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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Peru: Progress And Impact Of The Economic Reforms

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1970

INTELLIGENCE MEMORANDUM

Peru: Progress And Impact Of The Economic Reforms

Introduction

In the nearly two years since the Belaunde government was ousted, the long-term goals of Peru's military government have come into focus. The military cabinet headed by President Juan Velasco Alvarado has promulgated a series of "reforms" consistently expressing the themes of nationalism, accelerated long-term development, and greater economic and social equality. Although the reforms have enjoyed wide popularity, they also have inhibited general economic advance by alarming both foreign and domestic investors. So far, the self-styled revolutionary government has been able to concentrate on reform and financial stabilization without much concern for immediate economic growth. But continued stagnation would make it increasingly difficult to carry out reforms and might bring major changes in economic policy. This memorandum describes the nature and progress of the reforms and assesses short-term economic prospects.

Background

1. Although the scandal surrounding the Belaunde government's settlement of a dispute with the International Petroleum Company (IPC) provided the pretext

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for the military's takeover on 3 October 1968,* the new regime clearly had the primary objective of instituting sweeping economic and social reforms. Peru had lagged behind comparably developed Latin American countries in instituting economic changes and reducing income inequalities because the political system continued to be dominated by parties responsive to the oligarchy.

2. Largely because a favorable foreign investment climate contributed to rapidly expanding mineral and fishmeal exports, Peru's economic growth rate for some time surpassed that of most other Latin American countries. During 1951-67, growth averaged 6% annually, compared with 5% for the region as a whole. However, growth was concentrated in the Lima area and a few export-oriented enclaves and brought little benefit to most Peruvians, especially those in the rural areas. As a result, Peru became notorious for the sharp contrast between the oligarchy's wealth and privileges and the extent of the slums that sprang up around many cities.

** The International Petroleum Company -- a subsidiary of Standard Oil Company of New Jersey -- produced, refined, and distributed about 70% of the petroleum products consumed in Peru. The company's title to its main producing field, La Brea y Parinas, had been disputed since the company acquired the property in 1924, and the government had asserted a claim for back taxes. When Belaunde reached a settlement with the company, which was to cede its claim to the oilfield in exchange for a dropping of the tax claims, the military overthrew him, charging that the settlement (the Act of Talara) was a sellout. The military then seized the company's oilfield and refinery and refused compensation on the grounds that the company had illegally enriched itself and owed Peru some $690 million.* [redacted]

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3. Because the oligarchy for the most part was satisfied with the profits from its traditional agricultural, banking, and commercial enterprises, manufacturing and mining development was left mainly to US and other foreign investors. Foreign-owned businesses operated with few restrictions as long as they did not threaten the oligarchy's privileged economic position and access to political spoils. In this laissez-faire environment, foreign companies eventually emerged as highly visible owners of most of Peru's modern industry.

4. A military junta intervened in 1962 to prevent APRA from coming to power after winning the election and then engineered the election in 1963 of a new reformist coalition headed by Belaunde. The Belaunde government seriously tried to institute certain economic and social reforms but was blocked by vested interests and the opposition parties. Rapid economic growth continued during 1963-66, but Belaunde's inability to get Congressional approval of revenue measures needed to finance his public investment program caused large budget deficits. These, in turn, led to rapidly increasing short-term foreign debt, mounting inflation, and -- in 1967-68 -- to devaluation of the sol, loss of business confidence, and sharply reduced economic growth. Another factor contributing to the loss of business confidence was a smuggling scandal that involved various high government officials, including several cabinet ministers.

5. Impatient with the Belaunde government's shortcomings, the military decided it was the only force capable of undertaking measures necessary for the basic long-term reforms required to achieve greater social justice and stave off an eventual violent revolution. The military's self-confidence was reinforced by the success of the Argentine and Brazilian military governments in dealing with economic problems that had defeated civilian regimes.

