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DIRECTORATE OF
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Intelligence Memorandum

Peru: Economic Trends and Prospects

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
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INTELLIGENCE MEMORANDUM

PERU: ECONOMIC TRENDS AND PROSPECTS

Introduction

1. Over the last year or so, Peru's military government has modified its earlier, more radical posture to encourage investors to help develop the country's resources. More flexible policies have partly restored foreign investors' confidence, and ten major oil companies now have contracted to follow up on Occidental Petroleum Corporation's promising discoveries in the remote northeastern jungles. Domestic investors, after holding capital outlays to low levels for several years, began to restock and expand operations in 1971. Fallout from the uncompensated expropriation of a US-owned oil company four years ago continues to block some official foreign loans, however, and further difficult choices between socio-political and economic goals loom ahead. This memorandum reviews the economic difficulties deriving from the government's initial policies and describes subsequent efforts to stimulate the return of foreign capital and gain the confidence of domestic entrepreneurs. It also assesses the modified revolution's chances for economic success in the face of continuing thorny problems.

Discussion

Background: Early Revolutionary Policies and Their Effects

2. Upon seizing power in October 1968, the new government headed by General Juan Velasco moved quickly to strengthen the state's economic control and redistribute income at the expense of both foreign investors and the domestic elite. One of its first official acts was to expropriate the

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Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

properties of the International Petroleum Company (IPC) – a Standard Oil of New Jersey subsidiary. The new regime then initiated a far-reaching agrarian reform program by nationalizing the large coastal sugar estates and organizing them into worker cooperatives. It also charged state enterprises – some of them newly created – with primary responsibility for developing Peru's extensive natural resources and imposed strict investment schedules on foreign firms wishing to participate in the process. Foreign ownership in some fields was severely restricted and, in others, was subjected to terms stiffer than those subsequently called for under the Andean Foreign Investment Code. Finally, "worker participation" in the ownership and management of manufacturing, fishing, and mining companies was launched with the 1970 Industrial Reform Law. Under this law, each manufacturing firm was required to distribute a 25% share of annual pre-tax profits to its employees – 10% in direct cash benefits and 15% to be held in trust by an "industrial community" representing the workers. This latter share was to be used to purchase company stock until the community ultimately acquired 50% of the firm's equity and a concomitant role in managerial decision-making.

3. Because of the climate of abrasiveness and uncertainty produced by these moves, official foreign credits as well as foreign and domestic private investment declined dramatically. Although the Hickenlooper Amendment never was formally invoked in response to the IPC takeover, no new project loans were extended by the US Government after 1968 and disbursement of funds already in the pipeline slowed markedly. Similarly, no new project financing was extended by the International Bank for Reconstruction and Development (IBRD) during 1969-71, and new Inter-American Development Bank (IDB) loans totaled only US $56 million.* Net official capital inflows declined from an average $145 million annually in 1966-67 to an average $30 million in 1970-71, including earthquake relief loans (see Table 1). Even if disinvestment directly caused by nationalization is excluded, Peru suffered net losses of long-term private capital until 1971. Moreover, because of continued recession and uncertain business prospects, domestic private capital outlays plummeted some 17% between 1966 and 1968 and then virtually stagnated through 1970 (see Figure 1).

4. Despite the falloff in private investment and the avowed aims of expanding the state's economic role and effecting profound social reform, the Velasco government adopted highly conservative financial policies. By 1970 it had virtually eliminated the budget deficit – which equaled 27%

* Immediately following the 1970 earthquake, the US Government, IBRD, and IDB extended some $80 million in relief aid, part of which could be considered development assistance.

