By the mid-1980s, most Latin American governments had lost what little enthusiasm they may have ever had for orthodox stabilization programs sponsored by the IMF. When the debt crisis first erupted in 1982, most countries had turned to the fund for short-term finance and macroeconomic policy advice. But as stringent domestic adjustment measures had failed to alleviate the recession-inflation spiral, and as new supplies of capital had still not appeared, domestic-policy responses began to branch out in new directions. Argentina and Brazil, each with long histories of high inflation and eclectic approaches to economic adjustment in the post–World War Two era, launched “heterodox” stabilization programs in 1985 and 1986, respectively. Peru, with no comparable history of hyperinflation prior to the debt crisis, and closely wedded to a monetarist management approach since the late 1970s, also announced a heterodox program in July 1985.

At a broad level, the three programs displayed important similarities. Each was designed with the help of domestic economic advisors who had done some training in the United States or Europe and who imparted a more flexible diagnosis of the causes of inflation. Contrary to the IMF’s uniform insistence on excess aggregate demand as the driving force of inflation, these “neostructuralist” advisors saw price rises as rooted in the inertial effects of indexing wages and prices and the various shocks emanating from the international economy (Fishlow 1985, 143; Sheahan 1987, 103–10). Policy prescriptions for all three programs centered on monetary reform and the coordination of wage and price controls to break inflationary expectations, yet without the drastic output losses associated with orthodox strategies. All three can also be seen as compromise packages, as recently elected civilian regimes were pressed to juggle the demands of the international financial community with the social and political demands of their domestic constituencies.

This chapter examines Peru’s heterodox program—first as an attempt to utilize a more finely tuned set of state-led interventions in light of the disappointments associated with Velasco’s ambitious statist strategy and with Belaúnde’s social-market model; and then as a way of coping with the many new constraints imposed by the international political economy. The pro-
gram initiated by Alan García and his economic team differed from the Argentine and Brazilian efforts in three main ways. The first, which received the widest attention, was the official declaration of a partial moratorium limiting debt-service payments to 10 percent of annual export earnings. Second was an explicit policy to redistribute income to the poorest groups, rather than simply stabilizing the drop in income. Finally, Peru’s program also articulated a longer-term strategy that blended neostructuralist macro-policy management with more standard structuralist strategies of state-led industrialization (Thorp 1987).

This long-run policy thrust can be explained as a direct outcome of the special mixture of political liberalization and severe economic crisis that characterized the post-1983 period in Peru. As discussed earlier, a critical political realignment had occurred: within sections of business, labor, agriculture, and the internal organizations of the state, new patterns of cooperation and conflict had emerged. Thus, while the debt crisis hit Peru at its most vulnerable point, when economic policy was oriented almost entirely toward a declining external sector and the ability of state elites to respond was quite low, it also had a modernizing effect in terms of promoting a wide debate about the country’s overwhelming problems and their possible solutions. The demands of groups, especially within the popular classes and the private sector, became more cohesive and were taken up seriously by those ascendant center-left political parties discussed in the previous chapter.

As a catch-up strategy for economic restructuring, the heterodox program placed rigorous demands on the political capacity of the state to manage this project. Given the preceding analysis of the evolution of the Peruvian state sector, it will be seen that the program faltered rather quickly (Crabtree 1992; Pastor 1992; Sheahan 1999). Apart from the obvious explanation of stringent pressures from the international economy, some of the most basic bureaucratic instruments and institutional supports for such a program were still lacking. The first section of this chapter looks at the structural backdrop for the program, according to the four main institutional variables that have been discussed throughout this book. Following are two sections that analyze

1. Economists have used a number of variables to discuss the varying outcomes among the three heterodox programs. Explanations have centered on the differing levels of idle productive capacity present in the economy, price elasticity of exports, size and bargaining leverage on the external debt, incomes policy, fiscal and monetary control, and so on (World Bank 1989; Dornbusch and Edwards 1991; Pastor 1992; Edwards 1995).

2. As John Zysman (1983, 308) has argued: “A broad economic challenge that affects the national position may induce efforts to use the state to promote economic restructuring and competitive adjustments to the market. Yet, unless there exists a state structure that can be used as an instrument of such a policy, the effort is likely to fail.”
the rise and fall of Peruvian heterodoxy. The remaining sections address the broader consequences of the García period, the country’s desperate search for a viable development coalition in the wake of the program, and the realistic options for Peru’s reintegration into the international financial community after five years of a basically autarkic approach to economic management.

**State Intervention without State Capacity**

**Bureaucratic Autonomy**

Although the political complexions of the Belaúnde and García administrations were radically different, there was strong continuity in the area of exercising executive authority and the neglect of the state bureaucracy. If anything, García deepened the pattern established by his civilian predecessor of making policy almost solely by executive decree and with little regard for the mechanics of carrying it out. García’s resort to an almost purely presidential style quickly overshadowed the earlier campaign promises to modernize and upgrade the state’s administrative capacity. Initially, the president did move to improve wages for technical personnel in those state economic agencies that were crucial to the implementation of his program. But this was not accompanied by the delegation of greater decision-making leeway and authority to the relevant ministers or to their top staff. With García’s tendency to deal directly with a diverse range of representatives from special interests, it was not long before the political opposition was complaining of an “imperial presidency.”

García’s propensity toward an autocratic and exclusionary leadership style was bolstered by the very mediocre pool of technical and intellectual talent he had to draw on from the ranks of the APRA party (Graham 1992). Furthermore, the APRA’s apparent renovation in bringing the younger and forward-thinking García to office did not hold up under everyday political life. Faced with a local APRA leadership network stacked with conservative and sometimes corrupt caudillo types (Sanborn 1991), the president pursued a double track in the exercise of executive authority. First, to keep the peace, he permitted the widespread infiltration of lower-level party figures who were not likely to present a challenge into the state bureaucracy. Second, while filling

---

3. Wage data from Lima’s Institute of Public Administration (INAP) show that wages for technical personnel in the ministries of finance and agriculture and in the INP doubled over the 1985–86 period.

4. By one estimate, patronage appointments in the social security administration ballooned by nearly 100 percent between 1985 and 1990 (Keefer 1995, 2).
the lower-rung posts according to mainly political criteria, García cultivated his own private technical team of independent advisors.

The strong reliance on a presidential advisory team followed in the footsteps of Velasco’s COAP and Belaúnde’s technocratic “dynamo group” of the early 1980s; in all three cases, the format served to insulate policy making and to deflect challenges from the opposition or from within one’s own ranks. But the practice of a highly insulated group of technical advisors basically taking over the state apparatus virtually self-destructed under the García administration. The cumulative toll over the three administrations (the RGAF, Belaúnde, and García) was a situation whereby policy was basically made at the whim of the executive with few reliability checks.

