Peru's Tourism Cluster

Microeconomics of Competitiveness – Group Assignment

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Executive Summary

In this paper, we examine Peru's competitiveness, both at the national and tourism cluster levels. We draw on several data sources, including global comparative studies, academic literature and detailed Peruvian reports. We supplement this with over 15 expert interviews, including the Vice Ministers of Commerce and Tourism, the Director of the Peruvian National Tourism Observatory and the President of the Hotel's Association.

At the national level, we show that Peru is heavily reliant on endowment-based clusters, and that its recent impressive growth has been driven by mining with disproportionally little benefit for Peruvians. We find strong macroeconomic policies but weaker social infrastructure. In the national business environment, we highlight strengths in the context for firm strategy and rivalry but significant weaknesses in other areas. Our overarching proposal is for Peru to diversify its export basket, which we recommend it does by (i) promoting cluster development (ii) investing in health and education (iii) tackling corruption and (iv) securing a fair revenue stream from mining companies.

For the tourism cluster, we find that Peru has posted impressive recent growth in both number of tourists and revenues, but that this is growth from a very low base. We find that Peru has a wealth of high-quality natural and cultural endowments, but that the cluster is overly reliant on a single site and type of tourist. We identify significant potential related to the gastronomic boom in the related food cluster, but note critical weaknesses in transport infrastructure and institutions for collaboration. Our strategy for tourism is to diversify away from Machu Picchu and attract both more and higher value-add tourists by (i) initiating a national tourism strategy (ii) developing new tourism products (iii) upgrading the transport infrastructure and (iv) strengthening the institutions for collaboration.

I. Peru – Country Analysis

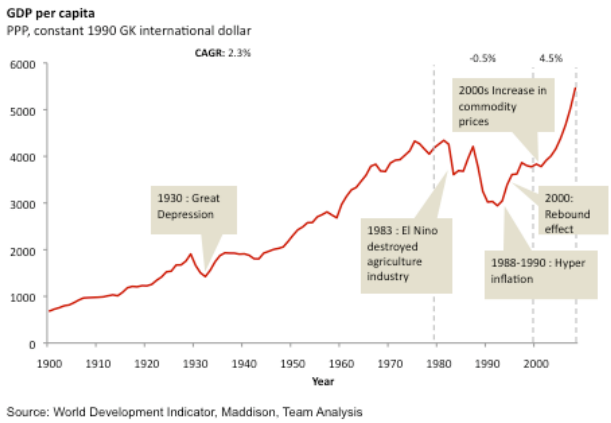
Peru is a Spanish speaking South American country with a population of 29.8 million[1] and a GDP per capita of $8,722[2]. It has 3,362 kilometers of Pacific coastline[3], and shares borders with Ecuador, Colombia, Brazil, Bolivia, and Chile.

1. Overall Economic Performance

1.1. Economic History

With GDP growing at a rate of 9.2%, Peru was the fastest growing country in Latin America and the 14th fastest growing country in the world in 2008[4]. In 2009, Peru continued to show impressive results, posting 1% growth while most countries faced shrinking economies[5].

Figure 1 – GDP per capita



This impressive growth follows almost two decades of lost progress. Like many Latin American countries, Peru experienced a disruptive military rule during the middle of the century and then a period of damaging import substitution policies in the eighties. In 1983, Peru was adversely affected by the El Nino weather phenomenon, which caused flooding in some areas and droughts in others. Following this episode, commodity prices dropped to their lowest levels since the Great Depression and the terrorist groups - Shining Path and Tupac

[1] INEI. Perú: Población estimada y proyectada, según departamentos, 1990 - 2015.
[2] PPP adjusted figure taken from IMF. 2009. 2009 World Economic Outlook
[3] INEI. http://www.inei.gob.pe
[4] CIA Factbook. http://www.cia.gov/library/publications/the-world-factbook/geos/pe.html
[5] ibid

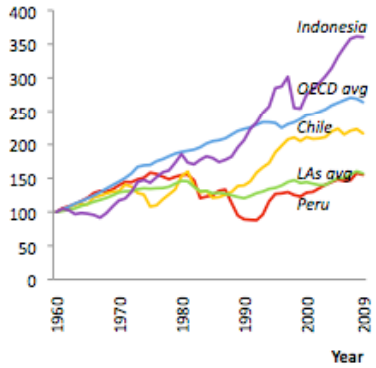
Amaru Revolutionary Movement - gained prominence, in part funded by narco-traffickers who had gained a stronghold in the Andean region[6].

The nineties were significantly better under the authoritarian administration of Alberto Fujimori. Fujimori opened the country to foreign investment by reducing the average MFN tariffs from 16.0% to 13.6% between 1993 and 1999, causing FDI to increase 5-fold between 1993 and 2000 (EIU 2008, WTO 2000). Fujimori also succeeded in dismantling the Shining Path, though using repressive and violence means to do so (WTO 2000). Moreover, his corrupt government stole almost $600 million while in power (Transparency International, 2004).

Figure 2 – Labor Productivity Trends

Index of GDP per Person Employed (1960=100)

Period	60-70	70-80	80-90	90-00	00-09
CAGR (%)	3.39	1.04	-5.36	3.74	2.09



Source: The Conference Board Total Economy Database, January 2010, http://www.conference-board.org/economics/database.cfm

Moving from GDP/capita to one of its key determinants, labor productivity levels ($22,800 per person employed) are currently in line with other countries of Peru's income level[7], though there has been poor growth in recent decades, consistent with the average trend in Latin America. This lackluster growth in productivity pales in comparison with countries like Indonesia, which is a leading exporter of copper, much like Peru.

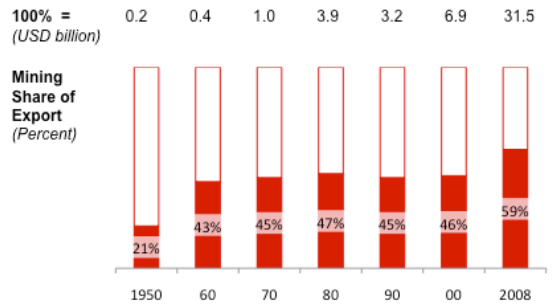
1.2. Recent growth: the importance and consequences of mining in Peru

The political stability of the 2000s and rising commodity prices have jointly contributed to significant growth of GDP in Peru. In particular, this growth has been driven by the

[6] United State Department of State. http://www.state.gov/r/pa/ei/bgn/35762.htm
[7] PPP adjusted figure taken from The Conference Board Total Economy Database, January 2010, http://www.conference-board.org/economics/database.cfm

mining sector, which has grown from $0.2 billion to over $31 billion in the past 60 years, and now represents 59% of exports[8].

Figure 3 – Mining as a share of exports



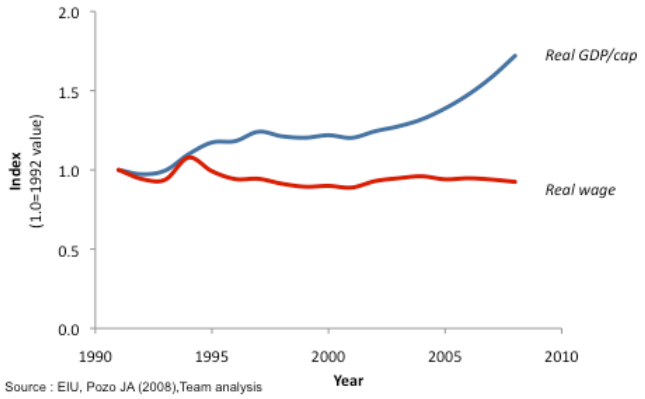
*Goods and services
Source: Gerencia Central de Estudios Economicos, Central Reserve Bank of Peru.

In 2006, mining companies accounted for over 50% of market capitalization of the Lima stock exchange (for a total of $30 billion) and were ranked highest for profitability[9]. The Central Reserve Bank of Peru predicts mining will dominate investment going forward, accounting for 58% of private investment over the next 3 years[10].

