PERUVIAN ECONOMIC POLICY IN THE 1980s:
From Orthodoxy to Heterodoxy and Back*

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Looking back over patterns of economic adjustment and structural reform in Latin America since the debt crisis began in 1982, two broad trends stand out. The first is the dramatic fluctuation in macroeconomic policy between the orthodox programs traditionally advocated by the International Monetary Fund (IMF) and the more interventionist or "heterodox" strategies that marked the policy environment after 1985 (Sheahan 1989). Although the orthodox-heterodox policy cycle is hardly new to the region and in fact has characterized the policy-making experience over the entire postwar era (Kaufman 1990), the 1980s represented the intensification of this cycle, especially in the extremity to which each set of policies was applied. The second trend follows from the first: the inability of states to follow through coherently on any given policy course (Fishlow 1989). While some exceptions to this trend can be cited (Chile, for example), the Latin American pattern has generally been one of failed adjustments and changed courses.

This article will examine the two themes of policy fluctuations and inconsistencies as they have been played out in Peru over the last decade. Having grappled with an unprecedented bout of recession and hyperinflation as well as a violent guerrilla insurgency, Peru is perhaps the most extreme example of what went wrong in the 1980s. Yet until the 1970s, this medium-sized South American country registered economic growth rates second only to Mexico and had effectively avoided many of the political

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excesses characteristic of the region. Part of Peru's instability is rooted in the country's relatively late start in embarking on a full-fledged industrial strategy and the political and social upheaval that have accompanied this transition (Fitzgerald 1979; McClintock and Lowenthal 1983). But Peruvian politics and economics have been particularly volatile in the 1980s, and this phenomenon merits a detailed explanation.

The interplay of Peruvian politics and economic policy over the last decade has been studied extensively (Conaghan et al. 1990; Schydlowsky 1986; Webb 1990). Our analysis differs from some earlier efforts in several ways. First, we question the assumptions, whether implicit (Lago 1990; Webb 1990) or explicit (World Bank 1989), that a properly applied orthodox program would have worked in Peru and that a return to neoliberalism could remedy the current difficulties. We argue instead that the neoliberal strategy of the early 1980s was inappropriate to the Peruvian economic structure and failed to address class and distributional dynamics. We are therefore skeptical that an orthodox rerun, as is now the case under President Alberto Fujimori, will be any more successful. As Miles Kahler has noted, the failure of heterodox experiments in the 1980s does not automatically vindicate orthodoxy as an alternative (Kahler 1990, 60–61).

A second distinction between our work and previous analyses lies in our characterization of the heterodox program. Although some have viewed the experiment as classic Latin American populism (Dornbusch and Edwards 1989; Sachs 1989), we believe that the economic program and its accompanying political coalitions were more sophisticated. Heterodox policy was based on a coherent (although incoherently applied) structuralist model of the Peruvian economy, and post-1985 politics represented not only an appeal to popular classes but also a serious attempt to solicit participation by local capital in medium-term economic restructuring. Unfortunately, the unraveling of the program produced outcomes so similar to traditional populism that this important distinction has been ignored by the Peruvian electorate and many analysts.

A third difference is that we stress the role of limited administrative capacity. Both the conservative Belaúnde regime in the early 1980s and the interventionist García administration in the latter half of the decade employed a highly autocratic style of policy-making that bypassed the state institutions that normally monitor economic policy. Relations between the Ministerio de Economía y Finanzas, the Banco Central, and the Instituto Nacional de Planificación were conflictual, and middle-level managers, weary of the rapid succession of policy objectives, often failed to carry through the designated economic measures. Under these circumstances, it became difficult to carry out a sound program of any sort (Wise 1990).[1]

1. Evans offers a comparative account of how this scenario of administrative incapacity and

This article is divided in three parts. The 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 chart the progress of this neoliberal strategy and suggest that the falling output and accelerating inflation that resulted indicted "orthodox" policy and also paved the way for acceptance of a "heterodox" alternative. In particular, the distributionally harsh nature of the orthodox program heightened social tensions and helped to produce the radical redistributive tone of the administration that followed (Dornbusch and Edwards 1989, 6–7).

The second section will examine the underpinnings and outcomes of the heterodox program launched in 1985 by President Alan García and his party, the Alianza Popular Revolucionaria Americana (APRA). We will 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 weakness. This section will end by examining the political and policy paralysis that prevented the García administration from shifting gears and more effectively combating the hyperinflation and recession that began in 1988.

The final section will discuss briefly the chances for an economic and political turnaround under the new Fujimori regime. We remain pessimistic about the fate of the present economic strategy for reasons rooted in the analysis developed here. First, the new president's campaign promises of "gradual stabilization" were immediately followed by the adoption of a Bolivian-style "shock," a turn of events suggesting that the era of dramatic policy shifts is not over. Second, the Fujimori administration's rush toward orthodoxy seems to have occurred without fully analyzing the problems with the earlier neoliberal strategy. Finally, any adjustment program is bound to be undermined by the heightened polarization of the country's political and economic groups, the persistent weakness of the Peruvian state, and the continuing wariness of international lenders. In short, Peru is poised to repeat the orthodox policy experiment of the early 1980s in a social, administrative, and international context that is even more unfavorable than the one it faced in the earlier era. Whether orthodox policies will be more successful this time round remains to be seen.[2]

institutional debility has been played out within states at various stages of development (Evans 1989, 581–83).

2. See "Hurtado Is Out after Only 200 Days," *Latin American Weekly Report,* 28 Feb. 1991, p. 2; "Peru Despairs of 'Reinsertion,'" *Latin American Weekly Report,* 14 Mar. 1991, p. 7; and "Fujimori Springs Deal on Congress," *Latin American Weekly Report,* 30 May 1991, p. 10.

PERUVIAN NEOLIBERALISM, 1980–1985

Peru's shift toward a market-based strategy by 1980 can be traced to historical as well as international factors. Prior to the statist military coup of 1968, the country had exhibited a strong bias toward laissez-faire economic policy, and the swing toward orthodoxy in the 1980s was consistent with Peru's historical tendency to revert to a liberal economic policy regime when direct state intervention failed (Thorp and Bertram 1978).[3] In addition, transnational actors like private banks and the IMF 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 demanded that Peru adopt monetarist stabilization and adjustment guidelines.

Why was the neoliberal strategy embraced so enthusiastically by Peru when it had already stalled in the Southern Cone nations of Argentina and Uruguay? First, until late 1980, the Chilean economy was still being trumpeted by the banks and multilateral lending agencies as a free-market miracle (Stallings 1989, 185). Second, the Belaúnde economic team was assembled from technocrats who had sat out the military years working abroad in banks and multilateral institutions, a period in which the Chilean-style pro-market mind-set predominated (Webb 1987, 30).[4] Third, the fortuitous turnaround of prices of Peruvian mineral exports in 1979 and the brief economic reactivation that followed led domestic elites to believe that the orthodox remedy foisted on them by the IMF and the banks had indeed worked (Paredes and Pasco-Font 1987).[5] Finally, the distributional consequences likely to result from orthodoxy, which generally involved severe wage compression (Ramos 1986; Pastor 1987), appealed to the business elites that made up the social basis and political backing of the incoming Belaúnde regime.[6]

In the end, the program implemented in Peru in mid-1980 was a reflection of some parts of the Southern Cone strategy and an extension of

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

4. This explanation is a major one given by Roberto Abusada, Vice-Ministro de Industria y Comercio in the second Belaúnde administration, in an interview, 12 Aug. 1987, in Lima.

5. Such views are expressed by Ferrand and Salazar (1980, 70–75).

6. The influence of international institutions and business elites should be stressed. As Kahler notes, "orthodoxy's principal political asset is typically the international financial support that it can bring; secondarily, it may fit the preferences of certain domestic groups, particularly internationally connected business groups" (1990, 60). He also notes that the "political liabilities with much of the population are great . . . , which is one reason for the appeal of heterodoxy in situations of democratization." We echo this argument in our analysis of how orthodoxy's distributional consequences paved the way for heterodox policy.

