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The great Latin America debt crisis: a decade of asymmetric adjustment

A grande crise da dívida latino-americana: uma década de ajustes assimétricos

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RESUMO: A América Latina entrou em uma nova fase de abundância de entradas de capital, com alguma semelhança com o episódio dos anos 70. Neste artigo, é feita uma revisão das origens do endividamento nos anos 70, do surgimento da crise no início dos anos 80 e da gestão por credores e devedores durante essa década. Algumas lições são derivadas sobre o funcionamento dos mercados financeiros internacionais e implicações políticas.
PALAVRAS-CHAVE: Fluxos de capital; crise cambial; estabilização; crise da dívida.

ABSTRACT: Latin America has entered a new phase of abundance of capital inflows, bearing some resemblance to the episode of 70's. In this paper a review is made of the origins of indebtment in the 70's, of the emergence of the crisis in the early 80's, and of the management by creditors and debtors during that decade. Some lessons are derived about the working of international financial markets and policy implications.
KEYWORDS: Capital flows; currency crisis; stabilization; debt crisis.
JEL Classification: F11; F31; F34.

1. INTRODUCTION

In the 80's, Latin America experienced the worst economic crisis since the world-wide depression of the 30's. A common link running through this crisis was external indebtedness with the international private banking system.

The crisis was spawned in the 70's by a systemic process in which three parties – debtors, private creditors and governments and their multilateral institutions – were protagonists. The debtor party, which included most of the Latin American countries, incurred debt at a pace and at levels that were difficult to sustain – that

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is, they were guilty of short-sightedness. In effect, debtors fell into the trap of taking the easy way out of their flagging inward-looking development strategy by boosting their spending capacity (for consumption and/or investment) through use of external bank loans. This was a drawn-out, expanding process, which gained increasing momentum between 1976 and 1981.

For the Latin American countries to incur debt, lenders had to be willing to provide the resources. They showed no reticence to do so; in fact, beginning in the 70's market dynamics made them very eager lenders. This eagerness became magnified when they actively sought to transform the abundant financial resources, they were attracting from oil producing countries into LDC loans. Indeed, breaking the norms of traditional banking, they aggressively marketed themselves in the region in search of borrowers. It was during this process that prudential safeguards and guarantees were gradually relaxed banks, then, clearly bore a share of the responsibility in the gestation of the crisis.

The third party was the multilateral institutions, such at the International Monetary Fund and the World Bank, and the governments of the industrialized countries. In general, they had a benign view of growing indebtedness from private international markets and encouraged debtor countries to remove restrictions on capital flows to their public and private agents. It apparently did not occur to these international institutions that the abundance of financial resources and the low real interest rates in effect were, in part, a cyclical rather than equilibrium phenomenon and that the situation could suddenly reverse itself. Indeed, some IMF officials noted on the eve of the crisis that: "The overall debt situation during the 70's adapted itself to the sizable strains introduced in the international payments system ... Though some countries experienced difficulties, a generalized debt management problem was avoided, and in the aggregate the outlook for the immediate future does not give cause for alarm" (Nowzad and others, 1981).

The reversal of the situation occurred in 1982 and it was widespread. The abrupt cut-off in bank financing to Latin America plunged the region into a serious crisis that spread all over the region and lasted an entire decade. The abrupt macroeconomic overadjustment caused by a shift from a superabundance of external funding to a severe shortage carried a very high economic and social price. Indeed, the debt crisis left an indelible mark on Latin American society. For one thing, economic growth was seriously retarded, giving rise to the commonly used term "lost decade". For another thing, the model in vogue in Latin America, based on inward-looking import substitution and state intervention, was dealt a death blow, with neoliberal-style strategies emerging to take its place.

When external credit was cut off by bank creditors, the Latin American countries were forced to curb their spending. They thus went from a situation in which they were spending more than they produced to one in which they had to spend less than they produced. This phenomenon reflected the fact that a sizable amount of domestic resources had to be channeled into effective servicing of the external debt; this is what is known as negative net financial transfers (NFT) (interest and principal payments exceed new loans). The problem of transfers, moreover, was ag-

gravated by the flight of resident capital, in anticipation of a devaluation, a potentially costly and protracted adjustment process and uncertainty.

When a positive net financial transfer does a drastic, sudden turnaround, macroeconomic disruptions normally occur. The disruptions in this case were reflected in severe underutilization of the region's productive capacity, and, consequently, a drop in productivity, employment and wages, and a decrease in tax revenue. In the face of this situation, governments reduced their spending and pruned social service network, while the private sector invested less in a depressed domestic market.

A representative committee of creditor banks was responsible for managing the crisis, in conjunction with support from the IMF, the World Bank and industrialized governments, especially the United States. They initially believed that the crisis was conjunctural and would be rapidly brought under control at moderate cost. However, creditors considerably underestimated the depth of the adjustment needed to cope with such drastic cuts in financing and the slowdown in the world economy.

Indeed, the decision-taking bodies that initially managed the external debt crisis were primarily composed of economic institutions and agents specializing in short-term financial solutions. This meant that actors with a broader outlook and which placed greater emphasis on the real economy and productivism were displaced. In that process, social equity was the loser, and distributive inequality became more acute in almost every country of the region (ECLAC, 1992).

With the passage of time, the Latin American countries managed to reorient their economies towards less intensive expenditure (consumption and investment) on import items, and more intensive production for export. A decisive factor in this was massive currency devaluation, which together with other stimuli – including excess capacity due to the recession – promoted export development. Indeed, from 1983 onward, there was a healthy expansion in export volume. The expansion, however, which also occurred in other developing regions, confronted international markets that were not particularly buoyant. Consequently, there was a fall in unit prices and thus earnings' growth was less than that recorded for the quantum of exports.

Finally, in the early 90's external private financial flows to the region sharply rebounded. This was due partly to restored confidence in financial markets on account of a number of Latin American countries consolidating their structural reforms. Nonetheless, perhaps the most decisive factor was the prolonged recession in the United States; the resultant sharp decline in dollar interest rates improved the region's credit-worthiness and created large interest rate differentials, which induced residents to repatriate capital and foreigners to exploit much higher yielding financial placements in the region. Almost all countries have benefited from the turnaround in capital flows, including those with major adjustment problems and debt service arrears. The return of capital helped greatly to reduce the external constraint and allowed countries to introduce more expansive macroeconomic policies. But it also created problems as flows often became so large as to threaten stabilization efforts and the competitive levels of exchange rates.

The very tight restriction on external finance was one reason why the social

cost of the reform process of the 80's was so high. The recent return of private capital to the region has confirmed that financing was "a missing ingredient" in that period of adjustment: indeed, with the relaxation of the external constraints, countries have finally been able to achieve the elusive goal of simultaneous growth and reform of their economies. With good reason, this latest situation has sparked an optimism that had been absent for an entire decade. However, it is clear that the region has to begin to redefine a strategy for development and macroeconomic management that would not reproduce sharp economic cycles of booms and busts, but rather would generate sustainable productive development over time, with greater and more effective social equity (ECLAC, 1994).

2. THE GESTATION OF THE DEBT CRISIS IN THE 70'S

2.1 A lost opportunity

The 70's introduced factors that, for a time, facilitated LDCs access to international financial markets. This was reflected in a rapid increase in their external debt (Table 1).

On the one hand, in the post-war period, the commercial banking industry in North America underwent major structural change, which gave rise to more aggressive lending behavior. This new trend had its origins in the United States market in the 20's, but did not become international in scale until the late 60's and the 70's. At first, competition among banks for new borrowers was primarily concentrated in the industrialized countries; however, as of the early 70's, the search for new customers became so intense that lending spilled over into the developing regions. Latin America was the most sought after market, owing to its relatively greater development and its situation as a natural market for United States banks, which, at the time, were spearheading the international banking boom (Devlin, 1989).

Moreover, although this structural change in the banking industry stimulated the most significant credit cycle Latin America had known since the 20's, the oil price hikes in 1973-1974 and 1979-1980 had the effect of considerably magnifying the process of indebtedness with banks. The oil-exporting countries channeled their surplus foreign currency into bank Euro-markets, providing lenders with greater liquidity with which to consolidate their expansionary strategies in the region. An estimated 41% of this surplus was deposited in the international banking system in 1974.