Unfortunately, this impressive mining-driven growth in GDP has not resulted in improved incomes for Peru's population, due to the highly capital-intensive nature of mining, which employs only 1% of the population while generating 6% of GDP[11].

Mining companies currently benefit from highly favorable contracts. These Legal Stability Agreements were awarded under the Fujimori administration and guarantee the stability of the legal framework in place at the time the investment was made, including labor, tax, and income policy (United Nations, 2000). As a

Figure 4 – GDP per capita and wages



Source : EIU, Pozo JA (2008),Team analysis

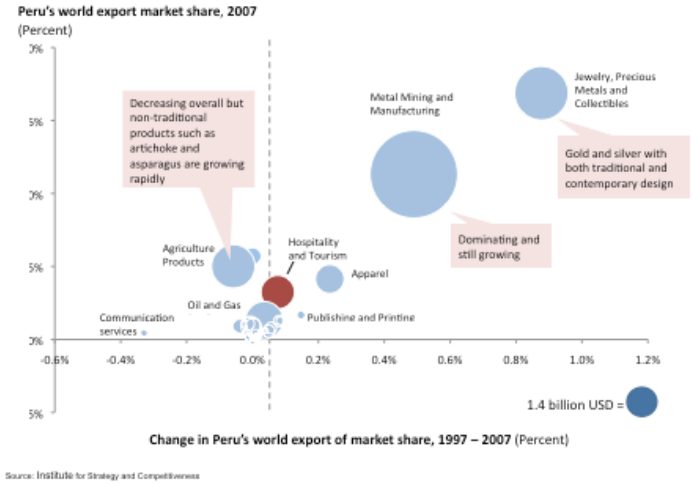
[8] Central Bank of Peru http://estadisticas.bcrp.gob.pe/
[9] Lima Stock Exchange. 2006. Informe Bursatil. http://www.bvl.com.pe/pubdif/infmen/M2006_04.pdf
[10] Central Bank of Peru http://estadisticas.bcrp.gob.pe/
[11] Central Reserve Bank of Peru. http://www.bcrp.gob.pe

result, 25 of the 27 top mining companies currently pay no royalties, even though current laws would require royalties of between 1-3% of revenues[12]. Had royalties been collected in the fiscal year 2006-7, Peru would have collected an additional $2.7 billion in taxes[13].

1.3. Composition of the Economy

More generally, the Peruvian economy has come to rely heavily on endowment-based industries such as mining, oil and gas, gold and silver jewelry, and agriculture. The largest of these industries are still growing, a good sign for Peru's economy. However, somewhat worrisome is the sparseness of the cluster map; there are few clusters and even fewer that qualify as high value-added. One promising cluster, tourism, we will discuss later. Another is the non-traditional sub-component of the agriculture cluster, a sector than has recently shown promising growth. Exports of asparagus and artichoke, which grew 33% and 19% in 2007, respectively, have received positive attention in the press and from donors for their inclusive supply chains (Shimizu, 2006)[14].

Figure 5 – Peru Cluster Map



Peru's reliance on endowments is not surprising given the abundance and high quality of these resources. Peru is the third largest country in Latin America and boasts three diverse climates –

[12] According to the Ministry of Energy and Mines as quoted in Salazar, Milagros. "Government Generosity Swells Mining Company Profits". IPS News Service 4 February 2009. http://ipsnews.net/news.asp?idnews=41061

[13] Ibid

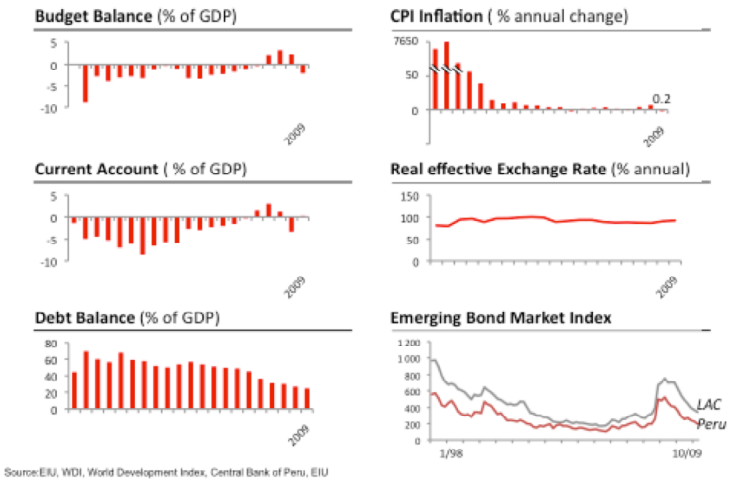
[14] PROMPERU. 2008. Tendencias de la Agro-Exportacion. http://www.siicex.gob.pe/siicex/ resources/ sectoresproductivos/d92ddd0c-f3ae-4d16-b528- 7e046ef0a7b3.pdf

coastal, Amazon, and Andean highlands. This diversity in climates provides Peru with extreme biodiversity. As one of the world's 10 "mega diverse" countries Peru is first in the number of fish species; second in bird fauna; third in amphibians; and third in the number of mammals[15]. This abundance extends to the realm of minerals. Today, Peru is the leading producer of silver, second in copper, and third in bismuth, tin, and zinc[16].

2. Macroeconomic Factors

2.1. *Strong macroeconomic policy*[17]

Figure 6 – Macroeconomic Policy Results



The Peruvian government has pursued prudent fiscal and monetary policy. After a long period of hyperinflation, (from 1984 to 1990 when inflation surpassed 7000%) recent administrations have been able to bring inflation under control and maintain a stable real exchange rate. This monetary discipline has been mirrored by fiscal discipline. Peru was able to post a fiscal surplus over the past few years (e.g., 2.1% of GDP in 2008) and has halved its debt balance. In 2009, the budget went back into deficit (-1.9% of GDP), as the government engineered a fiscal expansion as part of a countercyclical policy response to the economic downturn. In general, global markets have recognized this discipline. Peru's

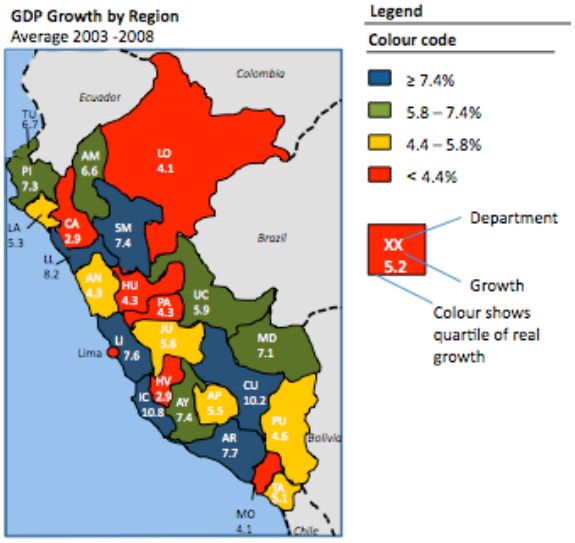
[15] The Earthday Network http://www.earthday.org/countries/peru
[16] CIA Factbook. https://www.cia.gov/library/publications/the-world-factbook/geos/pe.html
[17] Unless otherwise noted, this section draws on data provided by the statistics bureau of the Central Bank of Peru. http://estadisticas.bcrp.gob.pe/

emerging bond market index shows a smaller spread than the Latin American average and in 2008, Peru was awarded investment grade status by leading rating agencies[18].

2.2. Weak social infrastructure and political institutions

This fiscal restraint may have come at the cost of social policy priorities. Peru shows concerning education and health outcomes. While school attendance and years completed have increased[19], the quality of education is poor. Peru has the lowest Program for International Student Assessment (PISA) score for all Latin American countries, and the highest internal inequality of PISA scores (World Bank, 2007). In 2006, investment in education was only 2.5% of GDP, putting it 157th out of 182 countries[20]. Similarly, investment in health is troubling; at 4.3% of GDP, Peruvian investment health is the lowest in Latin America[21]. The World Health Organization ranks Peru's health system poorly, 129th out of 190 countries (World Health Organization, 2000).

