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## ECUADOR AND PERU: COMPETING STRATEGIES OF ECONOMIC GROWTH

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### INTRODUCTION

Both are located on South America's west coast and both share much in terms of resources and history. Yet today Ecuador and Peru are veering increasingly apart as they pursue different strategies of economic growth. In Ecuador, two years ago, Leon Febres Cordero Rivadeneyra was elected president on a free enterprise platform, calling for reduced tariffs, more foreign investment, and improved competition for Ecuador's exports. By contrast, about a year later in Peru, Alan Garcia Perez was elected president on a platform calling for increased state intervention in the economy, rigid wage and price controls, higher tariffs, limited servicing of the foreign debt, import substitution, cooperative agriculture, and nationalization and state control of primary industries.

Both strategies face obstacles. Ecuador's vested political and economic interests oppose Febres Cordero's stratagems. Peru, meanwhile, is having trouble borrowing money abroad because it has scared off lenders by its reluctance to pay all the interest due on its existing foreign debt and for having nationalized a foreign oil company.

The jury is still out on which strategy will succeed in the long run. So far, however, Ecuador's free market effort is winning. Ecuador has successfully renegotiated its foreign debt with both commercial bankers and governments, reduced agricultural subsidies, restructured its monetary affairs, and is promoting foreign direct investment. Peru, in contrast, has refused to honor its foreign debt

obligations to commercial banks, has increased its agricultural subsidies through price controls, is discouraging foreign direct investment, and has made no effort to restructure its monetary affairs. What makes matters worse is that Garcia's flirtations with the radical politics of the Group of 77 nations and with the Non-Aligned Movement give little hope to those who believe he can be convinced to stop or slow his leftward drift.

In its attempt to construct a market economy, Ecuador deserves full United States support. Non-military assistance should be increased 25 percent from the \$48 million which Ecuador received in 1986. The new funds should be used for private enterprise projects in the agricultural, industrial, and fishing sectors. U.S. military aid, meanwhile, should be doubled to \$10 million, the bulk of it for anti-narcotics efforts.

As for Peru, Washington should not try to impede sanctions if they are imposed on Peru by the commercial banks to which Peru owes money. Washington should encourage Garcia and his administration to return to the international monetary system. Should Peru decide not to make reasonable efforts to come to an agreement with private banks, it may find it very difficult to win necessary new funding. Because Peru cooperates with the U.S. in the fight against narcotics, Peru should continue receiving the \$80 million in non-military U.S. aid appropriated in 1986.

Other Third World states should pay close attention to the strategies adopted by Peru and Ecuador. Ecuador could provide a valuable example of how to promote economic development through free enterprise while Peru almost surely will demonstrate those policies which ought not be followed in economic development. Ecuador is dynamic, while Peru has entered a period of stagflation. The U.S. should support those Third World leaders sensible enough to give a free market strategy a chance.

#### PERU AND ECUADOR: SIMILARITIES AND DIFFERENCES

Located on the west coast of South America with an area of 496,224 square miles, Peru is about three times the size of California and ranks behind only Brazil and Argentina as South America's third largest nation. It borders Ecuador, Colombia, Brazil, Bolivia, and Chile. The population in 1985 was estimated at 19.6 million, with an

annual average growth rate of 2.6 percent. Gross domestic product for 1985 was about \$17.5 billion, amounting to a per capita GDP of \$870.<sup>1</sup> For Latin America, average population growth rate is 2.3 percent and average per capita GDP is \$1,760.<sup>2</sup>

Ecuador, with an area of 104,506 square miles, is the continent's second smallest Spanish speaking nation, equal in area to Colorado. Ecuador's neighbors are Colombia, Brazil, and Peru. The nation's population in 1985 was about 9.6 million, with an annual average growth rate of 2.8 percent. Gross domestic product for 1985 was \$12.1 billion with a growth rate of 3.8 percent. Per capita income was about \$1,300.<sup>3</sup>

Ecuador and Peru share much history. The Spanish conquered what are now the two countries in 1531-1532. Ecuador and Peru were part of the Royal Audiencia of Lima from 1563. Ecuador was made part of the Vice Royalty of New Granada in the late 1600s. Both nations participated in the War of Independence (1810-1822) which saw Peru become an independent nation in 1822 while Ecuador became part of the Republic of Greater Colombia. In 1830 Ecuador formed its own government.

