

2024 Money and Banking Conference

*Fiscal Deficits, Monetary Policy
and Inflation*

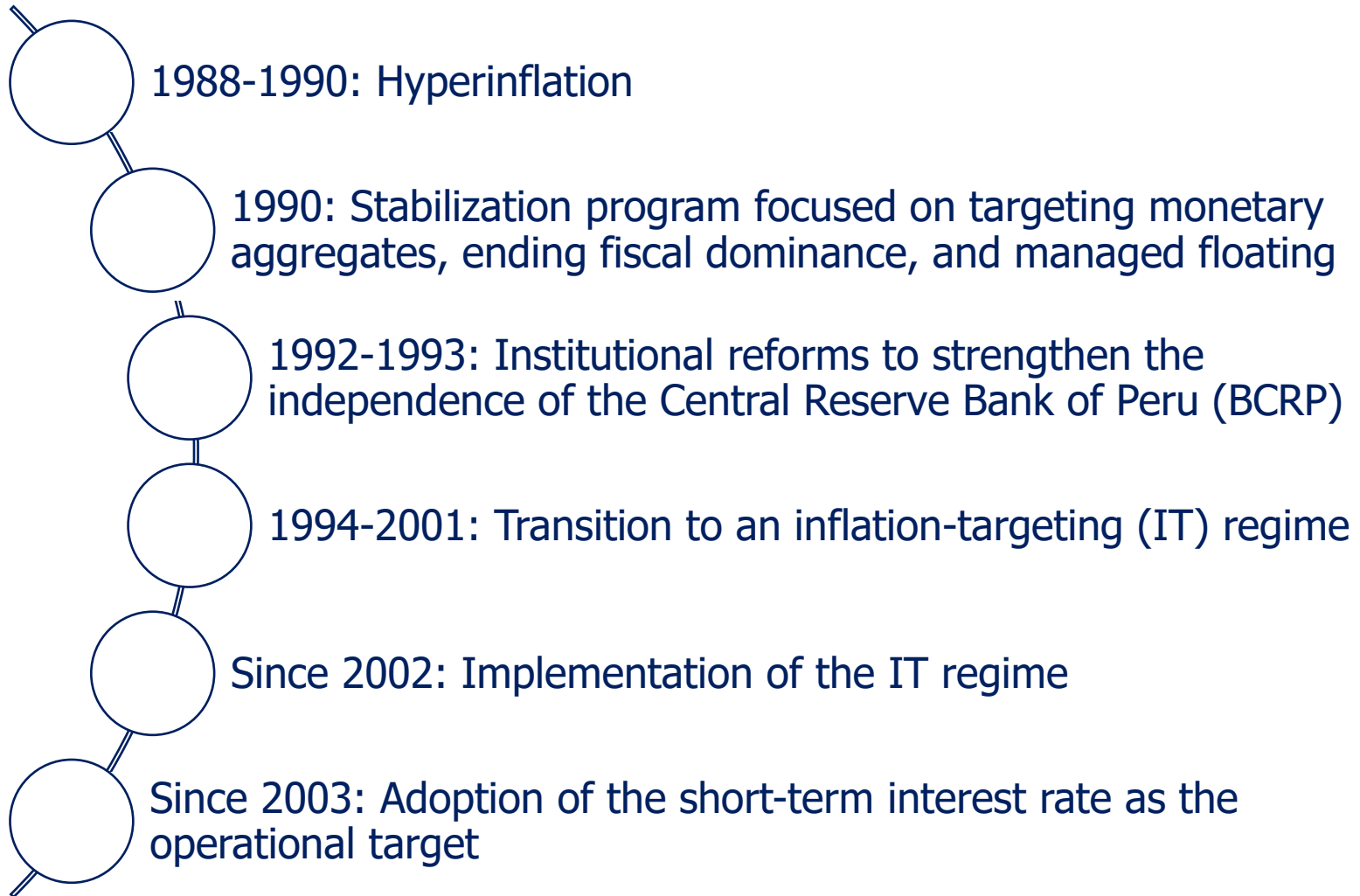
Experiences in Economic Stabilization: The Case of Peru (1990-1991)

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* The views expressed in this presentation are those of the author and do not necessarily reflect the views of the Central Reserve Bank of Peru.

Monetary Policy Timeline (1988-2003)



I. 1989-1990: Key Issues

1. Hyperinflation
2. External debt default and international isolation
3. Negative international reserves
4. Multiple exchange rate system
5. Extreme capital and exchange controls
6. Large fiscal imbalance and unsustainable public debt
7. Minimal financial intermediation after compulsory de-dollarization (1985)
8. Numerous economic distortions, especially in relative prices
9. Sharp economic decline

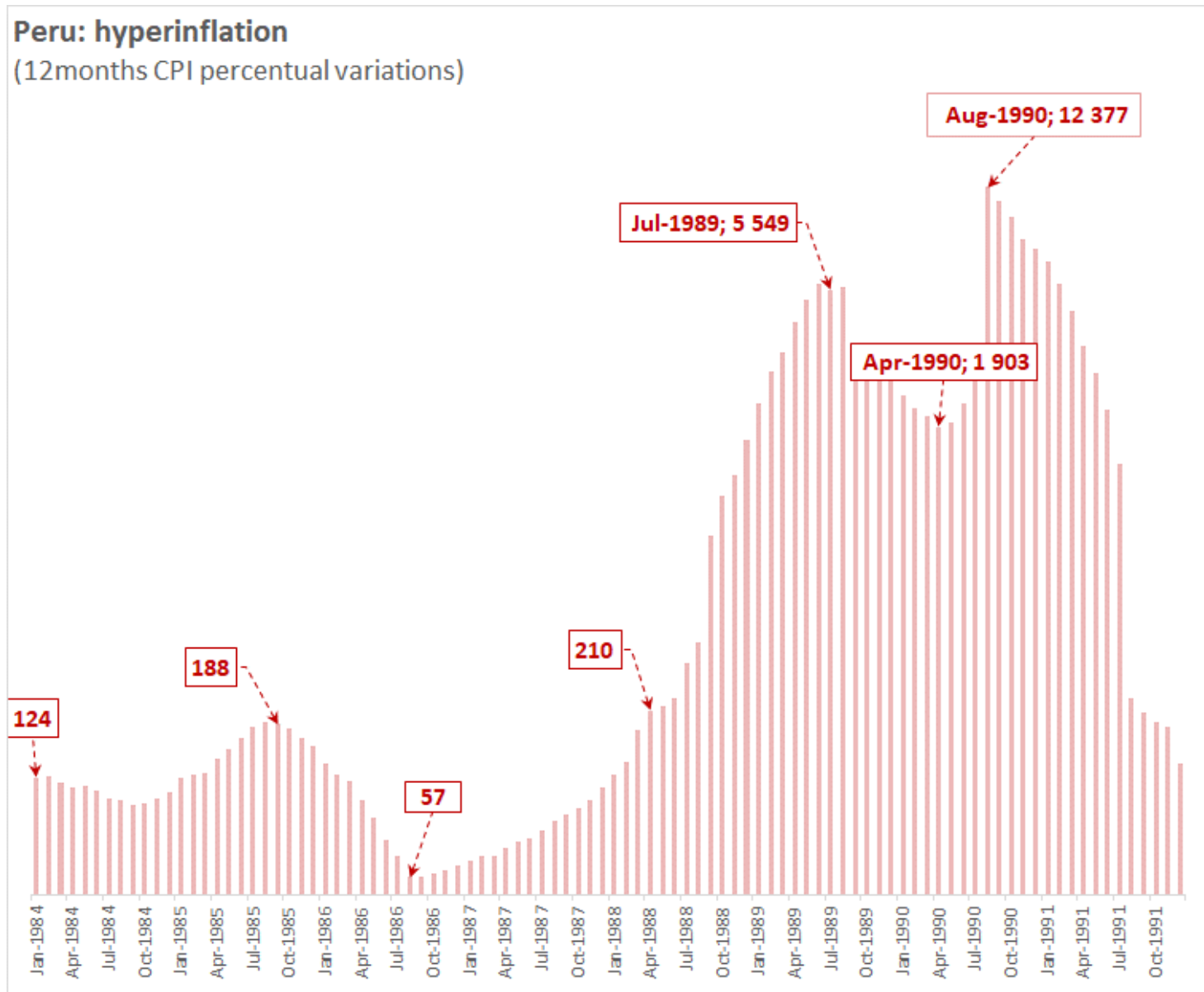
II. Since August 1990: Stabilization Measures

1. Fiscal consolidation and debt reduction
2. Legal prohibition on BCRP lending to the public sector
3. Increased BCRP autonomy in the conduct of monetary policy
4. Shift from fixed exchange rate to managed floating
5. Elimination of price controls and subsidies
6. Use of monetary base as nominal anchor
7. Accumulation of international reserves
8. Free capital mobility
9. Halting hyperinflation and gradual inflation reduction

By the end of the 1980s, GDP was contracting at annual double-digit rates; prices and the nominal exchange rate had soared to hyperinflation levels; and the current account and fiscal deficits, along with public external debt, had become unsustainable.

