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Learning from Latin America: Debt crises, debt rescues and when and why they work

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CAF DEVELOPMENT BANK OF LATIN AMERICA

Latin America's debt crisis and "lost decade"

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Latin America´s State-led industrialization model began to come under criticism in the 1960s both from the advocates of orthodox economic thinking and from the political left.[1] The former criticized it for its lack of macroeconomic discipline and inefficiencies generated by high tariffs and quantitative import restrictions and, more generally, by excessive State intervention. The latter criticized it because of its inability to overcome the economy's external dependence and, in particular, the unequal social structures that were a legacy of the past. Although he did not necessarily share the views of the political left, Hirschman (1971, p. 123) expressed this idea brilliantly: "Industrialization was expected to change the social order and all it did was to supply manufactures".

As this model matured, it came to be associated with a great deal of economic, social and political tensions. Social conflicts first arose in the Southern Cone countries, which had been the first to witness major social changes as well as a slowdown in growth. The opportunities that growth periods provided for enhancing well-being and social entitlements were taken advantage of by vehement social and political movements, some of socialist inclinations while others of more populist leanings. However, as external shocks hit and balance-of-payments crises followed one upon another, these adjustments fueled growing discontent and opposition on the part of either popular sectors that demanded greater improvements in social conditions, or the elites, which saw their profit margins threatened by increased government regulation. The authoritarian response was not long in coming.

Fishlow (1988, p. 118) provided a very cogent description of the connection between social conflict and the transition to market economies in the midst of the wave

* Universidad de la República, Uruguay, and Columbia University, respectively. These are excerpts from chapter 5 of the forthcoming book of the authors, *The Economic Development of Latin America since Independence,* New York: Oxford University Press, forthcoming.

[1] See, for example, the reviews of this debate by Hirschman (1971), Fishlow (1988) and Love (1984).

of authoritarian military regimes that engulfed the Southern Cone: “Military instincts are interventionist. But military leaders can conveniently rationalize political repression in the name of the needed price and wage flexibility. The objective is not adaptation to a given economic structure but radical reconstruction of civil society”. This implies that the changeover to a market economy was initially a defensive strategy in reaction to what was seen as an expansion of socialism. In this sense, the Latin American response differs from that of the industrialized countries, starting with the election of Margaret Thatcher in Great Britain in 1979 and Ronald Reagan in the United States in 1981, which were clearly on the offensive. Indeed, the industrialized countries’ response was a reflection of the confidence of private enterprise that it could do without State protection and even the belief of large sectors of the business community that State intervention had actually become an obstacle to its development. This offensive would be taken up by Latin America later on, chiefly in the last decade of the twentieth century.

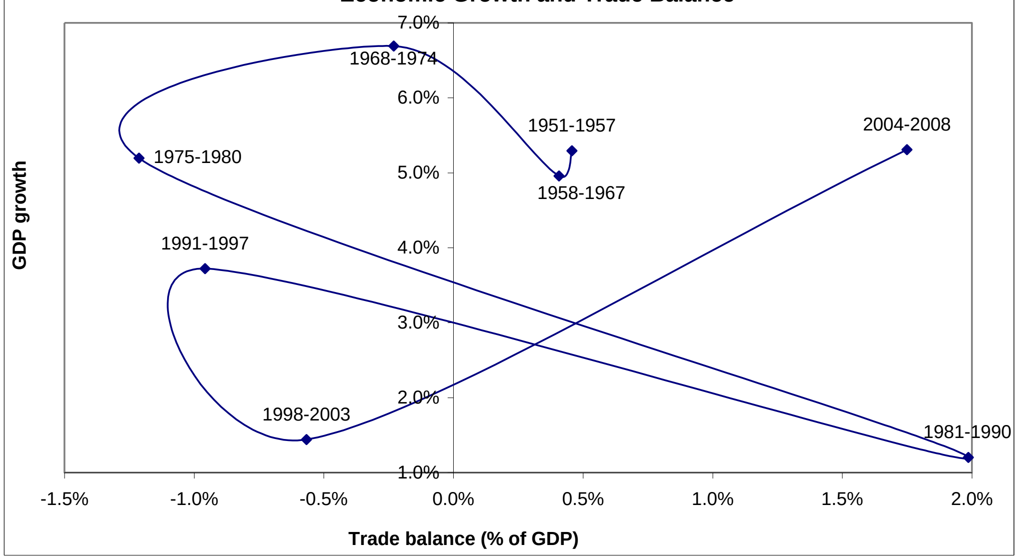
Outside of the Southern Cone, although social unrest was also on the rise, it did not have any direct link with the transition to market economies. In Central America, which became the epicenter of the conflict in the 1980s, confrontations occurred primarily in rural settings and stemmed from the concentration of land ownership and, perhaps, from the commodity–export-led growth model rather than from its somewhat peculiar connection with a feeble form of State-led industrialization. Colombia’s long history of internal conflict was also rooted in rural problems but, starting in the mid-1980s, it took on quite a different character as drug trafficking gained ground, which provided funding for all sorts of violence: rural conflicts, para-military groups and guerrillas (or, at least. funding for the largest guerilla organization). The violence associated with drug trafficking would later engulf Mexico and Central America in the first decade of the twenty-first century.

The lack of macroeconomic discipline was less widespread than it is often portrayed as having been.[2] In fact, it was primarily a problem in Brazil and the Southern

[2] See Bértola and Ocampo (2012), chapter 4.

Cone, rather than in the rest of the region, at least until the mid-1970s. However, the tendency to run an external deficit, which had indeed been a long-standing trend, was growing stronger toward the end of the phase of State-led industrialization in almost all the countries of the region. This was the result of both the behavior of the trade balance and an increasing demand for investment (which economic theory tells us are actually two facets of the same problem). These imbalances were dealt with by resorting to greater and greater amounts of external borrowing. This, however, turned out to be the sword of Damocles of the model, given the volatility associated with such financing. Figure 1 depicts the first of these trends. As the reader will see, until the industrialization process was quite far along, growth was coupled with small trade surpluses (generated, no doubt, by massive balance-of-payments interventions). It can even be said that the small deficit registered in 1967-1974 was not a problem, given the striking upswing in growth experienced during those years. It proved impossible, however, to sustain growth during the period between 1974 and 1980 (at rates not unalike those observed prior to 1967) without generating a deepening trade deficit.

