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Management"**

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Peruvian Economy:

Key Reforms of the 90's and its Assessment

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Abstract

The present work includes four parts, chapter one illustrates a broader picture of Peru, its position in the world, main characteristics and figures.

Chapter two describes the precarious situation in which the previous governments, particularly the one of Alan Garcia, former President, had left the country in 1990: out of control inflation, increasing external debt and foreign exchange deficit added to other factors that affected the economy such as the upsurge of terrorism. All these factors left Peru in a total crisis and turned it, in one of the countries with highest poverty rates in the Latin America.

The third chapter covers all the implementation process. In Peru, the Economic Program was based on the Principles of the Austrian School of Economics. The series of structural reforms proposed among others the deregulation of the market and the minimization of the State, they were adapted to the prescriptions of John Williamson in the Washington Consensus, envisioned by the World Bank, the IMF and US Treasury Department.

The fourth chapter is an assessment of the results of the implementation, which has created two disparate sides: one is an outstanding macroeconomic performance leader in the region, prospects of growth, a friendly investment environment and continuously reducing rates of poverty. However, the negative side include the decline of the manufacturing industry, underperformed health and education services, a rooted corruption and the gap between richer and poorer becoming broader.



Chapter 1: Introduction: A Broader Picture of Peru

1.1. Peru for the World

Peru is a Republic located in South America, facing the Pacific Ocean and bordering Ecuador, Colombia, Brasil, Bolivia and Chile. Its capital is Lima, some major cities are: Arequipa, Trujillo, Cusco, Chiclayo, Ica, Piura and Callao, which houses the most important port terminal in the Pacific.

Peru is one of the countries with greatest biological diversity, as well as one of the largest in terms of possession of mineral resources in the world. It is also known for being the heritor of one of the most important civilizations of ancient times, the Empire of the Incas.



Figure 1.1: Peru in the World

Source: maps-Peru

1.2. Peru's Geography

Peru has a total land area of 1,279,996 km² and a total water area of 5,220 km², it is the 3rd largest country in South America and the 19th in the world. The presence of the Andes Mountains divides the territory into three natural macro-regions; called

coast, highlands and jungle, each with a completely independent climatic, morphological and even historical personality.



Figure 1.2: Geographic macro-regions of Peru

Source: geology.com

1.3. Peru's Demographics

With about 31.5 million inhabitants, Peru is the 4th most populous country in South America, with the population being expected to reach approximately 42 million by 2050. Peru is divided into 24 Departments, plus the Constitutional Province of Callao in which is the most important port in the country.

76% of population live in urban areas while 24% in rural areas. The metropolitan area of Lima is home to nearly 9.8 million people, the seventh-largest metropolis in

the Americas. As shown on figure 1.3, most of the population is concentrated mainly on the coast line.

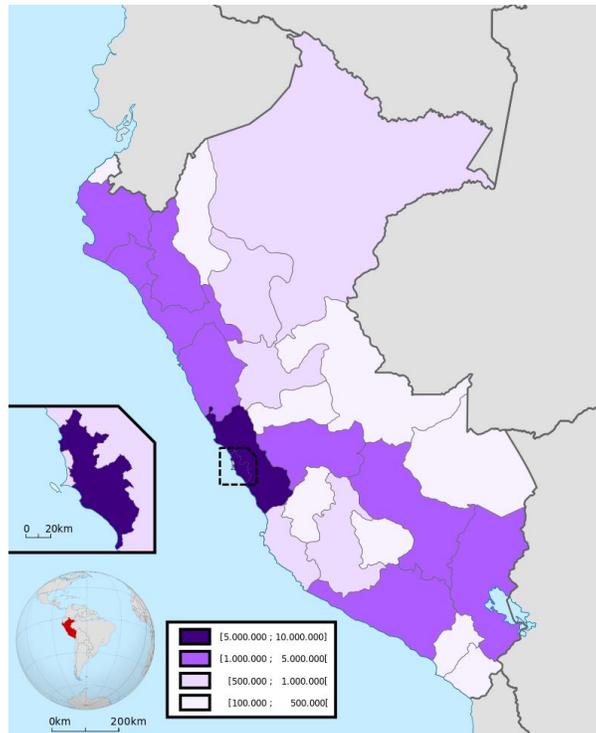


Figure 1.3: Population Density Map of Peru

Source: wikipedia.org

Peru is a multiethnic nation formed by successive waves of different peoples over five centuries. Amerindians, Spaniards, and its mixture. After independence from Spain, there was gradual immigration from European, Chinese and Japanese, and even Africans, who have since become a major influence in Peruvian society.

The official languages in Peru are Spanish, “Quechua” and “Aymara”. Spanish is spoken by approximately the 85% of the population, is the mainstream language of the country, which is used by Government, the media and in educational systems and commerce. Quechua, Aymara and other declining languages make up the remaining 15%.



The predominant religion in Peru is Catholicism, albeit with a high degree of syncretism with indigenous traditions.

Literacy rate of Peru is estimated at 94.1%; this rate is lower in rural areas (84.9%) than in urban areas (96.4%). Primary and secondary education are compulsory and free in public schools.

The Government of Peru is a presidential representative Democratic Republic with a multi-party system, with three branches: Executive, Legislative and Judicial. The President, the head of Executive branch, is elected for five years and cannot serve consecutive terms. The President designates the Prime Minister and, on his advice, the rest of the Council of Ministers. The Congress of the Republic or Legislative branch is unicameral with 130 members elected for five-year terms. Laws may be proposed by either the executive or the legislative branch. The Judicial branch is an autonomous body of the Republic of Peru constituted by a hierarchical structure, which exercise the power to administer justice. The Peruvian Government is directly elected, and voting is obligatory for all citizens aged 18 to 70.

1.4. Peru's Economy and Infrastructure

The economy of Peru is within the 50th largest economies in the world, and the income level is classified as upper middle by the World Bank. Peru is one of the fastest-growing economies of the world owing to the economic expansion started in 1992. It has a Human Development Index of 0.74 which has seen steady improvement over the last 25 years.

Peruvian economic performance is tied to exports, which provide solid currency to finance imports and external debt payments. Although they have provided substantial revenue and steady growth; a more equitable allocation of income continue to be distant achievement. According to statistics, 21.7% of Peruvian population is considered poor. In rural areas, poverty rose to 44.4%, while in urban

areas this condition affects 15.1% of the population. Extreme poverty figure is 3.8% of the total population.

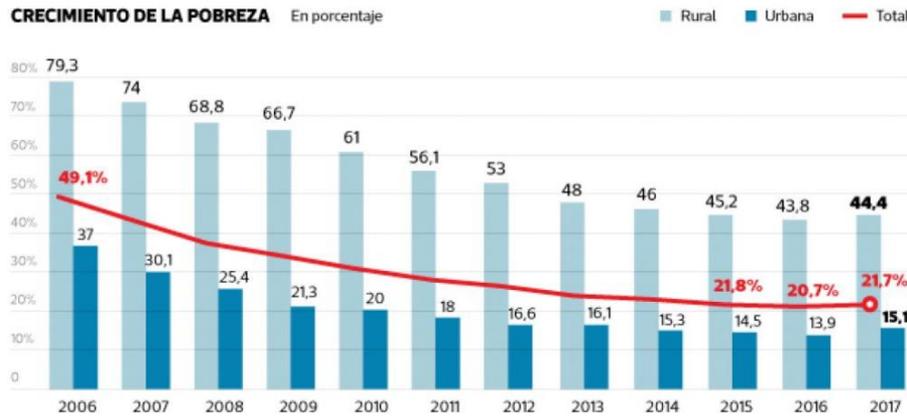


Figure 1.4: Rates of Poverty in Peru

Source: INEI

Services sector account for 54.1% of Peruvian gross domestic product, followed by manufacturing (16.5%), extractive industries (15.1%), agricultural (6%) and taxes (8.3%). Recent economic growth has been fueled by macroeconomic stability, improved terms of trade, and rising investment and consumption.

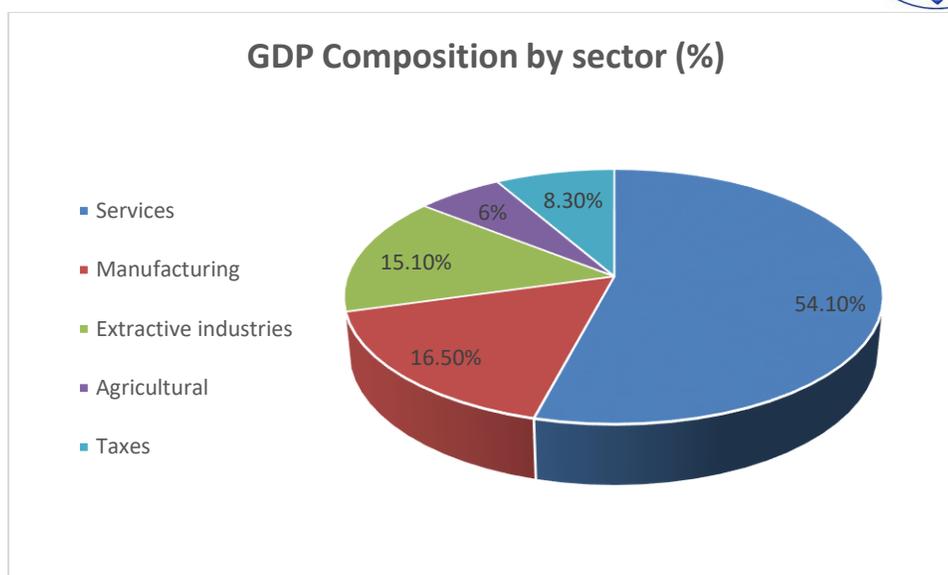


Figure 1.5: GDP Composition by Sector

Source: INEI

Economy in Peru reflects its varied geography: A wide range of important mineral resources are found in the mountainous and coastal areas, and coastal waters of Peru provide excellent fishing grounds. Main exports are copper, silver, gold, zinc, textiles, and fishmeal; its major trade partners are the United States, China, Brazil, and Chile. Peru is the world's 2nd largest producer of both silver and copper.

From 1992 a new period of expansion began, which was possible not only for the application of economic reforms, but also due to different factors such as the elimination of terrorism, technological innovations specially in mining process, and the reorganization of agriculture focus on exports.

Peruvian economy grew by an average of 4.4% per year from 2009-2018 with a stable exchange rate and low inflation. This growth was due partly to high international prices of metals and minerals exports, which accounted for most of the half of the total exports. Growth slipped from 2014 to 2017, averaging 3.6% yearly, due to weaker world prices for mineral resources.

The structure of Peruvian economy nowadays stand out the gradual increase in mining, construction and services, particularly modern services such as information and telecommunications. Conversely, there is a decline in agriculture and manufacturing industry.

Mining output helped Peru attain one of the highest GDP growth rates in Latin America. However, economic performance was depressed by delays in infrastructure mega projects and the start of a corruption scandal associated with a Brazilian firm. Natural disasters also were a drag on growth, offset somewhat by additional public spending aimed at recovery efforts.

Peru follows a free trade policy, and since 2006 has signed trade deals with the US, Canada, Singapore, China, Korea, Mexico, Japan, the EU, the European Free Trade Association, Chile, Thailand, Costa Rica, Panama, Venezuela, Honduras, concluded negotiations with Guatemala and the Trans-Pacific Partnership, and begun trade talks with El Salvador, India, and Turkey. Peru also signed a trade pact with Chile, Colombia, and Mexico, called the Pacific Alliance, that seeks integration of services, capital, investment and movement of people.

Its main agriculture products are: artichokes, asparagus, avocados, blueberries, coffee, cocoa, cotton, sugarcane, rice, potatoes, corn, plantains, grapes, oranges, pineapples, bananas, apples, lemons, pears, coca, tomatoes, mangoes, medicinal plants, quinoa, palm oil, onions, wheat, dry beans; poultry, beef, pork, dairy products; guinea pigs; fish.

Key Industries: mining and refining of minerals; steel, metal fabrication; petroleum extraction and refining, natural gas and natural gas liquefaction; fishing and fish processing, cement, glass, textiles, clothing, food processing, beer, soft drinks, rubber, machinery, electrical machinery, chemicals, furniture.

1.5. Peru in Numbers

Main Economic Variables

Index	Measure (US\$/%)	World ranking
GDP (Purchasing Power Parity)	430.3 billion	46
GDP (Nominal)	214.2 billion	
GDP (Growth Rate)	4.1%	132
GDP Per Capita (PPP)	13500	119
GDP Per Capita (Nominal)	7300	
Gross National Saving	19.8% of GDP	100
GDP composition (by end use)	household consumption: 64.9% government consumption: 11.7% investment in fixed capital: 21.7% investment in inventories: -0.2% exports of goods and services: 24% imports of goods and services: -22%	
GDP composition (by sector of origin)	agriculture: 7.6% industry: 32.7% services: 59.9%	
Industrial production growth rate	2.7%	113
Labor force	17 million people	36
Labor force (by occupation)	agriculture: 25.8% industry: 17.4% services: 56.8%	
Unemployment rate	6.9%	104
Population below poverty line	21.7%	
Budget	Revenues: 58.06 billion Expenditures: 64.81 billion	
Taxes and other revenues	27.1% of GDP	103
Budget surplus +(or deficit -)	-3.1% of GDP	135
Public debt	25.4% of GDP	174
Inflation rate	2.0%	128
Central bank discount rate	4.25%	97
Commercial bank prime lending rate	16.6%	29
Stock of narrow money	33.41 billion	61

Stock of broad money	33.41 billion	61
Stock of domestic credit	56.7 billion	62
Market value of publicly traded shares	56.56 billion	49
Current account balance	-2.414 billion	172
Exports	44.92 billion	54
Exports (partners)	China 26.5%, US 15.2%, Switzerland 5.2%, South Korea 4.4%, Spain 4.1%, India 4.1%	
Exports (commodities)	copper, gold, lead, zinc, tin, iron ore, molybdenum, silver; crude petroleum and petroleum products, natural gas; coffee, asparagus and other vegetables, fruit, apparel and textiles, fishmeal, fish, chemicals, fabricated metal products and machinery, alloys	
Imports	38.65 billion	62
Imports (partners)	China 22.3%, US 20.1%, Brazil 6%, Mexico 4.4%	
Imports (commodities)	petroleum and petroleum products, chemicals, plastics, machinery, vehicles, TV sets, power shovels, front-end loaders, telephones and telecommunication equipment, iron and steel, wheat, corn, soybean products, paper, cotton, vaccines and medicines	
International Reserves	63.83 billion	35
External debt	66.25 billion	60
Stock of direct foreign investment – local	98.24 billion	46
Stock of direct foreign investment - abroad	5.447 billion	74
Exchange rates	3.33 “nuevos soles” (PEN) per dollars (US\$) at February 12, 2019	

