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9 The Illusion of Pursuing Redistribution through Macropolicy: Peru's Heterodox Experience, 1985–1990

Ricardo Lago

9.1. Introduction

From the Inca empire to the viceroyalty and then to the Republic, Peru has enjoyed both international prominence and open opportunities for economic development. The "guano era" in the nineteenth century gave Peru considerable surpluses, as did mining, fishing, and petroleum in more recent times. Yet, despite its generous resource endowment, Peru has failed to find its way to a stable political, social, and economic environment in which to prompt balanced growth and equitable development. Economic decline has been particularly notorious over the last three decades, when Peru's income per capita fell from the eighth highest in Latin America in the 1960s, to the fourteenth position in the late 1980s.[1] At the turn of the decade, Peru's economic retrogression can be gauged by an income per capita equal to that of 1960 and by a level of exports 40 percent lower than that of 1979. Peru's frustrated economic and social expectations were eloquently described by its leading historian, Jorge Basadre, who defined Peru as a "beautiful promise yet to be fulfilled."

The object of this paper is to analyze the economic process undergone by Peru during the period 1985–90 during which the legendary APRA party (American Popular Revolutionary Alliance) assumed presidential office, for the first time, under President Alán García. Following closely the methodol-

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1. *World Development Report,* various issues (Washington, D.C.: World Bank).

ogy recently developed by Dornbusch and Edwards (1990), the paper is organized as follows.

The next section provides a brief background on Peru's economy and recent history. The third section analyzes the "heterodox" economic policies of the period 1985–90 an their results. The section opens with a description of the macroeconomic legacy—of high inflation and low income, but also of competitive exchange rate, high public tariffs, and sizable international reserves—left by the second administration of Fernando Belaúnde. This legacy represents the initial conditions of the period under examination. The section continues with a discussion of the analytical framework underlying the macroeconomic program launched in August 1985. The focus then shifts to an analysis of the expansionary phase of the heterodox experiment (1985–87), starting with a description of the economic measures—of demand expansion, price freeze, and unilateral default—contained in the 1985 policy package, and following with an examination of the dynamics of the consumption boom, in which GDP expanded by a cumulative 16 percent and inflation initially declined but at the expense of mounting financial and external disequilibria.

This main section closes with a detailed analysis of the recessionary phase (1988–90) during which, after three unsuccessful corrective attempts, the economy lapsed into an incipient hyperinflation and a major recession and real wage decline. Particular attention is given to the period September 1988 through June 1989 in which the Central Bank took an independent course of credit restraint, whereby it managed to partially hold back the hyperinflationary course and to accumulate a considerable level of international reserves. This trend, however, was later reversed in 1989 when economic policy engaged again in another round of expansionary policies in an attempt to reactivate economic activity through depletion of international reserves.

The fourth section sums up some of the devastating effects of the experiment on income distribution, other welfare indicators, resource allocation, rural incomes, the tax system, public infrastructure, and the financial viability of the public sector.

Finally, the fifth and last section contains a few thoughts and concluding remarks on demand-led experiments in the light of Peru's recent experience. The main ones are the following. First, the phases of the Peruvian process of 1985–90 match closely those of the paradigm established by Dornbusch and Edwards (1990). Second, the idea of finding strategies for rapid reactivation of severely depressed economies—typically coming out of a previous stabilization phase—has indeed long appealed to politicians and economists alike. However, the recent Peruvian experience proves, as many others have, that this type of policy course almost inevitably implies disregard for the constraints imposed by flow of funds accounting and thus leads to macroeconomic failure. On the other hand, the policies utilized to prompt the recovery—comprising typically a broad array of subsidies, controls, and import restrictions—are diametrically at variance with the incentive structure re-

quired to move the economy into the desired follow-up phase of investment and export growth. Therefore, demand-led macroeconomic booms have an inevitable and devastating aftermath of high inflation and decline. Third, of the different theories that attempt to explain why politicians launch self-defeating policies, Peru's recent experience provides some evidence supporting the hypotheses of high discount rate and faulty economic framework. However, these explanations are partial and somewhat naive and therefore, a more thorough consideration of political agents and factors is probably called for. Finally, Peru's very unequal income distribution and acutely diverging interests between urban and rural groups, on the one hand, and labor and capital, on the other, makes it particularly prone to unstable stop-and-go economic policy cycles.

9.2 Background and Recent History

Efforts to forge physical, economic, linguistic, and cultural links between Peru's three distinct regions—the highlands (*sierra*), the rain-forest (*selva*), and the coast—have long confronted the formidable natural barrier of the Andean mountains. About half of Peru's population of about 22 million live in the coastal region, while 40 percent live in the Andean highlands and the rest in the Amazon region. Income per capita, which has declined steadily since the mid-1970s, is now about $1,000 (in U.S. dollars). Income distribution is one of the most uneven in Latin America, and other welfare indicators, such as life expectancy and infant mortality, are among the worst in the region (see table 9.1). More than half of Peru's poorest 30 percent live in the Andean highlands and are self-employed peasants. Agriculture and mining have long lost their predominance in the economy due to the import substitution model

Table 9.1 **Income Distribution (% of Total Income)**

Percentile	1961 (Earners)	1972 (Household Consumption)	1985–86 (Household Consumption per Capita)
Poorest			
20%	2.5	3.2	4.1
21%–40%	5.5	7.3	8.9
41%–60%	10.2	13.3	14.0
61%–80%	17.4	21.5	21.6
81%–90%	15.2	17.7	16.2
Wealthiest 10%	49.2	37.0	35.2

Source: Data for 1961: Webb (1975); for 1972: Amat y Leon (1979); for 1985–86: Glewwe (1987), based on data from Peru's 1985–86 "Living Standard Measurement Survey," The World Bank.

Note: Figures are not comparable across years due to different methods.

followed since the sixties that gradually made manufacturing the mainstay of the economy.

Peru's modern history has been marked by political and economic instability. Single-term democratically elected governments have usually been followed by periods of military juntas and vice versa, in an almost alternating sequence. In turn, recurrent expansionary macroeconomic policies have ultimately run into foreign exchange crises and subsequent stabilization episodes. The Peru of the 1950s has been characterized as a laissez-faire economy. The country was open to foreign trade; exports of raw minerals, mostly exploited by foreign interests, and fish meal paid for imported manufactures. In turn, the government had little direct participation in the economy, and economic activities were largely unregulated. Industrialization by import substitution and government spending in the infrastructure started with the first government of Fernando Belaúnde (1963–68). A long-pursued tax reform needed to restore macroeconomic stability was systematically opposed by an uncooperative Congress, and Belaúnde's first term ended with an economic crisis and a military coup.

During the nationalistic rule of General Velasco Alvarado (1968–75), the government embarked on an inward-looking growth strategy, established a broad array of controls on economic activity, nationalized foreign corporations—particularly in mining and hydrocarbons—gave workers participation in ownership and management of private firms, and undertook a global agrarian reform. Large-scale public investment projects and a rapidly growing state enterprise sector brought about a mounting foreign debt.

Favorable external conditions during 1970–74 allowed rapid expansion of employment and incomes. In fact, income per capita had grown steadily, at an average annual rate of about 2.7 percent, during the entire 1950–74 period, with the exception of the years 1968–69. In parallel, inflation during that period had been moderate but growing. It rose from an annual average of 7 percent in the 1950s to the teens in the 1960s and early 1970s (table 9.2).

Starting in 1974, a deep downswing in the terms of trade together with a sudden withdrawal of foreign financing sources, in the wake of overly expansionary public spending, set the ground for a long recession. In that process, General Velasco Alvarado was forced out of office in 1975 by an internal coup that put his prime minister, General Morales Bermúdez, into the presidency. Income per capita stagnated in 1974–76 and then dropped, for two consecutive years, 1976–78, by a cumulative 5 percent, while inflation accelerated from single-digit rates early in the decade to nearly 70 percent in 1978.

A strong stabilization attempt was initiated in 1978–79, with the help of favorable terms of trade. In 1979, confident that economic growth had resumed and international reserves had been restored, the government initiated an import liberalization program. In that year, general elections were held and Fernando Belaúnde was voted back into the presidency. Belaúnde enjoyed massive international support but inherited a country with formidable social

Table 9.2 Public-Sector Finances and Overall Economic Performance

Years	Public Sector (% of GDP)			Annual Inflation Rate (%)	Annual Rate of GDP Growth (%)	Total External Debt (in Millions of U.S. dollars)[b]
	Gross Expenditure[a]	Investment	Deficit			
1950–62	12.5		.2	7.0	5.3	158
1953–68	19.1		2.1	11.6	4.4	737
1969–73	22.0	5.1	1.8	7.4	4.4	3,835
1974–75	35.9	8.3	7.0	21.6	6.3	5,748
1976–77	39.1	7.1	8.7	38.6	1.2	7,976
1978–79	39.6	5.2	3.2	70.2	3.1	9,329
1980–82	40.5	7.8	6.0	68.8	3.1	10,222
1983–85	43.1	7.3	6.1	131.6	−1.7	13,974
1986	36.7	5.2	9.1[c]	62.9	9.5	14,976
1987	30.6	4.0	12.9[c]	114.5	7.8	16,263
1988	28.3	3.0	15.6[c]	1,722.3	−8.8	18,018
1989	19.9	2.0	9.8[c]	2,775.3	−10.4	19,156

Source: Central Reserve Bank, National Statistical Institute; Paredes and Pasco-Font (1987).

[a]Results from adding central government expenditures (excluding transfers to state enterprises) and state enterprises' gross expenditures.

[b]End of period, includes imputed interest on arrears.

[c]Includes Central Bank financial and foreign exchange losses, as well as transfers to development banks.

problems, an income per capita below its 1974 level, and major economic distortions. However, during its first three years, his government engaged in expansionary fiscal and monetary policies, which caused inflation to double to 100-plus percent in 1983. Subsequently, the foreign trade liberalization process was reversed. Likewise, the parceling out of land plots that had been granted to cooperatives by the military rulers was effected in a less than orderly fashion. In 1983, after frustrated negotiations on foreign debt rescheduling and fresh financing with commercial creditors, the government switched into a policy of "undeclared" arrears. As explained below, efforts to stabilize the economy were made in 1984–85.

9.2.1 Brief History of the Traditional Economic Program of the APRA

Carol Graham (1990) argues that Peru's age-old paradox is "an extremely poor record of social reform in spite of the long-term presence of a strong reformist party." The APRA is one of the oldest mass-based reform-oriented parties in Latin America. Originally inspired by the Mexican Revolution, the APRA experienced a significant transformation both ideologically and tactically from a radical and revolutionary party in the 1930s and 1940s to become a more compromising and pragmatic party in the 1950s and 1960s. The

APRA's history and ideology are intertwined with the life of its founder and main exponent, Victor Raúl Haya de la Torre, who died in 1979.

Throughout its history, the three central tenets of the APRA have been: establishment of an anti-imperialist state; creation of a multiclass coalition of the oppressed (*Frente Unico de las Clases Explotadas*); and pursuit of the unification of Latin America. The APRA's economic strategy has traditionally swung from the sometimes radical and occasionally socializing proposals of the *Programa maximo* to the more moderate *Programa minimo*. The *Programa maximo* included the nationalization of some resource-based industries in the hands of foreign firms; agrarian reform, whereby large latifundia would be expropriated and given to peasant cooperatives; and the creation of a sector of state-owned firms and worker-owned cooperatives. But at the same time it also recognized the need for private property.[2] By contrast, the *Programa minimo*, approved by the first party congress in 1931 as the platform for that year's general elections, attempted to rule out any socializing fear by emphasizing respect for private property and recognizing the need for properly regulated foreign capital.

The APRA's most original proposal is the creation of the "Democratic State of the Four Powers": executive, judiciary, legislative, and economic. The economic or "fourth power" would be exercised by a National Economic Congress made up of representatives of the state, labor, and capital as a device to conciliate the interests of the different classes (*planificacion concertada*). The National Economic Congress would be a colegislative chamber and the supreme authority for economic policy planning and design.

The *Programa minimo* of 1931 established that the intervention of the state in economic activity would consist of:[3]

- control over production conditions, prices, and firms' profits;
- repression of speculative maneuvers of monopolies and oligopolies;
- surveillance of industrial and economic activities;
- reform of banking legislation;
- adjustments to private and public utility tariffs;
- regulation of rents;
- guarantees of "fair" wages and employment conditions.

The APRA suffered persecution at different times in the 1930s, early 1940s, and again in the first half of the 1950s. After the general elections of 1962, the possibility that the APRA could assume the presidential office was ruled out by a preemptive military coup (Tamayo Herrera 1986, p. 356). The APRA assumed presidential office for the first time in July 1985, after its candidate for president, Alán García, obtained 48 percent of the popular vote in the first round of the presidential elections that had taken place in April of that year.

2. V. R. Haya de la Torre, *Obras Completas*, vol. 4, pp. 110, 156, 169, 171, 192, 193; vol. 5, pp. 17, 18, 19, 34, 73 (as cited by Vasquez Bazan 1987, pp. 37–47).

3. V. R. Haya de la Torre (n. 2 above, vol. 5, pp. 11–29; in Vasquez Bazan 1987, p. 45).

The runner-up candidate, Alfonso Barrantes of the United Left, who had obtained 24 percent of the vote in the first round, declined to contend in the runoff election in view of the popularity ratings of Alán García. In the legislative elections the APRA also obtained absolute majority in both chambers of Congress.

9.3 The Heterodox Experiment

9.3.1 The State of the Country Inherited in 1985: The Initial Conditions

At the time Alán García was sworn in as president in July 1985, Peru's income per capita was comparable to what it had been in the late sixties, more than half of the labor force was registered by official statistics as not properly employed,[4] and inflation was nearing 200 percent in the 12-month period ending in August 1985. Although the official tenet of the second Belaúnde administration (1980–85) had been orthodox public finance and free markets, it undertook, during its first three years, ambitious infrastructural investments that required inflationary financing. Macroeconomic imbalances were compounded by the international recession, the drying up of voluntary external financing due to the onset of the debt crisis in 1982, and a severe natural disaster in 1983, when *El Nino* caused floods in the north and droughts in the south. These factors materialized in a 13 percent decline in GDP per capita in 1983–85.

Against this economic background, the sociopolitical situation had quickly deteriorated with continuous labor strikes and frequent attacks by Peru's two terrorist movements (the sierra-based and Maoist *Sendero Luminoso,* a Shining Path, and the urban, Cuban-style guerrilla group, MRTA). A further complication was constituted by the flourishing of drug cropping in the Upper Huallaga Valley where cocaine growers and *Sendero* had reached a morbid symbiosis. *Sendero* provides cocaine growers with protection against the government and, in return, the growers provide *Sendero* with a tax base. Export revenues from drug exports have been conservatively estimated at $1 billion per year or about 4 percent of GDP (Abusada 1987).

In its last two years (1984–85), the Belaúnde administration engaged in a serious effort to stabilize the economy. Public-sector prices were raised significantly and an aggressive exchange rate policy was pursued. The Central Bank took an independent stance from the executive and forced the latter to effect expenditure cuts and seek genuine sources of revenues. This policy course left a good legacy for the incoming APRA government in terms of a competitive

4. Official statistics estimated unemployment at 12 percent and "underemployment" at 54 percent of the labor force. Of course, underemployment is an imprecise, arbitrary concept. The Peruvian Ministry of Labor classifies workers as underemployed if their incomes are lower than the minimum real wage of 1967 or if they are working part-time involuntarily.

exchange rate, high public-sector prices, and relatively strong international reserve position.

These initial conditions, which characterize the end of a recessionary phase in Latin America's chronic stop-and-go economic policy cycles, provided one of the basic premises, as stated in Dornbusch and Edwards (1990) and Sachs (1989), for a short-lived consumption-led boom. The other basic premise is, of course, a poverty-stricken country with unsettled and mounting social and political conflicts, of which Peru is a good example. An additional ingredient for a populist course was suitably offered by the preexistence of an incipient and undeclared policy of external arrears, which had been initiated by the Belaúnde administration in late 1983. At the time of the changeover of administrations, external arrears on Peru's then-$14 billion debt had surpassed $2 billion. The preexistence of de facto arrears also provided a convenient departure point for a policy of confrontation with Peru's creditors.

9.3.2 Theoretical Underpinnings: Does Demand Create Its Own Supply?

A problem confronting the APRA party since the Velasco years had been that many of the reforms implemented unsuccessfully by the latter in the late 1960s and early 1970s—such as the nationalization of foreign firms, worker participation in firm ownership and management, and agrarian reform—had preempted many key issues of the APRA's traditional reform agenda. Moreover, the rhetoric of Alán García in the electoral campaign had been sufficiently conciliatory to gain support from business and the middle class, a key element emphasized by Drake (1982) in his characterization of populism. The nationalization of private banks—which accounted for about half of total deposits, but only one-third of credit—had been ruled out by the then–presidential candidate in his book *El Futuro Diferente*.

On the other hand, many influential advisers shared the view that the neoliberal agenda had been repeatedly tested, in Peru and elsewhere in Latin America, with an overwhelming evidence of failure. This was a basic claim of the book *El Peru Heterodoxo* (Carbonetto et al. 1987), written by the architects of the "heterodox program" launched in August 1985. As a result, the absence of an agenda for structural reforms, coupled with the distrust on the functioning of markets, resulted almost inevitably in a policy of intervention and widespread, haphazard subsidies. The following two excerpts summarize these views:

> When we took over, orthodox economists wanted us to tell semi-paralyzed companies they ought to be saving! Existing theories are no good. One difference between us and them is that we believe in controls rather than "opening up" to a historically unequal world market. Our approach is also more micro-economic.[5]

5. Interviews with D. Carbonetto (Peru Reporting EIRL 1987a, p. 11).

> It's a response to the failure of traditional models. It draws on attempts in South America, the USA and England during the 1970s to rethink the workings of the capitalist system under conditions of oligopoly and heterogeneous development. . . . In heterogeneous economies, the way prices are formed varies tremendously according to particular markets. All this conduces to a different vision of how to control inflation. . . . Another thesis we have abandoned is the appropriateness of the exchange rate as the main, generalized and almost automatic instrument to regulate the foreign sector. We have gone in for planned, selective, differential exchange rates.[6]

Several macroeconomic beliefs were broadly held by the economic team. One was that demand management policies were both recession inducing and ineffective in dealing with inflation. The widespread existence of excess industrial capacity was interpreted as indicating that excess demand was not a problem. Aggregate demand expansion would only cause inflation beyond full employment of both labor and capital. In other words, aggregate supply was thought to follow a reversed L-shaped curve against the price level. Further, a reactivation of aggregate demand would lead to higher firm activity levels and thus to lower per-unit-of-output costs, thereby contributing to deflation rather than inflation. Hence, it was argued that periods of expansion of aggregate demand are associated with low inflation and vice versa. No distinction was drawn between real and nominal aggregate demand. Thus, it was noted that:

> It is necessary to spend, even at the cost of a fiscal deficit, because, if the deficit is the result of transferring public resources to consumption of the poor so as they can demand more products and firms are able to reduce unitary costs, this deficit will not create inflationary pressures, but all the contrary. . . . This constitutes our major departure with respect to the previous strategy of demand restraint. (Carbonetto et al. 1987, p. 82)

Inflation was viewed as being exclusively a "cost-push" phenomenon. Hence, setting or, more generally, managing adequately the key prices—exchange rate, interest rates, and public-sector prices and tariffs—in combination with controls on private-sector prices, would provide a solid cure for inflation. Initially, a price freeze would brake inflationary expectations and dynamics. Another belief was that domestic consumption patterns were unduly dependent on imported goods. Therefore, import restrictions were required to change consumption patterns into local goods so as to reactivate internal activity and improve the balance of payments. Furthermore, scarce foreign exchange could not be wasted in sumptuary imports. Beyond import restrictions, a policy of "relative prices," so as to make goods with high direct or indirect import content more expensive, was suggested as a tool to change

6. D. Carbonetto (Peru Reporting EIRL 1987b, p. 24).

consumption patterns and ease pressure on the balance of payments (Instituto Nacional de Planificacion 1986, pp. 75–86).

