934	8,356	6.7	9.6	7.7
a. Exports	17,368	23,800	27,956	21.9	25.5	25.6
b. Imports	-12,082	-14,866	-19,599	-15.2	-15.9	-17.9
2. Services	-834	-781	-928	-1.1	-0.8	-0.8
a. Exports	2,289	2,647	3,343	2.9	2.8	3.1
b. Imports	-3,123	-3,428	-4,270	-3.9	-3.7	-3.9
3. Investment income	-5,076	-7,583	-8,418	-6.4	-8.1	-7.7
a. Private	-4,211	-6,903	-7,985	-5.3	-7.4	-7.3
b. Public	-865	-679	-433	-1.1	-0.7	-0.4
4. Current transfers	1,772	2,185	2,495	2.2	2.3	2.3
of which: Remittances	1,440	1,837	2,131	1.8	2.0	2.0
II. FINANCIAL ACCOUNT	**141**	**639**	**8,558**	**0.2**	**0.7**	**7.8**
1. Private sector	1,818	1,941	9,002	2.3	2.1	8.2
2. Public sector	-1,441	-738	-2,473	-1.8	-0.8	-2.3
3. Short-term capital	-236	-563	2,030	-0.3	-0.6	1.9
III. EXCEPTIONAL FINANCING	**100**	**27**	**67**	**0.1**	**0.0**	**0.1**
IV. NET ERRORS AND OMISSIONS	**239**	**-668**	**-476**	**0.3**	**-0.7**	**-0.4**
V. BCRP NET RESERVE FLOWS	**1,628**	**2,753**	**9,654**	**2.0**	**3.0**	**8.8**
(V = I + II + III + IV)						
1. Change in NIRs balance	1,466	3,178	10,414	1.8	3.4	9.5
2. Valuation changes and monetization of gold	-162	425	760	-0.2	0.5	0.7

Source: BCRP, MEF, SBS, SUNAT, Ministry of Trade Affairs, Cofide, ONP, FCR, Zofratacna, Banco de la Nación, Cavali ICLV S.A., Proinversión, BIS and companies.

The **trade surplus** this year amounted to US$ 8,356 million, a sum slightly lower than that of 2006 (US$ 8,934 million) given that imports grew at a higher rate than exports: in 2007 imports grew 31.8 percent, while exports grew 17.5 percent. The deficit in **services** increased from US$ 781 million in 2006 to US$ 928 million in 2007 due to higher freight expenses.

[3] An example of this was the establishment of the Foreign Trade Single Window, a mechanism that seeks to promote the use of electronic means to obtain permits, certifications, licenses, and other authorizations required by the State to import and export goods.

The higher deficit observed in terms of **factor income** relative to the previous year reflected the higher return of enterprises with foreign shareholding in a context of high economic growth and higher prices of mining products. Firms' profits in 2007 amounted to US$ 7,865 million, a sum 16.7 percent higher than in 2006. On the other hand, remittances from Peruvians residing abroad grew 16.0 percent, accounting for US$ 2,495 million of the higher flow of **current transfers**.

The sustained growth of the Peruvian economy in a context of macroeconomic stability and optimistic business expectations encouraged the inflow of capitals oriented to financing investments in the private sector. As a result of this, the **financial account of the private sector** amounted to US$ 9,002 million (US$ 1,941 million in 2006). Direct foreign investment and long-term loans accounted for this financing, which showed historical records of US$ 5,343 million and US$ 3,995 million respectively.

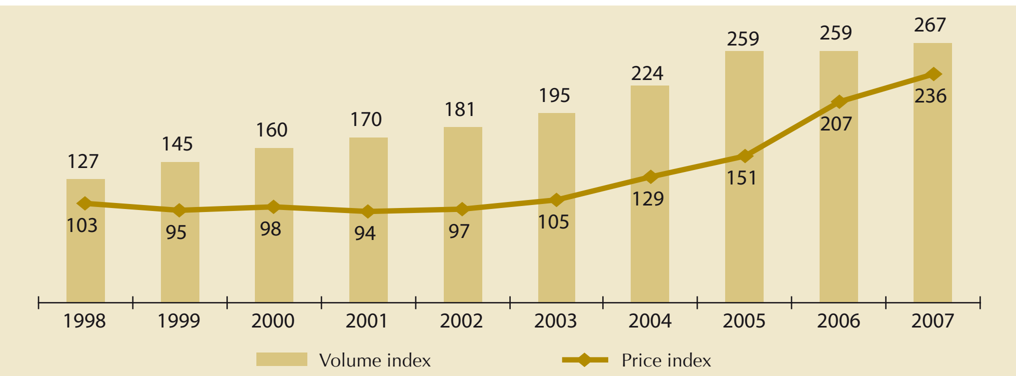
These financial flows are consistent with the dynamism of economic activity and with the country's favorable economic prospects. It should be pointed out that a part of these funds are profits reinvested in all the sectors, although the inflow of external capitals oriented to investments in bonds issued in the country was also significant.