IMF stabilization policies that had been underway since 1978. The strongest vestiges from other neoliberal experiments surfaced in the Belaúnde administration's call for reducing state enterprise and stimulating private investment. Opening the economy domestically and internationally was also a priority, as evidenced by several government actions: eliminating government intervention in pricing, marketing, and the financial system; reducing tariffs and trade barriers; and maintaining crawling-peg currency devaluations in order to maximize Peru's competitiveness in foreign export markets.[7]

Peru's neoliberal strategy quickly collapsed. Our analysis of its failure is organized around the four major tenets of Belaúnde's program: privatization, trade liberalization, public investment, and ongoing management of the macroeconomy. While we acknowledge that the international economic shocks that hit in 1981 would have limited the success of any program, we nonetheless contend that the package itself was inappropriate, contradictory, and socially divisive.[8]

The Neoliberal Track Record: Four Policy Currents

Privatization and Private Investment / In accordance with the neoliberal framework, the Belaúnde regime sought to shed state-owned enterprises and encourage private investment. The government initially announced that more than eighty public enterprises would be sold, turned into joint ventures, or liquidated.[9] This program was clearly too ambitious. Private-sector resources were inadequate to the task, particularly following the collapse in business confidence and private investment that had set in with the recession in 1982–83. Foreign investment was also in short supply. Estimates of the value of the enterprises targeted for sale ranged from two hundred million dollars to four hundred million, while direct foreign private investment from 1981 to 1983 barely totaled two hundred million (Thorp 1986), implying that little divestiture to foreigners could realistically take place. Meanwhile, the ministers responsible for the privatization drive were generally reluctant to erode their base of power and hence made few attempts to privatize their own firms (Branch 1982, 4).

7. The initial program was presented to congress by Finance Minister Manuel Ulloa in his "Mensaje al Congreso del presidente del Consejo de Ministros," delivered in Lima on 27 Aug. 1980. A full reprint of the speech, as well as the immediate reaction by a local group of prominent opposition economists, can be found in IEP (1980).

8. Other analyses of the Peruvian neoliberal experiment include Conaghan, Malloy, and Abugattas (1990), Reid (1985), Schydlowsky (1986), Thorp (1986), and Webb (1987). Webb's analysis is particularly interesting because he was president of the Banco Central during the Belaúnde administration.

9. "State Company Sell-Off to Begin," *Andean Report*, Feb. 1981, p. 21; "Mining and Oil Get Going While Government Streamlines State Companies," *Andean Report*, Nov. 1981, p. 213; and "State Companies for Sale," *Andean Report*, Oct. 1982, p. 183.

TABLE 1 *Investment in Peru as Percentages of the Gross Domestic Product, 1980–1989*

Year	Gross Fixed Investment (%)	Private Investment (%)	Public Investment (%)
1980	24.2	18.0	6.1
1981	26.9	20.4	6.5
1982	26.3	18.8	7.5
1983	21.3	14.2	7.1
1984	19.1	13.2	5.9
1985	16.7	12.0	4.6
1986	18.2	13.8	4.4
1987	19.4	14.3	5.2
1988	18.5	14.5	4.0
1989	16.7	8.5	8.1

Sources: Data on real GDP were taken from INE (1989, 195) and INE (1990, 11). Data on investment were taken from INE (1989, 202–3) and INE (1990, 69).

The limited divestment that occurred 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, the government fully liquidated only a few insignificant enterprises, including 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 summarized in table 1, 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 with historical trends (Thorp and Bertram 1978, 288–91). This dismal performance resulted from several factors: the government's trade liberalization policy, which effectively canceled out many investment incentives for local capitalists; erratic disbursement of export subsidies; and undercutting trends in the overall macroeconomy, especially the fall in gross domestic product (GDP) and hence in market size.[10]

Attracting higher levels of foreign direct investment presented perhaps the biggest challenge, particularly after the ambiguous signals sent out in 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 returned to Peru

10. "Funding Private Sector Growth," *Andean Report,* Apr. 1981, p. 63.

with any force. In the wake of the debt crisis, foreign direct investment hit an all-time low of a negative 89 million dollars in 1984.

Trade Liberalization / The trade liberalization program was begun in 1978 under strong pressure from the IMF and received a boost with the change of administration in 1980. The Belaúnde team broadened the critique of the country's existing trade regime, coupling the usual dismissal of import-substitution efforts with an attack on the interventionist strategies used to promote nontraditional exports. Such exports had risen to 845 million dollars by 1980 (BCRP 1987a, 167). But the Belaúnde technocrats regarded this record as inadequate in light of the incentives offered to industrialists, which included abundant credit at subsidized interest rates and cheap intermediate and capital goods imports. In keeping with orthodox logic, the administration opened the economy, hoping to shift resources toward Peru's traditional production of mineral and other commodity exports and to introduce competitive pressures on the domestic industrial sector. A wide range of duty exemptions and quantitative import restrictions were removed. The average nominal tariff was reduced from 46 percent to 32 percent, and by the end of 1981, 98 percent of all registered items could be imported freely, as opposed to only 38 percent in 1978 (World Bank 1985, 48). A tax subsidy for priority exports known as CERTEX was maintained but at a reduced level, and interest rates on credit lines available through the state industrial bank were set according to market trends.

The effects of the trade liberalization policy were immediate. Lower tariffs brought a flood of foreign products into the domestic market. Some of the new imports were necessary industrial inputs, but the import of luxury consumer goods also skyrocketed. Losses resulting from increased competition gave rise to higher demands for credit on the part of local industry. Because financial liberalization was also part of the program, credit became more expensive, and many firms that had been forced to borrow went into the red quickly. As a result, manufacturing output dropped by nearly 20 percent between 1980 and 1983, and idle capacity in industry rose to well over 50 percent (Reid 1985, 85). Under strong pressure from local industry, the administration began rescinding some of the liberalization measures. 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 goal of neoliberal policy was to reroute state investments into economic infrastructure to support private enterprise and primary exports. Public investment plans from 1981 to 1985 included more than eighty projects and budgeted an annual average expenditure rate of 2.3 billion dollars over the five-year period. In the end, however, the government did not meet its rather optimistic spending

TABLE 2 *Macroeconomic Performance in Peru, 1980–1989*

Year	Growth of Real GDP (% of change)	Growth of Manufacturing (% of change)	Inflation Rate of Consumer Price Index (%)[a]
1980	4.5	5.7	60.8
1981	4.4	0.7	72.7
1982	0.3	-1.0	72.9
1983	-12.3	-16.9	125.1
1984	4.8	5.5	111.4
1985	2.4	4.9	158.3
1986	9.5	16.8	62.9
1987	7.8	13.7	114.5
1988	-8.8	-13.9	1722.3
1989	-10.4	-19.2	2775.6

Sources: Growth of real GDP and real manufacturing based on data in INE (1988, 133), INE (1989, 195), INE (1990, 11), and Cuánto (1990a, 168). Inflation rates calculated using the Lima consumer price index available in Cuánto (1990a, 602).

[a] Measured from December to December.

targets. By 1982 many projects still lacked financing, with the result that public investment slumped 40 percent below the amount originally projected (World Bank 1985, 30). After the deep recession of 1983, state capital formation took on the same stop-and-go character exhibited 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.

Thus the public investment program had an effect quite contrary to the neoliberal intentions. First, absorption of state attention in managing public investment diverted energy and resources from the problem most harmful to the private sector: the increasingly chaotic macroeconomy. Second, the inability to complete the projects initiated left the subsequent administration burdened by and locked into the prevailing project portfolio.

Macropolicy / In theory, the macroeconomics of the neoliberal program were vintage IMF: restraining monetary growth, devaluing the local currency, encouraging private initiative, and lowering trade barriers. In practice, the Belaúnde administration's management of macroeconomic policy was inconsistent, as evidenced by the reversal of trade liberalization, the initially expansive public investment program, and the "softening" of fiscal policy when municipal elections were held nationwide in November 1981.

