THE LATIN AMERICAN DEBT CRISIS IN HISTORICAL PERSPECTIVE

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Abstract

The explanation for the worse performance of Latin America in the 1980s vs. the 1930s must be found, not in the magnitude of the trade and capital account shocks, which were in fact worse during the Great Depression, but in the international response to the crisis. During the 1930s, external debt default opened the space for counter-cyclical macroeconomic policies. In contrast, during the 1980s, Latin America faced strong pressures to avoid prolonged defaults and was forced to adopt contractionary macroeconomic policies. Averting default helped the U.S. avoid a banking crisis, but at the cost of a lost decade of development in Latin America. The Brady Plan came very late, but helped create a market for Latin American bonds. Two basic implications are that there is a need to create an international debt workout mechanism and that international financial institutions should never be used to support the interests of creditor countries.

Keywords: Debt crisis, default, debt restructuring, lost decade, macroeconomic policies, Latin America.

The debt crisis of the 1980s is the most traumatic economic event in Latin America's economic history. During the "lost decade" that it generated, the region's[1] per capita GDP fell from 112% to 98% of the world average, and from 34 to 26% of that of developed countries (Bértola and Ocampo, 2012, Table 1.1). In terms of its strong adverse effects, the only comparable case is the "lost half-decade" of 1998-2003 induced by the sequence of emerging country crises that started in East Asia in 1997. The Great Depression of the 1930s and the recent global financial crises serve as important contrasts, as Latin America performed relatively better on both occasions.

This paper analyzes the characteristics of the 1980s debt crisis: its precedents in terms of regional developments, the international context in which it took place, the dynamics of the crisis and its results in terms of economic and social development. It

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[1] The term "region" is used throughout the paper as a short hand or synonym for Latin America.

makes several comparisons with the 1930s. As I will argue, better performance of Latin America during the Great Depression was associated with external debt default, which opened the space for counter-cyclical macroeconomic policies. In contrast, in the 1980s continuous service of the (rescheduled) debt, under strong international pressures, associated to the management of the domestic banking crisis which the U.S. simultaneously faced, led to contractionary macroeconomic policies and to more than a decade-long fall in per capita GDP. The contrast between these two episodes underscores the need to create an international debt workout mechanism, which is absent in the current international financial architecture.

The other interesting point of comparison, the recent global financial crisis, is an entirely different episode to both previous crises, because its distinguishing feature was the lower debt ratios that Latin America has achieved by 2007-08. It is also different because access to international financing was renewed early on, despite the persistent turmoil in developed countries, and there was therefore no prolonged absence of external financing. The paper thus compares the 1980s with the major previous episode in which the region faced a sudden interruption of external financing with the burden of high debt ratios.

I. A recurrent phenomena in Latin American history: financial crises

Financial crises, in their different dimensions –external debt, balance-of-payments and banking crises or, frequently, a mix of them— have been a recurrent phenomenon in Latin America's economic history. The upper part of Figure 1 depicts the historical frequency of crises. As has been underscored in a massive literature on the topic,[2] the region's crises have followed periods of large capital inflows that have their origin and thus follow what are essentially international financial booms: financing to Latin America during Independence, the years that preceded the international crisis of 1873, the debt boom of the 1920s, that of the 1970s (and particularly, the second half of that

[2] See, particularly for Latin America, Bacha and Diaz-Alejandro (1982), Marichal (1989), Stallings (1987) and, for the more specific case of the debt crisis of the 1980s and the years leading up to it, Devlin (1989). For the global situation, see also the now classic work of Charles Kindleberger (a recent edition can be found in Kindleberger and Aliber, 2005) and the more recent analysis of Reinhart and Rogoff (2009), which is the source for the data used to construct Figure 1.

decade) and the boom of 1991-97. The major crises have affected a large number or even all Latin American countries (19, or 18 after 1960, as we exclude Cuba) in one way or another.

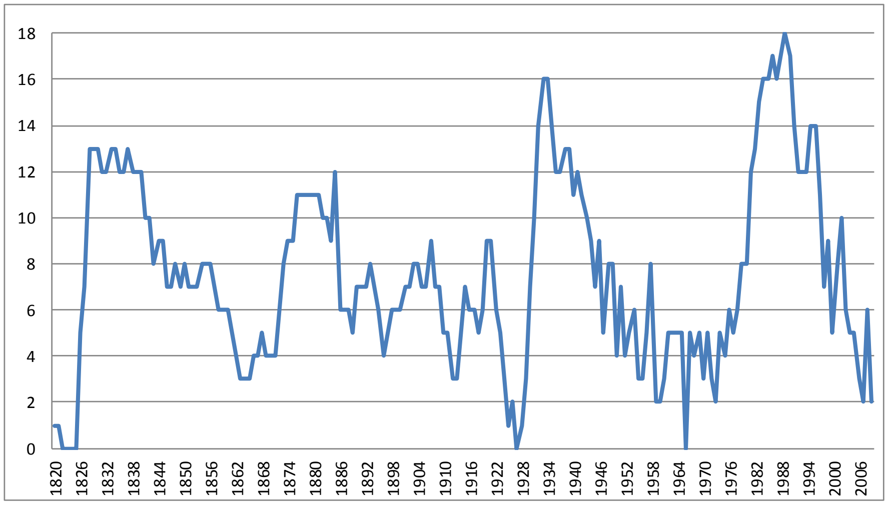
The boom of the 1880s also triggered an international financial crisis, the 1890 Baring crisis, whose international epicenter was Argentina, but whose impact in the region was more limited. Only two of the major international financial booms have not been followed by financial crises in the region: that which preceded the First World War, and the one that gave way to the Great Recession of 2008-2009. In both cases, however, booms were followed by regional recessions and, in the first case, by the temporary abandonment of the gold standard by several countries.