	GDP	Inflation	Exchange rate	Balance of payments: Current account	Non financial Public Sector balance	Public sector external debt	International reserves
	Annual percentual variations			Percentages of GDP			
1980	5.9	60.8	29.6	-2.3	-4.6	29.9	8.5
1981	5.6	72.7	44.1	-10.5	-8.0	24.2	3.8
1982	-0.2	72.9	65.7	-9.7	-8.9	27.3	4.3
1983	-10.4	125.1	137.1	-6.4	-11.6	44.6	5.3
1984	3.6	111.5	120.3	-1.6	-7.9	46.7	6.6
1985	2.1	158.3	-99.7	-0.5	-3.7	69.5	10.3
1986	9.4	62.9	40.3	-7.2	-7.8	61.0	4.7
1987	9.7	114.5	77.9	-7.5	-10.1	65.5	0.2
1988	-9.4	1722.3	834.2	-8.1	-11.5	96.2	-1.6
1989	-12.3	2775.0	1388.2	-2.4	-11.3	65.7	1.4
1990	-5.0	7649.6	4545.0	-5.0	-8.9	70.4	1.8
1991	2.2	139.2	278.7	-4.5	-2.9	60.8	3.9
1992	-0.5	56.7	60.8	-5.4	-4.0	59.5	5.6
1993	5.2	39.5	59.1	-7.2	-3.1	53.5	8.0
1994	12.3	15.4	10.4	-6.3	-2.9	53.3	13.4
1995	7.4	10.2	2.7	-9.0	-3.4	47.7	12.9
1996	2.8	11.8	8.8	-6.8	-1.1	45.1	16.0
1997	6.5	6.5	8.5	-6.0	0.1	31.8	18.1
1998	-0.4	6.0	10.0	-6.2	-1.0	34.4	17.0
1999	1.5	3.7	15.5	-2.8	-3.4	41.5	17.2

Attempts to stabilize the economy using a fixed exchange rate anchor proved ineffective amid persistent large fiscal imbalances and low credibility.

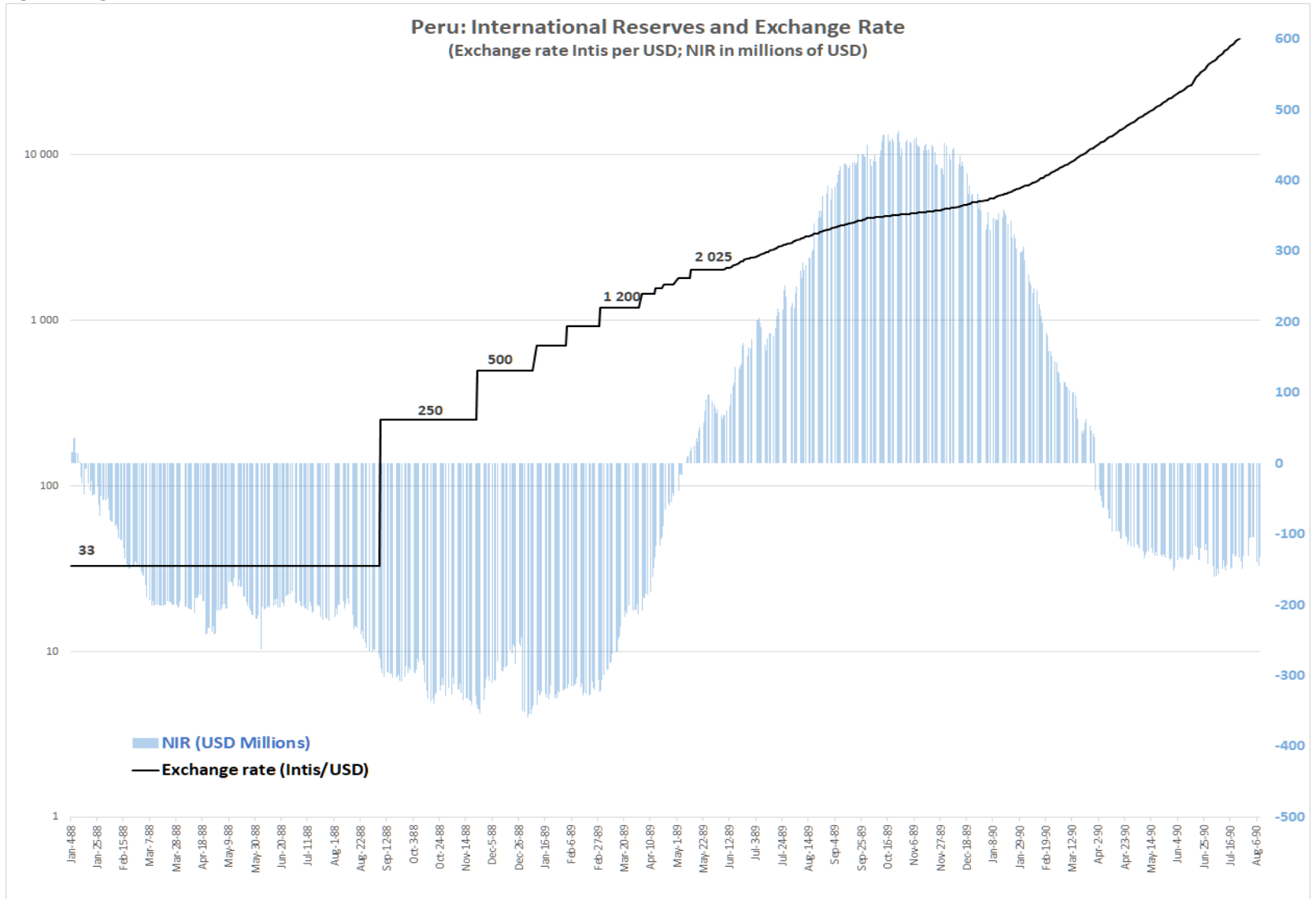


By mid-1987, there were nine different exchange rates for exports and ten for imports.

Exporting activities	Exchange rate (Percentage of MUC)	Exchange rate Intis per USD	Importing activities	Exchange rate (Percentage of MUC)	Exchange rate Intis per USD
Small and medium scale mining	140.7	22.41	MUC 1	100.0	15.93
Large scale mining (Southern-Cuajone)	100.0	15.93	MUC 2	125.5	20.00
Other large scale mining	114.9	18.31	MUC 3	156.9	25.00
Energy	117.1	18.66	MUC 4	207.2	33.00
Cotton	132.0	21.02	MUC 5	219.7	35.00
Sugar, Coffee and industrialized fish	125.7	20.03	MUC 6	282.5	45.00
Other traditional exports	119.8	19.09	CBME	394.0	62.77
Non-traditional exports	168.1	26.77	Consumption goods	232.6	37.05
Prioritized non-traditional exports	181.7	28.95	Intermediate goods	192.2	30.62
			Capital goods	302.6	48.20

Negative International Reserves

Any reserve accumulation resulting from economic recession induced by partial fiscal adjustments and exchange rate devaluations, quickly vanished as efforts to anchor the exchange rate were undermined by ongoing fiscal imbalances.



Stabilization Program

1. Fiscal Policy

- End of fiscal dominance
- Strict public expenditure control (creation of the Cash Treasury Committee)
- Support for social programs
- Temporary tax on exports (10%) and net worth/insured assets (1%)
- Elimination of tax exemptions

2. Foreign Exchange Market

- Elimination of multiple exchange rates
- Adoption of managed floating

3. Monetary Policy

- Ban of BCRP financing for government spending and development banks
- Introduction of a monetary control regime
- Reduction in the marginal reserve requirement ratio from 80% to 40%
- Liberalization of market interest rates with non-binding caps

4. Price Adjustments

- 3,000% increase in energy prices
- 1,000% increase in utility tariffs (electricity, water, and telephone)

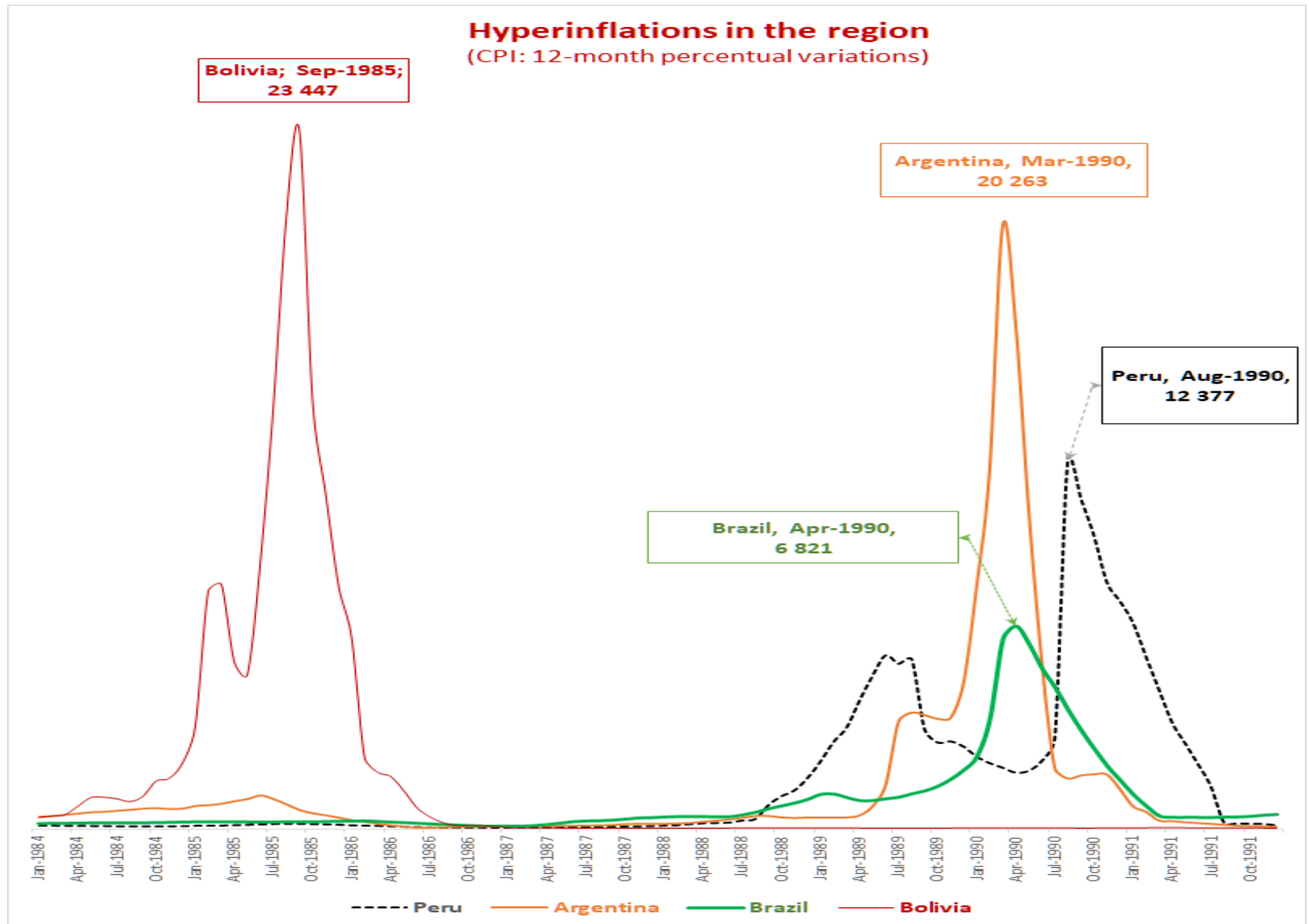
5. Trade Policy

- Removal of quantitative trade restrictions
- Simplification of tariff structure from 38 rates to 3 (15%, 25%, and 50%)
- Elimination of tariff exemptions