During 2007, a strong inflow of short-term external capitals was also observed. This was associated both with bank's higher requirements of foreign currency in a context of liquidity tightness due to the hedging of their forwards operations and with non-residents' demand for BCRP Certificates of Deposit.

3.1 Exports

Exports amounted to US$ 27,956 million, which represented a 17.5 percent increase compared to 2006. This increase was explained by both higher prices (14 percent) and by larger volumes of exports (3.3 percent).

GRAPH 15
EXPORTS PRICE AND VOLUME INDICES
(1994 = 100)



The **main destination markets** of our exports were the United States (with 19.7 percent of total exports), followed by China and Japan (with 10.9 and 7.8 percent of total exports respectively). However, the weight of the United States in terms of our foreign trade has been declining, whereas exports to China and Japan have been increasing. It is worth pointing out that exports to Japan increased by over two-fold compared to 2005. Likewise, the relative weight of Switzerland and Spain in terms of our exports has also increased.

The growth of exports was mainly associated with higher prices for our **traditional products** (15.9 percent in 2007), reflecting the higher international average prices of copper, gold, silver, tin, lead, zinc, molybdenum, coffee, and fish meal and fish oil.

In terms of volume, traditional exports grew only 1.0 percent, mainly due to larger shipments of copper and zinc.

TABLE 26
EXPORTS INDEX[1/]
(Percentage change)

	Volume	Price
	2007 / 2006	2007 / 2006
Total	**3.3**	**14.0**
Traditional Exports	**1.0**	**15.9**
Particularly:		
Fish meal	-6.0	8.0
Coffee	-27.0	9.1
Copper	10.1	9.0
Gold	-10.6	15.4
Zinc	16.8	12.7
Petroleum and derivates	8.3	18.3
Non-traditional Exports	**8.0**	**10.5**
Particularly:		
Agriculture and livestock	9.2	12.9
Fishing	5.7	9.2
Textiles	5.8	10.5
Chemicals	22.9	8.8
Metal industry[2/]	-7.2	17.8

1/ Calculated on the base of unit value (after dividing total value between total volume).
2/ Includes jewelry.
Source: BCRP and SUNAT.

Thus, the flow of traditional exports amounted to US$ 21,493 million in 2007, a sum 17.0 percent higher than in 2006. In GDP terms, this flow was equivalent to 19.7 percent of the product, a similar level to that of the previous year. The exports of mining products, which showed the highest increase in both absolute and relative terms, amounted to US$ 17,328 million. This sum represented 80.6 percent of traditional exports and 62.0 percent of our overall sales abroad during 2007.

Copper continued to be the main export in terms of the exported value. Copper exports in 2007 amounted to US$ 7,241 million, which represented a 19.6 percent increase relative to 2006. This increase is not only explained by the higher average price of copper (4.7 percent), but also by the larger volume of copper exports due to increased shipments of copper concentrate from Cerro Verde.

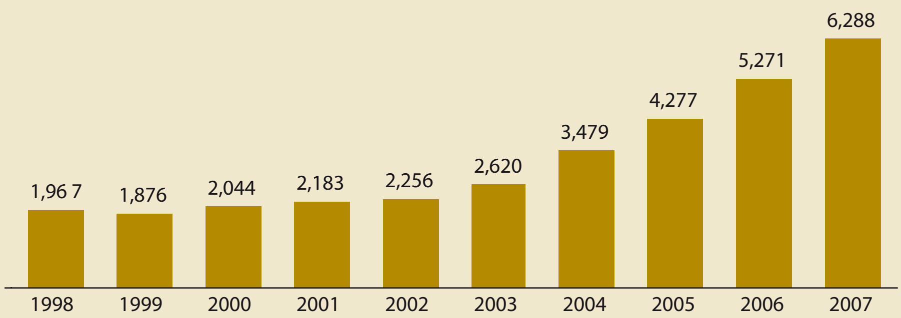
TABLE 27
FOB EXPORTS BY GROUP OF PRODUCTS

