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Investment Policy Review

Peru



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ABBREVIATIONS

APEC	Asia-Pacific Economic Cooperation (forum)
CANATUR	Cámara Nacional de Turismo (National Chamber of Tourism)
CAN	Community of Andean Nations
CETICO	Centros de exportación, transformación, industria, comercialización y servicios (industrial and trade free zones)
COFIDE	Corporación Financiera de Desarrollo (Development Finance Corporation)
CONITE	Comisión Nacional de Inversiones y Tecnologías Extranjeras (National Commission for Foreign Investment And Technology)
COPRI	Comisión de Promoción de la Inversión Privada (Commission for the Promotion of Private Investment)
CTAR	Consejos Transitorios de Administración Regional (Regional Departments of Investment Promotion)
FDI	foreign direct investment
FTAA	Free Trade Area of the Americas
FTZ	free trade zone
GDP	gross domestic product
GSP	General System of Preferences
ICSID	International Convention on the Settlement of Investment Disputes between States and Nationals of other States
INDECOPI	Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual (National Institute of Fair Competition and Intellectual Property Protection)
INRENA	Instituto Nacional de Recursos Naturales (National Institute for Natural Resources)
IPO	Initial Public Offering
JICA	Japan International Cooperation Agency
LCV	light commercial vehicle
M&As	Mergers and Acquisitions
MERCOSUR	Mercado común del Sur (Southern Cone Common Market)
MFN	most-favoured nation
MITINCI	Ministerio de Industria, Turismo, Integración y Negociaciones Comerciales Internacionales (Ministry of Industry, Tourism, Integration and International Trade).
PROMCEPRI	Comisión de Promoción de Inversión Privada en Concesiones (Commission for the Promotion of Private Investment in Concessions)
R&D	research and development
SMEs	small and medium-sized enterprises
SNMPE	Sociedad Nacional de Minería, Petróleo y Energía – Perú (National Society of Mining, Petroleum and Energy – Peru)
TNC	transnational corporation
WTO	World Trade Organization

PREFACE

The UNCTAD Investment Policy Reviews are intended to familiarize Governments and the international private sector with an individual country's investment environment and policies. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review of Peru was initiated at the request of the National Commission for Foreign Investment and Technology (CONITE), and has received the full support of its Secretary General and staff. The UNCTAD missions received the full cooperation of all relevant senior officials and Ministries of the Government of Peru and the Permanent Mission of Peru to the United Nations Organizations in Geneva.

The views of the international donor community in Peru, the international private sector and domestic business were canvassed at various stages of the project.

The report has also benefited from the contribution of a number of experts within and outside Peru. The national experts included Mercedes Araoz and Carlos Casas of the Universidad del Pacifico; Jorge Fernández Baca and Fernando González Vigil of the Centro de Investigación de la Universidad del Pacifico were advisers to the programme; and Manuel Luy Molinié, Juan Francisco Casto Carlin, Luis Lituma Sánchez Checa and Marisol Inurritegui Maúrtua provided research assistance. The international experts included Rory Allan, Ludovico Alcorta and Alejandro Vera Vassallo. The UNCTAD staff involved were Khalil Hamdani, Fiorina Mugione and Prasada Reddy; Celia Cornejo, Luis Castro, Cathy Dawson, Hector Rincon-Ortiz and Luis Toral also provided inputs. Chiraz Baly, Stefano Ricciardi and Airton Valente provided research assistance.

The United Nations Development Programme provided funding through the Support Services for Policy and Programme Development (SPPD) and the UNCTAD/UNDP Sectoral Support Programme. Financial support was also provided by the Government of Peru and the Government of Switzerland.

It is hoped that the analysis and recommendations emanating from this review will promote awareness of the investment environment, contribute to an improvement in policies and catalyse increased investment in Peru.

Geneva, September 2000

INTRODUCTION

Peru's investment climate improved dramatically in the 1990s. The hyperinflation, high government deficits and economic turmoil of the 1980s are long gone. Durability and stability are the cornerstones of the new policy orientation.

The main objective of the Government since 1990 has been to create an economic and political environment that allows privately owned businesses to emerge and develop. On the economic front this has meant creating a solid fiscal and monetary base, a reduction in the trade deficit, and a sound exchange rate regime for Peru's latest currency, the Nuevo Sol. On the political front it has involved efforts to reduce terrorist activity, and the conclusion of a peace agreement between Peru and Ecuador that has settled the border dispute between the two countries. The peace agreement entails, inter alia, the design of mechanisms and modalities to foster public and private investment flows within the framework of the Binational Border Integration Plan.

The change in economic policy has been accompanied by a fundamental redefinition of the role of the State. The 1993 constitution strongly encouraged private initiatives — from a large range of State-controlled business holdings cutting across all sectors, the Government has now divested itself of most of its productive ventures. All government holdings in the fisheries and financial sectors, more than two thirds of those in mining, oil and telecommunications and, to a large extent, electricity generation and distribution have been privatized. The construction and management of roads, ports, railroads and airports is also in the process of being granted in concessions to private investors.

Other landmark events include the passage of a state-of-the-art investment law in 1991, the settlement of three major foreign investment disputes and the introduction of pro-market regulatory policies.

This policy shift has not been without hardship. The 1990 stabilization programme was severe — during 1990-1992, per capita income fell to its lowest level in several decades. However, since then, per capita income has grown steadily. Private enterprise also bore the burden, with most companies being forced to restructure during the 1990s. Industrial production and economic activity in the private sector has nonetheless flourished.

Over the last nine years Peru has been successful in attracting foreign direct investment (FDI). The volume of FDI grew dramatically, leading Peru to become among the top recipients of FDI in the world. The main reasons for such success are the privatization of public assets and a favourable investment climate created by the Government. With privatization opportunities dwindling, the question arises as to whether FDI inflows will also subside or whether Peru will be able to build on its past success and attract FDI into new areas.

Attention must now turn to policies for the next decade that will enhance Peru's potential for FDI. This report examines the strategic directions that would enable the country to continue to attract investment. It emphasizes the need for strategies to deepen the impact of existing FDI and to encourage new investment — domestic and foreign — into Peru's emerging industrial clusters of core competence. In brief, Chapter I analyses Peru's success in catapulting into the ranks of the top 10 host developing countries for FDI. The growth in FDI inflows has been high by world standards, and particularly so for a country whose comparative advantage rests on its natural resource endowments. However, FDI has been concentrated in a few large projects and it has not substantially contributed to a diversification of economic activity or exports. If inflows are to be sustained at the current high levels, there is need to promote growth in the rest of the economy by strengthening technological capabilities, education, infrastructure and enterprise support institutions.

Chapter II reviews the policy and operational framework for FDI. Peru has substantially achieved best practice in key aspects of investment protection and specific standards of treatment. In this respect the country's investment policy regime compares very favourably with that of the other economies of the Asia-Pacific Economic Cooperation (APEC) forum, including those with strong natural resource sectors.

Chapter III considers Peru's FDI strategy. Resource-seeking FDI is likely to remain important for many years and there is a need to enhance the competitive strengths of the resource-based industries by encouraging investment in the linked and supplier industries. In these and other industries, existing foreign firms should be encouraged to diversify their activities and build vertical and horizontal linkages with the local economy. There is also the need to create competitive advantages for Peru so as to attract FDI in the manufacturing sector to cater to the domestic and regional market.

Chapter IV examines three core industries which can play lead roles in stimulating investment and economic activity in the larger economy. One is mining, where Peru can strive to create a highly efficient industrial cluster. The second, is tourism, whose potential has not been adequately exploited. The tourism industry can attract many more visitors if cultural sites are made more easily accessible and safe, are well-maintained and presented, and if there is increased investment in providing the standards of hotels, restaurants and other facilities and services required by the international tourist market. The third, agribusiness, benefits from favourable location and climate, but it requires large investment and high technology as well as an entrepreneurial vision, totally distinct from past practices, to stimulate value-added activities that would build on agriculture-based industrial production.

Table. Indicators of macro-economic performance, 1994-1999
(Millions of US dollars and percentage)

Key indicators	1994	1995	1996	1997	1998	1999
Real GDP growth (%)	13.1	7.3	2.5	6.9	0.30	3.8
GDP per capita	2174	2514	2543	2675	2532	2263
GDI/GDP	21.8	24.3	23.3	24.4	24.3	21.7
Private investment, % GDP	17.6	20.2	19.4	20.4	20.3	17.5
FDI inflows (US\$ millions)	3108	2048	3242	1702	1930	2068
FDI stock % GDP	8.9	10.1	10.9	11.9	12.8	15.6
Domestic savings % GDP	16.5	17.1	17.4	19.4	18.3	18.1

Source: Central Bank and CONITE.

I. Foreign Direct Investment in Peru

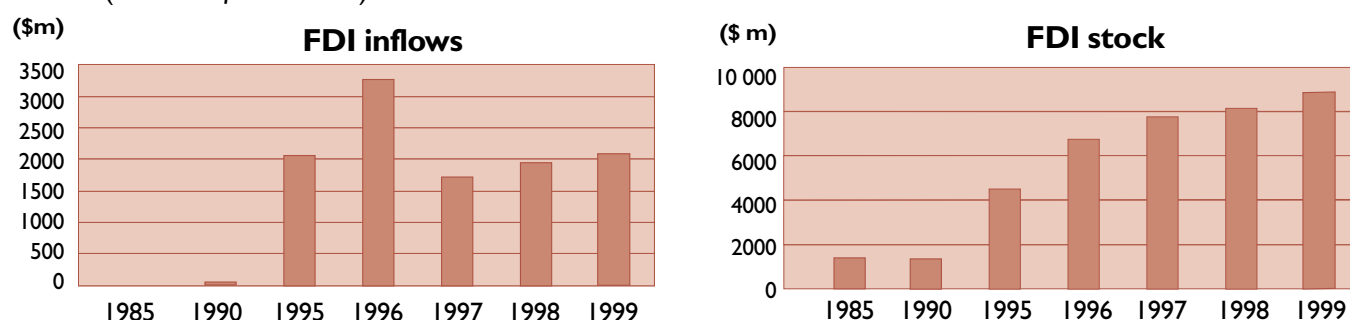
A. Recent investment trends

I. Foreign direct investment inflows

Peru has been successful in attracting substantial inflows of FDI in recent years. From an annual average of US\$ 30 million in the 1980s, FDI inflow rose to around US\$ 2 billion per annum in the second half of the 1990s. By 1996, Peru had joined the league of the top 10 recipients of FDI among developing countries (UNCTAD, 1999)¹ and in 1998, Peru's FDI inflows were the sixth largest in Latin America. Peru has also weathered external shocks — the fallout from the Asian crisis in 1998 and the ensuing financial turmoil in Brazil, the largest economy in Latin America — better than anticipated.

A large part of the inflows into Peru in the 1990s — 35 per cent of registered FDI — came in through the privatization programme. Over the current decade the Peruvian State divested most of its holdings in the fisheries and financial sectors and more than two thirds of those in mining, oil and telecommunications. The aggressive privatization programme in mining opened the door to new foreign firms to invest in the country, including Newmont Mining Corporation, Noranda, Anglo American, Doe Run, Cyprus Amax and Broken Hill Proprietary (see box I.1). A noteworthy feature of the privatization programme is that the new owners committed themselves to further new investments of about US\$ 9.1 billion for modernization and expansion of the firms acquired. As these investments are realized, the stock of FDI in Peru will almost double. By end-1999, it stood at about US\$ 9 billion (see figure I.1).

Figure I.1. Flows and stocks of foreign direct investment in Peru, 1985-1999
(Millions of US dollars)



Source: UNCTAD database on FDI and TNCs.

The privatization programme has meant not only huge quantitative inflows of FDI but also qualitative improvements in production. In fisheries, for example, Peru was one of the top fishing nations in the world in the 1950s, but it lost this position by the mid-1970s due to overfishing. The State had taken over this sector in the 1970s. The sale of plants in the 1990s has prompted a process of modernization and diversification of the industry led by business restructuring, new investment and growing efficiency. For example, Sindicato Pesquero's (SIPESA), bought three State plants for US\$ 22 million and plans to increase its investment to US\$ 400 million. Its new investments include the purchase of advanced trawlers, waste recovery equipment and a new fishmeal plant in the southern port of Matarani. There are a variety of similar investments by other firms, including one by Austral SA (a joint venture between Peruvian and Venezuelan capital) involving sophisticated environmentally friendly technology. These investments and modernization have enabled Peru to regain its position among the top fishing nations. Fish products today account for 15 per cent of the country's total exports and the fishing industry (including fishmeal, fish oil and fish canning) contributes over 3 per cent to GDP.

¹ UNCTAD (1999). *Foreign Direct Investment and the Challenge of Development*, United Nations publication, Sales No. E.99.II.D.3.

Box I. 1. A golden joint venture: Minera Yanacocha S.A.

Minera Yanacocha is a gold producer located in the department and province of Cajamarca in northern Peru. Its operations started in 1993. The mining group exploits five different fields that were incorporated into production between 1993 and 1998 and it also has two treatment plants. Yanacocha is a joint venture between Newmont Mining Corporation (United States), the Peruvian mining group, Buenaventura, and the International Finance Corporation of the World Bank with 51.35 per cent shares, 42-65 per cent shares and 5 per cent shares respectively. Newmont is the largest gold producer in the United States and the second largest worldwide. Its competitive advantage lies in the long experience gained and technology and innovation processes introduced in one of the largest goldfields discovered this century, Carlin Trend located in Nevada. After a period of diversification in several mining and extraction activities (copper, zinc, oil and gas), Newmont decided in 1987 to concentrate all its activities in gold.

Buenaventura is one of the strongest mining groups in Peru with almost 50 years of operation. It has consolidated different mining and related activities, including engineering consulting, oil extraction and mineral production. The joint venture between Newmont and Buenaventura brought to both partners many benefits. Newmont gained access to a field with very low production costs (US\$ 104 per ounce), which counterbalanced the high costs of production in the company's other operations located in United States (US\$ 225), Eastern Europe (US\$225) and Indonesia (US\$ 224). This company was therefore able to maintain its lead position in the gold industry. By entering into partnership with a local firm, Newmont also reduced its investment risk and was able to gain a better understanding of national economic, political and social conditions. Finally, as the geology of the Yanacocha mine was very similar to that of Carlin Trend, Newmont was able to transfer to its partner its proven expertise in geology and mining. Through its participation in Yanacocha, Buenaventura became the first Peruvian group able to participate in and develop a large-scale mining project, it consolidated its position as a precious metal producer, and gained expertise in hydrometallurgical treatment. Finally, all components of the Buenaventura Group got access to subcontracting in support activities for the gold mine.

The configuration of the industrial network set by Minera Yanacocha SA included backward and forward linkages. All the gold production of Yanacocha is sold to a gold refining based in the United States with no involvement of the Peruvian industry. Backward linkages include providers of goods and services for Minera Yanacocha SA, mainly national producers and distributors of imported goods. The latter have a strong relationship with the mining project. Linkages with national producers, by contrast, are weak since they cannot offer the high technology inputs required by a large mining project. However, there is potential for further development of industries and service providers linked to the mining industry both to deepen the economic contribution of mining and to enhance its competitive position (see chapter IV).

Source: Juana R. Kuramoto (2000). *Las aglomeraciones productivas alrededor de la minería: el caso de la Minera Yanacocha S.A.*, ECLAC, Sales No. S.00.II.G.12.

Other sectors have had similar experiences. Privatization has attracted large investments by strategic foreign investors in natural resources and has contributed to the expansion of productive capabilities in the primary sector. The privatization of telecommunications, energy and banking has also attracted high levels of FDI and has resulted in the expansion, modernization and consolidation of the services sector (see box I.2).

Box I.2. Privatization of the telecommunication sector in Peru

Peru's large telecommunications companies were privatized in 1994. Telefónica de España of Spain acquired 35 per cent of the equity in the Empresa Nacional de Telecomunicaciones (Entel), and in the Compañía Peruana de Teléfonos (CPT S.A.) and merged the two companies into Telefónica del Perú. The US\$ 2 billion acquisition amounted to about 30 per cent of Peru's inward FDI in 1997. By mutual agreement between the Government and Telefónica del Perú, the monopoly of basic telephone services granted for five years ended a year earlier than the contracted date, opening up the sector to competition in August 1998. As of 1998, Telefónica del Perú had invested more than US\$ 2.5 billion to expand fixed lines, cellular phone, cable television, Internet connection and satellite communications services. Between 1994 and 1999, the installed lines increased from 874,760 to 2,021,576. The density of telephones increased from 4 to 7 lines per 100 people. The lines installed per worker increased by 235 per cent. Digitalization in the Peruvian telecoms reached 90 per cent, facilitating the growth of value-added services, including data storage and retransmission, Internet services and teleprocessing.

As signatory to the World Trade Organization (WTO) agreement to eliminate barriers to trade and investment in telecommunication services, Peru was committed to the total opening of its market by June 1999. Other commitments included open numbers of operators that could be restricted only for technical reasons and connections guaranteed to new entrants. Introducing competition in long distance telecom services, both national and international, meant allowing new operators to enter and position themselves in the fixed telephony. However, there were some disagreements between Telefónica del Perú and new operators concerning the cost of connection and network pre-selection. In this regard, Bellsouth of the United States recently drew the attention of its Government to the difficulties it was experiencing in entering the Peruvian market. Osiptel, the Peruvian telecom authority, announced that it will take steps shortly to resolve disputes between the dominant operator, Telefónica del Perú, and new entrants seeking reasonable and non-discriminatory interconnection rates for the use of its network. As for mobile telephony, the first concession was granted to STET (Italy) and two more are expected to be leased in 2000. Regarding concessions in local fixed telephony there are three operators in Peru — Bellsouth, FirstCom and Boga Communications. The Government has also made efforts to develop public telecom services in rural areas. Although Telefónica del Perú had made a commitment to install public telephones in 1,500 rural areas, it had actually installed 1,521 by March 2000. However, these have proved insufficient for existing needs and a special investment fund, FITEL, was launched with the aim of improving services in rural areas. Concession schemes were devised and the participation of foreign investors sought. For example, a project to install public services in the northern area, Frontera Norte, was granted to Global Village Telecom, an Israeli firm. A local firm, Telerep, has associated with Hughes (United States affiliates of General Motors) to develop three major projects in rural areas. The combined investment of the many different operators in Peru is estimated at US\$ 1.4 billion in 1999-2000. In addition, the forming of an alliance in 1998 among Telefónica de España, Worldcom and MCI has enhanced the viability of a mega project which plans to lay a 7,000 kilometre pan-American fibre-optic telephone cable network, which will cover the entire Pacific and Caribbean coast. The Peruvian company will manage and operate the pan-American cable system, investing 30 per cent of the total planned investment.

Source: ECLAC (1998). *Foreign Investment in Latin America and the Caribbean*, United Nations publication, Sales No. E.98.II.G.14, Telefónica del Perú, *Annual Report*, 1999, and Universidad del Pacífico, mimeo.

2. FDI by sector

Privatization has changed the sectoral composition of FDI. In earlier decades, FDI was concentrated in mining, manufacturing and trade. In the 1990s, the services sector has been a dominant recipient of FDI attracting investment from 29 countries. Telecommunications and energy attracted a large share of FDI inflows during 1993-1999. Another characteristic of privatization is the high concentration of recent FDI in a few large projects, rather than more diversified investments across industries (see figure I.2).

FDI has been relatively limited in the manufacturing sector, where domestic capital has played a more important role in the privatization process. As of 1997, some 70 per cent of State-held assets in manufacturing industries were acquired by domestic investors. FDI in manufacturing has relied on reinvestments by existing investors. For example, Nestlé Peru invested US\$ 16 million between 1996 and 1998 to modernize its plants. In other industries, such as metals and machinery, and construction, investments increased to meet the growing demand generated by large mining projects and infrastructure development. For example, BICC Cables Peru, a joint venture of BICC of Spain and SEPER, a domestic manufacturer, invested in building a new line for cables. In food and beverages, foreign companies used acquisitions as a strategy to gain control of local companies. For example, Inchcape Overseas Ltd., (United Kingdom) acquired Embotelladora Latinoamericana, Unilever (United Kingdom/Netherlands) acquired Industria Pacocha, and Coca Cola (United States) took a minority share in the manufacturer of a favourite local drink, Inka Cola.

There appears to have been a process of fairly rapid industrial concentration with the gap widening between large and small firms and micro-firms within the informal sector.

Table I.1. Inflows of FDI in Peru's manufacturing industries, 1992 and 1999
(Percentage)

Industry	1992	1999
Food, beverages, tobacco	75.8	7.2
Textile, garments, leather	6.7	17.6
Wood	0.5	0.1
Paper	0.2	21.9
Chemicals	54.1	9.2
Minerals, non-metallic	0.1	0
Basic metals	0.1	0
Metallic, machinery and equipment	-37.1	44.0
Other	0.4	0
Total manufacturing	100	100

Source: CONITE, 2000.

The early wave of FDI was in the mining sector, accounting for 43 per cent of FDI inflows in the early 1990s. Although this share has dipped in recent years, mining is expected to continue to dominate Peru's FDI profile. Significant mineral developments include: Antamina zinc/copper deposits being developed by the Canadian firms Rio Algom Ltd, Naranda Inc. and Teck Corporation; gold mining in Pierina mine by Barrick Gold (United States) and the expansion of Southern Peru Limited (United States). Some large investments in the pipeline include the extraction of the La Granja and Quellaveco mineral deposits owned respectively by Cambior Inc. (Canada) and Anglo American (South Africa).

In the hydrocarbon sector, the most significant prospective development is the Camisea natural gas deposits open to an international bidding process. A Shell-Mobil consortium had a first option on the Camisea deposits but pulled out in 1998. The Government has redrawn the bidding rules and charged the privatization and concession agency, Copri, with securing private investors to develop Camisea and call the tender. Under the new scheme, there were two separate tenders: first for transport and distribution, and then for production. The 33-year concession for transport and distribution will go to the company that offers it at the lowest cost and has yet to be awarded. The Camisea fields, granted under a 40-year concession, have been awarded to the bidder offering the highest annual royalties on production. This has turned out to be a consortium comprising Pluspetrol (Argentina) and Hunt Oil (United States) each with 40 per cent share and SK (Republic of Korea) with the remaining 20 per cent share. The planned investment to the year 2003 is US\$ 400 million.

Another concession programme has resulted in the privatization of the bulk of electricity generation and distribution. In addition, concessions have been granted for the management of infrastructural facilities (see chapter II). New concessions include the State railway system, several ports, Lima's international airport, and the 25-year concession for the so-called "highway network number five". The highway, the first of 11 such packages, should build a stretch of the Pan-American Highway north of Lima to Pativilca and several interlinked roads — a total of 410 kilometres. The investment for widening, resurfacing and upgrading is estimated to be \$140-180 million. New investment projects have also started in tourism and related activities (see chapter IV). During the first quarter of 2000, a total of US\$ 272 million had been raised by the sale of shares in Edegel, the sale of share of two electricity companies and the granting of a mobile telephone license for personal communication services.

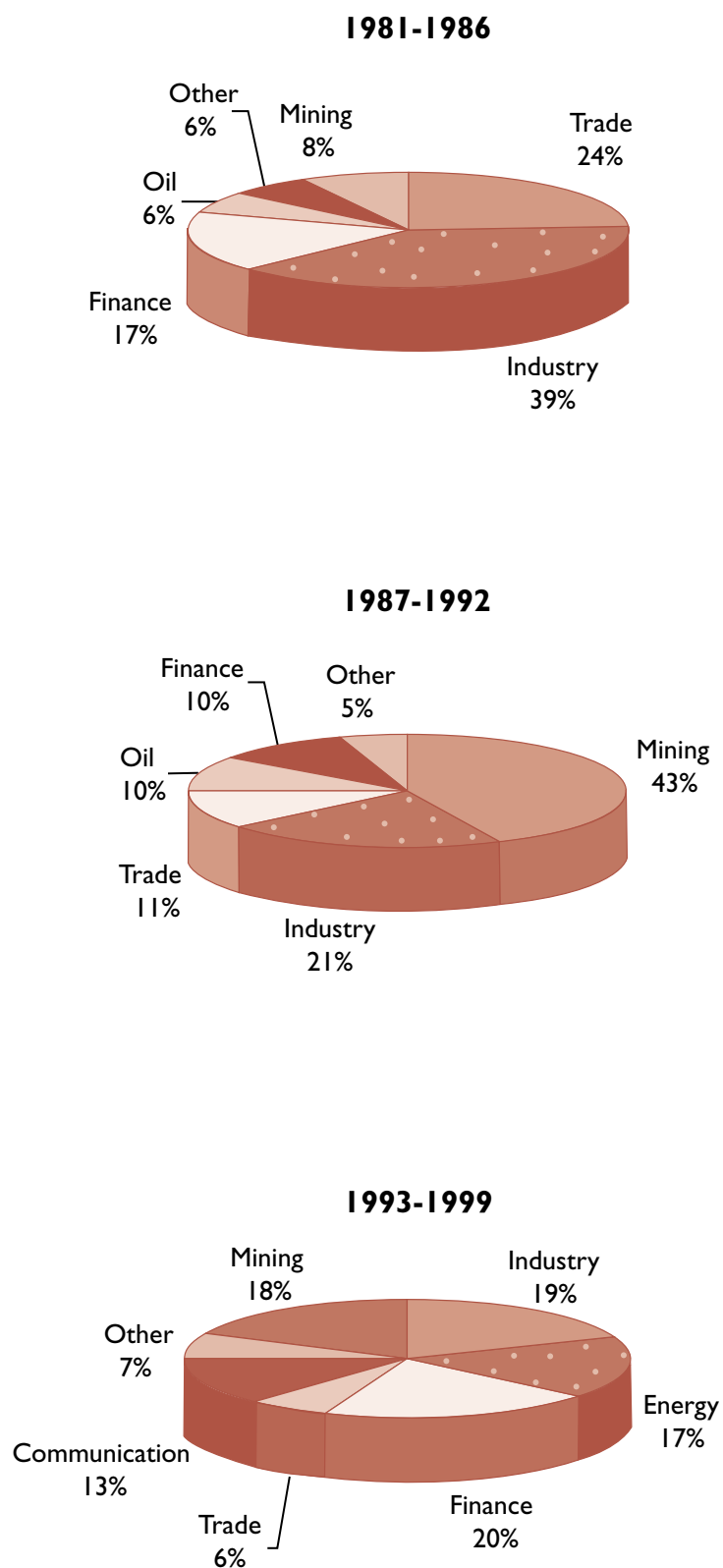
Finally, it should be noted that in the 1990s there has been little FDI — or domestic investment for that matter — in agriculture. This is surprising, as Peru has exceptional conditions for agricultural products. Unrestricted private ownership of agricultural land in Peru only began in 1991, but there is still a lack of detailed rules and regulations that would facilitate the application of the law. A business restructuring process has begun in the sugar cooperatives, allowing private domestic and foreign investors to become partners and manage some plantations. But most sugar plantations have been trying to raise funds in the open market and only a few have succeeded, as illustrated by the tenders for five of the largest plantations, which did not attract a single bidder. Shares seemed to be overpriced, bidders were required to purchase a majority stake, corporate liabilities were exceedingly high and many of the potential investors could not afford to make the investment commitments requested by the Government. Yet there is evidence of innovation. For example, thanks to partnerships between domestic and foreign investors, a small number of new agricultural products, such asparagus, have emerged as export items.

3. Sources of FDI

In the 1980s, the United States was the largest foreign investor in Peru, accounting for 48 per cent of total FDI. Other sources were somewhat more diversified, with the "other countries" category accounting for 26 per cent of the total FDI inflows (see table I.2).

During 1990-1996, Spain overtook the United States as the largest investor, accounting for almost 50 per cent of the total FDI inflows, mainly as a result of the acquisition of Peruvian telecommunications companies by Telefónica of Spain. On a smaller scale, Spanish institutions, such as Banco Santander, Banco Bilbao Vizcaya (BBV), Banco Central Hispano (BCH) and Mapfre Seguros, entered the financial services market through acquisitions of local banking institutions. Also during this period, the United Kingdom and the Netherlands doubled their respective shares. New investors, such as Canada and Chile, became important sources of FDI, accounting for 15 per cent and 4 per cent respectively of the total FDI inflows in 1999.

Figure I.2. Foreign direct investment inflows in Peru by industry, 1981-1999
(Percentages)



Source: CONITE, elaborated by Universidad del Pacifico, 1999.

In 1999, almost two thirds of inward FDI originated in just three countries — Canada, the United Kingdom and the United States — largely due to investment in mining. Panama invested in 1997 in the privatization of the electric power sector; however, over 50 per cent of FDI from Panama is in fact a capital contribution by companies from other countries. For example, in the electric power sector, the investment came from Entergy Corp (United States) and Endesa (Chile). Some Peruvian firms also channel their investments through Panama.

Table I.2. Inflows of FDI in Peru by country of origin, 1980-1999
(Percentage)

Country	1980-1989	1990-1996	1997	1999
Canada	4	2	-	15.9
Chile	0	5	2	3.7
China	-	2	-	-
Netherlands	3	6	13	1.0
Panama	12	2	26	2.2
Spain	0	48	-5	0.1
United Kingdom	7	14	22	38.7
United States	48	13	23	27.5
Other countries	26	8	21	10.4

Source: CONITE, 1998.

There are many transnational corporations (TNCs) with relatively advanced technologies, either wholly-owned or in joint ventures, operating in the Peruvian economy, (see table I.3). Among these, mining and food companies seem to be involved in exporting, while others are catering to the domestic market.