The bottom panel of Figure 1 shows changes in the composition of crises over time, focusing on periods when this phenomenon has been particularly intense. As the figure makes clear, debt crises were the most common problem in Latin America through the nineteenth century. Strong exchange rate depreciations associated with balance-of-payments crises have been frequent since the First World War, and this situation was also the main element behind the crises that occurred between the mid-1950s and mid-1960s (a period of external crises that was not associated with a previous boom in external financing). Finally, the most recent dimension has been banking crises, which have become increasingly frequent since the 1980s. As a result, since the 1930s, most crises have been "dual" in character (combined debt and balance-of-payments crises) and, since the 1980s, many of them have been "triple" crises (the above two plus banking crises). Actually, in recent decades, we should also add a number of other dimensions, such as high inflation (which, in Latin America, has historically been closely correlated with balance-of-payments crises) and, in fewer cases, domestic debt crises.[3]

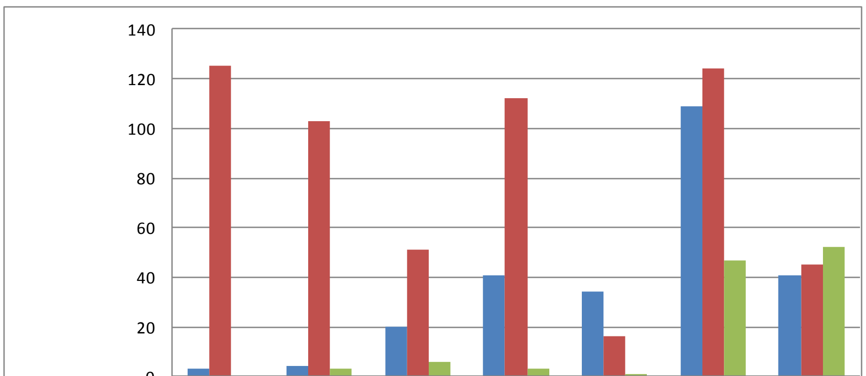
[3] These are other different dimensions of crises included in Reinhart and Rogoff (2009).

Figure 1. Economic Crises of Latin America 1820-2008.

A. Number of countries on a currency, external debt, or banking crisis



B. Number of country/years in crisis by period



	1828-1837	1876-1885	1914-1923	1930-1939	1957-1966	1981-1990	1994-2003
Currency	3	4	20	41	34	109	41
External Debt	125	103	51	112	16	124	45
Banking	0	3	6	3	1	47	52

Source: Database for Reinhart y Rogoff (2009) kindly provided by the authors.
The definition of crisis according to Reinhart and Rogoff is the following:
Currency crisis: annual devaluation greater than (or equal) 15 percent with respect to U.S. Dollar (or the relevant currency)
External debt crises: outright dafault on payment of debt obligations including principal or interest.
Banking crisis: bank run that lead to the closure, merging, or takeover by the public sector of one or more financial institutions If there are no runs, the closure, merging, takeover, or large-scale government assistance to an important financial (or group of institutions) that marks the start of a string of similar outcomes for other financial institutions.

Among Latin American financial crises, that of the 1980s has been the worst of all. It involved all 18 countries –i.e., including Colombia, which did not experience a debt crisis but did face a strong balance of payments disturbance as well as a moderate banking crisis. Furthermore, this has been the worst crisis in terms of multiplicity of dimensions and duration –measured in the lower panel as the number of months-country during which a particular dimension of the crisis was manifested. The 1930s follows in terms of intensity.

These two crises are, nonetheless, different in several ways. That of the 1930s was global in scope: its epicenter was the United States and it heavily affected Europe. In contrast, that of the 1980s was a crisis of the developing world, and more particularly of Latin America and Africa. In addition, the crisis of the 1930s lacked international institutions to manage it. Indeed, the existing institutions, notably the gold standard, collapsed, and the international financial system went into total disarray, and would not be reconstructed until the 1960s. In contrast, the crisis of the 1980s was managed under a elaborate (though incomplete) international financial architecture. As I will argue here, this was not necessarily better, as it was initially used to back a creditors' cartel and forced Latin America to adopt strongly contractionary macroeconomic policies. This does not mean that it is better not to count with an institutional architecture, but rather that it should include debt workout mechanisms to manage problems of over-indebtedness.

II. The precedents

Debates around the origins of the Latin American debt crisis are immersed in controversies on the State-led industrialization model[4] that had been adopted by the region after the Second World War, following in some countries precedents which go back to the Great Depression and, in terms of high levels of protection in several countries, to the late nineteenth century. This model began to come under criticism in the 1960s both from orthodox economists and the political left.[5] The former criticized it for its lack of macroeconomic discipline and inefficiencies generated by high levels of protection and, more generally, excessive State intervention. The latter criticized it

[4] I prefer this concept over the traditional one of "import-substitution industrialization", which only captures one aspect of the model in place in Latin America from the 1950s to the 1970s, and not necessarily the most important one. See Cárdenas, Ocampo and Thorp (2000) and Bértola and Ocampo (2012),

