

THE DEBT CRISIS AND ECONOMIC ADJUSTMENT IN LATIN AMERICA

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Abstract

This paper discusses several aspects of Latin America's adjustment process following the debt crisis. Some of the issues addressed include the role of the international financial system, the role of the IMF and the World Bank, and the costs of the adjustment. The discussion also deals with individual countries' experiences, with special emphasis on the heterodox anti-inflationary programs.

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I. Introduction

As we enter the final years of the 1980s we find the Latin American countries struggling to get back on their feet. After what seemed to be an auspicious beginning, the decade has become an economic nightmare for the region; in the last few years it has suffered the worst recession since the 1930s. What in August 1982 -- when Mexico disclosed its financial difficulties -- seemed to be an isolated case of temporary illiquidity soon spread out to most of the developing world, placing the stability of the international financial system in serious jeopardy. The adjustment process followed between 1982 and 1987, which can best be described as emergency stabilization, has been extremely costly; real income per capita experienced steep declines in most countries.¹

A direct effect of the crisis has been the mushrooming of books, pamphlets and manifests dealing with different aspects of the problem. Some of this literature is of a remarkably high quality, some will be quickly forgotten and a non-trivial proportion is plainly awful. In this article I review a small number of volumes that in one way or another deal with the crisis. Many of them are collections of articles, making the reviewer's task rather difficult. The different components of these books not only differ in quality, but many times they also lack unity. For this reason I will deal with these collections in a rather selective way; I will dwell on some of the essays and will almost ignore others. I will try, however, to provide an assessment of each volume as a whole.

The article is organized as follows: in Section II I deal with the role of the international monetary system in the unleashing of the crisis. Section III focuses on the specific role of the International Monetary Fund (IMF) and its policies. In Section IV I review individual country experiences, placing particular emphasis on the recent attempts to implement unorthodox stabilization programs (i.e., the Austral and Cruzado plans and the APRA experience in Peru).

II. The International Monetary System, Latin America's Development Strategies and the Debt Crisis

The book by Griffith-Jones and Sunkel (Debt and Development Crises in Latin America: The End of an Illusion) constitutes an ambitious attempt to insert the debt crisis within the evolution of the international monetary system. In a nutshell the authors' position can be summarized as follows: the debt crisis is a representation of a broad and deep crisis of the international monetary system and of the development strategies followed by the developing world in the last decades. Consequently, they argue, a solution to the debt crisis presupposes reforming the international monetary system and drastically changing the focus of the developing strategies. With respect to the international monetary system the authors point out three areas of failure: first, it has been unable to provide to the LDCs the amounts of funds "required" to achieve their development targets. Second, capital flows to the developing countries have been procyclical, making it difficult for these countries to use foreign funds to face world recessions. And third, contrary to the 1950s, 1960s and 1970s, in the 1980s we have not witnessed the emergence of a new financial sector that would have led the world out of the crisis. The book contains abundant statistical information, and the authors provide a fairly detailed plan for reforming

the international system.

Griffith-Jones and Sunkel have written a nostalgic book whose tone evokes the earliest structuralists thoughts of the 1950s and 1960s. None of the criticisms of structuralism of the last two decades, nor the developments introduced by the neostructuralists in the last few years can be found here. The book contains a number of claims that are either inaccurate or unsupported by empirical evidence. For instance, on page 11 the authors sustain that in response to the crisis the Latin American nations implemented "restrictive policies ... to stabilize the balance of payments and keep the economies open" [emphasis added]. However, it is well-known by careful observers of the Latin American economic scene that the vast majority of countries in the region imposed extremely restrictive trade, capital and exchange controls (i.e., they closed their economies) as a response to the crisis. Only very recently, and slowly, some countries are venturing into trade liberalization reforms.² Another example can be found on pages 61-62 where the authors claim that banks made large monopolistic rents in the rescheduling process. Certainly, the brief paragraph in Chapter 8 (pages 113-114) does not provide a rigorous empirical verification of the hypothesis. In fact, in a recent extensive empirical study that covers a large number of banks and loans to the LDCs, Ozler (1988) found that although banks made above normal profits for the reschedulings of the 1970s, they made below normal profits during the reschedulings that followed the 1982 crisis.