Figure 1
Economic Growth and Trade Balance



Source: Authors' estimations based on ECLAC historical series.

Growth was also associated with increasing investment requirements that countries with endemically weak national savings rates found hard to meet. The investment rate had fluctuated between 19% and 22% of GDP up to the mid-1970s, reaching its lowest point in 1958-1967, the years of what ECLAC called "external strangulation". It climbed to 25% during the final phase of this stage of development (see Table 1). This indicates that the higher levels of external borrowing seen during the 1970s were reflected in higher investment rates (which no doubt included a number of white elephants in some countries), in sharp contrast to subsequent periods, when higher levels of external borrowing instead drove up consumption.

Table 1
Gross Fixed Capital Formation (% of GDP)

	1950-1957	1958-1967	1968-1974	1975-1980	1981-1990	1991-1997	1998-2003	2004-2008	2008-2010
Simple average									
Large countries	23.9%	20.1%	21.6%	24.3%	19.1%	19.6%	18.3%	21.5%	23.3%
Small countries	14.2%	15.7%	18.1%	21.5%	17.0%	19.2%	20.0%	19.8%	19.1%
Latin America	19.1%	17.6%	19.5%	22.6%	17.8%	19.4%	19.4%	20.5%	20.8%
Weighted average									
Large countries	21.0%	19.5%	22.2%	25.1%	18.9%	18.2%	18.0%	19.9%	20.9%
Small countries	15.8%	16.8%	17.7%	22.2%	16.9%	18.6%	19.3%	19.1%	18.7%
Latin America	20.7%	19.1%	21.9%	24.9%	18.8%	18.2%	18.1%	19.8%	20.7%

Source: ECLAC historical series at constant prices. Costa Rica data are available since 1952, El Salvador since 1962, Nicaragua since 1960, and Uruguay since 1955.
The figures correspond to the average of all countries for which data are available.

State-led industrialization also ran up against other constraints: those associated with the tendency to overwhelm the State with fiscal responsibilities without giving it sufficient resources to meet them. As noted by FitzGerald (1978), this was reflected in three main trends: (i) an upward trend in public expenditure as a proportion of GDP, combined with a downward trend in the share of spending on social welfare programs relative to industrialized countries; (ii) a shift in the composition of the tax structure away from property and income taxes and toward indirect taxes and taxes on wage income; and (iii), as a result, rising borrowing requirements, given the need to finance transfers to the private sector rather than redistributive social policies. This was particularly a problem in the second half of the 1970s, when the widespread access of Latin American countries to external financing led to rising fiscal deficits, which then made public-sector accounts highly vulnerable to any tightening of external credit, which eventually did, in fact, occur.

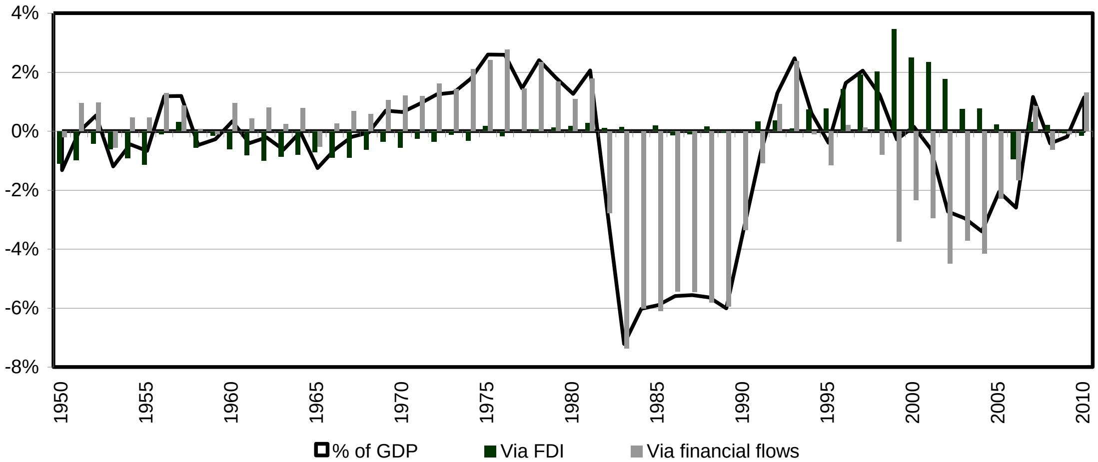
It is unlikely, however, that, if the debt crisis had not occurred, any of the Latin American economies would have collapsed under the weight of the inefficiencies generated by State-led industrialization or of these types of macroeconomic tensions. What is more, it is unclear why they could not have adopted or further developed a more balanced strategy, as the smaller countries had begun to do in the mid-1950s and most of the mid-sized and larger countries began to do in the mid-1960s. As was discussed in the preceding chapter, early on the region had begun to take advantage of the opportunities which the growth in world trade had started to open up and had evolved toward a mix of protection and export promotion. In fact, the literature of the 1970s portrays a number of Latin American countries, particularly Brazil, as international export success stories on a par with the Asian tigers.

Thus, the Latin American countries could have moved toward a development model more along the lines of the East Asian model, which was also State-led and also somewhat protectionist, but which placed more emphasis on building a solid export base and, in most cases, showed a clear preference for national over foreign investment. As it turned out, however, the scale and speed of events ruled that option out. We have also noted in the previous chapter that this was not the only possible path. Earlier on, the Southern Cone countries had in fact taken a different route, with slow growth combined with an improvement in distribution and mounting social conflict.