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

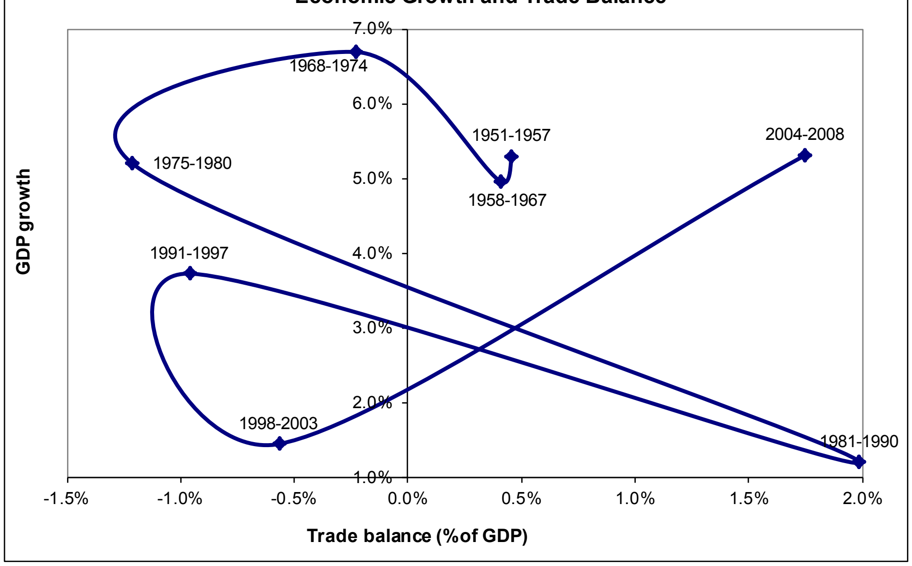
because of its inability to overcome the economy's external dependence and to correct the highly unequal income distribution that characterizes the region.

The lack of macroeconomic discipline was less widespread than it is often portrayed as having been (Bértola and Ocampo, 2012, ch. 4). In fact, at least until the mid-1970s, it was primarily a problem in Brazil and the Southern Cone rather than the rest of the region. The average inflation rate of the non-inflationary economies as well as the median inflation for the region as a whole fluctuated between 2 and 4% between the mid-1950s and 1972 (see Figure 8 below); even in the four inflationary economies, inflation tended to fall back to a 10-20% range after major domestic price surges. Inflation picked up in the 1970s as part of a global trend, but the regional average for the non-inflationary economies was 14.2%, below IMF's estimate of 17.1% for the developing countries as a whole. During this decade, two of the inflationary economies (Argentina and Chile) generated three-digit inflation rates, associated in both cases to major political crises. But the broad-based inflationary burst was a phenomenon of the 1980s, and must thus be seen as an *effect* rather than a cause of the debt crisis.

Something similar can be said about the fiscal accounts. Government spending tended to increase: from an average of 12% of GDP in 1950 to 22% in 1982 in the case of central government spending. However, this expansion was financed by increased taxes, thus generating central government deficits in the range of 1 to 2% of GDP up to the mid-1970s, except in 1972 (see Figure 8 below). The major exceptions were again to be found in Brazil and the Southern Cone countries. Thus, although FitzGerald (1978) is correct in arguing that there was a tendency to overwhelm the State with fiscal responsibilities – transfers to the private sector rather than social welfare programs— without giving it sufficient resources to meet them, the budget deficits only became a reality when the broad-based access to external funds generated the possibility of financing them in the second half of the 1970s.

The tendency to run an external deficit was a more common phenomenon and became a strong problem at the end of the phase of State-led Industrialization. This was the result of both the behavior of the trade balance and an increasing demand for investment in the face of low domestic savings rates (which economic theory tells us are actually two facets of the same problem). However, again, these deficits remained repressed with massive balance of payments interventions –high tariff and non-tariff protection, exchange controls and multiple exchange rates in several countries— while there was no access to external financing. Overvaluation of the exchange was not necessarily part of the package or the effect of these interventions, as has been argued by orthodox economists. Indeed, in contrast to traditional interpretations, Jørgensen and Paldam (1987) have shown that there was no long-term appreciation of the real official exchange rate in any of the eight largest Latin American countries in 1946-85.[6] The most disturbing feature of the exchange-rate regimes in place during this period were their high degree of volatility around the long-term trend of the (basic) real exchange rate, especially in economies that were prone to inflation. Starting in the mid-1960s, crawling exchange-rate peg systems were introduced in an effort to manage this problem (Frenkel and Rapetti, 2011).

Figure 2
Economic Growth and Trade Balance



Source: Author's estimations based on ECLAC data

[6] Quite to the contrary, according to their results, real devaluations occurred over the long term in Brazil and Venezuela. Even more importantly, there were discrete devaluations of the real exchange rate in a number of countries between the end of the Second World War and the early 1960s that had long-lasting effects (Mexico in 1948, Peru in 1949-50, Brazil in 1953, Chile in 1956, Colombia in 1957 and Venezuela in 1961). This could mean that the exchange rates inherited from the War were significantly overvalued and were then corrected.

Figure 2 shows the relation between trade balance and economic growth. As it indicates, until well advanced, the industrialization process was compatible with small trade surpluses. The moderate external deficit of 1967-74 was still not a major source of concern, given the acceleration of growth during those years. So, the really important problem erupted in 1975-80, when persistent economic growth –slower, nonetheless, than in 1967-74— was accompanied by a large external deficit.

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 21% of GDP up to the mid-1960s, reaching its lowest point in 1958-67. It climbed to 22% during the 1968-74 and peaked at 25% in the second half of the 1970s (see Table 1). This indicates that the higher levels of external borrowing experienced during the 1970s were reflected in higher investment rates (which no doubt included a number of white elephants in some countries), in sharp contrast with 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 1
The figures correspond to the average of all countries for which data are available.

