Journal of Development Economics 32 (1990) 247–277. North-Holland

MACROECONOMIC POPULISM*

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Macroeconomic populism is an approach to economics that emphasizes growth and income distribution and deemphasizes the risks of inflation and deficit finance, external constraints and the reaction of economic agents to aggressive non-market policies. The purpose of our paper is to show that policy experiences in different countries and periods share common features, from the initial conditions, the motivation for policies, the argument that the country's conditions are different, to the ultimate collapse. Our purpose in setting out these experiences, those of Chile under Allende and of Peru under Garcia, is not a righteous assertion of conservative economics, but rather a warning that populist policies do ultimately fail; and when they fail it is always at a frightening cost to the very groups who were supposed to be favored. Our central thesis is that the *macro*economics of various experiences is very much the same, even if the politics differed greatly.

1. Introduction

The purpose of the study is to develop a paradigm of populist macroeconomics.[1] Macroeconomic populism is a policy perspective on economic management that emphasizes economic growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints and the reaction of economic agents to aggressive non-market policies.

We analyze two populist economic programs, Chile during Allende's Unidad Popular (1970–1973) and Peru under Alan Garcia. We show that policy experiences in different countries and periods share common economic

*This is a much shortened and revised version of a paper presented at the second meeting of the InterAmerican Seminar on Economics, IASE, Bogota, Colombia, March 30–April 1, 1989. The authors are indebted to conference participants, Eliana Cardoso, Vittorio Corbo, Al Fishlow, Javier Iguiniz, Richard Eckaus, Eduardo Engel, Jose de Gregorio, Caterina Nelson, Eva Paus, Andres Solimano, Jose Pablo Arellano, Miguel Savastano, and Andrew Zimbalist for helpful suggestions. The research reported here is part of a project supported by the World Bank. S. Edwards gratefully acknowledges the support of the University of California Pacific Rim Program.

[1]See, also, Sachs (1989) where the same issue is pursued.

features, from the initial conditions, the motivation for policies, the argument that the country's conditions are different, to the ultimate collapse. It is clear that the Unidad Popular of 1970–73 experience in Chile had political goals that were very different from the experience in Peru. Even so, we want to emphasize that the political mobilization strategy had strongly similar elements and that, overall, there are remarkable similarities between the Allende experience and that of Alan Garcia's Peru.

The similarities in approach in Chile and Peru are particularly striking with respect to the way policymakers viewed the objective conditions of their economy, how they proposed that strongly expansionary policies should and could be carried out, and how they rationalized that constraints could be dealt with. Most impressive is the fact that in the end, foreign exchange constraints and extreme inflation forced a program of violent real wage cuts that ended in massive political instability, violence, and in the case of Chile even in a coup. We do not doubt the sincerity of the policymakers who embark on these programs, and we share their conviction that income distribution is unacceptably unequal. The very sincerity of these policymakers convinces us of the usefulness, and indeed the necessity of laying out exactly how and why the programs do go wrong.

External influences (debt crises and economic blockades, among others), domestic structural policies (socialization of firms, banks nationalization), and inconsistent fiscal and exchange rate policies bring about an unsustainable situation; inflation goes out of control, and the foreign exchange constraints force realism on policymakers. Accounts of these experiences often emphasize politics and, especially, external factors as central to the demise. External destabilization can be an important part of the unravelling of an economic program. But we emphasize the extreme vulnerability that makes destabilization possible. By and large this potential results from unsustainable economic policies. We think that only to the extent that the mechanics of the macroeconomics of populist programs are fully understood, will these policies cease to be popular among politicians.

Before embarking on the case studies we emphasize that we do not cover the political issues which surely are equally if not more important in the historical developments in the two countries. We omit politics not because we think they are irrelevant, but because we want to highlight to the clearest extent possible the economic developments. The view we present is therefore possibly biased because it omits the political motivation, on occasions, for economic motives.

2. The populist paradigm

Populism has traditionally been a fuzzy concept. Political scientists have struggled to provide a meaningful and precise definition. Drake (1982), for example, emphasizes three elements of a tentative definition: populism uses 'political mobilization, recurrent rhetoric and symbols designed to inspire the people', it draws on a heterogeneous coalition aimed primarily at the working class, but including and led by significant sectors from the middle and upper strata and, third, populism 'has connoted a reformist set of policies tailored to promote development without explosive class conflict'. He notes [Drake (1982, p. 218)]: '[The programs] normally respond to the problems of underdevelopment by expanding state activism to incorporate the workers in a process of accelerated industrialization through ameliorative redistributive measures'.

Conniff (1982, p. 5) has argued that 'populist programs frequently overlapped with those of socialism'. We emphasize that the redistributive objectives are a central part of the paradigm. Whether they are motivated by a strategy of massive social reform is consequential, but is not central to our own discussion.

Populist economic programs exhibit strong similarities. In this section, we set out in paradigmatic fashion what we see as the critical common factors. In later sections we analyze these for the experiences of Chile and Peru.[2] The intellectual identification of issues is summarized under the following headings:

Initial conditions. Dissatisfaction with the country's growth performance. Most typically, though not always, the country has experienced moderate growth, stagnation or outright depression as a result of previous stabilization attempts. The experience, often – though not necessarily – under an IMF program, has reduced living standards. Serious economic inequality provides economic and political appeal for a radically different economic program. Preceding stabilizations have improved the budget and the external balance sufficiently to provide the room for, though perhaps not the wisdom of, an expansionary program.

No constraints. Policymakers explicitly reject the conservative paradigm. In their view idle productive capacity provides the leeway for expansion. International reserves and the ability to ration foreign exchange give room for expansion without the risk of running into external constraints. The risks of deficit finance are portrayed as exaggerated or altogether unfounded. It is argued that expansion is not inflationary (if there is no devaluation), because spare capacity and decreasing long-run costs contain cost pressures; in any event there is room to squeeze profit margins by price controls.

The policy prescription. Populist programs emphasize three elements: reactivation, redistribution of income and restructuring of the economy. The common thread here is 'reactivation with redistribution'. The recommended

[2]In a larger project we expect to look at a significant number of experiences in Latin America to get a sharper picture of the phases and ultimate breakdown of programs.

policy is to redistribute income, typically by large real wage increases that are not to be passed on into higher prices. Inflation notwithstanding, devaluation is rejected because of the inflationary impact and because it reduces living standards. The economy is to be restructured to save on foreign exchange and support higher levels of real wages and higher growth.

In populist experiments events tend to evolve in four phases or stages:

Phase I. In the first year or so, the policymakers are fully vindicated in their diagnosis and prescription: growth of output, real wages and employment are high, and the *macro*economic policies are nothing short of successful. Controls assure that inflation is not a problem, and shortages are alleviated by imports. The run-down of inventories and the availability of imports (financed by reserve decumulation or suspension of external payments) accommodate the demand expansion with little impact on inflation.

Phase II. Bottlenecks, partly as a result of a strong expansion in demand for domestic goods, and partly because of reactions to the scarcity of foreign exchange, start to appear. Whereas inventory decumulation was an essential feature of the first phase, the low levels of inventories and inventory building are now a source of problems. Price realignments and devaluation, exchange controls, or increased protection become necessary. The government tries to stabilize, but fails to put a check on wage increases and on the growth of government expenditure. Inflation increases significantly, but wages keep up. A massive underground economy emerges. The budget deficit worsens tremendously as a result of pervasive subsidies on wage goods and foreign exchange.

