Monetary and Fiscal History of Peru
1960-2005:
Radical Policy Experiments and Inflation

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Three stages in Peru’s modern fiscal and monetary history

1. 1960s-70s: a large fiscal expansion without tax increases resulted in a large increase in public debt; as in Sargent-Wallace (1981), stock of public debt hits a ceiling, and financing the deficit via seigniorage leads to high inflation

2. 1980s: an unusual policy experiment combining debt repudiation, price controls and loose credit, inspired on the idea that inflation is not a monetary phenomenon, spiralled into hyperinflation

3. 1990s: price stabilization: demise of price controls and generalized subsidies, Central Bank independence (credible change from fiscal to monetary dominance), and introduction of market-oriented reforms
Peru in the 1960s

- economy based on exports of primary products, approaching the end of a cycle because of supply limitations and paucity of investment
- state was small and ostensibly “laissez faire,” but controlling the state was crucial to access to rents linked to exports—long periods of military government
- pent up demand for public services, education and redistribution from growing urban middle class
- “dependency school” makes inroads among politicians, intellectuals and the military academy (CAEM)
Dependency school

- some sensible ideas with some not so much so...
- need for greater equality of opportunities (e.g. land reform, public education) to unleash productivity growth
- barriers to foreign capital because it does not create “linkages” with local industries
- greater role for public investment and publicly owned enterprises
- dependency ideas were not only espoused by radicals; Peru’s most influential economic history (Thorp and Bertram 1987) adopts the same viewpoint
- military nationalistic Junta (1968-1979) would take this view seriously
First Belaunde government, 1963-1968

- 1962, founding of the National Planning Institute during a brief military coup
- 1963: electoral triumph of candidate (Belaunde) espousing redistribution, the expansion of public services, feeble attempt at land reform
- Tax increases blocked in congress until too late, inspire of the government full knowing that public deficit was mounting
- In the end, both lost: BOP crisis and devaluation followed by military coup in 1968
General Velasco, 1968-1975

- Velasco military junta implements a number of radical reforms inspired in dependency school: land reform, expropriation of foreign-owned oil, mining, public services, large public investments
- secretive arms deals, likely very expensive
- interestingly, no tax increases: fear of alienating urban middle class (even military regimes face political constraints); fiscal expansion supported by public debt
- growth under the shadow of increased government intervention in the economy proved disappointing
- Sargent-Wallace: public debt seemed to near a ceiling, the government had to resource to seigniorage
- General Velasco ousted in 1975 and replace by General Morales Bermúdez until 1980

- Belaúnde reelected after military relinquished power
- Attempt at price stabilization (via fiscal balance and assertion of central bank independence) was thwarted by exogenous shocks: world recession in 1981, “El Niño” phenomenon of 1983, leading to looser credit of central bank to government
- “concertación:” belief that income policies negotiated with trade unions, including managing prices, were necessary for successful stabilization
- Richard Webb (then president of central bank): “Monetarism is a theology, and central banks are not theology seminars.”
- Alan Garcia elected in 1985
“An examination of the Peruvian record reveals that periods of moderate inflation are associated with expansionary policies. And periods of major inflation are associated with fiscal restraint. Thus, the record shows exactly the opposite of what is predicted by a theory that explains inflations by fiscal deficits.” (pp. 75-76)
Second period: “heterodox Peru”

Heterodox Peru: An Economic Model, 1987, some more unconventional thinking:

“If it were necessary to summarize in two words the economic strategy adopted by the government starting in August 1985 they are control (meaning control of prices and costs[...] and spend, transferring resources to the poorest so that they can increase consumption and create demand for increased output. [T]his will bring about a reduction in unit costs. Thus, the deficit is not inflationary, on the contrary! ” (pp. 82)
The heterodox plan, July 1985

- limitation of debt payments to 10% of exports (after previous government doing quiet arrears)—this gave the government some initial room
- controlled prices
- multiple exchange rates
- massive credit subsidies
Consequences of the heterodox plan

