Orthodox Stabilization with Populist Overtones

Peru’s Social-Market Model and Its Southern Cone Counterparts

During the final two years of military rule, from 1978 to 1980, new political and economic events converged to set the country off on another erratic course for the 1980s. Peru’s penchant for a more market-based strategy by 1980 can be partly traced to the specifics of this transition and to factors that were discussed earlier, in chapters 2 and 3. First, until the 1960s, the country had a strong bias toward laissez-faire and a historical tendency to revert back to a liberal economic policy regime when attempts at direct state intervention failed. Second, transnational actors had a much greater influence during the last half of the 1970s; for example, the private banks and the IMF were unequivocally pro-market in meting out stabilization and adjustment guidelines for Peru. Although these programs had been unduly harsh in distributional terms, political elites went into the 1980s convinced that the orthodox cure had worked. Domestic entrepreneurs shared this perception to a large extent, as ADEX (the industrialists’ exporting society) and the more domestically oriented Industrialists’ Society pushed hard for future economic policies based more solidly on market signals.

The other obvious influence was the neoconservative management approach underway in various Southern Cone countries in the 1970s (Foxley 1983; Ramos 1986). In Chile, Argentina, and Uruguay, military juntas had intervened in the face of high levels of social conflict and political polarization, blaming most of the domestic turmoil on the state-led development strategies that had been in vogue within each country since the outbreak of the Great Depression. By rallying around a purist free-market banner, these regimes promised to put an end to the slow growth and high inflation that had plagued the Southern Cone throughout the post–World War Two period. These projects were both economic and political. By placing almost limitless faith in the dynamism of the private sector and clamping down on civil society, neoconservative leaders sought nothing less than a complete structural transformation of the political economy along market lines.

The specific policies that stemmed from the neoconservative school included the following: (1) attacking inflation through monetary control and exchange-rate devaluation, then pegging the exchange rate to the U.S. dollar
once prices had fallen (Fishlow 1985, 135); (2) privatization and abrupt cutbacks in the public sector’s share of GDP; (3) an open door for foreign investors (Fishlow 1985, 134); (4) a rapid reduction in tariffs and the reorientation of trade toward comparative advantage on world markets (Ramos 1986, 10); (5) freeing interest rates and eliminating controls over the allocation of private credit in order to promote domestic capital markets; and (6) the dismantling of any potential opposition, particularly organized societal interests (Ramos 1986, 10).

Peru’s comparison with this group goes just so far. As in the Southern Cone, market policies were embraced as part of the ongoing battle against inflation and as a reaction to what was perceived as the excesses of statism. But Peru’s social-market model was meant to form an economic cornerstone in the transition to democracy and in this sense lacked the fervor of the Southern Cone for a full-scale transformation of state-society relations through harsh authoritarianism. The question of why the neoconservative strategy was taken up so enthusiastically by Peruvian policy makers, at least in rhetorical terms, when it had clearly failed in Argentina and Uruguay, demands some explanation. Part of the answer lies with the performance of the Chilean economy, which, with its relatively higher growth and lower inflation up until late 1980, was still being trumpeted by the banks and the multilaterals as a free-market success (Stallings 1987, 185). As the Belaúnde economic team was gradually assembled from technocrats who had sat out the RGAF years working abroad in these institutions, the Chilean-style promarket mind-set had more or less been instilled from afar (Webb 1987, 30).

The following sections examine Peru’s efforts to implement the social-market model in four parts. First is a brief analysis of the political-economic context that framed the choice of this particular economic strategy. Second is a review of the policy goals as they were originally set forth by the Belaúnde administration. Third is a brief look at those institutional variables discussed in chapter 1 and the changes that occurred on this front during the 1980s. In terms of the arguments running throughout this book, this period is pivotal in the sense that it represents a further deterioration of those bureaucratic, institutional, and coalitional variables introduced earlier as contributing most to the political capacity of the state to effectively carry out a designated set of policies. This observation is substantiated in a fourth section that analyzes the social-market program in practice. Because the program never came together in a cohesive manner, but rather as a cluster of measures applied somewhat sporadically, what follows here is a disaggregated look at the main policy initiatives as they unfolded prior to the onset of the debt crisis in 1982.
Peru’s Return to the Market: The Political-Economic Context

The results of the June 1978 elections to the Constituent Assembly provided a fairly good barometer reading on the direction that electoral politics would take over the next decade. The APRA, having made its historic peace with the military during this period (Sanborn 1991), won a respectable 35.3 percent of the assembly vote. Although Belaúnde’s AP had registered for the 1978 elections, in the end the former president sat out the competition so as to concentrate on the 1980 presidential race. This cleared the way for the Popular Christian Party (PPC), founded from the more conservative bases of the Christian Democrats by former Lima mayor Luis Bedoya, and for the array of leftist parties that had come to the fore since 1975. Bedoya’s PPC won 23.7 percent of the 1978 vote, while the left together garnered an unprecedented 30 percent (Reid 1985, 76).

The subsequent assembly debates over the new constitution differed in at least two ways from those that had occurred during Peru’s democratic transition in the early 1960s. First, the positions of the three representative blocs in the assembly were not nearly as compatible as before. Second, a much stronger presence and more militant agenda was set forth by the left-wing groups in the assembly. In response to the heightened political and economic repression of the 1970s, the newly elected left-wing representatives of labor and the popular sectors had become more vociferous about demanding their basic civil rights. The strident stance assumed by each side meant that the final draft of the new constitution passed by the assembly in 1979 stood as more of a reflection of what these emergent factions hoped to gain under civilian rule and less of a guideline for resurrecting Peruvian democracy according to any formula based on political consensus.

Those constitutional articles that pertained to economic strategy and administrative reform of the state are of most concern here. Not unexpectedly, those delegates representing the interests of private capital from within the ranks of the PPC joined with the conservative wing of the APRA in setting a free-market tone for the debate. With Haya de la Torre at the helm as president of the assembly, the APRA-PPC alliance prevailed in passing a section on Peru’s economic system that reassigned the state its pre-1968 role of strictly complementing, rather than displacing or confronting, private enterprise. On this count, the key constitutional clauses guaranteed a pluralistic or

---

mixed economy organized around a “social-market model.” This redefinition of the role of the state in the economy directly overrode the left’s call for centralized planning, a strong state presence, and a deepening of the distributive reforms initiated under Velasco.²

Other constitutional debates relating to state reform were conducted with an eye toward avoiding the political-economic pitfalls of the 1960s, particularly the need for a stronger executive and a more direct and salient role for the BCRP in economic policy making. Provisions were passed allowing congress to delegate power to the president to rule by legislative decree for set periods of time, and, similar to the intentions underpinning the governance of the U.S. Federal Reserve, the head of the BCRP was to be appointed to a set five-year term, meant to allow him or her to stand above the fray of political influence and infighting. For most of the APRA’s opponents, the infusion of greater policy-making freedom into the executive was a thin veil for the party’s attempt to usher itself into the presidency with a virtually unrestricted mandate (Graham 1992).

In the end, some of the APRA’s more progressive elements did support the left in winning a broader range of constitutional rights and a call for better access to state resources in the areas of health, education, and welfare.³ In terms of expanding the opportunities for political participation, the major innovation was the enfranchisement of illiterates and of all citizens over the age of eighteen, which would bring an additional two million voters to the polls in 1980 (Reid 1985, 78). Finally, out of this legislative grab bag, the military successfully asserted its claims on state resources by winning continued budgetary autonomy for its ongoing operational expenditures and arms transfers (Graham 1992).

The predominant trend on the economic front during this period was Peru’s transformation from rags to riches in a matter of months. Just as Silva Ruete’s more technocratic economic team had finally buckled down in its commitment to adhere to the IMF stabilization targets, international prices for Peru’s mineral exports saw a dramatic turnaround. Having recently completed the Transandean oil pipeline and the Cuajone copper mine, the country was well positioned to benefit from this rise in the export price index between 1978 and 1980. The volume of oil exports, for example, increased 488 percent, while oil revenues grew at an annual rate of 254 percent. The windfall profits meant a substantial increase in tax payments on corporate income and international trade (Paredes and Pascó-Font 1987, 45). Overall, when export receipts began their unexpected takeoff in May 1978, net foreign

reserves had hit an all time low of -US$1.3 billion. By late 1979, this deficit had been turned into a US$1.6 billion surplus.4

The treasury had received an additional boost from nontraditional exports, the annual proceeds of which rose from US$96 million to US$845 million between 1975 and 1980 (BCRP 1987, 167). With the 1976 reform of the export-tax-rebate program (CERTEX, or Certificado de Reintegro Tributario a las Exportaciones) that had been initiated under Velasco, and a 50 percent exchange-rate devaluation that had been implemented over the same time period, nontraditional exports grew to account for one-fifth of all exports by 1979. Silva Ruete and BCRP president Manuel Moreyra had made the promotion of primary and nontraditional exports a centerpiece of the civilian recovery strategy in 1978 and had begun to reverse the severe credit squeeze on the private sector that occurred during the worst of the balance-of-payments crisis (Thorp 1977, 57). Industrialists, meanwhile, had lobbied successfully for the modification of the Social Property and Job Stability legislation, and the exporting industrialists’ association (ADEX) had been guaranteed a decade of government support under the expanded export-incentive system beginning in 1979 (Schydlowsky 1986b, 229).