6. Elimination of Capital and Exchange Rate Controls

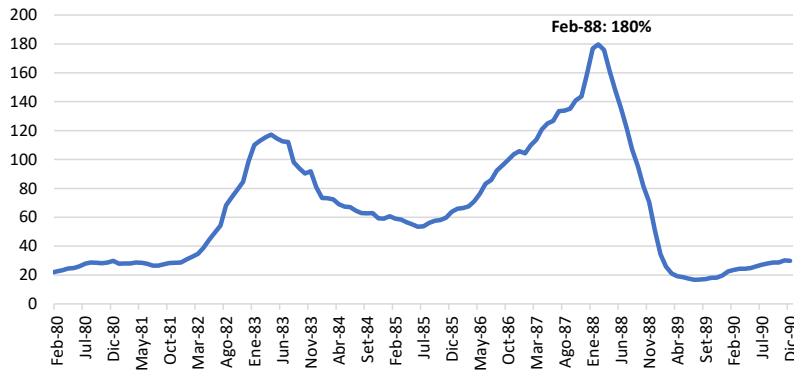
7. External Debt Negotiations

Like other countries in the region, Peru faced hyperinflation during the 1980s.

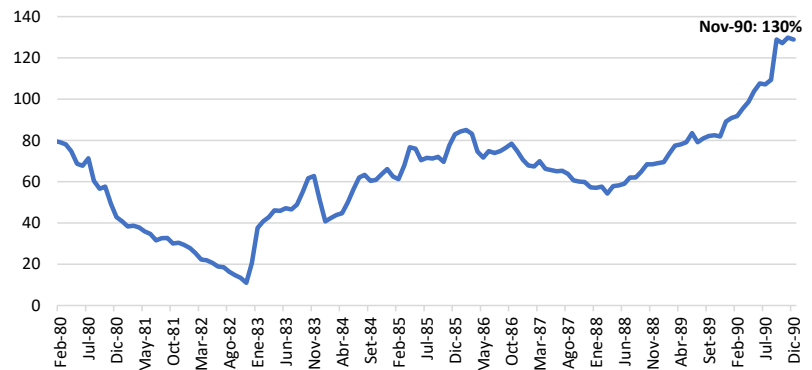


Other LAC countries also experienced triple-digit inflation during the 1980s and beginning of 1990s.

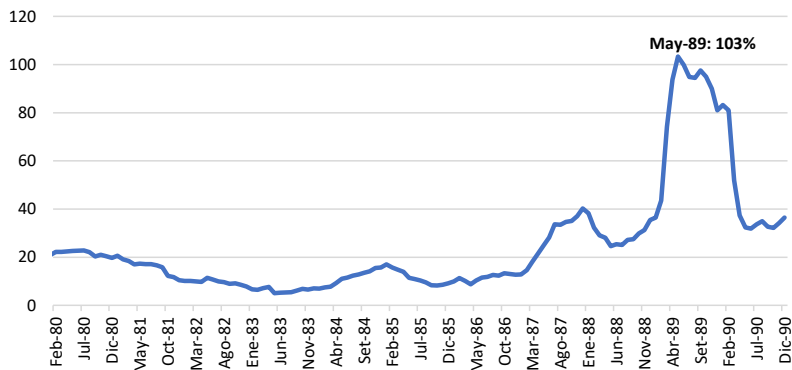
**IPC variación 12 meses de México (%):
enero 1980 - diciembre 1990**



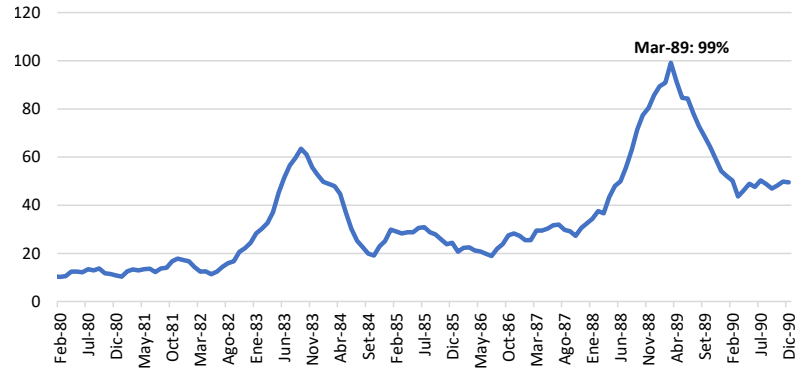
**IPC variación 12 meses de Uruguay (%):
enero 1980 - diciembre 1990**



**IPC variación 12 meses de Venezuela (%):
enero 1980 - diciembre 1990**



**IPC variación 12 meses de Ecuador (%):
enero 1980 - diciembre 1990**



Rationale for Using a Monetary Anchor to Combat Hyperinflation

- Uncertainty regarding real exchange rate equilibrium due to significant distortions in relative prices
- Lack of international reserves
- Recent failures of stabilization programs based on exchange rate pegs
- Uncertainty about the future direction of fiscal policy
- Public understanding of the link between money supply growth and inflation made it straightforward to communicate the benefits of monetary control

Stabilization Program: Day One

Peru launched a rigorous adjustment program to stabilize the economy and correct distortions in relative prices; e.g., the price of 84-octane gasoline rose by 3,114%

Energy	July 28, 1990	August 8, 1990	Adjustment
Gasoline 84-octane (Intis per Gal)	21 000	675 000	3 114 %
Gasoline 95-octane (Intis per Gal)	41 800	1 120 000	2 579 %
Domestic Kerosene (intis per Gal)	19 000	608 000	3 100 %
Propane gas (Intis per 24 Lbs.)	55 000	1 500 000	2 627 %

“Last night, the government unveiled a drastic plan to tackle hyperinflation, the heart of the country’s economic crisis.”

Drástico plan contra la hiperinflación anunció ministro Hurtado Miller

- Desaparece el dólar MUC. ■ IGV 14 %
- Impuesto del 10 % a las exportaciones
- Alimentos importados sin subsidios
- Eliminan exoneraciones arancelarias
- Arancel mínimo 10% para importaciones.
- Cuota extraordinaria al impuesto patrimonial
- Bonificación de un sueldo a trabajadores
- Anularán nombramientos y promociones

El gobierno del presidente Alberto Fujimori anunció anoche un drástico programa para combatir la hiperinflación, “el más grave y urgente de los problemas” que enfrenta el país.

Acompañado por su Gabinete Ministerial, el presidente del Consejo de Ministros y ministro de Economía y Finanzas, ingeniero Juan Carlos Hurtado Miller, describió un conjunto de políticas, que significan el fin de los controles y la corrección de los graves desequilibrios por la acción del mercado, es decir, de las leyes de la oferta y la demanda.

Así el dólar, el más influyente precio de la economía, flotará, eliminando el tipo de cambio del Mercado Único de Cambios o MUC.

GASOLINA	l/ .675,000.00
LECHE	l/ .330,000.00
FIDEOS	l/ .775,000.00
PAN	l/ . 25,000.00
AZUCAR	
BLANCA(Kg.)	l/ .300,000.00

“.. Each year, 20,000 children die in Peru... the previous administration is to blame, having run the country with absurd policies, gross inefficiency, and blatant, widespread corruption.”

