Web Links

Central banks in the advanced industrialized countries maintain websites with plenty of information about monetary and exchange-rate policy. Visit

The Federal Reserve Board: *http://www.federalreserve.gov/.*

The Bank of England: *http://www.bankofengland.co.uk/.*

The European Central Bank: *http://www.ecb.int/.*

The *Bundesbank*: *http://www.bundesbank.de/ind.ex_e.html.*

The Bank of Japan: *http://www.boj.or.jp/en/.*

Bank of France: *http://www.banque-france.fr./gb/home.htm.*

New York University maintains a website dedicated to the study of central banks. You can visit this site at *http://www.law.nyu.edu/centralbankscenter/.*

Suggestions for Further Reading

Perhaps the most comprehensive work on central-bank independence is Alex Cukierman, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence* (Cambridge, MA: MIT Press, 1992). A good treatment of the politics of central banking in Western Europe before the EMU can be found in John B. Goodman, *Monetary Sovereignty: the Politics of Central Banking in Western Europe* (Ithaca, NY: Cornell University Press, 1992).

The classic statement of the time-consistency problem can be found in Finn Kydland and Edward C. Prescott, "Rules Rather than Discretion: The Dynamic Inconsistency of Optimal Plans," *Journal of Political Economy* 83: 473–91.

The best discussion of the European Monetary System as a commitment mechanism is found in Francesco Giavazzi and Alberto Giovannini, *Limiting Exchange Rate Flexibility in Europe* (Cambridge, MA: MIT Press, 1989). For a contrasting view, see Michele Fratianni and Jürgen von Hagen, *The European Monetary System and European Monetary Union* (Boulder, CO: Westview Press, 1992).

CHAPTER 14

Developing Countries and International Finance I: The Latin American Debt Crisis

Developing countries have had a difficult relationship with the international financial system. At the center of these difficulties lies a seemingly inexorable boom-and-bust cycle. The cycle typically starts with changes in international capital markets that create new opportunities for developing countries to attract foreign capital. Wanting to tap into foreign capital to speed economic development, developing countries exploit this opportunity with great energy. Eventually, developing countries accumulate large foreign debt burdens that they cannot easily repay and are pushed toward default. The looming threat of default frightens foreign lenders, who refuse to provide additional loans to developing countries and who attempt to recover many of the loans they had made previously. As foreign capital flees, the developing countries are pushed into severe economic crises. Governments then turn to the International Monetary Fund and the World Bank for assistance and are required to implement far-reaching economic reforms in order to gain those organizations' aid. This cycle has repeated twice in the last 25 years, once in Latin America during the 1970s and 1980s, and once in Asia during the 1990s. A similar, though distinct, cycle continues to afflict sub-Saharan Africa. The political economy of North–South financial relations focuses on this three-phase cycle of overborrowing, crisis, and adjustment.

Each phase of the cycle is shaped by developments in the international financial system and inside developing societies. Developments in the international financial system, including changes in international financial markets, in the activities of the International Monetary Fund and World Bank, and in government policies in the advanced industrialized countries, powerfully affect North–South financial relations. They shape the ability of developing countries to borrow foreign capital, their ability to repay the debt they accumulate, and the economic reforms they must adopt when crises strike. Events that unfold within developing countries determine the amount of foreign capital that developing societies accumulate and influence how governments and economic actors in those countries use their foreign debt. These decisions in turn shape the ability of governments to service their foreign debt and therefore influence the likelihood that the country will experience a debt crisis.

This chapter and the next examine the evolution of this cycle in North–South financial relations through the last 50 years. We begin with a short overview of international capital flows in order to understand why they are important for developing societies and how developing societies gain access to foreign capital. We then briefly examine the relatively stable immediate postwar period during which capital flows to developing countries were dominated by foreign aid and foreign direct investment. The rest of the chapter focuses on the first major financial crisis of the postwar period: the Latin American debt crisis of the 1980s. We examine how it originated, how it was managed, and its consequences, political and economic, for Latin America.

Foreign Capital and Economic Development

If a cycle of overborrowing, crisis, and adjustment has characterized the history of capital flows from the advanced industrialized countries to the developing world, why do developing countries continue to draw on foreign capital? Why do they not simply refrain from borrowing that capital, thus bringing the cycle to an end? Developing countries continue to draw on foreign capital because of the potentially large benefits that accompany its apparent dangers. These benefits arise from the ability to draw on foreign savings to finance economic development.

Investment is one of the most important factors determining the ability of any society to raise per capita incomes (Cypher and Dietz 1997, 239). Yet, investment in developing societies is constrained by a shortage of domestic savings (Bruton 1969; McKinnon 1964). Table 14.1 illustrates average savings rates during the last 40 years throughout the world. The most striking difference that the table highlights is between the high-income OECD countries and the world's poorest countries. On average, the high-income countries saved almost one-quarter of their national income each year between 1960 and 1999. In contrast, the least-developed countries have saved less than 10 percent of their national income per year. Even when a developing country has a high savings rate, as in East Asia and the Pacific and in Latin America, the low incomes characteristic of a developing society mean that the total pool of savings generated by even a high savings rate is small. The scarcity of savings limits the amount, and raises the cost of, investment in these societies.

Foreign capital adds to the pool of savings available to finance investment. The ability to import capital from the rest of the world, therefore, allows developing countries to invest more at lower interest rates than would be possible otherwise. Many studies have found a one-to-one relationship between foreign capital inflows and investment: one dollar of additional foreign capital in a developing country produces one dollar of additional investment. (See e.g., Bosworth and Collins 1999; World Bank 2001a.) Higher investment in turn promotes economic development. Indeed, a considerable body of research suggests that developing countries which have participated in international financial markets during the last 30 years have experienced faster economic growth rates than countries that have insulated themselves from international financial flows. (See IMF 2001; World Bank 2001a.) Although foreign capital does not always yield higher growth (see, e.g., Rodrik 1998a), a country that draws on foreign capital has the *opportunity* to reach a higher development trajectory. Many other factors, some of which lie inside developing countries and others that inhere in the international financial system, shape the extent to which a developing country can take advantage of this opportunity.

Table 14.1
Average Savings Rates as a Percent of GDP, 1960–1999

High-Income OECD	24.12
Least-Developed Countries	8.03
East Asia and the Pacific	31.43
Latin America and the Caribbean	21.1
Sub-Saharan Africa	17.73
South Asia	16.65

Source: World Bank, *World Development Indicators on CD-ROM*, 2001.

Foreign capital can be supplied to developing countries through a number of channels. The broadest distinction is between foreign aid and private capital flows. **Foreign aid,** or official development assistance, is foreign capital provided by governments in the advanced industrialized countries and by multilateral financial institutions such as the **International Bank for Reconstruction and Development** (IBRD), known more commonly as the **World Bank.** The largest share of foreign aid is provided as **bilateral development assistance**—that is, foreign aid granted by one government directly to another government. In 2003, the advanced industrialized countries together provided $50 billion of bilateral assistance to developing countries. The World Bank and other multilateral development agencies provided an additional $17 billion. The United States provided the most aid in absolute terms in 2003, about $16.2 billion (Figure 14.1). Japan, France, Germany, and Great Britain were the other large donors in absolute terms. The rankings change considerably when we measure aid as a share of the donor country's national income (Figure 14.2). By this measure, the smaller northern European countries are the most generous, dedicating between 0.6 and 1 percent of their total national incomes to foreign aid. The United States emerges as the least generous country, dedicating only 0.15 percent of its national income to foreign aid.

Foreign aid can be provided as a grant, which does not require repayment, or as a loan requiring repayment. Most bilateral aid is offered in grant form. Multilateral agencies provide all of their assistance as loans. These development loans are in turn divided into two categories. Under **nonconcessional lending programs,** the interest rate charged on a loan is close to market interest rates. Under **concessional lending programs,** interest rates are below market interest rates. In general, the world's poorest countries draw a higher proportion of their aid from concessional lending programs. In contrast, middle-income developing countries draw a higher proportion of their aid from nonconcessional aid programs.

