PERUVIAN ECONOMIC POLICY IN THE 1980S: 
FROM ORTHODOXY TO HETERODOXY AND BACK

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and
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ABSTRACT

This paper examines the dramatic fluctuations in Peruvian macroeconomic policy in the 1980s. We trace the failure of “orthodox” or neoliberal policy in the first half of the decade to external shocks, economic inconsistencies, and the erosion of the state’s institutional and administrative capacities. These difficulties paved the way for the triumph of the American Popular Revolutionary Alliance (APRA) party in 1985 and the subsequent adoption of a “heterodox” economic program. This program “worked” briefly, then collapsed owing to inattention to the external sector, a flawed approach to inflation control, rising class conflict, and the state’s continuing inability to implement its decisions. We close by reviewing the legacy of the decade: deepening social cleavages, highly volatile politics, international isolation, a severely weakened state, and a populace wary of new policy shifts.

RESUMEN

El trabajo examina las dramáticas fluctuaciones de las políticas macroeconómicas peruanas en los 1980s. Trazamos la fallida política “ortodoxa” o neoliberal de la primera mitad de la década debido a “shocks” externos, inconsistencias económicas y la erosión de las capacidades institucionales y administrativas del estado. Estas dificultades facilitaron el camino para el triunfo del partido Alianza Popular Revolucionaria Americana (APRA) en 1985 y la subsecuente adopción de un programa económico “heterodoxo.” Este programa “funcionó” brevemente, después se derrumbó debido a la falta de atención del sector externo y del control inflacionario, incrementando el conflicto de clase, y a la ineptitud continua del gobierno para implementar sus decisiones. Terminamos revisando el legado de la década: profundización de las divisiones sociales, políticas sumamente volátiles, aislamiento internacional, un estado severamente debilitado y una población desconfiada ante nuevos cambios políticos.
INTRODUCTION

If we look back at patterns of economic adjustment and structural reform in Latin America since the advent of the debt crisis in 1982, two broad trends stand out. The first is the dramatic fluctuations in macroeconomic policy between the orthodox remedies traditionally advocated by the International Monetary Fund (IMF) and the more interventionist or “heterodox” strategies that marked the policy environment post-1985 (Sheahan 1989). While the orthodox-heterodox policy cycle is certainly not new to the region, and in fact aptly characterizes the policy-making experience over the entire postwar era (Kaufman 1987), the 1980s is outstanding for the intensification of this cycle and the extremity with which policies were applied from each standpoint.

The second trend is linked to the first: the inability of states to follow through consistently and coherently on any given policy course (Fishlow 1989; Wise 1990). While there have been some exceptions to this trend (for example, Chile), the Latin American pattern has generally been one of failed adjustments and changed courses.

This paper examines these two themes of policy change and instability as they have been played out in Peru over the last decade. As a country grappling with an unprecedented bout of recession and hyperinflation, as well as the most violent guerrilla insurgency in the region, Peru is perhaps the most extreme example of what went wrong in the 1980s. Yet, it is useful to remember that this medium-sized South American country registered economic growth rates second only to Mexico up until the 1970s, and it effectively avoided many of the political excesses for which the region had become famous over the same time period. Part of Peru’s instability, of course, is structurally rooted in the country’s relatively late start in embarking on a full-fledged industrial strategy and the attendant political and social upheaval that accompanied this transition (Fitzgerald 1979; McClintock and Lowenthal 1983). But Peru’s rapid transformation in the 1980s into a state that has displayed some of the most politically volatile and economically unstable outcomes in the region is of particular interest, and merits a detailed explanation.

The paper is divided into three parts. A first section looks at the attempts of the civilian administration of Fernando Belaúnde, elected in 1980, to implement a Southern Cone-style neoliberal economic model in conjunction with an IMF stabilization program. We suggest that this neoliberal strategy failed in macroeconomic terms: the falling output and accelerating inflation that resulted both indicted “orthodox” policy and paved the way for acceptance of a “heterodox” alternative. Moreover, the distributionally harsh nature of the orthodox program exacerbated social tension and helped to produce the redistributive and radical tone of the following administration (Dornbusch and Edwards 1989: 6-7).

A second section examines the conceptual underpinnings and outcomes of the heterodox program that was launched by President Alan García and his American Popular Revolutionary Alliance (APRA) party in 1985. We explain the logic of Peruvian heterodoxy and then argue that the program was
marred by insufficient attention to the external sector, a confused approach to inflation control, severe class conflict, and administrative incapacity. We close this section by examining the paralysis that prevented the García administration from shifting gears and devising a more viable set of policies to avoid the hyperinflation and recession that began in 1988.

The final section briefly discusses the chances for an economic and political turnaround under the new Fujimori regime. We are pessimistic about the future, for reasons rooted in the analysis developed here. First, some of the immediate challenges to the incoming administration, such as the increasing polarization of the country’s political and economic groups, severely constrain Peru’s options. Second, the specter of the new President’s campaign promises of “gradual” stabilization being immediately followed by the adoption of a Bolivian-style “shock” suggests that the era of dramatic policy shifts may not be over. Finally, the new government’s ability to maintain consistency in its policies will be limited by the aforementioned social cleavages, limited administrative capacity, and an international scenario that remains unfavorable.

**PERUVIAN NEOLIBERALISM 1980-1985**

Peru’s shift toward a market-based strategy by 1980 can be traced to both historical and international factors. Until the statist military coup of 1968, the country had exhibited a strong bias toward laissez-faire and the swing toward orthodoxy in the 1980s partly reflects a traditional tendency to revert back to a liberal economic policy regime when direct state intervention failed (Thorp and Bertram 1978). Second, transnational actors such as the private banks and the IMF had acquired significant influence over Peru in the late 1970s primarily because of a series of debt servicing difficulties; in return for debt rescheduling, these actors had demanded the adoption of monetarist stabilization and adjustment guidelines. With the fortuitous turnaround of prices on Peruvian mineral exports in 1979 and the brief economic reactivation that followed, domestic elites entered the 1980s convinced that the orthodox remedy had worked (Paredes and Pasco-Font 1987).

The other obvious factor influencing Peru’s shift toward a more market-oriented strategy was the neoconservative management approach underway in the Southern Cone countries of Chile, Uruguay, and Argentina in the 1970s (Foxley 1983; Ramos 1986). Why was the neoconservative strategy taken up so enthusiastically by Peru when it had already seemed to fail in Argentina and Uruguay? First, the Chilean economy was, until late 1980, still being trumpeted by the banks and the multilaterals as a free market

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1 Hernando de Soto’s (1989: xvi) historical characterization of the Peruvian state as “mercantilist” does not rule out the successful maintenance of a liberal economic policy regime over time. Underlying de Soto’s account of a law-ridden bureaucratic state, which granted favored status to a small domestic elite, was the triumph of that elite in preventing macropolicy and government economic regulation from being turned against it.