En mensaje a la Nación Primer ministro expuso anoche medidas destinadas a acabar con la hiperinflación

■ Programa de ajuste partió de riguroso y dramático balance de herencia dejada por el gobierno anterior con niveles nunca vistos de pobreza, mortalidad infantil, desempleo y corrupción

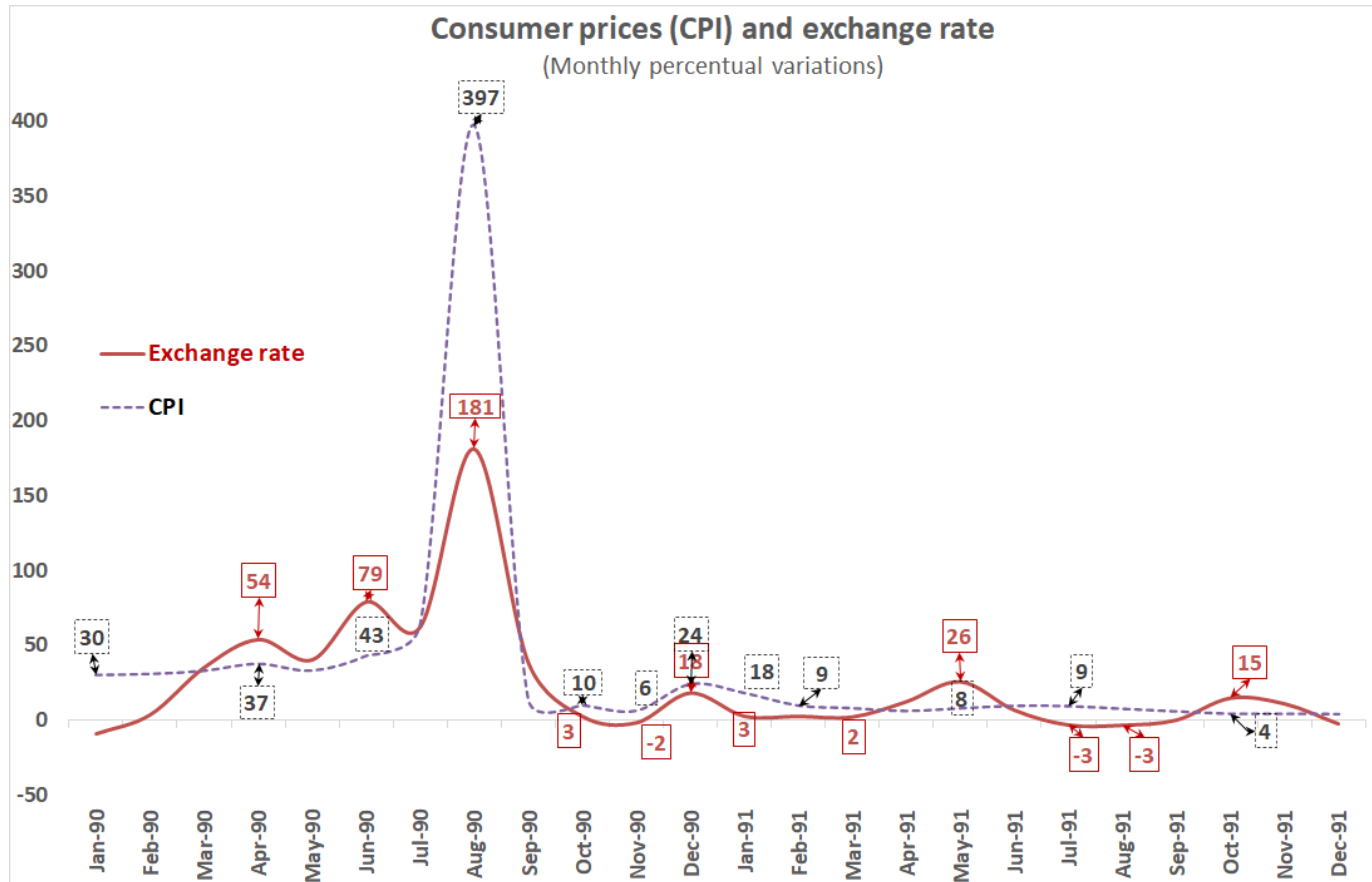
Dando inicio a una política que tiene intenciones de alcanzar la estabilidad económica y luchar contra la hiperinflación, el presidente del Consejo de Ministros y titular de Economía, Juan Carlos Hurtado Miller, expuso en un mensaje transmitido a nivel nacional por los medios de comunicación parte del conjunto de medidas que desde hoy empiezan a regir, tales como el alza del precio de los alimentos -leche, azúcar, pan, fideos- y de la gasolina; así como lo referido a la "notación" del dólar, es decir el metimiento de su valor a la oferta y demanda; y la eliminación del dólar MUC, con el cual algunos se han enriquecido indebidamente, según tuvo el propio Hurtado Miller. El ministro también anunció que el



gobierno ha dispuesto el otorgamiento de una compensación extraordinaria para todos los trabajadores, equivalente al 100 % de la remuneración recibida en julio. En el sector público deberá entregarse a más tardar el viernes; y en el sector privado este sábado 11. "Cada año mueren en el Perú 20,000 niños que hubieran podido vivir y crecer si hubieran nacido al otro lado de la frontera", enfatizó, añadiendo que ello "no es, como algunos piensan, culpa del imperialismo, ni de los términos del intercambio comercial". De ello -prosiguió- es responsable, en gran medida, el gobierno anterior, que manejó al país con políticas absurdas, con una grosera ineficiencia y una corrupción manifiesta y generalizada".

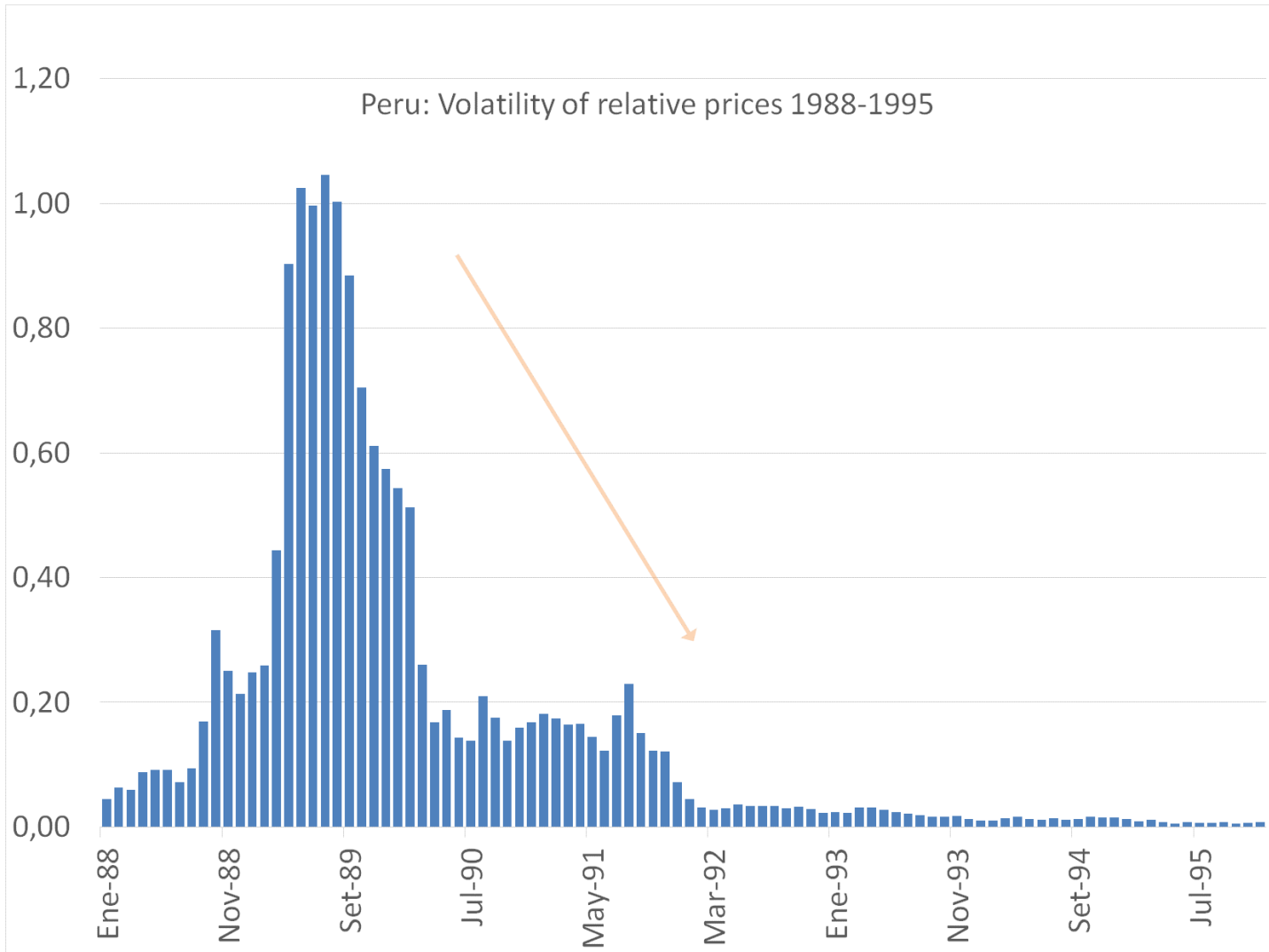


■ Presidente del Consejo de Ministros y titular de Economía, Ingeniero Juan Carlos Hurtado Miller.