The Reforms' Goals and Progress

General

6. The Velasco regime has two primary long-range goals. The first is to decisively increase Peruvian ownership and control of the economy's

modern sector at the expense of foreign influence, and the second is to alter income distribution substantially by neutralizing the economic power of the oligarchy and integrating the large Indian population into society.* In turn, the regime expects more equal income distribution to accelerate industrial development by broadening the market. The regime has indicated that several years will be needed to achieve these goals and that it intends to remain in power for at least five years and perhaps as long as 20.

7. The government already has gone far in assuming control over export industries, petroleum refining, banking, and foreign exchange transactions and recently announced plans for far-reaching participation in manufacturing. Expropriation of the IPC in October 1968 was followed two months later by a measure reducing foreign influence in banking. In June 1969, Velasco introduced a land reform that turned over all the large sugar estates to government-controlled worker cooperatives and provided for redistribution of all other large holdings. During the past 12 months the government has nationalized the principal telephone company and the marketing of major exports products and has reserved development of additional key economic activities to the state. The decree on manufacturing enterprises, issued on 28 July 1970, provides for gradually increasing worker participation in the ownership, management, and profits of all private establishments.

8. Although these reforms represent an enormous change for Peru, they are not unprecedented or even radical by Latin American standards except in the case of the new manufacturing decree. Peru's seizure of the IPC was strikingly similar to Mexico's seizure of foreign oil company properties in 1937, which marked the course of the nationalistic Lazaro Cardenas administration and its successors. In several Latin American countries, the government has long dominated

* *About 5 million of Peru's 13 million people are Indians. Most Indians live in small, isolated mountain communities, speak little if any Spanish, and participate only marginally in the money economy.*

certain important industries and guided private investment. The planned gradual acquisition of majority control of foreign firms by domestic interests also has precedents in several other Latin American countries. Mexico, the best known example, requires a minimum of 51% domestic public or private ownership of all firms. Peru's move to gradually transfer ownership of private manufacturing firms to their employees has no precedent in Latin America, however.

Position of Foreign-Owned Enterprises

9. The Velasco government has substantially reduced the scope of foreign-owned business in Peru. Expropriating IPC's properties placed almost all petroleum refining and marketing under government ownership, and the banking decree that soon followed restricted foreign ownership of domestic banks to a maximum 25% interest. During 1969 the regime negotiated the nationalization of the Peruvian Telephone Company, an International Telephone and Telegraph (ITT) subsidiary serving Lima, and announced plans to eventually nationalize all remaining privately owned communications and electric power facilities. Subsequent decrees provided for government control of mineral exports by nationalizing marketing facilities and building state-owned refineries. Marketing of all fish products including fishmeal, a leading export, also has been placed in government hands. The industrial decree specifies eventual government ownership of all basic manufacturing industry. Future investments in such industries as steel, chemicals, paper, and cement would be carried out by the government, which already owns Peru's only steel mill, and ownership of existing private firms would be acquired gradually.

10. Because Peru needs capital for resource development, the Velasco government from the beginning has tried to combine economic nationalism with continuing opportunities for private foreign investment. This policy was first manifested shortly after the IPC expropriation, when Peru signed a contract allowing Belco Petroleum -- a US-owned firm -- to expand its oil extraction facilities under favorable terms. In the copper industry, the regime has pressured the large foreign-owned mining companies to initiate expansion programs or risk

losing their concessions. Foreign-owned fishmeal enterprises not only are keeping their properties -- at least for the present -- but are being urged to build plants to process fish for human consumption. The nationalization agreement negotiated with ITT also committed the company to build a tourist hotel in Lima and enter a joint venture with the government to produce communications equipment for the Andean market.

11. The regime apparently expects the state or Peruvian nationals to share in the ownership of nearly all future mining ventures by foreign firms. Although not prohibiting full ownership by foreign firms, it offers them financial incentives to form enterprises with at least 25% government ownership. In negotiations with Anaconda on a $50 million to $75 million project to develop the Cerro Verde copper deposits, the government has indicated that it will insist on a minimum of 51% state ownership. In the case of other more costly or technically difficult projects, however, such as developing the Cerro Corporation's copper concession, the government is expected to be satisfied with a smaller share, at least in the short run.