Private capital flows transfer savings to the developing world through the activities of private individuals and businesses. Private capital can be transferred to developing countries in a number of ways. Commercial banks transfer capital by lending to private agents or governments in developing societies. Private capital is also transferred when individuals and large institutional investors purchase stocks traded in developing-country stock markets. Private capital can also be transferred through bonds sold by

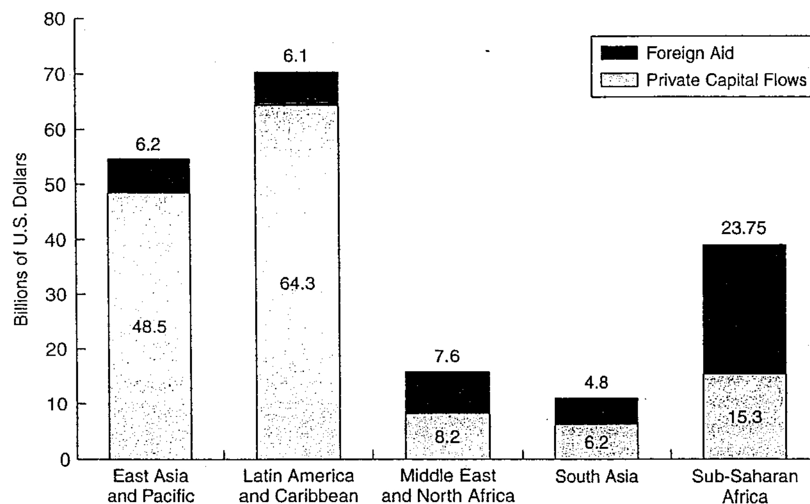

Figure 14.3 Private Capital and Foreign Aid Flows, 2003.
Source: Foreign aid flows from OECD, *Statistical Annex of the 2004 Development Co-operation Report*, Table 4, *http://www.oecd.org/dataoecd/52/9/1893143.xls*; private capital flows from World Bank, *Global Development Finance 2004*, Table B.36. *http://siteresources.worldbank.org/GDFINT2004/Home/20175282/gdf_statistical%20appendix.pdf*.

back to our discussion of comparative advantage.) Consequently, private lenders should earn a higher return on an investment in a developing country than on an equivalent investment in an advanced industrialized country. This acts to pull private capital in. On the other hand, foreign investment is risky. Private lenders face the risk of default—the chance that a particular borrower will be unwilling or unable to repay a debt. Private lenders also face political risk—the chance that political developments in a particular country will reduce the value of an investment. Political risk arises from political instability—coups, revolution, or civil war—and, less dramatically, from the absence of strong legal systems that protect foreign investment. When such risks are large, they substantially reduce an investment's expected return. This risk acts to push private capital away from a country. Indeed, such risks are one of (if not the) principal reasons why sub-Saharan Africa attracts so little private capital.

Developing societies import foreign capital, therefore, because it makes it possible to finance more investment at a lower cost than they could finance if they were forced to rely solely on their domestic savings. And while developing countries can import some capital through foreign aid programs, such programs are quite limited. Thus, if a developing society is to import foreign savings, it must rely on private capital. The desire to import foreign savings and the need to rely on private capital flows to do so creates difficulties for developing societies. For private capital never seems to flow to developing societies in a steady stream. Instead, financial markets shift from excessive concern about the risk of lending to developing societies to exuberance about the opportunities available in those societies and then back to excessive concern about the

risk. As a consequence, a country that is unable to attract private capital one year is suddenly inundated with private capital the next, and then, just as suddenly, is shut out of global financial markets as private investors cease lending. The consequences are often devastating. We turn now to look at the first revolution of this cycle.

Capital Flows in the Early Postwar Period

The principal problem that most developing countries faced in the first 20 years following World War II was a shortage of foreign capital. Foreign aid and foreign direct investment were the principal sources of foreign capital for developing countries in the 1950s and 1960s, and neither was abundant. The United States was the only country capable of providing foreign aid. Western Europe was undergoing reconstruction following the Second World War, and this left no resources available to finance foreign aid programs. In fact, Western Europe was a large recipient of foreign aid, as most American aid was directed at postwar reconstruction until the end of the 1950s. Little aid was allocated to Latin America, because the American government believed that private markets would invest in the region. Most of sub-Saharan Africa remained part of colonial empires, the responsibility of the colonial power rather than of the broader international community. Thus, Africa attracted no foreign aid. World Bank lending to the developing world was also limited. It perceived its mission as providing loans at "close-to-commercial rates of interest to cover the foreign exchange costs of productive projects" (Mason and Asher 1973, 381). And most of its lending in this period also financed postwar reconstruction in Europe (Mason and Asher 1973).

Private capital flows were also quite limited, and they were dominated by foreign direct investment. The dominance of direct investment resulted from two considerations. First, many Latin American governments had defaulted on their foreign debt during the 1930s, and few lenders were willing to extend new loans to governments that had so recently defaulted. Second, the slow recovery of international financial markets in the immediate postwar period meant that few bank loans or bonds crossed international boundaries. To the extent that private investment flowed to developing countries at all during the 1950s, therefore, it tended to flow in the form of direct investment.

Governments in most developing countries were not content to rely so heavily on direct investment, which posed two problems for them from the perspective of developing countries' governments (Nurske 1967). First, most foreign direct investment was concentrated in primary commodities, particularly mining and petroleum, and thus did little to promote domestic manufacturing industries. This approach was inconsistent with the determination of developing countries to industrialize. Second, the slow growth of demand for primary commodities in the advanced industrialized world meant that the amount of investment made by MNCs in developing countries' primary-commodity sectors was likely to decline over time. Thus, while developing countries did not necessarily discourage private investment, they did not believe that it would help them achieve their development objectives.

Desiring additional foreign capital, but having little opportunity to borrow on private markets, developing countries pushed for expanded foreign aid programs. This

A CLOSER LOOK

The World Bank

The World Bank was created at the Bretton Woods conference in 1944 to finance development projects that could not attract private financing. The World Bank is owned and controlled by its member governments. Ownership is based on the shares that each country purchases upon joining, and the number of shares each country purchases is determined by its economic size. The Board of Governors, composed of representatives of all member countries, has ultimate decision-making authority, but responsibility for most of the Bank's operation rests with its executive directors, of which there are 24. Each of the Bank's five largest shareholders (the United States, Japan, Germany, France, and Great Britain) appoints its own executive director. The remaining executive directors are elected every two years to represent groups of countries. Decisions by the Board of Directors are made on a weighted voting scheme in which each country has votes equal to the number of shares it owns. Larger shareholders therefore have greater influence over World Bank decisions. The United States is the largest shareholder and hence has the most votes.

The World Bank functions like a private investment bank. It sells bonds to private investors and lends the resulting funds. It differs only in that its clients are restricted to developing-country governments. World Bank regulations limit the total amount the Bank can lend at any point in time to the combined total of its capital and reserves. This restriction ensures that the Bank always has the funds necessary to repay its bond-based debt. As a consequence, the World Bank is a very low risk borrower and pays very low rates of interest on the money it borrows. It can then pass these low interest rates on to the developing countries that borrow from it. World Bank loans typically carry maturities of 15 to 20 years and a 3- to 5-year grace period before repayment begins. Interest rates on World Bank loans are slightly higher than the interest rates the World Bank pays on its debt. Since its creation in 1945, the IBRD has loaned more than $360 billion to developing countries.

In 1960, the member governments created a new lending agency within the World Bank called the **International Development Association** (IDA). A concessional lending agency, the IDA provides development finance at below-market rates of interest. IDA lending terms are quite generous. Loans have maturities of 35 or 40 years, and most loans have a 10-year grace period before repayment begins. All IDA loans are made at zero interest rates. The IDA lent only to the poorest developing countries, however. Currently, a country must have a per capita income below $885 to qualify for IDA lending. The IDA lent a total of $107 billion to 109 developing countries between 1960 and 2001, and it lends an average of $6–7 billion per year. Most IDA loans are targeted at basic needs, including primary education, health services, and clean water and sanitation. In contrast to the IBRD, the IDA is funded by contributions from World Bank member countries. Historically, the United States has been the largest contributor, providing about 24 percent of all contributions to the IDA. Japan is a close second, having contributed about 22 percent of the total. Germany is the third-largest contributor, accounting for 11 percent of the total.