	Millions of US$			Percentage change	
	2005	**2006**	**2007**	**2006**	**2007**
I. TRADITIONAL PRODUCTS	**12,950**	**18,374**	**21,493**	**41.9**	**17.0**
FISHING	**1,303**	**1,334**	**1,456**	**2.3**	**9.2**
Fishmeal	1,147	1,137	1,208	-0.9	6.2
Fish oil	156	196	248	26.1	26.4
AGRICULTURAL PRODUCTS	**331**	**573**	**460**	**73.2**	**-19.7**
Coffee	307	515	427	67.8	-17.0
Sugar	13	43	19	238.0	-56.3
Cotton	3	7	3	112.5	-54.0
Other agricultural products 1/	8	9	11	3.2	32.0
MINERAL PRODUCTS	**9,790**	**14,707**	**17,328**	**50.2**	**17.8**
Copper 2/	3,472	6,054	7,241	74.4	19.6
Gold	3,095	4,004	4,157	29.4	3.8
Zinc	805	1,991	2,535	147.3	27.3
Lead 2/	491	713	1,033	45.0	45.0
Molybdenum	1,107	840	982	-24.1	16.9
Silver (refined)	281	480	537	70.9	12.1
Tin	301	346	507	14.7	46.7
Iron	216	256	286	18.5	11.6
Other mineral products 3/	21	24	51	13.6	109.7
PETROLEUM AND DERIVATIVES	**1,526**	**1,760**	**2,248**	**15.4**	**27.8**
II. NON-TRADITIONAL PRODUCTS	**4,277**	**5,271**	**6,288**	**23.2**	**19.3**
Textile	1,275	1,471	1,730	15.4	17.6
Agriculture and livestock	1,008	1,216	1,503	20.6	23.7
Basic metal industries and jewelry	493	829	907	68.0	9.4
Chemical	538	601	803	11.9	33.6
Fishing	323	433	498	34.1	15.0
Timbers and papers, and related manufacture	261	333	360	27.4	8.3
Fabricated metal products and machinery	191	163	215	-14.5	31.9
Non-metallic minerals	118	135	165	14.6	21.7
Other products 4/	70	89	107	27.4	19.9
III. OTHER PRODUCTS 5/	**141**	**156**	**175**	**10.3**	**12.1**
IV. TOTAL EXPORTS	**17,368**	**23,800**	**27,956**	**37.0**	**17.5**

1/ Including coca leaves and derivatives, molasses, wools and furs.
2/ Including silver contents.
3/ Including bismuth and wolfram.
4/ Mainly fur, leather and handcrafts.
5/ Fuel and food sold to foreign ships and aircrafts and repairs of capital goods.
Source: BCRP and SUNAT.

Non-traditional exports in 2007 totaled US$ 6,288 million, a sum 19.3 percent higher than in 2006 due to higher prices (10.5 percent) and larger volumes (8.0 percent). The growth of non-traditional exports was led by the sectors of agriculture and livestock, textiles, and chemicals, while fishing exports –particularly giant squid and species for canned products– showed a lower growth due to adverse climatic conditions.

GRAPH 16
NON-TRADITIONAL EXPORTS
(Millions of US$)



Source: BCRP and SUNAT.

Agriculture and livestock exports increased 23.7 percent in nominal terms, due both to prices (12.9 percent) and volumes (9.2 percent). The higher exports of fresh asparagus and asparagus conserves (both of which amounted to US$ 100 million) were noteworthy.

Textile exports increased 17.6 percent due to higher average prices and volumes (10.5 and 5.8 percent respectively). It is worth mentioning the higher exports of t-shirts, which increased by US$ 76 million. This sector's result was also favored by Venezuela's increased demand for garments, as well as by larger sales to the United States.

Exports of chemical products increased 33.6 percent, due to larger volumes (22.9 percent) and, to a lesser extent, to higher prices (8.8 percent). The larger shipments of flexible laminate for wraps, destined mainly to Venezuela, should be pointed out.

3.2 Imports

Imports grew from US$ 14,866 million in 2006 to US$ 19,599 million in 2007 (31.8 percent increase) as a result of higher volumes of imports associated with increased economic activity and the higher prices of inputs used to elaborate foodstuffs and fuels.

Higher imports of capital goods and inputs, particularly for industry, were seen in 2007. The former amounted to US$ 5,885 million, while the latter amounted to US$ 10,416 million.

