

University of London
Institute of Latin American Studies
Occasional Papers No. 1

LIFE AFTER DEBT:
THE NEW ECONOMIC
TRAJECTORY IN LATIN AMERICA

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The Institute of Latin American Studies publishes as Occasional Papers selected seminar and conference papers and public lectures delivered at the Institute or by scholars associated with the work of the Institute. Occasional Paper No. 1 is the inaugural lecture by Victor Bulmer-Thomas, delivered at Queen Mary and Westfield College, London, on 5 March 1992.

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Occasional Papers, New Series 1992-
ISSN 0953 6825

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University of London 1992

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The last ten years in Latin America have been dominated by the debt crisis, which has forced the region – traditionally a net recipient of foreign resources – to transfer to the rest of the world some \$220 billion.¹ Despite the widely-held view that the twenty republics in the region could only be saved by wholesale debt forgiveness, the economic and social upheavals associated with this change have been absorbed with remarkable success by political systems which are now guided in virtually all cases by civilian governments subject to periodic elections. The myth that only authoritarian regimes can carry out tough economic and social policies has now been well and truly laid to rest.

The debt crisis of the last ten years has been portrayed as an exceptional event requiring an exceptional international response. Yet it is in fact only the last in a long series which have plagued Latin America since independence. Indeed, major debt crises have recurred at approximately 50-year intervals – 1820s, 1870s, 1930s and 1980s – which has led some scholars to argue that debt is one of the phenomena subject to the 50-year long waves first studied by Kondratief.² Like most Kondratief waves, this one is hard to justify on theoretical grounds, but if any of my grandchildren go into banking I shall certainly take out insurance by recommending some serious reading of economic history as the year 2030 approaches.

The exit from each debt crisis in Latin America has been marked by the transition to a new economic trajectory. The first, in the 1820s, was associated with the wholesale adoption of export-led growth based on primary products destined for the new markets of the North Atlantic. The second, in the 1870s, was linked to the rise of modern manufacturing as the larger republics attempted to link export-led growth based on primary products with industrialisation geared to the home market. The third, in the 1930s, was marked by the adoption of aggressive import substitution policies as republics began to delink from the world economy. Today, in the 1990s, a new trajectory is taking shape which has been moulded by the response to the debt crisis of the last decade and which marks a significant break with the past.

If the debt crisis is passing, that does not mean that debt has ceased to be a problem. Some republics, notably Argentina and Brazil, are currently involved in major negotiations with their creditors to reduce the debt burden. Even those republics, such as Chile, which have reduced the nominal value of the external public debt, must still exercise prudence in debt management techniques. Yet the situation today is qualitatively different from five years ago when the private creditors had still not formally acknowledged the difference between the

market and par value of the debt. Today it is clear that – as in all previous debt crises – the private, and in some cases even the public, creditors have accepted that the debt will not be repaid in full. Although many republics still have to establish the precise terms for repayment, sufficient precedents have been set to avoid the need for a punitive final agreement. The debt *crisis* of the 1980s has given way to the debt *problem* of the 1990s.

The threat of default by the Mexican government in August 1982 on its external public debt was the trigger which finally unleashed the most recent debt crisis. The flow of new bank lending to Latin America ground to a halt and the net transfer of resources suddenly turned negative.³ Even countries, such as Colombia, which had been prudent in accumulating foreign debt obligations were affected as private financial institutions in the developed countries reversed their previously optimistic forecasts about the region.

This decline in bank lending has set in motion a chain of events which is leading to a new growth model based on exports. The transition to a new trajectory is not painless and is still incomplete even in those countries prepared to carry out the most far-reaching programme of reforms. Yet countries face few alternatives, for the logic of the situation has demanded a response from governments right across the political spectrum. The old growth model, based on a central role for the state in the process of capital accumulation, has been attacked on one side by the decline in capital flows to state-owned enterprises and on the other by the emerging consensus in favour of neoliberal economics and a smaller state.

The new export-led growth model is emerging in part as a pragmatic response to the series of adjustment and stabilisation programmes adopted in each republic in the 1980s. Forced by the negative transfer of resources to accumulate trade surpluses, Latin American republics are finally giving higher priority to the question of export promotion which has been on the agenda in many republics since the 1960s. Unable to finance deficits with funds borrowed from abroad, governments have also begun to address the problems of fiscal reform, inefficient state-owned enterprises and indiscriminate subsidies.

The new growth model, however, is also a reflection of the unprecedented agreement found among International Financial Institutions, academics and governments in the developed countries in favour of free markets, trade and financial liberalisation and privatisation of public enterprises. This orthodoxy, despite its sometimes fragile theoretical and empirical underpinnings,⁴ has overwhelmed the remaining Latin American voices in favour of inward-looking policies and an interventionist state. Governments ostensibly committed to shrinking the boundaries of the state have come to power throughout the region while the intellectual climate in Latin America has turned sharply in favour of free market economics. Research institutes and universities committed to the

new orthodoxy are flourishing, while traditional centres favouring even a reformed version of the old model are steadily eclipsed. It is only in the area of hyperinflation, a phenomenon far removed from the experience of the developed countries, and in stabilisation programmes to fight it that an original Latin American voice can still be heard.⁵

Nowhere has the change in attitude been more apparent than in relations with the United States. Although the US invasion of Panama in December 1989 was widely condemned, the points of friction between Latin America and the United States have been steadily eroded. As the Cold War ended and the socialist experiment in Eastern Europe and the Soviet Union collapsed, Cuba became more isolated and traditional US security concerns less pronounced. Drugs replaced communism in the foreign policy priorities of the US administration and drug control programmes necessitate a high degree of cooperation between the United States and many Latin American republics. US multinationals, once widely condemned for their monopolistic practices, are now courted for their investment and technological potential. The election of governments with a strong ideological preference for the private sector in many parts of Latin America has delighted Washington and the defeat of left-wing parties in free elections has eased the traditional dilemma faced by the United States in choosing between security and democracy.⁶

Trade liberalisation has also brought North and South America closer together. Driven by the imperative of seeking markets for their new non-traditional exports, many Latin American republics fear the arbitrary nature of a world trading system in which protectionist voices remain powerful. As difficulties surfaced in the Uruguay Round of GATT negotiations, Mexico responded by asking for a Free Trade Agreement with her northern neighbour to secure guaranteed access for her exports and closer integration into the US economic system. President Bush, more sensitive than his predecessor Ronald Reagan to Latin American priorities, has responded positively and both countries have emphasised the possibility of drawing other Latin American republics into the network of Free Trade Agreements.