2 These views are expressed, for example, by Ferrand and Salazar (1980: 70-75).
The strongest vestiges from the neoconservative experiments came through in the Belaúnde administration’s call for the reduction of state enterprise and the stimulation of private investment. Opening the economy domestically and internationally was also a priority, as evidenced by the elimination of government intervention in pricing, marketing, and the financial system; a reduction in tariffs and trade barriers; and the maintenance of crawling peg currency devaluations in order to maximize Peru’s competitiveness on foreign export markets. 4

As it turns out, Peru’s neoliberal program rapidly collapsed. We organize our analysis of its failure along four broad lines of policy: the privatization drive, trade liberalization, state investment to support export-led growth in the raw material sectors, and the ongoing management of the neoliberal macroeconomic targets. While it is difficult to separate the impact of domestic policies from that of the international economic shocks that hit in late 1981, the policies were clearly contradictory and inappropriate. To see this, let us turn to each policy area. 5

3 This is one of the main explanations given by Roberto Abusada, Vice-Minister of Commerce under the second Belaúnde administration, author’s interview, August 12, 1987. 4 The initial program was stated most succinctly in a lengthy presentation to congress by Finance Minister Manuel Ulloa in “Mensaje al congreso del presidente del consejo de ministros,” Lima, August 27, 1980. A full reprint of the speech, as well as the immediate reaction by a group of local prominent opposition economists, can be found in Crisis económica y democracia (Lima: Instituto de Estudios Peruanos, noviembre 1980). 5 Other analyses of the Peruvian neoliberal experiment include Conaghan, Malloy, and Abugattas (1990), Reid (1985), Schydowsky (1986), Thorp (1986), and Webb (1987). Webb’s analysis is particularly interesting as he was Central Bank President during the Belaúnde administration.
The Neoliberal Track Record: Four Policy Currents

Privatization and Private Investment

In keeping with the neoliberal framework, the Belaúnde regime sought to shed state-owned enterprises (SOEs) and encourage private investment. The government initially announced that over 80 SOEs would be sold, turned into joint ventures, or liquidated.6 While some opportunities were present, the aspirations were clearly unrealistic. On the one hand, the ministers made responsible for the privatization drive were generally not eager to erode their base of power and hence made few attempts to privatize their own firms (Branch 1982: 4). On the other hand, private sector resources were inadequate. Various estimates of the value of the planned SOE sales ranged from $200-400 million, or 1-3% of GDP. Unfortunately, Peru’s total net private direct investment from 1981-1983 barely surpassed $200 million (Thorp 1986; BCRP 1987a) implying that little divestiture could realistically take place.7

The limited divestment that did occur mainly consisted of the sale of government assets to special interests (Saulniers 1988: 36). The government did weaken some state companies by slashing investment funds, allowing unrestricted imports, and promoting private sector rivals (Alvarez 1984). But in the end, just a few insubstantial full liquidations were undertaken, for example, of a supermarket chain, a machine tool factory, and a fish freezing and canning plant (Reid 1985: 83-84).

The other major aspect of the privatization drive, the attraction of much higher levels of foreign and local private direct investment, met with disappointing results. As Table 1 shows, private sector gross capital formation fell from 18 percent of GDP in 1980 to 12 percent of GDP in 1985, an especially poor showing when compared to historical trends (Thorp and Bertram 1978: 288-291). The dismal performance was partly because the government’s many investment incentives for local capitalists were quickly cancelled out by the trade liberalization policy (see below), the erratic disbursement of export subsidies, and other undercutting trends in the overall macroeconomic policy, especially the fall in GDP and hence market size.8

The attraction of higher levels of foreign direct investment presented perhaps the biggest challenge, particularly after the many ambiguous signals that had been sent out over the previous decade (Hunt 1975). Despite the generous treatment, and substantial breaks on export and other taxes, neither the manufacturing nor mining and petroleum multinationals could be enticed to return to Peru with any force. In the wake of the debt crisis, foreign direct investment hit an all-time low.

7 The data on private investment in Peru, both foreign and local, are disparate and confusing. All sums include investment and reinvestment, but vary in accounting for depreciation of fixed assets, amortization, and loan repayments. The Central Bank figures cited here subtract out the last three factors.
TABLE 1
Investment in Peru, 1980-89

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Fixed Investment as % of GDP</th>
<th>Private Investment as % of GDP</th>
<th>Public Investment as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>24.2</td>
<td>18.0</td>
<td>6.1</td>
</tr>
<tr>
<td>1981</td>
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<td>26.3</td>
<td>18.8</td>
<td>7.5</td>
</tr>
<tr>
<td>1983</td>
<td>21.3</td>
<td>14.2</td>
<td>7.1</td>
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<td>13.2</td>
<td>5.9</td>
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<td>4.6</td>
</tr>
<tr>
<td>1986</td>
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<td>13.8</td>
<td>4.4</td>
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<tr>
<td>1987</td>
<td>19.4</td>
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<td>5.2</td>
</tr>
<tr>
<td>1988</td>
<td>18.5</td>
<td>14.5</td>
<td>4.0</td>
</tr>
<tr>
<td>1989</td>
<td>16.7</td>
<td>8.5</td>
<td>8.1</td>
</tr>
</tbody>
</table>


Trade Liberalization

The thrust toward trade liberalization, started in earnest in 1978 under strong pressure from the IMF, received a boost with the change of administration in 1980. Indeed, the Belaúnde team broadened the critique of the country’s existing trade regime, slighting both import substitution efforts and the active promotion of nontraditional exports. Despite the fact that such exports had risen to $845 million by 1980 (BCRP 1987a: 167), the Belaúnde technocrats viewed the record as inadequate in light of the incentives afforded industrialists, including abundant credit at subsidized interest rates, cheap production inputs, and the protection of capital goods imports. In keeping with orthodox logic, the policy remedy was to introduce competition as a way of forcing the industrial sector to become more efficient. A wide range of duty exemptions and quantitative restrictions were removed. The average nominal tariff was brought down from 46% to 32%, and by the end of 1981, 98% of all registered items could be imported freely, as opposed to 38% in 1978 (World Bank 1985: 48). Though maintained, a tax subsidy (CERTEX) for priority exports was reduced, and interest rates on credit lines available through the state industrial bank were set according to market trends.

The effects of this liberalization policy were immediate. The lower tariffs brought a flood of foreign products onto the domestic market; while some of the new imports were necessary industrial inputs, the import of luxury consumer goods also skyrocketed. Losses stemming from increased competition gave rise to a new level of demand for credit on the part of local industry, which now more expensive, sent many firms deeply into the red. The final toll was a nearly twenty percent drop in manufacturing output between...
1980 and 1983, and the operation of industry at only forty percent of its installed capacity (Reid 1985: 85). Under strong pressure from national industry, the administration began backtracking on the measures almost immediately. The 1984 CERTEX tax subsidy rose above the amount that the government had spent in 1979, and nominal tariffs were brought back up to their pre-1978 levels (World Bank 1985: 49).

The State Investment Program

The third set of neoliberal policy goals centered on rerouting state investments into economic infrastructure to support private enterprise. 1981-1985 public investment plans included over 80 projects and budgeted an annual average expenditure rate of $2.3 billion over the five-year period. In the end, however, the government did not meet its overly optimistic spending targets. By 1982, many projects still lacked financing with the result that public investment slumped 40% below the amount originally sought (World Bank 1985: 30). Once the severe stage of the crisis set in after 1983, state capital formation took on the same stop-and-go character it had during Peru’s 1977 economic crisis. Some projects simply stood still, as unpaid contractors and suppliers stopped work. Others moved along at a greatly reduced pace, hoping to fend off stiff penalties for cancellation.

The very large-scale nature and ultimate disarray of many of the inherited ventures produced the opposite effect of the neoliberal intentions: the state was ever more burdened by its investment program, and the private sector weakened by the state’s neglect of macropolicy owing to energies involved in implementing the project portfolio. Moreover, the persistence of the economic crisis throughout the 1980s meant that the portfolio handed down from this period would form the core of the state investment program indefinitely, tying the hands of the subsequent administration.

