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## PERU'S RETURN TOWARD AN OPEN ECONOMY: MACROECONOMIC COMPLICATIONS AND STRUCTURAL QUESTIONS

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ABSTRACT

Among the many stabilization and liberalization programs in Latin America, the Peruvian version from August 1990 has been the most extreme so far. The results have been in some respects positive but in important ways perverse. Comparisons with some of the key aspects of liberalization programs in other countries, especially with the two different versions tried in Chile, point to alternatives that might be helpful for Peru, while Peru's own experience helps brings out problems that other countries might be able to avoid.

The conflicts and still-unanswered questions in Peru include: (1) adopting a floating exchange rate and ending controls on capital movements under conditions of tight liquidity made the currency appreciate in real terms, blocking exports as well as investment while stimulating imports; (2) in the context of prolonged decreases in production and employment, a strong drive to raise taxes plus quasi-indexing of prices for energy and public services have unnecessarily aggravated contraction and kept the price index rising; (3) steep cuts in tariffs went against the drive to raise government revenue and, in combination with appreciation, badly damaged the competitive position of all producers of tradable goods; (4) cutting government capital expenditures after two decades of deteriorating infrastructure added to the problems of producers, and cutting social expenditures weakened possibilities of response to falling employment and wages, worsening poverty, and growth of violence.

# PERU'S RETURN TOWARD AN OPEN ECONOMY: MACROECONOMIC COMPLICATIONS AND STRUCTURAL QUESTIONS

Economic liberalization can take a multitude of forms, with significantly different consequences. It did not take the same form in Peru in 1990 as it did in Mexico in the 1980s, or in the far milder version of Colombia from 1967, or in Chile under the Pinochet government, or for that matter under the Pinochet government in the 1970s and the same government when reacting to Chile's crisis of 1981-83.[1] That last contrast, between the original version in Chile and the more successful version from 1984, could be particularly instructive for Peru, and both countries' experiences perhaps for others.

The Peruvian stabilization and liberalization program has been more extreme than any of the others. That extremist character has resulted in exceptionally high costs. Peru has so many deeply rooted problems that the best of all possible economic strategies would be bound to run into trouble, but this

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[1] José Pablo Arellano, "Crisis y recuperación económica de Chile en los años 80, Colección Estudios CIEPLAN, no. 24, Junio 1988; Sebastian Edwards and Alejandra Cox Edwards, Monetarism and Liberalization: The Chilean Experiment (Cambridge: Ballinger, 1987); Patricio Meller, "Revisión del proceso de ajuste chileno de la década del 80," Colección Estudios CIEPLAN, NO. 30, Diciembre 1990; Eva Paus, "The Viability of the Neoliberal Model in Chile," paper presented at the International Conference of the Latin American Studies Association, Los Angeles, September 1992; Joseph Ramos, Neoconservative Economics in the Southern Cone of Latin America, 1973-1983 (Baltimore: Johns Hopkins University Press, 1986); John Sheahan, Conflict and Change in Mexican Economic Strategy: Implications for Mexico and for Latin America (La Jolla: Center for U.S.-Mexican Studies, University of California, San Diego, Monograph Series 34, 1992.)

particular version has created special difficulties of its own. The immediate problem is that changes which could be individually desirable for longrun growth are interacting with each other in ways that could block recovery indefinitely. The longer term problem is that this new orientation, though potentially helpful in many respects, could exclude the kinds of directive action needed to provide any bearable answer to the strains of poverty, inequality, and violent rejection of the social order.

The key conflicts on the macroeconomic level center on: (1) relationships among domestic monetary and fiscal measures, the trade regime, and the exchange rate; (2) the drive to rebuild the shattered base of government revenue under conditions of severe depression; (3) domestic and external pressures to hold government spending at extremely low levels in the context of deteriorating basic infrastructure, increasing violence, and worsening poverty.

These macroeconomic conflicts are closely related to persisting questions about the structure of the economy and the causes of deteriorating economic performance since the 1960s. That deterioration coincided with a period in which economic strategy was based, with one brief interruption, on protection and control. Will the reversal of that protective strategy help get the country out of its prolonged economic morass? Or will it instead renew all the frustrations associated with the open economy before the turn to protection and control in the 1960s? Prior to that time, overall economic growth was much more successful than it proved to be under protection, but widespread dissatisfaction with the character of the country's development resulted in attempts to move away from the open economy every time a democratic choice became possible. The dissatisfaction and accompanying social conflict centered on extreme inequality, impatience with dependence on primary exports, lack of dynamism in the industrial sector, extensive foreign ownership and influence, and the mutually reenforcing effects of political control by a privileged minority with an open-economy orientation serving mainly its own interests. Is it possible to reorient the current version of liberalization in ways that could realize the potential gains of liberalization without the costs and conflicts associated with it in the past?

Section 1 summarizes the initial context and the main characteristics of the stabilization and liberalization program. Section 2 is focused on interactions among domestic macroeconomic policies, trade strategy, and the real exchange rate. Sections 3 and 4 are concerned with questions of government revenue and expenditure, and their relationships to trade policy as well as the possibilities of recovery. Section 5 relates these issues to underlying questions of economic structure and goals.

## 1. Redirection of economic strategy: 1990-1992

The Peruvian government elected in July 1990 had to face a persistently rising inflation and a prolonged depression at the same time, with the added complications of high external debt and disrupted relationships with the international financial community, deepening poverty, and deteriorating public order.[2] The government chose to focus on stopping inflation and restoring external acceptance, by resuming payments on external debt and adopting a strong program of economic liberalization. These two objectives jointly overcame concerns for immediate response to problems of production, employment, and poverty.

The main lines of the adjustment and liberalization program introduced by the Fujimori government follow those of Chile under the Pinochet government from 1973, and of Mexico in response to its debt crisis from 1982, but with some important differences. As in the other cases, the Peruvian reforms abruptly tightened monetary and fiscal policies, allowed interest rates to rise steeply, cut public sector spending and employment, increased taxes, reduced tariffs and practically eliminated quantitative restrictions on imports, eliminated price controls for products of the private sector, greatly increased prices for products of state firms, began to put state-owned firms up for privatization, and removed nearly all restrictions on foreign investment. In addition, Peru pushed its reorientation toward free markets a crucial step past those of Chile and Mexico: where they both continued to control an official exchange rate and used it to

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[2] Carlos E. Paredes and Jeffrey D. Sachs, eds., Peru's Path to Recovery: A plan for economic stabilization and growth (Washington: Brookings Institution, 1991); Efraín Gonzales de Olarte, Una economía bajo violencia: Perú, 1980-1990 (Lima: Instituto de Estudios Peruanos, documento de trabajo 40, 1991).

implement sharp initial devaluations in real terms, Peru went all the way to a floating rate to be left up to market forces.[3]

The new set of economic policies eliminated all subsidies, including those for food production and low-cost food supplies for the poor, and the CERTEX program of subsidies for non-traditional exports which had been in effect since the 1960s. That sweeping rejection of subsidies could be seen as a response to the massive exaggerations of such expenditures under the preceding government of Alan García, or as an expression of all-out free market ideology. It could also be seen as a step away from efforts to help the poor, and from responsibility for promotion of new exports.