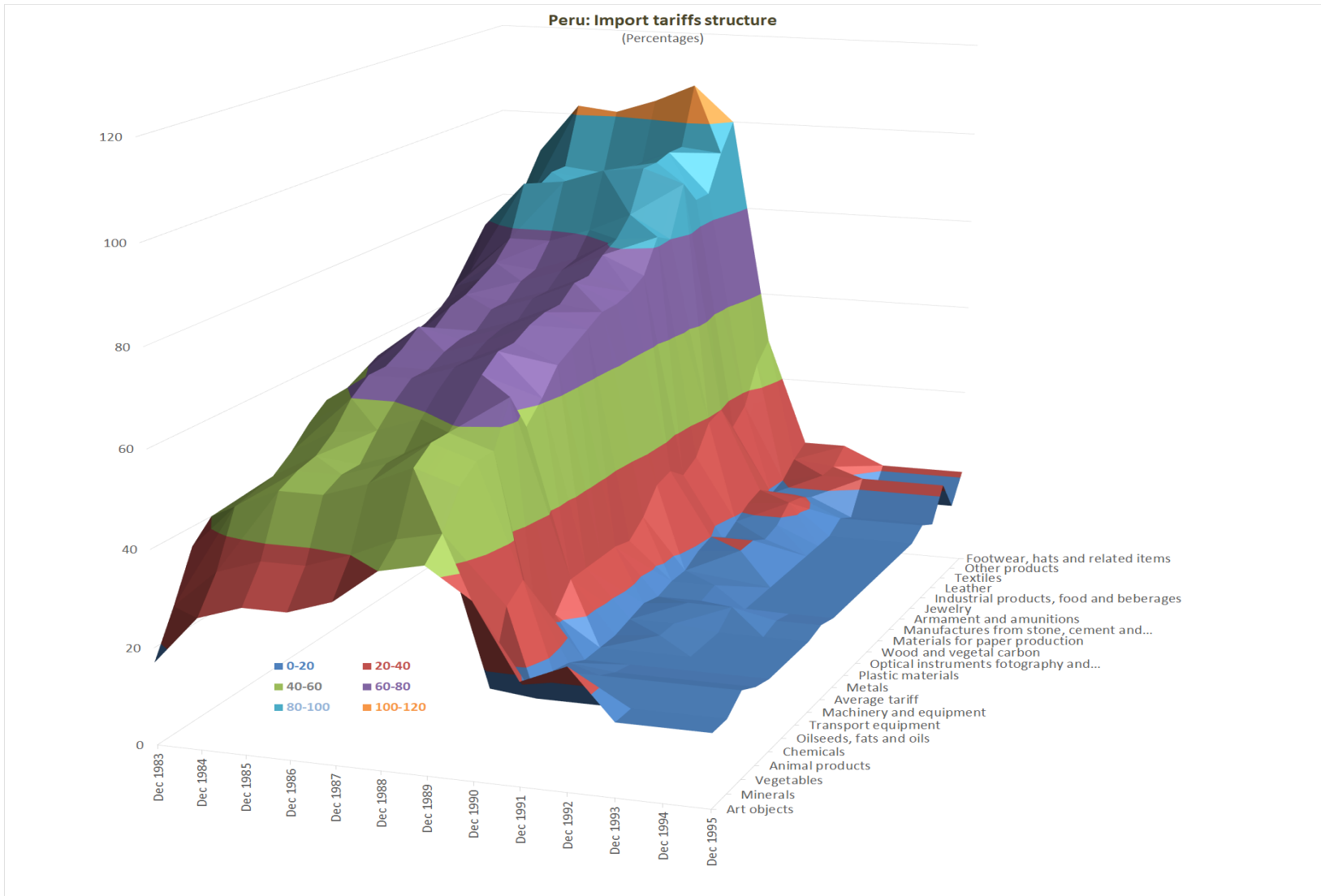
Relative Price Correction

As inflation receded and price controls and subsidies were eliminated, the shift to a market economy allowed relative prices to stabilize, quickly restoring their role in signaling efficient resource allocation.



Trade Reform

Tariff reduction and the simplification of the tariff system, along with the removal of quantitative trade restrictions, liberalized trade and expanded Peru's access to global markets.



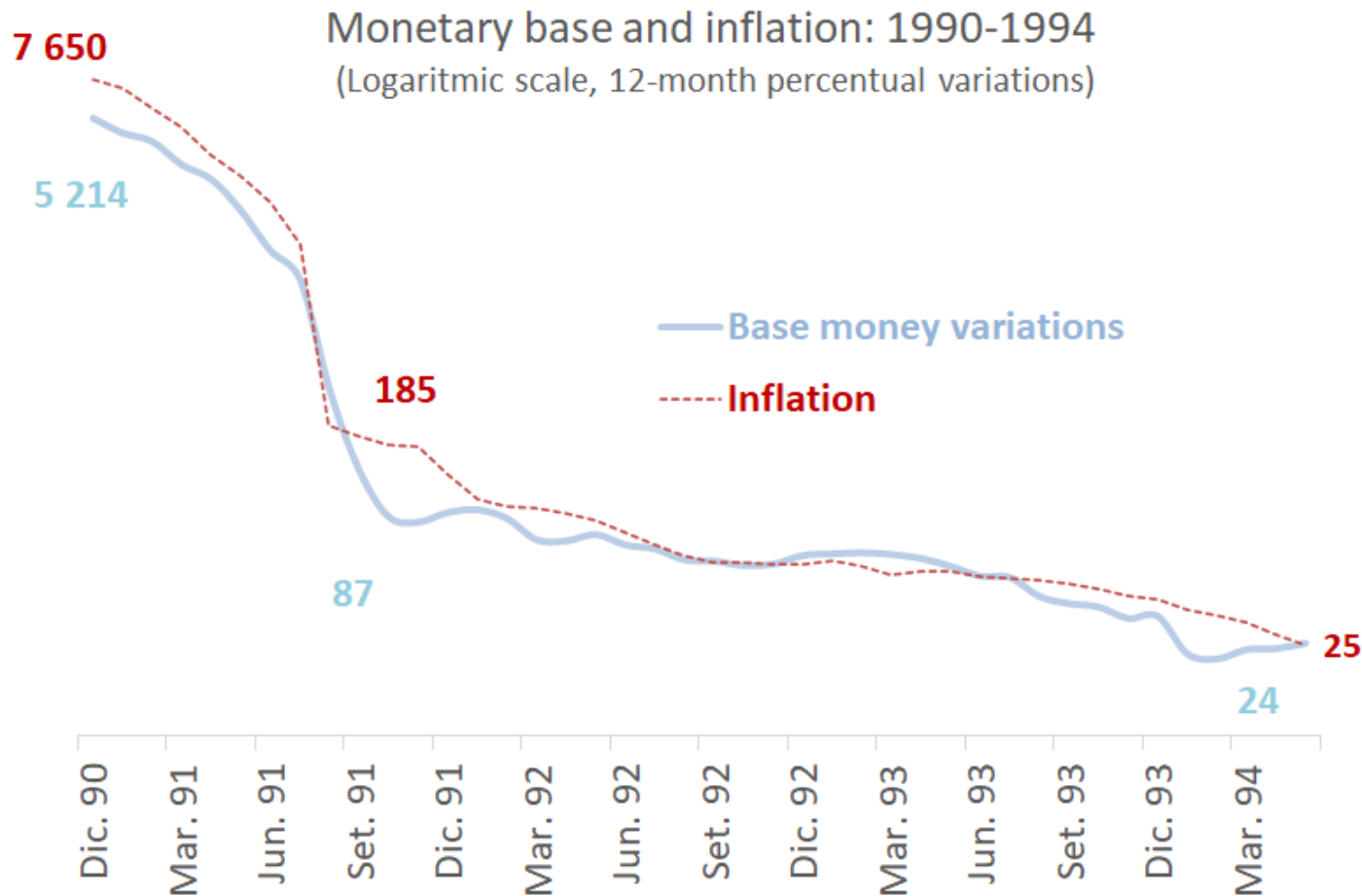
International Reserve Accumulation

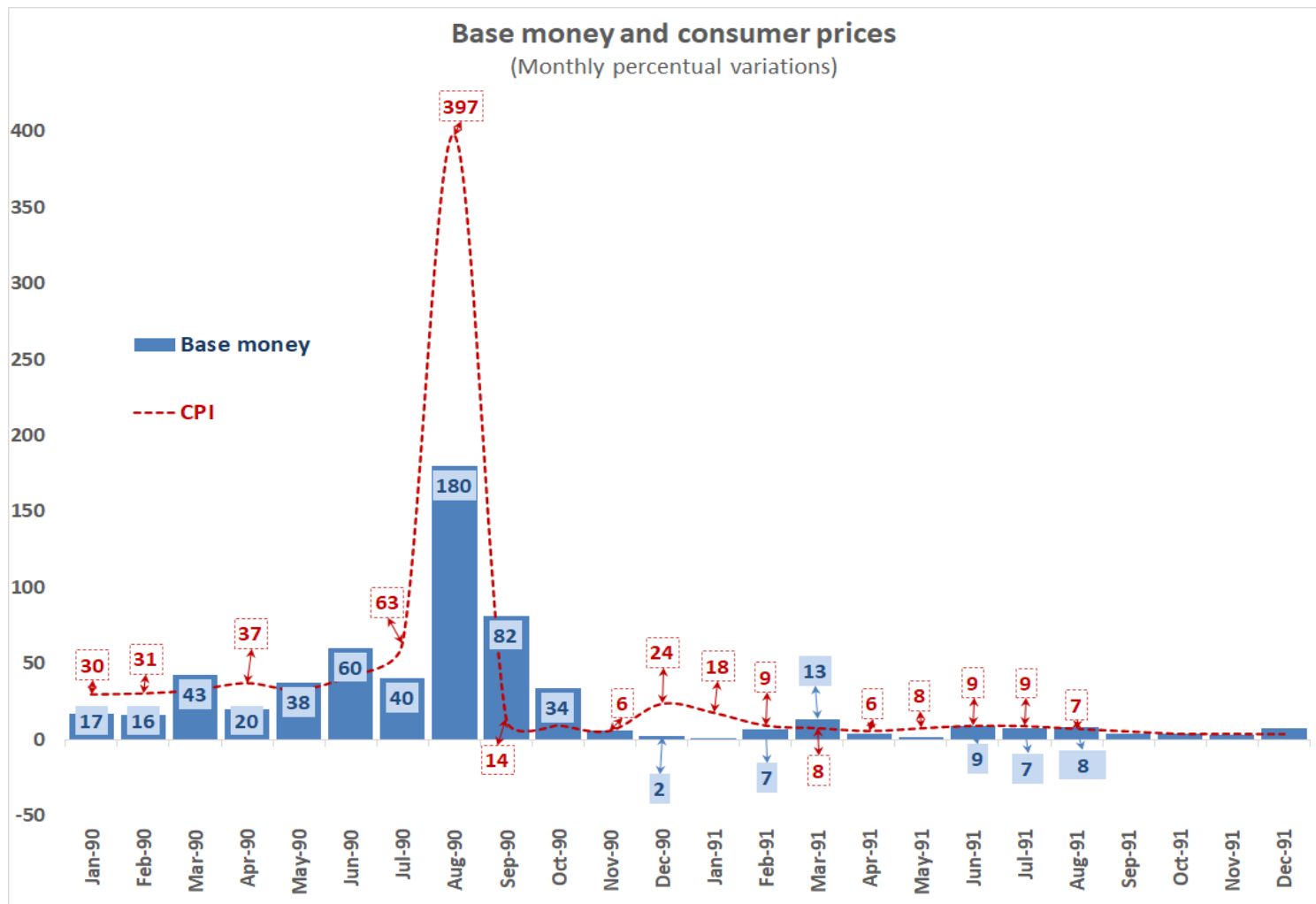
Dollar purchases replaced NDA as source of M0 expansion