Table 1.1: Main Economic Variables in Peru

Source: Moody's Analytics

Transportation Infrastructure

Index	Measure	World Comparison
National air transport system	number of registered air carriers: 7	
	inventory of registered aircraft operated by air carriers: 35	
	annual passenger traffic on registered air carriers: 13,907,948	
	annual freight traffic on registered air carriers: 223,643,434 mt-km	
Airports	191	30
Airports - with paved runways	59	
Airports - with unpaved runways	132	
Heliports	5	
Pipelines	786 km extra heavy crude, 1526 km gas, 679 km liquid petroleum gas, 1033 km oil, 15 km refined products	
Railways	total: 1,854 km	76
	standard gauge: 1,730.4 km 1.435-m gauge (34 km electrified)	
	narrow gauge: 124 km 0.914-m gauge	
Roadways	total: 140,672 km (18,699 km paved) (2012)	28
	note: includes 24,593 km of national roads (14,748 km paved), 24,235 km of departmental roads (2,340 km paved), and 91,844 km of local roads (1,611 km paved)	

Waterways	8,808 km (8,600 km of navigable tributaries on the Amazon River system and 208 km on Lago Titicaca)	14
Merchant marine	total: 88 (2017)	91
	by type: container ship 2, oil tanker 12, other 74	
Ports and terminals	major seaport(s): Callao, Matarani, Paita	
	oil terminal(s): Conchan oil terminal, La Pampilla oil terminal	
	container port(s) (TEUs): Callao (1,616,365) river port(s): Iquitos, Pucallpa, Yurimaguas (Amazon)	

Table 1.2: Transportation Infrastructure in Peru

Source: Moody's Analytics

Energy Figures

Index	Measures	World ranking
Electricity access	population without electricity: 2.9 million	
	electrification - total population: 91%	
	electrification - urban areas: 98%	
	electrification - rural areas: 73%	
Electricity production	50.13 billion kWh	54
Electricity consumption	44.61 billion kWh	53
Electricity - exports	55 million kWh	86
Electricity - imports	22 million kWh	112

Electricity - installed generating capacity	14.73 million kW	51
Electricity - from fossil fuels	61% of total installed capacity	128
Electricity - from nuclear fuels	0% of total installed capacity	164
Electricity - from hydroelectric plants	35% of total installed capacity	60
Electricity - from other renewable sources	4% of total installed capacity	116
Crude oil - production	43,520 bbl/day	56
Crude oil - exports	7,995 bbl/day	61
Crude oil - imports	86,060 bbl/day	46
Crude oil - proved reserves	434.9 million bbl	47
Refined petroleum products - production	166,600 bbl/day	57
Refined petroleum products - consumption	250,000 bbl/day	50
Refined petroleum products - exports	62,640 bbl/day	49
Refined petroleum products - imports	65,400 bbl/day	71
Natural gas - production	12.99 billion cu m	37
Natural gas - consumption	7.483 billion cu m	53
Natural gas - exports	5.505 billion cu m	28
Natural gas - imports	0 cu m	174
Natural gas - proved reserves	455.9 billion cu m	32
Carbon dioxide emissions from consumption of energy	55.94 million Mt	55

Table 1.3: Energy Numbers in Peru

Source: Moody's Analytics

Telecommunications

Index	Capacities	World Comparison
Telephones - fixed lines	total subscriptions: 3,082,036	46
	subscriptions per 100 inhabitants: 10	
Telephones - mobile cellular	total subscriptions: 38,915,386	37
	subscriptions per 100 inhabitants: 125	
Internet users	total: 13,975,422	42
	percent of population: 45.5%	
Broadband - fixed subscriptions	total: 2,310,217	50
	subscriptions per 100 inhabitants: 7	

Table 1.4: Telecommunications Numbers in Peru

Source: Moody's Analytics



Chapter 2: Before the Implementation of the Reforms

The reforms applied in the Economic Program of President Alberto Fujimori in 1990, marked a breaking point against the predominant model of public administration of the previous governments, whose starting from the decade of 1950 imposed market regulations and diverse scales of State intervention in economy matters.

To get a quantitative idea of the results of the Economic Program applied in Peru, the focus of attention will be on the main variables of the economy. For this purpose, it is essential to review some fundamental concepts at the beginning of this chapter.

Later on this chapter, is detailed the process of elaboration of the crisis, making a brief analysis of each of the governments that preceded the one of Fujimori in 1990 and the additional issues such as terrorism and the natural disasters that all together provoked the collapse of the economy in Peru.

2.1. Economic Indicators

Economic indicators judge the overall health of an economy, figures and variations drawing a picture that approximate what happens in an economy. They allow analysis of economic performance and also make predictions of future ones.

When the economy of a country is healthy, its indicators move smoothly and in a balanced way. There are no sudden variations in the factors that influence the decision making of economic agents.

Some of the main indicators are inflation, fiscal deficit, the GDP and the GDP growth, exports and international reserves. We briefly analyze each of them:

2.1.1. Inflation

Essentially inflation consists of the generalized rise in prices over a period of time, reducing the purchasing power of a currency. Peruvian economy has suffered its consequences several times along its history.



In a healthy economy, although prices vary, they do so in isolation and according to either changes in consumer preferences, the demand; or in the quantity of goods and services produced, the supply. Conversely, during an inflation process, rise of prices has not been caused by variations in the supply or demand of goods and services. It is the result of inflating the means used to carry out transactions in the market.

The exchange of goods and services is not done as barter. To facilitate this, we use exchange means, such as money. It is the State, who controls the supply of those monetary means that are used to carry out this exchange. Therefore, inflation happens when the State puts more money in the economy than is required to exchange existing goods and services; this precisely happened during the regimes before 1990, the fact that the State was using its power to create money to finance unbalanced budgets.

2.1.2. Fiscal deficit

The deficit is the gap, the negative balance in the Government accounts. Generally, governments generate inflation to cover it. Any governing party who makes a public expenditure to meet the demands of one sector of the population, can obtain approval at the time and even in the short term but the problem comes usually later. The previous administrations to the reform, were fell into temptation of passing the bill for later and thus avoiding the bitter drink of strict management of it expenses, constructed on tax revenues.

In order to measure the magnitude of the shortfall in the fiscal accounts and be able to compare it with that of other years, the deficit is expressed as if it was a part of the total of goods and services produced in a fiscal year, that is, as a percentage of the GDP.

2.1.3. Gross Domestic Product

Measures the production of national economies and represents the total of goods and services exchanged in the market. Variations in GDP reflect the growth or decline of economic activity of the whole nation.

Well-being and quality of life improve when the country uses its resources: natural, human and capital efficiently. It creates less wealth who needs to use a greater amount of resources in a certain productive process. This reasoning is also accurate for a company, a country or a family.

2.1.4. Exports

Another way to measure the economic efficiency of a country is through its exports; that is, the ability to sell their goods abroad. Companies all over the world are increasingly interconnected and achieve economies of scale because they relate to other markets more easily. Foreign trade is a key element in the growth of production.

With increasingly integrated economies, the ability to export measures the degree of connection between a given country and the others. This ability to export can be expressed by comparing the total of what is sold abroad with the total of what is produced in the country, measuring exports as a percentage of GDP.

Trade integration, however, means acquiring of the foreigner all those inputs required by a production in process of expansion, especially if it must cover the demand of big international markets. The balance left by exports against imports can be added to those resulting from other foreign operations, such as those that leave obligations and financial commitments among others.

2.1.5. International Reserves

International Reserves measure, indirectly, the degree to which a country is vulnerable to changes in the world economy. The variations in the value of the

currencies, in the prices of the raw materials or of the manufactured products will determine variations in the amounts obtained by exports and those required for importation.

These reserve assets are immediately available and are used to finance payments abroad, such as import payments. International reserves can also be used by the Central Reserve Bank to intervene in the foreign exchange market and protect the exchange rate when necessary.

2.2. Elaboration of the Crisis: Previous Governments

The crisis inherited in 1990 was not only the result of the, former President Alan García administration. The García regime was the end to which came the mismanagement and irresponsibility, as well as the ideological and operational faults and omissions committed in the decades prior to the Reform. During all that period of time, the political decision was privileged over the technical criteria that should be required for handling public affairs. Table 2.1 shows the list of Presidents of Peru and their political view, starting from 1950.

President	Year	Political Party
Gral. Manuel Odria	1950 - 1956	"Restorative Party"
Manuel Prado Ugarteche	1956 - 1962	"Peruvian Democratic Movement"
Gral. Ricardo Perez Godoy	1962 - 1963	Military
Gral. Nicolas Lindley	1963	Military
Fernando Belaunde Terry	1963 - 1968	"Popular Action"
Gral. Juan Velasco Alvarado	1968 - 1975	Military
Gral. Francisco Morales Bermudez	1975 - 1980	Military
Fernando Belaunde Terry	1980 - 1985	"Popular Action"
Alan García Perez	1985 - 1990	"Aprista Peruvian Party"

Table 2.1: Presidents of Peru (1950-1990)

Source: congreso.gob.pe

Along the republican history of Peru, it was observed the triumph of politics over economics. The system ended in an extreme crisis in the late 80s, but since the 1950s there were symptoms of its negative effect on the economy. This is demonstrated by the main economic indicators.

By the end of the 50's average inflation in Peru showed relative high values, since it was around 9% per year. It was under the Government of Manuel Prado in 1961, that inflation reached levels of 6% per year principally by balancing government accounts and a slight increase in exports; in a context of State intervention in a quite limited economy, there was also a sustained growth of production. The exports "boom" had not been occurred yet and economy reached GDP growth rates of 7% per year on average.

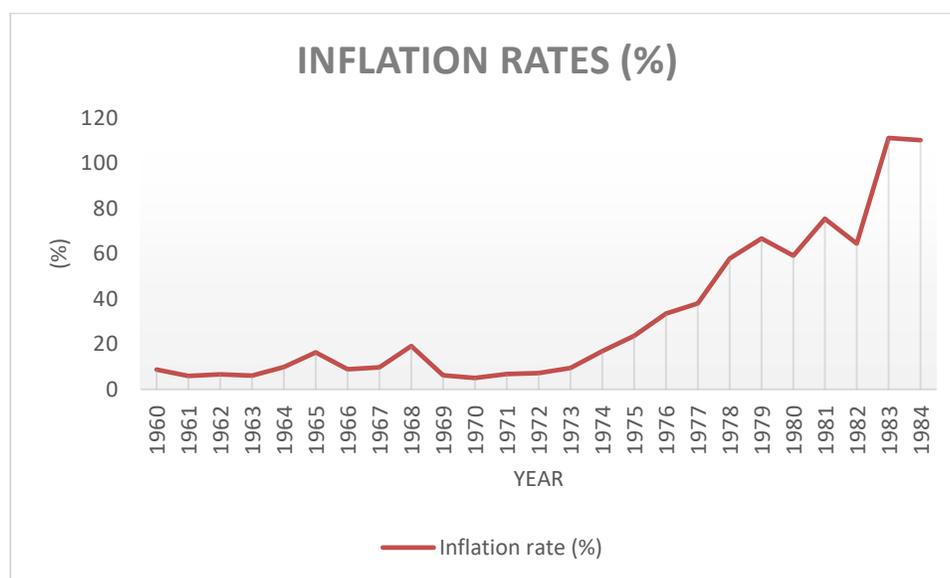


Figure 2.1: Annual Inflation rates in Peru (1960 – 1985)

Source: World Bank

During the first years of the 60's, economy had a high degree of connection with international markets, since exports represented around 20% of GDP. In 1960 exports grew by more than 100% compared to 1950, going from US\$ 194 million to

US\$ 444 million. There were satisfactory levels of foreign investment and the State could also capture external savings through indebtedness. However public debt grew in permanent form.



Figure 2.2: Annual Exports in Peru, as percentage of the GDP (1960 – 1985)

Source: Own elaboration

Politics, however, stopped the tendency towards recovery and stabilization of the main indicators. Far from taking advantage of the economic results, both the military regimes of Ricardo Perez and Nicolas Lindley, and also the Government of Fernando Belaunde (1963-1968), expanded the range of economic intervention of the State, injecting more money to Public companies, making the public administration grew and disregarding balance and fiscal discipline issues.

At that time, most of the people did not perceive inflation as a big problem and the size of the Government increased even against its own will, due to the very logic of the system. In fact, in late 60's inflation reached 19% per year.

Then, nationalist ideas appeared. Under the left-wing model, during the decade of 1960, fiscal deficits were about 2%. It was assumed that the model of import substitution could improve the growth rates of production or, at least, they would

have remained. The results yet, were different: the annual average of the GDP growth rate went from 7% in the 50's to only 5.3% in 60's.

Peruvian economy could not keep up with the increase of the export capacity and consequently, in the degree of interconnection of the economy with the rest of the world. As a percentage of the product, exports fell to 17% of GDP and the flow of foreign investment decreased, but not the external debt. In a context of a decreasing tendency in production, the increase in debt represented a risk.

In 1961, Peru had an external public debt of US\$ 140 million and exports of US\$ 510 million. By 1969, the debt was 874 million, compared to exports of US\$ 880 million. The harmful effects of economic mishandling were first public spending, which passed from 13.3% of GDP in 1961 to 18.6% in 1967 and inflation, from 3.6% in 1961 to 10.8% in 1967. The fiscal accounts went from the surpluses to a deficit of 3% of GDP in 1967.

Meanwhile, GDP growth saw its rates decline to levels of 3.6% in 1967. The situation went from bad to worse, and that was the reason why there was no rejection by the population when the Army General Velasco Alvarado completed a military coup in 1968.

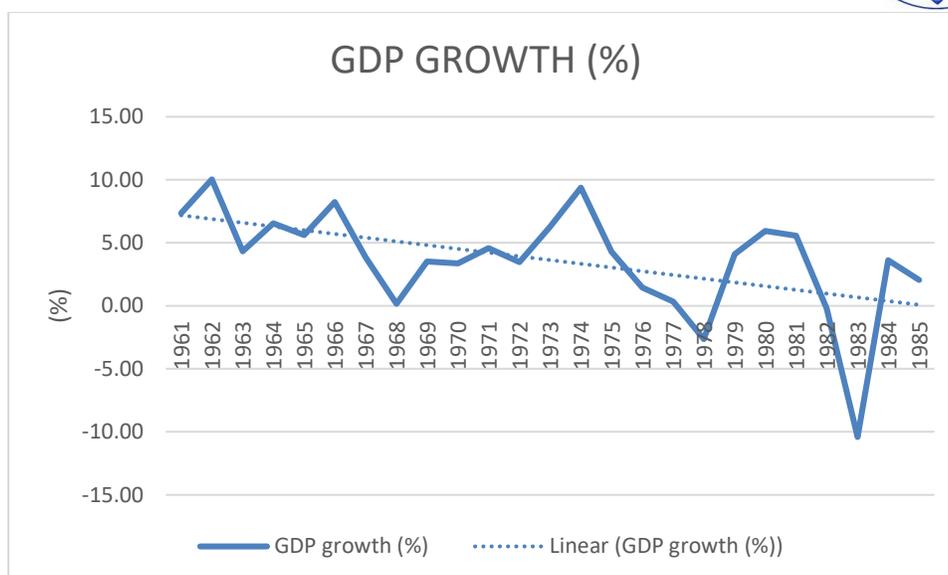


Figure 2.3: Annual GDP Growth in Peru (1960 – 1985)

Source: World Bank

The new regime evidently supported State intervention and since the partial intervention in the economy had not worked, it was thought, it had to be deepened and generalized, protecting the national industry from competition and regulating the main economic variables.