Table 1

Peru: Net Long-Term Capital Flows

Million US $

		Official Flows			
Year	Private Flows	With Debt Servicing as Scheduled	Gained From Debt Renego-tiation	Total Official Flows	Total
1966	+35	+143		+143	+178
1967	+27	+147		+147	+174
1968	-15	+54	+51	+105	+90
1969	-10	+71	+59	+130	+120
1970	-10 a/	+22	+7	+29	+19
1971	+7	+43	-13	+30	+37

a. Excluding disinvestment through nationalization.

of expenditures in 1967 – and had cut the inflation rate from the 1968 high of 20% to only 5%. Fiscal austerity and sharply curtailed foreign assistance combined to keep public investment at very low levels through 1969. The spurt in public capital outlays in 1970-71 and re-emergence of a substantial budget deficit in 1971 had little inflationary effect. The high degree of domestic liquidity created by the forced repatriation of private foreign currency holdings in 1970 permitted financing of the deficit through bond issues.

5. Although its foreign capital account steadily deteriorated, Peru added some $300 million to its net foreign reserves during 1969-70 (see Figure 2). The trade balance improved considerably because of (a) generally weak import demand, (b) continued government restraints on luxury goods imports, and (c) a jump in exports in 1970 – reflecting good crop weather, a record fish catch, and high world prices for minerals and fishmeal. These factors, combined with a surge in domestic demand for manufactured goods, generated a 7.3% rise in real gross domestic product (GDP) in 1970 (see Figure 1). Revived economic growth, however, spurred import demand in 1971, while exports declined to more normal levels. As a result, a $70 million balance-of-payments deficit was incurred, and net foreign reserves by the end of the year had declined to $340 million – a level still sufficient to finance about six months' imports.