Another economic sideshow that began to take off during this time was the cocaine trade. Even the most conservative estimates gauged Peru’s exports of illegal coca-based products to be worth US$500 million by 1980, third only to copper and oil.5 While the bulk of this revenue went to the top wholesalers, the need to launder the increasing quantity of coca dollars to purchase Peruvian currency to pay off local suppliers drew this cash closer into the domestic financial system in the late 1970s. The government, desperate for foreign exchange in 1977, began encouraging this cash flow through the creation of certificates of deposit (CDs) and by basically looking the other way on any bank deposits under half a million dollars. Thus, clandestine coca dollars also provided an unregistered reserve cushion for Peru.

From the standpoint of top policy makers at the time, inflation was the only remaining economic problem on which no headway had been made. Despite the rigorous orthodox stabilization program that had been in effect since 1978, inflation was still running at about 6 percent a month. Within state financial circles, there was no shortage of diagnoses as to the roots of inflation. Collectively, the economic team pointed to the rapid accumulation of reserves and the upward pressure on prices created from too much money chasing too few goods. The chosen remedies centered on increasing the flow of goods through rapid import liberalization, as the list of items whose import was prohibited

dropped from 670 to 9, and the launching of a range of financial measures geared toward halting excess liquidity. Still, at the end of his term as BCRP president in mid-1980, Moreyra admitted that “inflation is not coming down as fast as we want. We don’t have a real explanation, although we think economic theory is not working as it used to work 10 years ago.”

By the time of the 1980 presidential elections, the fortuitous turnaround of the external sector had influenced domestic economic policy perceptions in three major ways. First, the price boom served to bolster an unwarranted optimism over the permanency of positive shocks for prices on Peruvian raw material exports, while adverse trends were still viewed as transitory (Paredes and Pascó-Font 1987, 54). Second, because the rapid comeback enabled the country to initiate another major round of external borrowing (Stallings 1987, 285–87), it served to distract from other warning signals already flashing on international debt markets. Finally, having come on the heels of the stabilization program, the boom served to sway policy preferences in favor of orthodox management approaches, ignoring the fact that much of the IMF’s highly touted budget balancing and reduction in the public deficit were due to increased revenues, while state spending actually continued to rise.

It was against this unrealistic political-economic backdrop that the 1980 presidential campaign was conducted. With the exception that the AP had now joined the race, the protagonists in 1980 were the same as 1978. While each side basically reiterated its position from before, the difference this time around was that all but the PPC had been wracked with intense internal conflict. The APRA, by far the more cohesive and well-grounded of the participating parties, found itself torn by a fierce succession battle due to the death of Haya de la Torre in 1979. And the various parties on the left, having glimpsed their potential to assume a major role in Peruvian politics for the first time, quickly splintered over differences concerning ideology and strategy (Haworth 1983). As a result, the barrage of left-wing parties captured just 19 percent of the 1980 vote, and the APRA 27 percent.

Into the void stepped Belaúnde, with a broad platform stressing personality over program and offering something for everybody. Given little noticeable improvement in the AP’s organizational stature since the 1960s, its success in capturing 45 percent of the 1980 vote had more to do with the collapse of the opposition; the very low level of debate surrounding the campaign; and the fact that Peru’s electorate was now larger, younger, and not entirely cognizant of Belaúnde’s previously poor performance. Sixty-three percent of the

public was voting for the very first time.7 Also of note was the high percentage of blank votes (15 percent) that had been cast in the Andean departments of Ayacucho, Apurimac, and Huancavelica at the beckoning of Sendero Luminoso, the guerrilla movement that had sprung from the PCP in the late 1970s.8 Its attack on an Andean polling station in the context of the 1980 presidential elections, although ignored at the time, proved to be an ominous warning of things to come.

While the PPC had received just 10 percent of the 1980 vote, the party ascended in forming a postelection congressional alliance with the AP. Despite the AP’s more progressive, or at least centrist, reputation of the 1960s, and its larger presence in the congress vis-à-vis the PPC, it was the latter’s free-market stance on economic policy making that prevailed. The following section looks at the attempts of this new center-right AP-PPC alliance to carry out the “social-market” mandate that had been written into the 1979 constitution. Because the first two years of the second Belaúnde administration (1980–82) represent Peru’s final phase of financial solvency for the entire decade, the question of what was done with this last bit of economic room to maneuver becomes especially relevant for understanding the country’s plight through the remainder of the 1980s.

**Market Policies a la Criolla**

Rather than set forth a comprehensive economic program along the lines of the 1971–75 National Development Plan, the Belaúnde team’s strategy was laid out in a more piecemeal manner. Finance Minister Manuel Ulloa stated the initial program most succinctly in a lengthy presentation to congress in August 1980.9 Other aspects of the strategy were set forth in the 1981–85 public-investment program, and the president himself reiterated some policy goals from the AP campaign platform.10 Overall, what emerged from these various expressions of state policy was an approach that was considerably

---

8. The literature on Peru’s Sendero Luminoso is vast; good starting points are McClintock 1984; Reid 1985, chap. 7; Degregori 1989; and Gorriti 1999. Raúl González and José María Salcedo in various issues of a Peruvian magazine, *QueHacer*, provide excellent journalistic accounts throughout the 1980s. Also see Raúl González, José María Salcedo, and Michael Reid, “The Dirty War,” *Report on the Americas*, June 20, 1986, 33–45.
softer than the pro-market platform detailed earlier and more a reflection of the different policy influences that had played upon the Peruvian economy since the breakdown of the primary-exporter model in the late 1950s.11

The strongest vestiges from the neoconservative experiments came through in the administration’s call for the reduction of state enterprise and the stimulation of private investment. The latter included the offering of highly advantageous terms to foreign and local private capital to promote raw-material exports in the oil and mining sectors (Reid 1985, 82); a generous increase in credit to the private sector; lower taxes, with a broadening of the tax base; and the maintenance of the CERTEX tax subsidy for priority-export firms. Other measures were more a continuation of the 1978 IMF program—for example, the elimination of state subsidies and government intervention in pricing, marketing, and the financial system; a further reduction in tariffs and trade barriers; and the maintenance of a crawling-peg exchange-rate regime in order to maximize Peru’s comparative advantage on export markets.

Some of the president’s own initiatives were a direct throwback to his first term and the developmentalist era of the 1960s. This included a mammoth US$11 billion public-investment program for highways, health, housing, electricity, and agriculture, which envisioned 50 percent foreign financing and was endorsed by the World Bank on the basis of favorable commodity-price projections.12 The price tag was double Peru’s outstanding public debt in 1980. Similar was the administration’s commitment to develop the central jungle and to transfer tax proceeds from mining and petroleum to local-level social-emergency programs. Belaúnde also vowed to adjust wages and salaries on a quarterly basis and to create “one million new jobs” through the incorporation of more labor-intensive projects into the development program.

Ironically, despite the strong deflationary underpinnings of the Southern Cone plans, no concrete anti-inflationary shock program was put forth by the incoming team. Ulloa had stressed the need for fiscal restraint, wage controls, and the phasing out of food subsidies as the first steps toward fighting inflation, all of which ran counter to the president’s plans. The result was that the battle to stabilize prices was never fought as consistently or coherently as some analysts outside the administration argued it should have been (Schydowsky 1986b). The program that did begin to come onstream in late 1980 can be broken down into four main lines of policy: the privatization drive, state capital formation, trade liberalization, and ongoing macroeconomic policy approaches. The outcomes of the social-market strategy will be

11. Haggard and Kaufman (1989) remind us that development models are not simple packages of policies; rather they are configurations of political, institutional, and historical events.

reviewed through a look at each of these policy areas after a short inquiry into the political capacities of the Peruvian state to carry out the program.

The Political Capacity to Implement the Program

Bureaucratic Autonomy

The earlier discussion of bureaucratic autonomy in chapter 1 stressed the importance of insulated political structures within the state apparatus for carrying out a designated set of policies. Three different kinds of autonomy were discussed: the ability of politicians and bureaucrats to make decisions independently of dominant social groups; the freedom of the state bureaucracy from the control of patron-client networks; and the level of managerial discretion afforded government bureaucrats (Willis 1986). Thus far, this study has looked at two separate development phases within the Peruvian state bureaucracy.