Macropolicy

In theory, the macroeconomics of the neoliberal program were the traditional IMF recipe: restraining monetary growth, fighting inflation, devaluing local currency, encouraging private initiative, and lowering barriers in order to integrate Peru more closely into the world economy. In practice, the Belaúnde administration never found its footing in managing macropolicy policy. Because of nationwide municipal elections that were called early in the Belaúnde regime, the government “softened” policy: the public sector deficit was tolerated, the exchange rate allowed to appreciate, and government-controlled prices were held down. Belaúnde’s Popular Action (AP) party did manage to score a victory at the polls, but the half-hearted nature of the economic measures set in motion a three-way tug of war between the AP, the more orthodox Popular Christian Party (PPC) with whom the AP shared a majority coalition bloc in congress, and the president’s more technocratic economic team made up largely of party independents. The resulting divisions produced policy paralysis.

One area in which orthodox policy was indeed pursued, however, was in the management of domestic inflation. Belaúnde’s policymakers took power convinced that the 1980 inflation rate of 61%
stemmed from the 1979 balance-of-payments surplus (since, in the simple monetarist model dear to these
policymakers’ hearts, reserve accumulation necessarily produced both monetary growth and inflation).
The solution then was to combine fiscal and monetary restraint with a “burning off” of reserves; this
partially explains why the Belaúnde team was seemingly unconcerned about the import boom of the
administration’s early years. The IMF, sharing the basic monetarist framework, blessed these prescriptions
and as a result, Peru operated under a series of IMF programs until mid-1984. The results were
unappealing: between 1980 and 1985, GDP stagnated, inflation doubled, and external debt rose over 70
percent (see Tables 2 and 3). Meanwhile, real wages fell over 35 percent, wage share fell by 3.4 percent
of GDP, and the persistence of inflation tended to shift resources toward financial and commercial
speculation (see Table 4). Given these patterns, even policymakers within government circles began to
criticize packaged orthodox solutions to Peru’s macroeconomic problems; outside the government, the
chorus of doubters was even larger.

The Political Capacity to Implement the Program

While the orthodox program may have been flawed in theory—privatization was unrealistic, trade
liberalization was ill-advised, and inflation was excessively focused on monetary or demand restraint rather
than cost control—the poor performance of Peru’s orthodox interlude was also due to difficulties and
inconsistencies in the implementation of that program. The first source of difficulties was exogenous:
price shocks emanating from the world economy (see Table 4 for evidence on the deterioration in the
terms of trade), the abrupt cutoff in external credit, and the freak weather conditions caused by the El Niño
current, all conspired to limit performance potential. Performance, however, was also constrained by
weaknesses inherent to the Peruvian bureaucracy, the configuration and balance of power between the
main state financial and planning institutions, and the nature of the coalitions that backed the program.

While much of the erosion in the capacity of the Peruvian bureaucracy to successfully execute
state policy had occurred with massive layoffs of top public personnel in 1978 (Vallenlas and Bolanos
1985), the Belaúnde administration made no effort to reverse this trend. Instead, a near obsession with
the expansion of executive authority took precedence over the need to foster pockets of expertise within
the bureaucracy to carry out the executive will (Rueschemeyer and Evans 1985). Policy-making came to
rely almost solely on executive decree, with its implementation of only peripheral concern.10 The
relations among state institutions responsible for economic management were marked by conflict and
hence a lack of coordination. Tensions between the finance ministry and the central bank were especially
severe. Meanwhile, the National Planning Institute was physically relocated from downtown Lima to a

9 Peru’s largest private bank at the time, the Banco de Crédito, owned by the powerful Romero-Raffo
business empire, cashed in quickly on tax breaks, low interest rates, and high inflation; in 1981 alone, its
net profits increased by 78% (Reid 1985: 84-88).
10 During 1981, for example, major laws concerning agrarian reform, taxes, and the media were passed
through a barrage of executive decrees, as was the entire economic program (Malloy, 1982: 7).
remote suburban zone, a move that reduced its ability to interface with other state agencies on daily policy matters to a minimum (Cornejo 1985: 117). Peru thus suffered from both a “balkanization” of economic policy-making (Webb 1987: 47) and a neglect of long-term planning.

**TABLE 2**

**Macroeconomic Performance in Peru, 1980-89**

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth of Real GDP (% change)</th>
<th>Growth of Manufacturing (% change)</th>
<th>CPI Inflation (Dec-Dec)</th>
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<tbody>
<tr>
<td>1980</td>
<td>4.5</td>
<td>5.7</td>
<td>60.8</td>
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<td>1981</td>
<td>4.4</td>
<td>0.7</td>
<td>72.7</td>
</tr>
<tr>
<td>1982</td>
<td>0.3</td>
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<tr>
<td>1989</td>
<td>-10.4</td>
<td>-19.2</td>
<td>2775.6</td>
</tr>
</tbody>
</table>


**TABLE 3**

**Trade, Reserves, and Debt Service in Peru, 1980-89**

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports ($US mil)</th>
<th>Imports ($US mil)</th>
<th>Balance ($US mil)</th>
<th>Terms of Trade (1978=100)</th>
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<tr>
<td>1980</td>
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<td>3,090</td>
<td>826</td>
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<td>1981</td>
<td>3,249</td>
<td>3,802</td>
<td>-553</td>
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<td>1982</td>
<td>3,293</td>
<td>3,722</td>
<td>-429</td>
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<td>1983</td>
<td>3,015</td>
<td>2,722</td>
<td>293</td>
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<tr>
<td>1984</td>
<td>3,147</td>
<td>2,140</td>
<td>1,007</td>
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<tr>
<td>1985</td>
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<td>1,806</td>
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<td>1,399</td>
<td>76.7</td>
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<tr>
<td>Year</td>
<td>Debt Service Accumulated Long-Term as a % of Interest</td>
<td>Net International Reserves ($US mil)</td>
<td>$US mil</td>
<td>$US mil</td>
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<tr>
<td>------</td>
<td>---------------------------------------------------</td>
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<tr>
<td>1980</td>
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<td>6,043</td>
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<td>1989</td>
<td>546</td>
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**Notes:** Data on exports, imports, and the trade balance from Cuanto (1990a: 827) and Cuanto (1990b: 12). The terms of trade are calculated as the price of traditional exports relative to imports and are taken from Cuanto (1990a: 84). Net international reserves taken from Cuanto (1990a: 827) and Cuanto (1990b: 12). Long-term external public debt from Cuanto (1990a: 827). Debt service figures are for non-BCR (Central Bank) debt and taken from Banco Central de Reserva del Peru (BCRP 1987: 59) and National Institute of Statistics (INE) (1989: 605); exports of goods and service calculated from data in Cuanto (1990a: 827, 831). Interest arrears are from World Bank (1989: 306); arrears including principal are substantially higher.

### TABLE 4

**Real Wages and Distribution in Peru, 1980-89**

<table>
<thead>
<tr>
<th>Year</th>
<th>Index of Real Salaries (1980=100)</th>
<th>Index of Real Wages (1980=100)</th>
<th>Index of Informal Income (1980=100)</th>
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</thead>
<tbody>
<tr>
<td>1980</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>1981</td>
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<td>1982</td>
<td>109.7</td>
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<td>131.1</td>
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Notes: Real salaries are for non-manual workers and real wages for manual workers; both series taken from Cuanto (1990a: 718). Index of informal income is for December of each year and is taken from Cuanto (1990a: 730). Wage and profit shares taken from data in Cuanto (1990a: 275). National income is national product minus net interest payments abroad; profit share includes rent, profits, and domestic net interest payments; the remainder of income accrues to independent producers in both agricultural and nonagricultural activities. The agricultural-manufacturing terms of trade taken from sectoral GDP deflators reported in National Institute of Statistics (INE) (1989: 214).