Given the authors backgrounds and previous writings, it is puzzling that this book makes so little reference to historical events. Latin America's economic history is replete with debt crises. Although very few episodes exhibited the depth and seriousness of the current crisis, there

are many lessons that can be learned from the past. A fascinating literature on the subject has emerged in the last few years. Just to mention two studies, Eichengreen (1988) discusses why in the 1930s the debtor countries failed to form a united front to negotiate with their creditors; at the end in the 1930s, as in the 1980s (at least up to now) the case-by-case approach was adopted. Lindert and Morton (1988) have shown that after the debt crisis of the 1930s the international financial community failed to differentiate between "well" and "bad" behaved debtors. Even those countries that kept current in their payments were subject to "penalties", and did not have access to voluntary lending. Naturally, this information is extremely valuable when evaluating the costs involved in not paying all or part of the debt.

Tsoukalis and Posner have put together collections dealing with the international monetary system. Although the aim of both of these volumes goes beyond the developing countries and the debt crisis, they contain some interesting articles on the poorer nations. The Tsoukalis volume (The Political Economy of International Money) contains three articles that are particularly relevant. In a highly informative paper Susan Strange analyzes the evolution of the monetary system from the mid-1970s to the mid-1980s. This paper provides a much needed survey on the evolution of the views of different schools of thought. According to Strange monetary mismanagement in the industrialized world is at the core of many of the current international problems. She persuasively argues that the current wave of protectionism in much of the industrialized world is one of the most serious consequences of their lax monetary policies. In the same volume Bird and Killick provide a summary of their research on the role of the International Monetary Fund in developing countries' macroeconomic adjustment. (Section

III of this review article deals specifically with the IMF.)

Finally, Lewellyn discusses the role of private banks. There is no doubt that understanding the behavior of private banks is an essential component of any serious evaluation of the role played by the international monetary system in the unleashing of the debt crisis. Lewellyn provides some helpful elements towards the fulfillment of this task. He starts by pointing out that two major developments in the 1970s were the shift from bond to bank financing, and from official to private sources of funds. He argues that after some years of smooth functioning the system faced a confidence problem in the early 1980s. There was mounting concern on the poorer countries' ability to service their debts. Lewellyn goes on to question the adequacy of the case-by-case approach towards solving the crisis that followed in 1983-84. He argues in favor of a long term solution that would include some reforms of the international monetary system, including taking provisions to avoid a similar crisis in the future.

Overall Tsoukalis has put together a useful volume. Among the chapters not reviewed above I particularly recommend Williamson's piece. By focusing on the role and activities of international economists he masterfully discusses important aspects of the sociology of the economic profession.

The Posner book (Problems of International Money, 1972-1985) is a natural complement for the Tsoukalis volume. Many authors appear in both collections, and there is an unavoidable sense of dejà vu. What makes Posner's book interesting in its own right is that it brings together articles by a number of senior IMF officials and some of the most perseverant Fund critics. The book is in fact a joint venture of the IMF and the Overseas Development Institute, a London research institution directed by Tony Killick a well-known Fund critic. Although not directly related to the

LDC debt the paper by G.G. Johnson on Fund surveillance is particularly interesting since it clearly explains the evolution of the Fund's role after the abandonment of the Bretton Woods system. One gets a clear impression that the abandonment of the fixed exchange rates system in 1973 provoked a serious process of soul-searching at the Fund; all of a sudden it was not clear what was the role of the institution. What is ironic, perhaps, is that the debt crisis and the concomitant need for massive macroeconomic adjustment in the LDC's has given a new and important role to the Fund. In another paper, Michael Dooley provides an interesting study of the role of international reserves in the international monetary system. His analysis of the currency composition of reserves holdings by a large number of LDCs is particularly interesting, since it uses data not generally available to academic researchers. Dooley, however, says very little about the nature of the optimizing problem that gives rise to a demand for international liquidity by the developing countries. What he says is, in fact, tautological: "Countries tend to adjust their reserves holdings until the benefits derived from such holdings are equal, at the margin, to the net cost of holding them" (p. 108). One can only hope that any junior majoring in economics would, under pressure (i.e., in an exam), be able to say that much!