These long-term trends notwithstanding, what sounded the death knell for that paradigm was the boom-and-bust cycle of private external financing, which began slowly in some countries in the mid-1960s, spread out to the rest of the region in the 1970s and culminated in the debt crisis of the 1980s. This kind of cycle had been experienced before, most recently in the boom-bust cycle of external financing of the 1920s and early 1930s. The sources of external finance were different, however, as syndicated credits from the international commercial banking system now took over the role that bonds floated on international capital markets had played in the 1920s.

One of the conspicuous features of the quarter-century following the Second World War had been the absence of large volumes of private external financing and the rather modest level of official finance. As shown in Figure 2, net resource transfers from abroad[3] were slightly negative in the 1950s and 1960s. Against the backdrop of recurrent external shocks, the fact that countries lacked sufficient means to cover their balance-of-payments deficits, including the very modest financing available from the International Monetary Fund (IMF), obviously heightened the temptation to resort to protectionist policies as an adjustment mechanism. The countries that were the first ones to gain access to private external financing (Mexico and Peru, in particular) were also some of the first to run into problems of over-indebtedness.

Figure 2
Net Resource Transfer
(% of GDP at current prices)



Source: Estimates based on ECLAC data.

The new boom in external financing for Latin America was part of a broader move to rebuild the international capital market that had first taken shape in the 1960s (when it was dubbed the "eurodollar market"). The hallmark of this process was competition among a growing number of formerly national banks that had begun to operate as international institutions that provided financing in global markets, generally syndicated loans at variable interest rates pegged to the three- or six-month London Interbank Offer Rate (LIBOR). This mode of operation facilitated the entry of smaller banks with less international experience, which trusted almost blindly in the credit evaluations of the large banks that led the process (and that received hefty

[3] Net resource transfers are defined as the balance on the capital account minus debt service (interest payments on the external debt and dividends sent abroad by foreign corporations).

commissions). By pegging the interest rate to the interbank market, which was the source of financing for banks actively involved in the international market, the risk for creditors represented by variations in those rates was reduced by shifting it onto borrowers. As we will see, this had become dramatically evident since late 1979 and ultimately proved to be disastrous. These laxly regulated banks first ran into problems in late 1974 when some of them, particularly the Herstatt Bank in Western Germany and the Franklin National Bank in the United States, lost heavily on foreign exchange operations. The recycling of petrodollars on that market in the following years gave it a strong boost that was reflected in the abundant financing received by the region in the second half of the 1970s (Devlin, 1989, Chapter 2).

Within an oligopolistic setting, in which large banks sought to place loans in a way that would allow them to expand or at least maintain their market share, external lending activity began to increase steeply and was leveraged by the additional resources provided by smaller banks with usually small spreads over LIBOR (between one and two percentage points, with the spread usually being closer to one point as the boom neared its end). High levels of liquidity in the eurodollars market and low real interest rates (which at some points were actually negative) in the 1970s combined with high commodity prices (for oil, in particular, but for other products as well) to generate strong incentives for heavy external borrowing (Devlin, 1989; Ffrench-Davis, Muñoz and Palma, 1998). In fact, Latin America accounted for over half of all private debt flows to the developing world in 1973-1981 (Ocampo and Martin, 2004, Chapter 3) while at the same time continuing to be the developing region that attracted the largest share of foreign direct investment (FDI).

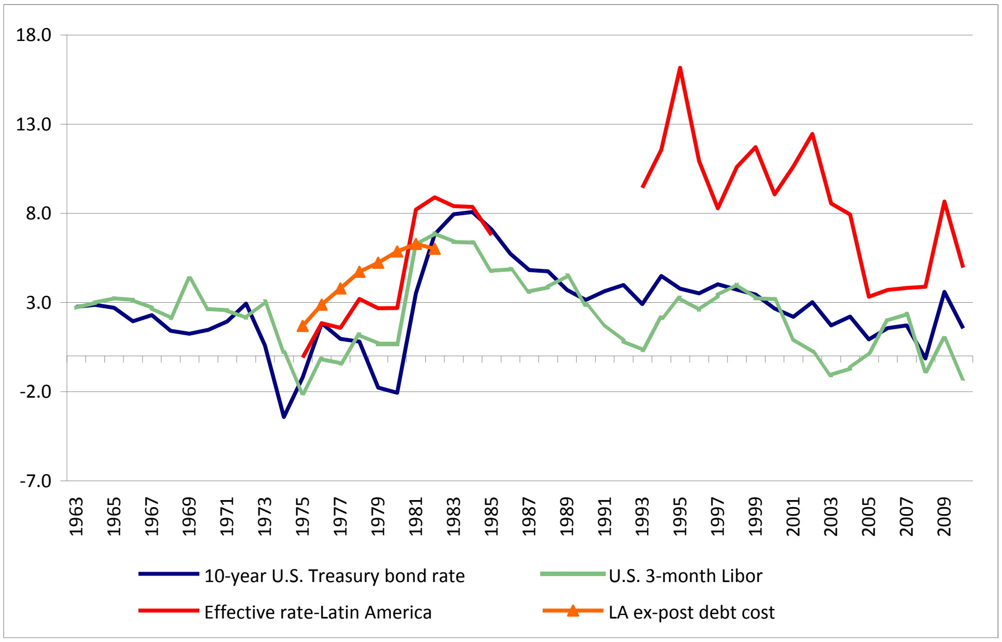
The counterpart of booming lending was the growing trade and fiscal deficits that the region built up. National financial institutions that served as intermediaries for transactions involving those external funds also began to find themselves taking on higher and higher levels of credit and exchange risk. This problem was, however, associated with a new trend: liberalization of domestic financial markets. This is why it was more serious in the countries of the Southern Cone, since they were the first to undertake market reforms. The governments' ability to enforce exchange controls aimed at preventing capital flight once the crisis had broken out was also an important factor. Capital flight occurred throughout the region, but took place on a massive scale in Argentina, Mexico and Venezuela, which lacked sturdy mechanisms for controlling capital movements.