Table I.3. Main foreign investors in Peru, 1990-1999
(Millions of US dollars)

Foreign investor	Home country	Affiliates in Peru	Sector	Investment 1990-1999
Telefónica de España	Spain	Telefónica Perú S.A.	Telecom	2 002 179
Southern Perú Limited	United States	Explosivos S.A.	Mining	331
		Recursos e Inversiones Andinas S.A.		15 425
		Southern Perú Limited, Sucursal del Perú		373 343
Endesa	Chile	Generandes Perú S.A.	Energy	235 463
Dominion Energy Inc.	United States	Inversiones Dominion Perú S.A.	Energy	228 200
Ontario-Quinta A.V.V.	Chile / Canada	Luz del Sur S.A.	Energy	211 112
Global BHP Copper LTD.	Australia	BHP Tintaya S.A.	Mining	188 095
E.P. Edegel Inc.	Spain/Chile	Entergy Power Perú S.A.	Energy	164 995
Banco Bilbao Vizcaya S.A.	Spain	Holding Continental S.A.	Banking	156 688
Ral Cayman Inc.	Canada	Compañía Minera Antamina S.A.	Mining	153 542
Holbah II Limited	Spain	Santander Perú Holding S.A.	Banking	152 000
Noranda Antamina	Canada	Compañía minera Antamina S.A.	Mining	150 959
Shougang Corporation	China	Shougang Hierro Perú S.A.	Mining	122 134
Repsol YPF Perú S.A.	Spain	Compañía Peruana de Gas S.A. Solgas	Petroleum/Gas	23 325
		Corpetrol S.A.		185 40
		Grupo Repsol del Perú S.A.		500
		Planta Envasadora Rimac S.A. (PERSA)		2 390
		Refinadores del Perú S.A.		77 025
		YPF del Perú S.A.		42 385
The Coca Cola Export Co.	United States	Coca Cola Interamerican Corporation Sucursal del Perú	Beverage	104 000
Teck Base Metals Limited	Canada	Compañía minera Antamina S.A.	Mining	101 508
Endesa Desarrollo S.A. - ENDESAR	Spain	Consorcio Cabo Blanco S.A.	Energy	29 400
Nestlé S.A.	Switzerland	Generalima S.A.	Food/Pharmaceuticals	60 296
		Alcón Pharmaceutical Del Perú S.A.		311
		D'Onofrio S.A.		70 861
		Industria Cajamarquina de Lácteos S.A.		772
		Nestlé Perú S.A.		15 068
The Shell Petroleum Company Limited	Netherlands	Sociedad de Negocios Inmobiliarios S.A.	Petroleum/Gas	1 177
		Compañía de Petróleo Shell del Perú S.A.		77 907
Bellsouth Perú BVI Limited	United States	Tele 2000	Telecom	76 587

Source: CONITE, *Peruvian Business Directory*, January 2000.

B. Impact of FDI in Peru

I. Technology

To attract FDI and benefit from its positive effects, a host country should have adequate capacity to absorb new technologies, to adapt products and processes to local conditions and to innovate. Peruvian enterprises appear to be sufficiently able to absorb imported technologies but their innovative capabilities are less developed, and they receive little support from a weak national system of innovation.

The downward trend in patent statistics is indicative of weak innovation activity. The number of registered patents decreased from an annual average of 240 during the period 1978-1987 to 180 during 1988-1997. Moreover, 93 per cent of all registered patents during the latter period were granted to foreigners. Another indicator is the low proportion of gross domestic product (GDP) spent on research and development (R&D) in Peru (an average of 0.24 per cent) relative to other developing countries (0.64 per cent) during 1993-1997. However, other indicators show a revival of entrepreneurial activities. The registration of trademarks, for example, grew by 110 per cent between during the same period.

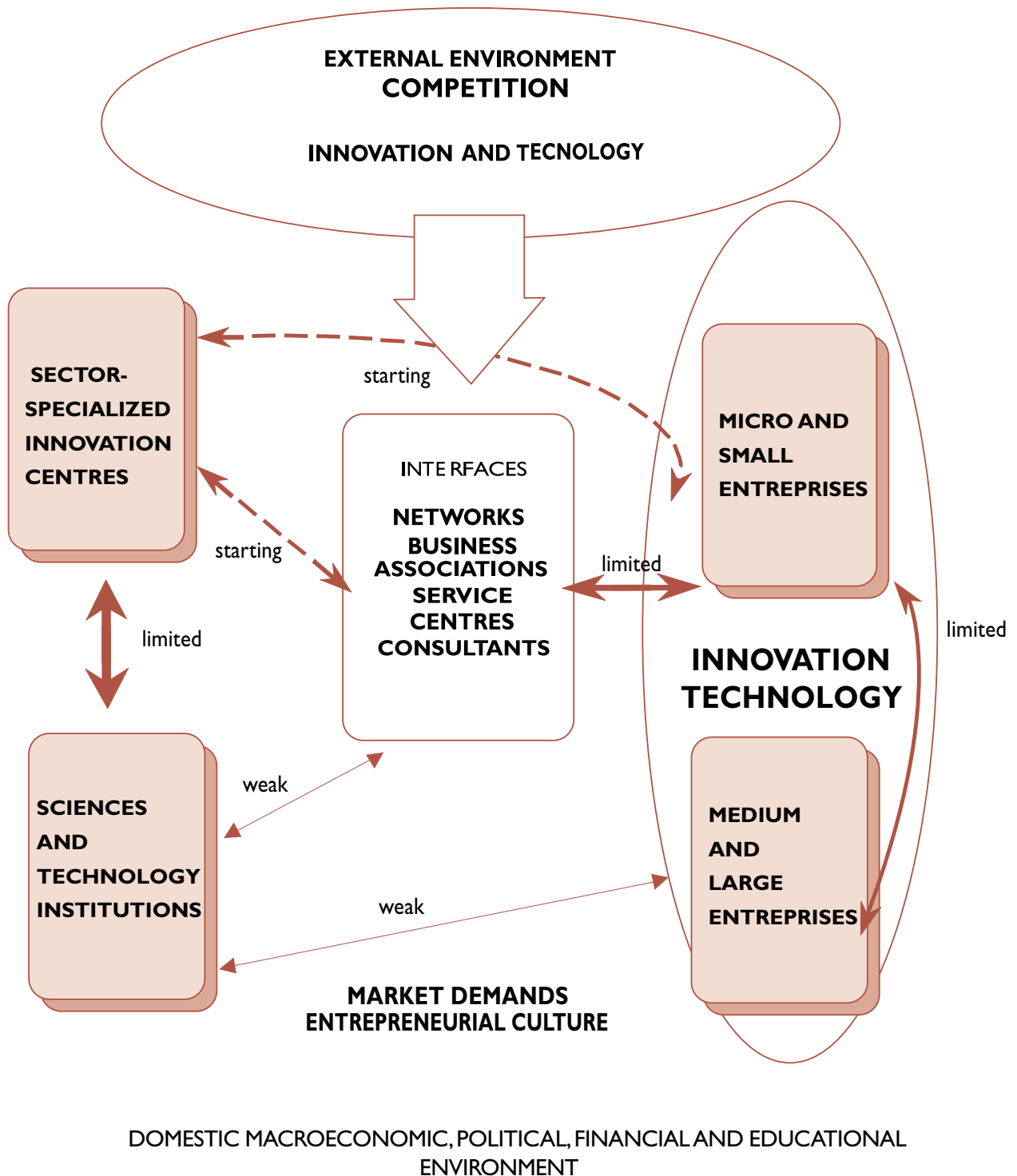
A stylized mapping of the national system of innovation shows limited or weak linkages in the industrial sector between productive enterprises (firms), knowledge centres (science and technology institutions) and business associations (see figure I.3). Linkages between large and small firms are also weak. However, the Ministry of Industry is developing a network of “diffusion centres” for providing online technological information to firms and of “business service centres” aimed at supporting small and medium enterprises (SMEs). It has also started several “technology innovation centres” aimed at supporting innovation and training in the garments, leather and shoes, pisco, wood and furniture industry.

A recent development in technology policy is a draft law to promote innovation, currently under discussion by the Congress. The draft law essentially acknowledges the importance of technological development and provides income and sales tax rebates to R&D start-ups and projects. It also allows the Government to borrow externally for R&D and to establish R&D-oriented funding programmes, but does not make budgetary allocation for this purpose. Also, other innovation promoting mechanisms for providing technological information, encouraging linkages and supporting early adoption of new technology have not been included.

Peru has a number of public R&D organizations in agriculture, mining, fishing, nuclear energy, health and telecommunications as well as specialized institutes for forestry, geophysics, metrology and geography. They function well enough but are not particularly effective at R&D, and financing has generally been inadequate. The institutes have begun to obtain funding from the private sector, although efforts are limited. INDECOPI, the national competition authority, has started a campaign aimed at making government and financial institutions more conscious of the value of intangible assets and intellectual property. It has promoted four national invention competitions, and some winners have participated successfully in international competitions (see box I.3).

Tough action on copyright offenders reduced business software piracy from 84 per cent of total sales in 1995 to 60 per cent in 1998, and video piracy declined from 95 per cent of total sales in 1995 to 42 per cent in 1998. According to the Business Software Alliance, Peru has the highest rate of reduction in software piracy in Latin America. Technology transfers through FDI are partly reflected in royalty payments and licensing fees. Between 1994 and 1996, payments for imported technologies amounted to US\$ 50 million, or more than three times the payments made between 1991 and 1993 (see table I.4). However, these payments, as a percentage of FDI inflows, were only 1.7 per cent between 1994 and 1996, compared to 6 per cent between 1991 and 1993.

Figure 1.3 Peruvian Innovation System (SIPAN)



Source: Ministry of Industry, 1998.

Box 1.3. Peruvian innovations – some examples

Milton Torres Rodríguez invented a hand-powered washing machine which won a prize in the national invention competition. It functions rather like a palette-based electrical machine without wetting the operator's hands and is now being manufactured by a domestic plastic firm for sale in rural areas where there is no electricity. José Luis Vargas Monroy, a chemical engineer, developed a glass bottle-cutting machine based on the thermal properties of glass. Vargas undertook his own manufacturing and distribution of the machine and has sold about 400 units during the last 10 years. Some of his customers from abroad have even ordered it through the Internet. In the medical field, Eduardo Devotto has invented a light and cheap biologically inactive implant based on a mammal's bone that facilitates the growth of tissue and veins. The implant has been tested by health authorities and is currently in use in a university hospital. In electronics, engineer Luis Jiménez Troncoso has invented an electronic device for measuring the speed of movement of fluids.

A recent invention that transcended Peru's borders is the 'covered ice maker', invented by Hernán Garrido Lecca. It consists of a rectangular ice container — like those currently available in most refrigerators — with a lid specially designed to seal the water while permitting a single ice cube, or the entire contents, to be extracted as required. It won first prize in the 1997 national invention contest and a gold medal in its category in the 1998 International Exhibition of Inventions, New Techniques and Products in Geneva, Switzerland. The 'covered ice maker' has been patented in Peru and the United States and 1 million units are to be produced and sold in North America by Rubbermaid. In Peru, a local model is being produced and distributed by the largest local supermarket chain.

Examples of innovation at the corporate level include investment in R&D by ALICORP (a Peruvian food conglomerate) to add palm oil to its range of cooking oils and to develop new forms of packaging that appeal to local consumers; Backus and Johnston (Peru's largest brewery and a soft drink manufacturer) is investigating the properties of Camu-Camu, a jungle fruit rich in vitamin C, for possible use in a new soft drink; DROKASA, a local pharmaceutical company, is researching cholesterol-reducing medicines based on indigenous plants.

Discussions with successful and not so successful inventors suggest several factors that hinder commercialization of innovations: lack of adequate information on patent and licensing procedures and practices; lack of adequate protection of inventions from potential imitators; lack of adequate finance, particularly venture capital, or other mechanisms to fund the innovation process; and the high cost of patenting.

Source: Indecopi and mission interviews.

The potential for subcontracting is under-exploited in Peru. Barriers include a near exclusive export focus on natural resources, high financial and services costs, a limited 'quality culture' and a business culture that discourages networking. Firm-specific barriers include lack of technological and labour specialization, and limited managerial and organisational capabilities. Peruvian business is dominated by family firms, which compete on price and are less concerned with standards or quality. Firms often have poor maintenance, tend to neglect delivery dates, and lack transparency in accounting. These management practices can adversely affect subcontracting operations of foreign affiliates, which follow different corporate practices and standards. However, large firms are improving their managerial standards and between 1994 and 1998, more than 30 enterprises obtained ISO 9000 certifications.

Table I.4. Latin America: payments of royalties and licence fees, 1991-1996
(Millions of US dollars and percentage)

Country	Millions of US dollars		Percentage of FDI inflows	
	1991-1993	1994-1996	1991-93	1994-96
Latin America	1073	1566	6.5	5.1
Argentina	266	206	9.4	1.1
Brazil	76	384	5.1	9.6
Chile	39	49	5.8	1.9
Colombia	18	37	2.6	1.5
Costa Rica	9	11	3.9	3.2
Mexico	462	504	10.2	5.4
Peru	16	50	6.0	1.7

Source: UNCTAD (1998). *World Investment Report 1998: Trends and Determinants*, United Nations publication, Sales No.E.98.II.D.5.

According to a recent survey, foreign firms purchased 54 per cent of their equipment and inputs from abroad, mainly because of poor quality of local products and late delivery.² Domestic firms also indicated price and delivery as the main factors influencing their decisions on whether to buy locally or from abroad. The survey found that foreign mining and manufacturing firms purchased 92 per cent and 70 per cent respectively of their inputs and equipment from abroad. However, the survey also found that 34 per cent of all interviewed firms adapted imported equipment, 43 per cent improved on foreign machinery, 20 per cent developed new machinery and 40 per cent improved production techniques.

Box I.4 illustrates one experience in adapting to local market demands. Another example of adaptation is that of Pavco SA, a Swiss manufacturer of plastic tubes for construction, which responded to deficiencies in local suppliers and buyers by starting a training school for plumbers, construction workers and entrepreneurs.

² Casas C. and Mercedes A. "El Impacto económico de la inversión extranjera directa en el Perú", Centro de Investigación de la Universidad del Pacífico, December, Lima, Perú (mimeo), 1998.

2. Human resources

According to a recent survey analysing available skill levels of the Peruvian labour force, one in two workers has completed secondary education and more than a third of the labour force has higher education, either technical or academic. Managers, professionals and technicians account for about 15 per cent of the employed population (see table I.5). Unemployment is high among professionals, technical workers and mid-level managers and employees. However, there is a need to raise labour productivity and ensure an adequate and sustained supply of highly qualified personnel, particularly managers.

Overall labour productivity in Peru is between half and one fourth of the Latin American average and 40 per cent of the work force is unskilled.³ Labour productivity increased between 1990 and 1995 — it was about 2.2 per cent, compared with 3.3 per cent in Chile and 4.1 per cent in Argentina. However, the cost—including benefits — of an unskilled worker in Peru was about US\$ 2.5 per hour, which is lower than in Argentina (US\$ 6), Brazil (US\$ 5.4) and Chile (US\$ 3.5).⁴

Box I.4. Reverse engineering at Toyota del Perú

Since the 1970s, Toyota has been operating in the car and light commercial vehicle (LCV) market in Peru. However, liberalization of vehicle imports in 1991 and cost considerations led the company to close its local car manufacturing section. At the same time, in the Peruvian market competition from used vehicles imported from East Asia by small workshops had affected Toyota's sales. These used vehicles required repairs and adaptation from right- to left-hand drive. In spite of the lower safety standards, this business grew because the lower costs appealed to local consumers. In 1995, 67 per cent of the 114,330 cars and LCVs imported into Peru were used ones. After deliberations about safety concerns, the Government allowed imports of used vehicles and levied lower taxes, provided they were 'rebuilt' in specially designated free trade zones (FTZs). A number of small workshops relocated their operations to the FTZs, and their production process continues to use labour-intensive methods and simple tools. Stringent safety standards are not necessarily observed. As Toyota began losing its market share, Mitsui, Toyota's largest domestic dealer, suggested that Toyota start its own vehicle 'rebuilding' unit. Although initially hesitant due to concerns about safety and brand image, Toyota also saw that it needed to redeploy its locally developed engineering capability. Consequently, it established a factory in the Tacna FTZ in 1998 and, unlike its competitors, the company adopted a mass production approach to 'rebuilding' vehicles. The local engineering team designed a production line, which reversed all steps leading to the disassembly of jigs and parts related to right-hand drive models, and then built the car in much the same way as new vehicles. The prototype car was sent to Japan for testing, and was approved with minor modifications. Automation is limited as experienced workers are available and production volumes are low. Major parts, such as front panel, steering and headlamps, are new. Although this makes Toyota vehicles more expensive than its competitors, the company is able to compensate this by giving the same warranty for 'converted' cars as for new ones. Local suppliers are requested to deliver parts on just-in-time basis. The plant is open for inspection by competitors, as the intention is to make it a showcase for the upgrading of the technological capabilities of local workshops. The Peruvian experience, the first of its kind ever, led to a major rethinking of the potential for used car sales within Toyota. A new division was created in Japan that assesses, buys and distributes second-hand cars. Toyota is now considering establishing similar plants in other developing countries.

Source: Medio Empresarial (1998), and UNCTAD survey.

³ By sector, labour productivity is above the national average in mining, construction, electricity, finance, fishing and manufacturing industries and lower in agriculture and services. Ministerio de Trabajo y Promoción Social (MTPS). "Productividad de la mano de obra en el Perú: situación actual y perspectivas", *Boletín de Economía Laboral*, 1998.

⁴ Ministerio de Trabajo y Promoción Social. "Productividad de la mano de obra en el Perú: situación actual y perspectivas", *Boletín de Economía Laboral*, 1998.

There are several industry-specific training centres run on a public-private partnership such as the National Building Industry Training Center (CENCICO), the Tourism and Travel Industry Training Center (CENFOTUR) and the Manufacturing Industry Training Center (SENATI). In addition, Peru has 58 universities offering a wide range of studies. However, there is a mismatch between supply and demand — many of the technical and professional schools do not offer programmes responding to business demands. New initiatives by the Ministry of Labour aimed at establishing such programmes are short of resources.

Table 1.5. Economically active population by skill level, 1996
(Percentage)

Economically active population	Employed	Unemployed
Management	1.1	1.0
Professionals	9.2	10.2
Technical	4.6	8.1
Mid-level managers/employees	5.2	11.8
Skilled workers (except agriculture)	11.5	9.0
Skilled agriculture	17.8	4.5
Unskilled	22.2	29.1
Unskilled agriculture	18.6	..
First-time job seekers	1.6	22.7
Unspecified	8.2	3.6
Total	100.0	100.0

Notes: In 1996, Peru's economically active population was 6.5 million; it comprised all persons over 14 years of age with a job or actively looking for one without finding it. In addition, there were approximately 8.5 million inhabitants over 14 years of age who were not employed or seeking a job. This group comprised students, retired workers and pensioners, rent-earners and others. Unemployment data is for urban areas only.

Source: Roca et al (1998). *Peru: A Place to Invest 1997-1998*, Lima: Esan ; Webb and Fernández Baca (1997). *Perú 97 En Números*, Lima: Cuánto. .. = not available.

3. FDI and trade

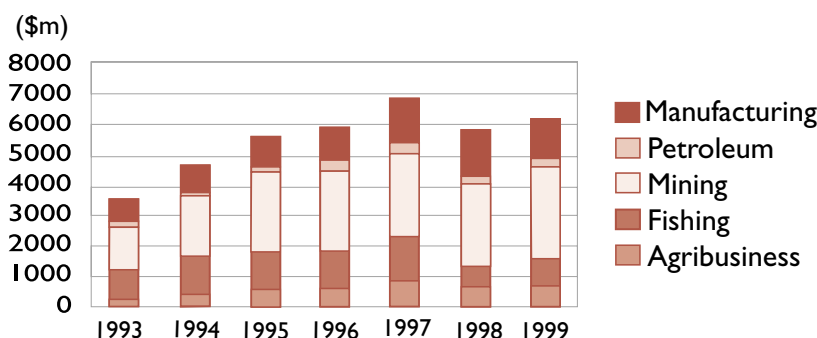
Peru's generally open trade regime has favoured trade development. Growth in imports outpaced growth in exports. The structure of imports remained remarkably stable, with raw materials and intermediate goods accounting for the largest share. In terms of sectoral composition, manufactured products accounted for over 70 per cent of total imports. Peru's total exports increased two and half times during the period, 1986-1998. However, they continue to be concentrated in a few sectors, led by mining (50 per cent of the total in 1999) and followed by food items, particularly fishing and some agricultural products (see figure 1.4). The improved economic environment and the investment-friendly framework were conducive to the steady expansion of exports. However, several adverse external shocks experienced in 1998, such as the El Niño weather phenomenon and the fall in commodity prices, affected export performance.⁵

In the mining sector FDI played a major role in Peru's export performance. Foreign affiliates were responsible for the exploitation of new fields, increased productivity and improved management practices introduced by the parent companies. Among the country's largest exporters are Minera Tintaya owned by BHP (Australia), Southern Perú Limited owned by Asarco (United States) and Shougang- Hierro Perú (China). Some joint ventures, such as the Newmont Gold Yanacocha (United States and national investor, Minas Buenaventura) and Cominco and Marubeni (Canada and Japan) also enjoyed favourable access to export markets through their international networks. New marketing channels, improved distribution and access to new markets contributed to the good export performance.

⁵ World Trade Organization (2000). *Trade Policy Review, Peru*, WT/TPR/S/69.

Foreign direct investment also contributed to expanding exports in the fishing industry. For example, in 1997 *Pesquera Austral* — a Peruvian and Venezuelan joint venture — accounted for about 5 per cent of the world's fishmeal and fish oil sales. It opened offices in Indonesia, the Russian Federation, Thailand, Sri Lanka, South Africa and the United Kingdom.

Figure I.4. Peru's exports by main categories, 1993 and 1999
(Millions of US dollars)



Source: CONITE database, 2000.

The manufacturing sector accounted for only 20 per cent of total exports in 1999. Textiles and clothing is the most important industry (comprising 48 per cent of all manufactured exports); it is also the largest employer in the manufacturing sector, accounting for half a million jobs. There are several local companies operating in this industry. The garments segment consists of 14,000 companies, of which 82 per cent are small firms. This industry has developed substantial technological competence (although this varies considerably by firm size) in the supply of inputs, skills and design capabilities. Peru is especially known for its sportswear in which it has a comparative advantage owing to the availability of raw materials, including pima and tangüis cotton and alpaca wool. The sector experienced a slow down in the face of strong competition from East Asia as a result of currency devaluations in that region since 1997. Nonetheless, some large firms were able to win export markets by increasing efficiency in production and by forging export links with foreign firms. In 1999, apparel industry exports grew by 19 per cent, a growth sustained as a result of exports by some large enterprises with foreign linkages⁶ (see box I.5).

C. Overall assessment

Peru has been successful in attracting substantial inflows of FDI largely as a result of its privatization and concessions programmes, and market-oriented policies. The country's comparative advantage lies in its natural resource endowments and its domestic market demand for services. As a result, FDI has been concentrated in a few large projects and has not contributed to the diversification of economic activities. This is also reflected in the composition of Peru's exports, where the predominance of a few products persists. To be able to attract further FDI, Peru needs to develop new areas of competitive advantage. This would require building up technological capabilities by strengthening the national system of innovation, of which human resources and support institutions constitute vital elements.

⁶ América Economía "América Economía 500: Las mayores empresas de América Latina", 29 July 1999.

Enhanced productivity and efficiency in industries which have received FDI shows that such investment can play a key role in strengthening existing competencies and in building new ones. Foreign investment has also contributed to the development of new production, such as asparagus. Peru should also strive to diversify the sources of investment, as a number of potential new investor countries, both within and outside the region, can be tapped.

Box I.5. Nettelco: a strategic alliance with foreign investors

In 1987, La Fabril SA (the affiliate in Peru of Bunge y Born of Argentina), bought Industrias Nettelco SA, a company that produces 100 per cent cotton knit garments for export markets, mainly in Europe, Japan and the United States. Products targeted the mid to high end of the market segment. In 1995, after Bunge y Born offered to sell Nettelco, senior management decided to bid for the company through a management buyout. Due to lack of resources, they invited other firms, local and foreign, to act as third-party investors with them. A foreign company (Amarte Investment from Netherlands), with many years of experience in Peru as owner of a cotton-spinning mill, decided to invest in the company.

The alliance brought managerial, financial and technological upgrading, which made Nettelco probably the most competitive firm in the Peruvian clothing and textile industry with strong penetration and exposure to foreign markets. Its products are sold mainly to catalogue companies promoting Peruvian products with worldwide mailings of more than 30 million catalogues a year. To become a catalogue supplier, Nettelco had to invest in technically preparing all its personnel. Catalogue shoppers, who buy without seeing the actual product, expect to receive defect-free merchandise that looks better than the picture in the catalogue otherwise they expect to have the option to return it. Nettelco's strong customer service has enforced the application of quality controls throughout the production process and in the final products. Just-in-time techniques, flexible production and many other modern managerial practices are applied.

In addition, management is aware that its main competitive advantages are the Peruvian Pima cotton, considered the longest and softest cotton fibre in the world, the proactive service to customers, favourable pricing, and "on time" deliveries. Nevertheless, increasing competition from Asia, Mexico, the Caribbean, and other Latin American countries are a permanent threat. Continuous improvement in management practices and a strategic alliance with foreign investors, help the company to maintain its competitive advantage and win new export markets. In 1998, Nettelco ranked among the 50 largest exporters in Peru.

Source: Company interview conducted by the Universidad del Pacifico.

II. The Investment framework

A. General framework

Within a few years Peru has effected a truly extraordinary improvement in its investment climate from the crippling investment and economic conditions of the 1980s. A major landmark was the introduction of a revised Constitution in 1993. This Constitution contains explicit provisions in favour of free enterprise, private property rights, freedom to undertake foreign trade, limited business involvement by the State and competitive market practices. Other key events included the passage of the new investment law in 1991, the settlement of three major foreign investment disputes, the introduction of pro-market and pro-private enterprise policies, and the near completion of a far-reaching privatization programme.

Peru has substantially achieved best practice in a number of key aspects of investment protection and specific standards of treatment, and its regime compares very favourably with that of other economies within and outside the region.

I. Investment treatment

Since 1991, Peru has operated an open investment regime — all sectors and regions of the economy are open to FDI except for the constitutional exclusion of foreign ownership of natural resources within 50 kilometres of Peru's international borders. This exclusion can be waived by decree on a case-by-case basis.

Prospective foreign direct investors are not required to obtain special approval or registration before investing, and there is no minimum size of investment restriction on FDI. No restrictions apply exclusively to foreign investors as to the degree of ownership interest or management control that they may exercise in any form of investment. There are provisions for employees to acquire up to 10 per cent ownership interest in enterprises being privatized but such provisions apply equally to enterprises owned by foreign and national investors.

Further, there are no performance obligations or operating restrictions that apply exclusively to FDI. These standards of treatment arise from a clear constitutional provision that forbids discrimination between national and foreign investors, and are covered by the Foreign Investment Promotion Law (Decree Law – DL 662 of September 1991), which is the principal law governing foreign investment. This principle of national treatment can be contractually guaranteed by the State in respect of larger foreign investments in the form of a “legal stability agreement” (see below).

The important Framework Law for Private Investment Growth (DL 757 of November 1991) sets out in greater detail the pro-market principles guiding Government conduct towards commercial activity. By virtue of their entitlement to national treatment, foreign investors benefit from these liberal standards of business treatment.

Policies areas of particular importance to FDI include:

- *Foreign exchange:* local currency is freely convertible to hard currency for current and capital transactions and investors are legally entitled to seek the most favourable exchange rate. There are no restrictions on holdings by residents of foreign currency either domestically or abroad. These measures are supported by the independent monetary management of the Central Bank.

- u *Taxation*: taxation has been simplified with the aim of applying general measures at competitive rates across a wide base. The principal business taxes are income tax, value-added tax, and import duties. Several tax incentives are offered on a regional and sector-specific basis (see Section B below for a summary of taxation).
- u *Labour*: labour law sets flexible labour regulations (DL 728 of 1991 as amended). It contains a number of provisions including a minimum wage (less than the equivalent of US\$ 100 per month), statutory profit-sharing schemes to be offered by larger employers and restrictions on their ability to retrench redundant employees. Residence and hiring rights pertaining to non-citizens are liberal.
- u *Property rights*: intellectual property rights are protected by law and enforced through a centralized agency, INDECOPI.⁷ Enforcement is reported to be improving although Peru is on the United States' "Watch List" (see page 11). Real property rights have constitutional and legal backing but their judicial enforcement could be improved.
- u *Local taxes and charges*: Local authorities have restricted tax powers and are limited to charging for municipal infrastructure and services on a non-profit basis.
- u *Sectoral regulation*: Special legislation is in place for the regulated industries. Later sections of this report review the legal regime for infrastructure and mining.

2. Investment protection

The Constitution provides that all foreign and national investors must be treated equally. The State reserves the right to discriminate between foreign investors on the basis of home country and to accord less than national treatment if other countries adopt measures harmful to Peru.

The Constitution forbids expropriation except in the public interest, or for national security and as a result of due process. Fair compensation must be paid in advance. The foreign investment law gives specific assurances to investors in relation to convertibility and repatriation, in particular:

- (a) Free remittance abroad of profits, proceeds of asset disposals, royalties and payments for the use of technology; and
- (b) Access to the most favourable exchange rate for currency conversions for inward and outward remittances.

The State reinforces investor protection by entering into legal stability agreements both at the level of the investor and at the enterprise level. These agreements give contractual assurances for 10 years (or longer in the case of concessions to cover the entire period of the concession) of protection from any change in certain key policies. Even relatively small investors and enterprises may qualify to enter such agreements.

The criteria for eligibility and the matters covered by these agreements are set out below. Considerable variations have developed across different sectors including mining, power, hydrocarbons and infrastructure, which have arrangements that are more favourable to investors. The general terms of legal stability agreements are summarized below:

⁷ INDECOPI is the National Institute of Fair Competition and Intellectual Property Protection.

A qualified investor can execute an agreement with the State, which gives contractual stability for 10 years from signature in the following matters:

- u Sectoral regulation: Special legislation is in place for the regulated industries. Later sections of this report review the legal regime for infrastructure and mining.
- u Assurance of national treatment;
- u Foreign exchange matters in (a) and (b) above; and
- u Income tax payable on dividends or other forms of profit-sharing (currently such income is exempt from tax).