Continued

World Bank loans fall into two broad categories. Investments loans are long-term loans dedicated to "creating the physical and social infrastructure necessary for poverty reduction and sustainable development" (World Bank 2000a, 5). Such loans were originally oriented toward creating physical infrastructures—buying capital goods, constructing buildings, providing engineering assistance, and the like. Now investment loans are increasingly oriented toward what the World Bank calls institution building and social development. In Turkey, for example, the World Bank lent $300 million to support the Turkish government's plan to extend compulsory education from five to eight years. Other projects include urban poverty reduction, rural development, water and sanitation, natural resource management, and health. Investment loans have accounted for 75 to 80 percent of World Bank lending. Adjustment loans have become an important component of World Bank lending during the last 25 years. These short-term loans are advanced in support of structural reform. Adjustment loans seek to promote the creation of competitive market structures by supporting legal and regulatory reforms, the reform of trade and taxation policies, and the political reform of institutions (World Bank 2000a, 13). During the last 20 years, adjustment loans have accounted for between 20 and 25 percent of all World Bank lending.

pressure began to bear fruit in the late 1950s and early 1960s. The World Bank created the International Development Association (IDA) and began to provide concessional loans to many of its member governments. At the same time, a number of **regional development banks,** such as the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank, were created to provide concessional lending on the model of the IDA. Advanced industrialized countries also expanded their bilateral aid programs during the 1960s. As a consequence, the amount of aid provided through multilateral development agencies increased fourfold between 1956 and 1970, while bilateral development assistance more than doubled during the same period. (See Table 14.2.) By the end of the 1960s, official development assistance to developing countries was almost twice as large as private capital flows.

The expansion of foreign aid programs during the 1960s reflected changing attitudes among governments in the advanced industrialized countries. These changing attitudes were in turn largely a product of the dynamics of decolonization. World Bank officials recognized that governments in the newly independent countries would have great difficulty borrowing on private capital markets and would be unlikely to qualify for lending under the World Bank's normal terms. The World Bank therefore began to reconsider its resistance to concessional lending. American attitudes toward foreign aid were also beginning to change in response to political concerns that arose from the process of decolonization. American policy makers believed that the rising influence of developing countries in the United Nations would eventually lead to the creation of an agency that offered development loans at concessional rates. The creation of such a UN agency could undermine the World Bank and weaken American influence over development lending. U.S. officials

Table 14.2
Financial Flows to Developing Countries, Millions of U.S. Dollars, 1956–1970

	1956	1960	1965	1970
	Official Development Assistance			
Official Government Aid	2,900	4,236.4	5,773.1	6,587.4
Multilateral Organizations	272.5	368.5	312.9	1,176
OPEC				443.5
	Private Finance			
Foreign Direct Investment	2,500	1,847.9	2,207.4	3,557.2
Portfolio Flows	0.0	408.2	836.0	777.0

Source: Wood, 1986, 83.

began to support a concessional lending agency within the World Bank, therefore, in order to prevent the creation of a rival within the United Nations, where developing countries had greater influence.

At the same time, during the late 1950s and early 1960s American policy makers increasingly came to view foreign aid as a weapon in the battle against the spread of Communism throughout the developing world. Nowhere was this more evident than in the Kennedy administration's "Alliance for Progress," which was designed to use U.S. government aid to promote socioeconomic reform in Latin America in order to prevent the spread of Cuban-style socialist revolutions throughout the region (Rabe 1999). These changes in attitude contributed to the tremendous growth of foreign aid programs during the 1960s.

Commercial Bank Lending and the Origins of the Latin American Debt Crisis

The composition and scale of foreign capital flows to parts of the developing world changed fundamentally during the 1970s. A trickle of private capital was transformed into a flood as commercial banks began lending heavily to a select group of developing countries, especially in Latin America. In the course of the decade, Latin American debt grew dramatically, as did the share of that debt owed to commercial banks. These dynamics culminated in a debt crisis in the early 1980s as Latin American governments proved unable to service their foreign debt and commercial banks thus ceased lending.

The changes in private capital flows to the developing world were driven by the interaction between developments within the international economy and dynamics internal to the political economy of import substitution industrialization. The two factors combined to generate an increase in developing countries' demand for, and commercial banks' willingness to supply, foreign capital. Growing demand for foreign capital in the developing world was generated by international and domestic developments. The most important international source of this greater demand lay in the

sharp rise in the price of oil brought about in 1973. Higher oil prices cost developing countries about $260 billion during the 1970s (Cline 1984). Because most developing countries were oil importers, higher prices for their energy imports required them to reduce other imports, to raise their exports, or to borrow from foreign lenders to finance the larger current-account deficits they faced. Cutting imports was unattractive for governments deeply committed to ISI strategies. Increasing exports was also difficult, as import substitution had brought about a decline in the export sector in most countries. Consequently, the higher cost of oil widened current-account deficits throughout the developing world.

Import substitution industrialization also generated a growing demand for foreign capital. Most governments played a leading role in capital formation. Latin American governments were responsible for between one-third and one-half of total capital formation (Thorp 1999, 169). Governments created state-owned enterprises to drive industrialization, and they provided subsidized credit to targeted sectors. Reliance on both tools strengthened as governments shifted to secondary ISI. These strategies led to an expansion of government expenditures in connection with the initial investment and then in connection with continued subsidies to the unprofitable state-owned enterprises they created (Frieden 1981, 420). Government revenues failed to grow in line with these rising expenditures. As a consequence, budget deficits widened, reaching, on average in Latin America, 6.7 percent of GDP by the end of the 1970s. In some countries, deficits were even larger. Argentina's budget deficit rose to over 10 percent of GDP in the mid-1970s and remained above 7 percent of GDP until the early 1980s. Mexico's budget deficit increased in the early seventies and then exploded—to more than 10 percent of GDP—in the early 1980s. Governments needed to finance these deficits, which generated a demand for foreign capital.

The greater supply of foreign capital resulted from the oil shock's impact on commercial bank activity. The oil shock generated large current-account surpluses in the oil-exporting countries. Saudi Arabia's current-account surplus jumped from $2.5 billion in 1973 to $23 billion in 1974 and then averaged about $14 billion during the next three years. These surpluses, called **petrodollars,** provided the financial resources that developing countries needed to cover their greater demand for foreign capital. Commercial banks intermediated the flows, accepting deposits from oil exporters and lending the funds to other developing countries. The process came to be called **petrodollar recycling.**

Commercial banks loaned directly to governments, to state-owned enterprises, and to government-owned development banks. Most commercial bank lending was syndicated. In a **syndicated loan,** hundreds of commercial banks each take a small share of a large loan to a single borrower. Syndicated loans allow commercial banks to spread the risk involved in such large loans among a number of banks, rather than requiring one bank to bear the full risk that the borrowing country will default. Some banks involved in the syndicate were large and had considerable international experience; others were small and had little experience with international lending (Solomon 1999, 35).

