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# IV. THE GREAT LATIN AMERICAN DEBT CRISIS: A DECADE OF ASYMMETRIC ADJUSTMENT*

## INTRODUCTION

In the 1980s, Latin America experienced the worst economic crisis since the worldwide depression of the 1930s. A common link running through this crisis was external indebtedness to the international private banking system.

The crisis was spawned in the 1970s 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 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 LACs to incur debt, lenders had to be willing to provide the resources. In fact, beginning in the 1970s, market dynamics made foreign banks 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.

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The third party were the multilateral institutions, such as the International Monetary Fund (IMF) 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 1970s adapted itself to the sizeable 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 *et al.*, 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 a decade. The abrupt macroeconomic over-adjustment 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.[1] The vigorous post-war Latin American growth was brought to an end. Between 1950 and 1980, the average GDP growth had been an annual 5.5 per cent, one of the highest in the world during that period.

When external credit was cut off by bank creditors, the LACs were forced to curb their aggregate demand. 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

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[1] The crisis was widespread and covered LACs with diverse degree of interventionism. However, the country that experienced the deepest drop in GDP and unemployment rates was Chile, which had made broad neoliberal reforms and exhibited a fiscal surplus in the late 1970s and early 1980s (see Ffrench-Davis, 2002, chs. 5 and 6).

the fact that a sizeable 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 aggravated by the flight of resident capital (in anticipation of a devaluation, a protracted adjustment process and uncertainty), and a worsening in the terms of trade.

When a positive NFT undergoes 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 networks, while the private sector invested less in a depressed domestic market (see ch. III).

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 US. The leading actors initially believed that the crisis was conjunctural and would be rapidly brought under control at moderate cost. However, creditors had considerably underestimated the depth of the adjustment needed to cope with such drastic cuts in financing and the slowdown in the world economy.[2]

Indeed, the decision-making bodies that 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 who placed greater emphasis on the real economy and productivism were displaced. In that process, the efficiency of adjustment and social equity were the losers, and poverty and distributive inequality became more acute in almost every country of the region (ECLAC, 1992; 2004).

During the 1980s, LACs managed to reorient their economies towards less intensive expenditure (consumption and investment) on import items, and more intense production for

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[2] Chapter IX analyses the role of the international environment which contributed to intensify the debt crisis in the early 1980s,

export. A decisive factor in this was massive currency devaluation which, together with other stimuli -including excess underutilized productive capacity due to the recession- promoted export development. Indeed, from 1983 onwards, there was a vigorous expansion in export volume. The expansion, however (which also occurred in other developing regions), faced international markets that were not buoyant. Consequently, there was a fall in unit prices and thus growth of foreign currency proceeds was less than that recorded for the quantum of exports.

Finally, in the early 1990s 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 LACs consolidating their structural reforms. Nonetheless, the most decisive factor appears to be the liberalization of financial outflows and a prolonged recession in the US; the resultant sharp decline in dollar interest rates improved the region's creditworthiness and created large interest rate and profits differentials, which induced LACs residents to repatriate capital and US investors to exploit high-yielding financial placements in the region (see ch. IX).

Having very little latitude to manage the crisis of the 1980s, and subject to severe domestic and external pressures, Latin American governments shifted to neoliberal-type economic policies. The very tight restriction on external finance, active in the region for almost a whole decade, was one reason why the social cost of the reform process was so high. The return of private capital to the region confirmed that financing was “a missing ingredient” in that period of adjustment, removing the binding external constraint. Additionally, the recovered access to finance sparked an optimism that was absent for an entire decade. However, it was clear that the region needed to redefine a strategy for development and macroeconomic management that avoided reproducing sharp economic cycles of booms and busts, and to, instead, generate sustainable productive development over time, with greater and more effective social equity (ECLAC, 1998).

In section 1, we examine the building up of the debt crisis during the 1970s. In section 2, we describe the emergence of the crisis in the 1980s, comparing its features with other regional crises in the past. In section 3, we analyze the different phases in the management of the debt, the

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while at the same time strongly moderated the “Tequila effect” in 1995.

role of the International Monetary Fund, the World Bank and the U.S Treasury, and the consequent economic adjustment LACs had to implement. In section 4 we examine the nature of this recessive adjustment and their associated costs. In section 5, we present some concluding remarks.

## 1. THE GESTATION OF THE DEBT CRISIS IN THE 1970s

### a) A lost opportunity

The 1970s introduced factors that, for several years, facilitated LDCs' access to international financial markets. This was reflected in a rapid increase in their external debt (see table IV.1).

(Table IV.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 US market in the 1950s, but did not become international in scale until the late 1960s and the 1970s. At first, competition among banks for new borrowers was primarily concentrated in the industrialized countries; however, particularly after the oil shock of 1973, the search for new customers became so intense that lending spilled over massively 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 US 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 1920s, the oil price hikes in 1973/74 and 1979/80 had the effect of considerably magnifying the process of indebtedness to 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.

Over the decade, participation by developing countries in international banking flows grew tremendously. In particular, the nominal value of Latin American countries' bank debt increased by nearly 30 per cent annually in the 1970s (see table IV.2); of this, 17-20 percentage points reflected the global expansion of the international financial market (in current dollars) and the rest represented Latin America's rising participation in that growth.

