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Summary

INVESTMENT POLICY REVIEW

PERU

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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 of the trade deficit, and a sound exchange rate regime of Peru's latest currency, the *Nuevo Sol.* On the political front, it has involved the reduction of terrorist activity and the conclusion of the peace agreement between Peru and Ecuador and the settling of the border dispute. The peace agreement includes specific ways to foster public and private investment flows within the framework of the Binational Border Integration Plan.

The changes in economic policy were accompanied by a fundamental redefinition of the role of the State. The 1993 constitution strongly encouraged private initiatives. The Government has since divested itself of most of its productive ventures in a wide range of State-controlled business holdings that cut across all sectors. 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 and distribution have been privatised. The construction and management of roads, ports, railroads and airports is also in the process of being turned over 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.

The policy shift was accompanied by some hardships. The 1990 stabilisation programme had severe repercussions. Per capita income fell to its lowest level in several decades during 1990-1992. However, since then, per capita income has grown steadily. Private sector also shared the burden, with most companies forced to restructure. 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 grew dramatically, leading Peru to become one of the top recipients in the developing countries.

The main reasons for such success are the privatization of public assets and the 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 emphasises 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.

Chapter I analyzes Peru’s success in catapulting into the ranks of the top 10 host developing countries for FDI. The growth of FDI inflows was high by world standards, and particularly so for a country whose comparative advantage rests on natural resource endowments. However, foreign investment has been concentrated in a few large projects, and has not substantially contributed to economic diversification or exports. If inflows are to be sustained at the current high levels, the country must continue to promote economic growth, strengthen the technological, educational and infrastructure capabilities, and promote its 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 Peru’s investment policy regime compares very favourably with that of other APEC economies, 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 competitive strengths in the resource-based industries by encouraging investment in related and supporting 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 the need to create competitive advantages for Peru so as to attract FDI in the manufacturing sector to cater to the domestic and regional markets.

Chapter IV examines three core industries that can play lead roles in stimulating investment in the entire 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 industry can attract many more visitors if cultural sites are made more easily accessible and safe, are well maintained, and if there is more investment in providing hotels, restaurants and other facilities and services required that are up to standards common in the 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 the production of higher value-added and industrially-based agricultural goods.

Conclusions and recommendations include the following:

- **Fine-tuning the 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. Moreover, bolder initiatives in investment promotion should be envisaged to go beyond the successes achieved so far with privatization.

- **Enhancing legal stability agreements.** The principal effect of the legal stability agreements 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 stabilised is too limited to protect an investor or lender against a general or even sectoral deterioration of the investment climate.

- **Reforming the fiscal regime.** Peru offers some attractive fiscal incentives. However, withholding tax is applied to most payments abroad. Interest on shareholder debt can be deemed to be "in lieu of " dividends (from post-tax income) and is taxed at 30 per cent. 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. In addition, the level of import duties warrants general review with a view to their eventual reduction.

- **Strengthening 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 investment facilitation, business support, and aftercare services. These services should be demand-oriented and partially user-supported, and should be co-ordinated 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 co-ordination and build strong links with the private sector. The establishment of a single investment promotion agency would facilitate this process.

- **Strengthening Peru's competitiveness and diversifying FDI.** The country 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 the emerging hub industries. General policy actions involve improving the physical and human capital through development of infrastructure and education. Specific measures may include consolidating the competitiveness of established hub industries, mining, tourism, and agribusiness, and 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.

- **Encouraging regional co-operation.** Peru should participate fully in regional arrangements that promote investment and bring regional market opportunities to Peruvian industries. As a member of APEC since 1998, Peru could seek assistance from APEC working groups and participate in the assistance programme developed by APEC for small and medium-sized enterprises. 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 it.

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