Over the decade, participation by developing countries in international banking flows grew tremendously Latin American participation rose even more rapidly than that of other regions. In nominal terms, the volume of Latin American countries' bank debt increased by nearly 30% annually in the 70's (see Table 2); of this, 17 to 20 percentage points reflected the global expansion of the international financial market (in current dollars) and the rest, Latin America's relatively greater participation in that growth.

TABLE 1

Latin America and the Caribbean: total disbursed outstanding debt[a] (Year-end balance in millions of dollars)

	1978	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993[b]
Latin America and the Caribbean	155 022	231 019	287 887	331 470	356 231	372 790	383 990	400 918	427 445	419 553	422 749	439 094	456 686	468 067	486 965
Oil-exporting countries	69 138	104 126	134 101	150 772	164 395	168 593	173 054	179 262	186 217	186 095	180 749	190 465	204 978	206 220	219 290
Bolivia[c]	1 778	2 340	2 653	2 803	3 176	3 208	3 294	3 536	4 162	4 066	3 492	3 779	3 628	3 774	3 900
Colombia	4 060	6 805	8 518	10 269	11 458	12 350	14 063	15 950	17 047	17 359	17 007	17 556	16 975	16 779	17 120
Ecuador	2 975	4 167	5 272	5 365	7 381	7 596	8 111	9 063	10 320	10 581	11 322	11 856	12 271	12 122	12 635
Mexico[d]	33 946	50 700	74 900	87 600	93 800	96 700	97 800	100 500	102 400	100 900	95 100	101 900	114 900	114 000	125 000
Peru	9 324	9 595	9 606	11 465	12 445	13 338	13 721	14 477	15 373	16 493	18 536	19 762	20 735	21 333	21 685
Trinidad and Tobago	487	911	1 052	1 220	1 423	1 539	1 763	1 898	2 082	2 012	2 097	2 520	2 433	2 212	1 950
Venezuela[e]	16 568	29 608	32 100	32 050	34 712	33 862	34 302	33 838	34 833	34 684	33 195	33 092	34 036	36 000	37 000
Non-oil exporting countries	85 884	126 893	153 786	180 698	191 836	204 197	210 936	221 656	241 228	233 458	242 000	248 629	251 708	261 847	267 675
South America	75 360	112 774	136 389	159 853	168 379	178 543	182 835	191 931	209 825	201 012	206 752	212 611	215 876	225 292	231 115
Argentina	12 496	27 162	35 671	43 634	45 069	46 191	49 326	51 422	58 324	58 473	63 314	60 973	63 700	65 000	68 000
Brazil[f]	53 614	70 957	80 373	92 812	98 269	105 254	105 126	111 045	121 174	113 469	115 096	122 200	123 910	130 200	131 700
Chile	7 011	11 207	15 591	17 159	18 037	19 659	20 403	20 829	20 660	18 960	17 520	18 576	17 371	18 926	19 915
Guyana	330	449	694	807	963	1 114	1 308	1 542	1 736	1 778	1 801	1 784	2 063	2 190	2 250
Paraguay	669	861	948	1 203	1 469	1 654	1 772	1 855	2 043	2 002	2 027	1 695	1 666	1 279	1 350
Uruguay	1 240	2 138	3 112	4 238	4 572	4 671	4 900	5 238	5 888	6 330	6 994	7 383	7 166	7 697	7 900
Central America and the Caribbean	10 524	14 119	17 397	20 845	23 457	25 654	28 101	29 725	31 403	32 446	35 248	36 018	35 832	36 555	36 560
Costa Rica	1 870	2 209	2 687	3 188	3 532	3 925	4 140	4 079	4 384	4 470	4 488	3 930	4 016	4 022	4 200
El Salvador	986	1 176	1 608	1 710	1 890	1 949	1 980	1 928	1 880	1 913	2 169	2 226	2 216	2 338	2 015
Guatemala	821	1 053	1 385	1 839	2 156	2 495	2 694	2 674	2 700	2 599	2 731	2 602	2 561	2 582	2 480
Haiti[c]	210	290	372	410	551	607	600	696	752	778	803	861	826	845	860
Honduras	980	1 388	1 588	1 986	2 162	2 392	3 034	3 366	3 773	3 810	3 374	3 547	3 174	3 538	3 595
Jamaica	1 200	1 734	2 212	2 690	2 920	3 207	3 355	3 575	4 014	4 002	4 038	4 152	4 456	4 450	4 500
Nicaragua[c]	1 251	1 825	2 566	3 139	3 788	4 362	4 936	5 760	6 270	7 220	9 741	10 504	10 312	10 806	10 910
Panama	1 875	2 271	2 430	2 917	3 145	3 181	3 642	3 835	3 731	3 771	3 814	3 714	3 699	3 548	3 500
Dominican Republic	1 331	2 173	2 549	2 966	3 313	3 536	3 720	3 812	3 899	3 883	4 090	4 482	4 572	4 426	4 500

Source: ECLAC, on the basis of official figures.

[a] Includes debt to the International Monetary Fund.

[b] Preliminary figures.

[c] Public-sector debt.

[d] Since 1991 figures for the private debt have been adjusted to take account of the privatization process and the elimination of the exchange-control system.

[e] Total debt according to figures supplied by official source and international financial institutions.

[f] Until 1984, corresponds to figures provided by the World Bank.

Table2: Externai debt of Latin Ame rica and all LDCs -1973-1982

	1973	1977	1980	1981	1982
			Total		
Latin America	42.8	104.2	204.3	241.5	260.7
LDCs	108.2	238.8	444.6	520.6	574.4
			Banking		
Latin America	25.7	72.9	160.1	194.1	213.4
LDCs	42.5	114.8	257.1	304.2	337.6

Note: calculations based on data of the World Bank and the BIS. Latin America excludes Cuba and Panama; LDCs exclude oil-exporters with current account surplus (Saudi Arabia, Kuwait, etc.).

The plentiful supply of funds available to Latin America was therefore the result of both the accelerated growth of the international financial market in itself and the extent to which the region participated in that expansive trend. Neither of these two phenomena could last forever or sustain their intensity. On the one hand, the private banking system was in the midst of a one-time "stock adjustment" after more than 30 years of relative inactivity in the region. On the other, there was an element of overshooting in this adjustment, caused by major institutional flaws in international banking that gave rise to a "herd effect" and other phenomena related to financial "bubbles" (Devlin, 1989; Kindleberger, 1978). Nevertheless, many – particularly the proponents of the monetary approach – believed that these developments were a new, purely rational feature of a highly efficient private international financial market. Thus, they did not perceive the temporary character of the sudden acceleration of the pace of new lending, a phenomenon which is common to the formation of new markets in an environment of uncertainty. Another very significant development in the international financial markets was that real interest rates were low or negative. It is true that they were higher than those charted on official loans; but with international inflation, which rose from an annual average of 2% in the 60's to 12% in 1973-1981, even bank interest rates that were nominally higher than the official rates ended up being negative in real terms much of the time. What happened, of course, was that the huge supply of funds and competition among banks for placements on the international markets pushed the price of loans down.

The repayment periods of the loans extended by the international banking system were much shorter than those granted by official agencies which, in the 60's, accounted for most of the accumulated debt stock. However, owing to the intense competition among banks to lend out their funds, around 1977-1980, rollovers of debt service were granted so easily that they became virtually automatic. Thus, the prevalence of short-term loans was not believed to entail greater risks. History would later prove this assessment to be wrong (see Ffrench-Davis, 1982; Feinberg & Ffrench-Davis, 1988).

In any event, in late 70's the prevailing conditions of external finance seemed to be relatively favorable and helped to offset the instability and deterioration in the terms of trade of non-oil-producing countries. The expansion of the private in-

ternational financial apparatus to developing areas actually had the effect of mitigating the trade problems of non-oil countries on account of the deteriorating terms of trade after the petroleum shock.

At the same time, there was a healthy expansion of exports from developing countries. Notwithstanding the difficulties that arose in 1974-1975, the volume of sales abroad expanded considerably between 1973 and 1980. Exports rose slightly slower than they had in certain earlier periods, but they were nevertheless significant and outstripped the growth rates of GDP, which were also satisfactory: in the same interval, the gross domestic product in Latin America rose by 5.5% yearly and exports, by 8% in real terms. At the same time, international inflation – 12% annual average – eroded the real value of debt, and, hence, the increase in the amount and service of debt did not arouse the concern that it should have.