(Table IV.2)

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 nearly four decades of relative inactivity in the region and, 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” (Kindleberger, 1978; Devlin, 1989). Nevertheless, many -particularly the proponents of neo-liberalism- 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 a new credit market.[3]

Another very significant development in the international financial markets was that real interest rates turned low or negative in the 1970s. It is true that they were higher than those charged on official loans, extended by governments or multilateral institutions; but with international inflation, which rose from an annual average of 2 per cent in the 1960s to 12 per cent in 1973-81, 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 the banks for placements on the international markets pushed the price of loans down.

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[3] See the insightful analyses of Bacha and Díaz-Alejandro (1983) and Williamson (1983), both written in 1981.

The repayment periods of the loans extended by the international banking system were much shorter than those granted by official agencies which, in the 1960s, accounted for most of the accumulated debt stock. However, owing also to the intense competition among banks to lend out their funds around 1977-80, rollovers of debt service were granted so easily that they became virtually automatic. Thus the prevalence of short-term loans was believed to entail no greater risks. History would later prove this assessment to be fatally wrong (Ffrench-Davis, 1982 offers one of the few warnings published before the crisis; and 1984).

At the same time there was a healthy expansion of exports from developing countries. Notwithstanding the difficulties that arose in 1974-75, the volume of exports expanded considerably between 1973 and 1980 and outstripped the growth rates of GDP, which were also satisfactory: in the same interval, GDP in Latin America rose by 5.8 per cent yearly, and exports quantum by 6.4 per cent.[4] At the same time, the high international inflation (12 per cent 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.

Therefore, the expansion of the private international financial flows towards the end of the 1970s, seemed to be relatively favorable and helped to offset the instability and deterioration in the terms of trade of Latin American non-oil-producing countries, after the negative shocks brought about by the remarkable increment in oil prices.

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 repercussions 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 1960s, 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 helped to alleviate

[4] Figures for 18 LACs, excluding those of Venezuela.

the recessive impact of adjustment policies. On the other hand, bank loans, often extended without any conditions attached, were in many cases used for the import of non-essential 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 reforming the international monetary system had lost priority. 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. On the other hand, for the first time since the 1920s, debtor countries experienced plentiful low-interest external credit. 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.[5]

It is true that trade in the Latin American countries became more unstable during the 1970s 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 1980s. However, by then it was already too late: the time had been ripe in the 1970s for implementing reform and more effectively balancing the pro- and anti-cyclical aspects of the international financial system, but that opportunity had been lost.

b) Maturity terms, costs and debt guarantees

Traditionally, whenever a country's external debt was mentioned, one tended to think of

[5] An excellent analysis is presented in Devlin (1989).

public-sector commitments, rather than those incurred by private individuals or firms. Moreover, during the 1970s the non-publicly guaranteed private debt and short-term debt were gaining a fast rising share. However, these components usually were not to be recorded in the conventional debt statistics. Indeed, in 1980, the difference between the standard definition of the outstanding Latin American debt and a more comprehensive estimate was around 40 per cent of the revised total: the guaranteed debt was US$124 billion, out of a total of US$204 billion (Ffrench-Davis, 1982).[6] 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 maturity terms (less than half) and interest rates (twice as high).

Consequently, 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 liabilities came to represent a larger share of the total. These types of loan were extended by hundreds of transnational banks, without a 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 private debt in conventional statistics. Indeed, it was argued that, as the loans had been incurred among private agents, without the involvement of the public sector, the debtor's host country was not accountable for those resources, which moreover would be used in accordance with the rational profit-making criteria of the private sector, and could therefore be serviced with no problem since the income yield would be higher than the interest rate. The underlying hypothesis was that the private agent always weighs his 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. This was an argument systematically put forward in the region, in international financial circles and by the 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 1980s, the Latin American bank debt already accounted for nearly 80 per cent of the total debt, including short-term obligations that were not

[6] Estimates made in 1981, based on BIS and World Bank data for LDCs. These results and an analysis on policies in 14 countries were written in 1981 and published in Ffrench-Davis (1984).

publicly guaranteed (see table VI.2).

Countries had three different reactions to the permissiveness of international financial markets during the 1970s.[7] 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 channelling 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 accepting all the funds supplied to them, even if they exceeded the volume of resources that 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 freely determine the volume of credit) were gaining ground. These countries were thus being pushed into increasing their foreign currency expenditures -expanding imports of consumer, intermediate and capital goods. They ended up generating increased current account deficits, as a result of appreciating exchange-rates and the resultant 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 growth 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 due to exchange revaluations (sometimes in parallel with intense import liberalization (see chapter IV)).

[7] See essays on Argentina, Brazil, Colombia, Chile and Mexico in Ffrench-Davis (1983); see also Wionczek (1985).

## 2. THE EMERGENCY IN THE EARLY 1980s

### a) Destabilizing adjustment before and after the crisis

In 1981, the current account deficit of the Latin American countries was equivalent to 6 per cent of GDP (and 44 per cent of their exports of goods), which was financed by the net inflow of financial capital. This was more than double the 1973 ratio and those typically registered through the 1960s. 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 uncertain, since bank loan agreements established that each installment would be subject to variable interest rates, payable at the market levels in force at the moment each payment was due.

For several years, the rise of bank debt resulted in an intense build-up of international reserves in LACs, creating a perception of abundance that exerted pressure to appreciate exchange-rates in most countries. Even in 1980, when the LIBOR interest rate had risen to 14 per cent, 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 financial transfer of US$16 to finance net imports or accumulate reserves. In parallel, exports increased around 8% per year, thus complementing the large foreign currency availability. Not until 1981 and in 1982 did these economic relations reverse themselves.