Scheduled Institutional Changes in Manufacturing

12. If fully implemented, the recent industrial reform would radically change the present pattern of ownership and control in manufacturing. Foreign-owned firms are required to conclude contracts with the government setting up timetables for partial nationalization. Once it has recouped its original investment and a "reasonable profit," a foreign company is to retain a maximum ownership interest of only 33%, with the balance to be acquired by the state or, perhaps in some cases, private Peruvians. The new decree, however, provides for exceptions to these provisions "when in the national interest or necessary for economic development." The decree directs both domestic and foreign firms to institute immediately a profit sharing system for distribution of 10% of pre-tax profits to workers. In addition, all manufacturing firms are required to contribute 15% of pre-tax profits to a state-controlled "industrial community fund" and to set aside 2% of profits for research and development. In basic industries, the "industrial community" will buy bonds and distribute the interest received among the workers. In

other industries, it will use its profit share to buy stock in the firm; if the enterprise needs funds for expansion, the "industrial community" will receive newly authorized rather than existing shares. When the "industrial community" has obtained 50% of the stock outstanding, it will transfer the shares to the firm's employees. Other, more complicated measures enable the employees to acquire a progressively larger part of the firm's equity and allow new employees to share some of the benefits. Workers are to participate in management to the extent that they or the "industrial community" have equity in the enterprise.

Control of New Investment

13. The decree governing manufacturing also outlines an incentive system aimed at stimulating and shaping the composition of private investment. The decree provides for substantial revisions in import duties on capital goods and industrial inputs, lowering those applicable mainly to high-priority industries and raising those for low-priority industries. Import duties on capital goods are set at only 10% for first-priority industries (basic industry and other fields reserved for state development), at 30% for second-priority fields (primarily export industries), and 60% for third-priority industries, mainly those producing non-essential goods. Producers of luxury goods generally will have to pay still higher duties. Imports of raw materials and components would be subject to duties ranging from 20% to 80%, depending on the industry's priority. In addition, the law indicates that development banks will provide subsidized credit to industries according to their priority. Higher priority industries are allowed tax-free reinvestment of profits, and tax advantages are granted to companies locating outside of Lima. To spur a rapid increase in investment, the decree provides special tax benefits for firms investing during 1970-72.

14. The Velasco administration also plans to guide development by allocating bank credit. To stimulate inflows of foreign capital, domestic bank credit for foreign-owned firms has been limited to the amount outstanding at the beginning of 1969. To stimulate agricultural development and support the agrarian reform, commercial banks

must allocate to agriculture 25% of the increase in credit since January 1969. Credit allocation will be facilitated by the recent entry into commercial banking of the government-owned *Banco de la Nacion* -- formerly the holder of government accounts only. In addition, the government's takeover in June 1970 of the bankrupt *Banco Popular* (Peru's second largest commercial bank) provides a national network of branch banks for direct credit allocations to favored ventures.

Measures to Improve Income Distribution

15. The regime has announced several measures to improve the welfare of lower income groups, but except for land reform their implementation has been restricted, partly for financial reasons. In addition to land redistribution, the measures call for the following:

-- Establishment of self-help organizations to provide public services in the *Pueblos Jovenes* (Young Towns), the official name for the slum settlements surrounding Lima and other cities.

-- Tax incentives to stimulate location of new enterprises outside the few coastal cities where they are now concentrated.

-- Educational reform aimed at greatly expanding basic literacy and job skills in low income groups while de-emphasizing the more traditional preparation for higher education.

16. Land redistribution has been carried out rapidly.* With almost no external financial or technical assistance, the government has organized 15,000-20,000 families into cooperatives on expropriated sugar estates and has settled more than 20,000 families on other expropriated land during

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the past year. This progress compares very favorably with that in Chile, where only 20,000 families have been settled in the past five years despite large expenditures aided by external financial assistance. The land reform has not yet significantly burdened government finances, because most expropriated land is being paid for with long-term government bonds and few expenditures have been made to provide needed but costly rural infrastructure and technical and marketing services. Among other reasons, the regime moved rapidly in order to slow migration of unskilled, illiterate peasants from the highlands to the rapidly growing urban slums, which it views as a serious threat to internal order. Lima already has 3 million of Peru's 13 million people, and perhaps half of them live in vast slum areas.