Bank credit was also extended for any purpose whatsoever, unlike the official loans whose use was and still is restricted to investment or specific balance-of-payments adjustments. The permissive nature of market-based lending had far-reaching repercussion on the behavior of national economies, especially in the countries that took monetarist approaches. While official conditionality, which had dominated development finance since the early 60's, had many flaws, including the burden of extra-economic pressures, it had positive dimensions too in the sense that it linked external financing to the implementation of investment projects or adjustment policies.

On the other hand, bank loans, often extended without any conditions attached, were in many cases used for the import of unessential consumer goods, military expenditures, or to finance capital flight and unmanageable fiscal deficits, all of which undermined the sustainability of national production and ultimately creditworthiness.

At a time of abundant private finance, easy access and low real interest rates, it seemed to many experts and observers that there was less reason to be concerned about reforming the international monetary system. On the one hand, those who believed in "the discipline of the private market" interpreted the banking boom as a kind of substitute for "paternalistic" financing by official agencies, thus ensuring, in their view, a better allocation of resources (Devlin, 1989). On the other hand, for the first time since the 20's, debtor countries experienced plentiful, low-interest external credit. Since the quantity of private resources loaned to the region grew in the latter part of the decade at an annual rate of 30%, and the real interest rate was close to zero, conventional wisdom was that "going into debt was good business", and a parallel interpretation was that the international financial system was functioning quite well for developing countries, thanks to the arrival of market-based bank lending.

It is true that trade in the Latin American countries became more unstable during the 70's than it had been in the previous decade. Nevertheless, as mentioned, the fluctuating terms of trade were also offset by those countries' newfound access to the international market for private capital. Developing nations with abundant private finance lost interest in promoting initiatives to change the criteria for IMF

conditionality, create IMF special drawing rights (SDRs), increase available multilateral funding and establish a Common Fund for Commodities, as suggested by UNCTAD. Some of these topics would later regain importance when bank credit disappeared in the 80's. However, by then it was already too late: the time had been ripe in the 70's for implementing reform and more effectively balancing the pro and anti-cyclical aspects of the international financial system – and that opportunity had been lost.

2.2 Repayment schedules, costs and debt guarantees

Traditionally, whenever a country's external debt was mentioned, one tended to think of public-sector commitments, more than those incurred by private individuals or firms, and medium to long term obligations. Moreover, this is what information obtained from international sources would indicate. During the 70's the other components – that is the private debt that was not publicly guaranteed and short-term debt – was growing in importance. However, these components tended not to always appear in the conventional debt statistics. Indeed, in 1980, the effective difference between the standard definition of the amount of the Latin American debt and a more comprehensive estimate was on the order of 40%: the guaranteed debt was US$ 124 billion, out of a total of US$ 204 billion (see Ffrench-Davis, 1982). Thus, analysis that did not go beyond the conventional statistics left out a major and growing share of the debt, which, moreover, had been incurred on less favorable terms, as regards repayment periods (less than half) and interest rates (twice as high).

As a result of the above, that analysis of debt was skewed and became more so with the passage of time, as the non-government-backed private debt and short-term obligations came to represent a larger percentage of the total. These types of loans were extended by hundreds of transnational banks, without any reciprocal systematic knowledge of how much the other creditor banks had loaned and to whom. The situation was ripe for market failure.

During those years, however, some important experts maintained that it made little sense to include the private debt in conventional statistics. Indeed, it was argued that, as the loans had been incurred among private individuals, without the involvement of the public sector, the debtor's host country was not accountable for those resources, which, moreover, they would be used in accordance with the rational profit-making criteria of the private sector, and could therefore be repaid with no problem since the income yield would be higher than the interest rate. The underlying hypothesis was that the private agent always weighs its options accurately and goes into debt only when there is certainty that the returns derived from the use of the funds will be greater than the interest rates charged by foreign creditors. Hence, this private debt would pay for itself. This was an argument systematically put forward on the continent, in international financial circles and by IMF, and it seemed to be borne out by the ease with which loans were paid and renewed. Thus, Latin American's debt was growing, apparently with no problem. Towards

the early 80's, the Latin American bank debt already accounted for nearly 80% of the total debt, including short-term obligations that were not publicly guaranteed.

Countries had three different reactions to the permissiveness of international financial markets during the 70's. This range of responses shows that there was room for choice. Some countries took advantage of the supply of external funds to finance their investment processes. This was the path taken by Brazil and Korea; each had its own style of development, but both absorbed and refinanced their international bank loans, largely for use in productive investment projects. A second type of reaction – more the exception than the rule – was displayed by countries such as Colombia, which, in addition to channeling external credit into investment, controlled the volume of new indebtedness in a strongly anti-cyclical fashion.

Still other economies, either willingly or under pressure from banks and domestic actors, chose to go the route of borrowing more resources than they could efficiently absorb. On the one hand, there was the pressure of bankers who in herd-like fashion roamed the world aggressively marketing huge loans; on the other, orthodox monetarist approaches – which advocated relaxing the controls on the capital account in order to let the market determine the volume of credit – were gaining ground. These countries were thus being pushed and pulled into increasing their foreign currency expenditures – on imports of consumer and intermediate goods and/or investment. They ended up generating a current account deficit, as a result of appreciating exchange rates and a surge in imports, which was in turn attributable to the abundance of external credit. Outstanding examples of this situation are furnished by Argentina, Chile and Uruguay (Ffrench-Davis, 1983; Ramos, 1986).

There is thus one use of indebtedness that spurs long term and another that finances the consumption of imported articles and/or capital flight; the latter leads to a lower rate of domestic capital formation and to a slackening of national production, which must compete in artificially weakened conditions.

3. THE EMERGENCY IN THE EARLY 80'S

3.1 Destabilizing adjustment

The economies of the debtor countries generally responded passively to the persistent growth in the supply of external loans. For example, in 1981, the current account deficit of the Latin American countries was equivalent to 6% of GDP (and 44% of their exports of goods), which was financed by the net inflow of financial capital. This was more than double the 1973 figure and those typically registered through the 70's. In other words, for a number of years, the region was increasingly adjusting to what seemed to be an endless and growing flow of foreign currency, but which, in reality, had important temporary, reversible components. Moreover, the ultimate cost of this foreign currency was in practice impossible to predict, since bank loan agreements were concluded at market-based variable interest rates which, as mentioned, in certain periods, were negative in real terms.

The volume of bank debt grew very quickly and the net capital inflow more than exceeded interest payments. For several years, this resulted in an intense build-up of international reserves in the Latin American countries and created a perception of abundance that exerted pressure to appreciate exchange rates in most countries. In 1980, when the average bank interest rate (including spreads on financial intermediation) was 14%, for every US$100 of outstanding debt, net credits of US$30 were received and US$14 of that amount went towards interest payments. Therefore, there was a net remainder of US$16 to finance other foreign trade operations or accumulate reserves. At the same time, the value of exports grew on the order of 9% a year, thereby adding to the already abundant supply of foreign currency. Not until 1981 did these economic relations begin to reverse themselves.

During the 70's, a number of industrialized countries progressively relaxed their controls on domestic interest rates, capital flows to other countries and the operations of their national financial markets. Moreover, the unregulated euro dollar market was flourishing. However, towards the end of the 70's, reducing inflation was becoming more of a policy priority in the industrialized world. The international context rapidly took a tum for the worse and this had repercussions in the financial sphere, which were felt more acutely after 1980 and were particularly damaging to Latin America, heavily leveraged on foreign debt.

By the late 70's, nominal interest rates were adjusting to international inflation, in response to the more restrictive financial and macroeconomic policies adopted by industrialized nations. In 1977-1980, both nominal and real rates rose, albeit moderately. In 1981, the situation grew worse for debtors: the international economy entered into recession; the terms of trade also deteriorated for debtor countries and external inflation came to an abrupt halt, while nominal interest rates continued to climb.

The choice of an appropriate inflation indicator is based on the prices at which international trade is conducted. The relevant trade price indexes in this case show a decline in prices in the 1981-1982 biennium compared to 1980. This is basically attributable to the appreciation of the dollar against other hard currencies (and, therefore, a constant price in marks or yens is expressed in less dollars), and to the fact that, by and large, debts were expressed in United States currency, unlike trade, which was conducted in a broader range of currencies. Thus, bank interest rates deflated by an international trade price index were extremely high in 1981-1982: of the order of 20% in real terms, measured as described above. Because of the way the market operates, with flexible day-to-day interest rates, the rise in the rate affected not only new loans but most of the accumulated outstanding bank debt as well.