In order to qualify for a stability agreement an investor must:

- (i) Invest at least US\$ 2 million; or
- (ii) Invest at least US\$ 500,000 and either create 20 jobs or generate US\$ 2 million worth of exports over the first three years.

As of 6 September 2000 a new law covering the stability agreements established under DL Nos. 662 and 757 will stabilize the income tax payable on dividends at two percentage points above the applicable rate. In addition, to qualify for a stability agreement an investors must :

- (i) Invest at least US\$ 5 million (US\$ 10 million in mining and hydrocarbons).

The threshold in (i) could apply equally to a new investment or capital expansion and to acquisition of an existing interest, whereas the threshold in (ii) clearly applies to new investments only. In the special case of privatization there is the additional condition that, in respect of both (i) and (ii), the transaction must result in the acquisition of more than 50 per cent of the State's shareholding of the company being acquired.

An enterprise, provided it obtains investment from a qualified investor, can also enter into a 10-year legal stability agreement in relation to the following:

- u labour "hiring systems"⁸ ; and
- u export promotion schemes⁹ ; and (subject to the provision below)
- u corporate income tax.

Corporate income-tax stabilization carries the additional qualification requirement that it must be for a new investment or (broadly) a 50 per cent expansion of the capital and reserves of an existing enterprise. Where the existing enterprise is being privatized no additional qualification of this kind applies.

In neither form of legal stability agreement is the investor or company entitled to the application of a more favourable future change in law. While such "cherry picking" is not permitted, it is possible on a once-only basis to move to the general legal regime then prevailing. The model contract for investors suggests that these rights are automatically assignable.

Foreign investors have equal access to the local courts for disputes. International arbitration can be provided for in agreements between investors and State bodies where Peru is party to a relevant international treaty. Peru has signed bilateral investment treaties with 25 countries. In addition, it is a member of the Multilateral Investment Guarantee Agency and of the Overseas Private Investment Corporation, and has acceded to the International Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID). Peru's membership was ratified by Congress in 1993 by DL 26210.

⁸ No precise meaning is given but the reference is to the Work Promotion Law (DL 728). See Article 19 f. of DS 162-92-EF.

⁹ This refers to the drawback system of DL 668 and temporary imports and customs procedures of DL 809. These schemes are reviewed in Section B.

3. Overall assessment

How do Peru's standards of treatment and protection afforded to foreign direct investors compare with practices elsewhere? ¹⁰ Peru joined the Asia-Pacific Economic Cooperation (APEC) forum¹¹ in November 1998 and this review examines to what extent this country's standards achieve best practice in relation to other members of APEC.

APEC is a regional forum in which government and business leaders of member economies aim to liberalize trade and investment on a voluntary basis and to improve conditions for business. In the Bogor Declaration of 1994 the members set out an ambitious goal of a creating free trade area and open investment regimes by 2010 for developed economy members and 2020 for developing economy members. In 1994, APEC adopted a charter of Non-Binding Investment Principles (the APEC Investment Principles), which sets out 11 principles for public policy and one principle for investor conduct.

Table II.1 below compares Peru's standards of treatment and protection in five key areas with those of fellow APEC members based on member's reports to APEC and published in the 1998 APEC Investment Guide.¹² The response of each member was ranked on a score of 1 (worst practice) to 5 (best practice) and then averaged for all APEC members and grouped by OECD and non-OECD membership. These comparisons are limited to standards of specific interest to foreign investment, except in the case of foreign exchange convertibility where the standard applies to all transactions and not only those related to repatriation of profits and shareholder capital abroad.

It should be noted that the APEC principles are, for the most part, drafted in highly conditional language or are restricted in scope. For example, the principle of national treatment can be varied if a member's domestic laws or policies provide for exceptions. The comparisons made here are against the best available standards based on APEC nomenclature. Further explanation is given in annex I.

Table II.1. Standards of foreign investor treatment and protection in Peru and all APEC economies

(Numbers)

Principle	Scores			
	OECD	Non-OECD	All	Peru
National treatment	2.8	2.5	2.6	5
Non-discrimination	4.3	3.9	4.1	5
Repatriation and convertibility	4.8	4.1	4.4	5
Expropriation and compensation	3.8	4	3.9	5
Settlement of disputes	4.3	4.6	4.2	4

Source: UNCTAD survey and APEC (1998).

¹⁰ This section of the report reviews the specific standards of treatment and protection afforded by Peru to foreign investors. Comments on general standards of treatment are made selectively in later sections dealing inter alia with incentives, the infrastructure concession schemes and the regulation of mining. The legal stability arrangements are reviewed in section B.

¹¹ Members of APEC include: Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong (China), Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Singapore, the Republic of Korea, Russian Federation, Taiwan, Province of China, Thailand, Viet Nam and the United States.

¹² APEC (1998). *Guide to the Investment Regimes of the APEC Member Economies*, Third Edition, APEC.

The following conclusions can be drawn from the results presented in table II.1:

- u *National treatment*: Peru provides higher standards of national treatment than the average for both OECD and non-OECD members of APEC. Peru's foreign investment law, backed by the Constitution, clearly provides for national treatment. Further, Peru offers contractual assurances of national treatment to larger foreign investors through legal stability agreements. Almost all other APEC members (with the exception of Hong Kong (China) and the United States) depart significantly from national treatment. These departures include sectoral restrictions on foreign ownership (media, fisheries, various modes of transport are frequent departures), continued screening of foreign investment applications and, in some cases, restrictions on access to local finance.
- u *Non-discrimination*: Peru's standards of non-discrimination are above average for APEC members. Peru's approach includes a firm Constitutional provision (save for the right to reciprocate against discriminatory practices of others) backed by an expanding network of bilateral investment treaties which are understood to provide for most-favoured-nation treatment (MFN). Countries with low standards of non-discrimination include the United States and Mexico.¹³
- u *Repatriation and convertibility*: Peru's standards exceed the average for the APEC group. In fact, most APEC members offer freedom from current and capital account exchange controls. The exceptions include the Republic of Korea, China, Taiwan, Province of China and Malaysia. In many non-OECD countries the move to fully convertible currencies is recent. The best foreign investment regimes among them offer to significant investors contractual assurances of convertibility for profits and capital remittance and the right for exporters to hold offshore retention accounts. Peru's general legal stability agreements are confined to a limited range of foreign exchange transactions.
- u *Expropriation and Compensation*: A number of OECD countries do not feel the need to legislate specific assurances concerning expropriation and compensation to foreign investors and reserve a wide domain for public purpose actions. The non-OECD members often provide a higher level of legal assurance in this regard. Peru's standards are among the best of this group because of its clear Constitutional provisions, including the requirement, as in the case of Chile, that cash compensation be paid in advance.
- u *Settlement of disputes*: Peru, along with most APEC members, offers equal access to local legal and other dispute mechanisms. Table II.2 compares, on the same basis, Peru's investment standards with those of a peer group of competitor APEC countries for mining investment – Australia, Canada, Chile, Indonesia, Mexico, Papua New Guinea and the United States. Again, Peru compares favourably.

Finally, it is useful to compare Peru with Chile because Chile is a neighbouring country that offers similar sectoral investment attractions (apart from tourism) and has long been in the vanguard of investment policy reforms in Latin America. Unsurprisingly their investment policy regimes are quite similar and no doubt Chile's reforms, which were bold breaks from past custom in Latin America, provided a model for Peru when it undertook its own reforms in the 1990s. It is arguable whether Peru's standards are now better than those of Chile. With regard to national treatment, Chile restricts the admission of FDI to several industries including shipping, television, cable and print media and some aspects of fisheries.

¹³ Robert M and Wetter T. "Bilateral investment treaties in the Western Hemisphere". In: OECD (1997). *Investment Policies in Latin America and Multilateral Rules on Investment*, Paris: OECD.

Table II.2. Investment standards of Peru and APEC mineral producers
(Number)

Principle	Scores	
	Mineral producers	Peru
National treatment	3	5
Non-discrimination	3.9	5
Repatriation and convertibility	4	5
Expropriation and compensation	4.1	5
Settlement of disputes	4	4

Source: UNCTAD survey based on APEC (1998).

Chile may restrict foreign investors' access to local finance although currently it does not do so. Peru applies none of these restrictions. Both countries have firm legal provisions governing expropriation and the payment of compensation in advance. Both countries offer high standards in relation to convertibility and repatriation. However, Chile has a more bureaucratic procedure in relation to investments under the legal stability contracts. Remittances of profit and capital require certification from the Foreign Investment Committee, and foreign currency conversion must be done through the "formal exchange market". Finally, in Chile there is a one-year quarantine on capital repatriation through investments under legal stability contracts.

Peru has substantially achieved best practice in relation to a number of key aspects of investment protection and specific standards of treatment. In this respect the country's investment policy regime compares very favourably with that of other APEC economies, including those with strong natural resource sectors, such as Chile. Of course, it is not unknown for a country to have high legal standards but to frustrate prospective investors by bureaucratic and non-transparent application. A number of interviews conducted with foreign investors, revealed remarkably little concern in this respect — there were no complaints of discriminatory treatment at a policy or administrative level and little of the usual investor fears of red-tape or unpredictable policy.

B. Investment incentives

In the course of improving the investment climate, Peru has sought to create an incentive regime that benefits many investors and includes features which are particularly attractive to foreign investors. The principal components of the incentive regime are: fiscal incentives; legal stability agreements; and residence privileges for non-citizen employees and owner-operators.

As already noted, foreign and national investors have equal access to investment incentives arising from constitutional provisions against discrimination in this respect. Certain aspects are of special relevance to foreign investors including contractual assurances of national treatment and guarantees of profit and capital repatriation. Peru has been willing to unilaterally grant incentives that benefit foreign investors; that is without expecting reciprocity from investors' home countries. Examples are an exemption from taxation on profit distributions and residence privileges for foreign nationals.

It is important to note the context of Peru's investment incentives. Peru has adopted a sound general policy and operational climate. It is not uncommon for an emerging market to offer "incentives" in order to redress or compensate for obstacles and policy defects which frustrate the investment climate. This is not the case with Peru's incentive measures — they are additional measures on the whole, and not substitutes. The three components of the incentive regime are described below.

I. Fiscal incentives

The standard taxes that affect business are corporate income tax, general sales tax (IGV), import duties, and withholding taxes on royalties, fees and interest.

- u **Corporate profits**¹⁴ are taxed at 30 per cent. A wide range of expenses is allowed although there are anti-avoidance limits on deductibility of certain costs such interest, directors' fees and travel expenses. Depreciation is allowed at 20 per cent p.a. on most machinery and equipment, and buildings can be depreciated at 3 per cent p.a.. Losses can be carried forward for up to four years from the first subsequent year of profit and there are no annual limits on the application of previous years' accumulated losses. Dividends are exempt from tax.
- u **Withholding tax** is applied to a most payments abroad. For example, royalties paid for the use of intellectual property are taxed at 30 per cent whilst technical service fees are taxed at 12 per cent of the gross amount. Foreign interest payments are subject to 1 per cent withholding tax whenever they fulfill the following requirements: the loan cash will be proved with the entrance of the currency into the country; the credit does not yield annual interest on the balance due superior to the preferential rate in the market where it comes from, plus 3 points. However, interest on shareholder debt can be deemed to be in lieu of dividends (from post-tax income) and is taxed at 30 per cent.
- u A general sales tax, (**IGV**) of 18 per cent applies to a comprehensive range of transactions, including imports of capital items.
- u **Import duties** are set in the range of 12-20 per cent, with capital items generally charged at 12 per cent. There are drawback schemes for goods for re-export.
- u Employers pay **payroll taxes** for health and housing totalling about 14 per cent. Foreign employees are taxed on Peruvian income at a top marginal rate of 30 per cent. They become resident for tax purposes after living in Peru for two years and thus subject to tax on worldwide income. However, a 3-month absence restarts calculation of the time lived in Peru.

Peru has introduced quite wide-ranging concessions to the standard fiscal arrangements to promote national and foreign investment. These incentives are summarized in table II.3.

The principal effect of the legal stability agreements in their general form is that it reassures investors that they will not be singled out for adverse treatment on a discriminatory basis. However, the range of areas covered by stabilization is too limited to protect an investor or lender against a general or even sectoral deterioration of the investment climate. But to what extent should the key financial provisions of these agreements be widened? It is inevitable that foreign investors will seek to widen the matters that are subject to legal stability agreements, especially in the areas of taxation and foreign exchange. No doubt the Government has faced these requests. It has responded by offering enhanced legal stability agreements to larger projects in particular sectors. For example, stability agreements for larger mining projects may stabilize all tax matters, which is much more favourable than the general stability agreement. Further, such agreements provide for continued free disposition of export proceeds and oblige the State to ensure that local currency can always be converted for a wide range of payments in foreign exchange.

¹⁴ Income Tax Law (DL 774) and subsequent modifications.

Table II.3. Fiscal incentives for investment in Peru

Zone incentives	<p>Jungle and frontier zones</p> <ul style="list-style-type: none"> u Manufacturers are exempt from income tax, IGV and excise duty but continue to pay import duties and municipal taxes. u Concessional rates of income tax apply to non-manufacturing activities in the Amazon zone.
	<p>Export free zones (CETICOs)¹⁵</p> <ul style="list-style-type: none"> u Established in Ilo, Matarani, Paita and Tacna. Companies in the zones should devote 92 per cent of their activity to export. Benefits include exemption for 15 years from import, sales and consumption taxes as well as municipal duties. Exports from the zones to the rest of the country are considered imports, with the exception of used cars that enjoy a special regime. Tacna's exports to the rest of the country are charged at a flat rate of 8 per cent.
Export incentives	<p>Exporters of services and non-traditional goods</p> <ul style="list-style-type: none"> u Payments of VAT, import duties, housing fund contributions and selective consumption tax can be credited against corporate income tax and any unused credits may be transferred to other IGV payers. <p>Re-exporters</p> <ul style="list-style-type: none"> u Duty free admittance.
Relief	<ul style="list-style-type: none"> u Anticipated recovery for IGV paid on capital assets in the pre-production stage u Instalment payments of import duty on capital items on a case-by- case basis
Sectoral incentives	Special sectoral fiscal incentives apply to oil and gas, mining and infrastructure investment
Other incentives	Simplified tax regime available to small and medium enterprises, which, in lieu of most fiscal charges, pay a unique contribution of 1 per cent of their monthly turnover.

Source: National legislation.

The widening of the ambit of tax and foreign exchange stability provisions is sometimes justified but should be considered very selectively because it places powerful constraints and obligations on the Government. For example, a blanket reassurance of non-application of capital and current account controls would amount to a guarantee by the Government always to provide foreign currency to the investor if exchange controls were reintroduced in the future. This could create great difficulties and carries the risk of potentially massive litigation in a situation where the Government might feel obliged to reapply exchange controls in response to a financial crisis.

In respect of the financial provisions of legal stability agreements two suggestions are made for possible enhancements:

(i) **Foreign exchange regime:** for all agreements with eligible enterprises, consider allowing the freedom to export and the right to retain export proceeds abroad as required. This will help exporters to obtain hard currency financing. However, for the reasons noted above, the general stability agreements should not contain additional¹⁶ convertibility undertakings by the Government for assisting non-exporters. Such undertakings should only be contemplated in exceptional cases. For example, when non-export projects are too large to obtain convertibility insurance cover, and preferably where the benefit of such a guarantee is reflected in the project terms for the sponsor (e.g. in the power charges bid for an independent power generation project). This appears to be the approach being taken by the Government.

¹⁵ Centros de exportación, transformación, industria, comercialización y servicios (CETICOs).

¹⁶ The discussion refers here to enterprise level stability agreements and does not suggest that the existing convertibility guarantees to investors in relation to profits, royalties and capital be changed.

(ii) **Taxation:** consider offering legal stability to withholding tax rates since these are taxes where a foreign investor would derive least comfort from the guarantee of national treatment. These include withholding rates on interest (and subject to the suggested amendment to the deemed dividend regime), royalties and technical fees.

A fairly specific enhancement should be considered to improve the bankability of the legal stability agreements by liberalizing their assignment provisions. It appears that not all forms of agreement have freely assignable rights. In some circumstances this may impede the rights of lenders under pledge to take over assets. Lenders should be able to automatically assume rights under stability arrangements when foreclosing and then have the ability to re-assign these rights with safeguards upon disposal of the secured assets.

No other obvious changes of a general nature stand out. In particular it is not recommended that the tax ambit of the general form of stability agreements be widened, apart from those on withholding taxes. Given the low thresholds of eligibility, this could over time create confusion in the administration of tax, and perhaps lead to some inequity. It is best to continue to handle the ambit of tax matters to be stabilized on a sectoral basis.

2. Residence privileges of non-citizens

A Peruvian employer may obtain residence rights for foreign employees, renewable every three years, provided these do not exceed 20 per cent of the employer's workforce and 30 per cent of the payroll.¹⁷ There are a large number of exceptions to this limitation — for example, individuals with special links to Peru are not counted,¹⁸ while foreign-owned banks, service companies and international transport operators are exempted. It can also be applied flexibly on a case-by-case basis for foreign management and technical personnel. There is no requirement to justify foreign recruitment on the basis of the level, qualifications and skills and location for each position occupied by a foreign employee.

A foreign employee who maintains an investment of at least 5 tax units (about US\$ 5,000) in the company employing him or her is also excluded from the above ceilings. This can assist owner-operators as well as larger employers. The own-investment provision for foreign employees also opens up the possibility of a form of economic migration to Peru of small owner-operators. An interesting and pioneering concept would be for Peru to have an open door policy for very small foreign investors.

It is understood that, at the early stages of reforms, the intention was indeed to provide a window for economic migration although there were misgivings in many quarters. In the event this provision in the law has not been actively promoted as a source of FDI. The programme is administered by the immigration authorities and not by an investment promotion unit of the Government. No statistics are available on the number of small foreign investors who have entered through the programme or on the size and nature of their investments. It appears that whatever limited response there has been to the opportunity is mainly in the garments and services industries.

An open door policy towards foreign-owned operators, if confirmed, is a highly novel approach. On the one hand, FDI through economic immigration programmes, such as those practised by Canada and Australia, usually set much higher thresholds for the level of investments required. On the other hand, the protection of small local investors is often one of the most sensitive aspects of FDI regulation in developing countries. It is also an issue in the developed economies. APEC, for example, has been considering the impact of

¹⁷ DL 689.

¹⁸ Including foreigners with Peruvian spouses or children, and those who hold an immigrant visa.

greater trade and investment liberalization on small and medium-scale enterprises (SMEs) including both means of supporting internationalizing SMEs and assisting other SMEs which are “most at risk” from liberalization. If Peru truly aims to have an open door for economic migration, there are implications of national significance for how such investment is targeted, promoted and facilitated in order to maintain the objective of building efficiency and competitiveness of local firms. Since APEC is undertaking work in the area of SMEs, Peru could gain from APEC’s research when developing its own policies and activities on targeting and promotion and also with regard to the special problems faced by internationalizing SMEs.

3. Overall assessment

The creation of free zones is most obviously warranted when sound investment opportunities are frustrated by poor policies and administration within a country at large. A free zone provides a micro-climate of internationally competitive practices in which investment can take place. This justification for free zones is clearly not applicable in the case of Peru where investment policies for creating a generally favourable business climate are administered to exemplary standards. The establishment of free zones in some locations along Peru’s borders was a strategic measure in response to the offer of similar or better advantages being offered by neighbouring countries (e.g. Chile) in their borders areas.

Free zones succeed in creating investment when special factors exist such as a large and inexpensive labour force or a strategic location. However, if the general investment climate is supportive, there is no particular need to create a free zone to capture such investment. The principal argument for a special zone in this case is that it provides a focal point for improving infrastructure and for more efficient administration of generally applicable relief schemes for indirect taxes. For example, export manufacturers should have effective customs duty drawback and value-added tax refund schemes for re-exports. That is not an argument for direct tax incentives, such as relief from income tax, which is a feature of several Peruvian free zone schemes. It is therefore difficult to see the justification, from a public interest standpoint, for such incentives in the case of industrial free zones and tourism free zones.

Additional fiscal incentives are sometimes regarded as compensating for poor infrastructure in remote areas and hence have a regional development objective. However, it is questionable whether zone-based fiscal incentives will ever be powerful enough to overcome these handicaps. A more appropriate policy is for the Government to tackle the problems of expensive access and poor infrastructure more directly where regional development is the prime objective of free zone schemes. This should be done through infrastructure programmes, involving private/public finance partnerships wherever possible.

In respect of exporters of services and non-traditional goods the incentives appear to be unnecessarily wide. It is reasonable to provide a prompt general sales tax refund system via transferable income tax credits. However, the purpose of refunding housing fund contributions is unclear and the fact that import duties are also part of the refund scheme is perhaps an acknowledgement that the general levels of import duty are uncompetitive. Certainly this scheme with respect to service industries could cause compliance problems. A scheme with similar effect exists in the natural resources sector although it applies only to import duties on capital items. An overall review of the import duty regime is needed, especially in relation to capital imports.

No empirical review of the effect of these fiscal incentives has been undertaken for this report. However, the following preliminary conclusions and recommendations are made for further consideration:

- (i) Peru has less need than other countries for special fiscal incentives, although the levels of import duties warrant general review rather than piecemeal attention through incentive schemes;

(ii) The direct tax incentives offered in the free zones are of questionable merit from a public policy standpoint and in addition they are applicable for 15 years for eligible enterprises; and

(iii) Action in relation to (i) and (ii) above should aim to remove much of the fiscal underpinning of free zones and other special incentives. Those schemes designed to assist exporters could be scrapped in their present form and re-designed, if necessary, strengthening the administration for the more effective implementation of relief and drawback schemes. Those schemes, aimed at disadvantaged areas, should be temporary and the Government would give more credible help through resolving access and infrastructure problems. Infrastructure development should involve private-sector participation where possible through the use of concession programmes, although substantial co-investment or subsidy with public funds is likely to be needed.

One recommendation is made in relation to the general fiscal regime:

iv) The “in lieu of” dividends rule (see “withholding tax”) is a disincentive. It is an anti-avoidance mechanism, which is itself avoidable — at a cost — by routing shareholder debt through a financial intermediary. A preferable approach is to treat shareholder and third-party debt in the same manner provided a minimum equity-to-debt ratio is achieved and reasonable caps on loan interest are maintained.

C. Privatization and infrastructure concession

Since 1990, public and private sector initiatives have boosted investment in infrastructure and public services, allowing for the rehabilitation of a good part of the existing infrastructure and the launching of new projects. On the positive side, the World Economic Forum, in its annual Global Competitiveness Report,¹⁹ has ranked Peru fourth in Latin America (after Chile, Mexico and Argentina) and fourteenth in the world in terms of infrastructure development.

The largest investments have been concentrated in telecommunications, accounting for 34 per cent of total investments in infrastructure — compared with 28 per cent for energy and 20 per cent for roads — and for more than 1 per cent of total GDP. Overall, public investment in infrastructure accounts for 1.7 of GDP compared with 1.3 per cent by the private sector. The objective set by the Government is to achieve 4.25 per cent of infrastructure investment in total GDP. Thanks to realized investment, all indicators related to infrastructure development have improved (see telecommunication, electricity, roads, airports and ports, for example).

I. Privatization

Peru began the decade with an extraordinarily large range of State business holdings. An aggressive and professionally executed privatization programme in recent years has divested most of these holdings to private hands and the programme is now nearing its natural end. Proceeds from 220 completed transactions amount to US\$ 9.2 billion and there are new investment commitments of US\$ 9.1 billion.²⁰

The extent of State divestment in individual sectors is shown in table II.4. Wisely, the expertise developed during the privatization programme by the government agency the Commission for the Promotion of Private Investment (COPRI) is being put to good use by redeploying the personnel for the structuring of private concession awards for greenfield infrastructure developments (see box I.1).

¹⁹ World Economic Forum (1999). *Global Competitiveness Report*, Geneva: World Economic Forum.

²⁰ Source: COPRI (2000).

The privatization programme has four objectives:

- u Contribution to wider goals of enhancing the market economy;
- u Promotion of private investment;
- u Promotion of the domestic capital market; and
- u Generation of government budget revenues

Table II.4. State divestment by sector and new investment commitments, first semester 2000
(Percentage and millions of dollars)

Sector	Percentage divested	New investment commitments
Telecoms	100	3 400
Finance	100	422
Industry	85	604
Oil	65	915
Electricity	66	2 008
Mining	90	1 169
Fishery	100	165
Agriculture	35	46
Others	75	354

Source: COPRI

Greater emphasis has been placed on securing new investment commitments and improving the economic performance of industry than on the maximization of sales proceeds. A successful restructuring of companies to be privatized was undertaken which focused on the essential aspects related to enterprise competitiveness, such as legal status, financing and personnel. Overall, the privatization programme has promoted a more positive image of Peru among international investors, reduced the country risk perception and stimulated the local capital market. It has also generated sufficient revenues to finance the Government's social investment programme. A number of complementary schemes have sustained the privatization process, including:

- u **A labour retraining programme**, aimed at mitigating the impact of labour reduction by providing support in finding new jobs and training in new skills;
- u **Sales of shares to workers**, offering workers the option to purchase up to 10 per cent of shares of State-owned enterprises under privatization;
- u **Citizen participation**, through a global offering of shares to maximize the dissemination of shares' ownership in privatized companies.
- u **Business promotion**, by financing the purchase of companies targeted for privatization by small and medium enterprises;

2. Concessions programme for infrastructure

Peru is keen to involve private finance in the development of its infrastructure and has put in place a concession regime to attract private investment. The concession regime is governed by the Law on Promotion of Private Investment in Public Infrastructure and Public Services (the "new concession law") that was passed in 1996²¹ to replace an earlier concession law which operated from 1991. The most important change from the early concession regime is the reduced scope for the private sector to initiate a project.

²¹ DL 839 of 1996 and regulations DS 059-96-PCM and DS 060-96-PCM.

Box II.1. The role of COPRI in privatization and concession

COPRI is an inter-agency commission at ministry level acting as the privatization board. Its legal mandate includes making all important decisions required to transfer the Government's participation in companies or assets targeted for privatization. At present, it is also in charge of carrying out the public infrastructure and public utilities concession programmes, which will promote the involvement of private investors.

In undertaking privatization, COPRI placed greater emphasis on securing new investment commitments and improving the economic performance of industry than on maximizing sales proceeds. When designing a strategy for the transactions, COPRI first emphasized sales to industrial investors rather than to financial investors, including the general public and institutional markets, who were able to acquire remaining shares – of strong and profitable companies – after controlling stakes were transferred to qualified operators. This strategy was based on the fact that the enterprises were generally in poor shape and required significant injections of new capital and management discipline by committed investors. The Government was willing to sell controlling stakes, but privatization was accompanied by the prior establishment of regulatory regimes and industrial restructuring for those transactions in regulated industries.

The scheme for supervizing and executing privatization transactions was well designed. COPRI, which has a small professional staff of 12, mandated investment banks and technical advisers to advise on the execution of transactions and prepare the pre-qualification procedures for the bidding process. Examples provided by COPRI show significant gains in service coverage, cost and quality in the sectors that have been privatized, such as telecommunications, electricity generation and distribution, banking, mining and hydrocarbons. New investments are concentrated in different areas but mainly in four sectors – telecommunications, electricity, mining and gas. Some of the national and international investors attracted through COPRI's targeted drive for privatization include Telefónica (Spain), BHP (Australia), Cominco/Maribeni (Canada/Japon), Endesa (Spain), Grupo Gloria (Peru), Mobil Oil (United States), Hunt (United States), Pluspetrol (Argentine), and HydroQuebec (Canada). In 1999, COPRI received an award by the British publication, Privatization International, for its efficient handling of the privatization and concession programmes.

Having largely tackled privatization in many of the selected areas, COPRI has taken a lead in implementing the concession programme for infrastructure development. Within this programme, it has defined 18 new projects for infrastructure development, and monitored compliance with existing concession contracts (established industry regulators include water, electricity, and telecommunication sectors).

Source: UNCTAD survey and www.copri.gob.pe, 2000.

A specialized agency, the Commission for the Promotion of Private Concessions (“PROMCEPRI”), which is part of COPRI, originates, structures and executes the award of concessions. Responsibility for monitoring compliance with concession contracts is undertaken by the industry regulator, where established (such as in the water, electricity and telecommunications sectors), or otherwise by COPRI (for example major road projects). Municipalities are responsible for concession programmes for municipal services (markets, parking, tourism and cultural centres) and implement these according to the principles and incentives of the concession law.

A variety of concession structures is available within a build-operate-transfer regime and may include cofinancing or operating subsidy participation by government bodies.

Certain incentives apply including the ability to extend the term of legal stability agreements to match the term of the concession, elimination of the asset withholding tax and the provision of accelerated depreciation.

Under the new concession law, concessions have already been awarded by COPRI for:

- u The Mantaro – Socabaya transmission line (see box II.2)
- u A cellular telephone licence outside Lima
- u The Macchu Picchu cable car
- u The southern electricity distribution network
- u Three railroads.
- u Camisea gas field

3. Overall assessment

An overview of the privatization programme suggests the following conclusions:

- u The strategic design of the transactions has correctly emphasized sales to industry investors rather than to financial investors, including the general public.
- u The enterprises were generally in poor shape and required significant injections of new capital and management discipline by committed investors. Moreover the Government has been willing to sell controlling stakes.

However, it is arguable whether minority stakes could have been retained in more cases for sale to financial investors. This may have generated additional revenues for the State as well as provided greater opportunities for deepening the capital market and promoting Peru to the international investment markets. This scheme was effectively employed in some privatizations (e.g. Telefónica del Perú, Luz del Sur, Banco Continental, Cementos Lima). In these cases, minority stakes were sold on the local capital market, giving Peruvians a chance to finance shares in privatized companies and on international capital markets.