Peru: Selected Economic Indicators

Figure 1

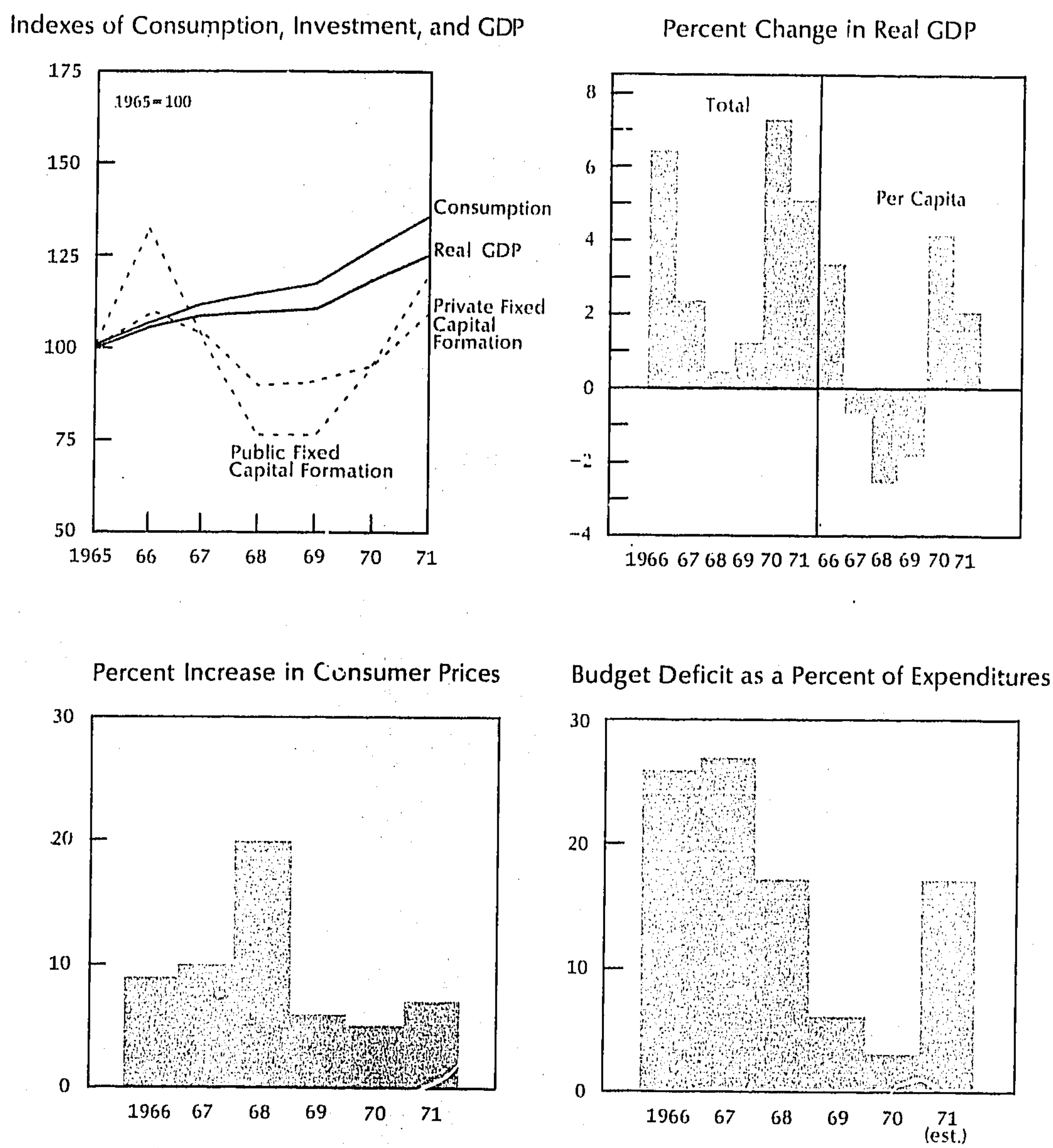

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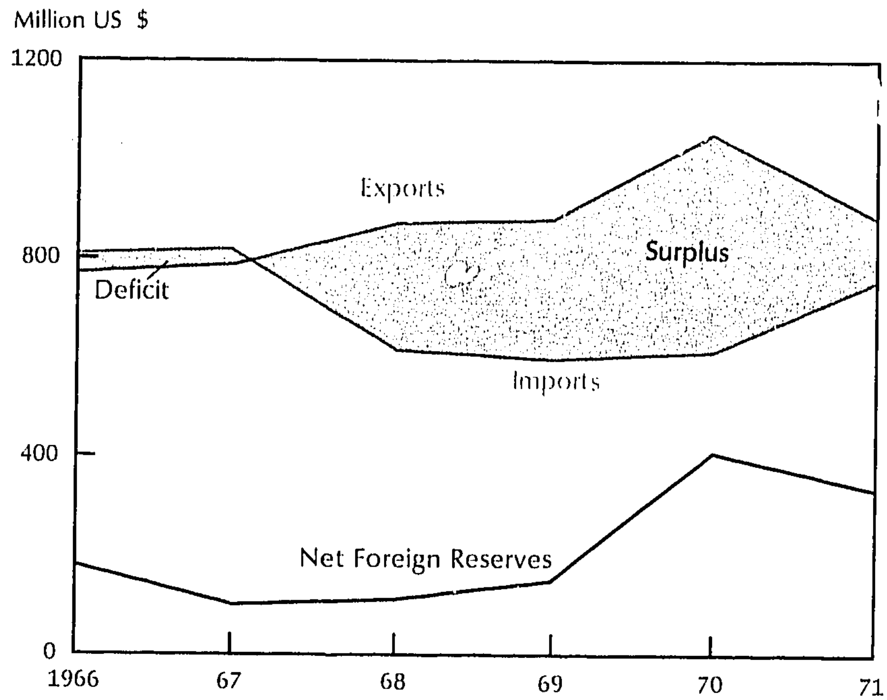
Figure 2

Peru: Exports, Imports, and Net Foreign Reserves



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6. Private investment, which had not responded markedly to the 1970 boom, jumped 17% in 1971 as rising demand pressed against production capacity. Although the investment trend indicated private industry's growing confidence in its ability to operate within the system, few if any new enterprises were created. Capital expenditures – financed by amply available credit – went mainly to refurbish concerns that had stagnated since the investment boom of the mid-1960s. At the same time, dwindling public savings threatened to reduce the growth in public investment. After rising by almost one-fifth in 1970, government revenues declined slightly in 1971 because export earnings dropped and economic growth slipped to 5%. Although a somewhat rejuvenated private sector boosted manufacturing output by 9%, less favorable weather and the threat of expropriation limited agricultural growth, and labor unrest cut mineral production substantially.