TABLE 28
IMPORTS INDEX [1/]
(Percentage change accoding the same period of the previous year)

	Volumen 2007 / 2006	Price 2007 / 2006
Imports	**19.6**	**10.0**
Of which:		
Core foodstuffs	4.8	30.2
Wheat	4.7	45.2
Maize	6.4	41.6
Rice	81.0	18.9
Sugar	0.5	-17.0
Soy	2.4	29.0
Diary	-13.2	46.6
Meat	12.7	4.1
Petroleum and derivatives	12.7	14.8

1/ Calculated on the basis of unit value (after dividing total value between total volume).
Source: BCRP and SUNAT.

Imports of **consumer goods** increased 22.2 percent. Imports of durable goods grew 24.6 percent, while non-durable consumer goods grew 20.3 percent. The higher imports of automobiles, motorcycles, and television (as a whole grew 36.3 percent), while the larger imports of medicines, prepared and edible products, dairy, and footwear were noteworthy among the latter.

Purchases of inputs, which represented 53.1 percent of imports, increased 30.4 percent. It is worth pointing out the larger purchases of inputs for industry, which increased from US$ 4,742 in 2006 to US$ 6,205 million in 2007.

Imports of food inputs increased by 43.7 percent and amounted to US$ 1,000 million, reflecting the higher prices of wheat, maize, and soybean. Wheat and maize imports increased by over 40 percent, while imports of soybean increased 29 percent. Although the growth of imports of industrial inputs was generalized, the higher imports of plastics, iron and steel products, textiles, chemicals, and fertilizers were noteworthy.

The oil balance was negative by US$ 1,242 million due to the higher imports of crude and derivatives, which amounted to US$ 3,490 million as a result of both higher prices (14.8 percent) and volumes (12.7 percent) given increased domestic demand.

TABLE 29
IMPORTS FOB, BY USE OR ECONOMIC DESTINATION

	Millions of US$			Percentage change	
	2005	2006	2007	2006	2007
I. CONSUMER GOODS	**2,308**	**2,611**	**3,191**	**13.2**	**22.2**
Non-durable	1,338	1,457	1,753	8.9	20.3
Durable	970	1,154	1,438	19.0	24.6
II. INPUTS	**6,600**	**7,987**	**10,416**	**21.0**	**30.4**
Fuel, lubricants and related	2,325	2,808	3,623	20.8	29.0
Raw materials for agriculture	384	437	589	13.7	34.8
Raw materials for industry	3,890	4,742	6,205	21.9	30.8
III. CAPITAL GOODS	**3,064**	**4,145**	**5,885**	**35.3**	**42.0**
Construction materials	305	475	590	55.8	24.1
For agriculture	37	31	51	-16.0	62.6
For industry	2,114	2,800	3,988	32.4	42.4
Transport equipment	607	839	1,257	38.2	49.8
IV. OTHER GOODS[1/]	**110**	**122**	**106**	**10.8**	**-13.3**
V. TOTAL IMPORTS	**12,082**	**14,866**	**19,599**	**23.0**	**31.8**
Note:					
Main food products[2/]	**746**	**880**	**1,203**	**17.9**	**36.7**
Wheat	209	224	345	7.2	53.9
Maize or sorgo	123	172	259	40.2	50.1
Rice	43	14	31	-67.1	118.6
Sugar[3/]	68	100	84	47.2	-16.2
Dairy	34	46	61	33.9	31.4
Soybean	246	299	396	21.6	32.4
Meat	23	24	27	3.7	15.9

1/ It includes the donation of goods, the purchase of fuel and food from peruvian ships ant the repair of capital goods in other country, as well as the other good considered according to the classifier used.
2/ Excludes food donations.
3/ Includes unrefined sugar cane.
Source: BCRP, SUNAT, Zofratacna, Banco de la Nación and companies.

The purchases of **capital goods** increased (42.0 percent) due mainly to higher imports of capital goods for industry (42.4 percent) and transport equipment (49.8 percent), both of which reflected the onset of investment projects in the hydrocarbon sector, as well as the expansion of production plants in the manufacturing sector.

By **market of origin**, the main supplier of imported products was the United States with 17.7 percent of total imports, followed by China and Brazil (12.0 and 9.1 percent respectively). In contrast with exports, it should be pointed out that imports from USA to Peru show a similar level to the one observed over the last three years. On the other hand, the relative higher participation of China in the structure of our imports should also be pointed out.

3.3 Services

The service component showed a deficit of US$ 928 million due to outlays for a total of US$ 4,270 million and incomes for a total of US$ 3,343 million. The deficit for services in 2007 was US$ 147 million higher than in 2006, mainly due to higher freight expenses paid to non-resident firms for the trade of goods, which grew by US$ 354 million between 2006 and 2007. It should be pointed out that freight costs for the transport of bulk products increased significantly: the average price per ton of food increased 49.8 percent compared to 2006, reflecting the higher prices of fuels and the lower availability of free carriers given the demand of China and India (See box).