During the 1970s, a number of industrialized countries progressively relaxed their controls on domestic interest rates, capital flows and their national financial markets. Moreover, the unregulated Eurodollar market was flourishing. However, towards the end of the 1970s, reducing inflation was becoming more of a policy priority in the industrialized world. The international context rapidly took a turn 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.

In fact, by the late 1970s, nominal interest rates were adjusting to international inflation, in response to the more restrictive financial and macroeconomic policies adopted by industrialized nations. Between 1977 and 1980 nominal rates rose, but this was countervailed with increasing export prices. In 1981-82, the situation changed abruptly and worsened for debtors (see table VI.3). As a matter of fact, the nominal bank credit cost rose to 17%, the terms of trade deteriorated for debtor countries and the strong external inflation in force until 1980 came to an abrupt halt and became negative. As a result, real interest rates which had been negative on the second half of the 1970s, climbed spectacularly in 1981-82.

(Table VI.3)

An appropriate inflation indicator should be based on the prices at which international trade is conducted. The relevant trade price indices in the case of LACs show a remarkable decline in the 1981-82 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 fewer dollars), and to the fact that, by and large, debts were mostly expressed in US 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 1981-82: of the order of 20 per cent 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 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 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 interest payments 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 (with a recessive adjustment during that year) a large trade surplus (US$10 billion), but registered a US$34 billion deficit in net

payments of profits and interest. The problem was even further complicated by the private sector's increasingly negative expectations, which gave rise to substantial capital flight.[8]

Simultaneous with the accelerated increase in the demand for loans to refinance growing debt service, the banks themselves became progressively more alarmed by their credit exposure in the region. It is interesting to note that, already by 1977, the leading US banks established in Latin America restricted 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 other 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 US banks went down from 29 per cent in 1975-77 to 8 per cent in 1978, the rate of non-US banks went up from 30 per cent to 50 per cent. As a result, the average global expansion of bank credit remained practically unchanged, at nearly 30 per cent 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 spreads; however, this policy at the aggregate level only served to heighten the debtors' demand for refinancing and increase the stress in the system.

Considering only liabilities with the official sectors, the annual amortization coefficient in 1980 was of the order of 15 per cent of the outstanding debt. On the contrary, the coefficient for bank debt, which constituted a constantly rising share of the total, reached 40 per cent, 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 (Ffrench-Davis, 1982; Fishlow, 1983; Williamson, 1983);

[8] There is no conventional definition of what constitutes capital flight. For further discussion on this issue, as well as different measurements of capital flight, see Lessard and Williamson (1987).

and then both the use the countries had made of the credits, the outstanding debt stock, and the current account deficit, 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 1970s, the nine leading US banks registered a loan/capital coefficient of 180 per cent in 1982 with LACs: 50 per cent in Mexico, 46 per cent in Brazil, 26 per cent in Venezuela, 21 per cent in Argentina, 12 per cent in Chile, with the balance distributed among the other countries of the region. In response to the countries' payments problems and the banks' dangerous overexposure, the net annual flow of bank credit fell abruptly during 1982. Here it is useful to point out the contrast with the net flow during the situation which had immediately preceded this one. The outstanding bank debt grew around 10 per cent in 1982, while the interest rate was of the order of 16 per cent. In other words, for every US$100 of debt, they had to take US$6 from other sources, resulting in severely negative NFTs. Such transfers were covered by dipping into international reserves, which rapidly fell in Latin America (by 40 per cent between 1980 and 1982); and by drastically reducing imports (42 per cent in 1981-83). 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 individual country. Thus the hitherto latent possibility that various debtors would have problems rolling over their debt service became a reality, occurring on a wide scale in the second half of 1982.

In this latter context, the shortness of maturity structures emerged as a serious actual problem. In an international market that had abruptly tightened with respect to the easy financing environment of earlier years, having to renew 40 per cent of the debt from year to year was a very difficult proposition. Coupled with this was the need for financing to cover increased interest payments, which quintupled between 1977 and 1981.

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.

b) 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 had already experienced periods of intense external indebtedness followed by massive defaults three times in the nineteenth century, and again in the 1920s/1930s (ECLAC, 1965).

In previous crises, the region's external financial problems had been resolved through the typical mechanisms of a competitive decentralized private market. Indeed, LACs bonds (the credit instrument used previously) were bought up by diverse 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 being overly willing to take advantage of the permissive situation, led to an accumulation of external liabilities that eventually created serious debt-servicing difficulties. Obviously, the general pattern closely parallels what happened in the crisis of the 1980s (Kindleberger, 1978; ECLAC, 1990; Eichengreen, 2003).

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 loans. 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 more creditworthy 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 (e.g., 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 1930s, of all the Latin American nations, only Argentina, the Dominican Republic and Haiti managed to avoid declaring a moratorium on debt service (Jorgensen and Sachs, 1988).

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 was disbursed in order to cover themselves for such an eventuality, had not always built up sufficient reserves to absorb the losses caused by defaults; therefore some creditors had serious problems and even went bankrupt. The insolvency 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.

## 3. MANAGEMENT OF THE CRISIS DURING THE 1980s

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 over-extension of the international financial system. But the similarities end there. The 1980s crisis is radically different from former ones, not in its general origin but rather in how it was faced.