Phase Two: A Modified Revolution

7. The Velasco government began to modify its policies in 1971 because of the economic slowdown and a more pragmatic appraisal of how social and economic goals should be balanced. The military rulers from the beginning had recognized that both domestic private investment and foreign capital were essential to reach their development goals. They almost

certainly, however, underestimated the negative impact their new rules would have on these capital sources. Once some of the easier social reforms were under way and the economic development task had to be faced, the Velasco government apparently decided that a change in both rules and rhetoric was necessary to attract the large resources required.

8. Amendment of the Industrial Reform Law is perhaps the most difficult and significant compromise made thus far. In 1971 the highly criticized provision regarding workers' managerial rights was modified substantially. Under the amended law, worker communities in key manufacturing industries and joint state-private manufacturing firms declared "strategic" will purchase company bonds or bonds issued by the government's newly established Development Finance Corporation (COFIDE) instead of company shares, thus avoiding a dilution in management control. Because the firms still must fund these purchases, however, the amendment does not soften the adverse impact of the original law on their profitability nor does it exempt them from what is in effect a forced re-investment of 15% of pre-tax earnings.

9. Although the Velasco government still is deeply committed to agrarian reform, it has minimized the economic costs involved. To help preserve private landowners' incentives, the government has emphasized that future expropriations will affect only those holdings exceeding 370 acres in the irrigated coastal area or their productive equivalent in other areas. The large coastal agro-industrial complexes expropriated early in the program have been kept intact, and their output of sugar and cotton has held up well. Some 88,000 families were settled on these and other expropriated properties by December 1971. The reform pace has slowed during the last year or so, however, as the program shifted to the interior, where the breaking up of large, underused ranches entails much higher investment costs. Originally scheduled to be completed in 1973, land redistribution now is considered a much longer-term program.

10. Recent efforts to stimulate private foreign investment have taken various forms. The government recognized that settling outstanding investment disputes would be highly important in luring new investors. Except for IPC, mutually agreeable compensation arrangements had been worked out by the end of 1971 for those few foreign properties that had been nationalized outright and secret negotiations had been undertaken in an attempt to settle the sensitive IPC problem.

11. The government also made special efforts in 1971 to stimulate new foreign investments in mining and petroleum exploration. It exempted private foreign firms in these sectors from the Andean Foreign Investment

Code provisions requiring them to sell 51% of their equity to Peruvian citizens by 1986. Moreover, the Mining Law issued in June 1971 provided that mine employees are to receive only a 10% share of pre-tax profits (compared with 25% in manufacturing), and, in the case of joint state-private ventures, the workers' communities are to purchase bonds rather than company shares. The Mining Law also offers tax and credit incentives for new mining investments that are particularly liberal for joint ventures. To further encourage private foreign investors, the government opened to oil exploration by joint ventures much of the western Amazon basin, where large oil deposits have been discovered in an area previously reserved to the State Petroleum Company (Petroperu). The new oil ventures will not be required to pay their employees a share of pre-tax profits.