State Economic and Planning Institutions

The tendency for the two main state economic institutions—the finance ministry and the BCRP—to become the focus of fierce conflicts over the content and operationalization of economic policy continued post-1985. On the one hand, the MEF became the bureaucratic fiefdom of APRA finance minister Luis Alva Castro and his own team of técnicos, who were frequently at odds with the directives stemming from the executive. On the other hand, as party politicking rapidly pervaded the recruitment, hiring, and promotion process, the central bank’s status as the more autonomous of the two institutions was put to an even greater test than during the Belaúnde administration. Despite the stipulation in the 1979 constitution that the bank’s executive chair was to be appointed to a five-year uninterrupted term, BCRP chair Leonel Figueroa was effectively forced to resign in mid-1987 in the throes of a dispute over the need to change course on a range of monetary and fiscal targets.5

The prime attempt at institutional innovation under the García administration was the revival of the INP as a major force in the policy-making arena. The merits of this move stemmed from the INP’s historical bias in favor of the structuralist policy approaches being embraced by the president and his team and from the perceived need to bring Peru’s planning system back to life. Yet it turned out that housing the program at the INP was, in fact, the most effective way for the president’s special advisory team to circumvent the more economically conservative finance ministry and central bank in pushing its highly experimental policy package through the congress. While the INP was ostensibly responsible for the 1986–90 National Development Plan,

and for mapping out the government’s overall economic strategy, the plan expressed a range of neostрукtralist ideas and strategies that heretofore had not surfaced at the INP per se.6

The plan, for example, rejected the use of the exchange rate as a tool for adjusting the economy; it also expounded on a range of fiscal and monetary issues concerning the relationship between inflation and the fiscal deficit, which typically fell within the domain of the MEF and the BCRP. Some of these ideas had been voiced at the top echelons of the BCRP toward the end of the Belaúnde era and had also been tossed about from time to time within the impressive network of private economic think tanks and research institutes that had sprung up in Lima during the early 1980s. But the INP itself never stood out as a credible institutional base for formulating the much more macroeconomically complex tenets of the heterodox program.

The Leadership Coalition

Once it had made the decision to at least temporarily go it alone on the international front, and had received a massive electoral mandate in 1985, there were a number of possibilities open to the García administration for pursuing a development coalition. On the domestic side, the guerrilla insurgency now cast a long shadow over civil society, and as economically and politically divided as Peruvians had been historically, the threat from Sendero and other violent splinter factions placed unprecedented pressure on national groups to set aside their differences and to seek a consensual solution to the problem (McClintock 1989). Similarly, the severe pressures from the external sector fueled a sense of urgency over facing the economic crisis from a position of national unity.

With almost universal agreement in 1985 that the country’s two greatest challenges were the reactivation of the economy along more distributive and self-sufficient lines and the reduction of daily political violence, new coalitional possibilities were present along both the executive-parliament-party and the state-capital-labor axes discussed in chapter 1. On the former, the most logical alliance would have been between the APRA and the IU factions, which together controlled the congress. After all, the strongest constituency of each came from the middle and poor sectors of society, and in the end, much of the IU platform would be adopted by the APRA. While García and Lima mayor Alfonso Barrantes courted each other publicly until the latter’s

resignation as leader of the IU in 1987, a true alliance between these two main political forces met with firm resistance within the ranks of each.

From the point of view of the IU, there were questions about the possible deals the APRA may have cut with the military and distrust stemming from the belief that the opportunistic style of Haya de la Torre still lay just below the party’s surface. García’s bravado and omnipresent approach to politics did little to dispel these fears. Finally, it had been the left’s initial distrust of the APRA that had enabled it to surmount its own formidable internal rifts in order to participate successfully in the 1983 and 1985 elections (Sanborn 1991). An APRA-IU coalition may have been more palatable to the center-left segments of the APRA, as the two had frequently acted in concert as part of the congressional opposition under the second Belaúnde administration (Woy-Hazleton and Hazleton 1987, 111). But the APRA party as a whole was still seen as having “sold out” ideologically in the 1950s and was thus repugnant to the bulk of the IU.

As for an alliance along the state-capital-labor axis, the difficulties here were threefold. The first difficulty was the division of organized labor and the less organized working poor along party lines, with the former largely in league with the IU and the latter with the APRA. The second was the lack of a cohesive core constituency within the state itself, be it within the planning institute or the main state institutions, with the initiative and vision to play a part in such an alliance. The third, ironically, was that although domestic capital had now come around to accepting the idea of closer collaboration with the state, it was plagued by the president’s highly impulsive maneuvers and the paucity of sound administrative follow-up on many of the promised policies. The failure of domestic groups to coalesce around the heterodox program along either of the two axes left the fate of the program up to the vicissitudes of internal party politics and bureaucratic back-biting, which had by now become the most constant features of the Peruvian policy-making process.

The Intermediation of Societal Interests

By 1985, the composition of organized societal interests in Peru, and their position vis-à-vis the state, had joined step with other Latin American countries, such as Argentina. That is, interest representation had become more articulate and assertive, while the state’s ability to intermediate had not improved proportionately and had even deteriorated. Thus, García’s call for serious tripartite negotiations could not have been more timely as an appro-
appropriate approach to the country’s problems, but again the state was not able to follow through on its side of the bargain. In the course of trying to please all sides at once, the administration succumbed to the familiar populist pitfall of pleasing no one. Apart from these state-related difficulties in launching García’s “social concertación” strategy, its implementation was riddled with numerous other contradictions.

Early on, three of the four major labor confederations had signed an agreement with the main national business associations stating their intention to support concertación (Bollinger 1987, 20). Yet the president had also made it clear from the start that he favored those poorest and most disenfranchised segments of society, who did benefit briefly from state-sponsored employment programs like the Temporary Income Support Program (PAIT) (Vigier 1986; Graham 1994, 101–2). Although the García administration proved much more skillful than its two predecessors in dealing with organized labor, it missed an important opportunity to harness the energy of this more organized constituency to the development program.

