

# WIDER

STABILIZATION AND ADJUSTMENT  
POLICIES AND PROGRAMMES

**COUNTRY STUDY**

**8**

**PERU**

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STABILIZATION AND ADJUSTMENT  
PROGRAMMES AND POLICIES

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COUNTRY STUDY: **PERU**

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## PREFACE BY THE DIRECTOR

This monograph is part of a series being published by WIDER on the experience of developing countries with stabilization and adjustment programmes in the 1970s and 1980s. Each study analyzes the package of policies implemented by a specific country; its relations with the IMF and World Bank; the effects of the policies on production, employment, the balance of payments and social welfare; and what other policies might have been followed instead.

The intention of the series is to assist developing countries to devise adjustment policies that would, while accomplishing desirable adjustment and growth objectives, simultaneously remain politically viable in the particular country settings studied.

For this purpose it was thought desirable to explore policy alternatives to the adjustment programmes being implemented. Built into the design of the series, therefore - and constituting indeed its special feature - is the requirement that each study include a 'counterfactual' exercise to illustrate the effects of alternative policies. Utilizing econometric models adapted or specifically developed for each country, the probable effects of alternative policy packages are estimated; the object was to see how far the balance-of-payments adjustment and growth goals of a particular programme might have been achieved at a possibly lower social cost with a different policy mix.

Each country study is written by an independent scholar and expert in the relevant country. First drafts of the studies in this series were discussed at the WIDER conference on stabilization and adjustment policies in developing countries which was held 19-22 August, 1986 in Helsinki. Each study has been reviewed by WIDER's research advisers for the project, Professors Gerry Helleiner and Lance Taylor, and revised substantively by the author as necessary; subsequent editing has been conducted under the overall supervision of Mr Robert Pringle, Senior Fellow, who serves also as editorial adviser on WIDER publications.

A companion volume by Professor Taylor summarizing the experience of the countries surveyed will draw broader implications for the theory and practice of stabilization and adjustment policies; this volume will be published by Oxford University Press. The individual country studies in this series will subsequently be grouped into separate volumes, also for eventual publication by Oxford University Press.

Lal Jayawardena  
Director  
March 1987

## EXECUTIVE SUMMARY

Peru ran out of cash in July 1984; a year later President Garcia rejected an IMF agreement and limited debt service payments to 10 per cent of export earnings; and in mid-1986 the President said that Peru would pay 'when it chose and when it could'.

Creditors understandably tried to present Peru as a special case. This line wore thin, however, as other countries made clear in various ways that they were not willing to continue full debt service.

Peru suffered in 1983 from an improbable and unfortunate combination of shocks: the terms of trade sinking to their lowest level in two decades, withdrawal of trade credit, and freak weather conditions that by themselves caused an estimated 5.4 per cent loss of GDP. For an economy already weakened by misuse of foreign borrowing, poorly managed state intervention and six or seven years of financial instability and capital flight, these shocks precipitated a crisis from which Peru has failed to recover.

But this was all made worse by the blunt instruments used to effect adjustment - notably cuts in real government spending and generalized deflation. The economy seemed to be caught in a series of vicious circles in which further adjustment efforts had both positive and negative effects, exacting a high price in both inflation and recession, and in political erosion, for marginal fiscal and balance-of-payments improvements. Significantly, even such severe adjustment efforts could not prevent the breakdown of normal debt service.

There was a clear failure to see the need for a major political input in the management of what had become an emergency. When it came to designing a political programme for dealing with the emergency, the Fund and Bank had no expertise.

Peru has still not achieved stability, despite the energy of the 1985 anti-inflationary plan and the severity of balance of payments measures. Output growth over 1986-87 will total between 14 and 15 per cent, meaning a recovery of most of the 1983-85 loss, and a runaway inflation has been arrested and held at about 60 per cent per year. A radical position on debt servicing has created some room for manoeuvre. These short run gains, however, have been achieved through measures that are effective only in the short run. The costs of the debt stance, through reduced disbursements and higher import prices, will increase. The check on inflation is creating relative price distortions that cannot be sustained. The reduction of imports is so far based entirely on controls: the exchange rate appreciated substantially between 1985 and early 1987, and import pressures are building up rather than decreasing. All exports have been penalized by the exchange rate appreciation, despite higher export subsidies. Capital flight is increasing.

## I. INTRODUCTION

Peru's economy has swung through two strong cycles since the early 1970s. The starting point was an internal demand-led expansion in the early 1970s that broke a long record of price stability. During this first cycle, inflation rose from about 10 per cent per year to between 60 and 70 per cent and the economy suffered a severe recession during 1977-78. The cycle closed with an exceptionally sharp export boom in 1979-80. The second cycle was even more violent. Output first stagnated during 1980-82 and then fell 16 per cent over 15 months. Inflation followed a step pattern: after running steady for five years along a 60 to 70 per cent plateau, it doubled suddenly to 120 per cent in early 1983, and doubled again to about 250 per cent in early 1985. The end of this second cycle has been equally exceptional: shock treatment dropped inflation to about 60 per cent after August 1985 and output, with symmetric justice, recovered 16 per cent over the fifteen month period ending in December 1986.

As elsewhere, these cycles were closely related to external events during the 1970s and 1980s, including fluctuations in commodity prices, and changes in interest rates, in the degree of protectionism, and in access to foreign capital.

But, to an increasing extent, these cycles have been 'made in Peru'. A 31 per cent drop in export prices between 1974 and 1978 could be blamed for the crisis during those years, but Peru had ridden out a series of sharp export fluctuations in the past with less output loss and without losing its record of relative price stability. Two reasons may be suggested for the greater disruption after 1974. One is the particularly immoderate expansion of domestic demand during the preceding years. A second explanation could be structural weakening of the economy produced by over a decade of increasing intervention and distortions in

markets, and by growing insecurity as a result of legislative changes and, especially, the property reforms of the early 1970s.

The severity of the 1976-78 crisis could also be attributed, in part, to poor management: neglect of exports and agriculture, foreign exchange controls that greatly increased capital flight, and a lack of timely expenditure switching measures followed by excessive deflation.

The same argument holds for the 1982-85 crisis. This time, external factors ganged up on Peru: the effects of world recession, protectionism, higher interest rates and closure of financial markets were aggravated by a natural disaster - a climatic change associated with the El Nino current which caused enormous damage to crops and infrastructure and an estimated total loss equal to 5 per cent of GDP.

Once again, however, the unprecedented scale of disruption - three digit inflation, massive capital flight and loss of investment, a 16 per cent fall in real GDP - suggests some help from domestic causes.

The purpose of this paper is to identify those causes.

Section 2 below describes some features of the structure of the economy that bear on macro policy and its effects between 1979 and 1985. Sections 3, 4 and 5 review the evolution of policy and the economy with a view to understanding the origins of the crisis, and then during up to just before the change of government in July 1985 and launching of a new shock programme. Section 5 discusses some of the general issues that are raised by these events.



## II. SOME STRUCTURAL FEATURES

This section will describe some structural features of the economy that help to explain policy decisions over recent years and that influence the effects of those policies. The first is the social matrix, which bears on both cause and effect of policies. The second is market structure, from the point of view of output vs. price adjustment. The third is the set of less tangible, qualitative features that include business confidence, degree of distributive conflict, and entrepreneurial flexibility, features that condition the response of economic agents to shocks and to policy measures.

### 1. The social matrix

From the point of view of both the causes and effects of economic policy, the main social divisions in Peru continue to be those between the urban and rural populations, and between those employed in the modern and informal sectors.

