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MACROECONOMIC POPULISM IN LATIN AMERICA

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ABSTRACT

Macroeconomic populism is an approach to economics that emphasizes growth and income distribution and deemphasizes the risks of inflation and deficit finance, external constraints and the reaction of economic agents to aggressive non-market policies. The purpose of our paper is to show that policy experiences in different countries and periods share common features, from the initial conditions, the motivation for policies, the argument that the country's conditions are different, to the ultimate collapse. Our purpose in setting out these experiences, those of Chile under Allende and of Peru under Garcia, is not a righteous assertion of conservative economics, but rather a warning that populist policies do ultimately fail; and when they fail it is always at a frightening cost to the very groups who were supposed to be favored. Our central thesis is that the <u>macro</u>economics of various experiences is very much the same, even if the politics differed greatly.

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THE MACROECONOMICS OF POPULISM IN LATIN AMERICA[1]

This paper addresses the _macro_economics of populism in Latin America. We mean by "populism" an approach to economics that emphasizes growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints and the reaction of economic agents to aggressive non-market policies. The purpose of our paper is to show that policy experiences in different countries and periods share common features, from the initial conditions, the motivation for policies, the argument that the country's conditions are different, to the ultimate collapse. Our purpose in setting out these experiences, those of Chile under Allende and of Peru under Garcia, is not a righteous assertion of conservative economics, but rather a warning that populist policies do ultimately fail; and when they fail it is always at a frightening cost to the very groups who were supposed to be favored. A central thesis we advance is that the _macro_economics of various experiences is very much the same, even if the politics differed greatly.

We are struck by the strong similarities in Chile, Peru, and in other episodes not developed in detail here of the way policy makers viewed the objective conditions of their economy, how they proposed that strongly expansionary policies should and could be carried out, and how they rationalized that constraints could be dealt with.[2] And, of course, we are impressed by the fact that in the end, foreign exchange constraints and extreme inflation forced a program of violent real wage cuts that ended in massive political instability, coups and violence. There is no doubt in our mind about the sincerity of the policy makers who embark on these programs, and we share their conviction that income distribution is unacceptably unequal. The very sincerity of these policy makers convinces us of the usefulness, and indeed the necessity of laying out exactly how and why the programs do go wrong.

The combination of external influences (debt crises,economic blockades etc.), domestic policies (socialization of firms, bank nationalization, etc.) and macroeconomic policies bring about an unsustainable economy where inflation is out of control, and the foreign exchange constraints force realism on policy makers. Accounts of these experiences by sympathizers often emphasize politics and, especially, external factors as central to the demise. Our purpose is not to belittle these factors. There is no question in our mind that external destabilization can be an important part of the unravelling of an economic program. But we want to emphasize that the extreme vulnerability that makes destabilization possible is, by and large, the result of unsustainable policies. This is one more reason to focus sharply on the <u>macro</u>economics of populist programs.

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[2] See Sachs (1989) and Dornbusch (1988b) for this same theme.

In this paper, we analyze the most important historical features of populist economic programs. We do this by contrasting the experiences of Chile during Allende's Unidad Popular (1970-1973) and Peru under Alan Garcia. It is clear that the Unidad Popular of 1970-73 experience in Chile had political goals that were very different from the experience in Peru. Even so, we want to emphasize that the political mobilization strategy had strongly similar elements. Moreover, we will show that there are remarkable similarities between the Allende experience and that of Alan Garcia's Peru. In fact, we believe that an important cause of the Peruvian economic catastrophe was that the architects of the program, and their economic advisors, failed to learn the lessons of recent Latin American history and, in particular, of Allende's Chile.

I. THE POPULIST PARADIGM

Populism has traditionally been a fuzzy concept. In fact, for many years political scientists have struggled to provide a meaningful and precise definition. Drake (1982) emphasizes three elements of a tentative definition: populism uses "political mobilization, recurrent rhetoric and symbols designed to inspire the people", it draws on a heterogeneous coalition aimed primarily at the working class, but including and led by significant sectors from the middle and upper strata and, third, populism "has conoted a reformist set of policies tailored to promote development without explosive class conflict. He notes (Drake (1982,p.218):

> "[The programs] normally respond to the problems of underdevelopment by expanding state activism to incorporate the workers in a process of accelerated industrialization through ameliorative redistributive measures."

Conniff (1982,p.5) has argued that "populist programs frequently overlapped with those of socialism". We emphasize that the redistributive objectives are a central part of the paradigm. Whether they are motivated by a strategy of massive social reform is consequential, but is not central to our discussion.

We have asserted above that many populist economic programs exhibit strong similarities. In this section, we set out in paradigmatic fashion what we see as the critical common factors. In later sections we document these for the experiences of Chile and Peru.[3]

Seers (1964) summarized the great difficulty in achieving consensus in the debate between "monetarists" and "structuralists." The names have changed, but the discussion between those who emphasize the limited scope for financial experiments and others who see the need for social progress and are impatient about the means, who believe the special conditions of their country yields a fruitful yet unexploited strategy for social progress continues. As Seers (1964,p.89) states:

> "This is not just a technical issue in economic theory. At the hearty of the controversy between "monetarists" and "structuralists" are two different ways of looking at economic development, in fact two

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[3]In a larger project we expect to look at a significant number of experience Latin America to get a sharper picture of the phases and ultimate breakdown programs.

completely different attitudes toward the nature of social change, two different sets of value judgments about the purposes of economic activity and the ends of economic policy, and two incompatible views on what is politically possible."

The populist paradigm is typically a reaction against a "monetarist" experience. The phases of the experience are the following:

• Initial Conditions. The country has experienced slow growth, stagnation or outright depression as a result of previous stabilization attempts. The experience, typically under an IMF program, has reduced growth and living standards. Serious economic inequality provides economic and political appeal for a radically different economic program. The receding stabilization will have improved the budget and the external balance sufficiently to provide the room for, though perhaps not the wisdom of, a highly expansionary program.

• No Constraints: Policy makers explicitly reject the conservative paradigm. Idle capacity is seen as providing the leeway for expansion. Existing reserves and the ability to ration foreign exchange provide room for expansion without the risk of running into external constraints. The risks of deficit finance emphasized in traditional thinking are portrayed as exaggerated or altogether unfounded. Expansion is not inflationary (if there is no devaluation), because spare capacity and decreasing long run costs contain cost pressures and; there is room to squeeze profit margins by price controls.

• The Policy Prescription. Populist programs emphasize three elements: reactivation, redistribution of income and restructuring of the economy. The common thread here is "reactivation with redistribution". The recommended policy is a redistribution of income, typically by large real wage increases. Inflation notwithstanding, devaluation is rejected because of the inflationary impact and because it reduces living standards. The economy is to be restructured to save on foreign exchange and support higher levels of real wages and higher growth.

• Phase I: In the first phase, the policy makers are fully vindicated in their diagnosis and prescription: growth of output, real wages and employment are high, and the <u>macro</u>economic policies are nothing short of successful. Controls assure that inflation is not a problem, and shortages are alleviated by imports. The run-down of inventories and the availability of imports (financed by reserve decumulation or suspension of external payments) accommodates the demand expansion with little impact on inflation.

• Phase II: The economy runs into bottlenecks, partly as a result of a strong expansion in demand for domestic goods, and partly because of a growing lack of foreign exchange. Whereas inventory decumulation was an essential feature of the first phase, the low levels of inventories and inventory building are now a source of problems. Price realignments and devaluation, exchange control, or protection become necessary. Inflation increases significantly, but wages keep up. The budget deficit worsens tremendously as a result of pervasive subsidies on wage goods and foreign exchange.

• Phase III: Pervasive shortages, extreme acceleration of inflation, and an obvious foreign exchange gap lead to capital flight and demonetization of the economy. The budget deficit deteriorates violently because of a steep decline in tax collection and increasing subsidy costs. The government attempts to stabilize by cutting subsidies and by a real depreciation. Real wages fall massively, and politics become unstable. It becomes clear that the government has lost.

• Phase IV: Orthodox stabilization takes over under a new government. An IMF program will be enacted; and, when everything is said and done, the real wage will have declined massively, to a level significantly lower than when the whole episode began! Moreover, that decline will be very persistent, because the politics and economics of the experience will have depressed investment and promoted capital flight. The extremity of real wage declines is due to a simple fact: capital is mobile across borders, but labor is not.

We now turn to the experience of Peru and Chile to study in more detail the policy makers' diagnosis and the actual events. We start with the Chilean case, because the facts of the entire experience can be seen. The results suggest what to look for in the Peruvian experience.

II. ECONOMIC POLICIES IN ALLENDE'S CHILE

In September of 1970, after a hard-fought election, Salvador Allende, the socialist candidate of the Unidad Popular (UP), was elected President of Chile. For Chile, this was the beginning of a unique political and economic experience that continues to be analyzed and discussed today.[4] The Unidad Popular was a political coalition of left and center-left parties dominated by the Socialist and Communist parties, both of which had a Marxist-Leninist ideology and aspired, in the long run, to construct an orthodox socialist type society. The smaller parties comprising the coalition were of Christian democrat, middle class extraction. Although they backed profound structural changes, they did not subscribe to the Leninist view of the world.[5]

Both communists and socialists initially recognized the multiclass nature of the Unidad Popular and considered the alliance and the politics that sustained it to be a tactical intermediate step that would help set the basis for the transition to socialism.[6] Vuscovic (1973,p.50) noted:

> "..economic policy is subordinate, in its content, shape and form, to the political need for increasing the Popular Unity's support....The urgent need to achieve rapid recovery of the economy, and to extend the benefits to the mass of the working population, cannot be undertaken in isolation from the structural changes; they are all necessarily interdependent. It is not possible to make deeper changes

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[4]See Oppenheim (1989) for a recent review of the literature.

[5]See Stallings (1978) and de Vlyder (1974) for a discussion of politics and economics in Chile.

[6]See the discussion in Zammit (1973).

without broadening the Government's political support, and economic reactivation and income redistribution will provide an impulse to these fundamental changes."

The UP program called for deep institutional and economic reforms, including the replacement of the bicameral congress by a unique legislative body -- the "People's Assembly", and the nationalization of the mining, banking and, agricultural sectors and a substantial number of large manufacturing firms. All of this was to be accomplished within the existing legal framework. The program called for a democratic "Chilean road to socialism."

The UP program, and most of the technical literature written by the UP economists, characterized the pre-1970 economy as "monopolistic" and "dependent."This diagnosis was strongly influenced by the structuralist thought developed in the United Nations Economic Commission for Latin America (CEPAL) during the 1960s. Many of the top officials in the administration were, in fact, CEPAL staff (on leave). It was argued by the UP program, and in the related literature, that the most serious problems faced by the country were unequal income distribution and chronic inflation and unemployment. It was also argued that the structure of internal demand, the semipermanent crisis in the external sector and the low level of capital accumulation conspired to prevent a sufficiently high rate of growth. It was then postulated that the implementation of deep institutional reforms -- or "revolutionary reforms" according to the jargon of that time -- plus improvement in the distribution of income would not only constitute an important step towards the construction of socialism, but would also generate a fast pace of growth for the economy.

