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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Peru: Economic Recovery In 1970 And Prospects For Continued Improvement

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1971

INTELLIGENCE MEMORANDUM

PERU: ECONOMIC RECOVERY IN 1970 AND PROSPECTS FOR CONTINUED IMPROVEMENT

Introduction

1. Peruvian economic growth picked up notably in 1970 after two years of near stagnation. Foreign exchange reserves reached a record level, and conservative financial policies brought continued price stability. Last year's progress was largely the result of good weather, high export prices for minerals and fishmeal, and a large inflow of foreign grants for earthquake relief. Foreign reserves were further enhanced by the forced repatriation of foreign balances. Improved economic performance, however, will not necessarily be maintained during the next few years. Mineral prices already have turned down, and no further windfalls in foreign exchange are in view. At the same time, the social and economic reform goals of President Juan Velasco's regime continue to inhibit investment by both Peruvian and foreign businessmen. This memorandum examines recent economic trends and assesses prospects for the next few years.

Discussion

Background

2. The Velasco regime came to power in October 1968, during Peru's first major postwar economic crisis. After averaging 6% annually for two decades, economic growth fell to 2.4% in 1967 and 0.5% in 1968. Although political factors were the immediate cause of the military takeover – with the controversy over the International Petroleum Company (IPC) serving

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as a pretext – general dissatisfaction with economic conditions and concern for social reform were important in prompting General Velasco's move against the government of Fernando Belaunde.

3. The Velasco government has pursued two basic goals -- strengthening the state's economic control and redistributing income at the expense of foreign investors and the domestic economic elite. A rapid and pervasive land reform is being carried out, some industries have been reserved for the state, and foreign ownership has been severely restricted. The government also has taken over the marketing of Peru's principal exports, imposed rigid exchange controls, and forced repatriation of private bank deposits held abroad. Under the 1970 industrial reform law and related decrees, fishing and manufacturing firms were ordered to distribute 10% of pre-tax profits to their workers and to gradually give them half-ownership. Profit-sharing and worker ownership arrangements now are being applied to the mining companies as well.

4. The government's first action – expropriating IPC – solidified popular support but created serious economic problems. 1/ In the aftermath, foreign investment and banking credit flows fell sharply, as did new economic assistance from international agencies and the United States. Despite massive efforts, the regime was unable to obtain much usable assistance from Communist countries or attract substantial new capital from such non-US sources as Western Europe. While the government's stabilization policies improved public finances, the balance of payments, and price stability, the economic and social reform program caused domestic businessmen to hold back with investments. The recession continued through 1969, with per capita output declining for the third successive year (see Figure 1).

Domestic Economic Developments in 1970

Output and Investment

5. Fortuitous circumstances led to a resumption of economic growth in 1970. Except for private construction, all sectors contributed to the advance in output of about 6%. Good weather increased agricultural output by about 5%, and the fish catch soared by 40% to a record high. Despite continued strikes by rival unions, mine output rose in response to high world market prices, and increased liquidity and rising wages helped fuel an 11% increase in manufacturing output. Even construction rose slightly