The first phase, during the 1960s, stood out as lacking in this regard, even though the research did uncover a well-educated policy-making segment within the state that could have risen to the occasion if properly cultivated. The second phase, under the Velasco administration in the early 1970s, emerged as the country’s first attempt at constructing an autonomous policy-making unit within the state. The effort floundered in that it focused too narrowly on the insulation of a small executive-level working group around the president, without nurturing strategic sectors of the bureaucracy to carry out executive policy preferences.

On this last point, Philip Keefer (1995, 16) has observed that “the conditions for autonomy to be advantageous are unlikely to hold where: the policy environment changes rapidly; there is no agreement on appropriate objectives even by trained professionals; the agency lacks expertise; and there is no consensus in the society, or agreement across the spectrum of relevant political organizations, about appropriate agency decisions.” This being precisely the situation that Belaúnde had inherited in 1980, the president’s efforts to use the office of the executive as the basis for autonomous policy decisions met with predictably disadvantageous results.

Having been granted the power by the 1979 constitution to legislate by special decree on certain issues and for set periods of time, Belaúnde began compensating with a vengeance for the prior weaknesses of the executive office that had plagued him in the 1960s. With regard to state autonomy, the pattern was not far off from that of the RGAF era, whereby the near obsession with the expansion of executive authority took precedence over the need to foster pockets of expertise within the bureaucracy to carry out the executive’s
will. While much of the erosion in the capacity to successfully execute state policy had already occurred with the massive layoffs of top public-sector personnel in 1978, the Belaúnde administration made no visible effort to reverse this trend. As policy making came to rely almost solely on executive decree, its implementation was of peripheral concern.

State Economic and Planning Institutions

Those institutions that emerged as central to the economic policy-making process in the 1980s included traditional entities such as the MEF, the BCRP, and the national treasury (Banco de la Nación), as well as newer entities like Petroperu and COFIDE that had been created during the military era. One new institutional player to emerge in the 1980s was CONADE (Corporación Nacional de Desarrollo), which was created in mid-1981 when COFIDE was divided up into three parts: CONADE was to set policy, ICSA (COFIDE’s investment group) would serve as the state’s holding company, and COFIDE S.A. was to monitor policy outcomes (Saulniers 1988, 39).

Two trends marked the institutional setting in the state sector under civilian rule in the early 1980s. The first was the squaring off of the most powerful economic institutions, such as the MEF and the BCRP, along lines described by Richard Webb (1987, 47), BCRP president from 1980 to 1985, as the “balkanization” of economic policy making. The problem was partly historical, representing an ongoing competition and jealousy between the two entities (Cornejo 1985, 131); it also had to do with the return of party politics in 1980 and, despite the AP’s claims to the contrary, the tendency to place party faithfuls in strategic posts whenever possible. The BCRP, run historically on a much stricter merit system than any of the other state economic institutions, and now with greater constitutional protection to fight off the exigencies of party politics, became a logical scapegoat for frustrated party dignitaries intent on shaping policy to suit their own needs.

The second trend was the visible neglect of any serious attempt at planning. The INP drops off the earlier list for this very reason. Although the institute’s development reports had improved immensely, from newsprint mimeos describing the country’s problems in the 1960s to fairly in-depth analyses, it had been increasingly marginalized during the Morales Bermúdez years. In late 1980, the INP was physically relocated from downtown Lima to a remote suburban zone, where transportation, phone lines, and the ability to coordinate with other state agencies on daily policy matters were all reduced to a minimum (Cornejo 1985, 117). The time lines on the development plans had become shorter by the late 1970s, and some plans, such as the 1979–82 plan, did not even correspond with a given administration. The most long-
range plan to emerge under the second Belaúnde administration was the 1981–85 public-investment program, which was more a reflection of the president’s zeal for building public works and a necessary prerequisite to securing the external financing to do so.

The Leadership Coalition

In chapter 1 different coalitional styles were identified as contributing to the political capacity of the state to intervene in the economy. The first is the “triple alliance” of state, foreign, and domestic capital that served countries such as Brazil and Mexico in their drive to kick off heavy industry (Evans 1979; Gereffi and Evans 1981). The second, which prevailed to some extent in most of the East Asian industrializing states, consists of a strong collaboration between the state and domestic entrepreneurs, without necessarily permitting foreign capital’s entry into the development coalition. This study has emphasized the difficulties that Peru has had over time in forging a coherent coalition to push a development program forward (Cotler 1975).

The analysis of the 1960s pointed to the longevity of the old dependency-style coalition between foreign capital and domestic elites in Peru, sustained by an unusually buoyant primary-export economy. The weakening of these ties during the first Belaúnde administration was marked by the rise of middle-class party politics, but in the most chaotic fashion. As the analysis showed, coalitions were broken as easily as they were made, leading ultimately to the end of civilian rule. The military era, rightly, had made the dissolution of this “backward” alliance one of its prime goals. But having dissolved it with excessive and erratic state intervention, the RGAF did little to endear domestic capitalists to its program. Peruvian entrepreneurs thus came out of the 1970s suspicious of the state and uncertain of their future role in the economy.

Yet, although business clearly went into the 1980s poised to catch up from the crisis of representation that it had experienced over the previous decade (Conaghan and Malloy 1994), in fact, the government succeeded in alienating the private sector very early on. Part of the problem was the outdated mind-set of the AP-PPC coalition and its unrealistic goal of turning the country back into a primary exporter spurred by foreign investment and domestic capital. Although some local investors were still active in primary exports, domestic capital overall was no longer just of one mind. The diversification of local private investment into manufacturing, agroindustry, real estate, and banking in the interim since Belaúnde’s first term made for a more complex set of policy demands from the private sector, something that the administration failed to grasp.
As in the 1960s, with the lack of any cohesive alliance among domestic actors, party politics again took precedence and produced the same chaotic results. With the heavy reliance on centralized executive authority to carry out its program, the government succeeded in polarizing the policy-making process along three main axes. First was a three-way tug-of-war among Belaúnde and the office of the executive, Ulloa and the economic team, and the congress (Malloy 1982, 8). Along the second axis, the “internationalist” faction in the government (MEF, BCRP), which favored a more orthodox approach to economic management, was pitted against the “nationalists” (INP and the line ministries), who called for a softer developmentalist strategy. As the short-lived mineral price boom kicked into recession by late 1981, the growing distance between the haves and the have-nots represented a third axis, which was increasingly symbolized by the guerrilla insurgency.

The Intermediation of Societal Interests

Peru’s first attempt at interest mediation along corporatist lines was analyzed in chapter 3. The analysis showed that the RGAF’s efforts to radically restructure the interests of labor and capital vis-à-vis the state had deteriorated into a situation of mutual distrust among all three by late 1975. The question was not taken up explicitly again until the early 1980s. While domestic capital had supported the incoming Belaúnde administration, organized labor made it clear immediately that the AP-PPC lacked a support base with workers. More than one million work hours a month had been lost in September and October 1980 due to strike activity, and by mid-1981, organized labor had staged over 180 strikes. In January 1981, the government initiated a more modest attempt at interest mediation that, in contrast to the RGAF’s grandiose corporatist design, sought labor peace through a National Tripartite Commission composed of representatives from industry, government, and the major labor confederations (Malloy 1982, 8; Bollinger 1987, 18).

Initially, the commission’s goal was to steer labor and capital away from adversarial relationships, under the guidance of the state, and toward settlements beneficial to both. At the top of the agenda was the need to fight inflation, which the government intended to do by negotiating wage and price targets with the representatives of business and labor. But the government was ultimately not able to persuade workers and employers to accept its income and price proposals, because of the failure of its earlier efforts to actually bring inflation down.13 As the commission became a forum for reaching agreement on a wide range of economic policy objectives, and the means to

obtain them, the possibilities for consensus faded. The attempt broke down, mainly because of the lack of confidence in the government’s ability to uphold its part of the bargain, and the relationship among the state, capital, and labor proceeded in a highly conflictual fashion.

Throughout its first year in office, the Belaúnde government promulgated 212 executive decrees, while less than twenty laws were passed by congress (Woy-Hazelton and Hazelton 1987, 112). The barrage of executive legislation caught the opposition somewhat off guard, as it interpreted the constitution as granting the executive such powers only under exceptional circumstances. The catch was that it was up to congress to decide when to delegate authority to the president, and with its newfound majority in the congress, the AP-PPC coalition basically granted itself the go-ahead in passing a number of key laws. During 1981, for example, the entire economic program was legislated in this vein, with congress acting mainly as a rubber stamp (Malloy 1982, 7). The president even succeeded in passing a law that expanded executive and ministerial functions in several areas, thereby single-handedly altering the structures of the state.