The differing sizes of the various countries' external and fiscal deficits and the differing degrees of their financial systems' fragility placed a crucial role in determining the relative impact of the 1980s debt crisis. This indicates that the countries' *macroeconomic* dynamics, rather than defects in the production structure created by the preceding model, were the decisive factor. And this is why the problem arose both in the more tightly regulated economies (e.g., Brazil) and in the more liberalized ones (those of the Southern Cone). Indeed, in financial terms the problem was most serious in the latter countries, where it triggered some of the most dramatic domestic financial crises in history. Moreover, the fact that Latin American exporting countries had faced similar difficulties in striving to manage the sharp external financing cycle of the 1920s and 1930s and that the more liberalized economies were confronted with a similar situation in the 1990s (see below) indicates that boom-bust cycles fueled by the volatility of external financing is a general phenomenon rather than a feature of State-led industrialization as such.

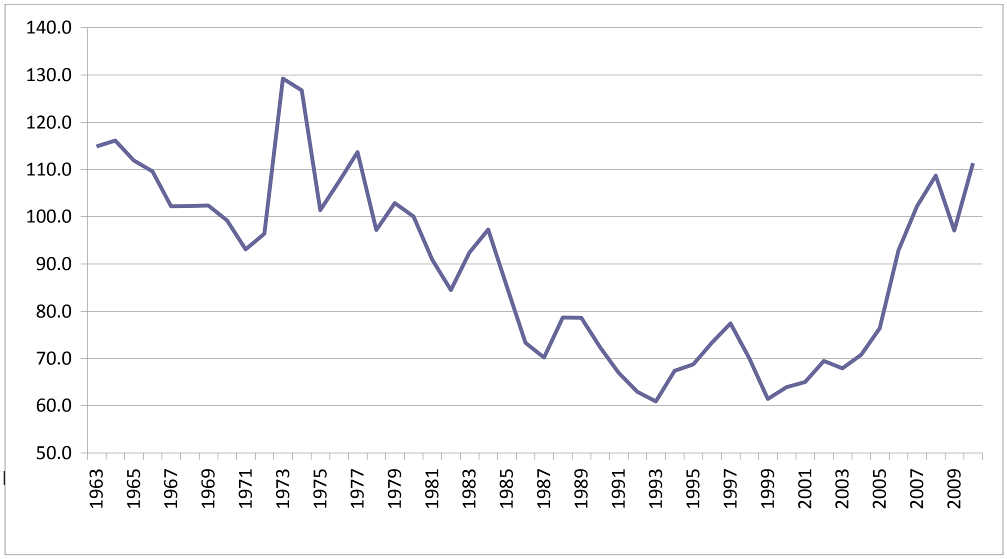
This is why external shocks played such a pivotal role in determining how the crisis unfolded (ECLAC, 1996, Chapter 1). The turning point was the decision, made in late 1979, by the Federal Reserve Board of the United States to raise interest rates steeply (this became known as the "Volker shock", after the Federal Reserve Chairman of the time) in order to stamp out the inflationary spiral that the US was experiencing at the time. This had a direct impact on the debt service, since much of Latin America's external debt had been contracted at floating interest rates. This situation was compounded by a sharp drop in the real prices of raw materials. Both of these adverse shocks *were to last nearly a quarter of a century*. This factor, which, of course, is only apparent in hindsight, is generally overlooked in analyses of this period of economic history (see Figure 3).

Figure 3

A. Real Interest Rates



B. Real Non-Oil Commodity Prices (1980=100)



Sources:
A. Authors's estimations based on Global Financial Data, Inc. for Libor rates;
U.S. Federal Reserve for the Treasury rates; and Data Stream to calculate the effective rate of Latin America.
The latter is estimated as Libor+2 in 1975-85 and and the yield of the Latin American bonds from 1993 on;
according to JPMorgan. (For the 1993-97 period, these were reestimated with the data on the yield of the
Treasury bonds and Latin American EMBI). The U.S. CPI is used as a deflator in all cases.
B. Data updated with the sources listed in Ocampo and Parra (2010).

Real interest rates in the US had been very low right up to the 1960s and were actually negative in the mid-1970s, but then shot up in the late 1970s and remained high for the rest of the century, and this was especially true of long-term rates. This pattern was even more marked for the rates relevant for Latin America. The real effective interest rate on the Latin American region's debt fluctuated between -1% and 2% between 1975 and 1980 (estimated at one percentage point above the three-month LIBOR and with current inflation rates). Even taking into account the subsequent rate hikes (what is referred to in Figure 3 as the "ex-post rate"),[4] it averaged no more than 4% during those years, reaching a peak of 6% in 1981-1982. In contrast, when the Latin American countries returned to the capital market in the 1990s (when the reference rate had become the rate on 10-year US Treasury bonds), the real interest rate generally stayed above 10% (once the corresponding spreads are factored in). Thus, the region did not again see rates similar to those charged in 1975-1980 until the international financial boom of 2005-2008.

The decline in commodity prices also proved to be a long-run break from the earlier trend and would last until the mid-2000s (Ocampo and Parra, 2010). At their lowest point, between 1992 and 2001, real commodity prices were 37% (and at times as much as 40%) below their average for the 1970s, which was in turn actually slightly below the average for 1945-1980. These two long-run adverse factors were joined, in the early 1980s, by a sudden slowdown in the industrialized world and an outright recession in the US.

International interest rates had never before been so high for so long.[5] Recessions such as those experienced by the industrialized countries had, on the other hand, occurred before, as had a long-term steep decline in the terms of trade. In the

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[4] This real ex-post interest rate was calculated as the average annual rate for the year in which the loan was taken out and the six following years (based on the assumption that a loan typically matures in seven years) using the LIBOR + 1 as the nominal rate and as a deflator for the US consumer price index.