The erratic course of macroeconomic policy led some to suggest that the Belaúnde program was not really orthodox or that neoliberalism was not given a fair shake in Peru during the early 1980s (see table 2).[11] It is not surprising that proponents of orthodoxy should wish to disassociate themselves from the 1980–1985 period, in which GDP stagnated, inflation doubled, debt rose over 70 percent, and real wages declined by more than 35 percent. But cases involving a "pure" application of any strategy are rarely found, and elements of Belaúnde's macroeconomic policy, particularly the monetarist framework underlying its inflation-management program, certainly fit the orthodox mold.[12] Moreover, the administration operated until mid-1984 under a succession of IMF programs, lending further credence to applying the orthodox label. Eventually, the dismal results evident by mid-decade led even policymakers within the government to criticize packaged orthodox solutions to Peru's macroeconomic problems. Outside the administration, the chorus of doubters was both larger and more vocal.

Administrative and Political Capacity

The orthodox program was flawed in theory: privatization was unrealistic, trade liberalization was ill-advised, and inflation management focused excessively on monetary or demand restraint rather than on cost control. But the program also faced additional hurdles at the level of implementation. The first source of difficulties was exogenous: price shocks emanating from the world economy (see table 3 for evidence on the deterioration in the terms of trade), eventual curtailment of external credit, and freak weather conditions caused by the El Niño current all conspired to weaken performance. Implementation was also constrained by weaknesses inherent in the Peruvian bureaucracy, the configuration and balance of power between the main state financial and planning institutions, and the unstable nature of the coalition backing the program.

Although the capacity of the Peruvian bureaucracy had already been eroded by massive layoffs of top public personnel in the throes of the 1977 crisis (Vallenas and Bolanos 1985), the Belaúnde administration made no effort to reverse this trend. Instead, a near obsession with expanding executive authority took precedence over the need to foster pockets of

11. This opinion was commonly expressed during interviews obtained by both authors in 1986 and 1987 with key government officials who had served under Belaúnde and were subsequently ousted during the heterodox change of guard.

12. Belaúnde's policymakers took power convinced that the 1980 inflation rate of 61 percent stemmed from the 1979 balance-of-payments surplus (because according to the simple monetarist model, reserve accumulation necessarily produced monetary growth and inflation). The government therefore sought to combine fiscal and monetary restraint with a "burning off" of reserves, a policy that partially explains the administration's seeming lack of concern about the import boom of the early 1980s.

TABLE 3 *Trade in Peru, 1980–1989*

Year	*Exports (millions of U.S. dollars)*	*Imports (millions of U.S. dollars)*	*Trade Balance (millions of U.S. dollars)*	*Terms of Trade (1978 = 100)*
1980	3,916	3,090	826	152.5
1981	3,249	3,802	-553	124.9
1982	3,293	3,722	-429	103.0
1983	3,015	2,722	293	110.6
1984	3,147	2,140	1,007	100.9
1985	2,978	1,806	1,172	90.6
1986	2,531	2,596	-65	66.4
1987	2,661	3,182	-521	66.9
1988	2,695	2,750	-56	73.5
1989	3,540	2,141	1,399	76.7

Sources: Data on exports, imports, and the trade balance taken from Cuánto (1990a, 827) and Cuánto (1990b, 12). The terms of trade were calculated as the price of traditional exports relative to imports and were taken from Cuánto (1990a, 84).

expertise within the bureaucracy (Rueschemeyer and Evans 1985). Policymaking came to rely almost solely on executive decree, with implementation warranting only peripheral concern.[13] Relations between 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, particularly when the eventual monetary restrictions of the Banco Central impeded the president's public investment program (Webb 1987, 31). Meanwhile, the National Planning Institute was physically relocated from downtown Lima to a remote suburban location, a move that sharply reduced its ability to collaborate with other state agencies on daily matters of policy (Cornejo 1985, 117). Thus Peru suffered from a "balkanization" of economic policymaking (Webb 1987, 31) and from neglect of long-term planning, both of which contributed to the increasing reliance on external debt, as witnessed in table 4.

The inability of the Peruvian neoliberals to implement their program partly resulted from their attitude toward the state. In rejecting state-led development and embracing a market strategy, the Belaúnde government tended to work around the bureaucratic, institutional, and coalitional structures that were crucial to effectively implementing any development program. One lesson of this period is that market policies are also "interventions" that demand a basic level of capacity, coordination, and political support to be effected (Haggard and Kaufman 1989).

13. During 1981, for example, major laws concerning agrarian reform, taxes, and the media were passed via a barrage of executive decrees, as was the entire economic program (Malloy 1982, 7).

TABLE 4 *Reserves and Debt Service in Peru, 1980–1989*

Year	Net International Reserves (millions of U.S. dollars)	Long-Term External Public Debt (millions of U.S. dollars)	Accumulated Interest Arrears on Long-Term Debt (millions of U.S. dollars)	Debt Service as a % of Exports of Goods and Services (%)
1980	1,276	6,043	0	28.6
1981	772	6,127	0	45.8
1982	896	6,825	0	36.7
1983	856	8,256	0	20.1
1984	1,103	9,648	374	17.4
1985	1,383	10,462	703	16.3
1986	866	11,068	1,319	14.7
1987	81	11,747	1,904	11.7
1988	–317	12,465	2,489	4.3
1989	546	—	—	—

Sources: Data on net international reserves were taken from Cuánto (1990a, 827) and Cuánto (1990b, 12). Data on long-term external public debt were taken from Cuánto (1990a, 827). Interest arrears data were taken from World Bank (1989, 306); arrears that include principal would be substantially higher. Debt-service figures refer to debt other than that owed by the Banco Central de Reserva and were taken from BCRP (1987, 59) and INE (1989, 605). Exports of goods and services were calculated from data in Cuánto (1990a, 827, 831).

The anti-state attitude among neoliberals thus led them to discount the very tools they needed for program implementation (Wise 1991).[14]

Implementation was also constrained by fragmented politics. In order to push the program forward, a viable coalition was needed along the axes of executive-parliament-party and state-capital-labor. On the former front, any semblance of a parliamentary consensus quickly eroded when fierce conflicts broke out concerning the extent and pace of the neoliberal reforms. These disagreements were aggravated by attempts by the majority bloc, led by Belaúnde's Acción Popular (AP) and the more conservative Partido Popular Cristiano (PPC), to reorganize the legislative committees in the Congress and thus short-circuit opposition to the government's program (Woy-Hazleton and Hazleton 1987). State-class relations were equally problematic. On the one hand, the business community was eager to reverse the crisis of representation that it had experienced over the previous decade and was initially pleased by the pro-capitalist tone of the administration. Organized labor, on the other hand, opposed this emphasis and was equally eager to demonstrate that the AP-PPC coalition lacked any base of support among workers (Bollinger 1987).

14. Kahler makes this general point when he observes that "orthodoxy has not dealt successfully with the paradox of using the state—its only instrument—to change policy in a less statist direction" (1990, 55).

TABLE 5 *Real Wages in Peru, 1980–1989*

Year	Index of Real Salaries (1980 = 100)	Index of Real Wages (1980 = 100)	Index of Informal Income (1980 = 100)
1980	100.0	100.0	100.0
1981	105.6	105.1	125.1
1982	109.7	105.1	131.1
1983	94.1	87.2	103.5
1984	86.7	74.4	102.6
1985	80.0	64.1	105.6
1986	99.8	87.2	151.9
1987	106.0	94.9	195.9
1988	70.0	61.5	75.8
1989	54.5	48.7	72.3

Sources: Real salaries are those of non-manual workers and real wages those of manual workers. Both series were taken from Cuánto (1990a, 718). Index of informal income is for December of each year (Cuánto 1990a, 275).