The higher deficit in transport was partially offset by incomes associated with travels (visitors' spending), which grew 22.9 percent relative to 2006 due to a higher number of visitors in the country (12.2 percent) and a higher average spending per person (9.4 percent). On the other hand, the expenditure of Peruvians visiting other countries increased 27.6 percent. It is worth pointing out the incomes resulting from travels represented 58 percent of total incomes associated with this heading.

TABLE 30
SERVICES

	Millions of US$			Percentage change	
	2005	2006	2007	2006	2007
I. TRANSPORT	**-858**	**-934**	**-1,257**	**-8.9**	**-34.5**
1. Credit	440	525	632	19.3	20.4
2. Debit	-1,298	-1,460	-1,889	-12.5	-29.4
II. TRAVEL	**557**	**788**	**931**	**41.5**	**18.2**
1. Credit	1,308	1,577	1,938	20.5	22.9
2. Debit	-752	-789	-1,007	-4.9	-27.6
III. COMMUNICATIONS	**-28**	**-27**	**-21**	**4.0**	**20.1**
1. Credit	69	82	88	19.4	7.8
2. Debit	-96	-109	-110	-12.7	-0.9
IV. INSURANCE AND REINSURANCE	**-115**	**-163**	**-13**	**-41.8**	**92.1**
1. Credit	118	103	297	-13.5	189.5
2. Debit	-233	-265	-310	-13.7	-16.8
V. OTHER 1/	**-391**	**-446**	**-568**	**-14.0**	**-27.4**
1. Credit	354	361	388	2.0	7.4
2. Debit	-744	-806	-955	-8.3	-18.5
VI. TOTAL SERVICES	**-834**	**-781**	**-928**	**6.3**	**-18.7**
1. Credit	2,289	2,647	3,343	15.6	26.3
2. Debit	-3,123	-3,428	-4,270	-9.8	-24.6

1/ Includes services of government, financial, information technology, royalties, equipment rental and business services, among others.
Source: BCRP, SUNAT, Ministry of Trade Affairs and companies.

BOX 1

FOOD IMPORT SHIPPING COSTS INCREASED

Bills for import freights in 2007 amounted to US$ 1,447 million –a sum equivalent to 7.4 percent of total imports–, with shipping rates accounting for 90 percent of this total. The prices of international maritime transport showed an upward trend since September 2006, leading food import bills to increase by 56.6 percent in 2007 due to higher shipping rates. The shipping rates for moving maize, wheat, and soybean increased even more due to the higher prices of fuels and the lower availability of free maritime carriers, given the higher demand of China, India, and the main global steel producers and copper users for transport services.

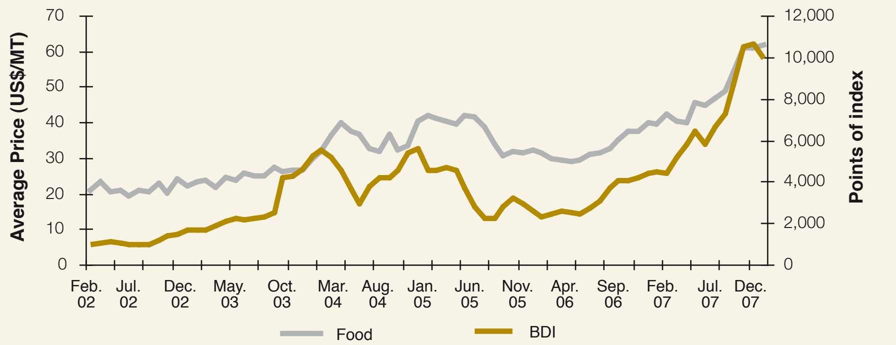
AVERAGE PRICE OF SHIPPING OF FOOD IIMPORT, YEARS 2003 - 2007

	2003	2004	2005	2006	2007
Foodstuffs (US$/MT)	25	35	37	33	50
Percentage change (%)	17.6	39.2	4.7	-10.4	49.8
Maize (US$/MT)	23	35	36	31	50
Percentage change (%)	31.5	53.6	2.9	-16.1	63.7
Wheat (US$/MT)	22	27	31	29	46
Percentage change (%)	17.6	25.7	13.3	-8.1	61.3
Soybean (US$/MT)	29	41	42	39	54
Percentage change (%)	21.2	43.1	1.7	-6.6	37.8
Other foodstuffs (US$/MT)	82.5	54.3	47.6	44.0	48.3
Percentage change (%)	72.1	-34.1	-12.3	-7.7	9.7

1/ Percentage change respect to the same period of previous year.

