



THE DEBT CRISIS AND STABILIZATION  
POLICY IN LATIN AMERICA  
NEW INSIGHTS FROM RECENT RESEARCH

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### Abstract

This report synthesizes the papers and presentations made at the Kellogg Institute conference on "Debt Adjustment in Latin America: Is the Crisis Over?" on April 16, 1985. The paper argues that 1) the debt crisis is far from over as long run solutions to the crisis have not been enacted, and 2) IMF-style stabilization efforts made in response to the crisis have largely failed, suggesting some flaws in the IMF approach.

### Resumen

Este trabajo sintetiza los ensayos y presentaciones de la conferencia del Kellogg Institute sobre "Ajuste de la Deuda en América Latina: ¿Está Terminada la Crisis?" llevada a cabo el 16 de abril de 1985. El trabajo sostiene que 1) la crisis de la deuda está lejos de ser superada ya que no se ha encontrado soluciones de largo plazo; y 2) los esfuerzos de estabilización al estilo FMI han fracasado, lo cual sugiere algunas fallas en el enfoque del FMI.



## INTRODUCTION

The international recession of the early 1980s and the attendant debt crisis in Latin America in 1982-1983 certainly rank in many scholars' books as the most significant, if not most painful events in Latin American economic history since World War II. The inability of Latin American economies to meet soaring debt-servicing requirements made itself known with the Mexican default of August 1982. Soon afterwards the cutoff of additional bank credit for Latin America exacerbated the situation for other debtors in precarious financial positions, leading to debt crises for other large debtors such as Argentina and Brazil.

Initial emergency measures were taken on a case-by-case basis to avoid the collapse of the international banking system and to avoid the spectre of full-fledged "default." In addition, traditional IMF stabilization policies were implemented in a number of countries, often as a prerequisite for receiving IMF help in arranging debt rescheduling.

After the crises of 1982, late 1983 and 1984 saw a welcome turnaround in the debt-servicing capacity of many Latin American economies, as many a country achieved a significant surplus in the current account. Growth rates also turned weakly positive, tentatively indicating the end of the horrid recession of the past couple years. Hence, it appears to many that, under the aegis of IMF stabilization policy, Latin America has adjusted satisfactorily to both the severe

international recession of the early 1980s and the concomitant debt crisis. Nevertheless, many questions remain: what were the origins of the crisis? How much of the recent improvements in Latin America are due to the success of IMF stabilization policy, and how much to the world recovery and the explosion of the U.S. trade deficit? And if IMF stabilization has been so successful, why is the economic recovery in Latin America so weak? Exactly what are the prospects for continued and more vigorous growth?

To answer these questions, the Helen Kellogg Institute for International Studies at the University of Notre Dame invited a number of prominent scholars to a conference on April 16, 1985 entitled "Debt Adjustment in Latin America: Is the Crisis Over?" Papers presented at the conference dealt not only with country or region studies (Central America, Peru, Chile, Argentina, Colombia, and Mexico) but also with the rationale behind IMF stabilization policies and the problems, both in theory and practice, with such policies.

This paper draws on the research papers and presentations made in conjunction with the conference to bring out new insights into the debt crisis and stabilization policy in Latin America. In short, conference participants argued that 1) IMF style stabilization efforts in the face of recession and external imbalance often do not work, and in the process exact high social costs; 2) economic recovery at the present time is quite weak, and the vulnerability to future

downturns in the international economy does not rule out future debt crises; and 3) the international recession was not the only cause of the debt crisis, as policy mistakes--sometimes because of misguided economic theory, sometimes because of political pressures--contributed significantly to the debt crisis erupting in 1982-1983. In sum, the temporary respite in the debt crisis is no reason for complacency, as medium and long-run solutions to the problem have not been enacted.

This paper is structured in the following manner. The first section provides a quick synopsis of the origins of the debt crisis. The second section consists of an overview and critique of IMF stabilization theory. Within this second section a discussion of "dollarization," a phenomenon that is making IMF policies backfire, is also presented. This presentation of IMF stabilization theory and its weaknesses provides a useful framework for analyzing the success and failure of economies to adjust to the debt crisis. The third section offers illustrative country studies of stabilization policy in the wake of the international recession and debt crisis.<sup>1</sup> Finally, a brief section summarizing the main themes of the country studies concludes the paper.

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<sup>1</sup> The country studies on Chile and Argentina largely focus on stabilization efforts in the 1978-83 period, before the IMF came on the scene. However, since neo-conservative stabilization efforts in both countries during this period had implicit IMF approval, the experience of Chile and Argentina in 1978-83 is illustrative of the consequences of following IMF stabilization policies.

## I. Origins of the Crisis

To gain a proper perspective on the debt crisis, a long-run view of Latin American development since World War II is necessary.<sup>2</sup> In particular, the structural changes occurring in the region's economies sheds much light on the emergent financial gap that required financing (debt) in the 1970s and earlier. In the 1940s, increasing food consumption led to a trade imbalance in foodstuffs; with the import substitution of the 1950s, the trade imbalance was found with respect to raw materials. In most of Latin America the maturation of industrialization did not resolve the problem, as nontraditional exports were unable to pay for the intermediate import bill. Hence, Latin America has traditionally had current account deficits that had to be "paid for" with capital inflows. In the 1970s excess world liquidity was the rule of the day, facilitating the financing of Latin America's trade imbalance at historically low real interest rates.

The fundamental cause of the debt crisis is rooted in the fact that this "basic transfer" of capital from the rest of the world to Latin America (L.A.) turned negative in the early 1980s.<sup>3</sup> That is, L.A. began exporting, rather than im-

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<sup>2</sup> This section is based on comments by Professor Rosemary Thorp at the conference.