17. The land reform represents a drastic and seemingly irreversible change in an agrarian structure that had changed little since the early 1800s. Although it may reduce marketed output for a time, land redistribution should help in the long run to bring the Indians into the money economy and broaden the national market. Land reform also should generate political support for large, continuing public investments needed in agricultural infrastructure if food production is to be expanded appreciably. In both Mexico and Venezuela, for example, the rural interest groups required to support successful long-term agricultural programs were created by widespread land reforms.

Repercussions and Problems of the Reforms

18. The economic reforms -- together with the government's financial stabilization program, drought, prolonged strikes at major copper mines, and a shortage of anchovies for the important fishmeal industry -- have resulted in very sluggish economic growth in recent years. Growth averaged only 1½% in 1968-69, well below the rate of increase in population, and apparently has changed little so far in 1970. This slow growth has made it difficult for the regime to finance some investments that its programs call for. The May earthquake helped to unify the regime and rallied public support, but these improvements could prove fleeting if no economic progress is made.

19. The government's expropriation of IPC and its strident nationalism caused capital inflows to largely dry up. The reluctance of the US government and many US enterprises to provide funds came as no surprise, but the cutback in capital inflows from international institutions and other sources probably exceeded the regime's expectations. Until the 31 May earthquake, the regime had obtained only two small loans from the Inter-American Development Bank and none from the World Bank. Peruvian leaders also have been disappointed by the response of Japanese and West European businesses to their overtures. The Japanese refused even to consider committing resources to develop several large US-held copper mining concessions that might be relinquished. The USSR's failure to offer substantial assistance likewise has deflated the regime's hopes of obtaining non-US financing for these copper concessions, as well as funds for several large agricultural development projects.

20. Even more vexing to the regime has been the failure of domestic business interests to invest. Because many members of the oligarchy had supported the military coup and the expropriation of IPC, the regime has been surprised by their continuing failure to proceed with planned investments. It seems clear that many Peruvian businessmen are passively resisting the Velasco government and its reformist programs.

21. In response, the regime has attempted to force several foreign firms as well as Peruvian businessmen generally to invest. The first step was an effort beginning in 1969 to force the foreign-owned mining companies to start developing their concessions or give them up. A second step, aimed at Peruvian enterprises and moneyed interests generally, was an exchange control decree issued in May 1970. Among other things, the decree ordered Peruvians to repatriate funds held abroad or risk criminal prosecution, sharply restricted their freedom to send funds out of the country, and forced them to convert their dollar holdings in domestic banks -- perhaps as much as $100 million-$150 million -- to soles. [redacted] 25X1
this decree will be supplemented in the next few weeks by a currency reform requiring individual holdings in excess of $20,000 to be invested directly or exchanged for government bonds, thus making more funds available for public investment.

22. In successfully carrying forward the financial stabilization program initiated under Belaunde, the Velasco administration clearly has circumscribed its reform efforts. By the end of 1969 the government had balanced the budget by imposing new taxes and slashing public investment, liquidated a large backlog of unpaid government bills, sharply reduced the inflation rate, and restored foreign reserves to normal levels by imposing an import surcharge and prohibiting luxury imports (see the chart). The program had a harsh impact on output and employment in late 1968 and early 1969, however. Per capita output has dropped slightly since 1967 and would have dropped more if high prices for minerals and fishmeal had not boosted export earnings. The number of people without regular full-time jobs rose sharply as construction and other economic activities slowed and has probably increased by almost 10% of the labor force since 1967, to perhaps 15%-20% of the total. Although the regime relaxed the stabilization program in mid-1969, the economy has not responded very strongly, mainly because of the continuing depression of both public and private investment.