The scheme for supervising and executing transactions has been well designed by COPRI. Transaction structures appear to have been appropriately designed in respect of:

- u The attention given to prior establishment of regulatory regimes and industry restructuring for transactions in regulated industries;
- u The introduction of pre-qualification procedures into the bidding process;
- u The emphasis given to ensuring transparent selection by focussing bidding on the fewest possible variables;

- u Creation of competitive tension among bidders;
- u The use of privatization forms which are industry-context sensitive. For example: privatization in several mining transactions has taken an option structure approach. This mirrors the “farm-in” techniques used in private transactions in which an investor earns the right to acquire equity in return for funding an agreed exploration programme. In some power generation transactions the so-called “capitalization” approach has been used in which a given new capacity installation target has been bid against the least dilution in State ownership — 280MW of new capacity have been committed in this fashion.

Box II.2. Concession for the Mantaro-Socabaya transmission line

In 1997, a 30-year BOOT concession was awarded to the TransMantaro Consortium headed by HydroQuebec of Canada for a power transmission line to link Peru’s southern and central power grids. The link will increase efficiency in the use of generation capacity by enable load sharing between the grids.

The concession structure offered a 12 per cent real rate of return in US dollars and the contract was to be awarded to the pre-qualified bidder proposing the lowest investment cost. The transmission tariff is payable by the eight generators in the two systems with payment to be underwritten by the Government.

The TransMantaro Consortium won the concession against two other bidders. It bid a US\$ 179 million investment cost compared with the other bids of US\$ 241 and US\$ 254 respectively. Legal stability arrangements were executed which contained the enhancements available for concessions programmes and their term was extended to match the duration of the concession. Construction is now under way with the construction contractor bearing the completion risk.

The Consortium found the bidding process to be transparent and COPRI to be very diligent although the overall process was found to be overly bureaucratic because of the number of government agencies involved. An initial problem concerned the poor draft documentation prepared by COPRI’s financial adviser although this was rectified through representations made by the Consortium and another bidder, National Grid of the United Kingdom.

In Latin America, HydroQuebec has invested in Costa Rica, has a failed project in Brazil and was outbid on a distribution company in Argentina, which is a more mature market. Peru’s investment policy climate is regarded as sound – on a par with Chile and Argentina and better than in Bolivia – and HydroQuebec would be interested in further investment in Peruvian power concessions, within its country risk limits, provided Peru maintains competitive rates of return.

Source: UNCTAD survey.

Examples provided by COPRI show significant gains in service coverage, cost and quality in the privatized sectors²² although these stem from a low base — from a demoralized and undercapitalized public sector operating in poor business and macroeconomic conditions. No direct assessment has been made in this review.

²² Examples relate to telecommunications, electricity generation and distribution, and banking.

Public offerings have made a modest contribution to the domestic capital market. Understandably, in relatively few privatizations were they the primary means of disposal. In only two cases – soon to be three – has an initial public offering (IPO) followed a primary disposal by strategic sale. Telefónica del Perú raised US\$ 1,239 million for a 23.6 per cent interest and a public offering of Luz del Sur (electricity distribution) raised US\$ 66 million for a 30 per cent interest.

The new investment commitments of US\$ 9.1 billion achieved are very impressive. When realized, they will add 66 per cent to Peru's existing (1999) stock of FDI.²³ Two factors should be kept in mind when assessing this information. First, the three largest privatization transactions account for over two thirds of these new investment commitments. Of these Antamina, whose investors only recently confirmed their intention to proceed, accounts for US\$ 2.5 billion alone. Secondly, these new investment commitments are concentrated in two sectors – telecommunications and mining. The electricity sector appears to have generated relatively modest new investment obligations. Local regional investors were the main participants in the bidding process, partly because of the merger control in the electricity sector.

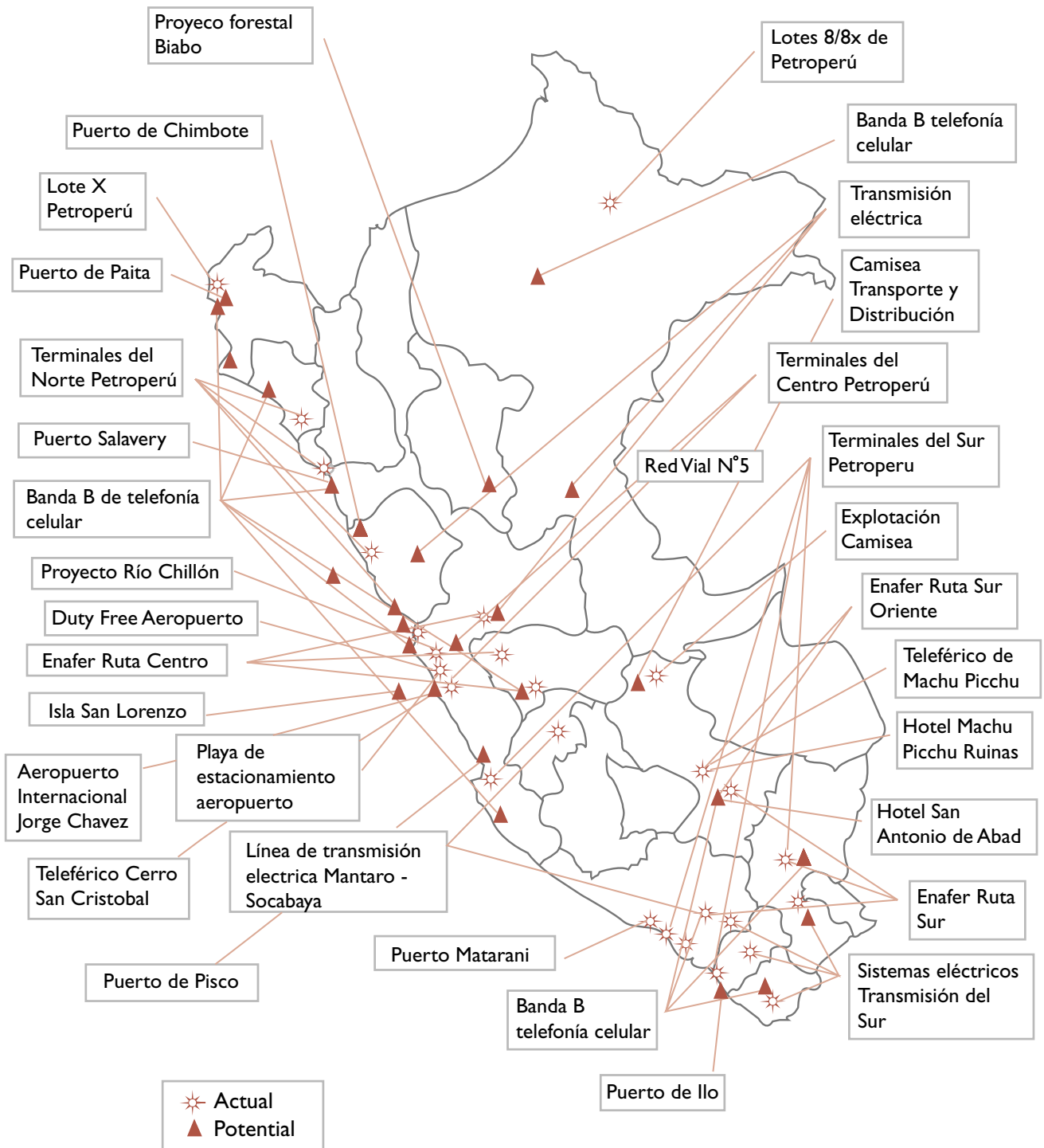
With regard to concessions, since the introduction of the revised regime in 1996, there have been three concession awards at national level and an unknown number at provincial level. The legal framework appears to be sound and it was wise to use COPRI's privatization expertise for implementing the concession programmes. The process for awarding concessions is transparent and focused on competitive outcomes, which is vital given the long-term nature of the concessions and, often, their importance to the economy.

Concession origination has been slow but sure. Relatively few concessions have been offered since the private sector's role in origination was reduced. Over time, the development of an adequate project pipeline should be kept under review, and in due course more latitude could be given to origination by the private sector. The public sector should not be given a long-term monopoly of the generation of investment ideas for infrastructure. For example, as Peru has a number of World Heritage sites that are outstanding international tourist attractions, it might consider inviting bids from investors in the travel/leisure industries to prepare a comprehensive tourism investment and promotion plan. The successful bidder would prepare a plan identifying a comprehensive range of concession activities within a development plan acceptable to Peruvian national and local interests and consistent with World Heritage principles (see chapter IV).²⁴ The bidder's reward would be a share of royalties from induced third-party concessions and the opportunity to invest in agreed non-regulated facilities that would benefit from the growth in tourism generated by the plan. This would involve investors in a more pro-active role and could be a useful initiative to develop within APEC's very active group on infrastructure.

²³ Noting that not all the new investment commitments represent foreign direct investment and that a portion of the new investment would be internally financed.

²⁴ UNESCO assisted the Government to prepare a master plan.

Figure II.1. Actual and planned concession in Peru, 2000



Source: prepared by the Universidad del Pacifico based on official information provided by CONITE and COPRI, 2000.

D. Other policy issues

I. Fair market practices

(a) Competition policies

Peru's constitution bans monopolies, oligopolies and restrictive practices, except in some circumstances, and for limited periods.

The Community of Andean Nations (CAN) — comprising Bolivia, Colombia, Ecuador, Peru, and Venezuela — took the lead in establishing common rules to protect free competition by enacting Decision 285 of the Cartagena Agreement in 1991, and initiated progress towards competition policy enforcement among the Andean countries. Peru's competition law is based on three decrees enacted in 1991:

- u Decree Law DL 691, establishing consumer defence rules on advertising;
- u Decree No. 701, defining consumer rights and suppliers' obligations; and
- u Decree Law DL 701, the anti-trust law

According to existing legislation, the State holds an effective monopoly in some areas — for example, water distribution and certain types of rural construction projects. DL 701 of 1991 enforces this provision by banning (i) discrimination in setting commercial conditions for similar products and activities and (ii) the application of local prices higher than those offered abroad for a given product or service.

Decree Law DL 25868 of 1992 established the Institute for Protection of Fair Competition and Intellectual Property Rights to promote and enforce the newly passed regulation concerning competition, consumer protection, intellectual property rights, dumping and subsidies, metrology and technical norms, unfair practices, supervision of publicity and market access and exit. It is divided in two sections — one relating to economic policy and the other to jurisdiction — both supported by a single administrative structure that is controlled by a board of directors.

The National Institute of Fair Competition and Intellectual Property Protection (INDECOPI) has consolidated in a single agency many functions, which in other countries are spread among different institutions. The jurisdictional area is divided in two: the market competition chamber (composed of seven commissions) and the intellectual property chamber (composed of three offices). The commissions and offices are INDECOPI's first instance administrative judicial bodies, while INDECOPI's tribunal resolves cases in the second instance. Tribunal decisions may be appealed directly in Peru's Supreme Court. INDECOPI has quickly secured its reputation as an "independent body", vital to the good functioning of the review system (Araoz, 1999).²⁵

INDECOPI does not regulate mergers and acquisitions (M&As). It prefers an ex-post control of firm behaviour rather than an ex-ante control, which may be very costly and complex. The decision also responded to the current situation and the size of the Peruvian economy. Peru was trying to promote investment by attracting foreign and international capital and an ex-ante control of mergers was considered an unnecessary obstacle and a drag on limited financial resources.

INDECOPI is autonomous and takes decisions without the involvement of any other State institution. Although public services that have been privatized or granted in concessions are regulated under specific legislation and regulatory bodies, INDECOPI remains in charge of investigating restrictive competition practices in all areas. The only exception is the telecommunication sector, which falls under the jurisdiction of the regulatory agency for telecommunications, OSIPTEL. However, INDECOPI consults with all other

²⁵ Araoz M. "Competition policies in the FTAA: progress in the working group and Peru's approach as chair". Paper presented at the Pacific Economic Cooperation Council, Kuantan, Malaysia, September 1998.

regulatory bodies in specific sectors where there are regulatory agencies, such as energy and water: This enables the exchange of experience regarding market analysis methodologies and the determination of dominant position.

INDECOPI has ruled against some public enterprises that were abusing their dominant market position. These include Empresa Nacional de Puertos and Empresa Nacional de la Coca. It has also assisted in resolving some conflicts involving TNCs operating in Peru. For example, it examined and resolved the conflict concerning advertising campaigns on butter (FERN-New Zealand Milk Producers) against margarine (Unilever and Alicorp).

There are industry regulatory agencies for regulating public services in such areas as water (SUNASS), energy (OSINERG) and telecommunications (OSIPTEL). As in the case of INDECOPI, there is the possibility of appeal to the judicial authority concerning the procedures and administrative sanctions applied by these agencies. At times, the private sector has felt that the application of regulations on vertical integration business by OSINERG has been too restrictive. For example, it is understood that one reason the Shell consortium did not proceed with development of the Camisea gas field is that the Government was reluctant to grant the investor rights to both distribute the gas and to supply it.

The telecommunication agency OSIPTEL, regulates tariffs on telecommunication services and supervises the quality of local operators. The national telephone company Telefónica del Perú was granted a monopoly for fixed-line service through June 1999 as part of its privatization contract in 1992, but that monopoly was terminated retroactively in August 1998, opening the market to competition. The telecommunication legislation of 1994 introduced the principle of free competition, and any investor, both national and foreign, can invest in this sector. Since operations are permitted through concessions, they must have an open architecture and allow interconnection among concessionaires under the principle of equal access, neutrality and non-discrimination. OSIPTEL can play the role of referee in the case of any conflict.²⁶

The Commission of Electricity Tariffs regulates the sector. Tariffs are based upon the marginal costs, which follow the principles of neutrality, fairness and efficiency. In a recent assessment, it was noted that tariffs are neutral because clients can choose freely the tariff option according to the level of consumption. Tariffs are fair because they are fixed according to the cost involved, without taking into consideration use or activity. Finally, they are efficient because when consumers know the real cost of energy, they tend to use it efficiently.²⁷

At the international level, Peru is playing an active role in discussions on competition policy within the Free Trade Area of the Americas (FTAA) negotiations. So far, progress has been made in defining the issues related to linkages between competition and trade policies. Peru has also submitted four written contributions to the WTO working party on the relationship between trade and competition.²⁸

(b) Environmental policies

The environmental law (Código del Medio Ambiente y los Recursos Naturales, DL 611) enacted in 1990, supported by various decrees, sets stringent environmental-protection standards.

Investment projects are required to undertake an environmental impact study. The study must be conducted by a firm registered with the national institute for natural resources, INRENA. Article 28 of DL

²⁶ Fernandez Baca J.(1998). "La experiencia regulatoria en el Perú II: los casos de electricidad y agua potable". Apunte 43, Lima,

²⁷ Fernandez Baca J.(1998). "La experiencia regulatoria en el Perú". Apunte 42, Lima, Universidad del Pacífico, pp. 93-105.

²⁸ World Trade Organisation (1999).WT/WGTCP/W 3,36,59 and 74, Geneva:World Trade Organization.

611 also establishes that any polluting enterprises should incorporate all possible cutting-edge technologies to reduce or eliminate pollution. Special measures address marine protection and water treatment, and follow international standards set by the United Nations. However, major deficiencies lie in the monitoring of the law's application.

The environmental law also requires all industries to change operations, procedures and facilities in line with the guidelines of Environmental Adaptation and Management Programmes. Each ministry designs the technical guidelines of these programmes and administers compliance in conjunction with a special permanent committee for overseeing their enforcement.

2. Trade Policy

Since 1990, when Peru began trade liberalization, its policy objectives of openness have been geared towards integrating into the global economy. The average level of tariffs has been sharply reduced — from 66 per cent in 1988 to 13 per cent in 1999. Current tariff levels are 12 per cent, and 20 per cent for some goods (agriculture) affected by a surcharge of 5 per cent. The average tariff rate, including the surcharge, is 13.5 per cent and the weighted average is 13.3 per cent, with a deviation of 3.5 percentage points. The Government has eliminated most tariff exemptions and rebates. Remaining exemptions are those applied in the established industrial and trade free zones (CETICOs) and those set by bilateral trade agreements.

Exporters of non-traditional goods, including manufactures, crafts and certain agricultural products, are eligible to use a drawback mechanism to recapture tariffs paid on imported inputs. Exporters are also allowed duty free import of inputs under the temporary admission regime.

There are four industrial and commercial free zones: Ilo, Matarani, Paita and Tacna. Law No. 26593 of 1998 created an additional CETICO in Loreto Department but its operations have not yet been defined. Companies established in the free zones receive a 15-year exemption from all national, regional and municipal taxes, with the exception of the obligation to contribute to the social insurance funds. Companies in these zones are allowed to perform all commercial activities including processing, packaging and warehousing of goods. Inputs for, and exports from, the CETICOs must transit through the ports of Ilo, Matarani and Paita. Exports from CETICOs to the rest of the country are permitted but they are considered as imports for customs purposes, with the exceptions of used cars that have a special regime. In this respect, Tacna enjoys some additional advantages, namely a single 8 per cent duty on exports to the rest of the country. Despite the tax advantages, CETICOs are not very active as an export base owing to infrastructure bottlenecks, and the fact that the zones do not enjoy privileged access to main export markets.

At the international level, Peru as a member of WTO, has duly adopted the rules and provisions incorporating WTO agreements fully into the national legal structure. Its domestic legislation in such areas as anti-dumping, subsidies and countervailing measures, safeguards and intellectual property, among others, are also in line with WTO provisions. Since 1 April 2000, Peru has been applying the WTO Agreement on Customs Valuation to 100 per cent of its imported goods, following a one-year waiver requested within the framework of the Agreement. Under the WTO's General Agreement on Trade in Services (GATS), Peru undertook horizontal commitments with respect to the movement of natural persons and treatment of foreign investment. Sector-specific commitments cover 7 out of 12 broad categories of services. Reflecting Peru's legislation, there has, in general been full commitment to market access and national treatment for services supplied through commercial presence (i.e. treatment granted to foreign investment). The opening up of telecommunication services is particularly comprehensive.²⁹

²⁹ World Trade Organization (2000). *Trade Policy Review: Peru*, WT/TPR/S/69, Geneva : World Trade Organization.

In parallel to its participation in the multilateral trading system, Peru also belongs to regional free trade agreements. It was a founding member of then Andean Pact but discontinued participation between August 1992 and July 1994; Peru favoured faster liberalization and a lower common external tariff. On resuming full membership of CAN, Peru negotiated its participation in the proposed Free Trade Area to be completed in 2005. However, 80 per cent of its tariff items are already liberalized, and the remaining are likely to be liberalized by the year 2002.

Peru has a free trade agreement with Chile and is negotiating within the CAN framework the formation of a single free trade area with MERCOSUR. A preferential tariff agreement between Brazil and CAN was signed on 3 July 1999, after the two regional blocs failed to meet a March 31 deadline to agree on a new preferential tariff system. While Argentina, Uruguay and Paraguay adopted a cautious wait-and-see approach, Brazil decided to press ahead with bilateral negotiations with CAN countries. The agreement includes 70-100 per cent tariff reductions on most of the 3,000-plus items discussed during the negotiations. The most significant aspects of the agreement are the acceptance of past bilateral exemptions and special concessions, and a two-year agreement period.

Peru benefits from a number of trade preference schemes, such as the General System of Preferences, the ANDEAN Trade Preference Act granted by the United States and the Special Regime for Supporting the Fight Against Drugs, granted by the European Union. As of 1999, Peru became a full member of APEC, and is actively participating in negotiations for a Free Trade Area for the Americas. In the first round of meetings, Peru was the coordinator for the CAN group.

E. The role of the institutions

The main agencies in charge of investment in Peru are:

- u National Commission for Foreign Investment and Technology (CONITE);
- u Commission for the Promotion of Peru (Promperu);
- u Commission for the Promotion of Private Investment (COPRI);
- u Investment Promotion Division of the Ministry of Foreign Affairs; and
- u Regional departments of investment promotion — Consejos Transitorios de Administración Regionales (CTARs).

Established in 1981, CONITE has changed its role from a regulating body to a facilitator of the investment process. It was responsible for designing the new legal investment framework and submitted the draft legislation for approval. With the introduction of the new law in 1991, CONITE continued to register FDI only for statistical purposes since prospective foreign direct investors do not need to obtain special approval or registration before investing. However, foreign investors who wish to sign a legal stability agreement must register with CONITE. In such cases, CONITE provides assistance in the pre-establishment phase. It also offers some post-investment services, including collection of FDI statistics, information dissemination and assistance in the legal area. It has a staff of 15 professionals.

Promperu was set up in 1993 with the aim of projecting an attractive image of Peru abroad, specifically in order to encourage investment and tourism. In the area of investment, Promperu designs information material and organizes presentations (“road-shows”) in key countries to attract investors. A small team of three professionals works in its investment section. The board is not active in the design of a promotion strategy, but it cooperates with the private sector and the different ministries in the organization of specific events such as participation in international fairs and conferences.

COPRI, with a small professional staff of 12, is responsible for supervising and executing privatization transactions but it does not monitor transactions after privatization. It mandates investment banks and technical advisers to advise on the execution of transactions. The agency also supervises the concession schemes and coordinates activities with local authorities, as appropriate (see box II.1).

The Investment Promotion Division of the Ministry of Foreign Affairs is responsible for negotiating bilateral investment treaties with technical support from CONITE. In the near future it will also be in charge of double taxation treaties. Through the external network of 130 embassies abroad, the Ministry disseminates promotion material prepared by all national agencies and specialized institutions. It also assists COPRI in its efforts to attract potential international investors to take advantage of the privatization and concession programmes. The network of embassies plays a leading role in coordinating the visits of groups of international investors to Peru as well as in organizing seminars and investment forums abroad in collaboration with Promperu, COPRI and business associations. Embassies also respond to queries from international investors and facilitate contacts with their correspondents in Peru. The Foreign Affairs Division, in collaboration with other relevant ministries, has identified a number of providers of high technology in countries and targets efforts to promote investment in such areas. Finally, the Division analyses and evaluates FDI in Peru.

These efforts at national level are complemented by investment promotion activities carried out by the Consejos Transitorios de Administración Regionales (CTARs) or regional departments of investment promotion. These departments fall under the supervision of the Regional Development Section of the Presidency Ministry. As of June 2000, there were 25 CTARs. These public agencies have the highest authority in each region. They have been traditionally devoted to infrastructure development but are being reoriented to foster trade and investment. The activity of each agency is dependent on available capacity, human resources and different managerial ability in each region. CTARs have, in some areas, played a key role in project formulation. They have recently initiated collaboration with the private sector to identify projects and facilitate financing.

The three main types of investment promotion activities — image building, investment-generating and after-care services — are split among different agencies. A number of initiatives are currently taking place to coordinate actions among the different government agencies involved in investment promotion as well as with the private sector. Recently, a committee has been established under the auspices of the national Confederation of Business Associations (CONFIEP) with all three main investment agencies and key ministries represented (such as tourism and mining). This committee is expected to make proposals for a coherent investment promotion strategy. However, based on best practices, investment promotion would be much more effective if undertaken by a single agency. As the privatization programme comes to its natural end, there is potential for bolder actions in investment promotion with regard to image building and investment generation. Moreover, a number of important post-investment services are not available in Peru and should be introduced to trigger additional investment by established TNCs.

F. Conclusion

There can be no doubt that Peru has created an attractive policy framework from the standpoint of the foreign investor. The rapid growth of FDI over the last five years is a testament to the quality of the reforms and their administration.

This acknowledgement should be the starting point for considering future initiatives. Is there a need for further initiatives by way of reforms to the investment policy framework? This review has made a number of suggestions, but not for fundamental reform because in the judgement of this review the existing fundamentals are sound. Rather, they concern areas of quality improvement to maintain Peru's position at the leading edge of investment policy regimes.

The clearest initiatives advisable for Peru relate to a bolder promotion of the country as an outstandingly well-organized investment destination. Peru's attractions have been well promoted among foreign investors in specific projects through the privatization programme and the concessions programme. However, they are less well known to the wider international investment community including market-seeking investors and portfolio investors. It is not widely appreciated, for example, that Peru has twice the population of Chile and an investment policy regime that is at least as favourable to FDI. In respect of generalized promotion, Peru undersells its attractions and achievements.

A number of potential initiatives could lift Peru's international recognition level. First, more attention could be given to attracting institutional portfolio investment in the Peruvian capital markets. There is insufficient coverage of Peru at the country and company level by major securities houses. Measures to increase the number of quality listings should be identified, including ensuring that more portfolio investment opportunities are generated by the privatization programme. A lively and actively reported capital market would improve the visibility of Peru among potential strategic investors.

Secondly, the undoubted international tourist potential of Peru could be better harnessed. This review has suggested an investor-based initiative which would aim at accelerating tourism and, as a by-product, promoting the country to the wider world. Peru might consider incorporating the development of this initiative into APEC's work on encouraging private investment in infrastructure.

III. Building on success: what next in Peru's FDI strategy

Peru's success in attracting FDI this decade has rested overwhelmingly on two factors, namely, a sound investment framework and an astute privatization programme. The latter has combined the sale of prime assets with a commitment from the purchaser to invest significant amounts on rehabilitation and new development. These two factors provide a solid basis for building on success.

The privatization already completed should be seen not as one-off deals but as catalytic transactions with a potential to generate new FDI through the medium term. This additional FDI can be substantial — in the order of a doubling of the cumulative stock of FDI. Realizing this potential has immediate implications for investment promotion policy, particularly with regard to the establishment of investor facilitation and aftercare investor services, which can help ensure that investment commitments and plans fully materialize.

Concurrently, from the perspective of long-term strategy, it is prudent to recognize that the privatization programme has already disposed of almost all the earmarked assets and it is time to begin to address the question of how to sustain investment inflows. The main industries now attracting FDI should be viewed as part of a system of linked supplier and related industries, and measures to build hub industries into industrial clusters need to be considered. Longer-term policy and capacity-building measures are required to enhance innovation activities in the productive sector.

In this respect, the sound investment framework provides a credible foundation on which Peru can position itself as the best location in the sub-region to do business. A number of improvements can be identified that could form part of a strategy for the next decade to create a high quality business environment.

A. Key strengths and weaknesses of the Peruvian economy

Managers of foreign affiliates in Peru and potential investors interviewed by UNCTAD, hold positive views on the country's investment prospects (see table III.1). The main competitive advantages they identify are: growing domestic market, access to natural resources, the liberal investment environment and opportunities offered by the privatization and concession programme.

I. A growing market

Peru's market offers good opportunities, according to investors. It has a population of 25 million and is classified by the World Bank as a middle-income country. With a per capita GNP of US\$ 2,490 in 1997, it ranked as 53 in the world (World Bank, 1998). On a purchasing power parity (PPP) basis, Peru's per capita GNP increases to US\$ 4,390, and it is the sixth largest in South America. In addition, between 1991 and 1996, the Peruvian economy created over 800,000 jobs in the middle-income bracket, increasing the number of urban dwellers with purchasing power (Saavedra, 1998).³⁰

³⁰ Saavedra, J. (1998) "Empleo, productividad e ingreso en el Perú, 1990-1996", Lima: Peru, Documento de Trabajo 67, Oficina Internacional del Trabajo.

A factor that affects market prospects is financial risk. In developing countries, investors tend to be wary of such risk, and executives interviewed by UNCTAD expressed the same concern about Peru. However, the country risk indicator for Peru has retained a stable B rating by main rating agencies. In the view of investors, Peru's main weakness is its external imbalance. In addition, the launching of large investment projects in mining can activate the market but also destabilize it due to the inherent uncertainty of investment profitability, timing and results of exploration.

2. A favourable policy environment

During the 1990s, Peru has maintained strong economic fundamentals, creating a solid fiscal and monetary base and reducing public debt and inflation. It had attained the highest GDP growth in Latin America by the mid-1990s. The Government has created an excellent legal and economic framework for FDI in respect of both specific and general policies of importance to foreign investors. A number of international investors interviewed by UNCTAD considered the investment climate in Peru to be generally sound and made only a few negative observations on policy variables. They suggested that improvements were needed in the judicial system.

Of paramount importance to foreign investors are the scope and speed of the privatization programme. From a large range of business holdings cutting across all sectors, the Peruvian State has divested most of its commercial ventures, and the privatization and concession programmes have been professionally managed, winning the trust of foreign investors.

Peru has a reasonably low and well-structured system of taxation (described in chapter II) and offers different incentives. Foreign and national investors have equal access to investment incentives arising from constitutional provisions against discrimination in this area. Certain aspects are of special relevance to foreign investors, including contractual assurances of national treatment and guarantees of profit and capital repatriation. However, there is a need to reduce import duties especially on capital items.

3. Ample natural resources

Peru's endowment of natural resources is a magnet for FDI. The country's wealth of oil, mining, agriculture and agribusiness as well as tourism assets are considered by international investors to be one of Peru's strengths. Yet, although these resources have enormous development potential, they have not been fully exploited.

A phase of intensive growth of investment in mining is being carried out by large transnational corporations (TNCs), mainly in explorations for new deposits. Compared to other developing countries possessing similar resources, the availability of a trained and experienced labour force and some of the support services necessary to meet the demands of mining firms facilitate mining investment in Peru (see chapter IV).

In agriculture and agribusiness, Peru's principal competitive advantages are considered by investors to be its geographical location and favourable climate. Thanks to these factors, the country is able to satisfy demand for seasonal products, such as asparagus production, which has attracted FDI. Crops such as this are mainly directed towards foreign markets. Yet only 33 per cent of the total cropland is being used, and it is also possible to develop new product varieties. Larger volumes of investment are needed in irrigation works, biotechnology and quality control. Concerning productivity and quality, Peruvian yields are below international averages.³² Exports have been facilitated by improvements in infrastructure services, such as refrigerated facilities at Lima's international airport, but there are still severe constraints in shipment and air transport.

³² Eurocentro (1998). *Peru: Investment Opportunities in Agricultural Exports*. Lima: Eurocentro.