Primary concern for stopping inflation was more than understandable. It had been worsening persistently since the mid 1970s. As shown in table 1, it went from 158 percent in 1985 to over seven thousand percent for the year to December 1990. The stabilization program adopted in August 1990 added greatly to the rate for that year, by freeing all controlled prices and greatly increasing those of the state firms, but then succeeded in bringing inflation down sharply in the next two years. Still, the rate of 57 percent for 1992 remained three times as high as

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[3] Banco Central de Reserva del Perú, "Perú: Estabilización Económica y Reformas Estructurales," Julio de 1991; Carlos E. Paredes, "Epilogue: In the Aftermath of Hyperinflation," in Paredes and Sachs, eds., Peru's Path to Recovery, pp. 299-322; World Bank, Trade Policy Division, Peru: Toward a More Open Economy (Washington: World Bank, 1992).

Table 1. Peru: economic indicators, 1985-1992.

| | 1985 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|
| Inflation, year to December | 158 | 2775 | 7639 | 139 | 57 |
| Indexes on base 1980 = 100 | | | | | |
| GDP at 1979 prices | 99.0 | 94.9 | 91.6 | 93.1 | 90.8 |
| GDP per capita | 88.2 | 77.7 | 72.8 | 73.2 | 69.9 |
| Employment, manufacturing | 83.4 | 83.5 | 81.4 | 77.2 | n.a. |
| Average real wage, Lima (a) | 60.5 | 45.0 | 37.0 | 30.4 | 31.5 |
| Minimum real wage | 54.5 | 31.3 | 26.8 | 16.4 | 16.4 |
| Indexes based on 1985 | | | | | |
| Households in critical poverty (b) Jan. 1985 = 100 | 103 | 125 | 156 | 179 | n.a. |
| Real effective exchange rate for exports, December (c) July 1985 = 100 | 103 | 53 | 38 | 32 | 35 |

Note (a): daily wages for manual workers in firms employing 10 or more workers; series for 1986-91 at December 1991 prices linked to preceding series at 1990 prices. Estimate for 1992 based on data through August only.

Note (b): index of number of households in Metropolitan Lima in critical poverty; initial estimate = 21 percent.

Note (c): real exchange rate is index of nominal rate corrected for domestic and external inflation; a decrease means that the real price of foreign exchange has fallen. Estimate for 1992 derived from change shown for Central Bank buying rate on new base of August 1990.

Sources: based on Banco Central de Reserva del Perú, Nota Semanal, for inflation and real exchange rates and for real wages in 1992; Memoria 1991, for GDP through 1991; ECLAC, Preliminary Overview, 1992, for 1992 GDP; Richard Webb and Graciela Fernández Baca, eds., Perú en Números 1992, for employment in manufacturing, real wages, and index of critical poverty.

the median for Latin American countries.[4]

The contractionary measures hit an economy in which ouput and employment had already been falling badly. Peru's economic growth had slowed down from the mid 1960s, and turned negative in the 1980s. GDP per capita fell 22 percent between 1980 and 1989. The initial impact of the stabilization program drove it down by a further 6 percent in 1990. After signs of recovery in the first half of 1991 it then headed down again. GDP per capita for 1991 ended up practically unchanged from 1990, and then in 1992 fell approximately 5 percent. For 1992, its level was back down to about that achieved a third of a century earlier.

Wage policies in the adjustment and liberalization program were more severe than those in Chile and Mexico. Where the government could set nominal wages directly, for public sector employees and for miniumum wages, it held the adjustments far below the jump in prices at the start of the program. Real wages of government employees were cut by 71 percent between July and December 1990, and then held at that level through December 1991.[5] In the private sector, real wages were not forced down but encouraged to fall, by abstention from prior government

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[4] Preliminary estimates for 1992 give a median inflation rate of 18 percent for nineteen Latin American countries (excluding Cuba and the English-speaking Çaribbean countries): U.N., Economic Commission for Latin America and the Caribbean, Preliminary Overview of the Economy of Latin America and the Caribbean, 1992 (Santiago: ECLAC, Dec. 1992), table 5, p. 43.

[5] Richard Webb and Graciela Fernández Baca, eds., Perú en Números, 1992: Anuario Estadistico (Lima: Cuánto, 1992), p. 462.

support for renegotiation of contracts, by changes in labor legislation making it easier to discharge workers, and of course by contractionary policies driving down demand for labor. Employment in manufacturing, already 16 percent below 1980 as of 1989, fell by a further 7 percent from 1989 to 1991. It must have continued to fall in 1992, because industrial employment as whole fell 8 percent for the first 11 months of the year[6]. Average real wages for private sector workers in Metropolitan Lima, already down by 55 percent between 1980 and 1989, fell by another third from 1989 to 1991. Minimum real earnings were cut by 48 percent between 1989 and 1991, to a level only 16 percent of that in 1980. They remained at this level in 1992.[7]

The reorientation of Peruvian economic strategy as initially presented included considerable attention to problems of poverty, proposing both a social emergency program to alleviate the immediate impact of adjustment and a longer term reallocation of resources to raise productivity and improve employment potential of the poor. In practice, in one of the most painful of the many contradictions quickly encountered, the priority given to holding down government spending in order to stop inflation paralyzed action to alleviate poverty.[8] An index of the number of

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[6] Banco Central de Reserva del Perú, Nota Semanal, 11 de enero de 1993, cuadro 60.

[7] Table 1 and Banco Central, Nota Semanal, 11 de enero de 1993, cuadro 58.

[8] Adolfo Figueroa, "La economía política de la pobreza: Peru y América Latina," CISEPA, Serie Documentos de Trabajo, no. 94, mayo 1991.

households in Lima living in conditions of critical poverty, calculated from 1985 by the private research organization, Cuánto, indicates an increase of 21 percent between 1985 and 1989 (table 1). Under the impact of the new economic program, the number of households in critical poverty then increased a further 44 percent between 1989 and 1991.[9]

The last entry in table 1, the real exchange rate applicable for exports, is a measure of the real price of foreign exchange: the nominal exchange rate corrected for domestic and foreign inflation. In 1985, it was at a level consistent with approximate external balance on current account. The real price of foreign exchange, by this measure, then fell by 73 percent between 1985 and 1990. The negative effect on exports was partially offset by falling real wages, as discussed below, but even taking this factor into account incentives for exports were greatly reduced. Up to August 1990, the plunge could be blamed on the García government's use of controls to hold down the price of foreign exchange, in a futile attempt to restrain inflation. But then the removal of controls by the Fujimori government, under conditions of tight liquidity and very high interest rates, had the singularly perverse consequence of making export incentives even worse: the real price of foreign exchange fell an additional 16 percent in 1991. Central Bank intervention in the market began to drive the rate back up slowly in the second

[9] The meaning of the index of critical poverty, and methods of calculating it, are explained in Instituto Cuánto, Ajuste y Economía Familiar, 1985-1990, (Lima: Cuánto, 1991), pp. 65-77.

half of 1992; by the end of the year it was 8 percent above its level at the end of 1991, though still less than half that of 1985.[10]

The downtrend for inflation has been the most successful result of the stabilization program so far, though at 57 percent for 1992 it remained too high to be considered under adequate control. The problem is that this incomplete achievement has depended on the combined downward pressures of tight fiscal and monetary restraint, deep depression, and an appreciating real rate of exchange: conditions that have worsened poverty and that work against any possibility of sustainable recovery.