Figure 7 – GDP Growth By Region



Source: Team analysis, INEI

Despite, strong economic growth, Peru continues to face significant poverty with 36% of the population under the poverty line in 2008[22]. Some progress against poverty has been made since, in 2003, 52% of Peruvians lived under the poverty line. Similarly, extreme poverty has been reduced from 21%

[18] http://www.reuters.com/article/idUSN0246026220080403
[19] Team Analysis of ENAHO Household survey 2008, e.g, today's 6-15 year olds will receive over eleven years of education compared to just seven years, the level attained by today's 56-65 year olds.
[20] CIA Factbook. http://www.cia.gov/library/publications/the-world-factbook/geos/pe.html
[21] WHO 2006 numbers. http://www.who.int/countries/per/en/
[22] INEI. 2009. La Pobreza en Peru en el 2008.

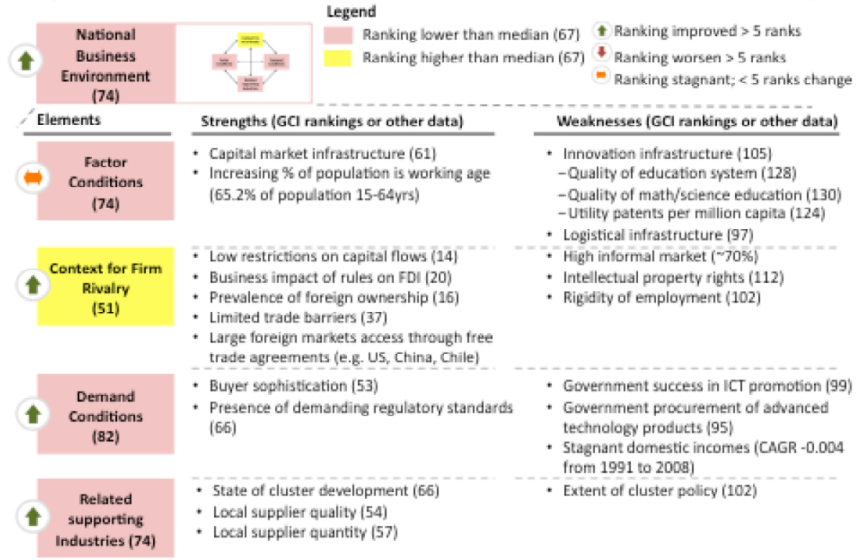
in 2003 to 14% in 2008. However, most of this improvement has been concentrated in Cusco, Lima and other coastal areas, giving rise to severe geographic inequalities and contributing to a Gini coefficient increase from 46.2 in 1996 to 52.0 in 2008[23].

Corruption has also been a problem in Peru. In 2009, Peru ranked 75 out of 180 countries on Transparency International's Corruption Perceptions Index, far behind Chile, which came in at 25[24]. As recently as 2009, the Minister of the Interior was accused of negotiating an overvalued contract for police cars in which two million dollars may have been embezzled. Similar scandals have erupted over Chinese army tanks, ambulances, a handful of infrastructure contracts, and the national oil company, Perupetro.

3. National Business Environment

With these macro foundations we come to Peru's national business environment, which shows particular strengths in the context for firm rivalry but significant weaknesses in the other major categories.

Figure 8 – National Business Environment, Diamond Summary



3.1. Factor Conditions[25]

Peru will soon benefit from a "demographic window of opportunity". Over the next few generations, as today's 10-14 year olds become adults, the

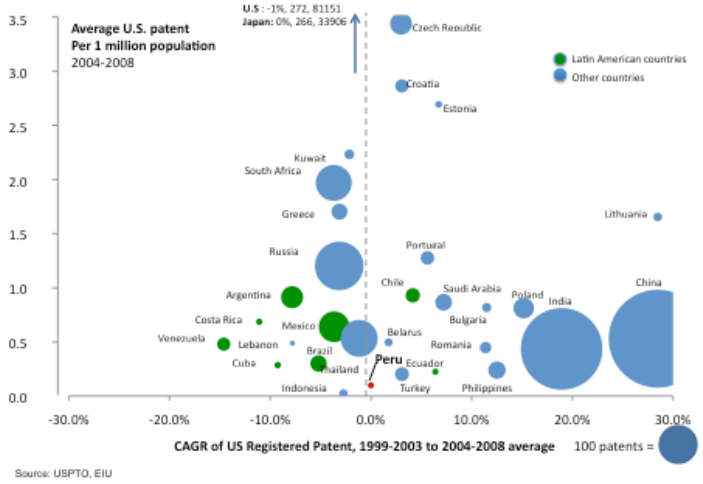
[23] World Bank. World Development Indicators. http://data.worldbank.org/
[24] Transparency International http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table
[25] Unless otherwise noted, this section draws on Team Analysis of ENAHO Household survey 2008

proportion of working-age Peruvians will grow as the burden of dependent generations (elderly and youth) shrink, thus boosting the productive potential of the economy. Furthermore, labor force participation rates have been improving, reaching almost 75% in 2008.

However, innovation infrastructure is a clear weakness for Peru, ranked 105 out of 133 countries on the Global Competiveness Index (GCI). This results in a poor patent output as shown in the figure below. Underlying this poor performance is the poor overall education, particularly in math and science, ranked 130th in GCI.

A further issue for Peru is that bulk of the population works in the informal sector. Share of informal employment in the economy has been steady at around 70.1% since 1997, thus excluding many Peruvians from strong formal sector growth.

Figure 9 – Innovation outputs, global comparison

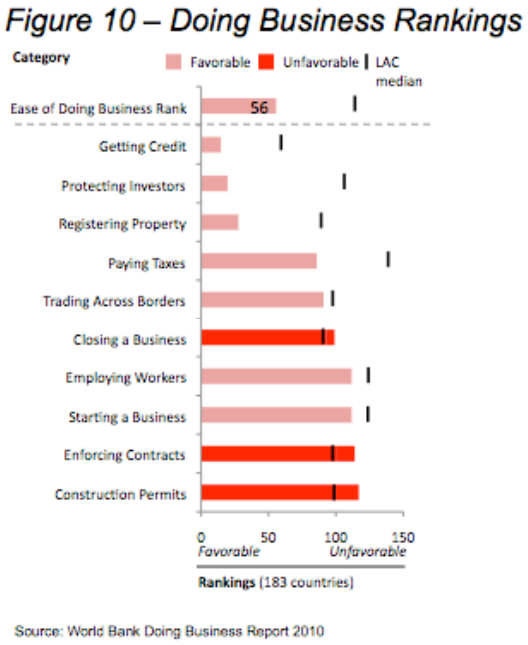


3.2. Context for Firm Strategy and Rivalry

Peru performs well on the Doing Business report, moving up 9 places from last year to receive an overall ranking of 56 out of 183 countries in 2010. While there are areas that need particular focus such as construction permits and closing businesses as shown in the figure below, only 4 countries conducted more reforms than Peru[26]. Recent reforms include

[26] World Bank Doing Business Report 2010. http://www.doingbusiness.org/features/Reformers2010.aspx

improvement in land titling, simpler labor regulation for small businesses, online services for enforcing contracts and filing taxes, and additional equipment at the ports to expedite transit times.



Moving to FDI, Peru ranks better than India, China, and Brazil in terms of FDI openness according to OECD[27] rankings, and also earns a high ranking of 20 on GCI for "business impact of rules on FDI" and 14 for "openness to capital flows". Foreigners can invest in Peru under the same terms as domestic investors with very few exceptions (restrictions only apply near the border). They are able to remit profits and dividends without limit, and have the right to use the most favorable exchange rate on the market (United Nations, 2000). As a result, the prevalence of foreign ownership in Peru is high, ranking 16 in the world according to the GCI.

