Stabilization, Debt and IMF intervention:
Development trade-offs in Ecuador and Peru

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Ecuador and Peru have adopted different strategies in coming to terms with domestic inflation and encouraging long term development. Ecuador was remarkably successful in achieving stabilization while Peru's economy, under IMF stand-by agreements, went from crisis to chaos. Paul McNelis, SJ examines the reasons for these two widely differing results. The author, who is attached to the Department of Economics, Georgetown University, Washington DC, wrote this article while on a year's sabbatical at Trinity College, Dublin, and the Central Bank of Ireland.

Introduction

Elementary textbooks teach us that the efficient allocation of resources between government and private sectors, the maintenance of stable prices, balance in the external trade account, long term development, and an equitable distribution of income and wealth are the proper goals of economic policy. Yet in many less developed countries, policy-makers have to face short-run trade-offs in the pursuit of these goals. The short-run trade-off between price stability and development is particularly sharp in Latin America, because policies implemented to control inflation, and thus restore stable prices, have led so often to low or even negative growth rates.

The justification of stabilization policies which cause short-term losses in economic growth rests not only on the goal of stable prices, but also on the improvement of long-term development prospects. Persistent high inflation rates increase uncertainty in an economy, reduce investment, increase labour market tensions, strikes and work stoppages, and shrink saving when domestic interest rates do not adjust quickly to inflation rates. Thus, one can argue that credible stabilization is a necessary precondition for the implementation of a development programme with any chance of success.

Many countries often experience a build-up of foreign debt when the inflation problems occur. During high inflation, it is often cheaper for countries to borrow abroad than at home. In addition, exports of the inflation-ridden countries are more expensive, but imports become relatively cheaper than home-produced products. The trade deficit deteriorates, and further borrowing is necessary for countries to import inputs for development programmes (such as steel, energy, or blast furnaces). Countries battling inflation often have to ask for concessions on debt servicing from their international creditors in order to reduce the hardships of the stabilization programmes.

Most international creditors to high inflation developing countries rely on prior approval by the International Monetary Fund (IMF) before granting concessions on outstanding debt. The IMF "seal of approval" for borrowing countries is called a "standby agreement", and the IMF teams which set the terms of these agreements usually require debtor countries to adopt a mix of stabilization programmes ranging from deregulation of interest rates, reduction of tariffs, removal of controls on foreign capital movements, curtailment of government spending, and a tightening of domestic credit expansion.

Brazil is one of the largest debtor nations in Latin America, and has received most of the attention in the popular press as well as in academic and professional discussion. Brazil followed IMF-style policies in varying degrees in the late 70's and early 80's, with mixed results, even though it did not have any "standby agreements" with the IMF, in order to gain concessions on its outstanding debts. Argentina, Uruguay, and Chile did have standby-agreements with the IMF, and in following these policies, Chile experienced a deep recession, Argentina went to the brink of a hyperinflation, and Uruguay saw large outflows of capital.

Ecuador and Peru are much smaller countries, both in population and in per capita output, than Argentina or Brazil. While these two countries also have had inflation and a build-up of foreign debt, their experiences receive less attention. This is unfortunate, because both of these countries are similar in size and development, yet have had very different outcomes in coming to grips with their economic difficulties, in spite of IMF intervention. Ecuador implemented a successful stabilization programme, which rapidly cut inflation with little or no loss in economic growth, without relying on IMF intervention or IMF-style policies, while Peru suffered from one unsuccessful IMF standby agreement to the next in the 70's and 80's. Ecuador was able to reduce inflation in 1983 from an annual rate of over 50 per cent to virtually zero, whereas inflation continued to increase in Peru, despite deep cuts in the standard of living dictated by IMF standby agreements.

Assuming that stable prices are necessary preconditions for long term economic growth and development, IMF involvement in Latin America appears to be a history of one failure after another. The argument of this paper is not that stable prices are unnecessary for long term development but rather that the model of inflation underlying IMF prescriptions for many Latin American countries does not fit the underlying economic structures. The imposition of IMF-style programmes will bring lower economic growth rates and living standards, but despite all of this austerity, may not succeed in reducing inflation or promoting longer-term development.

The experiences of Ecuador and Peru are telling examples of the irrelevance (at best) or the inappropriateness of the IMF policy directives. These experiences will be the subjects of this paper. However, before examining these two countries, I shall briefly review the history of indebtedness in Latin America.