The military Government sought to change all aspects of the economic and political life of the country. Private activity was subordinated to the compulsive planning of the Government. It swept away the private property rights through the Agrarian Reform, for which millions of agricultural hectares were awarded to cooperatives and peasant communities in favor of the so-called “social property”. Another measures were the control of the manufacturing production and the creation of the Labor Stability Law under the assumption that State legislation could replace the demand for labor by simply giving a Government decree. The regime nationalized private companies and also increased public investment, adding more debt to national accounts.

Unfortunately, the cure can be worse than the disease. In the late 60’s and 70’s, that is, during military regimes, annual inflation was over 27% on average. There was a



rapid and disproportionate growth of the Government apparatus, in which more than 200 Public companies were formed, inescapably using resources of the Public treasure, and as a consequence generating even larger deficits.

Despite increasing public spending and investment, production growth rates fell. In the decade of 1960, the average rate was 5.3% per year, while in the 70's it was 3.7%.

During the 70's, the average of exports capacity continued its fall to 15.7% of GDP and, as a result of nationalizations and expropriations, the foreign investment of the country was scared away. Peru lost the opportunity to take advantage of the years of the "boom" in the prices of raw materials, especially in the industry of minerals and oil, and fish derived products which are key resources for Peru. International Reserves reflected the impact of debt, recording negative outcomes for consecutive years.

Towards the end of the decade the economic crisis made the political regime unsustainable and elections were called, creating optimism expectations in the population. However, for the pockets of the people, few things changed with the upcoming of democracy.

The second government of Fernando Belaunde (1980-1985) maintained all the heavy and inefficient business apparatus of the State, did not make major efforts to rationalize the public administration, nor eliminated the excessive regulations on private activity. State intervention remained, although moderately managed, in almost all productive and commercial fields. In the financial aspect, even increased the governmental power for economic decision making. Price controls were continued on key products for the economy, such as fuel, food, cement, steel, credit and exchange rate, among many others.

In trade aspects, a minimum reduction in tariff levels was made. In some sectors the exposure to foreign competition felt more, because there was a large dispersion in tariffs. In addition, innumerable quality controls were maintained on the imported goods. These controls became barriers to prevent competition from foreign products.

Public companies were maintained through subsidies for production and price control in order to avoid competition. This caused huge transfers from the Public treasury and, at the same time, annulled private initiative and created serious distortions in the market.

This structure made the economy vulnerable. The average annual inflation for the period 1981-1985 was 105%. The fiscal deficit averaged 7.1% of the GDP. Production practically did not grow in the period, showing virtually no variation of the GDP. Similarly, Exports had minimum growth rates. But not all indicators were wrong, since International Reserves, did show a rebound, going from US\$ 1.7 billion in 1981 to almost US\$ 2.5 billion in 1985, passing from 43% to 57% of Exports.

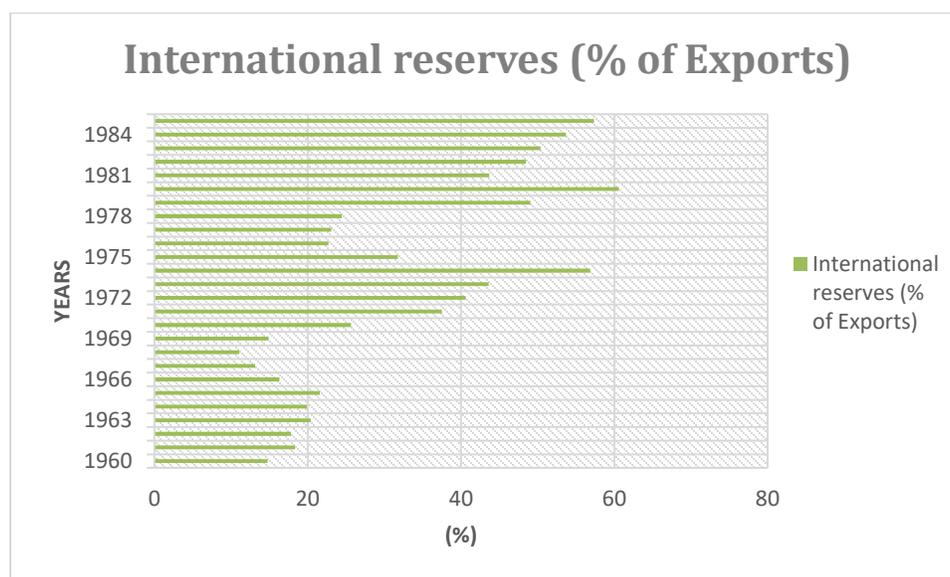


Figure 2.4: Peru's International reserves, as percentage of Exports (1960 – 1985)

Source: Own elaboration

2.3. Additional Conditioning Factors of the Crisis

2.3.1. Terrorism: “Sendero Luminoso”

Economic stability was strongly affected by attacks on public and private property; but it was above all the integrity of the citizens that was at risk during this dark period

of Peruvian history, the man who led terrorist and genocidal organization called "Shining Path" was Abimael Guzmán. A subversive movement plagued by marxist leninist ideologies; that initiated infamous activities in the decade of the 80's, acting with impunity for 12 years until Guzmán was captured and imprisoned in 1992. Shining Path is responsible for the murder of thousands of people. During this period, terrorist intrusions caused economic losses of more than US\$ 42 billion and 1 million displaced persons, and 22 thousand people died.

	Quantities	Units	Remarks
Economic losses	42	US\$ (billion)	22 (in material goods)
Displaced persons	1	million	240 mil. (abroad)
Fatalities	22	mil.	

Table 2.2: Terrorism in Numbers (1980-1992)

Source: CVR

Terrorist barbarism during the 1980's, amounted a damage for US\$ 22 billion in material goods. The attacks produced more than 20 billion, 1.1 billion of which were committed against high voltage towers. The nefarious actions caused a great flight of capital, scared off foreign investment and caused the migration of about 240 thousand Peruvians overseas, among which there was of course a large number of professionals. It had generated, finally, a loss of international confidence in Peru as attracting country for commercial transactions.

2.3.2. Natural disasters: “El Niño” phenomenon

The weather phenomenon that affected Peru during 1982 and 1983, implied basically the raise of water temperatures, which caused rainfall that increased rivers flows and as a consequence generating floods, avalanches and paradoxically drought in other regions of the country.

There were huge damages to production and infrastructure, these occurred mainly in the sectors of agriculture, industrial, energy and hydrocarbons, transportation and communications, mining, fishing industry, housing, tourism, health and education.

Effects were damaged roads, collapsed bridges, severe damage on airports, destruction of several sections of Peruvian main pipelines, affected plants and transmission lines. Thousands of homes and sewage systems were affected, outbreaks of diseases, schools destroyed and thousands of hectares of crops were lost. 16 out 24 regions in Peru were affected and the total number of affected people reached 1 million.

The phenomenon was very intense and produced great economic losses amounted to more than US\$ 2 billion, bringing with it an augmented decay of the Peruvian economy.

2.4. The Government of Alan García

Alan García offer was a greater intervention of the State in the economy, since the market did not adequately distribute revenues. According to García, the Government had this fundamental role, he promised to expand the business activity of the State and restructure consumption patterns based on the demand of the country. His Government Plan, proposed concertation, the control of prices, a differentiated exchange rate and the reduction of the deficit literally "not from a drastic reduction of expenses".

García led Peru to a hyperinflation of 7,482% yearly at the end of 1990.

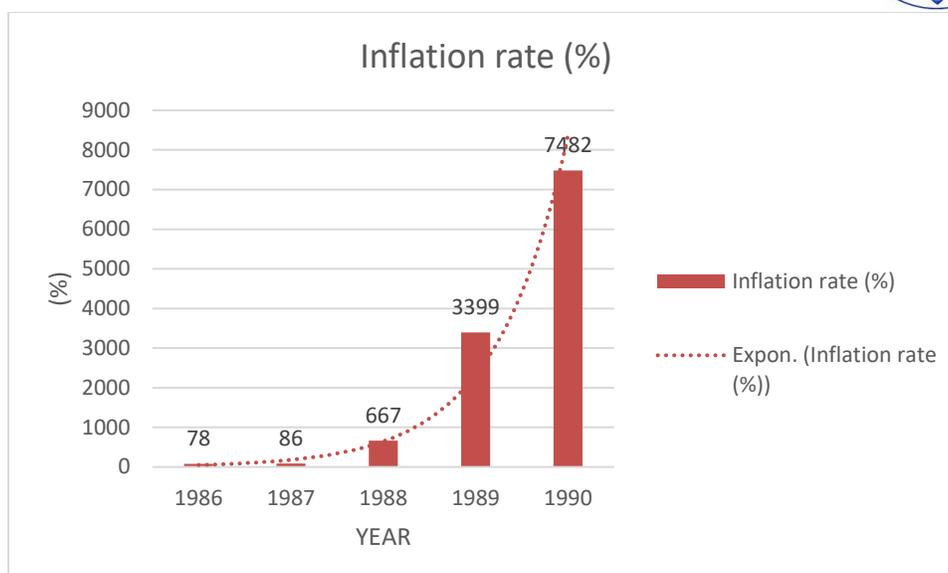


Figure 2.5: Inflation during Alan García's Regime (1985 – 1990)

Source: World Bank

The fiscal deficit was 6.4% for its five years of government. Taking into account the fiscal and quasi-fiscal deficit, that is the emissions of the Central Bank to finance public spending, the figure corresponds to 16% of GDP in 1990. One of the most controversial measures was to stop paying the external debt, the results would be seen later.

Production, far from being reactivated, fell. It was useless to have "inflated" the economy during the first two years with artificially rates of 9.4% and 9.8% of GDP growth. In the last three years of the decade there was a fall on average of more than 9%. Exports stagnated and in comparative terms fall, around 14% of the GDP. The same situation occurred with International reserves, during the quinquennium of governance were reduced to an average value of 8.7%, as percentage of the GDP.

Reserves were used to "reactivate" the economy, according to García. The Government injected funds of the Central Bank into the economy, charging less soles per dollar, so entrepreneurs could import more and thus produce in greater

quantity; unfortunately this reasoning was a big mistake, because dollars were auctioned off to those who managed to put themselves on favored lists.

Essentially, they could get dollars cheaper than those sold on the market. Peruvian entrepreneurs did not rely in their local currency, so they used the dollars for their personal accounts. This dollar full of good intentions but lacking of economic support was called dollar MUC for its acronym in “Mercado Único de Cambio” or Single Market of Exchange.

Undoubtedly, the scheme encouraged corruption. Moreover, as the other Peruvians paid more soles for each dollar, the result was not and it was never going to be an improvement in the economy as a whole since only a few filled their pockets.

The political and economic failure of the government of Alan García can be summarized in the following points.

- Led Peruvian economy to bankruptcy.

During his government, he led Peru to the biggest economic crisis in its republican history. The bankruptcy that it caused was more serious than that experienced during the Pacific War, the armed conflict against Chile, in 1879. The accumulated inflation from 1985 to 1990 reached the rate of 2.2 million percent. The accumulated GDP growth in that period fell by 7%. The GDP per capita reached lower values than the ones in 1960.

During his government, International Reservations reached only US\$ 1.2 billion. The fiscal deficit reached 16% of GDP and the tax burden fell to only 4.1% of GDP. The public companies lost more than US\$ 1,650 million.

- Impoverished the population.

The legal minimum income was reduced in half. In comparison to predecessor administration, public spending on health and education fell 5% in real terms. Consumer spending fell by 46% between 1986 and 1990.

The Peruvian population became impoverished to unprecedented levels. During his Government 13 million of Peruvians were consider poor, that was the 54% of the population.

- Weakened national infrastructure.

The national infrastructure presented deterioration since minimum investments were made to increase the supply of potable water, provide sanitation nor increase the supply of electricity or build roads, national road network were in particularly poor condition. There was also a deficit in energy sector.

- Nationalized important areas of private property.

Private ownership suffered serious assaults. Oil companies, private banks, financial and insurance companies were nationalized, thus generating chaos and bewilderment.

- Isolated Peru from the world.

Peru was isolated from the international market because it followed an unilateral policy of nonpayment of the external debt. Peru was described as ineligible for new credits, both from international organizations and from banks and suppliers. Similarly, the policy of dedicating only 10% of exports for the payment of foreign debt, increased the latter from US\$ 13 to US\$ 20 billion. The foreign currency deposits of the Peruvian State could not be kept

in the majority of foreign banks for fear of being seized. Foreign investment inflows virtually disappeared from the country, it amounted US\$ 41 million.

- Passive behavior in the face of the advance of corruption and terrorism.

Corruption propagated alarmingly. Between 1985 and 1990 the area dedicated to the cultivation of coca practically doubled reaching 200 thousand hectares. The dollar MUC, the negotiation of debt papers and also the imports of food products, positioning national reserves in the BCCI (Bank of Credit and Commerce International), , were among the major fraudulences committed to obtain personal benefits in Public administration of those years. Garcia also had the support of some biased media.

Terrorism advanced frightfully. The attacks both on public and private property increased drastically, the number of high-tension towers damaged by subversives were almost tripled. Also, the fatalities caused by political violence almost doubled.

- Concentrated political power.

Garcia tried to concentrate political power in his hands. The Legislative and also the Judiciary branches had the interference of the Executive branch. The same happened with the National Elections Jury and the Organizations of control. The Central Reserve Bank of Peru lost its autonomy, accepting requests for money emission without objections.

By the end of Alan García's regime in 1990, the decline of Peruvian economy was completed. There was no foreign investment, no debt capacity and to make matters worse, no reserves. Peru had hyperinflation and production fell drastically. In summary, the country was broken.



Chapter 3: The Implementation of the Reforms in 1990

Alberto Fujimori unexpectedly won the elections in Peru and assumed the Presidency in 1990, defeating Mario Vargas Llosa, the right-wing political candidate and who would later be awarded Nobel Prize in 2010.

Fujimori was essentially unknown in politics, he won the electoral process with a last-moment sprint and according to some specialists without having a clear government plan nor a solid political party. One key character was the economist Hernando de Soto, advocate of liberalism and market economy, he convinced Presidency and led other advisers and technicians in order to apply the reform needed by the Country. Among those, Carlos Boloña, the Minister of Economy during the critical initial years of the implementation of the structural reforms, also called Economic Program.