In sum, the macroeconomic model the team had in mind was a static one in which a "Keynesian cross" determines the level of output and a "mark-up" equation determines the price level—very much in the tradition of the first Wharton models seasoned with import-substitution thinking. The econometric macromodel utilized for policy-making along with the aforementioned beliefs are fully documented in the book *El Peru Heterodoxo* (Carbonetto et al. 1987).

The effectiveness of multiple exchange rates for exports, among other incentives, as a device for export promotion was a long-standing claim of some Peruvian heterodox economists.[7] According to this theory, export commodities with higher supply elasticities should be given higher exchange rates—and other stimuli—in order to maximize export levels. Thus, manufacturing exports were to be granted a more competitive exchange rate than minerals and other traditional exports. This rationale led at some point in 1986 to attempts to establish contract programs with each major export firm. Under these programs the firm would commit itself to a certain export target and in return the Central Bank would grant the firm its own tailored real exchange rate (in terms of the firm's own cost formula). The essence of multiple exchange rates as a policy tool can be captured in the following paragraph:

> Multiple exchange rates are a kind of laser beam, allowing for greater flexibility. As a whole, though, we are aiming at a balance between the degree of devaluation created by the whole set of devaluatory instruments at our disposal and increases in exporters' costs. We are out to ensure exporter's profitability. At the moment, the incentives are concentrated in a few lines that we know are especially beneficial for Peru, like garments and fish for human consumption. Others are being studied by the Institute of Foreign Trade.[8]

Rules-versus-discretion debaters would find a good test case study in the economic policy of the period 1985–90. Indeed, most "prices" were subject to some sort of administrative regulation. Adjustments by decree in the structure of exchange rates, controlled prices, wages, interest rates, import tariffs, and so on, became a daily event. Over the period 1985–89, there were 186 decrees (about one per week) modifying the rules and structure of the exchange rates (Banco Central 1986–90). This continuous maneuvering with policy instruments stemmed from a wholehearted belief in *fine-tuning* as a means of allocating resources better than the market, promoting specific sec-

7. The debate on export promotion instruments acquired particular resonance in Peru since 1983 when the Association of Peruvian Exporters issued a report on export promotion prepared by Schydlowsky, Hunt, and Mezzera (1983). This report argued, along "second-best" lines, that export promotion incentives should be used to compensate for distortions so as to conciliate private and social costs.

8. Interview with D. Carbonetto (Peru Reporting EIRL 1987a, p. 11).

tors, benefiting the poor, and as a vehicle for negotiations with business groups (the so-called *concertacion*). The essence of *concertacion* was defined as follows:

> [This process enables parties] to agree on how much to produce, export or import and at what prices (including agreements on input prices), and under what conditions the State would provide the necessary *approval* (in the case of social returns not very low and high private returns), *support* (in the case in which social and private returns are high), or *subsidy* (in the case of high social returns and low private returns). The support and/or subsidy can be effected through preferential credit, tax and/or tariff exemptions, guarantees of provision of foreign exchange, outright subsidies, profit guarantees, etc. The agreements on investments should include amounts, location, and terms as well as the conditions for approval, support and or subsidy by the State. (Ferrari 1986, p. 522)

The unilateral default on the foreign debt is undoubtedly the best-known policy of President Alán García. The 10-percent-of-exports ceiling on debt service payments was announced by the president at his inauguration. The belief that debt servicing was putting undue pressure on Peru's meager savings capacity was, at the time, shared by business and parties of the left and right alike. The net resource transfer had been negative since 1984 and was unlikely to become positive any time soon.

9.3.3 Contentment and Contentiousness: The Expansionary Phase of the Experiment, 1985–87

The Strategy

In August 1985, President Alán García launched an economic recovery program based on this set of unconventional economic premises and guidelines. As Ortiz de Zevallos (1989) describes, the program had been assembled in a three-day emergency summit shortly before the inauguration. The negotiated program represented a compromise between a "cautious" group of advisers, the APRA's own economic campaign team, and a group of "audacious" heterodox advisers of President García.

The compromise strategy was to prompt a quick economic recovery by boosting consumption demand, which would be accommodated by existing slack industrial capacity. Consumption demand would be fueled by increasing real wages, implementing direct subsidy programs and temporary employment-generating public works in marginal areas, and transferring disposable income from the public sector to the private sector. The latter was effected through reducing taxes and freezing public sector prices and tariffs. The use of slack capacity would be guaranteed by closing the domestic market to imports competing with domestic production. In addition, the government instituted a price, cost, interest rate, and exchange rate freeze geared to breaking inflationary expectations. The main policy measures included in the program are presented in table 9.3.

Table 9.3 **Main Policy Measures of "Plan de Emergencia" from August 1985 to December 1986**

Wages and Employment	Exchange Rate	Interest Rates	Taxes and Public-Sector Tariffs and Prices	Private-Sector Prices	Public Expenditure and Social Programs
Periodic nominal hikes so as to reach a 7% annual increase in real terms. In practice, minimum real wages rose 34% in the 17-month period. Tax exemption to employees on the share of income tax paid by them. Two one-time interest-free loans to civil servants. Reduction of *probation* period from three years to three months. Establishment of PROEM allowing firms to hire temporary workers for up to two years without adhering to labor stability laws.	Initial 12% devaluation and subsequent freeze of official rate. Later, introduction of multiple exchange rates; first, only for exports and then for imports as well.	Lending rate of commercial banks: gradual reduction from 280% to 40% annual rate. Saving rate (one year deposits): gradual reduction from 107% to 31%. Lending rate by Agrarian Bank: *a*) Regular rate reduced from 116% to 25% *b*) Establishment facility at *zero* interest rate for the Andean highlands farmers.	Reduction of sales tax rate from 11% to 6%. Enhanced tax exemptions to selected sectors on sales tax, import tariffs, and other taxes. Freeze of public-sector prices and tariffs. In February 1986, reduction of water and electricity tariffs by 20% and of prices of petroleum products by 10%.	Freeze of all prices. Later periodic adjustment and/or liberalization of most agricultural prices. Creation of a price authority (CIPA) coordinated by the Ministry of Finance.	Establishment of the following programs totalling expenditures of about 2% of GDP: *a*) FRASA: to fund price support schemes and subsidies for agricultural products. *b*) PAIT: temporary labor-works programs in marginal areas. *c*) Support to peasant communities. *d*) Microregional development in emergency zones. *e*) PAD: direct support program to provide social services and food in the *pueblos jovenes* (shanty towns). Establishment of credit lines and /or credit guarantee facilities for microentrepreneurs by the newly created IDESI, Peru's Development Finance Corporation (COFIDE), and the Industrial Bank.

Peru's pervasive and often romanticized informal sector would be instrumental in both the output recovery and employment generation. The demand boost, together with the establishment of several credit and credit-guarantee programs for microentrepreneurs, would stimulate the informal sector. The agricultural sector was also made a high priority: guaranteed prices to producers of the main staples were significantly raised, input subsidies increased, and lines of agricultural credit on preferential terms considerably expanded. The poor *campesinos* of the sierra, the most backward part of the country, would be the main beneficiaries. Raising incomes in the sierra also had the key purpose of pacifying this terrorism-stricken part of the country.

The necessary resources to finance the strategy were to become available from reductions in external debt payments and from Central Bank financing. The political rhetoric was confrontational with external creditors and conciliatory with domestic economic agents—designed to bring about contentment at home and contentiousness abroad.

The government's heterodox economic program, officially termed the *Plan de Emergencia*, was expected to last 12 months, from August 1985 to July 1986, but was subsequently extended through December 1986. The authorities stated that this recovery program, based on consumption-led expansion, could only last insofar as there was unutilized capacity. Therefore, the government envisaged a second phase for the postrecovery era where the focus would be on investment and exports, so as to make the transition from short-run output expansion to long-run sustainable growth. However, the economic strategy to be followed in the second phase was never consistently developed. Furthermore, the measures implemented to prompt the recovery were at variance with the rules of the game required to promote investment, exports, and growth. It was assumed that the government would be able to negotiate (*concertar*) with business groups the reinvestment of the profits accrued during the boom into export industries.

The Consumption Boom

After a few months of initial sluggishness, the response of the economy to the program was an unprecedented output expansion. The GDP expanded 9.5 percent in 1986 and 7.8 percent in 1987 (fig. 9.1 and table 9.4). Along with output, employment in the formal sector of the economy grew by a cumulative 12 percent in the two-year period (fig. 9.2), mainly through temporary recruitment under the newly instituted temporary employment program (PROEM). This program enabled employers to circumvent the government's decision of reducing probation from three years to three months as well as other restrictive layoff procedures in Peru's labor legislation. The price-cost freeze, coupled with initially moderate monetary policy, reduced inflation from 200 percent in the 12-month period immediately preceding the freeze to 63 percent in 1986 (fig. 9.3). Real wages grew 24 percent over the two-year period. During 1985–87, the combination of price controls for industrial products, generous

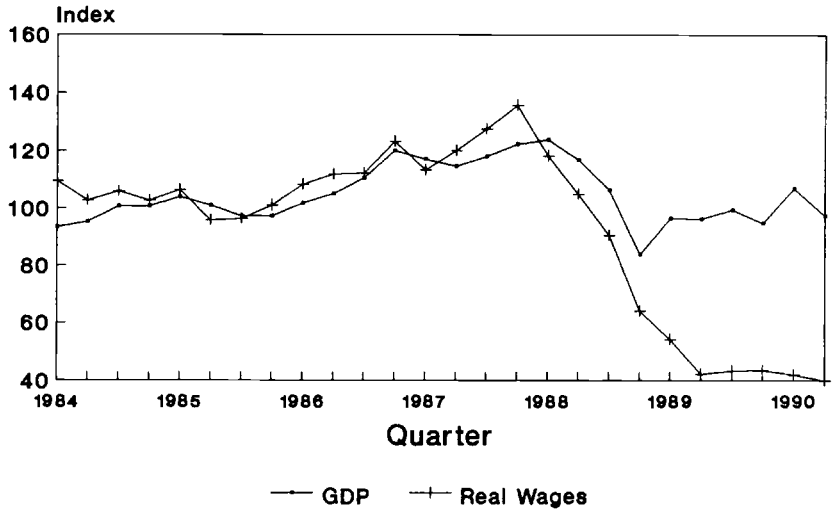

Fig. 9.1 Evolution of real GDP and real wages (1985 = 100)

agricultural price guarantees, and huge input and credit subsidies for agriculture translated into a 90 percent improvement in rural-urban terms of trade and a corresponding significant improvement of agricultural incomes. Some basic macroeconomic indicators are presented in table 9.4.

These results, however, were reached at the expense of growing financial and external imbalances and of increasing misalignments in key relative prices. These imbalances, in turn, signaled that the model being followed was unsustainable and that the economy would lapse into an open crisis if corrective measures were not adopted. *First*, total public-sector revenues dropped by a cumulative 18 percent of GDP in 1985–87.[9] In turn, foreign exchange and financial losses of the Central Bank—resulting from the operation of the multiple exchange rate system and interest rate subsidies, respectively—grew rapidly to a level equal to 3.7 percent of GDP in 1987. As a result, and notwithstanding a reduction in public investment, the public-sector imbalance—as gauged by the domestic financing of the public-sector deficit—jumped from 0.6 percent of GDP in 1985 to 10.5 percent in 1987. The decline in the ratio of public investment to GDP was largely a "cost of default," rather than a conscious decision, because many projects depended on either foreign technology or were linked to foreign financing. The minister of planning put it this way:

9. Here we refer to public-sector revenues as defined by simply adding tax revenues and state enterprise gross revenues (excluding transfers from the government). Obviously, there is double counting and other problems with this measure, but it provides a very good rough graphical indicator of the total revenue loss.

Table 9.4 Main Economic Indicators, 1980–89

	Average, 1980–84	1985	1986	1987	1988	1989
Real GDP growth (%)	−1.0	2.4	9.5	7.8	−8.8	−10.4
Real per capital GDP growth (%)	−3.6	−.2	6.9	5.2	−11.4	−13.0
Real consumption growth (%)	−.4	2.3	13.3	8.3	−11.5	−7.5
Inflation rate (%)	87.0	158.3	62.9	114.5	1,722.3	2,775.3
Broad money supply growth (%)	94.0	122.4	64.4	113.0	585.1	2,028.7
Public-sector borrowing requirements (% of GDP)	7.8	5.8	9.1	12.9	15.6	9.8
Tax revenues/GDP (%)	13.5	14.9	12.4	8.9	9.1	5.4
Public enterprises revenue/GDP (%)	25.3	26.1	18.4	14.1	8.9	7.2
Current account deficit/GDP (%)[a,b]	3.9	.3	6.0	7.2	7.4	1.0
Gross international reserves (in Millions of U.S. dollars)	. . .	2,283.0	1,861.0	1,130.0	1,125.0	1,512.0
Foreign debt/GDP (%)[a]	51.0	76.8	67.8	62.4	77.0	103.5
Accrued debt service ratio (%)	61.1	69.8	77.9	77.0	79.3	64.0
Paid debt service ratio (%)	53.7	22.5	19.6	13.4	5.4	5.6
Real exchange rate (December 1978 = 100)[c,d]	77.1	99.6	86.8	74.9	91.2	59.0
Terms of trade (1978 = 100)	118.4	90.6	66.4	66.9	72.8	68.9
Real wage (1979 = 100)	95	64	73	79	60	29
Employment growth (%)	2.2	1.9	6.4	4.7	−6.5	−3.6
Utilized capacity index (%)	56.0	45.0	71.0	79.0	59.0	46.0

Source: National Statistical Institute, Central Reserve Bank, Ministry of Finance and author's estimates.

[a]Ratios obtained using the July 1985–based purchasing power parity exchange rate.

[b]Includes interest imputed on arrears.

[c]Evaluated at the weighted average of all current commercial exchange rates (intis per US$).

[d]An increase in the series means real depreciation of the effective exchange rate for trade accounts transactions.

The deficit, including unpaid interest due on the foreign debt, was the equivalent of about 5.6 percent of Gross Domestic Product in 1986. One reason why it was not larger is that the state companies have spent less than they were supposed to. Up to the end of September, the figures show state companies using only 30 percent of their budget, partly because of problems getting foreign financing, quarrels with foreign companies contracted by previous governments, investigations and so on. It was a disaster.[10]

Second, the real exchange rate appreciated 26 percent between July 1985 and October 1987. This, together with booming aggregate demand, made the GDP expansion highly import intensive contrary to the initial designs of the

10. Interview with J. Tantalean (Peru Reporting EIRL 1987a, p. 13).

Fig. 9.2 Evolution of real GDP and employment (1985 = 100)

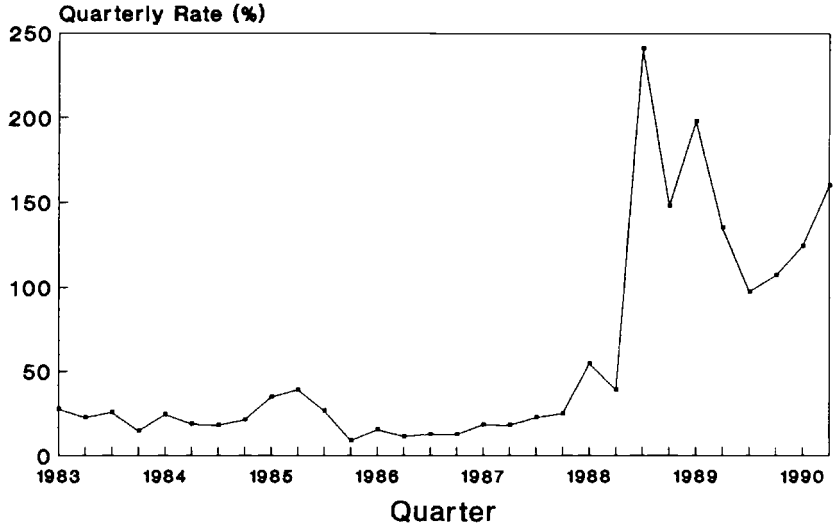

Fig. 9.3 Inflation rates by quarters (1983–90)

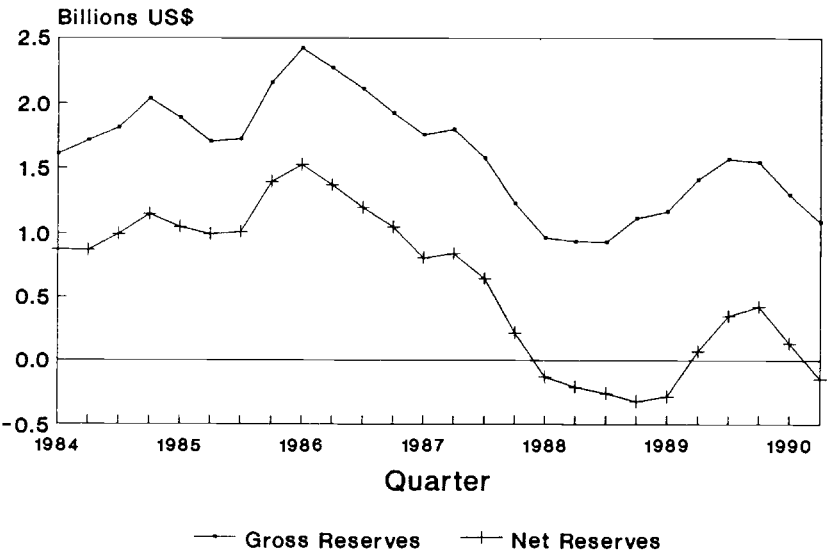

Fig. 9.4 International reserves of the Central Bank

government. With the parallel decline in exports, the external current account went from near equilibrium in 1985 to a deficit of about 6.5 percent of GDP in 1986–87. The ultimate effect of this was a sustained drop of net international reserves from a peak of $1.5 billion in March 1986 to roughly zero in December 1987 (fig. 9.4).[11] *Third*, the focus on boosting consumption reduced the potential for investing the surplus gained by the external moratorium, thereby trading off short-run expansion for future sustainable growth.