Phase III. Pervasive shortages, extreme acceleration of inflation, and an obvious foreign exchange gap lead to capital flight and demonetization of the economy. The budget deficit deteriorates violently because of a steep decline in tax collection and increasing subsidy costs. The government attempts to stabilize by cutting subsidies and by undertaking a real depreciation. Real wages fall massively, and politics become unstable. It becomes clear that the populist policies have failed.

Phase IV. Orthodox stabilization takes over under a new government. An IMF program will be enacted; and, when everything is said and done, the real wage will have declined abruptly, to a level significantly lower than when the whole episode began! Moreover, that decline will be very persistent, because the politics and economics of the experience will have depressed investment, decapitalized the manufacturing sector, and promoted capital flight. The severity of real wage declines is due to a simple fact: capital is mobile across borders, but labor is not. Capital can flee from poor policies, labor is trapped.

After briefly analyzing the propagation mechanisms of high inflation in populist-type experiences, we turn to the episodes of Peru and Chile to sketch the policymakers' diagnosis and the actual events. We start with the Chilean case, because the facts of the entire experience can now be seen. The results suggest what to look for in the Peruvian experience.

3. The mechanisms of high inflation under populist macroeconomics

In this section we briefly review the relationship between key macroeconomic variables and sketch the propagation mechanisms of high inflation in populist experiments. The emphasis is put on the relationship between real wages, the real exchange rate, real interest rate, the fiscal budget and inflation. We show that policies based on wage increases and deficit expansions face severe tradeoffs. While higher wages will be achieved, inflation will erupt, competitiveness will be eroded and an external crisis will take place. We show in this section that in the short run, while international reserves last, the more severe aspects of this tradeoff can be kept under control.

The starting point is the relation between real wages, w, the real exchange rate, R, and employment. Consider a world where there are exportables, importables and nontraded goods. The consumer price index is

$$P = P_x^x P_m^m P_n^n, \tag{1}$$

where the superindexes x and m are the share of exportables and importables in consumption. The home goods share thus is $n = 1 - x - m$. Home goods are produced using labor and importables:

$$P_n = aWZS, \tag{2}$$

where a is the per-unit requirements of labor and imports, W is the nominal wage, Z represents the profit markup and S the subsidy [i.e., $S = 1/(1+s)$ with s the percentage subsidy rate]. As discussed later, the subsidy may either take the form of direct cash transfers or of negative interest rates on credit.

Exports prices are given in the world market so that the domestic price of exportables is equal to the world price P^* times the exports exchange rate e:

$$P_x = P^*e. \tag{3}$$

On the imports side prices are determined by the given world price, P^*, the imports exchange rate and the tariff, T:

$$P_m = \alpha\beta P^* eT, \tag{4}$$

where α denotes the terms of trade and β, if it differs from unity, measures the differentiation of the exchange rate structure between imports and exports. Define the real exchange rate, R, as the ratio of wages to traded goods prices on a weighted basis for export and import competing industries:

$$R = (W/P_x)^{1-\sigma}(W/P_m)^{\sigma} = (W/eP^*)K^{-\sigma}, \quad K = \alpha\beta T. \tag{5}$$

Eq. (5) indicates, then, that the real exchange rate is given by the nominal wage rate measured in terms of exportables with an adjustment for the terms of trade and for exchange rate or tariff protection.

The real consumption wage, w, is given by the ratio of money wage to the consumer price index:

$$w = W/P = \theta(R, K, ZS). \tag{6}$$

Eq. (6), substituting from (1) to (5) in W/P, highlights that real wages and competitiveness are negatively related. Subsidies or reductions in profit margins play a special role since they increase real wages without a deterioration in competitiveness. Protection increases competitiveness, but it reduces real wages.

On the other hand, assume that employment, L, is demand determined by profitability in the traded goods sector and by the derived demand for labor in the home goods sector. A fraction κ of labor income is spent on home goods, and G represents government spending on home goods. In addition there is credit expansion Q which is made available to state enterprises or the private sector for spending on home goods. We then have

$$L^d = \rho(R) + \gamma\kappa(WL + P_n G + Q)/P_n, \quad \rho' > 0 \tag{7}$$

or

$$L = \rho(R)/(1 - \kappa/ZS) = L(R, ZS, G, K/W). \tag{7'}$$

According to (7′) employment is positively affected by subsidies or by a squeeze of profit margins because these raise real wages and hence demand for nontraded goods. Moreover, according to this equation, an increase in government spending and a gain in competitiveness (i.e., a decline in R) will raise the level of employment.

We further assume that there are various sources of *acceleration* of the rate of inflation:

$$\Delta\pi = \cap(L^d - L) + \lambda(w' - w) + \delta\Delta R/R - \phi\Delta S/S. \tag{8}$$

It is implicit in this formulation the presence of automatic indexation and hence inertia. According to eq. (8) inflation stays constant unless one of three shocks occur:

- corrective inflation from real depreciation or subsidy removal,
- demand inflation associated with an excess of labor demand over the level of full employment,
- social conflict shocks which arise when the target real wage, w', exceeds actual real wages.

The model is closed by the financing equations: the external balance and the budget. The external deficit depends on competitiveness and the interest differential between domestic and foreign assets adjusted for the anticipated depreciation of the exchange rate, v:

$$b = B(R, v); \qquad b_1 > 0, \quad b_2 > 0. \tag{9}$$

The budget deficit, on the other hand, is assumed to depend on subsidies, on foreign exchange losses and tariff revenues, and, via tax collection, on the level of activity and hence on competitiveness:

$$d = D(S, \beta T, R). \tag{10a}$$

The deficit, in turn, is financed by reserves decumulation and by money creation. Money creation depends on the budget (b), the external balance (d) and credit expansion (q) each measured relative to nominal income:

$$\dot{M} = (d + b - q)PY. \tag{10b}$$

To derive actual time paths of alternative policies and their impact on the path of employment, real wages and inflation the model would have to be simulated. For our purposes, however, it is already instructive in that it highlights the basic tradeoffs that are faced by a policymaker who seeks to expand the level of economic activity (i.e., reducing unemployment) via wage rate and expansionary fiscal policies. The model in fact shows that real wages can be raised either by a real appreciation (i.e., real exchange rate overvaluation) or by subsidies. But real appreciation interferes with the external constraint and subsidies are inflationary. Employment can be expanded by subsidies or by real depreciation. The former is inflationary and the latter hurts real wages. The room for policies that raise real wages *and* employment is therefore severely limited. While there is foreign exchange available the tradeoffs are not apparent, but once reserves run out the tradeoffs will suddenly, and cruelly, appear: inflation will then rapidly accelerate.

The acceleration of inflation, once it takes place, is magnified by adjustments in the financial sector.[3] Velocity rises in response to increased inflation and that implies a decline in the base for the inflation tax. But with a decline in real balances, even higher inflation rates are required to finance a given budget deficit. The increasing inflation, in turn, interferes with the efficiency of revenue collection, leading to a widening of the deficit. Once inflation becomes very high the relation between inflation and the budget becomes dominant. Moreover, because of the sharp rise in velocity the deficits that can be financed at a given inflation fall radically. At this point a vicious circle takes over, and the only way out is by implementing a severe stabilization program that cuts the deficit, generates a major real depreciation and reduces real wages. As will become apparent from our analysis of the Chilean and Peruvian cases in sections 4 and 5, this model captures some of the most important aspects of the mechanics of macroeconomic crises under populist regimes.