3.1. The Principles behind the Reforms

The basic principles for a market economy were taken from the Austrian School of Economics and particularly in, remarkable economist, Ludwig von Mises ideologies. The objective was to guarantee the existence of a free political order, and in this way guarantee the reform itself. Those basic principles are:

- Freedom is the fundamental political value of this doctrine and is understood as the ability to choose between different options, it is an attribute that refers to the individual human being considered and not to the aggregates or collectivities that they form.
- Peace is another fundamental political principle of liberal doctrines; is referred to peaceful coexistence. It is necessary that people do not affect its rights and in case, this happens, there is a system for detecting the infringements of freedom and peace of others, as well as a system of proportional sanctions to the faults committed.
- Private ownership is one of the main sources of rights. Rights in general resemble an extension of the principle of private ownership to fields that are



not strictly material. Private ownership is a political and economic principle; is not only the result of the social division of labor, it also generates rights and obligations, hence, is one of the cornerstones of liberal doctrine.

- Equality under the law is a principle that implies the legal rights and obligations, in turn, must be equitably distributed. This means that the standards of conduct enforceable by society must be identically applied to each individual.

- The Limitation of the State. The State is an essential entity for peaceful coexistence and the maintenance of a civilized order. The State, however, in having the right to use force, may be tempted to make illegitimate use of it. A fundamental principle for maintaining a free social order is one that refers to the limitation of state activities for the purposes they were established. Government authorities must be limited to guarantee over their prerogatives the property rights and equality under the law that coordinates individuals. The State must ensure the physical safety of citizens, as well as the legal security of their contracts and rights. It must avoid and sanction any abuse of power aimed at creating situations of privilege and monopoly. The State must not intervene in the competition.

- Democracy is the way for citizens to express their will on how to allocate public funds, is required a system of electing authorities that represents preferences of the citizens. The least imperfect system for the selection of officials that handle the coercive powers of the State is democracy. It is not understood as the absolute power of majorities, but as the system that, through the consultation of the majority opinion, adopts decisions pertinent to public functions. Democracy must be the competition regime between the different options for political action, for which it is essential that its institutions function effectively.

- Tolerance is the fundamental value that sustains the democratic institution. It means accepting the various creeds, ideologies and activities that do not violate the rules of peaceful coexistence, even if they do not obtain from the others a kind of moral approval. Tolerance is the basis of peaceful disagreement and this, in turn, the foundation of democracy, peace and freedom.

The fundamental principles for a market economy, had its origins from the Austrian School of Economics, established in 1871, after the publication of the Principles of Political Economy by Carl Menger. Later those liberalist ideas were reinforced by the “School of Chicago” lead by Milton Friedman and George Stigler.

The Economic Program applied in Peru was based precisely on the principles that support an open market economy. Both in the Austrians and those of the Chicago School can be found a coincidence with respect to these fundamental principles. They can be summarized in seven points:

- ✓ Stability of the main variables.
- ✓ Free competition.
- ✓ Private ownership of the means of production.
- ✓ Consumer sovereignty.
- ✓ Free trade and world integration.
- ✓ Free mobility of production factors.
- ✓ Relief of extreme poverty.

With the crisis of socialism around the world, the arguments were affirmed in favor of a return to the old principles of justice, peace and freedom that characterized the development of industrialized countries. Traditionally, Peru has been one of the richest countries in terms of natural resources but there are other types of resources, the ones related to the work of man, which involved technology and innovation, which have had slight development. The best mechanism to discover resources and most important make them available to consumers, is a global market. The market

economy and political freedom was imperative. Peru needed to start diversifying markets, be open to foreign countries to grow and capitalize in order to take advantages of economies of scale, and eventually overcome poverty and achieve the desired levels of prosperity and well-being. Those were the maximum objectives of the reform.

3.2. The Structural Reforms

The Structural Reforms were carried out during the key years of 1991 – 1992, they were basically arranged in three stages: the first one began in 1991. It approved 61 supreme decrees. This first wave included regulations such as the reduction of tariffs and the elimination of para-tariff measures, the liberalization of the foreign exchange market, the elimination of public monopolies, the liberalization of the labor market and the first privatization order for public companies.

The second stage of reforms occurred at the end of the same year. In it, 117 legislative decrees were passed under the protection of the law on delegation of powers in matters of pacification, promotion of investment and promotion of employment.

The third stage of reforms began in 1992. At this stage, 745 decrees were enacted. The reforms were aimed at the trade sector, the financial sector, the public sector, productive sectors, social sectors and the restoration of the Rule of Law.

The structural reforms can be grouped into four, according to the achievement of their objectives in: The stabilization of the macro variables, the modernization of the economy, the restructuring of the private property system and finally the minimization of the State.

3.2.1. The Macroeconomic Stabilization

In order to reach macroeconomic stabilization, one of the purposes was to recover the image of Peru in front of the international financial Organizations such as the Monetary Fund and the World Bank, to a certain extent the connections were made thanks to the intermediation of Javier Perez de Cuellar, a Peruvian diplomat formerly United Nations Secretary General.

There was a series of negotiations. They are listed below in order of occurrence:

3.2.1.1. The Reference Program with the IMF (1990 – 1991)

The reference Program was the first step for reintegration in international commerce, referring to sectors: trade, financial, labor and public.

Probably the most important reform of this stage was restrained the Central Reserve Bank of Peru (BCR) of finance public spending, guarantying its autonomy. On the other hand, the national budget was restructured, since tax pressure was below levels of 8% of GDP.

The new national budget was approved and hyperinflation began to ease. In opposition, the exchange rate, which was stuck began to increase. With regard to international access to credit, the Inter-American Development Bank (IDB), the American Treasury and the Government of Japan, committed themselves effectively for the establishment of the Support Group.

An important measure of the Government during the first year was the monthly adjustments in the price of fuels.

Because of dollar devaluation began to rise steeply, the BCR intervened in the market, selling dollars, stopping the speculative wave and reducing the exchange rate.



The coverage of the General Sales Tax (IGV) and the Income Tax (IR) were modified and increased. There was an increase in taxes on fuels of 18% for fiscal reasons and because of disagreements for sales revenues between the Treasury and the Peruvian oil Company “PETROPERU”. As expected, the increments reduced credibility to the Economic Program. Additionally some taxes were needed and were approved by Emergency Decrees, those modifications were key for the tax reform detailed later.

To make it worse, there were strikes promoted by workers of Education and Health sectors. Eventually the authorities managed to control the public protests ending inflationary expectations, tracing a downward trajectory that ended 1991 close to 400%. The decrease of inflation rates was achieved thanks to the fact that public spending was maintained adjusted well, that taxation was increased and monetary emission was contained.

Also in 1991, the Support Group was obtained which contributed with donations and loans to cover a financial gap that was calculated in US\$ 1,300 million for the period 1991-1992, granting money to Peruvian Government after more than seven years of being isolated from the international financial system.

3.2.1.2. The Rights Accumulation Program (1991 – 1992)

The Rights Accumulation Program was the first formal program with the International Monetary Fund, it was signed on 1991 and lasted 15 months. The Rights Accumulation Program was a mechanism created to restore confidence after the unilateral scheme of no-payments of the external debt applied by García, since by its regulation, the IMF and the World Bank could not give loans to a country that has not complied with previous loan payments.

The agreement implied that no obligations would be paid until 1993. The Program was approved by the IMF Board. The objectives were met and allowed to accumulate the rights to obtain, by the end of 1992, a loan of US\$ 873 million for a period of eight



years, which would include a grace period of three years. By 1993, Peru obtained a bridge loan to cancel the debts with the IMF, using funds for the same amount to cancel the bridge. From that moment, the Country was eligible to receive fresh economic resources from the IMF to finance or support its balance of payments and enter into negotiation for an Extended Facility Program (EFF) for the period 1993-1995.

The Economic Program was based in a uniform external tariff of 15%, which was established. The laws of debt and financing were also approved. Respecting the latter, the new Income Tax was incorporated which, apart from a series of corrections and improvements, extended to the Tax on Assets.

Evidently, there was a need for greater taxation, consequently a tax package was applied. This was based on modifications to the General Sales Tax (IGV), the Income Tax and the elimination of tax exemptions. Again, the taxes were approved by supreme emergency decrees.

By 1992, a significant fiscal surplus was experienced as a consequence of the National Housing Fund (FONAVI) accumulation in the Treasury, own resources from the National Superintendence of Tax Administration (SUNAT), privatization funds and the own revenues of the Ministries. The amount reached levels of US\$ 330 million in 1992.

On the other hand, recession significantly worsened due to natural disasters ("El Niño" phenomenon), and the effects of terrorism: the rationing of electrical energy, restrictions due to terrorist attacks and the economic adjustment. Growth, initially estimated at 2.5% of GDP for 1992, presented negative figures (-0.5%).

The situation led to the introduction of a package of measures, with the aim of reducing the effects of the severe recession, without falling into the temptation of "reactivation". The package included higher spending on public investment, alleviation of extreme poverty and support for the anti-subversive struggle. The refund was granted to the General Sales Tax, which taxed the exportable production. Anti-technical taxes were eliminated, such as the tax on the checks and the reduction



of the Selective Consumption Tax. About US\$ 100 million were allocated for medium and long-term financing and bonds were issued for financial restructuring. The package was financed with the fiscal surplus that had been generated.

Later, pressure began for a further devaluation of the exchange rate, motivated by an increase in public spending of US\$ 85 million (100 million “nuevos soles”). This injection of local currency in the economy led to a reduction in its interest rates, which in turn attracted debt conversions from dollars to local currency, increasing in return the demand for dollars. The devaluation of the exchange rate was underway, reinforced by the change in the deposit and payment system of the National Superintendence of Tax Administration (SUNAT), which was extended from the Bank of the Nation (BN) to the Private Banking. The sum of all of these factors led to an approximated devaluation of the exchange rate of 20%. This devaluation accelerated and was controlled by the sale of dollars by the BCR, since greater devaluations also put at risk the inflationary goals of the Economic Program.

In the 15 months of application of the Rights Accumulation Program with the IMF, the figures showed the compliance with fiscal, monetary, international reserves and external debt goals. They also evidenced a significant advance and an intensification of the structural reforms. It was the first case of achievement of the RAP with the IMF and a great success for Peru in its fight against inflation and in the process of achieving greater external credibility, in this manner Peruvian Government earned the right to eliminate the delays on its debts with the World Bank and the IMF.

3.2.1.3. The Extended Fund Facility Program (1993 – 1995)

The Government developed a three-year economic program that was supported by an extended facility arrangement from the IMF in an amount equivalent to US\$ 1,467 million.

The advantages obtained from the negotiation were: the reduction in the fiscal deficit; an increase in the tax pressure and the GDP growth in following years; and also the

possibility of having higher emission margins to buy dollars and maintain the exchange rate, while not affecting the inflationary goals.

During 1993-1995, output growth averaged 8.3 percent a year, while inflation was reducing uninterruptedly, and the net international reserves position of the Central Reserve Bank improved significantly. This performance can be traced to a large extent to prudent fiscal and monetary policies later detailed, a comprehensive program of structural reforms, and the continued support of the international financial community.

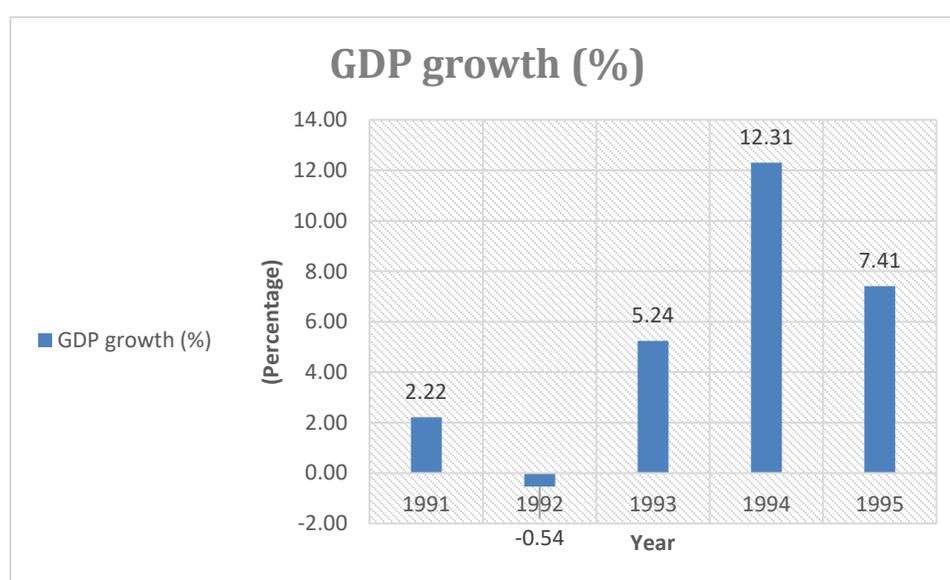


Figure 2.6: GDP Growth rates (1990 – 1995)

Source: World Bank

Economic stability aimed to control inflation was the first step in order to achieve economic growth in the medium and long term. For that, a sufficient balance was required, mainly of the macroeconomic accounts, which implied viable balance of payments, by fiscal and monetary policies, and also savings and investment accounts.

3.2.1.4. Macroeconomic Policies

- **Monetary policy.**

Monetary emission was ordered being consistent with the targets of inflation and GDP growth. So, in this matter, one of the first measures of the Economic Program was to reduce the monetary emission by the BCR.

The proportional relationship between the issuance of currency and inflation before and during the years of the reforms:

Year	Monetary emission of local currency (%)	Inflation (%)
1987	11	86
1988	439	667
1989	1783	3398
1990	5214	7482
1991	96	409
1992	62	73

Table 3.1: Correlation Monetary Emission - Inflation (1987-1992)

Source: Change of Course

The year 1991 meant the change towards the current local currency: the Nuevo Sol, instead of the previous one and extremely unstable “Inti”.

With the new image of the Peruvian currency, the monetary authority of the Central Reserve Bank of Peru was also strengthened, which had been very permissive before 1990. The Central Bank was also specifically warned of not grant credits to the public or private sector.

The rate of reserve in foreign currency did not vary. The interest rates were set free, rediscounts were given according to specific situations and in very

short-term manner. Additionally the BCR created instruments to carry out open market operations.

The remonetization of the Peruvian financial system succeeded. It took place gradually through issuance of the Central Bank that was used to buy dollars and attract foreign currency, internally and externally. During first years of the reform, dollars kept in households because of the distrust generated by expropriation of previous regimes began to return; besides that, Peruvian capital abroad began to be repatriated. A large amount of investment money was brought in the economy, propitiated by the reforms.

Peruvian financial system was in a very fragile situation, featuring Banks facing economic difficulties or in some cases bankruptcy risk, reduction of personnel and reduction of agencies. For that reason, these Institutions went through a process of severe adjustment and in parallel investment in modernization.