## 2. Interactions among macroeconomic and trade policies

Given the initial conditions of wildly accelerating inflation inherited by the new government, it was clearly essential to tighten monetary and fiscal policy abruptly. The jump in domestic prices when controls were removed at the start of the stabilization program, combined with sudden reversal to strict monetary constraint, implied a sharp drop in liquidity and generated exceptionally high real interest rates. The liquidity squeeze had the familiar effect of encouraging, or forcing, the private sector to repatriate dollars and seek

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[10] Nota Semanal, 11 de enero de 1993, cuadro 66. World Bank, Peru: Toward a More Open Economy, discusses alternative measures of the real exchange rate and emphasizes, in contrast to the discussion here, that it should be left entirely up to market forces: pp. 14-20 and appendix 2, pp. 101-110.

external loans in order to continue operating.

Liquidity in real terms as of December 1989 had fallen to 29 percent of its level in December 1985. The initial impact of the stabilization program drove it down to 13 percent of the 1985 level in August 1990. It was then allowed to start back up, and reached 29 percent again by the end of 1991 (table 2). Real interest rates for credit in domestic currency reached 26 percent per month in September 1990. Dollar deposits constituted 45 percent of the total supply of money and near money at that time. They then increased 3.6 times between September 1990 and December 1991. The dollars helped keep business going, to the extent it could keep going, but the counterpart is that firms have built up liabilities in dollars for activities mainly earning domestic currency, with all the dangerous implications of such debts under any transition to more viable exchange rates.[11]

As real liquidity increased in the course of 1991-92, and the rate of inflation decreased, both nominal and real rates of interest for loans in domestic currency came down considerably. But the real rate was still 3.3 percent a month at the end of December 1992, an annual rate of 48 percent.

In terms of the asset model of factors determining exchange rates in the short run, higher rates of interest for loans in national currency increased returns for holding it relative to holding assets in foreign markets, and thereby favored

[11] Cecilia Valdez L., "El Sistema Financiero y el Tipo de Cambio," Moneda, Marzo 1992, pp. 50-52.

Table 2. Real liquidity, interest rates, and dollar deposits, specified months, September 1990 to December 1992.

| | Sept. 1990 | Dec. 1991 | Dec. 1992 |
|---|---|---|---|
| Liquidity in real terms as percent of Dec. 1985 | 16.4% | 29.10% | 33.6% |
| Monthly interest rate for credit in soles, nominal | 40.0% | 9.9% | 7.1% |
| Monthly interest rate for credit in soles, real | 26.2% | 6.2% | 3.3% |
| Annual interest rate for credit in dollars | 15.9%(a) | 23.2% | 18.3% |
| Deposits in U.S. dollars | | | |
| Total, million dollars | 698 | 2539 | 3010 |
| Percent of total money and near-money supply | 45% | 59% | 64% |

Note (a): dollar interest rate is for October 1990.

Sources: Banco Central de Reserva del Perú, Moneda, setiembre 1991, p. 75, and Nota Semanal, 27 de julio de 1992, p. 2 and 11 de enero 1993, pp, 2, 12, 28, 69.

appreciation of the currency, as is normally to be expected when capital markets are open.[12] In terms of financial flows, street corner sellers of currency in Lima learned to explain recurrent decreases in the number of intis they would trade for a dollar as perfectly natural because "ya no hay intis."

Appreciation of the currency in real terms could be seen as a desirable complement to other forms of anti-inflationary policy. It discourages exports and makes imports less expensive, so output is redirected toward the domestic market while domestic demand is increasingly supplied by imports. But by the same token it has been a potent obstacle for any hope of recovery of production and employment. In Peru's case, the negative side was magnified by two special factors. The first was that the real price of foreign exchange had already fallen greatly in the second half of the 1980s (table 1). The second was that the structure of protection built up over two decades to promote industrialization, which had to some extent sheltered producers from the effects of currency overvaluation, was suddenly cut down by trade liberalization. Liberalization in turn could be seen as a desirable longrun goal, given a competitive exchange rate, but in the presence of serious overvaluation of the currency it could be devastating for producers of tradable goods.

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[12] Michael Mussa, "Empirical Regularities in the Behavior of Exchange Rates and Theories of the Foreign Exchange Market," in Karl Brunner and Allan H. Meltzer, eds., <u>Policies for Employment, Prices and Exchange Rates</u> (Amsterdam: North Holland, 1979), pp. 9-57; Paul R. Krugman and Maurice Obstfeld, <u>International Economics: Theory and Policy</u> (New York: Harper and Collins, 2nd edition, 1991), ch. 13-14.

The meaning of "overvaluation" is a treacherous matter when considering a flexible exchange rate. Unlike the prior context in which a web of exchange controls and multiple rates held down the price of foreign exchange by interfering with market forces, the floating rate expressed market forces and so could hardly be considered overvalued in the same sense. The problem is that market forces themselves, working freely, can make the price of foreign exchange too low for even the most efficient producers of tradable goods and services to compete against foreign sellers. That can happen when asset market valuations in response to high domestic interest rates drive down the price of foreign exchange despite a worsening balance on current account, as in the United States from 1980 to 1985. The price of foreign exchange is in equilibrium in terms of financial valuation but can be--and in Peru's case has so far proven to be--too low to allow growth of exports to match growth of imports, or even come close, unless the latter are held down by severe depression. A possible answer is that once expansion gets underway and demand for imports rises even faster, market forces should make the real price of foreign exchange rise. They might, but that answer could obscure the fact that market forces are at present working to prevent any such expansion.

The real exchange rate is only one possible measure of conditions of competition, and may cease to be a useful guide when costs of production diverge widely from prices. They have diverged in Peru: wages and labor costs have fallen greatly relative to product prices. An index created to measure trends in the profitability of exports shows that it has not fallen nearly as much as suggested by the real exchange rate. Using the levels of July 1985 as reference bases for parity in terms of the two measures, the nominal exchange rate in May 1991 was 80 percent of parity in terms of the profitability index, compared to only 40 percent of parity in terms of the real exchange rate.[13] By the end of June 1992 the actual rate had fallen even further by both measures, to 62 percent in terms of the profitability index and to 30 percent in terms of the real exchange rate.[14]

Judging by the actual stability of exports in this period, the profitability index must be a better guide to incentives than the real exchange rate: non-traditional exports in the first three quarters of 1992 were almost exactly equal to their levels in the corresponding quarters of 1990 and 1991. On the import side, appreciation in real terms plus decreases in protection led to an increase of 28 percent from the first three quarters of 1990 to the same quarters in 1992. Imports of consumer goods more than doubled. Imports of supplies for production and of capital equipment also increased, though not because of any increase in production and investment: they were essentially

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[13] Renzo G. Rossini, "Liberalización Comercial y Establización Económica," artículo preparado para el Tercer Foro Económico organizado por la Fundación Friedrich Ebert, Lima, 26 de junio de 1991, pp. 12-13.

