Case Study No. 2

How drug dollars loot Peru's economy

by Gretchen Small

There is a widespread belief that if the governments of Ibero-America would only legalize the dollars flowing from the drug trade, they could thus access desperately needed liquidity. The monies might be immoral in origin, the argument goes, but if legalized, drug dollars can be turned to good, by saving the economies of the region. The experience of President Alan García's efforts to crush the drug trade and rebuild a productive economy in Peru, demonstrates that, where implemented, the result of the legalization policy is exactly the opposite.

Wherever drug monies have been permitted to enter the legal economy—whether formalized as in Colombia's "sinister window," or tolerated as a "legal" black market as on Lima's Ocoña street—that window of legality functions, not as a source of capital for the country, *but as the window through which capital flight loots that country of its resources.*

Two primary domestic factors have led to the failure of the García government's efforts to crush the drug trade inside Peru. One factor has been the warfare waged by the narco-terrorist insurgency led by Shining Path, in defense of the drug trade. The second cause, however, lies in the government's failure to break the control of the narco-bankers over the nation's credit system.

Stemming the looting

President García was the first President in ten years in Peru to commit his government to "totally eradicate drug trafficking," the promise García made in his inaugural speech on July 28, 1985. Within two weeks of taking office, García's government had raided more coca laboratories and fired more corrupt policemen than either of the two previous governments had done in their terms in office.

The steps were long overdue. By the time García took office, Peru had become the single largest producer of coca leaves in the world. Under the careful watch of his two immediate predecessors, Gen. Francisco Morales Bermúdez (1975-80) and Fernando Belaúnde Terry (1980-85), land under coca cultivation in Peru had skyrocketed from the estimated 14-18,000 hectares planted in 1975, to over 135,000 hectares by 1985. Industrial and agricultural production, however, had plummeted.

As a result, by 1985, the dollar had overtaken the sol as the currency used in Peru, with the sol devalued to the point of worthlessness. "The growing informal economy is underpinned by the drug trade, mainly cocaine business, which authorities have done little to stamp out, and which is reckoned to account for 10% of the money supply," the *Financial Times* admitted on Nov. 27, 1984.

The leading drug-legalization advocates in Peru today, continue to be the two finance ministers most responsible for the "cocaization" of the economy under those regimes: Javier Silva Ruete and Manuel Ulloa.

When García took office, the nation's reserves were almost nonexistent. Two strategies were proposed to resolve the problem. One was to continue the "open economy" policies of the International Monetary Fund, while formalizing the de facto legalization of drug dollars which had occurred under the past regimes. This option was promoted in the *Wall Street Journal* in August 1985, which asserted that people "deep within" García's government considered this as the way to pay the debt.

The other, adopted by García, was that of restricting payments on the foreign debt to 10% of export earnings, with the money thus saved to be invested in increasing national production and consumption. García ordered that the dollarization of the economy cease, insisting that "wages and profits will be measured in the national currency, and not in foreign coin."

Although no formal exchange controls were adopted, García threatened to shut down the main source of dollars for capital flight: the "informal" drug-dollar market on Ocoña Street. On July 30, police raided Ocoña, arrested some 200 money-changers, and seized documents proving Ocoña's role as a drug money laundromat.

García's policies worked. Over the next year and a half, Peru's reserves rose from about \$350 million to a high of \$1.5 billion. In 1986, the economy grew an unprecedented 8.9%; manufacturing rose even faster, by 17%. Most of that growth was achieved simply by gearing up productive capacity idled under previous regimes.

As the limits of using previously existing production were reached, the question of generating new capital for investment became primary. With the international banking cartel cutting most of Peru's foreign credits, by December 1986, reserves gained by limiting debt payments, were being drawn down to sustain the growth.

For the next six months, the banking cartel attempted to force García's government to accept their argument that Peru's only hope was to adopt the coca-dollar strategy cited by the *Wall Street Journal* in 1985. Cartel mouthpieces from London's *Economist* to Silva Ruete's *La República* in Lima, put out the line that Peru's reserves depended on Ocoña's laundering.

The Peruvian private sector joined international bankers' in squeezing the economy to force Peru to accept drug dollars. In an April 12, 1987 interview with *Visión* magazine, Manuel Ulloa outlined the terms of their squeeze-play: "We can forget any idea of receiving any foreign resources for the next five years . . . either credits or investments. No investment from private interests should be expected either, under current government policies. Tell me who is going to deposit money so that through the banking system, the development of production can be aided?" Sooner or later, the government will be forced to "rectify" its policies, Ulloa stated.