4. Economic policies in Allende's Chile

In September of 1970, Salvador Allende, the socialist candidate of the Unidad Popular (UP), was elected President of Chile. A unique political and economic experience evolved in the following three years.[4] The Unidad Popular was a political coalition of left and center-left parties dominated by the Socialist and Communist parties which sought to implement deep institutional, political and economic reforms. Its program called for a democratic 'Chilean road to socialism'.[5] Both communists and socialists initially recognized the multiclass nature of the Unidad Popular and considered the alliance and the politics that sustained it to be a tactical intermediate step that would help set the basis for the transition to socialism [see the discussion in Zammit (1973)]. Vuskovic (1973, p. 50) noted:

> . . . economic policy is subordinate, in its content, shape and form, to the political need for increasing the Popular Unity's support . . . The urgent need to achieve rapid recovery of the economy, and to extend the benefits to the mass of the working population, cannot be undertaken in isolation from the structural changes; they are all necessarily inter-

[3] See Dornbusch and de Pablo (1988) on the inflation dynamics.
[4] See Oppenheim (1989) for a recent review of the literature on this experience.
[5] See Stallings (1978) and de Vlyder (1974) for a discussion of politics and economics in Chile.

dependent. It is not possible to make deeper changes without broadening the Government's political support, and economic reactivation and income redistribution will provide an impulse to these fundamental changes.

4.1. Initial conditions, diagnosis and short-run program

The Unidad Popular faced a somewhat stagnated economy with a rapidly increasing rate of inflation. Between 1967 and 1970, Chile's real GDP per capita grew only at 1.2% – significantly below the Latin American average. Inflation had steadily increased during the last few years of the Frei administration, reaching 35% in 1970. On the positive side, the balance of payments showed substantial surpluses during all but one of the Frei years and the central bank had a significant stock of international reserves of approximately U.S. $400 million or half a year of imports.

The short-run economic objectives of the UP included:

- initiating, at a rapid speed, a whole range of structural economic transformations, including a massive nationalization program;
- raising real wages, especially for the lower classes;
- reducing inflation;
- increasing the rate of output growth;
- increasing consumption, especially among the poorer groups; and
- reducing the economy's dependence on the rest of the world.

The nationalization program was to be achieved by a combination of new legislation, requisitions, and stock purchases from small shareholders. The other goals – output and consumption growth, with rising salaries and declining inflation – were to be accomplished by an increase in aggregate demand, mainly generated by higher government expenditures, accompanied by income redistribution measures and severe administrative controls over prices.

This macroeconomic program, in the structuralist tradition, was based on a number of key assumptions. First, it was believed that there was ample excess capacity in the manufacturing sector. Second, it was thought that this low rate of capacity utilization was closely related to the existing pattern of consumption and income distribution. Third, it was assumed that there was a dualistic manufacturing sector, where firms producing 'luxury' goods had excessively high capital/labor ratios. Fourth, inflation was considered to be a reflection of the economic structure, not of financial or monetary pressures. In what follows, we will analyze these key assumptions in some detail.

Significant excess capacity in the manufacturing sector was at the center of the macroeconomic program and provided the intellectual base for the belief that large fiscal deficits would not necessarily be inflationary. Americo Zorrilla, Allende's first Minister of Finance said:

> The subutilization of installed capacity is another feature of the current economic situation . . . In 1969 it was possible to increase production, due to subutilization, by more than 30 percent . . . [A]ccording to recent studies . . . unutilized capacity has reached, in the last few years, 61 percent in the cloth industry, 50 percent in the baking industry . . . 74 percent in the shoe industry, etc. [As reproduced in Garcia (1972, p. 72).]

An important corollary of the unutilized capacity hypothesis was that firms in many sectors faced decreasing average costs so that, under proper administrative price controls, demand increases would not generate inflationary pressures. Moreover, to the extent that many of the larger firms were indeed nationalized, as called for by the UP program, it was thought that output could be greatly increased even with price reductions. In a document prepared by the Planning Office (ODEPLAN) in 1971, it was stated that by 'combining the increase in production derived from a higher use of installed capacity . . . the former monopolies will be able to absorb, without problems, the required wage increases, while maintaining, *or even reducing*, prices and still generating the same surplus'.

The lack of 'full' utilization was, in turn, attributed to two fundamental factors: The monopolistic nature of the manufacturing industry and the structure of income distribution [Vuskovic (1970)]. Based on this diagnosis, it was thought that if income was redistributed towards the poorer groups through wage increases and prices were properly controlled, there would be a significant expansion of demand and output.

Regarding inflation, the UP program emphasized rigidities, bottlenecks, and the role of monopolistic pricing and played down the role of fiscal pressures and money creation.[6] Very little attention was given to the financial sector. In fact, in his memoirs, the former Allende Minister and Vice President Clodomiro Almeyda relates how, in the first meeting of the economic team after the elections, the CEPAL-oriented technocrats expressly, and convincingly it would seem, argued that monetary and financial management did not deserve too much attention.[7] Alfonso Inostroza, the President of the Central Bank, stated in early 1971 that the main objective of the monetary policy was to 'transform it into a key instrument . . . to achieve the complete mobilization of productive resources, and their allocation to

[6]Of course, this was consistent with the structuralist view on inflation. See Sunkel (1960) and Baer and Kersternetzky (1964).

[7]See, for example, the 1971 CIAP Report reproduced in *Panorama Economico*, no. 260, Feb.-Mar. 1971, p. 36.

those areas that the government gives priority to . . .' [see Inostroza (1971, p. 8)].

As to Chile's external vulnerability, the UP basic program stated that, along with a reduction in import dependence, a priority of the new government would be to 'execute a foreign trade policy tending to expand and diversify our exports . . .' [Unidad Popular (1969, p. 24)]. This objective was to be achieved without providing any price incentives. Quite the contrary, the UP economists thought that changes in the exchange rate had very little, if any, effects on exports or imports. In fact, it was stated that an important goal of the policy was to 'avoid the scandalous devaluations of [the] . . . currency' (p. 24). Indeed, one of the first measures undertaken by the Allende administration was to eliminate the system of crawling peg that had been adopted, with great success, by the Frei administration.

The UP view of the way the economy functioned ignored many of the key principles of traditional economic theory. This was reflected not only in the greatly diminished attention given to monetary policies, but also by the complete disregard for the real exchange rate as a key variable in determining macroeconomic equilibrium. Moreover, the Unidad Popular failed to recognize that their policies would be unsustainable in the medium term and that capacity constraints were going to become an unsurmountable obstacle to rapid growth. Also, the UP technocrats greatly underestimated the role of expectations and the capacity of the public to react to severe inflationary pressures. Bitar (1986, ch. 5) portrays very clearly the government's inability to control events, and to shift the emphasis from redistribution to accumulation.

> It turned out to be very difficult to contain the forces unleashed in 1971. The sequential conception of redistribution followed by accumulation assumed that basic political and social conduct could be altered and popular expectations changed virtually instantaneously. In the next few months [early 1972] it proved impossible to apply this thinking with the facility that had been hoped for.

4.2. *Phase I: Rapid growth with repressed inflation*

Armed with the intellectual framework analyzed above, the UP rapidly began to implement its program in late 1970. In terms of structural reforms, two basic measures were immediately undertaken: First, the Agrarian Reform was greatly intensified with a very large number of farms being expropriated.[8] Second, a project for a Constitutional Amendment aimed at

[8]The agrarian reform law passed by Congress during the Frei administration provided the necessary tool. See Alaluf et al. (1972).