[14] Banco de Credito, <u>Perú Informe Económico Trimestral</u>, Junio 1992, p. 59.

replacing domestic alternatives. The export surplus of 1990 turned into a trade deficit of $490 million for the first three quarters of 1992, despite lower production and income.[15]

It is not easy to find a safe path through the conflicts built into the present liberalization and stabilization program. Prior analysis of the difficult problems of sequence might have made clear the dangers of trying to liberate everything at once.[16] It would have been preferable to retain control of the exchange rate and use it to devalue in real terms in the first place, instead of leaving it up to market forces in such twisted economic conditions. Failing that, it might have helped to use controls to restrain capital inflows. But perhaps a more sustainable course now would be to intervene in the determination of interest rates for domestic credit: to switch the focus of Central Bank policy from the monetary base to the level of interest rates. Real interest rates of close to 50 percent a year as of the end of 1992, after two years of the stabilization program, are more a matter of pathology than of any positive economic function. They practically preclude any revival of

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15 Banco Central, Nota Semanal, 11 de enero 1993, pp. 30 and 34.

16 Vittorio Corbo, Jaime de Melo, and James Tybout, "What Went Wrong with the recent reforms in the Southern Cone?" Economic Development and Cultural Change, vol. 34 (April 1986); Sebastian Edwards, "The Order of Liberalization of the External Sector in Developing Countries," Princeton Essays in International Finance, no. 156, 1984; Ronald McKinnon, The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy (Baltimore: Johns Hopkins University Press, 1991); Ramos, Neoconservative Economics in the Southern Cone.

domestic investment and maintain powerful pressure against correction of the real exchange rate and revival of export growth. This is not a peculiarly Peruvian problem: it also undermined the first decade of stabilization and liberalization in Chile.[17] Real interest rates there remained above 30 percent through 1978, five years after the start of stabilization, and then after a brief drop went back over 30 percent in 1981-82, during exactly the kind of crisis toward which Peru may now be heading.[18] The new set of economic policy makers who helped Chile get out of this trap implemented a drastic devaluation in real terms (by directly changing the exchange rate, not by leaving it up to the market), and brought real interest rates down from 35 percent in 1982 to 11 in 1984 and 8 in 1985.[19] The case against fixing interest rates at levels that leave them negative in real terms is valid and important, but it does not mean that reducing them from near 50 percent to a positive level

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[17] See especially McKinnon, The Order of Economic Liberalization, ch. 6. He explains the rationale for interest rate management in conditions of transition from high rates of inflation, and contrasts the effects of allowing disfunctionally high real interest rates in Chile to the successful use of direct management in the Korean stabilization program of 1981-84. The case for intervention to reduce real interest rates in Peru has been particularly well explained in an unpublished paper by Bolivar Patiño, the economic advisor for the national association of exporters.

[18] Colección Estudios Cieplan no. 16, diciembre 1983, statistical annex, p. 136.

[19] Arellano, "Crisis y recuperación," p. 81 for real interest rates.

around 10 percent is equally harmful.[20] On the contrary: such a move could cut through an impasse that is holding down both production and exports, and building up pressure for a new crisis ahead.

### 3. Government revenue, tariffs, and possibilities of recovery

The conflict between monetary restraint and achievement of a viable exchange rate has a close counterpart in the second set of contradictions: the conflicts among a drive to raise taxation, a simultaneous cut in tariff rates and revenue, and the hope for recovery. A deep depression can scarcely be an appropriate time to increase taxation. But Peru had a serious longterm problem to answer: government revenue had practically disintegrated during the 1980s, accompanied by both accelerating inflation and depression. A particularly suggestive interpretation, by Richard Webb, is that the collapse of government revenue has been due to specific changes in the structure of the economy, and that the macreconomic imbalances of the last two decades reflect mainly a hopeless effort to keep up a high level of government spending that could not be financed by current revenue.[21]

Whether or not one accepts Webb's interpretation, it is

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[20] McKinnon suggests a range of 10 to 14 percent for real loan rates, and 8 to 12 for deposit rates: The Order of Economic Liberalization, pp. 41 and 76. These are for conditions of fiscal balance, which has been the case in Peru since 1990.

[21] Richard Webb, "Prologue," in Paredes and Sachs, Peru's Path to Recovery, pp. 1-12.

evident that government revenue at the beginning of the Fujimori administration was far below levels necessary to finance essential public functions. Current revenue of the central government, expressed in constant prices, had fallen by 70 percent from 1985 to 1989, from 14.8 percent of GDP to 6.8 percent (table 3). Current revenue of the non-financial public sector as a whole fell from 41.0 percent of GDP in 1985 to 20.2 percent in 1989.[22]

Some of this decline could be explained by the familiar "Tanzi effect" of high inflation on tax revenues: delays in payments make their real value drop swiftly relative to current income.[23] But that was not the only problem: revenue had also been undermined by reductions in tax rates along with promotional exemptions and blocked prices of public firms, by a near collapse of tax administration, by the depression itself, and by changes in the structure of the economy.

The Peruvian tax system has long been shot through with inconsistencies and plagued by weak administration. These basic problems were compounded under the García administration. Tax rates were cut to stimulate consumption, multiple exemptions allowed for specific promotional objectives, prices of state firms frozen to hold down reported measures of inflation, and

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[22] Banco Central de Reserva del Perú, Memoria 1991 (Lima: BCRP, 1992), p. 166.

[23] Vito Tanzi, "Inflation, Collection Lags, and the Real Value of Tax Revenue," IMF, Staff Papers, vol. 24, March 1977, pp. 154-67.

Table 3. Central government current revenue, current expenditures, and capital expenditures: indexes at constant prices and percentages of gross domestic product, 1985 and 1989-91.

| | 1985 | 1989 | 1990 | 1991 |
|---|---|---|---|---|
| Indexes on base 1985 | | | | |
| Current income | 100 | 30 | 31 | 31 |
| Current expenditures | 100 | 42 | 38 | 37 |
| Capital expenditures | 100 | 54 | 27 | 29 |
| Percentages of GDP | | | | |
| Current income | 14.8 | 6.8 | 8.7 | 8.1 |
| Current expenditures | 14.7 | 10.0 | 10.8 | 8.2 |
| Capital expenditures | 2.7 | 2.2 | 1.3 | 1.3 |

Sources: indexes based on Perú en Números, 1992, p. 967; percentages of GDP from Banco Central de Reserva del Perú, Memoria 1991, pp. 170, 172, and 174.

corruption of the collection process allowed to grow worse than ever.[24] The Fujimori government reversed the process by restoring rates or raising them to new levels, inventing new taxes, eliminating most exemptions, raising prices of the products of state firms, and putting new people in charge of a restructured system of tax administration.