Finally, implementation was constrained by fragmented politics. The possibilities for forging a viable coalition to push the program forward were present along both the executive-parliament-party and the state-capital-labor axes. On the former front, any semblance of a consensus quickly eroded over fierce conflicts concerning the extent and pace at which the neoliberal measures should be brought forward. These disagreements were aggravated, furthermore, by the attempts of the AP-PPC bloc to reorganize the legislative committees in congress and short-circuit the opposition to its program (Woy-Hazleton and Hazleton 1987). On the latter count, while business clearly went into the 1980s poised to catch up from the crisis of representation that it had experienced over the previous decade, organized labor made it clear immediately that the AP-PPC lacked a support base with workers (Bollinger 1987). During its first year, the administration initiated a modest attempt at interest mediation by forming a National Tripartite Commission composed of representatives from industry, government, and the four major labor confederations (Malloy 1982: 8). But the government was eventually unable to persuade business or workers to accept its income and price proposals. As the commission unraveled, the relationship among the state, capital, and labor became more conflictual, a phenomenon that helped fuel inflation.

In the end, the inability of the Peruvian neoliberals to implement their program was a result of their own attitude toward the state. In rejecting state-led development and embracing a market strategy, the
Belaúnde government tended to work around those bureaucratic, institutional, and coalitional structures that would have been crucial for the effective implementation of any development program. The lesson of this period, particularly the more severe crisis context after 1982, is that market policies are also “interventions” that demand a basic level of capacity, coordination, and political support to be carried out effectively (Haggard and Kaufman 1989). The prevailing antistate attitude on the part of neoliberals led them to discount the very tools they needed for program implementation.

The Neoliberal Legacy

By 1985, the fallout from nearly a decade of regressive austerity measures had provoked a dramatic response from below. On the one hand were the growing number of poverty-related insurgent factions, Sendero Luminoso being the most prominent, that completely eschewed all legal forms of political participation.11 While the Belaúnde administration attempted to disregard the indigenous guerrilla problem by phrasing it in Cold War terminology, the insurgents made serious inroads in first the southern and then the central Andean provinces. As Sendero proceeded from low-level political agitation in 1981-82 to violent assassinations of locally elected officials and destruction of major state investment projects, the government switched course and declared much of the southern Andes an emergency zone. A full-scale military operation was deployed in 1983, and the government turned to U.S., Argentine, and Israeli advisers for counterinsurgency training (Reid 1985: 114). Adopting a no-holds-barred strategy of mopping up the guerrillas, the conflict quickly escalated into an Argentine-style dirty war between the state security forces and Sendero by 1983.12

On the other hand, Peru’s newly enfranchised poor took advantage of the 1983 nationwide municipal elections to register their grave discontent. The elections produced a critical political realignment in the form of a new hegemonic bloc consisting of the center-left sections of the APRA led by Alan Garcia, and a group of six leftwing parties that had organized into a United Left (IU) coalition. The APRA moved up to capture 33% of the vote, and the IU another 29%, with the latter winning the municipality of Lima. In policy terms, the 1983 results also signalled the first phase of an archetypical Latin American populist cycle: a proto-strong negative reaction to the hardships of orthodox management (Sachs 1989; Dornbusch and Edwards 1989: 5-7).

By 1985, the political momentum had shifted such that APRA’s Alan Garcia won the Presidency with a convincing majority and enjoyed both a tacit alliance with much of the left opposition (IU) and even the support of certain business sectors. As the following section shows, the new APRA government

11 Out of the growing literature on Peru’s Sendero Luminoso, good starting points are McClintock (1984), Reid (1985: chapter 7), and Degregori (1986). Excellent journalistic accounts throughout the 1980s are provided by Raul Gonzalez and José Maria Salcedo in various issues of DESCO’s magazine, Quehacer.
quickly picked up where the conservative Belaúnde government left off: central to APRA’s concerns was the achievement of inflation reduction and new economic growth while redistributing income in order to stave off the challenge from below. As we will see, the method for doing this—“heterodox” economic policy combined with a social-democratic commitment to private investment—proved disastrous.

THE RISE AND FALL OF PERUVIAN HETERODOXY

The era of Peruvian heterodoxy was signalled by President García’s inaugural address: an attack on the International Monetary Fund coupled with an announcement that Peru would limit debt service to 10 percent of export earnings. While the debt service limits drew immediate international attention, the domestic policies soon introduced were equally crucial to Peru’s future and represented a sharp break with the neoliberalism of the previous administration (Wise 1986).

The economic team responsible for articulating and eventually implementing the new program emerged from a small group of economists that had long stood in the wings offering criticisms of IMF-style policy and suggestions of an alternative (Carbonetto 1987; Carbonetto et al. 1987; Dancourt 1986a, 1986b; and Ferrari 1986). Rooted in the Latin American structuralist tradition, they argued that various rigidities present in the Peruvian economy made orthodox stabilization policy inappropriate. Prices in industry, it was suggested, were mostly set via a mark-up on costs (including wages, interest payments on working capital, imported capital goods, and intermediate goods provided by state-owned firms). Prices of exports and imports were set by the world markets and neither exports nor the import share of output were very responsive to devaluation-induced changes in their domestic value; exports were largely driven by supply (that is, previous investment in capacity) while import coefficients were mostly fixed by the technical requirements of production. Spending patterns were varied by socioeconomic class: workers and peasants spent virtually all their income while capitalists engaged in capital flight or consumed luxury imports and only occasionally invested. Finally, unlike industry, agricultural prices were flexibly determined by demand but supply responses were slow and uncertain.

Taken together, these features implied that IMF-style policy was ineffective and, in fact, stagflationary. While the orthodox view saw inflation as a signal of excess demand and trade imbalance as the result of an “incorrect” exchange rate, devaluation might, in fact, barely budge exports while leaving the import coefficient untouched; any improvement in the trade balance would therefore require a recession. Meanwhile, devaluation would raise import costs while orthodox deficit-cutting would force increases in the prices of state-supplied inputs and monetary restraint would elevate interest costs on
working capital. Real wages would fall as unemployment and inflation rose in tandem; even agricultural prices and peasant income would shrink owing to reduced urban demand.\(^\text{13}\)

That this aptly described the results of Belaúnde’s orthodoxy is not so surprising upon examination of the Peruvian economic structure. In 1985, nearly 80 percent of Peruvian exports were of the price-insensitive “traditional” sort described above; a similar percentage of imports were intermediates and capital goods used in domestic manufacturing in relatively fixed proportions (Cuanto 1990a: 838, 845). As for pricing behavior, former Central Bank President Richard Webb (1987) estimated that the prices of thirty-three percent of final domestic demand was determined by direct government control while twenty-three percent was determined by a mark-up rule. Seventeen percent of the economy was in a “semi-flex” price sector, mostly tradeables or high import-content goods in which prices were largely determined by the government-set exchange rate. This left only twenty-seven percent of final demand in the “flex-price” sector that might be subject to the “excess demand” explanation typical of orthodox theory.\(^\text{14}\)

If orthodox policies could not combat inflation, reactivate growth, and raise real wages in such an economic structure, what could? This issue was central to the political forces aligned with García, particularly in light of the need to derail the threat from the Sendero Luminoso, but it was a novel question for a structuralist vision in which inflation had been considered an acceptable outcome of growth and the pressure it placed on food prices. Now, however, was the time to move beyond critique to prescription.