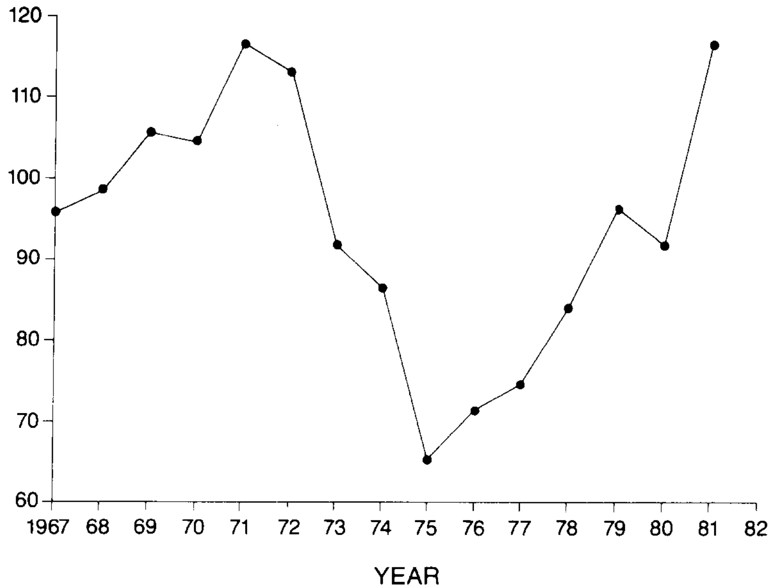

Fig. 1. Chile: The real wage (index 1967–69 = 100).

nationalizing the large copper mines – until then jointly owned by large U.S. firms and the Chilean state – was studied.[9]

In terms of macroeconomic policy, the government rapidly applied measures that were consistent with its program. Government expenditures greatly expanded and in 1971 real salaries and wages in the public sector increased by 48%, on average. Salaries in the private sector grew at approximately the same rate. Fig. 1 shows the gain in real wages during this year. The short-run package was topped by a generalized scheme of price controls.

In the first two quarters of 1971, manufacturing output increased 6.2% and 10.6% compared to the same periods in the previous year. Manufacturing sales grew at even faster rates: 12% during the first quarter and 11% during the second quarter. Overall, the behavior of the economy in 1971 seemed to vindicate the UP economists: real GDP grew at 7.7%, average *real* wages

[9]On June 11, 1971, Congress unanimously approved the constitutional reform that nationalized large copper mines. See Geller and Estevez (1972), and Ffrench-Davis and Tironi (1974). The reforms of the banking system and large manufacturing firms were somewhat more difficult, because the government lacked the institutional channels for implementing the nationalization program. Initially, this obstacle was overcome by purchasing blocks of shares – especially bank shares – at very high prices. These acquisitions were complemented by a process of requisition based on an old, and until then forgotten, decree law promulgated during the short-lived Socialist Republic of 1932.

increased by 17%, aggregate consumption grew at a real rate of 13.2%, and the rate of unemployment dipped below 4%. Not too surprisingly, given the behavior of real wages, there was a significant improvement in income distribution. In 1971 the labor's share of GDP reached 61.7%, almost 10 points higher than its 1970 level of 52.3%; and this happened without an acceleration of inflation. What was even more important for the UP was that the policies rapidly paid off politically. In the municipal elections of 1971, the UP parties saw their share of the vote climb from the 36% they had received in the 1970 presidential election to around 50%.[10]

All of this created a sense of euphoria in the government. The fact that the fiscal deficit had jumped from less than 3% of GDP in 1970 to almost 11% in 1971 did not worry the UP technocrats. Nor did they think much on the fact that the rate of growth of the money supply had surpassed 100% in annual terms in the fourth quarter of 1971, and that the rate of growth of domestic credit to the public sector was approaching 300%. All of this, in fact, was part of the plan [see Lopez (1972)].

Of course, these macro policies were rapidly generating a situation of repressed inflation. The high growth rate of GDP in 1971 rested heavily on an almost 40% increase in the imports of intermediate goods. As a result, the stock of international reserves inherited by the Allende government was reduced by more than one-half in that year alone. A steep reduction of inventories was another important factor contributing to the expansion of consumption. By the end of 1971, the mounting inflationary pressures became evident (see table 1). The supply problem was aggravated by a series of labor disputes in many large establishments that resulted in the takeover of those firms by their workers. In fact, this procedure became the institutionalized way in which the government seized a large number of firms.[11]

4.3. Phase II: Inflation, bottlenecks and failed stabilization programs

During 1972, the macroeconomic problems continued to mount. Table 1 shows that inflation reached 217% and the fiscal deficit surpassed 13% of GDP. Domestic credit to the public sector grew at almost 300%, and international reserves dipped below $77 million. Consumption growth dominated the expansion in demand (see table 2).

The underground economy grew as more and more activities moved out of the official economy, and as a result more and more sources of tax revenues

[10] The strong showing in early municipal or Congressional elections was not uncommon in Chile. In fact, the Frei government had a similar experience in 1965.

[11] See Dornbusch and Edwards (1989) for a more detailed discussion of the nationalization process. See, also, Alaluf et al. (1972).

Table 1

Chile: Main macroeconomic indicators.

	1970	1971	1972	1973
Inflation[a]	34.9	34.5	216.7	605.9
Growth	2.1	9.0	−1.2	−5.6
Real wages (1970: 3 = 100)	98.4	115.1	103.5	70.3
Government revenue[b]	23.7	20.4	18.2	20.2
Government spending[b]	26.4	31.1	31.2	44.9
Budget deficit[b]	2.7	10.7	13.0	24.7
Money growth[a]	52.9	99.3	100.9	264.4
International reserves ($ million)	320	129	95	36
Trade balance ($ million)	246	73	−161	−73
Black market premium (%)	99	358	898	2349

[a]Percent, Dec.–Dec.
[b]Percent GDP.

Sources: Banco Central de Chile; International Monetary Fund; Edwards (1986); Edwards and Cox-Edwards (1987); Solimano (1988).

Table 2

Chile: The growth rate of real GDP and demand (percent per year).

	1970	1971	1972	1973
GDP	2.1	9.0	−1.2	−6.6
Consumption				
Private	−0.5	13.2	7.7	−6.6
Government	5.9	12.4	5.7	1.7
Investment	6.5	−2.0	−20.1	−6.0
Exports	2.1	0.8	−15.1	2.8
Imports	0.9	8.5	3.2	−5.4

Source: Banco Central de Chile, *Indicadores Economicos y Sociales 1960–1985*.

disappeared. A vicious cycle took over; repressed inflation encouraged the informal economy, resulting in reduced taxes, higher deficits, and, thus, in even higher inflation. In 1972, two stabilization programs were implemented, and boith failed.

When evaluating the difficulties, the dominant view among UP economists was that the authorities had failed to impose appropriate controls in implementing the macroeconomic program [Garcia (1972)]. This view guided the first, rather weak, attempt at stabilizing the economy which was launched in February of 1972. No serious measures aimed at correcting the major macroeconomic causes of these problems were undertaken. It simply was not convenient to reduce government expenditures, the policy of granting salary

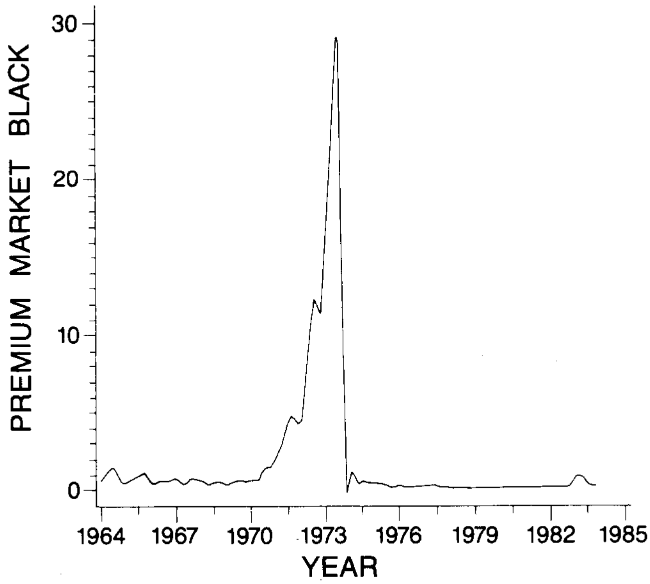

Fig. 2. Chile: The black market for dollars.