The determined drive to improve tax administration and collection has included dramatic measures to get people to rethink the long-established presumption that tax avoidance is both normal and safe. It has also included direct negotiation with small sellers in the informal sector to collect a tax of 5 percent of value added, a modest fraction of the rate due in principle but a great deal more than actual prior collections. On the one hand, this is a problem: a depression is not an ideal time to raise taxes on people with low incomes. On the other hand, it may be a step toward a much-needed broadening of the tax base. Beyond that it is an example of real possibilities for constructive negotiation between the government and the informal sector: a positive step toward making the informal sector less separate from the country's legal system without implying restrictions in the sense of interference with these activities.

The government's initial target was to raise current revenue to 12 percent of GDP, from 6.9 percent for 1989. For 1990, with

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[24] Jorge Vega Castro and Jorge Gonzales Izquierdo, "El sistema tributario Peruano: análisis y lineamientos para una propuesta de reforma," Lima, Pontificia Universidad Católica del Peru, junio de 1989.

only five months of attempted stabilization, the ratio was raised to 8.7 percent (table 3). But then in 1991, despite all the effort, current revenue relative to GDP fell to 8.1 percent. For 1992, provisional estimates indicate an increase to 8.5 percent, partly from a small rise in real revenue but mostly for the frustrating reason that GDP fell.

Beyond the evident strains of any attempt to raise government revenue relative to GDP at severely depressed levels of national income, Richard Webb sees the fundamental problem as a historical process of change in the environment within which the government must operate: a shrinking base of revenue and of capacity to respond to problems, due to changes in both economic structure and political balance. The two main sources of government revenue--foreign trade and the modern sector--have both lost importance relative to the informal sector, and to state firms unable to generate net income. At the same time, "The political cost of collecting taxes grew with the increasing voice and empowerment of the people, while that same proces "increased the demand for direct benefits from the public purse."[25]

In Webb's interpretation, the long history of macroeconomic instability under so many differently oriented governments has been caused by attempts to escape the consequences of this squeze between increasing pressures to spend and a shrinking tax base, using one non-sustainable dodge after another. The new strategy

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25 Webb, "Prologue," p. 7.

of the Fujimori government could then be seen as an attempt to face reality by turning the economy back to market forces, to shrink the government to fit the reduced resources available to it. In a way, this view is profoundly pessimistic: there is not much to be done except to go through the pains of transition to a smaller state and a poorer society, with the eventual possibility of recovery in a system better adapted to its real limitations. In another way, Webb sees it as more hopeful: the society has become more participatory, and recovery will mean "accepting and working with the multitude of organizations and groups that make up the new polity. Both politics and economics are pushing the state into a partnership with the rest of society."[26]

While much of this analysis rings true as an explanation of the problems of the last two decades, it seems more doubtful as a guideline for the future. The structural changes adverse to legal foreign trade and to the modern sector certainly undercut state revenue but they are explicable in terms of economic policies that are themselves in process of being corrected.

The main negative factors for foreign trade were the exaggerated levels of protection applied through the 1970s and 1980s, combined with failure to recognize the necessity to make the industrial sector turn away from protection toward export competition and technological change. Protection has been greatly reduced, perhaps too quickly given the current deep depression, but convincingly so in terms of genuine reopening of

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[26] Webb, "Prologue," p. 12.

the economy. Quantitative restrictions have been eliminated and the rate of effective protection for industry fell from 83 percent in June 1990 to 24 percent by March 1991.[27] These changes should be helpful for exports, though they have not responded yet because of the lack of either an exchange rate favorable for exports in general or specific incentives for non-traditional exports. This problem remains a severe impediment to recovery, but when it is corrected external trade will resume its old importance and perhaps more than that, which in turn implies a greater role for the modern sector as a whole.

The decline in importance of the modern sector has had many causes but the most important have been the joint deterioration of the economy and of public order. The great majority of the people and small firms in the informal sector are not there because they preferred it to employment and investment opportunities in legally recognized activities: most of them are there because of the massive failure of the modern sector to provide new openings. The causes of that failure have been partly structural and partly matters of macroeconomic misdirection.[28] If the quality of Peruvian macroeconomic policy

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[27] Renzo G. Rossini, "Las Medidas Recientes de Apertura Comercial," Moneda, Marzo 1991, pp. 47-57.

[28] Rosemary Thorp, Economic Management and Economic Development in Peru and Colombia (Pittsburgh: Pittsburgh University Press, 1991); Eva Paus, "Adjustment and Development in Latin America: The Failure of Peruvian Heterodoxy," World Development, May 1991; Ricardo Lago, ch. 9 in Rudiger Dornbusch and Sebastian Edwards, eds. The Macroeconomics of Populism in Latin America (Chicago: Chicago University Press, 1991); Manuel Pastor and Carol Wise, "Peruvian Economic Policy in the 1980s:

remains in the 1990s as dubious as in the two preceding decades, the game will be lost. If it is more responsive to reality, both in holding back inflation and in promoting expansion when there is scope for it, a broader modern sector will come back strongly, bringing with it a stronger base for government revenue and functions.

The drive to increase government revenue has been made more difficult than it would otherwise have been by the sharp reductions in tariff rates in 1990 and 1991. The reductions brought the average down from 66 percent at the end of the García administration to 17 percent a year later.[29] Revenue from tariffs fell from 17 percent of current government revenue in 1989 to 11 percent by December 1990. Even with the steep rise in imports during 1991 the ratio fell further, to 10 percent, for the year.[30] The reduction of average tariff rates can be seen as an important change improving microeconomic efficiency but it has also involved both a loss for government revenue and a loss in terms of macroeconomic efficiency: the reductions have shifted demand from domestic to external suppliers under conditions of severe unemployment and idle capacity. They have increased the odds against recovery.

To raise average tariffs even part way back to their earlier

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From Orthodoxy to Heterodoxy and Back," Latin American Research Review, 27-2 (1992).

[29] Rossini, "Liberalización Comercial, p. 10.

[30] Nota Semanal, 27 de julio de 1992, p. 52.

level could add further damage to exports. A possible answer to that could be to restore direct incentives for non-traditional exports. These have so far included mainly textiles, processed agricultural and fish products, chemicals, and some metal alloys. To stimulate and diversify these exports by direct incentives would be another departure from pure free-market solutions. It could also be a great blessing for production, employment, and future growth, both favoring recovery and fostering the relative growth of the particular industries best able to compete in external markets.

Whatever the optimum level of tariff rates might be, it should surely be higher during a period of combined currency overvaluation and deep depression than it would be in one with a more reasonable exchange rate and higher level of economic activity. The average tariff level could be increased as an explicitly temporary action, keeping the newly simplified structure of rates intact but moving the whole set up by a common percentage (and then back down again when the macroeconomic context makes such action appropriate). That is just what the Chilean government did in the early 1980s, under a government determined to maintain an open economy but with new economic officials trying to promote recovery from deep depression.[31]

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[31] Chile brought average tariff rates down to 10 percent for 1978-82, but then began to use increases as an important help for recovery from the crisis of the early 1980s: to 20 percent for 1983 and 35 percent in 1984, then with recovery underway back down to 20 percent from 1985 and to 11 percent in 1991: Paus, "The Viability of the Neoliberal Model in Chile," note 2, p. 2.