Meanwhile, the AP’s powerful general secretary and second vice president of Peru, Javier Alva Orlandini, had succeeded in reorganizing the legislative committees so as to further circumvent congressional debate and short-circuit the impact of the opposition. In their study of congressional politics under the Belaúnde administration, Woy-Hazelton and Hazleton (1987, 114) aptly summarize the toll taken by these “autonomous” legislative maneuvers: “Instead of being ‘taught democracy’ through effective participation . . . citizen confidence in a democratic system’s ability to produce results declined, while traditional patron/client relations were reinforced at the national level.”

**Peru’s Social-Market Model in Action: Four Policy Currents**

**The Privatization Drive**

In line with its goals of reviving private-sector participation to pre-1968 levels, the administration placed top priority on the reduction of the SOEs and the stimulation of foreign and local private investment. The privatization theme was also applied to other reform measures, such as the Agricultural Promotion and Development Law of 1980, meant to reward efficiency by allowing the agrarian cooperatives inherited from the RGAF to parcel out individual plots for private ownership. Because the reform of the SOE sector and the concern with attracting private direct investment dominated the domestic debate over privatization, these two objectives will be dealt with in turn.
On the privatization front, the government succeeded in passing the long-awaited Law of Entrepreneurial Activity of the State in mid-1981. While the law was in many respects a reiteration of the 1979 constitutional clauses on the new role for state intervention, it finally joined together in one legal document all the norms applicable to public firms. It distinguished between those companies of public and private legal status and between mixed entities and shareholdings of the state. The law also represented the first formal attempt at regulating the SOEs in the areas of labor relations and financial procedures and in specifying the organizational ties with other central government entities (Branch 1982, 7; Ortíz de Zevallos 1986, 136). But the law stopped short of addressing the more controversial issues surrounding the privatization debates in congress, such as concrete guidelines for divestiture and the future objectives for those firms that were to be retained by the state (BCRP 1985a, 14–15).

Other SOE reform measures taken in 1980–81 included the transfer of most firms to limited-liability corporations under private law (Ley de Sociedades Mercantiles) and the passing of a budget resolution stating that those SOEs operating at a deficit would be sold, liquidated, or merged (Branch 1982, 4). The administration had also designated yet another multisectoral commission for the evaluation and reorganization of public enterprises, comprising representatives from the central government ministries and from a cross-section of private-sector associations. Through a combination of these quasi-legal mechanisms, and by setting forth a survival-of-the-fittest standard for SOE performance, presumably the administration intended to better clarify the dimensions of state entrepreneurial activity not addressed by the new law.

The flurry of SOE legislation passed in 1981 also attempted to institutionalize a new flowchart within the central government to facilitate the coordination and consolidation of the SOE sector. Oversight was to begin with the Council of Economic and Financial Cabinet Ministers (CIAEF), with CONADE acting as its technical secretariat. CONADE would monitor and evaluate the performance of the firms, reporting back to the CIAEF and the relevant sectoral ministries (World Bank 1982, 32). In their reform efforts, however, both CONADE and the CIAEF’s multisectoral commission quickly ran up against the many unresolved managerial and institutional drawbacks within the SOE sector that were discussed earlier. In the absence of more explicit or forceful policy directives from the top levels of the administration, the privatization drive was informally relegated to the ministerial level. And the ministries, not eager to erode their base of power, made few attempts at large-scale privatization of their own firms (Branch 1982, 4; Yarrow 1999).
Originally, Ulloa had announced that over 80 SOEs would be sold, turned into joint ventures, or liquidated. Shortly thereafter, COFIDE produced two lists. One contained those companies that the state would hold on to, which included Centromin, Electroperu, Petroperu, the railway (Enafer), and other large productive enterprises created during the Velasco era. Later, another list began circulating in top government circles, which included around 40 “nonessential” firms to be sold off through direct purchase, public tender, tax exemptions, or other incentives. To provide an idea of the concrete possibilities for privatization in Peru at the time, the World Bank’s fairly cautious estimate was that of some 140 firms existing in 1981, the state held 90 to 100 percent of the assets in nearly 100 of these companies (World Bank 1982, 10).

While opportunities were clearly present, the aspirations for privatization were highly unrealistic. Apart from all the bureaucratic foot-dragging, various estimates of the value of the planned SOE sales ranged from US$200 to 400 million, or 1 to 3 percent of GDP. To put these figures in perspective, Peru’s total net private direct investment from 1981 to 1983 hardly surpassed US$200 million (Thorp 1987; BCRP 1987). The estimates meant that local officials had not done their homework in assessing the formidable market constraints to privatization, although they had already begun including the proceeds from the expected sales in short-term state revenue projections (World Bank 1982, 49–50).

The very limited divestment that did occur consisted mainly of the sale of government assets to special interests, facilitated by the fact that many technocrats and politicians close to the administration had moved into top-level jobs as directors and managers of the state corporations (Saulniers 1988, 36). Where special interests could not be called into play, little headway was made in cutting back the state. In the end, just a few insubstantial full liquidations were undertaken, for example, with a supermarket chain, a machine tool and tractor factory, and a fish freezing and canning plant (Reid 1985, 83–84).

The practice of blaming most of Peru’s economic ills on the SOEs, while employing them for private benefit, left many of the formidable problems handed down from the 1970s unresolved. First, pricing policy still subjected many firms to the whims of the central government. Second, external borrowing by the firms was still not properly monitored, despite new efforts by COFIDE to more strictly control debt financing (World Bank 1982, 32–34). Third, the sector was still plagued by a high turnover of top personnel and the

---

long-term deterioration of public-service salaries. By the end of the Belaúnde term, the debate over these hard issues had degenerated to the level of panel discussions where state functionaries and private-sector representatives each summarized the problems from their own viewpoint and then shelved the findings.¹⁵

The other major aspect of the privatization drive—the attraction of much higher levels of foreign and local private direct investment—also met with disappointing results. As table 13 shows, private-sector capital formation hit an all-time low in 1985. The figures are especially disheartening when compared with those discussed in chapter 2 (see table 8), which showed Peru’s private-investment share of GDP averaging around 17 percent through the 1950s. Furthermore, the dynamic of the 1970s, where the public sector virtually displaced the private sector in leading the economy, had still not been reversed. The economic participation of the two ran neck and neck throughout the 1980–85 period, until the public sector’s share of gross fixed investment again outpaced the private in the wake of the 1982 debt crisis.

<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDPGRO</td>
</tr>
<tr>
<td>GNPPCGRO</td>
</tr>
<tr>
<td>INF</td>
</tr>
<tr>
<td>PRIVGDP</td>
</tr>
<tr>
<td>PUBIGDP</td>
</tr>
<tr>
<td>INVEST</td>
</tr>
<tr>
<td>RER</td>
</tr>
<tr>
<td>TRADEBAL</td>
</tr>
<tr>
<td>CURACCT</td>
</tr>
<tr>
<td>FDI</td>
</tr>
<tr>
<td>PORT</td>
</tr>
<tr>
<td>DEBT</td>
</tr>
</tbody>
</table>


Note: GDPGRO = growth of real GDP; GNPPCGRO = growth of real per capita GNP; INF = Dec.–Dec. inflation; PRIVGDP = private investment as % of GDP; PUBIGDP = public investment as % of GDP; INVEST = total domestic investment as % of GDP; RER = real exchange rate (1990 = 100), calculated using period average exchange rate, U.S. WPI, and domestic CPI; TRADEBAL = trade balance (mil$) = merchandise exports − merchandise imports; CURACCT = current account (mil$); FDI = foreign direct investment (mil$); PORT = foreign portfolio investment (mil$); DEBT = total external debt (mil$).

¹⁵. See, for example, ESAN 1986.
During the last year of military rule, the Silva Ruete–Moreyra team had begun a high-profile campaign to revive private investment in Peru, and this continued after 1980. For example, in its attempt to create a more favorable investment environment, the Belaúnde government lifted the ceiling on profit remittances from 20 percent to 40 percent, which ran counter to the Andean Pact’s Decision 24—a provision that Peru had been instrumental in enforcing during the early 1970s. The CONITE (or Comisión Nacional de Inversiones y Tecnologías Extranjeras), which was the office within the finance ministry responsible for supervising foreign investment, also passed a regulation permitting subsidiaries of foreign companies operating in Peru to buy into Peruvian firms. Foreign mining and petroleum companies received particularly generous treatment, as they were given greater access for exploration and substantial breaks on export and other taxes (Reid 1985, 84).