increases that exceeded inflation was maintained, and a significant devaluation was ruled out.[12]

The most serious problem was the loss of control over wages. Unions in both nationalized and private firms demanded increasingly higher wage adjustments. The government faced a dilemma. If it refused to grant the wage adjustments, it would help the macroeconomy, but would hurt its political objectives. Under these circumstances, the government chose, every time, to uphold its revolutionary label.[13]

By mid-1972, it became apparent that the February stabilization program was a failure. The underground economy was now generalized, output began to fall, open inflation reached an annual rate of 70% in the second quarter, foreign exchange reserves were only $82 million, and the black market rate was climbing at a very fast pace (see fig. 2). From a political perspective, parliamentary elections scheduled for March of 1973 made the situation particularly difficult. An economic crisis would work against the UP in those elections. In August of that year, and under the political monitoring of the Communists, a new stabilization program was launched.

Unlike the previous plan, the cornerstone of the August program was a massive devaluation of the escudo. It was expected that, as a result, the ever-

[12]In 1971 a small devaluation was followed by the creation of four different exchange rates.

[13]Moreover, a number of economists argued that higher real wages could be sustained as long as the government was able, via increased controls, to extract additional 'surplus' from the private sector. See Bitar (1979).

mounting pressures on the balance of payments would subside. The program also called for two basic measures to contain the fiscal pressures. First, price increases for the nationalized firms were authorized so as to reduce the financing requirements of the newly formed nationalized sector. Second, the program called for a massive increase in production as the major way to close the gap between aggregate supply and aggregate demand. This increase in output was expected to be a response to *political* rather than economic incentives. In fact, at that time, the Communist Party's main slogan became 'Let's win the battle for increased production!'. The devaluation and a large number of price increases resulted in a monthly rate of inflation of 22.7% in August and 22.2% in September.

In spite of the action taken on the exchange rate front, the program failed as no change in the wage rates policy was introduced. In the second week of August, the government announced that it had reached an agreement with the national federation of workers (Central Unica de Trabajadores, CUT) with respect to an across-the-board wage adjustment to be granted on October 1st, except for firms subject to private bargaining. The new wage policy called for an increase in public and private sector wages by a proportion equal to the accumulated rate of inflation between January and September. In addition, the new policy called for more frequent wage adjustments (*Que Pasa*, no. 70, Aug. 17, 1972, p. 14). In this way, by a stroke of the pen, the effects of the devaluation were fully offset.

4.4. Phase III: Acceleration of inflation and chaos

During the first quarter of 1973 Chile's economic problems reached chaotic proportions. Compared to the first quarter of 1972, inflation reached an annual rate of more than 120%; industrial output declined by almost 6%; the real exchange rate was even more overvalued, and foreign exchange held by the Central Bank was barely above $40 million. The black market by then covered an ever widening range of transactions in foreign exchange. The fiscal deficit continued to climb as a result of ever higher expenditures and of rapidly disappearing sources of taxation. In that year, the fiscal deficit exceeded 23% of GDP.

Once more the policymakers faced the options of implementing a major corrective stabilization program or of furthering the extent of controls. And once again they opted, in March of 1973, for the latter. The extent of the economic crisis quickly alienated the middle classes, and the political confrontation with the opposition became increasingly severe.[14]

[14]Of course, it must be remembered that, in the midst of this polarization, the support commanded by Allende actually grew: whereas in 1970 the UP received the votes of 30% of the electorate, in the municipal elections of 1971 it reached 50% and even in 1973 its share still stood at 44%.

In concluding, we must comment on the role of domestic economic opposition and the foreign economic blockade. The strategic use of economic disruption by the opposition, foreign enterprises and foreign governments indeed played a role in the ultimate unravelling of the Allende policies. A more neutral external environment probably would have allowed the Allende experiment to continue for some time. But the uncontrolled side effects of the consumption growth policy (shortages, inflation and related effects) sufficiently weakened the ability to govern.[15] As a result, destabilization by domestic opposition forces and foreign companies and governments could be effective. We advance this view as a hypothesis.

On the 11th of September 1973, the Allende presidency came to a sudden and shocking end. When the military took over, the country was politically divided and the economy was in shambles. Inflation was galloping, relative price distortions – stemming mainly from massive price controls – were generalized; black market activities were rampant; real wages had dropped drastically; the economic prospects of the middle class had been greatly damaged; the external sector was facing a serious crisis; production and investment were falling steeply; and the government finances were completely out of hand. This was the beginning of Phase IV, a stage where frightful real wage cutting (see fig. 1 above) took over.

5. Growth with redistribution in Garcia's Peru

When Alan Garcia assumed the Peruvian Presidency in August 1985, he captured the world's imagination: a dynamic, charismatic leader taking charge of a country desperately in need of social and economic progress. The fact that he adopted a confrontational attitude on external debt did not hurt his image, either in Latin America or in progressive circles in Europe and the United States. On the domestic front, he had an unambiguous message: growth and redistribution. That policy lasted two years before running aground in a catastrophic manner.

In early 1988, Alan Garcia's populist government staged a dramatic turnaround on the policies that had driven the country to bankruptcy: budget cutting, real wage cutting and massive exchange depreciation were the predictable aftermath of three years of reckless mismanagement. But that was not the end of the story, hyperinflation was to follow and the political consequences of economic destruction and pauperization are still to come. Real wage cutting and yet worse poverty, in the Peruvian context, may well

[15] Rosenstein-Rodan [in Orrego Vicuna (1975, pp. 219–220)] notes of the Allende policies, oriented toward consumption: 'This part of Allende's policies was more Populism than Socialism. Even Fidel Castro is supposed to have observed 'Marxist socialism is a revolution of production – this is a revolution of consumption'.

Table 3

Peru: Growth and inflation (percent per year).

	1950–60	1960–70	1970–75	1975–80	1980–85
Growth per capita	2.8	2.6	1.6	−1.0	−4.2
Inflation	8.0	9.3	12.6	50.0	102.1

Source: Kuczynski (1977), Central Bank and Ministry of Finance.

be the opening phase for massive and perhaps violent confrontations.[16] In the rest of this section we analyze in some detail the recent experience with populist policies in Peru. The analysis shows a remarkable similarity between this case and the Chilean episode.

5.1. From Belaunde to Garcia

In the 1950s and 1960s Peru experienced significant growth of real per capita income and moderate rates of inflation.[17] Table 3 shows that the problems of declining per capita income and high inflation date from the second half of the 1970s.

In the past 25 years, three major stop-go phases can be discerned. The first was the Belaunde expansion which crashed in 1967–68. The second phase ran until 1974. During this period the extremely favorable world environment permitted a massive expansion until 1974, with an average growth rate of per capita income of 3.7% per year in the 1969–74 period (see fig. 3).

The second Belaunde administration (1980–85) had to cope with extraordinarily adverse conditions. Belaunde inherited an economy with deep social problems: Per capita income had declined since 1974 and, the external balance improvement of the late 1970s notwithstanding, the interventionism of the military government had created pervasive distortions. The possibility of advancing the economy was drastically limited as a result of a combination of shocks: the world recession of 1980–82, terms of trade deterioration, the explosion in world interest rates and the resulting rise in debt service obligations, external credit rationing, and natural disasters. These shocks combined to choke off any room for expansion. In 1982–83, under an IMF program, real GDP per capita declined by 16% and inflation nearly doubled to 112%.