Various investment opportunities exist in fisheries which involve a high degree of processing. Fishmeal and fish canning have been modernized substantially during the 1990s with the participation of FDI. A number of programmes have also encouraged the introduction of environmentally friendly technology to control pollution, increasing at the same time the efficiency of the plants. According to investors, important issues remain, such as how to ensure sustainable fishing levels, given past experiences of depletion and the unpredictable El Niño effect; how to induce investment in less polluting technology; and how to move up the value chain in fishmeal production to higher value feeds.

4. Weak infrastructure

Overall, according to international investors, the quality of the country's infrastructure needs upgrading. Years of underinvestment, poor management and the destructive actions of the terrorist movement, Shining Path (the latter alone is estimated by some to have cost US\$ 20 billion), left an exceedingly poor infrastructure by 1990. Power and water cuts became the norm and getting a telephone connection required a waiting period of 2-8 years.

Since then the liberalization programme has brought considerable improvement but the following issues remain:

- u Some foreign firms interviewed stressed that the price of electricity for industrial use in Peru is much higher than in most Latin American countries in which they operate. Significant hydro and natural gas resources suggest that Peru has the potential to produce power at a much lower cost.
- u During this decade, the telecommunications industry has changed from a State monopoly to a thriving and competitive industry with more than 100 firms offering a variety of fixed and cellular telephony services. More than 1 million new and replacement fixed and cellular lines have been installed. Despite this immense effort, telephone penetration has increased to only 6.8 per thousand inhabitants in 1998 compared with 12.9 per thousand on average in Latin America.
- u Roads and rail conditions are below standard. Privatization and concession awards will improve railways and some key roads but a high level of private and publicly funded expenditure will be needed. Contracts were awarded for the concession of three main railways. Central Railway will be operated by Ferrocarriles del Peru, a consortium of 8 companies including mining investors. Its main cargo is mineral from the mines located in the Andes. The Southern Railway and the South Eastern railroad covering tourism circuits will be operated by Sea Containers and its affiliate, Orient Express, which leads a consortium of foreign and local investors and won the privatization and concession awards for hotel and transport assets for the Inca region (see chapter IV).
- u Until recently, the Government managed all ports, and the quality of infrastructure and management was a contentious topic with foreign investors, especially the heavy users such as mining companies. Since then, management has improved and some port services have been liberalized. It is claimed that by 1996, servicing a ship took "only" two days, as opposed to 8 days in 1992, and that costs were halved. Private companies, however, claim that there are still significant delays in receiving their cargo although this may be partially the result of red tape. Customs-related activities have, however, improved. Nevertheless, some firms add that there should be more updated and specialized facilities for different types of cargo.
- u Airports are in need of upgrading or expansion. Only five airports in Peru can take large planes and only 17 are paved. The availability and reliability of domestic flights is another problem. INDECOPI consumer protection campaigns, which include monthly reports on flight delays and cancellations, are having a positive impact on domestic air transport that has considerably improved.

5. Poor linkages

Comparing Peru with other possible investment locations, managers indicated that their main concern for improvement related to productivity and the availability of skilled labour. At present, most of the foreign firms interviewed had no difficulty in finding appropriate management, technical and shop floor personnel. However, it was generally felt that this was not so much due to an adequate supply of trained manpower, as to the high levels of unemployment and underemployment that permitted them, with the help of good screening mechanisms, to select the most able workers. A large foreign entrant can have difficulty in obtaining seasoned skilled staff. For example, one investor was pleased to recruit many of the accounting and environmental monitoring staff made redundant due to the postponement of the Camisea project.

As more foreign investors enter the Peruvian economy, it will be increasingly difficult for them to find skilled personnel as only few training institutions provide the necessary quality. Some manufacturing companies also pointed out that the training provided in top training institutes and colleges, while delivering on general skills, did not provide the industry-specific skills they expected and which could be obtained at educational institutions in other countries. Investors are also wary of social inequalities. Some investors also point to high social levies imposed on employers of labour and to mandatory labour profit-sharing as burdens. However Peru's overall wage costs compare favourably with other Latin American countries.

Another concern of investors relates to the guaranteed quality of supplies. Peruvian firms are markedly heterogeneous (having substantial differences in productivity and quality of output, due in part to years of operating in a relatively protected economy), place an emphasis on price and not quality competition, and suffer technical limitations in managers and entrepreneurs.³³ Some managers said that there are plenty of opportunities for intermediate suppliers and subcontractors who are willing to improve efficiency and quality, although entrants would probably have to build a reputation and create trust among buyers. A more integrated industrial structure would ease the introduction of just-in-time techniques of inventory management. These techniques do not appear to have been widely incorporated into the Peruvian economy.

The domestic private sector has not been very active in seeking partners among international investors. The potential for entering into joint ventures, alliances, and subcontracting has clearly not been exploited in Peru, with the exception of a few industries such as garments and metal mechanics.

B. Strategic directions for new foreign direct investment

Resource-seeking FDI is likely to remain important for many years and there is a need to enhance competitive strengths in the resource-based industries by encouraging investment in the linked and supplier industries. In these and other industries, existing foreign firms should diversify their activities and build vertical and horizontal linkages with the local economy. There is also potential to attract FDI in the manufacturing sector to cater to both the domestic and regional markets.

The strategy for the next decade should focus on:

- u Consolidating the competitiveness of established hub industries and attracting investments to suppliers and related industries;
- u Supporting the emergence of potential hub industries and attracting new entrants in the manufacturing sector to cater to the domestic and regional markets;
- u Encouraging established foreign affiliates to diversify their activities and also build vertical and horizontal linkages within the local economy.

³³ Togo E. (1998). *Salvando la distancia*. Lima: MITINCI.

The environment must be conducive to the emergence of clusters/systems of industries. In an industrial cluster, the firms, their suppliers, customers and support institutions, such as research institutes and business associations, form a dynamic network of interactions creating synergies for enhanced value creation.³⁴ The establishment of a cluster requires a sound policy environment and an adequate operational environment in terms of infrastructure facilities and support services, such as research and training centres and financing.

The new strategy should be based on building up systems/clusters of industries. These include:

I. Main hub industries

(a) Mining

Peru's vast mineral resources are being handed over to the private sector for more efficient exploitation and substantial foreign investments have flowed into this sector. Peru must now strive to create a highly efficient mining system in which all parts of the industry — its producers, suppliers and the Government through its tax policies — will play their part to sustain attractiveness for investment.

In addition, in recent years, Peru has been successful in exporting mineral/metal-based products such as zinc oxides, copper cables and precious metals. The demand for these products is growing internationally. For instance, even though optical fibres have been replacing the copper wire, the demand for the latter continues to be strong because the application areas, such as local area networking (LAN) — where short distances are involved — continue to justify the use of copper cables.

To support investment in processing activities, it would be necessary to upgrade technical training. Peruvian universities should, therefore, have graduate programmes in metallurgical science and engineering. There should also be research facilities with strong linkages to the firms involved in processing activities.

(b) Fisheries

Investment opportunities exist in the fishing industry. However, for reaping the full benefits of opportunities in this sector, the innovation system must have strong capabilities in plant and marine biology and biotechnology. Peru's innovation system already operates support institutes. The Sea Institute carries out technical and scientific research on Peru's ocean and continental waters for rational utilization of available resources, and the Technical Fisheries Institute carries out research on processing of hydro-biological resources to develop high nutritional quality but low-cost products. However, their linkages with the business sector need to be strengthened (see box III.1)

(c) Tourism

Peru's renowned natural, historical and archaeological assets are very competitive in the global tourism markets. But for many years Peru has significantly under-performed its undoubted potential for cultural tourism because the system as a whole has not functioned adequately. The tourism industry operates within a system which will only attract visitors if tourism destinations are easily accessible, safe, well-maintained and provide the standards of hotels, restaurants and other facilities and services required by the tourist market (see chapter IV).

³⁴ A cluster is defined as interactions between the value chain (activities performed by a firm) and the value system (the stream of activities required to reach buyers). See Porter, Michael (1990). *The Competitive Advantage of Nations*. New York: Macmillan.

2. Potential hub industries

(a) Agriculture

Peru has fertile coastal farmlands that produce a variety of crops, including new varieties such as asparagus. Investments can also be attracted into industries that could be developed around agricultural activities. Nurseries are needed to provide top-quality seeds and genetic R&D to guarantee a supply of the varieties required. Collecting points and processing plants, packaging, cold storage, canning and dehydrating plants are also related industries.

To support investment in Peru's agro-based activities, several structural problems need to be addressed. Legal aspects that need improvements are the legislation on water management and property rights. Technological development should be enhanced, for example, by supporting the installation of plant biotechnology laboratories, establishing quality control and providing technical training to improve processing technology and managerial capacity. Despite the progress made in improving the infrastructure for transport, the road network is insufficient and port services providing cold storage capacity need to be upgraded.

(b) Hydrocarbons

Peru has adequate reserves of oil and natural gas resources, which are the base for developing a strong chemical industry. The chemical industry attracts the second largest inflows of FDI in manufacturing. The development of industries based on hydrocarbon resources is important both for export-oriented and domestic market-oriented production. In addition to producing intermediate chemicals, the focus should be on downstream industries such as fertilizers, agricultural chemicals and pharmaceuticals. An added reason for Peru to develop the pharmaceutical industry lies in its medicinal plant resources. Developing this sector requires an innovation system that is strong in chemical science and engineering.

Box III.1. The experience of Austral SA

Austral SA, one of the country's leading fishing companies, is a joint venture involving Peruvian and Venezuelan capital. It began operations in 1993 at its fishmeal plant in the port of Pisco, south of Lima. Since then, the company has grown continuously and today has 39 vessels —mostly refrigerated— with a total hold capacity of 14,530 metric tons and an average age of seven years. Austral also owns six fishmeal plants, two fish canning factories, one of which (pilchard) is claimed to be the largest in the world, and a can-making factory. At the end of 1999, Austral had 1,450 employees.

The company based its expansion on strategically locating its processing plants along Peru's coastline and the use of advanced technology. Location permits fish to be delivered within 4-8 hours of being caught, ensuring freshness. Fishmeal and fish oil processing plants, in turn, use modern German and United States machinery and equipment, and a proprietary very low temperature but fast two-phase drying process. Packaging is done in restricted areas in accordance with exacting hygienic standards and techniques. The company has also established a modern quality control laboratory that checks the technical characteristics of its products and provides customers with any requested testing.

The use of sophisticated technology is not limited to fishmeal plants. Australia's Metalpack tin can factory uses state-of-the-art German, Swiss and Italian printers, slicers, cutters and pressing and welding machines. Management points out that the factory, which was inaugurated in 1997, is the only one in Peru's canning industry to use brand new equipment, as most other companies use second-hand machines.

Austral's technological efforts have clearly paid off. Efficiency is 4.35 tons of fish to 1 ton of fishmeal, nearly 8 per cent higher than the national average. The fishing industry is, however, highly cyclical and suffers from exogenous factors related to the exploitation of natural resources. El Niño in 1998 strongly damaged the fishing industry resulting in export losses. Furthermore, the international price of fishmeal dropped causing further losses. In 1999, prices began to increase, but did not recover to previous levels. After a period of strong growth, with sales increasing from US\$ 82 million in 1994 to US\$ 127 million in 1997, the company suffered losses and is now undergoing financial restructuring. Notwithstanding these problems, Austral is still a leader in production, sales and exports in premium markets. In 1999, Austral accounted for the country's largest sales and exports of fishmeal and fish oil. It has representative offices in Indonesia, Sri Lanka, the Russian Federation, Thailand, South Africa, Australia and the United Kingdom.

Source: Apoyo Consultores (1998). *Situación y perspectivas del sector pesquero*, Lima: Apoyo Consultores; Austral SA. *The Peru Report 1998*, and mission interviews.

(c) Textiles and garments

Peru has well-developed capabilities in the textile and garments industry, and it manufactures high-end products. The role of FDI in the industry is limited (only 5 per cent of the total inward FDI in the manufacturing sector), with subcontracting providing the main link between foreign and local firms. Efforts should be made to attract greater foreign investments into this sector, to diversify the product range, as well as to access new technologies and new markets. Peru grows a special variety of cotton considered environmentally friendly, or clean cotton, as no fertilizers or pesticides are used on the crops. This variety, also known as brown packucho or pax cotton, grows naturally in different tones of brown with green and purple hues. Clothing manufactured with this variety of cotton will have good commercial prospects, especially in Europe. Other textiles with competitive advantages are fine wool products such as alpaca.

(d) Food and beverages

Peru can attract investments in this sector aimed at catering to the growing domestic and regional markets.

Peruvians from all social segments spend a considerable amount of their income on food and drink. Core products include milk-based products, bread and biscuits, pasta, cooking oil and beer. Since 1990, major international brands began positioning themselves in the Peruvian market. Large international food companies, such as Nestlé, Unilever and Nabisco, and Latin American newcomers, such as Chile's Carozzi and Luchetti in pasta goods and Mexico's Bimbo in industrial bread products, have invested in expanding plants and acquiring leading local companies.³⁵ Coca-Cola has recently acquired a minority share in the Peruvian soft-drink company, Inka Kola, its staunchest local competitor with about 50 per cent of the local market. Nonetheless, demand for variety continues to grow. Thus, other food industry multinationals such as M&M Mars from the United States, which is planning to establish a chocolate factory, Friesland Dairy Products from the Netherlands, and Parmalat of Italy, are also beginning to produce milk products locally. The beer industry, which is presently controlled by only two firms, is also a potential area for new foreign investors.

Existing foreign firms may be encouraged to diversify their activities, and thereby develop vertical and horizontal linkages with the local economy. The key is to improve the ability of domestic suppliers to meet the requirements of price, quality, delivery and flexibility to introduce new products and processes. Improved technical training, better managerial capabilities and quality control could be introduced through joint public and private sector programmes. Despite growing demand for food and beverages, packaging remains extremely basic and does not provide the range of options in sizes and types of material that normally accompany the evolution of these types of products. Hence, there seem to be opportunities for FDI both in the plastic and metal packaging industries. Finally, the larger presence of food and drink-related TNCs will require 'globalized' advertising and market research agencies, given the growing interest for enhancing brand characteristics worldwide.

C. Policy implications

There are a number of areas where government policies could contribute to create an environment conducive to investment. Actions identified in table III.2 can be grouped under a few common policy themes aimed at consolidating the competitiveness of main hub industries as well as of those with potential growth prospects.

Improvement in infrastructure is one such policy theme. The Government has been successful in ensuring that infrastructure development projects meet both investment objectives and the public interest. The participation of the private sector in infrastructure development has been crucial for raising financing, and securing improvements in service performance. But foreign investors point out that the quality of a number of services is still inadequate. Modern communication and transportation systems, in particular, are a prerequisite for attracting export-oriented investment and the establishment of corporate functions serving regional or global networks (UNCTAD, 1996).³⁶

³⁵ Since 1990, about 40 per cent of new investment into manufacturing has been directed to the food and beverages industry. Chemicals have followed, at around 30 per cent.

³⁶ UNCTAD (1996). *World Investment Report: Investment, Trade and International Policy Arrangements*, United Nations publication, Sales No. E.96.II.A.14, New York and Geneva.

An acceleration of the “investment concession” programme for gas-based energy, telephone services, roads and ports by the Government would also help attract new FDI. The large Camisea gas field project is still to be developed. The use of gas for energy generation would mean a major diversification of sources of energy away from hydroelectricity and oil, undoubtedly a project that only very large TNCs, or a consortium, could undertake. As far as telecommunications are concerned, further opening of the fixed line and cellular phone markets should also bring new foreign players into the country.

Priority to education is a second important policy theme involving three key issues: the educational content of training programmes should adequately prepare pupils for the demands of work; the quality of training should be comparable with international standards; and variability in the performance of educational and training institutes should be narrowed. The Ministry of Education has already restructured the educational curriculum to make it more work oriented. The Ministry of Industry has also established a number of training and technology centres for specific products, and is working more closely with the private sector in devising promotional instruments. Some firms and business associations are collaborating closely with universities and vocational training institutes in developing content and new products. These efforts need to be multiplied and sustained.

A Government-led effort to increase quality standards, especially of small and medium enterprises, is necessary to upgrade the technical, organizational and managerial capabilities of firms. Achieving high quality standards across the board could well be conceived as a public good and therefore meriting government intervention. Creating awareness about the importance of international quality ISO certification, and providing support for the introduction of quality programmes or for the establishment of quality control, certification and metrology companies, would be very helpful in the upgrading of most enterprises. There is also a need for allocating more resources than are currently available to training, information and consultancy services and financial support mechanisms aimed at medium and small-scale enterprises. It is also necessary to introduce technical norms and quality seals that are recognized by manufacturers and consumers alike.

Technology policy is a third thematic area, and its emphasis should be on enhancing the diffusion of technology and innovation. Such policy would entail strengthening the scientific and technical base of public research institutes and universities while, at the same time, refocusing them on market demands. It would imply increasing the number of programmes and specializations in sciences and engineering at universities. In addition, it would require the establishment of product-based training, technology transfer and cooperation, and research and development centres aimed at diffusing the use of new technologies. Other activities would include the creation of venture capital funds for the financing of innovation, and other financing schemes for technological acquisitions. It could also involve the creation of mechanisms of financial support to firms engaged in technical change.

Technology and innovation policy should encourage cluster formation. There is potential for the development of subcontracting arrangements between large and small firms as well as the development of types of consortia between small firms. There are possibilities for cooperation between firms and educational institutes in devising appropriate educational content and in sharing each other’s facilities and expertise for training, research and development. There are opportunities for coordination between financial institutions, the Government and firms for creating mechanisms to finance innovation, particularly by small and medium enterprises, and of establishing criteria for the valuation and recognition of intellectual capital and intangible assets. In general, there are prospects for bringing together business associations, government agencies, educational institutions and representatives of specific firms to develop ad hoc training, quality or financing programmes. The establishment of industrial parks can facilitate the strengthening of business relationships among firms and provide for common quality control, training and other facilities.

Finally, the Government should develop investment promotion mechanisms. To promote FDI inflows at least three functions are typically performed: image building, investment generation and aftercare services. These three main functions are separated in Peru among different agencies and there are some tasks that are not undertaken by any:

(a) Image building

Image building aims at developing the perception of a country as a “high quality location” for FDI among companies, banks, financial institutions and opinion-leaders. In Peru, these activities are carried out by Promperu. They include general public advertising, the preparation and distribution of information material and the convening of special events. The agency, however, does not provide information directly to investors and does not respond to specific enquiries. Direct contacts with investors and brokers should be done through direct mailings to potential investors and the organizing of site visits and follow-up on information requirements. Typical information sought by investors at the early stage of project appraisal may include the availability of a selection of sites and premises, communications and utilities available for each site, labour availability and cost, legal issues and counselling on establishment procedures, as well as information about local partners.

(b) Investment generation

There is a growing awareness that potential investors respond more positively to a focused approach. Many investment promotion agencies target specific industrial and commercial sectors, main potential investors and types of projects that they wish to attract. In Peru, the only targeted investment promotion has been carried out through COPRI. This has been successful but is limited to attracting FDI to privatization and public infrastructure opportunities.

In identifying key targets for investment attraction, leading investment agencies, (such as the Economic Development Board of Singapore) conduct evaluations of industry patterns and trends, identify prospective investors and initiate personal contacts. Other agencies have initiated “catalyst projects” to attract investment in particular sectors. These projects may include the development of special zones, such as science parks or food parks, to provide infrastructure and common facilities to targeted investors.³⁷ The most effective facilities are privately managed. Efforts are under way to promote investment in selected regions (see box III.2).

(c) Aftercare services

This function is underdeveloped in Peru. CONITE monitors only the application of legal stability agreements, and the granting of related incentives. However, aftercare comprises all potential services offered at the company level by the promotion agency and are designed to facilitate additional and more varied investment by existing investors. Services are also designed to facilitate the continuing development of a foreign affiliate in the host country with a view to maximizing the local economic development contribution of that affiliate.

The investment promotion agency takes charge of presenting the case for reinvestment and of encouraging investors to establish other functions at the plant (e.g. sales, research and development). The agency may also identify opportunities for the supply of components and services that can generate new investment by overseas suppliers. Additional programmes are created to train and assist local firms to meet the quality, delivery and price standards required by the foreign affiliate.

³⁷ Tillet C. (1996). *Foreign Investment: Targeting and Promotional Strategies*, London, Commonwealth Secretariat, Occasional Paper No.2.

As competition to attract investors has become stronger, investment promotion agencies have broadened their activities and provide comprehensive services. Therefore, consideration should be given to rationalizing the institutions dealing with investment promotion with a view to ensuring effective investment promotion in Peru.

Box III. 2. Investment opportunities in the Chavin region

The Government is supporting the development of the Chavin region in north-central Peru, which holds promise of becoming a development centre for tourism, fisheries, steel and the shipbuilding industries. Covering about 3 per cent of the country's total area, its major cities are Huaraz, in the Andean highlands, and the port of Chimbote.

Huaraz, the capital of the Chavin region, is the tourist centre of the Callejón de Huaylas, one of the most important tourist attractions of Peru. Its scenic landscapes and pre-Inca archaeological sites provide opportunities for cultural, leisure and adventure travel. Private investment to upgrade the physical and service infrastructure is necessary to develop tourism there.

The region's resource endowments in mining are also vast, with the country's two largest deposits — including Pierina (gold mine) and Antamina (zinc and copper deposits) — located there. They are being developed by foreign investors, and once on-stream, these projects will bring economic and employment benefits to the region. There are also other deposits that could prove sufficiently attractive for development in terms of reserves and costs.

The port of Chimbote, a dynamic, industrial and commercial centre, hosts export-oriented industries, such as fishmeal, oil and canning. Chimbote has the potential to diversify fisheries activities into a larger variety of sea products for both industrial use and human consumption, and also to develop aquaculture and processed products. Other important industries located in the area are iron, steel and related metal-mechanical industries that support the shipbuilding industry. The establishment of a Peruvian naval base and of a branch of the navy's industrial services prompted new investment in shipbuilding. Technical skills are also being developed to meet the demand for vocational training. In addition to universities, a training and technology centre sponsored by SIDERPERU (a privatized iron and steel company) provides skilled labour for the iron and steel industries. A local branch of the Manufacturing Industry Training Centre, run on a public-private partnership, is also located in Chimbote. The development of agricultural activities, around the surrounding valleys, will be facilitated by the CHINECAS Special Irrigation Project which aims at integrating the coastal valleys through rational and planned use of the water of local rivers for the development of agriculture and the generation of energy. Once completed, this project will expand the land under cultivation thereby enhancing the economic prospects for the development of food-processing industries.

In short, there are many investment opportunities in the Chavin region that can be facilitated by additional improvements to infrastructure and by targeted investment promotion. FDI can contribute to the emergence of competitive industrial clusters in the region.

Source: Roca S et al. (1998). *Peru: A Place To Invest 1997-1998*. Lima: Esan and UNCTAD survey.

Table III.2. FDI strategy for the next decade in Peru

MAIN HUB INDUSTRIES			SELECTED POTENTIAL HUB INDUSTRIES		
u MINING	u TOURISM	u FISHERIES	u AGRICULTURE	u TEXTILES & GARMENTS	FOOD & BEVERAGES
SHARE OF FDI: 13%	SHARE OF FDI: 1%	SHARE OF FDI: 1%	SHARE OF FDI: 1%	SHARE OF FDI: 1%	SHARE OF FDI: 6%
SUPPLIER AND RELATED INDUSTRIES			SUPPLIER AND RELATED INDUSTRIES		
u HEAVY EARTH MOVING	u ALL TRANSPORTS INFRASTRUCTURE	u PORTS	u FERTILIZERS	u ANCILLARY FIRMS	u AGRICULTURE
u MILLING	u HOTELS	u BOAT BUILDING & REPAIR	u PESTICIDES	u SUBCONTRACTOR FIRMS	u BIOTECHNOLOGY
u PUMPS, SCREENS	u TOUR OPERATORS	u REFRIGERATION	u BIOTECHNOLOGY	u DESIGN HOUSES	u PACKAGING
u STEEL	u TRAVEL AGENCIES	u PRODUCTION OF FISH PROCESSING PLANTS	u ROADS/PORTS INFRASTRUCTURE	u DYERS & FINISHERS	u DISTRIBUTION
u CEMENT	u ENTERTAINMENT	u ENVIRONMENTAL TECHNOLOGY	u UTILITIES	u PACKAGING	
u CONSUMABLE AND POWER	u UTILITIES			u DISTRIBUTION	
u TECHNICAL SERVICES					
Infrastructure upgrading	POLICY ACTIONS: Infrastructure upgrading	Infrastructure upgrading	Infrastructure upgrading	POLICY ACTIONS: Certified technical training	Certified technical training
Tax reforms	Site conservation	Quality control	Legal framework (land/water)	R&D	Quality control
Tariff reforms	Certified technical training	Environmental standards	Certified technical training	Quality control	Quality control
Fiscal incentives to supply industries	Business culture	Certified technical training	Quality control	Business culture	R&D
		R&D	R&D	Industrial parks	Business culture
					Industrial parks
FINE-TUNING	CURRENT STATUS RATING: TO BE DEVELOPED	TO BE DEVELOPED	CURRENT STATUS RATING: TO BE DEVELOPED	TO BE DEVELOPED	TO BE DEVELOPED

IV. Investment Opportunities in Peru

Peru has competitive advantages in mining and tourism. In order to sustain the competitiveness of these industries it will be helpful to consider each as forming the hub of an industry system. The system approach recognizes an industry as forming part of a set of interdependent businesses of suppliers and customers. Where the linkages between them are strong these businesses form a cluster which, when operating effectively over time, can be a source of sustaining competitive advantage for reducing costs and developing new products.

A. Mining

I. Overview

Peru has a long-standing mining tradition. Gold and silver were used for ceremonial and religious purposes and by the nobility during pre-Inca and Inca times and as a major source of income for the Spanish crown. Precious metals continued to be a key source of foreign exchange after independence until the early part of this century when Cerro de Pasco Corporation came to Peru and began diversifying into copper, lead, zinc, tin and iron ore.

During the 1990s, mining, including refining and smelting, accounted for about 11 per cent of GDP and 45 per cent of total exports (INEI, 1999).³⁸ By 1998, Peru exported US\$ 3.3 billion worth of mineral products, of which copper was the largest single export product. It accounted for average earnings of more than US\$ 1 billion per year between 1995 and 1997. Gold production (worth US\$ 925 million in 1998) has increased a hundred-fold since the start of the decade leading Peru to overtake Brazil as the largest gold producing country in Latin America. Largely responsible for the increased production is the Yanacocha project owned by Newmont Mining Corporation, a leading United States mining company, and Buenaventura, a Peruvian mining group (see chapter I).

Peru now ranks among the top five producers in the world of several minerals (see table IV.1), and gold may join this ranking in the near future given its rapid growth. This year Pierina, another world-class gold project, was commissioned by Barrick, a United States company. A recent estimate suggests that mineral production will continue to grow rapidly over the next five years on the basis of recent and expected developments in mining (see table IV.2). Currently six projects are under construction and a further 14 are undergoing feasibility studies.³⁹ It is possible that mining will become a US\$ 5 billion a year industry by 2005.

Peru's mineral resource endowments are substantial but known reserves are not of bonanza scale or outstanding grade. For example, copper grades account for only 0.6 per cent of the total output at La Granja, which has the third largest of Peru's proven reserves, and for only 0.75 per cent at Southern Perú Limited, which produces over half of the total national output. Indeed production from the company's Cuajone deposit was curtailed in 1998 due to low world copper prices. In some cases, access to easily treatable ores compensates for their low grades (e.g. in the case of Yanacocha, where production costs are believed to be as low as US\$ 100 per ounce).

³⁸ Instituto Nacional de Estadística e Informática (1999). *Annual Report*, Lima: INEI.

³⁹ Source: Sociedad Nacional de Minería, Petróleo y Energía - Peru (SNMPE) (1999). *Mining Energy and Oil*, Lima: SNMPE (March).

Table IV.1. Peru's ranking in mining world-wide, 1998

(Number and percentage)

Mineral	Peru's ranking among world producers	Peru's share in world production	Projected increase in production increase 1998-2004 (%)
Copper	5	4	107
Gold	8	4	30
Lead	3	8	11
Silver	2	13	16
Tin	3	18	17
Zinc	3	12	27

Source: Sociedad Nacional de Minería, Petróleo y Energía - Peru (SNMPE) (1999). *Mining Energy and Oil*, Lima: SNMPE (March).

2. FDI in the revival of mining

Until the 1990s, the mineral sector was predominantly under State ownership. Only Southern Perú Limited, an important copper mining and refining company owned by Asarco of the United States, and smaller ventures owned by private Peruvian companies, remained in private hands. During this decade, 70 per cent of State mining assets have been privatized and new opportunities have been opened up to private investment under a revised legal and fiscal regime.

An important breakthrough for the investment climate was achieved in 1991 by the resolution of a long-running dispute with Southern Perú Limited. This company has since made significant new investments. Today, about 100 foreign companies are represented in Peru, including almost all of the major international mining companies. Many of them have significant production interests as well as exploration property in Peru.

A Canadian-led consortium recently approved the financing of the US\$ 2.5 billion Antamina copper/zinc project, which was acquired in 1996 under the privatization programme. This represents Peru's first opportunity to develop a megaproject that would rival the landmark Escondida copper project in Chile. It will set the seal on a successful privatization programme and indeed on Peru's re-entry into the international financial markets.

Up to 1997, development and exploration had benefited from high levels of investment (see table IV.2). Investment in production had been directed at both increasing capacity and reducing operating costs. The recent fall in exploration expenditure is part of a worldwide cutback by the major companies due to low product prices. Also, financial crises in the emerging markets have affected the ability of junior firms to raise funds for exploration. Investor interviews suggest that about 25 foreign-owned junior firms remain active in Peru. Industry sources believe that, despite this downturn, Peru has maintained its share of worldwide expenditure on mineral exploration.