It should be noted that the demand-led course was initially counteracted to some extent by the Central Bank. During its first five months, the new administration had maintained the governor of the Central Bank of the previous administration. In this period, monetary policy was reasonably restrictive in an attempt, on the one hand, to sterilize the huge balance of payments surpluses (reserve inflows) originating from the limitation on foreign debt service payments, and, on the other hand, to decelerate the growth of monetary aggregates in accordance with the lower rate of inflation achieved with the price freeze (table 9.5). To this end, tighter legal reserve requirements were imposed on commercial banks' deposits, and although interest rates were scaled down, initially this reduction was matched by a similar decline in inflation, and thus real interest rates did not fall further. In August 1985, foreign cur-

11. However, gross reserves reported by the Central Bank in December 1987 still totaled $1.1 billion (with $800 million in gold). But Peru needed a large carryover of reserves to finance imports because the default had caused a withdrawal of external trade finance.

Table 9.5 **Financial Survey: Uses and Sources of Broad Money[a] (Percentage Changes with Respect to the Stock of Broad Money Outstanding at the End of the Previous Period, Six-Month Rates)**

	1985 I	1985 II	1986 I	1986 II	1987 I	1987 II	1988 I	1988 II	1989 I	1989 II	1990 I
A. Broad Money Supply (Uses)	50.7	46.2	22.5	35.4	34.3	58.5	45.4	371.2	443.1	292.0	278.6
1. Money	6.4	31.8	12.7	20.5	12.6	37.9	26.8	152.5	113.1	107.4	96.3
2. Near money	44.3	14.4	9.8	14.9	21.7	20.6	18.6	218.7	330.0	184.6	182.3
Domestic currency	7.1	27.3	17.5	17.9	21.7	13.2	17.1	76.4	175.9	132.8	97.2
Foreign currency	37.2	−12.9	−7.7	−3.0	.0	7.4	1.5	142.3	154.1	51.8	85.1
B. Broad Money Supply (Sources)	50.7	46.2	22.5	35.4	34.3	58.5	45.4	371.2	443.1	292.0	278.6
1. Net international reserves	10.1	26.5	−3.8	−7.6	−2.0	−14.2	−7.8	−86.1	87.1	42.4	−34.6
2. Domestic credit to nonfinancial public sector	9.5	−9.8	−5.2	22.0	11.7	34.7	4.1	69.8	27.5	63.7	156.8
3. Domestic credit to private sector	48.4	25.6	19.0	33.0	32.0	40.3	32.1	245.0	290.8	149.5	191.6
4. Net unclassified assets	−17.3	3.9	12.4	−11.9	−7.3	−2.3	17.0	142.5	37.7	36.3	−35.6
Memo items:											
Base money growth[b]	54.8	90.4	23.0	13.3	27.1	67.6	54.0	373.6	365.8	226.2	394.5
Inflation rate[c]	87.7	37.6	28.5	26.8	40.1	53.1	115.2	746.5	601.2	310.0	484.0
Money supply multiplier[d]	1.9	1.4	1.4	1.7	1.8	1.7	1.6	1.6	1.9	2.2	1.7
Income velocity of broad money:											
Including dollar-indexed deposits	3.1	3.3	3.3	3.6	3.7	3.8	4.9	6.4	9.5	9.8	n.a.
Excluding dollar-indexed deposits	6.8	5.6	4.3	4.2	4.1	4.2	5.3	8.8	14.3	13.0	n.a.

Sources: Central Reserve Bank and author's estimates.

[a]Includes all financial operations of financial institutions of the formal sector (banks and other nonbank) with economic agents.

[b]As a percentage of the previous period's base money (six-month rate).

[c]Inflation for the semester (six-month rate).

[d]The ratio of broad money to the base money.

rency deposits were made redeemable only in local currency at the official exchange rate plus a small premium. Monetary policy eased in the first half of 1986 and became overtly expansionary in the second half.

When the price and cost freeze was lifted in December 1986, price controls on several groups of products were eased somewhat. In January 1987, a mild crawling peg for the two benchmark exchange rates was instituted. The "crawl" was halted in July 1987 following concerns over inflationary pressures.

The Rise and Fall of Private-Sector Confidence

Prior to 1987, private-sector confidence in and support of the government's economic policy could only be described as being unanimous. In his July 1986 presidential address, President Alán García reaffirmed the partnership with the private sector and ruled out expropriation or other statist measures. Negotiations (*concertacion*) were continuously carried out during the second half of 1986 to persuade the principal industrial groups (the so-called twelve apostles) to invest in export-oriented businesses. Virtually every incentive was open for negotiation: preferential exchange rates, credit subsidies, tax exemptions, and so on.

The troubles started in 1987, when some sources began claiming that the private sector, while benefiting from the boom, was not delivering the quid pro quo of reinvesting surpluses so as to contribute to exports and growth. As this view was not corroborated by provisional Central Bank estimates—which indicated that private investment had grown 18 percent between 1985 and 1986—the National Planning Institute commissioned an independent study in early 1987 to analyze investment data from the financial statements of 62 firms listed in the stock exchange (Thorne 1986). The study found that in 1986 gross fixed investment had grown at most 7 percent and that most of this increase could be accounted for by inventory accumulation. Moreover, the firms that were investing more were those oriented to the internal market—just the contrary to the government's wishes.

The paradox was that, in practice, while seeking to induce firms to switch into export-oriented investments, the government was shifting all incentives toward the internal market. Indeed, by 1987 all imports were made subject to both an import license and a foreign exchange license, whereas in 1985, 61 percent of all tariff code items stood free from quantitative restrictions. Similarly, the maximum tariff rate had been raised from 91 percent in 1985 to 155 percent in 1987.

Table 9.6 shows that the claim of unresponsive private investment turned out to be unfounded. Final official data revealed that private investment doubled between 1985 and 1987, although it is true that the major share of new investment was in construction and inventories rather than in equipment. In the wake of the contention over private investment, the government tried

Table 9.6 **GDP and Aggregate Demand[a] (Index Numbers in Real Terms)**

	1980–84	1985	1986	1987	1988	1989
Aggregate supply	123.3	113.9	126.4	137.4	124.5	109.7
GDP	100.0	99.0	108.4	116.9	106.6	95.5
Imports	23.3	14.9	18.0	20.5	17.9	14.2
Aggregate demand	123.3	113.9	126.4	137.4	124.5	109.7
Consumption	72.9	72.4	82.1	88.9	78.6	72.8
Private	62.6	62.2	71.4	78.1	70.4	69.1
Public	10.3	10.2	10.6	10.8	8.2	3.6
Investment	26.4	16.0	21.4	26.5	25.5	12.9
Equipment	10.6	6.1	7.0	7.9	5.7	N.A.
Construction	13.1	10.4	12.8	14.8	14.0	N.A.
Inventories	2.7	−.5	1.6	3.8	5.8	N.A.
Exports	23.9	25.5	22.9	22.0	20.3	24.0
Memo items						
Private investment	19.2	10.1	15.8	21.8	22.3	11.0
Public investment	7.2	5.9	5.6	4.7	3.2	1.9

Source: National Statistical Institute and Central Reserve Bank.
[a]The average GDP for 1980–84 was taken as the base (GDP in 1980–84 = 100). As a result, all figures in the table are index numbers refered to the average GDP of 1980–84 and should be read as proportions of GDP of that period.

first a highly subsidized investment scheme,[12] and, shortly thereafter, devised a compulsory program aimed at forcing private firms to invest in export activities. Under this program, a large percentage of firms' profits had to be traded for compulsory investment bonds.

The honeymoon was finally over when President García launched his initiative to nationalize private commercial banks and insurance companies and to establish foreign exchange controls. These measures were announced in his second annual address to the nation in July 1987. These political events, together with the emerging concerns on the sustainability of the economic program as exemplified by the free fall of international reserves, triggered the onset of the crisis, with the free market exchange rate commanding growing spreads over the official rate (figs. 9.4 and 9.5).

The "10 Percent Default": Rhetoric and Practice

President García's announcement, in July 1985, of the 10 percent of exports cap on debt payments broke with the arrears-cum-best-effort-to-pay tenet of the last Belaúnde years. Shortly thereafter, Peru's debt was declared value impaired by the United States. The government attempted unsuccessfully to convince credits that *new debt* commitments would be fully serviced while *old debt* would, as a rule, be serviced only when creditors provided a positive

12. The *Fondo de Inversion y Empleo* granted prospective investors of approved export projects, largely located outside Lima, a cost-free equity contribution from the government equal to one-third of the project cost.

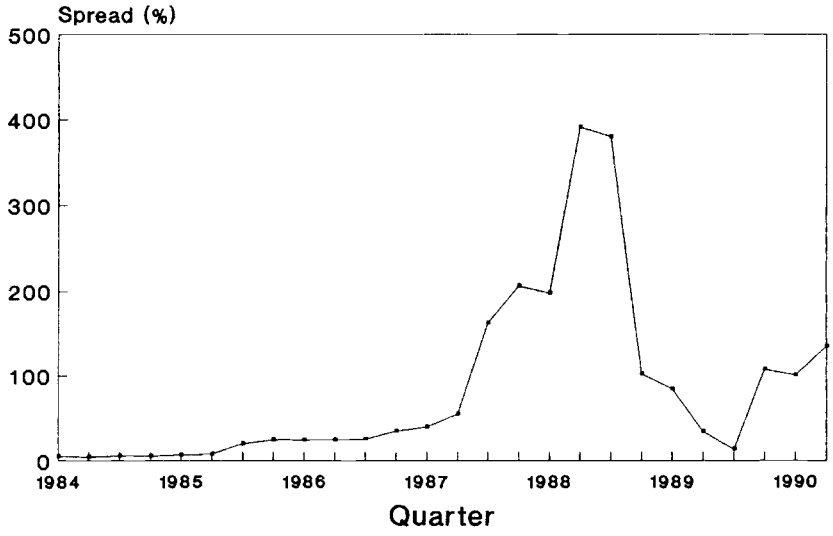

Fig. 9.5 Spread between parallel and official exchange rates

net transfer to Peru. Therefore, the trick with the 10 percent rule was that Peru would only pay as long as creditors provided the money to pay themselves. The reality was that, rhetoric to the contrary, from July 1985 to December 1986 Peru's actual debt service to creditors was around 20 percent of exports for public debt alone (table 9.7) and over 25 percent of exports for total debt, and the negative net transfer was almost as high as it had been in the last two Belaúnde years. The assumption, later proven erroneous, that Peru could selectively default against some creditors while obtaining financing from others led progressively to defaults with initially nontargeted creditor groups. It was only in 1988 that total debt service descended to the 10 percent limit.

In August 1986, Peru was declared ineligible for IMF lending, and one year later was placed on "nonaccrual" status by the World Bank. In early 1989, the Inter-American Development Bank also took the step of classifying Peru as a nonaccrual country due to protracted default. In 1986, the external debt moratorium was extended to private-sector liabilities. In his second presidential address to the nation in July 1986, President García announced the suspension for two years of both private debt service and profit repatriation by foreign corporations.

Another contentious issue was the renegotiation of exploration and production contracts with the three multinationals operating in Peru's hydrocarbons sector. Arguing that the hydrocarbons law issued by the previous Belaúnde administration had not paid due regard to the interests of the nation, the authorities forced renegotiation of the contracts under less favorable conditions. One of the three multilaterals, Belco, refused to accept the new conditions,

Table 9.7 **Debt Service Payments on Public External Debt[a] (In Millions of U.S. Dollars)**

	1985	1986	1987	1988	1989
Central bank debt	236	165	58	42	71
Rest of public sector	617	495	422	158	183
Bilateral creditors	43	71	108	45	56
Commercial banks	133	27	5	3	5
Multilaterals	171	226	155	74	28
Socialist countries	170	111	94	11	63
Suppliers	100	60	60	25	31
Total debt service	853	660	480	200	254
Debt service ratio[b]	22.5	19.6	13.4	5.4	5.6

Source: Central Reserve Bank and author's estimates.
[a]Debt service is defined as the sum of interest and amortization actually paid.
[b]Amount paid as a percentage of exports of good and nonfactor sevices.

leading to termination of the contract in 1986 and de facto, to expropriation of the assets without compensation.

Growing isolation from creditors and foreign investors inevitably meant growing isolation from trading partners, rendering Peru particularly vulnerable to import restrictions in creditor nations and contributing to vanishing domestic confidence.

9.3.4 Decline and Despair: The Recessionary Phase of the Experiment, 1988–90

By late 1987, the dynamics of the economics and the politics of the experiment turned an originally "well-orchestrated," center-right, "demand-led boom" into an openly confrontational, both abroad and at home, populist experiment. Net international reserves had reached "the red," Central Bank external deposits had to be moved from one country to another to avoid potential seizure by creditors, letters of credit for imports had to be collateralized with cash, and the Central Bank had to start drawing down gold reserves.[13] Public-sector real prices and tariffs, running on average at less than half of their levels of July 1985, were adjusted infrequently and insufficiently. The number of exchange rate categories increased from three in 1985 to nine in mid-1987. The Agrarian Bank continued allocating low- or zero-interest loans to farmers, and wage increases continued to be granted by decree every four months. Meanwhile, the domestic financing of the public-sector imbalance had soared from 0.6 percent of GDP in 1985 to close to 10.5 percent in 1987 (table 9.8).

13. In January 1988 the business newsletter "Efficacia" published the names of the international banks in which Peru's Central Bank maintained its reserves at the time. During the following days the Central Bank had to redeploy its reserves elsewhere (Peru Reporting EIRL 1988a).

In a country with a very narrow financial system, this represented a huge burden for the Central Bank to finance. Hence, an inflationary momentum was set in motion, with inflation jumping from 64 percent in 1986 to 115 percent in 1987.

Despite the unfolding crisis, policymakers still remained unconvinced of the need for macroeconomic stabilization. Some sectors maintained that although high capacity utilization had been achieved in several industrial sectors, other sectors still registered slack capacity. Since, on average, capacity use was still 70 percent, the doubling of inflation could not be attributed to excess demand pressures. Measuring excess demand *in real and static* Keynesian effective demand instead of *in nominal and dynamic* terms was a

Table 9.8 **Public Finance, 1984–87 (% of GDP)**

	1984	1985	1986	1987	1988	1989
1. Public-sector revenues	39.7	41.0	30.8	23.0	18.0	12.6
Tax revenues	15.8	14.9	12.4	8.9	9.1	5.4
State enterprises revenues	23.9	26.1	18.4	14.1	8.9	7.2
2. Public-sector expenditures	45.5	44.6	36.7	30.6	28.3	19.9
of which, investment	7.4	6.0	5.2	4.0	3.0	2.0
of which, wages	8.9	7.9	8.5	9.0	6.8	5.5
3. Nonfinancial public-sector deficit (2–1)	5.8	3.6	5.9	7.6	10.3	7.3
4. Central bank losses	. . .	1.9	1.8	3.7	3.8	0.6
5. Overall deficit (3 + 4)	5.8	5.5	7.7	11.3	14.1	7.9
6. Central bank transfers to development banks	1.4	0.3	1.4	1.6	1.5	1.9
7. Total public-sector borrowing requirements (PSBR)	7.2	5.8	9.1	12.9	15.6	9.8
8. Financing of PSBR	7.2	5.8	9.1	12.9	15.6	9.8
Foreign PSBR	5.1	5.2	3.4	2.4	4.3	2.9
of which, extant international arrears	2.5	4.4	2.9	2.0	4.2	2.7
Domestic credit	2.1	.6	5.7	10.5	11.3	7.1
of which, domestic arrears	.5	1.3	1.6	1.1	3.2	2.8

Source: Central Reserve Bank and author's estimates.
Note: The reason why gross revenues of state enterprises and gross expenditures of the public sector are used here is to show the reader the phenominal decline of the ratios to GDP of both items. We are, however, aware of the imperfections implied by these measures. In particular, adding tax revenues and state enterprise revenues (item 1) implies double counting of taxes paid by state enterprises. Besides, state enterprise revenues are gross and thus not strictly income. The same occurs with item 2, which is the sum of central government expenditures and public enterprise gross expenditures (the latter including intermediate expenditures and therefore not strictly comparable with Central Government expenditures, which are final aggregate demand). Double counting, however, affects equally both revenues and expenditures and therefore does not alter the deficit figures.

very common analytical framework used at the time (Postigo de la Motta 1988, p. 21). Some sources even suggested selectively "targeting" aggregate demand to sectors with slack capacity, while others came to defend that industrial capacity was still underutilized in most sectors since industry was operating on average at less than two shifts while full use was at three shifts of eight hours each.

On the eve of its collapse, the designers of the program published the book *El Peru Heterodoxo* (Carbonetto et al. 1987), in which they claimed to have discovered a new policy approach and recommended the application of their model to other countries:

> At the time of sending this book to print we are witnessing the first one and a half years of the implementation of Peru's reactivation policy. The results obtained prove most of the guiding thesis according to which it is possible to reactivate (in the presence of slack capacity) and simultaneously reduce inflation. (p. 16)
>
> We trust the book will be a useful tool for developing countries confronting similar problems to ours. (p. i)

The glamorous boom seduced even some foreign academics. In June 1987, a few months before the devastating collapse, Rosemary Thorp, after an in situ examination of the evolution of the program, and notwithstanding a few disclaimers, wrote:

> Gradually both the thinking behind the policy approach and its actual implementation have become more coherent, more interesting and more audacious. It is too early still to define phases, since the development has been continuous, marked by the appearance of coherent planning models for the Planning Institute (the first dated May 1986) and by the beginning of thinking on how reactivation should become growth and resulting policy initiatives in the second half of 1986. . . . The three areas in which new thinking has been most conspicuous and impressive are closely interrelated: *concertacion*, the external sector, and the issue of long run structural change. Short-term price and exchange rate management have also evolved—less confidently. (Thorp 1987, p. 5)

The Failed Stabilization Attempts

With the pressure of rapidly vanishing international reserves (fig. 9.4), failure to have adjusted the exchange rates for exporters as well as the fact of having channeled subsidies indiscriminately to all sectors, instead of a few priority sectors, were made the culprits for all troubles. The increasingly meager fiscal and foreign exchange resources prompted the National Planning Institute to launch its proposal for "selective growth" in late 1987. Subsidies channeled through foreign exchange, taxes, tariffs, credit, or any other means would, from then on, be addressed exclusively to predefined priority sectors. The problem was not the size of the subsidies per se, but rather that a large

part had been wasted on promoting undeserving sectors (Postigo de la Motta 1988, pp. 28–31). Also in late 1987, the Ministry of Economy proposed a *Programa Trienal* that set the policies and targets for the next three years in the areas of increasing the tax-burden ratio, simplifying the exchange rate structure, and divesting several public enterprises. These measures sought to partially reverse the precarious financial situation and cumbersome incentive structure, but were to a larger degree designed as a strategy for resumed dialogue with multilateral credit agencies. This rapprochement to the multilaterals has been viewed as an application of President García's theory of the two fronts: the country could be in contentiousness either on the external front or the domestic front, but not simultaneously in both. Since the nationalization of the banking system had damaged relations at home, it was necessary to portray improved attitudes abroad. Nevertheless, neither selective growth nor the *Programa Trienal* were carried through. Instead, a sequence of destabilizing economic measures started to unfold.