Historically speaking, the 1980 crisis is unique because of the systematic 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 this crisis, some of the financial rescue mechanisms that governments typically used to deal with their systemic domestic financial problems 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 (ILLR) 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 (G7, led by the US), some of the larger lending banks, and multilateral financial organizations, especially the IMF. In effect, the ILLR helped coordinate hundreds of creditor banks in the negotiations with each debtor country, a process designed to oblige those countries to adjust their economies sharply downwards, thus avoiding a formal default which could have destabilized the international financial system. The strategy of the ILLR went through four very distinct phases, as presented below.

a) Phases in the management of the crisis

*i) First phase: August 1982-September 1985*

Official efforts were aimed at promoting a downward adjustment in the debtor country (through classic economic adjustment policies, more intensive in demand reducing policies rather than in switching policies), a restructuring of the external debt and the normal payment of interest. Several mechanisms were used to achieve these goals.

**- Unprecedented coordination among creditors**

Unlike anonymous bondholders during the 1930s, it was easy for commercial banks to coordinate themselves after the crisis surge, since they had granted a significant share of their loans (syndicated 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 (such as Jamaica, Peru and Turkey) during the 1970s, the banks had already set up a mechanism to coordinate their actions in cases of 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 1980s, the banks deployed the 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 providing guidance to its member banks and pressuring those banks that were reluctant to act collectively and follow the recommendations of the advisory committee (Devlin, 1989).

**- Adjustment in the debtor country**

At that time, the conventional wisdom in the creditor countries was that the debt crisis represented a short-term liquidity problem and not a problem of solvency (Cline, 1984). It was in this context that, through the advisory committee, creditors collectively insisted that the debtor country take drastic domestic adjustment measures to release foreign exchange quickly to service the debt. These measures, which will be analysed 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 that averaged US$25 billion in 1983-87. Thus, a large amount of foreign exchange was generated each year to service the debt.

**- Restructuring of debt service**

Even with a large trade surplus, the debtor countries could not pay their committed debt service in full, partly because it was inflated (i) by the tendency of banks to grant shorter repayment periods during the years immediately preceding the Mexican crisis of 1982, (ii) by the high level of international interest rates (a LIBOR rate plus intermediation costs of 17 per cent in 1981-82), (iii) by the international recession which limited the region's expansion of exports, and (iv) by the fact that, in opposition to the high external inflation of the 1970s, an external deflation which drastically increased the real cost of the debt service was registered. 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”) by creditor banks to finance part of the interest payments due to them. These new loans indeed constituted a novel approach to debt renegotiation since banks typically rejected new lending, but were forcefully pushed by the IMF to lend. The banks, in turn, usually pressured governments of debtor countries to assume responsibility for unguaranteed private-sector debt, which was an unprecedented demand.[9]

Three rounds of renegotiations were carried out during the first phase of official management (see table VI.4). With the explicit aim of protecting the debtor's image of credit-worthiness (and of course, avoiding losses for the banks), renegotiations were always carried out on regular commercial terms. The first two rounds were extraordinarily onerous for the debtors.

In the first round, the banks rescheduled US$50 billion of debt in 13 LACs. Moreover, under the agreement with the IMF to collectively expand credit by 7 per cent, the banks granted US$14 billion in involuntary loans to nine countries. Typical conditions for these exercises were short consolidation periods (only one or two years), spreads over LIBOR of more than 2-2.5 per cent, amortization periods of barely 6-8 years, and high up front cash commissions (1-1.5 per cent or more over the amount rescheduled or loaned). If a composite index of the “negotiated cost of credit” is calculated on the basis of these terms, one finds that for most LACs that price rose by between 100 and 250 per cent in comparison with its pre-crisis level (see table VI.4). This explains the paradox whereby Latin America became an important profit center for the banks in the midst of the region's worst economic crisis since the 1930s (ECLAC, 1988).

(Table VI.4)

Given the debtors' weak financial capacity and the tough and short-term character of the restructuring terms, some of the first countries to renegotiate needed to initiate a second round of these exercises almost immediately after the first one was over. The negotiated cost of credit was slightly lower than that of the first round.

[9] The pressure for the nationalization of the debt was arbitrary because the banks had already charged the private sector a risk premium for their loans, and did not compensate Latin American Governments for assuming the new burden.

The third round followed quickly, in 1984. At that time, US$113 billion of principal was rescheduled (including already restructured loans) in 11 countries, while involuntary loans of US$6 billion were granted to six countries. On this occasion, credit terms improved significantly: using the above-mentioned composite index, the negotiated cost of credit in this round was below the pre-crisis level (see table VI.4).

**- The active role of the official sector**

Government agencies and multilateral institutions were active throughout the crisis. The IMF 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 programme 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.

*ii) Second phase: September 1985-September 1987*

At this stage, it was evident that the crisis was lengthy. Consequently, in the annual meetings of the IMF and the World Bank, held in South Korea in September 1985, the US Secretary of the Treasury, James Baker, announced a new scheme for managing the problem of debtor countries. In recognition of the costly recessionary effects of the first phase, the labeled "Baker Plan" introduced a new approach to management, 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 LACs), new loans for US$29 billion over a three-year period: US$20 billion from banks (a net credit expansion of 2.5 per cent 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 World Bank, with its Structural Adjustment Loans Programmes (SALs), was the pioneer of the neoliberal reforms prevailing in Latin America in the 1990s.

The Baker Plan launched a fourth round of reschedulings, which began in mid-1986 with Mexico. This round restructured US$176 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: the consolidation period typically covered a period of six years; the spread over LIBOR dropped to 0.8-0.9 per cent; the amortization period was extended to 15-20 years, and no fees were charged.

*iii) Third phase: September 1987-March 1989*

During this period, the Baker Plan and the fourth round of reschedulings formally continued to operate. However, in 1987 the scheme changed enough to distinguish another phase, which we will call the 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, and debt-equity swaps. Thus creditors, for the first time, 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, 1988).