These capital inflows generated a rapid expansion of foreign debt in developing countries. (See Table 14.3.) In 1970, the developing world as a whole owed only $72.7 billion to foreign lenders. By 1980, total foreign debt had ballooned to

Table 14.3
Developing-Country Foreign Debt, Billions of U.S. Dollars, 1970–1984

	All Developing Countries[1]	30 Most Heavily Indebted Countries[2]	7 Most Heavily Indebted Latin American Countries (See also remaining columns)	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
1970	72.7	65	28	5.8	5.7	3.0	2.2	7.0	3.2	1.4
1971	84.3	75	32	6.3	7.4	3.1	2.5	7.5	3.3	1.9
1972	98.7	88	39	6.8	11.5	3.5	2.8	8.2	3.5	2.5
1973	117.7	104	46	7.2	14.7	3.9	3.2	10.5	3.9	2.8
1974	147.1	129	60	7.6	22.0	5.2	3.3	14.0	5.2	2.7
1975	194.0	157	71	7.7	27.3	5.5	3.8	18.2	6.1	2.2
1976	235.6	192	89	9.3	33.3	5.6	3.9	24.0	7.6	4.9
1977	313.7	258	116	11.4	42.0	5.9	5.1	31.2	9.2	10.7
1978	391.7	317	142	13.3	54.6	7.4	5.1	35.7	9.7	16.6
1979	480.8	377	174	21.0	61.3	9.4	5.9	42.8	9.3	24.1
1980	586.7	461	214	27.2	71.5	12.1	6.9	57.4	9.4	29.3
1981	703.2	539	261	35.7	81.5	15.7	8.7	78.2	8.6	32.1
1982	809.9	606	294	43.6	93.9	17.3	10.3	86.1	10.7	32.2
1983	880.1	661	316	45.9	98.5	17.9	11.4	93.0	11.3	38.3
1984	921.8	686	328	48.9	103.9	19.7	12.0	94.8	12.2	36.9

[1] All 157 low- and middle-income countries as defined by the World Bank.
[2] Comprises Algeria, Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Egypt, India, Indonesia, Jamaica, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, South Korea, Sudan, Syria, Thailand, Turkey, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia.
Source: World Bank, *World Development Indicators on CD-ROM*, 2001.

$586.7 billion. Most of this debt was owed by a small number of countries. The 30 most heavily indebted developing countries owed a total of $461 billion in 1980, close to 80 percent of the entire developing world's foreign debt. Latin American countries were among the largest borrowers. The foreign debt of the 7 most heavily indebted Latin American countries—Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela—increased by a factor of ten between 1970 and 1982. By the early 1980s, these 7 countries accounted for about 80 percent of all Latin American debt and for about one-third of all developing-world foreign debt.

Initially, these capital inflows fuelled robust economic growth. The positive impact of commercial bank lending is quite clear in aggregate statistics for the period. In Latin America as a whole, economic growth averaged 5.6 percent per year between 1973 and 1980. Some Latin American countries grew at even faster rates. In Brazil, one of the largest borrowers, economic growth averaged 7.8 percent per year between 1973 and 1980, while Mexico, another of the large borrowers, realized an average rate of growth of 6.7 percent over the same period.

Behind this robust economic growth, however, lay some worrying trends. Debt problems begin to emerge when foreign debt grows more rapidly than the country's ability to service its debt. A country's **debt-service capacity**—its ability to make the payments of interest and principal required by the terms of the loan—is defined as the ratio of its debt service to its export revenues. As a country increases its foreign debt, it must also expand its exports to service the debt comfortably. Latin American governments did not expand their exports. Instead, foreign capital was invested in the nontraded-goods sector. Mexico, Argentina, and Venezuela, for example, created massive hydroelectric projects that were unnecessary, given realistic assessments of those countries' energy needs (Thorp 1999, 209). In addition, governments borrowed to buy military equipment, to pay for more expensive oil, and to subsidize consumer goods. Even when foreign capital was invested in the traded-goods sector, the preference for capital-intensive projects failed to generate exports. As a consequence, debt service grew faster than export revenues, causing debt service ratios to rise sharply (Table 14.4). In 1970, Latin American governments were using only 13 percent of their export revenues (on average) to service foreign debt. By 1978, debt service was consuming 38 percent of Latin America's export revenues. Debt-service ratios were even higher in Brazil, Chile, Mexico, and Peru, and rising ratios rendered Latin American countries vulnerable to international shocks.

Three such shocks hit Latin America hard in 1979 and the early 1980s. The first shock came from rising interest rates in the United States and Western Europe. The United States began raising interest rates in 1979 in an attempt to reduce inflation. Rising American interest rates were transmitted directly to Latin America, because two-thirds of Latin American debt carried variable interest rates. The ensuing higher interest rates on Latin American debt raised the cost of servicing the debt. The second shock came from the recession in the advanced industrialized world, caused by the higher interest rates. Recession reduced the demand for Latin American exports, causing their terms of trade to decline by 10 percentage points in the early 1980s (Cline 1984). Latin America's export revenues thus declined. By 1980, therefore, Latin American governments were facing larger debt-service payments and declining export earnings. As if this wasn't enough, oil prices rose sharply again in 1979, imposing a third shock.

Table 14.4
Debt Service Ratios in Latin America
[(Payments of Principal plus Interest)/Export Earnings], 1970–1984

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	All Latin American Countries
1970	n.a.	n.a.	n.a.	28	n.a.	n.a.	4	n.a.
1971	n.a.	n.a.	n.a.	27	n.a.	n.a.	5	n.a.
1972	n.a.	n.a.	n.a.	26	n.a.	n.a.	8	n.a.
1973	n.a.	n.a.	n.a.	22	n.a.	n.a.	7	n.a.
1974	n.a.	n.a.	n.a.	21	n.a.	n.a.	5	n.a.
1975	n.a.	43	35	14	n.a.	n.a.	6	n.a.
1976	34	38	40	13	n.a.	n.a.	4	n.a.
1977	27	42	46	11	n.a.	53	8	27
1978	42	58	54	12	n.a.	50	9	38
1979	23	63	44	14	66	34	19	38
1980	37	63	43	16	44	45	27	36
1981	46	66	65	22	46	59	23	40
1982	50	82	71	30	51	49	30	47
1983	70	55	54	38	45	34	27	41
1984	63	45	60	30	45	30	25	39

n.a. = not available.
Source: World Bank, *World Development Indicators on CD-ROM*, 2001.

Many governments responded to these shocks by borrowing more from commercial banks. As a result, foreign debt jumped after 1979, rising from $481 billion in 1978 to $810 billion in 1982. Even more worrying, debt-service ratios rose sharply. (See Table 14.4.) For Latin America as a whole, debt service consumed almost 50 percent of all export earnings in 1982. Brazil's position was the most precarious, as debt service consumed more than 80 percent of its export revenues in 1982. Finally, an active debt-service crisis arose on August 18 of that year, when Mexico informed the United States government that it could not make its scheduled debt payment. (See Kraft 1984.) Mexico had in effect defaulted on its foreign debt. Commercial banks immediately ceased lending to Mexico and to other developing countries, fearing that Mexico's problems were not unique.

The abrupt cessation of commercial bank lending forced governments to eliminate the macroeconomic imbalances that their commercial bank loans had financed. Current-account deficits had to be eliminated because governments could not attract the capital inflows required to finance them. Budget deficits had to be reduced because governments could no longer borrow from commercial banks to pay for them. Rapid adjustment in turn caused economic activity to fall sharply throughout Latin America (Table 14.5.) The most heavily indebted countries suffered the worst. Argentina's economy shrank by 6 percent in 1981 and then by another 5 percent in 1982. Brazil's economy shrank by 4 percent in 1981 and then by another 3 percent in 1983. Mexico's economy shrank by 1 percent in 1982 and by another 3 percent in 1983. The end of capital inflows, therefore, brought an abrupt end to the economic boom of the 1970s.

Table 14.5
Economic Growth Rates (Percent) in Latin America, 1979–1983

	Latin America	Argentina	Brazil	Chile	Mexico	Peru	Colombia	Venezuela
1979	7	10	7	9	10	6	5	1
1980	9	4	9	8	9	3	4	−4
1981	−1	−6	−4	5	9	7	2	0
1982	−1	−5	1	−10	−1	−1	1	−2
1983	−2	4	−3	−4	−4	−12	2	−4

Source: World Bank, *World Development Indicators on CD-ROM*, 2001.