Killick and Tsoukalis argue in their respective contributions that one of the most serious flaws of the international monetary system is the lack of symmetry in international adjustment; surplus countries should share the burden of adjustment with deficit countries. By doing this, they argue, the world economy as a whole would benefit. The authors, however, don't discuss how this symmetric adjustment can be enforced. If surplus countries have not yet willingly participated in a major program along these lines, what could make them participate? How can free-rider problems be avoided? None

of these questions is addressed in this book. In fact, ignoring the international political economy dimensions of this problem constitutes the major shortcoming of an otherwise interesting volume.

Perhaps one of the most important question regarding the debt problem is why the unfavorable external terms of trade and interest rate shocks -- which had a recent historical precedent in the 1975 world recession -- have resulted in the unleashing of such a major crisis that has brought regional growth to a halt for a number of years? Why weren't the Latin American countries able to quickly recover as they had done after the even more severe 1975 world recession? In a characteristically stimulating article in the Thorp and Whitehead volume, Diaz-Alejandro argues that the shocks of the 1980s were greatly compounded by the "breakdown" of the international financial system that occurred in 1982. Contrary to 1975, when the Latin American nations "borrowed" themselves out of the recession, in 1982 the financial community cut the flow of loans to Latin America, rather than increasing it. Diaz-Alejandro goes as far as saying: "[W]hat could have been a serious but manageable recession during the early 1980s in Latin America has turned into a major developing crisis mainly because of the breakdown of international financial markets and an abrupt change in conditions and rules for international lending" (Thorp and Whitehead, 1986, p. 12). This is, in fact, the view taken by the majority of the contributors to the volumes reviewed in this section.

Although these authors are right when pointing out that the international financial system exhibited some serious deficiencies in the period surrounding the crisis, it is not clear whether there was a complete "breakdown". Of course, the reason why Latin America could "borrow" itself out of the recession in 1975 and could not do it in 1982 is that in the late

1970s and the first years of the 1980s Latin America borrowed so much that, when the 1982 recession erupted, most of these countries had already used their borrowing capacity. Perhaps the main inefficiency of the system was that international banks failed to exercise the prudence traditionally associated with bankers. They massively lent to Latin America in the mid- to late-1970s, disregarding issues as important as how the funds were being used (i.e., to finance investment or to fuel capital flight), and whether the countries were following "sound" policies. Indeed, in the process of competing to recycle the abundant petrodollars the banks literally "pushed" loans down the throats of the Latin American countries. The result was a highly procyclical lending pattern. A second area of inefficiency was that when the crisis actually erupted, the banks failed to distinguish between the different Latin American nations; the banks exhibited a remarkable herd instinct pulling out simultaneously from the region as a whole. Even Colombia, a country without major problems is finding it increasingly difficult to get their loans rolled over.

Now that the collapse of the international monetary system has been aborted the most important outstanding issue refers to working out debt relief packages (including debt forgiveness) that would alleviate the burden of making huge transfers and would solve the debt overhang problem. Whether banks will participate willingly in such a scheme is not clear. Sadly, recent evidence suggests that shortsightedness is one of the banks more prominent characteristics.

III. The Role of the International Monetary Fund

The International Monetary Fund (IMF) is a mysterious, and often feared institution. Among the many myths that surround it, perhaps the best known

and least accurate is that its staff members fly around the world (First Class, naturally) imposing unnecessarily harsh adjustment policies to the poor countries. This, of course, is far from the truth. Strictly speaking the Fund has no real power to impose any policy. The Fund is, however, a combination of a financial examiner and an international lender of last resort. Member countries that face financial difficulties approach the Fund for short and medium term financial help. Before providing such assistance, and this is the catch, the Fund requires from the country an agreement that the "house will be put in order". This usually means undoing the policies that in the first place led into financial trouble, or adjusting to new international circumstances in those cases when the difficulties have an external origin. Most times these programs call for devaluation, credit restraints, regaining fiscal discipline and hiking public enterprises prices. Only when this agreement has been reached does the IMF disburse part of the money. Further disbursements are made after the Fund is satisfied that the country is indeed following the agreed upon policies. This concept of tying financial assistance to a certain policy package is known as IMF conditionality. Three of the books and several of the essays reviewed here deal with this issue.

