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I. Abstract and Policy Options

A. Introduction

By early April the U.S. Government must make decisions concerning Peru which will profoundly affect the future of our long-term relationships with that country and may also alter the course of U.S. relations with Latin America generally. The principal problems are (1) the International Petroleum Company (IPC) dispute and (2) the territorial waters dispute (in which Ecuador as well as Peru is involved).

This study describes the background for those impending decisions and the various options, but does not recommend what the decisions should be. Nor does it take into consideration purely domestic U.S. political factors.

The first section summarizes the problem and alternate policy options open to the U.S. Government in conducting its relations with Peru during approximately the next six months.

Subsequent sections deal with the background: the political and economic setting in which the events in Peru

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have transpired; U.S. relations with Peru since 1962; the history of the IPC and territorial waters disputes; steps now under way by the United States to influence Peruvian actions; and the implications of invoking the sanctions required by U.S. law if the Peruvians do not alter their course.

B. Summary of Current Situation

On October 4, 1968, the Government of Peru, having the day before seized power in a military coup d'état, nullified an agreement which had been signed August 12, 1968 between the International Petroleum Company and the previous Peruvian Government headed by Fernando Belaunde Terry. 1/ The cancelled agreement had resolved a long-standing dispute between IPC and the GOP which involved the validity of IPC's subsoil rights in the La Brea y Pariñas oil field of northern Peru. By the terms of the agreement with Belaunde, IPC had accepted the transfer of its subsoil rights to the Government of Peru; in return, the GOP had dropped any and

1/ IPC is a corporation chartered in Canada, 99.9 percent of whose common stock is owned by the Standard Oil Company of New Jersey.

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all financial claims against IPC arising out of IPC's possession of the oil field between 1924 and the date of the agreement.

On October 9, 1968, the new Peruvian military government expropriated IPC's refinery and related installations at Talara. Although the GOP theoretically recognized its obligation under international law to compensate IPC for the expropriation of the refinery and related installations, the new Government held that IPC's subsoil rights had <u>never been valid</u>. The Government later alleged that IPC owed $690 million to the Peruvian nation for crude oil "illegally extracted" over the 44 year period.

The Peruvian Government maintains that any compensation due to IPC for the loss of its refinery and above-ground installations would be offset by the alleged debt, the clear implication being that IPC would receive <u>no compensation</u> for the loss of either its subsoil rights or its above-ground facilities and, indeed, would be left in a position of net debtor to the GOP.

If by April 4, 1969, the GOP has not taken appropriate steps to discharge its obligations under international law

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arising from its cancellation of the agreement between IPC and the previous Peruvian Government on subsoil rights, the United States Government will be obligated by Section 620(e) of the Foreign Assistance Act of 1962 (the Hickenlooper Amendment) to suspend U.S. economic and military assistance to Peru.

If by April 9, 1969, the GOP has not taken appropriate steps to discharge its obligations under international law arising from its expropriation of IPC's above-ground facilities, the United States Government will be obligated by Section 408(c) of the Sugar Act of 1948 to suspend Peru's quota for the export of sugar to the U.S. market.

Invoking these sanctions would spark a confrontation with profound political and economic consequences throughout much of Latin America. Peru's economy would be severely damaged by the sanctions and by reductions in international lending and private investment which would necessarily follow. Peruvian reactions could well go beyond blocking of profit remittances by U.S. firms to expropriation of other U.S. investors, a demand for withdrawal of U.S. military advisors, an increased flirtation with the Soviet Union, reduction of U.S. diplomatic representation, and a sharp wave of anti-U.S. nationalism throughout Peruvian society.

Elsewhere in Latin America public reaction would condemn the U.S., hardening Peru's conviction that its cause is just. Widespread anti-U.S. resentment over other economic issues which plague our hemisphere relations would rise sharply.

Superimposed on the IPC dispute and interacting with it is the dispute between the United States and Peru (as well as Ecuador) over territorial waters, which has resulted in repeated interference by Peru (and Ecuador) over a period of some fifteen years with American fishing vessels operating in waters which the United States and most nations of the world consider to be the high seas. Peru's most recent seizure of a U.S. fishing vessel on February 14, 1969, has called into play sanctions enacted by Congress in the past two years which will likely require the recall prior to April, 1969, of a U.S. destroyer on loan to Peru, as well as cessation of J.S. Government military sales to Peru. 1/ Both of these ctions are likely to further inflame Peruvian passions.