Peasant farmers in the Sierra or Andean region are the 'hard core' poor. Despite a radical land reform, and decades of road-building, mining investments, growth of local small towns, and migration westward down to coastal farms and cities and eastward into the jungle frontier, about one million families, or 25 per cent of the population, continue to live extremely isolated, neglected, and precarious lives depending on very small plots and herds. About one third of their output is for subsistence or for local consumption, and the rest is sold to urban markets. Most of these families, however, supplement their farm income by doing wage labour on larger farms, particularly in coca-rich jungle areas or on the more developed coastal estates - now all turned into co-operatives. Others supplement their incomes working seasons or for a year or two in mines, as

construction labourers, or in a variety of urban trade and service activities.

Other farmers are less poor, though most would classify in the poorest three quartiles of the population. A small group of some 50,000 families were the recipients of estates expropriated during the 1970 land reform. Most sugar, about half of the cotton crop, and a quarter of the rice crop are grown on co-operative estates. Sugar and cotton were principal export crops thirty years ago but are now almost entirely directed at supplying urban needs. Along with rice, these crops are subject to considerable marketing control by the government and, as a result, are involved in a continual tug-of-war with local textile interests and politicians demanding cheap rice and sugar. Despite their centre-stage role in the early 1970s under a government looking for third-way modes of production, the co-operatives have had little leverage on subsequent regimes and their economic base has been eroded by a combination of poor management and price squeeze.

About half of total farm output is produced by a less conspicuous class of medium scale, commercially-oriented farmers who account for between 20 per cent of rural farm households. These farmers produce most of Peru's farm exports - coca, coffee, and some minor products - and supply most of the urban population's food needs. As a group, however, they have had virtually no voice. In addition to the handicaps created by social and geographical fragmentation, they are politically separated from leftist co-operative leaders, and from the even more leftist groups who claim to represent the indigenous peasant communities. One exception has been the rice-growers organization, made up largely of medium-scale farmers on the coast and jungle, whose strength derives from the fact that their crop is sold entirely to the government.

The urban population can be divided into five groups differentiated according to the nature of their main income source and the technology and size of the enterprises they work for, as shown in Table 1.

In 1981, 62 per cent of the population lived in urban areas and received 85 per cent of national income. About two-thirds of national income originated in large-scale, modern business or in government, which together employ a quarter of the labour force (Table 1). That income was shared by two relatively small groups: some 500,000 employees (9 per cent of the labour force) of private and publicly owned mining, banking, manufacturing and other modern sector, mostly large scale enterprises, and the capitalists, rentiers and interest recipients of those enterprises.

The workers in these enterprises have well-developed unions at the plant level. Broader union organizations, by contrast, are relatively weak, with a few exceptions, such as the union of bank workers. Wages are set through annual collective bargaining at the plant level, with the Ministry of Labour acting as arbiter and usually also as an advocate in one direction or the other. Even during the years of highest inflation, 1983-85, collective wage agreements continued to be the principal determinants of wage adjustments, though the degree of government intervention increased through an obligatory partial indexation clause that required two cost of living adjustments during the annual agreement. Over 80 per cent of these workers live in Lima and a few other large cities; their level of schooling is relatively high; and a large proportion are non-manuals and professionals. Payment in kind - transport, medical attention, housing and other benefits - tends to be large. Throughout the 1980-85 period the communist or opposition APRA union leadership of almost all these unions sought to unsettle the centrist Accion Popular regime, by repeatedly calling for general strikes, for instance, in addition to

seeking maximum wage increases. As will be seen below, however, the unions were unable to prevent a substantial loss of real purchasing power by their members during the crisis.

Government employees are a comparable modern sector group. They numbered 467,000 in 1981, 9 per cent of the labour force. Unions are forbidden in government employment, but collective organizations exist anyway and were active in formulating demands, organizing demonstrations, and making public statements on a variety of political issues as well as on their wage demands. As with enterprise employees, these organizations were almost entirely run by communist or Aprista political groups. Perhaps the most powerful of these unofficial unions is the teacher's organization that groups the largest single category of government employees, some 120,000 teachers, and which has one of the most radical leaderships.

The military and police are a separable subgroup within government employment. They are barred from any public representation of their economic interests but, of course, have an enormous capacity for private pressure. The outbreak of Sendero Luminoso in 1981 followed by an annual escalation of violence, gave both military and police security forces an even stronger bargaining position than they have normally.

The largest category of employees are the non-unionized workers of small scale or informal enterprises, mostly in urban areas. This group totalled 1.3 million workers, or 21 per cent of the 1981 labour force. They tend to be young, unschooled and unskilled, and on the move. Wages are increasingly influenced by the official minimum wage but the weakness of government administrative or policing capacity outside the modern sector, the absence of any form of worker organization, the prevalence of payment in kind (including apprenticeship and inter-family reciprocal or barter

arrangements), as well as the dispersion and lack of correlation with legal minimum rates, all suggest that supply and demand dominate the wage-setting process. This group is the closest to a proletariat in their dependence on pure labour and in their poverty, so it is interesting to note again that they account for only a fifth of the labour force, and that they are devoid of any organization, and occupied principally in service rather than manufacturing activities.

Non-agricultural property income is shared by modern sector capitalists, including the state, and a large class of proprietors of small scale establishments in all activities. A difficult to estimate proportion consists of rents and interest income that is received by the population at large. Also, the national accounts do not attempt to separate out the property income component in the net entrepreneurial income of small enterprise owners.

Owners of informal sector establishments, including their family workers, account for a full quarter of the labour force. Like their employees, discussed above, they participate in an enormous diversity of activities, though preponderantly in services, with an increasingly large component of modern technology, and in a variety of business relationships running from inter-family reciprocal arrangements to subcontracting for the government and modern sector. Their economic interests coincide, to a large extent, with those of the modern sector. At the same time, the greater labour intensity of their establishments, compared with the modern sector, means a sharper conflict with labour. Their relationship with the government is also more conflictual than that of large enterprises: they are forced to operate outside the law by the impossible cost and formality of legal requirements; they pay almost no taxes and receive few of the credit, exchange rate, licensing and other benefits obtained by larger establishments.

Modern sector capitalists are entirely non-agricultural, since the 1970 land reform. Foreign ownership is concentrated in oil, mining, and manufacturing, although nationalizations during the 1970s reduced the share considerably. Dividends and undistributed profits accruing to foreign owners accounted for only 3 per cent of GDP in 1981. State enterprises now own about half the modern sector capital stock, mostly in oil and mining, energy and communications.

As a class, capitalists are relatively weak in Peru, divided across activities, and lacking organization and lobbying capacity.

## 2. Price and output determination

The structure of domestic final demand in terms of price formation mechanisms over the 1980-85 period is summarized in Table 2. Even before the extension of direct controls in August 1985 under the anti-inflationary shock programme, the extent of direct price setting by the government was one third of domestic final demand. The largest category, however, corresponded to goods and services subject to some degree of mark-up pricing: 23 per cent of final demand to a strong degree, due to greater concentration in the structure of output and more product homogeneity, and 17 per cent to a lesser degree due to greater competition, particularly in the form of a large share of small scale output, and more product diversity. By this classification, only 27 per cent of final demand was bought in flex-price markets.

Most personal services and perishable farm products have been counted as flex-price sectors, but output response is relatively quick in the case of vegetables, beans, and some other farm products which can be grown in about three months at any time of the year in Peru.