From the standpoint of domestic capital, interest mediation centered almost immediately on whether local investors would actually be willing to step forward and meet the state halfway with the necessary investments in new export-oriented industries—or on the degree to which the Peruvian private sector would continue to squeeze idle industrial capacity without putting up a substantial amount of its own risk capital. The situation remained highly ambiguous through the first year of the program. While private investment during 1986 was up 18 percent over the previous year (BCRP 1987, 25), capital-flight estimates were also running between US$600 million and US$1 billion for the same period.8 The difficulties of forging ahead with the investment program were aggravated by García’s impetuous decision in mid-1987 to nationalize that portion of the financial system that still remained in private hands (ten commercial banks, seventeen insurance companies, and six finance companies). This was a last straw in the sense that whatever business confidence had been mustered quickly faded.9

But the interest-mediation process between the state and domestic capitalists was also hampered by organizational weaknesses within the private sector that had still not been resolved. Interest representation in this sector had definitely come a long way from the almost strictly personalistic style that had

---

8. The figures cited here are from MACROCONSULT, a Lima think tank, and were conveyed to me by its former director Claudio Herzka.
prevailed through the 1960s via traditional organizations such as the National
Industrial Society and the National Agrarian Society (Astiz 1969). It had also
emerged from the rut of the early 1980s, which saw any number of private-
sector representatives integrated into executive-level consultative commis-
sions meant to tackle a specific problem, only to have their final recommenda-
dations buried or ignored (Conaghan 1988, 56–57). The turning point had
been the 1983 annual executives’ meeting (CADE), where an explicit decision
was reached by the private sector to begin “making policy” on its own with
the formation of the umbrella organization CONFIEP a year later (Durand
1994, 12–13).

Although CONFIEP’s membership included fourteen major business
groups by late 1986, Francisco Durand (1994) notes that CONFIEP’s internal
organization was still too incipient for it to achieve any true clout in the pol-
icy-making process. Given the historical tendency of the Peruvian private sec-
tor to band together in times of crisis and to otherwise fragment in pursuit of
short-term individual gains, CONFIEP still had not made the full transition
to a viable institutional entity. Clearly, with the abrupt drop in external capi-
tal flows, a state-capital alliance geared toward leveraging local investment,
and acted out institutionally through CONFIEP, was the logical path forward
for the García administration. The inability to properly pursue this path, for
all the reasons discussed earlier, left the task open for García’s successors.

Heterodox Reactivation**

When García assumed office in July 1985 the APRA did have an emergency
plan for the first one hundred days of government. This, combined with 50
percent of the popular vote and a majority in both houses of congress,
enabled García to act quickly. The immediate tasks lay in controlling domes-
tic inflation and currency speculation and in alleviating an explosive current-
account deficit. The APRA’s earlier calls for a unilateral debt moratorium
were substantiated by the fact that service payments on the debt had
approached 50 percent of the country’s export earnings when Belaúnde
stopped paying and that Peruvian debt had already been written down to less
than half its value on an emergent secondary-debt market trading out of New
York. These steep discounts implied that an imminent return of voluntary
lending to Peru was not likely.

García’s inaugural announcement of the “10 percent solution,” limiting
service payments on Peru’s medium- and long-term public debt to no more
than 10 percent of annual export earnings, differed from Belaúnde’s ad hoc moratorium in two ways. First, García won a wide national consensus for his unilateral stance and was therefore able to turn the problem around and make it work for him. Second, with its focus on selectively honoring those obligations necessary to maintain trade and development financing, and on seeking alternative methods of debt repayment (e.g., debt equity swaps), the 10 percent solution represented Peru’s first attempt at a coherent debt strategy since the problem originated in the mid-1970s. Stated policy through 1987 was to keep up on payments to the multilaterals and on food imports and regional trade agreements and to punctually service any debt contracted after July 1985.

On the domestic side, the emergency plan sought to halt inflation through direct price administration and the control of imports and foreign exchange. Peru’s venturing from conventional orthodox wisdom was a long time coming and obviously a response to past policy failures. The embracement of this experimental mix of policies can be explained, ironically, by the very limited and weak technical expertise within the ranks of the APRA. As García was forced to reach outside of his party, bringing in local consultants from the European Economic Community, the International Labour Office, and academia, neostructuralist policy influences from other settings were quickly put into action by the president’s economic team.

This first phase of heterodox shock set a price freeze on all goods and services; the exchange rate was devalued and then fixed at an official rate; all dollar accounts were also frozen on the condition that they could be turned into local currency at the new official rate plus a 3 percent premium. The fixed exchange rate was combined with wage hikes and lower interest rates to encourage a transfer of income from financial and speculative activities to the productive sector. The partial debt moratorium, combined with import controls and long-overdue cuts in arms purchases, did provide a cushion to spur economic reactivation. Treasury reserves were also built up by the BCRP’s highly unorthodox decision to purchase dollars, made cheap by a fixed exchange rate, from those regional banks flush with the proceeds from Peru’s illicit US$500–800 million annual cocaine trade.

By early 1986, the economic program began to move forward in a series of quarterly packages aimed at taking advantage of the high levels of idle capac-

---

11. García’s original core team consisted of Argentine economist Daniel Carbonetto and Pierre Vigier, on loan respectively from the International Labour Office and the European Economic Community; Cesar Ferrari, a Ph.D. economist trained at Boston University; and APRA party faithful Javier Tantalean. Both Ferrari and Tantalean headed up the INP during García’s first two years. Also influential was Carlos Franco, editor of Lima’s prestigious academic journal Socialismo y Participación. Franco represented the strongest Velasquista faction among the president’s advisors.
ity present in the economy. The medium-term strategy hinged, first, on coordinating the expansion of productive capacity with the expansion of mass consumption; and second, on the need to capture and reinvest the economic surplus in order to sustain a consumer-led economic recovery. García’s team also stressed the need to coordinate import substitution with export promotion and to integrate the popular sectors via redistributive reforms. 12 If the Velasco era was the heyday of structuralism in Peru, then the García administration was an attempt to refine this same strategy. However, the differences this time around were considerable. Not only did García lack the breathing room that external borrowing had afforded the RGAF in the early 1970s; he also inherited an exceedingly more volatile macroeconomic scenario than that taken over by Velasco in 1968.

The reactivation strategy deepened throughout 1986 with periodic wage hikes, emergency work programs, and generous subsidies for Peru’s depressed agricultural sector. García had begun urging business executives to invest at their 1985 annual meeting (CADE) and offered tax refunds and credit incentives for companies that created new jobs. By year’s end, a complex economic superstructure had evolved that combined import controls with multiple exchange and interest rates, with the bulk of the tax breaks and subsidies channeled into manufacturing and agroindustry. The short-term success of the program was tremendous: real wages increased by 30 percent in the countryside, with the average urban correlate up by 20 percent; industry grew an astounding 15 to 20 percent; and the growth of GDP surpassed post–World War Two records at 9.2 percent (see table 14). Inflation, moreover, was reduced from an average rate of 163 percent in 1985 to 78 percent in 1986. The boom made for APRA’s clean sweep in the November 1986 municipal elections, and García held his ground as perhaps the most popular president to date.