Available information on developing countries in general and the Latin American countries in particular reveal that, by 1980 the financial balance was already weighing heavily within the current account of the balance of payments. Thus, even then the external deficit was not only linked to the deterioration in the terms of trade, as it had been in the past, but also to the burden that the payment of interest on the debt had come to represent. In other words, financing terms took their place alongside the terms of trade as a significant destabilizing factor. For instance,

it is worth noting that in 1982 Latin America as a whole achieved a large trade surplus (US$ 10 billion) but registered a US$34 million deficit in net payments of profits and interest. The problem was even further complicated by the private sector's increasingly negative expectations concerning the sustainability of the credit cycle; this gave rise to substantial capital flight.

Simultaneous with the accelerated increase in the demand for loans to refinance growing external debt service, the banks themselves became progressively more alarmed by their credit exposure in the region. By 1977, the leading United States banks established in Latin American market were already attempting to restrict the growth rate of their loans. This, however, had little impact at the global level, because their progressive lowering of the rate of credit expansion was more than offset by loans from new banks entering the international arena. In fact, the number of new banks in the market averaged 65 per year between 1976 and 1980, mainly from Europe, Japan and the Middle East. Thus, even when the annual rate of credit expansion to the region by United States banks went down from 29% in 1975-1977 to 8% in 1978, the rate of non-United States banks went up from 30% to 50%. As a result, the average global expansion of bank credit remained practically unchanged, at nearly 30% a year (Devlin, 1989). Only around 1981 did the system as a whole – feeling pressured by its huge credit exposure on the one hand and the accelerated demand to refinance debt on the other – openly begin to show signs of stress. Perceiving problems, banks individually began to shorten repayment periods and increase margins on the variable interest rate; however, this policy at the aggregate level of course only served to heighten the debtors' demand for refinancing and increase the stress in the system.

Considering only obligations with the official sectors, the annual amortization coefficient in 1980 was on the order of 15% of the outstanding debt. On the other hand, the coefficient for bank debt, which constituted a constantly rising share of the total, reached 40%, and was even higher the year after. This highlighted the great potential volatility of private financial resources, which did not manifest itself, when the market was operating smoothly in its expansive phase, for rollovers of debt service were virtually automatic. It became clear, however, that the permissive situation could not go on for too much longer; at some point, it was going to reverse itself and create serious difficulties (see Ffrench-Davis, 1982; Fishlow, 1983; Williamson, 1983). And then, both the use the countries had made of the credits and the accumulated debt stock, would acquire crucial importance.

When the debt crisis broke out in 1982, banks were seriously overexposed in the region. As an illustration, despite their more cautious lending policy in the late 70's, the nine leading United States banks registered a loan/capital coefficient of 180% in 1982 – 50% in Mexico, 46% in Brazil, 26% in Venezuela, 21% in Argentina, 12% in Chile, with the balance distributed among the other countries of the region. In response to the countries' payments problems and the banks' tremendous overexposure, the net annual flow of bank credit fell abruptly during 1982. Here it is useful to point out the contrast with the flow statistics during the situation which had immediately preceded this one. The outstanding bank debt

grew around 10% in 1982. As the interest rate was on the order of 16%, the funds that debtors received amounted to less than what they had to pay in interest. In other words, for every US$100 of debt, they had to take US$6 from other sources, resulting in severely negative net financial transfers. Such transfers were covered by dipping into international reserves, which rapidly fell in Latin America (by 40% between 1980 and 1982); and by drastically reducing imports (42% in 1981-1983). Exports, on the other hand, confronted an international environment of declining prices and restricted market access; consequently, their value registered negative growth between 1980 and 1983.

Added to all this was the instability in the access to financial resources. It was no longer merely a question of lower overall volume and an inordinately high interest rate, but also great uncertainty as to the quantity of resources available to each country. Thus, the latent possibility that various debtors would have problems rolling over their debt service became a reality, occurring on a wide scale in the second semester of 1982.

In this latter context, the shortness of maturity structures was indeed perceived as a serious problem. In an international market that had abruptly tightened with respect to the easy financing environment of earlier years, having to renew 20% or 40% of the debt from year to year was a very difficult proposition. Coupled with this was the need for financing to cover interest payments, which tripled between 1977 and 1980.

In short, all of these variables put together created an external shock of proportions that had been unimaginable, dealing a severe blow to the vast majority of debtor countries.

3.2 A brief review of past financial crises

The 1982 financial crisis was yet another episode in the series of booms and busts that have punctuated the history of international finance. Indeed, Latin America itself already experienced periods of intense external indebtedness followed by massive defaults three times in the last century, and again in 20's/30's (ECLAC, 1965; Skiles, 1988).

In previous crises, the region's external financial problems had been resolved through the typical mechanisms of a competitive decentralized private market. Indeed, bonds (the credit instrument used previously) issued by the Latin American countries were bought up by disperse and anonymous portfolio investors. A set of recurring factors, such as excess international liquidity, the keen competition among investors in search of placements, the inadequate circulation of information, coupled with debtor countries overly willing to take advantage of the permissive situation and incur ever-greater obligations, led to an accumulation of external liabilities that eventually created serious debt-servicing problems. Obviously, the general pattern closely parallels what happened in the recent crisis (Kindleberger, 1978; ECLAC, 1990).

For their part, creditors are in the habit of responding to the debtor countries'

payment problems by raising the cost of new credit (a higher risk premium and shorter repayment terms), and drastically rationing the loan volume. While this behavior may have been rational from the viewpoint of each individual lender, an attempt by many creditors to reduce their exposure could only serve to make the debtors' liquidity problems worse and diminish the quality of the aggregate loan portfolio of all foreign creditors. In each crisis, this behavior culminated in an explosion of panic on the credit market, giving rise to a near absolute rationing of new loans – in other words, even the debtors prepared to pay a higher interest rate could not obtain new credit.

The suspension of new loans halted the rollover process and as a result, the debt service burden increased even more in real terms. Moreover, in previous crises, creditors, being scattered and anonymous, had difficulties in communicating among themselves; this undermined their capacity to collectively manage indebted countries' payment problems in order to prevent default (for example, by applying pressure on the debtor to implement economic adjustment). The counterpart to this was that the debtor country, overwhelmed by payments that could not be refinanced, and without effective channels for renegotiation with its creditors, frequently opted for unilateral default. Indeed, in the 30's, of all the Latin American nations, only Argentina, the Dominican Republic and Haiti managed to avoid declaring a moratorium on debt service.

It is interesting to note that in previous crises, default functioned in practice as a market-based risk sharing device between creditor and debtor. Indeed, confronted by an excessive accumulation of loans and debts, moratoria constituted a way for the borrower to transfer a significant share of the costs involved to the creditors. The creditors, who had charged the debtors a risk premium at the time the loan in order to cover themselves for just such an eventuality, had not always built up sufficient reserves to absorb the losses caused by defaults, and therefore some had serious problems and even went bankrupt. The solvency problems of a debtor or a major creditor frequently created a series of negative externalities in the financial market, which dragged down other more solvent lenders and borrowers. Furthermore, even when default in some sense brought relief to the debtor, it was often at the expense of the overall confidence of the private investors. In the end, the market solution was not socially efficient, but it did have the virtue of spreading the costs of the systemic credit problem between debtor and creditor.

4. MANAGEMENT OF THE CRISIS DURING THE 80'S

As has been seen, certain parallels can be drawn between the causes of the 1980 crisis and those of previous crises: excessive enthusiasm on the part of debtors to extend finance and on the part of countries to go into debt, which ended in an overextension of the international financial system. But the similarities end there. This recent incident is radically different from former ones not in its general cause but rather in how it was resolved.

Historically speaking, the 1980 crisis is unique because of the tremendous coordination creditors achieved among themselves. That allowed them to delay, or to stop the defaults by the Latin American countries that would have threatened the solvency of the international banking community. Indeed, during the 1980 crisis, some of the financial rescue mechanisms that governments typically used to deal with systemic financial problems in their national markets were employed at the international level.