The extent of government influence on pricing is larger than the 33 per cent shown in Table 2. In addition to direct price-setting of final demand items such as fuels, rice and bread, and public services, the government influences prices in the fixed and flex-price sectors through the prices of key inputs, particularly the exchange rate, and interest rates. To a much lesser extent, the government also influences wage-setting in the modern sector. Imports of goods and services amounted to 19.4 per cent of final demand over the crucial 1982-83 period which saw inflation double under the effect of cost shocks, including a doubling in the rate of devaluation. The prices of key inputs also become signals, especially the exchange rate and the price of gasoline which, in Peru is commonly believed to affect food and other prices.

Outside the direct price fixing sector, the extent of flex-pricing probably diminishes as inflation accelerates, since prices must be adjusted more frequently and normal lags in market feedback force producers to rely more and more on some form of indexation, generally to key input prices or to general price signals in the economy, such as the rate of inflation or of devaluation.

In all, there is a considerable degree of price administration by government and producers, with adjustment occurring through output or, in the case of government controlled prices, through changing levels of subsidy.

### **3. A weakened economy**

Peru's stabilization experience between 1980 and 1985 was conditioned by the weakening of the economy that took place during the previous ten to fifteen years. Heightened macroeconomic and legal instability during those years affected business confidence, and raised the level of distributive conflict; the large expansion of government

intervention reduced the efficiency and flexibility of markets.

That prior experience had two stages. The first (1970-75) saw a marked increase in government regulation and direct participation, through public enterprises, in the economy. Dirigisme was accompanied by redistributive measures that broke the rules of the game with respect to investor guarantees, for both foreign and national investors. Those measures included an agrarian reform carried out with minimal compensation and a great deal of hostility, and laws that transferred part of mining and manufacturing sector share ownership, as well as profits, to workers, giving them a say in company boards and access to company books. Similar laws were drawn up for commerce and other sectors and, though they never appeared, the threat remained. Business was also affected by a labour stability law that gave workers virtual job tenure, and which continues to be a major disincentive to investment, particularly in labour-intensive processes. Finally, the government expropriated a large part of the mining, fishing, communications, and banking sectors, and some manufacturing companies, of both national and foreign ownership. Both the rules for, and terms of expropriation were ad hoc.

Regularly intervention was increased through import and exchange controls, detailed rules for investment, and many other rules governing economic activity.

The second stage (1975-79) added macroeconomic instability to legal insecurity. As we mentioned at the start of this paper, inflation jumped from its traditional 10 per cent level to an average 44 per cent for the period 1975-79 and relative prices, specially of government controlled items such as the exchange rate, fuels, and some basic foods, suffered large and sudden swings. Access to foreign exchange became uncertain, after 25 years of easy



and certain availability. Output stagnated and investment dwindled.

The sharp recovery of the economy at the end of the decade helped to recover confidence but also exacerbated the impression of instability. Export volume grew 65 per cent over that period with the completion of an oil pipeline to the jungle, the opening of a major new copper mine, and an impressive boom in non-traditional exports which rose from \$96 to \$845 million in 4 years. A drastic austerity-imposed reduction in imports added to the improvement in the balance of payments. Output began to recover, growing 5.8 per cent in 1979 and 4.5 per cent in 1980, despite a rigorously orthodox stabilization programme.

The net effect of so much instability, however, was to shorten planning horizons, and to increase capital flight and other forms of non-productive savings. The turn to speculation was given an additional push by negative real interest rates for credit in intis. The decline in investment over most of the decade reduced growth potential and entrepreneurial flexibility. Gross private investment averaged 18 per cent of GDP in the 1950s, 12 per cent in the 1960s, and only 8 per cent in the 1970s. There are no direct measures of capital flight, but the sum of short term private capital movements and errors and omissions in the balance of payments switched from an inflow of 0.7 per cent of GDP per year over 1950-69, to an outflow equal to 1.1 per cent of GDP per year over 1970-79.

Changes in the structure of output over the 1970s added to the weakening of the economy. Agriculture was neglected even more than in previous decades, paradoxically, as a result of the agrarian reform which directed all government efforts to changes in tenure and which eliminated most private investment and technical expertise on medium and large farms. And overvaluation of the exchange rate over most of the decade countered the scarcity of foreign

exchange and contributed to an increase in the dependence of industry on imports, despite the scarcity of foreign exchange.

## III. THE HEART OF THE CRISIS: JUNE 1982 - JUNE 1983

The chronology of the crisis points to the mechanisms that were involved. The fall in production and jump in inflation occur almost simultaneously, and with comparable sharpness, during the last quarter of 1982 and first of 1983. Output begins to decline earlier, in mid-1982, but accelerates in the last quarter, falling 10 per cent in just six months. Inflation rises a little later, but more sharply: the jump from an annual rate of 86 per cent to 164 per cent occurs in the first quarter of 1983.

The crisis, therefore, was well on its way before El Nino appeared in December of 1982. Inflation was also on the rise, from a 1982 second quarter 59 per cent annual rate to a third quarter 68 per cent and fourth quarter 86 per cent. The natural disaster hits a previously weakened and now deteriorating economy, and the effect is to multiply recession and inflation. In all, GDP falls 16 per cent from its mid-1983 peak before it bottoms out at the end of 1983. Food prices soar during the whole of the first semester of 1983 as crops are damaged by heavy rains, and shipments blocked by flooding and landslides, but some abatement occurs towards the end of that period, and food inflation subsides during the second semester.

The sudden step from moderate stagflation to major crisis therefore has an immediate explanation in El Nino. The world recession seems to be an innocent bystander in this brief sequence, despite the presumption created by the combination of falling export prices, high interest rates, and Mexican collapse with its sequel in financial markets. That presumption is reinforced by the fact that most developing countries suffered severe recession and inflation during this period. Yet Peru's export prices, adjusted for foreign inflation, fall only 1.8 per cent between the second semester of 1982 and the first semester of 1983. Comparing the years as a whole, the decline is only 3.2 per cent. And

interest rates on the external debt actually fall, from a Prime-Libor average of 14 per cent in 1982 to 10 per cent during the first semester of 1983. Exports fall by \$231 million (12 per cent) during that semester but the fall can be traced directly to lost oil, fishing and mineral exports caused by flood damage and by the climatic change in the ocean.

But, standing back from the sequence of events during this short and shattering period, it seems that some connection must exist between the crisis and world recession, lower export prices, higher interest rates, and greater protectionism in trading partners (particularly neighbours), all of which affected Peru over the longer period 1980-85.

Also, the size of the output loss and inflationary jump beg the question of domestic policy. Different estimates of El Nino's impact on production attribute a maximum loss of between 4 to 5 percentage points of GDP during 1983, yet output fell 12 per cent. The impact of El Nino on inflation is measured by the 203 per cent annual rate of increase in the price of non-tradeable foods during the first semester of 1983. These items, however, account for only 13.4 per cent of the cost of living basket and their rise explains only 17.7 per cent of total inflation over that period. The government's decision to raise the price of gasoline and, in consequence, of bus fares, contributes almost as much - 16.8 per cent - to total inflation over that period.

For a more complete account of the crisis, therefore, it is necessary to step back and review the impact of world recession on Peru starting in 1981, as well as policy reactions to the weakening of the balance of payments and economy in general.

#### IV. IMMEDIATE BACKGROUND TO THE CRISIS: 1980-82

The disproportionate output and inflationary consequences of El Nino can be attributed, in part, to a failure in diagnosis during the immediately preceding years, and to the external shock that resulted from world recession during that period. The effect of that shock was to weaken the economy and increase its vulnerability to the additional shock of El Nino.