Upon taking power in 1970, the Unidad Popular faced a somewhat stagnated economy with a rapidly increasing rate of inflation. Between 1967 and 1970, real GDP per capita grew only at 1.2% -- significantly below the Latin American average -- while urban unemployment crept up to 9.2% in 1970. Inflation, on the other hand, had steadily increased during the last few years of the Frei administration, reaching 35% in 1970. On the positive side, the external sector was in good shape; the balance of payments had experienced substantial surpluses during all but one of the Frei years. As a result of this, when Dr. Allende became president, the central bank had a significant stock of international reserves of approximately $400 million U.S. or half a year of imports.

III.1 The Short Run Economic Program

The most important short run economic objective of the UP included:

- initiating, at a rapid speed, a whole range of structural economic transformations, including the nationalization program;
- raising real wages, especially for the lower classes;
- reducing inflation;
- increasing the rate of output growth;
- increasing consumption, especially among the poorer groups and
- reducing the economy's dependence on the rest of the world.

The first objective -- the nationalization program -- was to be achieved by a combination of new legislation, requisitions, and stock purchases from small shareholders. The other goals -- output and consumption growth, with rising salaries and declining inflation -- were to be accomplished by a macroeconomic policy characterized by an increase in aggregate demand, mainly generated by higher government expenditures, accompanied by income redistribution measures and severe administrative controls over prices.

This macroeconomic program followed the structuralist tradition and was based on a number of key assumptions. First, it was believed that there was ample excess capacity in the manufacturing sector. Second, it was thought that this low rate of capacity utilization was closely related to the existing pattern of consumption and income distribution. Third, it was assumed that there was a dualistic manufacturing sector, where firms producing "luxury" goods had excessively high capital/labor ratios. Fourth, inflation was considered to be a reflection of the economic structure, not of financial or monetary pressures. In what follows, we will analyze these four key assumptions in some detail.

The assumption of significant excess capacity in the manufacturing sector was at the center of the short run macroeconomic program and provided the intellectual base for the belief that large fiscal deficits would not necessarily be inflationary. This view is clearly captured in the following statement made by Americo Zorrilla, Allende's first Minister of Finance:

> "The subutilization of installed capacity is another feature of the current economic situation ... In 1969 it was possible to

> increase production, due to subutilization, by more than 30 percent ... [A]ccording to recent studies ... unutilized capacity has reached, in the last few years, 61 percent in the cloth industry, 50 percent in the baking industry ... 74 percent in the shoe industry, etc. (As reproduced in Garcia, 1972, p. 72)

An important corollary of the unutilized capacity hypothesis was that firms in many sectors faced decreasing average costs so that, under proper administrative price controls, demand increases would not generate inflationary pressure. Moreover, to the extent that many of the larger firms were indeed nationalized, as called for by the UP program, output could be greatly increased even with price reductions. In a document prepared by the Planning Office (ODEPLAN) in 1971, it was stated that by "combining the increase in production derived from a higher use installed capacity ... the former monopolies will be able to absorb, without problems, the required wage increases, while maintaining, <u>or even reducing</u>, prices and still generating the same surplus".

The lack of "full" utilization was, in turn, attributed to two fundamental factors: The previously mentioned monopolistic nature of the manufacturing industry and, the structure of income distribution. According to this interpretation, the unequal income distribution resulted in a highly diversified pattern of consumption. Vuskovic stated this view as follows:

> "[There is] ... an obvious association between income distribution and the composition of demand and, consequently, the structure of production ... Given current income distribution ... the effective market is limited to higher income groups ... [I]t is a restricted ... and highly diversified demand ... [A] broad range of industries producing nonessential consumption goods operate an insufficient scale ... (Vuskovic, 1970)

Based on this diagnosis, it was thought that if income was redistributed towards the poorer groups through wage increases and prices were properly controlled, there would be a significant expansion of demand and output. According to Sergio Bitar, former Minister of Mining in the Allende government,

> "[I]n order to expand demand there would be a hike in white and blue collar workers salaries, and there would be an increase in government expenditure on education, health, housing and public works." (Bitar, 1979, p. 78)

And with respect to the price effects of these measures, he said:

> "Since there was a substantial margin for expanding supply, it was concluded that the increase in demand would not provoke an acceleration of inflation. With respect to costs, severe price controls were supposed to ensure that the higher wages would not be passed on to prices ... Since sales were supposed to grow substantially, global profits in each firm would be affected only slightly, even though the per unit profit would decline ..."
> (Bitar, 1979, p. 79)

An important component of this short term macroeconomic program was the existence of substantial international reserves. It was expected that because of these reserves, the expansion of demand would not run into foreign-exchange related bottlenecks. Moreover, the program expected that the nationalization of the large copper mines plus planned increases in copper production would allow the central bank to maintain a relatively high level of international reserves.

In spite of the fundamental role assigned to increasing capacity utilization, the UP economic team was aware that investment was required to sustain the expansion in the medium to long run. Here, however, the program was based on two important assumptions. The first was that with the new structure of demand, lower investment would be required to achieve significant growth. This was based on the belief that until 1970 the industrial structure had emphasized on the production of "luxury" goods, which required excessively high capital/labor ratios. It was argued that basic consumption goods, however, had a much lower capital/output requirement. A very convenient side effect of this change in the demand structure was that employment could grow very fast. Vuskovic's fundamental article captures this view quite vividly:

> [T]he new dynamic sectors ... will, in general, be characterized by lower capital requirements and greater capacity to absorb labor; consequently, a rapid increase in savings and capital formation will cease to be a requisite to accelerate the global rate of growth .." (Vuskovic, 1970, p. 58)

Regarding inflation, the UP program followed the structuralist approach, which emphasized rigidities, bottlenecks, and the role of monopolistic pricing and played down the role of fiscal pressures and money creation.[7] In accordance with this position, the UP paid very little attention to the financial sector when implementing its short run program. In fact, in his memoirs, the former Allende Minister and Vice President Clodomiro Almeyda relates how in the first meeting of the economic team after the elections the CEPAL-oriented technocrats expressly, and convincingly it would seem, argued that monetary and

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[7]See Sunkel (1960) for a discussion of structuralist inflation theory. See, too, Baer and Kersternetzky (1964).

financial management did not deserve too much attention.[8] Alfonso Inostroza, the President of the Central Bank, stated in early 1971 that the main objective of the monetary policy was to

> "transform it into a key instrument ... to achieve the complete mobilization of productive resources, and their allocation to those areas that the government gives priority to ..."[9]

The final component of the short run program referred to reducing Chile's external vulnerability. The UP basic program stated that a priority of the new government would be to "execute a foreign trade policy tending to expand and diversify our exports ..." (Unidad Popular 1969, p. 24). What is interesting, however, is that this objective was to be achieved without providing any price incentives. Quite the contrary, the UP economists thought that changes in the exchange rate had very little, if any, effects on exports or imports. In fact, in the same paragraph where the program called for expanding and diversifying exports, it was stated that an important goal of the policy was to "avoid the scandalous devaluations of [the] ... currency" (p. 24). In line with this belief, one of the first measures undertaken by the Allende administration was to eliminate the system of crawling peg that had been adopted, with great success, by the Frei administration. It was expected, then, that expansion of exports would be the result of administrative decisions geared towards centralizing foreign trade activities.[10]

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[8]See, for example, the 1971 CIAP Report reproduced in Panorama Economico, No.260 Feb.-March 1971, p.36.
[9]See Inostroza (1971,p.8).
[10]See Plan Anual 1971 (Odeplan, 1971).

An important, indeed crucial, objective of the economic program was to broaden the UP's political base of support very quickly. The UP leaders thought that it was necessary to obtain the support of the middle classes and, more specifically, to draw a large number of voters that had, until then, supported the Christian Democrats into the UP in order to move towards a socialist system. This political objective plays a significant role in explaining the heavily populist content of the short run program and should be kept in mind when evaluating the short term achievements of the Allende government.

To sum up, the short run macroeconomic program of the UP was aimed at provoking a rapid economic recovery after years of semi-stagnation and at generating a significant improvement in the living conditions of the poorer groups. The main tool for achieving this was a fast growth in government expenditures geared especially at increasing the real incomes of the lower classes. The intellectual underpinnings of this plan were basically given by the structuralist model that attributes a great role to rigidities and bottlenecks and looks with great contempt at the financial and monetary sectors. A key element of the plan was the belief that, if channeled to the appropriate groups and if accompanied by the right kind of administrative controls, fiscal deficits would not be inflationary.

Needless to say, this view of the way the economy functioned ignored many of the key principles of traditional economic theory. This was not only reflected by the greatly diminished role given to monetary policies, but also by the complete ignoring of the real exchange rate as a key variable in determining macroeconomic equilibrium. Moreover, the macroeconomic view of the Unidad Popular failed to recognize that their policies would only be able to generate a burst of economic activity that would be unsustainable in the medium term if the transition from recovery to sustainable growth was not handled with extraordinary circumspection. Also, the UP technocrats greatly underestimated the role of expectations and the capacity of the public to react to severe inflationary pressures. Bitar (1986, chapter 5) portrays very clearly the government's inability to control events, to shift from redistribution to accumulation.

> "It turned out to be very difficult to contain the forces unleashed in 1971. The sequential conception of redistribution followed by accumulation assumed that basic political and social conduct could be altered and popular expectations changed virtually instantaneously. In the next few months [early 1972] it proved impossible to apply this thinking with the facility that had been hoped for."