During the administration's first year, it initiated a modest attempt at mediating these interests by forming a National Tripartite Commission made up of representatives from industry, government, and the four major labor confederations (Malloy 1982, 8). The government, however, was unable to persuade business or workers to accept the administration's income and price proposals, and as the commission disintegrated, even the seemingly favored business sector lost confidence in the government. Relations among the state, capital, and labor all quickly deteriorated, a phenomenon that helped fuel inflation.

The effects of macroeconomic austerity and orthodox policy further sharpened social divisions.[15] As noted, real wages fell over 35 percent from 1982 to 1985 (see table 5). Meanwhile, profit share, after suffering a sharp hit in the 1982–83 slowdown, soon recovered to levels above those achieved in the first years of the Belaúnde administration. In the same years, the agricultural-manufacturing terms of trade also fell by more than 35 percent, with negative effects for peasant income. Even the informal sector, a part of the economy that can sometimes benefit from rising inflation, saw its income fall by nearly 20 percent between 1982 and 1985. In short, the popular classes bore a disproportionate share of the adjustment burden, and the resentment of the poor grew steadily.

This context provided fertile ground for poverty-related insurgent

15. For comprehensive treatments of the social and political backlashes related to economic austerity in Latin America during the 1980s, see the edited collections by Handelman and Baer (1989) and Thorp and Whitehead (1987).

factions, the most prominent being Sendero Luminoso.[16] Eschewing all legal forms of political participation, Sendero made serious inroads first in the southern region and then in the central Andean provinces. After the insurgency swelled from low-level political agitation in 1981–82 to assassinations of local elected officials and destruction of major state-investment projects, the government declared much of the southern Andes an emergency zone. Although the political opposition at large argued that the conflict could only be quelled through a massive development effort in the long-neglected sierra region, the administration opted for what it perceived to be the fastest solution to the problem. A full-scale military operation was deployed in 1983, and the government turned to U.S., Argentine, and Israeli advisors for counterinsurgency training (Reid 1985, 114). Adopting a no-holds-barred strategy of mopping up the guerrillas, the government's campaign had turned into an Argentine-style dirty war by 1983.[17]

Meanwhile, other elements of the Peruvian poor were taking advantage of legal channels, including nationwide municipal elections in 1983, to register their grave discontent. The 1983 elections produced a critical realignment toward the center-left. APRA, led by Alan García, garnered 33 percent of the vote; and the Izquierda Unida (IU), a coalition of six left-wing parties, won another 29 percent and captured the municipality of Lima. These results signaled Peruvians' deep frustration with Belaúnde's policies and may have marked the first phase of an archetypical Latin American populist cycle: a strong negative reaction to the hardships of orthodox management (Sachs 1989; Dornbusch and Edwards 1989, 5–7).

By 1985 the political momentum had shifted enough to allow APRA's Alan García to win the presidency with a convincing majority. He even enjoyed a tacit alliance with much of the opposition on the left (the IU) as well as the support of some business sectors, particularly those tied to finance and nontraditional exports, such as the Romero-Raffo group (Reid 1985). The new APRA government promised to reverse previous policies and pursue worthy social-democratic goals, including inflation reduction, economic growth, and income redistribution toward the poor. Unfortunately, however, the method chosen to achieve this goal—"heterodox" economic policy combined with a commitment to private investment—proved disastrous.

16. Of the growing literature on Peru's Sendero Luminoso, good starting points are McClintock (1984), Reid (1985, chap. 7), Degregori (1986), and Gorriti (1990). Excellent journalistic accounts throughout the 1980s have been provided by Raúl González and José María Salcedo in various issues of the DESCO publication *Quehacer.*

17. Raúl González, "Gonzalo's Thought, Belaúnde's Answer," *NACLA Report on the Americas* 20, no. 3 (June 1986):34–36. Some argue that this decision to resort to a military strategy helped make the conflict between Sendero and the Peruvian state the intractable problem that it is today (Gorriti 1990).

THE RISE AND FALL OF PERUVIAN HETERODOXY

The era of Peruvian heterodoxy was signaled in President García's inaugural address: an attack on the International Monetary Fund followed by his announcement that Peru would limit debt service to 10 percent of export earnings. The debt-service limits drew immediate international attention, but the domestic policies promptly 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 who had long stood in the wings offering criticisms of IMF-style policy and suggestions for an alternative strategy (Carbonetto 1987; Carbonetto et al. 1987; Dancourt 1986a; Dancourt 1986b; and Ferrari 1986). Rooted in the Latin American structuralist tradition, these economists argued that various rigidities in the Peruvian economy made most elements of orthodox stabilization policy inappropriate. In their view, prices in industry were set mostly via markups 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 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 (which was in turn due to previous investment in capacity), while import coefficients were mostly fixed by the technical requirements of production. Spending patterns varied according to socioeconomic class: workers and peasants spent virtually all their income, while capitalists engaged in capital flight or consumed luxury imports and only occasionally invested. In contrast to industry, agricultural prices were flexibly determined by demand, while supply responses were slow and uncertain.

Taken together, these features implied that IMF-style policy was ineffectual and indeed likely to cause stagflation. Although the orthodox view perceived inflation as a signal of excess demand and trade imbalance as the result of an "incorrect" exchange rate, heterodox analysis implied that devaluation might barely budge exports while leaving the import coefficient untouched. Therefore, any improvement in the trade balance would 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 due to reduced urban demand.[18]

18. For general models of Third World economies and the possible perverse results of

Several key elements of the Peruvian economic structure lend credence to this heterodox analysis. In 1985 nearly 80 percent of Peruvian exports were of the price-insensitive "traditional" kind described above. A similar percentage of imports were intermediates and capital goods used in domestic manufacturing in relatively fixed proportions (Cuánto 1990a, 838, 845). Pricing behavior was also consistent with heterodox assumptions. Richard Webb, former president of the Banco Central, estimated that the prices of 33 percent of final domestic demand were determined by direct government control while 23 percent was determined by a markup rule (Webb 1987). Seventeen percent of the economy was in a "semi-flex price sector," mostly tradables or goods with high import content in which prices were largely determined by the exchange rate set by the government. This pricing scenario left only 27 percent of final demand in the "flex-price sector" that might be subject to the "excess demand" explanation typical of orthodox theory.[19]

If orthodox policies could not combat inflation, reactivate growth, and raise real wages in such an economic structure, what could? This question was central to the political forces aligned with García, particularly given the importance of meeting the needs of the poor and working classes who had supported him and mitigating the threat from Sendero Luminoso. Inflation reduction, however, was a novel focus for a structuralist vision in which price hikes had long been considered a "natural" result of the pressure placed by healthy economic growth on inelastic food supplies. It was nonetheless time to move beyond formulating critiques and devise a specific plan of action.

The result was heterodox economic policy, a strategy that sought to contain inflation by directly controlling prices and 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 the costs of working capital. The real price of government-supplied inputs was also reduced, producing a favorable impact on cost pressures. The effects on inflation were reassuring: within a year, the rate of price increase had fallen from 158 percent to 63 percent.

This Peruvian attempt to reduce inflation was similar to the Argen-

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orthodox policies, see Krugman and Taylor (1978) and Taylor (1981, 1988). For a model of the Peruvian economy in particular as well as a formalization of the heterodox logic, see Pastor (1988).

19. Most of this flex-price behavior occurred in agriculture, a sector that had little short-term macroeconomic impact because price hikes in this sector merely redistributed the source of the demand for manufactures from workers to peasants without generally diminishing the level of demand. In the long run, agriculture could make an important contribution to the macroeconomy by helping reduce the reserve drain prompted by food imports (see the model in Pastor 1988).

tine and Brazilian "heterodox" experiments carried out during the same period.[20] All these programs stressed the role of costs and emphasized the need to break inertial inflation, in which past cost and price hikes, through formal and informal indexation, fed directly into current inflation. The remedy, it was argued, lay in cost controls combined with a price freeze designed to thwart indexation and alter inflationary expectations. Yet Peruvian heterodoxy differed from its neighbors' programs in several key ways: it explicitly tried to relieve the external growth constraint through limiting debt service; it discounted the possibility of excess demand inflation and sought instead to stimulate demand by hiking real wages and widening government deficits; it explicitly sought to cement an alliance with private capital through *concertación,* a type of ongoing consultation about macropolicy with the country's most prominent capitalists; and it included a medium-term objective (albeit an unfulfilled one) of reorienting the economy toward industrial exports and greater self-sufficiency. We will explore here the main policy currents—debt service limits, inflation and demand management, and relations with private capital and other classes—and touch briefly on issues pertaining to medium-term restructuring. We will also explore the state's limited administrative capacity for such an interventionist program and suggest why, despite seemingly more coherent policy in its last years, the García team could not avoid the startling hyperinflation and recession witnessed in Peru since late 1988.