/ A temporary suspension of military sales went into effect ı February 18, 1969, as a precautionary step.

During March, a special Presidential emissary to President Juan Velasco Alvarado of Peru will explore avenues of possible negotiation in an effort to head off this confrontation. The Peruvian Government has taken an emotional, nationalistic position, however, with regard to both the IPC and territorial waters questions--a position which has struck a popular responsive chord among the Peruvian public and elsewhere in the Hemisphere. Chances are very slim that the Peruvian military regime will depart from its present intransigent course before deadlines arrive for U.S. sanctions to be applied in early April.

C. U.S. Objectives in the Next Six Months

Regardless of the action taken when the April deadlines for sanctions arrive, the United States objective in the months after April should be to return relations with Peru to a friendly basis and to initiate progress toward long-range solutions of both the IPC and the territorial waters disputes. We must pursue these goals in ways which will assure maximum favorable results in other key Latin countries. It would accomplish little to solve U.S. problems with Peru by strong-arm methods, only to find that U.S. relations elsewhere in Latin America had been badly damaged by widespread condemnation of U.S. actions.

Peru's de facto government has declared its intention to reform public administration and society. It is a military government, however, headed by an increasingly anti-American general, which threw out a democratically-elected administration to assume power. President Velasco is increasingly subject to criticism privately from more moderate officers of the armed forces and from influential Peruvian businessmen worried about the effects of Velasco's political extremism upon the economy. At the same time, Velasco's popular appeal remains strong and may grow temporarily if U.S. sanctions make him a nationalist martyr. He may be replaced by another general within the next six months, and there is a good chance that any replacement would be a man of more moderate views. However, there is little chance of any early return to elected government. U.S. goals for this time frame must concentrate on establishing a satisfactory relationship with the military junta.

In earlier years the Peruvian officer corps was content to be the behind-the-scenes arbiter of political power, intervening overtly only when the equilibrium among the active political forces in the country was disturbed and political and economic stability seemed threatened. Today, however, military officers feel a new responsibility to defend the national dignity and to put right the pressing social problems of the country, believing that unless these things are done soon there will be a resort to radical egalitarian solutions which could bring political and economic chaos and destroy the armed forces as they presently exist. The military have lost confidence that democratic government can take the necessary steps, and they have given every indication that they intend to remain in office a long time.

D. Policy Options Open to the United States After April 9

Policy options fall under three possible cases, which are differentiated by their assumptions as to what the Peruvians will do between now and the sanctions deadlines. Hopefully the United States will have some influence on what Peru does, through the steps now being taken which include the sending of a Presidential emissary.

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1. Case One: No Progress in Resolving Problems - Sanctions Invoked

(Assumes that Peruvian Government remains unwilling to take any credible steps toward a settlement)

a. "Hard-Line Option

1. Actions Required by Law:

- Suspend all military aid;
- Suspend all economic aid, including disbursement of funds under previous agreements;
- Halt sugar imports from Peru;
- Exercise U.S. veto on loans to Peru by IDB from its soft-loan Fund for Special Operations;
- Issue no new investment or housing guarantees, except where irrevocable investment commitment already made;
- Terminate PL 480 sales or grants, except grants for famine and disaster relief.

2. Optional Additional Measures

- Recall U.S. military missions (strict interpretation of Hickenlooper Amendment could make this mandatory);
- Withdraw AID personnel and terminate projects abruptly;
- Deny Export-Import Bank loans;
- Dissuade private U.S. investment;

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- Discourage private U.S. banks from renewing credit lines;

- Use U.S. influence and voting power to discourage credits or loans from IMF, IBRD, and IDB (hard-loan Ordinary Capital) 1/;

- Withdraw U.S. Ambassador.