III.2 The First Year: Rapid Growth With Repressed Inflation

Armed with the intellectual framework analyzed above, the UP rapidly began to implement its program in late 1970. In terms of structural reforms, two basic measures were immediately undertaken:[11] First, the Agrarian Reform was greatly intensified with a very large number of farms being expropriated. Second, a project for a Constitutional Amendment aimed at nationalizing the large copper mines -- until then jointly owned by large U.S. firms and the Chilean state -- was studied.[12] Their reforms of the

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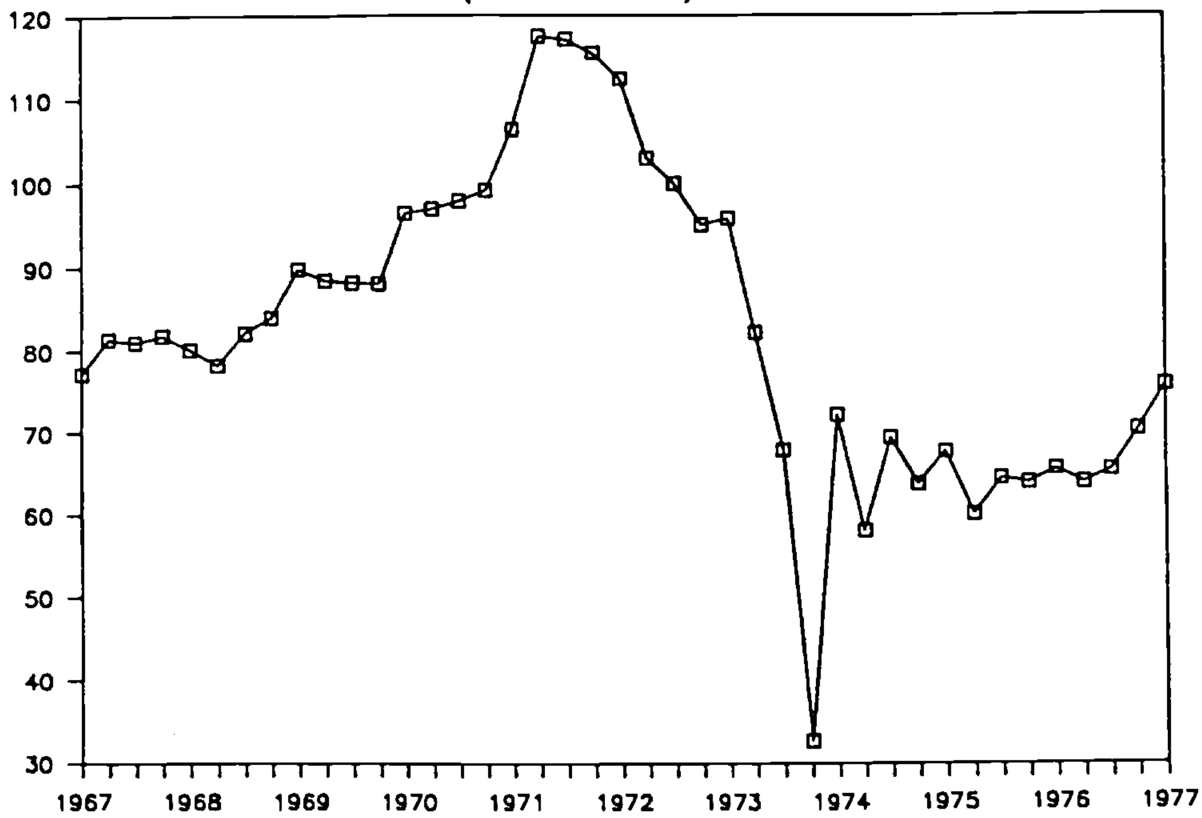
[11] The agrarian reform law passed by Congress during the Frei administration provided the necessary tool. See Alauf et al (1972).

[12] On June 11, 1971, Congress unanimously approved the constitutional reform that nationalized large copper mines. See Geller and Estevez (1972), and Ffrench-Davis and Tironi (1974).

CHILE: THE REAL WAGE

(Index 1970:3=100)



banking system and large manufacturing firms were somewhat more difficult, because the government lacked the institutional channels for implementing the nationalization program. Initially, this obstacle was overcome by purchasing blocks of shares -- especially bank shares -- at very high prices. These acquisitions were, in turn, financed with loans from the Central Bank to the Corporacion de Fomento de la Produccion (CORFO).

These acquisitions were complemented by a process of requisition based on an old, and until then forgotten, decree law promulgated during the short lived Socialist Republic of 1932.

In terms of macroeconomic policy, the government rapidly applied measures that were consistent with its program. Salaries and wages in the public sector were raised, on average in 1971, with wages for the lower segments of the bureaucracy increasing relatively faster than those for the higher echelons. Salaries in the private sector grew at approximately the same rate. Unions used public section salary adjustments as a benchmark in their negotiations. Figure 1 shows the gain in real wages. Also, government expenditures were greatly boosted via the so-called "Special Programs for Expansion and Development." This higher expenditure was mainly directed towards construction, farming and social security[13] and was financed with loans from the Central Bank (i.e., with money creation). The short run package was topped by a severe and quite generalized scheme of price controls.

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[13]The new program assigned 66% of its resources to these three sectors.

The expansion of demand quickly affected sales and production. During the first and second quarters of 1971, manufacturing output increased 6.2% and 10.6% compared to the same periods in the previous year. Manufacturing sales grew at even faster rates: 12% during the first quarter and 11% during the second quarter. Overall, 1971 was a good year. Real GDP grew at 7.7 percent, average <u>real</u> wages increased by 17 percent, aggregate consumption grew at a real rate of 13.2 percent, and the rate of unemployment dipped below 4 percent. Not too surprisingly, given the behavior of real wages, there was a significant improvement in income distribution. In 1971 labor's share of GDP reached 61.7 percent, almost 10 points higher than its 1970 level of 52.3 percent; and this happened without an acceleration of inflation. What was even more important for the UP was that the policies rapidly paid off politically. In the municipal elections of 1971, the UP parties saw their share of the vote climb from the 36% they had received in the 1970 presidential election to around 50%.[14]

Needless to say, all of this created a sense of euphoria in the government. The program was working as planned. The fact that the fiscal deficit had jumped from less than 3% of GDP in 1970 to almost 11% in 1971 did not worry the UP technocrats. Nor did they think much of the fact that the rate of growth of the money supply had surpassed 100 percent in annual terms in the fourth quarter of 1971, and that the rate of growth of

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[14]The strong showing in early municipal or congressional elections was not uncommon in Chile. In fact, the Frei government had a similar experience in 1965.

domestic credit to the public sector was approaching 300 percent. All of this, in fact, was part of the plan. When evaluating the results from the first year of Allende's government, Julio Lopez, a prominent UP economist, stated that "the economic recovery policy was based on a significant increase ... in the government deficit. We ignored those orthodox recommendations that look for ... budget equilibrium." And, then, he said that it was precisely because of these policies that it was possible to "achieve the political objective of quantitatively broadening the base of support for the government".

Of course, these macro policies were rapidly generating a highly explosive situation of repressed inflation. The rapid growth of GDP in 1971 rested heavily on an almost 40% increase in the imports of intermediate goods. As a result, the stock of international reserves inherited by the Allende government was reduced by more than one half in that year alone. A steep reduction of inventories was another important factor contributing to the expansion of consumption.

By the end of 1971, the mounting inflationary pressures became evident. The combination of the expansion in demand and price controls resulted in growing scarcity of some consumption goods. Production responses, on the other hand, became more and more sluggish. The supply problem was aggravated by a series of labor disputes in many large establishments that resulted in the takeover of those firms by their workers. In fact, this procedure became the institutionalized way in which the government seized a large number of firms. The government made use of a 1932 Decree-Law that provided that whenever a labor dispute generated a serious disruption in supply, the authorities could take over the firm in question.

By the end of 1971, the government had used this channel to expropriate more than 40 large firms. Naturally, this process disrupted production not only in the firms that were seized but also in the rest of the industrial sector where uncertainty was quickly mounting. Moreover, the level of productivity in the nationalized firms began to drop rapidly, contrary to the thinking of the architects of the UP plan, these firms generated no surpluses but instead incurred huge losses that resulted in additional pressures on the government's budget.

III.3 The Second Year: Failed Stabilization Programs

During 1972, the macroeconomic problems continued to mount. As can be seen in Table 1, in that year inflation reached 217% and the fiscal deficit surpassed 13% of GDP. The rate of growth of domestic credit to the public sector reached almost 300%, and international reserves dipped below $77 million.

Table 1 Chile: Main Macroeconomic Indicators

	1970	1971	1972	1973
Inflation[a]	34.9	34.5	216.7	605.9
Growth	2.1	9.0	-1.2	-5.6
Real Wages (1970:3=100)	98.4	115.1	103.5	70.3
Gov't. Revenue[b]	23.7	20.4	18.2	20.2
Gov't. Spending[b]	26.4	31.1	31.2	44.9
Budget Deficit[b]	2.7	10.7	13.0	24.7
Money Growth[a]	52.9	99.3	100.9	264.4
Int'l. Reserves ($Mill.)	320	129	95	36
Trade Balance ($ Mill.	246	73	-161	-73
Black Market Premium	99	358	898	2349

[a] Percent of GDP [b] Percent, Dec.-Dec.
Sources: Yanez (1978); Banco Central de Chile; International Monetary Fund; Edwards (1986); Edwards and Edwards (1987), Solimano (1988).

What was even more serious was the continuous growth of the underground economy. As more and more activities moved out of the official economy, more and more sources of tax revenues disappeared. In this context, a serious vicious cycle took over. Repressed inflation encouraged the informal economy, which in turn resulted in reduced taxes, higher deficits, and, thus, in even higher inflation. In 1972, two stabilization programs were implemented, and failed.

When evaluating the causes of difficulties, the dominant view among UP economists was that the authorities had failed to impose appropriate controls in implementing the program. For example, when discussing the severe external crisis already evident in late 1971, Garcia argued that it was incorrect to attribute the loss of reserves to the significant real overvaluation of the escudo. He then pointed out, matter-of-factly, that "since the Central Bank has the power, and administrative mechanisms, to slow down imports, it is possible to control them [imports] without devaluing ..." (Garcia, 1972, p. 206). And with respect to the overall strategy, he recommended that in order to solve the mounting disequilibrium "the State should, necessarily, increase the degree of direct control ..." (Garcia 1972, p. 255).

This dominant view was indeed the one that guided the first, rather weak, attempt at stabilizing the economy which was launched in February of 1972.[15] This package sought to: (a) solve the problems derived from the growing underground economy and the related scarcity of goods at official prices; (b) avoid an outburst of inflation; (c) maintain, or further improve, income redistribution; and (d) solve the serious crisis of the external sector. However, no serious measures aimed at solving these problems were undertaken. For instance, it was argued that it was not convenient to reduce government expenditures, the policy of granting salary increases that exceeded inflation was maintained, and a significant devaluation was ruled out.[16]

The combination of generalized price controls and unchecked fiscal and monetary policies acted as a major encouragement for the black

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[15]Bitar (1986) in his insider's account of policy making tells of how this view was opposed by a small group of technocrats who argued for a correction of the fundamental source of the disequilibrium. But they encountered two difficulties, the technical accuracy of their position was in doubt and the politics of major budget and exchange rate correction was perceived to be too costly.

[16]In 1971 a small devaluation was followed by the institution of four separate exchange rates.

market economy. What made things even worse was that the government completely lost control over wages. Unions in both nationalized and private firms demanded increasingly higher wage adjustments. This produced a dilemma for the government. If it had refused to grant the wage adjustments, it would help the macroeconomy but deeply hurt its political constituency and objectives. Under these circumstances, the government chose, every time, to uphold its revolutionary label. Moreover, a number of economists argued that higher real wages could be sustained as long as the government was able, via increased controls, to extract additional "surplus" from the private sector.[17]

By mid-1972, it became apparent that the February stabilization program was a failure. The underground economy was now generalized, output began to fall, open inflation reached an annual rate of 70 percent in the second quarter, foreign exchange reserves were only $82 million, and the black market rate was climbing at a very fast pace (see Figure 2). From a political perspective, what made the situation particularly difficult was that parliamentary elections were scheduled for March of 1973. It was increasingly clear that the economic crisis was going to work against the UP in those elections. In August of that year, and under the political overview of the Communists, a new stabilization program was launched. The Communist party favored tackling the financial disequilibria.