Commercial bank lending therefore proved a mixed blessing. On the one hand, it allowed many developing countries to finance the large current-account deficits generated by the oil shock. In the absence of these loans, governments would have been forced to reduce consumption sharply to pay for energy imports. Commercial bank loans also allowed developing countries to invest more than they could have otherwise. Private capital flows therefore relaxed many of the constraints that had characterized the foreign aid–dominated system of the 1950s and 1960s. On the other hand, the rapid accumulation of commercial bank debt rendered developing countries vulnerable to international shocks. As shocks hit, governments faced severe debt-service problems, causing commercial banks to stop lending and thereby precipitating a severe economic crisis. The management of this debt crisis dominated North–South financial relations throughout the 1980s.

Managing the Debt Crisis

By 1982, the 30 most heavily indebted developing countries owed more than $600 billion to foreign lenders. Few of these governments could service that debt. International power asymmetries shaped the management of this crisis. The creditor coalition, which included the commercial banks, the IMF, and the advanced industrialized countries, created an international **debt regime** that pushed the costs of the crisis onto the debtor countries by linking access to additional foreign capital to the adoption of market-oriented policy reforms.

The Debt Regime

The debt crisis was managed within a framework that reflected the interests of the creditors' coalition. This regime was based on a simple, if somewhat unbalanced, exchange between the coalition and the debtor governments. The heavily indebted countries were provided new loans and were allowed to reschedule their existing debt payments in exchange for implementing policy reforms.

The debt regime was based on the creditors' coalition's strongly held belief that developing countries eventually could repay their debt. The coalition initially diagnosed the debt crisis as a short-term balance-of-payments dilemma, or **liquidity**

problem. In other words, the creditors believed that high interest rates and falling export earnings had raised debt service above the debtor governments' current capacity to pay. Once this liquidity crisis eased as interest rates fell and growth resumed in the advanced industrialized world, developing countries could resume service.

This diagnosis shaped the creditors' initial response to the crisis. Because they believed that the crisis was a short-term liquidity problem, they prescribed short-term remedies. On the one hand, they required the debtor countries to reduce their expenditures by implementing macroeconomic stabilization programs. **Macroeconomic stabilization** was intended to eliminate the large current-account deficits in order to reduce the demand for external financing. The centerpiece of most stabilization programs was the reduction of government budget deficits. Balancing the government budget has a powerful effect on domestic economic activity, reducing domestic consumption and investment and thereby the demand for imports. The resulting unemployment would reduce wages, making exports more competitive. Exchange rate devaluation would further improve the balance of trade. The smaller current-account deficits that would follow would require smaller capital inflows. In the ideal world, stabilization would produce current-account surpluses.

On the other hand, the creditor coalition provided new loans and rescheduled existing debt in order to reduce the severity of the liquidity shortage. New loans were made available by the IMF and by commercial banks through a process called **concerted lending.** In 1983 and 1984, the IMF and commercial banks provided a total of $28.8 billion to the indebted governments (Cline 1995, 207). Developing countries were also allowed to reschedule existing debt payments. Debt owed to commercial banks was rescheduled in the **London Club,** a private association established and run by the large commercial banks. Rescheduling agreements neither forgave debt nor reduced the interest payments attached to the debt. They merely rescheduled the payments that debtor governments had to make, usually offering a grace period and extending the maturity of the debt. Access to both, however, was conditional on prior agreement with the IMF on the content of a stabilization package.

By 1985, the creditor coalition was revising its initial diagnosis. Latin American economies failed to recover as growth resumed in the advanced industrialized world. While creditors still believed that countries could repay their debt, they concluded that their ability to do so would require more substantial changes to their economies. Stabilization would not be sufficient. This new diagnosis generated a second, more invasive, set of policy reforms known as **structural adjustment,** premised on the belief that the economic structures developed under ISI had limited the ability of countries to expand their exports. Governments were too heavily involved in economic activity, economic production was too heavily oriented toward the domestic market, and locally produced manufactured goods were uncompetitive in world markets. This economic structure stifled entrepreneurship, reduced the capacity for economic growth, and limited the potential for exporting. Structural adjustment programs sought to reshape the indebted economies by reducing the role of government and increasing the role of the market. Reforms sought substantial market liberalization in four areas: trade liberalization, liberalization of foreign direct investment, privatization of state-owned enterprises, and broader deregulation to promote economic competition.

Structural adjustment programs were supported by additional financial support provided by the World Bank, new IMF programs, and commercial banks. Commercial

A Closer Look

The International Monetary Fund

The International Monetary Fund is based in Washington, DC. It has a staff of about 2,690, most of whom are professional economists, and a membership of 184 countries. The IMF controls $311 billion that it can lend to member governments facing balance-of-payments deficits. Two ruling bodies—the Board of Governors and the Executive Board—make decisions within the IMF. The **Board of Governors** sits at the top of the IMF decision-making process. Each country that is a member of the IMF appoints one official to the Board of Governors. Typically, the country's central-bank president or finance minister will serve in this capacity. The Board of Governors meets only once a year, however; therefore, almost all IMF decisions are actually made by the **Executive Board,** which is composed of 24 executive directors, each of whom is appointed by IMF member governments. Each of eight countries (the United States, Great Britain, France, Germany, Japan, China, Russia, and Saudi Arabia) appoints an executive director to represent its interests directly. The other 16 executive directors represent groups of IMF member countries. For example, Pier Carlo Padoan (an Italian) is currently the executive director representing Albania, Greece, Italy, Malta, Portugal, and Spain, while B. P. Misra (from India) is currently the executive director representing Bangladesh, Bhutan, India, and Sri Lanka. The countries belonging to each group jointly select the executive director who represents them. A managing director appointed by the Executive Board chairs the Board. Traditionally, the managing director has been a European (or at least non-American).

Voting in the Board of Governors and the Executive Board is based on a weighted voting scheme. The number of votes each country has reflects the size of its quota in the stabilization fund. The United States, which has the largest quota, currently has 371,743 votes (17.14 percent of the total votes). Palau, which has the smallest quota, currently has only 281 votes (.01 percent of the total votes). Many important decisions require an 85 percent majority. As a result, both the United States, with 17 percent of the total votes, and the EU (when its member governments can act jointly), with more than 16 percent of the total vote, can veto important IMF decisions. As a block, developing countries also control votes sufficient to veto IMF decisions. Exercising this developing-country veto requires a level of collective action that is not easily achieved, however. In contrast with other international organizations, therefore, the IMF is not based on the principle of "one country, one vote." Instead, it is based on the principle that the countries which contribute more to the stabilization fund have a greater say over how that fund is used. In practice, this means that the advanced industrialized countries have much greater influence over IMF decisions than developing countries have.

The IMF lends to its members under a number of different programs, each of which is designed to address different problems and carries different terms for repayments:

- Standby arrangements are used to address short-term balance-of-payments problems. This is the most widely used IMF program. The typical standby arrangement lasts 12–18 months. Governments have up to five years to repay loans under the program, but are expected to repay these credits within two to four years.

Continued

- The Extended Fund Facility was created in 1974 to help countries address balance-of-payments problems caused by structural weaknesses. The typical arrangement under this program is twice as long as a standby arrangement (three years). Moreover, governments have up to 10 years to repay loans under the program, but the expectation is that the loan will be repaid within 4.5 to 7 years.
- The Poverty Reduction and Growth Facility (PRGF) was established in 1999. Prior to that year, the IMF had provided financial assistance to low-income countries through its Enhanced Structural Adjustment Facility (ESAF), a program that financed many of the structural adjustment packages during the 1980s and 1990s. In 1999, the PRGF replaced the ESAF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper, which is prepared by the borrowing government with input from civil society and other development partners, including the World Bank. The interest rate on PRGF loans is only 0.5 percent, and governments have up to ten years to repay loans.
- Two new programs were established in the late 1990s in response to financial crises that arose in emerging markets. The Supplemental Reserve Facility and the Contingent Credit Line provide additional financing for governments that are in the midst of or are threatened by a crisis and thus require substantial short-term financing. Countries have up to 2.5 years to repay loans under both programs, but are expected to repay within 1.5 years. To discourage the use of these programs, except in a crisis, both programs carry a substantial charge on top of the normal interest rate.

banks were asked to provide $20 billion of new loans over a three-year period in order to refinance one-third of the total interest coming due in the period. Multilateral financial institutions, particularly the World Bank, were asked to provide an additional $10 billion over the same period. In all cases, fresh loans from commercial banks hinged upon the ability of debtor governments to gain financial assistance from the IMF, and loans from the IMF and World Bank were contingent upon the willingness of governments to agree to structural adjustment programs.