<sup>3</sup> This explanation of the cause of the debt crisis emphasizes external factors. It should not be forgotten, however, that it was internal forces that generated the demand for foreign debt; this point comes out clearly in the country studies presented in section three.



porting, financial capital. The problem was exacerbated by the suddenness of the shift, as well as the fact that many of the payments on the loans made to L.A. came due in the early 1980s, at a time when cheap new financial capital to roll over the debt was not forthcoming.

What were the causes of the reversal of capital flows? First, real interest rates jumped dramatically in the 1979-1982 period, from a 1% real rate in 1979 to 3.3% in 1982. Not only did the cost of new loans increase, but old loans with floating interest rates increased debt-servicing costs drastically. Second, the world recession took the bottom out of commodity prices and export earnings, lessening the region's ability to pay. Third, international confidence was shocked after the Mexican crisis of August 1982, drying up new sources of debt financing.

Of particular interest in analyzing the origins of the debt crisis is an examination of the role of U.S. economic policy.\* As an antecedent to a discussion of this topic, it is well to note that much of the debt acquired by Latin America was denominated in dollars. Why did L.A. contract loans in dollars, instead of a weighted basket of foreign currencies? This is perhaps even more surprising in light of the fact that U.S. interest rates were higher at the time than those of other countries. However, the desire to acquire dollar-denominated debt was not so illogical when one

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\* This discussion is based on comments made by Laurence Whitehead at the conference.

considers that the dollar was thought of as a weak currency for much of the 1970s. With the installation of Paul Volcker as Federal Reserve Chairman in 1979, the advent of monetarism in the U.S. was inaugurated and the day of the cheap, inflated dollar was destined to end. The tight monetary policy of Volcker succeeded, resulting in high interest rates, a decrease in inflation, and appreciation of the dollar. And while the tightening of U.S. credit was meant to cut off credit demand in the U.S. by weak domestic borrowers, the end result of the policy hit the weakest borrowers outside the U.S.--particularly, Latin American nations.

The crucial role of the U.S. in the debt crisis is also illustrated by the reaction of U.S. monetary policy to the spectre of a world financial system crash after the Mexican debacle of August 1982. Monetary policy eased in August 1982, as the crisis threatened disaster for the U.S. banking system. U.S. growth in the 1982-84 period has also been instrumental in improving the trade balance of L.A. Not only has U.S. real growth exceeded Europe's, but the percentage of debtor country exports bound for the U.S. (45%) has increased in the past two years (up from 40%). Unfortunately, the U.S. import bonanza is not likely to continue. The U.S. trade deficit has increased to politically and economically unsustainable levels, reaching \$123 billion in 1984 and a predicted \$150 billion for 1985. The U.S. may likely react to sectoral pressures with protectionism; already some in

Congress are advocating a 20% trade duty. The passage of such legislation would surely cause confrontation between L.A. and the U.S., as L.A. can rightly claim that it cannot pay off the debt without exporting. Hence, the ability of L.A. to service its debt is quite dependent on U.S. economic policy, both at the macro and micro (sectoral) levels.

While L.A. export growth picked up considerably in 1984 and early 1985, one may wonder how much this is really a consequence of U.S. economic growth. Could it not also be due to the proper adjustment of the economies to IMF stabilization policy? Before reviewing country experiences, a review of IMF stabilization theory and the problems with this theory are now outlined.

## **II. IMF Stabilization in Latin America: Theory and Critique**

In any discussion of IMF stabilization theory, a distinction must be made between the "traditional orthodox approach" practiced in the 1960s and 1970s and the "monetary approach to the balance of payments" espoused by the IMF in the 1980s.<sup>5</sup> Under both approaches, the common theoretical theme is that external imbalance (balance of payments difficulties) reflect internal imbalances (such as budget deficits and excess demand). Combining the elasticities approach with this absorption focus, the traditional IMF

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<sup>5</sup> This section is based on Patricio Meller's presentation at the conference and his paper, "EL Rol del FMI en America Latina," to be published as a Kellogg Institute working paper.

program calls for 1) a reduction of the fiscal deficit and 2) restoration of international competitiveness through exchange rate devaluation. With the monetary approach of the 1980s, target indicators are tied to 1) changes in high-powered money (including reserves) and 2) the fiscal deficit.

The rationale for the IMF's traditional stabilization scheme can be found with a simple manipulation of national accounting identities. The basic identity of the national accounts states that

$$Y = C + I + G + X - M \quad (1)$$

where  $Y = \text{GNP}$ ,  $C$  is consumption,  $I$  is investment,  $G$  government spending,  $X$  exports, and  $M$  imports. Internal demand is equal to the sum of  $C+I+G$ , and can be represented as  $A$ , "absorption" of the national economy.

Assume for the sake of simplification that the trade balance ( $X-M$ ) equals the current account balance, i.e., there are no unilateral transfers, there is no income from foreign investment, etc. Assuming this, and taking  $B$  as  $X-M$ , where  $B$  represents the current account balance, it can be said that

$$Y - A = B \quad (2)$$

When absorption equals income, that is, when the country is not "spending beyond its means" ( $Y-A=0$ ), then the external account is in balance ( $B=0$ ). If absorption exceeds income

( $Y - A < 0$ ), then  $B$  is less than 0 ( $M - X < 0$ ), implying a deficit in the current account. From these national accounting identities, the IMF has appended a theory of causality, suggesting that the cause of the external deficit ( $B < 0$ ) is rooted in internal imbalance, where absorption ( $C + I + G$ ) exceeds income. Hence one can see the focus on reducing internal demand through reduction of the budget deficit, in addition to increasing the relative price of tradeables through devaluation.