- **Fiscal Policy.**

In order to achieve a correct balance of payments, discipline in fiscal accounts was essential; to reduce the deficit it was necessary to cut expenses and increase tax revenues based on the extension of the General Sales Tax and the Income Tax, lowering percentage of taxes but reaching a broader base of taxpayers, that is increasing the tax burden. Detailed measurements are listed ahead.

- **Exchange rate Policy.**

The exchange rate was also set free, that is determined by the market, unique interventions of the BCR were made for reasons of international reserves or

to avoid fluctuations in the exchange rate, but did not affect the inflation targets.

The decline of the real exchange rate meant that the devaluation of the local currency was slower than inflation. Noticing the information on the table, the inference is that both had positive correlation:

Year	Inflation	Devaluation of local currency
1988	667%	684%
1989	3,398%	1,118%
1990	7,482%	3,750%
1991	409%	87%
1992	73%	63%

Table 3.2: Correlation Inflation – Devaluation of local currency (1988-1992)

Source: Change of Course

The process of exchange overvaluation took time to correct itself. It was from 1992 that it began to gain parity, in order to correct this position, the Government reduced a series of internal cost overruns in foreign trade and encourage exports and production more competitive for the local market.

The modification towards a regime of free or floating exchange rate, eliminated the problem of international liquidity. The flexible exchange rate allowed the fiscal and the monetary policies to be oriented towards internal stability without having to be distracted by balance of payments problems.



Just as hyperinflation took years to control, interest rates both in local and foreign currency took years to reduce. The reduction was hand in hand with the fall in inflation.

- **Interests rates Policy.**

In order to decrease interest rates, a series of conditions were driven by the State, such as the reduction of inflation, the decrease in the country risk, the decrease in cost overruns caused by the Government itself to the financial system and the contribution of financial institutions to the Superintendence of Banking and Insurance (SBS).

The State also encouraged greater competition within the financial system by attracting foreign investment through the privatization of financial institutions. Another fundamental conditioning elements to lower interests, were the Banks and financial institutions themselves through economic adjustments such as rationalize personnel, reduce the number of offices and costs in general; as well as create new products and introduce new strategies.

- **Pricing Policy.**

Prices were also set free, determined by supply and demand. Conversely, some administered prices were adjusted by expected inflation and restructured according to international prices to allow balance the finances of the respective Public companies which were later privatized. Administered prices, also known as key prices, were fuels, electricity, water and communications.

- **Savings and Investment.**

Savings and Investment are determining factors for growth. Higher investment rates are associated with higher growth rates and to the extent that the productivity of investment increases, growth will also increase. The Economic Program encouraged investment public or private and the latter, national or foreign. Particularly opened to foreign investment since it has the characteristic of mobilizing more capital and being more productive than national investment.

In the table is observed the results of hyperinflation over the levels of Investment both public and private:

Years	Public investment	Private investment
1980 - 1984	8%	18%
1985 - 1989	4%	15%
1990	1.7%	13%
1991	2.4%	14%
1992	3%	13%

Table 3.3: Variation of Public and Private Investment, as Percentage of GDP (1980-1992)

Source: INEI

Savings that finance the investment can be foreign or internally, those are savings of individuals, companies or the Government. Savings in Peru were mainly external and from the private sector. The Public sector did not save because of the presence of a strong fiscal deficit. Total savings in Peru were reduced to 16% of GDP.

Savings are determined by the level of current and future income of citizens, as well as the profitability of savings. Positive real interest rates were reached, higher than inflation, thus people saved more, and the supply of loanable funds was increased by financing larger volumes of investment and

generating greater growth. Evidently this was a way to do it, but up to a limit, because positive real interest rates are associated with higher rates of economic growth in the countries where they occur.

3.2.2. The Modernization of the Economy

The macroeconomic stabilization was the necessary condition for markets to work and structural reforms to be successful. The next step was to achieve greater efficiency, and increase production.

Under a liberalist proposal what the private sector can do, should not be carried out by the public sector, that means reducing the size of the State and its intervention in the economy. This aspect of the reform looked for a successful transition from stabilization to economic growth.

The microeconomic reform consisted in the liberalization of the main markets in the Peruvian economy; that is, the market for goods and services, the monetary market and the labor market. Following the analysis of each of them:

3.2.2.1. Goods and Services Market

Liberalization included both goods and services produced internally and those imported from abroad. The measures taken, regarding foreign trade were:

For Imports:

- Import tariffs were reduced to only two rates: 15 and 25%, until reaching standard tariffs close to 15%.
- Prohibitions, restrictions on imports and para-tariff barriers such as phytosanitary, zoosanitary and health registration regulations were eliminated.

- Import monopolies by public companies were eliminated. Likewise, some regulations that required the use of national raw materials in different manufacturing processes were annulled.
- Restrictions on tariff surcharges were imposed on four agricultural products: wheat, milk, rice and sugar, which were phased out until 1995.
- The free import of used goods was allowed, with the exception of clothing, footwear and toiletries. The fractionation of import rights of capital goods was also allowed to stimulate investment.
- The National Superintendence of Customs Administration (ADUANAS) was reformed to simplify procedures and reduce corruption and smuggling. Import supervisors were hired to reduce undervaluation and corruption.
- Regulations against dumping or any price discrimination, and countervailing rights were approved and applied, in accordance with the rules of the General Agreement on Tariffs and Trade (GATT).

Regarding to Exports:

- The taxes on traditional exports and subsidies on non-traditional exports were eliminated; In addition, the general sales tax (IGV) was refunded to all types of exports. It was sought to find, particularly private mechanisms for the promotion of exports.
- Various controls and export monopolies were eliminated, as well as the certification of exports and other cost overruns.
- Some existing export contracts were renegotiated and new contracts were prohibited.
- The liberalization of foreign trade allowed the Peruvian consumer to have the freedom to choose between a great variety of domestic and imported goods, at affordable and competitive prices.

Regarding trade in general:

- A reduction of port costs to international levels. The cargo reservation for maritime transport was eliminated; it was established a policy of open skies

and a freeing of tariffs in air transport, and tariffs and routes in urban terrestrial transport.

- Various State trade monopolies were eliminated.
- The Consumer Defense Institute (INDECOPI) was created, in charge of approving consumer protection regulations, free competition and antitrust norms.
- Commercial Free Trade Zones were eliminated to reduce unfair competition with the domestic market. Conversely, Industrial Free Trade Zones were promoted for exports.

3.2.2.2. Monetary Market

The objective of the reform in the money market was to achieve an efficient, competitive financial system, open to the outside world and characterized by its solvency and prudence. The financial sector was conceived as the foundation for economic growth and the efficient intermediary of private and public savings to finance the different sectors of the economy.

Regarding the foreign exchange market, authorities sought to unify the exchange rate and its determination through the market. The most appropriate alternative was to apply a floating system with restricted intervention of the Central Bank, so called "dirty float", based on international reserves and monetary goals. Recalling that, according to liberalism doctrine a free floating exchange rate is theoretically the ideal.

It was arranged the free convertibility of the national currency and the free possession and transaction of the foreign currency; currency controls were eliminated in the transactions of the current and capital accounts. The remittance of utilities abroad was allowed without limitations, as well as patents and royalties.

Some of the specific measures taken, were:

- A new law was issued whereby the Central Reserve Bank (BCR) guarantees its autonomy and prevents it from financing public sector expenditures.
- Several financial institutions were privatized and restructured and expropriated ones were returned to their legitimate owners. The BCR credits were eliminated to the public and private sectors. The apparatus of the Bank of the Nation (BN) was significantly reduced.
- It was carried out the liquidation of insolvent and cooperative financial institutions.
- The savings in foreign currency, expropriated by policies of previous Government were returned to their holders.
- It was established a uniform law for all financial institutions and any type of discrimination was eliminated. The Superintendence of Banking and Insurance (SBS) was restructured. It was created a Deposit Insurance Fund in order to guarantee savings for the public and avoid bank runs.
- The insurance and reinsurance market was liberalized making possible to contract them in the national or international market. It was established a new law of securities market that allowed its liberalization, eliminating barriers to entry and taxes on capital gains.
- It was eliminated the priority of the agricultural warranty for the State Bank, in order to allowed commercial bank loans to farmers. In addition, were also eliminated the government warranties in private sector transactions.

3.2.2.3. Labor Market

In this matter, there were two main types of reforms, the first was the flexibility of the labor market, that is, the autonomy to reduce and increase personnel, and also the free determination of wages and reduction of labor costs. This included ending the monopoly of the labor unions in negotiations on working conditions and in the use of strikes as a negotiating mechanism.

The second big reform had to do with the Peruvian pension system. The objective of this reform was the creation of a pension system based on freedom of choice, market mechanisms and the management of the private sector.

The liberization of labor market, included the following reforms:

- The State withdrew from fixing the minimum living wage, allowing its fixation to be given according to the market and productivity.
- Salaries of the public sector were adjusted also. As can be seen in the following table, the salaries of both sectors, public and private, were immediately reduced:

Year	Public Sector	Private Sector	
	Salaries	Salaries	Wages
1987 (base salary)	100	100	100
1990	14	29	32
1992	28	34	48

Table 3.4: Variation of Salaries and Wages (1987-1992)

Source: Change of Course

- It was established the obligatory nature of the compensation for length of service (CTS).
- Strikes were regulated and democratized. Collective negotiations between companies and their workers were arranged by the Government to promote dialogue; in this manner deconcentrating the power of sectoral unions, of business associations.
- It was agreed to close work centers. It were reduced labor interests to market rates. The working hours and the modification of shifts and working conditions were made more flexible.
- It was abolished the “job market” in construction sector and similar practices in other sectors.

- It was approved a private pension system administered by a Pension Fund Administrator (AFP), and for its regulation, was created the Superintendence of AFP's.
- The intervention of the State as benefactor was avoided, practices such as the creation of unemployment insurance, medical insurance, supplementary aids to families with minor children, etc. were discarded because of its inefficiency and the fact that generated bureaucracy.
- The National Pension System (SNP) and the Peruvian Institute of Social Security (IPSS) were going through a critical situation: inefficient management, cases of corruption, an evidence was the debt of the SNP with current pensioners and contributors was close to US\$ 29 billion, by 1993. The private pension system was the only effective solution to the problem.
- The (IPSS) was liquidated only on pension issues, due to its critical insolvency. This involved carrying out the auction of some of its assets.
- Finally regarding to labor modifications, the retirement age was increased to 65 years and the retirement regimes were standardized.

3.2.3. The Reform for Private Property

The reforms sought to take advantage of the benefits of the private sector, be more efficient and increase productivity. The main modifications on this subject were referred to:

3.2.3.1. Privatization of Public Companies

It was necessary the transfer of public companies to the private sector through efficient procedures. In the case of insolvent companies, they were liquidated.

The strategy consisted in starting with the smallest companies, then go to the largest ones. Large companies were restructured before privatizing them, encouraging the participation of its own employees in the ownership of companies to be privatized.



Another strategy of the process was to sell the companies in cash, thus avoiding that they could return to the State, moreover private sector assumed the risk entirely.

Government was particular concern of not selling monopolies or privileges in the process. It was important also do not allow that the book valuations were an impediment for the sales. Hence, the market was the most transparent and appropriate mechanism for privatization.

In 1990 there were 180 public companies, whose employees amounted to about 200 thousand and whose value of book assets was US\$ 5.5 billion. The most important companies were in the oil, energy, mining and telecommunications sectors. Another justification for privatization was the precarious situation of most of them, in the previous five years to the beginning of reforms they had lost US\$ 1.7 billion.

The process began in 1991. In that year, shares of mining companies were sold to the private sector, obtaining US\$ 2.3 million. During 1992 and 1993, several public companies were sold, either by public auction or stock market, obtaining for them around US\$ 245 million. The companies sold were in several industries: Transportation (US\$ 66.8 million), oil (US\$ 37.4 million), mining (US\$ 122.7 million), financial (US\$ 5.4 million), chemical (US\$ 4.4 million), gas (US\$ 7.3 million). Most important transactions were carried out between 1993 and 1996 when nearly 110 State-owned companies were privatized, it was the most dynamic period. 1997-2001, presented a significant reduction in the dynamics of privatizations. Although the main State assets had already been transferred to the private sector, there was still an important space for concessions, whose regulations were redefined as of 1996.

3.2.3.2. Opening to Foreign Investment

Investment in physical capital is a prerequisite for economic growth. It came from national or foreign sources and for that, it required clear rules and a series of

measures that promote investment and do not discriminate against it for reasons of origin. The most important measures adopted were:

- It was promulgated a framework law for domestic and foreign investment, which, with its respective regulations, sought to attract investments to Peru.
- Assurance agreements were signed for foreign investment, bilateral agreements, etc.
- It was approved a Legislation on industrial property that incorporated the concept of patentability in medicines, inventions and other activities.
- Several legal disputes with foreign companies were resolved.
- It was promulgated legislation on concessions of public goods and services to the private sector, as well as sectoral laws that allowed the sale or concession of the exploitation of natural resources.
- Another legislation, specifically on bankruptcy issues was enacted, which allowed companies in economic distress to exit the market, in a short period of time and in a transparent manner.

3.2.3.3. Private Structure: Sectors

Private ownership in the ample industry of the economy was the central piece of economic behavior and in the structural reforms. It were eliminated practices that restricted the use, availability and transferability of the property; as well as the expropriatory measures that fixed prices in the markets. These principles were applied in sectors such as agriculture, industry and housing, among others, measures taken for key sectors, included:

- **Agriculture:** It was arranged the free transfer of land and the elimination of subsidies. Similarly the deregulation of internal and external trade in agricultural products. It was also established the collection of water according to market prices. The Agrarian Reform of military regime of Velasco Alvarado was definitely dismissed.

- Fishery: It was eliminated the intervention of the State in some technical procedures of fishing boats, etc.
- Energy and Mining: The objective was to liberalize the prices of fuels and energy or regulate them by taking efficient international models in cases of State monopoly. Clearly, the State was removed from the exploitation work of mining deposits.
- Industry: Normativity referred to consumer protection that allowed patentability, was legislated.
- Housing: The rental market was liberalized. The normativity for new buildings also was made more flexible.
- Infrastructure: The objective was to eliminate monopolies in the allocation of construction projects, through domestic and international competition. The construction market had to be carried out by the private sector.

3.2.4. The Reform of the State

The objective of this reform was to reduce the size of the State, as well as its intervention in the economy. This meant the restructuring of the State, the tax reform, the reform of public spending and the attention of the poorest sectors:

3.2.4.1. Size of the State

It was necessary to reduce the Public Administration. Ministries should have a more normative than executive function, consequently the number of decentralized public ministries and agencies was reduced.