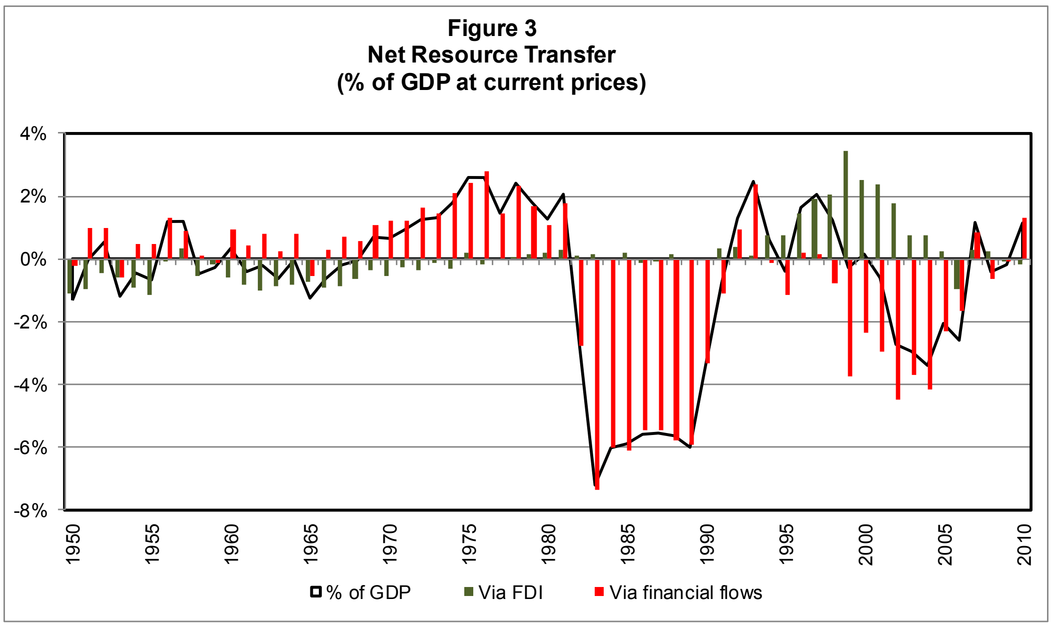
A very simple way to summarize these results is to indicate that fiscal, external and savings gaps remained latent in most countries while there was no external financing available, and only led to inflationary spurts in a few countries.

To these macroeconomic tensions we could add the inefficiencies of State-led industrialization, an issue that has been subject to an extensive debate that I cannot review here. But this was not the most important problem. In fact, Latin America had grown under this model at the fastest rates of history for more than three decades. It is also unlikely 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. What is more, it is unclear why they could not have adopted 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, thus evolving toward a "mixed model" that combined protection with export promotion and regional integration (Bértola and Ocampo, 2012, ch. 4). In fact, the literature of the 1970s portrayed a number of Latin American countries, particularly Brazil, as international export success stories on a par with the Asian tigers. Finally, and very important to discard the structural problems as a major explanation of the debt crisis, the countries that had liberalized the most during the 1970s, those of the Southern Cone, were equally affected and, in some dimensions (banking crises), even more than other countries in the region. I come back to this issue below

III. The boom-bust cycle in external financing and the long-term character of the shock

The latent macroeconomic and the structural problems of State-led industrialization notwithstanding, what sounded the death knell for that paradigm was the boom-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 banks 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 3, net resource transfers from abroad were slightly negative in the 1950s and 1960s.[7] 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), multilateral development banks and bilateral cooperation, obviously heightened the temptation to resort to protectionist policies. 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.



Source: Author's estimations 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 (the "eurodollar market"). The hallmark of this process was competition among a growing number of formerly national banks that began to provide 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 commissions). By pegging the interest rate to the interbank market, which was the source

[7] 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 investors).

of financing for banks actively involved in the international market, the risk for creditors associated with variations in those rates was reduced by shifting it onto borrowers. As we will see, this became 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 eurodollar 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 non-oil 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 1973-81 while at the same time continuing to be the developing region that attracted the largest share of foreign direct investment (Ocampo and Martin, 2004, Chapter 3).

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 rate 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.

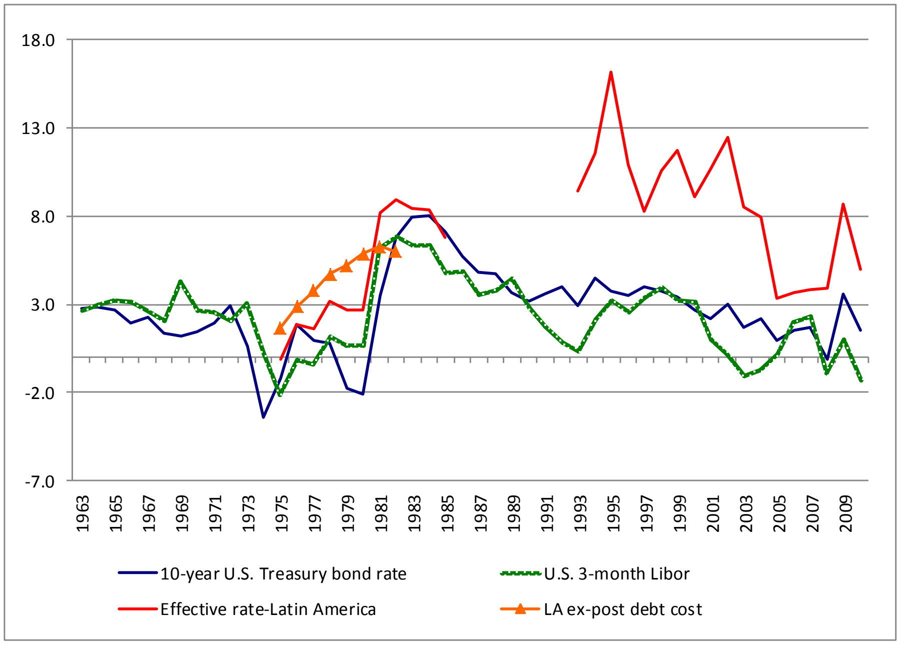
Capital flight occurred throughout the region, but took place on a massive scale in Argentina, Mexico and Venezuela, the countries that lacked mechanisms for controlling capital movements.