The objections to the IMF program found in the Latin American literature are numerous. To begin with, the IMF analysis of the cause of external imbalance almost always singles out excess absorption (excess demand) as the culprit, with the fiscal deficit usually being the root problem. No analysis is done with respect to how the deficit came about, which leads to serious errors in their interpretation of the cause of the external imbalance. For example, how can excess demand be said to characterize an economy with 15% unemployment and excess industrial capacity? This is exactly the kind of macroeconomic conditions one finds in Latin American economies in the wake of the international recession of 1982. Furthermore, the IMF does not take into account the fact that the fiscal deficits can come about by falling tax revenues as a result of recession. Hence, the emphasis on the fiscal deficit as the driving force in external and internal imbalance is misleading.

Furthermore, the short-run impact of IMF policies differs more in practice than in theory. For example, devaluation is often contractionary rather than expansionary. In addition, the monetary contraction the IMF often prescribes (with a view to lowering inflation) raises interest rates, boosting the cost-push component of inflation through higher working capital costs. On top of a simultaneous reduction in the fiscal deficit, this monetary contraction and devaluation can plunge the economy into a deep recession. Hence, the IMF program is not only recessionary, but can also add to inflation.

While disequilibria in the world economy (such as trade deficits in less developed countries (LDCs)) indicate a need for some kind of adjustment, the IMF's prescription for external imbalances puts an unfair burden on LDCs. Why do countries with deficits in the current account necessarily have to adjust? Why cannot the surplus country adjust, for example, through an expansion of exports? In the same vein, why do the costs of stabilization policy within LDCs have to fall on the poor? For example, IMF packages often involve wage controls and devaluation, which decrease real wages, as does the reduction of subsidies for consumption goods such as foodstuffs. Also, the reduction of the public sector increases unemployment. There is no reason why the burden of adjustment cannot be shared more widely, e.g., through higher taxes on capital or on high-income individuals.

Another serious flaw with IMF stabilization policies is their myopic focus on short-run adjustment, often to the detriment of long-run performance. The IMF's time horizon for achieving external balance is without a doubt too short; reviews are now made on a quarter-by-quarter basis, as opposed to the yearly assessments common in the 1950s and 1960s. Furthermore, the long-run consequences of the policies taken to achieve these short-run goals are not taken into account by the IMF. For example, the destructive effects of IMF-sponsored recessions on capital accumulation are not considered. Hence, IMF policies designed to restore the conditions for healthy economic growth may in fact debilitate the economy's ability to grow.

Thus, IMF stabilization policies are often inconsistent with the long-run goals of stabilization and macro-economic adjustment. This inconsistency problem plagues IMF policies in the short-run as well. The typical IMF package calls for simultaneous achievement of external and internal balance. Recent experience shows that both cannot be achieved simultaneously; Brazil's economic record in 1983 provides a good example. While the IMF stabilization package involved an inflation goal of 37%, inflation instead more than doubled to 211%. On the other hand, Brazil surpassed the IMF goal on export growth for the same year. For many it is apparent that the policies taken to achieve external balance (real depreciation) also significantly added to inflationary pres-

asures in Brazil. How, then, can the IMF claim its packages are able to simultaneously achieve internal and external equilibrium?

A new phenomenon that deserves special mention in any discussion of the efficacy of IMF stabilization policy is dollarization.<sup>6</sup> That is, the substitution of dollars for local currency by economic agents is contributing to the perverse impact of orthodox IMF-style stabilization efforts. Take Peru, for example. Dollarization has increased dramatically in the past 4 years, as dollar deposits as a percentage of total deposits increased from approximately 15% in 1981 to 50% in 1984. Counting externally-held deposits, the figure is probably closer to 70%. Dollarization is also found in Chile, Uruguay and Brazil to a certain degree. Within a dollarized economy operating under a flexible exchange rate regime, tight monetary policy is ineffective as an anti-inflationary tool, and even stagflationary in its impact. The key mechanism that brings this about is the unintended devaluation and ensuing cost-push inflation that accompanies tight monetary policy. In theory, tight monetary policy should reduce the demand for credit, leading to lower investment, lower aggregate demand, and hence lower inflation. In a dollarized economy, however, things are not that simple. In Peru, for example, when the Central Bank reduces credit in soles (tight monetary policy), firms and

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<sup>6</sup> This discussion is drawn from the presentation of Professor Paul McNelis at the debt conference.



investors seeking credit do not necessarily cancel their spending plans, but instead seek dollar-denominated credit from alternative sources. This results in an increase in the demand for dollars, which under a flexible exchange rate regime increases the value of the dollar relative to the sole. This devaluation of the sole increases the price in soles of imported inputs, as these imports must often be paid for in dollars. These higher input prices are passed along as higher final-good prices, so that the net result of the tight monetary policy is to increase the cost-push component of inflation. Furthermore, the inflation set off by credit tightening in soles may lead to a self-sustaining inflationary spiral, given flexible exchange rates or a government policy that attempts to maintain the official exchange rate close to the "market" rate. Thus, allowing the "market" to determine the exchange rate, or using government policy to accommodate market movements, contributes to the kind of devaluation and inflation explosions witnessed in Peru. This implies that government intervention in the exchange market, always abhorred by the IMF, may be necessary to truly "stabilize" the exchange rate. A comparison of the recent experience of Ecuador and Peru indicates that Ecuadorian intervention has been both effective and necessary in bringing order to the exchange rate market.

### **III. Country Studies: Adjustment to International Recession and the Debt Crisis**

## Peru

A useful way to analyze the stabilization experience of Peru<sup>7</sup> from 1973 to 1985 is in the context of the following four questions: 1) Could the problems actually encountered have been avoided with better policy? 2) How much of the economic problems of Peru today are actually due to the 1982 crisis and debt per se? 3) How successful has IMF-style stabilization policy been? 4) What are the prospects for substantial economic recovery?