Foreign Investor Response

12. Foreign investor confidence has been partly restored by these policy changes, and the government has been able to sign a number of joint-venture contracts with major foreign corporations. For example, Holiday Inns, Marriott, and Braniff agreed to invest some $15 million in constructing six new hotels in a joint-venture with the State Tourist Agency. Bayer Company of Germany decided to double its acrylic fiber plant capacity when the government agreed to declare the enterprise "strategic," thus exempting it from Industrial Reform Law provisions requiring workers' equity and management participation. The limits of the new foreign investment policy are being further tested by ongoing negotiations between the US-owned Dresser Industries Inc. and COFIDE for a mixed company to manufacture drill bits for the Andean market. Final agreement, which apparently is contingent on the new firm's being declared "strategic," would usher in Peru's first totally new foreign manufacturing investment in several years.

13. The favorable response of major foreign petroleum companies to new government initiatives has unquestionably generated the most excitement in Peru. In June 1971 the Occidental Petroleum Corporation and Petroperu signed a long-term contract that has served as a model for subsequent agreements involving ten other foreign oil companies and for current negotiations with firms competing for the remaining 2.4 million acre exploitation areas. Under the Occidental contract, the company pays all exploration and development costs and receives one-half of the oil and gas recovered, while Petroperu pays all taxes and receives the remaining one-half of output. At the end of 35 years, the developed areas revert to the state without additional compensation to Occidental. These terms are relatively favorable to the company, reflecting the substantial costs and risks of oil exploration in the remote jungle region. All equipment must be flown in by helicopter and, in addition to other infrastructure projects, a $250 million pipeline will have to be constructed across the Andes.

14. No official estimates of Peru's oil reserves have been made, but the government optimistically forecasts the country's emergence as a major exporter by the late 1970s. The basin is adjacent to large Ecuadorean deposits that went into production last month, and Petroperu – which has reserved a substantial area for its own operations – has struck oil with its first three wells. Estimated investment in oil development in the area over the next five years now exceeds $700 million.

15. The response of foreign mining companies is far less encouraging to the Velasco regime. The Southern Peru Copper Company has committed $48 million to cover the next phase of its Cuajone copper project, completion of which would require $355 million. On the other hand, Mineroperu – the State Mining Company – has had little success in securing foreign financing for its $600 million, five-year investment program to develop US-held concessions taken over in December 1970, when the companies failed to meet the government's development deadline. Thus far, it has made only one firm agreement. A British-led consortium has committed $55 million to finance the first stage of the Cerro Verde copper project, a concession given up by the Anaconda Company. Mineroperu has signed preliminary agreements to develop two of the smaller properties in joint-ventures with the Swedish Granges Company and the Romanian foreign commerce agency Geomin, but some important issues still are unsettled. The Cerro Corporation wants to pull out of Peru because of labor unrest and bleak profit prospects; it thus has offered to sell Mineroperu its properties, valued at $110 million. Cerro, at the same time, is willing to provide technical assistance and help find funds for a proposed $185 million expansion of its facilities if Peru can finance the initial purchase.

Foreign Creditor Response

16. Peru's more moderate stance also helped in obtaining new long-term credits from European and Japanese sources in 1971. These included a number of government-guaranteed credits to finance more than $150 million in work on two major irrigation projects designed to transform large desert areas into productive farmland. Moreover, improved relations with the United States, in part because of the Peruvian government's agreement to compensate W.R. Grace and Company for expropriated sugar properties and its restraint on fishing vessel seizures, led to a presumption in late 1971 that increased assistance from the US Government and international lending agencies would soon be forthcoming. The path toward substantial expanded assistance was further cleared in February 1972 at

a meeting of an international consultative group sponsored by IBRD.* Although no funds were committed, the member nations agreed in principle to support Peru's proposed $1.8 billion investment program for 1972-74 with up to $780 million in new project loans.

17. Peru's hopes for large new official credits were substantially dimmed, however, by two related events in early 1972: a press leak concerning the secret IPC talks in Peru and passage of the Gonzalez Amendment in the US Congress. In political defense against the brouhaha caused by the press leak, the Peruvian government "officially" expropriated IPC, in effect without compensation – thus virtually eliminating any chance for a negotiated settlement. At the same time, flexibility in US aid policy was limited substantially by the Gonzalez Amendment, which requires a negative US vote in international financial agencies' deliberations on assistance to any nation that has expropriated US property without compensation.