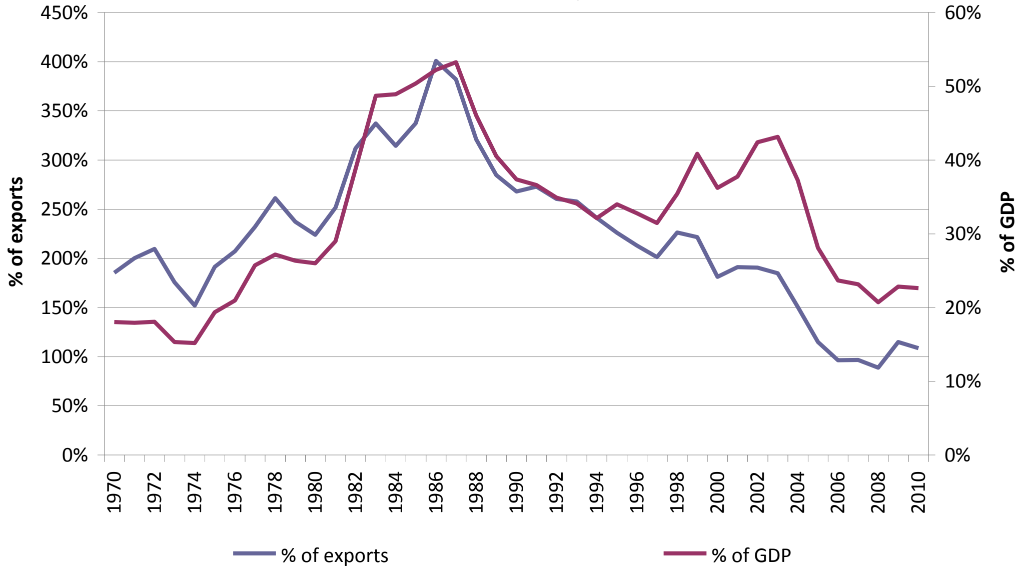
[5] The deflation associated with international crises up until the 1930s did drive up real short-term interest rates. These increases were strictly temporary (lasting for three years during a serious crisis such as the Great Depression of the 1930s), however, since, as nominal interest rates began to decline as a result of the crisis, real rates came down rapidly – so much so, in some cases, that they became negative in real terms.

first case, however, the 1982 economic slowdown in the industrialized world was somewhat steeper than that of 1975, and was thus the worst of the post-war period (until it was surpassed by the deep 2008-2009 recession). In the case of the terms of trade, the last time that anything similar had occurred had been when commodity prices had plummeted in the 1920s and 1930s. Consequently, the ex-post risks that Latin America had to assume were not only unexpected, but also quite difficult to foresee.

The debt crisis erupted *after* the shock generated by the hike in interest rates. External debt coefficients had been climbing steadily, but slowly, since the 1970s and, on average, were still moderate in the 1980s (below 30% of GDP, on average, and slightly more than two times the value of exports), thanks, no doubt, to the favorable conditions associated with the boom. In the years following this period, a steep increase was seen in those coefficients as a result of sharply higher interest rates, sinking commodity prices and the even more precipitous drop in Latin America's GDP, measured in dollars, which was in turn caused by the combination of a deep recession with the huge devaluations triggered by acute foreign exchange shortages. In slightly more than half a decade, Latin America's external debt coefficients had doubled and, as a consequence of the long-run factors mentioned above, did not drop back to their pre-crisis levels until the first decade of the twenty-first century (see Figure 4).

The situation reached dramatic proportions as the adverse conditions persisted and the international policy response to the debt crisis in Latin America (and in some other parts of the developing world) proved to be quite feeble. The combined effect of the sudden and protracted (nearly decade-long) absence of external financing and mounting debt service generated a massive external shock that turned the region's positive net resource transfers, which had been equivalent to 2% or 3% of GDP, into negative transfers amounting to about 6% of GDP (see Figure 2).

Figure.4
Dynamics of the Latin American External Debt
(% of GDP and exports)



Source: Authors' calculations based on data of external debt from The World Bank, and nominal GDP and exports from ECLAC historical series. The data for 2010 were updated with the growth rate of debt according to The World Bank.

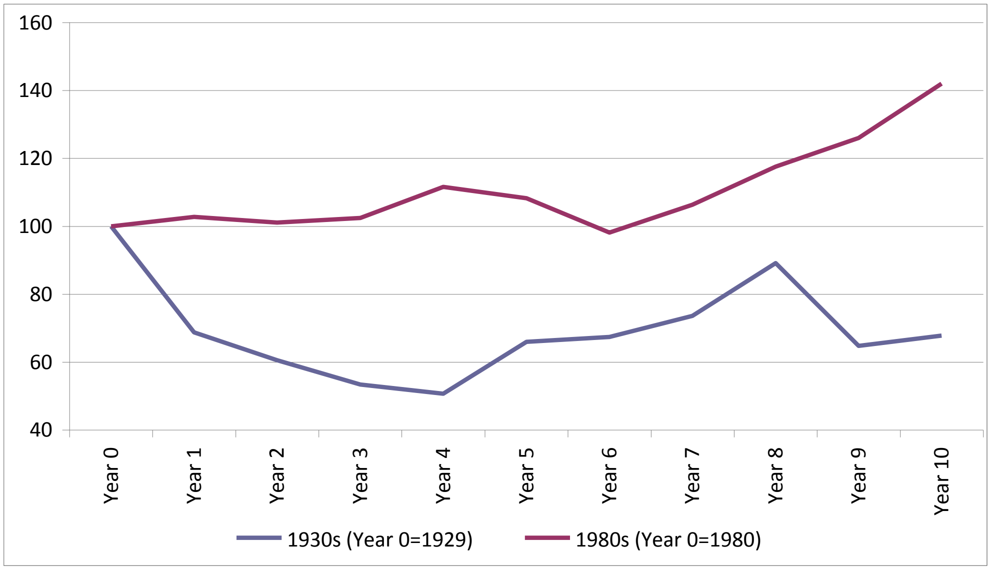
Díaz-Alejandro (1988, p. 310) summed up all of these events masterfully when he said that: "what could have been a serious but manageable recession has turned into a major development crisis unprecedented since the early 1930s mainly because of the breakdown of international financial markets and an abrupt change in conditions and rules for international lending. The non-linear interactions between this unusual and persistent external shock and risky or faulty domestic policies led to a crisis of severe depth and length, one that neither shocks nor bad policy alone could have generated".