It would both raise government revenue and favor recovery of the economy. It need not mean repudiation of liberalization: it would only mean reducing the terrible strains of the moment, to help Peru move to a more bearable future.

## 4. Government expenditures and macroeconomic balance in a more open economy

Deficit spending has been a plague for Peru much of the time since the early 1970s. In the last three years of the Velasco government, under conditions of strong aggregate demand outrunning the productive capacity of the economy from 1972 to 1975, defict spending was the key problem that put Peru into deep external debt and set the country off on its prolonged course of increasing inflation.[32] It was an aggravating factor that kept inflation rising in the early 1980s under the Belaúnde administration, and then later in the decade under García. But by the last years of the 1980s the macroeconomic context had changed greatly. It was no longer one in which rising demand was outpacing growth of productive capacity, with the strains coming from the demand side. It was a much more complex situation of worsening problems on the side of supply, with output falling

[32] John Sheahan, "Peru: Economic Policies and Structural Change, 1968-78," Journal of Development Studies, vol. 7, no. 1 (1980).

steeply.[33] That change of context did not by any means make deficit spending irrelevant: it had to be cut back, as an essential feature of the drive to stop inflation. But three serious complications need to be taken into account.

The most familiar of the three complications is the conflict among goals when inflation is still a problem but economic activity is severely depressed. Possible reasons for continuing high inflation despite greatly underutilized capacity and underemployment include specific shortages, indexing and non-competitive pricing, continuing inflationary expectations, depreciation of the currency in nominal terms if not in real, and extraordinarily high financial costs. Such conditions, and Peru's many years of experience with rising inflation despite depressed output, suggest the possibility that even moderate increases in spending could start a new upswing of inflation. That possibility can never be ruled out, but one of the key consequences of the return toward a more open economy is that the danger should now be distinctly less than it has been in the last two decades.

The existence of widespread excess capacity is clear. Two indications of the scale of underemployed labor are that manufacturing employiment in 1991 was nearly one-fourth below its level of 1980 (table 1), and that the proportion of the labor

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[33] Felipe Larraín, Carlos E. Paredes, and Jeffrey D. Sachs, "Elements of a Stabilization Program," in Paredes and Sachs, Peru's Path to Recovery, pp. 117-38; Manuel Pastor, Inflation, Stabilization, and & Debt: Macroeconomic Experiments in Peru and Bolivia (Boulder: Westview, 1992), ch. 5.

force in Lima categorized as "adequately employed" fell from 67 percent in 1980 to 16 percent by 1991.[34] Similarly, measures of capacity utilization for 41 industries as of December 1991 show only two using more than 80 percent of their capacity; the majority, 25 industries, were operating at less than 50 percent of capacity.[35]

Excess capacity in the sense of underemployed labor and idle industrial capital is an important factor but not a dependable guide to safe levels for aggregate demand. The supply limitation that has more often been the trigger for inflation in Peru is the availability of foreign exchange to keep up imports.[36] That is bound to become a crucial constraint again if nothing is done to stimulate growth of exports, but it has not been so far under the liberalization program: the actual problem has been instead one of too much and too cheap foreign exchange. The potential foreign exchange constraint does not argue against current expansionary measures; what it argues against is allowing market forces to paralyze exports.

The industrial sector should be able to raise output

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[34] Peru en números, 1992, p. 485. The definition of "adequately employed" is regular employment at real wages above the minimum wage of January 1967.

[35] Perú en números, 1992, p. 802.

[36] Pastor, Inflation, Stabilization, & Debt, pp. 48 and 123. Pastor's underlying explanatory model uses the seriously misleading assumption that export volume does not respond to changes in either exchange rates or world prices, but his emphasis on import capacity as a key constraint on non-inflationary expansion fits Peruvian experience well.

considerably, without running into increasing costs, in response either to better export incentives or rising aggregate demand. But supply may be more tightly constrained for agriculture, electricity, and mining, all handicapped by deteriorated infrastructure and by violence. Under the semi-closed economic system of the preceding two decades, even modest increases of aggregate demand could be expected to stimulate rising prices of food and raw materials, regardless of underemployment of labor and industrial capital. But a more open economy, with the help of adequate foreign exchange, means that specific shortages can be answered by imports holding down resulting increases in prices, limiting the danger of generalized inflationary repercussions.

The more essential question concerns the scope for self-reenforcing increases in productive capacity: the extent to which supply elasticity can be kept high and rising once recovery is under way. The turn toward an open economy may be even more important for this question. More reliable access to imported inputs increases flexibility of supply, both for individual producers and for the economy as a whole. It should relieve specific bottlenecks both for end-products and for inputs into production. It is equivalent to an increase of resources: it can permit a higher level of demand without inflationary consequences than would be possible in a closed system.[37]

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[37] Vito Tanzi, "Fiscal Policy, Growth, and Design of Stabilization Programs," in Ana Maria Martirena-Mantel, External Debt, Savings, and Growth in Latin America (Washington: International Monetary Fund and Instituto Torcuato di Tella, 1987), pp. 121-41, especially pp. 131-37.

Indexing has played a role in keeping up the rate of inflation despite macroeconomic contraction, as it did for a time in Chile. The Peruvian liberalization program did not follow Chile's example of indexing wage rates--real wages have been allowed to fall brutally--but it has maintained a special kind of indexing for prices. Prices of all public services and of state firms, including energy, had been frozen far below costs in the last years of the García administration, adding to inflationary pressures through the resulting public sector deficits while trying to hide inflation by holding down this component of the cost of living index. The Fujimori government had to take the painful step of raising these prices sharply to bring non-tradable goods and services into line with costs, and tradables into line with world prices. But beyond that initial adjustment these prices have since been increased repeatedly, to keep them approximately constant in real terms, without regard to current demand and marginal cost conditions. Macroeconomic constraints intended to stop inflation had to run against state decisions on pricing that raised prices of energy and public services by seven percent a month through 1991.[38] That of course fed into costs of production for everyone, and to prices set by firms with some degree of shelter from competition.[39]

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[38] Banco Central, Memoria 1991, cuadro 9, p. 20.

[39] Mario Tello gives a detailed account of the pricing behavior of Peruvian industries during phases of expansion and of contraction, making clear that the group of industries with least competitive pressure has been able to raise their relative prices persistently during contractions: "Mecanismos hacía el

This pattern of informal indexing by both state firms and those private firms that are relatively free of competitive pressure means that any given target for a ceiling on inflation has to rely on more intense fiscal and monetary contraction than would be necessary in a context of fully competitive pricing. Economic theory does not provide any clear-cut answer about what to do about this, but certainly suggests that a great deal of inefficiency is involved if total output and employment are held down to compensate for arbitrary, non-competive, price increases. A compromise that worked well at a crucial juncture for Brazil in the 1960s might point to a helpful response: in 1967, after three years of contraction had brought the inflation rate down to 25 percent and created conditions of generalized excess capacity, the Brazilian government decided to shift from contraction to expansion, but with the protection of selective price controls for non-competitive firms. This decision helped lead to seven years of extraordinarily rapid growth of output with no rise in inflation.[40]

The second commplication with the case for strict avoidance of government deficits is that severe constraints on public

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crecimiento económico, pasado, presente, y futuro" (Pontificía Universidad Católica del Perú, 1992, manuscript pending publication).