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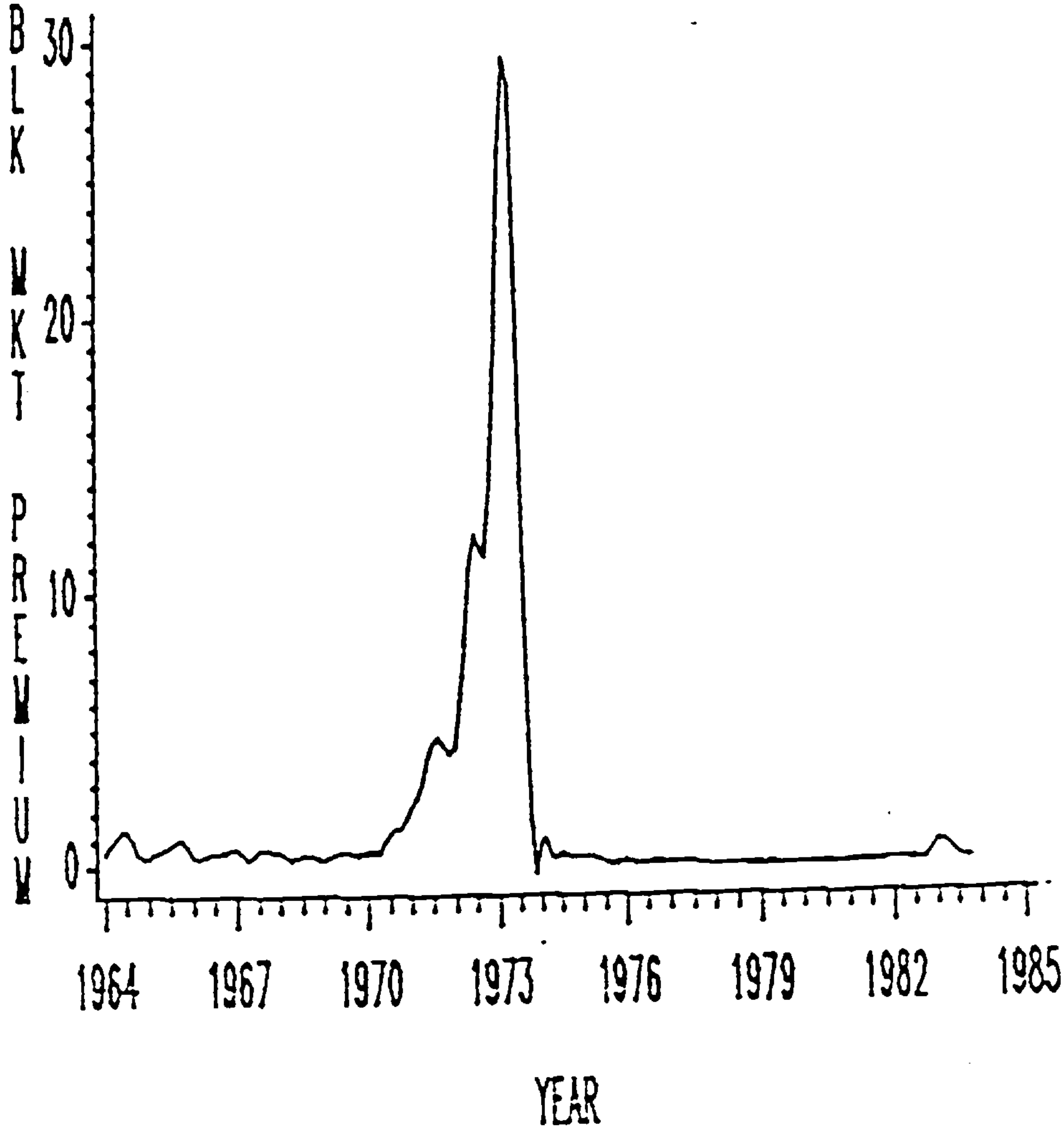
[17] See Bitar (1979).

CHILE: THE BLACK MARKET IN DOLLARS



Unlike the previous plan, the cornerstone of the August program was a massive devaluation of the escudo. The exchange rate for imports was raised by almost 90 percent, while that for exports increased by 33 percent. It was expected that, as a result, the ever-mounting pressures on the balance of payments would subside. The program called for two basic measures to contain the fiscal pressures. First, price increases for the nationalized firms were authorized. It was thought that their losses would decline and, consequently, there would be a reduction in the rate creation required to finance the newly formed nationalized sector. Second, the program called for a massive increase in production as the major way to close the gap between aggregate supply and aggregate demand. This increase in output was expected to r be a response to <u>political</u> rather than economic incentives. In fact, at that time, the Communist Party's main slogan became "Let's win the battle for increased production!" The devaluation immediately affected the prices of those goods not still subject to severe controls. This plus the authorization of a large number of price increases resulted in a rate of price increase of 22.7% in August and 22.2% in September.

In spite of the action taken on the exchange rate front, the program was destined to fail as no change in the wage rates policy was introduced. In the second week of August, the government announced that it had reached an agreement with the national federation of workers (<u>Central Unica de Trabajadores</u>, CUT) with respect to an across-the-board wage adjustment to be granted on October 1st except for firms subject to private bargaining. The new wage policy called for an increase in public and private sector wages by a proportion equal to the accumulated rate of inflation between January and September. In addition, the new policy called for more frequent wage adjustments.[18] In this way, by a stroke of the pen, the effects of the devaluation were fully offset.

In order to combat the general scarcity of goods and of food in particular, the government tried to organize a rationing scheme, where a certain amount of food (the so-called "popular basket") was made available to each household through neighborhood organizations specially created for this purpose. This rationing scheme, however, generated a massive reaction by the opposition, who argued that Chile was being transformed into "another Cuba". In October, 1972, the opposition parties organized a national strike as a protest against what were considered to be erroneous and antidemocratic government policies. The protest was particularly directed against the government's economic and educational policies. This strike generated significant economic costs and greatly aggravated the situation. In fact, the strike could only be solved after President Allende included representatives of the armed forces in his cabinet.

III.4 The Third Year: Economic Chaos and Coup

During the first quarter of 1973 Chile's economic problems reached chaotic proportions. Compared to the first quarter of 1972, inflation reached 22%; industrial output declined by almost 6%; the real exchange rate was

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[18] Que Pasa No.70, August 17th, 1972,p. 14.

even more overvalued, and foreign exchange held by the Central Bank was barely above $40 million. The black market by now covered every single transaction in foreign exchange. The fiscal deficit continued to climb as a result of ever higher expenditures and of rapidly disappearing sources of taxation. In that year, the fiscal deficit exceeded 23% of GDP!

Once more the government faced the options of implementing a major corrective stabilization program or of furthering the extent of controls. And once again it opted for the latter. This decision, made in March of 1973, sealed the fate of the government. The extent of the economic crisis quickly alienated the middle classes; and, after March 1973, the political confrontation with the opposition became increasingly severe. Of course, it must be remembered that, in the midst of this polarization, the support commanded by Allende actually grew: whereas in 1970 the UP received the votes of 30% of the electorate, its share rose to 44 percent in 1973.

The opposition, after an important victory in the parliamentary elections of March 1973, became extremely impatient. By mid-1973, the opposition parties were demanding the resignation of President Allende. In addition, an even more serious problem within the UP was developing. The UP parties -- in particular the Communists and Socialists -- had entered into a serious feud, strongly disagreeing on how to face the crisis.

In concluding, we must comment on the role of domestic economic opposition and the foreign economic blockade. There is little doubt that the strategic use of economic disruption by the opposition, foreign enterprises and foreign governments played a role in the ultimate unravelling of the Allende policies. We doubt, although we certainly cannot demonstrate this point, that a more neutral external environment would have allowed the Allende experiment to continue for a significant period. Our view is that the uncontrolled side effects of the growth policy (shortages, inflation etc.) sufficiently weakened then ability to govern, so economic destabilization by domestic opposition forces and foreign companies and governments could be effective. We advance this view as a hypothesis and propose further research to substantiate this critical feature of the unravelling of populist experiences.

On the 11th of September 1973, the Allende presidency came to a sudden and shocking end. That day the armed forces staged a coup. When the military took over, the country was politically divided and the economy was in shambles. Inflation was galloping, relative price distortions -- stemming mainly from massive price controls -- were generalized; black market activities were rampant; real wages had dropped drastically; the economic prospects of the middle class had been greatly damaged; the external sector was facing a serious crisis; production and investment were falling steeply; and the government finances were completely out of hand. This was the stage where frightful real wage cutting (see Figure 1 above) took over.[19]

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[19] Even if the real wage decline of 1974-75 is in part due to the dramatic terms of trade deterioration, one should not minimize the aftermath of the Allende policies.

III. GROWTH WITH REDISTRIBUTION IN GARCIA'S PERU

When Alan Garcia assumed the Peruvian Presidency in August 1985, he captured the world's imagination: a dynamic, charismatic leader taking charge of a country desperately in need of social and economic progress. The fact that he adopted a confrontational attitude on external debt did not hurt his image, either in Latin America or in progressive circles in Europe and the United States. On the domestic front, he had an unambiguous message: growth and redistribution. That policy lasted two years before running aground in a catastrophic manner.

In early 1988, Alan Garcia's populist government staged a dramatic turnaround on the policies that had driven the country to bankruptcy and near-hyperinflation: budget cutting, real wage cutting and massive exchange depreciation were the predictable aftermath of three years of reckless mismanagement. But that is unlikely to be the end of the story. Even if the economic measures were to succeed, the political consequences are still to come. Real wage cutting and austerity, in the Peruvian context, may well be the opening phase for massive and perhaps violent confrontations.

More so than in any other country of Latin America, economic performance is central to maintaining the very precarious social peace in Peru. At issue is not only the possible confrontation between left and right. Far more dangerous is the widening conflict opened by the Maoist

Shining Path guerilla. The outcome is wide open because of the divisions between rich and poor, the city and the sierras, white and indios. Further deterioration of economic performance with declining per capita incomes, explosive inflation and real wage cutting would make Peru ungovernable. Yet these events almost certainly lie ahead. Unless a massive improvement of export prices or external assistance on a major scale provide foreign exchange resources to help achieve (together with policy reform) a gradual adjustment, an out-and-out economic crisis is inevitable.