Critics of the Fund have traditionally argued that IMF policies narrowly focus on short term financial and external targets paying little, if any, attention to growth. In his new book (The International Monetary Fund and Latin America: Economic Stabilization and Class Conflicts), Manuel Pastor criticizes both the Fund and its traditional critics. Taking a neo-Marxian perspective Pastor argues that the critics excessive focus on growth (or lack of it) is misplaced, and that the most serious limitation of Fund programs refers to their disregard for income distribution and for poverty.

In many ways Pastor's book is a refreshing contribution. First, he has attempted to make his neomarxian view accessible to those that are not initiated into the political slang of the marxian left. Second, and contrary to so many Latin American marxists, Pastor makes a serious effort to document with empirical evidence his theoretical and analytical claims. However, the author's enormous enthusiasm -- which is what makes the book refreshing -- is also its main limitation. The style and the inability to follow the arguments all the way through constantly remind the reader that this book has grown directly (and with little revisions, I would guess) from the author's doctoral dissertation. Obviously, the fact that this work is based on a Ph.D. thesis is not a drawback on itself. Many modern classics in the social sciences had their origins in doctoral research. Pastor, however, has not polished the material sufficiently.

The most interesting part of this book is contained in Chapter 4 where Pastor presents empirical findings regarding the effects of Fund programs (both stand-by and Extended Fund Facility) in 18 Latin American countries. Using a battery of statistical tests he finds that Fund programs have improved the balance of payments, have not improved the current account, and have reduced labor shares in real incomes. With regard to real growth he finds that there is no clear cut evidence. The most important new result, and the one on which Pastor focuses most of his remarks, is that Fund programs have a negative effect on income distribution. Although highly useful the analysis has some methodological limitations. First, it is concentrated on the very short run, looking only at what happens one year after the program. Undoubtedly some of the Fund policies, and especially those geared at aggregate supply, take a longer period of time to bear fruit. Second, the analysis is based on a before and after methodology, where values of the

key indicators before and after the programs are compared; no effort is made to separate the effect of Fund programs from those stemming from other disturbances. Third, the author does not provide a coherent "counterfactual" adjustment policy.³

Margaret de Vries was, until her recent retirement, the official historian of the International Monetary Fund. In her new book she traces the evolution of the Fund's involvement with adjustment programs from 1945 to 1986. The approach followed is historical, and de Vries makes great efforts to document a number of small details regarding Fund operations. This attention to minutia makes the book somewhat boring to those interested in the big picture and not in the day-to-day working of the Fund. However, what is interesting about this book is the chronicle of the evolution of the Fund from its original role, as envisaged by the Articles of Agreement, to its recent participation in the debt crisis. What emerges from these pages is a rather dynamic institution that has been able to adapt to new times and even to invent new tasks for itself (surveillance, for example) when, after the breakdown of the Bretton Woods system its own raison d'être was under question. The book failed, however, in addressing any of the criticisms that have been made about Fund operations throughout the years.⁴

SELA's El FMI, el Banco Mundial y la Crisis Latino Americana includes a collection of articles, mostly by prominent Latin American economists, dealing with the Fund and the World Bank relations with the Latin American countries. The general tone of the book is critical and a number of reform proposals are offered. The book contains three general articles by Edmar Bacha and Miguel Rodriguez Mendoza, Bacha, and Richard Feinberg and Bacha, as well as articles dealing with specific countries relations with these institutions -- Argentina, Brazil, Colombia, Jamaica, Mexico, Peru and the

Dominican Republic. Although the criticisms of the Fund presented here are not new, I found Bacha's article on reforming IMF operations particularly interesting. The most important changes he advocates refer to: (1) implementing two-tier conditionality -- one tier for variables expressed in foreign exchange and one for variables in domestic currency; (2) adopting "inverted conditionality" where the local authorities offer their program and the IMF monitors its achievement; and (3) adopting an analytical framework to formulate programs that incorporate the development of the 1960s and 1970s on disequilibrium macroeconomics. There is no doubt that Bacha is a formidable critic of the Fund; he understands its operation and has thought carefully about alternatives. His proposals, however, are impractical and, I would even say somewhat naive. Why would the IMF (or, to put it more brutally, its larger members), agree on adopting the most radical reform propositions?⁵ The answer to this question lies on the realm of international political economy, an area completely absent from this volume. In addition a number of Bacha's propositions are doubtful from a purely economic point of view. For example, the economics profession has largely abandoned disequilibrium models. After a promising beginning it has been found that these models are difficult to manipulate and that they often fail to provide useful insights. Also, it is unclear whether it is useful to dichotomize the functioning of an economy between "variables expressed in foreign exchange" and "variables in domestic currency". The general equilibrium interrelations in modern economies are extremely complex; there is little doubt that the evolution of "domestic currency" variables such as inflation will have an impact on foreign sector variables.