After Mexico defaulted in August 1982 – the event that formally sparked the crisis – a kind of "international lender of last resort" was rapidly organized, whose function was to stabilize a financial system in the midst of a crisis. This ILLR was the outgrowth of informal measures taken by the governments of the Group of Seven – led by the United States – some of the larger lending banks, and multilateral financial organizations, especially the International Monetary Fund (IMF). In effect, the ILLR helped coordinate hundreds of creditor banks in the negotiations with each debtor country, a process designed to oblige that country to sharply adjust its economy, thus avoiding a formal default which could have destabilized the international financial system. The strategy of the ILLR went through four very distinct phases, presented below.

4.1 Phases in the management of the crisis

a) First phase: August 1982 – September 1985

During this period, official efforts were aimed at promoting austerity in the debtor country – through classic economic adjustment policies –, a restructuring of the external debt and the normal payment of interest. Several mechanisms were used to achieve these goals.

(i) Unprecedented coordination among creditors. Even though each debtor country owed money to hundreds of banks, these lenders had institutionalized ways of coordinating their actions. Unlike anonymous bondholders during the 30's, commercial banks were easily identifiable since they had granted most of their loans through publicly organized credit syndicates. Moreover, it was not a common practice to sell loans to third parties since there was no developed secondary market for their financial instruments. Finally, since some isolated but serious payment problems had arisen with a few developing countries (like Peru, Jamaica or Turkey) during the 70's, the banks had already set up a mechanism to coordinate their actions in cases of potential default. In effect, creditor banks formed a small advisory committee to negotiate with the debtor country. The committee was normally composed of lenders with the greatest exposure in the debtor country. During the crisis of the 80's, the banks deployed their system of an advisory committee; moreover, behind the scenes, the governments of the creditor countries intervened to enhance the effectiveness of the committee's coordinating actions by pressuring those creditor banks that were reluctant to act

collectively and follow the recommendations of the advisory committee (Devlin, 1989).

(ii) Adjustment in the debtor country. The conventional wisdom in the creditor countries was that the debt crisis in America was due to a short-term liquidity problem and not to a problem of solvency (Cline, 1984). It was in that context that, through the advisory committee, creditors collectively insisted that the debtor country take drastic domestic adjustment measures to quickly release foreign exchange to service the debt. Those measures, which will be analyzed below, led to a rapid turnaround in the trade balance of the debtor countries, which for the region as a whole went from an average annual deficit of US$7 billion between 1978 and 1981 to a huge surplus of US$25 billion per annum in 1983-1987. Thus, a large amount of additional foreign exchange was generated each year to service the debt.

(iii) Restructuring of debt service. Even with a large trade surplus, the debtor countries could not pay their debt service in full, partly because it was inflated by the tendency of banks to grant shorter repayment periods during the years immediately preceding the Mexican crisis, the high level of international interest rates (an average nominal rate of almost 15% in 1982-1983), and by the acute international recession which limited the region's expansion of exports. The response to this problem was to fully reschedule the amortization of the debt – a common financial practice for dealing with payment problems-while new loans were collectively granted (called "involuntary" loans or "new money"). Those new loans indeed constituted a novel approach to debt renegotiation – since banks typically rejected new lending –, and was strongly encouraged by the IMF. The banks, in tum, usually pressured governments to assume responsibility for unguaranteed private-sector debt, an unprecedented demand.

Three rounds of renegotiations were carried out during the first phase of official management (see Devlin & Ffrench-Davis, 1995, Table 3). With the explicit pretension of protecting the debtor's image of creditworthiness (and of course, avoiding losses for the banks), renegotiations were always carried out on regular commercial terms.

(iv) The active role of the official sector government agencies and multilateral institutions were active throughout the crisis. The International Monetary Fund served as a bridge between the banks and the countries. On the one hand, the banks could count on the Fund's presence in the country's adjustment processes only if they had previously agreed to reschedule debts (and grant involuntary loans); on the other, the countries could gain access to rescheduling only if they had a "green light", that is, an adjustment program with the Fund. The central banks and finance ministries of the industrialized countries pressured the banks (especially the smaller ones, less exposed and therefore less willing to support new involuntary lending) to act collectively. Official agencies also granted bridge loans to debtors, which allowed them to service the debt during the long negotiations with the banks. Finally,

creditor governments rescheduled (also on relatively difficult terms) official debts in the framework of the Paris Club, and, in their capacity as the main shareholders, they promoted disbursements of loans by the multilateral institutions, which in practice refinanced an important share of the interest payments on bank debt.

b) Second phase: September 1985 to September 1987

This period corresponds to what was called the "Baker Plan". In the annual meeting of the lMF and the World Bank, held in South Korea in September 1985, the United States Secretary of the Treasury, James Baker, announced a new scheme for managing the problem of debtor countries. In recognition of the tremendous recessionary effects of the first phase, a new approach to management was introduced, called "structural adjustment with growth". The financial policy instruments were identical to those of the first phase; that is, rescheduling debts due under regular commercial loan terms and with new money. However, given the continuous and significant erosion of the amount of new involuntary loans during the first three rounds of rescheduling, Baker publicly committed himself to mobilizing, for 15 developing countries willing to cooperate with the new strategy (mostly Latin American countries), new loans for US$29 billion over a three-year period: US$20 billion from banks (a net credit expansion of 2.5% per annum) and US$9 billion from official agencies. Moreover, in view of the new structural framework for adjustment, he assigned a more active role to the World Bank, which up until then had been relatively passive in the official management strategy.

The Baker Plan launched a fourth round of rescheduling, which began in mid-1986 with Mexico. This round restructured US$ l76 billion in debt (including debt that was already rescheduled) in six countries (Argentina, Brazil, Chile, Mexico, Uruguay and Venezuela). It also mobilized US$14 billion in bank loans to three countries, Argentina, Brazil and Mexico, with more than half that amount going to Mexico. The conditions, or negotiated cost of credit, continued to soften (see Devlin & Ffrench-Davis, 1995).

c) third phase: September 1987 to March 1989

During this period, the Baker Plan and the fourth round of rescheduling formally continued to operate. However, in 1987 the scheme changed enough to distinguish another phase, which we will call Baker Plan "B". What was to be known as a "market-based menu approach" came into being. The menu included the traditional mechanisms of rescheduling with new loans, but it also allowed for the possibility of using debt-reduction mechanisms, such as operations to buy back debt at a discount, exit bonds at a below-market interest rate, debt swaps and conversions. Thus creditors, for the first time tacitly, admitted that the region's bank debt was at least partially unpayable at its face value. Nonetheless, emphasis was placed on the fact that the new scheme would be exclusively voluntary, based on private market principles, without cost to taxpayers in the industrialized countries, and exclude official Paris Club debt (ECLAC, 1990).

d) fourth phase: March 1989 to the present

A new scheme arose in 1989, called the Brady Plan, for the United States Secretary of the Treasury, Nicholas Brady, who proposed it. Formally, the new plan was said to be simply an extension of the Baker Plan. However, it marked an important new stage in managing the problem.

Indeed, the Brady Plan gave priority to the debt-reduction operations that had been rather timidly put forward by the Baker Plan "B". But even more importantly, it committed the direct financial and institutional support of the international public sector to the debt-reduction process. The new scheme recognized that one of the reasons for the lack of success of the Baker Plan "B" was the fact that the debtor countries did not have enough resources of their own to buy back their debts at a discount. To overcome that problem, the Brady Plan mobilized US$30 billion in loans (US$24 billion in equal parts from the World Bank and the IMF and US$6 billion from the government of Japan) which could be used to finance debt buybacks or its conversion into discount bonds.

Brady also proposed changes in regulatory and tax regimes for banks, with a view to reducing obstacles to debt reduction (Rodríguez & Griffith-Jones, 1992). And finally, the Plan also implicitly allowed debt restructuring agreements to be delinked from IMF programmes. Thus, a country, on a case-by-case basis, could sign an adjustment program with the IMF, even though it had not necessarily reached an agreement with the banks on how to manage its debt problem. Although it was never formally articulated, the new policy made it possible for a country to arrange for an adjustment program with the Fund even when it was in arrears on its debt service with the banks (ECLAC, 1990).

The Brady Plan launched the fifth round of debt restructurings. To date, six debt-reduction agreements have been reached in Latin America-Argentina, Mexico, Venezuela, Dominican Republic, Costa Rica, and Uruguay- and another one, Brazil, may be finalized in 1994.