*iv) The fourth phase: since March 1989*

A new scheme arose in 1989, called the "Brady Plan", for the U.S. Secretary of the Treasury, Nicholas Brady. 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 the conversion of debt into discount bonds.

Brady also proposed changes in regulatory and tax regimes for banks, with a view to reducing obstacles to debt reduction (Griffith-Jones and Rodríguez, 1992). And finally, the Plan also implicitly allowed debt restructuring agreements to be 'de-linked' from IMF programs. Thus a country, on a case-by-case basis, could sign an adjustment programme 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 programme 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. By 1993, six debt-reduction agreements had been reached for Argentina, Costa Rica, Dominican Republic, Mexico, Venezuela and Uruguay. Those six agreements eliminated US$11 billion net from bank debt at a variable interest rate and converted another US$39 billion of liabilities into long-term bond obligations at a permanent or temporarily fixed interest rate of 5-7 per cent, depending on the country and the period considered. Subsequently, Brazil and Peru signed Brady agreements in 1995 and 1997, respectively.

Moreover, during this period, the Paris Club, which traditionally has been rather rigid in its treatment of debt problems, softened its approach somewhat. In 1990, 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 programme allowed for a reduction of up to 33 per cent of the value of renegotiable debt (normally, 12-18 months of payments falling due). In 1991, the Club introduced the Houston Terms for low- and medium-income countries. This Plan, which was applied to the Dominican Republic, Ecuador, El Salvador, Honduras, Jamaica, Panama and Peru, allowed 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 per cent of the value of debt eligible for restructuring. Up to 1993 this last scheme was applied to Bolivia, Guyana, Honduras and Nicaragua.

a) 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 10 years. The emergence of an international lender of last resort (ILLR) 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 social costs of a crisis. Indeed, it manages the problem taking public welfare into account, since the crisis and its solution have an impact that extends beyond the parties directly involved and thereby affect the economic and political system as a whole. As observed in the US bailouts of the municipality of New York, the large corporation Chrysler and the savings 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, and so on. But now large sacrifices were also demanded of the creditors in order to support the debtor's adjustment efforts, such as a partial

writedown of problematic loans, a reduction of the interest rate and sometimes an injection of new capital, which could even be guaranteed by the Government.

The ILLR, in contrast, in the LACs debt crisis initially took a unilateral approach: to prevent any costs losses to the 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, those Governments, and particularly the US one, had a decisive influence in defining and changing the framework for negotiations and were in frequent contact with the negotiating parties.[10] Governments were also incurring contingent liabilities by encouraging multilateral lenders to indirectly refinance interest payments to the private banks.

As will be explained in the next section, 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 did not exemplify the statesmanship of an enlightened ILLR, 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 acted in cartel-like fashion quite openly. 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. The introduction of the Baker Plan was another clearly improvised response to a growing wave of public

[10] One obvious example, recorded in the case of Mexico, involved direct intervention by the US Treasury and the President of the US Federal Reserve, during a dramatic weekend in August 1982 (Kraft, 1984).

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 prospect 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 form a 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 junctures 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. 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.

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 1983-84 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 1987-88 offered average discounts of 40-50 per cent off the face value of bank-debt paper (see table VI.5)[11]. Second, due in part to this phenomenon, the creditor 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 programme's capacity to coopt 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 and Devlin, 1994).

(Table VI.5)

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, Colombia, Mexico, Uruguay and Venezuela) 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 uprisings in Venezuela at the beginning of 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

[11] Analyses of the principal experiences of Latin America are found in Bouzas and Ffrench-Davis (1990); the case of Chile is also in Ffrench-Davis (2002, Chapter 7).

in passing on most of the cost of the crisis to LACs: this was summarized in “a lost decade” for development. The predominant concern of the policy-makers and operators was not a socially-efficient adjustment of the international system as a whole, but rather the salvation of the commercial banks and their 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 per cent. 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 per cent 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, 1989).

## 4. THE RECESSIONARY DOMESTIC ADJUSTMENT OF THE 1980s

As seen above, the abrupt fall in external financing was a primary cause of the low level of economic activity during the 1980s. Together with the deterioration of the terms of finance and 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 productive resources dropped correspondingly. As a result of the gap between actual and potential GDP, long-term financing shortage and uncertainty, capital formation declined noticeably throughout the whole region during the 1980s (see chapter III). In sum, the recession in the region meant underutilization of installed capacity. Labour, land and physical capital were less active than they had been in the preceding decade and the investment ratio diminished.

In order to quantify the adjustment made in the main macroeconomic variables, table VI.5 uses the biennium 1980-81 as a base. Those years marked the peak of per capita output, utilization of capacity and investment in most LACs. All variables are expressed as a percentage of per capita GDP in that biennium.

Between 1979 and 1980, all the indicators of the region as a whole showed improvement. In 1981, or slightly earlier, countries such as Argentina, Brazil, Costa Rica and Uruguay experienced difficulties in financing their balance of payments and underwent recessionary adjustments (deliberate or automatic), while other countries, such as Chile, Ecuador, Mexico and Peru, 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 eight years of the 1983-90 period shows that the vigorous growth of Latin America had disappeared and investment was systematically reduced. The adjustment process was induced by external shocks, which are measured in items 7 and 8. There the averages for both periods, 1980-81 and 1983-90, can be compared.