	Jul 1990	Dec 1990	Feb 1991	Dec 1991	Dec 1992	06 Oct 2024
Net international reserves (millions of USD)	- 105	531	419	1 304	1 964	84 063
FX position of the central bank (Millions of USD)	-1071	-315	-386	-55	319	54 370
Official Exchange rate (Soles per USD)	0.057	0.528	0.560	0.970	1.640	3.735

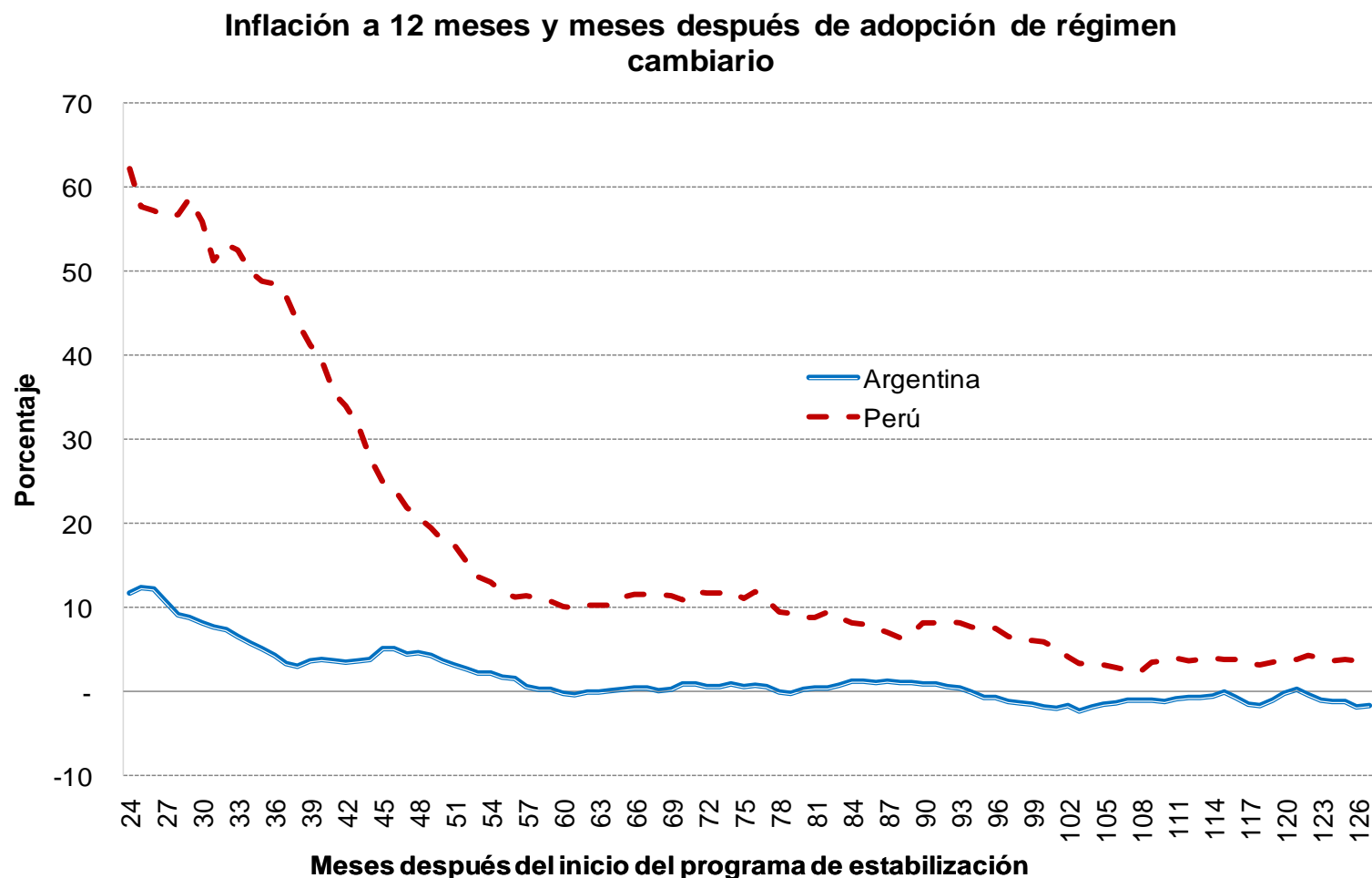
Monetary Control

Focus on slowing monetary base growth.
No numerical commitment.



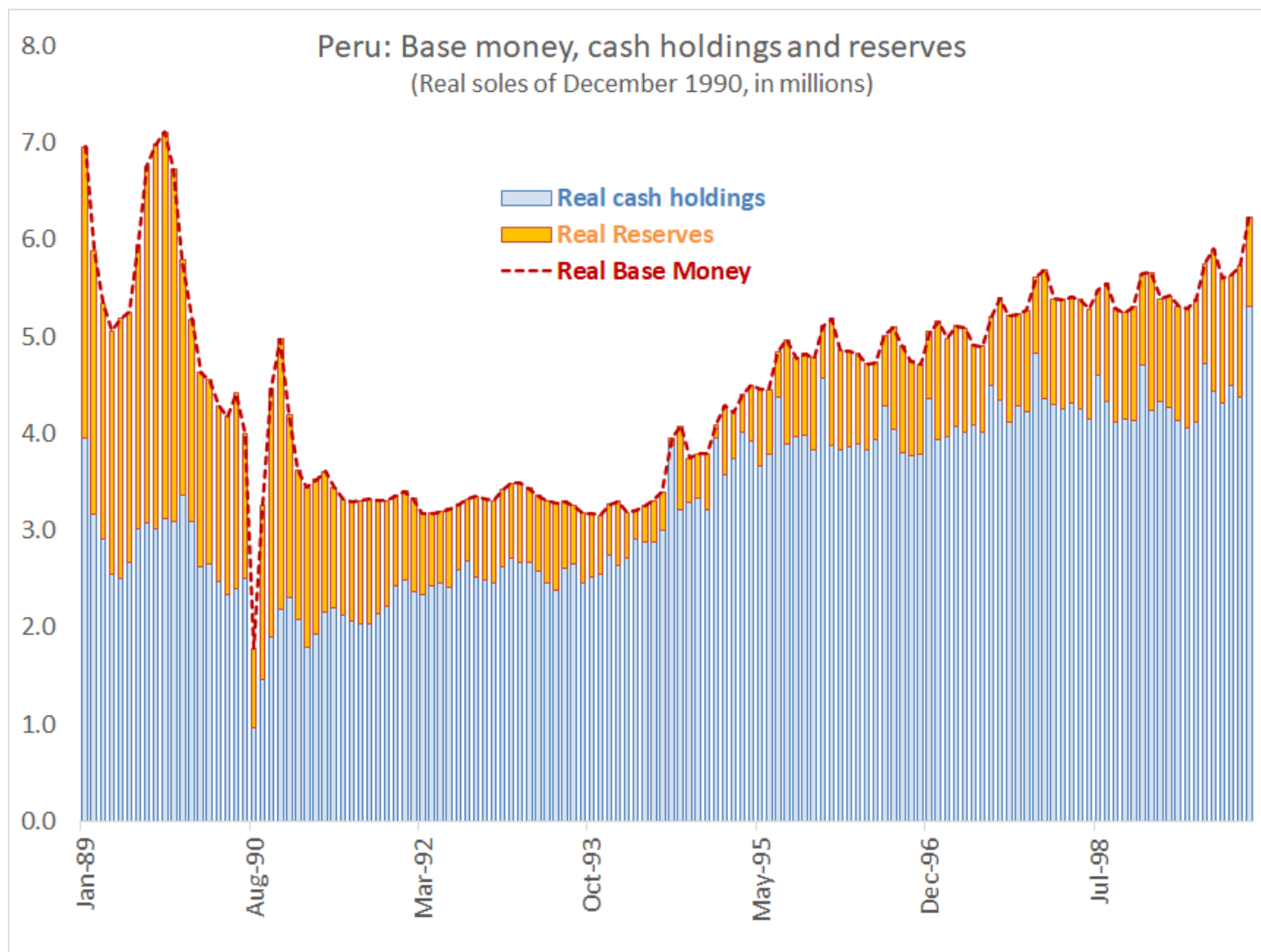


Alternatively, a fixed exchange rate regime (as implemented with the currency board in Argentina at the time) offered the potential for rapid inflation reduction if deemed credible but carried the risk of generating long-term vulnerabilities.