Both nations have gone through periodic political upheaval, with a succession of democratically elected presidents, military juntas, and both civilian and military dictators. Each recently saw military governments (Peru--1968 to 1980; Ecuador--1962 to 1979) succeeded by democratically elected presidents whose successors also were democratically elected. The military regimes of the 1960s and 1970s in both nations imposed agricultural reforms which destroyed the large land owners, nationalized some or all of the major minerals industries, and either nationalized or imposed heavy controls on primary industries.

Each military regime also adopted an "import substitution" strategy to promote industrial growth, imposing high tariffs ostensibly to allow local industry to produce products which otherwise would be imported. The strategy of "import substitution" was fashionable among influential international economists in the 1960s

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1. "Foreign Economic Trends, Peru," April 1986, U.S. Department of Commerce. Statistics on Peru's GDP/GNP probably understate actual production since there is no way to account for the contribution made by the "underground" economy. Estimates by the respected Institute of Liberty and Democracy in Lima put the "underground" economy at as much as one-third of GNP.

2. "World Development Reports," International Bank for Reconstruction and Development, Washington, D.C., July 1986, p. 154.

3. "Background Notes: Ecuador," U.S. Department of State, September 1986.

and most of the 1970s and was tacitly encouraged by the World Bank and International Monetary Fund. Generally, however, "import substitution" has retarded rather than spurred economic development because the locally produced goods are usually more expensive than the imported product would be, and may not be of equal quality. The result: the nations "protected" by tariffs become ever less capable of competing internationally.

Peru's President, Alan Garcia Perez, took office in July 1985 with three primary goals: to control inflation and reorganize the economy; to place his party firmly in command of the bureaucracy; and, to make an impact on the world political stage, primarily in the Non-Aligned Movement (NAM) and with the Third World nations collectively known as the Group of 77. His efforts to achieve these goals have moved Peru away from the private enterprise and free trade policies of his predecessor toward the statist, anti-business era of earlier repressive military regimes. Part of his economic package includes limiting foreign debt payment to about 10 percent of the value of Peru's exports. Meanwhile, Garcia faces a significant internal threat from two growing communist guerrilla movements, and a burgeoning group of narcotics traffickers.

Ecuador's new President, Leon Febres Cordero Rivadeneyra, entered office in August 1984 determined to right some of the economic wrongs of his predecessor. So far he has renegotiated Ecuador's foreign debt with governments and private bankers; promoted foreign direct investment; overturned some of the restrictions of the Andean Pact, a common market organization composed of Venezuela, Colombia, Ecuador, Peru, and Bolivia, which required majority local ownership of new business and industrial enterprises; reduced agricultural subsidies; and restructured Ecuador's monetary affairs. As in Peru, Ecuador faces a communist guerrilla movement, and has ever increasing problems with narcotics production and trafficking. Febres Cordero also faced an attempted military coup last January.

#### THE PERUVIAN CASE

Garcia took office with the Peruvian economy in shambles; inflation was running about 250 percent annually. To check this, he froze most wages and prices, devalued the currency 25 percent; raised tariffs; banned imports of some 500 items; and imposed controls on foreign exchange and foreign currency denominated bank deposits. In his inaugural address, Garcia declared that Peru would only pay a portion of its foreign debt, not to exceed 10 percent of the value of exports in any given year.

## Foreign Debt Situation

At least in de facto terms, Peru has defaulted on its foreign debt payments. Of Peru's \$14 billion foreign debt, \$2 billion is owed to the International Monetary Fund (IMF) and World Bank; about \$6 billion is owed to private banks; and about \$6 billion is owed to governments and other organizations. Arrearages to the IMF and World Bank are over \$300 million; arrearages to governments and other organizations are over \$500 million; and arrearages to private banks as of mid-1986 were over \$500 million and were expected to double by mid-1987. Payment of all arrearages, plus debt falling due in 1986, would cost Peru about \$3 billion. This about equals the estimated value of Peru's exports this year.

Garcia's proclamation of the ceiling on Peru's debt payments, followed immediately by failure to pay the commercial banks, caused great concern in world banking circles. The United States' Inter-agency Country Exposure Risk Committee (ICERC), which regulates foreign lending practices by U.S. commercial banks, declared Peruvian loans "value impaired" in November 1985. As a result, U.S. banks were ordered to set aside reserves equal to 15 percent of their outstanding loans to Peru.