The trend observed in Peru's import shipping costs is in line with the information provided by the Baltic Dry Index (BDI), an index on shipping rates elaborated by the Baltic Exchange. This index covers dry bulk shipping rates for carrying a range of commodities (excluding petroleum) by sea through 24 world shipping routes, of which around 30 percent originate in Latin America. The Baltic Dry Index increased by over two-fold in 2007, reaching a record level of 11,039 points on November 13.

BALTIC DRY INDEX VS AVERAGE PRICE OF SHIPPING OF FOODSTUFFS



This increase in shipping costs is explained by an over demand for dry bulk shipping services given the high pace of growth of international trade. In addition to the lag observed in terms of vessel production, there is also a lag of nearly 36 months between the order and delivery of vessels, as a result of which new carriers would only be available in 2010.

1/ Taking in the main shipping routes measured on a timecharter and voyage basis, the BDI –reference value for sea shipping rates– covers capesize, panamax and handy dry bulk carriers carrying a range of commodities. The index is made up of an average of the Baltic Supramax, Panamax and Capesize indices which are weighed in terms of the shipping costs for each main route.

2/ The Baltic Exchange is a British organization that operates the global marketplace for shipbrokers, ship owners, and charterers.

3.4 Investment income

The investment income deficit amounted to US$ 8,418 million in 2007. This deficit is mainly explained by the result observed in the private sector (a negative flow of US$ 7,985 million), while the deficit in the public sector fell from US$ 679 million in 2006 to US$ 433 million in 2007 due to increased incomes associated with the BCRP's higher international reserves.

The negative flow in the private sector is explained by a higher remittance of profits by companies with foreign shareholding, particularly mining companies[4] (70.2 percent of total) whose profits have increased due to the higher prices of minerals –profits increased from US$ 18 million in 1999 to US$ 7,865 million this year. It should be pointed out that profits include both dividends paid to investors abroad and non-distributed gains.

Outlays for interests associated with the public and private sectors' external debt amounted to US$ 2,120 million.

TABLE 31
INVESTMENT INCOME
(Millions of US$)

	Millions of US$			Percentage change	
	2005	**2006**	**2007**	**2006**	**2007**
I. INCOME	**625**	**1,033**	**1,567**	**65.4**	**51.6**
1. Private	208	368	594	76.6	61.5
2. Public	417	666	973	59.8	46.2
II. EXPENSES	**5,701**	**8,616**	**9,985**	**51.1**	**15.9**
1. Private	4,419	7,271	8,579	64.5	18.0
Profits 1/	4,030	6,741	7,865	67.3	16.7
Interests	390	531	714	36.2	34.6
· due to long-term loans	213	218	308	2.6	41.4
· due to bonds	16	98	133	529.5	35.9
· due to short-term loans 2/	162	215	273	32.8	27.2
2. Public	1,282	1,345	1,406	4.9	4.5
Interests by long term loans	738	695	716	-5.8	3.0
Interests by bonds	539	645	670	19.8	3.9
Interests BCRP 3/	5	5	20	-8.8	306.5
III. BALANCE (I-II)	**-5,076**	**-7,583**	**-8,418**	**-49.4**	**-11.0**
1. Private	-4,211	-6,903	-7,985	-63.9	-15.7
2. Public	-865	-679	-433	21.5	36.3

1/ Profits or losses accrued in the period. Includes profits and dividends remitted abroad plus undistributed gains.
2/ Includes interests of non-financial public enterprises.
3/ Includes interest of short-term and long-term loans.
Source: BCRP, MEF, Cofide, ONP and companies.

4 The highest earnings were generated in the mining sector, followed by the financial sector.

3.5 Current transfers

Current transfers increased 14.2 percent in 2007 due to higher remittances from Peruvians living abroad (16.0 percent). A lower relative participation of remittances from the United States is being observed due both to the slowdown of construction and to the weakening of the dollar against the euro and the yen. Current transfers in 2007 amounted to US$ 2,495 million, a sum equivalent to 2.3 percent of GDP.

3.6 Financial account of the private sector and short-term capitals

In line with the country's economic dynamism, the financial account was characterized by strong increases in the flow of external resources. In this context, the private sector financial account and short-term capitals amounted to US$ 11,032 million, invested in several economic sectors. This amount was US$ 9,654 million higher than in 2006 due to higher direct investment, long-term disbursements, and portfolio investment in the country.