Prospects

23. The Velasco regime seems likely in the next several months to move steadily ahead in implementing recent changes and to institute others in such areas as taxation, retail trade, and international commerce. How far the program will go over the next two years is less certain. Program implementation will depend both on political developments and on the general course of economic activity; the latter will be strongly influenced by the trend in private investment and export prices. If economic growth does not recover substantially and the rise in unemployment is not curbed, Peru's leaders will be under increasing pressures either to take more authoritarian and repressive actions to force investment and economic growth or to alter their economic aims.

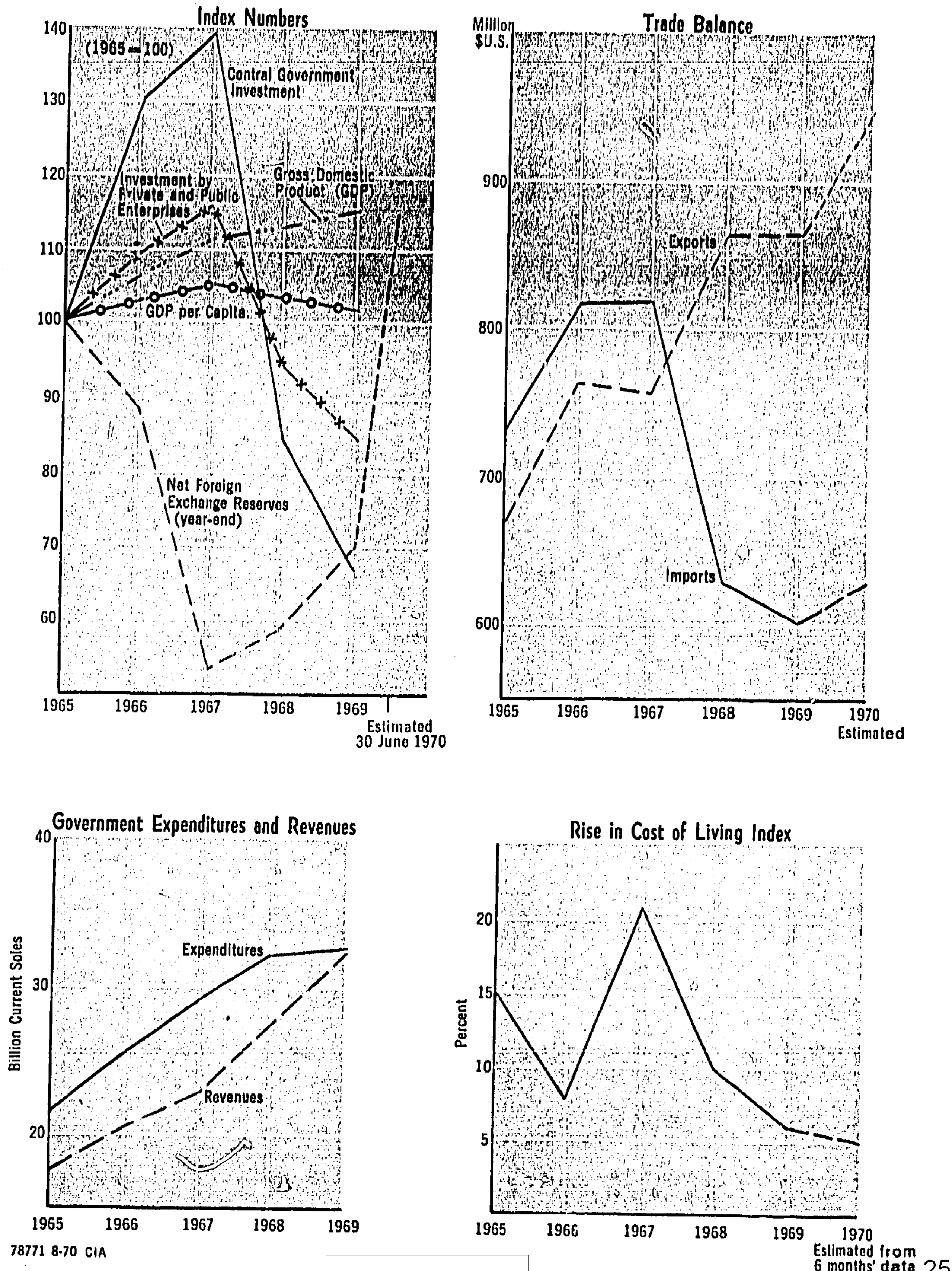
24. Although some short-run improvement in economic growth is probable, prospects for a return to the 6% annual gains of 1951-67 are poor. Recovery of sugar and fishmeal production, the opening of several small new mines, and the absence of prolonged strikes should give the economy a lift in 1970. If substantial foreign aid is forthcoming