Debt-Service Limits

Limiting 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 exchange rate (and hence prices), and the substitution of intermediate imports for debt payments was similarly expected to allow for economic reactivation.

This debt program was neither as dramatic nor as ill-considered as some observers seemed to think. For simple lack of financial resources, the Belaúnde government had already quietly stopped most payments to commercial creditors, reducing the debt-service ratio from more than 45 percent in 1982 to less than 20 percent by 1984. APRA's stated policy

20. The literature comparing the various heterodox stabilization experiments in Latin America since 1985 is abundant, but except for our brief attempt to distinguish Peruvian heterodoxy from its Argentine and Brazilian counterparts, a full comparison lies beyond the scope of this analysis. For early work reviewing the wave of heterodox programs, see Arida (1986), Cardoso (1986), Dornbusch and Simonsen (1987), and Mann and Pastor (1989). For excellent postmortems of the Brazilian and Argentine efforts, see Kaufman (1990) and Smith (1989).

through 1987 was actually more politic, in that it vowed to honor selectively obligations that would lead to trade and development financing. In this vein, Peru continued to service short-term trade finance and to make payments to multilaterals like the World Bank and the Inter-American Development Bank. In hindsight, the García strategy represented the first attempt at a coherent Peruvian approach to debt since servicing difficulties had emerged in the late 1970s. It also made particular sense in view of the dim prospects for new voluntary lending to Peru by commercial creditors (Wise 1988).

The strategy nevertheless presented several problems. First, the García government found it hard to make payments deemed important for maintaining trade and development finance and yet remain below the self-imposed limit of 10 percent. Not until 1988 did the debt-service ratio dip below 10 percent, reflecting mostly a severe incapacity to pay rather than a conscious strategy (see table 4).[21] Second, the public stance against the IMF and the anti-imperialist rhetoric accompanying it (unlike the quiet nonpayment of the Belaúnde administration) isolated Peru from the international financial community. The IMF declared Peru an "ineligible borrower" in August 1986, and flows from the other multilaterals fell steadily throughout the period of heterodoxy, reflecting a lack of confidence in the APRA program and irritation with the debt challenge issued by García.

The key problem with the debt stance, however, was its lack of a clear strategy for creating alternative sources of foreign exchange. Negative reactions from foreign creditors should have been expected, and attention should have immediately turned toward vigorous export promotion and more efficient import substitution. This approach, however, contradicted the desire to feed the reactivation with imports while holding down prices by means of a fixed exchange rate. The government allowed imports to rise from 1.8 billion dollars in 1985 to 3.2 billion in 1987. During the same period, export revenues fell by more than 10 percent, transforming the 1985 trade surplus of 1.2 billion dollars into a trade deficit of more than a half-billion dollars in 1987 (see table 3). Growth targets were more than met, as the GDP grew by nearly 16 percent in these two years, but net international reserves fell from 1.4 billion dollars at the end of 1985 to a paltry 81 million dollars by the end of 1987.

Thus rather than utilizing debt-service limits to preserve foreign exchange and buy time for a structural transformation that would have reduced external dependence, the government opted for a rapid expansion that depleted reserves, fed inflation, and eventually provoked an

21. The inability to stay within the "10 percent" limit led to a somewhat strained attempt by Peru's Instituto Nacional de Estadísticas (INE) to classify debt service in terms of what was included in the 10 percent and what was not. Such sleight of hand did not replenish the reserves being drained by excess debt payments.

economic crash. To be fair, some members of the team became conscious of the problems in the external sector by late 1986, but they were 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 reduce out-payments further until growth targets were met. As might have been expected, loan flows from the multilaterals rapidly vanished, and the last years of the García administration were marked by a tense standoff between Peru and its creditors. The debt limits that had held so much promise had yielded disaster instead.

Inflation and Demand Management

The heterodox program emphasized cost-push and inertial inflation, contending that excess demand was an unlikely culprit when Peru'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). Because economic reactivation was also a goal, the government mandated increases in real wages and allowed the government deficit to grow (mostly by reducing taxes and increasing subsidies). The results regarding growth and inflation were impressive: in 1986, Peru posted the fastest growth in Latin America and the inflation rate had been halved. By 1987, however, the inflation rate had nearly doubled, and in 1988, it rose to 1,722 percent as GDP plummeted by more than 8 percent. What went wrong?

At least three reasons explain the collapse of the program. The first involves 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 utilization of industrial capacity was cogent, but in an economy like Peru's, output is constrained less by plant and equipment than by the ability to import intermediate inputs (that is, goods, including capital equipment, used in producing final consumer output). The 1986–87 import boom drained reserves, which spurred inflation in two major ways. First of all, the subsequent reduction in import capacity constricted supply and allowed producers to increase markups, a phenomenon that also redistributed income toward capital (see table 6 for distributional patterns).[22] Second, the shortage of foreign exchange led nervous inves-

22. That such a markup adjustment occurred 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 by more than 20 percent (from 0.348 to 0.425), a trend that accords with such a markup adjustment (see table 6).

TABLE 6 Distribution in Peru, 1980–1988

Year	*Wage Share of National Income (%)*	*Profit Share of National Income (%)*	*Agricultural-Manufacturing Terms of Trade (1979 = 100)*
1980	37.7	38.1	115.1
1981	38.0	38.3	117.5
1982	39.0	34.9	104.5
1983	40.9	32.4	106.2
1984	37.2	35.2	96.0
1985	34.4	38.4	66.9
1986	36.4	34.8	87.9
1987	36.5	36.3	92.9
1988	28.8	42.5	53.5

Sources: National income was calculated as 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 were taken from sectoral GDP deflators reported in INE (1989, 214).

tors to convert their savings into dollars even before this trend was accelerated by García's attempt to nationalize the banks. This outcome drove up the exchange rate in the parallel market, put pressure on the official exchange rate, and led producers to seek "defensive" price hikes in anticipation of devaluation.

Another source of inflation was the government deficit. APRA economists were initially convinced that the budget deficit would have little inflationary impact in light of existing idle capacity. As a result, the "economic deficit" of the public sector was allowed to rise from 2.4 percent of GDP in 1985 to 6.5 percent in 1987 (see table 7).[23] The main source of the increase was not central government expenditures (which fell in real terms throughout the period) but shrinking tax revenues. Tax pressure fell from 12.4 percent of GDP in 1985 to 8.2 percent in 1987 and to 7.4 percent of GDP in 1988 (Cuánto 1990a, 263, 758–59). The first decline mainly resulted from deliberate policy on the government's part, while the second reflected the well-known "Olivera-Tanzi effect," in which high inflation erodes the real value of tax revenues because of fixed lags in tax collection.[24]

23. The "economic deficit" does not include amortization of debt, little of which was actually done anyway. The "financial deficit" that included amortization (usually financed in the García period by arrears) was naturally much higher but less important for determining demand pressure in the economy.

24. It is also likely that high inflation in Peru induced taxpayers to lengthen their usual delay in making tax payments in order to reduce the real value of their obligations. The government responded by attempting to shorten collection lags.