[16]More so than in any other country of Latin America, economic performance is central to maintaining the very precarious social peace in Peru. At issue is not only the possible confrontation between left and right. Far more dangerous is the widening conflict opened by the Maoist *Shining Path* guerrilla. The outcome is wide open because of the divisions between rich and poor, the city and the sierras, white and indios.

[17]See Thorp (1987), Thorp and Bertram (1978), and Kuczynski (1977) for history and extensive references.

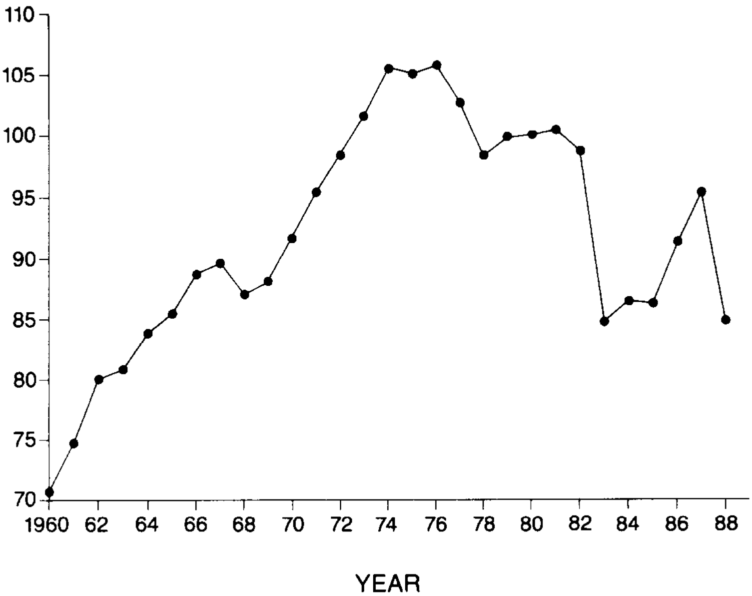

Fig. 3. Peru's real per capita income (index 1980 = 100).

This disastrous economic performance of the Belaunde government led to a total rout in the elections and thus brought Alan Garcia into power in 1985 with 45.8% of the votes.[18] The election which swept Garcia into office in a landslide victory carried one clear message: growth first! [see Ortiz de Zevallos (1989)]. This message, regardless of its feasibility, conditioned the economic policies of the Garcia Administration from the very beginning and is now taking the country to the brink.

5.2. Diagnosis and policies: The heterodox program

In July 1985, the last month of the Belaunde administration, inflation reached 250% at an annual rate. Unemployment was pervasive, idle capacity abounded, and real wages had been reduced in an effort to cope with the external crisis. Against this background, Garcia's government developed a populist project of expansion, entitled 'Growth with Redistribution', which emphasized economic recovery combined with disinflation.

Premises and policies. Three points are central to an understanding of why economic policy took the form it did. The first is the impressively unequal distribution of income. Fig. 4 shows the income distribution in Peru with a

[18]See Wise (1988) and Ortiz de Zevallos (1989) for a review of politics.

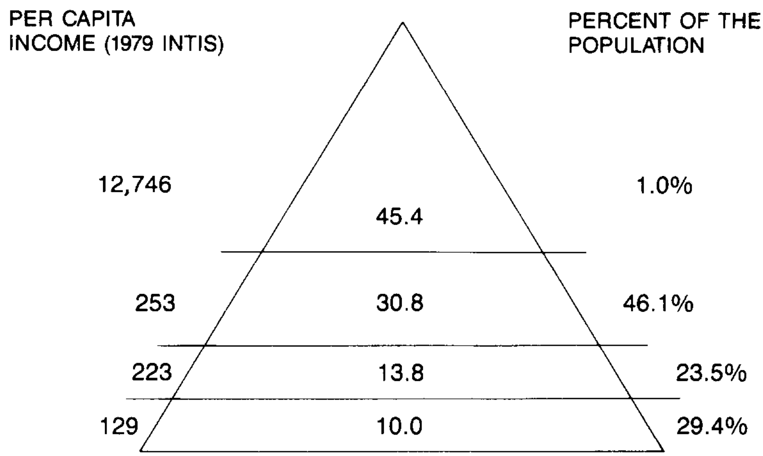

Fig. 4. Peruvian income distribution.

diagram widely used by the authorities. The striking fact is that 1% of the population receives nearly half the national income [see Glewwe (1988)].

The second is that policymakers were impressed with the large gap between actual and perceived potential output. In Carbonetto et al. (1987, p. 41), it is estimated that actual output was only 66% of potential output in 1984, leaving a 34% gap to be made up by the judicious choice of policy.

The third consideration is that Peruvian economists, in company with economists throughout Latin America, were unimpressed with the effectiveness of IMF programs. It should be remembered that at this time Israel and Argentina made their heterodox stabilization efforts, as did Brazil shortly afterwards. The orthodox approach to stabilization had been discredited by the strong recessionary effects and the absence of any success stories. The alternative, heterodoxy, had all the appeal of offering an end to inflation without the attendant costs of unemployment.[19]

Against this background, the general theme of economic policy was summarized in the *Plan Nacional de Desarrollo 1986–90* (p. 63) from which we quote extensively.

> The new economic policy seeks to pass from an economy of conflict and speculation to one of production and consensus. In this economy it is

[19]See Dornbusch (1982, 1988a), Bresser Pereira and Nakano (1987), and Bruno et al. (1988).

possible to make compatible stability, growth, distribution and development in a context of national planning which finds concrete expression in dialogue and social and economic concertation.

Planning of economic development will be full, decentralized and participatory and concertation will center on the effort to make compatible the generation of savings and productive investment with attention paid to the undelayable priority of attending to social needs. We need to reconcile economic efficiency with social equity in a productive dynamics which is fundamentally sustained by domestic resources.

Specific premises and prescriptions in the national development strategy can be paraphrased as follows [Plan Nacional de Desarrollo 1986–90 (pp. 63–65)]:

- The necessity to redistribute income as a means for sustained growth and the possibility to bring together with the redistribution process the necessary capacity to save and invest.
- Salaries and profitability: The generalized and open-ended restraint on wages reduces profitability because it reduces workers' purchasing power, bringing about recessive effects that reduce demand and thus the benefits of a dynamic economy.
- The fiscal deficit: The fiscal deficit is not necessarily inflationary. It only is so if domestic demand exceeds potential output. With substantial idle capacity there is a need for a certain deficit.
- Money creation: Must increase demand, thus allowing an increase in real liquidity since the opposite would slow growth.
- Interest rates: Increased real interest rates do not raise savings, since the latter depend fundamentally on income, but they discourage productive investment.

The specific targets of the economic program are set out in table 4. The new economic policy was based on four measures [Carbonetto et al. (1987, p. 15)] which in many ways resemble the Allende policies which we discussed above:

- Rapid expansion of effective demand via real wage increases.
- Financial de-strangulation to give firms relief and contain cost pressures by reducing financial costs of enterprises, effective interest rates, indirect taxes and other elements of costs.
- Reestablishment of selective exchange rates and abandonment of the devaluation policy.
- The external accounts were to be kept in balance by the growth in exports, import substitution and limitations on debt service to be compatible with acceptable growth. Of course, many of the foreign exchange and growth

Table 4

The 1986–90 Peruvian economic development plan.