[40] Albert Fishlow, "Some Reflections on Post-1964 Brazilian Economic Policy," in Albert Stepan, ed. Authoritarian Brazil: Origins, Policies, and Future (Princeton: Princeton University Press, 1978); John Sheahan, Patterns of Development in Latin America: Poverty, Repression, and Economic Strategy (Princeton: Princeton University Press, 1987), p. 190.

expenditure can damage the supply elasticity of the economy. Peru's infrastructure has been falling apart from prolonged cutbacks in productive components of government spending. The transportation system, capacity to supply electricity, public safety, and ability to provide basic public health protection, have all been falling apart. Measured in constant prices, current expenditures of the central government in 1990 were only 38 percent of their level in 1985, and capital expenditures only 27 percent (table 3). By the World Bank's measure of general government consumption, its ratio to GDP for Peru in 1990 was only one-half the average for countries in the Bank's grouping of "lower middle income countries."[41] From the point of view of essential public functions, the urgent need is to increase rather than reduce government use of resources.

The third complication, or overriding problem, is that the society is in danger of disintegration. The fundamental causes derive from the country's whole history of social fragmentation, racial and cultural discrimination, extreme inequality, exclusionary forms of political response, the aborted reforms of the last quarter century, and the rise of violence.[42] Many governmental actions in the past have aggravated these problems

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[41] World Bank, World Development Report, 1992 (Baltimore: Johns Hopkins University Press for the World Bank, 1992), p. 234.

[42] Of many good studies of these issues, see especially Julio Cotler, Clases, estado, y nación en el Perú (Lima: Instituto de Estudios Peruanos, 1978), and Efraín Gonzalez de Olarte and Lilian Sammamé, El Pendulo Peruano: Políticas económicas, gobernabilidad y subdesarrollo, 1963-1990 (Lima: Instituto de Estudios Peruanos, 1991).

rather than helped resolve them. But a government that wanted seriously to help, by direct social programs plus actions to improve employment opportunities and worker productivity, would need to raise its spending greatly from the repressed levels of the last few years. Necessity does not mean that limits can be ignored. The economy could be blown apart if increases are not kept within a moderate range: perhaps on the order of 5 percent a year in real terms until inflation is much lower than at present. If kept within such a range, and well-directed, it could significantly improve the longrun elasticity of supply. It could do so directly through expenditures aimed at restoration of damaged infrastructure, measures to increase electrical generating capacity and safeguard supply so that attacks on power lines do not disrupt production so frequently, and improved security for factories, transport, businessmen, peasants, and workers. It could do so indirectly by improvements in public health, education, training, research, and the whole range of activities in support of human capital that have been so starved in Peru.

If the government can demonstrate that recovery is possible by actually starting it, that might do something to lessen the fears of potential investors, reduce the pressures on professionals and skilled workers to leave the country, reduce the pervasive discouragement that clouds everyone's perceptions of the future, and relieve some of the bitterness that leads young people to join the destructive movements determined to tear the society apart.

It cannot be right, whether in the name of efficiency or liberalization or stopping inflation, to choke off the power of the government to act in response to the forces threatening to destroy the society. Any increase in spending implies potential risks, and that is a vital consideration arguing against raising it too rapidly to be handled by rising output. But the risks in failure to respond to the real needs of the society may be even greater. It would be hard to imagine a more dangerous economic strategy for Peru at present than one of holding down employment opportunities, worsening poverty, and allowing cities and national infrastructure to deteriorate even further. If the pressures acting to increase violence can be reduced by increased government spending, it could contribute directly to the country's capacity for production and investment. A more open economy could then play a crucial role by helping to make the productive system more flexible and by improving the possibilities for industrial growth through competitive exports.

## 5. Underlying questions of economic structure and goals

Peru moved away from its historical open-economy orientation in the 1960s, despite a fairly good record of overall growth, in response to widely shared impatience with extreme inequality, continued dependence on primary exports, pervasive foreign ownership and influence, and the identification of that strategy with political domination by a privileged minority. It is possible that the return toward an open economy now could cause or aggravate all the problems associated with it in the past, but it is not necessary to allow that to happen.

To rely fully on comparative advantage without selective intervention could mean continued dominance of primary exports, dependence of the industrial sector on earnings from primary exports to pay for its inputs, and strong constraints from import competition on movement into new industries in fields characterized by "knowledge intensity," technological change, and economies of scale.[43] Peruvian industry has more potential now than it did thirty years ago: the labor force is more educated, some industries have gained experience in new fields, and a few have even proven able to compete in external markets under adverse conditions. But the industrial sector needs help to get through the difficult process of transition. The dubious way to try to help would be to fall back into high protection. The more promising way would be to provide direct support for research, technological change, and competition in export markets. That would mean running against current comparative advantage in order to change its character, following its own version of the paths of Japan, Korea, and Taiwan. If that can be done, its return toward a more open economy could be favorable for more sustained gorwth of production and employment, and through the latter for

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[43] Mario Tello, Exportaciones y crecimiento económico en el Perú, 1950-1987 (Lima: Fundación Friedrich Ebert, 1990).

reduction of poverty.

On the side of primary products, structural conditions have changed in one respect for the better and in another for the worse. Much of the inequality of Peru in the past was due to reliance on primary exports under conditions in which ownership of land and minerals was highly concentrated. The bulk of the gains from exporting went to a privileged few and to foreign firms. Comparative advantage based on primary exports played a significant role in magnifying inequality, in Peru as in many other developing countries.[44] But the basic structure of land ownership in Peru has since changed greatly. First the land reform of 1969 eliminated the large private estates and replaced them with cooperatives. Then in the course of the 1970s and 1980s the members of most cooperatives voted to break them up into individual smaller holdings.[45] That gave Peru decentralized land ownership for the first time in its history. Agricultural exports should be more nearly favorable for equality and reduction of poverty than they were before the land reform.

The adverse change on the agricultural side has been the growth of coca and its derivatives. Estimates by the private statistical agency, Cuánto, suggest that in recent years the value of coca has been on the order of a tenth of total

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[44] Francois Bourguignon and Christian Morrisson, External Trade and Income Distribution (Paris: OECD, 1989).

[45] Michael R. Carter and Elena Alvarez, "Changing Paths: The Deollectivization of Agrarian Reform Agriculture in Coastal Peru," in William C. Thiesenhusen, ed., Searching for Agrarian Reform in Latin America (Boston: Unwin Hyman, 1989, pp. 156-87.

agricultural production, and about a third of total commodity exports.[46] In addition to all the associated corruption and violence, revenue from coca exports exerts continuing downard pressure on the price of foreign exchange, and thereby makes the chances of successful competition by new industries weaker than they otherwise would be. In this context, the consequences of leaving the exchange rate and export incentives fully up to market forces are likely to be more persistently negative than they otherwise would have been.