By the beginning of the 1990s the pessimism previously expressed throughout the world at Latin America's economic prospects had been replaced by optimism. Some international bankers and government officials in developed countries are lavishing praise on a region which only a few years before they had denounced for its incompetence and corruption. Last year, for the first time since 1981, the net transfer of resources to the region was positive.⁷ This change was achieved not so much through a reduction in debt service payments as through an increase in new capital inflows. Thus, despite all the publicity, Latin America's exit from the debt crisis appears to owe less to the enormous effort invested in debt reduction schemes (such as the Brady Plan⁸) and more

to the willingness of foreign capital once again to chance its arm in a region whose record of prompt servicing of its debts has been less than exemplary.

The turnaround has been remarkable. As recently as 1988, net capital inflows to Latin America were a mere \$5 billion – easily dwarfed by net payments of profits and interest of \$34 billion. By 1990, the net inflow of capital had jumped to \$18 billion while in 1991 it reached an estimated \$36 billion. Some republics (notably Mexico) have been much more favoured than others, but few have missed out altogether.⁹

The new capital arriving in Latin America is qualitatively different from the past. Unlike the commercial bank loans which sustained growth in the region in the 1970s, the new capital consists of bonds issued by blue-chip companies, investment by multinational companies, portfolio capital destined for emerging stock markets and – most important of all – the repatriation of flight capital. Driving all these flows is the gap in real interest rates and real rates of return on capital between Latin America and the developed countries – a gap which is no longer wiped out by the risk premium associated with the region.

To understand these changes we need to go back a decade. The arrival of the debt crisis in 1982 marked the end of the massive inflow of capital – primarily from international banks – to Latin America. Within a short space of time a trade deficit funded by borrowing from abroad had to be converted into a trade surplus to permit repayment of interest on past loans.

In the short-run, such a transformation – equivalent to five per cent of the region's Gross Domestic Product – could only be achieved by cutting imports. In the first three years after 1981, the value of imports was cut by 40 per cent bringing with it a sharp fall in income per head and in living standards.¹⁰

Import suppression was effective, but it was a short-term strategy with high costs. As inflation began to accelerate and real incomes continued to fall, it became clear that import suppression could not be used as a long-term response to a debt crisis which showed no signs of abating. By the middle of the 1980s, an important policy change was taking place in a number of republics in favour of trade liberalisation and export promotion in order to meet the demands both of debt servicing and renewed growth. As the decade came to a close, more and more republics had opted for the new outward-looking strategy. By the beginning of the 1990s a new trade orthodoxy had swept across Latin America.

Several factors contributed to the emergence of this new orthodoxy. It was argued that the debt crisis was more than a short-run liquidity problem, that the commercial banks were not going to continue to lend to Latin America at the same rate as before and that the region was going to have to compete in the international market place for scarce funds with other countries. Even those

Latin American countries which were successful in attracting foreign investment (direct and portfolio) could not at first expect to avoid a negative transfer of resources and this was more likely to be combined with the renewal of growth in a strategy which emphasised export promotion rather than import suppression.

The emphasis on the need for export promotion was shared by the official creditors, including the International Financial Agencies. The World Bank and the IMF in particular, together with the Inter-American Development Bank, used the leverage provided by conditionality to push the debtor countries in the direction of trade liberalisation. An over-simplistic contrast was drawn between export-led growth in East Asia and inward-looking development in Latin America from which the international agencies extracted the conclusion that the Asian model needed to be transplanted wholesale to American soil – an heroic, if unsuccessful, attempt to prove that Columbus was in fact correct when 500 years ago he confused the West for the East Indies. This pressure was not sufficient on its own to persuade countries to move towards export-led growth, but it did contribute to the momentum in favour of trade liberalisation in those countries where an internal consensus in support of policy reform was emerging.

Microeconomic considerations were also important in explaining the policy shift. Few, if any, policymakers favoured export-led growth on the basis of traditional exports. Priority was to be given to new non-traditional exports, including manufactured goods, where Latin America was at a disadvantage because of the high cost of many commodity inputs caused by import suppression and other trade distortions. Trade liberalisation was expected to bring the cost of material inputs closer into line with international costs, allowing local firms to exploit the long-run dynamic comparative advantage provided by the abundance of unskilled labour and natural resources.