Moreover, during this period, the Paris Club, which traditionally has been rather rigid in its treatment of debt problems, softened its approach somewhat. In1990, the so-called Toronto Terms – originally reserved for the poorest countries of Africa and Bolivia and Guyana, two countries of the region with extremely low income levels – were extended to other countries. This program allowed for a reduction of up to 33% of the present value of renegotiable debt (normally, 12-18 months of payments falling due). In1991, the Club introduced the Houston Terms for low and medium-income countries. This Plan, which was applied to Honduras, El Salvador, Panama, Jamaica, Peru, the Dominican Republic, and Ecuador, allows for a somewhat longer than traditional amortization period and for the reduction of very limited amounts of debt. Finally, in late 1991, the Club improved the relief for the poorest countries, allowing for a negotiated reduction of up to 50% of the present value of debt eligible for restructuring. Up through end-1993 this latter scheme was applied to Nicaragua, Bolivia, Guyana and Honduras.

4.2 The dynamics behind the negotiations

It is clear that the official management of the debt crisis was not static; important innovations were made over the course of ten years. The emergence of an international lender of last resort was undoubtedly a potentially very positive event. However, it is worth noting that its behavior was very different from the way governments normally intervene in national markets under similar circumstances.

A national lender of last resort usually acts to minimize the overall social costs of a crisis in the financial market. Indeed, it manages the problem taking public welfare into account, since the crisis and its solution has an impact that extends beyond the parties directly involved and thereby affects the economic and political system as a whole. As observed in the United States bailouts of the municipality of New York, the large corporation Chrysler, and the saving and loan associations, public management of the crises attempted to maintain a degree of symmetry in the distribution of the inevitable costs of a lasting social solution (ECLAC, 1990). Of course, structural adjustments were demanded of the debtors, which entailed a good deal of sacrifice; for example, the forced sale of shares, reduction of wages and personnel, etc. But equally large sacrifices were also demanded of the creditors in order to support the debtor's adjustment efforts; for example, a partial write down of the problematic loans, a reduction of the interest rate and sometimes an injection of new capital, which could even be guaranteed by the government.

The international lender of last resort, in contrast, initially took a unilateral approach: to prevent at all costs losses to the international and domestic financial systems (ECLAC, 1990). Moreover, the creditor governments participated in a kind of market "fetishism", formally pretending not to intervene directly in the negotiations between debtor and creditor and avoiding direct financial commitments. In fact, however, the governments, and particularly the US, had a decisive influence in defining and changing the framework for negotiations and were in frequent contact with the negotiating parties. Governments were also incurring contingent liabilities by encouraging multilateral lenders to indirectly refinance interest payments to the private banks.

As will be explained in section 5, the other side of the coin of the pro-creditor bias was "overadjustment" in the debtor countries. This brand of adjustment not only excessively sacrificed investment, output and employment in the debtor countries, but it probably also prolonged and deepened the crisis itself.

The concessions granted to debtors after the second and third round of rescheduling also did not exemplify the statesmanship of an enlightened international lender of last resort, either. They were rather "reactions" to difficult moments in the negotiations, in which the creditors perceived a growing uneasiness in Latin American circles owing to the onerous rescheduling terms and the recessionary effects of adjustment. Indeed, the creditors and their governments were frequently concerned about the formation of a debtors' club, that could have neutralized the negotiating power of the creditors. These, quite frankly, acted in cartel-like fashion. Thus, important concessions offered in the third round of rescheduling coincided

with an open rejection by the new democratic government of Argentina of the standard conditions for rescheduling and later, with the formation, in mid-1984, of a group of Latin American debtor countries, called the Cartagena Consensus (Tussie, 1988). The introduction of the Baker Plan was another clearly improvised response to a growing wave of public denouncements by Latin American governments about the management of the debt problem and adjustment (those of Alan García of Peru and Fidel Castro of Cuba being the best known).

Simultaneous expressions of discontent by a number of countries helped to soften the banks' stand, even though each debtor country objectively had a weak negotiating position. That happened because the prospects of cooperation among debtor countries was of great concern to the creditors; they wanted to diminish that possibility by all means.

Theoretically, the debtor countries had strong incentives to forma debtors' club, since that was the only way to offset the negotiating power of the creditor cartel, formed by close coordination between banks, the multilateral agencies and their governments. Although the debtor countries never progressed beyond some attempts to coordinate their positions on the general framework for negotiations, mainly through the Cartagena Consensus (Tussie, 1988), the efficacy of these efforts was undermined by the aforementioned concessions granted at critical conjunctures, by the banks and their governments, to certain debtor countries during the negotiating rounds. The concessions acted as a kind of "side payment" by the banks which eroded the unity of the Consensus (O'Donnell, 1985). Indeed, a government that received a concession had to compare the concrete and immediate benefit of the creditors' offer with the greater potential benefit – but one that was much less likely to occur – of negotiating jointly with a large group of countries with very different interests and economic and political situations. Moreover, the country knew that if it did not accept the concession, the banks could offer it to another member of the Consensus.

However, the possibility of a side payment by the creditors was perhaps not the main obstacle to the formation of a debtors' club. There was also an "internal" threat. The creditors' cartel had an inherent advantage in having to focus on only one variable: payment of the debt. In contrast, the governments of the Consensus had to share the external debt problem with a whole spectrum of other national interests, some of which, in a given moment, might have been more important than the renegotiation of the debt and would have suffered setbacks in any confrontation with the banks. For example, in 1983-1984 many countries were liberated from dictatorial regimes and their new civilian governments gave top priority to consolidating a democratic State and to demonstrating that democracy was consistent with social order and peace. Although the external debt created difficulties for economic and social management, a confrontation with the banks, even if successful, could have been a pyrrhic victory, had it destabilized other key variables of the debtor country's national political project (Devlin, 1989).

For its part, the Baker Plan "B" responded to diverse factors. First, the popular hypothesis that the debt problem was one of liquidity and not solvency was losing

credibility in the light of debtor countries' persistent problems and the development of an international secondary market for bank loans in the region, which in 1987 offered average discounts of 40%/50% off the face value of bank-debt paper (see Bouzas & Ffrench-Davis, 1990). Second, due in part to this phenomenon and to the eventual strengthening of their capital base, the international banks had openly resisted the Baker proposal to grant new involuntary loans. And finally, the reduced flow of fresh credit clearly helped to deteriorate the official program's capacity to co-opt the debtors: at the beginning of 1987 Brazil surprised the world with the announcement of a unilateral moratorium, and a significant number of other countries silently began to accumulate arrears in their debt service (Altimir & Devlin, 1994).

Baker Plan "B" never really got off the ground. In a situation where the banks were not particularly willing to lend and debtors lacked sufficient resources to finance a suitable market reduction of their debt, the official management strategy fell into a kind of limbo leaving only a few countries (Chile, Mexico, Uruguay, Venezuela and Colombia) which still had the capacity and willingness to service their debt in full. The lack of direction, together with the severe political consequences of pursuing adjustment without adequate financing – seen for example in the dramatic uprising in Venezuela at early 1989 – created a sense of urgency that gave rise to the announcement of the Brady Plan.

Thus, even though the official scheme evolved considerably, it clearly reacted to rather than anticipated problems. Also, the response was almost always late in coming and deficient in relation to what was needed for a systemic and socially efficient solution. Indeed, despite the rhetoric about the need to finance the adjustment of the debtor countries, the creditors succeeded in passing on most part of the costs of the crisis to the Latin American countries. The predominant concern was not a socially efficient adjustment of the international system as a whole, but rather the salvation of the commercial banks and national financial systems, at a minimum direct cost to the taxpayers of the creditor governments.

The rescue of the banks was quite successful. By 1987, they were already overcoming their crisis by increasing their capital and reserves. By 1989, outstanding loans to Latin America, as a percentage of the capital of US banks, dropped to a manageable 38%. This phenomenon transformed Latin America's insolvency from a crisis for the banking system into a mere problem. The improved solvency of the banks was moreover financed asymmetrically by a contraction of the Latin American economies, which permitted a large transfer of resources to the creditors. The magnitude of the annual net transfer was indeed remarkable: the equivalent of 4% of the region's GDP. This figure exceeds even that recorded by Germany after the First World War, when it had to pay war reparations to the allies (Devlin, 1987).