Since late 1987, the Central Bank started systematically to adjust the exchange rates for exporters without passing on the higher price of dollars on to importers. The best of both worlds was being pursued. By August 1988, the Central Bank was on average selling foreign exchange to importers at half the price it paid to exporters. Thus, foreign exchange losses in 1988 reached 3.8 percent of GDP, adding to an already precarious budget imbalance.

Three major one-shot economic packages were implemented during 1988: in March, September, and November. Table 9.9 presents the key elements of these packages. In the three cases the measures finally announced, although they embedded the same approach to adjustment as the technical proposal prepared by the economic team, had undergone a tough political filter.[14] The three announced packages were very similar. Namely, they decreed adjustments in public prices, exchange rates, interest rates, and wages. In addition, the first two included a follow-up 120-day freeze on prices, wages, and the exchange rate, and the second declared the unification of the exchange rates for commercial transactions (thereby transferring subsidies for several highly subsidized food and agricultural imports to the budget).

With the exception of the November package, nominal wage hikes were, in general, granted at higher rates than those decreed for regulated prices and exchange rates. In the March package the highest price adjustment was set at 51 percent while minimum wages were raised by 60 percent; in turn, in the September package the effective exchange rate was devalued by 95 percent—although the largely irrelevant official rate was devalued by 600-plus percent—while minimum wages were raised by 150 percent. Economic policy-making had, thus, engaged in the impossible task of trying to narrow the

14. Peru Reporting EIRL (1988a, 1988b, 1988c) and weekly magazines: *Sí* (28 November 1988, pp. 6, 7) and *Oiga* (12 December 1988, pp. 13–15). These press accounts illustrate President García's personal involvement, in great detail, in economic policy-making.

Table 9.9 Packages of Economic Measures, October 1987 through November 1988

	1987		1988		
	October	December	March	September	November
PRICES, WAGES AND EXCHANGE RATE			+ Adjustment & 120-day freeze (export exchange rate excluded from freeze)	+ Adjustment & 120-day freeze (freeze lifted 3 weeks later)	
Effective rate (devaluation) (%)	29	47	15	95	82
Number of exchange rates:					
Imports	3	7	6	1	1
Exports	3	2	3	1	1
Total	5	9	8	1	1
Minimum wage increases (%)	29	. . .	60	150	40
Public sector wage increases (%)	25	. . .	40	95	40
Private sector wage increases (%)	25	. . .	45	94	50
Increase of public tariffs:					
Gasoline (%)	0	0	51	296	140
Electricity (%)	24	12	29	136	114
Rice (%)	0	0	39	140	100
Increases of prices of controlled products (%)	5	6	15	148	40
TAXES					
Changes in existing taxes	+ Increase in surcharge on imports: 4%	+ Sales tax from 6% to 10% + Increase in all excise taxes + Indexation to inflation of prepayments of corporate profit taxes + Elimination of exemptions under import surcharge	+ Sales tax to 10.5%	+ Increase of excise tax rates on beer and cigarettes + Reduction of exemptions on import tariffs + Reduction in tax collection lags	+ Partial indexation of tax liabilities to inflation + Reduction of excise taxes (cigarettes and liquors) + Ad-valorem custom duties: from 10% to 16% + On exports: 10%

		+ Minimum duty to imports: 5%			
New taxes	+ On purchases of foreign exchange: 25%	+ Tax on personal property: 1–4%		+ On exports: 4%	
IMPORT TARIFFS AND RESTRICTIONS	+ All imports subject to licenses	+ Import licenses need approval of Institute of Foreign Trade (ICE) and Central Reserve Bank	+ Some imports can be financed with the importer's own foreign exchange	+ Shift of 35% of imports from official exchange rate market	
Evolution of quantitative restrictions (QRs) (% of total of tariff categories):					
Free from QRs (%)		.0			.0
License required (%)		89.7			89.7
Import prohibitions (%)		10.3			47.3
Evolution of tariffs:					
Average tariff (%)		67.0			70
Maximum tariff (%)		155.0			108
EXPORTS MEASURES					CLD[a] from 10 to 30
INTEREST RATE					
Lending rate (%)		From 32 to 40	To 55	To 255	20 per month
Deposit rate (%)			From 22 to 35.5	To 219	17 per month

[a]The Certificados de Libre Disponibilidad (CLD) is a tradable dollar certificate given to exporters for a share of their export porceeds that can be used by an importer.

internal and external imbalances without requiring economic agents to adjust ex ante their budget constraints.

Indeed, narrowing the budgetary gap required, in addition to tax measures, an increase in the relative prices of goods and services provided by the public sector in terms of nominal wages. At the same time, correcting the external imbalance required an increase in the ratio of the nominal exchange rate to nominal wages. Moreover, reducing inflation required that the adjustment of these two key relative prices be effected with at most a moderate escalation of these three key sets of prices. The policy course taken was just the opposite, namely, small adjustments in the relative prices with high nominal escalation of absolute prices. The paradox was that the September package was officially termed the "double-zero" plan, for it was intended to eliminate both the fiscal deficit and Central Bank inflationary financing. But, as explained below, the president of the Central Bank took the plan seriously.

The Trigger Point of Hyperinflation: Laffer Curves, Snowballs, and Social Turmoil

Monetarists think of inflation as too much money chasing too few goods, while flow of funds believers view inflation as a dirty transfer of real resources from individuals and firms to the public sector and other favored sectors, and yet structuralists think of it as the result of a race between prices, wages, and exchange rates reflecting the struggle for the distribution of income.

The three aforementioned packages failed the three tests: the monetarist, the structuralist and the flow of funds consistency. Indeed, by the second quarter of 1988 inflation had surpassed the level that would generate the "maximum-inflation tax" (fig. 9.6).[15] Furthermore, gross real resources raised by the government through inflation did not contribute much to closing the nonfinancial public-sector gap, for these resources were largely transferred back as foreign exchange and financial subsidies, the latter particularly, but not exclusively, to peasants (table 9.10). Even worse, the dynamics were explosive since, as the gross inflation tax was sliding down the inefficient portion of the Laffer curve, real financial subsidies were rising because nominal interest rates lagged increasingly behind inflation. In parallel, the evolution of wages, prices, and exchange rates was setting into motion a snowball, which aggravated inflationary dynamics and expectations.

By late 1988, the economy had taken off on a hyperinflationary path, with inflation accelerating from an annual rate of 360 percent in the first half to nearly 7,000 percent in the second half, and real money plummeting to one-third of its level one year earlier (figs. 9.3 and 9.7). Economic agents had

15. The trade-off between inflation and real resources raised through inflation presented in fig. 9.6 was calculated by Lago (1989). It results from fitting the path followed by inflation and real money, from the second semester of 1987 to the first of 1988, into Philip Cagan's demand for money. It is therefore an arch estimate and not a regression result. It is presented only as an illustration of the Laffer curve.

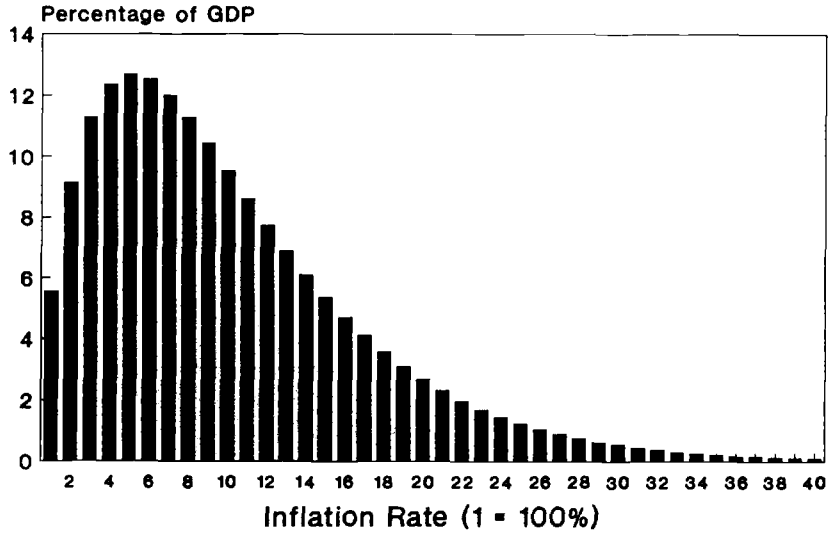

Fig. 9.6 Laffer curve: Revenues from inflation/GDP

Table 9.10 Inflation Tax, Inflation Subsidy, and Net Inflation Tax (% of GDP)

Year	Inflation Tax	Inflation Subsidy	Net Inflation Tax
1980	2.6	1.4	1.2
1981	2.1	1.4	.7
1982	.9	1.7	−.8
1983	2.1	3.0	−.9
1984	.9	1.9	−1.0
1985	3.2	2.9	.3
1986	3.6	1.8	1.8
1987	4.3	3.0	1.3
1988	5.2	4.3	.9

Source: Based on a very detailed calculation performed by Oks (1989) of the effect of inflation on financial assets and liabilities of the consolidated public sector (including the Central Bank and all public banks).

interpreted the government's corrective attempts as destabilizing, prompting a massive rush to the dollar, unprecedented black market premia (up to 400%) and the continuation of a free fall of both GDP and real wages that had initiated in early 1988 (fig. 9.1). Hyperrecession walked hand in hand with hyperinflation.

The recession was prompted by the collapse of private investment—brought about by the unstable inflationary trend—and also by the downfall of

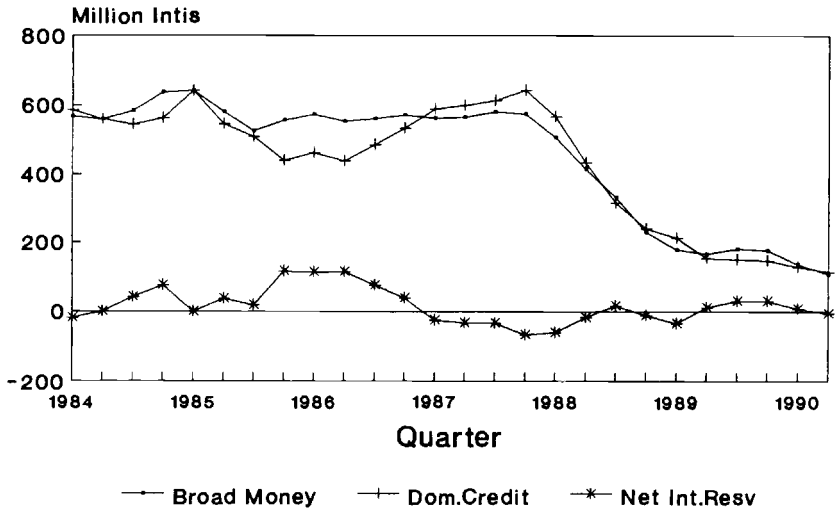

Fig. 9.7 Broad money supply and its sources (in real terms)

public-sector real aggregate demand. The latter resulted from the increasingly diminished expenditure capability, in real terms, of the public sector, in turn a consequence of shrinking real tax returns and state-enterprise revenues, and a vanishing real demand for money. These recessionary effects of falling investment and government expenditures were compounded by the dirty work of second-round multiplier effects on real consumption.

The sharp decline of labor incomes resulted from the procyclical character of real wages and the reduced scope and imperfection of wage indexation. Indeed, only unionized workers—about half a million of a total labor force of over six million—were subject to indexation clauses, and even for these quarterly indexation adjustments were significantly below inflation because the government established by law nominal inti ceilings to any indexed adjustment, which soon became binding. Regarding minimum wages, public-sector wages, and wages of nonunion workers, the government decreed frequent adjustments, but inflation always kept a faster pace. Escalating inflation depressed real wages so fast that soon private employers started to pay higher wages than those resulting from contractual or regulatory obligations. The low degree of wage indexation acted as a stabilizing force of the hyperinflationary trend.

Labor unrest soared amid widespread protests by unions, prompted by imperfect indexation of wages, and shortages of basic foodstuffs. Hours lost in strikes increased tenfold and were particularly acute in the two largest mining firms, the multinational Southern Copper Peru and the state-owned Centromin (fig. 9.8). Peru's terrorist Shining Path found in the crisis a promising breed-

ing ground. The situation at the time has been described by Smith (1989) as follows:

> In November, 1988, guerrilla units of the Communist Party of Peru, better known as Sendero Luminoso (Shining Path), laid the final crossbeam in an Andes-spanning strategy. They knocked down a vital power line between Lima and the Mantaro hydroelectric plant in the central Sierra. When the state electricity company moved to repair the downed pylons, Sendero quickly blasted others. Sendero also sabotaged the rail line between the mining center of Cerro de Pasco and Lima. Senderista columns moved viciously into the campesino communities and agrarian cooperatives in the countryside around Huancayo, the breadbasket of the national capital.
>
> Lima tottered on the verge of social and economic disarray. Already reeling from Peru's worst depression, the city and most of the coast sputtered on rationed electrical power and rotated blackouts and brownouts for six weeks. The troubled government of President Alan García declared a state of emergency in Junín, joining seven other departments under military control. Across a broad swath of Andean Sierra and Amazon jungle, roughly 750 miles long and 200 miles wide, the government recognized that it could not maintain a semblance of authority and order.

News reports claimed that the miners' strikes could not be settled by merely yielding on wage demands because the Shining Path was blackmailing union leaders. The type of demands made by unions included some of a very political nature, such as asking the government not to engage in any dealings with

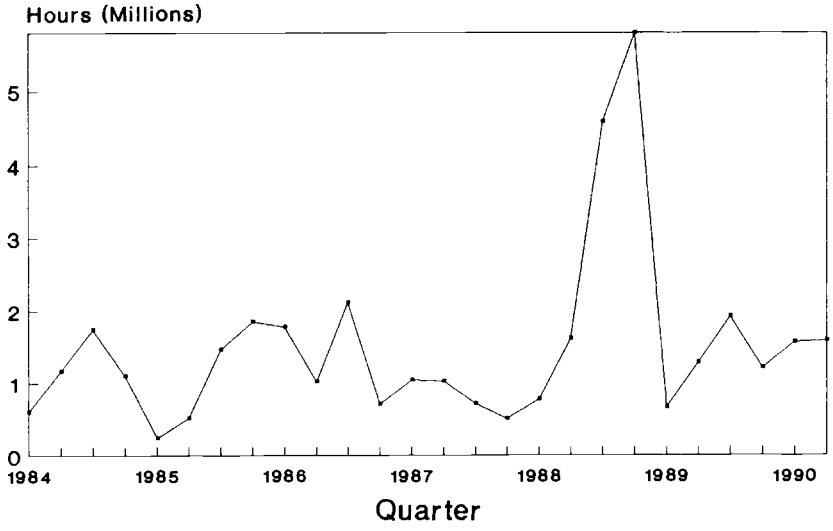

Fig. 9.8 Hours lost in strikes (1984–90)

the multilateral credit institution. The miners' strike lasted two and a half months, paralyzing Peru's main foreign exchange earning sector and thus aggravating the foreign exchange crisis and inflationary expectations.

Coronado and the Monetary Approach to the Balance of Payments

Central Bankers witness the hard way the correlation between money, the free market exchange rate, reserve losses, and inflation. Peru's Central Bank charter provides for a very independent Central Bank. Credit outstanding to the government is restricted to one-twelfth of the year's tax revenues, and net international reserves are subject to a minimum legal reserve requirement equal to one and a half months of imports (based on the average of the two previous years).[16] Central Bank independence is protected by the Constitution (Article 151) by providing that its president and board members, once appointed, can be impeached only by the Senate. In addition, Article 149 of the Constitution obliges the Central Bank to publish very detailed information on the economic and financial situation of the country, which the Central Bank does, inter alia, with a weekly publication called the "Nota Semanal."

During the last two Belaúnde years Central Bank Governor Richard Webb had already used the charter at its potential and succeeded in moderating the government's public spending plans. History repeats itself. Pedro Coronado, a lawyer appointed governor in late 1987 and who had presided over the Central Bank during the inherited nightmare of multiple exchange rates, cheap credit windows, and frequent recourse to government financing, took the step of regaining Central Bank independence at the time of the so-called double-zero plan of September 1988.

The tight new credit rule was to have been coordinated with the September and November adjustment measures which, at their original technical design, had been intended to reduce the government's deficit. This was particularly the case with the adjustment designed by then–finance minister Abel Salinas, who resigned in late November when his original proposal was turned down by President García. Despite the fact that the actual approved packages left unchecked the underlying budget imbalance, the Central Bank pursued a tight credit policy from September 1988 to July 1989. Only a fraction of the credit requests by the Treasury and public enterprises were accommodated, on occasion in exchange for price adjustments or other policy measures. The public sector was forced to adjust expenditures and resort to domestic arrears.

In November 1988, cargo ships loaded with wheat and corn supplied by USAID on grant terms waited idly day after day at Lima's Callao Harbor for their freight charges to be paid by ENCI (Peru's agricultural marketing board). The Central Bank was refusing to advance the funds to ENCI unless this institution would reduce subsidies. The rumor was spreading that there was no bread in Lima because of the Central Bank's monetarist policies.

16. Ley Organica del B.C.R.P., Articles 46, 47, 48, and 80, 82, respectively.

The credit crunch and its effects are illustrated in table 9.11. The effective flow of Central Bank domestic credit declined in nominal terms in several months and grew by very little in others. However, since an important share of both the monetary base and the money supply was in dollar-indexed accounts—which revalued whenever the exchange rate depreciated, as it did almost every month—the domestic "source" of the money supply continued to grow. The credit crunch managed to progressively drive down the free market premium of the inti and international reserves started to build up. By mid-1989, net international reserves had increased by $500 million, or 2 percent of GDP.