Latin American indebtedness and inflation

Latin American indebtedness is not a new phenomenon. Missions to Latin American debtor nations recommending orthodox policy measures were organized by international banks well before the IMF. In some ways, Latin America today resembles Central and Eastern Europe after World War I: indebtedness, financial instability, and high inflation. The problems are neither new nor unique. The fundamental lesson policy-makers can learn from past experience is the need for policy co-ordination and co-operation among creditor nations. Specifically, co-operation means co-ordination in monetary and fiscal policy across countries, in order to reduce world interest rates. Lower interest rates will ease the hardships of debt servicing in the less developed countries, and thus reduce the chance of widespread default and financial instability.

There is one major difference, however, between the present Latin American debt crisis and the crises after World War I. Today most of the debt is in the form of loans from a relatively small number of international banks, whereas after World War 1 the debt was in the form of bonds issued to large numbers of private creditors.

In practical terms, this difference means that "rescheduling" of outstanding debts is more likely to occur, and default less likely. When there are many creditors, as in the case of bonds, it is much easier for any country to default, and thus harm a large number of creditors in a small way, than it is to assemble the large number of creditors and negotiate new terms of repayment. When there are a few large creditors, as in the case of bank debt, one can predict the reverse. It is much less costly to assemble the small number of creditors and negotiate new terms, and much more risky to default and thus harm in a large way a small number of important and powerful creditors.

Another fact of the current debt crisis is that only about 30 per cent of the outstanding debt is with United States banks. The rest is with Japanese or European banks. As a percentage of total assets of United States commercial banks, the Latin American outstanding debt is also quite small, less than five percent. However, the Latin American component is rather large when one looks at the assets of the largest U.S. commercial banks (such as Chase Manhattan, Chemical Bank of New York, Manufacturers Hanover, and Bank of America). Because the Latin American debt is a "threat" to the largest banks, it is thus a threat to the U.S. banking system as a whole.

Again, in practical terms, the concentration of Latin American debt in a few large U.S. banks means that there is a need for "risk sharing" among a larger number of U.S. banks. The purpose of this risk sharing is to reduce the exposure of the larger key banks to the threat of default, and thus reduce the "crisis atmosphere" as well as the financial instability that could result from such a default.

Risk sharing among U.S. banks has been occurring during the last ten years when debtor countries have asked for a rescheduling of the terms of outstanding debt. Instead of the original bank offer of new credit, new banks have entered into the agreements and extended new credit. Plans in the U.S. and Japan provide special tax incentives for banks to enter into these risk-sharing agreements.

The interesting point about these developments in the debt issue is that they have taken place among the creditor nations without any initiative or directive of the IMF. One cannot help but suspect that the major steps leading to the resolution of the debt crisis in Latin America will come from private sector agreements and international monetary/fiscal policy cooperation on lower interest rates targets, and not from international organisations such as the IMF or World Bank.

Ecuador and Peru: structural analysis and history

These two Andean countries experience in a large degree a phenomenon prevalent throughout Latin America. This phenomenon is dollarization, and it is directly related to the extensive smuggling which occurs in this part of the world.

Dollarization is the increasing use of foreign currency, U.S. dollars, as the medium of exchange *within* the domestic economy, alongside the domestic currency. Dollarization is distinct from the related phenomenon of currency substitution, in which domestic residents simply use dollars as a store of value of personal saving.

Indicators of dollarization include the frequent quotation of prices of domestically-produced goods in dollars within the economy, increasing willingness of sellers to accept dollars instead of domestic money as payment for goods and services, and even the opening-up of the domestic banking system to dollar-denominated deposits.

A necessary condition for dollarization is the accessibility of dollars to domestic residents. In Latin America the accessibility of dollars is a result of extensive smuggling, both "small-time" and "big-time".

The growth of "small-time" smuggling in Latin America is due to the different price and tariff policies among neighbouring countries. For example, in Ecuador, the price of petrol had been quite low due to subsidies, about US$0.75 per gallon, whereas in Perù the price had been about US$2.00 per gallon. Thus there were strong incentives for "small-time" entrepreneurs to engage in illegal transport from Ecuador to Peru and to resell in informal markets. The penalties for small-time smugglers caught was not a very strong deterrent. The typical punishment was three days in jail. For a poor person this means three days of free room and food. Similarly, the low tariffs in Chile and relatively high tariffs in Peru encouraged other small-time smugglers to bring illegal commodities across the Chilean border into Peru for resale in the same type of informal markets.