In addition, Peru has initiated a number of trade reforms. Peru has free trade agreements with MERCOSUR members, Chile, US, Canada, Singapore, Thailand and China, and is seeking deals with South Korea, EFTA, Mexico, Australia, New Zealand, and the EU[28]. MFN tariffs have dropped even further, from 13% under Fujimori to 8.2% in 2007[29]. In 2008, the government created a single window for foreign trade paperwork. In addition, Peru has nine industrial and commercial free trade zones.

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[27] OECD (2006)." OECD's FDI Regulatory Restrictiveness Index: Revision And Extension To More Economies". http://www.oecd.org/dataoecd/4/36/37818075.pdf
[28] Economist Intelligence Unit. 2008. Peru: Country Profile.
[29] Ibid

However, both Doing Business and the World Competitiveness reports find that labor regulations are a significant weakness in the business environment. In the Doing Business report, Peru's worst ranking is in the "Employing workers" category where Peru comes in at 149 out of 181 countries[30]. The GCI also identifies labor rigidity as a problem, ranking Peru 102 out of 133 countries. However, our research shows that the labor market is actually quite competitive. Labor cost per hour is not unusual given Peru's GDP and is lower than countries with similar productivity levels such as Brazil and Colombia[31]. Furthermore, firing costs and social security costs are both extremely low given Peru's GDP per capita levels[32]. Overall, it seems that Peru's labor market is quite unrestricted.

3.3. Related and Supporting Industries

Though Peru appears to performing relatively well on both quantity and quality of suppliers, it has a clear weakness in the extent of cluster policy, ranked 103th. This is in part due to the poor resourcing and lack of coordinating power of Peru's institutions for collaboration (IFCs). Peru Compite, the National Competitiveness Council, is staffed by only six people and has an annual budget of only US$ 0.3 million (Tello, Mario De et al, 2010). . Furthermore, cluster development initiatives have, until now, been a subset of SME policy, rather than a stand-alone initiative (Tello, Mario De et al, 2010). As such, cluster strategy has only been applied to sectors dominated by small and medium enterprises, rather than the fast-growth sectors such as agribusiness and tourism, which are dominated by larger firms. Ultimately, firms rate Peru's handful of IFCs as only acceptable, rating them 3 on a

[30] Doing Business Report. http://www.doingbusiness.org/ExploreEconomies/?economyid=152
[31] Team analysis of EIU Database 2008
[32] Team analysis of EIU Database 2008, and Heckman and Pages 2003

scale of 5 (Tello, Mario De et al, 2010). GCI rankings have recognized these weaknesses, ranking Peru only 65 for the extent of cluster development.

3.4. Demand Conditions

Even though tax revenues as a percentage of GDP reached only 13.8% in 2009[33], many government institutions do not have the capacity to use these limited resources. For instance, in 2008, local governments used only 55% of resources budgeted for investment[34]. Government does not act as sophisticated buyer with "government procurement of advanced technology products" and "success in ICT promotion" ranking very poorly, 95 and 99 respectively on GCI.

Demand conditions among the population are improving, but are unremarkable. Wages have been stagnant for over a decade. Private consumption has grown 7% annually in the past five years but primarily in consumption credit and expenditures in retail stores. This improvement is also evident in the GCI rankings in which Peru ranks 45 out of 74 countries for improving demand sophistication as a result of an emerging middle class. According to Peruvian Association of Market Research Firms, the middle class in Lima grew from 14.0% to 16.5% between 2003 and 2009 (as % of total socioeconomic levels)[35].

4. National Recommendations

While Peru has shown impressive growth, to best take advantage of this growth and to sustain it going forward, Peru needs to diversify its export basket, and reduce its reliance on mining. The country's growth is currently largely determined by commodity prices, and

[33] Central Reserve Bank of Peru. www.bcrp.gob.pe
[34] Gobiernos Locales con baja ejecucion presupuestal in El Comercio, May 2009. http://elcomercio.pe/impresa/notas/gobiernos-locales-baja-ejecucion-presupuestal/20090511/284993
[35] "El 16.5% de los Limenos ya es de clase media" Givonio, Sonia. February 2010, Gestion. http://gestion.pe/noticia/413012/165-limenos-ya-clase-media

is thus at the whim of external, and often volatile factors. Furthermore, the highly capital-intensive nature and low tax revenue generated by this sector results in limited employment or financial benefit from mining for Peruvians. The government is facing decreasing approval rates and a surge in riots in the face of rising domestic inequality and limited wage growth, so a timely response is needed.

While strong endowments have been a strong base for growth, Peru needs to expand its national value proposition to other arenas. With a strong financial sector, political stability, and growing neighbors (Colombia, Brazil and Chile), Peru has the opportunity to develop new clusters that are less reliant on commodities. In general, the government must find a way to move Peru from a factor-driven to investment-driven economy. We outline four main recommendations for the Peruvian government, private sector, and civil society organizations to pursue with this goal in mind.

4.1. Promote cluster development through a restructured Peru Compite

Peru should apply the cluster development framework as an overarching national policy initiative, rather than embed it as a subset of SME development, which limits the scope of potential opportunities. Peru Compite would take the lead coordinating role and would be tasked with identifying emerging clusters with some demonstrated level of competitiveness, for upgrading. Peru Compite would facilitate dialogue between key private and public actors to identify initiatives for the government to adopt or to support the development of the clusters.

The government must significantly increase financial and human resources to ensure Peru Compite has sufficient capacity and capability to meaningfully play this role. To accomplish this task, Peru Compite has to engage with the private sector and decentralize

the scope of discussion and policy initiatives to reach outside Lima. Creating Regional Competitiveness Councils would also prove useful in achieving this goal.

4.2. Invest in health and education

Peru's ability to compete and develop new clusters will continue to be hampered while it suffers from poor health and educational outcomes. The government must set the improvement of these outcomes as a top priority; this has not been the case in the past.

On education, the key is to move orientation from a focus on quantity, which has been largely achieved, to one of quality. This will require clarification of standards and accreditation mechanisms and stringent implementation of accountability and monitoring mechanisms by the Ministry of Education and relevant civil society institutions. This can be achieved by creating a harmonized teacher education system, ongoing training programs for teachers, and by creating a national system to evaluate and accredit educative quality[36].

On health, the main need is to significantly increase spending. We recommend doubling spending to match Latin American averages (Poullier et al, 2002). The Ministry of Health will need to identify priority investments to ensure that the increased spending can be efficiently absorbed and effectively deployed to improve the concerning health indicators. In particular, the government should allocate efforts in improving universal coverage and development of human resources for the health sector[37].

4.3. Tackle corruption

As Peru looks to diversify away from mining, develop new Peruvian enterprises, and attract new players to the country, the government must invest in improving its credibility as a legitimate, non rent-seeking partner.

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[36] Consejo Nacional de la Educacion. 2006. Proyecto Educativo al 2021.
[37] Francke et al. 2006. Salud en el Peru: Diagnostico y Propuestas para el Periodo 2006-2011.

To tackle corruption, the government should streamline its processes and revise regulations. Moreover, the government should develop e-government processes, clarify procurement standards, and increase transparency in government procurement. Finally, the government, private sector, and civil society institutions should request accountability and progress reports on the implementation of the National Plan against Corruption.

4.4. Secure a fair, competitive revenue stream from the mining companies

The recommendations above all require significant funding. While the government may be able to reprioritize other activities or deploy funding that might otherwise have formed a fiscal surplus, we believe that it is essential to secure revenues from the mining companies. They currently enjoy contracts that, due to legacy agreements, are significantly beyond what is necessary for international competitiveness. For example, mining companies pay between 4-5% of royalties in Chile, totaling $24.8 billion in taxes over the past five years[38]. The government should at least charge what the legal royalty requirements stipulate, which would generate an estimated 10% increase in budget[39]. If a negotiation impasse is reached, and government continues to be unable to secure direct taxes in a timely fashion, one creative option would be for the mining companies to directly fund Peru Compite activities, but with no membership on the board. This may provide them with a face saving opportunity on the tax front, whilst allowing the government to pursue its aims.