The Four-Months-Ahead Tablita

Despite the credit squeeze, inflation did not decline significantly during the first half of 1989. In January 1989 a new minister of finance announced a *tablita* or schedule of monthly changes of key prices for the next four months (table 9.12). Again, the strategy was one of almost equiproportional albeit declining overtime, escalation of the exchange rate, prices, and wages, much in the same vein as the one-shot packages of the previous year but with more frequent, and thus smaller, changes. As it turned out, actual adjustments to wages were higher than those for the exchange rate and public prices. Preannounced cost escalation, together with the credit squeeze, maintained the economy in stagnation at the hyperrecessed plateau reached in late 1988, without helping on the inflation front. By June 1989, real wages and GDP had dropped by 67 percent and 23 percent, respectively, in comparison to December 1987, while inflation hovered at 45 percent between December 1988 and April 1989. Eventually, however, the monetary cure produced its effects: since May 1989 monthly inflation receded to around 30 percent for 12 consecutive months.

As the recession drove down import levels and some dynamic domestic producers shifted from the depressed internal market to exports, the economy started to run a large trade surplus (figs. 9.9 and 9.10). To a large extent, the inti counterpart of this surplus was absorbed in people's portfolios because the free market exchange rate was appreciating in real terms (following the overshooting in late 1988) and the Central Bank was not supplying domestic credit. Devaluation expectations of late 1988 and early 1989 became frustrated by the crunch and thus ex post returns in dollars of inti deposits, at the now-higher domestic interest rates, turned out to be higher than "betting on the dollar." A significant part of the trade surplus, thus, went into intis instead of capital flight. The depressed level of output and imports translated into an unprecedented real appreciation of the official and parallel exchange rates. From late 1988 to mid-1989, the official exchange rate appreciated 50 percent and the parallel rate appreciated 75 percent, in real terms, while the spread between both became virtually zero (figs. 9.5 and 9.11 and table 9.13).

In hindsight, the paradox of the period from September 1988 to June 1989

Table 9.11 **The Credit Crunch: September 1988 through June 1989**

	September	October	November	December	January	February	March	April	May	June
Central bank domestic credit (%)[a]	−34.0	7.4	−13.2	19.6	−5.5	4.2	−.7	−6.5	1.2	3.3
Central bank net international reserves (in millions of U.S. dollars)	−293	−317	−304	−352	−319	−323	−213	−45	79	176
Broad money growth (%)[b]	22.7	19.5	15.4	38.6	17.8	31.3	37.9	33.7	41.6	27.9
Inflation spread (%)	114	41	24	42	47	43	42	49	29	23
Free exchange rate/official exchange rate (%)	71	97	79	130	190	56	9	13	44	47
Interest rates on deposits (monthly rates) (%)	10	10	17	17	17	21	21	21	21	21
Real GDP (1979 = 100)	107	93	84	82	103	96	99	99	99	99
Real wage (July 1985 = 100)	81	64	78	72	66	60	55	46	47	48

[a]Monthly growth rate. Excluding losses arising from valuation adjustments on net dollars liabilities due to exchange rate devaluations.

[b]A significant part of it indexed to the official exchange rate.

Table 9.12 **The Preannouncement of Key Prices Four Months Ahead, February–May 1989**

	January	February	March	April	May
Exchange rate devaluation					
Announced	. . .	31	20	12	12
Actual	40	31	30	37	24
Gasoline price increase					
Announced	. . .	29	20	13	12
Actual	62	29	28	44	0
Minimum wage increase					
Announced	. . .	24	18	12	10
Actual	41	24	31	26	40

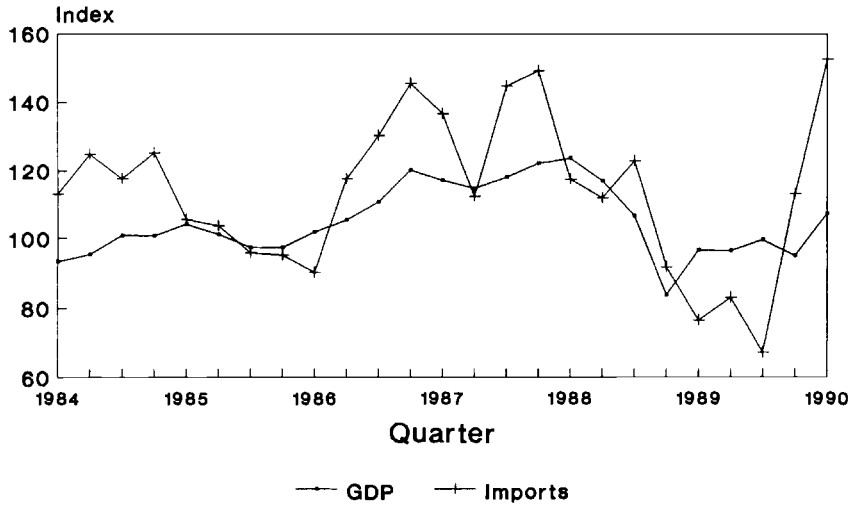

Fig. 9.9 Evolution of real GDP and real imports (1985 = 100)

is that the Central Bank's squeeze led to a massive buildup of international reserves, perhaps the least convenient avenue to have a good case to make with external creditors for the continuation of a unilateral default.

The monetary squeeze ended in July 1989 in the midst of strong arm-twisting between the Central Bank and the executive. The issue under dispute was the use of the foreign exchange reserves for yet another reactivation run with a view to the upcoming municipal elections in November 1989 and presidential elections in early 1990. Of the seven members of the Central Bank board, Coronado lost the one-vote margin that had permitted him to pursue credit restraint since September 1988; he resigned. From then on, Luis Guiulfo, who had systematically opposed any violation to the charter all along

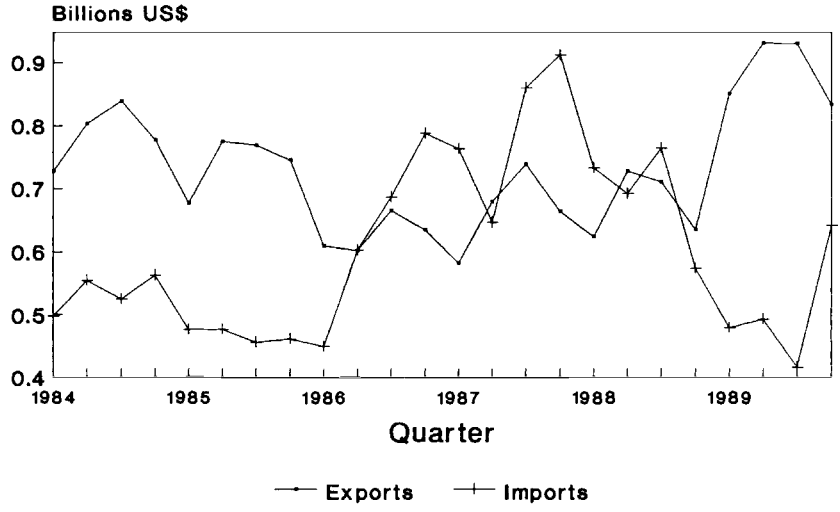

Fig. 9.10 Exports and imports of goods (1984–89)

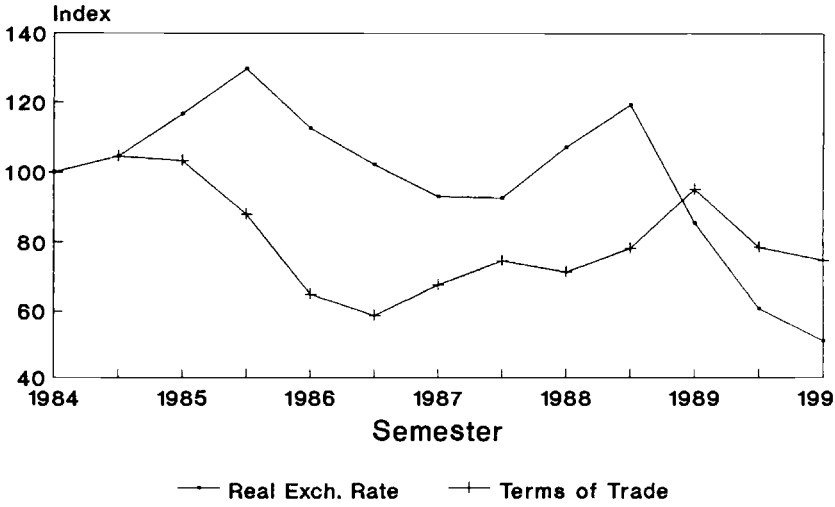

Fig. 9.11 Real exchange rate and terms of trade (first half of 1984 = 100)
Note: An increase in the Index of Real Exchange Rate means real depreciation. The index refers to the effective exchange rate.

Table 9.13 **Nominal and Real Exchange Rates, 1985–90**

	Official Exchange Market						Parallel Exchange Market		
	Official Exchange Rate[a]			Average Effective Rate[b]					
	Intis/ U.S. Dollars	Nominal Devaluation[c]	Real Exchange Rate Index[d]	Intis/ U.S. Dollars	Nominal Devaluation[c]	Real Exchange Rate Index[d]	Intis/ U.S. Dollars	Nominal Devaluation[c]	Real Exchange Rate Index[d]
1985:									
July	11.9	. . .	102.1	11.9	. . .	102.2	13.3	. . .	105.0
August	13.9	17.1	109.0	14.0	17.6	109.5	17.4	30.7	125.1
September	13.9	.0	106.3	14.0	.0	106.8	17.4	.1	122.2
October	13.9	.0	104.3	14.1	.5	105.3	17.4	.2	120.0
November	13.9	.0	102.5	14.1	.0	103.5	17.4	−.1	117.8
December	13.9	.0	100.7	14.1	.0	101.7	17.4	−.1	115.6
1986:									
January	13.9	.0	96.8	14.1	.0	97.7	17.4	.1	111.2
February	13.9	.0	95.3	14.1	.4	96.6	17.4	−.1	109.4
March	13.9	.0	92.3	14.1	.0	93.6	17.4	.0	106.0
April	13.9	.0	87.1	14.1	.0	88.4	17.4	.1	100.2
May	13.9	.0	85.1	14.1	.0	86.3	17.4	.0	97.8
June	13.9	.0	82.4	14.1	.0	83.5	17.4	.0	94.7
July	13.9	.0	80.5	14.2	.7	82.2	17.4	−.1	92.5
August	13.9	.0	78.8	14.3	.2	80.6	17.5	.7	91.2
September	13.9	.0	76.4	15.9	11.6	87.2	17.7	1.1	89.5
October	13.9	.0	73.3	15.9	.0	83.6	18.5	4.4	89.4
November	13.9	.0	70.5	15.9	.0	80.5	19.0	3.0	88.6
December	13.9	.0	68.0	16.6	4.1	80.8	20.0	5.3	90.0

(continued)

Table 9.13 **(continued)**

	Official Exchange Market						Parallel Exchange Market		
	Official Exchange Rate[a]			Average Effective Rate[b]					
	Intis/ U.S. Dollars	Nominal Devaluation[c]	Real Exchange Rate Index[d]	Intis/ U.S. Dollars	Nominal Devaluation[c]	Real Exchange Rate Index[d]	Intis/ U.S. Dollars	Nominal Devaluation[c]	Real Exchange Rate Index[d]
1987:									
January	14.2	2.2	66.8	16.9	2.2	79.3	20.2	.9	87.3
February	14.6	2.2	65.2	17.3	2.2	77.5	20.2	−.1	83.3
March	14.9	2.2	63.8	17.7	2.2	75.8	20.7	2.4	81.6
April	15.2	2.2	62.1	18.1	2.2	73.7	26.2	26.7	98.4
May	15.5	2.2	60.3	18.5	2.2	71.7	32.7	25.0	117.0
June	15.9	2.5	58.8	19.6	5.9	72.2	33.0	.6	112.1
July	15.9	.0	54.3	20.5	5.0	70.0	40.8	23.7	128.0
August	15.9	.0	50.6	20.5	.0	65.2	45.0	10.4	131.6
September	15.9	.0	48.1	20.5	.1	62.0	50.0	11.1	139.0
October	15.9	.0	45.6	26.5	28.8	75.7	61.8	23.5	162.8
November	15.9	.0	44.1	26.5	.0	73.3	63.5	2.8	162.0
December	33.0	107.2	86.5	38.9	46.9	101.8	92.0	44.9	222.1
1988:									
January	33.0	.0	76.6	40.3	3.8	93.6	89.5	−2.7	191.3
February	33.0	.0	67.8	43.0	6.6	88.3	102.0	14.0	193.1
March	33.0	.0	55.8	49.2	14.5	83.2	105.0	2.9	163.6
April	33.0	.0	47.7	55.9	13.5	80.7	150.5	43.3	200.3
May	33.0	.0	44.2	61.3	9.7	82.1	176.5	17.3	217.8
June	33.0	.0	40.2	74.1	20.9	90.2	177.5	.6	198.9
July	33.0	.0	29.9	89.0	20.1	80.7	204.0	14.9	170.3
August	33.0	.0	24.4	142.7	60.3	105.5	283.5	39.0	193.0
September	250.0	657.6	87.5	278.6	95.2	97.6	425.0	49.9	137.1

October	250.0	.0	63.1	292.1	4.8	73.8	508.6	19.7	118.3
November	500.0	100.0	103.0	532.5	82.3	109.7	700.0	37.6	132.8
December	500.0	.0	73.4	744.3	39.8	109.2	1660.0	137.1	224.4
1989:									
January	700.0	40.0	68.8	965.0	29.7	95.0	1740.0	4.8	156.6
February	920.0	31.4	63.4	1,062.0	10.0	73.2	1300.0	−25.3	82.5
March	1,200.0	30.4	58.2	1,339.2	26.1	64.9	1560.0	20.0	69.7
April	1,640.0	36.7	53.8	1,944.2	45.2	63.7	2177.0	39.6	65.7
May	2,025.0	23.5	50.9	2,584.0	32.9	64.9	3250.0	49.3	75.2
June	2,395.4	18.3	48.3	2,622.6	1.5	52.9	3070.3	−5.5	57.1
July	2,942.5	22.8	48.6	3,003.6	14.5	49.6	3094.7	.8	47.1
August	3,570.6	21.3	46.9	3,751.3	24.9	49.3	4061.1	31.2	49.2
September	4,132.2	15.7	42.6	5,012.3	33.6	51.7	5829.5	43.5	55.4
October	4,394.4	6.3	37.5	5,234.1	4.4	44.7	6241.9	7.1	49.1
November	4,701.2	7.0	32.1	7,900.9	51.0	54.0	12128.9	94.3	76.3
December	5,261.4	11.9	27.3	8,667.5	9.7	45.0	12821.3	5.7	61.3
1990:									
January	6,392.7	21.5	26.0	9,260.0	6.8	37.6	12,362.5	−3.6	46.3
February	8,146.2	27.4	25.4	11,039.9	19.2	34.4	13,920.2	12.6	39.9
March	11,225.4	37.8	26.3	17,215.0	55.9	40.4	23,098.0	65.9	49.9
April	15,892.8	41.6	27.3	21,806.4	26.7	37.4	28,133.3	21.8	44.4
May	22,501.0	41.6	29.4	30,944.7	41.9	40.5	49,624.6	76.4	59.8
June	33,720.6	49.9	31.0	63,891.7	106.5	58.7	103,268.4	106.1	87.3

Sources: Central Reserve Bank and author's estimates.

[a]MUC stands for Mercado Unico de Cambios and is the official exchange rate.

[b]Weighted average rate for all commercial transactions. There were multiple exchange rates.

[c]Percentage increase over previous month.

[d]An increase in the Real Exchange Rate Index means real depreciation. The base is December 1978.

since 1985, became the only member of the board favoring credit restraint. In the month of July, money printing for government financing (a traditional *maquinazo* in the local jargon) increased by 21 percent, compared to roughly zero in the previous semester (table 9.14).

The "30-percent Monthly Inflation" Knife's Edge Equilibrium

In May 1989, President Alán García had appointed his sixth minister of finance, a young economist of the left-wing of the APRA party. In his book entitled *The Forgotten Proposal* (1988), Vasquez Bazan had been critical of the government's economic policies, deeming them as a repetition of the traditional Latin American populist paradigm and at odds with APRA's traditional structural reform agenda. Notwithstanding this criticism, economic policy during the following 12 months engaged in an erratic sequence of ad hoc measures driven by short-run developments. In general, measures followed a "zig-zag" pattern, with later measures running in opposite direction to earlier ones in an attempt to correct their destabilizing effects. The initial new policies included, inter alia, introduction of a crawling peg (at a continuously fine-tuned rate), monthly wage increases, sporadic public price adjustments, and a few exotic tax measures, including a new tax on the turnover of checks (tables 9.15 and 9.16). Since July 1989, the Central Bank started to accommodate again government credit requests (tables 9.5 and 9.14). On the other hand, an increasing number of categories of imports were made eligible for foreign exchange at the highly subsidized official exchange rate. By December 1989, 72 percent of total imports were given access to the official market. The policy goal was to prompt a quick recovery by boosting import levels.

The free market exchange rate, however, very soon reflected expansionary financial policies. By the end of the year the spread over the official rate had surpassed 100 percent. At this point, the authorities switched into a containment effort aimed at avoiding a further explosion of the exchange rate and prices before the forthcoming presidential elections of 8 April 1990.[17] As part of this strategy, the Central Bank started to provide dollar loans to exporters and to sell term promissory dollar notes to importers in an attempt to depress the free market exchange rate. The Central Bank's financing of the government's deficit in 1989 was small, about 4.3 percent of GDP—most of it during the second half of the year (table 9.8). But, as often happens with high inflation processes, the pressure of just a little Central Bank financing on a tiny financial system was enough to sustain hyperinflation. Thus, the year 1989 ended with an inflation rate of 2,800 percent (after having peaked at nearly 6,000 percent during the 12 months ending in August 1989). Moreover, GDP dropped by 10 percent, adding to the 9 percent decline in 1988, and international reserves started to destock at a fast pace beginning in November 1989.