Smuggling becomes "big-time" when the costs of being caught increase. Thus, penalties for the illegal transport of drugs from Peru or Ecuador to Colombia or to the United States may involve execution or very long prison services. Small-time operators cannot afford to take these risks, nor can they pay the prices to reduce the risks of being caught. Big-time operators can. One way to reduce these risks is to establish a private army for the protection of the refining and transportation of drugs. The M-19 is such an army of the big-time *narcotraflicantes* or drug-traffickers in Colombia.

When smuggling runs a surplus with the U.S., when the value of the drugs shipped into the United States exceeds the value of merchandise and other goods smuggled into Latin America, the excess generates net receipts in dollars. These dollar-holdings would have to be laundered to be deposited in the U.S., so only a fraction can find its way into the U.S. Thus, the ongoing current-account surplus of the illegal drug trade generates a build-up of dollar-holdings in Latin America. These dollars are used in turn by drug-traffickers to finance private armies, as well as to pay for goods and services in both the informal and formal sectors of the economy.

The demand for foreign currency as a medium of exchange increases with growing uncertainty about the future course of monetary policy at home. In Peru, the exchange rate system switched four or five times within the past decade, from a fixed system to a floating one, to a system of preannouncing rates according to expected future rates of inflation, and then back to fixed rates. With this type of uncertainty about the future value of domestic money, and thus risks of sudden loss of purchasing power of domestic currency, it is not surprising that domestic residents desire to shift to dollars as a medium of exchange. With the growing availability of dollars through the continuing surpluses in the drug trade, this shift into dollars became possible.

As dollarization increases, the course of domestic inflation becomes detached from movements in domestic money. This phenomenon is related to the destabilization of demand for money as more and more people shift into dollar transactions in the domestic economy. The normal expectation is that domestic money demand is proportional to real income by a factor of proportionality.

This simple scenario no longer holds if domestic residents hold two monies. Consider what happens when residents want to shift their money holdings out of domestic money into foreign money. They will try to reduce their holdings of domestic money, and "buy" foreign money, either directly, with domestic money, or indirectly, by working for payment in foreign money, or through purchasing goods and selling them for foreign money. As domestic residents try to reduce their holdings of domestic money, the price level will rise (as they purchase more goods, or as they try to purchase more foreign money – this forces domestic money to be seen as less valuable to all in terms of foreign money, so sellers of all goods raise their prices in domestic money terms). As a result of this switch from domestic to foreign money, prices rise, without any expansion of the domestic money supply by the Central Bank.

This delinking of the course of domestic prices from the course of domestic money has drastic implications for stabilization policy. The traditional remedy for inflation is a reduction in the rate of growth of the domestic money. However, in a dollarized economy, a tightening of credit denominated in domestic currency may have the opposite effect. As credit becomes more scarce in domestic money, residents will have even more incentive to shift into foreign money for transactions. Thus domestic prices may rise even as a consequence of *restrictive* domestic monetary policy.

Unfortunately, the usual conditions of the IMF conditionality loans or standby agreements to Latin American debtor countries have been based on a simple proportional relationship between domestic inflation and monetary growth. Thus the typical IMF "package" for the blessing of conditionality lending has involved quite restrictive monetary growth targets. The IMF rationale is that lower inflation will improve conditions for stable growth. Since IMF conditionality lending is the *sine qua non* for further rescheduling agreements with commercial banks, debtor countries usually have to accept the restrictive monetary targets.

While the IMF goal of lower inflation for debtor countries may be debatable on its own merits, the more fundamental challenge to IMF policy-making is the lack of a sound model for the IMF prescriptions for Latin America. The two-currency model shows that restrictive domestic money policy may not reduce domestic inflation, and may actually increase it. Ecuador and Peru are clear examples where the two-currency model appears to be more realistic, but smuggling and dollarization are present to varying degrees in Argentina, Chile, Uruguay, as well as Brazil.

Typical IMF packages have also involved programmes for further liberalization of the domestic economy. Liberalization measures usually include the removal of controls on foreign money flows to and from the country, the lifting of ceilings on interest rates, the return to market prices rather than fixed prices, and the dismantling of barriers to trade, in the form of tariff and quota restrictions.

In a country with a single currency, these liberalization measures may help to reduce inflation, by forcing domestic manufacturers to set prices in competition with imported foreign goods. With lower tariffs, foreign goods are cheaper, so domestic price setters have less manoeuvering room to raise prices. Similarly, with freer capital flows to and from the country, producers would have to compete for funds in a wider "world market". This would force producers to be more efficient in their investment decisions, and thus improve resource allocation.