The first group of countries to embark on a wholesale strategy of trade liberalisation included Bolivia, Chile, Costa Rica, the Dominican Republic, Ecuador and Mexico. As early as 1984, the neoliberal governments in Chile and Ecuador had begun the process of tariff reductions, quota eliminations and export duty cuts. In mid-1985, as part of its anti-inflation stabilisation programme, Bolivia began its move to a single uniform tariff of ten per cent with zero dispersion. In the same year, Mexico accelerated the long process of dismantling its elaborate quota system and lowering tariffs.¹¹

The new trade policies were subsequently adopted in almost all the Latin American republics. Both Brazil and Colombia, which had been combining export promotion with import substitution since the late 1960s, moved towards more orthodox policies of trade liberalisation at the end of the 1980s. Argentina, despite continuing problems of inflation stabilisation, followed suit

at the beginning of the 1990s. In a reversal of his policies in the 1970s, President Carlos Andrés Pérez began to open up the Venezuelan economy after 1989. Only Cuba, abandoned by its former Eastern European allies, refused to bring domestic and international prices closer together despite its efforts to promote non-traditional exports.¹²

The new trade policies had implications which went far beyond the boundaries of each republic. The promotion of non-traditional exports rendered countries vulnerable to discrimination through countervailing duties, non-tariff barriers and 'voluntary' export restraints. Safeguards were therefore sought. Those republics which had not yet joined GATT applied to do so and the licensing systems for imports in Mexico and Venezuela were almost entirely abolished to facilitate membership. In response to the Free Trade Agreement between Canada and the USA agreed at the end of the 1980s, Mexico pressed for a North American Free Trade Agreement. In 1989 Haiti and the Dominican Republic joined the Lomé Convention – the only Latin American republics to be allowed to do so – in an effort to promote export-led growth.

These initiatives were also extended to intra-regional trade. A bilateral agreement in favour of closer economic integration between Brazil and Argentina evolved in 1991 into MERCOSUR – a four-nation integration scheme committed to free trade and a common external tariff by 1995. New life was breathed into the Andean Pact and the Central American Common Market. The proposed North American Free Trade Agreement was seen as a model by other Latin American republics, notably Chile, and bilateral agreements in favour of free or freer trade were reached throughout the region. Unlike the earlier attempts at integration, the new schemes were seen as complementary to the emphasis on extra-regional export promotion.

By 1992, a decade after the debt crisis first struck, the new policies were bearing fruit. The volume of exports had risen steadily and by 1991 was 78 per cent higher than in 1980. The performances of Chile, Colombia and Mexico were particularly impressive. The increase in the volume of exports was sufficiently strong to raise the value of exports sharply after 1987 – despite the continuing weakness of some commodity prices. The regional ratio of exports to GDP at constant prices – a useful indicator of trade policy – rose from eleven per cent in 1980 to seventeen per cent in 1990 with the ratio almost doubling in Argentina and Brazil.¹³ Trade liberalisation made possible fast growth of imports, but export expansion prevented a major erosion of the regional trade surplus which still exceeded \$10 billion in 1991.¹⁴

The new trade policies won applause from export interests and creditor countries, grudging approval from most business groups and acceptance by many intellectuals. Protests by groups whose interests were damaged were surprisingly limited. Yet many problems remained. By the beginning of the

1990s Latin America's share of world exports was still less than four per cent – less than half its share of world population.¹⁵ Several smaller countries, as a result of their vulnerability to commodity price falls, had still not recovered the 1980 level of exports. The geographical concentration of exports increased further with the US share rising sharply in most republics at the expense of the European Community.¹⁶ While intra-regional trade began to increase, its share of total exports remained modest.

The composition of exports was also a source of concern. Much of the increase in the value of exports came from traditional exports (for example, Chilean copper) or non-traditional natural resources (for example, Colombian coal). The region's exports remained heavily dependent on primary products which made earnings – despite the reforms expected under the GATT Uruguay Round – very vulnerable to external shocks. In the crucial area of manufactured exports, only a few countries made real progress. The sharp increase in the importance of metal manufactures in exports was almost entirely due to Brazil and Mexico. Many goods classified as manufactured were little more than 'screw-driver' industries consisting of products assembled in Export Processing Zones. While much had undoubtedly been achieved in terms of external adjustment in the decade after the debt crisis, much remained to be done with export performance still lagging behind the record of some Asian countries.

The debt crisis, by reducing the flow of new capital to Latin America, obliged each republic to cut imports and, if possible, increase exports quickly. However, this external adjustment was mirrored by a process of internal adjustment which was designed to lower aggregate demand to a level consistent with the reduced level of imports and provide the price and other incentives for a shift of supply from the home to the world market.

The trade surplus provided the foreign exchange for the net transfer of resources to the creditors in the developed countries. The trade surplus in most countries, however, accrued to the private sector while the vast majority of the external debt was in the hands of the public sector. Thus, there was an internal transfer problem in which the public sector had to secure access to the foreign exchange earned by the private sector. Only in those republics, such as Chile, Mexico and Venezuela, with a high share of export earnings accruing to state-owned enterprises was the internal transfer of resources relatively straightforward.¹⁷

Internal adjustment was therefore a complicated process involving a reduction in home demand, a shift in supply and an internal transfer from the private to the public sector. Each element of adjustment ran the risk of aggravating inflationary pressures. If home demand fell too slowly, excess demand would emerge even in a recession as the cut in imports after 1981 had reduced aggregate supply quickly. The shift in supply from the home to the

world market implied a change in relative prices which was likely to cause an increase in absolute prices. Finally, the internal transfer of foreign exchange to the public sector would be highly inflationary if the government printed money to secure control of the resources rather than using tax revenue to generate a sufficient level of public savings.

The problem of internal adjustment was therefore inseparable from both external adjustment and inflation stabilisation. At the same time, most Latin American republics entered the debt crisis with serious problems of internal instability – including high levels of inflation. In 1981, the last year before the eruption of the debt crisis, only five republics enjoyed annual inflation rates of less than ten per cent and in each case the exchange rate was pegged in nominal terms to the US dollar.¹⁸ Elsewhere, eleven had annual inflation rates above 20 per cent, four above 50 per cent and one (Argentina) above 100 per cent.