##### 1. The diagnosis

Policy response during this period was largely conditioned by Peru's experience during 1978-79. What stands out about those years is the particularly successful turn-around in the balance of payments that resulted from the happy coincidence of an energetically applied austerity programme, and an export price boom. By 1980, Peru was being held up as a model of good economic management by the IMF.

One effect of this success was to make it easier for policy-makers to ignore unresolved structural weaknesses, such as low productivity growth in agriculture, continuing low levels of saving and investment, and stagnating export volume. A second effect was to reinforce the presumption in favour of orthodoxy: the monetarist belief that most economic problems could be resolved through financial discipline.

During the following years, primary attention was given to fiscal and monetary policies, while growing overvaluation of the exchange rate was given little importance and the use of controls or other more direct interventions was dismissed. When the 1983 crisis arrived, it was a long time before non-monetarist solutions were even considered. Worries raised by emerging debt service difficulties towards the end of 1982 were dispelled by recalling a 'lesson' of the 1978-79 experience, namely that since balance of

payments deficits were the effect of monetary and fiscal looseness, debt payment capacity would be restored by balancing the budget.

This point of view can be illustrated by a phrase from a June 1979 IMF staff report on Peru: 'The key policy measures which account for the improvement in the balance of payments were the sharp reduction in the public sector deficit and the introduction of a flexible exchange rate in May 1978.' Yet, by the report's own figures, most of the improvement came from higher oil and mineral shipments made possible by a new copper mine and new oil pipeline, and by higher world commodity prices. Over the adjustment period, 1976-79, imports fell by \$350 million while exports rose \$1379 million. Moreover, two-thirds of the fall in imports was the effect of new oil production which made it possible to cut \$200 million in annual oil imports. Devaluation, however, did contribute to a \$670 million increase in non-traditional exports.

The Fund's argument was held consistently through the cycle: in an April 1984 press release it said that 'The major factor behind the imbalance in the Peruvian economy during 1982 and 1983 was the large deficit of the non-financial public sector.' El Nino and the 35 per cent fall in export prices during 1980-84 were mentioned but not stressed. What is more important is that most of the Peruvian government officials who had a hand in macroeconomic policy-making between 1977 and 1985 shared that diagnosis.

The approach to inflation, however, was less than fully orthodox during 1980-81. The diagnosis accepted the need to slow the growth of liquidity, driven during 1979-80 by a phenomenal increase in reserves, but placed considerable emphasis on both supply and expectational factors. It was also recognized that any anti-inflationary effort had to wait on the completion of a prior subsidy-elimination and

price-correction phase made necessary by the deliberate slowdown or freezes in key prices during late 1979 and early 1980 by the outgoing military government. It was realized that these corrections would cause a temporary jump in the rate of inflation, that would conflict with an effort to dampen expectations. The price corrections were originally scheduled for 1980, but were not carried out until January 1981. Another ingredient in the attitude towards inflation was the question of priorities: despite the conviction that the economy would never recover fully until inflation had been cut drastically, the government was unwilling to imperil the incipient output recovery that had begun in 1979. This choice has to be understood, partly, in the context of the preceding years: the repudiation of the military government carried a mental association between economic recovery and the return of democracy in mid-1980. At the same time, 1980 was seen as the end to a decade of economic frustration. The approach to inflation, therefore, was cautious, and monetary policy during 1980 and 1981 was designed to assure an adequate rate of growth of private sector credit.

The first anti-inflationary effort was an experiment in the control of expectations. After a rough, price-correction first quarter of 1981 - the annual inflation rate rose from 53 per cent in the last quarter of 1980 to 140 per cent in the first three months of 1981, including a brief acceleration in the rate of daily devaluation - the Central Bank announced a reduction in the rate of devaluation. The rate was not pre-announced, but an order of magnitude of about 2 per cent a month was hinted at. The objective was not to bring down inflation single-handed through the effect on expectations, but to reinforce the anti-inflationary effect of the anticipated monetary and fiscal discipline. The timing was also opportunistic in that good harvests were being projected for the following months.

Inflation fell in the following months: the annual rate was down to 50 per cent in the third quarter, while GDP continued to grow, but the effort was undermined that same year by the deterioration in the balance of payments, that forced the Central Bank to return to faster devaluation, and by the excessively expansionary nature of wage and fiscal policies.

By the end of 1981, the Central Bank had accepted the inevitability of a less accommodative monetary policy, partly to compensate for fiscal policy, and partly to restrain capital flight in the context of growing nervousness concerning the reserves. The effect on confidence of a loss of reserves in early 1981 was aggravated by political attacks that publicized and exaggerated that loss. During 1982, therefore, monetary targets were set below 1981 inflation but, to minimize the contractionary effect on production, the Central Bank allocated the entire projected growth of credit to the private sector, through reductions in commercial bank reserve requirements. The lack of a free credit market (or rather, the smallness and greyness of that market) make it hard to gauge the degree of monetary tightness achieved during 1982, but by July, 'informal market' rates for borrowing by large companies had risen to upwards of 15 per cent in real terms, well above official rates which, during most of the year, were about -5 per cent to -10 per cent. Real M2 fell 5 per cent and M1 12 per cent between the first and second halves of 1982, despite the normal higher level of activity in the second half. The degree of tightness, however, may have had more to do with growth in the demand for money: the slowing of inflation during 1981 and early 1982, higher real interest rates, and modest but positive growth of output during previous quarters, all suggest some increase in demand. Also, the downturn in the economy during the second half of 1982 caused a liquidity squeeze in company books that raised the demand for credit, and added to the degree of monetary tightness during the year.



Monetary tightness provides one explanation for the slowdown in economic activity after mid-1982. A second interpretation has to do with import policy, and will be discussed below. As a last point, however, it has to be noted that the monetary contraction had no effect on inflation, which rose to annual rates of 68 per cent and 86 per cent in the third and fourth quarters. In an October report to the Board, the Fund staff recommended an additional 'major tightening of fiscal and monetary policy' which 'is viewed by the staff as a critical factor in bringing about a substantial reduction of inflation in 1983.'

A second strand in the analysis was the advocacy of liberalization. The usual allocative arguments were strongly reinforced by one aspect of the 1978-79 experience: its major failure was that, despite a cut in the fiscal deficit to only 1.0 per cent of GDP, inflation doubled, from 37 per cent p.a. in 1977 to 68 per cent in 1979. The orthodox response was to blame import controls. The Fund's 1979 appraisal states that 'A major element in the anti-inflation drive is the reduction in the very high level of protection of local industry.' There were two reasons. One was the lack of competition from imports as a check on local price increases. The second was that monetary expansion was being driven by the accumulation of reserves. The Central Bank agreed and found itself in the unusual position of designing and lobbying for detailed changes in import rules. This policy continued and became more open after the change of government in July 1980 (from a military regime headed by General Morales Bermudez to an elected government headed by Fernando Belaunde) though, by this time, most of the liberalization had been carried out: the average tariff had been reduced from 69 per cent in 1973 to 39 per cent in June 1980, the list of import prohibitions had been cut from 1,852 items to 9, and that of items subject to quotas from 1,258 to 343. Nevertheless, officials of the Belaunde

government used the anti-inflationary argument to justify further liberalization.

Liberalization, in any case, was in the air in those years. The development establishment was impressed by the Chilean experience and the new Peruvian authorities, after the change of government in July 1980, were urged to learn from that experience. To help the educational process, lending was conditioned on further liberalization moves by both the World Bank and the Fund. In the case of the World Bank, liberalization became a major condition for structural adjustment assistance. Peruvian authorities also saw liberalization as a needed adjustment to correct for the interventionist excesses of the previous decade. Despite the general agreement, however, and the pressures that backed them up, there were few additional changes in import policy after 1980. In the end, the degree of liberalization was moderate: tariffs averaged 35 per cent at their lowest level, and then rose to about 40 per cent. Effective protection on manufacturing was reduced from 198 per cent in 1975, to 122 per cent in 1978 and 74 per cent in 1981.