But investors from abroad still complained that Peru’s government regulations were confusing and complicated by long administrative delays. Although the local private sector had won some reversals of the job-stability and worker-participation laws, the fact that these still remained on the books acted as a deterrent for foreign investment. Moreover, there were widespread rumors of corruption and of the need to bribe civil servants every step of the way in pushing through a foreign-investment proposal. The result was a brief spurt of FDI, mainly from the United States, which then dropped to historically low levels after the 1982 financial shocks hit. In spite of the very inviting terms offered to the mining and petroleum multinationals, the plunge in world mineral prices and continued failure to locate new reserves in Peru worked against a comeback in these sectors. In the end, Belaúnde’s major venture, the Tintaya copper mine near the southern Andean city of Cusco, was financed largely by the state.

State Capital Formation

A second set of policy goals centered on the rerouting of state investments into economic infrastructure to support private enterprise in the productive sectors. As can be seen from the decline in growth and investment rates in table 13, the administration had its work cut out for it in terms of reviving the country’s sagging productive sectors. The 1981–85 public-investment program included over eighty projects and estimated an annual average expenditure rate of US$2.3 billion over the five-year period. The program slated the distribution of state funds to be split: 40 percent for productive-sector projects, 35 percent for economic infrastructure, and 25 percent to social-sector

projects. More specifically, the stated objectives were: (1) the revival of agriculture; (2) improving the country’s physical infrastructure, especially in hydroelectric expansion and highways; (3) increasing investments in water, health, education, and rural and urban development; and (4) as discussed earlier, the leveraging of private investment in mining and petroleum through state support (World Bank 1985, 29–30).

Two trends stand out in the investment portfolio that gradually got underway after 1980. First was an erratic shift from the trajectory that state capital formation had been on during the previous major cycle of project investments under the RGAF. Industry, for example, after averaging 11 percent of all state investments from 1968 to 1980, dropped abruptly down to less than 2 percent after 1980. Similarly, agricultural investments dropped from 15 percent to 10 percent, and petroleum from 17 percent down to 7 percent (Wilson and Wise 1986, 99). The reductions were more than compensated for by a rapid 15 percent jump in electrical-power investment after 1980. In this quick reorientation of state investments, the administration overshot its mark on the earlier projections. Economic infrastructure ended up consuming nearly 50 percent of the state investment budget, while the productive and social-service sectors received only 30 percent and 12 percent, respectively.

The second notable trend had to do with the repetition of the mostly unfavorable patterns surrounding state capital formation that had been established over the previous decade. Peru’s brief economic revival from 1979 to 1981 had allowed for a second, albeit shorter, period of relatively unhampered commercial borrowing. As in the 1970s, 60 percent of the external public debt went toward investment projects (BCRP 1984), with the twenty major projects implemented between 1978 and 1982 accounting for nearly 50 percent of investment over these four years (Portocarrero Maisch 1982, 22). By 1982, the state enterprises had regained control of the public-investment program, and the three big SOEs in oil, mining, and electricity undertook 70 percent of all state investments (Portocarrero Maisch 1982, 18). Thus, as before, state capital formation remained highly aggregated—by project and also by sector and region. And the success or failure of the investment program still hinged largely on the outcomes of big project spending.

In agriculture, for example, just four large coastal irrigation projects dominated the portfolio, and these were the same kinds of costly large-scale investments that had done little to reduce the stagnation of agricultural production in Peru during the 1970s. The Majes irrigation project was among these. By now, finance costs alone on the project had hit US$300 million, a staggering figure given the original total estimate on the project of less than US$150 million; a ground feasibility study done very belatedly also showed a less than 10 percent return on agricultural production from the project, with
many of the difficulties due to unexpectedly rocky soil on the southern coast where Majes is located.17

Belaúnde’s jungle-colonization projects from the 1960s were also brought back into the agriculture portfolio. Although the jungle-colonization drive was ostensibly undertaken to produce food for domestic consumption and to facilitate the extraction of petroleum and wood for export, public officials involved in the projects complained that they were doing little to promote the long-term development of the Peruvian Amazon (Wilson and Wise 1986, 109). Rather, the projects were providing a noncoastal outlet for sierra migration related to conflicts over land title and serving as bases for the attempt to eradicate coca production. The future development of the area was being thrown into further question by the lack of any environmental controls to prevent soil depletion.

Both electricity and transportation were also dominated by three or four gigantic projects. The justification for the massive spending on hydroelectric power centered on meeting projected national demand for industrial energy; however, the failure to coordinate power expansion with a coherent industrial policy undermined this goal. As under the first Belaúnde administration in the 1960s, and during the RGAF regime, project spending basically took on a life of its own, propelled by special interests and their international allies. Highways, not surprisingly, represented the second-largest commitment in the program. The bulk of these projects consisted of new link-ups to the Carretera Marginal (jungle highway) of the 1960s and the reconstruction of a section of the Pan American Highway on the coast that feeds into Lima’s most popular beach resorts (Wilson and Wise 1986, 110).

In the end, the government did not meet its very ambitious spending targets. By 1982, many projects still lacked financing, with the result that about US$6.9 billion was invested over 1981–84, 40 percent below the amount sought (World Bank 1985, 30). Realized investment in the social sector also fell 40 percent short of the 1981–85 plan, leaving few resources for health, education, and other basic necessities felt most keenly in the traditional sectors (Wilson and Wise 1986, 110). Once the more severe stage of the debt crisis set in post-1983, some projects simply stood still as unpaid contractors and suppliers stopped work. Perhaps the most striking feature of this second investment cycle was the lack of any apparent learning curve. The very large-scale nature and ultimate disarray of many of the inherited ventures meant that the state was ever more burdened by its own investment program, and the private sector weakened by the neglect of macropolicy and institutional reform.

Trade Liberalization

As noted earlier, the thrust toward trade liberalization had started in earnest during the 1978–80 period under strong pressure from the IMF. Peru’s commercial opening also gained momentum at this time as key policy makers came to perceive the high levels of protection as a contributing cause of inflation and the whole set of existing incentives related to ISI as distortionary and detrimental to the country’s long-term prospects for industrialization. Under the impulse of competitive exchange-rate devaluations engineered by the Silva Ruete–Moreyra team and the CERTEX subsidy to promote nontraditional exports, Peru’s manufactured exports had grown from just 2 percent of total exports in 1970 to 18 percent by 1980 (Sheahan 1999, 50–55). Thus, the mood toward manufactured and nontraditional exports was still very upbeat on the eve of Peru’s return to civilian rule, as witnessed in the outgoing government’s proposal to maintain the CERTEX subsidy that compensated domestic exporters for tariffs paid on imported inputs.18

With the change of administration, however, the critique of the country’s existing trade regime came to encompass the structure of both ISI and nontraditional exports. The criticisms waged against Peru’s pattern of ISI were valid, and similar to those made in chapters 2 and 3.19 The first ISI stage of replacing manufactured consumer-good imports was completed during the early 1970s, and the second stage of developing intermediate and capital goods was initiated. The latter concentrated on “heavy” industries such as chemicals and the processing of minerals and metal products, which now accounted for 40 percent of manufactured value-added. Foreign ownership of the manufacturing sector had declined to 15 percent under Velasco, but only a little over half of industry was owned by private nationals. The complaints centered on the low levels of vertical integration, the high degree of enterprise concentration, and an incentive structure that encouraged capital-intensive industry at the expense of job creation. Profits were still high, wages were high when compared to the rest of the national workforce, and reinvestment was sluggish. The incoming team argued that the country was simply not getting back from industrialists what it had been putting out


19. This analysis of trade policy under the Belaúnde administration draws largely from a draft memo developed jointly by the World Bank and the United Nations Industrial Development Organization that circulated in Lima. The memo, entitled “Peru: Development and Policy Issues of the Manufacturing Sector” (Jan. 1981), was formulated by a group of consultants, including Roberto Abusada, who later assumed a frontline position on trade policy in the government.
in the way of abundant credit at subsidized interest rates, cheap production inputs, and the protection of imports. The policy remedy on the import side was to introduce competition as a way of forcing the industrial sector to become more lean and efficient. Thus, the average nominal tariff was brought down 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 38 percent in 1978 (World Bank 1985, 48).

Exporting industrialists also fell under attack, despite buoyant returns on nontraditional exports until 1980. Administration insiders advocated liberalization of this sector on two grounds. First, it was argued that the actual manufacturing component of nontraditional exports was too low and that 80 percent of these products (fish, wool, cotton, wood, and minerals) still involved raw-materials processing. And second, it was argued that those nontraditional exports were still too dependent on incentives and domestic market conditions. Those working within the trade secretariat of the finance ministry, such as Commerce Vice-Minister Roberto Abusada, questioned the high fiscal costs and alleged corruption surrounding the CERTEX system. This mounting pessimism over the future of nontraditional exports was also fueled by the 1979 mineral price boom and a lasting conviction that primary exports still represented the main path forward for Peru (Schydlowsky 1986a).