II.1 From Belaunde to Garcia[20]

In the 1950s and 1960s Peru experienced significant growth of real per capita income and moderate inflation. Table 2 shows that the problems of declining per capita income and high inflation date from the second half of the 1970s.

Table 2 Growth and Inflation
(percent per year)

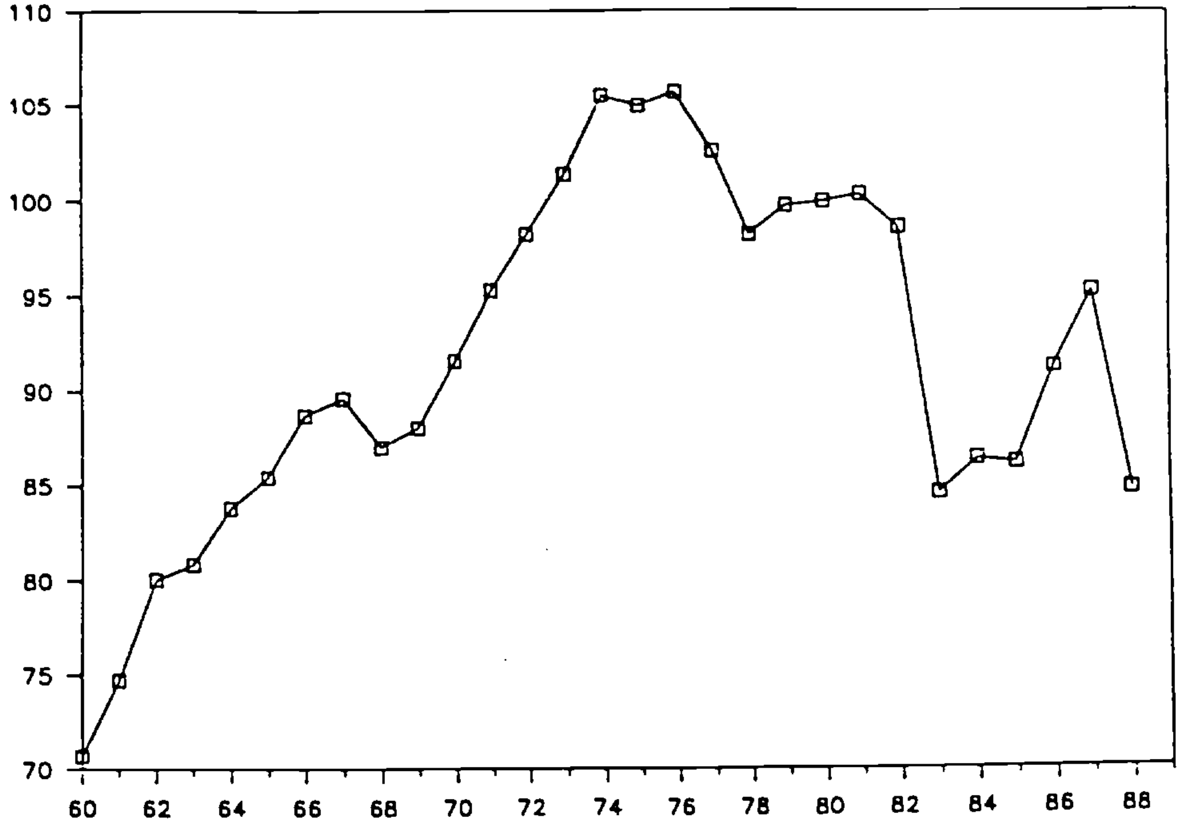
	1950-60	1960-70	1970-75	1975-80	1980-85
Growth Per Capita	2.8	2.6	1.6	-1.0	-4.2
Inflation	8.0	9.3	12.6	50.0	102.1

Source: Kuczynski (1977), Central Bank and Ministry of Finance

[20] See R. Thorp "Trends and Cycles in the Peruvian Economy." in P.Bardhan et al (eds.) International Trade, Investment, Macro Policies and History. North Holland, 1987, R.Thorp and G.Bertram Peru 1890-1977, Columbia University Press, 1978; and P.P. Kuczynski Peruvian Democracy under Economic Stress, Princeton University Press, 1977 for history and extensive references.

PERU'S REAL PER CAPITA INCOME

(INDEX 1980=100)



In the past 25 years, three major stop-go phases can be discerned. The first was the Belaunde expansion which crashed in 1967-68. The growth program faltered because it ran into external constraints. Budget correction and real depreciation were undertaken and prepared the ground for the economic expansion of the military government in the early 1970s. The extremely favorable world environment permitted a massive expansion until 1974, with an average growth rate of per capita income of 3.7 percent per year in the 1969-74 period. Figure 3 shows the rapid increase in real income during this period.

Deterioration of the terms of trade (a 27 percent decline between 1974 and 1977) occurred at the same time that the government was undertaking a massive investment program. As a result, the noninterest current account balance showed a deficit of 6 percent of GDP in 1974-77. This straining of external financing opportunities forced a slowdown of growth and a reshaping of economic policies. Exchange rate and trade policies introduced in 1978-79 emphasized export growth rather than government spending. While the resource transfer had been inward in 1973-78, now came three years of large external (noninterest) surpluses.

The second Belaunde administration (1980-85) had to cope with extraordinarily adverse conditions. Belaunde inherited an economy with deep social problems: Per capita income had declined since 1974 and, the external balance improvement of the late 1970s notwithstanding, the interventionism of the military government had created pervasive distortions. The possibility of advancing the economy was drastically limited as a result of a combination of shocks: the world recession of 1980-82, terms of trade deterioration, the explosion in world interest rates and the resulting rise in debt service obligations, external credit rationing, and natural disasters. These shocks combined to choke off any room for expansion. In 1982-83, under an IMF program, real GDP per capita declined by 16 percent and inflation nearly doubled to 112 percent.

The disastrous economic performance of the Belaunde government led to a total rout in the elections and thus brought Alan Garcia into power in 1985. In 1980 Belaunde had won the elections with the largest majority in history. In contrast, in the 1985 elections, his party was devastated in that they came out with a meager 6.2 percent of the vote! Alan Garcia's APRA party took 45.8 percent of the vote, and the United Left took another 21.3 percent.[21]

The election which swept Garcia into office in a landslide victory carried one clear message: growth first![22] This message, regardless of its feasibility, conditioned the economic policies of the Garcia Administration from the very beginning and is now taking the country to the brink.

II.2 The Heterodox Program

In July 1985, the last month of the Belaunde administration, inflation reached 250 percent at an annual rate. Unemployment was

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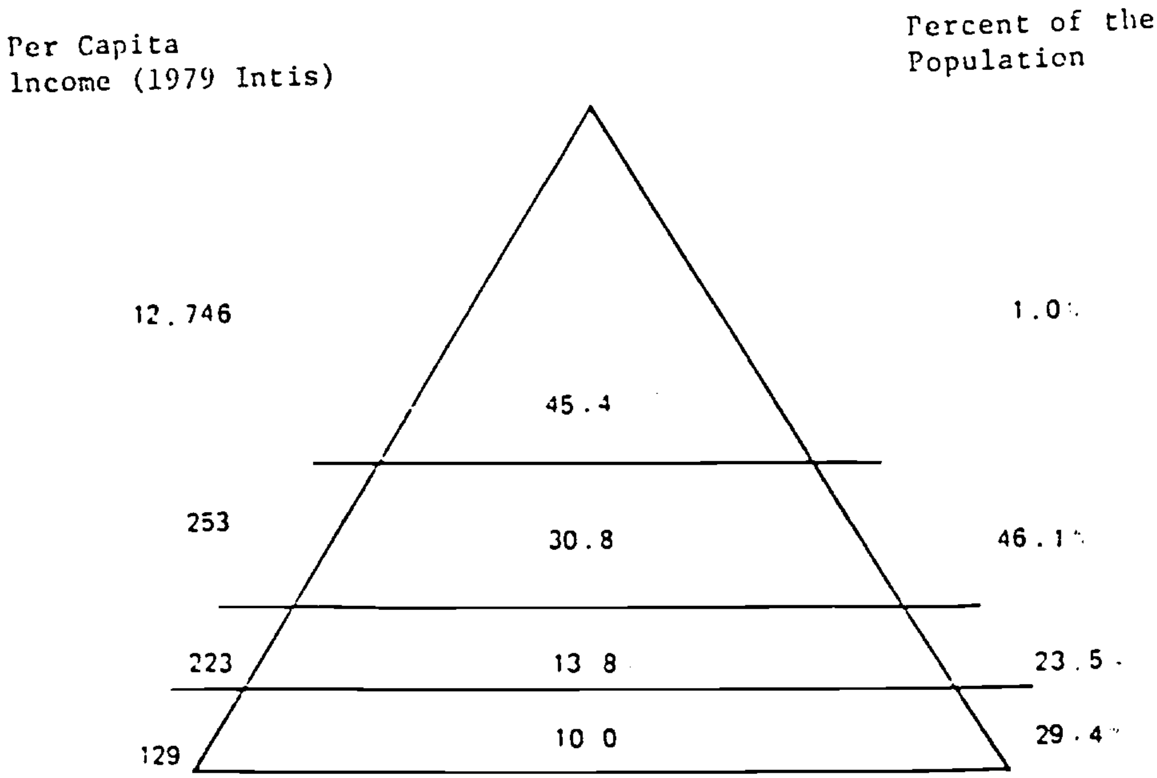
[21]See Wise (1988) and Ortiz de Zevallos (1989) for a review of politics.
[22]See Ortiz de Zevallos (1989).

Peruvian Income Distribution



pervasive, idle capacity abounded, and real wages had been reduced in an effort to cope with the external crisis. Against this background, Garcia's government developed a populist project of expansion entitled "Growth with Redistribution" emphasizing economic recovery combined with disinflation.

Premises and Policies: Three points are central to an understanding of why economic policy took the form it did. The first is the impressively unequal distribution of income. Figure 4 shows the Peruvian distribution with a diagram widely used in Peru. The striking fact is that 1% of the population receives nearly half the national income.[23]

The second is that policy makers were impressed with the large gap between actual and potential output. In Carbonetto et al (1987, p.41), it is estimated that actual output was only 66 percent of potential output in 1984 leaving a 34 percent gap to be made up by the judicious choice of policy.

The third consideration is that Peruvian economists, in company with economists throughout Latin America, were unimpressed with the effectiveness of IMF programs. It will be remembered that at this time Israel and Argentina made their heterodox stabilization efforts, as did Brazil shortly afterwards. The orthodox approach to stabilization had been discredited by the strong recessionary effects and the absence of any success stories. The alternative, heterodoxy, had all the appeal of

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[23]See Glewwe (1988).

offering an end to inflation without the attendant costs of unemployment.[24]

Against this background, the general theme of economic policy is summarized in the Plan Nacional de Desarrollo 1986-90 (p.6) from which we quote extensively.