These immediate gains aside, some predictable longer-range challenges had already surfaced. First was the difficulty of moving out of the price freeze without precipitating a new inflationary spiral, a dilemma that had similarly plagued Argentine and Brazilian policy makers. Second, it was not until early 1987 that the government formed a National Investment Board as the first formal step toward tripartite negotiation, or concertación. Third, because of the prolonged freeze on government-controlled prices and a continued world depression for oil and mineral prices, tax collections dipped to their lowest

12. As the country’s first development treatise since the Velasco period, the plan quickly became much bigger than the economic program it proposed. Many of the objectives worked at cross-purposes, pitting inward growth policies against outward ones and short-term goals against medium- and long-term concerns. For more detail on the nuances between the García and Velasco experiments, see table 2.
<table>
<thead>
<tr>
<th>Year</th>
<th>GDPGRO</th>
<th>GNPPCGRO</th>
<th>INF</th>
<th>PRIVGDP</th>
<th>PUBIGDP</th>
<th>INVEST</th>
<th>RER</th>
<th>TRADEBAL</th>
<th>CURACCT</th>
<th>FDI</th>
<th>PORT</th>
<th>DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>7.2</td>
<td>5.3</td>
<td>75.4</td>
<td>21.5</td>
<td>7.3</td>
<td>28.8</td>
<td>245.1</td>
<td>-553</td>
<td>-1,733</td>
<td>125</td>
<td></td>
<td>8,586</td>
</tr>
<tr>
<td>1982</td>
<td>-0.4</td>
<td>-2.8</td>
<td>64.4</td>
<td>20.8</td>
<td>8.7</td>
<td>29.5</td>
<td>251.1</td>
<td>-428</td>
<td>-1,612</td>
<td>48</td>
<td></td>
<td>10,709</td>
</tr>
<tr>
<td>1983</td>
<td>-12.6</td>
<td>-16.1</td>
<td>111.2</td>
<td>15.1</td>
<td>8.7</td>
<td>23.7</td>
<td>281.2</td>
<td>293</td>
<td>-875</td>
<td>38</td>
<td></td>
<td>11,339</td>
</tr>
<tr>
<td>1984</td>
<td>4.1</td>
<td>1.0</td>
<td>110.2</td>
<td>12.1</td>
<td>8.1</td>
<td>20.2</td>
<td>291.5</td>
<td>1,007</td>
<td>-235</td>
<td>-89</td>
<td></td>
<td>12,153</td>
</tr>
<tr>
<td>1985</td>
<td>2.3</td>
<td>0.4</td>
<td>163.4</td>
<td>12.0</td>
<td>6.1</td>
<td>18.2</td>
<td>348.7</td>
<td>1,219</td>
<td>102</td>
<td>1</td>
<td></td>
<td>12,879</td>
</tr>
<tr>
<td>1986</td>
<td>9.2</td>
<td>8.7</td>
<td>77.9</td>
<td>13.2</td>
<td>5.4</td>
<td>18.6</td>
<td>241.8</td>
<td>1,219</td>
<td>-1,393</td>
<td>2</td>
<td></td>
<td>14,882</td>
</tr>
<tr>
<td>1987</td>
<td>8.5</td>
<td>6.3</td>
<td>85.8</td>
<td>13.4</td>
<td>4.4</td>
<td>17.8</td>
<td>241.8</td>
<td>1,007</td>
<td>-2,064</td>
<td>32</td>
<td></td>
<td>17,485</td>
</tr>
<tr>
<td>1988</td>
<td>-8.4</td>
<td>-13.4</td>
<td>667.0</td>
<td>15.5</td>
<td>4.2</td>
<td>19.7</td>
<td>161.2</td>
<td>-73</td>
<td>-1,819</td>
<td>32</td>
<td></td>
<td>18,240</td>
</tr>
<tr>
<td>1989</td>
<td>-11.6</td>
<td>-11.4</td>
<td>3398.7</td>
<td>13.1</td>
<td>3.5</td>
<td>16.6</td>
<td>167.3</td>
<td>-500</td>
<td>-570</td>
<td>36</td>
<td></td>
<td>18,577</td>
</tr>
<tr>
<td>1990</td>
<td>-5.4</td>
<td>-8.5</td>
<td>3981.7</td>
<td>12.2</td>
<td>2.5</td>
<td>14.7</td>
<td>103.9</td>
<td>-1,346</td>
<td>-1,384</td>
<td>59</td>
<td></td>
<td>20,064</td>
</tr>
</tbody>
</table>

| Year  | 1986–90 (1) | |
|-------|-------------|
| GDPGRO| -1.6        |
| GNPPCGRO | -1.5       |
| INF   | -3.66       |
| PRIVGDP| 13.4        |
| PUBIGDP| 4.0         |
| INVEST| 17.4        |
| RER   | 100.0       |
| TRADEBAL | 399        |
| CURACCT| -1,384      |
| FDI   | 41          |
| PORT  | 18,577      |
| DEBT  | 20,064      |


**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$).

*García term average growth and investment*
point in a decade. García’s tax cuts to the business sector also failed to generate expected new revenues, as many firms evaded taxes by fleeing into the informal economy.\textsuperscript{13} The projected income from the sale of thirty to forty public firms was blocked by the lack of interested buyers and by the government’s reluctance to take on the complex problem of privatization, despite earlier campaign promises to do so (Ortíz de Zevallos 1986).\textsuperscript{14} The partial debt moratorium failed to help as much as expected, as it had been necessary to pay out close to 20 percent of export earnings during García’s first year just to maintain the necessary trade financing.\textsuperscript{15}

The success of the heterodox reactivation now rested on its medium-term goal of capturing new private-sector savings and investments before foreign reserves were depleted. In 1987 García finally launched a highly touted “national-industrial project” with the country’s top twelve business groups.\textsuperscript{16} Priority investment projects were defined as those that were decentralized, net savers of foreign exchange, and that promoted employment and intraindustry links. A special employment and investment fund was created to offer bonds to finance-approved projects, and a new foreign-trade institute was set up to promote in-kind debt-payment schemes based on the expected returns from nontraditional exports. With all the generous tax and credit incentives, the APRA government succeeded in taking the \textit{concertación} process up to the letter-of-intent stage. However, most of the US$400 million in new projects never moved forward as planned.

Potential investors had been put off by some of the government’s other, less appealing measures, such as a mandatory bond-purchasing scheme for 1986’s most profitable firms. And, there remained the confidence gap generated by the guerrilla insurgency and its targeting of local industrial plants for

\textsuperscript{13} By moving part of their operations into the informal economy, producers had realized their own reactivation by using cheap government-controlled inputs, while evading price controls and taxes on their own output (Thorp 1987).