Before addressing question 1, it would be helpful to look at Peruvian economic development in long-run perspective. Peru's chronic current account problems in the post-war era led to a persistent need for capital inflows. Pricing policy discriminating against agriculture led to a need for food imports in the 1950s, and poorly managed import substituting industrialization in the 1950s and 1960s led to a deficit in the raw materials balance. The military government that arrived in 1968 did get some successful exporting projects off the ground, but failed to resolve the fundamental weaknesses of the Peruvian economy--poor income distribution, and a weak industrial bourgeoisie incapable of igniting sustained capital accumulation and growth.

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<sup>7</sup> This section is based on the presentation made by Professor Rosemary Thorp at the conference, and her conference paper, "Peruvian Adjustment Policies 1973-85: The Effects of a Prolonged Crisis."

The financial gap of the early 1970s was financed with the cheap international bank credit available at this time, permitting an expansion of imports, defense, public investment, and consumption. Overexpansion and the OPEC oil price hikes of 1973-1974 ensued, leading to the need to adjust in 1976. The adjustment attempt of 1976-1978 had disastrous consequences, as per capita GNP fell by 9% and inflation accelerated from 17% in 1974 to 58% by 1978.

In answering question one, whether or not the debt crisis could have been avoided, we pick up the story in 1979. Corresponding with the prospect of democracy and high hopes for the future in 1979, there was a dramatic improvement in the terms of trade and export prospects. For example, the export price index soared 78% between 1978 and 1980.

During this transitional period from military to civilian rule, an economic team led by Silva Ruete implemented some moderately conservative economic policies. In particular, import policy was liberalized, a move usually cheered by the IMF. It was reasoned that expanding imports and reducing tariffs would put a damper on inflation. Counter to an IMF-approved strategy, controlled prices were not raised in line with inflation; subsidies were also increased. Higher export prices allowed the exchange rate to appreciate, continuing the trend toward overvaluation.

With the election of Belaunde in 1980, economy policy was directed in an even more orthodox and ideological fash-

ion by Manuel Ulloa until December 1982. Further import liberalization was pursued, as by December 1981 virtually all import categories were exempt from nontariff barriers. Average tariffs decreased from 56% in 1978 to 39% in 1980 and to 32% in 1981. Restrictive monetary and fiscal policies were also implemented, along with financial reform aimed at increasing the real interest rate and hence savings. Basically, Peru used the breathing space offered by the more favorable external environment of 1979-1980 to reduce "distortions" in the economy and open up the economy to international competition.

The subsequent crisis of the 1980s revealed that the room for maneuver given by the improved external environment in 1978-1980 was sadly squandered by Peru. Instead of using the breathing room to make long-run structural changes, the new wealth was largely wasted on imports. This import liberalization greatly harmed domestic industry, which was unable to cope with the competition from cheap imports. In this sense much of the crisis of 1983-1985 could have been avoided, as bad policy in the 1979-1982 period did nothing to prepare the economy to adjust to adverse or even normal international economic conditions.

1982 saw a precipitous drop in commodity prices and the dramatic rise of real interest rates. Natural disasters affecting exports such as fishmeal also rocked the economy in 1983. The flow of bank credit to Peru evaporated after the

Mexican default, despite some of the early repayment of the debt during the previous years. GDP growth slowed to 1.8% in 1982.

Peru's attempted adjustment to internal and external disequilibrium in 1983 followed the prescription of the IMF: Reduce aggregate demand. Aggregate demand did indeed fall sharply in 1983, yet adjustment was not forthcoming. While orthodox stabilization policies assume inflation and external disequilibrium are caused by excess demand, Peru in 1982 certainly showed no signs of this. The government budget deficit, while still in the red, was tending toward a surplus. Excess industrial capacity (as a consequence of the flood of imports) was also prevalent. Beyond this, the traditional measures taken to cure inflation were becoming increasingly ineffective. Monetary policy appeared to be impotent as an anti-inflationary weapon, due to the "monetization" phenomenon described earlier. Inflation zoomed from 35% in early 1983 to 129% by mid-year, falling to 113% by mid-1984.

It is clear that traditional stabilization theory leads to an incorrect diagnosis of the causes of inflation in Peru. Inflation seems more a function of costs than excess aggregate demand. As most costs are affected by government policy (import costs, wages, controlled prices, financial costs), government policy affects inflation directly, rather than indirectly through its impact on aggregate demand.

hence, measures taken to reduce aggregate demand which also increase the cost component of production tend to be inflationary.

The positive aspect of stabilization policy in 1983-1985 was the reduction of imports achieved. Nevertheless, the high cost in terms of lost GDP and employment gives pause to the suggestion that the draconian reduction in aggregate demand witnessed in the period was the most efficacious means to achieve this reduction in imports.

Regarding Peru's prospects for recovery, the picture is not bright. While reducing aggregate demand is not stabilizing, neither would a Keynesian-style spending spree bring any relief. The bottlenecks in the economy at this present time would prevent any substantial increase in aggregate demand from setting the stage for a prolonged economy recovery.

### Chile

The Chilean experience<sup>8</sup> with adjustment and the debt crisis can also be framed within the four questions used for the Peruvian case. Regarding whether or not the crisis of the past years could have been avoided with better policy, it is important to note that as late as 1979 Chile was seen as the shining example of correct economic policy by multilateral institutions such as the World Bank. One would have

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<sup>8</sup> This section is based on comments made by Laurence Whitehead at the conference.

expected the "Chicago Boys" to argue that the reforms made in the economy since 1973 to fashion a "free market" economy gave Chile the wherewithall to withstand an international crisis and adjust accordingly. However, the events of 1982-1985 exposed the egregious policy errors of the regime since 1979, and made clear that the international recession and the debt problem per se were not the chief cause of the economic hardship suffered in Chile since 1982. Rather, it was the dogmatism of policymakers, inspired by the Chicago school, that exacerbated an unfavorable situation and made it disastrous. In this sense much of the crisis in Chile has been self-induced and not a product of the collapse of international financing and the debt crisis after 1982.