	1985	1986	1987	1988	1989	1990
Growth						
GDP	1.4	6.5	6.2	6.1	6.3	6.2
Consumption	0.1	8.5	6.3	5.7	5.0	5.2
Exports	3.5	−13.6	4.8	5.8	5.9	5.9
Imports	−24.6	5.0	13.7	11.9	5.6	7.4
Investment	−12.3	12.0	14.4	11.8	11.6	10.7
Budget deficit[a]	0.6	2.3	2.3	2.1	1.8	1.6

[a]Percent of GDP.

Source: Presidencia de la Republica (1986).

Table 5

Peruvian macroeconomic indicators.

	1985	1986	1987	1988
Inflation[a]	158	63	115	1722
Growth	2.5	9.5	6.9	−8.4
Real wage[b]	111	126	137	105
Trade balance ($)	1173	−67	−463	−84
Government revenues[c]	42.7	32.1	25.9	23.5

[a]December–December.
[b]Index July, 1985 = 100.
[c]Percent of GDP.

Source: World Bank, Ministry of Finance, National Institute of Planning.

policies on which any success of the plan might have depended never saw the light of day. This is particularly the case for foreign exchange savings strategies.

5.3. Phase I: The first two years

The immediate priority for the Garcia administration was to introduce a 'heterodox' program of stabilization: inflation reduction via an incomes policy combined with a massive reactivation of the economy.

In the short term, the heterodox program was immensely successful. Inflation declined sharply (as shown in table 5), employment increased, and the real wage was pushed up substantially (as shown in fig. 5). In the last quarter of 1987, the real wage stood 52% above the level of 1985. Growth, too, had been very substantial. In 1986, the economy grew by 9.5%; and, in 1987, by another 6.9%.

It is important to recognize just how successful the heterodox approach is. Given enough foreign exchange and a depressed economy, expansion of

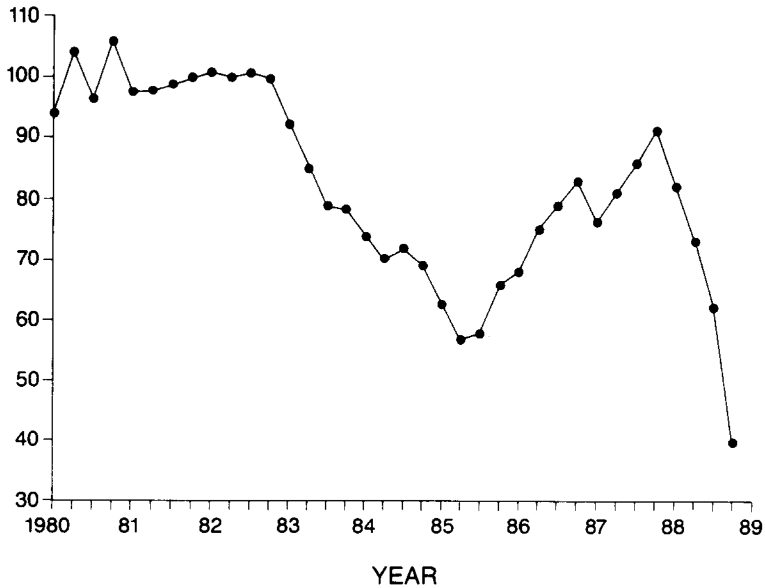

Fig. 5. Peru: The real wage (index 1982:2 = 100).

domestic demand can work. In fact, the success is broadly shared because the recovery of demand can raise firms' profitability by raising capacity utilization. That was indeed the case in Peru. A year after the program started Garcia was celebrated by the business class for the success of his recovery strategy. Private investment increased by 24% in 1986 and another 18.6% in 1987.[20]

By early 1987, the program was at the peak of its success: real GDP had grown cumulatively more than 20% since the third quarter of 1985, while inflation had been reduced from 188% to only 75%. Despite the startling success, the strain was starting to appear in rising cost pressures and a growing loss of foreign exchange. However, as in the case of Allende's Chile, these strains were obvious to economists, but were far from alarming to policymakers or the public.

5.4. Phase III: Inflation and collapse

The turning point came in July 1987, in the form of a political conflict that erupted as a result of a proposal to nationalize the banking system. On July

[20]See Centro de Economia Aplicada (1988) and especially Iguiniz (1988) for an evaluation of the first three years of the program.

27th, 1987, President Garcia declared [see Presidencia de la Republica (1987b, p. 1)]:

> In Peru, today, the financial system is the most powerful instrument of concentration of economic power and thus of political influence; it is the major obstacle to the democratization of production and the accumulation of the surplus.

At this time the right, with public appearances of Vargas Llosa, dramatized the shift in government policies toward socialism. This juncture also represented the end of the recovery policy and the turning point toward inflation and foreign exchange crises. Although the constraints tightened only gradually and bottlenecks emerged only in few places, during the remainder of 1987, it is fair to say that July–August of that year represented a crucial period, after which the continuation of expansionary policies could no longer be defended.

Populist programs such as that practiced in Peru fail when the economy runs out of foreign exchange and when the controls that support the initial redistribution and expansion have to be dismantled. By late 1987, growth was petering out and inflation, brought about by external constraints, bottlenecks and the adjustment of severe price distortions, exploded.

To understand what went wrong it helps to return to the basic philosophy of the program. This is fully documented in *El Peru Heterodoxo: Un Modelo Economico*, a 500-page book published in mid-1987 by the economic architects of the program [see Carbonetto et al. (1987)]. The most striking revelation of this book is the extraordinary extent to which policymakers in the Garcia administration, as had the Allende policymakers before them, diverged from accepted economics. Thus we learn (pp. 75–76) that

> An examination of the Peruvian record reveals that periods of moderate inflation are associated with expansionary fiscal 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 which explains inflation by fiscal deficits.

And, to dispel any doubts (p. 82):

> 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 recognizing that this could be done only temporarily for the first twelve months) and *spend*, transferring resources to the poorest so that they increase consumption and create a demand for increased output, thus 'justifying' that idle capacity be put to use.
>
> It is necessary to spend, even at the cost of a fiscal deficit, because, if this deficit transfers public resources to increase consumption of the poorest they demand more goods and this will bring about a reduction

Table 6
Peru: Real levels of controlled prices (July 1985 = 100).

	Dec. 1986	Dec. 1987	Dec. 1988
Average[a]	75	59	58
Rice	73	61	47
Light, electricity	49	40	16
Telephone	84	87	32
Gas	58	33	25

[a]Weighted by expenditure shares.
Source: *Apoyo*.

in unit costs. Thus the deficit is not inflationary, on the contrary! This constitutes without doubt the basic premise on which the economic team acted and the major departure from the earlier strategy that had emphasized adjustment from the demand side.

Peru learned in 1987–88 that there indeed are serious tradeoffs in policy: continued rapid growth and massive real wage increases are incompatible with moderate inflation.[21] In 1986 inflation was only 63%, far below the level at which the program started. But the experience of high growth with moderate inflation, after a while, became an artifact of the controls and subsidies on public sector prices and on foreign exchange. Subsidies and controls were used to avoid price increases in politically sensitive areas. In 1987–88, most petroleum products sold at one-third their July 1985 price. Electricity prices, the price of rice, and bus fares had declined by more than a third, as had the real price of foreign exchange (see table 6).

5.5. *Phase III: The hyperinflation*

When adjustments in the controlled prices had to be made, inflation accelerated rapidly.[22] Naturally, the massive increase in the budget deficit also contributed to the acceleration of inflation. The deficit, in turn, greatly increased as a consequence of a massive policy of subsidies, and as a result of the extraordinary decline in real tax collection (see table 7). In 1975–86, tax collection had averaged above 12% of GDP, and in 1985, it rose to 13.2%. However, by 1988, and as a result of a sharp decline in compliance, tax collection had fallen to only 7.5% of GDP. Additionally, the Central Bank's policy of multiple exchange rates contributed in an important way to the deficit. This policy alone resulted in losses amounting to 2% of GNP from buying foreign exchange at a high price from exporters and selling it at a low or subsidized price to importers.