The result was heterodox economic policy, a strategy that sought to contain inflation by directly controlling both prices and the cost-push factors (Schuldt 1986). The APRA government began its domestic policy with a single sharp devaluation to gain competitiveness and then froze the exchange rate to control import costs. Interest rates were mandated downward to reduce working capital costs. The real price of government-supplied inputs was also reduced, producing a favorable impact on cost pressures. The effects on inflation were immediate and reassuring: within a year, the rate of price increase had been halved.

This Peruvian attempt to reduce inflation by directly controlling costs was similar to the Argentine and Brazilian “heterodox” experiments in the same period (Arida 1986; Cardoso 1986; Dornbusch and Simonsen 1987). The Peruvian program differed, however, in several key ways: (1) it made an explicit effort to relieve the external growth constraint through limitations on debt service; (2) it discounted the possibility of excess demand inflation and sought instead to pump up demand through real wage hikes.

\(^\text{13}\) For general models of Third World economies and the possible perversity of orthodox approaches, see Krugman and Taylor (1978) and Taylor (1981, 1983). For a model of the Peruvian economy in particular as well as a formalization of the heterodox logic, see Pastor (1988).

\(^\text{14}\) Most of this flex-price behavior was in agriculture, a sector that had little short-term macroeconomic impact since price hikes there merely redistributed the source of the demand for manufactures from workers to peasants without generally diminishing the level of demand. In the long run, of course, agriculture could make an important contribution to the macroeconomy by helping to reduce the reserve drain prompted by food imports.
and widening government deficits; (3) it explicitly sought to cement an alliance with private capital through a process called *concertación*, a sort of ongoing consultation about macro policy with the country’s largest capitalists; and (4) it included a medium-term objective (albeit an unfulfilled one) of restructuring the economy toward industrial exports and greater self-sufficiency. Below, we follow the main policy currents of debt service limits, inflation and demand management, relations with private capital, and medium-term restructuring as well a related issue concerning the state’s limited administrative capacity for such an interventionist program. We then suggest why, despite seemingly more coherent policy in its last years, the García team could not avoid the startling hyperinflation and recession that characterized Peru in 1989 and 1990.

**Debt Service Limits**

A limit on debt service was the announced cornerstone of the heterodox notion of “inflation reduction with growth.” Reducing the outflow of dollars through restricting debt service was expected to stabilize the inflation rate (and hence prices) while the substitution of intermediate imports for debt payments would allow economic reactivation.

The debt program was neither as dramatic nor as ill-considered as some observers seem to have thought. The supposedly orthodox Belaúnde government had already quietly stopped most payments to commercial creditors, reducing the debt service ratio from over forty-five percent in 1982 to less than twenty percent by 1984. Moreover, APRA’s stated policy through 1987 was to selectively honor obligations that would lead to trade and development financing; in this vein, Peru continued to service short-term trade finance and make payments to multilaterals such as the World Bank and the Inter-American Bank. The García strategy was, in fact, the first attempt at a coherent approach to the Peruvian debt problem since servicing difficulties emerged in the late 1970s. It also made particular sense in light of the dim prospects of new voluntary lending by commercial creditors (Wise 1988).

There were, however, several problems with the strategy. First, the García government found it difficult to both make payments deemed important for maintaining trade and development finance and stay below the self-imposed limit of ten percent; not until 1988 did the debt service ratio dip below ten percent and this mostly reflected incapacity to pay rather than any conscious strategy (see Table 3).\(^{15}\) Second, the public stance against the IMF and the anti-imperialist rhetoric that accompanied it (in distinct contrast to the quiet nonpayment of Belaúnde) isolated Peru from the international financial community. The Fund declared Peru an “ineligible borrower” in August 1986 while flows from the other multilaterals fell steadily through the period of heterodoxy, reflecting both a lack of confidence in the APRA program and an irritation with the debt challenge being proffered by García.

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\(^{15}\) The inability to stick within the “ten percent” led to a somewhat strained attempt by the Institute of National Statistics to classify debt service in terms of what was included in the ten percent and what was not. Such sleight of hand did not replenish the reserves being drained by excess debt payments.
The key problem with the debt stance, however, was the lack of a clear strategy to create alternative sources of foreign exchange. The negative reactions from foreign creditors were to be expected (although some in the heterodox team had apparently not anticipated this) and attention should have been immediately turned toward vigorous export promotion and more efficient import substitution. This, however, contradicted the need to both import more to feed the reactivation and freeze the exchange rate to hold down prices. The government therefore let imports rise from $1.8 billion in 1985 to $3.2 billion in 1987; meanwhile, export revenues fell over 10 percent, yielding a shift from a $1.2 billion trade surplus in 1985 to a more than a half billion dollar trade deficit in 1987 (see Table 3). Growth was indeed fed—GDP grew nearly sixteen percent in these two years—but net international reserves fell from $1.4 billion at the end of 1985 to a paltry $81 million at the end of 1987.

Thus, rather than using debt service limits to preserve foreign exchange and buy time for a structural transformation that would reduce external dependence, the government opted for a rapid expansion that “burned” reserves, fed inflation, and eventually brought the economy to a standstill. To be fair, some members of the team were conscious of the problems in the external sector by late 1986 but proved unable to persuade García to slow the politically popular reactivation. With reserves in collapse through 1987, the government further antagonized official lending agencies by announcing a new “ability to pay” program which was supposed to further reduce outpayments until growth targets were met. Loan disbursements from the multilaterals rapidly turned negative and the last years of the García administration were marked by a tense stand-off between creditors and Peru. The debt limits that had held so much promise had instead yielded disaster.

**Inflation and Demand Management:**

The heterodox program emphasized both inertial and cost-push inflation, contending that excess demand was an unlikely culprit when the country’s productive capacity was half-idle. Price controls (to break inflationary expectations) were coupled with attempts to force down costs by lowering interest rates, stabilizing the exchange rate, and reducing the relative price of inputs from public enterprises (such as electricity). Since reactivation was also a goal, the government mandated increases in the real wage and allowed the government deficit to grow (mostly through reducing taxes and increasing subsidies).

The initial results on growth have already been mentioned; equally impressive was the fall from an inflation rate of 158 percent in 1985 to 63 percent a year later. By 1987, however, the inflation rate had nearly doubled and in 1988, Peru experienced its first bout with hyperinflation when the rate that year hit 1,722 percent. What went wrong?

There were at least three reasons for the collapse of the program. The first had to do with the behavior of the external sector and the exchange rate. The heterodox view that inflation would not be triggered short of full employment and full capacity was cogent, but in an economy like Peru’s output is constrained not so much by plant and equipment as by the capacity to import required intermediates. The
1986-87 import boom drained reserves with two inflationary effects. First, the subsequent reduction in import capacity constricted supply and allowed producers to increase mark-ups, a phenomenon that also redistributed income toward capital (see Table 4 for distributional patterns). Second, the shortage of foreign exchange led worried investors to “dollarize” savings (even before García’s attempt at bank nationalization accelerated this trend). This, in turn, drove up the parallel market exchange rate, put pressure on the official exchange rates, and led to “defensive” price hikes in anticipation of a devaluation.

The second source of inflationary difficulties was the government deficit. In their attitude toward the deficit, APRA economists were what Rudiger Dornbusch has labelled “poetic”: they saw little inflationary impact (because of idle capacity) and worried less. Between 1985 and 1987, the “economic deficit” of the public sector rose from 2.4 percent of GDP to 6.5 percent. The main source of the deficit widening was not central government expenditures (which fell in real terms throughout the period) but rather tax revenues. Tax pressure fell from 12.4 percent of GDP in 1985 to 8.2 percent in 1987 and fell even further to 7.4 percent of GDP by 1988 (Cuanto 1990a: 263, 758-59). The first decline was mostly a result of conscious policy on the government’s part while the second reflects the well-known “Tanzi-Olivera effect” in which, given fixed lags in tax collection, high inflation erodes the real value of tax revenues.