- initial decline of inflation (conjecture: linked to stop servicing debt?)
- value of debt fell to 7 cents per dollar; Peru declared ineligible and deteriorated value by the IMF; central bank reserves deposited at the BCCI for fear of American banks
- controlled prices and multiple exchange rates fed into deficit—paradoxically, controlled prices led to hyperinflation
- massive credit subsidies and sharp decline in tax revenues also contributed to increased deficit
- 1987: attempt to nationalize banking industry stopped by massive disobedience and endless legal challenges: critical juncture in public opinion regarding the proper scope of legitimate government action
Fujimori: stabilization and market oriented reforms

- huge increase in controlled prices (30 fold increase in oil prices), closing of the credit of the central bank to the government, fiscal balance
- closing of the National Planning Institute, central bank’s autonomy and focus on price stability are given constitutional status (new constitution in 1993, after Fujimori’s forceful closing of Congress)
- government resumes in full public debt service (why? signaling commitment to pro-market orientation?)
- privatization of industries nationalized by Velasco; liberalization of land and labor markets, financial liberalization
After Fujimori

- presidents after Fujimori:
  - Toledo 2001-2006 (a Belaunde-like populist)
  - Alan García 2006-2011 (again!)
  - Ollanta Humala (military nationalist)

- sensible fiscal and monetary policies and pro-market orientation have been held

- . . . different cast of characters with very similar results

- both García and Humala careful to signal commitment to monetary stability by appointing and re-appointing a conservative central banker
Stylized facts: Nominal instability
Inflation and prices
Inflation

Increasing trend inflation associated to continuous monetization of deficit. Inflation spikes associated with exchange rate devaluations.
Devaluation episodes and inflation
Continuous fiscal deterioration

- Non financial public sector to GDP (including interest rate payments)
- Inflation
Big inflation period

Inflation higher than 5 percent per month
Seignorage and inflation
Debt ratios

- Domestic public debt in soles as a percentage of GDP
- External public debt as a percentage of GDP
Laffer curve

Annual inflation and seignorage: Two observations to the right are 1989 and 1990
Big devaluation followed by floating regime
Big devaluation followed by floating exchange rate regime
Contrasting other stabilization episodes in the region, in Peru the monetary anchor was not the exchange rate but base money growth rate.

The exchange rate was devalued once to a sufficiently high level and then let to float.

In theory, this approach was more contractionary than an exchange rate stabilization.

Inflation fell but very slowly compared to an exchange rate stabilization.

It is important to remember also that Peru in the 50’s was one of the few countries that have a floating exchange rate system.
By how much to initially devalue?

- Too small a devaluation $\Rightarrow$ might have not been credible
- Too large a devaluation $\Rightarrow$ might have been more contractionary
- Documented account of price declines in the days after the *fujishock*
- Are they indicative that the devaluation was too strong?
- We are working with the daily data to explore this episode
Stylized facts: Real instability
Inflation and growth performance

Hyperinflation

Per capita GDP measured in international dollars

50 55 60 65 70 75 80 85 90 95 00 05
2,000 2,400 2,800 3,200 3,600 4,000 4,400
Hyperstanflation

![Graph showing Real GDP growth rate and CPI Inflation in Metropolitan Lima](image-url)
Inflation and growth performance

Terms of trade

The graph shows the terms of trade from 1950 to 2005. The terms of trade initially show a peak around 1955, followed by a steady decline until around 1970, where it stabilizes. After 1970, there is a steep decline until around 2000, followed by a slight recovery.
Composition of revenue taxes
Capital output ratio

PERU: Ratio Producto a Capital

Millones de soles de 1994

0.35 0.40 0.45 0.50 0.55
Concluding remarks
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- Nominal instability is marked by the low capacity of the state to generate income amid social demands
- This led to increasing debt that reached a limit
- The story that followed ended up in hyperinflation after almost 20 years of protracted high inflation
- Nominal instability is also associated to real instability, though proving causal effects is problematic here
- Stabilization was unique in the region but fairly orthodox
Modeling challenges

- Dynamics of populist hyperinflation: delayed adjustments of publicly controlled prices

- What has changed in Peru since 1990? Why the same or very similar politicians behave more responsibly? Social learning?