That Chile's comparatively worse fortunes were not solely caused by the downturn in the international economy is evinced by Bela Balassa, who shows that Chile suffered only an "average" shock vis-à-vis the rest of Latin America from the international recession of the early 1980s. Chile's self-induced injuries stem mainly from 1) the impact of financial liberalization and 2) exchange rate policy, under the dogmatic application of the monetary approach to the balance of payments. With respect to 1), the aftermath of financial liberalization and the attendant crisis in troubled financial institutions led to the government taking over 67% of bank assets in 1983, as the private financial system virtually collapsed. The impact of this financial

collapse on the economy is documented elsewhere, but leave it to say that this crisis was clearly predictable; only the unswerving faith in the efficiency of unregulated financial markets prevented a more timely and less drastic intervention.

Regarding exchange rate policy, the decision to fix the peso at 39 per dollar in June 1970 marked the implementation of the monetary approach to the balance of payments. While differing from traditional stabilization policy, the monetary approach maintains a belief in the flexibility of prices and the efficacy of aggregate demand changes to affect internal and external imbalance. Under this approach, the money supply is left endogenous, with variations in international reserves changing the money supply. A deficit in the current account should be self-correcting, as the subsequent outflow of reserves should reduce the money supply and aggregate demand. Real exchange rate overvaluation is prevented by flexible prices. With a balanced fiscal budget, the economy should be self-regulating and, furthermore, should experience little or no inflation.

It was precisely on this assumption of price flexibility that the monetary approach stumbled in Chile. As shown in other research, the exchange rate became seriously overvalued, with dire consequences. Underlying the consumer euphoria of cheap import prices, a flood of debt was contracted in dollars by domestic agents taking advantage of the



overvalued peso.<sup>9</sup> The extent of international indebtedness was masked in Chile by the fact that the majority of it was incurred by private agents, unlike the situation in the rest of Latin America. Chile's debt-service to export ratio looked quite good until 1982, if private debt is not included.

One might wonder why Chilean policymakers dogmatically stuck with their free-market policies until the point of economic ruin. The best answer to this is socio-political: dogmatism was necessary for the Pinochet regime to restore the confidence of asset holders shaken by the Allende government. The religiously dogmatic approach of the "Chicago Boys" assured domestic and international capital. Ironically, foreign capitalists were more impressed with this dogma than domestic capitalists in 1980-1981, as evinced by the relatively weak levels of private domestic investment and the high level of capital flight.

The prospects for Chile are grim. Debt-servicing ratios are extremely high, with little room for imports to fuel capital formation. Trade surpluses have been difficult to achieve, even in light of the boom in U.S. imports. Unfortunately, achieving large trade surpluses has become a prerequisite for receiving additional foreign credit. The repression of the Pinochet regime and the concomitant political instability of Chile do not make it a good bet for

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<sup>9</sup> As many in Chile learned, however, the subsidy to dollar-denominated debt ended as soon as exchange rate overvaluation was corrected.

private bankers. Hence, even the current weak recovery in Chile is quite fragile and liable to considerable downside risk.

### **Argentina**

The vicissitudes of Argentinian stabilization policy in 1979-1983 occurred more in response to the endogenous policy cycle unique to Argentina than to the debt crisis per se.<sup>10</sup> The cycle usually involves a "repressed" stage, aimed at lowering inflation, where key relative prices are distorted, inflation goes down, and internal and external disequilibria start to build up. This is followed by an "unloosening" stage where relative prices are freed and allowed to find their equilibrium levels, with the negative side effect of a reignition of inflation at higher levels than before. Cycles of "repression" and "unloosening" occurred in 1961-1962, 1969-1970, 1971-1973, and 1973-1975. The cycle of 1978-1983 will now be outlined in more detail.

Unique to the cycle of 1978-1983 was the neoconservative experiment with the monetary approach to the balance of payments started in late 1978. While certainly not predicted by its advocates, adherence to the new approach led to serious distortions in the economy, due principally to the overvaluation of the exchange rate. Starting in December 1978 the rate of devaluation was preannounced for the next 2

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<sup>10</sup> This section is based on Guido di Tella's paper, "Argentina's Recent Inflationary Cycle," a participant paper at the debt conference.

months, with the firm belief that the rate of domestic inflation would hence be equal to the rate of crawl plus international inflation. The faith shared by their brethren policymakers in Chile about the flexibility of prices and the convergence of domestic and international prices was found misplaced, as domestic inflation outraced the rate of crawl; this led to overvaluation. Additionally, Argentina's lack of fiscal discipline ran counter to the monetary approach, further contributing to internal and external imbalance.

The monetary approach seemed to be providing costless stabilization in 1979; real GDP grew by 7.1%, real wages by 12.1%, the trade balance was positive by 1.1 billion dollars, and inflation was down to 110% from 176% the previous year. The situation worsened in 1980, however, as the industrial sector stagnated under the impact of the overvalued peso. In 1981-1983 the inevitable "unloosening" stage occurred. This stabilization attempt was made all the more difficult by the debt problems and incredible capital flight that occurred in 1979-1981. Argentina's debt problems were largely self-induced, with the bizarre effects of financial reform playing a leading role. With real interest rates of over 30% prevailing for a while, there were strong incentives for foreign capital inflow in 1979. As evidence of the fact that Argentina was truly living on borrowed time in 1979, it is well to note that the fiscal deficit for that

year was financed in large part (90%) with foreign debt. Regarding capital flight, the record indicates that effective control of this would have significantly eased Argentina's problems. From 1976 to 1983 Argentina received 53 billion dollars in exports and 35 billion dollars of capital inflow (debt). Of these funds, 43 billion went to imports, 18 billion for interest payments, and a staggering 20 billion for remittances (capital flight). As in Chile, the overvaluation of the exchange rate in 1980-1981 gave significant impetus to capital flight, as confidence in the ability to maintain the overvalued exchange rate was weak amongst financial asset holders.