As a group, meanwhile, foreign commercial banks cut Peru's trade credit lines from \$880 million in March 1984 to about \$150 million today. Most of those lines are offered by European and Japanese banks. Banking sources believe that Peru's available credit dipped below \$100 million by mid-1986.

### The IMF Problem

Peru owes the IMF \$700 million.<sup>4</sup> The government of Peru signed a restructuring agreement with the IMF in early 1984, but found itself unable to comply with the terms. Last April, the Fund warned Peru that failure to pay its arrearages by August 15 would result in Peru's being declared ineligible for further drawings. Peru paid only \$35 million of its then current arrearages of \$196 million on August 12, and hence was declared ineligible on August 15. In response, Garcia blasted the IMF as "The great overseer and guardian of imperialist economy and international capitalism." He added, "We cannot accept that the economy of the nation be strangled to satisfy foreign demands, which may be supported by legal documents but which historically have no moral support."<sup>5</sup>

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4. International Financial Statistics, International Monetary Fund, July 1986, p. 391.

5. FBIS, Volume VI, August 18, 1986, page J1.

### Foreign Reserves

Peru's refusal to repay its debt predictably has boosted Peru's net foreign reserves. They have grown from \$1.46 billion in June 1985 to \$1.65 billion in July 1986. Gold holdings have climbed from \$483 million to \$887 million over the same period, using constant valuation for the gold.<sup>6</sup> Peru's tactics have produced some short-term gains, but the long-run costs will be expensive.

### New Economic Program

Garcia imposed wage and price controls on all sectors of the economy soon after taking office. While these since have been relaxed somewhat, dislocations still exist. The strict exchange controls froze foreign currency-denominated deposits in the Peruvian banking system, which amounted to about 60 percent of all deposits at that time. On August 27, 1985, Garcia rescinded the operating contracts of U.S.-owned Belco Petroleum Corporation, Occidental Petroleum, and the Argentine Oxy/Bridas consortium. Following heated negotiations, new contracts were written with Occidental and Oxy/Bridas while Belco's operation was nationalized. Belco is negotiating a claim for \$400 million with the Peruvians. In the middle of this year, Garcia prohibited the repatriation of profits, dividends, and licensing and royalty fees by all companies.<sup>7</sup> Coupled with his tight import controls and the debt situation, he has effectively ended further foreign investment in Peru.

The military regime which took power in Peru in 1968 already had nationalized most of the mining sector, petroleum, fishing and fish meal manufacturing, and restructured agriculture, breaking-up large holdings and distributing land to the poor and to small farmers. That, coupled with Garcia's measure, means that all traditional export sectors are either state-owned or the sale of their end product must be handled through state-owned enterprises. The results: in 1965 Peru was a net exporter of sugar, in 1985 it was a net importer; in 1965 it was the world's third largest producer of fish products; in 1984 its production was only slightly larger than Panama's shrimp catch.

### Guerrillas and the Drug Problem

Peruvians raise coca plants on more than 200,000 acres (less than 20,000 acres are licensed legally), most of it in the high jungle of the Eastern Andes. The crop, the raw material from which cocaine is refined, produces at least \$700 million for the economy, about 10

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6. International Financial Statistics, op cit., p. 49.

7. FBIS, Volume VI, August 11, 1986, p. J1.

percent of the value of the finished drugs. Garcia recognizes the threat illegal drugs pose to his society and government. He has ordered police and military forces to fight narcotics and is cooperating with the U.S., Colombia, and Ecuador in the campaign against drugs.

Peru is also home to two guerrilla factions: the nihilist, Pol Pot-style group called "Sendero Luminoso" (SL) or "Shining Path," and the Movimiento Revolucionario Tupac Amaru (MRTA), a communist, Moscow oriented and backed, urban terrorist band. While there is no solid proof that either group is working with the narcotics traffickers, a symbiotic relationship probably will develop. The SL now controls significant portions of Peruvian territory in the South central part of the nation. There is a possibility that such control will be extended further north, toward Lima, with serious destabilizing potential for the government. It is unlikely that SL could incite a successful revolution at this time, but it remains a serious threat to life and property.

#### THE ECUADORIAN CASE

Leon Febres Cordero, a Social Christian, was inaugurated President of Ecuador on August 10, 1984. Though he has faced a Congress controlled by his opposition, he built a working majority between 1984 and 1986. Last year's election gains by the opposition, however, might have destroyed his ability to forge a coalition in the Congress.