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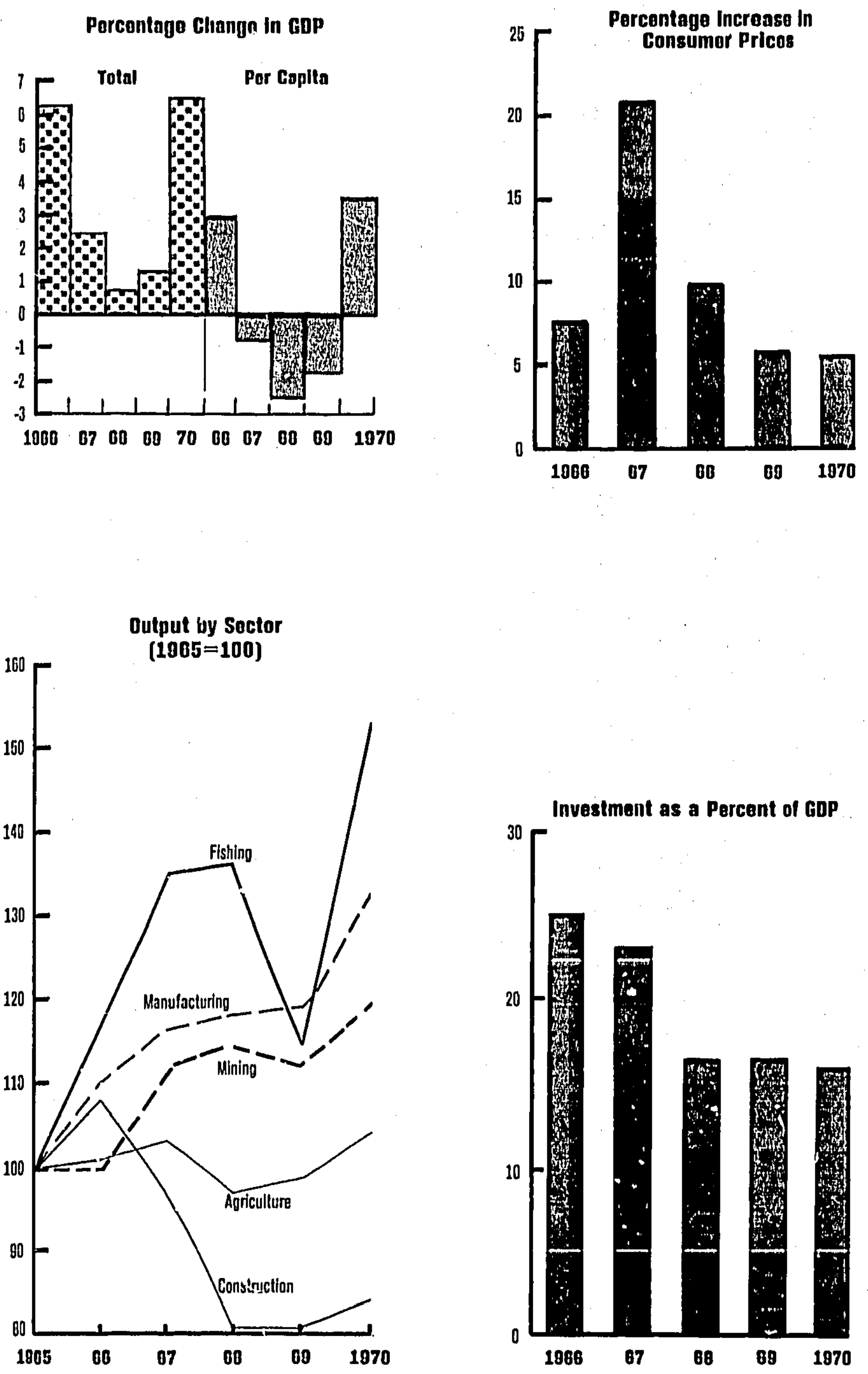
Figure 1

Peru: Selected Economic Indicators



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because of increased public investment and large earthquake relief expenditures at the end of the year (see Figure 1). Nevertheless, domestic private investment remained depressed, not only because of the regime's reform program but also because of the excess capacity created by the investment boom of 1964-67 – when gross domestic investment averaged 23% of gross domestic product (GDP).

6. Increasing government pressure on foreign investors to develop their long-held mineral concessions resulted during 1970 in the start of work on the $355 million Cuajone copper project and the $12 million Madrigal mine. In addition, work continued on a $25 million expansion program at the Marcona iron mine, and the Belco Petroleum Company initiated a $20 million investment program. Despite these developments, there was a net outflow on total direct investment of some $15 million, as in 1969. Moreover, the book value of direct foreign investment fell sharply because of the negotiated nationalization of foreign-owned equity in domestic banks and an International Telephone and Telegraph Company subsidiary and the sale of several US-owned properties to Peruvians.

Trade and Balance of Payments

7. High fishmeal prices and production and increased sugar output raised export earnings by 17% during 1970, while import controls and stagnating demand for capital goods by manufacturers held imports to a 4% rise (see Figure 2). Contributing to the boost in export earnings was the government's takeover of fishmeal marketing in mid-1970. Because Peru normally accounts for about 60% of world fishmeal exports, the new government marketing agency was able to fix prices at high levels despite a record catch and increasing stocks. High prices helped Peru to boost fishery export earnings by 58% (to $347 million) in 1970, but the fishmeal stocks are now proving troublesome because of deterioration and the high cost of storage.

8. Net foreign exchange reserves soared from $152 million at the end of 1969 to $410 million – the equivalent of seven months' imports -- at the end of 1970. In addition to achieving a record trade surplus, Peru obtained nearly $60 million in balance-of-payments relief in 1970 by renegotiating its foreign debt payments the previous year (see Table 1). This action helped to offset the reduction in economic assistance resulting from the IPC controversy. Moreover, Peru received about $60 million in US and other foreign grants for earthquake assistance and $14 million in special drawing rights from the International Monetary Fund. Nevertheless, the capital account would have had a substantial deficit had it not been for the forced repatriation of about $170 million in foreign currency deposits of Peruvian citizens.