The important point, in the context of this paper however, is not whether it was good policy to open the economy during 1979-81, but rather that liberalization was set up as a key target, linked to both short term stabilization and long term efficiency goals, and furthermore, that it came to be included in IMF and Bank conditionality at a time in which Peru's dependence on these institutions increased enormously. The effect on events after 1981 was perverse on at least three counts.

The first effect was to obscure the weakening of the economy, particularly the stagnation of manufacturing after 1980. Some contractionary effect on manufacturing, followed by public outcries, had been expected as a necessary part of the liberalization programme 'medicine'. When these occurred after 1980, it merely confirmed that the medicine was

working. But basic conditions underlying the programme were changing. Between late 1979 and the first half of 1982, for instance, the effect of liberalization on imports was increased by a 24 per cent appreciation in the real exchange rate. An even more powerful boost to imports came from widespread exemptions to import duties given to state enterprises, to the military and to some companies operating under special contracts. As a result of these ad hoc exemptions, between 40 per cent and 50 per cent of all imports came in duty-free, or with near zero duties.

One mechanism was for major importing state enterprises, such as Electroperu, the government power generating monopoly, to delay payment of duties on imported equipment. The 'delays' were later offset, in the Treasury's books, by a government 'capital transfer' to the company. Finally, contraband increased to an extent that could not be measured but which led to outcries by several commercial and manufacturing interests. Textiles, shoe and other consumer good producers were particularly affected. The growth of smuggling during those years may have been the effect of growing drug traffic and need for laundered currency; another cause may have been dumping by LDC exporters of manufactured goods hit by the world recession. Manufacturing was also hurt by the slowdown of exports that resulted from overvaluation, reduced export subsidies and the lack of an aggressive and effective commercial policy. All of these problems were recognized and addressed but were not seen as adding up to a fundamental weakening that required major changes in the government programme, such as a more interventionist and protectionist approach to trade and the manufacturing sector.

A second effect of the central role played by liberalization in the orthodox diagnosis was that, even after the crisis broke, the government refused to 'retreat' into direct interventions to cut the outflow of foreign exchange. Temporary import prohibitions were not discussed

until late 1983 and the suggestion, at that time, was rejected. When the government finally began to use import controls in 1984, the move was opposed by the Fund, and, even more vigorously, by the World Bank.

Finally, the continuing insistence on liberalization through the period of weakening, from 1981 to mid-1982, and even during the worst of the crisis in 1983, has had a backlash effect on current policy. Liberalization has always carried a considerable ideological charge, but this political charge was heightened. Liberalization has now become the shortcut explanation of the crisis. The result has been exaggeration in the other direction, and the multiplication of import controls well beyond any sensible limits.

Retrospectively, government policy during 1982-83 looks remarkably blind. The economic programme was designed for a benign balance of payments context that first evaporated gradually during 1981-82, as the fall in commodity prices continued to outlive world recession, and then shattered in 1983 when the international banking system panicked and withdrew. The programme was also designed for a domestic economy much closer to full capacity, and with more flexibility to adjust to new relative prices than was the case, particularly after mid-1982.

At the same time, the programme was failing on its own grounds. The central premise was fiscal control, but the fiscal deficit rose from 1.0 per cent of GDP in 1979, to 3.9, 6.7 and 7.3 per cent respectively in 1980 through 1982. The programme was also slipping with respect to other key objectives. Investment contracts to develop oil and copper exports were continually postponed. Nothing was achieved on the privatization of public enterprises front, and budget control of those enterprises continued to escape the Treasury. Non-traditional exports declined in real terms, a result that was related to the failure to depreciate the

real exchange rate after mid-1981: a presidential veto ruled out a maxi-devaluation, while stepped up daily devaluations, after mid-1981, were eroded by the continuing revaluation of the US dollar vis a vis other currencies. The faster rate of devaluation of the inti vis a vis the dollar that would have been required to compensate for that revaluation would have meant an additional political cost, and a greater inflationary impact, and was rejected by the government.

Retrospectively, therefore, it is easy to see that adjustments in the programme were needed, first to stop the slide into stagflation in 1982, and then, above all, to face the emergency that arose in 1983. Two factors that help to explain why a new programme was not adopted can be suggested.

The first was the information problem. The depth of the world recession was not foreseen, nor the durability of changes such as higher real interest rates, protection, closed windows in banks, and low commodity prices. The financial community worked against any realization of those changes. Through 1982, the commercial banks were expressing full confidence in Peru's future payment capacity, by lending heavily, implying that they believed in a prompt recovery of world trade and commodity markets, and implying also that they would continue lending. During the second half of 1982, the Minister of Finance was faced with almost daily cash crises to meet wage increases, enlarged investment bills, and public enterprise deficits; and the Central Bank refused to lend. Each day a crisis was solved by placing a telephone call to some bank. Public enterprises alone borrowed about \$500 million, or 2.5 per cent of GDP, in short term credits.

The Fund and Bank also contributed to a stubborn expectation that the external sector would soon return to normal and that there was no need to abandon a programme premised on open and eventually prospering world trade and

financial markets. On this basis, in November 1982, the IMF judged that Peru's 'debt service payments through 1986 are likely to remain manageable.' In the case of the Bank, external sector optimism was the premise for its energetic advocacy of trade liberalization.

A second reason for the failure to change the original programme has to do with the exigencies of life in the bunker. Major programmatic changes are difficult to decide, even as cool academic exercises. Surrounded by daily financial emergencies (road blocks by rice farmers waiting to get paid, banks going under, falling reserves, unpaid contractors threatening to stop work on key projects), and political emergencies (major strikes, military pressures, intense flak from lobbies, the media and Congressional opposition, including members of the government party), and in the context, furthermore, of a newly recovered and still slightly nervous democracy, major programmatic changes begin to appear heroic.

## 2. The external shock

The sudden 1982-83 collapse was not triggered by external events, according to the data presented in section III above. Export prices were almost constant between the second half of 1982 and first of 1983, and external interest rates actually fell.

But world recession had a major impact on Peru over the longer period 1981-86, and added to the weakening of the economy during the two years before the crisis, 1980-82. Over that period Peru's terms of trade fell by 35 per cent and debt service was burdened by record high interest rates, though the impact was softened by a large proportion of fixed interest debt - about half of the public debt - and by higher earnings on Central Bank reserves. Nevertheless, net interest payments on the external debt absorbed 21 per cent of 1981-82 exports of goods and services. The total loss

from lower export prices in those two years was \$967 million, or 4.7 per cent of GDP.

The impact was partly cushioned by a large inflow of medium and short term credits to the public sector which allowed the government to sustain an increasing level of public investment and high real public sector wages. The current account deficit averaged 8.3 per cent of GDP over 1981-82, and the loss of international reserves only 0.8 per cent of GDP per year. An inflow of private investment and short term money also contributed to the maintenance of reserves and aggregate spending. Not all the economy was cushioned, however. Mining continued to be squeezed by low prices and an overvalued currency, and the demand for manufacturing was diluted by large imports: the share of imports in the total supply of manufactures rose from 22.4 per cent in 1979 to 30.8 per cent in 1982, without counting the probable higher level of smuggling, and imports supplied 64 per cent of the incremental demand for manufactures between those years.