Table IV.2. Investment in exploration and development in the mining industry, 1996-1999
(Millions of US dollars)

Item	Value of investment			
	1996	1997	1998	1999
Exploration	83.2	56.5	48.1	42.8
Preparation	17.6	14.8	4.6	22.0
Exploitation	78.3	87.0	99.6	94.8
Infrastructure	74.4	59.0	195.9	168.6
Mining equipment	110.1	27.4	78.5	129.1
Plant equipment	76.7	107.6	177.1	289.3
Other	32.4	36.7	62.8	139.6
Total	472.9	389.0	667.0	886.5

Source: Ministry of Mines and Energy.

Looking ahead, the Ministry of Energy and Mining estimates that by 2007, the stock of investment in the sector should reach US\$ 7.8 billion of which privatization will account for US\$ 2 billion. FDI is playing a dominant role in this revival and will continue to do so in the near future. An independent estimate has identified US\$ 3.4 billion of committed new investment for the period 1999-2005 almost all of which is FDI in large-scale projects.⁴⁰ There has also been growth in the small and medium-scale sector⁴¹, which has little foreign investment.

3. From world class projects to a world class mining system

The revival in mining investment has been impressive, with a considerable amount of committed investment in the pipeline for the near term. But there is nothing automatic or axiomatic about the longer-term sustainability of the pace of investment. The present resurgence has been built on the acquisition of comparatively cheap assets through the privatization process. In many such cases, ore grades are not outstanding, stripping ratios can be high in the mature assets and some projects are not among the lowest-cost producers.

The international mining industry believes there is a potential for additional commercial discoveries of precious and base metal deposits in Peru. But there has been only one world class commercial discovery for several years (the Pierina gold project), and recent copper exploration has been disappointing. Indeed committed new investment is dominated by just two projects (Antamina and Southern Perú Limited). Two other important developments have been postponed due to "market conditions". Finally, the junior exploration sector is vulnerable owing to the small size of the domestic equity capital market and low confidence among financial investors in emerging markets.

⁴⁰ Campodónico H. *Structural Reform and Investment in the Mining Sector*, ECLAC (forthcoming).

⁴¹ Peru defines scale for mining rates as follows: small scale: up to 150 tonnes per day ; medium scale: 150-5,000 tonnes per day; large scale: over 5,000 tonnes per day.

For the foreseeable future, mineral production will be an anchor industry of the Peruvian economy. To sustain the industry's renaissance and to exploit fully its potential it is timely for Peru to review its goals and policies. This should start with recognition that mining constitutes a system of both mineral producers and a range of supplier industries that has an impact on the business efficiency of the producers. Government policies must promote competitiveness throughout the mining system. Key objectives should be to:

(i) Improve the legal and fiscal framework to stimulate exploration and to provide optimum arrangements for the development of commercial discoveries.

Goal: To provide global best practice arrangements.

(ii) To further the development of industries and service providers linked to the mining industry, both to deepen the economic contribution of mining and to enhance its competitive position.

Goal: To become the most competitive regional supplier of a range of mining equipment, supplies and services within 10 years.

These twin objectives are discussed below.

4. The legal and policy regime: special investment legislation in mining

The legal regime for investment in mining adopted during this decade comprises:

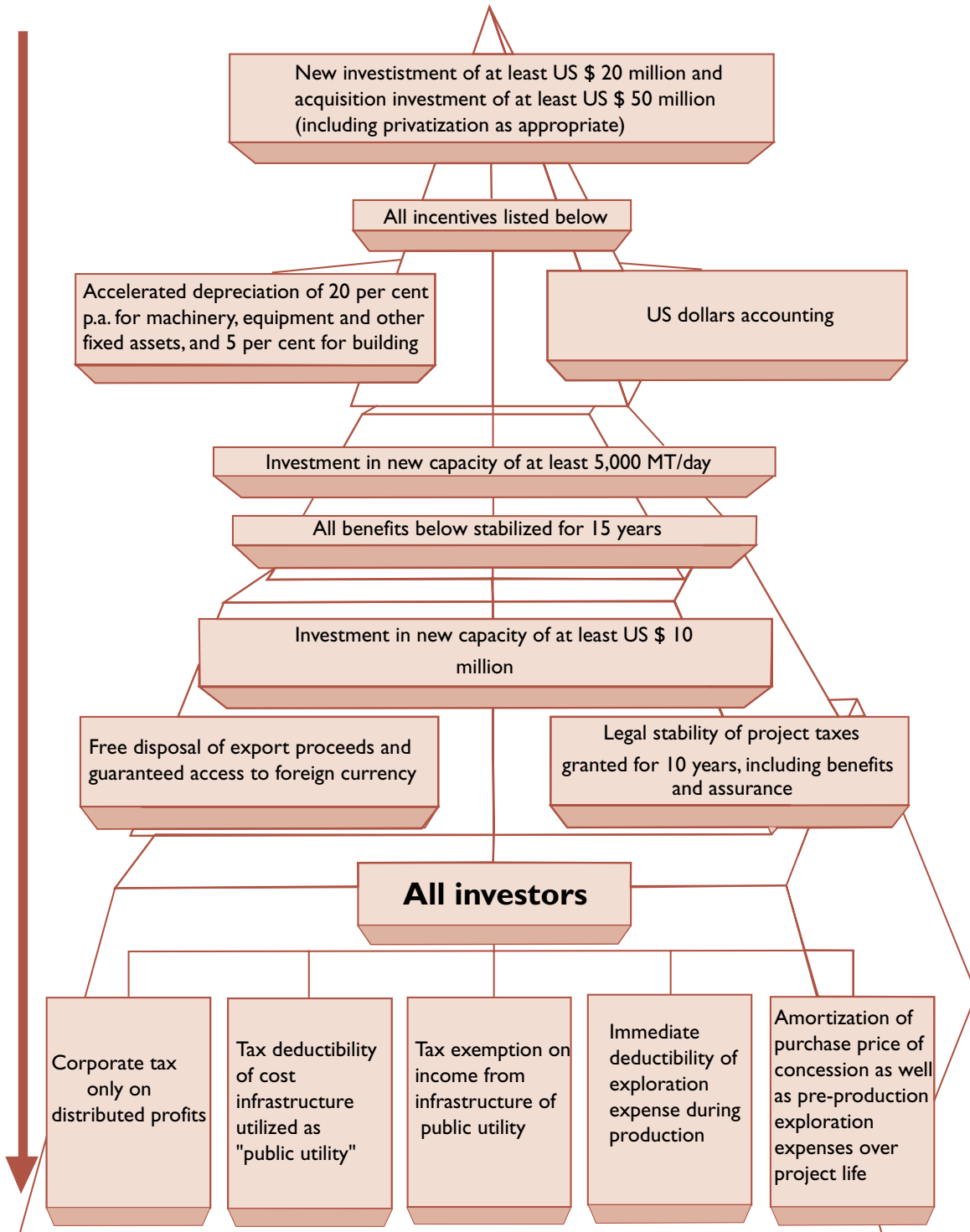
- u The General Mining Law (DL 109);
- u The Law for the Promotion of Investment in the Mining Sector (DL708);
- u Various amendments to the above laws; and
- u Fiscal incentive measures concerning import duties, general sales tax and reinvestment tax credits.

The mining laws in Peru have followed the example of Chile where the benefits and incentives offered have been highly successful in attracting large-scale mining investment.

In Peru, mineral resources belong to the State and may be commercially mined in accordance with concessions granted by the General Mining Bureau on behalf of the State. The General Mining Law sets out the procedures for acquiring and disposing of concessions to explore and develop mineral properties and associated concessions for the processing and transportation of minerals. It sets out the generic rights and obligations of holders of mineral concessions. These include the right to sell minerals at home or abroad — provided that market prices are obtained — and the right to hold a mineral title through various legal forms including unincorporated joint ventures.

For foreign investors, an important feature of the legal regime is the provision of special protections and incentives for larger-scale investments. These are set out below.

Figure IV.1 Protection and incentives for larger scale mining in Peru



Source: National legislation.

Investors in the mining sector are offered, depending on the size of their proposed investment, enhanced forms of legal stability arrangements and tax incentives compared with investors in other sectors. Figure IV.1 summarizes how these apply to larger-scale mining investment. The figure describes benefits that are additional to the general benefits available to investors (see chapter II). In addition to the above entitlements, schemes have been introduced to relieve the burden of import duties and general sales tax on capital items. Investors in mining who undertake lengthy exploration and/or mining investment programmes can obtain refunds of general sales tax on purchases of capital goods through a negotiable credits system and, in similar circumstances, can also pay import duties in instalments over periods of up to four-and-a-half years.

Law No. 27341 that will become effective on 1 January 2001 has changed incentives for mining companies operating in Peru. A minimum investment of US\$ 10 million will be required to be eligible for tax stability contract - up from US\$ 2 million. The existing stability contract will remain intact but they may not be transferred in the event of a corporate reorganization or merger. Reinvested mining profits will be taxed at 30 per cent rather than 15 per cent. The depreciation rate used by mining companies for building and construction will drop to 5 per cent from 20 per cent. The cost to maintain claim rights will rise to US\$ 5 per hectare from US\$ 2. In addition, an increased penalty for not exploiting claims will rise to US\$ 6 per hectare from US\$ 2 after six years from the start of the concession (previously, it was 8 years).

Substantial new foreign investment is taking place in the mining sector, which is a strong indication that the mining and general policy regimes were satisfactory from an investor standpoint. This is not, however, a conclusive indication. Peru, possibly more than any other country in the 1990s, has attracted new mining investment through privatization. Under privatization programmes, prospective investors can acquire substantial producing assets, and accordingly have the opportunity to offer prices for existing assets, which compensates for any possible unattractive features of the regime for new investment. In the case of Peru, the majority of privatizations concluded for mining have involved sales prices that are modest compared with the associated new investment commitments — in some cases, substantially lower. The importance of privatization can also be seen in exploration. In the period, 1996-1997, at least 43 per cent of exploration expenditure was attributable to investment commitments arising from privatization.⁴²

The key issues in a mining regime are to provide secure title rights to investors while ensuring that the exclusive rights they obtain are accompanied by appropriate commitments relating to exploration and development. Peru's mining law is a remarkably slim document that lacks the clarity and detail concerning the execution and administration of these rights and obligations that are typical of mining laws elsewhere. Such important details include matters to be considered by the State in permitting mine development, the term of licences and the rules governing relinquishment. It is presumed that more details of these rights are set out in the terms and conditions attached to individual concessions for mining, mineral transportation and processing. Interviews conducted with mining companies evinced no complaints about the governance of the mining regime.

Peru ranks among the top 10 world producers of copper, zinc, silver, lead, gold and tin, and undoubtedly, important new commercial discoveries could be made. However, in general the deposits operated by the larger mining companies are low grade. This makes them vulnerable to cycles of low prices in metals, and especially sensitive to the structure of the tax system. The fragile economic condition of these deposits is exacerbated in the case of privatized assets comprising mature mines with high stripping ratios.⁴³

In a context where ore grades are not outstanding, the fiscal regime for mining is more problematic than the regulatory regime. Some aspects are not satisfactory and are being handled by a piecemeal incentive-driven approach. Issues that should be addressed if Peru is to provide a competitive fiscal regime are set out below:

⁴² UNCTAD's estimate, based upon exploration expenditure reports made to the Ministry of Mines and Energy.

⁴³ The Tintaya copper project has a stripping ratio of 10/1 (source: UNCTAD survey).

- u Import duties of 12 per cent are very significant impositions on capital cost. Peru's rates of import duty on capital imports are high by international standards and reduce its competitiveness. In recognition of this burden, a regime for instalment payments over several years has been introduced for negotiation on a case-by-case basis. This is a second best approach to the problem. A better approach would be to consider considerably lowering the rates of import duty;
- u A regime has been introduced to provide monthly refunds of general sales tax paid on capital imports during any mining project development expected to last over two years. However, exploration-stage capital imports do not qualify unless project development is to last at least four years. These are rather arbitrary distinctions. It would be preferable to have a straightforward refund or negotiable credit system for all capital items that are imported prior to commencement of production;
- u Carry-forward of losses is restricted to the four years following the next reported profit although it is understood that some investors have negotiated more favourable treatment. There are no restrictions on the annual use of accumulated losses but a longer general arrangement would be more attractive to investors; and
- u Mining profits are exempt from corporate tax if they are reinvested in approved programmes.⁴⁴ This is an important incentive for an established project with significant undeveloped reserves or prospective exploration acreage. However, it unduly favours investment by established operators compared with investment by new entrants. In combination with normal depreciation on invested assets it becomes a double taxation deduction and thus exposes the Government to significant loss of revenue. Accelerated depreciation allowances would be a better targeted incentive, although commentators point out that Peru's depreciation allowance of four years for fixed assets and immediate deduction of exploration expenses are already the most generous in the region.
- u The impact of new measures (particularly the new depreciation rate) on the industry may be negative. They could discourage mining companies with long history of operating in Peru from pursuing new projects and can dissuade new entrants into the industry.

Finally, it would be worthwhile to consider widening the foreign exchange provisions of the mining legal stability agreements by giving contractual assurance that offshore retention accounts could be maintained. This would enhance the ability of investors to secure project debt finance on a limited recourse basis.

Peru's special mining legislation is generally sound from a public interest and investor standpoint. The comments set out below draw attention to improvements that could be considered (within the context of the economically fragile nature of Peru's known resource endowments).

The mining law could benefit from additional and more detailed regulations concerning the treatment of exploration rights, including relinquishment, and the rules governing the right to develop a mine following the discovery of a commercial deposit.⁴⁵ Peru's recent experience has been mostly with the privatization of producing assets and related exploration work commitments. Increasingly, emphasis will shift to less advanced exploration properties, and it is worth reviewing whether there is sufficient depth and clarity in the key provisions governing the disposition of these rights.

As noted, the fiscal regime seems to have a sub-optimal structure in terms of its reliance on indirect taxes. These unattractive features for investors are being addressed in a piecemeal incentive-based fashion.

⁴⁴ Undistributed profits must be reinvested in approved programmes.

⁴⁵ In August 2000 the Law No. 27341 introduced new regulations on concessions, reducing to six years the exploration period and establishing new penalties if not meeting the minimum production targets. New regime of mining fiscal incentives has been described in Chapter II and reported in figure IV.1.

Taxation in mining should be structured mainly on profits rather than on investment cost or revenues. In accordance with that principle, the following recommendations are made for review as a package of generally applicable measures:

- 1) Exemption of corporate tax on reinvestments should be reconsidered, possibly in favour of accelerated depreciation allowances;
- 2) Longer periods of loss carry-forward for corporate tax purposes could be allowed;
- 3) The “in lieu of dividends” rule applying to taxation of interest on shareholder debt should be removed. Tax avoidance through excessive shareholder debt should be tackled with a combination of a reasonable cap on interest and maximum gearing limitations. For example, shareholder debt should be treated in the same way as third-party debt, provided that both total no more than 75 per cent of project cost.
- 4) Import duties on capital items should be substantially reduced in the context of an overall review of import duties and the position of domestic producers of capital items;
- 5) Royalties (at rates not above international norms) should be considered if the Government fears undue revenue loss from a reduction in import duties;
- 6) Prompt recovery of general sales tax on capital assets purchased prior to production should apply universally; and
- 7) Given the long lead times in grass-roots mineral exploration, investors could be given the opportunity for renewal of legal stability agreements on no less favourable terms at the time mineral exploration projects move to the development stage.

Provided Peru has sufficient potential, the introduction of competitive bidding based around work programmes should be considered for the award of mineral exploration licences in grass-roots areas. The process, although not necessarily the level of interest generated, would be similar to common international practice for exploration licences for hydrocarbons.

5. Development of a competitive mining system

It is estimated that in 1998 Peru's growing mining industry made purchases of goods and services worth US\$ 1.37 billion, of which US\$ 800 million worth were purchased locally and US\$ 570 million worth were imported.⁴⁶ Local sourcing by the mining industry is higher in Peru than in many other developing countries (especially those in Africa and in parts of the Asia-Pacific region).

Indeed, a surprisingly wide range of mining capital and consumable goods is manufactured in Peru. The ability of Peruvian industry to design and manufacture milling and treatment facilities for medium-scale producers is an especially interesting feature. In this respect, Peru had a head start on other countries in the region, including Chile, which did not develop the medium-scale segment of its mining industry to the same extent.

⁴⁶ SNMPE (1999). *Mining, Oil and Energy*, Lima: SNMPE (March), p.13.

However, Peru's early lead in the region stagnated during the long economic malaise and difficult conditions for private investment that preceded the current reforms. Chile is now regarded as the regional leader in mining-support industries. The renaissance of its mining industry in the early 1980s provided a platform for new investment and better practices in the mining-supply industries. Moreover, recent Chilean mining development has been led by modern large-scale mines managed by the leading international mining companies. This has exposed the domestic mine suppliers in that country to international competition and best practice for almost 20 years. The Peruvian mining-supply sector is now reckoned to be 10 years behind Chile in its ability to supply to the standards required by the international mining community.⁴⁷ Indirect corroboration of this view is provided when management of Peruvian mining-supply companies talk of the challenges posed to them by economic liberalization.

A number of key suppliers remain Peruvian-owned — including some which have been privatized — and are adapting to new technical demands by entering into technology licensing agreements with leading foreign companies. Nevertheless the capital requirements, technical and management skills and relationships required to become preferred suppliers to world-scale mines do suggest opportunities for new FDI in the supplier industries.

(a) The supplier industries

Table IV.3 provides a preliminary survey of the current capacity of Peruvian industry to supply key goods and services to the mining industry. It is followed by a discussion of industry views as to the competitive capabilities of the Peruvian industry and likely future developments.

Table IV.3. Capacity and investment opportunities in the Peruvian mining supply industry

Industry segment	Mine scale		New investment potential
	Small-medium	Large	
A. Capital Goods			
u Heavy earthmoving equipment	Weak	Weak	Moderate
u Milling and treatment plants	Strong	Weak	Weak/moderate
u Pumps, screens, conveyors	Strong	Moderate	Moderate/strong
B. Building Products			
u Steel	Moderate	Moderate	Moderate
u Cement	Moderate	Moderate	Weak
C. Consumables and Power			
u Tyres	Weak	Weak	Weak
u Fuel	NA	NA	NA
u Lubricants	Strong	Strong	Moderate
u Explosives	Strong	Moderate	Strong
u Grinding balls	Available	Available	Moderate
u Power	Strong	Moderate/strong	Strong
D. Technical services			
u Geology and mine engineering	Strong	Moderate/strong	Moderate
u Environmental engineering	Strong	Strong	Moderate

Source: Investor interviews
NA = not assessed.

⁴⁷ Interview with leading foreign investors.

(b) Capital goods

The manufacturing of heavy earthmoving equipment (such as bulldozers, mechanized shovels and dump trucks) is dominated globally by a handful of international companies. Peru has no primary manufacturing capacity in this regard, and it is highly unlikely that the scale of requirements on a national or regional basis will induce FDI to locate to this industry in Peru. There is, however, a sizeable business in component rebuilding for this equipment (e.g. for shovel buckets) and it is potentially feasible for this to be located in Peru. Caterpillar of the United States has already established a rebuilding facility in Peru for some components of its equipment and is believed to be planning additional investment to expand its capacity over a wider range of components.

Peru has two firms with an unusual and interesting capacity to design, manufacture and install materials handling systems and milling and treatment plants for small and medium-scale mines (see box IV.I on FIMA the largest of these firms). This capacity has always been geared to supply medium-scale mines. Although medium-scale mining has grown faster this decade than large-scale mining, the total ore throughput of the latter is five times greater. Moreover, since large-scale operations are key to efficient mining, especially in base metals, this segment is the dominant growth pole of the industry.

Box IV.I. FIMA S.A.

FIMA is a 30-year-old Peruvian-owned company which designs, manufactures and installs ore milling and treatment facilities for mining operations, as well as fishmeal processing plants (in part through a license agreement with Atlas-Stord, a Danish enterprise) and cane crushing and refinery plants for the sugar industry (under license from Fletcher Smith, United Kingdom). The company provides turnkey systems for small and medium-scale operations.

For the mining industry, FIMA manufactures crushing, grinding, agitation, flotation and leaching equipment, as well as slurry pumps and thickening and filtering systems under licence from SVEDALA of Sweden. For gold and silver ores, it manufactures precipitation and foundry systems under licence from DME (Denver Minerals Engineering) of the United States. Recently, FIMA installed a complete gold ore concentrator plant, including a bio-leaching system, utilizing technology licensed to the producer by Gencor of South Africa. FIMA estimates that about 60-70 per cent of the market for small and medium-scale mine handling and treatment systems is supplied by Peruvian industry, of which it has an estimated 60-70 per cent share. It has in the past sold to markets within the region, such as Bolivia, Colombia and Ecuador, and to some other foreign markets. However, exports average only 10 per cent of its sales.

A significant element of FIMA's engineering and manufacturing business for mining has application in other resource-based industries. For example, FIMA supplies crushing and screening equipment to the aggregates industry; conveyers, screens, bins and steel structures are among these kinds of supplies. Over the last five years, mine-related products have accounted for 22 per cent of total sales, which in 1998 stood at US\$ 32 million. However, FIMA is not geared up to supply a range of equipment, much less turnkey systems, to modern large-scale mines which are expected to account for the bulk of future growth in the mining industry. Its principal sales to large-scale mines have been structural steel sections for mine buildings supplied through a joint venture company formed with EDYCE of Chile.

Source: UNCTAD survey.

Thus significant growth in the market for the design, manufacture and installation of medium-scale milling and treatment plants is unlikely. The most likely area of growth will be in providing facilities for the mining of precious metals – where efficiency of scale is much smaller than in base metals mining.

Milling and treatment plants for large mines around the world are not produced by a single supplier. They are typically an amalgam of units supplied by various specialized manufacturers through a lead contractor under an engineering, procurement and construction contract. Often the availability of export credit support for financing will have a bearing on the sourcing of such a plant. Since large-scale commercial discoveries are one-off unpredictable events in any one country, no matter what its potential, suppliers of “big ticket” items for milling and treatment facilities will tend to be centrally located in developed countries that have world-scale capital goods industries.

There is no immutable barrier to the reorientation of Peruvian industry towards supplying some elements of mills and treatment plants for large-scale mines, provided the standards and requirements of these operators can be met. Such items include pumps, screens, conveyor belts, and perhaps all but the largest flotation tanks. It would take time to address market needs and this process would undoubtedly be accelerated by the injection of foreign investment with its attendant know-how, established performance reputation and ability to provide supplier credit. The success of FIMA’s joint venture with EDYCE of Chile for the supply of steel sections illustrates this (see box IV.1 and the discussion below on “building products”).

(c) Building Products

The supply of building products for mine buildings and other infrastructure has some potential for additional investment. Developments will be driven much more by demand from other sectors, as mines are only one of a range of users of building products.

In the case of steel, two mills have been privatized. In one case, Siderperú was acquired by a subsidiary of GS Industries in association with financial investors. GS Industries is a major United States mini-mill operator and is among the leaders in the dramatic shift in United States production from large integrated producers to lower cost mini-mills. Labour costs and access to low-cost ore and scrap are key factors in the competitiveness of this industry. Thus Peruvian industry seems reasonably well placed to remain competitive, provided the new operators continue to invest in modernization of the mills. As already noted, FIMA’s recent joint venture with EDYCE of Chile to manufacture structural steel sections has enabled it to supply a number of major mining developments using both local and imported steel. The joint venture is now planning an investment to expand capacity by 40 per cent (see box IV.1).

Peru has also privatized a number of cement companies that were historically assigned to service three internal regional markets. The Gloria Group of Peru has acquired a significant stake in the industry. However, one mining investor has commented that the old regional market-sharing arrangements appear not to have entirely disappeared.

(d) Consumables and power

Peru has long-standing capacity in the manufacture of a number of mine consumables. A core group of manufacturers was spun off from a Cerro Verde venture in the 1950s to provide a domestic capability for the Peruvian industry. These enterprises have long been virtual monopolies serving a protected market. Further, the market was characterized by small and medium-scale private mining and State ownership of the large-scale sector, with limited foreign exchange to purchase abroad. However, according to one industry

view, a consequence is that product type, cost and service quality of Peruvian suppliers has not kept abreast of the international standards expected by large-scale mines that can purchase from the most competitive sources abroad.

Nevertheless, mine operators note positive features in the position of supplier industries. First, the established mining-supply industries have developed a pool of skilled and relatively low-cost labour that is a useful platform for expansion and modernization. Secondly, the mining industry is undoubtedly expanding its demands for consumables, and Peruvian suppliers can look forward to a much larger potential market. Thirdly, as current major investments move from the construction phase to operations, mining companies will increasingly be able to fine-tune their procurement decisions in a manner that is not always possible during the construction phase. These factors all point to an environment in which there will be opportunity for FDI to participate in the expansion and upgrading of these industries, either in partnership or in competition with existing Peruvian-owned operators.

The explosives industry illustrates a number of the above-mentioned features of the Peruvian industry. Major Peruvian firms are EXSA and INCASA. The latter was bought by the Gloria Group of Peru during the 1996 privatization programme. EXSA has traditionally supplied small/medium mining enterprises and State mining enterprises, but it has not been chosen to supply the Antamina zinc/copper project. While EXSA has some capacity to provide explosives, it appears to have lacked the fleet and experience needed to meet Antamina's requirements. Instead, a modern Chilean explosives manufacturer has invested in on-site facilities to prepare and deliver explosives from imported ammonium nitrate.

An important opportunity to improve Peruvian value-added in this product will occur when the Camisea natural gas project goes on-stream. The availability of large volumes of natural gas provides an opportunity to manufacture ammonium nitrate (and presumably ammonium sulphate fertilizer) in Peru from natural gas feedstock. Provided the feedstock can be sourced at competitive cost this would represent an excellent opportunity for Peru to build a major mine-supply industry. Investment in excess of a hundred million United States dollars would be needed to construct a competitive petrochemical facility.

Two manufacturers in Peru have established capability in the casting and forging of reasonably competitive high carbon steel grinding balls to all levels of the mining industry. One of the producers is MEPSA, which has also operated in Chile for 25 years and has no doubt benefited from that exposure. It should be noted that GS Industries, the main investor in Siderperu (see above), is the world's largest producer of forged grinding balls and rods and would seem well placed to consider investment opportunities in this industry in Peru.

Peru also manufactures drill bits and refines fuel and lubricants (apart from highly specialized lubricants). Parts of these industries have been acquired by foreign investors through privatization.

Tyres used on dump trucks are a major operating cost in mining. However, the enormous size (up to 240-tons) of dump trucks required by modern large-scale operations means that the mining industry has specialized requirements. Consequently, only a handful of factories around the world can be sustained on an efficient scale. Peru has no tyre manufacturing capability even for light vehicles. It is, therefore, unlikely that FDI will locate in Peru to make tyres for the mining industry.

As mines are heavy users of power in their milling and treatment operations, power costs are an important element in their operating costs. Peru seems well placed to be a low-cost power supplier. It has abundant hydroelectric generation potential, and significant natural gas potential for modern thermal power generation, although current installed capacity is a very modest 5,192MW. At present installed generation capacity is evenly split between hydro and thermal sources. However, most of the thermal capacity utilizes coal rather than lower cost natural gas. Presumably much of the coal-based capacity is marginal production, as in 1998, nearly 75 per cent of consumption was hydro-generated.

The grid system is relatively well developed. Over 90 per cent of consumption is supplied through the grid so that relatively few users need to rely on self-generated power.⁴⁸ This is a favourable position as many miners have been able to avoid the capital costs of power generation facilities, and should be able to benefit from scale efficiencies in large-scale generation. A 1992 reform opened the way for separate ownership of generation, transmission and distribution and, through the privatization programme, has permitted private investment in this sector. Privatization – mostly involving foreign direct investors – peaked in 1994 and 1995,⁴⁹ but the grid remains in State ownership. Private investment has been attracted through concession schemes to connect the regional grids and increase transmission capacity. The cumulative effect of these developments has been to enable miners and other industrial users to negotiate power offtake agreements directly with generators under competitive tender conditions.

The reforms have attracted considerable FDI in new generation capacity. The recent problems of supply constraints and interruptions due to natural disasters, which have affected expansion of mining and downstream, are expected to be overcome. During the period 1998-2002, an additional capacity of 689MW of hydro power and 347MW of thermal power is planned which should represent an investment of over US\$ 1 billion. This will increase total generation capacity by 20 per cent, and should enable the mining industry to purchase power at very competitive prices. Beyond 2002, further investment is expected – for example, the postponement of the Camisea gas project has led to the deferment of 300MW of new capacity. Restructuring reforms in the sector, grid interconnection schemes, the introduction of private investment in generation and the prospect of a major supply of low-cost natural gas are all working towards the creation of a highly competitive power supply to the mining industry.

(e) Technical services

A significant local capability has developed in technical services in mining (see box IV.2). This is supported by undergraduate and post-graduate courses offered — although of variable quality — at the main universities in the principal disciplines of geology, mine engineering, environmental engineering and metallurgy. Domestic firms are able to conduct technical studies up to feasibility level and have capabilities in associated civil and structural engineering and construction. Domestic environmental engineering design and monitoring services are considered to be of a very high standard. Peru's BISA is an example of a mining consultancy which has been developed from an existing mining capability (in this case the Buenaventura Group). In other areas a number of domestic firms have formed strategic alliances with leading international firms in order to be able to respond to the challenges of the trend towards large-scale developments which must meet exacting standards for international investment and finance. For example, Kilborn of Canada, a firm of international mining consultants, has formed a strategic alliance with Graña y Montero, a prominent Peruvian civil and structural engineering contractor. Similarly, Bechtel of the United States is partnering Brazil's Odebrecht and Peru's COSAPI in its role as lead contractor in the development of the Antamina deposit.

These developments all point to reasonable prospects for expanded investment in the provision of mining services. However, with the advent of Internet technology it is becoming easier for many services to be provided from offshore and this will temper investment in Peru-based services.⁵⁰

⁴⁸ SNMPE *ibid* p. 40.

⁴⁹ Campodónico H. (1998). *Las Reformas Energéticas y El Uso Eficiente de La Energía en El Perú*, ECLAC, p.8.

⁵⁰ For example the Tintaya mines' daily blasting programme is determined by specialist computer analysis performed in Denver based on pit photos e-mailed every evening. Previously this work would require specialists to be on-site.