\textsuperscript{14} The government did announce a divestiture plan in 1986 that targeted the sale of thirty to forty smaller companies, with the expectation of raising US$400 million within two years. But, similar to the pattern under the previous administration, the two-year period saw a divestiture of just two small shareholdings, plus one physical plant that sold for half a million dollars. These data are reported by Joseph Borgatti, “Divestiture Program of Inversiones COFIDE S.A. (ICSA),” USAID Bureau for Private Enterprise, Washington, D.C., Mar. 21, 1988, 50/2–50/3.

\textsuperscript{15} The intended debt-for-equity swaps had not materialized—mainly because such arrangements require a certain level of financial sophistication at the negotiating stage, which the administration lacked; and because Peruvian debt, now offered at about 17 percent of its original value on the secondary market, was without buyers.

\textsuperscript{16} Although minerals still accounted for over 60 percent of national income, mining representatives were excluded from these meetings, and minerals received the worst rates within the new multitiered exchange-rate system. The policy bias was an ideological one, reflecting APRA’s ambitions, originally expressed by Haya de la Torre, to move away from enclave development based on primary exports.
expensive physical damage. Peruvian entrepreneurs, though increasingly modern in their outlook, were still not accustomed to investing without the backing of foreign capital, and there were the usual suspicions from abroad about the ability of an inefficient state sector to execute the highly interventionist heterodox program successfully. Policy debates taking place within the government at the time did not help relieve these anxieties, as there was open confusion over the problem of reconciling popular demands and the attempted industrialist pact with the state’s rapidly diminishing resources. As the demands of labor and business began bearing down on the executive, the ongoing policy debate within the government erupted into a major dispute among state agencies.

The more fiscally conservative BCRP and MEF pointed to the mounting deficits and the imperative for slowed state spending accompanied by a tax overhaul. On the other side, the fiscal expansionists operating out of the INP favored a deepening of consumer-led growth and a stronger promotion of the export projects being discussed with the private sector. The president announced a major economic package in April 1987 meant to strike a compromise among all the various factions that were emerging. The MEF and BCRP won some tax and exchange-rate adjustments, while the INP secured wage hikes for labor and lower interest rates for the private sector. In order to preserve foreign exchange, García adjusted the debt strategy to a “capacity to pay” stance that further limited debt payments until after domestic growth targets had been met. Though intended to ameliorate conflict and win more time for the program to work, the economic package was the first clear sign that the heterodox policy was in serious trouble and that García had begun to lose control.

Under the capacity-to-pay policy, loan disbursements from the multilaterals began to turn negative, and previously negotiated in-kind debt-payback schemes were thrown into question. It was within this context of an increasingly desperate foreign-exchange situation and the unraveling of any semblance of a cohesive politics of growth that García announced his intention to nationalize all private banks and finance and insurance companies in mid-1987. Although this move contradicted García’s earlier campaign pledges, the immediate explanation for it centered on the need to democratize credit and make more working capital available for Peru’s small and medium-sized entrepreneurs. The decision is probably best interpreted in light of the gov-

17. Groundbreaking countertrade deals had been signed with two banks (Midland Bank and First Interstate of California) in late 1987, but this debt-repayment strategy was plagued by various bottlenecks. The basic problem was Peru’s inability to guarantee a steady flow of products contracted in a given agreement, with the investment lag in export-oriented projects adding to this shortage.
ernment’s frustration over what it perceived as high levels of capital flight, as up to this point the APRA had assigned small capitalists a marginal role in the national-industrial alliance. With the nationalization, García attempted to coopt a major position of the IU and further consolidate his largely unorganized grassroots political support base. Yet, at the same time, he succeeded in alienating those top economic groups with whom he had been cultivating a working relationship since the early 1980s.

The Antipopulist Backlash and Other Political Implications

With the collapse of public finances in late 1987, and the growing distance among those groups within the state and business community whose cooperation would be essential for any realistic attempt at economic restructuring, another Peruvian experiment had come to an abrupt end. Because the proposed nationalization caught even IU and APRA members of congress off guard, the outcome was the passing of a vague nationalization law that left the government and the private sector to battle out the initiative in the courts. The divisive issue brought Belaúnde’s dormant AP-PPC coalition temporarily back to life and gave rise to a conservative opposition Democratic Front (FREDEMO), which championed private-property rights and succeeded in keeping the conflict alive. As the García presidency wore on, time would quickly reveal the huge political and economic costs that the bank nationalization would inflict on the entire country.

Although the issues and actors were quite different, the standoff was similar to the pattern of the previous administration, whereby government policy broke down halfway through the presidential term and the executive became increasingly isolated. The pattern was obviously rooted in the complexities of constructing a constitutional democracy in the midst of ongoing economic crises and in the drawbacks to the executive office discussed in chapter 4. Yet it was also reinforced under García by a combination of political miscalculations and by the way the chosen economic policy interacted with unresolved structural limitations at the level of the state.

As for García’s domestic political strategy, a quick injection of populist wage policies and a brief reversal in the terms of trade between industry and agriculture, followed by a retraction, led to an urgent search for other ways of

18. Javier Iguiniz, Catholic University economics professor and chief economist for the IU coalition, pointed out that the professed goal of democratizing credit by way of the nationalizations was greatly hampered by the absence of any prior preparations, such as the establishment of local popular lending programs with clearly defined projects and investment schemes. See Peru Report, Sept. 1987.
maintaining alliances with organized labor and the popular sector. Rash actions to solve one problem created problems elsewhere, the ramifications of the bank nationalization law being the strongest case in point. The erratic handling of *concertación*, and the president’s insistence on negotiating directly and in private with the major representatives of economic power, as opposed to utilizing institutional channels within the state and the CONFIEP, left both sides vulnerable and with little recourse when personalistic ties began to sour. The exclusion of organized labor altogether from the negotiations made that alliance all the more difficult to maintain.

This inability of base groups to find effective political representation once they have played a key part in supporting candidates and parties in democratic transitions is a paradox common to all democratizing states in the region (Sanborn 1991). In the Peruvian case, even the interests of the influential economic elites who had promoted García were abandoned, as the APRA oscillated between a populist stance and its modernization pact. Apart from leading to the strategic error of pursuing neither course very efficiently, the stalemate underlined the ultimate weakness of representative groups, the difficulty all sides had in exerting their political will, and the challenge this augured for the survival of democracy in Peru.

Similarly, on the external front, one is left to wonder if greater economic breathing space could have been gained from a more consistent political approach. Early on, García won the support of prominent U.S. academic economists for his partial debt moratorium (Fishlow 1986). Moreover, the U.S. government, because it took the guerrilla insurgency seriously and because of the sensitive issue of Peru’s first democratic presidential succession in forty years, was treading softly with García.