The unloosening of 1981-1983 took full grip in 1982, with real devaluation, control on fiscal expenditure and a reduction of GDP by 6%, and a trade surplus of 2.3 billion dollars; as the usual consequence of unloosening, inflation accelerated.

By early 1983 the distortions in the Argentinian economy had been wiped away. The chronic inability of policymakers to control the the budget deficit, however, started a new round of distortions as the year progressed; the deficit climbed to 16% of GDP in 1983, an all-time high. This lack of fiscal control should not be seen as policymaker incompetence, but as symptomatic of the inability of the Argentinian state to arbitrate a satisfactory "social contract" between the diverse agricultural, industrial, construction,

and labor groups pressuring the government. Indeed, Argentinian stabilization experience indicates that successful long-run stabilization will only occur if a social contract between fighting factions is established. Exchange rate policy must avoid distorting the real exchange rate, as much to promote export growth as to avoid subsidizing capital flight.

### **Mexico**

Mexico presents an interesting case, as it has been heralded by the IMF as a case of "successful" stabilization under the aegis of IMF-approved policies.<sup>11</sup> However, a closer look at Mexico's adjustment to the debt crisis suggests that this country adopted rather heterodox measures to deal with its stabilization problems. In addition, the long-run success of Mexico's adjustment efforts is in doubt, as the current recovery is based upon larger fiscal deficits, as opposed to export growth. Let us look at the situation in more detail.

The petroleum boom of the late 1970s left Mexico extremely dependent on petroleum exports for foreign exchange earnings; by 1981 oil accounted for 66% of exports. Furthermore, non-petroleum exports were stagnant and imports exploded, tripling in dollar value between 1976 and 1981. Ironically, then, the boom era was associated with high def-

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<sup>11</sup> This section is based on the conference paper of Jaime Ros entitled "Notas Sobre Endeudamiento y Proceso de Ajuste en México 1978-84."

icits in the current account and the need to contract debt. Furthermore, firms increasingly engaged in dollar-denominated debt financing, in response to high domestic interest rates and positive expectations about the course of the exchange rate. Dollar debt as a percentage of total debt skyrocketed from 30% in 1978 to 63% in 1981. International credit abounded for Mexico, as bank loans increased by 33% in 1979, 38% in 1980, and 34% in 1981.

The heavy reliance on petroleum and primary product exports, as well as the dramatic increase in real interest rates, augured difficult times ahead for Mexico in 1981 when the international economy went into a recessionary phase. The poor prospects for export earnings triggered adverse exchange rate expectations and large amounts of capital flight. Further aggravating the problem was the circumstance that by 1982 fully half of all external debt owed to bankers, 27 billion dollars, was due in the next year. The pullout of creditors and continuing capital flight in 1982 precipitated the crisis of August 1982 and the arrival of the IMF on the scene.

The stabilization policy adopted by Mexico in 1982-1983 contained both orthodox and heterodox measures. On the traditional side, a reduction of the fiscal deficit, monetary restriction, and exchange rate devaluation were implemented, as well as wage constraint. Rather unorthodox measures taken by Mexico include nationalization of the banking system, ex-

tension of import controls to almost all imports, and the creation of dual exchange markets.

Adjustment was painful, as GDP per capita fell 3% in 1982 and 8% in 1983. The external account improved, but not because of the favorable growth of exports; rather, the sharp fall in imports (due to the large decrease in internal demand) was the cause of the improvement.

The lack of dynamism in export growth lends doubt to the assumption that Mexico is now on a self-sustaining growth path, as the export expansion of 1983 appeared to fizzle out in mid-1984. In fact, the real fuel for Mexico's 1% per capita growth in 1984 was more expansionary fiscal policy, as government consumption increased 7%. Regarding export growth, one of the chief factors weakening export prospects in 1984 was the tendency toward overvaluation of the peso. Over half of the international competitiveness gained by the maxidevaluation of 1982 was eaten away by 1984.

The tradeoff Mexico has faced with inflation and export performance is illustrative of the "consistency problem" discussed earlier regarding IMF policy goals. That is, Mexico has had to trade off success with inflation (down from 100% in 1982 to 60% in 1984) for deteriorating export performance. Contrary to IMF theory, Mexico, like Brazil and Argentina, has not been able to simultaneously achieve external balance (increased exports via devaluation) and lower inflation (internal balance).

Further reason for pessimism about Mexico is that the economy is still relatively dependent on imported capital goods, so that any expansion of the domestic economy is bound to generate balance of payment pressures. Unfortunately, Mexico demonstrates that significant real devaluation (the peso was devalued 600% in nominal terms in 1982) is not enough to generate self-sustaining export-led growth.

### **Colombia**

The economic hardships of the international recession and debt crisis have not been nearly as profound in Colombia<sup>12</sup> as in the rest of Latin America. Nevertheless, recent economic performance has been worse than in any time in the past 30 years. Let us now take a closer look at Colombian stabilization policy from 1980 to 1984.

In the late 1970s and 1980s Colombia's economy performed well, spurred on by high coffee prices and illegal drug traffic. Much of the exchange earnings of this time were "saved" in the form of international reserves, "sterilizing" the impact of the export boom on aggregate demand. Hence, the average yearly growth rate of 5.7% for 1975-1979 was only average by historical standards.