3. Probable Results

This "hard-line" policy would have a devastating effect on Peru's economy, with the impact becoming manifest to the average Peruvian within three to six months. President Velasco would at first be strengthened as a popular nationalist martyr, but influential military and civilian leaders would worry still more about the direction in which he was leading Peru. Gradually Velasco might lose public support as economic conditions worsened, and there might be more chance of his being replaced by a more moderate general. But in the meantime his nationalistic fury could stimulate demonstrations and violence against American installations and individuals, and he could be driven in desperation to move against other U.S. companies, capture U.S. fishing vessels, and seek closer

1/ In the case of the IDB's Ordinary Capital, a quorum cannot be obtained in the Board without the presence of the U.S. Executive Director.

relations with the Soviet Union. He might expel the U.S. Ambassador, or break relations.

It should be noted, of course, that even a new Peruvian President probably could not very soon reverse Peru's course and work toward a settlement, once hard-line sanction had been imposed.

In the Hemisphere at large and before the OAS Peru would charge "economic aggression" by the United States, and would garner widespread sympathy. Most people would remain ignorant of the detailed facts of the IPC case, and would be readily disposed to believe that the United States had abandoned the high principles of the Alliance for Progress in favor of a resort to "dollar diplomacy." Understanding of the mandatory nature of the U.S. sanctions and their political rationale would be poor, despite U.S. efforts to explain its position. Latin American Governments - being more familiar than the public with the facts of the case, and valuing their bilateral relationships with the United States - might be reluctant to side with Peru in any formal effort to condemn the United States. Most would, however, be compelled for political reasons publicly to declare their moral support for Peru.

Pros:

- In the long run Velasco's downfall and possible replacement by a moderate might be hastened.

- The United States would demonstrate to other governments that the sanctions in its laws are not idle threats - inhibiting expropriation elsewhere.

Cons:

- Velasco might become a martyr and be strengthened.

- Any possibility of return to friendly relationship with Peru would be sacrificed for the foreseeable future, whether Velasco remained in office or not.

- Innocent Peruvians would suffer from the effects on the economy.

- Velasco might undertake reprisals against the United States.

- He might try to draw closer to the Communist countries.

- U.S. prestige in Latin America would be badly damaged.

b. "Soft-Line" Option

The United States would apply only the sanctions described above as required by U.S. law, attempting to see that sources of external private and multilateral financing remain available to Peru. The reduction of aid might be done on a gradual basis. Inasmuch as the difference between "hard-line" and "soft-line" sanctions might not be readily perceivable in the Hemisphere, the United States would probably wish to announce that it was applying only the sanctions required by law, and it might go so far as to encourage the Export-Import Bank to make a loan, in order to demonstrate the milder policy and to encourage private investors to go forward with their plans to invest or lend in Peru.

The effects on Peru's economy would be much less devastating but still grave, while Velasco's personal position would be weakened less but nevertheless seriously. There would be a somewhat smaller chance that Velasco would move against other U.S. companies, declare all-out war on U.S. fishing vessels, or seek to move closer to Russia. The reaction in the Hemisphere at large to the soft-line option would be highly critical, but not as critical as under the hard-line option.

Pros:

- The unfavorable effects listed as "cons" under the hard-line option would be less likely to occur or would be of less intensity.

- The United States would be able to claim that its sanctions represented the minimum required by U.S. law.

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- Other Latin American Governments would be much less likely to support Peru in any formal effort to condemn the U.S. before the OAS.

- U.S. credibility would be maintained at less cost to long-term prospects for our relations with Peru.

Con:

- There would be less chance that U.S. sanctions would contribute to Velasco's downfall and possible replacement by a moderate.

2. Case Two: Slight but Inadequate Progress in Resolving Problems - Sanctions Not Invoked (Fig-Leaf Case)

(Assumes that Peruvian Government has taken some legally credible steps in the direction of a solution but the prospects for a solution are very remote; the U.S. Government has decided not to invoke sanctions, at least for time being)

a. "Hard-Line" Option

1. Possible U.S. Actions

- No new AID loans, MAP, military credit sales, or PL 480 sales;

- Veto IDB loans from Fund for Special Operations;

- Delay EXIMBANK financing;

- Encourage delay in U.S. private investment and bank credits;

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- Continue to stall loans from IBRD and IDB (Ordinary Capital)

- Tell Peru that sanctions being deferred to allow time to permit real progress toward compensation to occur;

- Continue AID disbursements, MAP deliveries, investment and housing guarantees, and PL 480 grants;

- Continue sugar purchases;

- Continue military advisory missions.