Again, one may debate the merits of these liberalization programmes. The problems involved with the implementation of similar liberalization programmes in Argentina, Chile and Uruguay, particularly the timing and sequencing of the liberalization of the various sectors, have been well documented. However, for a dollarized economy, such liberalization would "speed-up" the process of shifting out of domestic money into dollars, and further weaken the link between domestic money and domestic inflation. With liberalization, the acquisition and use of foreign money becomes simpler and easier, and with more foreign goods in the country, there is further incentive to price these goods in terms of their original dollar-price rather than converting these dollar-prices to domestic currency-prices. Thus, the IMF-sanctioned plan of reducing inflation by monetary restriction is made even more tenuous by IMF-sanctioned liberalization programmes in a dollarized economy.

The way out of an inflationary situation in a dollarized economy is thus not the IMF approach of tighter monetary policy, based on a simple proportionality view of the money/inflation link. Nor is further liberalization the solution. Rather, the first step for reducing inflation is to induce residents to use one currency as a medium of exchange. When there is one medium of exchange, there will then be a more stable relation between money and prices. Inflation may then be stabilized with a mild (rather than stringent) monetary policy. The recent history of Ecuador shows how this can be done. The history of Peru shows what can happen when IMF-style policies are repeatedly applied to a dollarized economy.

Ecuador's success story

Ecuador has had a history of low inflation. However, with the oil boom in the 1970's there was a large influx of dollars. As oil revenues increased, the government began an ambitious programme of social and educational expenditures. This spending programme turned into a deficit spending programme when the oil revenues dried up in the early 1980's. Exports also fell with the world recession in this same period. As the deficits continued, domestic inflation increased rapidly, up to over 50 per cent by 1983. At this time, the demand for dollars as a medium of exchange increased. This demand was accommodated by the easy accessibility of dollars from oil revenues, as well as by smuggling subsidized oil into Peru in return for dollar payments.

Inflation continued to rise in the early 1980's, as the link between domestic monetary growth and inflation progressively deteriorated with dollarization. However, Ecuador was able to change its fortunes with a move by the Central Bank, which brought more luck than the policy-makers ever intended or anticipated.

Ecuador achieved a dedollarization and a rapid fall of inflation from over 50 per cent to practically zero through *sucretizacion.* This programme was simply a bail-out plan for domestic industries with heavy foreign debts. The Central Bank assumed the private foreign dollar debt obligations, and the domestic industries were required to pay the Central Bank the equivalent of the debt in the domestic currency, or *sucre.* By assuming the foreign debt and requiring payment in domestic money, the Central Bank locked itself into a stable exchange rate, since any devaluation would bring losses to the Central Bank, since the private-sector payments would then be worth less than the dollar-value of the assumed debt. By locking itself into a stable exchange rate in this way, the Central Bank created new confidence in the value of the currency, and thus established stronger credibility. Soon after the implementation of the *sucretizacion* programme, there was a shift away from foreign money into domestic currency, and a quick fall in inflation, without a special programme of monetary austerity. What is unique is that it was successful not because of government announcements about monetary targets or IMF stand-by agreements, but because credibility was restored by an active (and risky) involvement of the government in the market place. In this case, involvement meant the intermediation of private-sector debt, which put the government financially on the line if the exchange rate became unstable.

Peru's continuing crisis and chaos

Peru is another story. Dollarization is an inescapable fact of life. It is estimated that the drug trade each day accounts for $20 million in transactions, which would amount to $6 billion annually, about one-third of Peru's gross domestic product. The influx of so many dollars has created a very large informal market in dollars, with vast amounts of *mercados ambulantes,* or walking street-vendors buying and selling dollars each day. In comparison with this informal market, the official market is trivial. For this reason, the exchange rate policy of the Central Bank quickly adjusts to the street-value of the dollar. Although the exchange rate is announced officially by the Central Bank, whenever there is a jump in the informal markets more than 10 per cent above the official rate, the Central Bank quickly closes the gap with a new exchange rate announcement. Peru thus has a government-determined exchange rate, which is really determined in the informal market.