1980-1982 saw a turn in policy for the worse. In light of the expected downturn in coffee prices, government spending was increased to avoid recession. At the same time,

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<sup>12</sup> This section is based on the conference paper by José Antonio Scampo, "Crisis y Política Económica en Colombia, 1980-84."



however, import liberalization was begun. As in the case of Peru, Chile, and Argentina, this ill-timed import liberalization turned out to be one of the principal causes of Colombia's external problems in the following years.

The sharp fall in coffee prices and the cutoff of private capital flows after the Mexican crisis in 1982 made managing the external sector in Colombia more difficult than before. Policy response to the fall in coffee prices was perverse; instead of devaluing so as to increase non-coffee exports, the Colombian peso was allowed to appreciate. Between 1977 and 1982, the peso appreciated 10-13% in real terms. Even worse, imports continued to flood the country. Apparently, policymakers felt that the large amount of international reserves garnered in the 1970s gave them considerable room for maneuver, so much so that negative trade balances and mounting foreign debt were not considered a problem.

By 1982 the external account was in serious trouble, threatening a large drop in international reserves. After the Venezuelan devaluation of February 1983, policy took on a new urgency. Exchange controls were tightened, so as to slow down capital flight. Import controls were reinforced. Regarding the capital markets in general, however, action was not so swift or correct. In fact, in 1983 215 million dollars of foreign commercial credit was secured, an unnecessarily large amount in view of the financing needs of the

country. Public enterprises were also encouraged to contract debt, and commercial credit was expanded.

The role of the fiscal deficit in the crisis is curious. The low income elasticity of the Colombian tax system contributed to higher deficits in the 1980s, as the deficit increased to 7.1% of GDP by 1982 and 9% in 1983. Fiscal expansion in 1983 was undertaken to reflate the economy, as the monetary contraction caused by the loss of international reserves was slowing down the economy. Credit expansion was also a significant factor in the economic recovery of 1983, as the government debt was largely financed by money creation. This method of financing the deficit took the place of the external credit which had been used in previous years to cover fiscal red ink. As in the case of Mexico, these expansionary fiscal policies had a favorable impact on aggregate growth; in comparison with the GDP growth of 1.0% in 1982, GDP grew by 3.0% in 1983. One could hardly call this good policy, however, as the fiscal deficits were very high by historical standards and obviously unsustainable.

1984 saw a new Finance Minister and new policy goals. Instead of focusing on reactivation of the economy and reducing inflation, policy was now oriented toward further improvements in the external account. Concurring with the orthodox IMF interpretation of the cause of external imbalance, the fiscal deficit was now to be attacked--even at the cost of recession. The fiscal deficit was cut from

9% of GDP in 1983 to 7-7.5% in 1984, and is projected to be, at most, 4.5% in 1985. This belt tightening was done in hopes of reattracting foreign bank capital to Colombia; thus far, however, the results are not promising, as no new credit is forthcoming.

Given the goals of fiscal austerity for 1985, growth prospects are not favorable. As in Mexico, exports have not performed well enough to be the catalyst in an orthodox export-led growth strategy.

### **Central America**

The smaller Latin American nations of Central America reviewed here (Guatemala, Nicaragua, El Salvador, and Honduras) have had a slightly different experience with stabilization policy than their southern neighbors.<sup>13</sup> Macroeconomic adjustment for Central America (C.A.) has traditionally been more successful than for much of Latin America. The region had little experience with IMF-sponsored stabilization prior to the 1980s, giving policymakers more of a creative edge in dealing with macro adjustment. Hence, the kind of entrenched pressure groups that stifle IMF stabilization efforts in Peru or Argentina are absent; this means that reductions in aggregate demand have usually led to deep cuts in real wages and real incomes, so that adjustment is pain-

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<sup>13</sup> This section is drawn from Victor Bulmer-Thomas's conference paper entitled "The Balance of Payments Crisis and Adjustment Programmes in Central America," as well as his comments made at the conference.

ful but quick.

1979 marks the beginning of the crisis in Central America. Coffee prices fell from their 1975 peak, oil prices increased, and international interest rates soared. Capital flight also increased, especially in Nicaragua in anticipation of the fall of Somoza. It should be emphasized, however, that capital flight was a problem for all the other countries in the region as well, playing perhaps the most important part of all in the region's economic difficulties.

Prudence suggested that macroeconomic adjustment start in 1979, at the time international economic conditions turned less favorable. Instead, as in much of Latin America, debt was accumulated to delay this needed adjustment. From its previously low level, foreign debt doubled between 1979 and 1982.

Why was this adjustment postponed? In El Salvador and Nicaragua, it was felt that the economy was already adjusting via the civil war in each country; furthermore, concessional financing was available for each of these countries. In Costa Rica, Guatemala, and Honduras, the inability to check the growth of the broader public sector (especially decentralized public agencies) made it impossible to curtail domestic demand. The problem was exacerbated in Costa Rica by the fact that the Carazan presidency of 1978-1982 did not control the country's Congress, and hence could never get a revenue-generating bill passed.

The end of the debt accumulation phase corresponded with the drying up of international reserves. This occurred at the end of 1980 in Costa Rica, and 1981 elsewhere, although in Guatemala this pattern continued until 1982. After this "finance" stage of debt accumulation, adjustment was attempted within an IMF framework, with the exceptions of Nicaragua and El Salvador. As it happened, however, IMF programs were abandoned within a very short period of time because of their ineffectiveness. The problem with the IMF solution to external disequilibrium--to cut internal demand--is that it works too slowly and is too costly a way to cut imports. Central American nations henceforth opted for import-restricting policies disdained by the IMF, such as import licensing and import quotas. These policies were successful, as by 1983 imports were half, in real terms, of their peak levels in 1973.