The U.S. government’s Inter-Agency Review Committee did request that the banks downgrade Peru’s debt in November 1985, but the country’s honoring of its private-sector commercial payments and the banks’ low level of exposure to Peru helped delay other commonly feared sanctions such as the freezing of the country’s foreign assets and the interruption of trade finance. The APRA also held Peru’s commercial and multilateral creditors at bay by presenting the moratorium as temporary and declaring its intention to form a new foreign-debt committee to negotiate directly with the country’s creditors.

The space afforded by international political and economic actors, and the astounding growth rates of 1986 and 1987, had the perverse effect of permanently postponing these negotiations on the Peruvian side.19 The result was

---

19. Peru’s delegation to the 1986 annual IMF–World Bank meetings made a particularly poor impression, reiterating the country’s debt stance with a lot of anti-imperialist rhetoric. If there had been a propitious time to negotiate with the multilaterals, this was probably it.
the IMF’s declaration of Peru as an “ineligible” borrower in August 1986 and the subsequent freezing of around US$900 million in multilateral loan disbursements to Peru. In view of Peru’s now precarious financial position (see table 14), the lesson of the partial debt moratorium was twofold. First, even small underdeveloped states with formidable internal security threats would not be let entirely off the hook, particularly when little effort was made to dialogue with international lenders. The paying out of 10 to 30 percent of annual export earnings to service the debt did not deter the usual trade and aid sanctions, although it did help to slow the pace with which they were applied. Second, the fiscal crisis resulting from this one-shot financing based on debt nonpayment confirmed the APRA’s original campaign statements on economic policy—that is, in the absence of sufficient quantities of external financing, sustainable growth policies would require a substantial increase in domestic resources, through taxes and private savings.

The double bind, of course, was that rigid limitations from the external sector quickly rendered what had been envisioned as a long-term policy for garnering domestic resources into a short-term crisis-management program, and not a particularly well-managed program at that. Heterodox policy, as nothing more than a short-run inflation-management strategy, had the disastrous effect of holding down those key prices, including interest and exchange rates, necessary to build a strong private-sector economy (Thorp 1987, 5/1). And, having lost its momentum as a long-run force for restructuring the economy, heterodoxy only served to intensify the increasingly inverse relationship between a more interventionist model and the poor capacity of the Peruvian state to intervene effectively.

At the level of the state, the most glaring limit to García’s program was the continued failure of any one development institution to take the lead in formulating and carrying out public policy. The reform stalemate in the public-enterprise sector also created a bottleneck in the government’s modernization drive, as the SOEs continued to control half of Peru’s modern-sector capital stock yet remained in limbo for all the reasons discussed in chapters 3 and 4.20 The locus of the reactivation program at the INP suited the APRA’s desire to project a broad multiclass image, as the planning institute still embodied much of the populist legacy from the Velasco period. But even under Velasco, the INP never came to fruition as a powerful development entity (Cleaves and Scurrah 1980, 74–75). Thus, García’s team easily penetrated the INP, making economic policy decisions at the top, with the

20. In the wake of García’s term it had become apparent that the SOE sector had actually expanded with the nationalization of the Belco petroleum company in 1986 and the creation of nine additional SOEs (Manzetti 1999, 65).
agency’s own bureaucrats often informed afterward through the media.21 The policy-making patterns at the BCRP and the MEF were similar, as the APRA literally battled out intraparty rivalries within the state financial institutions.

Despite García’s stated intention to reform Peru’s corrupt public administration, the filtering of the APRA party into the state bureaucracy brought out the worst traits in both. With the APRA having taken over with a sixty-year backlog of pent-up political patronage from within the party, the spoils of office augmented the APRA’s clientelistic tendencies and enhanced intraparty conflicts that had been temporarily assuaged by the prospects of finally winning the presidency. The older party bosses, not entirely at ease with García’s fast pace and independent leadership style, frequently challenged state policy decisions on these grounds alone. The younger APRA generation, with an eye toward permanently maintaining the party’s new hegemonic presence as the prime force in Peruvian electoral politics, undermined party cohesion and the overall policy-making process by going to battle early over the crucial question of who would succeed García.

The eruption of the biggest rivalry, between the president and APRA finance minister Luis Alva Castro, resulted in the latter’s resignation and a mass firing of his managerial counterparts within the BCRP in mid-1987. This politically motivated personnel overhaul and marginalization of the more economically astute central bank was disheartening, as this was the one state financial institution that had been intentionally cultivated to play a more autonomous and stabilizing role in the policy process.

The Consequences of Heterodox Policy

Through this analysis of Peru’s second major attempt at economic restructuring, it is possible to separate out two kinds of outcomes. The first outcomes are rather abstract and have to do with the interplay among economic crisis, state structures, and policy making under the García administration. The second outcomes are more concrete and relate to the dire political-economic situation that followed the heterodox program upon its demise in late 1987. While the latter must be seen as an accumulation of problems that had been festering since the 1960s, this period post-1987 is widely seen as having more firmly cemented a political economy of violence in Peru. On this last

21. My interviews with midlevel bureaucrats at the INP during this time revealed that the economic program was weakly rooted there, both as a development model and as a concrete plan of action. Although the INP still housed the ECLAC “heterodox line” upon which it was founded in the 1960s, for these frontline state planners in Peru during the mid-1980s, heterodoxy seemed more a matter of not going back to the IMF.
point, the discussion will focus on the more volatile socioeconomic impacts of García’s state-led strategy.

**State Structures, Economic Crisis, and Heterodox Policy**

On the interplay of these three factors, the similarities between Peru’s first attempt at economic restructuring, under Velasco, and the García era are striking. Under both experiments, the purposeful resort to statist policy approaches was preceded by economic crisis and then seriously undermined by the poor political capacity of the state to intervene in fostering higher levels of productive growth. Referring back to two of the institutional preconditions for effective policy reform discussed in chapter 1—political insulation of state policy makers and the consolidation of state economic institutions—the analysis reveals that the contingencies over time in Peru had been just the reverse of what was called for.

Political insulation during this period correlated less with state capacity or autonomy and more with unaccountable and loosely linked administrative structures controlled by special interests. At the highest levels of government—for example, the technocratic team surrounding the president—insulation led to isolation and hence fragility (Stepan 1978, 301). Similarly, the technical discontinuity and entrenched clientelistic norms that prevailed within the economic institutions of the state rendered them almost residual as points of causal analysis in the policy-making process.