#### The Economy and the Foreign Debt

When he entered office, Febres Cordero found the Ecuadorian economy in sharp decline. During the petroleum boom of the 1970s, Ecuador's oil wells were a windfall for the nation. But as the price of oil began to fall, Ecuador's economy stagnated. Real GDP growth for 1982 was only 1.4 percent, and the following year, the GDP actually fell 3.3 percent. Consumer prices rose 16 percent in 1982, 48 percent in 1983, and 31 percent in 1984.<sup>8</sup> The main causes were: 1) the effects of the world recession; 2) the sharp drop in oil prices; 3) rapid growth in the external debt; 4) declining world market prices for raw materials and agricultural products; and, 5) an erosion in private sector confidence in the system, prompting capital flight.

In marked contrast to Peru's Garcia administration, Febres Cordero and his team place renegotiation of Ecuador's \$7.3 billion

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8. International Financial Statistics, op. cit., p. 191.

foreign debt at the top of their agenda. In December 1984 the Ecuadorian government completed a multi-year rescheduling agreement (MYRA) with its commercial bank creditors. This private bank MYRA was the first such with any government and covered some \$4.4 billion in debt falling due between January 1985 and December 1989. This was followed in April 1985 by a similar agreement with the "Paris Club," composed of the U.S., Japan, and nine European nations, who are the most important government lenders to Ecuador. The Paris Club agreement rescheduled \$400 million of government-to-government credits due between January 1985 and December 1987. As part of this, Ecuador agreed to International Monetary Fund conditions for a \$105 million stand-by accord in March 1985, and successfully complied with the terms of that agreement last spring.

### Economic Reform

Linked to movement on the debt was Febres Cordero's decision to push for major economic structural reforms. In November 1984, Ecuador signed an agreement with the Overseas Private Investment Corporation (OPIC), a U.S. government agency, to promote and guarantee investment in Ecuador by U.S. firms. A potential obstacle to such investment was Andean Pact Decision 24. By this, the Pact (composed of Venezuela, Colombia, Ecuador, Peru, and Bolivia) requires domestic participation in any new business and restricts foreign ownership to 49 percent or less after a relatively short period. Febres Cordero has avoided the potential obstacle of Decision 24 by interpreting it in a way that expands the opportunity for foreign participation and repatriation of profits. At the same time, Ecuador reduced subsidies on agricultural and industrial items, cut tariff protection, and limited or erased price controls. In September 1984 a de facto devaluation of the Sucre, Ecuador's currency, began with the transfer of many transactions from the official rate of exchange to the market rate.

In 1985 the government of Ecuador repaid some \$283 million in foreign debt arrearages, and has remained current with all creditors. While the nation had a \$25 million balance of payments surplus in 1985, falling oil prices will probably lead to a 1986 deficit of about \$20 million.

Ecuador continues to liberalize its economy. Last August it deregulated interest rates on domestic savings and loans, allowing them to find their market levels. Companies earning foreign exchange were able to sell those funds on the free market, rather than to the Central Bank at the official rate of exchange. All private importers now buy their foreign exchange on the free market.

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9. "Background Notes: Ecuador," op. cit.



## Guerrillas and the Drug Threat

As in Colombia and Peru, Ecuador is challenged by a communist guerrilla movement and growing involvement in international drug trafficking. The "Alfaro Vive, Carajo!" (AVC) guerrilla movement is typical of the communist urban terrorist groups that have popped up in Latin America in the past two decades. While their numbers remain relatively small, the guerrillas have kidnapped prominent businessmen and bombed government offices. More than a dozen AVC troops went to Colombia for training with the M-19 communist revolutionaries. Ecuador's armed forces are ill-equipped to combat such activity, and look to the U.S. for training and improved equipment.

U.S. government sources believe that about 20,000 acres of Ecuador's high jungle are being used to grow coca plants. Although a small amount, the area is increasing. Most of Ecuador's coca paste is exported to Colombia for processing into cocaine. Ecuador is not yet willing to participate in cooperative action against drugs similar to that recently taken by Bolivia. Nonetheless, Ecuador needs U.S. assistance in combating its emerging drug problem.