The inherent instability of international financing cycles thus proved to be a decisive factor in determining the fate of the development model based on primary exports and the era of State-led industrialization.

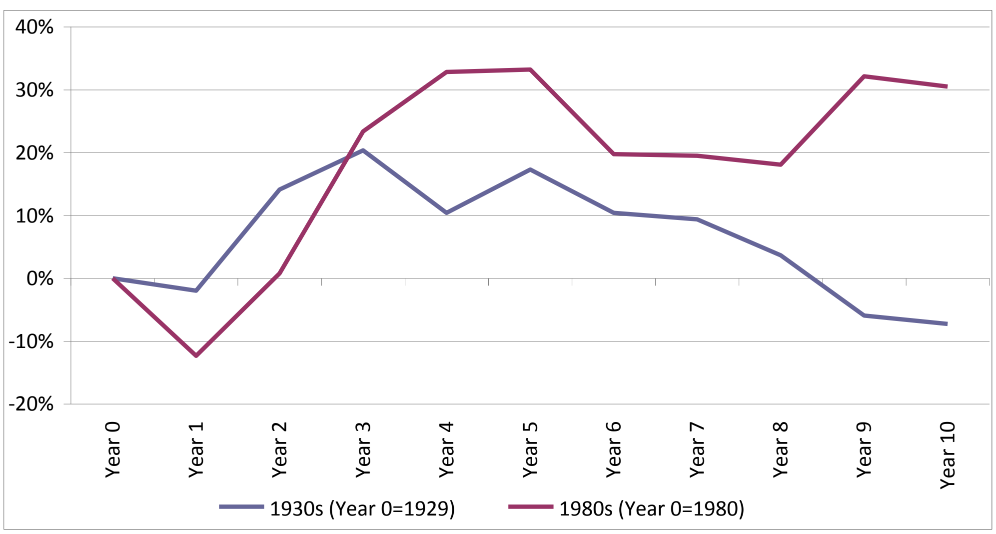
A comparison with the 1930s will help to show just how crucial the effect of the negative resource transfers of the 1980s was. As illustrated in Figure 5.A, the opportunities for boosting exports and their purchasing power were much greater in the 1980s than they were in the 1930s. Thus, the crucial difference between the debt crisis and the Great Depression was the massive, long-lasting shock to the *capital* account.

This situation was not properly addressed at the international level, with the result that the region sank into the worst crisis of its entire history.

Figure 5
Comparison of The Crises of the 1930s and 1980s
A. Purchasing Power of Exports



B. Trade Balance as % of Exports (vs. 1929 and 1980)



Source: Authors' calculations based on ECLAC (1976) for the 1930s and ECLAC historical series for the 1980s.

As the prospect of bank failures loomed for over-exposed banks worldwide and, in particular, in the US (Latin America's debt was equivalent to 180% of the capital of the nine largest US banks), the US and other industrialized countries' governments put pressure on the IMF and multilateral development banks to run to the rescue and started freeing up larger amounts of credit than they had in the past. The funds that they made available were, in any case, modest in comparison to the impact of the large-scale turnaround in private resource transfers and were also accompanied by unprecedented “structural” conditionalities (which took the form of what were, in most cases, draconian market reforms and fiscal adjustments). As was seen in the preceding chapter, in the 1930s external debt defaults proved to be a solution for most of the countries involved, just as they had been in all the previous external debt crises. As the 1980s unfolded, temporary “silent defaults” in the form of arrears in the servicing of commercial and bilateral (and, in a very few cases, multilateral) debts became more and more frequent. This was partly because of the internal tensions that this overly prolonged crisis began to generate in a region which was, moreover, witnessing a return to democracy (Altimir and Devlin, 1993). Be this as it may, the strong pressure brought to bear by industrialized countries and multilateral agencies prevented the Latin American countries from openly declaring defaults and pushed debtor countries into concluding renegotiation agreements that were clearly advantageous for the commercial banks involved. The 1989 Brady Plan opened the way for a few debt write-offs, but the amounts involved were moderate and the cancellations came too late to head off the damage caused by the debt crisis.

As a result, while, during the 1930s, the Latin American economies simply had to increase their trade surpluses for a fairly short period of time, in the 1980s they had to generate hefty trade surpluses for a period lasting over a decade (see Figure 5.B). The combined impact of all of this turned out to be that, while the initial effect of the Great Depression on per capita GDP in the Latin American economies was more severe, their subsequent recovery was quite energetic and, from 1937 on, per capita GDP was invariably above pre-crisis levels. In contrast, the recovery from the debt crisis of the 1980s did not come until 1994, i.e., 15 years down the road.

Three different stages in the debt crisis can be identified.[6] In the period up to September 1985, large-scale macroeconomic adjustments were made on the assumption that the crisis would be short-lived (i.e., that it was a liquidity crisis rather than a solvency crisis) and that voluntary lending would soon make a comeback.[7] There was also a powerful cartel of lenders that had the backing of the governments of industrialized countries, which intervened because they felt that their financial systems were under serious threat. On the other hand, although some governments adopted more radical stances, such as the decision taken by Alan García in 1985 to limit Peru's debt service to 10% of its export earnings, and although some unconvincing attempts were made to form some sort of association of debtors (the 1984 Cartagena Consensus being the best-known), there was never an effective move to form a "debtors cartel", which, if it had actually come into being, would no doubt have triggered a severe crisis in the private international banking system, especially in the US. The measures that were adopted were, therefore, very effective in averting a financial crisis in the US, but entirely inappropriate for handling the Latin American debt crisis. What is more, because of the asymmetrical nature of the negotiations, the Latin American countries ended up "nationalizing" large portions of the private external debt. Thus, Latin America can rightly be seen as a victim of the way in which what was also a US banking crisis was handled; oddly enough, this is not fully recognized in the existing literature.[8] The great irony was that, as a result, US banks were turning a profit while Latin America slipped into the worst economic crisis of its history (Devlin, 1989).