Central government budget deficits had also begun to increase before the debt crisis and almost half the countries in 1981 had a deficit in excess of five per cent of GDP.¹⁹ Public sector deficits, which included the losses of state-owned enterprises together with the deficits of municipal and state administrations, were usually even larger than those of the central government. With domestic capital markets in many republics unwilling or unable to absorb large issues of government paper, the inflationary consequences of even modest budget deficits could be considerable.

The situation inherited at the time of the debt crisis was therefore far from satisfactory. Furthermore, many of the measures adopted in response to the debt crisis in support of external adjustment aggravated the problem of internal instability even further. The sharp real effective exchange rate devaluations, although they contributed significantly to the creation of a trade surplus, added to inflationary pressures. Almost all republics abandoned fixed nominal exchange rates and the two exceptions (Haiti and Panama) were the only countries to keep the rate of inflation regularly below 10 per cent. In the smaller republics, as inflation accelerated, the change in the black market or parallel exchange rate became the signal for price increases throughout the economy, making it necessary for the authorities to carry out larger and larger nominal devaluations to achieve a given real depreciation.

External adjustment led to a sharp cut in imports and domestic recession with severe implications for government revenue. Smaller republics, still dependent on import duties for a high share of government revenue, suffered particularly from the decline in imports. Although tariff rates were at first increased in several republics, this could not offset the impact of the sharp decline in the value and volume of imports. The recession drove many firms and workers from the formal to the informal sector, making it more difficult for the state to extract taxation from the production and distribution of goods and services. At

the same time, incentives to encourage a shift of supply from the home to the world market often implied a tax reduction for exporters. Not surprisingly, central government revenue as a proportion of GDP fell in most republics in the first years of the crisis.²⁰

Although cuts were made in public expenditure as a result of numerous stabilisation programmes, the difficulty of increasing revenue after the debt crisis meant that few, if any republics, were able to generate a primary surplus large enough to finance out of income the purchase of foreign exchange from the private sector for debt servicing. Furthermore, many countries operated a multiple exchange rate system in which the public sector was able to buy foreign exchange at a special rate which implied huge exchange rate losses for the central bank. These losses typically did not enter into the definition of the budget deficit so that the latter often gave a misleading impression of fiscal and monetary orthodoxy.²¹

Many countries simply printed money in order to purchase the foreign exchange needed for debt servicing. However, the largest republics (Argentina and Brazil in particular) were able to issue bonds or other financial instruments to the private sector as a means of carrying out the internal transfer. Although in theory this was non-inflationary, in practice it had serious inflationary consequences. First, the nominal and real domestic rate of interest had to rise sharply to persuade the private domestic sector to absorb government debt and this was reflected in a sharp rise in the unit costs of many firms; secondly, the debt itself was highly liquid (particularly in Brazil) so that it was virtually quasi-money; thirdly, the internal debt rose so rapidly that nominal interest payments began to absorb a growing proportion of government revenue, thus undermining the public sector financial balance. Both Argentina and Brazil eventually declared a partial default on their internal debt, destroying temporarily private sector confidence in the domestic capital market and raising the cost of future borrowing for the government.²²

With the emergence of a secondary market in Latin American debt after 1982, the public and private sectors looked for ways of taking advantage of the steep discounts often available. Legislation was introduced in a number of countries permitting both debt-conversion and debt-equity swaps – the former leading to the replacement of external with internal debt and the latter leading to the replacement of external debt with equity.²³ Although both techniques could lower the face value of the public external debt (substantially in the Chilean case), they were not without inflationary risks. Both Brazil and Mexico suspended their debt-equity schemes temporarily when it became clear that the issue of domestic currency for the face value of the discounted debt was having serious repercussions on the growth of the money supply. These fears were aggravated in the case of foreign holders of discounted debt by the widespread belief that debt-equity swaps were subsidising foreign investment without

adding much to the total flow. Indeed, direct foreign investment in Latin America remained stubbornly low in most countries throughout the 1980s despite the subsidy implied by secondary market conversions.²⁴

By the middle of the 1980s inflation was substantially higher than it had been before the debt crisis in almost all republics. As inflation accelerated, it became clear that the budget deficit and the rate of inflation were interdependent. Although the orthodox claim that budget deficits would lead to inflation could not be denied, it was also true that the acceleration of inflation caused a widening of the budget deficit – at least when expressed in nominal terms.

In a few republics, the failure to adopt appropriate stabilisation and adjustment programmes in response to the debt crisis led to hyperinflation – usually defined as a monthly rate of inflation in excess of 50 per cent. By the end of 1984, Bolivia was covering only two per cent of government expenditure with tax revenue and the rate of inflation in 1985 exceeded 8,000 per cent.²⁵ Even this extraordinary figure was surpassed by Nicaragua in 1988 when defence expenditure was given overriding priority and the process of printing money pushed inflation over 33,000 per cent (the highest ever recorded in Latin America). The last years of the García administration in Peru were marred by a similar story with a flight from domestic currency and huge fiscal deficits pushing inflation above 7,000 per cent in 1990. Both Argentina²⁶ and Brazil – the true size of their fiscal deficits concealed by creative accounting at all levels of government – slid into hyperinflation at various points with administrations in both republics in the 1980s unwilling to make the fight against inflation their highest priority.

Internal adjustment required the adoption of stabilisation programmes throughout Latin America. Since the rescheduling of debt was generally only possible if a country had signed an agreement with the IMF, the Fund found itself playing a key role in the design and implementation of the first wave of stabilisation programmes in the 1980s. Only five countries were able to avoid submitting to Fund conditionality during this first wave – Cuba (not a member of the Fund), Nicaragua (denied IMF support through US pressure), Colombia (which never rescheduled), and Paraguay and Venezuela (where IMF balance of payments support was not needed).