The result of this cushioning was to postpone the adjustment required by the external shock until 1983, when it coincided with El Nino. The sudden shutdown of untied foreign credits to the government and reversal of private short term capital flows, including trade credits, meant an inevitably large and sharp reduction of imports. Long term capital disbursements to the public sector fell by \$501 million between 1982 and 1983; registered private long and short term capital flows fell \$1,395 million, of which about \$700 million were withdrawn trade credits. In addition, El Nino caused a \$500 million loss in exports (Table 3).

The total shock amounted to \$2,100 million, or 56 per cent of 1982 imports. Most of this was entirely exogenous to Peru, but part of the large loss registered under 'net private long and short term credits' was capital flight in the form of debt prepayment by Peruvian residents. About

\$300 million of the \$1,395 million loss under that item was the effect of lower imports and thus less need for import credits. To a large extent, however, that loss resulted from unilateral credit withdrawals by foreign banks in the wake of the Mexican collapse. Similarly, the reduction in long term credits to the government was a direct result of the general tightening of the market, but also of the induced financial chaos in Peru, which became the justification for holding back by both commercial banks and the international organizations.



This section is an account of the efforts to deal with the crisis that broke in January 1983. The story is divided into three stages.

### 1. Downpour

January 1983 brought two newcomers onto the scene: El Nino, and a Minister of Finance determined to redouble orthodoxy.

The main elements of El Nino have been described above. One feature of this disaster, however, needs to be mentioned: it was gradual. The main damage was caused by rains that lasted six months. Additional damage resulted from drought that continued into the second semester. The effect of this gradualness was that six months of reaction time were lost. El Nino is a regular phenomenon, hitting every six or seven years, but its normal intensity and duration is a fraction of that suffered in 1983. For this reason, concern grew slowly, and it was only after the rains stopped, in June, that the macroeconomic implication began to be added up. By that time, output was nearing its trough, tax revenues were 35 per cent below 1982 levels in real terms, and inflation had been running six months at three digit levels.

Most of those six months were spent dealing with the balance of payments crisis. As is indicated in Table 3, the balance of payments gap, even after a 27 per cent cut in imports, was \$1,000 million, and the only recourse was debt relief. The management of the balance of payments problem was hindered by initial reluctance; Peru was unwilling to lose its good credit rating and, in March, was still holding out for new loans (\$800 million) rather than roll-overs, and losing time. This reluctance, to some extent, reflected a slowness to grasp the size of the problem, but more

fundamentally, it stemmed from the fact that Peru's domestic and foreign finances were highly vulnerable to a loss of confidence: abroad, Peru depended on willingness by the international financial community to maintain a large volume of external short term credits and provide the new loans needed to meet debt service; at home, about 40 per cent of M2 was held in the form of foreign-exchange denominated certificates of deposit whose free convertibility hung as a sword of damocles over the government during the whole crisis period. The politicians' instinct for keeping up a good front was reinforced by the perception that confidence was a prerequisite of financial survival. This psychology applied equally to the officials of financial institutions who were dealing with Peru, and it helps to explain the lengths to which officials on both sides went to ignore the hard facts of the Peruvian situation. Ironically, the delay in arriving at a solution of the balance of payments problem was itself a cause of loss of confidence. One of the principal causes of that delay, during this period in early 1983 and the next two years of continuing crisis, was the Fund's (and Bank's) 'catch 22' conditionality.

The negotiations with the Fund during this first phase set a record for distance between the orthodox world view and what was happening in Peru. One measure of that distance is recorded in the following projection made by the Fund staff in March: GDP was projected to grow 0.9 per cent, exports 8.8 per cent and prices 55 per cent that year. The actual rates in 1983 were -12.3 per cent in GDP, -8 per cent in exports, and 111 per cent inflation. Tax revenue was projected to drop 6 per cent in fact it fell 31 per cent.

The discussions focussed almost entirely on the fiscal deficit. Real public expenditure was falling sharply, but not enough to match the fall in revenues. The fact that the deficit was growing, particularly when measured as a proportion of a declining GDP, effectively blocked further analysis, since it was taken as sufficient to explain rising

inflation, capital flight, falling investment, and declining reserves. The fall in revenues was attributed to 'an administrative collapse' in the Ministry of Finance. The suggestion that aggressive increases in government controlled prices, particularly fuels and public services, and food shortages were a major part of the inflation problem was brushed aside. But the orthodoxy of most of the government negotiators contributed to the lack of debate and to the failure on both sides to grasp the complications in the situation, and particularly, the interrelations between financial variables and the real economy.

In the end, some sleight-of-hand was called on to close the gap between reality and the model. The task of reaching an agreement was speeded by shared orthodoxy, and even more by the government's need to maintain appearances at least until banks had signed off on a loan package, but the resulting targets were wildly unreal. The key target was a reduction in the fiscal deficit from 7.3 per cent in 1982 to 3.8 per cent, despite the fact that first quarter tax revenues were running 28 per cent below 1982 levels. (The actual figure for the year turned out to be 9.8 per cent). Within a month or two of the February agreement it became evident that the June fiscal target would not be met, threatening the still unsigned agreements with banks and the Paris Club. The situation was saved by taking advantage of accounting loopholes in the formal agreement with the Fund. Government employees, for instance, received their June wages on July 1st, cutting second quarter government cash expenditures substantially, and helping Peru to 'meet' its June fiscal targets.

## 2. Rebellion

A common sense rebellion against orthodoxy set in during the second half of 1983. The principal change consisted of an anti-inflationary experiment based on a reduction in the monthly rates of the exchange rate and other key prices. To

a large extent, this change was imposed on an unwilling Minister by the combined pressure of Congress, which legislated a ceiling on monthly increases in the prices of gasoline, electricity, and other government-controlled items, and by the Central Bank, which simultaneously introduced 90-day preannouncements of the exchange rate. To reduce the potential loss of exchange rate parity and potential fiscal cost of holding back on gasoline and other prices, the measures were preceded by a 13.7 per cent maxi-devaluation (the only maxi accepted by President Belaunde in this and his previous terms in office), and by increases in other prices. The experiment lasted six months and succeeded in reducing inflation to an annual rate of 73 per cent during the last quarter. The cost was a net appreciation of the exchange rate of only 4 per cent, but the programme was vetoed by the Fund in early 1984, when Peru once more needed an agreement.

Another form of rebellion was the continued refusal by the Central Bank to raise interest rates against pressure from the Minister and the Fund. Nominal interest rates had been kept at 1982 levels (72 per cent on savings deposits) through the first semester, though inflation had soared from 73 per cent in 1982 to an annual rate of 144 per cent during the first semester of 1983. This amounted to a 180 degree policy reversal by the Central Bank, which had fought for positive real interest rates continuously since the beginning of the government. The decision not to raise rates was at first the result of an underestimation of the permanency of the inflationary jump that occurred in the first months of the year, and that were thought to be temporary effects of food shortages and faster rates of increase in government controlled prices, including the exchange rate. As time went by, the decision came to be justified by the Bank as a means of assisting a badly hit business sector: during the year between the fourth quarter of 1982 and third of 1983 the real cost of debt in intis averaged -26 per cent; the subsidy to borrowers during 1983

equalled 20.9 per cent of outstanding debt at the beginning of the year. The result was a substantial softening of the impact of recession on company balance sheets. By mid-year, what had begun as an almost inadvertent unorthodox measure became conscious rebellion in the face of stepped up pressure from the Fund and the Minister to conform.