TABLE 32
FINANCIAL ACCOUNT OF THE PRIVATE SECTOR AND SHORT-TERM CAPITALS
(Millions of US$)

	2005	2006	2007
FINANCIAL ACCOUNT OF THE PRIVATE SECTOR AND SHORT-TERM CAPITALS	**1,582**	**1,378**	**11,032**
FINANCIAL ACCOUNT OF THE PRIVATE SECTOR	**1,818**	**1,941**	**9,002**
1. INFLOWS	**4,122**	**4,347**	**10,608**
A. Direct investment	2,579	3,467	5,343
of which: Reinvestment	2,724	2,353	4,696
B. Long-term disbursements	647	725	3,955
C. Portfolio investment	897	155	1,310
2. OUTFLOWS	**-2,304**	**-2,406**	**-1,606**
A. Portofolio investment	-690	-1,885	-987
B. Long-term amortization	-1,614	-521	-619
SHORT-TERM CAPITALS	**-236**	**-563**	**2,030**
A. Banks	103	-348	1,552
B. BCRP	0	0	850
C. Others	-339	-216	-372

Source: BCRP, Cavali ICLV S.A., Proinversión and companies.

By components, the private sector financial account amounted to US$ 9,002 million, of which US$ 5,343 million was direct investment (including reinvestment of earnings, capital contributions, and privatization). Increased direct investment is mainly explained by a higher reinvestment of earnings (US$ 4,696 million versus US$ 2,353 million in 2006), especially in the mining and oil, where several investment plans are already in place for 2008 and the following years given favorable expectations about the evolution of economic activity in the country. This higher amount of retained earnings resulted mainly from the lower dividends paid by mining companies to foreign investment: dividends dropped 33 percent compared to 2006. Moreover, new investment was mainly oriented to the hydrocarbon, fishing and mining sectors.

BOX 2

DIRECT FOREIGN INVESTMENT AND REINVESTMENT OF EARNINGS

Direct foreign investment (DFI) was minimum and even negative until the early nineties. With the stabilization of the economy and the pacification of the country, the inflow of foreign capitals showed a more dynamic pace, especially in the sectors of communications, energy and mining.

The inflows of DFI observed in the country in the following years, mainly in the mining sector, as well as the higher prices of exports increased the earnings of said investments.

It is worth pointing out that firms' financing through capital contributions of the parent company, loans to third parties, or capital gain reinvestment depends not only on general economic and financial conditions, but also on firms' management plans.

When we analyze the overall flows of DFI until 2002 we see that DFI consisted mostly of new external financing: contributions of the parent company or incomes for privatization. On average, the payment of dividends was 78 percent of total earnings generated.

Dividend payment depends on firms' policies and plans for future investment in Peru and in the rest of the world. On the other hand, the reinvestment of earnings reflects investors' will to maintain gains in a country. Today, nearly 80 percent of reinvestment in the Peruvian mining sector comes from companies that have investment plans for 2008 and the upcoming years.

Dividend payment in the last five years represents around 50 percent of the earnings generated by these companies. However, the share of gain reinvestment in DFI has been 86 percent. This evolution reflects the current capacity of firms to finance their investment projects with the resources generated in the country. A similar situation is observed in Chile, for example, where gain reinvestment in the last five years represented 85 percent of DFI.

EARNINGS AND DIRECT FOREIGN INVESTMENT (DFI)

	Millions of US$			Percentage contribution		
	1990-2002	2003-2007	1990-2007	1990-2002	2003-2007	1990-2007
Total earnings	**4,096**	**22,314**	**26,410**	**100**	**100**	**100**
Dividend payment	3,211	10,039	13,250	78	45	50
Reinvestment	884	12,275	13,159	22	55	50
FDI	**19,526**	**14,262**	**33,787**	**100**	**100**	**100**
Reinvestment	884	12,275	13,159	5	86	39
Net capital contributions [1/]	12,885	1,791	14,676	66	13	43
Privatization	5,756	196	5,952	29	1	18

1/ Includes net loans of head office.

On the other hand, the net flow of long-term loans amounted to US$ 3,363 million, particularly due to direct credit to the financial sector (US$ 2,313 million) and to loans to the non-financial sector (the sale of an important bank's portfolio to foreign investors and the loans granted to the fishing and oil sectors should be pointed out here). Loan amortization was US$ 619 million in 2007.

The net flow of other external assets and liabilities amounted to US$ 194 million. In other words, the increase of liabilities with non-residents was higher than the increase seen in the assets that residents in the country purchased abroad. The investment portfolio in the country during the year was higher, especially due to the purchase of sovereign bonds and CDBCRP by non-residents. This compensated the lower portfolio of investments abroad since institutional investors diversified their portfolios to reduce risks given the volatility observed in the international market.