17. As explained in the publication *Peru Economico* of December 1989 (Apoyo 1989).

Table 9.14 **Monthly Economic Indicators, 1985–90**

	Real GDP (1979 = 100)	Inflation Rate[a]	Employment (1979 = 100)	Real Wage (July 1985 = 100)	Hours Lost in Strikes[b]	Broad Money (Nominal Growth Rate)[a,c]	Central Bank Domestic Credit (Nominal Growth Rate)[a]		Central Bank Net International Reserves (in Millions of U.S. Dollars)
							Total	Adjusted[d]	
1985:									
January	106.2	13.9	92.0	121	74.3	−.7	8.4		1,001
February	104.6	9.5	92.2	118	−81.9	.7	5.4		1,102
March	104.2	8.1	92.1	117	−81.0	7.7	23.6		1,048
April	102.3	12.2	91.7	111	−74.9	11.5	3.9		1,018
May	102.6	10.9	91.7	105	59.1	−1.9	6.9		997
June	102.6	11.8	91.6	104	−77.1	7.8	.3		971
July	104.0	10.3	91.5	100	44.9	13.7	9.5		894
August	98.7	10.8	91.4	111	−33.6	23.4	8.9		1,003
September	98.2	3.5	91.5	111	−47.6	17.2	3.1		1,144
October	100.9	3.0	91.7	112	−1.4	9.7	−3.9		1,310
November	105.3	2.7	92.3	113	139.0	9.8	18.4		1,388
December	104.7	2.8	93.8	113	69.8	20.3	15.6		1,493
1986:									
January	102.0	5.2	93.4	110	79.9	5.7	18.0		1,539
February	103.0	4.2	93.8	127	689.0	9.6	14.2		1,500
March	98.9	5.3	94.5	125	2,482.8	10.5	7.9		1,541
April	106.6	4.1	94.7	124	911.7	.7	7.3		1,434
May	108.7	3.3	94.6	123	−57.3	4.9	6.7		1,407
June	112.4	3.6	95.1	127	−34.2	6.1	11.5		1,278
July	114.0	4.6	95.9	125	−57.1	7.3	6.5		1,234

(continued)

Table 9.14 **(continued)**

	Real GDP (1979 = 100)	Inflation Rate[a]	Employment (1979 = 100)	Real Wage (July 1985 = 100)	Hours Lost in Strikes[b]	Broad Money (Nominal Growth Rate)[a,c]	Central Bank Domestic Credit (Nominal Growth Rate)[a]		Central Bank Net International Reserves (in Millions of U.S. Dollars)
							Total	Adjusted[d]	
August	114.4	4.0	96.3	125	−28.6	6.5	6.8		1,135
September	116.3	3.6	96.8	125	744.2	2.9	−3.5		1,239
October	122.2	4.0	97.7	140	−65.7	6.4	5.9		1,201
November	124.6	3.6	98.8	138	−85.4	4.9	13.5		992
December	128.4	4.6	99.8	134	−74.4	10.5	9.5		958
1987:									
January	118.1	6.6	98.7	129	−32.4	2.4	5.8		833
February	116.5	5.6	99.2	126	47.4	5.0	1.4		791
March	119.8	5.3	100.5	124	−77.7	7.7	2.5		820
April	121.8	6.6	100.8	138	−56.0	6.6	6.7		858
May	117.8	5.9	100.9	133	296.2	7.5	7.8		892
June	121.6	4.7	101.4	130	93.1	6.0	10.5		790
July	121.7	7.3	101.3	147	−22.7	13.1	12.7		765
August	124.0	7.4	101.6	141	−46.2	6.3	16.3		649
September	127.1	6.5	101.9	138	−82.0	4.0	7.1		533
October	128.5	6.1	102.7	152	16.1	5.9	10.6		405
November	130.5	7.1	103.7	155	79.5	6.6	11.9		194
December	128.6	9.6	104.5	146	−34.5	10.6	24.4		43
1988:									
January	122.1	12.8	101.8	134	157.5	.8	4.8	4.8	−50
February	130.8	11.8	101.6	126	−73.1	9.1	9.4	9.4	−153
March	129.5	22.6	102.1	135	−45.8	13.0	10.6	10.6	−194
April	122.9	22.9	102.0	121	−29.6	9.1	10.4	10.4	−237
May	120.1	8.5	101.5	117	−85.0	5.1	7.3	7.3	−219
June	118.2	8.8	101.1	113	146.3	4.4	8.6	8.6	−180
July	110.7	30.9	101.1	118	843.5	24.8	20.6	20.6	−222

August	110.8	21.7	100.9	104	714.2	15.6	18.4	18.4	−266
September	107.2	114.1	101.3	81	105.4	22.7	101.4	−34.0	−293
October	93.3	40.6	99.5	64	686.3	19.5	7.4	7.4	−317
November	83.9	24.4	97.4	78	1,095.5	15.4	58.2	−13.2	−304
December	81.8	41.9	97.7	72	1,767.7	38.6	19.6	19.6	−352
1989:									
January	103.4	47.3	95.9	66	146.2	17.8	24.8	−5.5	−319
February	95.7	42.5	95.1	60	94.7	31.3	30.5	4.2	−323
March	99.2	42.0	94.5	55	85.7	37.9	22.4	−.7	−213
April	99.0	48.6	94.0	46	40.4	33.7	26.9	−6.5	−45
May	99.3	28.6	93.4	47	−77.9	41.6	9.3	1.2	79
June	99.4	23.1	92.8	48	53.7	27.9	14.4	3.3	176
July	105.2	24.6	92.4	49	−75.7	40.8	32.3	21.0	222
August	98.8	25.1	92.8	48	−47.0	26.5	15.0	8.8	373
September	103.5	26.9	92.5	48	−32.9	30.7	16.8	13.6	450
October	97.1	23.3	93.5	51	−64.3	32.1	19.9	19.0	457
November	97.2	25.8	93.8	49	−85.3	28.3	14.8	14.1	453
December	99.0	33.8	94.2	46	−84.0	23.3	24.4	22.3	357
1990:									
January	113.7	29.8	94.1	46	314.4	13.5	27.3	22.4	301
February	109.9	30.5	94.4	46	87.8	17.6	29.0	19.7	131
March	107.1	32.6	94.4	44	131.5	27.8	57.2	38.8	−37
April	100.8	37.3	N.A.	44	86.1	22.2	25.9	7.0	−119
May	100.0	32.8	N.A.	44	125.1	31.8	38.8	17.4	−152
June	N.A.	42.6	N.A.	N.A.	N.A.	44.0	55.6	29.0	−143

[a]Percentage increase over previous month.

[b]Percent increase over same month of previous year.

[c]Excludes deposits denominated in dollars.

[d]Central Bank Credit netted out of losses arising from valuation adjustments due to exchange rate devaluation.

Table 9.15 Packages of Economic Measures, January–June 1989

	January	February	March	April	May	June
PRICES, WAGES, AND EXCHANGE RATE		+ *Tablita*: preannouncement for next four months of official exchange rate, gasoline price, and minimum wage				
Effective rate (devaluation) (%)	30	10	26	45	33	2
Number of exchange rates:						
Imports	1	1	1	1	1	1
Exports	2	2	2	2	2	2
Total	3	3	3	3	3	3
Minimum wage increases (%)	41	24	31	26	40	29
Public-sector wage increases (%)	46	15	35	24	30	38
Private-sector wage increases (%)	33	21	27	25	30	25
Increases of public tariffs:						
Gasoline (%)	62	29	28	44	0	0
Electricity (%)	60	25	30	27	0	0
Rice (%)	62	35	34	20	4	10
Increase of price of controlled products (%)	55	42	28	26	19	7
TAXES						
Changes in existing taxes	+ Decrease export tax from 10% to 6%			Reduction of excise taxes (cigarettes, beer, and soft drinks)		
New taxes						
IMPORT TARIFFS AND RESTRICTIONS		Reduction of % of imports eligible to the official market (from 65% to 50%)				
Evolution of quantitative restrictions (QRs) (% of total of tariff categories)						
Free from QRs						7.1
License required						82.7
Import prohibitions						10.2
Evolution of tariffs						
Average tariff						
Maximum tariff						
EXPORTS MEASURES	+ 127 of official exchange rate for Nontraditional Exports				+ CLD[a] from 30% to 40%	+ CLD[a] from 40% 50%
INTEREST RATE						
Lending rate (%)		25 per month				
Deposit rate (%)		21 per month				

[a]The Certificados de Libre Disponibilidad (CLD) is a tradable dollar certificate given to exporters for a share of their export proceeds that can be used by an importer.

Table 9.16 Packages of Economic Measures, July–December 1989

	July	August	September	October	November	December
PRICES, WAGES, AND EXCHANGE RATE						
Effective rate (devaluation) (%)	15	25	34	4	51	10
Number of exchange rates:						
Imports	1	1	1	1	1	1
Exports	2	2	2	2	2	3
Total	3	3	3	3	3	4
Minimum wage increases (%)	30	25	25	19	22	37
Public-sector wage increases (%)	15	57	18	61	24	28
Private-sector wage increases (%)	29	25	25	18	22	25
Increase of public tariffs:						
Gasoline (%)	11	0	25	5	6	18
Electricity (%)	10	25	31	13	0	42
Rice (%)	96	13	45	47	57	4
Increase of price of controlled products (%)	19	23	41	33	27	21
TAXES						
Changes in existing taxes				+ Reduction of excise taxes		
New taxes		+ Tax of 1% on checking account transactions	+ 2.5% of September sales for Social Compensation Fund and army		+ 1% of imports and 2% of traditional exports for National Defense Fund	
IMPORT TARIFFS AND RESTRICTIONS					+ Increase of % of imports eligible for the official exchange market (from 50% to 69%)	+ Further increase of % of imports eligible for the official exchange market (from 69% to 72%)

(continued)

Table 9.16 **(continued)**

	July	August	September	October	November	December
Evolution of quantitative restrictions (QRs) (% of total of tariff categories)						
Free from QRs						79.6
License required						10.2
Import prohibitions						10.2
Evolution of tariffs						
Average tariff						66
Maximum tariff						110
EXPORTS MEASURES			+ CLD[a] from 50% to 55%	+ CLD[a] from 55% to 45% but 10% in cash (U.S.$)	+ CLD[a] from 45% to 35% but 20% in cash (U.S.$)	+ Nontraditional exporters receive advance accounts (FENT) in U.S.$
INTEREST RATE						
Lending rate (%)				23.5 per month	21.5 per month	
Deposit rate (%)					19.0 per month	

[a]The Certificados de Libre Disponibilidad (CLD) is a tradable dollar certificate given to exporters for a share of their export proceeds that can be used by an importer.

Table 9.17 Packages of Economic Measures, January–June 1990

	January	February	March	April	May	June
PRICES, WAGES, AND EXCHANGE RATE						
Effective rate (devaluation) (%)	7	19	56	27	42	107
Number of exchange rates:						
Imports	1	1	1	1	1	1
Exports	3	3	3	3	3	3
Total	4	4	4	4	4	4
Minimum wage increases (%)	31	37	30	38	36	34
Public sector wage increases (%)	20	35	25	33	30	31
Private sector wage increases (%)	28	30	30	30	35	36
Increase of public tariffs:						
Gasoline (%)	12	38	0	29	31	96
Electricity (%)	29	42	30	38	36	34
Rice (%)	2	−2	9	42	64	24
Increase of price of controlled products (%)	18	24	21	36	25	32
TAXES						
Changes in existing taxes	Exemption on 1990 tax income for PETROPERU	+ Increase of excise taxes + Sales tax from 10.5% to 15%			+ Tax on checking accounts from 1% to 2% + Tax on loans from 10% to 20%	
New Taxes						

(continued)

Table 9.17 (continued)

	January	February	March	April	May	June
IMPORT TARIFFS AND RESTRICTIONS	+ Reduction of % of imports eligible to the official exchange market (from 72% to 67%)	+ Further decrease of % of imports eligible for the official exchange market (from 67% to 61%)	+ Additional decrease of % of imports eligible for the official exchange market (from 61% to 43%)			
Evolution of quantitative restrictions (QRs) (% of total of tariff categories)						
Free from QRs						
License required						
Import prohibitions						
Total number of tariffs categories						
Evolution of tariffs:						
Average tariff						
Maximum tariff						
EXPORTS MEASURES		+ CLD[a] from 35% to 45% but 10% in cash	+ CLD[a] from 45% to 35%	+ Advance accounts to exporters in intis		+ CLD[a] from 60% to 70%
			+ Elimination of advance accounts in U.S. dollars			
INTEREST RATE						
Lending rate	23.0% per month		29.0% per month		39.0% per month	
Deposit rate	21.0% per month		25.0% per month		32.0% per month	

[a]The Certificados de Libre Disponibilidad (CLD) is a tradable dollar certificate given to exporters for a share of their export proceeds that can be used by an importer.

In December 1989, following a warning by the IMF that it would initiate procedures that could ultimately lead to Peru's expulsion from the institution, the government resumed payments of current debt service to the IMF—thereby freezing arrears with this institution at the level of September 1989. The authorities came to terms with the institution against which they had been most vociferously confrontational, while continuing the default with the rest of the creditors.

The containment effort continued during the first half of 1990. But, as international reserves evaporated, imports were progressively transferred back from the official market to the free foreign exchange market and dollars supplied by the Central Bank for other transactions started to be tightly rationed. Hence, the burden of "controlling" the free exchange rate was now placed on monetary policy. Credit to the private sector was dried up, through increased reserve requirements on deposits. In parallel, the Treasury stretched payments of expenditures and incurred more domestic arrears rather than resort to price and tariff hikes and/or larger Central Bank financing. In this context, effective lending interest rates to the private sector reached 15-plus percent per month in real terms. To limit the pace of reserve depletion the authorities took the unprecedented step of going into a de facto default on ALADI (Latin American Trade Area), clearing payments owed to other Latin American Central Banks and requesting rescheduling of settlements so that the payments would fall due under the next presidential term. In spite of these efforts, reserves continued to decline—by June 1990, reported gross reserves totaled barely $600 million (most of them nonliquid), 1 billion less than in August 1989. After 12 consecutive months with an inflation rate of around 30 percent per month, inflation picked up again in June 1990, reaching 43 percent. In parallel, the free exchange rate took off in late June at spreads of 200 percent over the official rate. By late July, inflation was running at 6 percent per day.

To compound these formidable problems, that were handed over to president-elect Alberto Fujimori on 28 July 1990, a number of other obstacles to economic management during the next presidential term were established by the outgoing administration. Among them are a policy of active employment in public-sector entities launched in January 1990 and the issuance of a number of laws that will complicate some of the structural reforms that the next government may wish to embark upon. One of these laws affects the transfer of several key public enterprises to local governments, thereby preventing the central government from effective control over them.

9.4 Summing Up the Experience

Beyond its macroeconomic debacle, the policies of 1985–90 had devastating effects on income distribution, agricultural incomes, the financial system, the tax system, the financial viability of public enterprises, resource allocation, public infrastructure, and the health and nutrition of the poor. For a gov-

ernment whose main objectives were to expand the role of the state in the economy and to benefit the poor, the ultimate paradoxes were twofold. On the one hand, hyperinflation forced an ex post shrinkage of the size of the government by more than half—as gauged by the share of public expenditures on GDP—even though public-sector employment increased 30 percent. And, on the other hand, the poor ended up being hurt the most.

The government's attempts to protect wages notwithstanding, average real wages declined by a cumulative 60 percent in 1987–89, about three times the 20 percent output loss experienced in the period (fig. 9.1 and table 9.14). Peruvian workers and organized labor—in particular the left-wing CGTP, Peru's largest union—showed a considerable degree of pragmatism and restraint in accepting phenomenal real wage cuts in the form of imperfect wage indexation formulas, apparently in exchange for much less drastic reductions in employment levels. The reported cumulative decline of employment in 1987–89 was about 10 percent. By early 1990, however, 8 percent of the labor force was reported unemployed and 74 percent underemployed.[18]

Income distribution definitely worsened. As shown in table 9.18, the income shares of working-class recipients, after having experienced significant improvements in 1986–87 at the tie of the boom, went back in 1988 to levels lower than those of 1985. The Gini coefficient in 1988 had regressed to that of 1985. Moreover, as fig. 9.1 shows, the formidable widening of the gap between the paths of real GDP and real wages occurred after the fourth quarter of 1988, which indicates that probably the income shares of civil servants and nonagricultural workers must have deteriorated further in 1989. Likewise, as figure 9.12 shows, the rural-urban terms of trade plunged starting in 1988—in the wake of the fast real appreciation of the exchange rate and the impossibility of maintaining the subsidy levels of 1986–1987—leading to a decline in the share of agricultural incomes in GNP from 12.1 percent in 1986 to 9.3 percent in 1988. A probable further decline occurred in 1989 in view of the continued drop of the terms of trade. (At this writing, data on income distribution for 1989 was not available.)

On the other hand, most subsidies provided through low public-sector prices and tariffs—by June 1990, most of these were at 30 percent or less of their levels, in real terms, of July 1985 (table 9.19)—tended to benefit relatively more the less poor, the urban, and the rich consumers. The regressiveness of most of these subsidies is illustrated in table 9.20, in which it can be noted that Peru's 30 percent poorest barely purchase gasoline, electricity, and water or use telephone and transport, and, to the extent that they purchase or use these, they consume relatively less than the less poor consumers. Paradoxically, the price of rice, the poor's main staple, rose by far more than, say, gasoline, despite the clear progressiveness of the rice subsidy and the regressiveness of the gasoline subsidy. All this indicates that the deterioration in

18. See n. 4 above for the definition of underemployment.

Table 9.18 Income (at Factor Cost) Distribution by Groups of Recipients

	Percentage of Income				Percentage of Recipients			
Income Groups	1985	1986	1987	1988	1985	1986	1987	1988
Agricultural workers	10.8	12.1	10.9	9.3	36.3	35.5	35.0	35.2
Nonagricultural self-employed	15.7	17.9	16.7	19.7	23.2	23.3	23.2	23.8
Nonagricultural workers	21.3	22.8	22.3	19.5	26.0	26.3	26.3	25.1
Civil servants	11.0	11.8	12.4	7.2	11.6	12.0	12.0	13.0
Employers	41.2	35.5	37.7	44.3	2.8	2.9	2.9	2.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Gini coefficient	0.50	0.41	0.43	0.50	. . .	. . .	. . .	. . .

Source: National Statistical Institute.

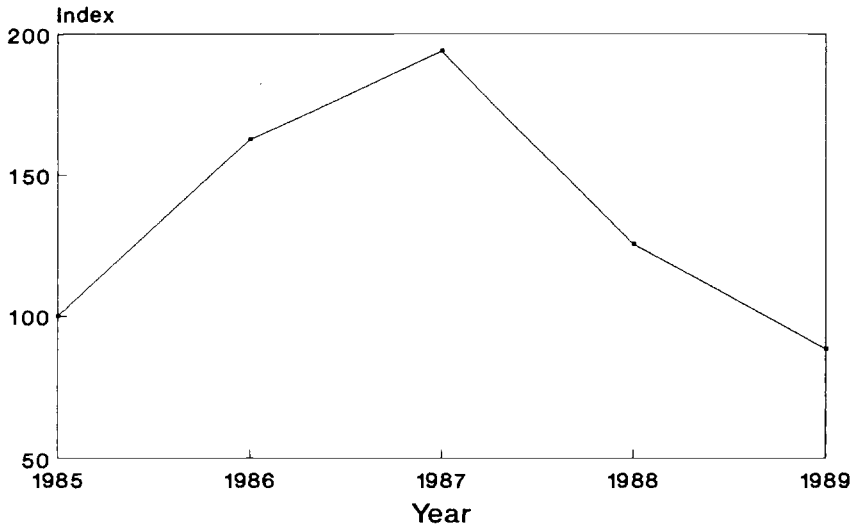

Fig. 9.12 Rural-urban terms of trade, 1985–89 (1985 = 100)

income redistribution, as portrayed in table 9.18, probably understates the real magnitude of the problem. Indeed, subsidies via prices and tariffs seem to have worsened distribution even further.