In spite of its limitations which include the disregard for international political economy aspects and considerations about the modern

theory of policy making in an uncertain environment, this is a valuable volume. The country chapters provide a number of details regarding Fund operations in Latin America -- including the contents of many letters of intent -- that cannot be found elsewhere.

IV. Country Experiences with Adjustment

Thorp and Whitehead's volume (Latin American Debt and the Adjustment Crisis) is the third in a series dealing with different aspects of adjustment in Latin America. As its two predecessors this book contains a number of country specific chapters as well as a couple of essays dealing with the region as a whole. The countries covered are Argentina, Brazil, Chile, Colombia, Peru and Mexico; in addition there is a chapter on the Central American nations. The unifying theme is the limitations of "orthodox" adjustment policies. These are described as policies centered around the need to impose fiscal discipline and restraining domestic credit creation. What makes this volume particularly interesting is that these essays were written before the different "heterodox" programs (the Cruzado and Austral plans and the APRA program) were implemented in full force. In fact a recurrent theme throughout the volume is the belief that inflation is an "inertial" phenomenon. The authors of these essays express great confidence that such heterodox plans would succeed and greatly help adjustment in the region. History has shown that their confidence mainly reflected wishful thinking. At the time of these writing there is wide agreement that these plans were a big flop. Their failure, however, does not necessarily reflect an incorrect diagnosis -- in fact there is little doubt that in Brazil inertia is a crucial force -- but rather very poor implementation. I will return to this theme below when reviewing the special issue of El Trimestre

Economico devoted to the heterodox programs.

On the whole Thorp and Whitehead have produced a valuable volume that not only contains a wealth of information about recent macroeconomic developments in the region, but also provides a glimpse of what some prominent Latin American economists -- some of which may be called to hold public office in the years to come -- think about a number of key issues. It should be noticed that the selection of the contributors reflects the particular views of the editors; there is a fair amount of Fund bashing and skepticism on the efficiency of markets.

The chapter by Carneiro on Brazil provides an interesting account of the Brazilian negotiations with the IMF. He clearly points out how this process can be draining for the local authorities, and agrees with the authors of the SELA volume about the difficulties usually found in achieving the domestic targets. Perhaps the most important point made by Carneiro is that since most of the Brazilian debt is government debt, its payment will require a transfer from the private to the public sector. This is in fact one of the most serious and least understood aspects of the crisis: the debt crisis is as much a domestic fiscal problem as an external problem. Carneiro's chapter is full of references to the inertial aspects of inflation and the needs to tackle the indexation mechanism in order to achieve a semi-permanent solution to the inflation problem. The Ros chapter on Mexico provides a large amount of information, and focuses on the role of capital flight in the Mexican crisis. This is an important issue since it clearly points out that those that benefited from the acquisition of the debt are not the ones that are now shouldering most of the costs implied in paying it. Surprisingly the essays in this volume do not devote much space to discussing this key issue.

In his chapter on Chile's economic policy under Pinochet, Whitehead analyzes the causes behind the collapse of the Chilean economy in 1982. After discussing the roles of exchange rate and monetary policies he devotes a section of the chapter to analyze the relation between the economic policy and the political nature of the Chilean regime. He argues that given the dictatorial and right wing nature of the government we should not be surprised by the inflexibility and dogmatism exhibited by the Chilean economic team -- the so-called "Chicago boys".⁶ Whitehead's argument goes as follows: since Pinochet's initial goal was to destroy the Allende legacy and to institute a free market system, the "Chicago boys" pushed the free market reforms at maximum speed, without any regard for their short and medium term consequences. He goes as far as saying that "high unemployment might actually have some attractions for the Chilean regime as a policy objective" (page 146). I find this view so far-fetched, that I can only compare it to the hypothesis entertained by the Chilean extreme right regarding the economic policies of the Allende government. According to this hypothesis Allende's Economics Minister Pedro Vuskovic deliberately designed a policy package aimed at destroying the Chilean capitalist economy; from its ashes a new socialist economy was to be built. Of course, all of this is rubbish.