5. THE RECESSIONARY DOMESTIC ADJUSTMENT OF THE 80'S

As mentioned above, between 1950 and 1980, Latin America's economy grew by an average of 5.5% per annum (see Ffrench-Davis & Muñoz, 1991). That

growth rate was higher than the prevailing trend in other developing regions (except for the petroleum-exporting economies and those of South-East Asia) and was clearly higher than the average in the industrialized countries (4.2%). In 1980, Latin America's gross domestic product quintupled that of 1950. That growth was associated with comparatively high investment levels of over 20% of GDP, the use of productive capacity at relatively increasing rates, an expansion of industrial sectors that intensively incorporated improved technology, and a gradual integration in international goods and capital markets.

During the 50's, Latin America had to deal with bottlenecks caused by a scarcity of external financing and difficult access during both the 40' s and 50' s to export markets and imported supplies. The region improved its access to goods and capital markets throughout the 50's and 60's, expanded the agricultural frontier in arable and irrigated land, and incorporated new crops, seeds and fertilizers. But the leading sector was manufacturing, which grew rapidly at an annual rate of 7% during the 60's. Indeed, 60's, was the decade with the greatest domestic and external stability in the postwar period in most of Latin America, with fewer balance-of-payment crises than in previous years and with higher overall productivity coefficients. While not always efficient, the progress was nevertheless notable.

However, the gradual exhaustion of easy import substitution limited investment opportunities for the domestic market and the utilization of installed capacity. Manufacturing activities increasingly underutilized economies of scale, in so far as they operated only for national markets. In response to this situation, the region began to expand its exports of manufactures. Countries like Brazil, Colombia and Chile established crawling – peg exchange-rate policies and provided other export incentives. During the second half of the 60's, real sales to the rest of the world grew by 12% per annum (more than double the growth of GDP) and intraregional exports increased by 16% (Ffrench-Davis, Muñoz & Palma, forthcoming). Also, the expansion of long-term loans by the World Bank and the creation of the Inter-American Development Bank (IDB) helped to expand financing for public investment.

During the mid-60's, the rate of capital formation began to climb steadily, and the pace quickened during the 70's. As already mentioned, that rise was associated with changes in the sources of external financing and with the way the countries of the region reacted to those options during that period.

As seen above, the abrupt fall in external financing was a primary cause of the low level of economic activity during the 80's. Together with the deterioration of the terms of trade (associated with the international recession) and capital flight, there was an acute shortage of foreign exchange, which provoked a burdensome binding external restriction on the economies of the region. The utilization rate of available productive resources dropped correspondingly. As a result, capital formation declined throughout the whole region during the 80's.

In sum, the recession in the region meant underutilization of installed capacity labor, land and industries were less active than they had been in the preceding decade. Capital formation suffered the same fate, both because of domestic recession and the reversal of external financing (Feinberg & Ffrench-Davis, 1988).

In order to quantify the adjustment made in the main macroeconomic variables, Table 3 uses the biennium 1980-1981 as a base. Those years marked the high point of *per capita* output, utilization of capacity and investment in most of the countries of the region. All variables are expressed as a percentage of GDP in that biennium and are adjusted by a population index so that all the series are expressed in *per capita* terms.

Table 3 describes the yearly changes in the main domestic macroeconomic variables relating to GDP, aggregate demand (domestic expenditure, the sum of consumption and investment), capital formation, exports and imports and the sources of external shocks: the decline in the inflow of capital (loans and direct investments), the rise in servicing of capital (remittances of interest and profits) and the deterioration of terms of trade. Between 1979 and 1980, all the indicators of the region as a whole showed "improvement". In1981, or slightly earlier, countries like Argentina, Brazil, Costa Rica and Paraguay experienced difficulties in financing their balance of payments and underwent recessionary adjustments (deliberate or automatic), while other countries, like Chile, Mexico, Peru and Ecuador, continued to expand expenditure and output, based on accelerated external indebtedness. As mentioned above, it was in 1982 that the recessionary adjustment became generalized.

The average for the 1983-1990 period shows that the vigorous growth that Latin America had exhibited disappeared and investment was systematically reduced. The adjustment process was induced by external shocks, which are measured in lines 8 and 9. There the averages for both periods, 1980-1981 and 1983-1990, can be compared.

As could be expected domestically, economic activity plummeted. A conservative estimate of the largest gap between utilizable productive capacity and that actually used is that it reached an annual average of close to US$40 billion. That is undoubtedly a spectacular figure and reflects the inefficiency of an adjustment aggravated by abrupt and massive worsening of financial transfers from abroad and a concomitant deterioration of the terms of trade. It is estimated that gross domestic investment recorded during the adjustment made it possible to maintain the capacity of *per capita* output at more or less constant levels. Nevertheless, actual *per capita* output in 1983-1990 averaged 7% less than that of 1980-1981. That was the "output-reduction" effect of policies that placed excessive constraints on demand and of weak policies regarding resource switching.

Line 3 of Table 3 shows that *per capita* consumption dropped sharply. But the biggest impact was on capital formation. During this adjustment process, investment and capital goods imports fell to substantially below their pre-crisis levels. *Per capita* capital formation was reduced by one-third between 1980-1981 and 1983-1990, with the resultant negative effect on the expansion of productive capacity and employment generation. The decline between both periods was not connected with lower domestic saving (line 5). It was the external shocks – despite higher total domestic saving –, which reduced available financing for capital formation.

The private sector, and especially the public sector, which became the main

TABLE 3

***Per capita* production, consumption, investment and external shocks: Latin America, 1980-1992 — (Percentages of 1980-1981 *per capita* GDP)**

														Averages		
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1980-81	1983-90	1991-92
1. GDP	101.0	99.0	95.6	91.3	92.2	92.6	94.5	95.7	94.5	93.4	91.9	93.6	94.6	100.0	93.3	94.1
2. Domestic expenditure	102.7	100.0	93.4	85.1	85.4	85.9	88.5	88.9	87.5	85.9	84.5	87.2	89.2	101.4	86.4	88.2
3. Consumption	77.8	76.3	73.8	70.1	70.3	69.9	72.5	71.9	70.8	70.4	70.4	71.7	72.2	77.0	70.8	72.0
4. Gross fixed capital formation	24.9	23.8	19.5	14.9	15.1	16.0	16.0	17.0	16.6	15.5	14.1	15.5	17.0	24.4	15.7	16.2
5. Domestic saving	23.3	22.7	21.8	21.2	21.9	22.8	22.0	23.8	23.7	23.0	21.5	21.9	22.3	23.0	22.5	22.1
6. National saving	20.7	18.4	14.5	14.1	15.0	15.6	13.8	15.8	15.4	14.8	13.4	13.6	13.8	19.5	14.7	13.7
7. Non-financial current account	(1.7)	(1.0)	2.2	6.2	6.8	6.8	6.0	6.8	7.0	7.6	7.4	6.4	5.3	(1.4)	6.8	5.9
a) Goods																
Exports	12.1	12.9	12.8	13.7	14.6	14.2	13.8	14.7	15.7	16.0	16.7	17.4	18.6	12.5	14.9	18.0
Imports	(12.3)	(12.3)	(9.8)	(7.5)	(7.9)	(7.8)	(8.3)	(8.6)	(9.2)	(9.2)	(10.0)	(11.3)	(13.4)	(12.3)	(8.6)	(12.4)
b) Services																
Exports	2.1	1.9	2.1	2.0	2.0	2.1	2.3	2.4	2.4	2.7	2.6	2.5	2.3	2.0	2.3	2.4
Imports	(3.6)	(3.6)	(2.9)	(2.0)	(1.9)	(1.7)	(1.8)	(1.8)	(1.9)	(2.0)	(1.9)	(2.1)	(2.3)	(3.6)	(1.9)	(2.2)
8. Terms of trade effects	0.0	(0.8)	(2.4)	(2.7)	(2.3)	(2.9)	(4.3)	(4.6)	(4.7)	(4.7)	(5.2)	(5.8)	(6.5)	(0.4)	(3.9)	(6.2)
9. Net transfers of funds	1.7	1.8	0.2	(3.6)	(4.5)	(3.8)	(1.8)	(2.2)	(2.3)	(2.8)	(2.3)	(0.5)	1.3	1.7	(2.9)	0.4
a) Capital movements	4.5	5.1	2.5	0.4	1.5	0.6	1.5	2.1	0.8	1.4	2.4	4.3	6.3	4.8	1.3	5.3
b) Net payment of profits and interest	(2.6)	(3.7)	(4.9)	(4.5)	(4.8)	(4.5)	(4.2)	(3.7)	(3.8)	(3.9)	(3.4)	(3.0)	(2.7)	(3.2)	(4.1)	(2.9)
c) Subtotal	1.8	1.4	(2.4)	(4.2)	(3.3)	(3.9)	(2.7)	(1.7)	(2.9)	(2.5)	(0.9)	1.3	3.6	1.6	(2.8)	2.4
d) Change in international reserves	0.2	(0.3)	(2.6)	(0.6)	1.2	(0.1)	(0.9)	0.5	(0.6)	0.3	1.4	1.8	2.3	(0.1)	0.1	2.0

Source: ECLAC, Statistics and Economic Projection Division, on the basis of official data in 1980 US$.

debtor in foreign currency (either for having directly incurred the external debt, or for having been pressured by creditors or local private debtors to assume private-sector debt), were obliged to channel a considerable proportion of their savings into interest payments on the external debt. In fact, the net outward transfer of funds in 1983-1990, which was known as a type of capital export, was equivalent to between one-half and twothirds of net capital formation during those years. Coupled with that was the deterioration in the terms of trade, which also reduced available investment funds.