(Table VI.6)

A strong reduction of aggregate demand and economic activity took place in the domestic sphere. A conservative estimate of the 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 the road taken by adjustment, aggravated by abrupt and massive worsening of financial transfers 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. [12] Nevertheless, actual per capita output in 1983-90 averaged 6 per cent less than that of 1980-81. This produced an "output-reduction effect", lead by the binding external restriction, that imposed

[12] The creation of new productive capacity (or potential GDP growth) was reduced from an annual average of about 5 per cent in the 1970s to 2 per cent in the 1980s. See chapter III.

policies that placed excessive constraints on demand and that made use of weak switching-policies.

Item 3 of table VI.6 shows that per capita consumption dropped sharply, but the biggest impact was on capital formation. During this adjustment process, capital goods imports fell to substantially below their pre-crisis levels. Per capita capital formation was reduced by one-third between 1980-81 and 1983-90, with a resultant negative effect on the expansion of productive capacity and employment generation. The decline between both periods was not connected with lower domestic saving (item 5). It was the external shocks (despite higher total domestic saving),[13] which reduced available financing for gross capital formation.

The private sector, and especially the public sector (which became the main 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. Coupled with that was the deterioration in the terms of trade in the 1980s, which also reduced available investment funds.

Trade and financial shocks are shown in items 7 and 8. Capital inflows were reduced to one-quarter of what they had been in the base biennium, while payments of interest and profits grew by a third. The deterioration of the net transfer of funds of 5 percentage points of GPD that converted the region into a “capital exporter”, explains close to 60 per cent of the decline in available resources caused by external shocks (8 percentage points) in 1983-90, in comparison with 1980-81. That item describes the magnitude of the external financial shock and its long duration. The remaining 40 per cent was the result of a marked deterioration of the terms of trade (the commercial shock of 3.2 per cent, measured by the difference between 1983-90 and 1980-81 in item 7, as a share of per capita GDP).

[13] Per capita domestic saving fell between 1982 and 1984, and subsequently recovered, while the total level of domestic saving rose. As a percentage of GDP, domestic saving rose from 23 per cent to 24 per cent between these periods.

The combination of these negative external shocks meant a significantly lower level of domestic expenditure, which in turn, in a vicious circle, led to a decline in output. As table VI.6 shows, per capita output (item 1) declined by 6 per cent between the two periods and domestic expenditure (item 2) dropped by 14 per cent. Both coefficients, moreover, point to a clear departure from trends recorded during the 1970s: annual growth in output (5.6 per cent), consumption (6.1 per cent) and investment (7.3 per cent), compared to an annual population growth rate of 2.7 per cent during that decade.

Also, during the 1980s, the State had to finance most (more than 70 per cent) 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, such as Mexico, Venezuela and Chile, could make the transfer more easily than other governments which 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 such as Argentina, Brazil, Peru and Uruguay.

In sum, both the recessionary domestic environment 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 national capital. The across-the-board repression of effective demand led to a substantial underutilization of installed capacity, which in turn naturally depressed investment even further as well as contributing to worsening income distribution, unemployment and skill loss. The continuous outward transfer of funds was an additional significant constraint on the investment capacity of debtor nations.

Given this devastating external and domestic framework, the debtor countries found it difficult to design a development strategy consistent with the need for domestic structural adjustment and the constraints imposed by the world economy. The predominance of short-term financial requirements led to the installation of a long-lived “financieristic” approach, at the expense of “productivism”. This situation led to a weakening of self-identity and the ability to design national development programmes and achieve consensus on them; it also diminished the

capacity of the governments of the debtor countries to think, freely and pragmatically about the future.

## 5. CONCLUDING REMARKS

Although the official strategy for dealing with the debt problem changed greatly over a decade, its dominant characteristic was the sharp asymmetry generated in adjustment processes. This is reflected in the contrast between the gradual adjustment of international banks during the 1980s and the abrupt and drastic adjustment of LACs. In this context, the emergence of the Brady Plan was conceptually a 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; 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 overindebtedness. By 1992, after a decade of great controversy, the debt problem was a secondary issue, since most countries experienced a remarkable recovery of capital flows and a turnaround in the net transfer of resources (see chapter VII).

The main factor behind this change was the sharp drop in international interest rates and consolidation of domestic adjustment efforts (Calvo, Leiderman and Reinhart, 1993). The lower interest rates was a key factor in reducing the debt burden and have allowed countries to regularize their interest payments. The lower international interest rates, in conjunction with domestic adjustment policies, also greatly increased the differential yields with Latin America, inducing both capital repatriation and foreign portfolio and direct investment. However, the capital inflow reached countries that had regularized their debt service through the Brady Plan as well as those such as Brazil and Peru that had not. The change in the international capital markets was the leading factor in most LACs to pursue expansive macroeconomic policies.

Even though the debt crisis faded into the background, the underlying situation in the region remained delicate. The new capital flows are not only heavily weighted by easily reversible securities and short-term deposits (commercial bank medium-term loans, in general, remained dry), but also became a source of macroeconomic disequilibrium through their depressing effects on exchange-rates and national savings. If another foreign exchange crisis is to be avoided, countries should manage capital flows pragmatically and regulate domestic financial markets in ways that are consistent with macroeconomic equilibrium, international competitiveness and increased domestic savings and investment performances (ECLAC, 1998, chapters 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. A prudential stance on accumulation of foreign liabilities may have short-term costs, but there are significant 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 the financial market is one of the most imperfect and pro-cyclical.

The asymmetric adjustment process of the 1980s should certainly warn Latin American countries of the dangers of delegating decisions on the volume and composition of external capital entirely to financial markets. Pragmatic authorities can constructively temper the casino instincts of financial market players, and provide incentives for the channeling of finance into productive investment.