This debt regime pushed the costs of the crisis onto the heavily indebted countries. Table 14.6 illustrates the economic consequences of the crisis for Latin America as a whole. Investment, consumption, and economic growth in the region all fell sharply after 1982. Indeed, by the end of the decade most of these indicators still had not recovered to their 1980 levels. The economic crisis hit labor markets particularly hard; unemployment rose and real wages fell by 30 percent over the course of the decade. Real exchange rates were devalued by 23 percent, on average, and by more substantial amounts in Chile (96 percent), Uruguay (70 percent), and a few other countries (Edwards 1995, 29–30). This adjustment brought a small increase in exports, a sharp reduction in imports, and an overall improvement in trade balances. From an aggregate $2 billion deficit in 1981, Latin America as a whole moved to a $39 billion trade surplus in 1984 (Edwards 1995, 23).

Latin American governments used these current-account surpluses for debt service. **Net transfers,** which measure new loans to a country minus interest-rate payments made by this same country, provides a measure of the scale of this debt service. In 1976, net transfers for the 17 most heavily indebted countries totaled $12.8 billion, reflecting the fact that these countries were net importers of capital. Between 1982 and 1986, net transfers for these same 17 countries averaged $26.4 billion per year, reflecting the substantial flow of funds from the debtor countries to banks based in the advanced industrialized countries (Edwards 1995, 24). Thus, domestic economic adjustment generated the resources needed to service foreign debt.

Table 14.6
Economic Conditions in Latin America, 1982–1990

	1980–81	1982	1983	1984	1985	1986–90
GDP[1]	100	95.6	91.3	92.2	92.7	94.1
Consumption[1]	77.0	74.0	70.3	70.4	69.9	71.6
Investment[1]	24.4	19.6	14.9	15.2	16.1	15.9
Unemployment[2]	6.7				10.1	8.0
Real Wages[3]	100.0				86.4	68.9
Imports[4]	–12.3	–9.7	–7.5	–8.0	–7.9	–9.2
Exports[4]	12.5	12.6	13.6	14.5	14.2	15.2
Net Transfers[4]	12.2	–18.7	–31.6	–26.9	–32.3	
Fiscal Deficit[5]	3.7	5.4	5.2	3.1	2.7	
Inflation	53.2%	57.7%	90.8%	116.4%	126.9%	

[1]As a percentage of 1980–81 GDP.
[2]Rate of open unemployment as a percentage of total labor force.
[3]Index of real wages in unemployment.
[4]$US billions.
[5]Percent of GDP.
Source: Thorp 1999; Edwards 1995, 24; Edwards 1989, 171.

The Sources of Bargaining Power

The creditors' coalition was able to push the costs of the debt crisis onto the debtor governments because it was better able to exploit its potential power than those governments were. Creditor power lay in the ability to control access to new financing. This control allowed the creditors to require debtor governments to adopt policy reforms in exchange for additional financing. Creating a creditor coalition to exploit this power was not a simple task, however. (See Lipson 1985.) It was certainly easy to deny new financial flows to the debtor governments. Commercial banks were unwilling to extend new loans after 1982, and the IMF would lend only in conjunction with stabilization agreements. In order to exploit this power, the creditors had to be willing to extend new funds, and that proved difficult, because of a free-rider problem. Each individual creditor recognized that debt service in the short run required additional financing and in the long run depended on structural reforms that governments would not implement without additional financing. But each individual creditor also preferred that other creditors provide these new loans. Thus, each creditor had an incentive to free ride on the contributions of the other members of the coalition.

Policy Analysis and Debate

IMF Conditionality

Question
Should the IMF attach conditions to the credits it extends to developing countries?

Overview
IMF conditionality has long been a source of controversy. Critics of the practice argue that the economic policy reforms embodied in IMF conditionality agreements force governments to accept harsh austerity measures that reduce economic growth, raise unemployment, and push vulnerable segments of society deeper into poverty. Moreover, the IMF has been accused of adopting a "one size fits all" approach when designing conditionality agreements. It relies on the same economic model in analyzing each country, and it recommends the same set of policy changes for each country that comes to it for assistance. Consequently, critics allege, IMF policy reforms are often inappropriate, given a particular country's unique characteristics.

The IMF defends itself by arguing that most developing-country crises share a common cause: large budget deficits, usually financed by the central bank. Such policies generate current-account deficits larger than private foreign lenders are willing to finance. Governments turn to the IMF only when they are already deep in crisis. Because most crises are so similar, the solution to them should also be similar in broad outline: governments must bring spending in line with revenues, and they must establish a stable base for participation in the international economy. And while the short-term costs can be high, the economy in crisis must be returned to a sustainable path, whether the IMF intervenes or not. Should the IMF require governments to implement policy reforms as a condition for drawing from the Fund?

Policy Options
- Continue to require conditionality agreements in connection with IMF credits.
- Abandon conditionality and allow governments to draw on the IMF without implementing stabilization or structural adjustment measures.

Policy Analysis
- To what extent are the economic crises which strike countries that turn to the IMF solely a product of IMF conditionality agreements?
- To what extend does conditionality protect the Fund's resources? What would happen to these resources if conditionality were eliminated?

Take a Position
- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How would you defend your recommendation against these criticisms?

Resources
Online: Do an online search for "IMF conditionality". Follow the links to some sites that defend conditionality and to some that criticize the practice. The Hoover Institution maintains a useful website that examines IMF-related issues. Search for "Meltzer Commission" to find some strong criticisms of the Fund's activities. The IMF explains and defends conditionality in a fact sheet. (Search "IMF facts conditionality".)

Continued

In Print: Joseph Stiglitz, "What I Learned at the World Economic Crisis," *The New Republic,* April 17, 2000, and *Globalization and Its Discontents* (New York: W.W. Norton and Company, 2002); Kenneth Rogoff, "The IMF Strikes Back," *Foreign Policy* (January–February 2003): 38–46; Graham R. Bird, *IMF Lending to Developing Countries: Issues and Evidence* (London: Routledge, 1995); Tony Killick, *IMF Programmes in Developing Countries: Design and Impact* (New York: Routledge, 1995).

Commercial banks had an incentive to free ride on IMF lending. Loans from the IMF would allow the debtor governments to service their commercial bank debt. If the IMF carried the full burden of new lending, commercial banks would be repaid without having to put more of their own funds at risk. Within the group of commercial banks involved in the loan syndicates, smaller banks had an incentive to free ride on the large banks. Smaller banks had much less at stake in Latin America than the large commercial banks had, because the smaller banks had lent proportionately less as a share of their capital. Consequently, default by Latin American governments would not necessarily imperil the smaller banks' survival. Thus, whereas the large commercial banks could not walk away from the debt crisis, the smaller banks could (Devlin 1989, 200–201). Smaller banks could refuse to put up additional funds knowing that the large banks had to do so. Once the large banks provided new loans, the small banks would benefit from the resulting debt service.

The effectiveness of the creditor coalition, therefore, hinged upon preventing free riding. The IMF played an important role in doing so. To prevent large commercial banks from free riding on IMF loans, the IMF refused to advance credit to a particular government until commercial banks pledged new loans to the same government. This linkage between IMF and private lending in turn encouraged the large commercial banks to prevent free riding by the small commercial banks. Because the large commercial banks were unable to free ride on the IMF, they sought to compel the small banks to provide their share of the new private loans. Large banks threatened to exclude smaller banks from participation in future syndicated loans—a potentially lucrative activity for the smaller banks—and threatened to make it difficult for the smaller banks to operate in the interbank market. American and European central-bank officials also pressured the small banks. Free riding thus became costly for the small banks.