Lagging public-sector prices—a permanent key feature of the government's strategy to fight "cost-push diagnosed" inflation—resulted in a fall of public enterprises' revenues from 26 percent of GDP in 1985 to 7 percent in 1989, and to a corresponding decline in investment expenditures from 6 percent of GDP to 2 percent (table 9.8). In parallel, the policy of discretionary tax exemptions together with collection lags—of three months on average—and imperfect indexation of the tax base gave rise to a caricaturized Tanzi

Table 9.19 **Relative Prices of Selected Goods and Services Provided by Public Enterprises (July 1985 = 100)**

	Average				June
	1986	1987	1988	1989	1990
Gasoline 84	81	57	47	35	12
Kerosene	54	32	26	31	21
Electricity:					
Residential	70	52	40	12	7
Industrial	76	60	48	28	24
Telephone	81	82	46	12	6
Public transportation	79	66	65	54	N.A.
Water					
Residential	112	100	69	38	33
Industrial	92	84	67	37	39
Rice	73	65	53	57	44

Source: Ministry of Finance and author's estimates.

Table 9.20 **Budget Shares of Selected Items (%)**

Item	Poorest 10%	Poorest 30%		Rest 70%	All Peru
		All	Urban		
Fuel and oil for vehicles	.0	.0	.0	1.9	1.7
(% who purchase)	(.8)	(1.1)	(.5)	(11.2)	(8.2)
Kerosene	.7	1.3	3.1	.9	.9
Electricity	.3	.5	1.4	1.0	.9
(% who purchase)	(11.7)	(21.6)	(56.1)	(58.8)	(47.8)
Water service	.3	.4	1.1	.5	.5
(% who purchase)	(11.7)	(26.8)	(65.3)	(51.5)	(44.2)
Telephone	.0	.1	.1	.4	.3
(% who purchase)	(.4)	(1.4)	(4.2)	(12.0)	(8.8)
Public transport					
Local	.8	1.7	3.6	2.3	2.2
Long distance	1.0	.9	.9	1.2	1.2
Rice	5.7	5.3	5.2	2.2	2.9

Source: Glewwe (1988), drawing on data from Peru's 1985–86 "Living Standard Measurement Survey," carried out by Peru's National Statistical Institute and the World Bank.

effect (fig. 9.13). In 1989, tax revenues barely totaled 5 percent of GDP, down from 15 percent in 1985, just sufficient to cover the public sector's payroll. In total, combined gross revenues of the consolidated public sector dropped to one-third of the 1985 level. Inadequate expenditures on investment and maintenance of infrastructure, together with the drought of 1989 and terrorist attacks on electrical networks (in 1988 the number of electrical facilities damaged by terrorist strikes increased 100% compared to 1987), made electrical

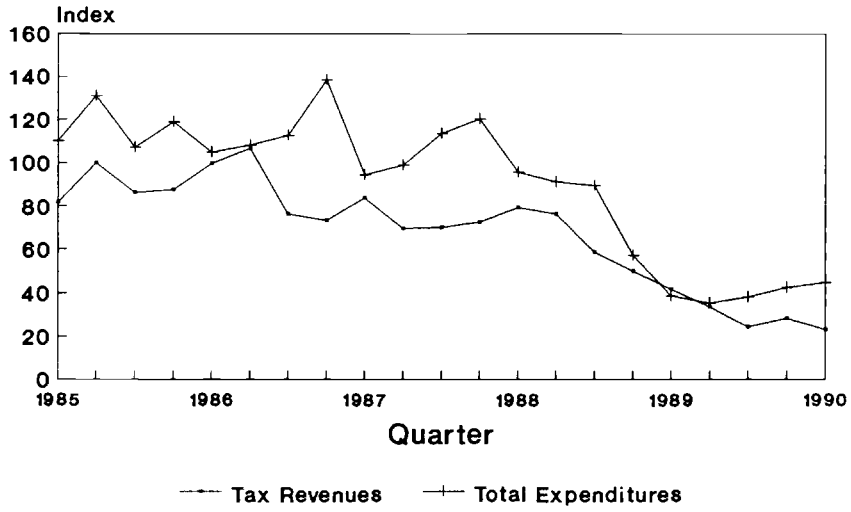

Fig. 9.13 Central government: Taxes and expenditures (real index 1985-II = 100)

shortages and acute water scarcity a daily event in Lima and other cities. Private electricity-generating systems became one of the fastest growing lines of business.

Even theoretically, it is difficult to quantify output and welfare losses resulting from price distortions. Indeed, it is even difficult to measure price distortions, more so in a hyperinflationary setting. Nonetheless, two illustrations of the problem can be provided. The first is price volatility, and the second consists of deviations from border pricing. Price volatility rises with the level of inflation, thus blurring the genuine informative content of prices and increasing information and transaction costs. All this leads to resource misallocation, uncertainty, and low investment levels. Table 9.21 provides information on price dispersion derived from the inflation indices of the eight broad categories of consumption "carried" in the CPI basket. The coefficient of variation of contemporaneous monthly inflation indices jumped fourfold from 1985 to 1989.

A second illustration of distorted price signals is provided by the "potential" deviations of domestic relative prices from border prices resulting from the tariff code, multiple exchange rates and quantitative restrictions. Table 9.22 presents the combined effects on nominal protection of the tariff structure and multiple exchange rates alone at two points in late 1987. It can be noticed that the relative price between a highly protected good and a highly unprotected good could potentially rise as high as nine times over the corresponding international relative price. It is also remarkable that in only two months both the levels of protection and the dispersion of protection rates increased signif-

Table 9.21 **Price Dispersion**[a]

Year	Dispersion[b]	Maximum Increase[c] (%)	Minimum Increase[c] (%)	Interval[d] (%)
1984	89.8	134.7	103.5	31.2
1985	100.0	214.3	137.8	76.5
1986	114.1	113.2	33.7	79.5
1987	139.2	177.9	66.6	111.3
1988	290.2	2,454.2	1,231.3	1,222.9
1989	426.9	10,017.9	1,632.9	8,385.3

Source: Apoyo (1990).
[a]Price indices of eight broad categories of the CPI.
[b]As measured by the ratio of the standard deviation to the mean of monthly inflation rates of eight categories. Index number (1985 = 100) reported is the average of 12 months of the year.
[c]Of annual inflation rate for each category of goods.
[d]Derived from (maximum increase) − (minimum increase).

Table 9.22 **Combined Nominal Protection from Tariffs and Multiple Exchange Rate (Unweighted Rates in %)**

	Exchange Rate as of 10/26/87				Exchange Rate as of 12/21/87			
	Minimum	Maximum	Mean	SD	Minimum	Maximum	Mean	SD
The whole economy	−35.3	237.4	95.5	56.6	−57.4	300.7	99.4	72.6
Agriculture	−35.3	187.0	79.9	55.5	−57.4	240.9	79.6	70.6
Mining	12.0	114.2	76.3	28.4	−26.0	154.4	51.9	28.3
Manufacturing	−19.2	237.4	96.6	56.8	−47.2	300.7	101.2	72.8
Consumer goods	−19.2	237.4	141.3	58.3	−46.6	300.7	166.3	79.0
Intermediate imports	−19.2	189.8	75.5	44.5	−44.4	244.2	56.6	43.2
Capital goods	.8	189.8	90.5	51.2	−47.2	244.2	108.7	57.7

Sources: Calculated by Lachler (1989) at the eight-digit tariff code level. Arancel Integrado de Aduanas del Peru 1987 and Diario Oficial "El Peruano," 10/26/87 and 12/21/87.

icantly (the maximum rate rose from 237 to 301 percent, while the standard deviation went from 57 to 73).

The formal financial system shrunk to less than one-quarter of its size in 1985. Indeed, while in 1985 total financial-sector internal liabilities amounted to 21 percent of GDP, by mid-1990 they barely represented 5 percent. About two-thirds of total credit was either utilized by the public sector or redirected to public development banks to be on loan to the private sector.

Economists hide behind what common people view as abstract magnitudes (GDP, inflation, etc.). These magnitudes are in general subject to considerable measurement error. However, the real ultimate effects of economic decline and more regressive income redistribution are best assessed by "impact," more

precise variables such as infant mortality. The destruction of the revenue base—and thus of the expenditure capability—of the government led to a decline in public social expenditures from $40 per capita in 1981 to $14 in 1989. Declining social expenditures and falling real wages provoked a marked deterioration of health and nutrition indicators, particularly among the poor. Comparable surveys undertaken by PRISMA, a Peruvian NGO, in a peri-urban Lima settlement, show that infant mortality for children five years old or younger increased 50 percent between 1987 and 1989, while the index of adequacy to the norm of weight and height of children under three years old worsened substantially.[19]

9.5 Concluding Remarks

Peru's economic policy between 1985–90 fits all the elements of the Dornbusch and Edwards (1990) paradigm: a stagnant economy with highly skewed income distribution and consistently unfulfilled expectations. The latter had been particularly frustrated with the failure of the sweeping social reforms attempted by military dictator Juan Velasco Alvarado in 1968–75, who had hoped to integrate this fragmented country.

The policy goals of the 1985–90 experiment were indeed reactivation and improvement of incomes of workers and peasants by use of macroeconomic policy. It was, however, believed—or at least the official rhetoric stated—that the improvement of real wages would not have to come necessarily at the expense of lower profit margins. Slack capacity and abundant foreign exchange reserves could allow everybody's income to expand. Moreover, the profits of firms in the "reactivation" phase were thought to provide the government with a good bargaining tool to use in negotiating private firms' reinvestment in exporting sectors during the subsequent "restructuring" phase. It was the dispute over private investment that seems to have prompted the initiative to nationalize banks and insurance companies and embark on a left-leaning agenda.

The nationalization of the banking system was the only social "reformist" step attempted by the government. The reality of the nationalization is, however, that it was de facto never implemented. It was contested in the courts and actively resisted by mass mobilization. When the law was finally issued by Congress in October 1987—three months after the presidential initiative—it permitted 51 percent employee-owned banks to remain nonpublic and offered banks the possibility of becoming private regional banks. The owners of Peru's largest private bank, Banco de Credito, rushed to block sell 51 percent of its shares to workers, with financing provided by a subsidiary of the same bank. As for the remaining banks, the process ended up in a precarious legal

19. Surveys undertaken in Pampas de San Juan by the Grupo de Trabajo A.B. PRISMA/UPCH. Report presented to UNICEF, September 1989.

status: banks were de facto allowed to continue in private hands but the Nationalization Law was not repealed.

The phases of the experiment match closely those described by Dornbusch and Edwards (1990). The expansionary phase was as spectacular—and indeed the government was fully vindicated even by big business—as the recessionary phase which ended in hyperinflation was formidable. Two striking features of Peru's hyperinflation were the rapid deindexation and real decline of wages and the independent course pursued by the Central Bank during 10 months in the middle of the process. These two factors reversed the explosive hyperinflationary trend and helped accumulate sizable international reserves. Two central lessons can be learned from Peru's experience. First, the devastating decline in real wages and agricultural incomes shows that populist experiments end up hurting most those whom they are intended to benefit. Second, clear rules of the game embodied in the laws, like charters that provide for an independent Central Bank, are a desirable commodity even in countries where laws are loosely enforced, as is the case in many developing nations. Somebody might come and use the laws!

Of the major Latin American debtors, Peru was the first one to embark on a broad-scale unilateral default. Unlike the cases of the other debtors, Peru's default was deliberately confrontational beginning in 1985 and was later extended to the multilateral credit institutions. Although assessing costs of default is beyond the scope of this paper, suffice it here to say that they were significant in terms of paralyzed development projects, reluctant new foreign investments, increased trade restrictions abroad, reduced aid flows, and, above all, a major macroeconomic failure. By early 1990, about 70 percent of Peru's $20 billion external debt was in arrears, and Peruvian commercial debt traded at 7¢ on the dollar in the secondary market. The ultimate debacle of the economic policies has been viewed by some as the example to prove that foreign debt is not the problem of Latin American countries, yet others have claimed that a debt overhang acts as a tax on the debtor country's predisposition to embark on sound policies (Sachs 1987). Peru's experience, however, appears to prove both, often presented as conflicting, theories: a debt overhang does not reward good performance and yet the burden of the debt is just only one of the many problems faced by Latin American countries.

Theoreticians of the now-fashionable topic of the economics of populism struggle to set forth theories attempting to explain why politicians engage in such adventurous experiments and why populist episodes have been a recurrent them in many Latin American countries. Several hypothesis put forward recently can be analyzed in light of Peru's recent experience.

The first hypothesis is that of a high discount rate. The policymaker prefers an early high payoff—at the cost of a later decline—to a steady path of improvement in incomes. Under this hypothesis, the policymaker is viewed as a rational agent, aware of the key interrelations and constraints among the eco-

nomic variables, who tries to maximize an intertemporal income stream at a high discount rate. To assess the relevance of this hypothesis in the Peruvian case the following simple exercise was performed: a comparison between the present value of the actual monthly real wage index for the period July 1985 to June 1990 (actual scenario) and the monthly real wage index that would have resulted from a sustained annual real growth of 2 percent (alternative scenario).[20] It can be seen in figures 9.14 and 9.15 that the actual scenario is preferable to the alternative one at annual real discount rates higher than 19 percent. This line of reasoning, however, does not explain why high rates of discount are indeed high. Political and social dimensions need to be considered to provide an explanation. Among these, Kaufman and Stallings (in this volume) have emphasized several factors that appear to shorten policy makers' time horizons. These include (1) political and social instability that may render the tenure of office insecure and (2) the arrival to power of parties after long periods of political exclusion. Both factors clearly apply to the Peruvian case. Moreover, Kaufman and Stallings also argue that in politically unstable societies it is more difficult for the people to assign responsibilities, and that politicians themselves might use this circumstance to put the blame for economic failures on "exogenous forces." In April 1990 President García declared that terrorism was responsible for hyperinflation.

The second hypothesis is "bad economics": policymakers do not know the real constraints imposed by macroeconomic variables and behavioral relations, and they act accordingly. Ample evidence was provided in this paper (section 9.3.2) of the departure from received mainstream economics of most economic beliefs of the team that designed the 1985 heterodox program. However, it is, in principle, difficult to know whether those theories are an exotic tailored rationalization of a set of inconsistent policy objectives established "a priori" by politicians or if they are indeed genuine guiding theories. In the case under analysis, it appears that the dominant line of thought in policy-making was misled most of the time, but this seems to have been overshadowed by the prevalence of a firm political agenda. In fact, once the crisis had already unraveled, the corrective attempts proposed by Coronado and Salinas were frustrated by political constraints.

The third hypothesis, proposed by Drake (1982), is that populism starts as a calculated effort to gain political support and momentum but subsequently fails to switch into orthodoxy at the right time. In this case, populism would be a combination of a high discount rate and bad economics. This explanation, however, raises the questions of why most if not all populist experiments end in macroeconomic disaster and why there is a failure to learn from previous similar experiences.

20. We are aware of the limitations of this exercise. Among others, real wages might not be the only variable to be maximized, and the planning horizon might go beyond the five-year presidential term.

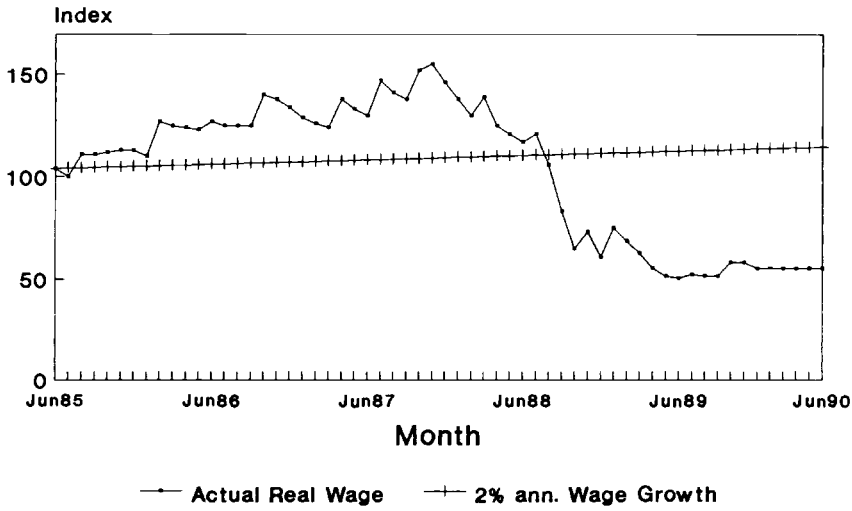

Fig. 9.14 Real wage: Actual versus 2% per year alternative (June 1985 through June 1990)

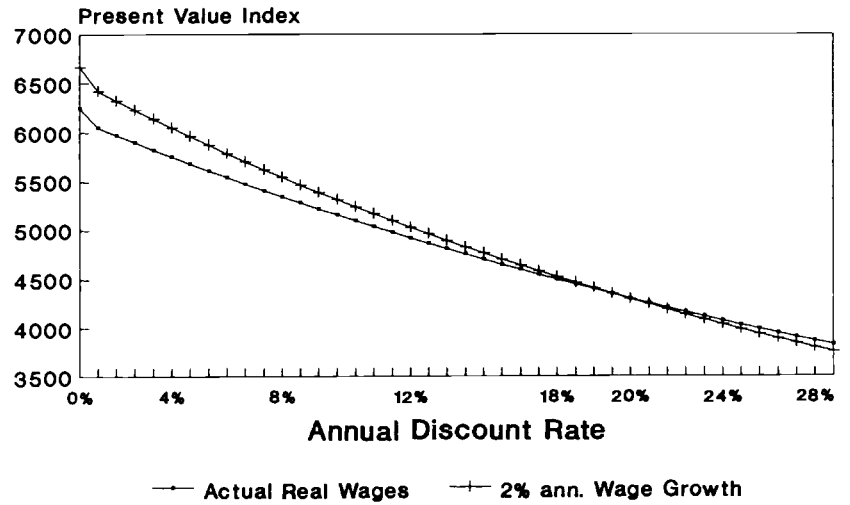

Fig. 9.15 Present value of real wages at different discount rates, demand-led boom versus stable 2% per year growth rate

The fourth explanation is that populism is a deliberate attempt to favor the interests of specific groups at the expense of other sectors. However, as noted above, the intended beneficiaries (i.e., workers and poor farmers) end up being major losers. Again, perhaps this comes as a consequence of a combination of a miscalculated effort, bad economics, and a high discount rate.