TABLE 7 Public-Sector Finances in Peru, 1980–1989

Year	*Central Government Income (% of GDP)*	*Central Government Spending (% of GDP)*	*Public-Sector Income (% of GDP)*	*Public-Sector Spending (% of GDP)*
1980	17.1	19.5	45.8	49.7
1981	14.3	18.2	39.2	45.9
1982	13.9	17.0	40.2	47.6
1983	11.5	18.7	43.8	53.6
1984	13.2	17.4	39.3	45.5
1985	14.1	16.2	43.2	45.6
1986	12.0	15.5	32.6	37.6
1987	8.7	14.3	26.1	32.6
1988	8.1	10.7	23.1	29.0
1989	—	—	—	—

Sources: Data on central government income and expenditures as a percentage of GDP were taken from Cuánto (1990a, 755–56). Public-sector income and expenditures came from Cuánto (1990a, 738–39), and nominal GDP figures from Cuánto (1990a, 263). Real tax income and central government expenditures were calculated by using the relevant expenditure deflator taken from INE (1989, 546, 548). The figures for the public sector include the central govern-

The government deficit was inflationary for three reasons. First, it added to demand when the economy had already spurted past the inflationary trigger of import capacity. Second, key economic actors in business and labor associated deficits with inflation and, whatever the real effects, tended to shift inflationary expectations upward. Finally, the deficits were accompanied by annual growth in the basic monetary supply of nearly 150 percent in 1987, a trend sure to feed into prices. Particularly troublesome was the differential between export and import exchange rates, a feature that contributed to Banco Central losses on the order of 2.8 percent of GDP in 1987 and poured excess liquidity into the economy.[25]

A final inflationary impetus was the misalignment in relative prices provoked by the combination of demand expansion and selective price controls.[26] While administered or controlled prices rose only 38.4 percent during the first seventeen months of the program (between July 1985 and

25. To see why a system of multiple exchange rates can promote monetary expansion and inflation, consider the case of an exporter who receives 200 *intis* per dollar of exports from the Banco Central but needs to expend only 100 intis for a dollar's worth of imports. The result is an extra 100 intis that can be spent locally. Because domestic production has not risen in the transaction, the exporter's expenditure will now drive prices up in order to ration others out of the market. In this sense, a traditional deficit is less damaging in that it generally adds to output and therefore dampens some of the inflationary pressure. The *brecha cambiaria* (or exchange gap) that arose from the multiple exchange-rate system was more dangerous. The figure for the impact of the brecha on Banco Central losses comes from Dornbusch and Edwards (1989, 43).

26. This argument borrows heavily from the analysis in Paus (1991).

Deficit of Central Government (% of GDP)	*Deficit of Public Sector (% of GDP)*	*Change in Real Tax Income*	*Change in Real Central Government Expenditures*
-2.4	-3.9	6.0	16.7
-3.9	-6.7	-22.0	-6.9
-3.1	-7.3	0.0	-8.1
-7.2	-9.8	-24.1	-1.4
-4.1	-6.1	13.2	-3.6
-2.0	-2.4	16.9	-5.4
-3.5	-4.9	-12.9	0.8
-5.5	-6.5	-22.9	-3.7
-2.6	-5.8	20.2	-9.9
-2.7	—	—	—

ment as well as state enterprises, local governments, public institutions, and the social security system. The deficit figures are for the "economic deficit" (not including amortization). The central government deficit as a percentage of GDP for 1989 was figured as a simple average of the monthly series reported in Cuánto (1990b, 11) and is preliminary.

December 1986), uncontrolled prices shot up 133.9 percent (Paus 1991, 419). The reason lay in the pressure placed by rising income on "flex-price" markets. This phenomenon yielded some progressive 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 5). This dramatic rise in unregulated prices, however, implied that inertial inflation had not been stopped beyond formal industry and that once the controls were lifted, industrialists would engage in an inflationary round of price hikes to restore the relative prices enjoyed prior to "stabilization." Inflationary pressures, in short, were bottled up but far from eliminated.

Class Relations

The APRA program represented a direct response to the intense social pressures that had been building since neoliberal measures were adopted in the late 1970s and early 1980s. Initially, wages grew as did farmer and informal-sector income, shoring up the administration's political base and providing the burst of aggregate demand needed to reactivate the economy. But the policies were not tailored solely to the needs and interests of these popular classes, nor was the program an effort at socialist transformation. Rather, it was a complicated social-democratic balancing act that attempted to incorporate workers, *campesinos,* and informal-sector participants via higher incomes while leaving investment decisions in the hands of private capital. Indeed, the long-run future of the program hinged on a boom in private investment that would expand export capacity and thereby relieve constraints on foreign exchange and inflation.

To convince business of the seriousness of its intentions, the APRA government reduced the public investment program, ostensibly to create space for the private sector—despite evidence that public investment had actually been complementary to private investment in Peru's past (Thorp and Bertram 1978, Pastor 1990b). The García administration also protected profit margins by combining real wage hikes with reductions in taxes, interest rates, and parastatal prices. It also initiated a series of direct meetings between García and representatives from the country's twelve largest business groups (the so-called *doce apóstoles*).

This process of government-business concertation or negotiation yielded some positive results: private investment rose from 12 percent of GDP in 1985 to over 14 percent of GDP in 1987. But the private sector remained wary, put off by an early government attempt to sop up profits with a mandatory bond-purchasing scheme (soon suspended on constitutional grounds) and by 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 "doce apóstoles" and preventing capital flight through the banking system. Devised in secret by a small group of advisors and announced in a presidential speech in July 1987, the bank nationalization was billed as a way to "democratize credit." The measure, however, signaled the death of any semblance of concertation and heralded the beginning of a war with private capital.[27]

The struggle over the banks won García few allies. Labor was already alienated by his previous courting of capital, and although the leftist opposition supported the attempted bank seizure, it criticized virtually every other initiative of the APRA government. The attempt at nationalization also reinvigorated the rightist opposition. Novelist Mario Vargas Llosa gained new political notoriety by forming his "Frente Democrático" from the remnants of Belaúnde's earlier AP-PPC coalition and by casting the nationalization as an arbitrary seizure of private property that threatened not only big business but middle-class entrepreneurs and even informal street vendors. In the end, the banks remained private due to a combination of legal challenges and the devolution in some banks of majority ownership to employees (a category exempted from the nationalization decree). The damage, however, was already done: García was

27. For a lengthy analysis of the Peruvian banking nationalization, including a defense of the democratization rationale, see Parodi (1991).

isolated politically, business was hostile, and the right, formerly marginalized by its poor showings in the 1985 elections, was reborn.

Administrative Capacity

The problems described above—excessive draining of reserves, scant attention to underlying inflationary dynamics, and an ill-considered attack on the same domestic capitalists in whose hands the fate of the program had originally been placed—were exacerbated by the glaring administrative incapacities of the government. As noted earlier, the already weak Peruvian state had been further gutted during the "free-market" era of the early 1980s. This trend was soon aggravated by inter-agency conflict, the isolation of key policymakers, and García's highly autocratic style (Wise 1989).

The inter-agency conflicts involved both politics and policy. The Ministerio de Economía y Finanzas was controlled by Luis Alva Castro, a potential challenger within the APRA to Alan García. Although generally supportive of the heterodox reactivation plan, Alva Castro resigned almost immediately after problems emerged, apparently to protect his status as a contender for the 1990 presidential race (in which García was constitutionally barred from succeeding himself). The Banco Central, although headed by a García supporter, retained its traditional support of more conservative policy, particularly in the ranks of middle management. The Instituto Nacional de Planificación experienced a brief institutional revival, attracting many of the economists and technicians who made up the heterodox team. But its long-term plans were ultimately ignored, and as it became increasingly marginalized from García's inner circle, the institute was torn by internal dissent.[28]

Given these conflicts, control over economic policy revolved around a small homogenous group consisting of the president and a handful of advisors.[29] Like Belaúnde's technocratic "dynamo" group of the early 1980s, this heterodox team was highly insulated and extremely influential, a combination that created several problems for implementing policy. First, middle managers in the various ministries neither understood the program nor believed in it, and they often carried out state directives reluctantly at best. Second, the wide discretionary power of the team allowed it to engage in sharp policy shifts, such as the bank nationaliza-

28. One of the authors discovered the extent of this internal dissent when making a presentation on macroeconomic stabilization at the Instituto Nacional de Planificación (INP) in mid-1988. Half the audience firmly agreed with the analysis and prescriptions while the other half found them wholly inappropriate, a division that clearly reflected the deep disagreements within the government itself.