> "The new economic policy seeks to pass from an economy of conflict and speculation to one of production and consensus. In this economy it is possible to make compatible stability, growth, distribution and development in a context of national planning which finds concrete expression in dialogue and social and economic concertation.
>
> Planning of economic development will be full, decentralized and participatory and concertation will center on the effort to make compatible the generation of saving and productive investment with attention paid to the undelayable priority attention to social needs. We need to reconcile economic efficiency with social equity in a productive dynamics which is fundamentally sustained by domestic resources."

Specific premises and prescriptions in the national development strategy can be paraphrases as follows : (op. cit. p.63-65)

- The complementarity of internal and external markets, rejecting the apparent dilemma between import substitution and exports and reaffirming the primacy of the internal market.

- The necessity to redistribute income as a means for sustained growth and the possibility to bring together with the redistribution process the necessary capacity to save and invest.

  The heterodox management of economic policy starts from a reinterpretation of traditional economic concepts in terms of their implications for the Peruvian economy.

- Prices and Rentability: Profitability cannot increase from an increase in profit margins because that would lead to a generalized decline in sales. Smaller margins yield lower prices, higher demand, higher sales and better utilization of capacity; higher sales allow a fuller scale of production.

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[24]See Dornbusch (1981, 1988a), Bresser Pereira and Nakano (1987) and Bruno et al. (1988).

•Salaries and Profitability: The generalized and open-ended restraint on wages reduces profitability because it reduces workers' purchasing power, bringing about recessive effects that reduce demand and thus the benefits of dynamic economy.

• The Recessive, Inflationary Crisis: This follows from the increase in costs and the fall in demand, not from an excess in demand. The contraction of public spending, credit and salaries reduces demand; at the same time devaluation and increases in interest rates incessantly raise costs. To talk of excess demand is erroneous when there idle capacity in almost all sectors and ample supply of unemployed labor.

• The Fiscal Deficit: The fiscal deficit is not necessarily inflationary. It only is if domestic demand exceeds potential output. With substantial idle capacity there is a need for a certain deficit....

• Money Creation: Must increase demand, thus allowing an increase in real liquidity and disponibility since the opposite would slow growth.

• Interest Rates: Increased real interest rates do not raise saving, since the latter depends fundamentally on income, but they discourage productive investment...

• Exchange Rate: Depreciation of the exchange rate does not constitute an effective means of balancing the external accounts since only 15% of imports and 20% of exports are sensitive (elastic) to exchange rate changes. As a consequence, although it is necessary to avoid devaluation, the external flows must be handled by more efficient selective methods.

The specific targets of the economic program are set out in

Table 3.

Table 3 The 1986-90 Economic Development Plan

	1985	1986	1987	1988	1989	1990
Growth						
GDP	1.4	6.5	6.2	6.1	6.3	6.2
Consumption	0.1	8.5	6.3	5.7	5.0	5.2
Exports	3.5	-13.6	4.8	5.8	5.9	5.9
Imports	-24.6	5.0	13.7	11.9	5.6	7.4
Investment	-12.3	12.0	14.4	11.8	11.6	10.7
Budget Deficit[a]	0.6	2.3	2.3	2.1	1.8	1.6

[a] Percent of GDP

Source: Presidencia de la Republica (1986)

The new economic policy was based on four measures, as noted in Carbonetto et al (1987,p.15):

- Rapid expansion of effective demand via real wage increases.

- Financial de-strangulation to give firms relief and contain cost pressures by reducing financial costs of enterprises, effective interest rates, indirect taxes and other elements of costs.

- Reestablishment of selective exchange rates and abandonment of the devaluation policy.

- The external accounts are to be kept in balance by growth in exports, import substitution and limitations on debt service to be compatible with acceptable growth. Of course, many of the foreign exchange and growth policies on which any success of the plan might depend never saw the light of day. This is particularly the case for foreign exchange savings strategies.

External Debt: The most widely noted measure of the Garcia government is no doubt the limitation of external debt service to 10 percent of exports. The move followed a policy of quiet arrears of the Belaunde government. It attracted attention because it was openly unilateral and thus potentially invited sanctions from the commercial bank creditors. The policy made the best of a situation where a conventional rescheduling, including an IMF agreement, was entirely impossible from a political point of view. Since then, debt service arrears have been extended to official creditors, including the IMF and the World Bank.

The policy of limiting debt service was not only an essential step on the political front. It effectively suspended the external constraint. With the foreign exchange savings resulting from limited debt service, a widening of the trade deficit became possible. Thus external constraints on growth, and the resulting need for realistic exchange rate policies, were suspended, at least for some time. That temporary reprieve, as we will see below, was already exhausted by mid-1988.

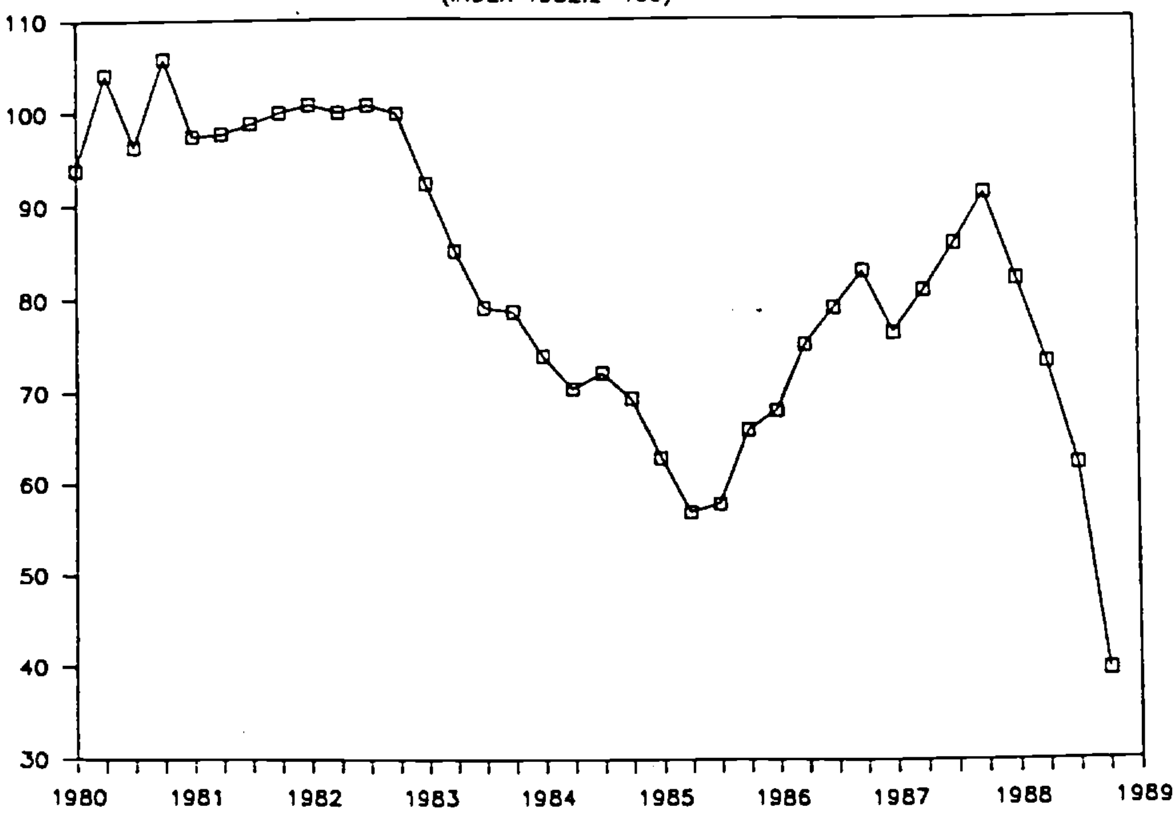
The quality of Peruvian debt, as viewed by the secondary market, has steadily declined since 1985. In July 1985, when Mexican debt traded at 60 cents on the dollar, Brazilian at 75 cents and Argentinean at 60 cents, Peruvian already was down to only 45 cents. By January 1986, the price had declined to only 25 cents per dollar face value. By the end of 1987, the external debt stood at $16.4 billion, with arrears on principal and interest of $6.1 billion. By early 1989 Peruvian debt could be bought at 5 cents per dollar. The low price is certainly explained by one single factor: it would be exceptionally difficult politically to achieve a stabilization in which real worker incomes were cut for the purpose of external debt service.

<u>The First Two Years</u> The immediate priority for the Garcia administration was to introduce a "heterodox" program of stabilization: inflation reduction via an incomes policy combined with a massive reactivation of the economy.

In the short term, the heterodox program was immensely successful. Inflation declined sharply (as shown in Table 4), employment increased, and the real wage was pushed up substantially (as shown in Figure 5). In the last quarter of 1987, the real wage stood 52 percent

PERU: THE REAL WAGE

(INDEX 1982:2=100)



above the level of 1985! Growth, too, had been very substantial. In 1986, the economy grew by 9.5 percent; and, in 1987, by another 6.7 percent.

Table 4 Peruvian Macroeconomic Indicators

	1985	1986	1987	1988
Inflation[a]	158	63	115	1722
Growth	2.5	9.5	6.9	-8.4
Real Wage[b]	111	127	138	106
Trade Balance ($)	1173	-67	-463	-84
Gov't. Revenues[c]	42.7	32.1	25.9	23.5

[a]December-December [b] Index 1975=100 [c]Percent of GDP
Source: World Bank, Ministry of Finance, National Institute of Planning.

It is important to recognize just how successful the heterodox approach is. Given enough foreign exchange and a depressed economy, expansion of <u>domestic</u> demand can work. In fact, the success is broadly shared because the recovery of demand can raise firms' profitability by raising capacity utilization. That was, in fact, the case. A year after the program started Garcia was celebrated by the business class for the success of his recovery strategy. Private investment increased by 24 percent in 1986 and another 18.6 percent in 1987.[25]

By early 1987, the program was at the peak of its success: real GDP had grown cumulatively more than 20 percent since the third quarter of 1985. Inflation had been reduced from 188 percent to only 75 percent. But while the success was startling, the strain was starting to appear in rising cost pressures and a growing loss of foreign exchange. But these strains, while obvious to economists, were far from alarming to policy

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[25]See Centro de Economia Applicada (1988) and especially Iguinez for an evaluation of the first three years of the program.

makers or the public.

The Turning Point: The turning point came in July 1987, ahead of the economic unravelling of the program, as a result of a proposal to nationalize the banking system. On July 27th, 1987, President Garcia declared:[26]

> "In Peru, today, the financial system is the most powerful instrument of concentration of economic power and thus of political influence; it is the major obstacle to the democratization of production and the accumulation of the surplus."

The immediate motivation for the nationalization was to get a hand in the allocation of credit and a better control of the saving generated by the business sector. Control of the financial system was also expected to help monitor profits and capital flight by the privileged groups in the economy. The private financial system was reproached for not belonging " to the necessities of economic development", with large parts of the country's saving being channelled by the few rich families who captured these savings into inventories, nonproductive assets, or accounts abroad.