In interpreting economic policymaking during Pinochet, Whitehead altogether misses a crucial point: although Pinochet and the Chilean armed forces were strongly anti-communist, or more accurately anti-Marxist, initially they were not in favor of a free market system. In fact it is well known that the Chilean military had traditionally been highly nationalistic in economic matters, and that they favored some type of indicative planning and an important government role in the economy (see Edwards and

Edwards, 1987, Ch. 4). A key question is why did the military end up embracing the policies of the "Chicago boys"? Why didn't they draw from the Christian Democrats program? After all, that party initially supported the coup and many of its militants participated in the government economic team. The "Chicago boys" were able to retain the military's confidence only to the extent that their policies "worked" in the sense of reducing inflation, and especially after 1975, generating growth. The policy mistakes that contributed to the collapse of 1982 were not the result of a conspiracy to starve the working classes, but rather the result of technical miscalculations that were fueled by arrogance. As I have argued elsewhere the dictatorial nature of the regime contributed to the maintenance of these incorrect policies for a long period of time (Edwards and Edwards, 1987).

Whitehead's article ends with a pessimistic assessment of the medium terms prospects for the Chilean economy. However, and to most observers surprise, in the last few years the Chilean economy has recovered with great vigor. At this junction Chile's problem is not strictly the economy but more fundamentally the political future of the country. When this article is published we will already know whether the Chilean people has succeeded in defeating the odds, and manage to head back towards democracy.

Although due to space considerations I cannot go in detail into the other chapters in this book, I strongly recommend Ocampo's chapter on Colombia. In a characteristically lucid style Ocampo analyzes how (and why) Colombia was spared from the general collapse of the Latin American economies. Unfortunately, recent developments, and in particular the hard-to-understand attitude of the private banks, may show that Ocampo's cautious optimism for Colombia's future was premature.

One of the most important lessons emerging from Latin America's macroeconomic experiences during the 1980s has to do with the dynamics of high inflation. As the IMF staff dealing with Brazil learned the hard way, in highly indexed economies inflation acquires a life of its own; inertial forces become dominant and the monetary authorities have little alternative but to validate these inertial pushes. The book by Bresser Pereira and Nakano (The Theory of Inertial Inflation: The Foundation of Economic Reform in Brazil and Argentina) deals with the theory of inertial inflation, while the articles of the special issue of El Trimestre Económico edited by José Antonio Ocampo deals with recent anti-inflationary programs in Latin America with special emphasis on the heterodox programs of Argentina, Brazil and Peru. Both volumes are highly recommended; they clearly capture an important new view on inflation.

In their book Bresser-Pereira and Nakano rightly note that in order to fully understand chronic inflationary processes it is necessary to go beyond the narrow realm of economics and tackle political and distributive issues. Indexation is nothing more than the institutionalization of a defense mechanism. Indexation can, however, become so entrenched as to alter the dynamics of inflation. In these cases (i.e., Brazil), inflation can only be reduced if the economy is de-indexed. There is little doubt that the Cruzado and Austral plans were based on the correct diagnosis regarding the role of indexation. The implementation of both plans, however, badly erred in not enforcing the required demand management policies alongside the incomes policies and the heterodox shocks. Bresser-Pereira and Nakano have a point when they argue that the orthodox approach that relates fiscal deficits to money creation, and money creation to inflation is very simplistic and almost tautological. But, it is exactly because it is a

tautology that it cannot be ignored when implementing a stabilization program. It doesn't matter how many heterodox shocks are applied, if the fiscal finances are not put in order inflation will not go down; ignoring this principle is not only bad economics but also irresponsible politics. Most of the Latin American democracies are too fragile as to put them at risk with irresponsible economic policies.