The close involvement of the Fund in the design of stabilisation programmes meant that policy was at first orthodox. Although the IMF remained committed to currency devaluation, financial liberalisation and domestic credit control, the Fund-inspired programmes emphasised in particular the need to reduce the fiscal deficit through increases in revenue and cuts in expenditure. The call for fiscal discipline was reinforced in several republics by agreements with the World Bank on structural adjustment and with USAID on reductions in public sector activity.

The need to reduce public expenditure was frustrated by the rising proportion of public revenue absorbed by interest payments on the debt (internal and external) and the reluctance of governments to reduce the public sector wage bill too drastically. Thus, the burden of adjustment fell disproportionately on capital rather than current expenditure with the share of investment in total public expenditure falling in the 1980s in almost all republics. Public works, health and education all suffered grievously from the reductions; the only country to resist the trend was the Dominican Republic, where public investment increased sharply after 1985 as the newly-elected Balaguer administration postponed internal adjustment in favour of the political advantages to be extracted from public works and increased public sector employment.²⁷

Public expenditure cuts were not sufficient to restore fiscal discipline. Indeed, the growth of interest payments on the debt (internal and external) meant that total public expenditure continued to rise in many countries as a proportion of GDP despite the curbs on government spending. In Brazil, for example, total central government expenditure jumped from 27 per cent of GDP in 1981 to 38 per cent in 1985. Even Mexico, where fiscal austerity was applied with greater conviction, saw an increase from 21 per cent in 1981 to 31 per cent in 1987. In both cases, the explanation was provided by the disproportionately rapid rise in interest payments, which were taking over 50 per cent of total Mexican central government expenditure by 1987 compared with less than ten per cent in 1980.²⁸

Orthodox stabilisation programmes therefore had to address the revenue side of the equation. Yet the circumstances could hardly have been less favourable. Recession after 1981 and the flight into the informal sector made tax collection harder and external adjustment required numerous tax concessions to stimulate exports. Thus, a policy of increasing tax rates (direct and indirect) was unlikely to meet with much success and the first wave of stabilisation programmes – with substantial prodding from the IMF – tended to emphasise the need to raise tariffs on all services provided by the public sector in order to reduce losses by state-owned enterprises.

As the present or expected profitability of public enterprises increased following these price rises, the possibility of selling public sector assets to the private sector (privatisation) became more realistic. Yet, despite IMF pressure, only Chile – continuing the policies adopted after 1973 – made much use of privatisation as a solution to the fiscal problem in the first half of the 1980s. Governments in other republics at first remained unconvinced, either because they feared that public sector assets could only be sold to the private sector at prices which did not reflect their present discounted value or because they feared the damage to long-run growth from public sector disinvestment. As the fiscal crisis continued, however, and as it became clear that foreign lending to

state-owned enterprises would remain restricted, other governments joined the bandwagon in favour of privatisation so that by the beginning of the 1990s the sale of public sector assets was contributing to fiscal revenue in almost all republics.²⁹

The problems of raising government revenue after 1982 emphasised the extremely fragile tax base in many Latin American republics and forced the issue of tax reform onto the agenda. Although marginal tax rates were often quite high, exemptions, evasion and avoidance reduced tax collection substantially. Even before the debt crisis, 12 republics generated less than 15 per cent of GDP in central government revenue and only five more than 20 per cent. Even state-ownership of mineral exports did not guarantee high tax receipts. Tax reform therefore could no longer be avoided and the highest priority was widening of the tax base. A favourite candidate was introduction or extension of a Value-Added Tax, providing broad coverage of all goods and services. Direct tax rates on business and individuals were changed, leading to lower rates and tightening up on exemptions and evasion. Chile and Mexico led the way, but other countries followed.

The first wave of stabilisation programmes after the debt crisis was not very successful. Despite the high profile adopted by the IMF and the widespread use of Fund conditionality, inflation accelerated in most republics after 1981. Failure to meet agreed targets led the Fund to suspend many of its standby agreements and Extended Fund Facilities. Brazil signed seven letters of intent with the IMF in the space of a few years and targets were often broken before the first funds were released.³⁰

The Fund blamed governments for lack of fiscal and monetary discipline, but it was clear that the problem was far more deep-rooted. Of the 15 countries suffering from internal disequilibrium and inflation before the debt crisis, only one (Costa Rica) had made real progress on stabilisation by the mid-1980s. The shock to internal stability delivered by the debt crisis was in general too severe to be handled within the framework of an orthodox IMF-inspired stabilisation programme because the inherited problem of instability was already so severe. Even some of those countries which had avoided severe internal disequilibrium before 1982 (for example, the Dominican Republic, Guatemala and Honduras) were unsuccessful in carrying out the necessary internal adjustments after the debt crisis.

As the limitations of an orthodox response became clear, interest in heterodox stabilisation programmes increased. A new theory of inflation began to gain acceptance which emphasised its inertial character and addressed the question of a coordinated reduction in prices in order to lower inflationary expectations.³¹ The orthodox approach was criticised for its reliance on market forces to break expectations in a context where inflationary expectations were

sustained by exchange rate devaluation, nominal interest rate increases and the rise in public sector tariffs. Without any nominal anchors, the rate of inflation in the orthodox approach could easily drift upwards despite the recession and tight fiscal and monetary policies.

Heterodox stabilisation programmes were adopted in a number of Latin American republics in the second half of the 1980s. A central element in the programmes was a sharp change in relative prices at the beginning to remove distortions followed by a freeze on certain prices (including nominal wage rates) to break inflationary expectations. The widespread use of indexation in high inflation countries was ended with only a few exceptions. As inflation came down, it was assumed that the so-called Oliveira-Tanzi effect would begin to operate in reverse³² – increasing real tax revenue and encouraging an increase in real money balances (and private sector savings). Architects of the programmes recognised that the price freeze could not be expected to last forever; a frozen exchange rate would lead to currency overvaluation, fixed nominal wages to a fall in real wages and price control to the emergence of new distortions, but it was assumed that by the time the freeze was lifted inflationary expectations would have been permanently lowered.