Sachs (1989) has established a formal dynamic framework aimed at explaining recurrent stop-and-go economic cycles in Latin American countries. He argues that secularly skewed income distribution and pressure from powerful urban lobbies, represented by inward-looking businesses and urban labor unions, are two key elements that prompt politicians to engage in an expansionary cycle at the end of a yet-not-totally-completed previous stabilization phase. Expansionary cycles seek to benefit urban groups at the expense of the incomes of resource-based exporting groups. The model fits Peru's characteristics well: (*i*) income distribution is worse than the average for Latin America (the ratio between the income shares of the top and poorest quintiles is 25 compared to an average of 21 for the region) and (*ii*) the development model followed since the sixties is perhaps the most inward-looking of the region (in 1989 Peru was still the Latin American country with the highest average and maximum tariff rates, as well as the one with the largest share of imports under licenses). In a sense, however, recurrent economic policies can be viewed as a particular case of the more general theme portrayed by modern Latin American novel writers. In his masterpiece *One Hundred Years of Solitude,* Gabriel García Marquez depicts a world in which the cast of characters changes, but everything else remains the same. History repeats itself over and over again. Therefore, the absence of an effective "learning process" from previous economic failures probably has cultural and other roots deeper than those purely economical or political.

Finally, a note on reactivation programs. At a time when the old Keynesian paradigm is being reincarnated into new fashionable and rigorous theories of "multiple real equilibria," the issue of the viability of recovery programs for severely depressed economies needs to be given consideration. The question is whether it is possible for an economy, which has undergone an unbalanced previous stabilization, to successfully run a demand-led experiment for a while and, from then on, return to orthodoxy. In other words, if during stabilization there was "excessive" hoarding of international reserves reached at the expense of overadjustment of real wages and depressed domestic real demand, it is possible for a "credible" incoming government to return real wages and GDP to more normal levels and then to switch into an orthodox approach?

It is conceivable that this may be possible at least in theory. The economics and politics of Peru in 1985 were particularly prone for such an experiment. But the easy part is the recovery, the difficult part is maintaining macroeconomic stability and resuming sustainable growth. More specifically, the difficult issue is to find consistency between the policies implemented for the recovery and the policies needed for stability and growth. The designers of Peru's program were certain that the limits of the recovery were set by international reserves and slack capacity, but they were not aware that the strategy followed to prompt the recovery—subsidies, controls, and import restrictions—were the antithesis of the incentive environment required to move the economy into the desirable second phase of investment and export growth.

Moreover, ideology aside, economic programs that rely heavily on naive "multiplier-accelerator" Keynesian models and price controls and, at the same time, disregard the inevitable restrictions imposed by budget constraints ultimately lead to macroeconomic collapse. While it is often argued that there is no agreement within the profession on economic theories—an argument often put forth by the designers of populist programs—disagreement on flow of funds accounting is nothing less than "bad economics." And populist programs end with macroeconomic failure because of their disregard for accounting constraints.

A country's economy is a complex system. Belief in virtuous-cycle policy interventions to improve the dynamics of complex systems is a dangerous strategy. Jay Forrester's (1972) two basic principles on the "counterintuitive behavior of complex systems" need to be borne in mind. The first is that complex systems have a few sensitive points of entry at which a small effort can yield a significantly larger return. The second is that a complex system tends to draw our attention to the very points at which an attempt to intervene will fail. It is far too simple to believe that the intricacies of "multiple real equilibria" could be exploited with price controls and public deficit financing.

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Comment Javier Iguíñiz-Echeverría

The title of Ricardo Lago's paper is misleading. It would seem to suggest that, in general, pursuing redistribution through macropolicy is an illusion. In that respect, I would like to say, first of all, that redistribution is a common feature of macropolicy, not an illusion. We all know, for instance, that exchange rate policies or, more precisely, real devaluation, a key element of almost any macropolicy, has fairly systematic regressive redistributive effects.

After reading the paper, a second possible meaning of the title came to my mind. Lago's main thesis seems to be that government attempts to prevent regressive income redistribution by, for instance, raising wages by the same amount as other price increments, are self-defeating. Its main policy conclusion appears to be that the best way to protect wage earners during an adjustment process is to increase wages by amounts less than exchange rate and public price increments. Actually, I think this is a well-known method for reducing aggregate demand while trying to establish a new structure of relative prices and income distribution. Before going into a more detailed analysis of the arguments supporting this thesis in the case of Peru, however, I would like to comment on some less technical and more historical matters in order to improve, I hope, descriptions of recent Peruvian experience.

I particularly feel that Lago's paper builds a stylized image of García's government that fits a well-structured and coherent "economic villain" model. García—or heterodoxy—is the obvious enemy, while on the other side of the (theoretical) coin are the friends or "heroes" at the Central Bank (Webb and Coronado) waving the flag of the monetary approach to the balance of payments. The main problem with this view is that García has been, above all, a noneconomic man with no economic program and with no stable class or social allegiances. He was at first antilabor, because organized workers were "the privileged," and also anti-industry, because this activity was imitative of Western production and consumption patterns and geographically concentrated in the capital city. Austerity at the top 25% of the income pyramid and reactivation from below (peasants as producers and shanty-town dwellers as direct consumers) were his stated goals, given that he considered himself the president of the lower 75%. The key issues were food and decentralization. This was his first redistributive program. Accordingly, he explicitly rejected any reactivation plan based on the growth of the modern sector of the country. At that time, García stressed the need to undergo sacrifices. This period coincided with the application of a variant of the Austral Plan that was incorporated into García's economic policy options a few days before he assumed office, and was influenced by the enormous popularity of Alfonsín in Argentina.

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From this mix of physiocratic polpotianism and practical short-run neostructuralist and truly heterodox view of reactivation, he was transformed (after a summer inflationary fever due to difficulties in the food area) into a proponent of urban consumption-led growth, modern agriculture, easy food importation, and easier import subsidies. His first redistributive project was discarded, heterodoxy was also abandoned and an old-fashioned Keynesian demand-led program was put in place. This second model is the one extensively considered by Lago in his paper. Mentioning the original project in spite of its short life span is meant to recall that García was never a prolabor politician, and that, therefore, once the recession started, his adjustment measures were antilabor ex ante, from the beginning. This viewpoint appears to run against Lago's thesis about the ex ante attempt to avoid the redistributive effects of adjustment measures. Let me examine this aspect of García's successive stabilization attempts.

According to table 9.9, for instance, Lago suggests that the economic "packages" attempted to keep the earnings/wages (e/w) ratio more or less constant. That is not right. In October 1987, measures of the increases in public-sector wages (25%) and private-sector wages (25%) appear more or less equal to the effective devaluation rate (29%); something similar can be found in the case of the March, September, and November 1988 measures. This information, however, is in fact misleading, because in practically all cases there were upper limits to the wage hikes that made the ex ante effective increase in those wages smaller than the devaluation rate. The important rise of the e/w ratio is not, as Lago suggests, an ex post result of the attempt to do otherwise; there was a conscious and very successful redistributive attempt. For instance, in the October 1987 measures, the 25% increase in private-sector wages applied, according to Decree 016-87-TR, only to those that were receiving at that time an income of 3,200 intis or less. The rest received less than that percentage since the maximum increment allowed was 800 intis. Moreover, the increment was due to become effective only in November. Something similar happened with the public-sector wages. The raise in wages was granted in July and there was an absolute limit imposed that month by Decree 077-87-PCM. Moreover, the 25% raise applied only to the "basic" income, which is smaller than the "net" or total "liquid" income to which workers are entitled. In October, the only raise in wages was 10% received by public blue-collar workers. It is true that the minimum legal wage rose from 1,710 to 2,200 intis, but the other wages were increased by less than the devaluation rate. In the March 1988 measures, the 45% increase in private-sector wages applied to wages of up to 5,000 intis per month, while the rest received a raise of only 2,250 intis. The 40% increase applied to public-sector wages also had a limit. The same type of rule was applied in the November measures. The rule has therefore been, to raise those wages at the bottom more and to set absolute ceilings to the increment. As we know, more or less three-fourths of the mass of wages is received by the upper one-quarter of wage earners. On the other hand, around

20% of the labor force received the minimum wage. In June 1988 there was a devaluation of the inti, and in July there was a raise in wages. These measures do not appear in Lago's table. This time the nominal increase in private-sector wages, established by Decree 021-88-EF, was 60% and was applied to those wages up to 6,000 intis per month. Those with larger salaries received an increment of only 3,600 intis. In the case of the public sector the raise was 51% of the "basic" income of those workers that had an effective wage of up to 20,000 intis. Those with wages between 20,001 and 25,000 intis received 40%, and smaller percentages were applied to higher wages. In September 1988 the measures were somewhat different. There were no wage hikes, and the policy was to give first an exceptional nominal bonus of 3,000 intis to both the private and public sectors and one of 9,000 intis, fifteen days later, to the public sector alone. In the case of the unionized workers of the private sector the 9,000 intis increase that was also granted to them would be an advance payment, anticipating the next general increment or individual pact. The same type of wage containment measures were to be found in the November measures.

All these measures and several other details suggest that the purpose of wage policies was to reduce aggregate demand and to alter income distribution between capital and wage labor as well as among laborers. The ex ante containment of wages was absolutely transparent and coherent with the structure of the successive adjustment "packages" that were implemented.

Several other aspects of the paper are worth commenting upon, but I will concentrate on some general views that require greater insight or at least some polishing. The first one refers to the interventionist nature of the Peruvian government. I feel that Lago applies to García some much-repeated features that are part of an abstract model of intervention that can be characterized by the use of multiple exchange rates, import restrictions, and expansionary policies and which appear in most critical evaluations by multilateral organizations. How important these specific features were in generating the crisis is open to question, as is the relative importance of these types of interventions within the whole set of García's manipulations. The lesson, in any case, would seem to be that if you unify exchange rates, eliminate import restrictions, and avoid growth, you are on the right track. Is it so simple? Are those necessary conditions to stabilize the economy? I do not think so, nor, much less, that they are sufficient. We know those policies become critically important and particularly dangerous in those cases in which you lack a long-term development program, state administrative capabilities, and a solid institutional base, all of which were the deeper weaknesses of García's government. In fact, in Colombia or Korea, for instance, those interventions have not been so dangerous.

Another aspect of the paper that would require a more sophisticated analysis is related to the government's objective with respect to the State. Lago says that it was to "expand the role of the state." Two comments may be relevant.

First, García has never been characterized by his prostatist ideology. He made explicit from the beginning that he was against planning and state control. What he wanted and practiced was the expansion of his own personal role. Second, Alán García ravaged the state to its roots. His most systematic behavior was to bleed public enterprises to death, decapitalizing them "at the service of particular interest groups." The attempted nationalization of the financial system had little to do with his vision about the state and, even less, as the official version states, with the resistance to invest on the part of the "12 apostles"; much more important was his political conflict within the party and his need to recover its leadership. This critical aspect of the problem explains the chaotic implementation of the measure, its extremely short preparation period, and the small size of the team that designed the nationalization attempt. García did not strengthen the National Planning Institute, did not establish any institution with enough power to coordinate state activities; he sucked resources from every corner of the state in order to empower himself and announced that the Social Security System would be privatized. His more common statements about the state stressed its mild regulatory function and always rejected its role as planner.

A final questionable aspect of Lago's view is the one related to the autonomy of the Central Bank with respect to the president. The argument goes as if the monetary approach to the balance of payments was the enemy of the Belaúnde government first and of the García presidency afterward.

Again, evidence shows that the problem was more complex than "Webb against Belaúnde's populist policies." In fact, the president himself was not totally innocent in relation to the poor electoral results of his own party because, as with García before the attempted nationalization, he had lost the control of his party and the new candidate of his party had to be destroyed, as, in fact, happened. A strict monetary policy was useful to him. This does not imply absence of conflicts between the Central Bank and the president, but it is not easy to reduce the conflict to the populist-versus-monetarist paradigm.

With respect to the Coronado versus García chapter, things are even more complex. During the first four months of 1989, Rivas Dávila, the secretary of economy and finance (MEF), did not demand a cent from the Central Bank. Monetary restriction was not strictly speaking a Coronado affair, since others in government backed that policy. One component of this policy was, by the way, the reduction in subsidies from $70 (in U.S. dollars) per month in November 1988 to $4 in April 1989. In December 1988 and January 1989, impact of several key products such as canned milk and corn were moved to the free exchange rate market. Summarizing, Coronado's policy was mainly part of government's policy. His conflicts with the executive were real, but not as significant as Lago considers.

The important question, however, is about populism. My impression is that the economic policy definition of "populism" does not appear to add anything

new to the traditional policy recommendations of the Bretton Woods institutions. I feel that the definition of several Latin American governments as "populist" helps to show that some basic macroeconomic rules should never be forgotten. This is, I think, the best application of that concept, but I do not believe we should go much further with it. To use that sensible recommendation in order to push for just one way of abiding by those rules is not helpful because the concrete economic and political methods and institutions cannot be derived from them. Perhaps that is why the problem is so stubborn.

Comment Miguel A. Savastano

Ricardo Lago has presented a very illustrative and well-documented description of Peru's heterodox experiment of the past five years. He shows in a detailed way how the recent Peruvian experience fits most of the elements of the populist paradigm described by Dornbusch and Edwards,[1] from the initial conditions to the different phases of the experiment, with the probable exception of the apocalyptic final phase predicted for Peru in that article. Although I find it hard to disagree with most of what Lago has said about the main features and flaws of this experience, I think that he has overlooked—or at least not emphasized sufficiently—some elements that turn out to be crucial for understanding the emergence and the chaotic results of President García's administration.

In the first place, regarding the initial conditions found by the APRA government, it is necessary to have clear the fact that populist regimes of different vintages have been the norm rather than the exception in Peru during the last 30 years. The degree of government intervention in almost all the spheres of economic activity has increased steadily since the first Belaúnde government—as reflected by the share of total public-sector expenditures on GDP that rose from 26% in 1968 to 58% in 1985—and the revealed preference for discretionary and short-lasting measures has been the commonplace of almost all finance ministers and Central Bank governors during this period. Even the second Belaúnde administration (from 1980–85) carried out mild populist policies, in spite of its initial rhetoric and its quickly aborted trade liberalization program. Public investment reached its highest level in Peruvian history in 1982 (10.5% of GDP), no privatization of the more than 200 public enterprises was even attempted—except for newspapers and TV stations—and the fiscal deficit averaged 7.5% of GDP during this period. The reader of this

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1. R. Dornbusch and S. Edwards, "Macroeconomic Populism in Latin America," *Journal of Development Economics* 32, no. 2 (April 1990): 247–77.

paper, then, should not be surprised to find out that the "only" reformist step taken by President García was the failed nationalization of the banking system. There was not (or is not, for that matter) much else to nationalize in Peru without the risk of transforming the country into an outright socialist economy.

On the other hand, I think that one has to be more careful before characterizing the stabilization attempts undertaken from 1980 to 1985 as "orthodox" or "serious." The continuous adjustment of the exchange rate and of public-sector prices during the last two years of Belaúnde's government represented isolated measures that reflected a concern for the deteriorating external position of the country in the midst of the debt crisis, but they were far from constituting a consistent strategy to stabilize the economy. In fact, it would not be difficult to show that the "overwhelming evidence of failure of orthodox policies" cited so effusively by the proponents of the heterodox plan and by many other economic advisors, including former Central Bank President Richard Webb,[2] was more the natural consequence of a badly implemented partial stabilization program than the reflection of the negative effects of an "overdone" stabilization as Lago seems to suggest.

Moving now to the initial phase of the APRA experiment, I think that—besides the price-cost freeze and the depressed domestic market—an important and downplayed factor that facilitated the disinflation achieved in the first two years was the forced conversion of dollar deposits that was decreed in August 1985. The "dollarization" of the domestic financial system had reached very significant levels during the Belaúnde administration (more than 70% of the private sector's financial assets were held in foreign currency by 1985), and the confiscation of these deposits represented for the government a sudden increase in the base of the inflation tax and the ready availability of approximately $1 billion. Indeed, the figures reported in table 9.5 of the paper show that the income velocity of money experienced almost a 40% decrease from June 1985 to June 1986. It is this forced increase in the demand for domestic money, and not the suggested independent stance of the Central Bank, that explains the lack of an aggressive expansion of monetary aggregates in the first phase of the experiment.

Another potential source of confusion that I have found in Lago's paper—as well as in the few other accounts of this experience—is the tendency to identify the turning point of the experiment with the government's attempt to nationalize the private banking system in July 1987. In spite of the great political, and not economic, significance of this move, one has to be emphatic in asserting that the anachronic and pernicious inward-oriented strategy adopted was deemed to fail even in the absence of this nationalization attempt. Perhaps

2. R. Webb, "La Gestacion del Plan Antinflacionario del Peru," in *Planes Antinflacionarios Recientes en la America Latina*, ed. J. A. Ocampo (*El Trimestre Economico*, special issue [September 1987]).

the eruption of the crisis would not have been as abrupt as it was, but the huge fiscal and current account deficits and the steady appreciation of the real exchange rate could not have been sustained much longer without some serious adjustment.

Finally, I think that a very interesting feature of the Peruvian experiment is that it ran out of steam without taking the economy to an open hyperinflation. Lago assigns the responsibility of this result to the independent stance adopted by the Central Bank's Governor Pedro Coronado from September 1988 to June 1989. Even if one is willing to be as generous as the author in describing Coronado's performance—leaving aside the fact that he maintained most of the pervasive foreign exchange controls as well as the credit and interest rates regulations—it seems to me that his partial and insufficient measures only contributed to jeopardize the success of the comprehensive stabilization program that is urgently required in Peru.

Undoubtedly the credit crunch of early 1989, together with the imperfect indexation of wages and the systematic delay in adjusting controlled prices, prevented the explosion of a hyperinflationary spiral at the cost of an enormous recession. However, it is also true that by mid-1989 inflation remained high and the private sector became an active supporter of the executive's demands for a looser credit policy. In this context, the fact that the so-called *maquinazo* of July 1989 (21% of the monetary base) did not have any noticeable effect on the inflation rate of the following six months ended up vindicating the president's position regarding the irrelevance of "monetarist" or "orthodox" predicaments. Moreover, the "bad" steady-state equilibrium in which the Peruvian economy appears to be currently trapped (which is documented in tables 9.6 and 9.7) has affected the general consensus regarding the need to stabilize the economy and is reviving the very same arguments of "lack of excess aggregate demand" that were used in late 1985 to justify the heterodox program.

To me this is just another illustration of the fact that the partial and ill-conceived stabilization attempts that are so common in recent Peruvian history do more harm than good by damaging the effectiveness of crucial policy instruments and by adding more noise to the perverse dynamics of high inflations. It also shows that the design of a coherent set of instruments capable of, among other things, enforcing the legally contemplated independence of the Central Bank is even more important than the laws themselves for avoiding what I see as the inevitable repetition of another populist blast. Sadly enough, however, even today I am not sure that Peruvians have learned this basic lesson.