Trade reforms on the export side centered on limiting the amount and raising the price of credit available to industrialists. The CERTEX program was revamped in 1981, as the range of basic deductions was reduced from 15–30 percent to 10–25 percent. Interest rates on credit lines available through the state industrial bank, typically much lower than market rates, were also set according to market trends (World Bank 1985, 49–50). With all the measures taken together, the effects of the trade-liberalization policy were immediate. The lower tariffs brought a flood of foreign products into the domestic market, some of which were necessary industrial inputs, but the import of luxury consumer goods also skyrocketed. Losses stemming from increased competition gave rise to a new level of demand for credit on the part of local industry, which, now more expensive, sent many firms deeply into the red.

As ADEX and the National Industrial Society vehemently protested the government’s measures as an attempt to “Chileanize” the economy under pressure from the IMF and the international banks, the administration began backtracking on these measures. At the 1983 annual convention for domestic exporters, members of the economic team reversed the government’s earlier position, repudiating the strong reliance on traditional exports and foreign borrowing in effect since 1980, and professed a new faith in the potential for nontraditional exports to lead the economy (Schydlowsky 1986b, 236). Nom-
inal tariffs were brought back up to pre-1978 levels, and the CERTEX subsidy was reinstated on agroindustrial products. The 1984 CERTEX subsidy was about US$180 million, more than 1979’s expenditure of US$150 million (World Bank 1985, 49).

As inefficient as Peru’s trade regime may have been prior to the liberalization measures, the government received universally poor marks for its handling of the trade reforms. To succeed, it had been acknowledged that trade liberalization would require a downwardly flexible exchange rate in order to promote exports and offset the flood of cheap imports. Yet the real effective exchange rate had been allowed to steadily appreciate. The failure to coordinate tariffs with exchange rates was felt strongly in the agricultural sector. The complete reduction of protective barriers for agriculture and the overvalued exchange rate worked together to prevent a reactivation in the countryside, despite government attempts to direct subsidized credit to the rural areas.

The inability of the private sector to penetrate policy making under Belaúnde through the usual personalistic and party ties led to new attempts at articulating and defending its interests. The ADEX, for example, began turning to sophisticated academic consultants to help bolster its participation in national policy debates and even created its own junior college in 1982 with course offerings in economics and international trade. A new association of private business institutions was also created in 1984, under the acronym CONFIEP (Confederation of Private Sector Firms), to serve as an umbrella for representing the interests of domestic capital as a whole. Looking back on the experience of the early 1980s, one former president of the National Industrial Society was still not completely able to explain the irony of a staunchly pro-private-sector government program that did so much in so short a time to alienate the bulk of the domestic entrepreneurial class:

We just never got to them. They were very cordial to us. We had access to the ministers. They would listen to us at meetings. But then we would leave and their advisers would come in (and they were very dogmatic) and they would get their point of view across. No matter how many meetings we had where we represented our point of view, the dogmatic técnicos and economists would have more influence.20

Macropolicy Trends

Another slant on the inability of the local private sector to influence policy making had to do with the grave internal conflicts within the administration.

20. The interview is cited in Conaghan 1988, 46.
over which direction to go.\textsuperscript{21} Hindsight readily shows that all of the competing views eventually tended to cancel each other out. Much of the conflict centered on controlling the president’s populist urges, given the espoused technocratic aspirations of his economic team. This helps to explain an erratic pattern of announcing mutually incompatible targets but not following through convincingly on any of them.

Finance Minister Ulloa and the economic team, nicknamed the “dynamo group” at the outset of Belaúnde’s second term, called immediately for wage and price adjustments to reduce inflationary pressures and recommended currency devaluation and the cutting of state subsidies to balance the budget. The president, however, had announced that nationwide municipal elections would be held in November 1980 and was thus reluctant to move too quickly on the reform front. Instead, the public-sector deficit was tolerated, the exchange rate continued to appreciate, and the liberalization of government-controlled prices slowed. Inflation was reduced in 1980, and the AP scored a victory at the polls, but at the expense of much lower public savings. This drop in public savings did not correspond with the needs of the state investment program, not to mention the expectations of the multilaterals.

In recognition of the need to remain on good terms with the banks and the IMF, the economic team upped its orthodox image in early 1981 and took steps to rationalize Peru’s borrowing procedures. A new debt law was passed requiring congress to set an annual ceiling on public-sector borrowing, the ratio of which now amounted to 35 percent of GDP, and a committee was set up to review the terms and conditions of possible loans on a case-by-case basis. COFIDE and the Banco de la Nación were to act exclusively as borrowing agents in the regulation of loans to the public sector.\textsuperscript{22} In this show of good faith, the government had prepaid US$377 million in previous refinancing credits, with the result that the banks disbursed US$1.7 billion in medium-term credits to Peru during 1981 and 1982 (more than their US$1.5 billion total exposure to the government at the end of 1980 [Webb 1988]).

Caught in a balancing act between financing Belaúnde’s spending urges and moving forward with the planned liberalization of the economy, the economic team was periodically able to exert some control. In January 1981, prices on the daily food basket were increased by 30 percent, other public subsidies were slashed, and the trade-liberalization measures mentioned earlier were brought onstream (Paredes and Pascó-Font 1987, 49–50). The government’s justification for these and other measures aimed at opening up the

\textsuperscript{21} Statistical trends cited in the next two sections are based on data gathered from the BCRP, the MEF, and the INP.

\textsuperscript{22} “Peru’s Long Haul Back towards Democracy,” \textit{Euromoney}, April 1982, 47.
economy was to make Peruvian industry more qualified to compete on world markets and to burn up excess foreign reserves that were believed to be creating inflationary pressures on the economy through an increase in the money supply.

On this last point, concerning the management of domestic inflation, Schydlowsky (1986b) notes that by the time the reins of the economy were handed over to Belaúnde and Ulloa in 1980, there was already a strong conviction on the part of policy makers that inflation stemmed from the balance-of-payments surplus and that it would require a burning-off of reserves, in combination with a tight monetary and fiscal policy, to halt the rise of prices (BCRP 1982). This being the basic IMF policy stance on inflation, Peru followed these prescriptions, even though inflation had actually doubled during 1977–79 when these same policies had been strictly applied (Webb 1987, 29). The early credit repayment and the seeping off of valuable foreign exchange on luxury imports during 1980–81 did quickly reduce Peru’s reserves, but so quickly that this itself became the first warning signal in the series of economic shocks that soon followed.

Alternative views on inflation hold that its sources are more complex, stemming from a combination of weak fiscal restraint and supply constraints related to the underdeveloped structures of the economy and, increasingly, to rising international interest rates and the dramatically difficult external circumstances of the 1980s (Foxley 1983; Sheahan 1987, 100–110). In the Peruvian case, Schydlowsky (1986b, 233) argues that inflation was also intrinsic to government policy:

The circle started with the removal of subsidies on food and gasoline. As the prices of these rose, the cost of living increased, which required a rise in the nominal wage in line with the policy objective of keeping real wages constant. At the same time, however, a higher domestic price level required devaluation in order to prevent the occurrence of overvaluation. The devaluation, in turn, caused an increase in the price of imported food and in the base price of gasoline, which required a further increase in the domestic prices of these goods, which in turn required further wage increases and devaluation. The economic team called the initial steps of this process a “corrective inflation.” Unfortunately, however, after a while only the inflation part of the label remained.

Inflation did indeed increase and was approaching 100 percent in 1982. By late 1981, the prices of Peru’s main commodity exports had fallen 19 percent in real terms and were to drop another 15 percent in 1982. Rising debt-service payments due to a five-percentage-point jump in the LIBOR (London Inter-
Bank Offer Rate) in 1981, and a government budget deficit approaching 10 percent of GDP, all signaled the need for help. Negotiations with the IMF began for a US$650 million extended fund facility loan and an additional US$200 million from the fund’s compensatory-financing facility to offset part of the decline in Peru’s commodity-export income. There was considerable disagreement over the pacing of the program, with the IMF pushing for a rapid shock treatment and the economic team for a softer approach. As Peru’s international reserves dropped below US$400 million, on par with the depths reached during the 1977 crisis, these differences were momentarily set aside, and Peru gained access to the fund’s compensatory-financing facility in June 1982.

The fund’s projections for Peru were optimistic and envisioned a rapid recovery in exports by 1983 and a mild comeback for GDP. Such projections, however, overlooked the dire state of public finances and the lack of discipline within the central government. In 1982, total outstanding short-term public and private debt grew to US$2.5 billion, the highest amount of loans contracted in Peru during any given year to date. The major SOEs, furthermore, had somehow managed to borrow around US$500 million in short-term credits on their own in 1982 (Webb 1987, 36). By now, nearly 80 percent of the budget deficit was financed externally, and rising interest rates in the United States had placed an additional US$300 million debt-service burden on this deficit in 1981 (Paredes and Pascó-Font 1987, 52).