6. Policy measures to facilitate the mining system

Peru has the potential to create a highly competitive mining-supply industry in all but the most specialized kinds of goods and services. A number of elements are already in place including:

- u Long-established capacity in a number of industries;
- u Experienced, skilled and relatively low-cost labour in the relevant industries;
- u Substantial market scale and likely market growth for at least the next five years to supply a mining industry comparable to any in the world in a diversified range of mineral products;
- u Pro-competition government policies;
- u A hospitable foreign investment climate, which has attracted leading foreign investors to certain industries, such as power and steel, and to the mining industry itself;
- u Successful technology agreements and strategic alliances between Peruvian-owned firms and leading international companies; and
- u Potential to supply mines in northern Chile (and Bolivia) from Peru.

Among the current limiting factors are:

- u Lack of experience among locally-owned groups and management in the requirements of large-scale mines; and
- u Limited availability of supplier credit from Peruvian-owned firms.

These limiting factors mean that Peru lags behind Chile, the regional leader, by at least 10 years, according to one view. But the weight of positive elements suggests substantial scope for new investment. FDI could contribute significantly to overcoming the limiting factors and improving the competitiveness of Peruvian industry. Privatization has run its course as a channel for additional FDI in the mining-supply industries (except for power generation). The next channel for FDI could arise from upgrading existing technology agreements and strategic alliances into equity relationships.

What policy measures will support private investment, including FDI, in the creation of an internationally competitive mining-supply sector? This question is addressed below.

Many developing countries, as a matter of policy, require, when granting mineral rights, that investors buy local goods and services if their cost and quality is at least equal to imported alternatives. Apart from this local procurement policy, mines are often under moral pressure to create fringe business development programmes at the local level. There is nothing inherently wrong with this approach but it is one of limited ambition. It is not recommended as a substantial policy for Peru, which already has a platform of established industries and skills. Instead, Peru should aim at attracting new investment that enhances the competitive profile of the supplier industries so that they offer compelling alternatives to imported supplies.

To attract the necessary FDI, the Government should, above all, maintain its current liberal policy framework of sound economic management, an favourable investment policy regime, openness to FDI and foreign trade and a pro-competition industrial policy. The existing policy regime has led to a revival of mining, which in time will induce further investment in the mining-supply industries so long as investors are confident in the sustainability of these policies. This must be the “golden rule”. There is no case for artificially forcing the pace of investment by adopting policies of protection, enforced local procurement, subsidies or special tax give-aways. These will be self-defeating and damaging to the mining industry if they increase its cost base. On the assumption that existing policies will be maintained, it seems reasonable to suppose that suppliers within the Peru mining system could match the regional leader, Chile, in 10 years.

Within and consistent with the “golden rule”, a number of specific measures are recommended for consideration to accelerate reform of the policy environment and to provide incentives for investment:

Undertake comprehensive tariff reform. Elsewhere, this report recommends that current levels of import duty be reduced or eliminated as part of a restructuring of the fiscal regime for mining. Unless domestic suppliers to mines also get tariff relief on their inputs they will be at a competitive disadvantage. Thus, reform of the fiscal regime for mining will need to be accompanied by a comprehensive reform of the tariff structure.

Monitor and maintain competition policy, especially in non-tradable goods and services. Specific measures should include privatization of the remaining State-owned power generators, privatization of electricity transmission, privatization of the key mineral handling ports under conditions which encourage competition and continued monitoring of trading practices in industries and high concentration of ownership.

Adopt a holistic approach to investment incentives. Mines and mining-supply industries form mining “clusters”. They should be treated holistically as export industries that together must be competitive in a world market. It is recommended that designated mining-supply industries be entitled to the same extended incentive arrangements as the mining industry itself. Thus, new investment of at least US\$ 10 million would attract the following kinds of extended incentive provisions:

- u Stability of all taxes and other key privileges for at least 10 years;
- u The right to be paid by customers in hard currency and the right to free disposal of hard currency proceeds, as well as guaranteed access to hard currency.
- u Choice of accounting in United States dollars.
- u Treatment of general sales tax payments during development on a comparable basis to the incentive for mining investment in the pre-production phase.

Sign double taxation agreements with major investor countries. Many developing countries have concluded numerous income tax treaties to avoid double taxation. These treaties usually provide for reduced rates of withholding tax on dividends, interest and royalties. In the presence of international capital mobility, tax on corporate income and rules governing how taxes paid in the host country are treated at home, influence FDI, particularly in large-scale mining investment. The Government of Peru should therefore initiate negotiations to conclude double taxation treaties with investor countries.

7. Conclusion

Sound economic and industry policies have led to a revival of the mining industry in the 1990s. FDI has played a central role especially due to the privatization of producing assets and advanced exploration properties. There are a substantial number of near-term investment projects ongoing or in the pipeline, but there can be no guarantees that Peru's mineral resource endowments will be explored and developed to their full potential.

Care must be taken that the legal and fiscal environment set by the Government for mining is competitive with the best in the world. The increasing size of the mining industry and the entry of international companies in large-scale operations present significant opportunities and challenges to the mining-supply industries. The industry and its suppliers should be treated as a mutually enhancing mining system, each drawing on the other's strengths in the pursuit of greater competitiveness and wider economic impact. Opportunities for additional FDI will emerge on an increasing scale.

The policy environment for the industry is generally sound and this is vital if the continuing attraction of FDI is to be maintained. Nevertheless, a number of recommendations have been made to improve the legal/fiscal regime for mining and to enhance the competitive position of supplier industries within the mining system.

Box. IV.2. Bacterial leaching at the Tamboraque gold mine

Tamboraque, an old poly-metallic mine located 90 kms east of Lima, is owned by a Peruvian company, Compañía Minera Lizandro Proaño Sa. It is being revamped by the new management, notably by re-equipping the mining process and installing a new concentrator plant. A state-of-the-art bacterial leaching plant for recovering gold and silver from mining waste has also been installed.

The use of bacterial leaching technology is relatively new to Peru. In the past, it was not possible profitably to extract gold from waste as the technique for breaking the cyanide-pyrite molecule and capturing the gold was not known. Gencor Limited of South Africa, a world leader in the field, provided the new technology. It consists of separating pyrites from cyanide-pyrites, and then preparing a solution of cyanide-pyrites that is attacked by bacteria, thus freeing the gold and silver content from the solution.

In order to implement the technology in Peru, the Instituto Tecnológico Superior (TECSUP), one of Peru's leading private technical training and research institutes, constructed a pilot plant in Tamboraque. The scaled-up plant was designed and equipped by the Peruvian engineering company, FIMA (see box IV.1) and funded by two foreign agencies — Repadre International Corporation (Canada) and the Global Environmental Emerging Markets Funds (United States).

Investment in the bacterial leaching plant totalled US\$ 28 million and involves two stages. The first was the construction of the bacterial leaching plant, and the second involved increasing the capacity of the concentrator plant. The project's estimated life span is 10 years.

Once full capacity is reached, the bacterial leaching plant will produce 35,000 ounces of gold and 70,000 ounces of silver. Daily output from the mine is aimed at 600 MT, up from 200 MT/day.

Source: Apoyo Consultoría (1998). *Situación y Perspectiva del Sector Minería*, Lima: Apoyo, SA; *Semana Económica*, 1998; and UNCTAD survey.

B. Tourism

I. Overview

Globally, tourism has been one of the fastest growing industries this century. It accounts for more than a third of international trade in services. In 1997, 613 million tourists spent US\$ 447.7 billion worldwide. Income generated by the industry accounts for a large proportion of foreign exchange revenues for several developing countries. By the year 2020, the number of tourists is projected to double and the tourism industry is expected to generate earnings estimated to reach US\$ 2,000 billion.⁵¹

Peru's tourism industry has enormous potential. The country has a legacy of historical assets and archaeological remains. At the same time, its scenic landscapes, including wide beaches, mountains and rivers, are attractive to tourists seeking adventure sports. It hosts 84 of the 103 microclimates in the world, giving rise to a variety of flora and fauna, especially in its natural parks in the Amazon Basin. Peru is diversifying its tourism products oriented to one or a combination of the three Es – entertainment, excitement and education. Several aspects of the culture, environment and lifestyle offer opportunities for tourists to gain special knowledge and experiences. The growth prospects for the industry make it one of the most attractive businesses in the country. Peru started to reap the benefits of the fast-growth in tourism only in 1994, when the industry began to recover after a plunge due to political and economic instability in the country. The share of tourism in GDP was 3.8 per cent in 1997, and the sector was the third largest generator of foreign exchange.

Tourists account for about 90 per cent of the foreign visitors to Peru. Statistics are collected regularly but information is not always reliable and complete. In the 12 months to August 1999, the number of international arrivals totalled 910,000. Flows are highly seasonal and concentrated in the holiday seasons of December/January and July/August. As a result, the annual average hotel occupancy rate is low (40 per cent). In 1998, tourists originated only from a handful of countries, the main sources being European Union member countries (26 per cent), the United States (21 per cent) and Chile (18 per cent). Other countries in Latin American and other European countries account for the remainder.⁵² While tourism in Peru has been growing at a high rate, the country still trails other countries in the region, and its share of world tourism is only 0.1 per cent.⁵³ It needs to restore its image in terms of security and safety and overcome deficiencies in tourism infrastructure. Since Peru intends to promote small-scale sustainable tourism development, efforts are being directed towards developing middle- and high-income tourists.

Peru's historical-cultural assets are the principal attractions for tourists, accounting for nearly 85 per cent of visitors. Unlike destinations in other countries, they tend to attract mainly individual travellers.⁵⁴ International tour operators are responsible for the largest proportion of group tourists. But for a number of reasons, Peru is not adequately marketed as a tourist destination, which results in a limited number of package-tour travellers. The average length of stay and expenditure per person is above the average for Latin America.

Worldwide trends point to a reduction in the length of stay of tourists and to a short-haul market that is growing faster than the long-haul market. But Peru has a strong appeal for the long-haul market, which is more profitable. Growing demand and developments in electronic and transport technologies are expected to foster travel. There will be more tourists but there will also be more competition between destinations and products.⁵⁵

⁵¹World Tourism Organisation (1998). *Tourism Economic Report (first edition)*, Madrid:WTO.

⁵² PROMPERU (1999). *Perfil del Turista Nacional 1998*, Lima: PROMPERU.

⁵³World Tourism Organisation (1998). *Tourism Economic Report (first edition)*, Madrid:WTO.

⁵⁴ PROMPERU (1999). *Perfil del Turista Nacional 1998*, Lima: PROMPERU.

⁵⁵Vellas F. "Le tourisme dans les pays en développement". Mimeo, presented at the Expert Meeting on "Strengthening the capacities of the tourism sector in developing countries", Geneva, 8-10 June 1998.

The tourism market is segmented according to specific lifestyles, interests and activities and the choice is constantly widening. The industry can be categorized according to the following specialized areas:

- u Cultural tourism
- u Ecotourism
- u Nature tourism
- u Leisure
- u Business tourism

In general, segmentation leads to a demand for more varied tourism products and services. Peru's main competitive advantage is in the cultural tourism segment, but even in this segment, the country has so far focused only on selected aspects. Among the numerous cultures that flourished in Peru over the millennia, only the Inca culture has built up market recognition. Nature and ecotourism are alternative market segments for Peru, based on its natural resources and its diverse geography. However, so far these other attractions have not been adequately projected as destinations for diversified tourism.

An added competitive advantage, is Peru's ample supply of comparatively low-cost labour required for the tourism industry. Demand for education and training in tourism services is very high at the vocational level. As a result, new institutes as well as universities have adapted their programmes to respond to this increasing demand. However, shortages are reported in the quantity and quality of tourist guides and middle managers.

Major weaknesses in the tourism sector are the underdeveloped infrastructure (ports, airports, roads) and deficiencies in the quality and quantity of accommodation, and in the supply of related services. Peru is already inviting investors in the travel/leisure industries to participate in comprehensive tourism infrastructure development. A number of efforts are under way to develop a national strategy, which identifies an appropriate role for tourism development as a means to alleviate poverty, create employment and contribute to environmental conservation.

2. FDI in the tourism industry

Only a few industries deal exclusively with tourism, the main ones being hotels and travel agencies. Nevertheless, demands from the tourism industry cut across different economic sectors, as many closely-related industries rely on business arising from tourism. (see table IV. 4).

FDI is yet to play a major role in Peru's tourism industry. In 1998, it represented a negligible share of total inward FDI. The main investors — from the United States and the United Kingdom — together account for 96 per cent of total FDI in the tourism sector. These investments are mainly in the hotel industry.

Non-equity forms of investments are also concentrated in the hotel industry. Investments in new hotels and in upgrading existing hotels are required to meet the growing demand in tourism. It is estimated that by the year 2000, Peru will have about 1 million visitors. The aim is to double the existing accommodation capacity by the year 2003.

The participation of domestic investment is crucial to the development of the industry. At the same time, hotels, once independent businesses, are increasingly banding together to ensure consistent standards throughout the world. The major international operations in the hotel industry, therefore, take the form of

a multitude of non-equity arrangements such as management contracts or joint ventures with local partners, rather than direct investment. The major contributions of foreign investors are thus management know-how, quality standards and training. In addition, the links with TNCs facilitate access to the corporate global reservation systems, and to advertising networks.

Table IV.4. Main types of foreign investment in the tourism system in Peru, 1999

Industry segment	Type of foreign investment
A. Tourism	
Hotel	Joint ventures/franchising/management contract
Restaurants	Franchising management contract
Travel agents/tour operators	Franchising/wholesale
B. Support industries	
Business equipment	Subcontracting
Business services	Subcontracting
C. Infrastructure	
Air	Privatization/concession
Road	Privatization/concession
Railway	Privatization/concession

Source: UNCTAD survey.

In the early 1990s, as the privatization of ENTURPERU, a State-owned hotel chain, did not attract foreign investors, its assets were taken over by domestic investors. Between 1995 and 1997, the industry had already invested US\$ 210 million in reconstruction and new hotels; local investors concentrated on developing the low end of the market. The participation of foreign investors in the hotel industry would be beneficial for upgrading services and diversifying products. So far, major international hotel chains are involved in the opening of eight new four- and five-star hotels — the upper segment of the market — thereby creating an oversupply in this category, particularly in Lima. In other tourist destinations, private investment is concentrated in the development of the low end of the market, but the offer of five-star hotels is very limited. Therefore, there is opportunity to attract FDI in the development of upper market hotel accommodation in historical cities. Many of these cities are of pre-Hispanic origin with archaeological sites nearby.

In 1999, the Government completed a new series of privatizations and concession awards for hotels and transport facilities for the Inca region. These attracted a consortium of foreign and local investors led by Sea Container (a train operator) and its affiliate, Orient Express, the well-known luxury travel operator. The consortium acquired:

- u Ownership of a hotel in Cuzco and of the hotels closest to Machu Picchu which will be refurbished and expanded to five-star standard;
- u A 30-year management franchise and non-exclusive operatorship of the Cuzco-Machu Picchu railway and the connecting rail line to Arequipa on the coast; and
- u A concession to construct a cable car to the site.

The consortium has achieved a strong position through integrated investments, and seeks actively to promote the Inca region in the international tourist market. These investments, along with the proposed construction of a new four-star hotel in Cuzco by the Accor group (see box IV.3), will improve the international image of the region.

According to an official estimate, FDI in the tourism industry in Peru, generated by investment projects in hotels, road, airports and other tourism-related services, could amount to US\$ 6 billion in the next 15 years.⁵⁶

Many of the tourist destinations lack adequate accommodation and infrastructure. As the case of Cuzco shows, foreign investors favour integrated investment to exploit untapped potential in culture, adventure and ecotourism and their participation in the development of new areas should be encouraged.

The hotel and restaurant equipment market is also growing rapidly. Much of the demand for equipment is met through imports, but there are some local manufacturers in selected products (e.g. furniture, refrigeration). Price, quality, financing and aftercare services are the key competitive factors in equipment purchasing decisions.

Local manufacturers cater mostly to the low end of the market, as four- and five-star hotels and first class restaurants prefer imported goods for their better quality, durability and design. According to the UNCTAD survey, however, since the quality of locally-produced goods has improved, foreign investors are beginning to place orders with local suppliers (see, for example, the Accor case). Local suppliers have also benefited from subcontracting arrangements with international chains and have introduced better quality control and aftercare services.

According to the Department of Tourism in the Ministry of Industry, Tourism, Integration and International Trade (MITINCI), the main government agency responsible for tourism, franchising in the fast food and restaurant business is increasing rapidly. International fast food chains are opening new outlets through franchising in order to meet growing demand. Local food chains (such as Bembo's and Mediterraneo's Chicken) have also successfully introduced international management and marketing techniques. They are also better at adapting food to local tastes and preferences. So far, fast food restaurants are only catering to medium- and high-income consumers, and as a result, they are concentrated in the capital city.

Travel agencies are also located mainly in Lima. There was a dramatic increase in the number of new agencies registered, but a recent process of concentration through mergers and acquisitions has finally reduced the total number of operators. There are only two foreign tour operators established in the country. Foreign travel agencies and tour operators operate through local agencies without having a direct presence. The tour operators offer packages either directly to tourists or through a travel agent. Typically, the travel agent and the tour operator enter into a principal/agent relationship. However, there seem to be weak linkages in Peru between travel agents and international tour operators.

Overall, the management of tourism is inadequate, including the lack of a marketing strategy and insufficient resources. For example, there is a common belief among local operators that advertising is too expensive and does not pay off.⁵⁷ Experience in other countries, however, shows that an advertising campaign can change a negative image, support new image-building, and create demand in new segments of the market.⁵⁸ Inadequate information and poor advertising often have exaggerated the security situation in Peru. However, a growing number of operators are developing new marketing techniques, including extensive use of the Internet and advertising.

General transport services in Peru are available but the quality does not always meet required standards. Improvement of roads, often badly affected by weather conditions, and new road networks are needed to connect tourism centres into a circuit. The extension of concession programmes could attract foreign capital in tourism infrastructure development.

⁵⁶ The Economist Intelligence Unit, 24 September 1999.

⁵⁷ CANATUR (1997). *De la Crisis al Desarrollo Sostenible del Turismo*, Lima: CANATUR.

⁵⁸ For example, Egypt was able to regain average occupancy rate only 9 months after the terrorist attacks in Luxor.

Regarding air transport facilities, there are 21 foreign airlines operating in Peru. In 1993, AeroMexico, and Delta Air Lines (United States) each acquired one-third of the equity in AeroPeru, the largest national airline. But operational problems persisted and AeroPeru has now filed for bankruptcy proceedings and is now being liquidated. Other local carriers include AeroContinente, TANS, Taca Peru, and LanPeru, an airline backed by a joint venture with LanChile.

Box IV.3. Accor: a regional strategy for Latin America

Accor is one of the largest tourism conglomerates in the world. This French-based transnational corporation has four major areas of business:

- u Hotels
- u Corporate services (such as catering)
- u Car rentals (joint venture with Volkswagen)
- u Travel agencies (joint venture with Carlson)

In Latin America, Accor started its operations in Brazil, the largest market within the region, in the late 1970s. Today, it operates more than 70 hotels in that country, with full ownership of some of them. Its regional operations are organized in three main areas as follows:

- u In Brazil a subsidiary oversees all group activities in the country;
- u A regional headquarters in Buenos Aires, Argentina covers MERCOSUR countries and Chile;
- u A northern Latin American headquarters, located in Bogotá, Colombia covers the region from Peru to Mexico.

The group actively pursues a strategy of introducing its hotel brands — Sofitel, Novotel, Mercure and Ibis — into the largest markets within the region. While investment plans have been slowed down or virtually stalled as a result of economic and political uncertainties in Ecuador and Venezuela, activities in Peru are on the fast track and advancing according to schedule. The tourism market is expected to contract only slightly due to external shocks and should recover to expected growth levels fairly rapidly.

The lack of a direct presence in Peru of many of the international hotel chains represents an opportunity for fast market entry and positioning in one of the growing tourism markets in the region. In Peru, the Accor group has confidence in developing successful partnerships with local investors and is about to finalize investment plans in Lima and Cuzco, both in partnerships with domestic firms. Partnership agreements are the company's preferred entry mode.

The Group's investment in Cuzco amounts to 30 per cent of total investment, with the remainder provided by local partners. Operations should start by October 2000. The investment climate is considered very favourable in Peru, with good availability of financial services and credit. In the company's view, the country's legal framework is adequate and guarantees and protection are offered to foreign investors. However, improvements are sought in the institutional framework, particularly for tourism promotion, and training. The human resource potential in Peru is deemed very good, and labour costs very competitive but there is a reported shortage of required skills. At this present stage of early market development, the group finds it difficult to fill these gaps with on-the-job training or private initiatives. Local suppliers are considered good, and can provide about 80 per cent of the group's needs. However, they are all located in Lima and there is need and scope for suppliers in other areas of the country.

Source: UNCTAD survey.

As a consequence of increasing competition, the major airlines have pursued global alliances and introduced the “hub” strategy to establish their regional and global networks. Investment potential increases when a country is designated as a regional hub by international airlines. So far, only one airline (Continental) has elected Lima as its regional hub. Other market niches are linked to the opening of new domestic connections and to the development of leisure air transport, such as helicopters. Additional investment is related to the growth of nature tourism, and tourism to archaeological sites situated in remote areas.

3. Policy measures to facilitate tourism development

International tourism has been credited with improving the balance of payments, employment generation and poverty alleviation. At the same time, tourism is related to and has an impact on almost every domain – the environment, infrastructure, education, agriculture and imports, for example. It is, therefore, necessary to carefully balance rapid tourism expansion with environmental protection and protection of cultural heritage, among others.

In promoting tourism, the Government of Peru seeks to comply with the national objectives of poverty alleviation and employment creation as well as to mediate between development and conservation. To this end, the Department of Tourism, with assistance from the Government of Japan, has adopted a master plan that sets a clear target for tourism growth and development. The objective of the plan is to set a national and regional development strategy, transfer the know-how of tourism planning to Peruvian agencies and introduce measures to alleviate poverty and achieve tourism development. The strategy outlined in the master plan centres on developing the middle-market, selective tourism segment, an approach that has been successfully developed in Costa Rica. An alternative would be the kind of selective approach adopted in Bhutan, but this would involve introducing a control system, which would mean that tourism could not be counted on as a measure for economic development or as a financial resource for conservation.

The middle-market segment includes people who are interested in Peru’s culture and ecology but are reluctant to travel because of difficult travelling conditions and poor standards of quality. In order to attract tourists, nature tourism, combined with archaeological attractions, should therefore be developed to standards of high quality. The master plan identifies tourism circuits, each with a large number of historical and natural attractions. The Government expects to generate interest among private investors in projects involving tourist resorts, visitor centres at archaeological sites, thermal spas, and tourism-related infrastructure. The master plan also recommends the strengthening of the institutions of tourism administration by creating a central coordination mechanism and at the same time decentralizing the administration at the regional level. At the central level, it has established a coordinating mechanism, called the Sub-Council of Tourism Affairs for governing tourism policies at the central level and for coordinating among different ministries and institutions.

Several public sector organizations in the Sub-Council have different mandates for tourism development and promotion. The master plan calls for the establishment of a section on environment within the main government agency responsible for tourism, MITINCI, to support the development of ecotourism. PROMPERU is in charge of tourism promotion, along with investment. The Ministry of Presidency (and COPRI) is in charge of the development of tourism infrastructure, while the planning of infrastructure and regional development falls under the Ministry of Transport, Communication, Housing and Construction. The National Institute of Culture (under the Ministry of Education) is responsible for archaeological sites and the Institute of Natural Resources (under the Ministry of Agriculture) manages national parks and reserves. The tourist police is the responsibility of the Ministry of Interior, with the tourist hot line managed by INDECOPI and PROMPERU. At the regional level, the plan envisages that three main development corporations should coordinate tourism development and should be able to launch and implement their own tourism projects. The master plan also provides for the involvement of non-governmental organizations in developing new forms of ecotourism and in providing information, education and user services, such as certification and guided tours by volunteers.

The institutional and legal framework for tourism development was set in 1997, when Congress approved a new law for the development and promotion of tourism. But the decrees, which should have accompanied its implementation, are pending approval. Furthermore, the privatization and concession programmes have failed to provide guarantees for the protection of the national and world heritage sites. Pending approval of the decrees and further improvements in the tourism administration, the legal framework remains incomplete. Table IV.5 compares the previous law (DS 24037 of 1984) and the new law for the development and promotion of tourist activities enacted in 1997 (DS 26961).

Table IV.5. The legal framework for the development of tourism, 1984 and 1997

u General law for tourism (24037 of 1984)	u Law for the development and promotion of tourism activities (26961 of 1997)
Institutional co-ordination	
u The National Council for tourism established as an organ of co-ordination and multi-sectoral consultation with the Executive.	u Establishes an inter-sectoral commission on tourism to advise on planned activities having a direct impact on tourism. u Establishes an Advisory committee for providing support services and the elaboration of a proposal for development of the industry.
Market promotion	
u Peruvian Tourist Board (FOPTUR), with offices abroad, is put in charge of promotion campaigns oriented to build a positive image of the country's assets in tourism.	u FOPTUR is dismantled. PROMPERU is made generally in charge of all aspects related to the country's image promotion, including tourism. It has no offices abroad.
Supply promotion	
u MITINCI is put in charge of the co-ordination with all other agencies responsible for cultural development, preservation of natural resources and formulation of specific action plans.	u MITINCI, in co-ordination with other competent institutions, can provide for licensing the management of tourism infrastructure.
Fiscal incentives	
u Fiscal incentives are granted to reinvestment in tourism activities, if oriented to new enterprises development, building or modernization of infrastructure and/or equipment.	u Regulations issued by decree (DL 820) grant exemption from the tax on assets for three years, if located in Lima, and five years in other regions.

Source: National sources elaborated by Universidad del Pacifico.

At the institutional level, there are a number of private sector agencies geared to tourism promotion and development:

- u National Chamber of Tourism (Cámara Nacional de Turismo), CANATUR
- u Peruvian Association of Hotels and Restaurants
- u Peruvian Association of Travel Agencies
- u National Association of International Air Transport
- u Peruvian Association of Tour Operators
- u Peruvian Association of Airlines
- u Peruvian Association of Tourism, Adventure and Ecotourism
- u Peruvian Association of Youth Hostels

CANATUR has developed an integrated proposal for tourism development in Peru.⁵⁹ It proposes private sector participation in the administration of tourist assets, in the development of infrastructure and services and in training. The proposals include development of an information service, identification of transport needs, establishment of credit facilitation for small and micro-enterprises, identification of tourism projects in which foreign investors could participate and upgrading of existing training institutions.

In the policy area, CANATUR calls for coordination between the private and public sectors, and proposes the establishment of a committee on tourism (with government institutions and business associations) to monitor and enforce policies that enhance tourism opportunities. Such a committee would be well placed to contribute to the development of an integrated tourism policy.

For government institutions the priority would be to strengthen intersectoral linkages. The master plan only partially tackles this issue, since the proposed horizontal co-ordination mechanism (sub-council) may prove ineffective. The experience of other developing countries shows that the establishment of a ministry of tourism or a single tourism authority facilitates government initiatives in tourism promotion. The central authority should also have the competence, as appropriate, to decentralize structures and programmes for tourism planning and development at the regional and local levels.

In addition, the degree of professionalism in the industry is dependent on the establishment of specialized training, and the safeguarding of quality standards. Private sector associations can devise standards and award classification rankings, but adequate control mechanisms are needed to enforce those standards.

Specific policy measures to attract FDI to the tourist industry should favour the development of partnerships between domestic and foreign entrepreneurs. Direct and indirect support measures to encourage new investment could be applied to tourism. In addition to fiscal incentives, such as reduction of capital and operating costs, credit facilitation could be provided, particularly to small and medium-sized enterprises (SMEs). Technical services could also be offered to SMEs to allow proper business assessment.

Other measures could include specific employment and training schemes. In addition, FDI could be encouraged to contribute to the stated objectives of diversifying tourism products (ecotourism) and destinations (new cultural circuits), and upgrading the quality of services. As for training, the international hotel chains are noted for their in-house training programmes. Their help may be sought in gaining access to local service providers for such programmes.

⁵⁹ CANATUR *Programa de desarrollo integral del turismo en el Peru*, 16 April 1999.

Overall, to bring in private investment and encourage FDI, concession schemes could be better developed and linked to conservation of national heritage sites. In view of their significant attraction, special consideration should be given to heritage conservation at sites in Cuzco and Machu Picchu as well as other world heritage sites. These include, among others, Trujillo circuit (archaeological sites of Chan Chan, El Brujo el Sol y la Luna), Chiclayo (Señor de Sipán). The centre of Lima is also considered a world heritage site by UNESCO. Heritage conservation and tourism development need not be in conflict. The following section presents one example of how a concession scheme that develops tourism infrastructure and services could be designed to involve private investors in heritage conservation. The same scheme may also apply to other tourism sites presenting similar characteristics.

4. A strategy for tourism development and heritage conservation in Cuzco and Machu Picchu

Cuzco and Machu Picchu, the foremost cultural heritage sites in Peru, have been declared World Heritage sites by UNESCO and are special attractions for international tourists. However, the region has not attracted as much tourism as it could (see box IV.4) owing mainly to the lack of infrastructure and services. Foreign investor should be attracted to concession schemes for the development of international tourist sites. Unlike infrastructure concession schemes in most other sectors (e.g. roads, power) tourism can generate hard currency sales and make it easier for investors to obtain debt finance.

The development of tourism and the conservation of heritage sites are important — and not necessarily conflicting — objectives for Cuzco and Machu Picchu. A concession scheme that develops tourism infrastructure and services in the region should be designed to involve private investors in the conservation of the sites. Since these sites constitute the core of the tourism market which the private investors would be servicing, they should have a strong interest in their conservation and proper management. Presently however, since the sites are managed as a public good, no individual investor is motivated to become actively involved in their conservation.