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 structural problems created by the preceding model, were the decisive factor. And this is why the problem arose both in the 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 any specific development model.

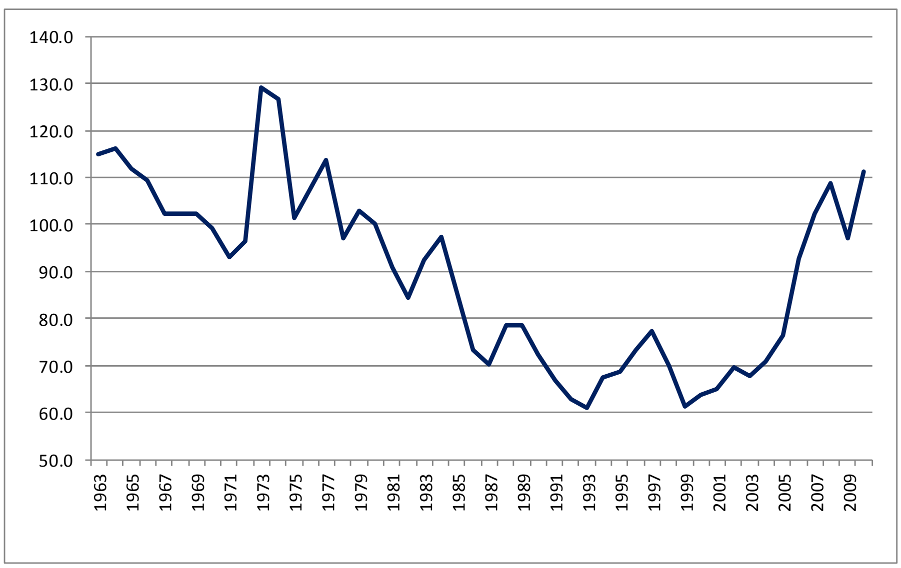
This is why external shocks played such a pivotal role in determining how the crisis unfolded (ECLAC, 1996, Chapter 1). The turning point was the decision, made in late 1979, by the Federal Reserve Board of the United States to raise interest rates steeply (this came known as the "Volcker shock", after the Federal Reserve Chairman of the time) in order to stamp out the inflationary spiral that the U.S. 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 commodity prices. Both of these adverse shocks *were to last nearly a quarter of a century*. This factor, which, of course, is only evident in hindsight, is generally overlooked in analyses of this period (see Figure 4).

Figure 4

A. Real Interest Rates



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



Sources:
A. Author'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 U.S. 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. 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 4.A as the "ex-post rate"),[8] it averaged no more than 4% during those years, reaching a peak of 6% in 1981-82. 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 U.S. 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 1975-80 until the international financial boom of 2005-08.

The decline in commodity prices also proved to be a long-run break from earlier trends and would last until the early-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 (Figure 4.B). 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 U.S.

International interest rates had never before been so high for so long.[9] Recessions such as those experienced by the industrialized countries had, on the other hand, occurred before, as had steep declines in commodity prices. In the first case, however, the 1982 economic slowdown in the industrialized world was somewhat stronger than that of 1975, and was thus the worst of the post-war period (until it was surpassed by the 2008-09 recession). In the case of real commodity prices, the last time that anything similar had occurred had been when they plummeted in the 1920s and 1930s. Consequently, the ex-

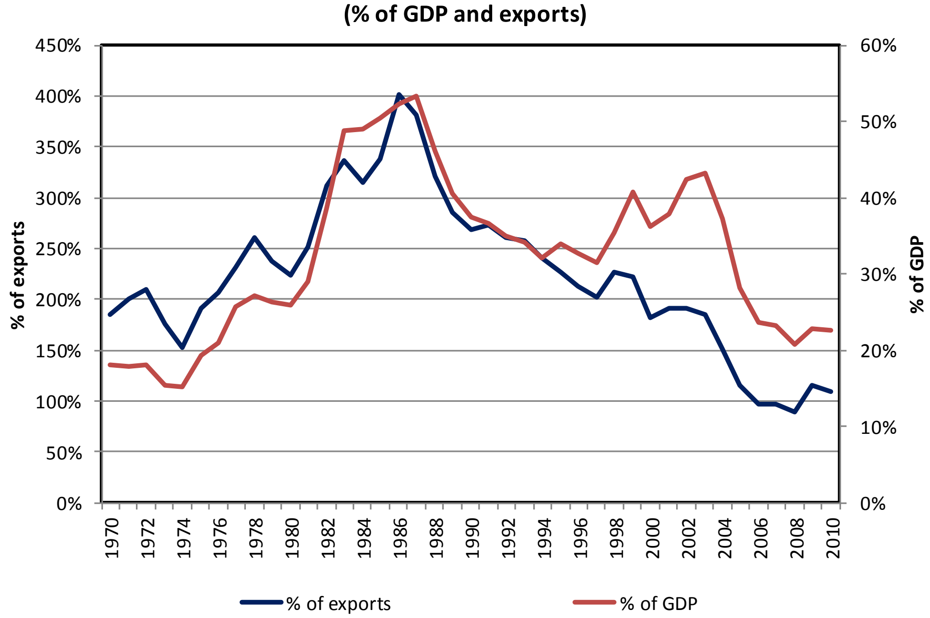
[8] This real ex-post interest rate was calculated as the average annual rate for the year in which the loan was taken out and the six following years (based on the assumption that a loan typically matured in seven years) using the Libor+1 as the nominal rate and as a deflator for the U.S. consumer price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

[9] However, 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) 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, they turned negative in real terms.