The more interesting, and troubling, contributions to the special issue of El Trimestre Economico are the articles on Peru by Richard Webb, Jurgen Schuldt and Rosemary Thorp. In August of 1985 the newly elected government of President Alan García instituted a new and "heterodox" anti-inflationary plan. The APRA had inherited a crippled economy with an annual rate of inflation that exceeded 200%. The Peruvian experience, however, has been significantly different from that of the other two heterodox cases -- Argentina and Brazil. First, in Peru wage and price indexation was not generalized and did not constitute a serious problem. Second, in Peru the economy had become highly "dollarized" during the last couple of years of the Belaunde government. Third, early on Peru reduced its foreign debt burden by limiting interest payments to approximately 10% of exports. And fourth and most important, the Peruvian program went well beyond reducing inflation; it was really a development plan whose ultimate aim was to redirect the Peruvian economy. Of the three articles on Peru in this collection Rosemary Thorp's is the most interesting one. Thorp has for a long time been a student of the Peruvian economy, and in this article she provides a clear description of the rationale behind the APRA program. It is difficult to understand, however, why even in the light of the very poor results of the program she insists on calling it a "success" (page 366).

The Peruvian program consisted of the following key measures: price freeze, wage rate increases, tax cuts, exchange rate pegging, reduced payments on foreign debt interest, and an increase in government expenditure. The program was put together in a hurry. As Webb explains it was only presented to Garcia on July 31, 1985; the main measures were implemented during the first week of August, 1985.

As Dornbusch (1988) has recently pointed out, the Peruvian program completely disregarded every basic principle in economics. For instance, its architects argued that the fiscal deficit has no effect on inflation. As an act of faith they pointed out that the Peruvian fiscal deficit was not a cause, but rather a consequence of inflation. What evidence backed this assertion? Certainly not the existence of indexation, since as Thorp recognizes this was not important in Peru. An important element of the Peruvian program was the belief that the economy had large "unutilized capacity" and that, consequently, higher aggregate demand -- stimulated via hikes in domestic credit -- need not be inflationary. All it takes, the argument goes, is to freeze prices and increase wages to the right groups. However, history has shown time and time again that this policy has a very short-run positive effect on output. As soon as inventories are exhausted and foreign exchange is used up, a serious process of repressed inflation takes over. The external sector enters into a crisis, the real exchange rate becomes seriously overvalued, severe exchange and trade controls are imposed and the productive side becomes highly distorted. The formal sector shrinks and the underground economy thrives. As activities shift into the informal sector, sources of taxation disappear. The fiscal deficit broadens and inflationary pressures become more important. Sadly, a vicious circle develops, and getting out of it becomes increasingly difficult. This is

exactly what has happened in Peru; the country is rapidly approaching economic and political suicide.

Why didn't the architects of the program or their academic advisors anticipate these developments?⁷ The problem, I think, is that they failed to learn the lessons from recent Latin American history. As it turns out the Peruvian program has a recent predecessor in the Unidad Popular program in Chile. The unutilized capacity diagnosis, the skepticism regarding the fiscal sources of inflation, the price freezes, the overvaluation of the exchange rate and the populist hike in wages, just to mention some elements, were all present in Allende's program. As any careful student of Latin America knows, the Unidad Popular program quickly resulted in unsustainable economic pressures, repressed inflation and a major crisis that ultimately helped trigger the coup that led to 15 years of Pinochet. One can only hope that President García will have the vision as to change course before it is too late. Democracy is too precious to risk it by implementing economic policies that have proven to be a disaster.

FOOTNOTES

¹On the debt crisis see, for example, the collection of articles forthcoming in Edwards and Larrain (1989) and Sachs (1988).

²See, for instance, the discussion in my forthcoming article in Sachs (1988) debt volume.

³The emphasis here is on "coherent". Pastor, of course, pushes the Marxist view that only structural (revolutionary) changes will in the end solve these problems. History, however, is stubborn and has shown that even socialist countries cannot escape the need to adjust when facing imbalances.

⁴Notice, however, that through the years the Fund has been receptive to criticisms and has made effort to establish an intellectual dialogue with the critics. In fact, the Posner volume reviewed above is a good example of this.

⁵The emphasis here is on "radical". The Fund has, in fact, already adopted some of the less radical proposals such as contingent conditionality.

⁶In this section Whitehead is partially reacting to my own view on the dogmatism of the "Chicago boys". See pages 140-145 of Whitehead's article as well as my 1984 article.

⁷In a recent book, El Perú Heterodoxo: Un Modelo Económico the architects of the plan expose the technical underpinnings of the program. The volume is full of equations and statistical jargon, and a number of econometric models of a 1960s vintage are presented and discussed. However, these technicalities fail to disguise the lack of economic coherence and judgment.

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