The nationalization crisis represents the beginning of open, dramatic political conflict. It represented the moment where the right, with public appearances of Vargas Lhosa, dramatized the shift in government policies toward socialism. It also represented the end of the

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[26]See Presidencia de la Republica (1987b,p.1).

recovery policy and the turning point toward inflation and foreign exchange crises. Although the bottlenecks opened up only gradually, during the remainder of 1987, it is fair to say that July-August of that year represented the turning point, after which the continuation of expansionary policies could no longer be defended.

Populist programs such as that practiced in Peru fail when the economy runs out of foreign exchange and when the controls that support the initial redistribution and expansion have to be dismantled. By late 1987, growth was petering out and inflation, brought about by external constraints, bottlenecks and the adjustment of severe price distortions, was exploding.

To understand what went wrong it helps to return to the basic philosophy of the program which is fully documented in a book, El Peru Heterodoxo: Un Modelo Economico, the economic architects of the program published in July, 1987.[27] The most striking revelation of this book is the extraordinary extent to which policy makers in the Garcia administration diverged from accepted economics. Thus we learn (p.75-7) that

> "An examination of the Peruvian record reveals that periods of moderate inflation are associated with expansionary fiscal policies. And periods of major inflation are associated with fiscal restraint. Thus, the record shows exactly the opposite of what is predicted by a theory which explains inflation by fiscal deficits."

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[27] See D.Carbonetto, I.de Cabellos, O.Dancourt, C.Ferrari, D.Martinez, J.Mezzera, G.Saberbein, J.Tantalean, and P.Vigier El Peru Heterodoxo. Un Modelo Economico, National Planning Institute, Lima, 1987.

And, to dispel any doubts:(p.82)

> "If it were necessary to summarize in two words the economic strategy adopted by the government starting in August 1985 they are control (meaning control of prices and costs and recognizing that this could be done only temporarily for the first twelve month) and spend, transferring resources to the poorest so that they increase consumption and create a demand for increased output, thus 'justifying' that idle capacity be put to use.
>
> It is necessary to spend, even at the cost of a fiscal deficit, because, if this deficit transfers public resources to increased consumption of the poorest they demand more goods and this will bring about a reduction in unit costs. Thus the deficit is not inflationary, on the contrary! This constitutes without doubt the basic premise on which the economic team acted and the major departure from the earlier strategy that had emphasized adjustment from the demand side"

Peru learned in 1987-88 that continued rapid growth and massive real wage increases are incompatible with moderate inflation. In 1986, inflation was only 63 percent, far below the level at which the program started. But the experience of high growth with moderate inflation, after a while, became an artifact of the controls and subsidies on public sector prices and on foreign exchange. Subsidies and controls were used to avoid price increases in politically sensitive areas. In 1987-88, most petroleum products sold at one-third their July 1985 price. Electricity prices, the price of rice, and bus fares had declined by more than a third, as had the real price of foreign exchange.

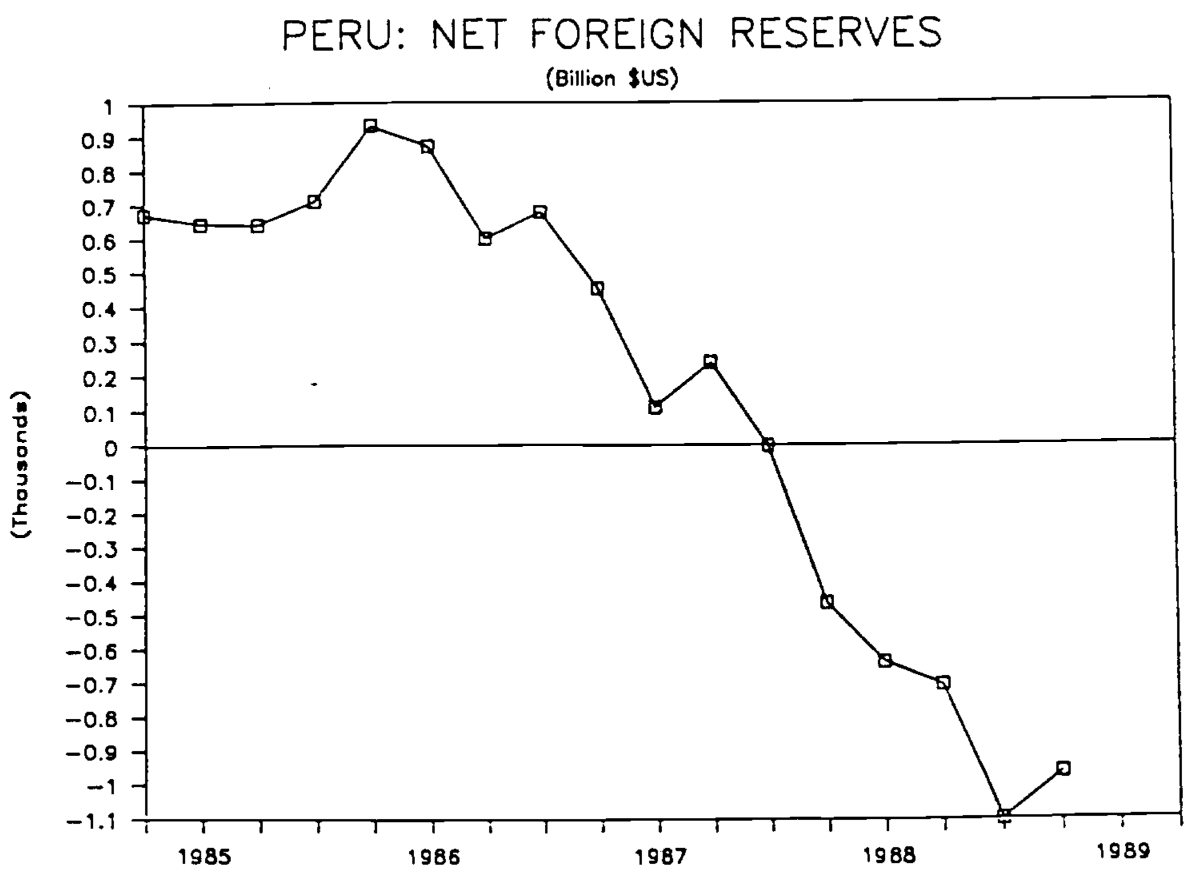
Table 5 Real Levels of Controlled Prices (July 1985=100)

	Dec.1986	Dec. 1987	Dec. 1988
Average[a]	75	59	58
Rice	73	61	47
Light Elect.	49	40	16
Telephone	84	87	32
Gas	58	33	25

[a]Weighted by expenditure shares
Source: Apoyo

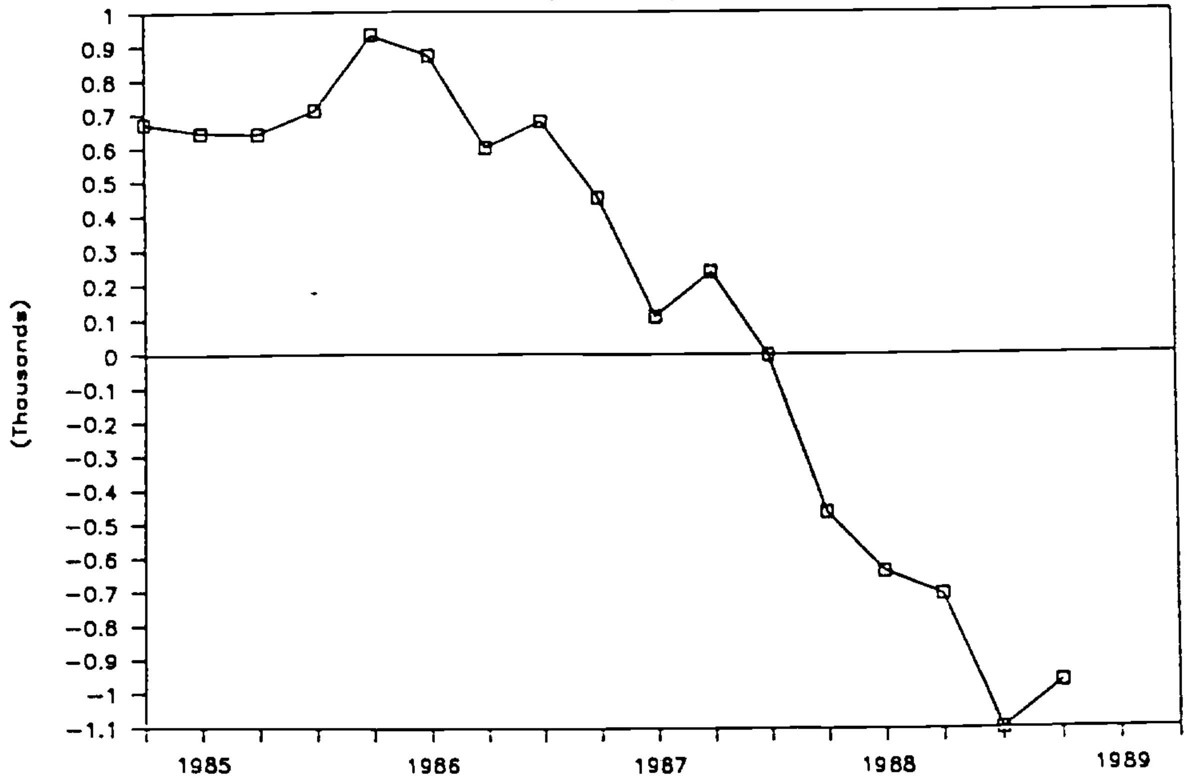
When adjustments in the controlled prices had to be made, inflation accelerated rapidly. Initially, the real wage gains and demand expansion pushed up inflation, but the catching up of lagging prices became increasingly important as the government had to undo, at least in part, the large drop in the real prices of subsidized goods, of foreign exchange, and of controlled goods. In 1987, inflation already reached 115 percent; and, by early 1988, the program was unraveling as inflation exploded. In the first quarter, it reached 470 percent per month. In March 1988, inflation at an annual rate already exceeded 1000 percent; and the year closed with a December-December inflation of 1722 percent. In December itself, the annualized rate of inflation was in excess of 6000 percent. Even at the end of 1988, after repeated attempts to realign controlled prices, the real level of prices in the public sector remained at less than 60 percent of their 1985 level.

Inflation was also a result of the massive increase in the budget deficit. The policy of subsidies, and the extraordinary decline in


PERU: NET FOREIGN RESERVES
(Billion $US)
(Thousands)
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
−0.1
−0.2
−0.3
−0.4
−0.5
−0.6
−0.7
−0.8
−0.9
−1
−1.1
1985
1986
1987
1988
1989

PERU: NET FOREIGN RESERVES

(Billion $US)



real tax collection increased the budget deficit. In 1975-86, tax collection had averaged above 12 percent of GDP, and in 1985, it rose to 13.2 percent. By 1988, because of a sharp decline in compliance, tax collection had fallen to only 7.5 percent of GDP.