Ulloa's newspaper, *Expreso*, published calls for mass capital flight. The private sector will be "going tomorrow to Ocoña Street, converting their businesses into dollars, and beginning again some place outside of Peru," one of Peru's "informal economy" advocates, Felipe Ortíz de Zevallos, told *Expreso* on April 12.

By June 1987, it was clear that the battle over economic policy, came down to the issue of how Ocoña and the drug dollars would be handled.

Ocoña has become the center of speculation in the country, and should be shut down, the chairman of the Congressional Budget Commission, Carlos Rivas Davila, proposed on June 7. Ulloa's *Expreso* answered that "not even a police regime like the U.S.S.R. has been able to eliminate the black market in foreign money. . . . It is an illusion that Ocoña could be eliminated."

Economics Minister Luis Alva Castro lined up with Ulloa's crowd, promising on June 13 that the government would not intervene in the "informal" dollar market. The central bank adopted the insane strategy of attempting to lower the price of the dollar on the black market, by selling dollars on Ocoña—in essence, a decision to throw Peru's official reserves out Ocoña's window!

On July 14, Planning Minister Javier Tantalean revealed that other options were being considered by the government. One billion coca-dollars going through Peru's economy have wrecked the stability of Peru's currency, now named the inti. "Initially it was thought that Ocoña was equal to 1-2% of our exports, but now it is said to be nearly one-third! We are seriously studying this situation, so that . . . proper measures can be taken. . . . Ocoña is the tip of the iceberg, which means there is something a lot bigger," he told reporters.

Defeating the nationalization strategy

On July 28, 1987, President García announced in his State of the Union address, that his government had drawn up a bill nationalizing Peru's banking system. While Congress studies the measure, the state will intervene into the country's financial institutions, to prevent the complete decapitalization of the country in the meantime.

Ocoña was finally shut down, and tight exchange controls adopted. "When one buys dollars from narcotics traffic, he is subsidizing its illicit activity and then carrying over the high price of those dollars to the price of goods and services. . . . This situation made it imperative to take an immediate decision. From this moment, the government, by sovereign decision, set up a strict regime of exchange controls, declaring that the use of foreign exchange has a social character and must be decided only by the state," García stated in his speech.

A few days later, García reiterated that the fundamental issue at stake in the bank nationalization is that "the government, not the drug traffickers, must run the country." The majority of capital flight Peru suffers involves "dollars from the black market, the majority of which come from the drug traffic," he charged.

The reaction from the banks, international and domestic, was violent. The champions of the informal economy in Peru at the Institute for Liberty and Democracy called in advisers from Coparmex, the Mexican businessman's association, most vociferous in its support for legalizing the black market. Coparmex's people advised the Peruvians to boycott the government's banks, and concentrate on building up parallel credit schemes, outside government control. The cry went up that García's government was moving toward communism.

The first sign that the government's will could be broken, sooner or later, was that by September, all mention of the drug economy was dropped by government spokesmen, including García. The government defended its proposed nationalization as only an effort to "democratize" credit, never again mentioning that the issue was one of sovereignty against the dope mob.

On Jan. 28, 1988, the government formalized its defeat. Supreme Decree 009-88-PCM was issued, allowing businessmen to import goods without using "official" dollars. The only source for non-official dollars? Ocoña. Lima's *El Comercio* named the measure for what it was: "Behind the bureacratic language . . . reality is that through such a decree, money of doubtful origin . . . is incorporated into the economy."

On March 11, then-Economics Minister Gustavo Saberbein declared that "it is no longer illegal to sell dollars on the Ocoña secondary market." The inti, trading at some 45 to the dollar on Ocoña during the height of the crisis in June 1987, immediately dropped to 110 per dollar. By the end of April, the commercial banks—now back in the hands of the private sector—were given the green light to buy "all the dollars they want" from tourists and "any other sources." *El Comercio* noted that the parallel market has thus been fully institutionalized in the national banking system.

Peru's economy has gained neither capital nor stability from the measure. In May, speculation against the inti on Ocoña drove its value down to 215 per dollar. The Lima daily *El Nacional* named the narco-mafias as the leading culprits in the binge. When it dropped to near 250, the government again resorted to selling its scarce dollars on Ocoña!

With ups and downs, the speculation has continued to this day. On June 18, García's third Economics Minister, Cesar Robles, acknowledged that one of the fundamental causes of the continuous crisis is the "parallel banking structure," which he estimated today handles 40% of Peru's total financial resources.