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 large 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 5).

Figure 5
Dynamics of the Latin American External Debt
(% of GDP and exports)



Source: Author's 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.

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 2-3% of GDP, into negative transfers amounting to about 6% of GDP (see Figure 3).

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".

As a point of reference, the 1930s were also characterized by a sudden stop in external financing. The financial boom of the 1920s had benefitted the majority of Latin American countries; the exception was Mexico, still immersed in the effects of its revolution and the consequent default on its external debt in 1914 (with only partial payments in the 1920s). This boom was followed by a significant reduction in financing since mid-1928 and the interruption of flows soon after. In the absence of balance of payments statistics, the best way to estimate the relative weight of the sudden changes in external financial conditions is to compare them with trade data. The bond emissions of Latin American countries in Wall Street peaked in 1926-28 at $346 million a year (ECLAC, 1964, Table 19), which were equivalent to 13% of exports. They fell to slightly more than half of that amount in the following two years, most of them associated with refinancing operations, and ceased altogether in 1931.

Furthermore, the dramatic U.S. financial crisis after the collapse of Wall Street in October 1929 led to the collapse of the international financial system, which included generalized defaults on external obligations. It would take three decades, until de 1960s for the eurodollar market to emerge, and even longer for most Latin American countries to have access to private external financing on a significant scale. To this, the 1930s added the collapse of the international monetary system, the gold standard. Thus, in terms of the disturbance of the international financial system and its effects on Latin America, the crisis of the 1930s was more severe than that of the 1980s. However, the net transfer of resources abroad was not as prolonged as in the 1980s. The basic reason, as we will see, was default on external obligations

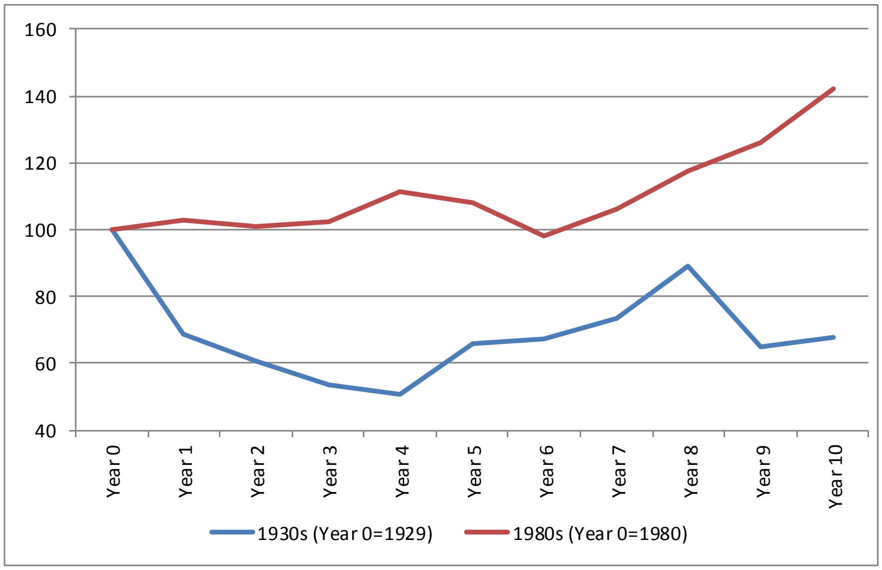
IV. The dynamics of the crisis: the external dimension

A comparison with the 1930s will help to understand the strength of the trade and financial shocks that Latin America experienced during the 1980s. Figure 6 shows the relevant comparisons.

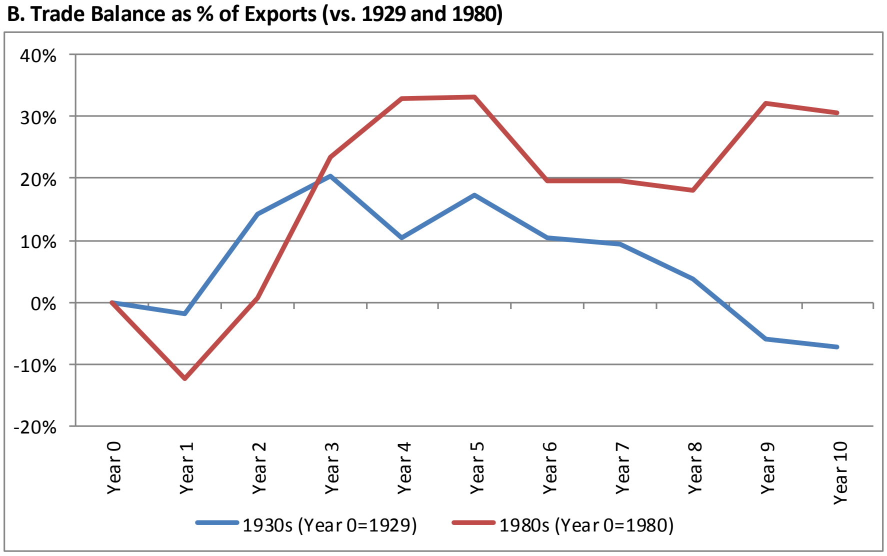
The trade effects of the Great Depression on Latin America were very strong. Measured as simple averages for the seven largest economies (weighted averages give a similar picture), the export quantum fell by 28% between 1929 and 1932; due to the simultaneous fall in the terms of trade, the purchasing power of exports fell even faster, 48% –51% at its lowest point, in 1933 (Bértola and Ocampo, ch. 4 and particularly Figure 4.1). Export recovery then took place, but even in 1937 the purchasing power of exports was still 21% below 1929 levels. With the new U.S. recession that started that year and its spread to Europe, Latin America's export recovery ceased and terms of trade deterioration again set in.