[38] Bloomberg News http://www.bloomberg.com/apps/news?pid=20601086&sid=afTImVbrHf6E
[39] Estimated $2.7 billion increases in revenues from 1-3% royalties, on an estimated budget of $26billion in 2007

II. Tourism - Cluster Analysis

The World Tourism Organization defines tourism as "travel and stay in places outside a person's usual environment for more than twenty-four hours and not more than one consecutive year for leisure, business and other purposes not related to the exercise of an activity remunerated from within the place visited."[40]

Tourism can be of several types. The Peruvian government has identified the most important ones to be: urban (cities), cultural (archeological sites, museums, etc.), nature (natural reserves, etc.), community, adventure, and beach tourism[41]. In this section, our discussion will center on international tourism, across all the above types, as it can be defined as an export and is more scalable than domestic tourism.

1. The rise of tourism

1.1. Global trends[42]

In 1950, there were only 25 million international tourist arrivals[43] worldwide compared to 922 million in 2008. This represents an average annual growth rate of 6.5%, making tourism now one of the largest and fastest growing economic sectors worldwide. The travel and tourism sector now accounts for 9.9% of global GDP, 10.9% of exports, 9.4% of investment[44] and 30% of commercial service exports. The share of arrivals received by developing countries has risen from 31% in 1990 to 45% in 2008. These statistics show the potential of international tourism to contribute to economic growth.

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[40] World Tourism Organization. 1995. Collection of Tourism Expenditure Statistics.
[41] PROMPERU. 2007. Perfil del turista extranjero.
[42] All figures taken from UNWO 2009 "Toursim Highlights" unless otherwise stated
[43] UNWTO "Historical Perspective of World Tourism", http://unwto.org/facts/menu.html
[44] WTTC, figures include estimates of T&T sector direct and indirect activities

1.2. History of Peruvian tourism

As the only seat of the ancient Incan empire, Peru is unique. In 1983, Machu Picchu and city of Cusco were declared World Heritage sites by UNESCO. An additional five sites were added in the eighties, two in the nineties, and two more this decade, bringing the total to eleven[45]. This places Peru in the top 20 countries globally, and third in Latin America behind Mexico (29) and Brazil (17).

In 1988, five years after the initial World Heritage Site declaration, Peru still received less than 200,000 tourists a year[46]. A key turning point occurred in 1992, when Abimael Guzman, leader of the Shining Path was captured. The disintegration of the terrorist organization led to increased safety and stability in the country, enabling an increase in tourism. The government created the Commission for the Promotion of Peru, PROMPERU, in 1996 and declared 1997 as the year of 600,000 tourists[47], acknowledging for the first time that tourism should be a priority. In 1999, the Vice Ministry of Tourism was created, and the National Strategic Tourism Plan was created in 2004. In 2007, in the associated food cluster, the National Gastronomic Association (APEGA) was created. In the same year Machu Picchu was declared one of the 7 new wonders of the world.

2. Tourism Economic Performance

2.1. Growth and current performance

The Peruvian tourism industry has grown at striking rates as the economy has stabilized and public safety has increased. Since 2004, tourism arrivals have grown 12% annually, over 3 times as fast as average growth rates in the world (UNWTO, 2009).

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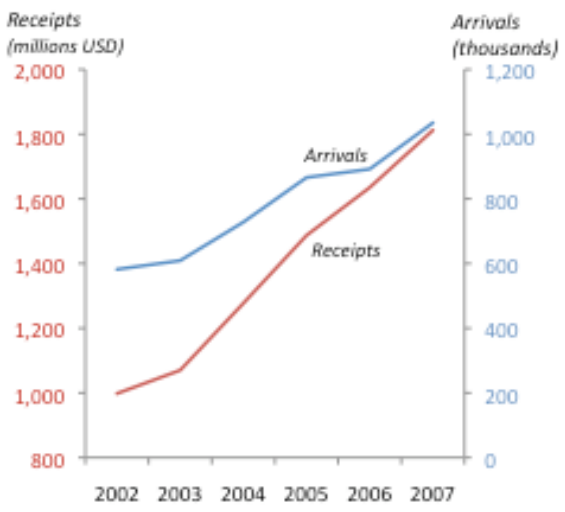
[45] UNESCO website http://whc.unesco.org/en/statesparties/pe
[46] Observatorio Turístico del Perú, http://www.observatorioturisticodelperu.com/badatur.php?pa=peru&id=datecoperu
[47] Target missed by 1 year – 576K in 1997, 616K in 1998

Figure A – Peru Growth Trends



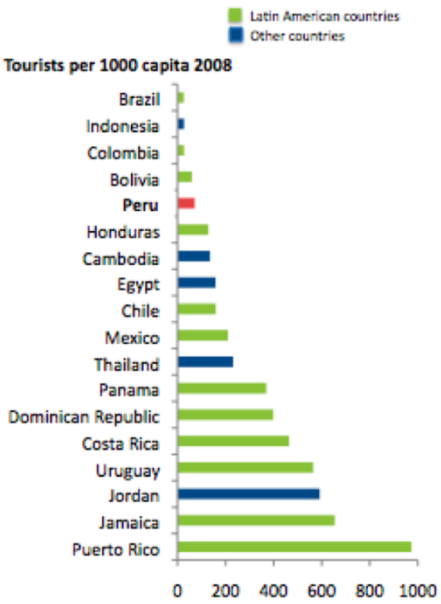
Source: PromPeru, UNWTO

Figure B –Growth Comparison

Source: PromPeru, UNWTO

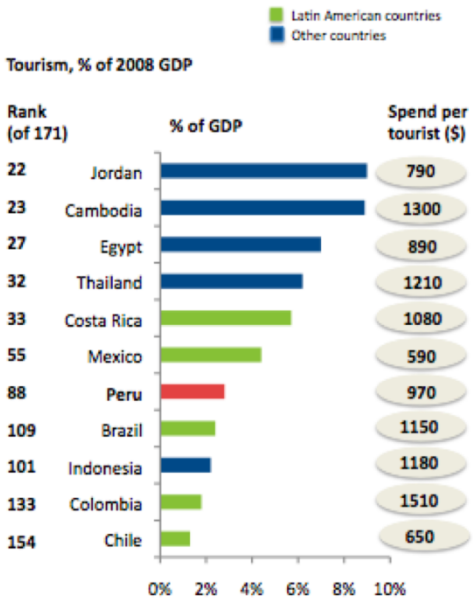
The story regarding total receipts (spending by tourists) is similarly advantageous. While this growth is impressive, it has been high on a low base level. As figure C shows, Peru receives only 71 tourists per 1000 capita, which is low relative to other Latin

Figure C – Number of Tourists



Source: UNWTO, IMG Population Statistics

Figure D – Contribution of Tourism



Source: UNWTO, IMG Population Statistics

American countries and also to other countries such as Cambodia, Egypt, Thailand and Jordan that are competitors for Peru[48] and help set a benchmark for desirable outcomes.

As Peru has Machu Picchu and the city of Cusco, these selected countries also have unique historical and cultural endowments, such as the pyramids in Egypt, Angkor Wat in Cambodia and Petra in Jordan. However, these countries have managed to build tourism into a more important part of their economy, representing 6-9% of GDP, compared to only 3% of GDP in Peru (WEF, 2009).

2.2. The importance and limitations of Machu Picchu

Part of the explanation of Peru's limited volume of tourism is that the country relies on the single major attraction of Machu Picchu, which dominates the sector. Tourists currently do not explore the rest of the country. Instead they fly into Lima, make their way to Cusco, visit Machu Picchu and then leave. Tourists are concentrated in these few areas: 73% of international tourists enter Lima, primarily in transit or on business, and 40% visit Cusco and Machu Picchu[49]. Only 20% of international tourists go on to visit the next most popular sites, Arequipa and Lake Titicaca.

Moreover, the number of tourists that Machu Picchu can absorb is limited by the need to preserve the site. Currently, the daily cap on tourists allowed into the sanctuary is 2,000 people. Machu Picchu is effectively saturated as a tourist destination and cannot be relied upon as a future source of growth for the cluster.