The third retreat from orthodoxy was a substantial expansion in Central Bank lending. During the first half of the year the Bank maintained a restrictive monetary policy that may have contributed to the business contraction, though the cost-induced increase in inflation, the sharp fall in real interest rates, the supply-side contraction in output and the generalized loss of confidence all had the effect of raising monetary velocity to an extent that is difficult to measure. In any case, monetary targets began to be set aside during the first semester to provide support for failing domestic banks and nonbank domestic borrowers affected by the natural disasters in the north and south of the country. This support, however, was expanded and generalized with refinancing credits for manufacturing and other activities, and, towards the end of the year, with major credits to the Treasury, chiefly to enable it to continue debt servicing.

### **3. Balkanization**

From early 1984 to July 1985 economic policy became balkanized. The President sought, above all else, to complete his public investment programme before his term of office ended in July 1985. In practice, this translated into a maximization of fresh money from abroad. The Central Bank returned to monetarism in an effort to minimize the loss of reserves. The Minister of Industry reversed trade policy, returning to import protection and greater export subsidies. Of the two Ministers of Finance during this period, one sought simultaneously to arrive at new agreements with the Fund and banks, while reversing the fiscal orthodoxy of his

predecessor. The second reversed this policy yet again, virtually ignoring the demands for payment by the banks, yet applying the most vigorous fiscal measures since 1978-79.

The economy had bottomed out in the last quarter of 1983, but adjustment continued during this period. Wages, imports, and public and private investment continued to fall, while the real exchange rate was depreciated substantially, the gasoline tax raised to record levels, and the fiscal deficit reduced from 9.8 per cent in 1983 to 2.3 per cent in 1985.

After the end of 1983, the balance of payments shock continued, though the El Nino shock reversed itself. The terms of trade continued to decline, falling 22 per cent between 1983 and 1985, but the effect on the current account was offset by the full recovery of oil, mineral and crop exports that had been hurt by El Nino. The balance of payments shock continued in the capital account, however, as long term capital inflow to the government (counting refinancing and arrears as inflows) fell \$630 million, and unregistered private short term capital flight, as measured by the change in errors and omissions, increased. Imports fell an additional 31 per cent to their lowest per capita level in 35 years (Table 4).

The economy remained recessed and inflation continued to climb, ending the period at about 250 per cent per year. By 1985, the exogenous component of GDP - farm output, mining, fishing and manufactured exports - had recovered fully, and even exceeded by 4.6 per cent its 1982 level, but demand-determined output grew barely 1.5 per cent in all over 1983-85, and was 11 per cent below its peak in 1981.

The fragmentation of policy began as an internal rebellion against the 1983 economic programme. Though orthodoxy had retreated somewhat in the second semester, as described above, the need for a new IMF agreement towards

the end of the year meant a return to tighter monetary and fiscal policies. Peru had drifted so far from Fund discipline, after falling to meet Stand-By targets in June, that the Fund now set higher interest rates, an end to exchange rate preannouncement, and major increases in the price of gasoline, rice etc. as preconditions for new negotiations. Strong objections within the government led to the resignation of the Minister before a new agreement was signed, but the President insisted on going ahead with the agreement, which he identified with a continuing flow of external finance for projects. Large new credits had been offered, or suggested, he believed, by both the World Bank and AID, as well as the possibility of the release of an undisbursed commercial bank credit, but all conditioned on an IMF agreement. At the same time, however, several of the critics of the orthodox scheme were appointed to a new cabinet, including the new Minister of Finance, at the beginning of 1984.

The new cabinet thus set out simultaneously to sign with the Fund and obtain fresh loans from various sources, and to follow a less orthodox, more expansionist and more protectionist programme. An agreement was arrived at with the Fund staff early in the year, but government tax and spending plans implied that the fiscal target would be broken almost immediately. Price adjustments in gasoline, foods and public services were carried out in the first months, in accordance with the Fund programme, but then began to fall behind schedule.

From the beginning of the programme, the Central Bank insisted that any monetary and fiscal expansion would have to be preceded by higher interest and exchange rates to assure that the additional liquidity would not be diverted into capital flight. The financial disruption and high inflation produced during 1982-83 was showing up in strong negative flows of private capital, and it was predictable that nervousness would increase during the coming electoral

period. As a way around the President's veto on a step devaluation, the Central Bank suggested the creation of a higher, parallel rate for capital transactions. This suggestion, in turn, was vetoed by the Fund. The President also refused to authorize an increase in interest rates. The upshot was that the Central Bank felt forced back into a tight monetary programme. The government refused to cut back its spending programme or raise more revenues.

The course of policy during 1984 was thus contradictory in several respects. Fiscal expansion meant an inevitable interruption of the freshly signed Fund programme, and a resulting cancellation of potential disbursements from AID, the banks and other sources. The Minister of Industry's rapidly multiplying import restrictions also conflicted with potential disbursements from the World Bank and with the terms of the letter of intent sent to the Fund. Central Bank monetary restrictions were inconsistent with the credit expansion publicly offered by several ministers to their respective sectors. The foreseeable interruption of the Fund agreement meant that external financing for spending plans would not be forthcoming, and also that it would soon be impossible to meet debt service commitments.

The President of the Central Bank, in June, attempted to draw attention to these inconsistencies by stating, firstly, that the agreed fiscal targets had been broken, and secondly, that Peru's excessive debt burden meant that it would have to choose between paying its debt or growing. The hope was that the statements would provoke a public debate on the arithmetic and options involved. Instead, there was an intense negative reaction by the banks and by the government. The Prime Minister accused the official of 'stabbing the country in the back', and initiated Senate proceedings for his impeachment. The public attacks on the official had not yet died out by August when, out of cash, the government started to slip in its debt payments, and by



which time the failure to meet Fund targets could no longer be concealed.

From the last months of 1984 up to the change of government, political attention was sufficiently distracted by the coming elections that a new Minister of Finance was able to reduce the deficit substantially, and to support the Central Bank on the need to accelerate devaluation and raise interest rates. The paradoxical result was a pre-election semester of severe price and fiscal adjustment, and a containment of the outflow of capital. These measures caused a new jump in inflation, which rose from the 1984 level of 111 per cent to over 200 per cent on an annual basis, but the gains were a reduction of the deficit to only 2.3 per cent of GDP in 1985, and a 25 per cent depreciation of the exchange rate over the ten month period from September 1984 to July 1985, results which proved a considerable asset to the incoming government in July.

## VI. ISSUES AND PROSPECTS

The exogenous shocks suffered by Peru between 1981-85, including El Nino, were large, but adjustment was highly inefficient. The loss of output, investment, monetary stability and social fabric multiplied the cost of those shocks.

If the loss of output is measured against a modest potential 4 per cent rate of growth from 1980 to 1985 it amounts to 23 per cent of actual 1985 GDP. To finance the raw material and capital good imports needed to sustain that higher GDP, Peru would have needed to spend about \$1.7 billion more on those goods in 1985 than it did. The additional foreign exchange requirement would have equalled about 8 per cent of that potential GDP, or 45 per cent of actual 1985 exports of goods and services.

A foreign exchange gap of that magnitude implies an inevitable large loss of output and major disruptions to the economy from adjustment efforts, even in a best-case adjustment carried out entirely through expenditure and production switching. In practice, the adjustment occurred almost entirely through output reduction, implying a double cost - the losses already borne, and the costs of the switching measures that are still needed.