Yet, at the same time, the García period shows how state-led expansion and interventionist reforms, while making economic management more chaotic and unruly, also politicized economic issues, thereby setting in motion those organizational bases within civil society that are also essential components for shaping a state’s capacity to act. The inability of all groups to find effective representation had to do with the incipient nature of these organizations and, even more so, with the tentative structures of the state. In fact, one of the greatest lessons of García’s attempt to form a more cohesive alliance between the state and society was the extent to which the Peruvian state—as a coherent set of administrative, political, and economic structures—was still very much the missing actor.

These observations provide part of the explanation for the outcomes of the program, which, if we were to ignore the “new” heterodox label altogether, looked more like a blueprint of the mid-1950s populist meltdown that marked the end of Juan Perón’s first administration in Argentina. There, the use of extended price controls and the expansion of wages and government spending met with brief initial success in terms of income redistribution and the moderation of inflation, only to be quickly followed by accelerating
inflation and a backsliding in distributive gains (Foxley 1983, 4). The results, under both Perón and García, stemmed from policy packages plagued with internal inconsistencies and erratic implementation.

Viewing the outcomes of the heterodox experiment from the angle of the economic crisis as another critical juncture for Peru, John Ikenberry (1988, 224) nicely summarizes the ways in which “crisis acts as a solvent, throwing into relief discontinuities between underlying social forces and existing institutions.” It is these episodic ruptures that prompt a reshaping of social relations and changes in institutional structure. Critical junctures can help drive institution building and, in turn, revitalize the policy-making process (Grindle 1996). In Peru, domestic responses to the crisis amounted to half of this equation. Political alliances were broken and reconstituted across the various sectors of civil society, as all groups struggled to defend their interests. Even in the wake of the heterodox program, the response within civil society and the private sector, in particular, had been to strengthen representative organizations and to formulate a more cohesive set of policy demands (Durand 1994; Stokes 1991).

But the relationship between this greater social determination to organize and the political will for building up the institutional capacities of the state was an asymmetrical one. Beginning with the Mexican Revolution, Latin American history is full of similar junctures where domestic elites “have seized the political initiative . . . and set down the initial orientations of the state by devising an array of institutions which embody their ideological vision” (Bennett and Sharpe 1980, 183). But each case shows that the internal strengthening of the institutions of the state does not follow naturally from the displacement of the ancien régime, as policy makers in Peru have frequently presumed; rather, this requires a conscious decision and a long-term purposeful effort on the part of a broad alliance of domestic actors.

Political alliances in Peru during the 1980s instead focused on the forging of social pacts between the state and representatives of business, labor, the military, and the rural sector. The resulting policy paralysis can be attributed to a number of political, economic, and institutional factors that have been discussed throughout this study. Yet the paralysis is also testimony to the failure of social pacts to smooth over the political struggles intrinsic to this diverse group of actors or to substitute for the kinds of internal reform and building up of administrative capacities that would be necessary prerequisites for instituting broad structural change. Many of the social pacts made during the democratic transition period in the early 1980s were at best tenuous, upsetting the wishful notion shared by many democratizing societies that the necessary changes can be ushered in free of conflict.
The Institutionalization of Political Violence

As for the socioeconomic impact of the heterodox program, the costs could not have been higher, particularly for those very groups whom the program was supposed to favor. Given the prevalence of poverty-based violence in the sierra region, the government’s immediate aim had been to raise the living standard of that region’s primarily self-employed agricultural producers. Through massive subsidies and price supports, the strategy succeeded, with a 75 percent improvement in the rural versus urban terms of trade by 1986.22 As a result of the overall employment and income policy, the formal sector of the economy saw a 10 percent expansion in the rate of employment, and the public-sector wage bill increased from 7.9 percent of GDP in 1985 to 8.7 percent in 1987.

But by late 1987 most of these gains had begun to erode. The rural versus urban terms of trade dropped back to the same low pre-1985 level, and real wages began to descend in the wake of massive inflation (see table 14). In short, the positive gains had only been realized at the expense of large financial and external imbalances. The public-sector deficit reached 11.2 percent of GDP by 1988, due mainly to the collapse of the tax system. While Garcia had followed through on his commitment to initiate a major income-tax reform in 1986, only 4 percent of the economically active population declared personal tax liabilities that year. As Peter Klarén (2000, 389) notes, in 1987 “three times as many Ecuadorians and twelve times as many Chileans (in relation to the total population) filed income tax returns as did Peruvians.” And contrary to the previous periods studied here, public investment accounted for little of the deficit. In the absence of foreign financing, state capital formation slumped to the average levels witnessed in the 1950s (4 percent of GDP).

In the end, with the drop in public investment, the shrinking of the tax base, and the overly expansionist budget, the government quickly lost whatever opportunities the partial debt moratorium may have afforded to chart the economy on a course of sustainable and more equitable growth. As economic adjustment became imperative, the government embarked on a series of reform packages throughout 1988 with the stated goal of equally distributing the adjustment burden among all social groups. But the packages, four in all, were mainly erratic and insufficient one-shot fixes based on hikes in publicly controlled prices, currency devaluations, and interest-rate adjustments. As annual inflation approached 2000 percent by late 1988, what had been promised as an orderly adjustment gave way to a chaotic and highly regressive.

distribution of the costs of stabilization under the thrust of hyperinflation. Spending on human capital was a main casualty of the crisis, as teachers’ salaries and current expenditures on education for 1990 were one-fifth lower than in 1975 (Sheahan 1999, 21).

Meanwhile, political violence had now become a permanent fact of everyday life in Peru. On the economic front, guerrilla hostilities had extended to the foreign sector, with major attacks on such local multinational subsidiaries as the Nissan assembly plant and the Lima offices of the Bank of Tokyo. The attacks on state infrastructure, agriculture cooperatives, and technological research centers also heightened, as did the assassinations of those employed in such endeavors. Of the roughly 9,000 official deaths that were registered during the 1980s, some 235 were of ranking government officials. The overall effect was to further weaken the capacity of the state to manage the economy, as qualified managers became increasingly deterred from assuming the responsibility of government service under such high stakes.

On the political front, the insurgency was clearly no longer just an Andean phenomenon. Terrorist actions in Lima were now estimated to account for 50 percent of the total activity, and Sendero had also infiltrated the jungle region, forming an apparent marriage of convenience with local drug traffickers. By 1990, this political violence had become institutionalized across broad segments of civil society. This was apparent, first, from the increasing number of insurgent groups apart from Sendero, such as the Tupac Amaru Revolutionary Movement and the Rodrigo Franco Command, that had so willingly taken up arms against the state; and second, from the role that the armed forces had come to play both in fighting the various guerrilla insurgents and in jumping onto the terrorist bandwagon themselves. Despite García’s commitment to reverse the previous administration’s policy of fighting terror with terror, the indiscriminate use of force by the military had now become commonplace in the designated emergency zones. Questions about the fate of two thousand to three thousand persons believed to have disappeared at the hands of either the guerrillas or the military since 1980, and numerous other instances of group massacres known to have occurred, simply went unanswered (Obando 1998).