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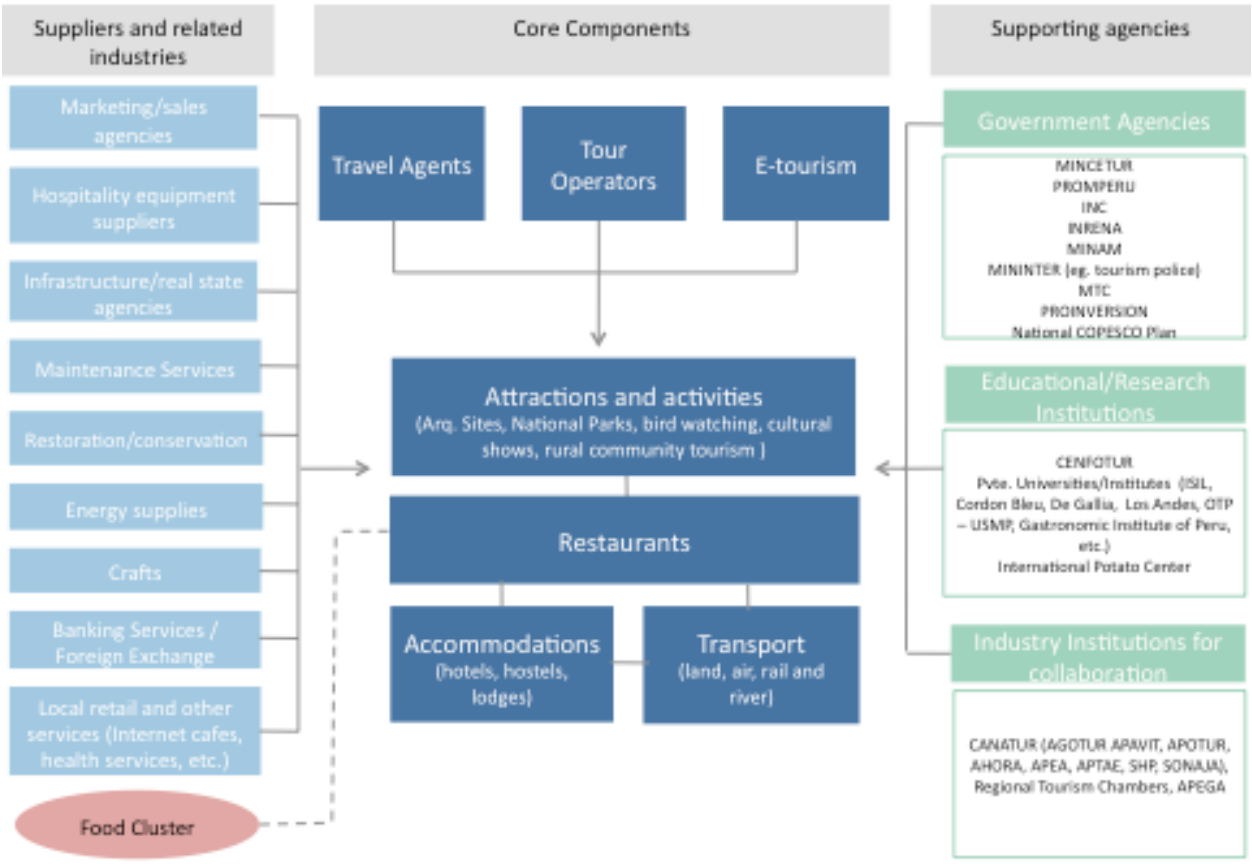
[48] In terms of attractions, and distance from the country of origin where largest share of tourists come from. Source: MINCETUR. 2008. Plan Nacional de Turismo.

[49] PROMPERU. 2007. Perfil del Turista Extranjero. http://www.peru.info/s_ftoPublicaciones.asp?HidAccion=Grupo&HidId=2&ic=1&SubTipo_ZP=1

3. Tourism Cluster

Peru has developed a fairly robust tourism cluster, which is displayed below:

Figure E – The Peruvian Tourism Cluster



At the center of the map are the key elements of the cluster: the attractions and activities, restaurants, accommodations, and lastly, transport. We have already discussed Peru's strengths in terms of cultural attractions. These are augmented by activities such as hiking and trekking in the Amazon, community development tourism in Lake Titicaca, and wildlife tourism in the mountains.

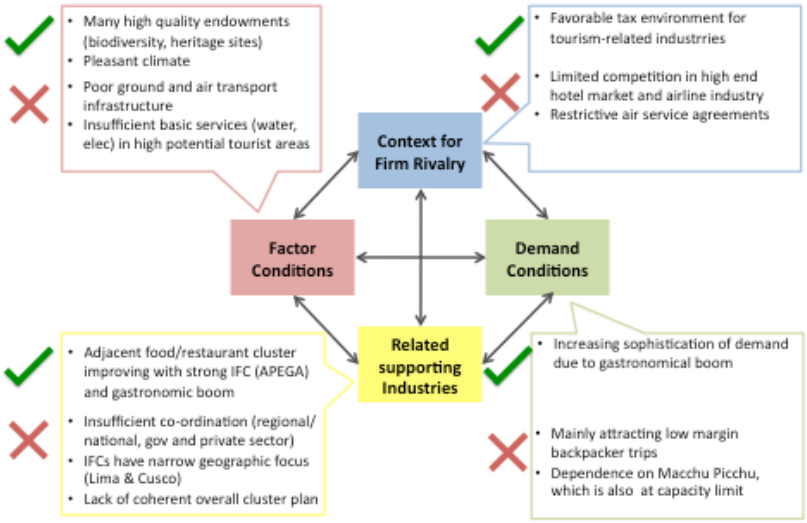
Also of note is the restaurant sector, which is the link to the associated food cluster, an increasingly important sector in Peru that will be discussed later in this document. We will also return to the issue of transportation in the following section.

On the left hand side of the cluster map are the related and supported industries for the tourism cluster which range from hospitality services and suppliers, to artisan and handicrafts, to conservation and preservation services to maintain historical and natural sites. On the right hand side are the supporting government agencies. It is clear that there are plenty of these agencies, though their efficacy could be improved, as we will discuss.

4. Tourism Business Environment

Peru's tourism cluster is extremely promising, but has yet to perform to potential. At the core of the cluster are rich historical and cultural endowments, which serve as a key driver for tourism. Beyond these endowments, Peru also has the benefit of a vibrant culinary cluster, which is showing promising growth. However, critical issues remain across all components of the diamond, including poor transport infrastructure, weak IFCs, limited competition, and the lack of diversification away from Machu Picchu.

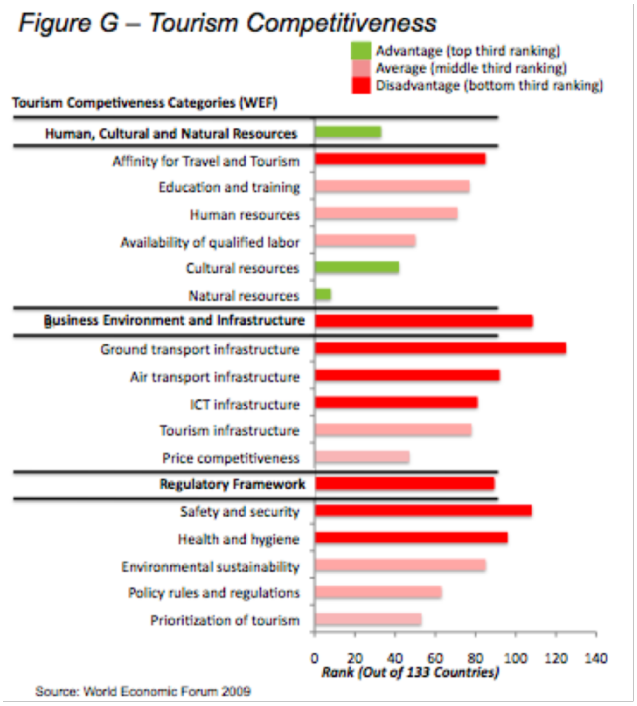
Figure F – Tourism Cluster Diamond



4.1. Factor Conditions

The Incan ruins and the biodiversity provide a strong base from which to attract tourists. As the Tourism Competitiveness ratings (WEF 2009) further illustrate in figure G

below, Peru has a strong competitive advantage here, particularly on natural resources where it ranks 8th globally.