29. Prominent among the latter was Daniel Carbonetto, an Argentine who shared Alan García's social-democratic vision and took the lead in implementing the heterodox model.

tion. Had the team exercised less influence with García, policy change would have been moderated by the typical interministerial consultations and negotiations. Third, the team's small size and its reliance on executive mandate gave the president an extraordinary degree of control over economic policy. García took carefully crafted adjustment packages and arbitrarily changed policy measures to soften the political impact, which resulted in economic inconsistency. By mid-1988, even the team members were bickering among themselves, particularly over exchange-rate policy.

Failure of the heterodox program and the passage into hyperinflation brought additional difficulties. Tax revenues fell, dragging down government expenditures as well. As government salaries and authority declined, so did the incentives for public-sector employment. Hyperinflation made planning as difficult for the state as for the private sector. Finally, the collapse of heterodoxy in 1988 led many on the policy team to abandon their positions (García's key economic advisor, Daniel Carbonetto, even left the country). This trend further isolated President García and left him with no economic advisor whom he truly trusted, a situation that posed severe problems in the final year and a half of the García administration.

Hyperinflation

By mid-1988, the desperate economic situation forced a major policy shift. In September the government pushed through a package involving a sharp devaluation, public-sector price hikes, and several tax-raising measures (including a shortening of collection lags to combat the Olivera-Tanzi effect and a misguided 4 percent tax on exports). The government also proposed an industrial price freeze but allowed adjustments prior to implementation. The result was an extraordinary round of preemptive price hikes. In September alone, inflation hit 114 percent while GDP fell 10 percent. Hyperinflation had set in as monthly inflation averaged 35 percent from October 1988 through July 1990, when the new president took power.[30] Meanwhile, output continued to fall. Although it recuperated a bit in mid-1989, GDP by April 1990 was 15 percent below its level in July 1985, the first month of the García administration, and 30

30. The classic definition of hyperinflation is found in Cagan (1956): it begins when monthly inflation exceeds 50 percent and ends when inflation dips below that level for a year. By this rather restrictive definition, Peru's price chaos was not officially "hyperinflation." But today's more common definition of 1000 percent inflation on an annual basis (or 22 percent monthly) qualifies Peru as a hyperinflationary economy (see Dornbusch and Fischer 1990, 663). Recent work by Dornbusch, Sturzeneger, and Wolf (1990) even suggests a definition of extreme inflation as occurring when monthly price hikes exceed 10 percent. This cutoff seems too low to us in that it amounts to an annual percent inflation rate of just over 200 percent. We therefore prefer the 1000 percent threshold.

percent below the December 1986 peak reached in 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 throughout this period.[31] Although the continuing price pressure was partly due to the government's strategy of reactivating the economy in time for the municipal elections in November 1989 and presidential elections in March 1990, 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; Sargent 1986). Unfortunately, instilling confidence that the fiscal and exchange reforms will stick usually requires a dramatic change in political or policy regime.

In neighboring Bolivia, the leftist administration of Hernán Siles Zuazo failed to stop a hyperinflation with several well-constructed orthodox packages. The government 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 macroeconomic problems. Vargas Llosa, heading his rightist coalition known as FREDEMO, promised to reduce annual inflation to 10 percent with a harsh program of cuts in public spending, mass firings of state workers, privatization of state-owned enterprises, devaluation, liberalization of imports and domestic markets, and tight monetary policy. He soon backpedaled, however, saying that he would only implement the proposed "shock" after engaging in a massive monetary emission that would drive inflation up and reduce the real value of government debt, a strategy designed to shrink domestic debt service and hence the government's structural spending.[32]

This curious attack on asset holders by a politician of the right was

31. 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. He suggests, "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.

32. The decision to delay the shock and "clear" internal debt through inflation was apparently rooted in the view that the orthodox program adopted by President Carlos Menem in Argentina failed precisely because inherited payments obligations on the domestic debt impeded budget correction. See "FREDEMO to Delay 'Shock' Measures," *Latin American Regional Reports, Andean Group,* 8 Mar. 1990, p. 6.

matched by the equally uncharacteristic nature of the left's proposal. Inspired by the analysis of Oscar Dancourt and Ivory Yong (1989), the left argued that because the final stage of hyperinflation (prior to its demise) involved total dollarization and because some Peruvian prices were still moving independently of the exchange rate, it would be best to accelerate the process "artificially" and dollarize all prices as soon as possible. Such an appeal to the "imperialist" currency was unusual but did offer 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. Why anyone would have faith in this new currency was an obvious question, but one that remained unanswered by its proponents.

Against this chaotic backdrop, Alberto Fujimori, the Peruvian son of Japanese immigrants, promised to lick inflation with "Honesty, Technology, and Work." He went on to win the election for a number of reasons, including a racial dynamic in which Vargas Llosa's European features and tastes counted against him with the large indigenous peasant and working populace that had traditionally been dominated by Peru's "criollo" class. Vargas Llosa was also viewed as an independent who had subsequently transformed himself into a tool of the traditional rightist parties. But apart from this rejection of entrenched party politics, perhaps the crucial reason behind 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 recent history suggests that positive results are unlikely?

Requiem for Heterodoxy

Given the demise of heterodoxy in Peru, it is useful to consider whether the experiment represented a new approach or simply a hybrid strand of traditional Latin American populism, as Dornbusch and Edwards (1989) have argued. Such populist episodes generally involve governments that try to put together a multiclass coalition that favors the working class but also courts capital. To achieve this end, the government tries to make up for squeezed profit margins with rapid growth that swells the amount of profits and hence the profit rate on installed capacity. Growth is achieved through a rapid expansion of demand, which in turn 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 via a military coup) to reverse both the macroeconomic policies and the distributional concerns.[33]

33. This populist "story" draws on Díaz Alejandro (1981), Drake (1982), Sachs (1989), Dornbusch and Edwards (1989), and our own experience in Peru.

The Peruvian pattern certainly fits this populist cycle in terms of macroeconomic and political outcomes. We would suggest nevertheless that Peruvian heterodoxy and García's political project were more sophisticated and coherent than their populist counterparts in Argentina under Perón and Chile under Allende. 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 the heterodox team forgot their structuralist roots and allowed the economy to expand beyond its external bottlenecks.[34] The government's strategy of controlling key prices in order to slow inertial inflation was coherent and has been used with success in countries like Mexico since late 1987. The problem in Peru was the blending of selective price controls with demand expansion, a combination that misaligned relative prices and only temporarily smothered inflationary pressures.

García's politics were also more enlightened than traditional populism. He sought to redistribute resources downward but never tried to create a basis of support exclusively in working and popular classes. Until the ill-fated banking nationalization, the private sector was actively courted with subsidies and political favors, and García saw himself as creating a social-democratic capitalism that could provide the social consensus necessary to promote development and counter the challenge posed by longstanding inequities and increasingly violent encroachment by Sendero Luminoso and others. As appropriate as this "Rooseveltian" response to economic crisis may have been, the problems encountered in actually implementing it were both structural and conjunctural. First, the rapid growth that was supposed to cement the new social democratic pact of capital and labor proved impossible because of the external-sector pressures and macroeconomic imbalances already elucidated.[35] Second, the dramatic shifts in García's approach to private capitalists sharply undermined business confidence and eroded the possibility of a cohesive state-capital alliance for medium-term restructuring.