State personnel was repositioned through the decentralization of education and health sectors, as well as privatization processes. Objective criteria for selection of personnel was also key. The adjustments allowed restructuring the salary structure of the public sector, the instauration of a permanent evaluation system and the creation of a "Public Career". Some measures taken, were:

- The Ministry of Construction and Housing was merged with the Ministry of Transport and Communications. Institutions such as the National Planning Institute (INP) and the Foreign Trade Institute (ICE), were liquidated.
- Regarding the rationalization of personnel in the Central Government, 70 thousand employees out of a total of 645 thousand were relocated.
- The structural reform of the State proposed that the Central Government should be simplified by reducing the number of ministries, suggesting that the government should go from fourteen to eight, leaving the following:
 - The Ministry of Foreign Affairs
 - The Ministry of Defense
 - The Ministry of Interior
 - The Ministry of Economy, Finance and Commerce
 - The Ministry of Social Affairs (Education, Health and Labor)
 - The Ministry of Productive Affairs (Industry, Tourism, Agriculture, Fishery, Mining and Petroleum)
 - The Ministry of Infrastructure (Energy, Transport, Communications, Housing and Sanitation), and
 - The Ministry of the Presidency (Presidency, Justice and Regional affairs).
- It was decided to conserve and fortify the Fund of Compensation and Social Development (FONCODES), aimed at alleviating extreme poverty.
- 52 decentralized Public Agencies were deactivated or privatized out of a total of 70 existing ones.
- The structural reforms also included restructuring and reinforcement as the following autonomous Institutions:
 - Central Reserve Bank of Peru (BCR)
 - General Comptroller of the Republic (CGR)
 - National Superintendence of Tax Administration (SUNAT)

- National Superintendence of Customs Administration (ADUANAS)
- Superintendence of Banking and Insurance (SBS)
- Superintendence of the Pension Funds Administrator (SAFP)

3.2.4.2. Tax Reform

The tax reform aimed to modernize the tax system and exercise better control in the collection of tax revenues. Taxation was applied to achieve greater collection, it was unbiased established; that is, not favoring any particular economic activity.

Taxation in general, was based on the nature of taxes that affected consumption and not investment.

- The reform reduced the number of taxes to only five:
 - General Sales Tax (IGV)
 - Selective Consumption Tax (ISC)
 - Import Tax
 - Income Tax (IR)
 - Wealth Tax

- With respect to the General Sales Tax, it was established a generalized rate of 18% without exemptions.
- The Selective Consumption Tax was applied to determined products, those that could generate negative externalities or were considered luxury; such as oil, beer, carbonated beverages and automobiles.
- The Import Tax consisted of a uniform tariff of 15%.
- The personal and business Income Tax was based on a reduced number of fees without deductions.
- The Wealth Tax has been conceived as a minimum income tax, which could be phased out due to its anti-investment nature.

- It was applied the General Sales Tax refund, in export activities. Exonerations and tax exemptions were eliminated.
- The following taxes were eliminated: a previous Decree of 1% tax on debits, the Selective Consumption Tax of 15% on active operations of financial institutions and a series of minor taxes and contributions that increased and distorted economic transactions.
- In legal aspects it was entailed to establish severe penalties for evasion of taxes, even jail in extreme cases.

Through this type of modifications, the number of taxpayers in the Peruvian fiscal system was significantly increased, conversely it was eliminated any type of contribution that did not encourage transactions in general.

3.2.4.3. Public Spending

An efficient and rational allocation of the national budget, investment expenditures were prioritized over the current. Public investment was restructured using cost-benefit criteria and leaving its execution to the private sector. The prioritization considered higher expenditures on basic infrastructure, such as roads, water, electricity and sanitation. Some specific actions were:

- Separate the budget organic law, from the annual budget law to make this process more transparent and less bureaucratic.
- Regarding public investment, no further reforms or restructuring were carried out. Although the priority were hydraulic and irrigation projects, in the first Government of Alberto Fujimori US\$ 5,800 million were executed in them.

3.2.4.4. Extreme Poverty Alleviation

State intervention was reduced in social sectors, basically because the Programs implemented by previous administrations did not yield the expected results, since they created distortions and privileges only for some.

The conversion into a small but efficient State, was only be possible through the participation of the private sector where it works better.

- The Compensation Fund for Social Development (FONCODES) was created, an autonomous organization and a mediator that allowed to obtain donations from countries abroad.
- The objective of education reform was to encourage investment in human capital through the use of market mechanisms and the initiative of the private sector. Government intervention in the administration of education had generated an educational system of very low quality, centralized, bureaucratized and socialized.
- Education centers owned by the State were transferred to municipalities and private investors. The Economic Program suggested an educational subsidy for these Institutions called educational bonus, the intention was assigned it only to the poorest people.
- In the education sector, three Laws were approved: decentralization, financing and promotion of private investment in education.

3.2.4.5. Institutional Reforms

One of the strategical measures was to change the legal framework, the Political Constitution of Peru of 1979 tended to socialist ideologies, contemplated concepts of a social market economy and consolidated the interventionist reforms of the military government of Velasco Alvarado. The Government of Fujimori proposed changing to a new Constitution, which was promulgated after submitting it to a referendum in 1993.



The modifications of the Institutional framework included the following reforms among the Institutions of the State:

- The reform of Legislative branch, included restructuring to obtain an autonomous, modern power that legislates and controls the Executive Power. According to the reform, parliamentary immunity should be guaranteed.
- Legislative efficiency could be achieved through the application of a system that guarantees speed in the approval and the quality of laws.
- It was necessary to reduce the lobbying and avoid conflict of interest situations, through the approval of broad rules and not of particular cases.
- Conditions and mechanisms were established to alleviate spending pressures, regulation and budgetary pressures in Congress.
- Reform of the Judiciary branch: promoted decentralization of the administration of justice, both in its physical location and in the greater use of arbitration. The courts of peace were established; as well as the employment of legal technicians to reduce the work of judges.
- Depoliticize, professionalize and "computerize" the Judiciary branch.
- It was proposed to decriminalize and use private or public services to provide security to prisons.
- The access of a greater number of professionals to the field of notary was opened, eliminating the monopoly position that they exercised.
- Reform of local and regional governments: Local governments should reduce their size and interference in the economic life of the regions and municipalities. They should be self-financing, do not impose excessive tax pressures and fully privatize the services they offered to their communities.
- Reform of the National Elections Jury (JNE): The Program included the modernization and automation of the Organization in charge of elections in Peru and putting into effect a unique identification card, later called the National Identity Document (DNI).



- Reform of property rights: The objective was to facilitate access to private property through an expedited and low-cost urban and rural titling, as well as guaranteeing property rights.
- Administrative simplification in terms of creating companies, carrying out procedures and obtaining documents.
- Reforms of the Armed Forces: a rationalization of personnel and fusion of institutions that fulfill the same functions among different armed forces. Some Armed Forces companies were privatized and liquidated.
- In order to obtain greater economic utility, the new administration proceeded to sell fixed assets, such as military facilities in central locations of the city, to move them to more suitable areas.
- The expenditure on armaments was rationalized and oriented towards the fight against terrorism and drug trafficking.
- Transparent bidding and procurement schemes were applied to expenses related to Ministry of Defense and Police forces.



Chapter 4: Assessment of the Key Reforms

When Fujimori assumed power in 1990, the crisis situation was total, then, it was possible to take two paths to get out of it. One consisted of making gradual adjustments and the other of going for a radical change. The first way can create the illusion that the government can maintain its popularity at the expense of the next, transferring a greater problem. The second option instead, although sacrifice the popularity of the short term in a kind of "political suicide", solved the problem for the long term.

The reforms indeed brought difficult adjustments: inflation and unemployment worsened as price controls were eliminated and real economic losses of some activities became evident. Political opposition increased in the face of this situation and the intensification of the inequality in the distribution of income that occurs after a radical modification of the structure of incentives, but eventually exports and availability of consumer goods began to increase.

The structural reforms produced unfavorable effects in the short term, such as unemployment and as a consequence of the decrease in monetary supply, recession. However, in the medium and long term its effects were positive and contributed to higher growth and employment, as well as to a better use of resources.

The Economic Program implementation applied in Peru during the government of President Alberto Fujimori reached four critical objectives:

4.1. International Financial Reintegration

A strategic aspect of the reform was referred to the international economic and financial reintegration, which meant normalizing the relationships with foreign countries in terms of payments in order to receive loans, investments and technology.

The no-payment policy applied for previous administrations closed the doors to credit and foreign capital. Since 1990, multilateral organizations began to be paid. Formally, the reintegration of Peru was achieved, the first step was the creation of the first Support Group, a Program with the IMF and the Paris Club. Peru once again

became a member of the international financial community, after having been excluded for more than seven years prior to the reform.

The second international reinsertion began to take shape with the negotiations with the IMF in 1992, achieving an Extended Facility Agreement, which in turn allowed for the update on debts with the World Bank and the IMF.

The reinsertion became even more solid with the formation of the second Support Group (1993-1996), renegotiations with the Paris Club and negotiations with the International Commercial Bank.

4.2. Establishment of the Macroeconomic Foundations

It is widely known that a country cannot grow without a macroeconomic equilibrium, the supports of a stable economy are:

4.2.1. Inflation

The imbalance was larger, and restoring a macroeconomic balance was a particularly challenging task that took almost a decade to solve.

To put things in perspective, the hyperinflation phenomena in Peru reached a peak values of 7,842% per year in 1990, was among the twelve largest worldwide in modern history and has been one of the longest in terms of duration. Hyperinflation was dealt straightway, and there was no other way to end it than to control the amount of money in the economy. This as a consequence led to high unemployment, but it was the price paid for the erroneous political and economic decisions of preceding governments. Clearly as a result of this treatment Hyperinflation was eliminated.

Within a liberal formula, inflation is the cornerstone of economic stability, the original goal of the Program to reach international levels, was accomplished. Inflation was reduced to 48% in 1993 and 11% in 1995 and then gradually decreasing, showing

during the past twenty years an average annual of 2.8%, the current inflation is around 2%, one of the lowest in Latin America.

Reviewing the figures of Inflation in Peru, of the past 25 years:

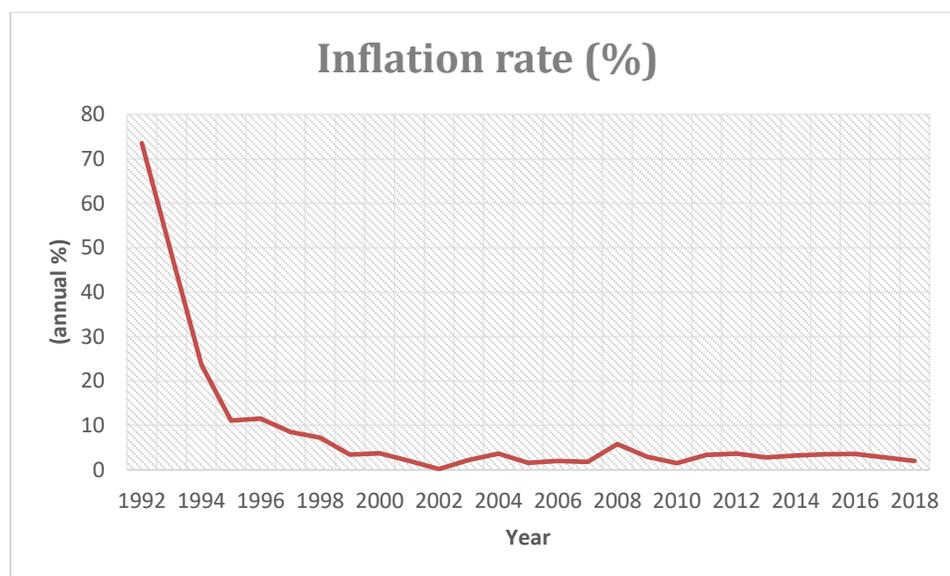


Figure 4.1: Inflation rates in Peru (1993 – 2018)

Source: World Bank

4.2.2. Unemployment

With the reduction of inflation came inevitably the increase of unemployment. The Economically Active Population (PEA) in Peru for 1990 was about 7.5 million people. Unemployment has maintained average rates of 6% annually but underemployment experienced a strong increase, it comprised the 79% of the PEA in 1991 and since then has been constantly reducing to current rates. The problem with underemployment is that it is an imprecise concept because depends on a minimum wage on the basis of which was calculated. When setting minimum wages the Government was really generating unemployment, because such wages were generally above the market wage, hence in this sense the reform was positive.

Currently PEA in Peru is around 17 million people and the rates of unemployment and underemployment are respectively 6.9% and 42.8%. As shown in Fig. 4.2

unemployment rates in Peru in comparison to the one of advanced Countries, although they differ in behavior, they present somewhat close averages during the period (1991-2018), in the case of Peru of 7.9% of the population, while in developed countries the rate is 6.7%.

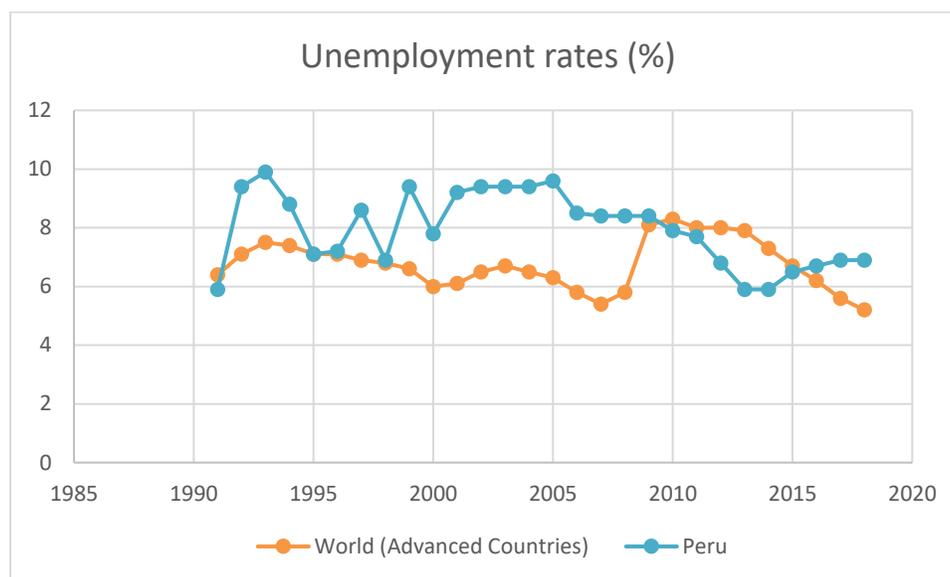


Figure 4.2: Comparison Unemployment rates World vs Peru (1991 – 2018)

Source: IMF

A long term goal is to reduce underemployment in Peru, it is likely that the reforms of labor flexibility and contracting modalities have caused these high levels, anyhow education and training are formulas for overcoming this problem but it is urgent the need for people to study what the country needs and what the labor market demands. Besides those, innovative ideas of entrepreneurs are also options to boost the economy.

4.2.3. Fiscal Deficit

It was essential for the success of the Program, to achieve a fiscal balance, capital expenditures were increased and current expenditures were reduced, since structural reforms absorbed revenues from privatization.