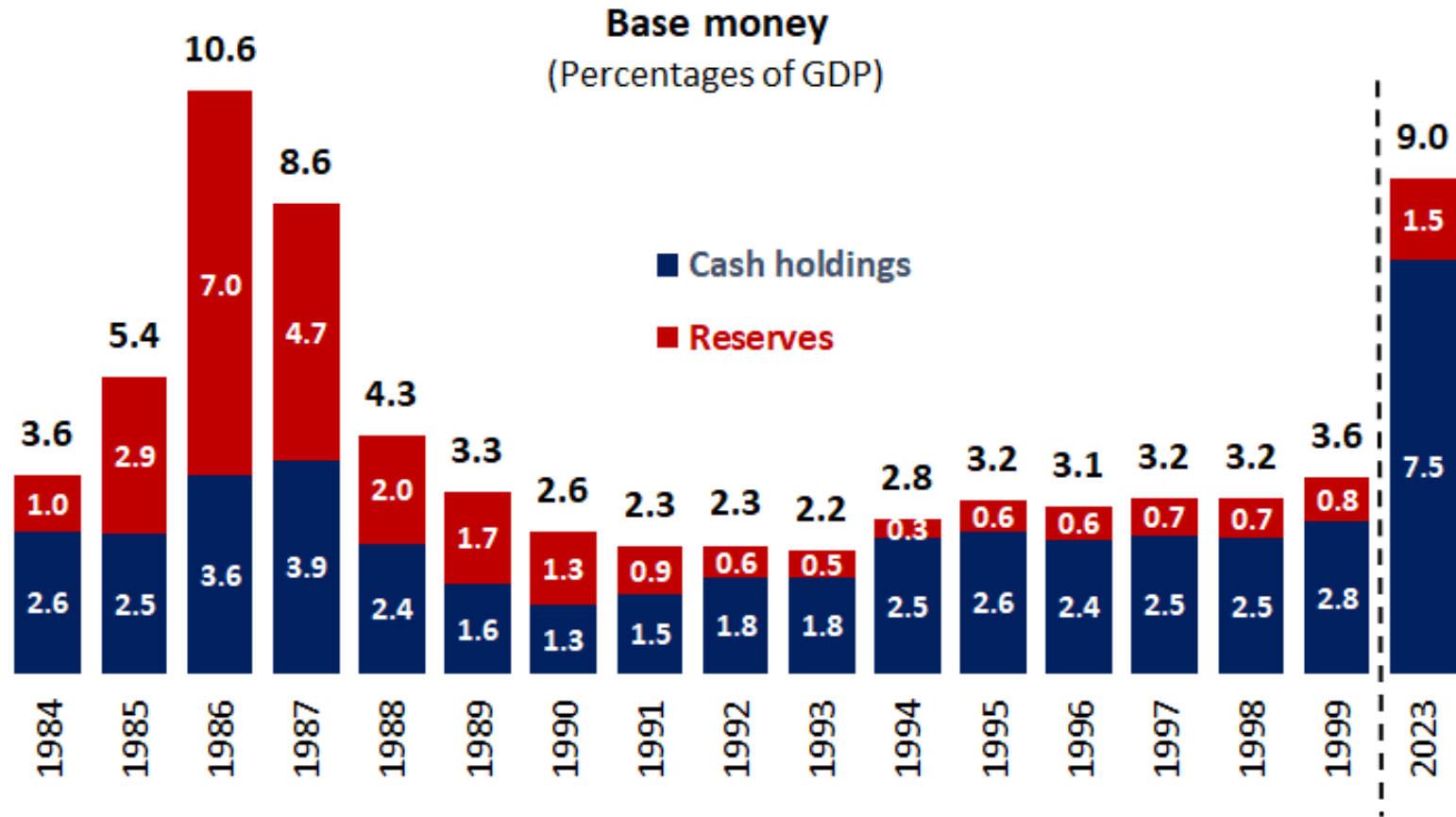


Real Base Money Recovery

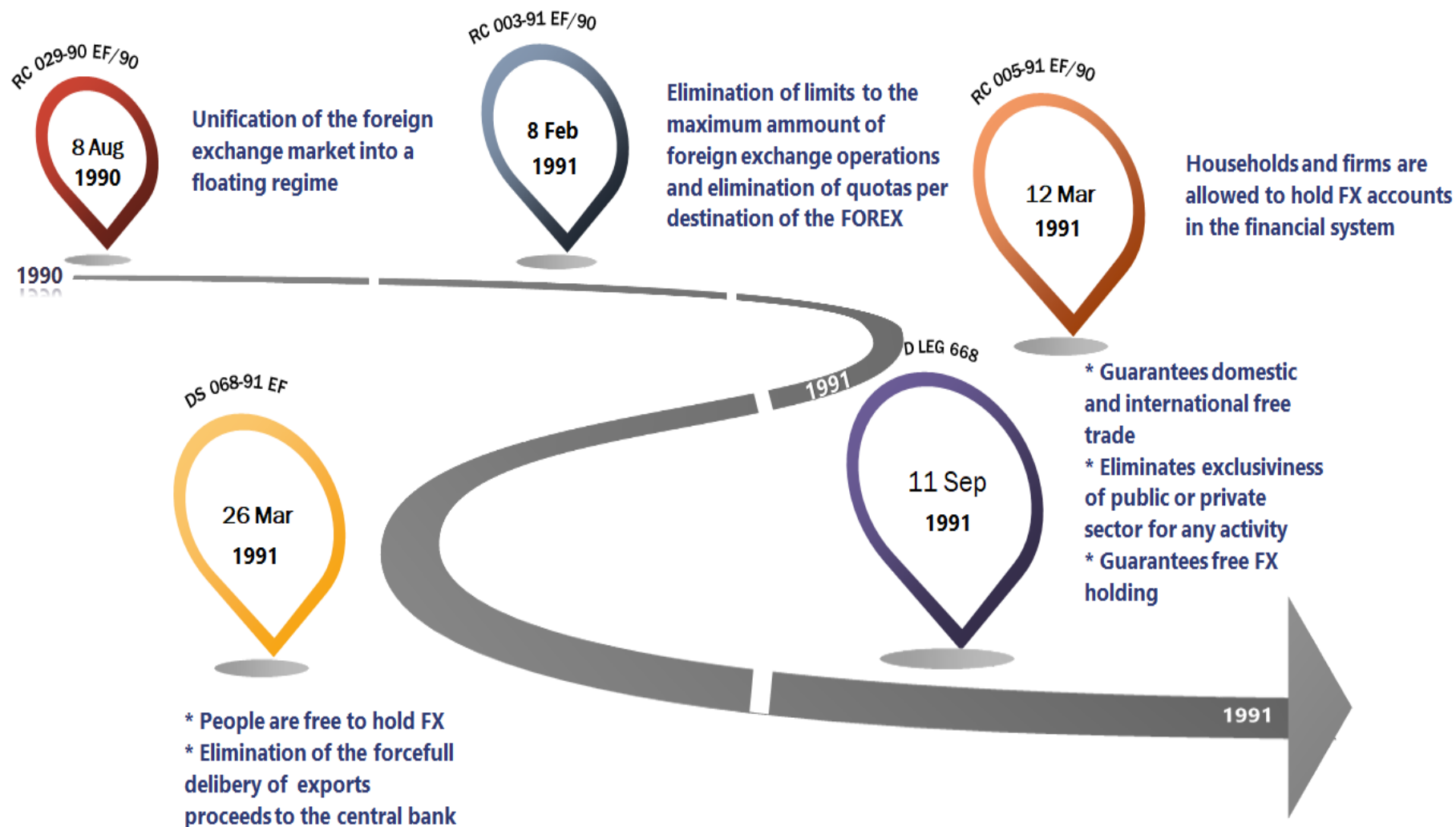
Following sharp declines during hyperinflation, real cash holdings rebounded within two years of the stabilization program's launch.



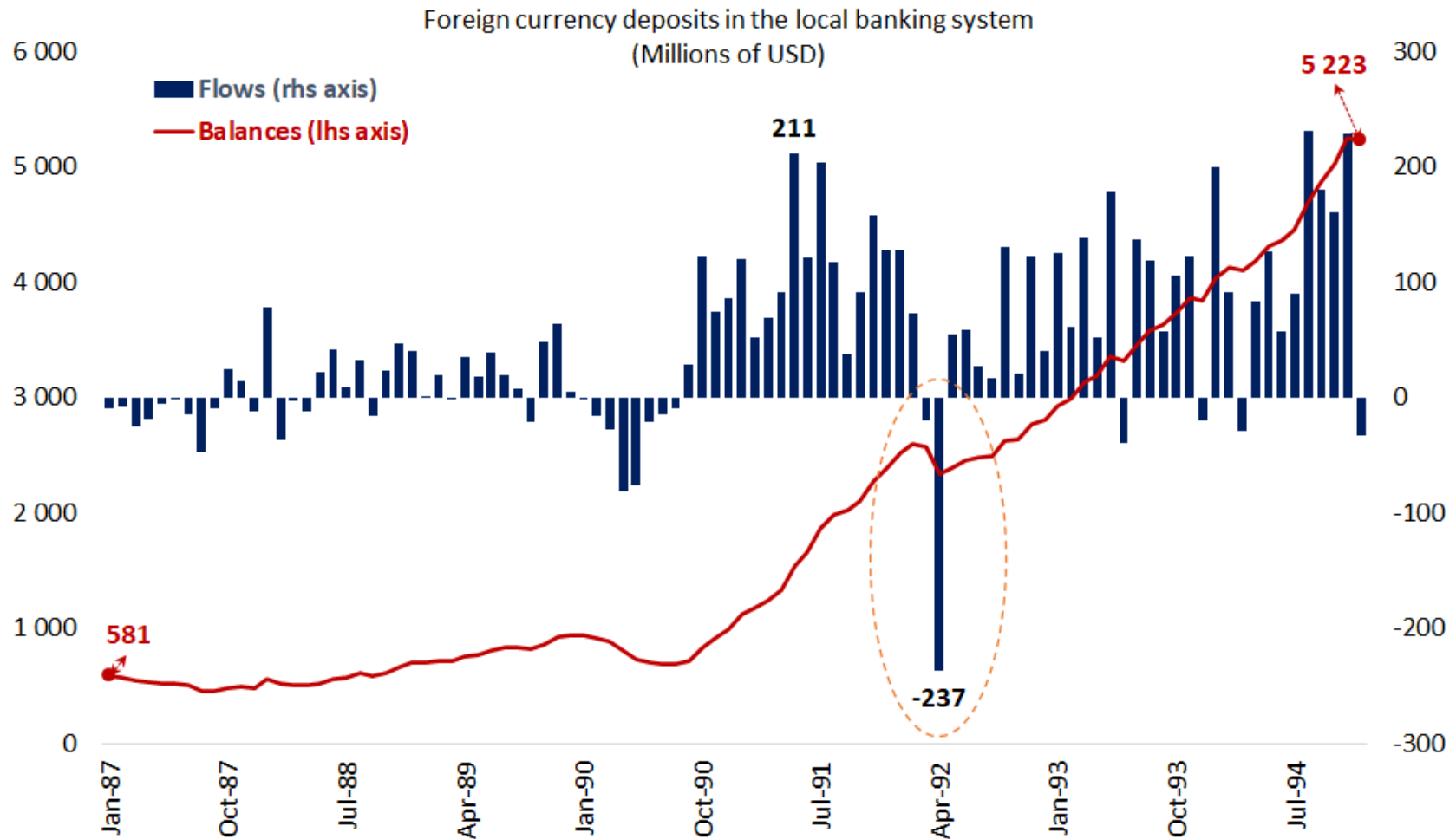
Cash holdings as a percentage of GDP began to rise in 1994 as inflation dropped to 15%.