However, for tourism to thrive, a robust transport infrastructure is needed in addition to the attractions. Peru does not perform well here as illustrated by very poor rankings on ground transport and air transport infrastructure. On ground transport, there are *quantity* issues in terms of road density which is ranked 114th out of 133 countries. One may argue that this metric is less relevant for a country with large areas of mountainous and jungle regions. However more worrying is the poor *quality* of the existing infrastructure. The road quality is ranked 99th and the overall quality of ground transport network, which reflects the country's inability to offer efficient, accessible transportation to key business and tourist attractions, is ranked 120th. This is likely a result of low investment; public investment in infrastructure is less that 1% of GDP compared to over 3% in Colombia and Bolivia[50].

On air transport infrastructure the picture is more complex. Peru does well in terms of the carrying capacity of its airlines, with a competitive advantage in available seat kilometers (ranked 33rd domestic and 47th internationally according to WEF 2009). Lima's Jorge Chavez airport recently retained its position as the best airport in South America in

[50] Drees-gros (2006), "Infraestructura para el Peru de manana" using data from Easterly and Serven (2003).

Skytrax 2010 World Airport Awards. This airport is operated under a thirty-year concession by a German consortium. Under this concession, the firm will build a second runway, construct a new terminal complex, expand the retail strategy, and develop new air cargo facilities.

However moving beyond this airport, the *quality* of airport transport infrastructure is low, ranked 94th by the World Economic Forum. Furthermore, for the size of the country, Peru has few airports, leading to a ranking of 73rd on airport density, putting it behind its neighbors Ecuador, Chile, Colombia and Bolivia. Peru also does particularly poorly in terms of international air transport network, ranked 90th, primarily due to restrictive Air Service Agreements as discussed next.

4.2. Firm Rivalry

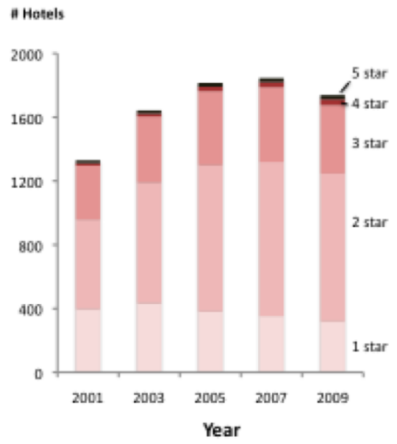
Restrictive Air Service Agreements mean that the number, size, and prices of flights in and out of Peru are subject to review by the government. Experts found that only one of Peru's air service agreements would qualify as truly "open skies", that with the US (Intervistas-EU, 2009). In 2004, Peru withdrew from an open skies agreement with Chile, the second largest origin/destination country from Peru (Intervistas-EU, 2009). Forecasts say that liberalizing the Air Service Agreements would increase international traffic to Peru by 2.2 million passengers, an increase of 56% from 2007 numbers (Intervistas-EU, 2009). The same report found that, for passengers, fares would decline by 35% if both market access and ownership restrictions were relaxed (Intervistas-EU, 2009).

The airline industry is restricted much like the air infrastructure sector. For example, Peru restricts foreign ownership and control in air carriers to 49% (Intervistas-EU, 2009). As a result, Lan Peru, a subsidiary of Lan Chile, serviced 80% of local flights in 2010. Star

Peru, another local firm, reached 12% of domestic flights but most small airlines have very limited participation and many have gone bankrupt[51].

The limited competition in the airline industry is mirrored by lack of competition in the high-end hotel market. Though the number of hotels has increased, occupancy rates for hotel rooms remain high relative to other tourist destinations. This suggests a higher than average profit margin, especially when combined with the insight from our interviews that high-end hotel rooms tended to be overpriced[52]. In a competitive market we would expect this apparent profitability to attract entry, resulting in a reduction in occupancy and prices to more competitive levels. However, we might be observing a time lag, as newspapers are noting the appearance and construction of several new five star hotels in Peru, including three by the Starwood Group[53]. These statistics should be monitored going forward to see if they move to levels that suggest there is a competitive environment without significant barriers to entry.

Figure H –Hotel Growth



(*) Big hotels, 2007.
Source: HVS 2009, Mincetur

Figure I –Upscale Hotel Occupancy

Source: HVS 2009, Hotel Associations of Greater Montreal, Thai Hotels association, Cushman and Wakefield Research Publication, midpoints taken when range given, Mincetur, "Hotels Hot in Peru" by Sophie Kevany (Dow Jones)

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[51] America Economica *http://www.americaeconomia.com/notas/peru-debate-sobre-una-competencia-para-la-aerolinea-chilena-lan*

[52] Interview with Diego Comin (HBS) after his work studying tourism in Peru, supplemented by Daniel Alfaro's (head of PENTUR) view of industry consolidation leading to lack of competition

[53] NASDAQ http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201003221725dowjonesdjonline000394&title=hotels-hot-in-peru-as-new-developments-drive-boom

Though competitiveness in the airline and hotel industries appears limited, signs for the future seem promising. Awarding a concession for the airport was a good first step. The government has gone further, enacting a tax break to help boost the sector. As of 2001, the sales tax on tourism-related industries including hotels, tourist packages, and restaurants was eliminated[54].

4.3. Related and supporting industries

As in the national business environment, the institutions for collaboration in the tourism cluster are quite weak. There are three main government bodies influencing the tourism cluster development. PROMPERU, the Peruvian Promotion Agency, has centered its efforts in promoting Machu Picchu as the main destination in Peru. CENFOTUR, the educational institution for tourism, is supposed to be decentralized; however, as most of the tourism institutions, its presence is concentrated in Lima and Cusco. Finally, PROINVERSION, the investment promotion agency, has allocated more efforts to attract investments in mining and infrastructure, while investment in the tourism sector has not been a priority.

The main private sector IFCs are CANATUR, the regional chambers of tourism, and APEGA. CANATUR, the main industry group, is composed of nine of the most important national chambers, including hotels, airlines, and travel agencies associations. CANATUR is based in Lima, as is its scope of discussion. Although regional chambers exist, according to our interviews, they are poorly coordinated with the national chambers[55]. Moreover, Lima and Cusco dominate discussions and influence the cluster's initiatives.

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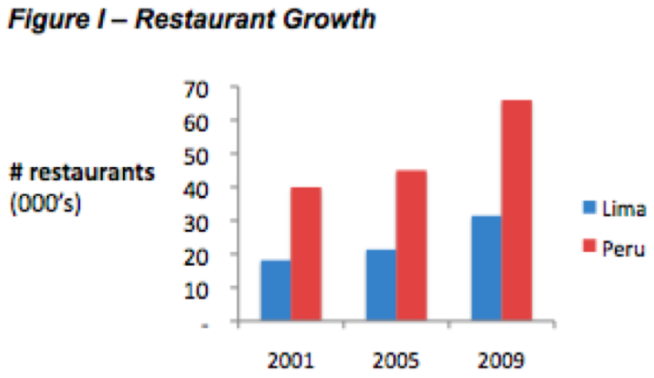
[54] Economist Intelligence Unit. 2008.Peru: Commerce Report.
[55] Henrique Urbano and Manuel Izaguirre. Observatorio Turistico del Peru. Interview held in March 2010.

Another IFC, APEGA (National Gastronomic Association) shows promise. Its leader, Gaston Acurio, is a leading restaurateur and has garnered broad public and private support for the organization. This brings us to the critical related food cluster, which is linked to the tourism cluster through the restaurant industry.