2. Probable Results

Under these circumstances the damage to Peru's economy would be less than under the two previous options (Case One), and would probably be within the capacity of the Velasco Government to sustain, depending on the degree of pressure the United States exerts. Velasco would not become a martyr but, rather, a hero--for having successfully faced down the United States, and he might conclude that he could outbluff the United States indefinitely. Moderate military officers and leading businessmen would be weakened in their ability to influence him or remove him from office.

Latin Americans throughout the region would publicly applaud the United States for its restraint, even though privately many would lose respect for this country for lacking the courage of its convictions. If, after delaying the formal sanctions for a period, the United States found itself forced to invoke them anyway, the economic damage to

Peru, the adverse political effects in Peru, and the psychological damage to U.S. prestige in the Hemisphere would be great.

Pros:

- This option would give more time to find a face-saving formula which would permit Peru to change course, while keeping substantial economic pressure on Peru to seek an adequate settlement.
- Some limited measure of U.S. credibility would be maintained.
- Some other nations could be restrained from following Peru's lead.

Con:

- The U.S. would engender substantial frictions with other nations by attempting to exert "political pressure" through the IMF, IBRD, and IDB.

b. "Soft-Line" Option

The United States would not adopt any of the measures listed above to keep pressure on for real progress toward a final settlement. The President might make a finding that some progress permitted him not to invoke the sanctions, and he might then ask Congress to repeal the legislative provisions which require them.

If prospects for repeal seemed dim, the President might rather choose to state that the minimum requirements of the law were being met, e.g., through the administrative and legal remedies available to IPC in Peru.

Selection of this option would imply a judgment that adverse effects from invoking these sanctions would inflict unacceptable damage to our long-range hemispheric foreign policy interests. The decision would clearly reject the future use of Hickenlooper-type devices for protecting U.S. investment abroad, at least in Latin America.

Under the soft-line option U.S. relations with Peru would be based on the same criteria that apply to relations with other Latin countries, regardless of these unresolved issues. Economic and military aid would continue and could even be increased if the Velasco Government satisfied our assistance criteria. (Principal standards would be its performance in the fields of economic and social reform and its degree of respect for civil and personal liberties).

A consequence could be that other countries in Latin America or elsewhere might feel freer to seize U.S. investments without adequate compensation if it were in their political interest to do so. Should Congress repeal the sanctions, the United States would be applauded in Latin America for its new policy stance.

Pros:

- The United States would avoid a dangerous confrontation with Peru which could snowball to other Latin countries.

- Peru's economic program could go forward with essential external support.

- U.S. Peruvian military ties would continue.

- Opportunities for Soviet mischief would diminish.

- U.S. foreign policy in Latin America would be less burdened by the need to invoke inflexible sanctions to protect U.S. private investments, and policy would gain in flexibility.

- If the amendments were repealed, U.S. prestige in Latin America would be enhanced, especially among liberal political elements.

Cons:

- Velasco's position would be greatly strengthened.

- Other governments might feel freer to expropriate U.S. investments without compensation, and the flow of U.S. private capital to Latin America might be reduced.

- Many Latin Americans would regard as weakness our having blustered so much about sanctions, and then "backed down."

3. <u>Case Three</u>: <u>Real Progress Toward a Solution--</u>

<u>Sanctions Not Invoked</u>

In the event the Peruvians changed their course and began earnest negotiations looking toward a solution, or agreed to arbitration, or took steps to make sure that IPC could get justice in the Peruvian courts, the United States and Peru would be headed back toward more normal relations. The United States still might be faced with choices, however. It might conclude that final resolution of the IPC dispute, and of the fisheries dispute, might best be obtained if pressure were kept on Peru. This could mean the continued withholding of new AID loans and P.L. 480 sales. Alternatively, the United States might conclude that continued progress on outstanding problems would best be assured by being relatively forthcoming on new aid authorizations.

[Omitted here are Section II, "Political and Economic Background;" Section III, "U.S. Bilateral Relations with Peru;" Section IV, "The IPC Case;" and Section V, "Current Status of IPC Problem and Likely Developments Between March 1 and April 9."]