In September 1985, the crisis entered into a second phase with the announcement of the first Baker Plan, which provided for a structural adjustment headed up by the World Bank, better lending terms and a modest amount of fresh

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[6] See, among many others, Devlin (1989), Altimir and Devlin (1993) and Ffrench-Davis, Muñoz and Palma (1998). Devlin divides each of the first two phases into two subperiods of debt renegotiations. The conditions associated with the various phases of the negotiations are covered in detail in the first chapter of Devlin (1989) and in the editions of ECLAC's annual *Economic Survey of Latin America and the Caribbean* published during those years.

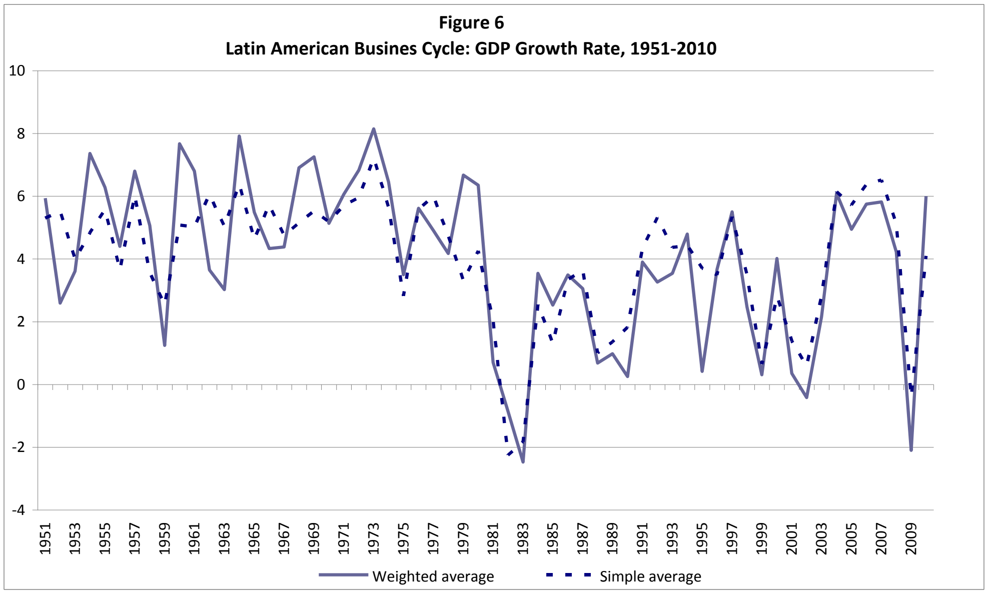
[7] Cline (1984), who authored what is perhaps the most well-known presentation of this view, argued that the crisis would be overcome once the industrialized economies made a recovery.

[8] In fact, it makes little sense that this crisis is not classified in the relevant databases as the US banking crisis that it actually was. See, for example, the IMF database (Laeven and Valencia, 2008).

credit. This package was insufficient, however, and, two years later, was replaced with a second Baker Plan which added debt buybacks, low-interest exit bonds and debt swaps. The final phase began in March 1989 (i.e., nearly seven years after the outbreak of the crisis) with the Brady Plan, which included a modest reduction in debt balances and was soon followed by renewed access to private external financing. The United States' involvement in these last two phases differed from its approach in the first, with the authorities working to offer actual solutions for what was now clearly seen as a solvency crisis at a time when there were also signs that Latin American countries were increasingly reluctant to continue following the earlier approach.

Although the Baker Plans and, especially, the Brady Plan finally led to reductions in the countries' external debt coefficients (see Figure 4), the upward trend in those coefficients had already been reversed by the large trade and current-account surpluses that the countries built up, at the cost of a "lost decade" in terms of economic growth. That loss represented a drop of somewhat more than 8% in their per capita GDP. Latin America's share of world GDP, which had been expanding for over a century, fell by 1.5 percentage points, while its per capita GDP shrank by 8 percentage points relative to that of industrialized countries and by 23 percentage points relative to the world average (see Bértola and Ocampo, 2012, Table 1.1).

The recession was initially very severe. The region's GDP shrank for three years in a row. The contraction was particularly sharp in 1983, when the full impact of the Mexican default of August 1982 made itself felt. This is generally considered to be the starting point for the debt crisis (see Figure 6). In 1984-1987 there was a moderate recovery, but the situation deteriorated in the closing years of the decade. Few countries were able to put their economies back onto a stable growth path in the second half of the 1980s; those that did were generally countries with moderate external debt coefficients (Colombia) or ones that received fairly hefty amounts of official external financing (Chile and Costa Rica). As will be seen later on, the decrease in per capita income was accompanied by a steep reduction in the manufacturing sector's share of economic activity.



Source: ECLAC. Excludes Cuba.

The social costs of the crisis were huge. The poverty rate climbed sharply between 1980 and 1990 (from 40.5% to 48.3% of the population). The deterioration of income distribution in a number of countries exacerbated the sharp inequality that was already a long-standing feature of Latin America, and reversed the progress that had been made in this respect during the 1970s by a number of individual countries and by the region as a whole. This was, in most cases, accompanied by a decline –a steep one in some cases-- in real wages in the formal sector and the expansion of informal employment. The rapid improvement in human development indices made during the period of State-led industrialization gave way to a much slower rate of progress and to an actual deterioration in some areas.

Huge adjustments in fiscal and monetary variables and in the exchange rate put added stress on what were already precarious economic structures. The depreciation of the real exchange rate, which was necessary in order to support external-sector adjustment, was inevitably accompanied by a surge in inflation, which reached proportions never before seen in Latin America, even taking into account the inflationary histories of some countries. Inflation had sped up in the 1970s, as was happening elsewhere in the world as well, and two countries had ushered in the era of triple-digit inflation in the midst of serious political crises (Chile and Argentina).