Economic Crisis and the Fragmentation of Policy

As domestic policy faltered and international economic contingencies hardened for all of Latin America, Peru had three choices for confronting the crisis of the early 1980s. The first two, not necessarily exclusive, consisted of negotiating with the banks and the IMF to reschedule outstanding debts and/or adjusting by cutting investments and generating large trade surpluses to help service the debt. A third option, unilateral default, was still unthinkable as long as Belaúnde and his party remained intent on completing the massive project portfolio that depended so heavily on external financing. At this early stage of the debt crisis, most states, including Peru, feared any sort of go-it-alone strategy due to the trade and aid sanctions believed to follow such a move.

The trade-surplus option, which was exercised initially by more industrialized and highly indebted states like Mexico and Brazil, was less possible in the Peruvian case—first, because raw-material exports still accounted for 80 percent of trade income, and prices for these goods were plummeting; and
second, because besides having to confront the rising protectionism on world markets, Peru’s trade liberalization, in effect up until the eve of the crisis, had already led to the deindustrialization of the small uncompetitive manufacturing sector that had been developed. Freak weather conditions stemming from the El Niño current, which simultaneously provoked floods in the north and drought in the south of the country, exerted additional pressure on trade balances in 1983.

The decision, then, was to go straight for debt renegotiation. Peru’s relations with the foreign banks became all the more important, and as testimony to this, Belaúnde called in Carlos Rodríguez Pastor, a foreign banker himself, to take over at the MEF. The new finance minister went to the banks, the Paris Club, and the IMF requesting a US$880 million loan to cover 1983 debt payments and the need for a new infusion of cash. What ensued was a complicated patchwork of refinancing and rollovers, with the securing of further credit and the drawing on the IMF’s compensatory-financing facility tied ever more strongly to external pressures for fund compliance and increased orthodoxy.

The fund’s stabilization parameters widened to include positive real interest rates, higher public tariffs, and supply-side tax cuts. Under the thrust of the program, public consumption dropped by 15 percent in 1983, and the growth of prices on goods freed from government control surpassed that of the regular market by 45 percent (Paredes and Pascó-Font 1987, 59). As local industry sunk under higher interest rates, restricted demand, and the cutoff of credit altogether, the IMF conceded to a temporary increase in trade tariffs. As inflation hit 111 percent in 1983 (see table 13), the prescription of tight monetary and fiscal targets as the main anti-inflationary strategy held sway.

Acting within the bounds of the IMF agreement, Peru was able to reschedule US$1 billion of its 1983 debt service and another half billion for 1984 (nearly double the amount originally sought). As a result of the rescheduling, the public sector was able to service its debt, although at the expense of a 30 percent overall increase in debt-service payments and at high interest costs. The rescheduling brought the promise of an additional US$450 million from a syndicate of banks, contingent upon compliance with the goals agreed on in the IMF plan. Yet, as early as June 1983, Peru’s compliance was a matter of question. In particular, the fund’s negotiators were dismayed to find that the Peruvians had delayed the public-sector payroll by three days, so as to slip under the quarterly target. The banks then withheld US$220 million of the fresh credits earlier committed, and the IMF agreement was all but dead.

23. During the Reaganomic heyday of the early 1980s, there was even some talk in the U.S. Congress of cutting aid to those Latin American countries that failed to implement supply-side tax cuts for domestic capital.
As table 13 shows, 1983’s year-end economic indicators were the worst ever. The collapse of Mexico’s finances the year before, along with Peru’s own increasing risk premium, prompted the banks to abruptly withdraw some US$739 million in trade credits. Chronic inflation had skewed the distribution of national income in favor of the owners of capital, with the result that financial and commercial speculation had exploded.\(^{24}\) An estimated US$600 million drain in capital flight during this brief time span led to the scrapping of a 1980 regulation requiring that local holders of CDs, financed largely by the cocaine trade, report these holdings for tax purposes. These and other efforts to shore up the central bank’s reserves did not reverse the downward trend. Reserves fell by US$700 million, public external debt jumped 21 percent, and there were few doubts as to Peru’s new status as a debtor country with a serious inability to pay.

As this is also the critical juncture at which policy makers within government circles began to reject packaged orthodox solutions (Conaghan 1998, 149), it is worth pausing to ask why so little was done so late to properly intervene.\(^{25}\) There was, of course, the problem of not feeling the shocks until they had fully hit, which was especially the case with Peru’s unforeseen natural disasters in 1983. Also, the behavior of international lending institutions, particularly the banks’ commitment to some new loans during the low point of 1983, as well as access to the IMF’s compensatory-financing facility—geared toward temporary balance-of-payment problems related to export shortfalls—no doubt fostered the perception that the recession would soon pass.\(^{26}\) On the domestic side, former BCRP president Richard Webb (1987, 36–37) attributes part of the policy paralysis to the trials 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 lob-

\(^{24}\) Peru’s largest private bank, the Banco de Crédito, owned by the powerful Romero-Raffo business empire, cashed in quickly on tax breaks, low interest rates, and high inflation: in 1981 alone its net profits increased by an amazing 78 percent (Reid 1985, 84–88).

\(^{25}\) The difficulty in responding more effectively to the crisis was certainly not due to the qualifications of the economic team. BCRP president Richard Webb and Commerce Vice-Minister Abusada held economics doctorates from Harvard and Cornell, respectively. Ulloa came with polished international banking credentials and Kuczynski with impeccable managerial experience.

\(^{26}\) Both Abusada and Webb, for example, stated that no one on the economic team perceived the shocks of 1981–82 as more than transitory and that a stronger motive for securing the US$1 billion from the fund was to buy fiscal time against Belaúnde’s spending spree on public-works projects. (Richard Webb, interview with the author, Sept. 10, 1986, Lima; and Roberto Abusada, interview with the author, Aug. 12, 1987, Lima.)
bies, the media and congressional opposition, including members of the government party), and in the context, furthermore, of a newly recovered and still highly nervous democracy, major programmatic changes begin to appear heroic.

Despite Peru’s bleak stabilization track record throughout the period, the IMF offered one more chance in 1984. The new plan pressed harder for a lower budget deficit, a tighter monetary stance, and higher interest rates, and the government agreed. An eighteen-month US$250 million standby loan was approved, and the banks released another US$100 million of the new credit promised the year before (World Bank 1985, 9). Looking back, this was the last fresh money Peru would see from the banks for an entire decade. The sharper external demands for orthodoxy contrasted starkly with the diminishing will to implement such measures within the congress, the executive, and the major state institutions. Additional tensions erupted among Peru, the banks, and the IMF over hidden arms expenditures, averaging US$400–500 million annually since 1980, which led to the termination of all pending agreements.27

Looking at the failure of IMF adjustment programs across the region at this time, Fishlow (1986, 79) concludes that “the IMF model, rather than its implementation, seems to be at fault.” For Peru, it is impossible to separate the two. In terms of the model, the fund’s insistence on the budget deficit as the driving force of inflation overlooked the increasing percentage of that deficit accounted for by servicing the external debt. Moreover, it was the IMF’s “stamp of approval” that facilitated 1982’s unprecedented rise in commercial short-term credit and hence an extension of Belaúnde’s spending binge. However, as much as the IMF may be to blame for perpetuating this moral hazard, and as wrong as its orthodox model may have been for a country with Peru’s vulnerabilities, domestic policy makers cannot be let off the hook for the considerable distortions that emerged in the gray area between the model and its implementation.

The Belaúnde administration showed no inclination to reform state institutions that were suffused with biases toward the rich and powerful. And by

27. The figures represent the outcome of the military’s success in maintaining autonomy over its budget under the Belaúnde administration (Obando 1998). The official rationale was that the external security threat of the 1970s had given way to the internal menace posed by the rise of domestic insurgencies. Yet only a small fraction of the sums went toward counterinsurgency equipment. Instead, the army, navy, and air force appeared to be locked into a contest to outspend each other on costly Mirage fighter jets and Black Hawk helicopters from the United States. Only in early 1985 did the army start purchasing a large amount of rifles and night-vision equipment for the antiguerilla operations that supposedly prompted the astronomical spending. See Latin America Regional Report: Andean Group, Oct. 5, 1984; Dec. 14, 1984; Apr. 5, 1985; and May 17, 1985.
its last year in office, it was no longer even clear who was responsible for government policy. Amid the economic policy vacuum that set in from 1983–85 came a US$4 billion increase in high-penalty refinancing credits (Webb 1988), with the result that Peru had little choice but to quietly halt service payments on its external debt in mid-1984. Although fiscal, monetary, and trade policy wavered post-1983 between the IMF’s tighter stance and a more slack approach, there was now a generalized backlash against orthodoxy within all sectors except the very minor political space still occupied by the far-right contingent within the PPC.