The decline in revenue and the large cost of subsidy programs, including interest subsidies in credit markets, created a vast budget deficit. The Central Bank's policy of multiple exchange rates contributed an important part of the deficit. It involved losses amounting to 2 percent of GNP from buying foreign exchange at a high price from exporters and selling it at a low or subsidized price to importers.

Table 6 Public Sector Financing Requirement
(Percent of GDP)

	1985	1986	1987	1988*
Overall Public Sector Deficit	4.4	6.7	9.9	6.1
Budget Deficit	2.4	4.9	6.5	5.3
Central Bank Losses	1.9	1.8	2.8	0.8
Credit to Development Banks	0.8	1.4	1.9	0.8
Public Sector Financing Requirement	5.1	8.1	11.2	6.9
Domestic Financing	1.2	5.7	9.8	6.9

*Estimate
Source: World Bank, Central Bank and Ministry of Finance

The large budget deficit had increasingly detrimental effects on the economy's performance. It directly contributed to inflation, but it also affected the allocation of credit and hence investment. While foreign exchange reserves lasted, the government could sell off foreign exchange rather than borrow in the home market or print money. Now, with reserves precariously low, there was no room left for further reserve sales to finance the deficit. [28] (See Figure 6) The declining reserves now forced a more consistent exchange rate policy which immediately raised the inflation rate.[29] Thus external financing of the budget deficit ultimately had an inflationary cost, even though it may have been delayed by a year or two.

Another way to finance the deficit was through the banking system. High reserve ratios for banks or direct financing requirements effectively achieved this. The counterpart of this policy was a 30 percent decline in real bank credit to the private sector in the past three years. The Central Bank could finance the deficit by printing money. That, too, had occurred and was one of the reasons for the accelerating inflation.

Since September 1987, the World Bank and Peruvian authorities have been discussing stabilization. But the political impetus for major policy changes so far has been missing. The only impetus for change came from the external balance side where a crisis has been building up quite visibly. The trade surplus of above $1 billion in 1985 had become a deficit by 1987. Reserves declined by over $1 billion to the point where net reserves were negative at the beginning of 1988. The response to the looming foreign exchange crisis was a major real depreciation in late 1987. This depreciation was one of the reasons for the sharp acceleration of inflation.

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[28]The net reserves included on the liability side $800 million of arrears to the IMF. The gold position of the central bank had been revalued at various points and amounted to $659 billion in December, 1988.

[29]By April 1989 the decline in economic activity and the restrictions of imports had become so massive that an actual reserve recovery had taken place. The reserve gains were sufficient to feed a rumor of another reactivation program.

The real depreciation helped stem capital flight and the widening trade deficit for some time. In a vicious cycle, accelerating wage and price increases which were triggered by this depreciation eroded the initial gain in competitiveness. The renewed real appreciation of the real exchange rate for imports since the end of 1987, and the resulting exchange losses of the central bank, signal the government's inability to force a real depreciation. And that simply foreshadows a certain foreign exchange crisis. In other sectors, too, real prices remain grossly misaligned as we already saw above in Table 5. This is the case for interest rates as well as for politically sensitive prices.

II.3 What Next?

By early 1989, there were less than $500 million in foreign exchange left as reserves. Another $628 million in gold were available, but trade had become a hand-to-mouth operation. Ships would not unload until receipt of payment abroad was confirmed. From this position, the Peruvian economy could move in one of three directions. The first possibility is a draconian stabilization. This would require a drastic increase in real tax revenues, a unification and real depreciation of the exchange rate, and a realignment of those relative prices which today sustain the overly high real wage. Policy reforms in these areas must eliminate the budget deficit and lessen the external constraint. The cost would be a decline in real wages and hence, at least in the short term, a reduction in growth of output and employment. In terms of Peruvian history, this amounts to a

1983-style program which is "politically impossible". Of course, that does not mean it will not happen. It merely means that it will come too late and hence will be far more expensive in economic and political terms.

The second possibility is a gradual stabilization, supported by increased tax compliance, exchange rate reform, and external support from improved export prices or resources provided by foreign governments. Many debtor countries have the capability of incurring arrears on interest payments or amortization of their external debt. This provides them with a temporary cushion on the foreign exchange side while gradual adjustments are made. Peru has already used and fully exhausted that capability: debt service was halted in 1985, and there now is a deficit even without interest payments. Only fresh external resources (net transfers) can do the job, but it is difficult to know whence they might come. The main reason to contemplate such a possibility at all is political. The U.S. has a lot at stake if Peru, as a result of political disintegration, comes to the brink. The growing power of the United Left and extremism of the Shining Path suggest possibilities much more difficult to live with than Nicaragua. But it is extremely unlikely that a stabilization program with external support would fall from heaven; more likely it would be the maiden gift after a right wing coup.

The third, and the most likely way, is a gradual but accelerating disintegration of the Peruvian economy. As the growing foreign exchange crisis forces more and more rapid depreciation, there will be demands for the maintenance of real wages. With both wages and the exchange rate showing accelerating inflation, prices will quickly follow. In fact, to avoid mammoth deficits or violent strikes, the government will be forced to run a fully indexed economy. But even as the economy becomes fully indexed, the real exchange rate has to be brought down and real public sector prices must rise. Accelerating inflation is the only way that can happen: prices and the exchange rate have to outrun wage increases, even as wages try to catch up. Moreover, as prices, the exchange rate and wages chase each other not only the size of increases but also the frequency of adjustments increase. Adjustment periods shrink from a year to, the adjustment to hyperinflation. Pazos (1972, p.92-3) has described the dynamics as follows:

> "When the rate of inflation approaches the limit of tolerance, a growing number of trade unions ask for raises before their contracts become due. And management grants them. These wage increases give an additional push to inflation and bring about a further reduction of the adjustment interval. Probably the interval is initially shortened to six months, and then, successively. to three months, one month, one week, and one day. At first the readjustment is based on the cost-of-living index; but since there is a delay of one or two months or more in the publication of this index, it must soon be replaced by another. The best-known and more up-to-date of the possible indicators in Latin America is the quotation of a foreign currency, generally the U.S. dollar."

The process is well underway, as inflation was running at an annual rate of 6000 percent at the end of 1988. The financial disintegration was apparent in the massive demonetization of the economy which was so significant that financing of the budget deficit was not consistent with stable inflation even at this incredible level. Real wages, as seen in Figure 4 above, had declined to a level far below 1985, the starting point of the program.

Somewhere in this process, the government might fall. But even that would not solve the problems of an economy where the basic fight is about income distribution. While foreign exchange reserves lasted, the country could spend more than the whole pie and grow in relative harmony. With reserves gone, the real income gains have to be paid back unless they can be earned by sharply higher productivity. Peru today is far away from the kind of policy reform that would try to make the best of its resources; and, hence, maximum pessimism is warranted.

Peruvian policy makers do not like to hear this, but the most likely course of Peru is that taken by Chile under Allende in the period from September 1970 to September 1973. The exact timing and details of the Peruvian experience may not match that of Allende, but the broad outline certainly does.

The unfortunate implication of having allowed so radical a deterioration of the Peruvian economy is that there is no longer any broad political support for reform. The center-left political concentration is vanishing, and new poles of concentration are emerging far away from where Garcia started his presidency: the right around de Soto and Vargas Llosa which is agitating for a Chilean style free market approach, and the United Left for whom the unfortunate nationalization of the banking system in 1988 was merely a first step in the direction of pervasive socialization. And then there is, far off at the extreme left, the Shining

Path whose vision is nothing short of a civil war along racial lines. Against this background of deteriorating economics and politics, where will the Peruvian economy be a year from now?

Economic mismanagement need not be shortlived. If the politics are supportive and external destabilization is not a factor, such a regime can last another year or even more. Garcia can make time by radicalizing his own position and policies in the direction of populism and increasing government intervention. A massive program of nationalization and control would give the government more than a few months of breathing space, except if it were overthrown. Garcia could adopt a gradualist, reformist policy and attempt a shift to the right! In the meantime, the political scene remains relatively calm: coups are not in sight for one simple reason: the right does not want to let Garcia off the hook, doing the hard and ungrateful work of stabilizing the economy only to see Garcia come back for another round. But while there is apparent stability, the extreme reduction in living standards and the growing number of strikes do suggest that surviving for another year, to the elections in April 1990, will not be easy.

Just how far the disintegration of the economy has gone is apparent from a survey reported by Apoyo, an economic consulting service in Peru. Middle and upper income respondents predominantly indicated that they would buy dollars given extra income. Of the lower income groups, more than half reported that they would spend the extra income on food.

IV. CONCLUDING REMARK

IMF-tyle policies, without concern for growth or social progress may well establish short run financial stability, but they inevitably open the door to yet another round of destructive reaction in the form of populist policies.

It is clear that the two instances of populism discussed here led to disastrous consequences for those who were meant to be the beneficiaries. The central question then is whether populist policies are outright unsustainable, or whether there is a variant which, properly executed can in fact succeed. We leave to a further paper the elaboration of the thesis that populist policies can succeed provided they stay far clear of foreign exchange constraints, emphasize reactivation only for a brief initial period and then shift to growth policies. Most importantly, they need to their financing on an extremely orthodox fiscal policy and rigorous tax administration. Within those restrictions, there is significant room left for the redistributive objectives of populism.

Table A-1 Peru: Macroeconomic Indicators

	Growth[a]	Inflation[a]	Terms of Trade[b]	External Debt[c]	Resource Transfer[d]	Real Wages
1970	7.3	5	100	3.68	4.1	
1971	5.1	7	85	3.69	0.8	
1972	5.8	7	80	3.83	1.0	
1973	6.2	10	101	4.13	-0.6	
1974	6.9	17	103	5.24	-5.4	
1975	2.4	24	88	6.26	-9.8	
1976	3.3	34	84	7.38	-5.6	
1977	-0.3	38	79	8.57	-3.4	
1978	-1.7	58	75	9.32	3.3	
1979	4.3	67	100	9.33	12.5	
1980	2.9	60	111	9.59	3.8	100
1981	3.0	73	104	9.63	-4.4	98
1982	0.9	73	94	11.1	-3.7	101
1983	-12.0	125	104	12.4	0.2	84
1984	4.7	112	96	13.3	4.5	70
1985	2.3	158	82	13.8	6.9	60
1986	8.9	63	64	14.4	-2.0	76
1987	6.5	115	61	15.4	-3.8	80
1988*	-8.5	1720		16.2		53

*estimates [a]Percent per year, [b] Terms of Trade Index, 1970=100, [c] Total external debt, Billion $; [d] Resource transfer abroad as a percent of GDP. Resource transfer is measured in the national accounts as net exports excepting factor payments.

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