Peru is experiencing a gastronomic boom reflected by a near doubling of restaurants over the last ten years. The cuisine benefits from the biodiversity of the region and is one of the most diverse in the world with almost 500 typical dishes[56]. In 2009, Bon Appetite magazine called Peruvian cuisine "the next best thing in world cuisines". Chef Gaston Acurio has been at the forefront of the expansion of Peruvian restaurants and has open highly rated restaurants in San Francisco, Mexico City, and Colombia, making him the only Latin American chef to open an international chain of restaurants.

This boom has benefitted the tourism industry as well. 42% of tourists note that Peruvian cuisine was a factor in their decision to come to Peru[57]. Over 90% of tourists are highly satisfied with the food and would recommend it to their friends and relatives[58]. Even more directly, a number of tourists are coming only for the food. 5% of tourists describe themselves as "gastronomic" tourists. In Mexico and Spain these tourists make up

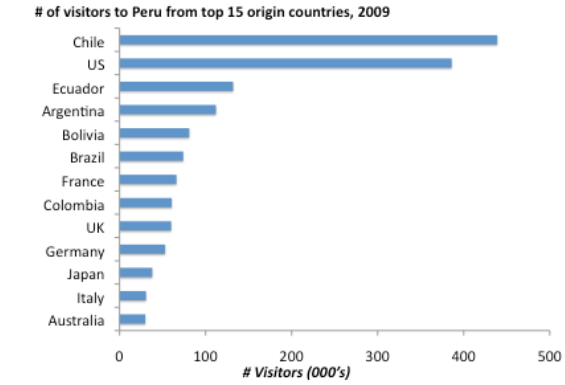
[56] Expat Peru, http://www.expatperu.com/peruvian-food.php
[57] PROMPERU. 2007. Perfil del Turista Extranjero.
http://www.peru.info/s_ftoPublicaciones.asp?HidAccion=Grupo&HidId=2&ic=1&SubTipo_ZP=1
[58] Ibid

8% and 10% of tourists respectively[59]. Travel agencies are now offering "gastronomic" tours of Peru. This industry could prove to be a real advantage for the tourism sector.

Demand Conditions

Peru currently appears to attract a predominately low-profit-margin backpacker segment. While tourists spend on average $970 per visit[60], this is spread over an 11-day trip on average[61]. 46% of tourists stay more than 2 weeks, and 26% stay more than 3 weeks[62]. Visitors to Peru tend to be less wealthy - 48% have an annual family income of less than $40,000. 52% stay in low-end accommodations (1-2 star or camping)[63]. An additional part of the explanation of low or low-margin spend is seen in the country of origin of tourists. Currently, Peru receives the vast majority of its international tourists from Latin American countries. While the US is the second largest sender, the other top five sending countries are all neighbors.

Figure J – Origin countries of visitors to Peru



Source: Observatorio Turístico del Perú

Peru is unable to attract significant numbers of tourists from more distant countries because Peru is undersold. To start, despite all the many issues that have been mentioned throughout this document,

[59] Secretaria de Turismo de Mexico. 2008. Perfil y Grado de Satisfaccion del Turista. http://www.sectur.gob.mx/wb/sectur/sect_perfil_y_grado_de_satisfaccion_de_los_turista, Instituto de Turismo de Espana. 2008. El Turismo Espanol en cifras. http://www.iet.tourspain.es/paginas/Publicaciones/FichasPSel.aspx?clase=12&option=public&idioma=es-ES

[60] World Travel and Tourism Council. http://www.wttc.org/eng/Tourism_Research/

[61] Ibid

[62] PROMPERU. 2007. Perfil del Turista Extranjero. http://www.peru.info/s_ftoPublicaciones.asp?HidAccion=Grupo&HidId=2&ic=1&SubTipo_ZP=1

[63] Ibid

the satisfaction levels of tourists are very high, reflected by the fact that 87% of visitors would recommend to others "without a doubt"[64]. Interviews also suggested that tourists are often "pleasantly surprised" by Peru, which suggests they had low expectations of the country[65]. The government launched a marketing campaign in 2008 using the slogan "Peru, Live the Legend", which replaced the previous "Pack your six senses, come to Peru". The new campaign was intended to target an audience of 510 million people across the US, Western Europe and the wealthier South American countries. However, advertising does not appear to be penetrating successfully, as evidenced by the lack of visibility of the campaign in the US, especially relative to Colombian and Chilean campaigns[66].

5. Cluster Recommendations

Peru needs to diversify its tourism offerings away from Cusco and Machu Picchu. It needs to attract more tourists and also move to higher value-add tourists, who will spend on higher margin activities. However, Peru should not lose its current tourist base, as they contribute to the economy and may return in later years when more wealthy and able to spend. To achieve this aim, we propose four specific recommendations.

5.1. Initiate a robust National Tourism Strategy

Given the potential of tourism, Peru must position this cluster's development as a national priority. It must develop a unique value proposition around its impressive cultural, natural and culinary strengths and a concrete national vision with specific targets (e.g. number of tourists, number of visitors to each site), timelines and intermediate milestones. The existing plans, which lack sufficient clarity and action steps (e.g., Tourism

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[64] MINCETUR. 2008. National Tourism Plan.
[65] Interview with Diego Comin (HBS) after his work studying tourism in Peru,
[66] Perceptions from interviewed Peruvians living in the U.S.

plan, COPESCO, CALTUR) need to be updated, revamped and if necessary, consolidated. We suggest that the Ministry and Trade and Tourism be held accountable for delivering the vision, but should be empowered to do so through allocating appropriate resources and decision-making power.

5.2. Develop and promote new tourism "products"

Peru needs to invest significantly in diversification of its tourism products. First, it must accelerate development of the other ruins and sites such as Kuelap to broaden the portfolio of tourism locations. Stronger ties and development of archeological training can be used as part of the drive in this area.

Second, in addition to *location development*, Peru must also focus on *thematic development.* The already-emerging gastronomic and ecotourism products should be supported. They both build on strong natural and historic endowments but will benefit from the development of specific infrastructure and training programs, which the government can support, bringing in the private sector where profit incentives are sufficient. Peru should also look beyond its geographic boundaries to co-ordinate cross-country initiatives such as Amazon adventures with Brazil and Colombia or Andean circuits with Bolivia and Ecuador to take advantage of and develop regional strengths.

However Peru should not assume that demand will grow sufficiently just by improving the supply of tourist products. PROMPERU should be tasked with promoting Peru as a diverse country with several destinations and activities in trade fairs, written media, and television. In addition to broad national campaigns, targeted messages for particular audiences should be developed (e.g. PROMPERU should delegate to APEGA to lead in marketing to international gastronomic audiences).

5.3. Upgrade transport infrastructure

The government should liberalize its air service agreements and allow market mechanisms to play a greater role in determining the number, size, and prices of flights. The government will also need to increase investment in regional airports, given the low airport density and our recommendation of developing new tourist sites and locations.

The government should accelerate relevant existing transport infrastructure projects by increasing the budget allocated to these initiatives and unlocking more of the budget for immediate deployment. However, focus should be applied to those projects that are critical to tourism. While the Ministries of Tourism and of Transport have taken first steps in coordination through the development of the COPESCO Infrastructure Plan, the government should strengthen this, and ensure adequate oversight, leadership and budget.

5.4.Strengthen IFCs

In order to support a diversification, the IFCs should decentralize the scope of discussions to prevent Lima and Cusco from dominating all initiatives. The government can encourage the existing IFCs to do this, or new IFCs to emerge, by sharing the new National Strategy, and earmarking funds that can be used for public good projects that align with the new plan. As part of the diversification the IFCs must focus on improve co-ordination between regional, national and local levels.

Currently, tourism's IFCs rely too heavily on government involvement and drive. Ownership must be shared with the private sector to secure necessary buy-in and ensure sustainability. While the government has successfully identified a few "champions" the base of private sector involvement should be broadened to include entrepreneurs from other regions and business lines e.g., travel agencies, Universities, training institutes.

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