Finally, there remains as pending, restarting the international discussion of reform of the architecture of the international financial system in a rational world with predominance of common good. In particular, issues such as more financial and supervisory power for counter-cyclical and compensatory action to official financial institutions, such as the BIS and the IMF, correction of the recessive-cum-regressive biases in conditionality and asymmetric adjustment, new issues of SDRs, and so on, all remain relevant objectives for more efficient and socially equitable economic globalization.

***Table VI.1*** **LATIN AMERICA: TOTAL DISBURSED OUTSTANDING DEBT, 1976-94**[a]
(Year-end balance in US$ billions)

| | 1976 | 1978 | 1980 | 1981 | 1982 | 1986 | 1990 | 1994 |
|---|---|---|---|---|---|---|---|---|
| Latin America (19) | 97.3 | 158.8 | 218.7 | 272.7 | 316.3 | 391.4 | 442.7 | 553.1 |
| | | | | | | | | |
| Argentina | 9.3 | 13.3 | 27.2 | 35.7 | 43.6 | 51.4 | 62.2 | 85.7 |
| Brazil | 33.3 | 54.6 | 64.0 | 71.9 | 83.2 | 111.0 | 123.4 | 153.6 |
| Chile | 5.6 | 7.4 | 11.2 | 15.6 | 17.2 | 20.8 | 18.6 | 21.8 |
| Colombia | 3.9 | 5.1 | 6.8 | 8.5 | 10.3 | 16.1 | 18.0 | 21.9 |
| Costa Rica | 1.0 | 1.7 | 1.8 | 2.3 | 3.0 | 3.5 | 3.2 | 3.3 |
| Dominican Republic | 0.8 | 1.3 | 2.2 | 2.5 | 3.0 | 3.8 | 4.5 | 3.9 |
| Mexico | 24.0 | 35.7 | 50.7 | 74.9 | 90.1 | 103.5 | 106.7 | 139.8 |
| Peru | 7.6 | 9.7 | 9.6 | 9.6 | 11.5 | 14.5 | 22.9 | 30.2 |
| Uruguay [b] | 0.7 | 0.8 | 1.1 | 1.3 | 1.7 | 2.9 | 4.5 | 5.0 |
| Venezuela | 4.9 | 16.6 | 27.0 | 29.2 | 29.2 | 30.8 | 35.5 | 41.0 |

*Source:* ECLAC, on the basis of official data.
[a] Includes debt to the IMF.
[b] Public external debt.

***Table VI.2*** **FOREIGN DEBT OF LATIN AMERICA AND ALL LDCs, 1973-82**
(US$ billions)

| | 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 in Ffrench-Davis (1984), based on data of the World Bank and the Bank for International Settlements (BIS). Latin America excludes Cuba and Panamá; LDCs exclude oil-exporters with a current account surplus (Saudi Arabia, Kuwait, etc.). ECLAC's figures (see table VI.1), subsequent to those appearing in this table, have an even larger coverage.

***Table VI.3*** **INTERNATIONAL REAL INTEREST RATES, WITH ALTERNATIVE DEFLATORS, 1977-85**

*(annual %)*

| | Nominal rate | Inflation in industrialized countries | External inflation confronted by developing countries | Real rates Deflated: by (2) | Real rates Deflated: by (3) |
|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) |
| 1977-78 | 8,4 | 7,6 | 10,1 | 0,7 | -1,5 |
| 1979-80 | 13,9 | 8,7 | 14,3 | 4,8 | -0,4 |
| 1981 | 17,4 | 8,8 | -2,3 | 7,9 | 20,2 |
| 1982 | 17,1 | 7,3 | -5,6 | 9,1 | 24,0 |
| 1983 | 12,7 | 4,9 | -4,5 | 7,4 | 18,0 |
| 1984 | 13,0 | 4,3 | 0,4 | 8,3 | 12,5 |
| 1985 | 10,7 | 3,9 | -3,0 | 6,5 | 14,1 |

*Sources*: OECD (1984) for column (1); IMF (1986) for column (2), which is the industrialized countries GNP deflator, and for column (3) which indicates the unit prices index for exports in non-oil-producing developing countries.

***Table VI.4*** **LATIN AMERICA: EVOLUTION OF THE TERMS OF DEBT WITH PRIVATE BANKS**[a]

(1980/81 = 100)

| | First round | Second round | Third round | Fouth round |
|---|---|---|---|---|
| Argentina | 319 | | 114 | 40 |
| Brazil | 144 | 107 | 43 | |
| Costa Rica | 151 | | 82 | |
| Cuba | 148 | 93 | 65 | |
| Chile | 250 | 151 | 89 | 50 |
| Dominican Rep. | 235 | | 61 | |
| Ecuador | 335 | | 107 | |
| Honduras | 152 | | 65 | |
| Mexico | 280 | 160 | 84 | 44 |
| Panama | 274 | | 79 | |
| Peru | 197 | 134 | | |
| Uruguay | 349 | | 98 | 44 |
| Venezuela | | | 68 | 47 |

*Source*: Devlin (1989).

[a] The index comprises the fee, the maturity term and the spread over LIBOR; the comparison is made with those prevailing immediately before the crisis.