Not surprisingly, in a 1988 survey commissioned by the Peruvian Senate

23. Throughout the literature, the usual rule of thumb on measuring hyperinflation is a rate of 40 to 50 percent a month. For a more thorough analysis of these economic technicalities under the García administration, see World Bank 1989.


Committee on Violence and National Pacification, the majority of the respondents pointed to the highly deficient security policy and the need to alleviate the plight of the country’s economically marginal masses as the two greatest challenges facing Peru in the 1990s. The survey, which involved 8,133 interviews throughout the country, showed that most Peruvians favored social change, the provision of greater economic opportunities for youths, and the pursuit of a national peace accord as the only way to halt the political violence. In other words, the majority of the respondents still endorsed what the García administration had set out to accomplish. The fact that it had failed miserably set the political winds in another direction, as the results of the November 1989 nationwide municipal elections soon showed.

Reconstructing a Development Coalition

In the two-year interim between the 1987 bank nationalization and the November 1989 nationwide municipal elections, the FREDEMO, formed under the leadership of famed Peruvian novelist Mario Vargas Llosa, enabled one last comeback for the dormant sectors of the AP and the PPC. Again espousing the implementation of the social-market model that had been written into the 1979 constitution, the FREDEMO coalition captured 37 percent of the nationwide municipal vote in the November 1989 electoral contest. The IU took another 21 percent of the vote, and the APRA 13 percent. The lack of a significant majority outcome in the November 1989 vote indicated the difficulty that all of the participants would have in capturing the presidency with the same winner-take-all outcomes that had occurred for the AP-PPC in 1980 or the APRA in 1985. This was confirmed by the remarkable outcome of the 1990 presidential race, where Vargas Llosa lost to the relatively unknown Alberto Fujimori, whose backing had come together in a loose coalition (Cambio 90) just a couple of months before the vote.

Putting aside the question of the depth of its support, the FREDEMO did succeed in reviving the liberal economic debate in Peru for the first time in nearly a decade. Drawing on many of the ideas put forth in Hernando de Soto’s (1989) regional bestseller *El otro sendero*, Vargas Llosa projected an economic scenario whereby the drastic reduction in government regulation would unleash the country’s true entrepreneurial forces and bring a booming informal sector into the legal economy. Grassroots capitalism on the home

front was to be bolstered by the country’s reinsertion into the international economy, which would revive private investment. On the surface, this latest turn of political-economic events in Peru resembled the Southern Cone pattern of erratic flip-flops between populism and orthodoxy during the post–World War Two period (Dornbusch and Edwards 1991). Yet, at a more penetrating level, this turn to orthodoxy and its embracement by a politically ascendant “new right” was not such a cut-and-dried matter.

As with the country’s social-market endeavor of the early 1980s, the FREDEMO’s liberal economic thrust seemed more a reaction against the statist excesses of the García era, rather than a new consensus over how to actually approach the country’s formidable problems. This becomes apparent when the coalition is broken down into its component parts. Apart from the economically orthodox Vargas Llosa faction was a more moderate segment of domestic capital that favored a gradual adjustment strategy.28 There were also populists who had rallied behind Belaúnde and who had already begun haggling with FREDEMO hardliners over the proposed privatization targets.29 Finally, there was the country’s burgeoning mass of small-scale entrepreneurs, who remained apart from the FREDEMO for reasons of ethnicity and socioeconomic position (Brysk and Wise 1997). The basic disaffection of this group, as well as the popular sectors, perhaps best explains the inability of the FREDEMO to prevent the presidency from falling into the hands of independents.

Conclusion

The previous three chapters charted the rise of the Peruvian state sector since the 1960s and along with this the evolution of a problematic pattern related to state expansion that had acted as a political-economic undertow to state-centered and market-oriented development strategies alike. The pattern, as described in chapter 1 and reiterated throughout this book, has to do with a strong dependence on external financing and a neglect of crucial macroeconomic policy variables against the cushion of foreign savings; a heavy reliance on state enterprises to provide employment and cheap inputs and services, with little regard for their productivity and profitability; the perpetuation of a conflictual relationship with domestic capitalists, who have benefited greatly from government largesse but have held back their investments due to all the macroeconomic uncertainties and the state’s obvious administrative weaknesses; and finally, social policies that have consistently taken a back seat to the pressing need to shore up the productive structure.

The present chapter finds the country at a particularly painful juncture, whereby the resolution of the worst symptoms of state intervention had become a prerequisite for reestablishing relations with the international financial community, not to mention fending off a full-blown civil war on the domestic front. This was true for each of the four aspects of the pattern mentioned earlier. Although the strong reliance on external borrowing was never the same option for García, he fully exhausted the debt alternative by obtaining de facto financing with the unilateral moratorium on debt payments (World Bank 1989, xxv). The consequent outbreak of hyperinflation demanded that some action be taken in the way of solid macroeconomic policy reforms. Without such reforms, there was zero chance of reducing inflation or attracting foreign loans and increases in multilateral aid. The García recipe, where hyperinflation was left to do the dirty work of economic adjustment, turned out to be political suicide.

As in the 1970s and the early 1980s, the domestic debate over how to proceed with economic adjustment wavered between a draconian shock treatment and a more gradual approach to stabilization (Dornbusch and Edwards 1991, 45–46). The former strategy, which implied rapid increases in real revenue at the expense of short-term output and real wages, would surely throw fire on what had emerged as one of the region’s most volatile domestic battles. Pursuit of the latter, more cautious course left policy makers in the same situation that they had faced since 1985—that is, the need to seek a broad support base for adjustment from the country’s diverse social, economic, and political groups, as well as to insure that the poorest segments of the population were not left to bear the brunt of the adjustment effort. This very scenario, unfortunately, turned out to be the García era’s main legacy: incredibly high human costs, particularly for the very poorest.

In the context of the 1990 presidential campaign, some strands of the development debate directly took on these pressing problems. For example, the FREDEMO coalition emphasized the need for macroeconomic reform and to restore full relations with the foreign sector. Likewise, there was a renewed concern for cleaning up the mess in the SOE sector once and for all. Finally, missing in the electoral dialogue were the two elements most likely to make a future program work: broad consensus over an economic-adjustment strategy and a much deeper commitment to equitably distributing the costs. The increasing polarization between right and left, orthodox and heterodox, indicated that domestic groups were still at a loss over how to face the country’s problems head-on—hence the election of a maverick independent candidate who would steer the Peruvian political economy in yet another dramatic direction for the entire decade of the 1990s.