Liberalization of Financial and Capital Markets

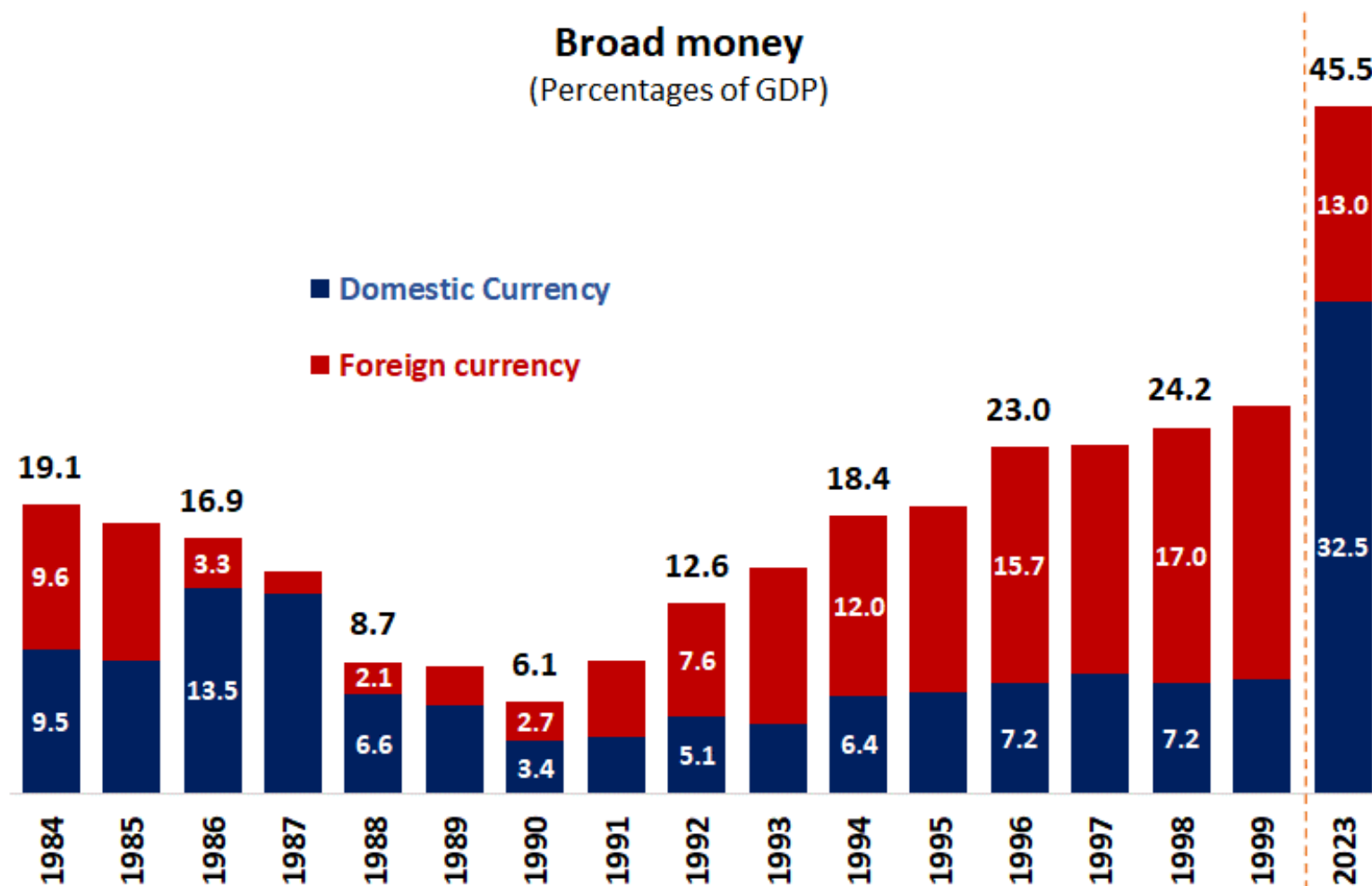


Following the stabilization program's launch, FX deposits in the financial system grew steadily due to capital repatriation. The political events of April 1992 triggered sudden capital outflows, which reversed after the announcement of new congressional elections.



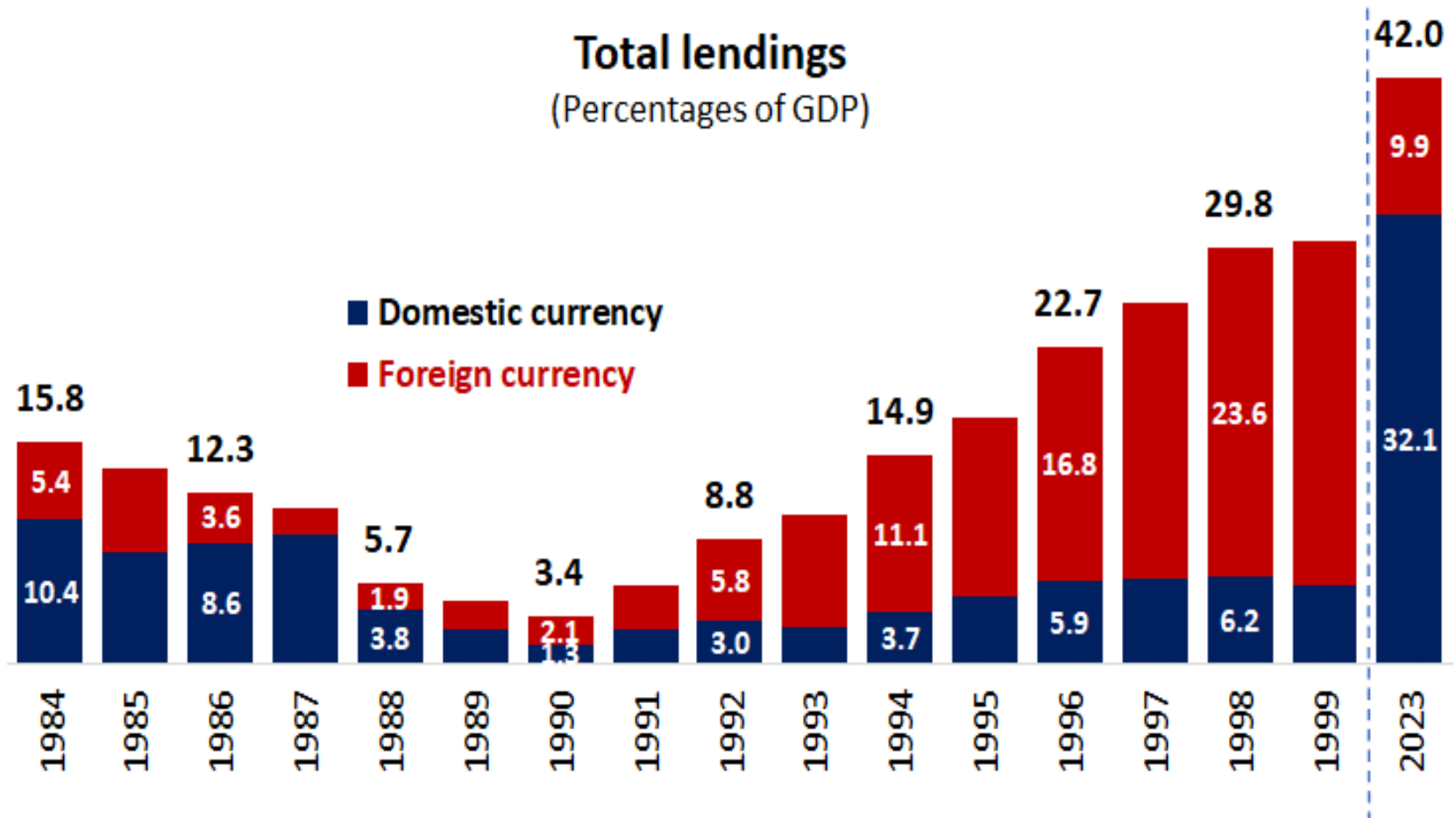
Financial Intermediation Recovery

Following economic stabilization and the removal of capital and exchange controls, financial intermediation recovered, driven by FX deposits linked to capital repatriation.



Financial Intermediation Recovery

With funding from dollar deposits, financial intermediation recovery was supported by FX lending.



Final Comments

- Central bank policies have evolved over time, and the learning process continues. Each crisis and shock brings unique challenges.
- The managed floating regime enables the exchange rate to act as a key shock absorber.
- Fiscal policy has been essential in preserving macroeconomic stability.
- Market participants exhibit “rational inattention” towards inflation.
- The main challenge is to boost potential GDP growth and avoid the middle-income trap. Key priorities include reducing labor market informality, enhancing infrastructure, developing financial markets, and strengthening institutions and governance.

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