Heterodox stabilisation programmes were not without their successes. The hyperinflation in Bolivia ended abruptly in 1985 following the adoption of a programme which froze money wages, reformed the fiscal system completely and liberalised the market for foreign exchange. The Mexican programme, launched in December 1987 with a tripartite agreement between business, unions and government, also brought inflation down rapidly with the controlled exchange rate playing a crucial role in breaking inflationary expectations; as inflation came down, nominal interest rates also fell and the fiscal burden implied by high levels of debt servicing became more tolerable.³³ The Nicaraguan hyperinflation was stopped dead in its tracks in 1991 as a result of a fixed exchange rate, tight monetary policy and access to foreign finance to support additional imports.

The heterodox programmes in Bolivia, Mexico and Nicaragua did not ignore the need for fiscal discipline. Thus, heterodox measures were combined with orthodox policies in a successful mix. By contrast, the heterodox programmes launched in Argentina in 1985 (the Austral Plan) and Brazil in 1986 (the Cruzado Plan) were notable for the absence of a tight fiscal policy. The rate of inflation at first fell sharply, in response to the freeze on prices and the fixing of the exchange rate, but nominal aggregate demand continued to outstrip available supply and inflationary pressures soon reemerged. As the distortions in relative prices reappeared, price controls had to be lifted before fiscal discipline had been restored. The result was an explosion in the rate of inflation which soon surpassed the rate before the adoption of the heterodox programmes.³⁴

The failure of these heterodox programmes in Argentina and Brazil did not at first lead to a restoration of orthodoxy. On the contrary, governments in both countries were even willing to freeze domestic financial assets in a desperate attempt to bring both inflation and the budget deficit under control. Yet by the beginning of the 1990s, after a decade of failed stabilisation programmes, the need to combine orthodox fiscal measures (including privatisation) with heterodox policies was finally recognised. Argentina was the great success story, reducing monthly inflation by the end of 1991 to negligible levels. By this time, a consensus on stabilisation had begun to emerge throughout Latin America which stressed tax reform, privatisation and 'realistic' prices for public sector services as a necessary condition for price stability. Indeed, at the end of 1991 only Brazil was still suffering from monthly rates of inflation in excess of five per cent and eleven republics had monthly rates below two per cent. The dragon of inflation is slowly being tamed.

The promotion of exports and the taming of inflation are the two most important milestones in Latin America's journey from the old to the new trajectory. Yet none of it could have happened without a radical overhaul of economic policy. As it became clear that the net supply of loans from the international banks to the public sector was drying up, governments throughout the region were forced to recognise that the model of development based on large-scale public investments by state-owned enterprises had collapsed. The preference for private over public investment became a matter of necessity as the state found itself obliged to cut back on investment programmes throughout the economy. Cuba – unmoved by the collapse of communism in Eastern Europe – defied the trend, although foreign investment through joint ventures was tolerated. Only in those countries where the public sector controlled a high proportion of export earnings through state-owned enterprises was it possible to anticipate a major renewal of public investment, with Venezuela's state-owned oil industry leading the way.

By the beginning of the 1990s it had become fashionable to compare reform in Latin America favourably with the policy agenda favoured by international creditors (the so-called Washington Consensus).³⁵ A composite distilled essentially from the experience of a number of East Asian countries, the Washington Consensus emphasised reform of balance of payments policy, fiscal policy, competition policy and financial liberalisation. Although neither Washington itself nor any East Asian country had ever implemented the whole agenda, the Washington Consensus acquired an almost mythical status as the alleged basis for successful adjustment and prerequisite for long-run sustainable growth.

There is a family resemblance between the Washington Consensus and policy reform in Latin America, but the differences are at least as important as the similarities. The vast majority of Latin American republics at first adopted

policy reform in the 1980s as a short-run response to the new circumstances created by the debt crisis. Thus, policy reform in Latin America emphasised those elements in the Washington Consensus which coincided with the new reality (for example, competitive real exchange rates) while paying much less attention to other policies (for example, deregulation) where reform could be postponed.

The difference between the two approaches to policy reform was brought out clearly by the practice of privatisation. While Chile and later Mexico recognised the desirability of privatisation on efficiency grounds, other governments promoted it primarily for fiscal reasons. Public sector enterprises were sold to the private sector at prices below the present discounted value in order to secure an immediate contribution to government revenues; public sector monopolies were converted into private sector monopolies with little or no attempt to increase competition. Highly profitable state-owned enterprises, which contributed handsomely to government income, were retained within the public sector although efficiency would almost certainly have improved if privatisation had been adopted.³⁶

Policy reform was needed to shift Latin America onto a new trajectory where fast growth of exports and low rates of inflation would continue to prevail. By the beginning of 1992, Latin America had achieved considerable success in both these areas. Yet policies to promote export-led growth were also fraught with difficulties. While most countries were able to increase the volume of exports, the international trading system continued to treat primary products less favourably than manufactured goods or services. The collapse of the international tin agreement in 1986 was a cruel reminder to Bolivia, for example, of the perils of high levels of commodity concentration in exports³⁷ and the persistent decline in the US sugar import quota wiped out most of the gains from increases in non-traditional exports in a number of Caribbean Basin countries.³⁸

The Uruguay Round of GATT negotiations placed trade in agricultural products firmly on the agenda. A possible agreement on trade liberalisation, after many disappointments and apparent failures, is raising expectations in some quarters that primary product exports would now be protected against arbitrary decisions and non-tariff barriers. The relative decline in the importance of agricultural trade, however, is a long-run phenomenon which cannot be reversed through a reduction in trade discrimination. The most dynamic branches of international trade remain manufactured goods and services, where Latin America entered the 1980s at a distinct disadvantage. A decade later, only Mexico and Brazil could claim to have shifted the structure of exports significantly in favour of products with dynamic long-run prospects.³⁹ Even Chile, despite its above average performance, was still

overwhelmingly dependent on a traditional export (copper) and a handful of non-traditional primary products (fruits, fishing and forestry).