Figure 2

Peru: Exports, Imports, and Net Foreign Reserves

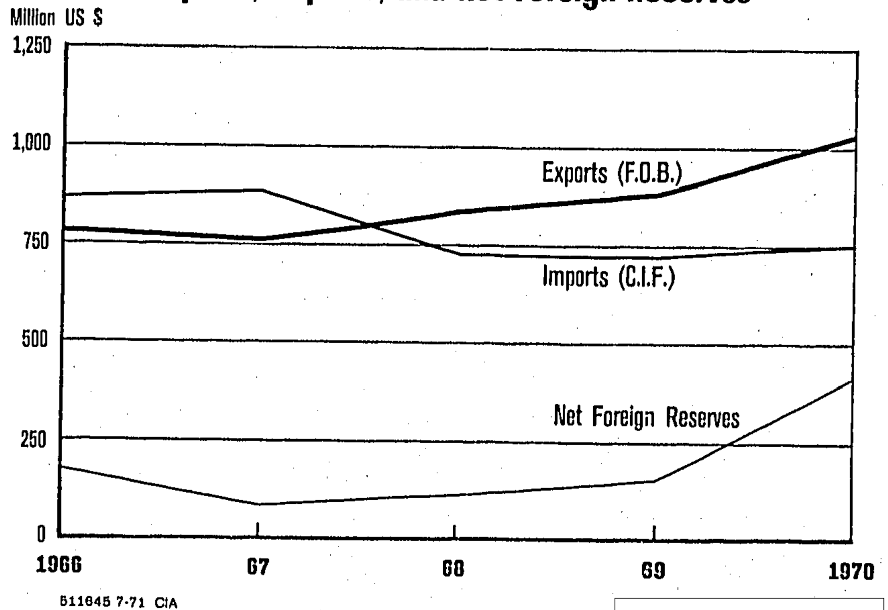

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Table 1

Peru: Net Long-Term Capital Flows

Million US $

Year	Private Flows	Official Flows: With Debt Servicing as Scheduled	Official Flows: Gained from Debt Renegotiation	Total
1966	+ 35	+ 143	–	+ 178
1967	+ 27	+ 142	–	+ 169
1968	– 15	+ 54	+ 50	+ 89
1969	– 11	+ 40	+ 80	+ 109
1970	– 23	– 55	+ 59	– 19

Public Finance

9. After two years of austerity, budget policy became expansionary during 1970. Investment expenditures increased by 38%, while current expenditures rose about 12%. Because revenues increased only 11%, the budget deficit widened considerably, although it remained much smaller than in 1966-68 (see Table 2). As in 1969 (but unlike previous years), public savings were sufficient to finance a large share of public investment. Moreover, despite the lack of new foreign loans to finance the budget deficit, little recourse to inflationary bank credit was necessary. The forced repatriation of Peruvian bank deposits abroad greatly increased domestic liquidity and allowed the government to place about $80 million in domestic bonds, which covered almost the entire deficit.

Implementation of Reforms

10. The Peruvian "revolution" appears to have entered a period of consolidation and, perhaps, reconsideration. 2/ Few new reforms have been introduced since mid-1970, although the regime has broadened the scope of some earlier bills and continued to increase its control over the economy. Recent developments – the replacement of the Minister of Agriculture and the Minister of Industry and Commerce by more moderate officers, the toughening attitude toward Communist union leaders, and the new favorable oil exploration regulations – indicate that the regime may be giving more consideration to the economic consequences of socially and politically motivated actions. There is little doubt, however, that it remains committed to the basic goals of economic independence, greater state control over the economy, destruction of the oligarchy's economic and political power, and more equitable income distribution.

11. Velasco views agrarian reform as a key program and has vigorously promoted it. In the first 15 months of his five-year program, some 50,000 families were settled on expropriated lands, compared with the 13,000 families settled during five years under the previous government. 3/ [redacted] 25X1

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Table 2

Peru: Government Finances

Billion Soles

	1966	1967	1968	1969	1970
Revenues	20.3	23.5	28.9	33.8	37.5
Current expenditures	19.5	23.6	27.5	28.4	31.9
Public savings	*0.8*	*-0.1*	*1.4*	*5.4*	*5.6*
Foreign grants for earthquake relief	-	-	-	-	0.4
Capital expenditures	5.9	6.3	6.1	6.3	8.7
Deficit	*5.1*	*6.4*	*4.7*	*0.9*	*2.7*
Financing of the deficit					
Foreign loans	1.8	3.2	1.8	1.7	-0.7
Domestic loans	3.3	3.2	2.9	-0.8	3.4
Of which:					
Central Bank credits	3.7	1.8	1.5	-0.2	0.3