Despite heterodox protestations, the deficit was inflationary for three reasons: (1) it added to demand when the economy had already spurted past the inflationary trigger of import capacity; (2) key economic actors in both business and labor associated deficits with inflation and, whatever the real effects of large deficits, tended to shift inflationary expectations upward; and (3) the deficits were accompanied by an annual growth in monetary measures (such as M1) of nearly 150 percent in 1987, a trend sure to feed into prices. A particular culprit was the differential between export and import exchange rates, a feature that caused the Central Bank losses on the order of 2.8 percent of GDP in 1987 and poured excess liquidity into the economy.

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16 That such a mark-up adjustment did occur is indicated by the fact that the ratio of consumer price inflation to wholesale price inflation rose from .95 in 1985 to 1.6 in 1987; moreover, between 1986 and 1988, the share of national income going to employers and owners rose over twenty percent (from 0.348 to 0.425), a trend that squares with such a mark-up adjustment (see Table 4).
17 The “economic deficit” does not include amortization of debt, little of which was actually done anyway. The “financial deficit” which included amortization (usually financed in the García period by arrears) was naturally much higher but less important for determining demand pressure in the economy.
18 It is also likely that high inflation in Peru induced taxpayers to lengthen their usual delays in tax payments in order to reduce the real value of their obligations. The government, as we note later, responded by attempting to shorten collection lags.
19 To see why a multiple exchange rate system can promote monetary expansion and inflation, consider the case of an exporter that receives 200 intis per dollar of exports from the Central Bank but only needs to expend 100 intis for a dollar’s worth of imports. The result is an extra 100 intis of money which can be spent locally: since domestic production has not risen in the transaction, the exporter’s expenditure will not drive prices up in order to ration others out of the market. In this sense, a traditional deficit is less damaging as it generally adds to output and therefore dampens some of the inflationary pressure; the
A final inflationary impetus was the misalignment in relative prices provoked by the combination of selective price controls and demand expansion. While administered or controlled prices rose only 38.4 percent in the first seventeen months of the program (between July 1985 and December 1986), uncontrolled prices shot up 133.9 percent (Paus 1990: 15). The reason lay in the pressure rising income placed on “flex-price” markets and the phenomenon did yield some positive distributional consequences: the rural-urban terms of trade shifted toward flex-price agriculture by nearly 40 percent between 1985 and 1987 and informal sector income rose over 80 percent in the same period (see Table 4). This, however, implied that inertial inflation had not been eliminated outside of formal industry and that once the controls were lifted, industrialists would engage in an inflationary round of price hikes in order to restore the relative prices they had enjoyed prior to “stabilization.” Inflationary pressures, in short, were bottled up but not eliminated.

Class relations

The APRA program was a complicated social-democratic “dance” in which the government tried to incorporate workers, campesinos, and informals via higher incomes while leaving the investment decision in the hands of private capital. Initially wages as well as farmer and informal income rose, cementing the political alliance with those sectors and providing the burst of aggregate demand needed for reactivation. In the long run, however, the very future of the program hinged on a private investment boom that would expand capacity, particularly in the export sector, in order to relieve foreign exchange and inflation constraints.

To convince business to play its designated role, the APRA government reduced its own investment program to create space for the private sector (despite evidence that public investment had actually been complementary to private investment in Peru’s past (Pastor 1990b); protected profit margins by combining real wage hikes with reductions in taxes, interest rates, and parastatal prices; and began a series of direct meetings between García and representatives from the country’s twelve largest business groups (the so-called “twelve apostles”).

brecha cambiaria that arose from the multiple exchange rate system was more dangerous. The figure for the extent of the brecha comes from Paus (1990: 20) citing Dornbusch and Edwards (1989).

20 This argument borrows heavily from the excellent analysis in Paus (1990).
TABLE 5
Public Sector Finances in Peru, 1980-88

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<tr>
<th>Year</th>
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Notes: Data on central government income and expenditures as a percentage of GDP taken from Cuanto (1990a: 755-56); public sector income and expenditures from Cuanto (1990a: 738-39); nominal GDP from Cuanto (1990a: 263). Real tax income and central government expenditures calculated using the relevant expenditure deflator taken from Institute of National Statistics (INE) (1989: 546, 548). The figures for the public sector include the central government as well as state enterprises, local governments, public institutions, and the social security system. The deficit figures are for the “economic” deficit (i.e., not including amortization). The central government deficit as a percentage of GDP for 1989 is figured as a simple average of the monthly series reported in Cuanto (1990b: 11) and is quite preliminary.
This process of government-business *concertación* or negotiation did yield some positive results: private investment rose from twelve percent of GDP in 1985 to over fourteen percent of GDP 1987. But the private sector remained wary, put off by an early government attempt to sop up profits with a mandatory bond-purchasing scheme (which was soon suspended because it was unconstitutional) and concerned about the generally unstable political climate. García, frustrated with the slow progress on the investment front, decided to nationalize the country’s remaining private banks as a way of gaining leverage over the “twelve apostles” and preventing capital flight through the banking system. Devised in secret by a small group of advisors, the announcement of the measure in a July 1987 speech by the President—billed as a way to “democratize” credit—signalled the death of any semblance of *concertación* and brought the beginning of a war with private capital.

Unfortunately, the struggle over the banks gained García few allies and gave birth to a new rightist opposition. Labor was already alienated from García owing to his previous courting of capital while the left opposition, the IU, supported the attempted bank seizure and criticized virtually every other initiative of the APRA government. Meanwhile, Mario Vargas Llosa became the darling of the Peruvian right by forming a “Liberty Movement” which cast the nationalization as an arbitrary taking of private property that threatened not just big business but everyone—from middle-class entrepreneurs to informal street vendors. In the end, the banks remained private owing to a combination of legal challenges and, in some banks, the devolution of majority ownership to employees (a category exempted from the nationalization decree). Unfortunately, the damage was done: García was isolated politically, business was hostile, and the right, once marginalized by its poor showings in the 1985 elections, was reborn.

**Administrative Capacity**

The problems described above—excessive consumption of reserves, scant attention to underlying inflationary dynamics, and an ill-considered attack on the same capitalist class needed to save the program—were exacerbated by the administrative incapacity of the government. The Peruvian state, already weak, suffered a further gutting during the “free-market” era of the early 1980s. The García administration aggravated this trend by provoking interagency conflict, isolating key policymakers, and because of García’s overly Presidential style (Wise 1989).

The interagency conflicts involved both politics and policy. The Ministry of Economics and Finance was controlled by Alva Castro, a potential challenger within the APRA to Alan García; while generally supportive of the heterodox growth model, Alva Castro resigned as soon as problems emerged, apparently to protect his political standing for the 1990 Presidential elections. The Central Bank, while headed by a García supporter, retained its traditional support of more conservative policy, particularly in the ranks of middle management. The Institute for National Planning experienced an institutional revival, becoming home to many of the economists and technicians who made up the heterodox *equipo*. Its long-
term plans were, however, quickly ignored and the Institute itself was torn by internal dissent, as one of the authors discovered when he made a presentation on macroeconomic stabilization at INP in mid-1988.