As illustrated in Figure 6.A, the opportunities for boosting exports and their purchasing power were much better in the 1980s. The fact that the crisis was not global in scope is the basic explanation. In fact, the increase in the export quantum compensated the deterioration of the terms of trade up to 1986, and was followed by a clear recovery in the purchasing power of exports in the later part of the decade. The comparison with the 1930s is striking: whereas in 1990, the purchasing power of exports was 42% *above* 1980 records, in 1930 it was still 32% *below* 1929 levels.

Figure 6
A Comparison between the Crises of the 1930s and 1980s: External indicators
A. Purchasing Power of Exports



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



Source: Bértola and Ocampo (2012).

Thus, the crucial difference between the debt crisis and the Great Depression should not be found in the trade figures but in the massive, long-lasting shock to the *capital* account. As this situation was not properly addressed at the international level, the result was that the region sank into its worst crisis in history.

As the prospect of bank failures loomed for over-exposed banks worldwide and, in particular, in the U.S. (Latin America's debt was equivalent to 180% of the capital of the nine largest U.S. banks), the U.S. 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 lending than they had in the past. The funds that they made available were, however, modest in comparison to 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, market reforms and draconian fiscal adjustments). As the 1980s unfolded, temporary "silent defaults" in the form of arrears in servicing of commercial and bilateral (and, in a very few cases, multilateral) debts became more and more frequent (Altimir and Devlin, 1993). This was partly because of the internal tensions that this overly prolonged crisis began to generate in a region which was, furthermore, witnessing a return to democracy. 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 permanent 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 not very large and the cancellations came too late to head off the damage caused by the debt crisis (see below).

In contrast to this, during 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 since the early nineteenth century.[10] Defaults began in January 1931 in Bolivia and spread to the rest of the region in the ensuing months and years. Argentina was an exception among the larger countries, as it was party to a trade agreement with the United Kingdom which is still a subject of heated debate (O'Connell, 2000). Venezuela was another exception, as it ultimately paid off its external debt in 1930. Many of the smaller countries continued to service their external debts, although, in most cases –notably the Dominican Republic, Honduras and Nicaragua—they did not so do so fully but instead paid the interest and only part of the amortizations due. Cuba suspended its debt service payments in 1934 but eventually covered them. Countries that declared defaults made partial payments in some years and bought back part of their debt bonds at depressed

[10] For a detailed analysis, see Marichal (1989, Chapter 7 and 8) and Stallings (1987, Chapter 2). Additional information and very useful analyses are provided by the United Nations (1955) and ECLAC (1964).

market prices. Nonetheless, in 1935, 97.7% of dollar-denominated bonds issued by Latin American countries (excluding Argentina) were in default and, as late as 1945, after some countries had renegotiated their debts, 65.0% of their debt (again, excluding Argentina) was still in arrears (United Nations, 1955, Table XII). As we will see later on, the external debt default turned out to be a good deal for the countries of the region.

Although the debt servicing performance of some Central American and Caribbean countries reflected the United States' influence over them, the truth is that the Hoover Administration refused to defend lenders,[11] and the Roosevelt Administration was much more interested in reviving trade and creating closer ties with Latin America through its "good neighbor" policy than in defending the interests of U.S. creditors. What is more, in the international arena, the tendency was to permit the suspension of debt servicing, even in industrialized countries, as evidenced by Germany's interruption of reparations payments in 1932, with the acquiescence of the victors in the First World War, and the one-year suspension of service payments on Europe's war-related debts with the United States, which became a permanent feature in 1934.

Thanks to the foreign-exchange savings made possible by the reduction in external debt payments, between 1932 and 1937 real imports made a much more robust recovery than other foreign trade indicators did, marking up an expansion of 115% versus the 52% increase in the purchasing power of exports in the seven largest Latin American economies (Bértola and Ocampo, 2012, Figure 4.1). They also weathered the ensuing two-year downswing in trade better than exports did. As a result of default, the need to generate trade surpluses to pay for the debt ceased early on, as reflected in the downward trend of trade surpluses since 1933. In contrast, during the 1980s the Latin American economies were forced to generate significant trade surpluses during almost a decade (Figure 6.B).

[11] In 1932, Secretary of State Stimson declared that no loan was backed by the United States government: "No foreign loan has ever been made which purported to have the approval of the American government as to the intrinsic value of the loan" (quoted by Stallings, 1987, p. 79).

In the evolution of the 1980s, it is useful to differentiate three different stages.[12] 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.[13] Bankers' committees facilitated the renegotiations of the debts but, under a strategy of "case by case" negotiations, they effectively operated as creditors' cartel that faced a disorganized set of debtors.[14] They had the backing of the governments of industrialized countries, and particularly of the U.S., which intervened because they felt that its banking system was 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 there were some attempts at collaboration among 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 U.S.

The measures that were adopted were, therefore, very effective in averting a banking 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 U.S. banking crisis was handled. Oddly enough, this is not fully recognized in the existing literature, which does not even include the Latin American debt crisis as the U.S. banking crisis that it actually was.[15] The great irony was that, as a result, U.S. banks were

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[12] 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.

[13] 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 started to recover.

[14] See Rhodes (2011), which also includes a Preface by the former chairman of the Federal Reserve, Paul Volcker, for a creditors' perspective on the renegotiations.

[15] See, for example, the IMF database on banking crises, which does not include it as a U.S. banking crisis (Laeven and Valencia, 2008).