The financial flow of short-term capitals amounted to US$ 2,030 million, mainly due to the higher financing provided to banks and to the acquisition of BCRP Certificates of Deposit by non-resident investors.

4. International asset and liability position

Peru's international position increased in terms of the external debt from US$ 28,395 to US$ 32,565 million, in line with the higher financing received by the private sector. The public debt decreased both in nominal terms and as a percentage of GDP, in line with the strategy aimed at reducing the debt in foreign currency.

The foreign investment position increased from US$ 19,356 million (equivalent to 20.8 percent of GDP) to US$ 24,744 million (equivalent to 22.7 percent of GDP) between 2006 and 2007, while capital participation showed an important increase, rising from US$ 9,043 million (equivalent to 9.7 percent of GDP) to US$ 19,077 million (equivalent to 17.5 percent of GDP) in the same period due to the higher value of assets held by non-residents.

BOX 3

THE SUBPRIME MORTGAGE MARKET AND ITS IMPACTS ON INTERNATIONAL FINANCIAL MARKETS

Subprime mortgage loans –or high risk mortgages– are loans granted to borrowers with low credit scores, and represent 13.7 percent of the US mortgage market[1/]. These loans are basically characterized by the amount of the loan –which is usually higher than 80 percent of the value of the mortgaged residence– and by a debt service-to-income ratio of over 55 percent, as well as by incomplete documentation.

Subprime mortgages are usually taken at variable interest rates (200-300 bps higher than rates on prime mortgages), especially at adjustable interest rates (the interest rate is fixed during two or three years and is then readjusted at much higher variable rate). The subprime mortgage market has shown a significant dynamism in the last years, growing from US$ 190 billion in 2001 to US$ 600 billion in 2006.

This evolution in the subprime mortgage market was coupled by a growing supply of securities backed by mortgages in the subprime segment. The demand for these securities was favored by the reduction of interest rates in the United States (due to the FED's expansionary policy at the beginning of this decade and to emerging economies' high demand for US Treasury bonds) and by the development of structured financial instruments[2/]. However, the mortgage boom started showing a reversal after the FED began to raise its interest rates in 2005, while the prices of residences initiated a downward trend.

Since early 2007, higher mortgage default levels –default rose from 13.8 percent in the first quarter to 17.3 percent in the fourth quarter– caused problems to the financial companies that had generated these mortgages (for example, New Century went bankrupt in March), as well as the reduction of the scores assigned to mortgage-backed securities (MBS) and collateralized debt obligations (CDO). Initially only investment funds with high exposure to these papers were affected –for instance, three Bear Stearn's funds collapsed in July–, but later generated stagnation in the operations of financial institutions[3/] receiving short-term funds for investments in said financial securities, also causing problems in the banks promoting the latter (i.e. BNP Paribas in August and Northern Rock in September).

The expected higher deterioration of the subprime mortgage market (due to the drop in the prices of houses and the expected adjustment of interest rates on mortgage loans) generated a reduction in credit scores, with the subsequent drop of value of securities associated with subprime mortgages. Little interest in said financial instruments then caused significant losses in most major banks worldwide, by the overvaluation in such securities, as well as liquidity problems.

The deterioration of liquidity conditions observed in the bank systems of developed economies led investors' risk perception to increase, which in turn contributed to increase fears of a greater slowdown in the global economy, generating subsequently the drop of stock markets and the decline of the yield on the US Treasury bond.

In this context, the main central banks started injecting liquidity into the bank system and then either reduced interest rates (USA and the UK) or postponed raising them (Eurozone and Japan). Given announcements of weak results and due to increased requirements of capital from major banks (especially Citigroup banks, Merrill Lynch, UBS), central banks reacted more vigorously implementing a series of measures aimed at reducing credit constraints (i.e. offering more liquid funds, extending the term of collaterals, and accepting a greater variety of collaterals.

The measures adopted by central banks and the announcements of capital contributions (mainly from governments' investment funds) made by the major financial corporations have prevented lending conditions from deteriorating even further, yet risks of new episodes of volatility remain since the losses officially recognized by banks are only a fraction of the losses incurred in the subprime mortgage market.

1/ The US mortgage market is estimated to be equivalent to 85 percent of GDP in the United States GDP and to 55 percent of the value of residences.
2/ Namely Mortgage Backed Securities (MBS) and Collateral Debt Obligations (CDO).
3/ Special Investment Vehicles (SIV) and conduits.