Economic policy-making quickly became the domain of the President and a small group of advisors. Like Belaúnde’s technocratic “dynamo” group of the early 1980s, the heterodox equipo was highly insulated but extremely influential, a combination that created several problems for actually implementing policy. First, middle managers in the various ministries neither understood the program, nor believed in it, and often carried out state directives with reluctance at best. Second, the wide discretionary power of the team allowed it to engage in sharp policy shifts (for example, the mandatory bonds and the nationalization); had the team exercised less influence with García, policy change would have been moderated by the typical interministerial consultations and negotiations. Third, the smallness of the team and its reliance on executive mandate gave the President, in turn, an extraordinary degree of control over economic policy. García, it is said, took carefully crafted adjustment packages and arbitrarily changed policy measures in order to soften the political impact; the result was economic inconsistency. By mid-1988, even the small team was bickering amongst itself, particularly over exchange rate policy.

The failure of the heterodox program and the passage into hyperinflation brought additional difficulties. Tax revenues fell, dragging government expenditures down with them; both government salaries and the ability to effect change declined, reducing the incentives for public service. Hyperinflation made planning as difficult for the state as it did for the private sector. Finally, the collapse of heterodoxy in 1988 led the equipo to abandon their positions (and, in the case of Presidential advisor, Daniel Carbonetto, the country). This further isolated the President and left him with no economic advisor with whom he was truly comfortable, a fact that would pose severe problems in the final year and a half of the García administration.

Hyperinflation

By mid-1988, the critical nature of the economic situation forced a major policy shift. In September, the government pushed through a combination of sharp devaluation, public sector price hikes, and several tax-raising measures (including a shortening of collection lags to combat the Tanzi-Olivera effect and a somewhat misguided four percent tax on exports). The government proposed an industrial price freeze but allowed adjustments prior to its imposition; the result was a extraordinary round of preemptive price hikes. In September alone, inflation hit one hundred and fourteen percent while GDP fell ten percent. Hyperinflation had set in and monthly inflation averaged thirty-five percent from October 1988 through July 1990 when the new President took power (see Figure 1). Meanwhile, output continued to fall; while it recuperated a bit in mid-1989, by April 1990, GDP was fifteen percent its level in

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21 Prominent among these latter was Daniel Carbonetto, an Argentine who shared Alan García’s social-democratic vision and who took the lead in implementing the heterodox model.
July 1985, the first month of the Garcia administration, and thirty percent below the December 1986 peak reached during the glory days of the heterodox experiment.
The persistence of hyperinflation through 1989 and 1990 may be somewhat surprising given the general improvement in the fiscal deficit, the trade balance, and the level of reserves through this period. While the continuing price pressure was partly due to the government’s strategy of reactivating the economy in time for the November 1989 municipal and March 1990 Presidential elections, it was also a “normal” part of hyperinflationary dynamics. Hyperinflations are generally characterized by large deficits and rising exchange rates; as the inflation progresses, all prices become tied to a foreign currency, implying that both fiscal discipline and exchange stabilization are crucial to finally stopping the price increases (Pastor 1991, Sachs 1986, and Sargent 1986). Unfortunately, instilling confidence that the fiscal and exchange reforms will stick usually requires a dramatic change in political or policy regime.

In Peru’s neighbor, Bolivia, the leftist government of Hernan Siles Zuazo failed to stop a hyperinflation with several well-constructed and quite orthodox packages. He eventually gave up, called elections early, and the incoming President implemented a similar set of macroeconomic reforms with much better results (Morales 1987, and Pastor 1991). García held on until the designated transfer of power; a positive turn for the Peruvian democratic tradition but a negative turn for the economy.

As the electoral season began, both the right and left offered their own solutions to the hyperinflation. Vargas Llosa, heading a rightist coalition labeled the Democratic Front (FREDEMO), promised to reduce inflation to ten percent with a harsh program of cuts in public spending, mass firings of state workers, privatization of public enterprises, devaluation, liberalization of both imports and domestic markets, and tight monetary policy. After observing the problematic experience of Argentine President Carlos Menem with such a program, Vargas Llosa backpedaled and said he would only implement the proposed “shock” after he engaged in a massive monetary emission that would drive inflation up and reduce the real value of government debt. This curious attack on asset-holders by a politician of the right was only matched by the seemingly odd nature of the left’s proposal. Fueled by the analysis of Oscar Dancourt and Ivory Yong (1989), the left argued that since the final stage of hyperinflation (prior to its demise) involved total dollarization and since some prices seemed to move independently of the exchange rate, it would be best to “artificially” accelerate the process and dollarize all prices as soon as possible. Such an appeal to the “imperialist” currency was unusual but offered one way to protect real wages during adjustment. To rescue national sovereignty and monetary independence, the proposal involved the creation of a new currency, the amaru, which would be tied to the dollar but not convertible, leading to obvious questions as to why anyone would accept it.

Against this backdrop, Alberto Fujimori, the Peruvian son of Japanese immigrants promised to lick inflation with “Honesty, Technology, and Work.” He won.

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Webb, in commenting on Kuczynski’s (1990) sharp attack on the García government, examines the contrast between raging inflation and the improvement in fiscal and external sector variables and suggests that “I have a sense that we do not know enough about what makes or breaks an adjustment program” (Webb 1990: 104). Would that other key protagonists in the Peruvian drama were so modest.
Requiem for Heterodoxy

With heterodoxy seemingly dead in Peru, it is useful to consider whether the experiment really represented a new approach or whether it simply constituted, as Dornbusch and Edwards (1989) argue, a new form of traditional Latin American populism? Such populist episodes generally involve governments that try to put together a multiclass coalition that favors the working class but also courts capital; to do this, the government tries to make up for squeezed profit margins with rapid growth that preserves the mass of profits and hence the profit rate on installed capacity. Growth is achieved through a rapid expansion of demand which in turns brings swelling imports, inflationary pressures, fears of devaluation, and eventually capital flight. As the class alliance shatters, the program collapses and a new government arrives (sometimes through a military coup) to reverse both the macroeconomic policies and distributional concerns.23

The Peruvian pattern certainly fits this populist paradigm in terms of macroeconomic and political outcomes. But both Peruvian heterodoxy and García’s political project were, we would suggest, more sophisticated and coherent than their populist cousins in Perón’s Argentina and Allende’s Chile. The limits on debt service were both necessary and initially well-designed; the program was shipwrecked primarily because the debt strategy was accompanied by attention-getting rhetoric and because, forgetting their structuralist roots, the heterodox team allowed the economy to expand beyond its external bottlenecks.24 Controls on key prices to slow inertial inflation were well considered and have been used with success in, for example, Mexico since late 1987; the problem in Peru was coupling selective price controls with demand expansion, a combination that misaligned relative prices and only temporarily smothered inflationary pressures.

On the political side, García’s social democratic project of redistribution downward while preserving the private sector’s investment role was a “last-ditch” effort to create a capitalism that could counter the violent challenge posed by long-standing inequities and the increasingly violent response by Sendero and others. The problem with this “Rooseveltian” response to economic crisis was both structural and conjunctural: (1) social democracy in small, dependent economies seems to traditionally collapse into populism, primarily because of the external structural constraints; and (2) García’s chaotic and shifting approach to capital was unlikely to have a positive effect on business confidence.

We do not intend here a defense of Peruvian heterodoxy as practiced. Elements of the program—the complete discounting of fiscal deficits and monetary emission, the notion that real wage increases would spur demand without denting profitability, and the view that real interest rates on the

23 This populist “story” draws from Diaz-Alejandro (1981), Drake (1982), Sachs (1989), Dornbusch and Edwards (1989), and our own experience in Peru.
24 Sachs (1989: 30-31) also suggests that “many actions of the populist governments (such as the debt moratoria of Peru and Brazil in the 1980s...) may be meritorious even though they are... part of an otherwise ill-designed program.”
order of minus thirty to minus forty percent in 1987 were not a real problem—defied common sense as well as economic logic. But, as Eva Paus has argued, “the failure of the Peruvian heterodox program does not warrant the conclusion that a well-conceived and implemented heterodox program cannot work” (Paus 1990: 25; emphasis added).