The ability to solve the free-riding problems produced a unified creditors' coalition that controlled financial flows to Latin America. The IMF and the commercial banks advanced new loans to Latin American governments (although the commercial banks did so quite reluctantly), and all accepted a share of the risks of doing so. This united front allowed the creditors to reward governments that adopted a cooperative approach to the crisis with new financing and deny additional financing to governments that were unwilling to play by the creditors' rules.

In contrast, the debtor countries were unable to exploit their potential power. Debtor power lay in the threat of collective default. While each of the large debtors owed substantial funds to American banks—in 1982, for example, Mexico's debt to

the nine largest American commercial banks equaled 44.4 percent of those banks' combined capital—no single government owed so much that a unilateral default would severely damage American banks or the American economy (Cline 1995, 74–75). Collective action could provide power, however. If all debtor governments defaulted, the capital of the largest American commercial banks would be eliminated, creating potentially severe consequences for the American economy. A credible threat to impose such a crisis might have compelled the creditors to provide more finance on easier terms, to demand less austerity, and perhaps to forgive a portion of the debt.

Yet, debtor governments never threatened a collective default (Tussie 1988). Latin American governments held a series of conferences in the early years of the crisis in order to discuss a coordinated response to it. Governments used these conferences to demand that the creditors "share responsibility in the search for a solution," and they demanded "equity in the distribution of the costs of adjustment," but they never threatened a collective default (Tussie 1988, 291). Argentina was the only country to adopt a noncooperative stance toward the creditors' coalition, and it tried to convince other Latin American governments to follow suit. Those governments, however, were unwilling to take a hard line; in fact, they encouraged Argentina to adopt a more cooperative stance (Tussie 1988, 288). Thus, instead of threatening collective default, debtor governments played by the creditors' rules.

Debtor governments never threatened collective default because they were caught in a prisoners' dilemma. While the threat of collective default could yield collective benefits, each government had an incentive to defect from a collective threat in order to seek a better deal on its own. The incentive to seek the best deal possible through unilateral action, rather than a reasonably good deal through collective action, arose because each debtor government believed that it possessed unique characteristics which enabled it to negotiate more favorable terms than would be available to the group as a whole. Mexico, for example, believed that it could exploit its proximity to the United States and its close ties with the U.S. government to gain more favorable terms. Brazil, which by 1984 was running a current-account surplus, believed that it could use this stronger position to its advantage in negotiations with its creditors (Tussie 1988, 288).

The bilateral approach embodied in the IMF and London Club framework reinforced these fears of defection. Because creditors negotiated with each debtor independently, they could adopt a "divide and conquer" strategy. They could offer "special deals" to induce particular governments to defect from any debtor coalition that might form. If one government did defect, it would gain favorable treatment, while the others would be punished for their uncooperative strategy. Punishment could include fewer new loans, higher interest rates and larger fees on rescheduled loans, and perhaps more stringent stabilization agreements. Thus, even though coordinated action among the debtor countries could yield collective gains, each individual government's incentive to seek a unilateral agreement dominated the strategy of a collective threat of default.

The debt regime reflected creditors' interests, therefore, because creditors were able to solve the collective action problem and develop a coordinated approach to the debt crisis and debtors were not. The creditors used their power to create a regime that pushed the costs of the debt crisis onto the heavily indebted countries. The regime was based on the dual premises that all debt would be repaid in the long run, but debt service would require the indebted governments to implement far-reaching economic policy reforms. Conditionality thus provided a powerful lever to induce developing countries to adopt economic reforms: Few developing countries could afford to cut themselves off completely from external financial flows. After 1982, these governments found that the price of continued access to international finance was far-reaching economic reform.

The Domestic Politics of Economic Reform

While the creditors' coalition established the structure for managing the debt crisis, used conditionality to promote economic reform, and set the parameters on the range of acceptable policies that could emerge from the reform process, the pace at which debtor governments adopted stabilization and structural adjustment programs was determined by domestic politics. Domestic politics caused most governments to delay implementing stabilization and structural adjustment programs.

Economic reform required governments to impose costs on powerful domestic interest groups. The need to impose these costs generated distributive conflict between those groups and thus delayed economic stabilization. Distributive conflict revolved around who would bear the costs associated with balancing the budget. To balance their budgets, governments had to make choices about which programs would be cut. Should the government reduce subsidies on basic consumption goods such as food or energy, or should it reduce credit subsidies to industry? In addition, governments had to decide which taxes were to be raised and upon which domestic groups the increases would fall. Each interest group lobbied the government to reduce expenditures on programs from which it did not benefit and impose higher taxes on other groups. This political dynamic generated a **war of attrition** between interest groups. Each group blocked meaningful policy reform because each believed that others would eventually agree to bear the costs of adjustment by accepting either large cuts to their favored programs or higher taxes (Alesina and Drazen 1991). This war of attrition drove the politics of stabilization throughout the early 1980s. The interest groups that had gained most from import substitution stood to lose the most from stabilization and structural adjustment. Import-competing firms that had benefited from government credit subsidies would be hit hard by fiscal retrenchment. State-owned enterprises would be particularly hard hit, as they would lose the government infusions that had covered their operating deficits during the 1970s. Workers in the urbanized nontraded-goods sector who had benefited from government subsidies of basic services, such as utilities and transportation, and essential food items would also be hit hard by budget cuts. Public-sector employees would suffer as well, as budget cuts brought an end to wage increases and forced large reductions in the number of government employees.

Unwilling to accept the reduction in income implied by fiscal austerity, interest groups blocked large cuts in government expenditures. In Brazil, for example, the military government attempted to implement an orthodox stabilization program in the early 1980s, but "both capitalists and labor in modern industry . . . demanded relief from austerity. So too did much of the urban middle class including government

functionaries whose livelihood was imperiled by attacks on public spending" (Frieden 1991, 134). These groups shifted their support to the civilian political opposition, which took power from the military. Once in office, the new civilian government abandoned austerity measures. The Brazilian case was not unique: the import substitution coalition was well positioned to block substantial cuts in government programs in most heavily indebted countries.

The inability to reduce government expenditures resulted in high inflation throughout Latin America. Facing widening deficits and unable to reduce expenditures, many governments financed the resulting deficits through their central banks. Printing money to pay for government expenditures sparked inflation. Annual average inflation in Latin America rose from about 50 percent in the years immediately preceding the crisis to over 115 percent in 1984 and 1985 (Table 14.6.) Worse, these regionwide averages hide the most extreme cases. In Argentina, inflation averaged 787 percent per year during the 1980s. Brazil fared a little better, enduring average rates of inflation of 605 percent throughout the decade (Thorp 1999, 332). Bolivia's experience was the most extreme, with inflation rising above 20,000 percent in late 1985.

Even rapid inflation was insufficient to induce governments to cut expenditures. In Argentina, Brazil, and Peru, governments responded to high inflation with **heterodox strategies.** (See Edwards 1995, 33–37.) Advanced as an alternative to the orthodox measures embodied in IMF stabilization plans, heterodox strategies attacked inflation with government controls on wages and prices. The Argentinian and Brazilian plans illustrate the approach. In both programs, the government froze prices and wages in the public sector. Each government also introduced new currencies and established a fixed exchange rate. Initially, the programs appeared to work, as inflation dropped sharply in the first six months. Early successes were reversed, however, because neither government was willing to reduce government expenditures. In less than a year, inflation rates rose again and the programs were scrapped (Edwards 1995, 37).

It wasn't until the late 1980s that Latin America governments began to implement stabilization and structural adjustment programs. Governments reduced fiscal deficits and brought inflation under control. Macroeconomic stabilization provided a base upon which to begin structural reforms. Governments began to liberalize trade and privatize state-owned industries. Many governments also began to reduce their role in domestic financial systems and liberalize capital accounts as well (Edwards 1995, 212).