The essence of a concession scheme would be to include private investors directly in conservation activities in return for valuable development and access rights. Such a scheme would involve:

(a) Developing a consensus among public and private interest groups on a conservation plan for the areas. This plan would include, zoning restrictions for new buildings, a conservation proposal for the cultural assets, guidelines for the numbers and movements of visitors to protect the assets and an enforcement plan.

(b) Updating the COPESCO report published by the Government of the Inca Region entitled, Opportunities for Investment in Tourism: Inca Region. This report identifies weaknesses in infrastructure and services, and examines the scenario of an increasing number of tourists to the region (see box IV.4).

(c) Preparing a Heritage Partnership strategy for the region that would balance development rights with conservation obligations, to be coordinated by COPRI.

(d) Invitations to private investors to make proposals for one or more concession schemes.

The Government recently completed a series of privatization and concession awards for hotels and transportation in the region that attracted a consortium of foreign and local investors led by Sea Container.

It is not clear if a balance between tourism development and heritage conservation has been achieved by imposing specific conservation obligations.⁶² According to UNESCO, there is a lack of clarity and coordination between various agencies and levels of government on the responsibilities for conservation and tourism policy.

The implementation of a Heritage Partnership strategy for the region would require a professional approach. It should take into account both conservation and tourism development objectives, the roles and powers of the regional and municipal authorities and the concerns of the industry and the community. It should also develop appropriate bidding procedures – balancing the merit of obtaining creative proposals from investors against the need for competitive and transparent contracting procedures.

It is recommended that Peru initially seek support from APEC in developing its Heritage Partnership strategy. APEC has established principles for facilitating private sector participation in infrastructure development and has active working groups concerned with the provision of infrastructure in several sectors. Moreover, as private investors and banks participate in its work, an investor perspective can be brought to bear from the outset.

The Heritage Partnership strategy could aim at several types of foreign investors, including hotel investors and managers, theme park operators, resort operators, hotel and gaming operators and airlines with partnerships in the touring business. The investment concepts to be developed are important. It may be that core investors should be sought for an integrated package of improvements in infrastructure, hotels and amenities. Core investors will have a natural interest in direct tourist promotion and in creating partnership with the authorities for conservation of the heritage sites that provide the basis for their business. Imaginative business solutions will be needed, and therefore the strategy should allow potential investors to propose core investment schemes.

When developing concession schemes, specific questions that will need to be addressed include:

- u What is the capacity of Machu Picchu in terms of number of visitors, and how should access rights be allocated? Can guaranteed access rights be sold or incorporated as incentives into new development schemes?
- u Should associated development rights (e.g. hotels) and Machu Picchu access rights be offered as a package to attract transport infrastructure investors?
- u Should conservation expenditure and management obligations be built into the development rights?
- u Is there more scope (in addition to that provided in the present concession law) for private investors to promote creative schemes which meet both commercial and conservation objectives?

⁶² The proposed Machu Picchu Cable Car has provoked international controversy, and UNESCO, which maintains the World Heritage listing, has expressed concern. However, this issue relates to whether the development is compatible with the site rather than the question of conservation obligations.

Box IV.4. Tourism profile: Cuzco and Machu Picchu ("Inca Region")

In 1996, the region containing the Cuzco and Machu Picchu World Heritage sites attracted 217,000 international visitors and 247,000 domestic visitors. Approximately 40 per cent of international tourists to Peru visit these sites.

The Japan International Cooperation Agency (JICA) which prepared the Master Plan Study points out a number of factors that are responsible for Peru's low share of international tourism despite the competitive advantages of its cultural assets. These include negative images of security, insufficient tourist promotion, poor quality of accommodation and poor access infrastructure. The study also reports an inadequate conservation programme due to lack of funds at municipal level, poor linkage of tourist sites and local communities and a need for more training in the industry.

In the Inca region, the Master Plan Study identifies a number of infrastructural improvements required to boost tourism, including:

- u Improved road access and traveller facilities in the Puno-Cuzco and Ayacucho-Cuzco corridors;
- u Railway rehabilitation for Puno-Cuzco (cost US\$ 85 million) and Cuzco-Agua Calientes (US\$27.5 million);
- u Day trip access and improvements in facilities in the environs of Cuzco (\$US 61 million);
- u Beautification and enhancement of tourist facilities in Cuzco city and Agua Calientes (US\$1.15 million); and
- u Hotel expansion mostly in the three- to five-star range (US\$ 614 million).

In addition to some of these suggestions, the earlier COPESCO Plan included:

- u Construction of a new airport to relieve operating restrictions at the present facility (limited to 3,500 arrivals per day) and to handle direct international flights.
- u Construction of a cable car to Machu Picchu.

The COPESCO Plan also stated that Machu Picchu could only absorb 584,000 visits per year based on two daily shifts. This points to possible future restrictions.

Source: UNCTAD survey.

5. Conclusion

The development of the tourism industry in Peru would benefit from a diversification of tourism products and the strengthening of the institutional support to the industry in both the public and private sector. The main attraction of Peru as a tourist destination, at least until the other areas are developed, would be the historical sites classified as World Heritage sites. The infrastructure and services need to be improved significantly to realize their full potential benefits. There should be a single agency responsible for developing, coordinating and spearheading initiatives in tourism and travel. Joint private and public sector programmes should promote education-business linkages, and encourage private sector finance in infrastructure and heritage conservation. Bolder promotion of investment opportunities is necessary to create niche markets by defining the country's strengths as a location for these types of activities.

A more systematic integration of tourism with the domestic economy could be achieved through incentives directed at facilitating credit to small and micro-enterprises, and support to upgrading the quality of their services.

Regional cooperation can play a useful role in tourism development, particularly in the design of complementary products with neighbouring countries. Initiatives are already being developed within the Community of Andean Nations for infrastructure development and tourism promotion. The establishment of joint ventures in investment, education and research will expand beneficial linkages for tourism within the region.

In addition, it is recommended that Peru seek support from APEC in order to develop a Heritage Partnership strategy. APEC has established principles for facilitating private sector participation in infrastructure development and has active working groups on infrastructure provision in several sectors. Innovative concession schemes can be developed to attract core investors for an integrated package of improvements in infrastructure, hotels and amenities.

C. Agribusiness

I. Overview

Agribusiness comprises agricultural and livestock products produced or considerably transformed through some industrial process which gives them a higher value added. Economic factors, such as globalization and liberalization, and their accompanying effects on agribusiness, as observed over the past decade, portray a steady long-term decline in agricultural commodity prices, changing relative factor and product prices, and vertical integration between agroindustrial firms and farms. FDI has often influenced the growth of agro-processing, distribution and farm-input provision activities off-farm.

Concomitant changes have taken place in product composition to meet changing consumer preferences towards shellfish, horticultural products, processed foodstuffs, and non-staple products. Technology and overall innovation of the industry have led to industrial production replacing artisanal farming and traditional methods of processing and distributing agribusiness products in many low- and middle-income economies. There is also increased attention to product quality and safety in order to comply with the international grades and standards required to access the most demanding export markets.

These global changes can favour the emergence of Peru as a world class producer and exporter of high-value tropical and semi-tropical fruit and horticultural products — both fresh and processed. However, in general, Peru's agriculture is still characterized by small farming and traditional methods. Entrepreneurship and export-oriented production, which are key to building up the agribusiness sector, have started to develop only recently. The sector requires large investment and high technology as well as an entrepreneurial vision totally distinct from past practices to stimulate value-added activities that build on agro-industrial production. Such changes are key to accessing export markets and improving living standards among poor rural populations in the interior highland regions.

2. FDI in agribusiness

In Peru, agribusiness comprises traditional and non-traditional activities. The first activity group includes industries based on milk, milling, sugar, rice, oil, edible fats, balanced food, sausages, oats and their resulting by-products. Non-traditional agribusiness includes industries based on vegetables, greens and fruit that generate dehydrated and frozen products, juices, pulp and concentrates. Most of the private investment in agriculture has gravitated towards crops for export. These grow mainly along the coast, except for the cochineal industry, which is centred in Ayacucho and the mountain areas around Arequipa. The main agro-industrial products cultivated in Peru are asparagus and fruits.

Data concerning FDI in Peruvian agribusiness is scanty because TNCs often enter into contractual arrangements with local firms, without involving equity investment. As far as registered FDI is concerned, agribusiness represented a small share of total FDI. The largest single investment took place in export-oriented asparagus production as a result of direct investment by a large Spanish firm. So far, the process of privatization has attracted little attention from international investors, but it is being revived and a new strategy is being put in place by COPRI (see chapter II).

The level of imports of capital equipment by agribusiness firms shows that they are undergoing rapid technology upgrading. New investments, also targeting irrigation systems, rose dramatically in 1998 due to commitments by asparagus producers (see table IV.6). Another indicator of growing investment is the rapid increase in credit provided by the multiple banks for agribusiness. Credit grew from US\$ 91 million to US\$ 393 million between 1991 and 1999.

Peru's coastal areas, which have the largest potential for agricultural development, boast 1,636,000 hectares of land. All the land is accessible and is located near infrastructure facilities such as ports, airports and roads. There has been a major effort to improve irrigation in order to create the basic investment conditions. Once these improvements are completed, the Government may be able successfully to attract the interest of potential national and foreign investors for participation in a tender co-ordinated by the special committee, CEPRI Tierras (Special Committee for the Promotion of Private Investment in Land with Irrigation).

Table IV.6. Indicators of investment and technology upgrading of firms in agribusiness, 1993-1999.

(Millions of US dollars)

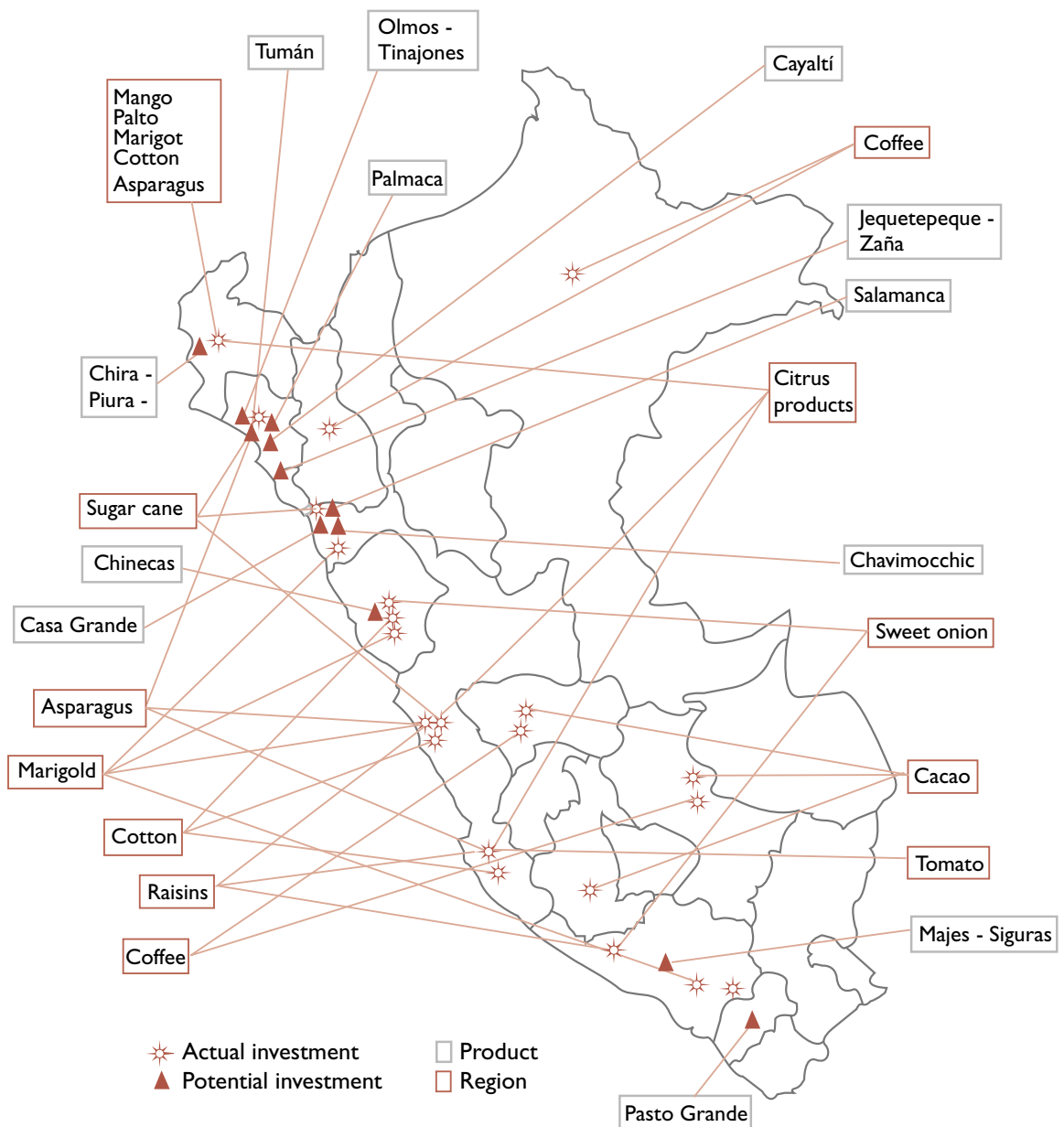
Item	1993	1994	1995	1996	1997	1998	1999
Machinery and tools	16.0	9.0	22.0	10.0	15.0	16.0	16.0
Other equipment	0.9	0.7	1.7	0.6	0.5	3.8	1.8
Transport equipment	26.0	24.0	18.0	11.0	16.0	24.0	45.0
Import of capital goods	43.0	33.0	42.0	22.0	31.0	44.0	63.0
Import of irrigation systems	1.2	1.8	1.8	2.2	5.4	15.8	8.6

Source: Inform@cción, 2000.

The programme requires investors to commit, for at least three years, an investment of US\$ 1,000 per hectare. It also requires investors to provide 50 per cent of the total amount of planned investment as a bank deposit, which can only be accessed after the project is half completed. The following projects are being offered to tender:

- (i) Chira-Piura – at the Ecuadorian border, close to the port and highly suitable for mango production;
- (ii) Pilot Project Olmos – located at north of Lima, has benefited of a special irrigation programme;
- (iii) Jequetepeque-Zaña – located on Panamericana North with access to two international airports;
- (iv) Chavimochic – located 500 km north of Lima, in the Libertad department. This area already has important asparagus production;
- (v) Majes-Siguas – located south of Lima in Arequipa department with access to a seaport.
- (vi) Pasto Grande – South of Lima at Chilean border with access to the seaport and airports.

Figure IV.2. Actual and potential investment in agribusiness in Peru, 2000



Source: Universidad del Pacífico based on COPRI and CEPRI Tierras, 2000.

As of March 2000, the special privatization programme run by CEPRI had elicited US\$ 34.3 million of investment commitments for a total land value of US\$ 43.7 million. To boost FDI flows into the programme, CEPRI intends to reorient the privatization strategy and is working in close collaboration with, and under the management of COPRI. The strategy being evaluated involves the targeting of joint ventures and/or direct sale to strategic foreign investors. It would seem that regional investors (Ecuador and Colombia) have already expressed an interest and are working with CEPRI to define their participation in the tender.

3. The legal and policy regime

Agribusiness, along with the other economic sectors, has benefited from the sound legal framework provided to national and foreign investment. In addition, the important structural reforms, started in the 1990s, included the withdrawal of price controls and a reduction in trade restrictions for most agricultural products. The loss-making agrarian development bank was abolished and the Ministry of Agriculture was reorganized and scaled down. At the same time, the development finance corporation, COFIDE, began granting agricultural credit lines to commercial banks through rural lending institutions — so-called *cajas rurales* — which proved a more efficient, though still insufficient, financing mechanism.

After agrarian reforms, the adoption of Legislative Decree No. 653 of 30 June 1991 constituted an important instrument for the liberalization and modernization of the sector since it relaxed and clarified ownership criteria for agricultural land. However, detailed rules and regulations are still lacking to support the application of the law.

In 1996, the Law for the Promotion of Agriculture promulgated by Legislative Decree No. 885 eliminated the minimum income tax until 31 December 2001. It also reduced the rate of income tax to 15 per cent (from 30 per cent) and exonerated all employees from payment of the housing fund contribution (FONAVI). Employees will benefit from a health insurance equivalent to 4 per cent of the minimum wage. These measures do not apply to poultry farming, the agro-industry and forestry so as to avoid a dramatic reduction in the Government's fiscal revenues. However, the lack of these incentives constituted a serious impediment to vertical integration of agribusiness into agro-industry. Furthermore, implementation of some of the incentives has been held back by delays in adoption of the necessary regulations. Similarly, delays in the adoption of a law on water pricing has affected the development of large agribusiness projects. Water management continues to be poor and inefficient — irrigation systems are not sufficient and their functioning has been seriously damaged by the El Niño weather phenomenon.

The programme of privatization included large areas of irrigated land and State-run cooperatives, in particular sugar cooperatives, which occupy some 80,000 hectares of prime coastal land. However, the privatization process has faced a series of juridical and legal problems. For example, lawsuits connected with sugar cane privatization and problems with the SUNAT (the National Tax Superintendency) delayed the allocation of a sugar firm to a Colombian investor. Another auction was cancelled due to disturbances caused by the workers during the sale.

With regard to sanitary norms, there have been serious efforts to improve awareness among all agents in the sector. In the case of asparagus, a special regulation was created and subsequently supported by the business association and the export promotion agencies. This enabled the sound functioning of processing in order to guarantee the necessary standards required by export markets. Similarly, in the case of mango production, sanitary certification was introduced that facilitated the successful export of the product. These cases have shown that the introduction of standards and certification is crucial for gaining access to export markets.

Trade policies are also important for accessing export markets. Trade in agricultural products is sales tax exempt for all types of producers. As for imports of food or agricultural products, some protection is provided from imports of wheat, corn, rice, sugar and other specific farm products. Peru also benefits from

the Andean Generalized System of Tariff Preferences that grants duty free access to a wide range of its products to the United States market. The same system is applied to Peruvian agro-exports to the European Union, Australia, Bulgaria, Canada, the Czech Republic, Hungary, Japan, New Zealand, Poland, the Russian Federation, Slovakia and Switzerland. The granting of these concessions has permitted the diversification of products and markets.

4. Trends and prospects

The change in the legal framework, especially in land administration, has facilitated private investment in agriculture. Capital inflow has concentrated in the export of non-traditional agricultural products and in the sugar industry. Favourable natural conditions and easy access to coastal markets are the main strengths of the sector. Peru has a climate that makes it possible to sow and harvest all year round. It also has a significant share in the world supply of several products (such as asparagus, cochineal, and *maca*). Recorded agricultural export earnings expanded considerably in 1998, outpacing total exports. However, exports are concentrated in two niche products, coffee and asparagus, which accounted for some 65 per cent of recorded exports in 1998 (see table IV.7).

One of the characteristics of modern agricultural exports in Peru's coastal region is that many firms do not concentrate exclusively on developing just one product, but prefer to practise alternate cropping. This practice reduces fixed costs and, at the same time, diversifies production. A number of firms from different sectors have showed interest in diversifying the risk involved in their activities and, consequently, have invested in agribusiness. This is a positive factor and should be encouraged. However, the fragmentation of agribusiness is a genuine concern. The grouping of small farm holdings to form larger companies would help by standardizing production and taking advantage of scale economies.

Crops with untapped potential for development are found mostly in the Amazon region. *Camu camu*, palm hearts, aromatic herbs, and cat's claw could easily find export markets as they are in great demand abroad. So far, the latter is simply based on extraction activities but not on regular cultivation of the plant. However, despite fiscal incentives offered under the Law for the Development of the Amazon area, there have not been significant volumes of private investment. Deterrents to investment are poor infrastructure related to road networks, access to seaports and airports, as well as marketing.

Table IV.7. Recorded exports in main agricultural products, 1998
(Millions of US dollars and percentage)

Product	Exports
Total F.O:B (US\$ million)	598.1
Traditional	52.4
Cotton	0.7
Sugar	4.5
Coffee	46.9
Wool	0.3
Non- traditional	47.6
Asparagus	19.0
Dyes (including cochineal, marigold, annatta)	5.1
Mango	2.0
Cocoa	2.9
Alpaca hair	2.7
Frozen vegetables	2.4
Others	13.7

Sources: Ministry of Agriculture and Central bank of Peru, 2000.

The successful development of agribusiness is dependent upon the upgrading of the irrigation system and the development of complementary business to support the industry. Nurseries are needed to provide top quality seeds and pest-free genetic material to guarantee a supply of the varieties required. The installation of plant biotechnology laboratories would make it possible to obtain a higher quality product and to develop new product varieties. Innovation in processing technology should also be contemplated to help overcome the problem of low harvest yields. Investment is needed in seed varieties, fertilizers, pesticides, collecting points and processing plants, canning and dehydrating plants, packaging, cold storage, transportation, chartering and insurance. Marketing and management skills also need to be upgraded

5. Conclusion

In Peru, exports of agro-industrial products show a rising trend despite the many constraints reviewed. These include fragmentation of the land into small plots, weak infrastructure, insufficiency of irrigation systems and weak sanitary standards, all of which hamper exports.

Larger volumes of investment are needed in irrigation, biotechnology and quality control. Also, to promote investment, an adequate legal framework is required for a clear and transparent definition of land ownership and the efficient allocation of water resources.

Peru requires significant FDI in this sector to bring in managerial expertise and state-of-the-art technology, and thereby encourage the integration of the production chain from the field to the market.

V. Conclusions and recommendations

The Government of Peru offers investors a sound economic and business environment, and a state-of-the-art investment framework. These are essential foundations that must be maintained if Peru is to continue to be an attractive destination for FDI.

The review of the investment policy framework concludes that only a few aspects warrant reforms. But attention should now turn to policies that will sustain investment flows and accelerate the creation of conditions which would make Peru the first-choice base for new FDI in the region. In order to sustain the competitiveness of FDI in existing hub industries, linkages between suppliers and related industries should be strengthened. Peru's potential for new FDI can be developed by longer-term policies to enhance innovation in the productive sector. A number of measures could facilitate the achievement of specific objectives in three broad areas: investment framework, competitiveness and regional co-operation.

A. Investment framework

The investment framework is sound. The recommendations provided are in the nature of enhancements and fine-tuning to remove disincentives and to improve the existing incentive arrangements. However, bolder initiatives in investment promotion should be envisaged to go beyond the successes achieved so far with privatization and concession of public assets and services.

Objective 1: Enhance legal stability agreements

The principal effect of the legal stability agreements in their general form is to reassure investors that they will not be singled out for adverse treatment on a discriminatory basis. However, the range of specific matters that are stabilized is too limited to protect an investor or lender against a general or even sectoral deterioration of the investment climate. Possible enhancements of the stability agreements in Peru include:

- u Extending them to all eligible enterprises, providing for the freedom to export and the right to retain exports proceeds abroad as required.
- u Liberalizing the assignment provision. Lenders should be able to automatically assume rights under stability agreements when foreclosing and then be allowed to re-assign these rights with safeguards upon disposal of the secured assets.
- u Consider offering a legal stability agreement with regard to withholding tax rates since these are taxes, which are not guaranteed of national treatment. These include withholding rates on interests, royalties and technical fees.

Objective 2: Reform the fiscal regime

Peru offers attractive fiscal incentives, but the following recommendations are made for improving the general fiscal regime:

- u The “in lieu of” dividend rule is a disincentive. A preferable approach is to treat shareholders and third-party debt in the same manner, provided a minimum equity-to-debt ratio is achieved and reasonable caps on loan interest are maintained.
- u The level of import duties warrants general review with a view to their eventual reduction.

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- u The level of import duties warrants general review with a view to their eventual reduction.

Objective 3: To strengthen investment promotion

International investors operate in a globalizing economy and adopt new strategies for international production, which have also changed requirements for investment promotion activities. Investment promotion in Peru should include the following functions:

- u Investment facilitation;
- u Business support; and
- u Aftercare services.

These services should be demand-oriented and partially user-supported, and should be coordinated by a single agency that should focus on investment promotion. The role of the existing agencies – CONITE, COPRI, Promperu — each of which is responsible for different aspects of investment promotion, should be redefined to achieve a high degree of policy coordination and build strong links with the private sector. The establishment of an investment promotion agency would facilitate this process.

B. Strengthening Peru’s competitiveness and broadening FDI

Peru needs to consolidate the competitive position of its main hub industries by ensuring that they form part of efficient industry systems. Moreover, some general policies should be implemented to improve Peru’s competitiveness in order to increase FDI in emerging hub industries. General policy actions involve improving the physical and human capital through development of infrastructure and education. Specific measures may include:

Objective 1: Consolidating the competitiveness of established hub industries

The main hub industries identified in the report are mining, tourism and agribusiness. The following measures have been identified for each of these sectors:

Mining:

- u Undertake a comprehensive tariff reform for the mining industry;
- u Monitor and maintain competition policy;
- u Extend to the mining supply industries the same incentives that are provided to the mining industry; and
- u Attract investments into industries that convert mineral resources into manufactured products for export.

Tourism:

- u Establish a single tourism authority;
- u Develop a strategy for tourism development and heritage conservation;
- u Develop concession schemes in tourism infrastructure;
- u Launch joint private-public sector training programmes; and
- u Involve domestic and foreign investors in the identification and management of projects to develop ecotourism.

Agribusiness:

- u Reform land and water laws;
- u Improve the irrigation system;
- u Launch a new privatisation/concession strategy;
- u Introduce certification and quality control;
- u Encourage the grouping of small farms to form large companies;
- u Encourage FDI in complementary business to support the industry; and
- u Establish a special plan to attract FDI to the Amazon region.

Objective 2: Developing production-oriented technology and education policies

To attract FDI in new areas, technology and education policies should encourage interactions among public R&D institutions, technology centres, enterprises, universities and financing institutions. Specific measures would include:

- u setting up specialized research and technical training (e.g. metallurgical science, engineering, marine biology and biotechnology);
- u establishing applied research priorities for cluster industries;
- u increasing the number and quality of vocational institutes; and
- u introducing quality control and promoting ISO certification.

C. Regional cooperation

Peru should participate fully in regional arrangements that promote investment and bring regional market opportunities to Peruvian industries.

Objective 1: Cooperating with APEC working groups

As a full member of APEC since 1998, Peru could seek assistance from APEC working groups in the following areas:

- u For developing a Heritage Partnership Strategy; and
- u Participating in the assistance programme developed by APEC for small and medium-sized enterprises.

Objective 2: Strengthen cooperation with CAN

One of the mandates of the Community of Andean Nations is to establish a programme to help its member countries improve their competitiveness in production by developing economic complementarities, supporting strategic alliances and strengthening their human resources and technological capacity. This programme has recently been reactivated and Peru could benefit from participating in such co-operation schemes.

Annex

I. Methodology for comparative tables of APEC investment standards

The scoring system in compiling tables II.1 and II.2 rates “best practice” as follows:

National treatment: The highest standard rating is given where there is an explicit legal provision (or long established practice) which guarantees national treatment, except on the grounds of national security (thus border-related provisions and defence industries are considered exceptions), and where there are no screening procedures for admitting FDI. Thus lower scores are accorded for screening mechanisms, sectoral restrictions on FDI participation — including outright bans of FDI in certain sectors and/or foreign ownership limits — and from operating restrictions which apply only to foreign investors (such as restrictions on access to local finance).

Non-discrimination: The highest rating is for no discrimination among investors on the basis of home country except in the context of regional economic agreements or bilateral tax treaties.

Convertibility: The highest rating is given where there are no exchange controls on the current and capital accounts. Countries whose currencies are not commonly traded “hard currencies”, contractual arrangements guaranteeing access to foreign currency for repatriation of profits and capital and the ability to hold export proceeds offshore also get high ratings.

Expropriation: The highest rating is given for a legal provision which states that expropriation will only be for a public purpose, will be done by due process of law and will result in internationally acceptable arrangements for compensation.

Dispute settlements: The highest rating is given where there is a legal provision in favour of equal access to the host country legal system, and where investors from a wide range of home countries have recourse to international arbitration to settle an investment dispute with the Government of the host country.

2. Survey methodology

In 1999, UNCTAD and the Universidad del Pacifico conducted a survey among managers of foreign affiliates and potential foreign investors among TNCs from the following countries, France, Italy, Germany, Japan, the United Kingdom and the United States. About 65 responses were gathered to identify investors’ interests and their assessments of the country’s strengths and weaknesses. The method used was a postal questionnaire, with close monitoring and follow-up interviews. A number of organizations supported the survey namely, the Government agencies Invest in France Mission, the Italian Trade Centre, the Japan External Trade Organization (JETRO), as well as the Chamber of Commerce of Chile and the Brazilian research centre SOBEET .

Annex table I draws on the results of the survey of investors by listing the negative and positive factors influencing investment in Peru. The frequency distribution of the weighted average of responses has been calculated and factors above the median value are considered strengths, and those below, as weaknesses to investing in Peru.

Annex table 1. Frequency distribution and evaluation of factors influencing business operations in Peru

	Weight average	Economic determinant	Evaluation
Judicial system	6.5	Policy framework	low
Qualified personnel	7.9	Business support	low
Financial risk	8.8	Market	low
Political stability	8.8	Policy framework	low
Good physical infrastructure	8.5	Infrastructure framework	low
Labour productivity	8.7	Cost	low
Good network of suppliers	9.1	Business support	low
Business information	9.9	Cost	low
Privatization programme	11.7	Policy framework	Median value
Market size	12.1	Market	high
Access to raw material	13.1	Natural resources	high
Low- cost labour	13.3	Cost	high
Tax incentives	13.7	Policy framework	high
Strategic business location	14.1	Market	high
Friendly regulatory environment	14.4	Policy framework	high
Market growth potential	14.8	Market	high
Preferential access to third markets	15.2	Policy framework	high

Source: UNCTAD survey, 1998.

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FDI Determinants and TNCs Strategies: The Case of Brazil. 195 p. Sales No. E.00.II.D.2, \$35.

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Division on Investment, Technology and Enterprise Development
Palais des Nations, Room E-9123
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Telephone: (41-22) 907-5707
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