It is common sense to warn that a government should not spend more than it has, what it receives by collecting taxes. If it were the case of spending over the budget, the only approach involves debt either internal through private sector or external by foreign loans. During the reforms, fiscal deficit was not financed with internal credit, only with external credit and did not exceed levels of 2.5% of GDP.

Fiscal discipline began to be applied from 1990. By 1991, solid fiscal discipline was underway; the deficit was reduced to 3% of GDP, externally it was financed in full, either with external credits or with concerted relief of non-payment. In 1993, the deficit was reduced to 2.9% of GDP, with zero domestic financing and a low level of external financing.

To reduce the deficit, was necessary to cut spending and increase tax revenues, for which the Peruvian government increased its tax pressure, through a broader base of taxpayers, increasing from 5.5% of GDP in 1989 to 9.5% in 1992, it has improved to 14% (currently) but not at the international standards, as comparison neighbor Chile has a tax pressure of 20% of its GDP, Countries members of the Organization for Economic Cooperation and Development (OECD) have 35% level rates of tax burden. Informality is essentially Peruvian's main problem; the level of informality is about 60% and that is a very big obstacle to be able to growth. If the State does not have formal contact with the transactions carried out, it is impossible to collect taxes. It is urgen to integrate its people into the formal labor market, thereby investing in the continued success of its economic future.

4.2.4. GDP Growth

Rates reached a peak of 12.3% in 1994, after the establishment of the reforms and it has shown constant increase of the GDP growth index between 1995 and 2018, at average levels of 5%.

Peruvian economy shows its fragility to international periods of crisis such as the Asian crisis from 1997 and the global financial crisis initiated in United States in 2009, natural disasters (El Niño 1992), among other unfavorable situations.

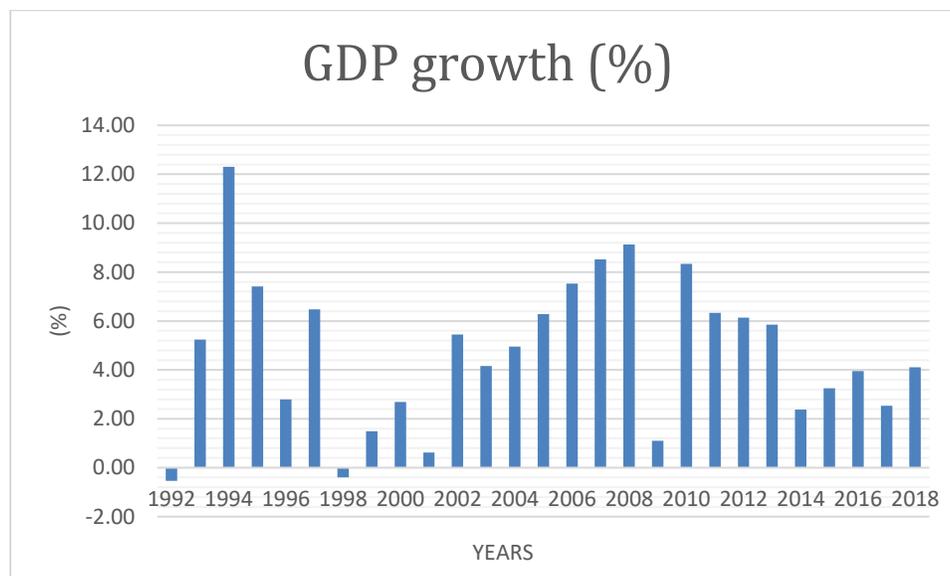


Figure 4.3: GDP Growth rates in Peru (1992 – 2018)

Source: World Bank

Still, the economic growth was the result of the long-term effects of the formation of physical capital, the increase of human capital and the technological change. These occurred in the context of a market economy to obtain higher levels of growth and thus obtain a higher yield of production factors. Additionally, economic growth had to do with the purchasing power of exports with respect to imports, the trade balance.

4.2.5. International Reserves

International reserve was another crucial macroeconomic variable to track, actually to maintain and increase progressively. They grew exponentially since 1990 reaching levels around US\$ 10,000 million in 1996 after the reforms, currently Peru has International reserves above US\$ 60,000 million, turning the country in the third largest in capacity within Latin America, only surpassed by Brazil and Mexico.

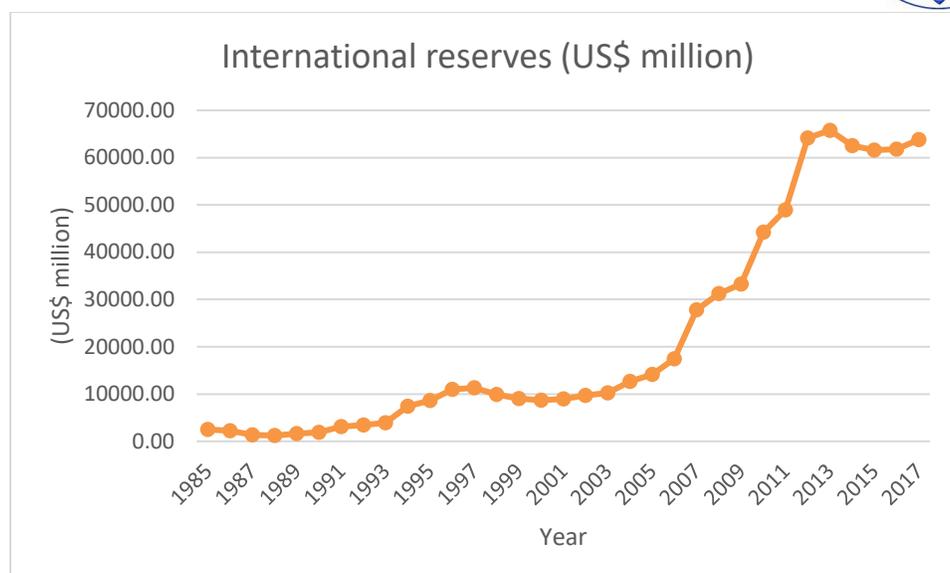


Figure 4.4: Peru's International Reserves (1985 – 2018)

Source: IMF

International reserves increase when foreign currency revenues are greater than expenditures. In this sense, the BCRP maintains a stock of international reserves to cushion fluctuations or imbalances between foreign currency revenues and expenses; as well as to stabilize the exchange rate.

A crucial element in determining the level and the need to accumulate reserves lies in the exchange regime. Under the fixed exchange rate system, a significant reserve value was required to avoid fluctuations in the exchange rate or that external shocks affect the local economy. However, under a regime of free/floating exchange rate, the problem of liquidity disappears. The flexible exchange rate allow the fiscal and monetary policy to be oriented towards internal stability without having to be distracted by balance of payments problems. A floating exchange rate regime would reduce the level required for reserves but meanwhile, it is still necessary to maintain a high level of those.

Furthermore, International reserves allowed Peruvian economy to remain stable. The international economic agents require a significant amount of support, for Peru

it was crucial to exhibit reserves, because of the necessity of trust and both external and internal credibility.

4.3. The Deregulation of the Markets

It was the one referred to the modernization of the economy, which allowed a significant growth due to greater investment, particularly private. The structural reforms were the foundations of the new ordering of the economic model which are microeconomic and target the deregulation of markets.

4.3.1. Liberalization of the Goods and Services Market

Prices determined by supply and demand tended to decrease because of the intensification of competition. Prices were liberalized, mechanisms that were not generated by the market such as controls, regulations and the internal price fixing were eliminated. Tariffs and import barriers were reduced to levels compatible with international averages to encourage competition between local and imported goods. One immediate result of the modifications was seen in Imports:

Imports (in US\$ millions)		
Years	1989	1991
Imports of consumer goods	US\$ 251	US\$ 638
Raw materials	US\$ 1,089	US\$ 1,597
Capital goods	US\$ 666	US\$ 934

Table 4.1: Variation after Reforms of Imports

Source: Change of Course

The liberalization of urban transport tariffs and routes was another successful case, results of the reform in the goods and services market was seen. Before the

liberalization there was a price control in the tickets and a monopoly in the concession of routes. This led to a shortage of transport service with large lines, deterioration of the vehicles and strikes every time the increase in tariffs was negotiated between the Government and the union of transporters.

The liberalization of the routes and the tariffs of air transport allowed that the service oligopoly passed from two airlines to six, and that these enter in a strong competition of prices. This has determined that today it is, cheaper to travel within the country by plane than by land. Nowadays this is a characteristic affecting worldwide air transportation business.

The elimination of the cargo reservation in maritime transport, that is, the provision that 50% of the Peruvian export or import cargo had to be carried out in Peruvian-flagged vessels, opened competition between national and foreign freights motivating a reduction of freight rates by up to 50% and the loss of the national market by domestic shipping companies that lost their legal advantage. This favored the producer and the national consumer by receiving both a cheaper and more competitive service.

The fight against smuggling was another factor to consider, since it not only evades tariffs, but also internal taxes (IGV, ISC, etc). Currently it is still necessary to correct this distortion, although there are increasingly more strict controls, especially in border areas.

4.3.2. Liberalization of the Monetary Market

There were positive results on this matter, like the remonetization. During the hyperinflation, the monetary mass had been reduced to 4% of GDP. After the beginning of the reforms, remonetization increased this mass to a level higher than 8% of GDP, with an upward tendency.

Investments in the Stock Exchange of Lima (BVL) experienced a strong growth and great activity since 1991 and with this, its stock indexes and the negotiated total

amounts. This was due to the greater confidence of the economic agents, the liberalization of the stock market and the processes of privatization.

Another consequence, in this case negative was the dollarization of the Peruvian financial system, which was accentuated by reasons of earlier hyperinflation. To 1993 of total liquidity, 37% was in local currency and 63% in foreign currency. This proportion was gradually reversed as inflation went down.

4.3.3. Liberalization of the Labor Market

The policies regarding this matter, established that salaries of Public sector were adjusted according to the availability of fiscal funds and reaching values that could not exceed the expected inflation. Consequently, salaries both public and private were reduced because of liberalization of labor.

The immediate results of the flexibilization of the labor market were seen in terms of lost man-hours as a result of strikes, these were considerably reduced, reaching the lowest levels registered in years.

Year	Lost man-hours (in millions)
1988	38
1990	15
1991	10
1992	1.2

Table 4.2: Reduction lost man-hours (1988-1992)

Source: Change of Course

As a negative and expected outcome, during the initial period of stabilization and structural reforms, employment indexes were significantly reduced from a base of



100 in 1980 to 84 in 1990 and 67 in 1992. The sectors most affected were commercialization, industries and services. Hyperinflation was the greatest enemy of remuneration, because reduced the purchasing power to extremely low figures in a short time basis.

The reform of the Pension system has generated diverse criticisms. The situation of the pension system in Peru at the beginning of the 90's was in a growing deficit. The crisis of the National System Pension occurred due to mismanagement and the prolonged economic crisis, which resulted in a growing degree of informality. It was imperative to find a solution and the only conceivable one was the creation of Private System Pension in 1992, as complementary to Public one.

In general terms the objectives proposed with the creation of the Private alternative are being shaped positively for the benefit of affiliates, but obviously there are still many things to improve. Currently in Peru, around the 60% of the Economically Active Population is affiliated to the private pension system. Regarding the accumulation of funds, the impact is positive on savings of the affiliates, which in the long term stimulated the economic growth of the country, reducing also the vulnerability to global economic crises.

Some criticisms are not only problems of lack of coverage but also from loss of prestige, which further limits the development of the private system and makes difficult to efficiently solve the problem that affects population which does not save enough funds for their retirement, leaving them exposed to the risk of poverty at old age.

Another critique is for AFP's model of business, for instance if they should only charge commission when they generate profitability for the fund of pensioners, after knowing that these companies obtained profits during 2018, while their pensioners statements reflected losses in the same period, explain the logic of this results it is a headache for insurers, even if it has information backup, common people finds it difficult to understand.

4.4. Results of the Reform of Private Property

It is probably the issue that has generated the most controversy, following the detailed results of each reform:

4.4.1. The Privatization Process

The minimization of the size of the State also meant reducing the number of Public companies, this process was carried out through the privatizations.

Revenues from privatizations amounted in the first three years US\$ 630 million. According to advocates of the liberal economy, the benefits of privatization not only were found in the sales value obtained, but also because the State stopped losing money in unprofitable companies that were going through financial and management crisis . With privatizations, the State could then start collecting taxes and promoting reinvestment, and the citizens take advantage of new efficient administrations and correspondingly new technologies.

Between 1990 and 2000, 228 sales, concession or liquidation operations of Public companies were executed, generating an amount of US\$ 9.2 billion. However, of this amount, only US\$ 6.5 billion were deposited in Public Treasury. The difference of US\$ 2.7 billion was used to pay consultants, investment banks and to clean up the accounts of the companies because in some cases the State assumed all its debts before selling them in order to favor the speed of execution.

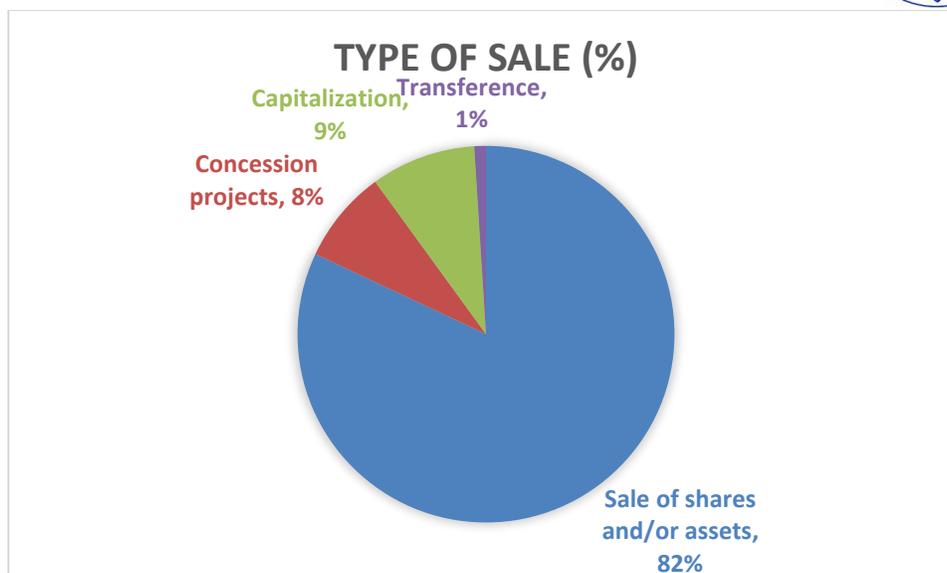


Figure 4.5: Public Companies Type of Transfer (1990 – 2000)

Source: CEPAL.org

The main complaints about privatizations were pressure from employees, bureaucratic opposition, and beliefs that some of the companies should not be sold because they still were profitable. Under the liberalism doctrine all had to be sold and in the shortest possible time.