Nonetheless, inflationary spirals were an *effect* rather than a cause of the debt crisis. The most bizarre manifestation of this effect was the bouts of hyperinflation that overtook five countries in the mid-1980s and early 1990s (Argentina, Bolivia, Brazil, Nicaragua and Peru). Another three registered triple-digit inflation at some point as well (Mexico, Uruguay and Venezuela). Panama (the only dollarized economy at the time) was the only country in which inflation did not climb above 20%. For the region as a whole, as shown in Figure 7, the median and mean rates of inflation soared, reaching nearly 40% and over 1,000%, respectively, in 1990 before beginning to subside in the years that followed. The crises that broke out in the financial sector were also massive, especially in the Southern Cone, where they took a toll in terms of fiscal and quasi-fiscal costs equivalent to as much as 40% or 50% of GDP.[9]

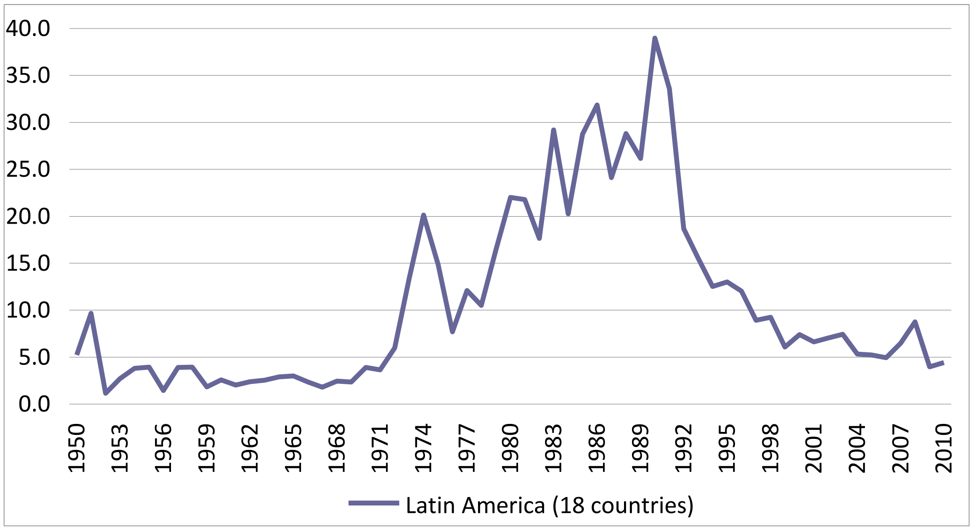
The distribution problems that arose within the countries as they strove to cope with the crisis were closely associated with the need to make transfers to the governments so that they could service their countries' external debt and pay the costs of the collapse of their domestic financial systems. These transfers could be made more easily in countries where the State had direct access to hard-currency export earnings (mainly through State-owned oil and mineral enterprises) and where the government consequently benefited directly from the devaluations. Others were confronted with a serious "domestic transfer problem" as they struggled to find ways of transferring fiscal resources to the State for use in servicing the public debt; as such service rose in terms of the local currency because of the devaluations, it became even more difficult to cover (ECLAC, 1996; Altimir and Devlin, 1993).

[9] See Laeven and Valencia (2008), which make it clear that the financial crises that hit the three countries of the Southern Cone in the early 1980s were some of the most costly to be seen in the last three decades and are actually comparable only to those experienced by some East Asian countries during the 1997 crisis.

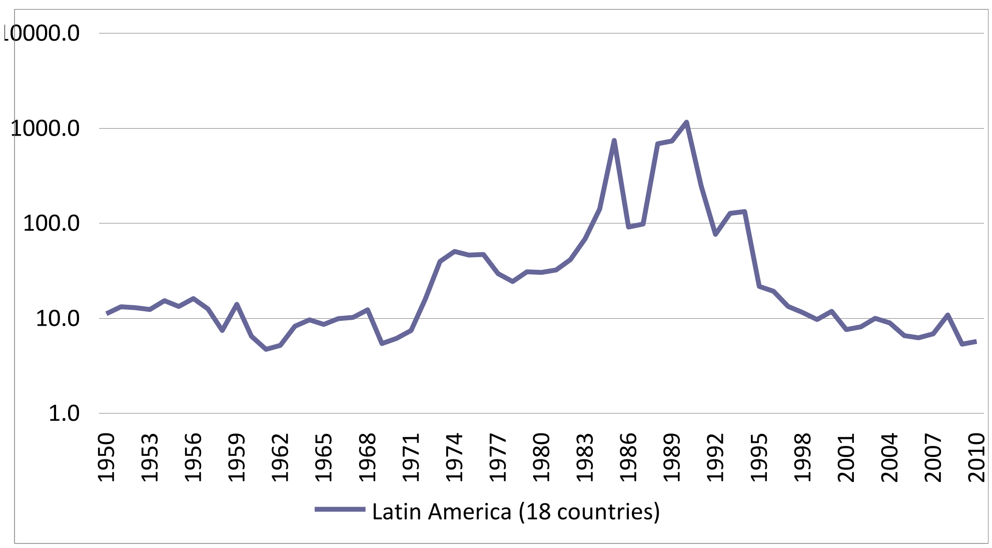
Figure 7

A. Inflation rate in Latin America (CPI, annual percentage change)

A. Median



B. Mean (annual percentage change in natural logarithm)



Source: IMF, International Financial Statistics.

The adjustment also entailed an enormous reduction in investment (a drop of 6 percentage points from its 1975-1980 peak, as shown in Table 1), even though domestic saving was on the rise. In this last case, the domestic transfer problem made it necessary to reduce the real income of wage-earners (the sector with the greatest propensity to consume) or, more often, oblige them to undertake "forced saving" via inflation. Against a backdrop of growing distributional conflict, this situation was reflected in surging inflation and in the high social costs of the adjustment.[10] Meanwhile, the investment rate would take a quarter of a century (i.e., until the 2004-2008 boom) to regain the levels attained prior to the mid-1970s, but it has still not returned to the levels achieved in the second half of the 1970s (see Table 1). There is, moreover, a consensus that forcing governments to cut back on infrastructure investment as part of the adjustment program stunted long-term growth (Easterly and Servén, 2003).

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[10] For a discussion of the various dimensions of the domestic transfer problem, including the fiscal transfers mentioned above, see Frenkel and Rozenwurcel (1990).

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