Three factors finally induced governments to implement reforms. First, the economic crisis altered the dynamics of interest-group politics. Key members of the import substitution coalition lost strength and faced higher costs from opposing reform. As a result, groups that had once been willing and able to block reform increasingly lost the capacity to do so. The economic crisis also caused "individuals and groups to accept [the fact] that their special interests need[ed] to be sacrificed . . . on the altar of the general good" (Williamson 1994, 19). Economic crisis thus created a new political consensus that the old order had failed and that reform was necessary. By weakening key interest groups and by forcing many of these same groups to redefine their interests, the severity of the economic crisis itself removed the political obstacles to reform.

Second, a new approach to the debt crisis initiated by the United States in 1989 created a greater incentive to adopt reforms. In March of 1989, the United States proposed a plan to encourage commercial banks to negotiate debt reduction agreements with debtor governments. Under this **Brady Plan** (named after Nicholas J. Brady, the secretary of the U.S. Treasury), debtor governments could convert their existing commercial bank debt into bond-based debt with a lower face value. The precise amount of debt reduction that each government realized would be determined by negotiations between the debtor government and its commercial bank creditors. To make the proposal attractive to commercial banks, the advanced industrialized countries and the multilateral financial institutions advanced $30 billion with which to guarantee the principal of these **Brady bonds.** This guarantee allowed commercial banks to exchange the uncertain repayment of a large bank debt for guaranteed repayment of a smaller amount of bond debt.

The Brady Plan strengthened the incentive to embark on reform by increasing the domestic benefits of reform. Large debt burdens reduced the incentive to adopt structural reforms because a significant share the gains from reform would be dedicated to debt service. Commercial banks would thus be the primary beneficiary of reform. It is not hard to see why domestic groups would be reluctant to accept costly reforms. Reducing the debt burden ensured that a larger share of the gains from reform would accrue to domestic groups and a smaller share would be devoted to debt service. As a result, the short-run costs of reform would be compensated for by gains over the long run. This plan created a greater incentive to accept the short-term costs that stabilization and structural adjustment entailed.

Mexico was the first to take advantage of the Brady Plan, concluding an agreement in July 1989. (See Cline 1995, 220–221.) The deal reduced Mexico's net transfers by about $4 billion, an amount equal to about 2 percent of Mexico's GDP. Reducing debt service allowed the Mexican economy to grow by 2 percentage points more than would have been possible without debt reduction (Edwards 1995, 81). By 1994, Brady Plan agreements covered about 80 percent of commercial bank debt and reduced debt service payments by about one-third (Cline 1995, 232).

Finally, as the economic crisis deepened, governments became more willing to recognize that the East Asian model offered lessons for Latin America. The Economic Commission on Latin America (ECLA) played an important role in prompting this recognition. (See Economic Commission for Latin American and the Caribbean 1985.) ECLA had begun to look closely at East Asia in the mid-1980s and was able to create a new consensus among Latin American governments that the East Asian model was relevant to Latin American development. As an ECLA study recommended in the late 1980s, "[T]he debt problem requires a structural transformation of the economy in at least two senses: the growth strategy needs to be *outward oriented* and largely based on a domestic effort to raise savings and productivity" (cited in Edwards 1995, 148). ECLA's transformation "was like 'Nixon in China.' When the institution that had for decades defended import substitution expressed doubts about its validity and recognized that there were lessons to be learned from the East Asian experience with outward-oriented policies, it was difficult to dismiss those doubts as purely neo-liberal propaganda" (Edwards 1995, 52).

The Latin American debt crisis was declared over in the mid-1990s (Cline 1995, 39). In hindsight, it is clear that the crisis was more than a financial one: it was a crisis of economic development strategy. The accumulation of foreign debt during the 1970s reflected developing countries' efforts to rejuvenate the waning energies of import

substitution industrialization. Moreover, the crisis itself, and the debt regime through which it was managed, transformed developing countries' development strategies. Governments abandoned import substitution industrialization and adopted in its place market- and export-oriented development strategies. As a consequence, developing countries fundamentally altered their relationship with the international economy. The full implications of these changes are not yet clear.

Conclusion

The Latin American debt crisis illustrates the tragic cycle at the center of North–South financial relations. A growing demand for foreign capital generated in part by international events and in part by domestic developments combined with a growing willingness of commercial banks to lend to developing societies in order to generate large capital flows to Latin American countries during the 1970s. The resulting accumulation of foreign debt rendered Latin American societies extremely vulnerable to exogenous shocks. When such shocks hit in the late 1970s and early 1980s, governments found that they could no longer service their commercial bank debt, and commercial banks quickly ceased lending fresh funds. As the supply of foreign capital dried up, Latin American economies were pushed into crisis.

The Latin American debt crisis also forced governments in the advanced industrialized world to establish an international regime to manage the crisis. In the resulting debt regime, the IMF, the World Bank, and commercial banks provided additional financial assistance to the heavily indebted countries on the condition that governments implement stabilization and structural adjustment packages. This approach pushed most of the costs of the crisis onto Latin America. Moreover, the reforms it encouraged provoked far-reaching changes in Latin American political and economic systems. With a few changes that we will examine in the next chapter, this debt regime remains central to the management of developing-country financial crises.

Although the Latin American debt crisis is unique in many respects, in others it is all too typical. For while this crisis was the first of the postwar period, it would not be the last. In fact, crises have become increasingly common during the last 20 years, and the more recent ones share many of the central characteristics of the Latin American crisis and have been managed in much the same way. They have also generated much discussion about whether and how the international financial system should be reformed in order to reduce the number and severity of such crises. We examine these issues in Chapter 15.

Key Terms

Bilateral Development Assistance
Board of Governors
Brady Bonds
Brady Plan
Concerted Lending
Concessional Lending Programs
Debt Regime
Debt-Service Capacity
Debt-Service Ratio
Executive Board
Foreign Aid
Heterodox Strategies
International Bank for Reconstruction and Development
International Development Association
Liquidity Problem
London Club
Macroeconomic Stabilization
Net Transfers
Nonconcessional Lending Programs
Petrodollars
Petrodollar Recycling
Portfolio Flows
Regional Development Banks
Structural Adjustment
Syndicated Loan
War of Attrition
World Bank

Web Links

Perhaps the most useful site for global financial developments is maintained by Nouriel Roubini at the Stern School of Business at New York University. It can be found at *http://www.stern.nyu.edu/globalmacro/*.

Visit the World Bank at *http://www.worldbank.org*.

The IMF website provides useful information about stabilization and reform packages at *http://www.imf.org*.

The Organization for Economic Cooperation and Development maintains a web site on foreign aid. Visit *http://www.oecd.org/department/0,2688,en_2649_33721_1_1_1_1_1,00.html*, or do a Web search for "OECD Development Assistance Committee".

Suggestions for Further Reading

For a comprehensive history of the World Bank's first 20 years, see Edward S. Mason and Robert E. Asher, *The World Bank since Bretton Woods* (Washington, DC: The Brookings Institution, 1973), and Devesh Kapur, John P. Lewis, and Richard Webb, *The World Bank: Its First Half Century* (Washington, DC: Brookings Institution, 1997). For a critical perspective, see Kevin Danaher, ed., *50 Years Is Enough: The Case against the World Bank and the International Monetary Fund* (Boston: South End Press, 1994).

On the 1980s debt crisis and the politics of economic reform see Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton: Princeton University Press, 1989), Stephan Haggard and Robert Kaufman, eds., *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State* (Princeton: Princeton University Press, 1992), and Robert Bates and Anne O. Krueger, eds., *Political and Economic Interactions in Economic Policy Reform* (Oxford: Blackwell, 1993).

Four short articles published in the IMF's journal *Finance Development* take a new look at the Washington Consensus; Jeremy Clift, "Beyond the Washington Consensus"; John Williamson, "From Reform Agenda to Damaged Brand Name"; Guillermo Ortiz, "Latin America: Overcoming Reform Fatigue"; and Trevor A. Manuel, "Africa: Finding the Right Path". All appear in *Finance and Development* 40 (September 2003), also available online at *http://www.imf.org/external/pubs/ft/fandd/2003/09/index.htm*.