One might wonder, then, why IMF help was henceforth needed or sought by Central America. The problem with the import-restricting policy is that it is not, in and of itself, enough to achieve internal and external equilibrium. First, it does not solve the internal disequilibrium problem caused by large fiscal deficits. Second, as deep as the import cuts were (and they seemed the maximum possible), they were not deep enough to allow full servicing of the debt (including arrears). Thus, by 1982-1983 Honduras, Guatemala, and Costa Rica were adjusting within the guidelines of IMF

conditionality, in order to receive IMF financing. Nicaragua did not receive IMF help at this time, while El Salvador received help under more slack conditions, so as to "sell" the regime internationally.

IMF stabilization program guidelines were fulfilled by Costa Rica and Honduras, but in Guatemala things did not go so well. The government-imposed value added tax of 10% met stiff resistance from the upper classes, and hence was reduced to 7%; because of this, IMF targets for the fiscal deficit were not met. Even with Costa Rica and Honduras, it should be emphasized that most of the required stabilization in light of the international recession occurred before adjustment was attempted within the guidelines of IMF conditionality. One salient lesson of the past years is that the IMF's emphasis on the budget deficit seems misplaced, at least in the Central American context; many countries have been able to stabilize without much progress on the budget deficit. One comes back to the question, then, of why these countries chose to deal with IMF conditionality. Beyond the reasons elucidated earlier, the experience of large debtors such as Mexico seemed to indicate that the "quid pro quo" of dealing with the IMF was that rescheduling with private creditors would ensue. Subsequent experience, however, has shown that small debtors such as the Central American nations do not receive such treatment. While the default of Mexico or Brazil presages disaster for the international

banking system, default by smaller Central American nations would not herald such catastrophe. Hence, even though Honduras complied with IMF conditionality, it was not able to arrange any new private finance. Thus, even though the IMF has been relatively flexible in the terms of its conditionality, the costs of obtaining IMF credit appear to outweigh the benefits.

The outlook for Central America is slightly better than for the Southern Continent. One important reason for this is the quantity of official credits flowing to the area. Nicaragua is receiving significant finance from Mexico and Eastern Europe; 1983 saw a slight recovery, and growth in 1984 was also positive. Costa Rica's 3.5% growth in 1984 was the best in all of Latin America. Long run recovery crucially depends on export growth. This is made difficult by the fact that the outlook for traditional exports is quite poor; hence, nontraditional exports must take up the slack.

#### **IV. Conclusion**

The experience of the various countries reviewed here sheds new light on the nature of stabilization policy and the role of the debt crisis in the economic difficulties of the past few years. First, it appears that many of the difficulties of 1982-84 were caused by policy mistakes in the 1979-1982 era. Import liberalization, often beloved by the IMF and multilateral agencies as a means to enhance the com-

petitiveness of domestic industry, had generally adverse effects on the current trade balance and encouraged debt. Flirtation with the concept of controlling the exchange rate as a means to bring down inflation had serious medium term consequences on the trade balance, while giving the appearance of being a costless cure for inflation. While the increase in real interest rates, international recession, and shutoff of credit after August 1982 could not be foreseen by policymakers in 1979, injudicious policies in the 1979-1982 period exacerbated the situation.

Attempts to adjust within a traditional IMF framework have not been highly successful. Effective stabilization efforts have in almost all cases involved import controls, always abhorred by the IMF. Instead of the fiscal deficit being the main culprit in generating inflation, it appears that exchange rate devaluation (done to promote exports) is far more inflationary. Hence, the IMF claim that internal stability (lower inflation) and external equilibrium (via increased exports) are compatible does not seem warranted. Furthermore, the long-run strategy implicit in IMF stabilization policy (export-led growth) has not panned out.<sup>14</sup> Much of the growth experienced in 1983-1984 was fueled by higher budget deficits.

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<sup>14</sup> Brazil is an exception to this case, at least in 1984; however, preliminary estimates for 1985 show that the export boom is coming to a close.



Hence, it appears that the burden of the debt crisis will be upon Latin America for some time to come. A successful long-term strategy for growth and stabilization has yet to be devised in the absence of robust export growth. This is the primary challenge to Latin American economists: to devise short and long-run stabilization policies so as to achieve not only stability and growth, but the provision of basic human needs for those who have borne the terrible human cost of the recent economic crisis.

### **Papers**

1. **Guido di Tella**, di Tella Institute, Buenos Aires, *Argentina's Latest Inflationary Cycle, 1979-1983*.
2. **Victor Bulmer-Thomas**, Queen Mary College, London University, *The Balance of Payments Crisis and Adjustment Programmes in Central America*.
3. **Patricio Moller**, CIEPLAN, Chile, *El Rol del FMI en América Latina*.
4. **Rosemary Thorp**, St. Antony's College, Oxford, *Peruvian Adjustment Policies 1978-1985: The Effects of a Prolonged Crisis*.
5. **Jaime Ros**, CIDE, Mexico City, *Notas Sobre Endeudamiento y Proceso de Ajuste en México 1978-1984*.
6. **José Antonio Ocampo**, Fedesarrollo, Bogotá, *Crisis y Política Económica en Colombia, 1980-1984*.

### **Presentations**

1. **Laurence Whitehead**, Nuffield College, Oxford, on Stabilization Policy in Chile, 1979-1983.
2. **Paul McNelis**, Georgetown University, on Dollarization, Devaluation, and Stabilization Policy.
3. **Anthony Tillett**, Canadian International Development Agency, on the Relation between Economic Policy Problems and Broader Development Needs.