The greatest threat to Peru is the country's intense social conflict. Sustainable recovery requires an effective response to the country's fundamental problems of poverty and inequality.[47] The stabilization and liberalization program as initially announced was intended to include significant action to improve opportunities for the poor, but then failed to do so. The more open economy might help through the creation of productive employment openings, once the perverse forces operating on the exchange rate are corrected, but even then it will not help much if comparative advantage continues to lie on the side of primary exports. If that is the way market forces turn out, the answer favorable for reduction of poverty would not be to turn away from the open economy itself, but to change incentives by specific

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[46] Perú en números, 1992, p. 641.

[47] Adolfo Figueroa, "Perú: Distribución de la crisis y crisis de la distribución," in Efraín Gonzalez de Olarte, compilador, Nuevos rumbos para el desarrollo del Perú y América Latina (Lima: Instituto de Estudios Peruanos, 1991), pp. 173-93.

intervention to promote industrial exports.[48]

For much of the country's history, an open economy was associated with a narrow base of political control: a very small minority of traditional families led both major political parties up to the 1930s, supported by a coalition of large landowners, financial interests, foreign firms, and the military. The great majority of the population was excluded from effective voice, by literacy tests in conditions of grossly neglected rural education, by obstacles to organization, by clientalism and favors, or when necessary by direct repression.[49] Although this system of political control was not the fault or necessary consequence of the open economy, that economic strategy served the interests of the upper income groups and fed their resources for retention of political control. An open economy became identified with defense of special privilege, and limited democracy. Will a return to an open economy now have similar effects?

It might not: the basic political conditions of the country have changed enormously. The greatest change has been a major diffusion of education and of public participation, with a vast network of civic, ethnic, labor, and political party

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[48] Tello, "Exportaciones y crecimiento;" John Sheahan, "Development Dichotomies and Economic Strategy," in Simón Teitel, ed., Towards a New Development Strategy for Latin America: Pathways from Hirschman's Thought (Baltimore: Johns Hopkins University Press for the Inter-American Development Bank, 1992), pp. 22-45.

[49] Cotler, Clases, estado, y nación.

organizations that scarcely existed before 1960.[50] New parties representing previously left-out interests keep trying to catch new adherents, and thus help widen participation still further. The problem is that these changes may increase, rather than rule out, the risks of reversion to repression. The Fujimori self-coup of April 1992, suppressing congress and the judiciary, may have been in part a response to fears that political opposition could use the strains of prolonged depression as a basis for effective criticism of the government and its present economic strategy.[51] An open economy could in the longrun favor the chances of democracy, if successful management makes it work to benefit the great majority of the people, but trying to force its continuance at great cost to the majority certainly will not.[52]

## 6. Conclusions

Peru's return toward an open economy offers a ray of hope for a better future, but its specific form of implementation has

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[50] Evelyne Huber Stevens, "The Peruvian Military Government, Labor Mobilization, and the Political Strength of the Left," Latin American Research Review, vol. 17, no. 1 (1982); Susan C. Stokes, "Politics and Latin America's Urban Poor: Reflections from a Lima Shantytown," Latin American Research Review, vol. 26, no. 2 (1991).

[51] Lagniappe Letter, March 20, 1992; Latin American Weekly Report, Dec. 12, 1991 and May 7, 1992.

[52] John Sheahan, Patterns of Development in Latin America: Poverty, Repression, and Economic Strategy (Princeton: Princeton University Press, 1987), ch. 12; Adam Przeworski, "The Neoliberal Fallacy," Journal of Democracy, vol. 3, no. 3 (July 1992), pp. 45-59.

brought costs so high they threaten survival. The shortrun costs in terms of blocked recovery, of worsening poverty and unemployment, are dangerously high for an economy under the strain of prolonged depression and high levels of violence. At the same time, the economy risks being pulled in directions opposed to the kinds of structural changes needed for a less unequal society.

The hopeful side of a more open economy is in part that it should favor increased efficiency, and beyond that could help in two ways of special importance for Peru. One is that greater access to imports can relieve inflationary strains by increasing the flexibility of supply: the prolonged inflation beginning in the 1970s was in large measure a result of repeated bursts of deficit spending, but restricted access to imports made things worse by impeding response on the supply side. The second way it could help is by leading toward a different kind of industrial growth, with more emphasis on opportunities for productive employment along with more emphasis on learning through participation in in external markets. The old conflict between interests favoring industrialization and those favoring trade could conceivably be resolved in favor of a path of industrialization directed more toward exports.

The shortrun problem with the move to a more open system is mainly that macroeconomic balance in the sense of putting productive resources to full use is being ignored in favor of a narrow vision of complete reliance on free market forces. A key specific problem is that tight monetary restraint led to appreciation of the real exchange rate, discouraging recovery through exports and encouraging a shift to external suppliers despite conditions of severely underemployed resources. Allowing both interest rates and exchange rates to be determined by market forces in this context has been seriously adverse for recovery. Where populist governments in the past ruined things by ignoring limits on spending, the present program is threatening to ruin things by the opposite kind of excess. Severely reduced real wages hold down consumption; tight liquidity, high interest rates, and fear of violence discourage investment; government spending has been blocked while taxes have been raised; appreciation of the currency in real terms makes imports cheap and discourages exports. The economy has been placed in a strait-jacket that nearly rules out recovery of production and employment.

Possible corrective actions could include returning to an official exchange rate that could be devalued in real terms, backing up real devaluation by reducing the non-functionally high levels of interest rates that are causing so much trouble for exports and investment, raising temporarily the average level of tariffs (without changing the new, more unified tariff structure), re-introducing extra-market incentives for industrial exports, and using increased revenue from tariffs to finance at least a modest revival of government spending on productive infrastructure and on programs to lessen poverty. All of these suggestions imply a more active governmental role, and more sense of responsibility for the direction of the economy, than this particular liberalization program has allowed. They do not imply backing away from a more open economy, just from an extreme version of liberalization that has unnecessarily high costs.

Recovery of production and employment might could lessen the discouraging perception of young people that they have nowhere to go, and create greater resistance to the forces threatening to destroy the society. But the magnitude of poverty and inequality, the enormous imbalance between growth of population and growth of opportunities for productive employment, and the weaknesses of the systems of public education and public health, mean that exclusive reliance on private market forces could leave much of the population outside the gains of renewed economic growth. The present stabilization and liberalization program fails to address questions of poverty and inequality, and thereby fails to constitute a path toward stabilization in the sense most fundamental to this tormented society.

The turn back toward the open economy is not intrinsically either a mistake or a solution. The closer it comes to a modified liberalization allowing for a directive role of government to reshape market forces in favor of lower income groups, of technological change and an export orientated industrial sector, and of greater integration of the society, the more positive the results are likely to be. Market forces can be either constructive or destructive; Peru needs to redirect and use them to meet the society's goals, not turn the future over to them.

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