Unfortunately, this “rush” did not allow to carry out clear and transparent processes, since corruption cases of undervaluation and underhand dealings covered the privatization processes. Some of the cases that particularly called the attention were the gas packing company Solgas, of which 84% of its shares were sold for US\$ 7.5 million in 1992 when a year earlier, it had had profits of US\$ 2.9 million. Another scandalous case of undervaluation was the one of the “La Pampilla” refinery. In 1996 the State sold 75% of the shares of the largest refinery in the country at US\$ 180 million, when in 1994 the company had generated revenues of US\$ 657 million and operating profits of \$ 85 million.

Criticisms included that the economic resources obtained from privatizations were not destined to investment expenses such as social or productive, as originally planned, but mostly they were used for current expenditures.

The expansion of the coverage of public services and technological modernization in various sectors of the economy, as well as the high levels of investment that have increased production in the mining sector are some of the notable features of this process.

One of the most notable effects of privatizations has been to have acted as a decisive catalyst for private investment that sustained the economic growth of the 90's. In fact, it is estimated that two thirds of the total of foreign investment originated directly as a result of the privatization process.

4.4.2. Promotion of Foreign Investment

In countries like Peru with low domestic savings capacity, and consequently a low level of internal investment, it was very important to resort to foreign investment as a source of growth. It is important to take into account that external capital has a greater capacity than internal one and that it typically also incorporates the most recent technological changes.

The reforms for promotion in foreign investment motivated that the figures, that reached average figures of US\$ 36 million during Alan Garcia regime, raised to figures of commitments of US\$ 675 million during the first three years of the reform. Foreign investment in Peru has increased substantially since, in 2012 it reached a peak of US\$ 11,800 million. The estimates for the year 2018 are the order of US\$ 8,000 million, this due to the better quotations of prices of metals that Peru exports like copper and gold, and the capital investments of the mining sector.

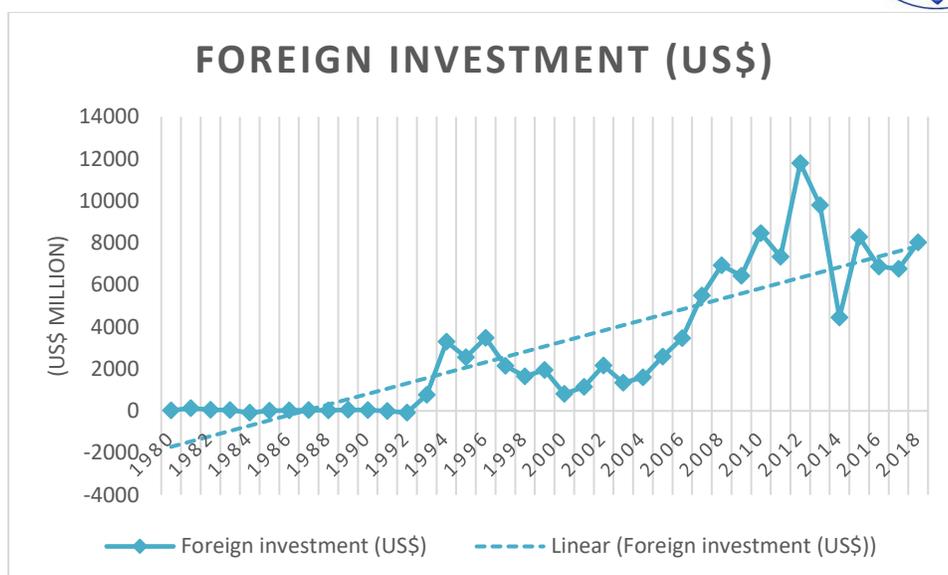


Figure 4.6: Growth of Foreign Investment in Peru (1980 – 2018)

Source: World Bank

4.4.3. Manufacturing Sector

Referring to the reforms aimed to liberalization of international markets, one of the industries more affected was manufacturing, which was clearly disregarded by the Economic Program. Manufacturing is conditioning factor for sustainable growth and long-term development.

Before the crisis of the government of Alan García, one of the impulses of growth was based on the manufacturing industry, tertiary sectors worked as auxiliaries and were expanded under its direction, and its expansion led to increase productivity. Regrettably, Peruvian economic could not take advantage of the sprint of manufacturing industry of those years, later accompanied by mistaken political and economic measures on the sector.

Nowadays manufacturing industry in Peru has several issues, it does not have a local market producing inputs, capital goods and technologies, its main weakness is its dependence on importations of capital goods; and the loss of demand compensated by the expenditure of the State, thus not generating productive

capacity. The specious substitution process that, as it increases production costs, giving rise to an industry that, as a whole, is not competitive in international markets.

4.5. Results of the Reform of the State

The state reform was the one that made the least progress, in comparison with the other structural reforms.

4.5.1. Poverty Alleviation

The program of reforms on this matter was initiated, but was later deactivated due to lack of funds and mismanagement. In 1992, expenses in poverty alleviation increased from \$ 48 million annually to \$ 360 million despite new administration provided by the private sector. Alleviate extreme poverty was not reached, in part because of the amount dedicated to social spending was considerably reduced. Nevertheless, the State is not the only responsible for poverty in Peru, the appropriation of its powers by sectoral interest groups trying to serve their own interests based on influences and privileges. The individualism with a negative connotation.

Corruption and bureaucracy effects covering almost all government agencies and needless to say, health and education Public services under performing are the main characteristics of State apparatus. Politics has intruded in economic matters through a progressive concentration of powers in the government. This explains why, although governments changed their political character, the result was consistently a growth of the State apparatus. This has been, among others, the reason for the decrease in the quality of life of Peruvians.

The relief against extreme poverty is still a pending task, The Government should organize social programs defining a target population, aid methods and a period of duration of the same. Assistance through employment, development of investment



in basic communal infrastructure and distribution of capital goods to the community that effectively uses labor.

4.5.2. The Reform of the Education System

The free entry of private investment into the education sector was guaranteed. Education was conceived as a profitable economic activity, and to that extent, it should not be exempt from taxes. The objective was to promote the educational industry through the free market and avoid a state monopoly in the sector.

Scholarships were provided for outstanding students. The State established educational credit systems, without discriminating between public and private entities. According to liberalists, higher education was a very praiseworthy purpose, as long as students pay the cost of it, as if it were a credit or an investment in securities, that is, as a percentage of the income that generated. Payments to this educational credit were made in conjunction with the payment of Income Tax. There were no further advances in higher education. Apart from this, basic education is still provided for all citizens without exemptions.

Currently, the main problems that afflict the basic education system are coverage and quality of service. It is clear that the resources allocated by the Government are low, and the State over the years has not had a clear policy to effectively address both problems. Another factor to consider is the low quality of Peruvian teachers in terms of methodology. Major reforms must be applied, taken into account educational decentralization and the recognition of the labor of professors, improving salaries and encourage them to specialize overseas among other policies.

4.5.3. Health Reform

The reform introduced the private sector as provider of health services, generating a freedom of choice between private and state assistance. For this, was necessary

to create decentralization instruments, introduce efficiency incentives in the state system and establish subsidies in inverse proportion to the income of the citizens. No further advances were made on this matter.

Currently, the health sector in Peru is going through a generalized crisis, there are shortage of medicines, absence of basic services, overcrowding in hospitals, lack of latest technology equipment, but the underlying problems are, just as in Education, the minimum investment, the public budget represents values close to 2% of the GDP while the World Health Organization (OMS) recommendation is of the order of 6%. The other main problem is the incapacity of management, and with this obviously the logistical problems, the increase of the administrative workers and not of doctors, an obsolete computer system, etc. In conclusion, there is still plenty of work to do regarding Health services.

4.5.4. Housing Reforms

The reform promoted the creation of a private housing savings and loan system that would replace the obsolete State system, more precisely, to create a system of long-term financing for housing to conserve the purchasing power of the contributions and to support the contributors of lower levels. The characteristics of the implemented system included: individual accounts, private financial system, market interests and compulsory savings.

4.6. Recovery of Citizen Security: The Rule of Law

This point of the reform focused on the maintenance of the Rule of Law, without security of citizens there could not be political stability. The search of law and order was initiated in a context of economic and political freedom, that is, establishing the rights of individuals. Similarly, respect for private ownership was fundamental for the reinforcement of the Rule of Law.



One of the more relevant modifications was the change of the Political Constitution of 1979 which had a socialist tendency.

Unfortunately, the balance and the independence of each branch of the State is a pending task for future Administrations, increasingly, there is concentration of power inside de Central Government, in this matter corruption is winning the battle against the original goals.

Terrorism was one of the main enemies of the Rule of Law in Peru, and none of the other aspects of the Economic Program could work, if terrorism was not controlled and defeated. This required join forces to dismantle the subversive structure through intelligence work, military operations, civic action and the mobilization of the population. The capture of terrorist leader Abimael Guzman was definitely an impulse for economic development in many ways mainly recovering citizen security but also because State assets were preserved and consequently reconstruction costs were not incurred.

The eradication of drug trafficking continues to be a pending task of the government in order to establish solid foundations for the Rule of Law of the country, because it distorts economic activity and corrupts people, institutions and society as a whole.

Another large problem affecting Peruvian economy is labor informality, it is estimated that more than 60% of the Peruvian workforce works in the informal sector, creating as a consequence a decrease in the amount of taxes to be collected by the Government and the consequence precariousness to which workers are exposed: no insurance, no pension fund, etc.



Chapter 5: Conclusions



The Peruvian country, during the government of Alan García (1985-90), experienced the greatest economic crisis in its republican history. Hyperinflation reached levels of 7,482% annually, the fall in GDP was 14%, international reserves were reduced to 8.7%, as percentage of the GDP, the fiscal and quasi-fiscal deficit reached 16% of GDP and the emission monetary policy went hand in hand with inflation. In terms of security, Peru was losing ground in the fight against terrorism, and in political matters, the government had concentrated excessively power.

In 1990, the engineer Alberto Fujimori, was elected President defeating traditional political parties. During his government was applied a straightforward Economic Program to control hyperinflation, it was based on major structural reforms, a foreign policy of openness and financial reinsertion, and on the maintenance of the Rule of Law.

The Structural Reforms were given by supreme decrees, these mainly included: the macroeconomic reform; the liberalization of markets for goods and services, money and labor; the reform of the structure of the property; the reform of the State in order to reduce its size and functions, and the institutional reforms.

In general terms, macroeconomic equilibria of main variables was achieved. The macroeconomic reform showed immediate positive results since inflation fell, during the first three years of reforms, to 48% per year and 11% in 1995; International Reserves increased to US\$ 10 billion in 1995, conversely the fiscal deficit was reduced from 16 to 2.5% of GDP. The monetary emission grew at lower rates than inflation and the tax pressure increased from 5 to 9.5% of GDP during 1990-1995. GDP growth during the first two years of the reform was null, mainly as an effect of natural disasters and the economic measures aimed to control hyperinflation, it was until 1993 than growth started consistently at an average level of 5% during the past 25 years.

The central problem of Peruvian economy is not the inability to growth, actual rates are close to 4% of annual growth, so that means development is not only an economical matter, it is also related to the application of political policies which tend

to preserve the condition of primary-export specialization. In order to converse this condition, policies must be in essence long-term.

Market reforms also showed significant progress. The prices of goods and services, the exchange rate, the interest rate, wages, as well as the prices of public services were liberalized, beginning to be determined by the market. Currently, markets have been deregulated almost completely and artificial monopolies were eliminated entirely. Foreign trade was opened, by reducing tariffs and liberalizing the foreign exchange market. A private system of pensions was created; education was also privatized; the tax burden grew; it was tried to aim the public spending at alleviating extreme poverty, but budget was minimally increased.

The reform of the property structure also presented important advances. Between 1990 and 2000, 228 sales, concession or liquidation operations of public companies were executed, generating an amount of US\$ 9.2 billion, unfortunately privatizations were loaded with irregularities and mismanagements. Foreign investment was stimulated by going from US\$ 36 million yearly average during the García (1985-1990) to more than US\$ 1,304 million average during Fujimori's first regime (1990-1995). Finally, the State approved the granting of concessions for infrastructure and public services.

The reform of the State exhibited important achievements but a lot of work must still be done, starting from the remove of a rooted corruption in Public apparatus and continuing the reduction of its size and functions.

In terms of foreign policy and in relation to financial reinsertion, the country was once again eligible, after isolation of seven years, to obtain new credits within its financial system, this through a series of negotiations involving the Support Group, the International Monetary Fund, the World Bank and the Paris Club, which allowed to inject fresh money into the economy, and without falling into fiscal deficit.

With the labor reform, the labor market was liberalized, achieving better levels of employment in real remuneration. In the field of retirement pensions and education, laws of transcendental importance were promulgated.



Regarding the maintenance of peace, law and order, significant progress was made. Terrorism was severely hit by the capture of the leaders of the most important subversive movements during 1992. Work must still be done in direct struggle against drug trafficking.

The economy recovered thanks to the efforts of the population, of their work, and the increase of local and foreign investment. Growth based on the exploitation of natural resources explains the failure of the economy to achieve a sustainable and broader development. The result in the long-term is a stagnated GDP growth, restricted to urban sector, concentrated on the coast of Peru. This structure prevents capitalism from spreading in all sectors and geographic regions. But how to overcome this situation; the solution is based on public control over the surplus, the capacity of innovation of locals and its adoption of new technologies, also internal sources of financing and economic policies that consolidate an integral growth process.

Peru is a country with future perspectives of growing in the upcoming years, but this will depend on the evolution of the global economy; in a favorable situation the internal factors that would drive expansion are: large infrastructure projects, service sector through the strengthening of small and medium businesses, exploitation of new mining projects and development of hydro-energetic potential.



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Acronyms and Abbreviations

ADUANAS	Superintendencia Nacional de Administración de Aduanas
AFP	Administradora de Fondos de Pensiones
BVL	Bolsa de Valores de Lima
BCR	Banco Central de Reserva del Perú
BID	Banco Interamericano de Desarrollo
BN	Banco de la Nación
CGR	Contraloría General de la República
CGTP	Confederación General de Trabajadores del Perú
CTS	Compensación por Tiempo de Servicios
CVR	Comisión de la Verdad y Reconciliación
DNI	Documento Nacional de Identidad
FONAVI	Fondo Nacional de Vivienda
FONCODES	Fondo de Cooperación para el Desarrollo Social
ICE	Instituto de Comercio Exterior
IGV	Impuesto General a las Ventas
INDECOPI	Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual
INEI	Instituto Nacional de Estadística e Informática
INP	Instituto Nacional de Planeación
IPSS	Instituto Peruano de Seguridad Social
ISC	Impuesto Selectivo al Consumo
IR	Impuesto a la Renta
JNE	Jurado Nacional de Elecciones
MEF	Ministerio de Economía y Finanzas



OMS	Organización Mundial de la Salud
PETROPERU	Petróleos del Perú
SAFP	Superintendencia de Administradora de Fondo de Pensiones
SBS	Superintendencia de Banca y Seguros
SNP	Sistema Nacional de Pensiones
SUNAT	Superintendencia Nacional de Administración Tributaria