Unfortunately, any such reconstituted heterodox program, whatever its merits, would have no chance in the current Peruvian context, primarily because of the painful memories of the last experiment. Indeed, one of the strongest indictments against García is that his government managed to completely discredit both the neostructuralist approach and the notion of progressive redistribution, paving the way for a new era of orthodox economic policy and the reduction in lower class income it is likely to bring. Through a combination of poorly designed policy, poorer implementation, and even poorer political coalition-building, the García government both hurt those it promised to help and fed into the continuing spiral of violence.

CONCLUSION

In this paper, we have reviewed Peruvian economic policy throughout the 1980s with an eye toward the issues of policy shift and consistency in implementation. On these fronts, the Peruvian record may be among the worst in current-day Latin America.

The neoliberal program of the early 1980s represented a continuation of the policy trends of the late 1970s but also constituted a dramatic change from the more interventionist Velasco period. The program failed in Peru because it was poorly conceived and executed: (1) the analysis of inflation generally ignored cost-push factors and the resulting policy focus on restricting demand produced recession without cutting inflation; (2) policy measures were often reversed mid-stream because of either economic or political pressures; and (3) the neoliberal intention to reduce the public sector made virtually no inroads, although it did do much to erode the administrative capacity to implement any development program at all. Those who so keenly embraced the neoliberal paradigm in the last elections seem to have forgotten its earlier failure; rather than subscribing to amnesia, neoliberal enthusiasts would have done well to study the previous experience and offer clear reasons why a rerun would have been less simultaneously painful and fruitless.

In the latter half of the 1980s, orthodoxy was dropped in favor of an untested heterodox program. While the heterodox analysis of both Peruvian economic structure and orthodox failures was compelling, the policy results have basically discredited any such approach to Peruvian reality. Part of the problem lay in conception: fiscal deficits matter, prices cannot be arbitrarily defined, and external constraints deserve early attention. But whatever the conceptual shortcoming, García’s implementation of the heterodox/social democratic program was even worse. Euphoric over the early success at rekindling growth, slowing inflation, and improving the lot of the poor, García and his highly insulated team refused to
make necessary mid-course corrections (Thorp 1987, and Mann and Pastor 1989). Meanwhile, García alienated labor and international creditors, then provoked a war with domestic capital by attempting to nationalize the banking system. With his political base evaporated and heterodoxy in shambles, García offered a series of one-shot orthodox policy packages which did little to slow Peru’s passage into hyperinflation and depression.

Now a new President has heralded yet another dramatic shift in policy. On August 8, 1990, Alberto Fujimori announced a series of measures that included a three thousand percent increase in gasoline prices (basically to raise government revenues), sharp upward adjustments in food and public sector prices, elimination of the multiple exchange rate system and thus an effective devaluation, and an unclear but generally unsupportive approach to wage compensation. In broad terms, the program resembles Bolivia’s 1985 orthodox stabilization package; matching Bolivia’s anti-inflation success, however, will be difficult given the legacy of the last ten years of policy shifts and inconsistency.

First, the issues of income distribution—a concern that was to be the special focus of García—remain largely unaddressed. After a brief improvement in the first years of the APRA government, real wages (and wage share) are now lower than at any time in the decade. Informal sector income has also plunged to its lowest levels while the rural-urban terms of trade have lost the ground gained in the first period of heterodoxy. Having promised to serve the poor, García instead created a situation in which the share of income accruing to property-owners (profits, interest, and rent) rose to its highest level in this decade. The inequalities wracking Peruvian society thus remain and have indeed been exacerbated by the failure of the heterodox experiment.

The worsened distribution of income has fed into the cycle of violence that began with Sendero Luminoso’s entrance onto the scene at the beginning of this last decade. After suffering a temporary setback in June 1986 with the mass execution of 270 of its militants by the armed forces in three Lima prisons, Sendero has managed to regroup. Its reach has extended beyond the central and southern Andes to the coca-producing region of the Upper Huallaga Valley and into Lima itself, particularly into the factories, universities, and social organizations that were the traditional political footholds of IU and APRA. A new leftist insurgency, the Tupac Amaru Revolutionary Movement, has arisen while the APRA party itself has fielded the Rodrigo Franco Command, a death squad that has readily claimed responsibility for assaults on Sendero sympathizers and, for that matter, anyone who openly criticized the García government. The military has responded with the indiscriminate use of force, intimidation, and human rights abuses, particularly in the designated “Emergency Zones.” Against this backdrop of social cleavages and intense violence, achieving consensus on an adjustment package is difficult, to say the least.

Second, the state has been weakened by both the collapse in tax revenues and the highly Presidential styles of both Belaúnde and García. Reviving the state is a priority but requires the recruitment and delegation of authority to qualified managers beyond the Presidential Palace. This shift in
decision-making style and concentration of power will obviously take time. For the short run, Fujimori seems to have recognized the weaknesses of the Peruvian state and has instead focused his efforts on a few simple policy measures designed to attack the hyperinflation. He has also assembled the most qualified economic team and cabinet to emerge during the period we have discussed.

Third, Peru has become increasingly isolated from the international economy in general and from the international financial system in particular. This legacy of the Garcia period will create several problems for the Fujimori administration. While the “Fuji-shock” of August 1990 has received quiet words of approval from international agencies, there are nearly $2 billion in arrears to the multilaterals and official lenders and this will impede any quick return of official capital. Bolivia survived the period between stabilization and the reopening of official lending bylegalizing the deposit of dollars without proof of origin, a thinly disguised ploy to tap the flow of coca-dollars. Coca-dollars have already been circulating in Peru’s formal and informal financial system with no questions asked since 1978, implying that this avenue of dollar inflows has already been used; hesitancy about the seriousness of the new Peruvian program, the matter of arrears, and the generally slow movement of international bureaucracies mean that Peru can expect no rapid relief on the external side.

Fourth, after a decade of dramatic swings in policy that have yielded little in the long term, the Peruvian people have little faith in promises of adjustment and hence low commitment to the success of a new program. Fujimori won the Presidency for a number of reasons, including a racial dynamic in which Vargas Llosa’s European features and preferences counted against him with the oft-exploited peasants and workers. Vargas Llosa was also seen as an independent who had subsequently transformed himself into a tool of the traditional rightist parties. But one key—and perhaps the crucial—reason for Fujimori’s victory was that he offered an opportunity to vote against the severe orthodox shock proposed by Mario Vargas Llosa. Why, Peruvian voters seemed to reason, should the country go through new and dramatic programs when history suggests that positive results are unlikely? This general lack of credibility will present problems for the Fujimori administration, particularly since the President began his administration by reversing his campaign promises and instituting harsh austerity measures.

Through the decade of the 1980s, Peru has been torn apart by exogenous shocks, continuing distributional and political conflicts, and shifting and ineffective macroeconomic policy. With a thin political base, little experience, and abundant skepticism, President Fujimori is trying to stop the hyperinflation with time-honored medicine: cutting the fiscal deficit, restricting monetary growth, and stabilizing the exchange rate by forcing a liquidity crisis that will induce economic actors to sell their dollars back to the Central Bank. Along the way, the poor—bewildered by Fujimori’s seeming betrayal but conditioned by a history of exploitation—will, as in the rest of the decade, ultimately pay the price.
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