It is therefore by no means certain that the transition to a new trajectory will bring rapid growth to all Latin America. Indeed, as each new trajectory has unfolded in Latin America, the failures have tended to outnumber the successes. If it is probable that there will be some success stories in the new trajectory, it does not follow that trade liberalisation, inflation stabilisation and policy reform can guarantee success. Furthermore, the region is still plagued by a highly unequal distribution of income and wealth on which the impact of the new growth model remains very uncertain. There is also the vexed question of the impact of renewed growth on the environment – a subject which is certain to become more important in the 1990s.

A decade after the debt crisis, economic recovery is still modest in Latin America. Growth in some of the smaller countries has been undermined by unfavourable movements in the net barter terms of trade. Investment and domestic savings are in many cases below the rates required to sustain long-run growth. The fiscal problems in some countries continue to rule out the public investments needed to 'crowd-in' private investment and reverse capital flight. And yet almost all economies have become more outward-looking, with the ratio of exports to GDP rising, while the level of imports has climbed steeply since the mid-1980s. Trade liberalisation has not brought the feared explosion in consumer goods and many firms are responding positively to the need to compete – often for the first time – with goods from abroad. Financial crisis at the beginning of the 1980s had driven down the value of nearly all assets, creating exceptional opportunities for those entrepreneurs willing to risk their capital in an uncertain environment. New conglomerates have been formed (often from traditional family groups) to secure industrial and financial leadership within each country. This younger generation of economic elites, many of whom have been trained and educated abroad, is more receptive to new business ideas and less committed to preserving a protected domestic market than its predecessor.

By the beginning of the 1990s, two countries – Chile and Mexico – had laid the basis for sustainable long-run growth as a result of successful internal and external adjustment and policy reform. The repatriation of capital has begun and policy reform has been rewarded with renewed access to voluntary capital flows and the international bond market. In both countries the unequal distribution of income and the absence of a safety net for the poor remains a serious cause for concern, but the return to democracy in Chile and the shift to greater political accountability in Mexico gives grounds for cautious optimism even on matters of equity.

A second group of countries – Argentina, Bolivia, Colombia, Costa Rica, Ecuador, El Salvador, Uruguay and Venezuela – has made considerable progress on policy reform and adjustment. Yet none had completed the process of adjustment by the beginning of 1992 so that many unanswered questions remained. Bolivia's stabilisation programme in 1985 had won much admiration, but external adjustment was still incomplete six years later and the fiscal problem not yet fully resolved. Fiscal difficulties remained at the heart of the problem in Colombia, Costa Rica, El Salvador and Uruguay, while Ecuador and Venezuela struggled to break free from their dependence on oil. Argentina had begun the task of reversing fifty years of relative economic decline with courage and determination, but its previous track-record and the accumulated problems led even the most enthusiastic supporters to postpone final judgement.

The remaining countries have all made some attempt at stabilisation, adjustment and policy reform, but the results are so far modest. Some members of this group – Cuba, the Dominican Republic, Guatemala, Haiti, Panama and Paraguay – had made only minimal attempts at reform by the end of the 1980s, valuing the political costs of adjustment far above any economic gains. Others – Brazil, Honduras, Nicaragua and Peru – have tackled the problems courageously, but the scale of the task and the delay in implementing reform had produced only modest results even a decade after the debt crisis first started. Few questioned the need for reform, but the obstacles standing in the path of successful adjustment blocked a swift transition to the new trajectory.

Just as after previous debt crises, therefore, the new trajectory will not offer equal benefits to all republics. In the first fifty years after independence, the republics benefiting most from the new model were Chile and Peru. The prize in the second cycle after 1870 undoubtedly went to Argentina and Uruguay, while few would deny that Brazil, Mexico and Venezuela were the major beneficiaries of the Kondratief wave after 1930. If no Latin American republic can yet be classified as developed, it is in no small part due to the failure of any republic to sustain rapid growth in each of the past three cycles. Yet all Latin American countries (with the exception of Haiti) are now classified by the World Bank as middle-income and those republics which are most successful in the current 50-year cycle can expect to reach the standard of living now enjoyed by the citizens of Portugal, Greece, Ireland and Spain.⁴⁰ That may not sound very exciting, but for the millions of Latin Americans who are still short of basic human needs it is a goal well worth striving for and one which sound economic policy can help to achieve.