18. Despite these setbacks, Peru has lined up in recent months some $320 million in project financing from other member nations of the IBRD consultative group (see Table 2), and negotiations for other loans are in progress. In addition, one small IDB loan recently was extended to help finance agricultural cooperatives. Other non-concessional loans from international financial agencies also can be authorized because the US Government has no veto on financial operations of this type. A negative US vote, however, does block soft-term loans of the sort normally extended for project assistance to Latin America.

Prospects

19. Peru's ability to match its earlier long-term growth record will depend heavily on its success in attracting large-scale foreign assistance in developing its resources, particularly its still-untapped mineral and petroleum deposits. For nearly two decades preceding the onset of recession in 1967, Peru's economy grew an average of 6% annually, thanks initially to sizable direct foreign investments and later to substantial investment-financing by the US Government, international agencies, and foreign private banks. Unlike its predecessor, the Velasco government has maintained a degree of fiscal responsibility that helps to inspire investor confidence both at home

* Countries represented at the meeting were Belgium, Canada, Finland, France, Germany, Italy, Japan, the Netherlands, Spain, and the United Kingdom. Representatives of the International Monetary Fund, IDB, the Inter-American Committee for the Alliance for Progress, the UN Development Program, and the International Coffee Organization also attended. The United States, Switzerland, and the Organization for Economic Cooperation and Development were represented by observers.

Table 2

Peru: Official Foreign Loans
Extended Since the February IBRD
Consultative Group Meeting

Country	Million US $	Projects Under Consideration
Finland	6	Transportation and communications equipment
France	60	Canon del Pato hydroelectric center Chimbote steel complex Polyethelene plant Tele-education service
Spain	37	Majes irrigation project Tuna boats Bulk carrier construction
West Germany	23	Tinajones irrigation project Chimbote fishing port Chimbote hospital Solvents complex Zinc concentration plant Tacna fishing port National Telex Service
United Kingdom (international consortium)	55	Chiefly Cerro Verde copper
Italy	65	Mantaro hydroelectric plant
Japan	72	Talara fertilizer plant Lima-Chimbote powerline Microwave system
Total	318	

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and abroad. Its moral commitment to radical change and its inability to resolve the IPC issue, however, will probably continue to seriously deter capital inflows of the type and in the amounts being sought. The military regime's apparent willingness to give economic goals precedence over social reforms – and to adjust its policies accordingly – will aid in obtaining private foreign capital and official loans from Western Europe and Japan. But because of the prohibitive political costs involved, it is unlikely that this or any succeeding government will pay compensation for the IPC property – even if failure to do so bars important loans from the US Government and international financial agencies.

20. Peru's National Development Plan, approved in May 1971, reflects both the Velasco government's commitment to rapid economic development and its recognition that the task requires large foreign capital inputs. The highly ambitious plan projects growth rates of 7.5% for GDP and 19% for investment and, thus, a rise in the investment share of GDP from 14% to about 20% during 1972-75. Because accelerated public sector spending is viewed as a catalyst to more rapid economic growth, such expenditures are scheduled to rise from about 19% of GDP in 1970 to some 26% by 1975 – still not an abnormally high share by Latin American standards. Public investment outlays, slated to rise by 32% annually, are to be re-directed to some extent from social and infrastructure projects into the vital manufacturing and mining sectors. Private investment, which now accounts for two-thirds of total fixed capital formation, is expected to grow 10% annually during the period. Foreign capital is counted on to finance an important share of both private and public investment.