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12. Industrial reform has advanced more slowly, probably reflecting growing concern in the government over the feasibility of some measures. The questionable workability of several provisions of the automotive decree (which drastically restricts the use of imported components while setting low price ceilings for vehicles) has caused widespread dissatisfaction, and doubts are growing about the economic costs of the decree granting workers eventual 50% ownership in manufacturing firms. The new Minister of Industry and Commerce has been welcomed by businessmen as being more moderate and realistic but thus far has given little indication of the path he actually will follow.

<u>Foreign Economic Relations and the Copper Expansion Program</u>

13. Velasco's foreign economic policies, emphasizing independence from the United States, have been reflected in nationalization of some US-owned firms, increased government control over others, and concerted attempts to increase economic ties with Japan, Western Europe, and Communist countries. Although Peru has increased its mineral and fishmeal exports to Communist countries, it has not been markedly successful in obtaining aid from them. Some $70 million in suppliers' credits have been extended by the Communists, but so far there have been no drawings on them. Two competing credit offers have been obtained from Western Europe -- a $69 million Belgian credit to finance a copper mine and refinery and a British offer of $100 million to develop the same deposit. In addition, a Yugoslav firm is negotiating to construct and help finance an $80 million irrigation project in northern Peru [redacted] 25X1 At the same time, there has been substantial disinvestment by US firms and a drop of more than $100 million in short-term credit outstanding from US banks. Moreover, aside from the earthquake relief and about $55 million in loans from the Inter-American Development Bank, Peru has received no economic aid recently from the United States or international financial organizations.

14. Foreign investors' wariness of the Peruvian "revolution" has been the major cause of Velasco's failure to locate financing for the important copper expansion program. Since the 1968 coup, the regime has increasingly pressured US concession holders to develop Peru's large known deposits while setting more and more stringent terms. The deposits' exploitation, which would almost quadruple Peru's copper output of 200,000 metric tons, would cost about $1.5 billion (see Table 3). Only the Southern Peru Copper Company (SPCC) thus far has signed a contract to develop one of the deposits -- a step taken largely because it feared that otherwise its large operating Toquepala mine might be taken. SPCC has agreed to put $25 million of its own money into the Cuajone deposit by October 1971, and

Table 3

Peru: Status of Major Undeveloped Copper Deposits

Name of Deposit	Present or Former Concession Holder	Estimated Ore Reserves (Million Metric Tons)	Production Target (Thousand Metric Tons per Year)	Expected Life of Mine (Years)	Estimated Development Cost (Million US $)	Status of Concession
Cuajone	Southern Peru Copper Co. -- SPCC (subsidiary of American Smelting and Refining Corp., Cerro Corp., Phelps Dodge Corp., and Newmont Mining Co.)	500	130	39	355	Under contract; in execution
Quellaveco	Southern Peru Copper Co.	183	46	37	166	Returned to the government
Michiquillay	Northern Peru Copper Co. (subsidiary of American Smelting and Refining Corp.)	455	121	31	334	Returned to the government
Cerro Verde	Anaconda Co.	149	40	37	155	Returned to the government
Morococha	Cerro Corp.	180	90	15	250	Canceled by the government, but a new contract is under negotiation
Antamina	Cerro Corp.	20	28	16	56	Canceled by the government
Tintaya	Cerro Corp.	8	18.6	13	37	Canceled by the government
Las Bambas	Cerro Corp.	30	65	10	150	Canceled by the government

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the regime recently accepted the company's guarantee that financing will be provided for the remaining $330 million cost of the project despite failure to obtain outside financing after lengthy negotiations with the Japanese and West Europeans. Cerro Corporation, which has a nonferrous mining complex that also is vulnerable to adverse Peruvian action, has tried -- so far without success -- to come to terms with the government.

15. Except for SPCC's Cuajone project, all major unexploited copper concessions now have reverted to state ownership because the companies failed to meet the regime's development deadlines. Although the companies were reluctant to lose their concessions, they decided that they had little alternative in the face of the government's increasingly confiscatory demands concerning ownership rights, tax rates, and control of refining and marketing. The companies were unwilling to risk their own capital in such an unstable investment climate and were unable to arrange financing from other private sources. Because of the IPC dispute, moreover, neither US government investment guaranties nor Export-Import Bank loans have been available for investments in Peru.