The 1983 Municipal Elections: A Critical Political Realignment

At this point in the democratic transition, Peru’s democracy was only surface deep. The fallout from nearly a decade of regressive austerity measures had by now provoked a dramatic response from below. A growing number of poverty-related insurgent factions, Sendero Luminoso being the most prominent, completely eschewed all legal forms of political participation. In contrast to the 1965 guerrilla uprising, Sendero proved itself to be much more than a transient phenomenon. While the Belaúnde administration insisted on phrasing the guerrilla problem in Cold War terminology, and tracing its roots to external “communist interference,” Sendero made serious inroads in first the southern and then the central Andean provinces.

As Sendero proceeded from low-level political agitation in 1981 and 1982 to violent assassinations of locally elected officials and destruction of major state-investment projects, the government upped the ante by declaring much of the southern Andes an emergency zone and sending in the military. While the political opposition in congress argued that the conflict could only be quelled through a blitzkrieg 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-force military operation was deployed in 1983, and the conflict quickly escalated into an Argentine-style dirty war between the state security forces and Sendero. By the end of Belaúnde’s term, unofficial deaths and disappearances related to the conflict were estimated by international human rights groups to be higher than five thousand (Woy-Hazleton and Hazleton 1987, 118).

At the same time, Peru’s newly enfranchised poor chose to register their

grave discontent by casting a ballot for the opposition in the 1983 nationwide municipal elections. Not surprisingly, the elections produced what political scientists refer to as a critical political realignment—that is, the electoral emergence of a new hegemonic bloc, in this case consisting of the center-left sections of the APRA led by Alan Garcia and a group of six left-wing parties that had organized into the United Left (IU) coalition. The APRA moved up to capture 33 percent of the vote, and the IU another 29 percent, with the latter winning the municipality of Lima and placing its leader, Alfonso Barrantes, in the office of mayor on a Marxist ticket. The elections highlighted two unfolding political trends related to the democratization process and shaped by the economic crisis.

The first concerns the effects of concentrating greater state power in the executive, promoted by the constitutional reforms and bolstered by the traditional propensity for special interests to seek to influence the executive through direct personal ties. Clearly, constitutional powers to legislate a program did not translate into the autonomy to carry one out, and the executive’s ultimate inability to orchestrate policy and exert control over other political and economic actors posed a serious challenge to the formulation of effective solutions to the crisis. The second reality brought home by the 1983 elections concerns the intrinsic weaknesses of the classic primary-export-led model as a viable development option for Peru and the dissolution of those traditional alliances that had held it together.

The vote confirmed that there was no turning back the clock or eradicating the various legacies of the military experiment, as Belaúnde’s social-market project had intended. In its attempts to reverse the labor and agricultural reforms of the Velasco period, the administration met with unexpected popular resistance that the reforms themselves had fostered. Similarly, it had misread the interests and needs of domestic capital, which by now had succeeded in reorganizing around a mixed economy, forming more modern groups like the Romero-Raffo consortium, based in the financial system and investing across sectors (Reid 1985, 86–88). The time lost by not formulating a coherent policy had given the political opposition a chance to regroup. The electoral emergence of the APRA and the more leftist IU as credible political machines, able to incorporate the diverse interests of this new constellation of social forces into winning party platforms, marked a turning point in Peruvian politics on par with 1968.

The electoral rise of the IU as the country’s second-largest political force was especially striking in view of Peru’s basically conservative past and can be explained by a decade of grassroots outreach, the cultivation of organized labor as a core constituency, and the eventual ability of all six parties in the coalition to compromise on the moderately left Barrantes as a candidate. The
APRA’s ability to win a victory in a legally contested race was even more remarkable, given the party’s unsuccessful attempts to do so since its inception in 1924. Although it is not possible to recount the full story of the APRA’s electoral breakthrough to assume its historic role as the country’s governing party, the death of Haya de la Torre and the party’s negotiated resolution of old enmities with the military helped open it up to intellectual cross-currents more appropriate to the 1980s and to nonaligned voters across classes and income groups (Sanborn 1991; Graham 1992).

This political realignment of 1983 kicked off the presidential campaign, and even though elections would not be held until 1985, García quickly moved to the front of the race. There were few substantive differences in the APRA and IU campaign platforms. Both worked on the theme of constructing a multiclass national alliance and advocated civilian solutions to the guerrilla-military conflict raging in the Andean emergency zone. Both geared their positions to Peru’s large, young popular-sector electorate. The economic platform of each centered on the declaration of an official debt moratorium to provide the breathing space for redistributional policies and for a reactivation strategy that would link industrial and agricultural production according to a more integrated and regionally decentralized plan.

The main differences were the IU’s status as a recently formed coalition of parties that lacked the internal discipline of a single party and its more extreme position favoring nationalization of the financial sector and raw-material production. In contrast, the APRA proposed to rationalize the state sector through privatization and administrative reform. Also, García recognized that economic reactivation in the wake of the debt crisis would require greater cooperation with domestic business and financial groups and sought a social pact with private industry along these lines. The rise of a more sophisticated and charismatic leader personified by García, a more modern business sector, and the country’s brief success with nontraditional exports during 1978–80 provided the vision for a locally financed national-industrial project meant to generate employment and economic dynamism. The fate of this APRA-led national project forms the subject of the next chapter.

**Conclusion**

In retrospect, Peru’s turn to a more market-oriented management model in the early 1980s is best understood as a quest to recapture or reinstate the buoyant economic indicators that prevailed prior to the 1960s. The trend until the 1960s was one of high growth fueled by foreign and domestic private investment, low levels of direct state economic participation, and little need...
for external borrowing; the budget was basically in balance, and compared to
the 1980s, the 1950s stood out as a period of next to zero inflation. The tra-
ditional primary-export model, and the liberal economic policy regime that
supported it, had not been at all successful in distributional terms, but given
the highly unstable economic environment that prevailed throughout the
1960s and 1970s, subsequent policy makers were apparently willing to
sacrifice equity over growth if that was what it would take to finally turn the
economy around.

However, given these aspirations, the outcomes of the program were
highly paradoxical. Rather than eliminating the cumulative distortions from
nearly two decades of chaotic state intervention, the social-market strategy
(or at least the manner in which it was implemented) actually served to dig
Peru deeper into the negative pattern of state-led development identified as
having taken root by the late 1960s. As discussed in chapter 1, this consisted
of (1) a high level of external financing to support the state’s endeavors; (2)
heavy reliance on public firms to perform the state’s development tasks; (3)
the perpetuation of an ambiguous relationship with crucial domestic private
investors; and (4) the inability to coordinate the necessary social policies with
the chosen development model.

On each of these four points, the track record worsened. The external debt
exploded under the thrust of more costly short-term borrowing, and
macropolicy trends during the second Belaúnde administration became per-
haps more incoherent and erratic than at any other time during the
post–World War Two period. The tax structure, after years of piecemeal mea-
sures following the major 1968 reform and the AP’s heightened reliance on
indirect taxes to finance its program, reached its most regressive point yet.
The more progressive taxes on income and wealth now accounted for just 25
percent of all state revenue, compared to 60 percent in 1950 (World Bank

Within the context of a highly touted privatization drive, the state firms
actually expanded their presence in the economy, as public officials openly
employed them for personal gain. In terms of the relationship between the
state and private capital, the approach of the Belaúnde team was every bit as
damaging to investors’ confidence as the nationalizations of the early 1970s;
as testimony, private investment hit an all-time historical low. The outright
neglect of social policy, under the guise of the belief that the social-market
program would prompt a distributive trickle-down, proved more costly than
ever imagined. During the five-year Belaúnde term, poverty-related insur-
gencies proliferated, and the synergistic effect of a regressive income policy
and staunch popular resistance exploded into what could best be described as
a political economy of violence.
In the end, the social-market model of the early 1980s was not as much a development strategy as it was an attitude toward the state. In its rejection of explicit state-led management approaches, the Belaúnde government tended to work around those bureaucratic, institutional, and administrative structures that would have been crucial for the successful implementation of any development program. In effect, the embracement of a market strategy became an excuse for not drawing on those planning and managerial resources that the state did have to offer. The lesson of this period, particularly in the more severe crisis context that set in post-1982, is that market policies are also “interventions” that demand a basic level of capacity, coordination, and willpower to be carried out (Kahler 1990).

The prevailing attitude toward the state as overly intrusive, yet at the same time weak and ineffectual, served to reinforce these very characteristics of the state (Sikkink 1991). When all else failed, profligate spending on large, poorly planned infrastructure projects came to substitute for any semblance of institution building. The incoming García administration recognized the need for a stronger and more autonomous state apparatus, as well as the importance of cultivating a set of agencies that better represented the general interests of the nation, but it would continue to wrestle with these problems all the same.