### RECOMMENDATIONS FOR U.S. POLICY

#### Ecuador

Ecuador's new government has gone far to liberalize its economy and reduce government intervention. Coupled with compliance with an International Monetary Fund restructuring program and the clearing of debt arrearages with its creditors, Ecuador was granted a \$150 million "bridge" loan by Washington in 1986.

Because of his efforts and successes, Febres Cordero merits continued U.S. support. A pillar of Ronald Reagan's foreign policy is its backing for free market economies. Ecuador clearly qualifies. In addition to the \$150 million bridge loan, the U.S. thus should boost its developmental, economic, and military assistance to Ecuador in the next two to five years. Non-military economic assistance has been \$48 million for each of the past three fiscal years. This should be increased to about \$60 million--consisting of at least \$30 million in Economic Support Funds and the rest in direct assistance and Food for Peace programs. Economic Support Funds are provided by the U.S. government to foreign nations for use in balancing their budget. The funds are not spent on specific projects, but generally are used either to pay bills or retire debt.

To spare Ecuador future burdensome debts, U.S. military assistance should be changed from sales to outright grants. These should be at least \$10 million annually (compared to \$5 million

currently in military sales). The bulk of these funds should be earmarked for Ecuador's efforts in fighting narcotics traffickers and guerrillas. Additional funds, probably in the \$2 million per annum range, should be made available for anti-narcotics work.

### Peru

Peru poses a difficult problem for Washington. Foreign commercial banks have a clear legal right to take appropriate steps to effect payment of monies owed them by Peru. These actions may include embargoes on further loans to Peru and attempts to seize Peruvian assets abroad. Both the International Monetary Fund and the World Bank find themselves forced to forgo new loans to Peru and may be required to stop disbursement of loans already agreed to. These are the result of Garcia's failure to honor his nation's prior commitments.

For the U.S., however, the case is not as clear-cut as it is for the banks. Although Peru for a time in 1986 was in arrears on repaying its military and economic assistance loans to the U.S., the repayments are now up to date. Peru, therefore, remains eligible for continued U.S. economic and military assistance programs.

The fiscal 1987 U.S. budget targets more than \$80 million in economic aid for Peru--\$37 million for Economic Support, \$20 million for Development Assistance, \$17.7 million for Food for Peace, and \$5.7 million for anti-narcotics work. Military assistance for fiscal 1987 is \$25.9 million. These levels are adequate.

What is not adequate is Peru's economic strategy. Statism cannot solve Peru's economic problems. Washington should thus encourage Peru to reduce barriers to business expansion and formation, re-privatize agriculture, improve tax collection, and shrink the bureaucracy. Although Garcia's stance on the international debt question has been extremely confrontational, efforts should be made by the U.S. and other governments, multi-lateral institutions, and commercial banks to get Peru back into the world economic system. The U.S., moreover, should not allow Peru's intransigency on the debt issue to interfere with Garcia's obviously strong interest in controlling drug trafficking and halting the spread of communism. Garcia has ordered his armed forces and police to interdict the drug traffickers and eradicate the coca production.

### CONCLUSION

Febres Cordero faces a difficult task in trying to free Ecuador from the burdens of statism and give market dynamics the chance to ignite economic growth. Deeply vested political and economic interests have attempted to thwart his efforts. It will take time to

convince Ecuadorians that these policies provide their best hope for stable, long-term growth and therefore the best opportunity for more jobs and higher income for all. In part, the success of his reforms rests on external factors: the price of oil and raw materials, including agricultural products, and Ecuador's ability to judiciously manage its foreign debt. In part it also depends on his ability to deliver on his electoral promises, such as constructing 120,000 housing units by 1988. What Febres Cordero needs is time--something that the U.S., with appropriate aid, can help him buy.

Ecuador's free market gains should be teaching a lesson to Peru. That country cannot expect to enjoy economic growth so long as state control and import substitution remain the basis of its economic strategy. While it may be difficult to convince Garcia of this, other Peruvian leaders may be willing to reassess the disastrous Garcia policies. At the same time, Garcia's efforts to fight the drug mafia must be encouraged and supported by the U.S.

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Paul R. Wisgerhof is a State Department officer on special leave to The Heritage Foundation. Mr. Wisgerhof has served in Lima as Counselor of Embassy for Economic Affairs, in Venezuela, Mexico, Germany, Ecuador, and Japan. The views expressed in this study are his own and should in no way be attributed to or necessarily reflect the views of the Department of State or the U.S. government.