External financial and trade shocks are shown on lines 8 and 9. Inflows of foreign capital were reduced to one-third of what they had been in the base biennium, while payments of interest and profits grew by almost a third. The deterioration of the net transfer of funds explains close to 53% of the decline in available resources caused by external shocks (7.5 percentage points) in 1983-1990, in comparison with the pre-crisis years (1980-1981). That item describes the magnitude of the external financial shock and its long duration. The remaining 47% was the result of a marked deterioration of the terms of trade (the commercial shock of 3.5 percentage points, measured by the difference between 1983-1990 and 1980-1981 on line 9).

The combination of these two negative external shocks meant that a given volume of national output was consistent with a significantly lower level of domestic expenditure, which in tum, in a vicious circle, led to a decline in output. As Table 5 shows, *per capita* output declined by 7% between the two periods and domestic expenditure dropped by 15%. Both coefficients, moreover, point to a clear departure from trends recorded during the 70's: annual growth in output (5.6%), consumption (6.1%) and investment (7.3%), compared to an annual population growth rate of 2.7% during that decade.

Also, during the 80's, the State had to finance most (more than 70%) of the net outward transfer. The fluidity of that transfer depended to a large extent on the degree of autonomy of public finances. ∫In other words, governments that directly owned exports of natural resources through public enterprises, like Mexico, Venezuela and Chile, could make the transfer more easily than other governments that had to depend on the efficiency of their national tax systems. The weaknesses of these systems were eventually reflected in the high inflation rates that accompanied the economic recessions of countries like Argentina, Brazil, Peru and Uruguay.

In sum, both the recessionary domestic context and the considerable uncertainty and constraint, which handicapped governments' management capacity and public and private capital formation, contributed to a decline in investment and the flight of capital. The repression of effective demand led to a substantial underutilization of installed capacity, which in tum naturally depressed investment even further. As well as contributed to unemployment and skill loss.

Given this devastating external and domestic framework, the debtor countries found it difficult to design a development strategy consistent with the needs for domestic structural adjustment and the constraints imposed by the world economy. This situation led to a weakening of self-identity and the ability to design national development programmes and achieve consensuses on them. The continuous out-

ward transfer of funds was an additional significant constraint on investment capacity of debtor nations.

6. CONCLUSION

Although the official strategy for dealing with the debt problem changed greatly over a decade, its dominant characteristic was the sharp asymmetry it promoted in adjustment processes. This is reflected in the contrast between the gradual adjustment of international banks during the 80's and the abrupt and drastic adjustment of Latin American countries. It is in this context that one can interpret the emergence of the Brady Plan. The Plan was conceptually the most daring management strategy to arise out of the crisis and indeed the only one to directly address the debtor countries' demands for real debt relief and economic reactivation. However, consistent with the asymmetric character of the decade-long rescue efforts, the Brady Plan was possible partly because of the perception that the banks had overcome their crisis and it was time to respond more integrally to the serious problems of the debtor countries.

The Plan corrected the asymmetry of adjustment to some extent through its debt reduction operations and its tolerance of arrears in debt servicing, which acted as an emergency "escape valve" for over-indebtedness. By 1992, after a decade of great controversy, the external debt problem was considered to be a secondary issue. Moreover, practically all the countries experienced a remarkable recovery of capital flows and a turnaround in the net transfer or resources (see in Table 5 the average figures for 1991-1992). The recent capital flow to the region has indeed been very abundant, averaging US$58 billion per annum in 1992-1993, or 4.7% of GDP at current prices[1], compared to only US$8 billion (1.2% of GDP) in 1983-1989, and US$29 billion (4.5% of GDP) in the five years immediately preceding the debt crisis. The net transfer of resources also has been large: US$3 3 billion (20% of export earnings) in 1992 and US$26 billion (15% of exports) in 1993.

The shift in trends was due partly to the Brady Plan. But the main factor seems to have been the sharp fall in international interest rates and consolidation of domestic adjustment efforts. (Calvo, Leiderman & Reinhart, 1993; Schadler, Carkovic, Bennett & Kahn, 1993). The lower interest rates have been a key factor in reducing the debt burden and have allowed countries to regularize their interest payments to creditors. The lower interest rates, in conjunction with domestic adjustment policies, have also greatly increased the differential yields in Latin America, inducing both capital repatriation and foreign investment.

The inflow of capital has affected both countries that have regularized their debt service through the Brady Plan and those that like Peru and Brazil which as of end 1993 had not. The return of capital moreover has allowed most countries

[1] At 1980 prices the share reached 5.6% of GDP.

to pursue more expansive macroeconomic policies, finally, bringing into sight the elusive goal of structural adjustment with growth.

Even though the debt crisis has faded into the background, the underlying situation in the region remains delicate. On the one hand, the new international credit cycle is beginning in a situation in which Latin America is still structurally overindebted, as reflected in several countries still in interest arrears and their high debt/export, debt/fiscal income and debt/GDP coefficients (Devlin & Ffrench-Davis, 1995, Tables 6 and 7; ECLAC, 1993, Tables VIII.5 and VIII.6). On the other, the new capital flows are not only heavily weighted by easily reversible securities and short-term deposits (commercial bank medium term loans are still in remission) but have also become a source of macroeconomic disequilibrium through their depressing effects on exchange rates and national savings (ECLAC, 1994).

If another foreign exchange crisis is to be avoided, countries will have to pragmatically manage capital flows and regulate domestic financial markets in ways that are consistent with macroeconomic equilibrium, international competitiveness and increased domestic savings and investment performances (ECLAC, 1994, chaps. IX and XI). Caution clearly must be exercised in terms of leveraging economies with external capital, both because of its short-term and reversible character as well as the notorious imperfections in international financial markets. They include, particularly, vulnerability to exogenous short-term shocks in these markets, which can adversely affect the disposition of international capital to make placements even in sound economies. If there was any lesson from the debt crisis of the 80's it was that a conservative stance on accumulation of foreign liabilities may have short term costs, but there are long term benefits in terms of providing incentives for domestic savings and a foundation for sustainable macroeconomic equilibrium and growth. Unfortunately, the neoliberal approach, which is dominant today in Latin America, is permissive regarding capital flows; it can be dogmatic in its defense of unregulated markets, even when it is evident that finance is one of the most imperfect of all markets and prone to crisis when loosely regulated or poorly managed by governments.

The repercussions of the crisis in external financial markets dominated by securities and short-term capital are still a matter of debate. But the asymmetric adjustment process of the 80's should certainly warn Latin American countries of the dangers of delegating decisions on the volume and composition of external capital entirely to the market. Clearly the market does not always "know best"; vigilant government authorities can constructively temper the casino instincts of financial market players and provide incentives for the channeling of finance into investment and savings instruments that support long term commitments and social cohesion.

Finally, it would be useful if Latin America and other developing countries took advantage of the more relaxed external environment to reinitiate the international discussion of reform of the international monetary system. In particular, issues such as more financial power for anti-cyclical and compensatory official financial institutions such as the IMF, correction of the problems of conditionality and asymmetric adjustment, SDRs etc., all remain relevant objectives for more efficient and socially equitable international economic relations.

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