The dollarization process in Peru was furthered by the *Decreto Ley* of November 1977, which permitted dollar-denominated deposits in Peruvian domestic banks. Thus Peruvian residents were able to deposit dollars and to write dollar cheques for *domestic* transactions. By 1982, the ratio of dollar deposits to *soles de oro* deposits grew to more than 60 per cent. The Central Bank's motive for allowing these dollar deposits, of course, was partly financial: with these deposits in Peruvian banks, dollar reserves are required at the Central Bank. These deposits are then lent in the inter-bank market at LIBOR rates, and thus provide an additional source of revenue to the government. In 1983 the government annulled a 1980 law which required dollar deposits to be declared locally for tax purposes. According to Rosemary Thorp, this is a revealing "indicator" of the "importance of illegal dollars to the Central Bank".[1]

The experience of Peru since the official dollarization of the banking system in 1977 shows increasing inflation and exchange rate instability. These results are consistent with the predictions of the two-currency model in the preceding section. Yet IMF conditionality and standby agreements with Peru on external debt (built up during the Bellasco "populist military" government) have continued to insist on monetary stringency and further liberalization measures begun with the Morales-Bermudez "pro-market military" government in the mid-70's, and continued with the Bellaunde civilian government in the 1980's. During the world recession of the early 1980's the sharp decline in terms of trade and export performance added to the "crisis atmosphere". According to Rosemary Thorp, the combined IMF standby agreement and World Bank SAL (structural adjustment loan) in 1983 pushed the economy from "crisis to chaos" by calling for "huge cuts in public spending", real wage reductions, and curtailment of credit, as each day saw an increase in the "invasion of contraband, dollarization of the economy, and capital flight".[2]

In April 1985 Alan Garcia and the APRA (American Popular Revolutionary Alliance) won in a swing away from the orthodox economic and social policies of the Bellaunde *Acion Popular* party. Garcia introduced a new stabilization programme based on the Argentine *Plan Austral,* which included the following measures: the fixing of the exchange rate, the switch to a new currency (*Inti*), and the freezing of dollar deposits. In addition, Garcia announced that no more than 10 per cent of export revenues would go to the servicing of external debts.[3] For this measure, Peru lost the blessings of the IMF and the "orthodox establishment" in the international financial community.[4]

The Garcia alternative is by no means a "sure thing". In particular, the fixing of the exchange rate may cause problems of overvaluation of the exchange rate, and thus cause artificially high export prices. This could cripple employment in the export sector, especially in the non-traditional products. Yet the Peruvian *Plan Inti* provides a more realistic alternative to the IMF orthodox models of the past. If it remains credible and effectively dedollarizes the economy, this plan may bring a relatively quick fall in inflation, as well as new confidence and renewed investment. The approach taken by Peru may thus turn out to be the most effective model for understanding and finding long-term solutions to the international debt issue.

Conclusion

This article has compared the experiences of Ecuador and Peru in coming to terms with domestic inflation in order to pave the way for long-term development. Like many countries, they labour under the burdens of high external debt.

For Ecuador, the Central Bank intervention in the intermediation of external debt turned out, by luck, to be the key to rapid stabilization with little loss of economic growth in the short run. By contrast, IMF stand-by agreements in Peru pushed the economy "from crisis to chaos".

Since cases of rapid and relatively recession-free disinflation are relatively few and far between in economic history, the experience of Ecuador has significance beyond Latin America. The Ecuadorian "success story" highlights the crucial role which expectations and credibility play in the implementation of stabilization policy and long term growth. By locking itself financially into agreements based on an announced exchange rate, the government created new confidence in a stable currency, and generated higher levels of investment, saving, and growth.

Peru is a telling example of so much of the frustration of debtor countries when confronted with IMF conditionality, when the IMF "models" do not fit the underlying economic realities. Peru was not able to stop inflation because the "standby agreements" were not credible. Instability increased, and economic growth continued to decline, and even became negative.

The stories of Ecuador and Peru in the early 1980's point to the need for greater flexibility of the IMF and the "establishment" in the international financial community in coming to terms with the actual policy "manoeuvering room" of debtor nations. While all countries labour under the trade-offs between price stability and economic growth, in less developed countries the initial levels of per-capita income are not very high, so there is less political and social tolerance for short-term output losses during stabilization programmes. Continued insistence on policies which do not fit the underlying macroeconomic conditions and which cannot work, only undermine the credibility of the governments in question, increase the instabilities these policies are intended to correct, and inhibit longer term growth and development.

Footnotes

1. See Rosemary Thorp, "Peruvian Adjustment Policies, 1978-85: The Effects of Prolonged Crisis", p.229. Fortheoming, 1987.
2. Ibid., 221-22.
3. In practice, the Garcia government has been paying more than the officially acknowledged 10 per cent of export earnings on debt service.
4. It should be noted that the Interamerican Development Bank or *Banco Interamericano de Desarollo* (BID) has not insisted on the orthodox measures of IMF standby agreements. In Peru and Bolivia the amount of BID lending often exceeded IMF or World Bank support.