[21]This, of course, is exactly what we point out in our model in section 2.
[22]See Dornbusch and Edwards (1989) for further details on this issue.

Table 7

Peru: Public sector financing requirement (percent of GDP).

	1985	1986	1987	1988[a]
Overall public sector deficit	4.4	6.7	9.9	6.1
Budget deficit	2.4	4.9	6.5	5.3
Central Bank losses	1.9	1.8	2.8	0.8
Credit to development banks	0.8	1.4	1.9	0.8
Public sector financing requirement	5.1	8.1	11.2	6.9
Domestic financing	1.2	5.7	9.8	6.9

[a]Estimate.

Source: World Bank, Central Bank and Ministry of Finance.

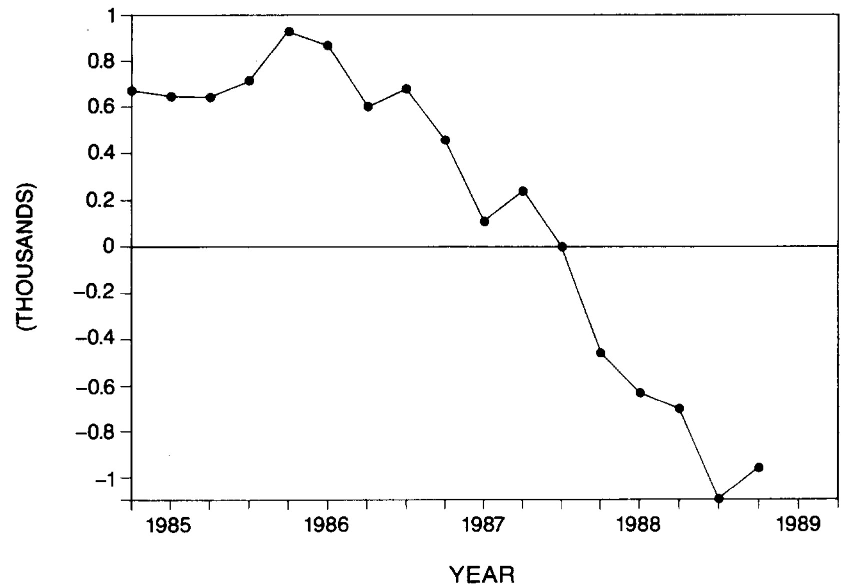

Fig. 6. Peru: Net foreign reserves (billion $U.S.).

The large budget deficit not only contributed to inflation, but also affected the allocation of credit and hence investment. While foreign exchange reserves lasted, the government could sell foreign exchange rather than borrow in the home market or print money. However, with reserves precariously low, there was no room left for further foreign exchange sales to finance the deficit (see fig. 6).[23] The declining reserves forced a more

[23]The net reserves included on the liability side $800 million of arrears to the IMF. The gold position of the central bank had been revalued at various points and amounted to $659 billion in December 1988.

consistent exchange rate policy which immediately raised the inflation rate. Thus external financing of the budget deficit ultimately had an inflationary cost, even though it may have been delayed by a year or two.

As has traditionally been the case in populist experiences, the government also resorted to the banking system to help finance the deficit. High reserve ratios for banks or direct financing requirements effectively achieved this. The counterpart of this policy was a 30% decline in real bank credit to the private sector in three years.

Since September 1987, the World Bank and Peruvian authorities had been discussing stabilization. But the political impetus for major policy changes was missing. The only impetus for change came from the external balance side where a crisis had been building up quite visibly. The trade surplus of above $1 billion in 1985 had become a deficit by 1987. Reserves declined by over $1 billion to the point where net reserves were negative at the beginning of 1988. The response to the looming foreign exchange crisis was a major devaluation in late 1987, which in the short run resulted in a small real depreciation. This helped stem capital flight and the widening trade deficit for some time. However, as in Allende's Chile, shortly after this corrective step, generalized and massive wage increases were granted. In a vicious cycle, then, accelerating wage and price increases eroded the initial gain in competitiveness. The renewed appreciation of the real exchange rate for imports since the end of 1987, and the resulting exchange losses of the central bank, signal the government's inability to force a real depreciation.

5.6. Phase IV: What next?

Economic mismanagement need not be shortlived. If the politics are supportive and external destabilization is not a factor, such a regime can last another year or even more. At the time of this writing there seem to be few avenues open to Peru. One possibility is that Garcia makes time by radicalizing his own position and policies in the direction of socialism and increasing government intervention. A massive program of nationalizations and control, of the type Allende pursued in his last year, would give the government more than a few months of breathing space, except if it were overthrown.

But while there is apparent stability, the extreme reduction in living standards and the growing number of strikes do suggest that surviving to the elections in April 1990, will not be easy.[24] The very depth of the economic collapse in late 1988 caused so sharp a fall in imports that the external constraint, for a while, was lessened. The real exchange rate in the informal

[24]By April 1989 the decline in economic activity and the restrictions of imports had become so massive that an actual reserve recovery had taken place. The reserve gains were sufficient to feed a rumor of another reactivation program.

Table 8

Peru: Real wages and real per capita GDP: 1985–1989 (index July, 1985 = 100).

	Real wages			
	National average	Minimum wage	Government	Per capita GDP[b]
1985	111	120	113	100
1986	126	124	118	107
1987	137	131	136	112
1988	105	118	101	110
1989[a]	56	64	43	81[c]

[a]July 1989.
[b]Index, 1985 = 100.
[c]April 1989.
Source: Peru: Ministry of Economics.

market actually declined to pre-1987 levels. But the collapse of real wages and activity was devastating. In fact, official estimates placed the decline in per capita real income, between 1987 and April 1989, at 25% (see table 8). Just how far the disintegration of the economy has gone is apparent from a survey in January 1989 reported by *Apoyo*, an economic consulting service in Peru. Middle and upper income respondents predominantly indicated that they would buy dollars given extra income. Of the lower income groups, more than half reported that they would spend the extra income on food.

6. Concluding remark

It is clear that the two instances of populism discussed here led to disastrous consequences for those who were meant to be the beneficiaries. The central question then is whether populist policies are outright unsustainable, or whether there is a variant which, properly executed can in fact succeed. We leave to further research the elaboration of the thesis that expansionary policies – somewhat similar in spirit to populist policies – can succeed provided they stay far clear of foreign exchange constraints, emphasize reactivation only for a brief initial period and then shift to growth policies. Most important for success, expansionary policies need to be aware of capacity constraints and have to rely for their financing on an extremely orthodox fiscal policy and rigorous tax administration. Within those restrictions it would appear that there is room left for achieving redistributive objectives in an effective way.[25]

[25]See Dornbusch and Edwards (1989) for a detailed discussion on three alternative future scenarios for Peru. See Edwards (1989) for a discussion on the inability of the Peruvian advisors to learn from the Chilean experience.

When looking forward into the next few years, one cannot avoid wondering whether economic systems have 'memory', and whether the mistakes of past populist regimes have been learned. This question is particularly relevant for the Chilean case where in March 1990 a new government – in all likelihood of centre-left persuasion – will face urgent and immediate pressures to improve the social conditions of the poor. Needless to say it is not possible to answer this question today. However, both the writings of the economic team of the likely new Chilean government, as well as the economic program of the *Concertación*, do suggest that some of the more important lessions regarding the design of economic policy have indeed been absorbed. Only the passing of time will allow us to verify this conjecture.

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