### *Table VI.5* LATIN AMERICA AND THE CARIBBEAN: PRICES OF EXTERNAL DEBT PAPERS ON THE SECONDARY MARKET, 1988-93

(percentages of face value)

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993[a] |
|---|---|---|---|---|---|---|
| Argentina | 26 | 15 | 15 | 27 | 45 | 54 |
| Bolivia | 11 | 11 | ... | ... | 14 | 16 |
| Brazil | 46 | 30 | 25 | 29 | 32 | 38 |
| Colombia | 62 | 59 | 62 | 73 | 75 | 78 |
| Costa Rica | 13 | 15 | 29 | 43 | 56 | 69 |
| Chile | 59 | 60 | 67 | 84 | 90 | 92 |
| Dominican Republic | 22 | 19 | … | … | 22 | 43 |
| Ecuador | 25 | 13 | 17 | 21 | 28 | 38 |
| Honduras | 22 | 20 | ... | ... | 29 | 32 |
| Jamaica | 37 | 40 | 28 | ... | 72 | 74 |
| Mexico | 48 | 39 | 43 | 53 | 64 | 73 |
| Nicaragua | 3 | 1 | ... | ... | 7 | 9 |
| Panama | 28 | 14 | 15 | 15 | 28 | 39 |
| Peru | 6 | 5 | 5 | 7 | 16 | 40 |
| Uruguay | 60 | 56 | 51 | ... | 72 | 74 |
| Venezuela | 50 | 36 | 44 | 60 | 62 | 66 |
| Average[b] | 43 | 32 | 33 | 41 | 49 | 55 |

*Source*: ECLAC, on the basis of offer prices compiled by Salomon Brothers, High Yield Department.
[a] Average of January, June and December. [b] Weighted by bank debt.

## *Table VI.6* PER CAPITA PRODUCTION, CONSUMPTION, INVESTMENT, AND EXTERNAL SHOCKS IN LATIN AMERICA, 1976-90

(Percentages of per capita average GDP in 1980-81)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | Average 1976-79 | Average 1980-81 | Average 1983-90 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. GDP | 101,0 | 99,0 | 95,8 | 91,7 | 92,8 | 93,3 | 95,1 | 96,3 | 95,2 | 94,2 | 92,7 | 93,3 | 100,0 | 93,9 |
| 2. Domestic absorption | 102,7 | 100,1 | 93,7 | 85,7 | 86,2 | 86,7 | 89,5 | 90,2 | 88,8 | 87,1 | 85,7 | 93,5 | 101,4 | 87,5 |
| 3. Consumption | 77,8 | 76,4 | 74,2 | 70,7 | 71,2 | 70,6 | 73,5 | 73,5 | 72,2 | 71,9 | 71,1 | 71,3 | 77,1 | 71,8 |
| 4. Gross capital formation | 24,9 | 23,7 | 19,6 | 15,0 | 15,0 | 16,1 | 16,0 | 16,7 | 16,6 | 15,2 | 14,5 | 22,2 | 24,3 | 15,6 |
| 5. Domestic savings[a] | 23,2 | 22,6 | 21,6 | 21,0 | 21,6 | 22,7 | 21,6 | 22,8 | 23,0 | 22,3 | 21,5 | 22,0 | 22,9 | 22,1 |
| 6. Non-financial current account[b] | -1,7 | -1,1 | 2,0 | 6,0 | 6,6 | 6,6 | 5,6 | 6,1 | 6,5 | 7,1 | 7,0 | -0,2 | -1,4 | 6,4 |
| a) Exports of goods and services | 14,2 | 14,9 | 14,8 | 15,6 | 16,6 | 16,4 | 16,0 | 16,9 | 18,0 | 18,6 | 19,2 | 13,3 | 14,5 | 17,1 |
| b) Imports of goods and services | -15,9 | -16,0 | -12,7 | -9,6 | -10,0 | -9,8 | -10,4 | -10,8 | -11,5 | -11,5 | -12,2 | -13,5 | -16,0 | -10,7 |
| 7. Terms of trade effect | 0,0 | -0,8 | -2,3 | -2,5 | -2,1 | -2,8 | -3,9 | -4,0 | -4,2 | -4,4 | -4,6 | -1,0 | -0,4 | -3,6 |
| 8. Net transfer of | | | | | | | | | | | | | | -3,2 |
| funds (c-d) | 1,6 | 1,8 | 0,1 | -3,8 | -4,7 | -4,1 | -2,0 | -2,5 | -2,7 | -3,1 | -3,0 | 1,1 | 1,7 | 1,1 |
| a) Capital movements[b] | 4,3 | 5,0 | 2,4 | 0,2 | 1,3 | 0,4 | 1,2 | 1,8 | 0,6 | 1,3 | 1,8 | 4,6 | 4,7 | |
| b) Net profit and interest | -2,6 | -3,6 | -4,8 | -4,5 | -4,8 | -4,5 | -4,3 | -3,8 | -3,9 | -4,0 | -3,4 | -2,0 | -3,1 | -4,2 |
| c) Subtotal | 1,7 | 1,4 | -2,4 | -4,3 | -3,6 | -4,2 | -3,1 | -2,0 | -3,4 | -2,7 | -1,6 | 2,6 | 1,6 | -3,1 |
| d) Change in international reserves | 0,2 | -0,4 | -2,5 | -0,5 | 1,2 | -0,1 | -1,0 | 0,6 | -0,7 | 0,4 | 1,4 | 1,5 | -0,1 | 0,1 |

*Source*: Author's calculations, on the basis of official data for 19 countries, processed by ECLAC. All figures expressed in 1980 US$ were deflated by population. The per capita GDP of 1980-81 is used as base 100. Then, all figures are measured as perce3ntages of that base.

[a] Calculated as the difference between GDP and consumption. [b] Public and private unrequited transfers are included in capital movements.