NOTES

1. See United Nations, *Preliminary Overview of the Latin American and Caribbean Economy 1991* (Santiago, December 1991), Table 16.
2. These successive debt crises are studied in Carlos Marichal, *A Century of Debt Crises in Latin America* (Princeton, 1989).
3. The transfer of resources is defined as the net inflow of capital less the net payments of profit and interest.
4. For a critique of the new orthodoxy, see Tariq Banuri (ed.), *Economic Liberalization: no Panacea* (Oxford, 1991).
5. Research institutes in Argentina and Brazil, both countries that have suffered from severe bouts of hyperinflation, have been at the frontier of this work.
6. The dilemma has not, however, been entirely resolved as was made clear by the (mild) US response to the *autogolpe* declared by President Fujimori in Peru.
7. Despite net payments of profit and interest of \$29.3 billion, it is estimated that the net transfer of resources in 1991 was \$6.7 billion. See United Nations, *op. cit.*
8. The Brady Plan, named after the US Treasury Secretary under President Bush, is the name given to the scheme – endorsed by the governments of the main creditor countries – that allows creditors to choose from a menu of debt-reducing options offered by the debtor country. Mexico took advantage of the scheme in 1989, followed by Costa Rica and Venezuela.
9. Some estimates put the inflow of capital to Mexico in 1991 as high as \$16 billion. This is consistent with the rise in international reserves despite a huge increase in imports.
10. The value (fob) of imports was \$101 billion in 1981. By 1984 this had fallen to \$61 billion. See Inter-American Development Bank, *Economic and Social Progress in Latin America, 1991 Report* (Washington, D.C., 1991), Table D-4.
11. The Bolivian and Mexican stabilisation programmes are examined in Michael Bruno, Guido Di Tella, Rudiger Dornbusch and Stanley Fischer (eds.), *Inflation Stabilization* (Cambridge, Ma., 1988).
12. These non-traditional exports include not only goods (e.g. nickel, citrus), but also services (e.g. tourism).

13. See Inter-American Development Bank, *op. cit.*, Tables B-1 and B-6.
14. Imports jumped from \$92.5 billion in 1990 to an estimated \$110.3 billion in 1991. See United Nations, *op. cit.*, Table 14.
15. Latin America's share of world trade is reported annually in International Monetary Fund, *Direction of Trade Statistics Yearbook* (Washington, D.C.).
16. See Instituto de Relaciones Europeo-Latinoamericanas (IRELA), *Economic Relations Between the European Community and Latin America: a Statistical Profile* (Madrid, 1991).
17. In all three countries earnings from the leading export accrued to state-owned enterprises so that the foreign exchange was 'purchased' by the state from itself.
18. The five republics were the Dominican Republic, Guatemala, Haiti, Honduras and Panama.
19. See Inter-American Development Bank, *op. cit.*, Table C-4.
20. In Uruguay, for example, the ratio dropped from 17.4 per cent in 1981 to 13.5 per cent in 1984.
21. A typical example is provided by Costa Rica, where the 'official' exchange rate – used for external debt payments – was set at 20 colones per US dollar, while the interbank rate – used for virtually everything else – steadily depreciated. See Consejo Monetario Centroamericano, *Boletín Estadístico* (San José, 1991).
22. See the chapters on Argentina and Brazil in Michael Bruno et al (eds.), *Lessons of Economic Stabilization and Its Aftermath* (Cambridge, Ma., 1991).
23. The difference between debt-conversion and debt-equity swaps is explained in Ricardo Ffrench-Davis, 'Debt and Growth in Chile: Trends and Prospects', in David Felix (ed.), *Debt and Transfiguration? Prospects for Latin America's Economic Revival* (Armonk, N.Y., 1990).
24. Direct foreign investment, which had reached \$8 billion in 1981, had fallen to \$2.8 billion by 1986. See Inter-American Development Bank, *op. cit.*, Table D-14.
25. There is a good account of the hyperinflationary episode and the subsequent stabilisation programme in Juan-Antonio Morales, 'Inflation Stabilization in Bolivia', in Bruno et al, *op. cit.*

26. The worst moment in Argentina occurred in March 1990, when the monthly rate of change of consumer prices reached 95.5 per cent. See CEDEAL, *Situación Latinoamericana* (Madrid), Diciembre 1991, p. 21.

27. It must also be remembered that the Dominican Republic had suffered from serious riots when an IMF-supported stabilisation programme was adopted in 1984.

28. See Inter-American Development Bank, *op. cit.*, Table C-17.

29. Privatisation has spawned a small cottage industry of publications in its own right. See, for example, *Latin Finance: Privatization in Latin America* (March, 1992), where an overview is given of the privatisation process throughout the region.

30. See Dionisio Dias Carneiro, 'Long-run Adjustment, the Debt Crisis and the Changing Role of Stabilisation Policies in the Recent Brazilian Experience', in Rosemary Thorp and Laurence Whitehead (eds.), *Latin American Debt and the Adjustment Crisis* (London, 1987).

31. On inertial inflation, see Edward Amadeo et al, *Inflación y Estabilización en América Latina* (Bogotá, 1990).

32. The Oliveira-Tanzi effect describes the decline in real tax revenues as a result of accelerating inflation in an economy with lags between tax liability and tax payment.

33. There have been a number of good accounts of the Mexican stabilisation programme. See, for example, Bruno et al, *op. cit.*

34. On the Austral plan, see José Luis Machinea and José María Fanelli, 'Stopping Hyperinflation: The Case of the Austral Plan in Argentina, 1985-87', in Bruno et al, *op. cit.*; on the Cruzado plan, see Eduardo Modiano, 'The Cruzado First Attempt: The Brazilian Stabilization Program of February 1986', *ibid.*

35. See John Williamson (ed.), *Latin American Adjustment: How Much Has Happened?* (Washington, D.C.), 1990.

36. Even in Chile, the country most committed to free enterprise and the private sector, much of the copper industry was retained in public ownership through the state-owned enterprise CODELCO.

37. Bolivia also suffered, however, from the repeated failure of Argentina to pay for gas exports – a reminder that Latin American countries could also be creditors as well as debtors within the region.

38. When the Caribbean Basin Initiative (CBI) was launched by President Reagan in 1984, sugar and other sensitive products were excluded from its provisions.

39. By the end of the 1980s, more than 50 per cent of exports consisted of manufactured goods and many of these were in fast-growing sectors.

40. In 1989, the average per capita income in Latin America was \$1,950, with the highest figure being recorded by Uruguay (\$2,620). In Portugal and Greece income per head was \$4,250 and \$5,350 respectively. See World Bank, *World Development Report 1991* (Washington D.C., 1991), Table 1.

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