16. Peru probably thought it was dealing from strength in negotiating with the US companies because of high world copper prices in 1969-70 and widespread interest in locating new copper supplies. The government established a state mining company, Minero Peru, to develop the lapsed concessions and apparently expected little difficulty in luring other foreign capital into joint ventures or credit financing of the projects. Thus far, Minero Peru has located financing for only one of its projects -- the first stage of the relatively small Cerro Verde deposit, previously held by Anaconda. Details of the competing British and Belgian credit offers are still being considered, and work on the project is unlikely to begin before 1972.

17. Aside from copper, the only other significant area of interest for foreign investors is petroleum exploration in the Amazon region. Because of the large oilfields discovered east of the Andes in both Ecuador and Colombia, there has been considerable speculation that Peru may have similar deposits. In late June, Peru signed a contract calling for Occidental Petroleum Company to invest $50 million in exploration over the next seven years. If oil is discovered, Occidental will share output equally with Peru. In addition, the company will build a trans-Andean pipeline to carry the crude oil if the strike justifies it. Occidental also has a contract for a much smaller offshore exploration program. Since Peru's production from the former IPC holdings is declining rapidly, output from new fields is needed to avoid increasingly large petroleum imports. Even if substantial reserves are found, their economic contribution will be small until the mid-1970s because of the time required to construct a pipeline.

Outlook

18. The economic growth rate probably will be relatively high during 1971, but such a pace will be difficult to maintain in subsequent years. Overall demand should continue to increase in response to rising wages and government spending, including an expanded public investment program. Because of the low level of industrial investment since 1967, however, manufacturing growth probably will soon be restrained by capacity limitations. Domestic private investment may recover somewhat as capacity output is reached, but much will depend on how the regime administers the industrial reform law. Although no major additions to mining capacity will occur in 1971, the government's hardening attitude toward disruptive labor activities should result in expanded production from existing mines. Prospects for continued rapid growth in agricultural output are not good, however, because production already has recovered to pre-drought levels and will be increasingly affected by agrarian reform.

19. Inflationary pressures will be strong during the next year or so unless the regime raises taxes or reduces public investment -- moves that would restrict growth. Because foreign loans probably will continue to be scarce, domestic financing needs will be large. Despite continued excess liquidity in the private sector, the government probably will be unable to meet its financial requirements through non-inflationary domestic bond issues, as in 1970. It thus will have to borrow heavily from the banking system if it is to carry out its investment plans. Moreover, the government will find it politically difficult to pursue a more austere wage policy and economically counterproductive to increase credit and price controls. Even if the government increases imports to offset slower agricultural growth and manufacturing bottlenecks, more rapid inflation seems inevitable.

20. Peru faces a marked reduction in its trade surplus during the next few years. Export earnings are expected to stagnate, and unless controls are tightened, imports should rise rapidly after being depressed for three years. The volume of mineral exports may rise slightly, but this gain could be offset by further price declines. Fishmeal output has about reached an ecological limit, and the large accrued stocks will tend to hold down prices in the near future. Although Peru has been able to increase fishmeal exports to Communist countries – including recent sales of 105,000 tons to Cuba and 200,000 tons to China – the shift of many US and West European consumers to other, less expensive protein sources could force price reductions. Agricultural exports – mainly sugar and cotton – also may suffer declines as growing domestic demand for foodstuffs causes shifts in land use. Moreover, sugar export proceeds are likely to fall because Peru's quota for the US market is facing a substantial cut and Chile, a traditional non-quota market, is now being supplied by Cuba.

21. Although large net payments for services are expected to more than offset a decreasing trade surplus during the next few years, capital transactions will largely determine how much Peru will have to draw down its foreign reserves. Foreign debt payments are scheduled to rise sharply in 1972-75 and, although Peru probably will request another rollover, its presently large reserve holdings may make creditors less forthcoming than they were in 1969. Barring a major shift in the investment climate -- which is not now anticipated -- receipts of economic assistance and private foreign investment are not likely to be sufficient to avoid fairly large balance-of-payments deficits during the next few years.

22. In the long run, Peru's economic growth and foreign payments position will depend heavily on its ability to attract large-scale investment, particularly in mining. Attracting capital in turn will depend upon the government's willingness to adopt policies more favorable to private business and the ability to convince prospective investors of their durability. Under the best circumstances, the long lead times and heavy costs involved in completing new mines and other large projects will preclude any major contribution to output capacity or export earnings before the mid-1970s. If the Velasco government -- or its successor -- adheres to the nationalistic and statist path it has thus far pursued, this timetable will almost certainly be considerably delayed and possibly indefinitely postponed.