A measure of the policy failure is that Peru continued to spend about \$200 million per year between 1983 and 1985 on tourism abroad, another \$200 million on non-essential consumer good imports, \$50 million on easily replaceable food imports (through better farm prices), and about \$200 million on defense equipment. At the same time, Peru lost about \$800 million per year over that period in registered short term capital and capital flight, if measured by errors and omissions. Finally, non-traditional exports fell from \$762 million in 1982 to \$714 million in 1985, despite record levels of idle manufacturing capacity. Relatively painless

balance of payments measures could have financed at least a third (\$600 million) of the import gap. Also, better macroeconomic management would have cut losses of short term capital: some \$600-800 million in unrecorded drug exports mean that Peru should normally show positive errors and omissions, as it did between 1979-82.

There was also scope for more fundamental, medium term switching that could have been initiated and advanced at least in part. The potential involves both solid increases in new exports, and import substitution through production and consumption changes, objectives that the APRA economic programme recognized in 1985.

Much of the failure to deal with the balance of payments shock must be blamed on the orthodox diagnosis, and to a lesser extent in Peru's case, to the imposition of orthodoxy. In essence, that diagnosis steered attention away from the switching problem. In addition, it aggravated instability, worsening the capital account, by underestimating the inflationary and output effects of policy shocks (chiefly through relative prices), and of demand contraction.

During 1983, a government official suggested that the \$8,000 foreign exchange allowance for Peruvians travelling abroad should be cut. The measure, however, would have contravened IMF foreign exchange regulations. The Fund was consulted, and permission was refused. The amount at issue was small, but the incident throws light on mind-sets.

Sheer lack of information played a role: the wrong guess concerning recovery of commodity prices, the delay in realizing the cost of El Nino, and statistical lags particularly regarding manufacturing production and unemployment. In early 1984, some members of the Central Bank board refused to believe the employment figures, and experience with Peruvian statistics made their position

plausible. Earlier, during 1983, an IMF staff member refused to believe government estimates of the fall in output, and the poverty of national accounts data made it difficult to refute his position. The early 1984 letter of intent to the IMF drawn up by a team of government and Fund officials is customarily precise in reporting GDP change in 1982 and the projected change in 1984, down to one decimal, but gives no figure for 1983.

The greater error, however, was in failing to see the need for a major political input in the management of what had become an emergency. When it came to designing a political programme for dealing with the emergency, the Fund (and Bank, AID etc.) were definitely in the way, and certainly had no expertise. This was not part of the 1980-85 (through July) problem because the government was unable, in any case, to fully realize or to react to that need, but it became central to the solution adopted by APRA in August 1985.

Peru has still not achieved stability, despite the energy of the 1985 anti-inflationary plan, the severity of balance of payments measures, and the high degree of political support for the government. Output growth over 1986-87 will total between 14 and 15 per cent, meaning a recovery of most of 1983-85 loss, and a runaway inflation has been arrested and held at about 60 per cent per year. A radical position on debt servicing has created some room for manoeuvre. These short run gains, however, have been achieved through measures that are effective only in the short run. The costs of the debt stance, through reduced disbursements and higher import prices, will increase. The check on inflation is creating relative price distortions that cannot be sustained. The reduction of imports is so far based entirely on controls: the exchange rate appreciated substantially between 1985 and early 1987, and import pressures are building up rather than decreasing. All exports have been penalized by the exchange rate

appreciation, despite higher export subsidies. Capital flight has reappeared, reflecting expectations of devaluation and exchange rate restrictions.

The failure to stabilize since 1985, despite the political resources behind the current programme, is a measure of both the size of the problem, and the continuing inadequacy of policy. A major gap in both pre-1985 and post-1985 analyses is the behaviour and power of expectations and confidence. The underestimation of the inflationary consequences of adjustment measures stemmed from ignorance regarding that psychology, and the overestimation of the power of direct controls, at present, arises out of the same failing.

More generally, a good emergency programme needs interventions to speed the adjustment that must eventually be made by markets. The danger is that intervention is easier to get into than out of. To public opinion, controls and intervention mean 'taking action' and 'being selective'; to rely on markets means the reverse. When political emotion is used to support the emergency measures, the return to a reliance on markets becomes even more difficult. This is the wisdom in much of orthodox preaching: intervention tends to ratchet, reducing the scope of markets, and the long run flexibility of an economy. The prospects for the Peruvian effort will turn considerably on the government's skill in avoiding the interventionist pitfall.

Table 1. SOCIAL ACCOUNTING MATRIX PERU 1981  
(millions of intis)

	Agriculture				Fishing Oil & Mining	Urban Large Scale	Small Scale	Government	Total Income	Labor Force ('000)
	Exports	Urban	Subst.	Total						
RURAL SECTOR	330	652	256	1238			236	20	1496	1922
Small farmers	32	124	222	369			147		516	1024
Medium farmers	212	290	34	536			76	20	632	454
Cooperative	26	120	--	146			15		161	154
Wage earners	69	118	--	187					187	230
URBAN SECTOR										
Wage earners					265	1279	624	852	3220	2358
Unionized					265	662	56		1003	400
Non unionized									1195	1491
: of which construct. workers						162			162	150
domestic service							105		105	170
others						425	493		928	1171
Government							170	852	1022	467
Self-employed & small proprietors					28	140	1005		1174	1250
Professionals						140	50		190	46
Others					28		955		984	866
Capitalists and rentiers					327	2640			3167	
NATIONAL INCOME				1238	620	4259	2068	872	9057	5190
Deprec. & net factor payments				20	367	377	42	5	811	
Net indirect taxes				2	303	332	37	39	713	
VALUE ADDED				1260	1290	4966	2147	916	10581	

Source: Own estimates based on Input-Output matrix 1981, National Institute of Statistics, and National Survey of Rural Households 1984.

Table 2. STRUCTURE OF PRICE DETERMINATION

	Proportion of Domestic Final Demand (%)
Direct government control	33
Mark-up	23
Semi-flex price	17
Flex price	27

Note: Concepts defined in text. Semi-flex includes goods such as milk, meat & household durables which are tradeables or have large import content, as well as some factory products produced by oligopolies.

Table 3. BALANCE OF PAYMENTS SHOCKS 1982-83  
( \$ millions )

	1982	1983	Change
<u>Exogenous Items</u>			
Exports	3293	3015	-278
:terms of trade effect			263
:El Niño effect			-500
:other			-41
Net disbursements of long term credits to public sector	886	385	-501
Registered Net Private long & short term credits	585	-810	-1395
Services & Other items	-1181	-1165	16
Errors and Omissions	175	211	36
<u>Balancing Items</u>			<u>2100</u>
Imports [increase(-)]	3721	2722	999
Refinancing	109	1024	915
Change in reserves [increase(-)]	124	-40	164

Source: Central Reserve Bank. Compendio Estadístico del Sector Externo 1970-1984. Terms of Trade and El Niño effects estimated by Central Reserve Bank.



Table 4. BALANCE OF PAYMENTS SHOCKS 1983-85  
( \$ millions )

	1983	1985	Change
<u>Exogenous Items</u>			
Exports	3015	2966	-49
:terms of trade effect			-410
:El Niño effect			500
:other			-139
Net disbursements of long term credits to public sector	385	-671	-1056
Registered Net Private  long & short term credits	-810	-307	503
Services & Other items	-1165	-1031	134
Errors and Omissions	211	-220	-431
<u>Balancing Items</u>			<u>-899</u>
Imports [increase(-)]	2722	1869	853
Refinancing	1024	1450	426
Change in Reserves [increase(-)]	-40	318	-380

Source: Central Reserve Bank. Compendio Estadístico del Sector Externo 1970-1984. Terms of Trade and El Niño effects estimated by Central Reserve Bank.