Our purpose here is not to defend Peruvian heterodoxy, at least not as practiced by the García team. Certain elements of the program defied common sense as well as economic logic: the complete discounting of the inflationary effects 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 order of a negative 30 to 40 percent in 1987 were not a significant problem. But as Eva Paus has

34. Sachs 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" (1989, 30–31).

35. For a review of the difficulties faced by newly established Latin American democracies in reconciling higher levels of political participation and poor economic performance in the 1980s, see Remmer (1990).

argued, "the failure of the Peruvian heterodox program does not warrant the conclusion that a well-conceived and implemented heterodox program cannot work" (Paus 1991, 426).

Unfortunately, any such reconstituted heterodox program, whatever its merits, would now be rejected by Peruvian society, primarily because of the painful memories of the last experiment. Indeed, one of the strongest indictments against García is that his government managed to discredit completely both the neostructuralist approach and the notion of progressive redistribution, thus paving the way for a new era of orthodox economic policy and a probable reduction in lower-class income. Through a combination of poorly designed policy, poorer implementation, and even poorer political coalition building, the García government hurt those it had promised to help and thus fed into the upward spiral of violence and instability in Peru.

CONCLUSION

This article has reviewed a decade of Peruvian economic policy in terms of policy fluctuations, program consistency, implementation difficulties, and overall political economic outcomes. On all these fronts, Peru's record ranks as perhaps the worst in contemporary Latin America.

The neoliberal program of the early 1980s represented a continuation of the policy trends of the late 1970s, but it also constituted a dramatic change from the more interventionist strategies employed by the Velasco government from 1968 to 1975. The Belaúnde program failed in Peru for the four reasons already detailed: the analysis of inflation generally ignored cost-push factors and the resulting policy focus on restricting demand produced recession without constraining prices; policy measures were often reversed midstream due to economic or political pressures; the neoliberal intention to reduce the public sector made virtually no inroads but did help weaken the administrative capacity necessary for implementing any development program at all; and the program's regressive distributional effects sharpened social divisions and paved the way for an alternative.

In the second half of the 1980s, orthodoxy was dropped in favor of an untested heterodox program. While the heterodox analysis of Peruvian economic structure and its critique of neoliberalism were compelling, the results of the new program landed the heterodox approach on the same policy junk-heap. Part of the problem lay in conception: fiscal deficits do matter, prices cannot be set arbitrarily, and external constraints demand early attention. But whatever the conceptual shortcomings, García's implementation of the heterodox social-democratic program was even worse. Euphoric over early success at rekindling growth, slowing inflation, and improving the lot of the poor, García and his highly insulated team refused to make necessary midcourse corrections (Thorp 1987; Mann and Pastor 1989). Meanwhile, García alienated labor and international creditors and then provoked a war with domestic capital by attempting to nationalize the banking system. With his political base destroyed and his economic program in shambles, García offered a series of one-shot orthodox policy packages that did little to slow Peru's slide into hyperinflation and depression.

Now a new president has heralded yet another dramatic shift in policy. On 8 August 1990, Alberto Fujimori announced a series of measures that included a 3,000 percent increase in gasoline prices (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 a generally unsupportive approach to any wage compensation for the resulting 397 percent monthly inflation.[36] In broad policy terms, the program resembled Bolivia's 1985 orthodox stabilization package. Matching Bolivia's anti-inflation success, however, will be difficult given the legacy of the last ten years in Peru.

For one thing, income distribution remains highly unequal, making social consensus on policy problematic. After a brief improvement during the first years of the APRA government, real wages (and wage share) are now lower than any time since 1980. Informal-sector income has plunged to a decade low, while rural-urban terms of trade have lost the ground gained in 1985–1987. Having vowed to serve the poor, García inadvertently created a situation in which the share of income accruing to property owners (profits, interest, and rent) rose to its highest level in the 1980s. Thus the inequalities wracking Peruvian society continue to constrain the possibilities for cross-class alliances.

This unintended outcome has been reflected in the waves of violence that began with Sendero Luminoso's sabotaging of electoral ballot boxes in 1980. 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 regrouped. Its reach now extends beyond the central and southern Andes to the coca-producing region of the Upper Huallaga Valley and into Lima itself, particularly in the factories, universities, and social organizations that were formerly the traditional political footholds of IU and APRA. A new leftist insurgency, the Movimiento Revolucionario Túpac Amaru (MRTA), has also arisen; and toward the end of García's term, the APRA party itself allegedly fielded the Comando Rodrigo Franco, a death squad that readily claimed responsibility for assaults on Sendero sympathizers and anyone who openly criticized the

36. See "Peruvians Stunned and Angered by Fujimori's Harsh Economic Measures," *Latin American Regional Reports, Andean Group,* 6 Sept. 1990, p. 1.

APRA government.[37] The military has responded in kind with indiscriminate use of force, intimidation, and human rights abuses, particularly in the designated "emergency zones." Against this backdrop of social cleavages and intense violence, the search for consensus on an adjustment package for Peru threatens to become an endless quest.

The crucial tasks of stabilization and adjustment have been made all the harder by Peru's continuing isolation from the international economy, especially the international financial system. This legacy of the García era has created several problems for the Fujimori administration. While the "Fuji-shock" of August 1990 has received quiet words of approval from international agencies, Peru still owes nearly 3 billion dollars in back payments to the multilaterals and official lenders, a sum that will impede any quick return to official lending. Bolivia survived the period between stabilization and the reopening of official lending by legalizing the deposit of dollars without proof of origin, a thinly disguised ploy to tap the flow of coca-dollars. Such 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. Although Peru may be a strong candidate for a "Polish-style" sharp reduction in official debt, hesitancy about the seriousness of the new Peruvian program, the matter of arrears, and the generally slow movement of international bureaucracies all work against rapid delivery of debt relief.

After a decade of dramatic swings in policy with mostly diminishing returns, Peruvians are weary and wary of new promises. If the Fujimori government's early track record is any indication, there is indeed reason for popular skepticism. As in the Belaúnde period, the economic team has set about liberalizing the trade account and banking system, allowed interest rates to float "freely," and targeted for privatization the same list of thirty state-owned enterprises cited since 1982. As in the past, hopes are unrealistically high that quick sale of these firms as well as the general embrace of market norms will fill the dire budget gap. Meanwhile, the government is chiseling away at the salaries of top state managers, exacerbating the disincentives for qualified individuals to remain in public service. Finally, consistent with Peru's pattern of policy inconsistency, the present government has lagged in trying to create a more effective tax system and zigzagged in managing the exchange rate. Credibility suffered early in the new regime when President Fujimori reversed his campaign promises of gradualism and instituted harsh austerity measures instead.

The political process has also been unable to escape the shadow of

37. For an explanation of APRA's reported ties to the Comando Rodrigo Franco, see Carol Graham, "A Peruvian Death Squad's Links to the Government," *Wall Street Journal,* 11 Aug. 1989, p. A13.

the past decade. The highly centralized process of decision making continues, whereby the executive is barely accountable to the congress, political parties, or public opinion. In less than a year, the Fujimori cabinet suffered five ministerial rotations, including the key posts of prime minister and economic minister. Political outsiders (almost everyone but Fujimori's small inner circle and his thinly based electoral coalition) have responded by calling for a "national agreement." Such calls for pacts and deals are the time-honored response of the opposition in Peru. Thus far they have amounted to little more than political grandstanding.

Throughout the 1980s, Peruvian society was wracked by exogenous shocks, continuing distributional and political conflicts, and shifting and ineffective macroeconomic policy. As tempting as it may be to focus on the external shocks and limits, Peru's alarming downslide fundamentally reflects the failure of the country's dominant groups to strike a viable compromise regarding a development model and the burden of the short-run adjustments necessary to achieve it. With a narrow political base and little experience, President Fujimori is at least trying to stop the hyperinflation. Unfortunately, the record since his inauguration, including an average rate of inflation of over 10 percent between the month following the "Fuji-shock" of August 1990 and April 1991, gives little cause for inspiration. Along the way, Peru's poor—bewildered by Fujimori's betrayal and hardened by a history of exploitation—are making it increasingly clear that they are no longer willing to bear the costs of elite policy experiments.

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