21. If foreign capital in the required amounts is available to Peru, these goals probably are not grossly unrealistic. IBRD's recent appraisal of Peru's likely economic achievements over the next few years – which served as the basis for economic assistance deliberations by the consultative group – projected growth rates of 16% for investment and almost 6% for GDP. A crucial assumption in this appraisal is that Peru will have available $1.1 billion in gross foreign capital resources during 1972-74. The sources of this financing are assumed to be as follows (in million US $):

Direct foreign investment	258
Official project assistance	668
Foreign reserves drawdown	100
Other (debt refinancing, non-project loans, etc.)	92
Total	**1,118**

22. The slippage on the IBRD's projected official capital inflows during this period could be very great, however. After several years of relatively small commitments, the project loan pipeline is badly depleted and at best could yield disbursements of only about $275 million during 1972-74. Thus, in order to meet projected official assistance levels, new project loans would have to yield almost $400 million during this period. According to IBRD estimates, the $780 million package approved in principle at the February consultative group meeting would allow disbursements of this magnitude during 1972-74, if acted upon promptly. Thus far, however, only minor lending commitments have been made by international financial agencies that were expected to fund a major share of this package. Projected direct investment inflows during this period also may be somewhat optimistic. They assume that the Cuajone copper project will move ahead as originally scheduled, but the Southern Peru Copper Company in fact has not yet secured financing for the period after 1972. On the other hand, annual capital inflows for oil exploration could considerably exceed the $20 million now estimated. It is also possible that Peru's creditors will agree to renegotiate part of the foreign debt, on which scheduled amortization payments during 1972-74 now total some $485 million. Peru's still large foreign reserves also would permit substantially more than the $100 million drawdown now contemplated.

23. Peru also certainly will not be able to mobilize domestic financial resources sufficient to offset any major shortfall in hoped-for foreign capital assistance. Increases in government tax revenues will be limited in part by the relatively slow growth in export earnings expected over the next few years. Price prospects for Peru's mineral and agricultural exports are mixed, and, under the best of circumstances, volume increases will not permit a recovery in earnings to the exceptionally high 1970 level. New oil and mining investments, even if they proceed apace, will not help export earnings over the next few years, because of the long lead times required to initiate production.

24. Although the government is considering various new tax proposals designed to channel a larger share of domestic financial resources into the public investment effort, there are limits to its ability to capture such funds without a counter-productive impact on private capital formation. Moreover, the recovery in private investment activity in 1971 was aided by extraordinarily free credit availability which is not expected to continue. This liquidity was largely a carry-over from the forced capital repatriation and high export earnings of 1970 and, because government credit requirements were low, benefited mainly the private sector. To the extent that the government does finance its investment effort through increased domestic borrowing, private outlays probably will be depressed by financial stringencies. Given its conservative financial philosophy, the Peruvian

Government is unlikely to opt for an expansionary monetary policy at the cost of accelerated inflation.

25. The Velasco government can, however, postpone a substantial portion of its ambitious investment program and still maintain a respectable growth rate over the next few years. To an important extent, performance will depend on its continued ability to pursue a non-doctrinaire approach to Peru's economic realities. Although land redistribution, industrial reform, and labor unrest are inhibiting factors, private producers – still the mainstay of the Peruvian economy – have been encouraged by pragmatic government efforts to release them from the more onerous provisions of extant reform laws and to crack down on disruptive labor union activity. The 1971 private investment spurt will improve industrial capability to fill rising consumer demand in 1972-73, while remaining capacity limitations provide an incentive to further expansion. Thus, given reasonable policies and favorable weather, economic output probably will rise by some 5% annually despite moderate balance-of-payments and other financial constraints.

26. Because economic growth apparently is being given primary consideration in government resource allocation policy, some social reform goals will have to be postponed. Despite mounting public expectations – some of them prematurely fueled by Peru's "oil boom" – such a shift in priorities seems feasible because of the absence of any serious threat to the military regime. To maintain its populist credentials, however, the regime will have to raise social welfare expenditures at least moderately over the next few years. Peru's ability to pursue both goals will be significantly affected by its ability to attract external support for its development process.