because of the devastating earthquake suffered in May -- as now seems likely -- the government should be able to boost output and employment further by means of increased public outlays. Stagnation of private investment seems likely to persist, and this is expected to hold the annual growth rate below 4%.

25. Public investment probably will rise appreciably in 1971. Sizable foreign-financed reconstruction expenditures should continue throughout the year. Work may start on state-owned industrial facilities, especially if forced private purchases of government bonds are large, as seems likely. Little private investment is in prospect for 1971, however, unless the government moderates its stand toward the private sector. If drastic government-imposed economic changes continue to be implemented, the US copper companies probably will invest only the minimum amounts necessary to retain their concessions. Mining investments in 1970-71 are not likely to exceed $30 million annually -- an amount that will scarcely induce much other private investment. By 1971, Peru faces a possible weakening of prices for its main exports, which could offset the stimulative effects of increased public investment. Prices for copper and other minerals already have dropped somewhat from their 1969-70 highs and may drop further.

26. Even if the Velasco government should succeed in bringing about an economic upsurge, it faces serious problems. The revolutionary rhetoric and sweeping promises of a better life for the lower classes may have already awakened unsatisfiable expectations. Continued financial constraints on the expansion of rural infrastructure may prevent the land reform from holding the peasants on the land, thus causing it to fail to halt the migration to the cities. Moreover, massive investments would be required to improve the lot of urban slum dwellers. If these people eventually become disenchanted with the slow pace of economic improvement, they could offer fertile ground for demagogic appeals by extremist groups or radical members of the Velasco regime.

PERU: SELECTED ECONOMIC INDICATORS



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Conclusions

27. The Velasco regime's economic reform program is intended to achieve a sharp reduction in the economic and political power of foreign investors and Peru's traditional elite and correspondingly to expand the government's role in economic development. The reforms introduced so far are transferring control over Peru's natural resource and export industries to the government, forcing increased domestic ownership of banking and manufacturing, and redistributing large estates among the peasants. Although most of the reforms are not particularly radical compared with policies followed by several other Latin American countries, they represent a drastic change from Peru's traditional laissez-faire approach to domestic and foreign investment. In many respects, the Velasco regime is following courses previously taken by Mexico, Chile, and, to a lesser extent, by Brazil, Argentina, and Venezuela.

28. The major repercussion of the reform program has been continuing economic stagnation. Growth has been depressed largely because the rapid pace of the reforms and the strident nationalism with which they have been introduced have greatly reduced foreign aid receipts and sharply depressed private investment by both domestic and foreign firms. In addition, public investment has been held down to promote financial stabilization. Because the economic growth rate averaged only 1½% during 1968-69 compared with 6% during 1951-67, unemployment increased rapidly and per capita income declined. These economic shortcomings contributed to dissension within the regime over the pace and scope of the reforms which in turn delayed additional reforms and added to business uncertainty.

29. The regime is likely to push ahead with reform during the next several months, but its course and pace over the longer term will depend on political circumstances and success in spurring economic growth. Partly because of prospective foreign aid of more than $100 million for earthquake relief and rehabilitation, improved growth is possible over the next two years or so. If the reforms continue at their present pace, however, private foreign and domestic investment seems unlikely to recover substantially in the next year or so, thus preventing a resumption of rapid economic growth. Moreover, growth could be

held down if the weakening of export prices continues. In any case, the regime faces difficult problems because the reform program may have awakened expectations among the urban and rural poor that cannot be fulfilled. Thus, although the Velasco regime has begun to alter Peru's economic and social structure irreversibly, the program's future remains uncertain and its path difficult.