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 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 debt haircut and was soon followed by renewed access to private external financing. Figure 3 indeed shows that the net transfer of resources finally turned again positive in 1992. The U.S.' involvement in these last two phases differed from its approach in the first, with the authorities working to offer a framework for Latin American economies to grow again and find actual solutions for what was now clearly seen as a solvency crisis, at a time when there were also signs that the region's increasingly democratic governments were reluctant to follow the earlier approach. The fact that U.S. banks –and, at a faster rate, non-U.S. banks— had made provisions against Latin American debts in their portfolios also made palatable the debt write-offs included in the Brady Plan.

Although the Baker Plans and, especially, the Brady Plan finally led to reductions in the countries' external debt coefficients (see Figure 5), the upward trend in those coefficients had already been reversed by the large trade and current-account surpluses that the countries had built up. The Brady Plan was used by ten Latin American countries, which in total issued bonds for $148 billion, equivalent to 35.7% of the region's external debt in December 1989. The main instruments were par bonds at lower than market interest rates and discount bonds issued at Libor+13/16. Both were bullet bonds issued at 25-30 maturities and with the principal guaranteed with U.S. Treasury bonds. There were other instruments, including those used to capitalize unpaid interest, but had smaller haircuts and were not always collateralized. The average debt reduction for the first two and major Brady instruments (in both principal and interest payments) was 30-45%, with a weighted average of 35.3% according to the data provided by Merrill

Lynch (1999). However, these cuts did not include all the debt that was restructured; so, the average haircut was 19.7% if we include only par and discount bonds. So, the total debt reduction facilitated by the Brady Plan was between 7 and 12% of the total Latin American debt at the end of December 1989 –between 8 and 15% for the ten countries that signed Brady deals.[16]

One major and perhaps the most important effect of the Brady Plan was to create to a liquid market for Latin American bonds, which attracted new agents into the market and was the platform for the broader bond market for Latin American bonds that developed in the early 1990s. Indeed, the Plan was soon followed by a sharp turnaround from negative to positive resource transfers in the early 1990s, with the bond market becoming the major new source of financing (see Figure 3 above).

The debt relief provided by the Brady Plan was less than that which was agreed when the debts of the 1920s were renegotiated after the Great Depression. Renegotiations with U.S. creditors started during the Second World War. These talks were encouraged by the U.S. for political reasons (to guarantee the alliance of Latin American countries during the War) and were buoyed by the possibility of securing credit from the Export-Import Bank (and, after the war, from the World Bank). The most successful deal was the one made by Mexico in 1941, which secured a 90% reduction in its debt, including the debts associated with the nationalization of U.S. oil and railroad investments (Marichal, 1989, ch. 8). This was, however, an accord designed to resolve one of the largest-scale defaults in world history. None of the other countries obtained reductions in debt principal, but they did secure cuts in interest, and creditors agreed not to compound their interest arrears.

Eichengreen and Portes (1989, Table 2.1) have estimated that the region paid an ex-post effective interest rate of slightly over 3% on the debts it incurred in the 1920s. This was between four and five percentages points less than the original terms, making the Latin American nations the most successful negotiators of all the countries that had

[16] The first number is the result of multiplying the haircut for only par and discount bonds to the share of Bradys in the total external debt; the second assumes an average reduction of 35.3% but it overestimates the benefits of the Plan.

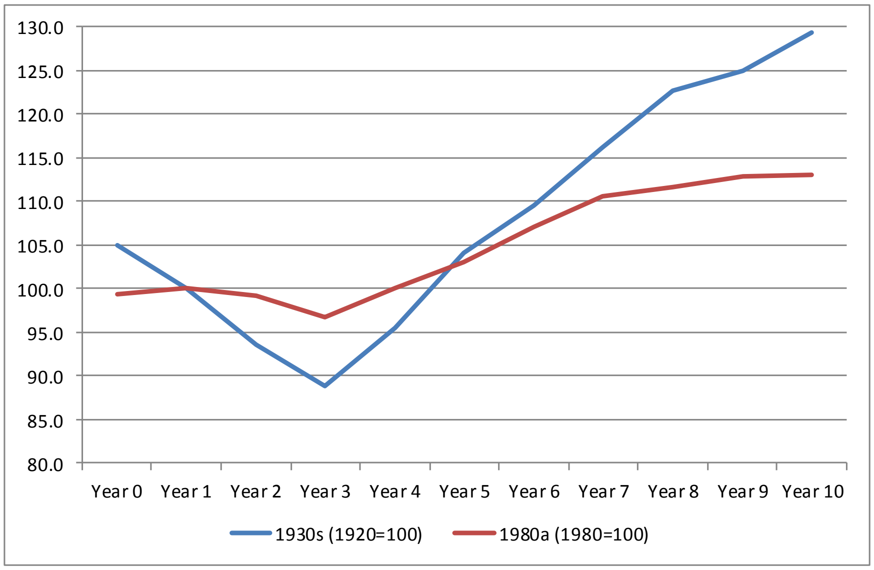
access to capital markets before the crisis. This implies a permanent debt relief of between 35 and 50% or more, to which the specific benefits of having been able to use the unpaid debt service to finance imports during the default period must be added. Using a different methodology, Jorgensen and Sachs (1989) have calculated that the present value of Colombia's external debt, discounted by the interest rate on U.S. bonds, was reduced by 15%, whereas countries that entered into negotiations later on (Chile in 1948, Peru in 1953 and Bolivia in 1958) obtained reductions of between 44% and 48%. This methodology underestimates, however, the benefits for debtor countries which had taken on debts at a higher interest rate than that for U.S. government bonds. According to these estimates, Argentina paid 25% more than the U.S. Treasury and failed to obtain any benefits in terms of access to capital markets during the 1930s or after the war, because that market had ceased to exist.

V. The domestic economic and social effects of the debt crisis

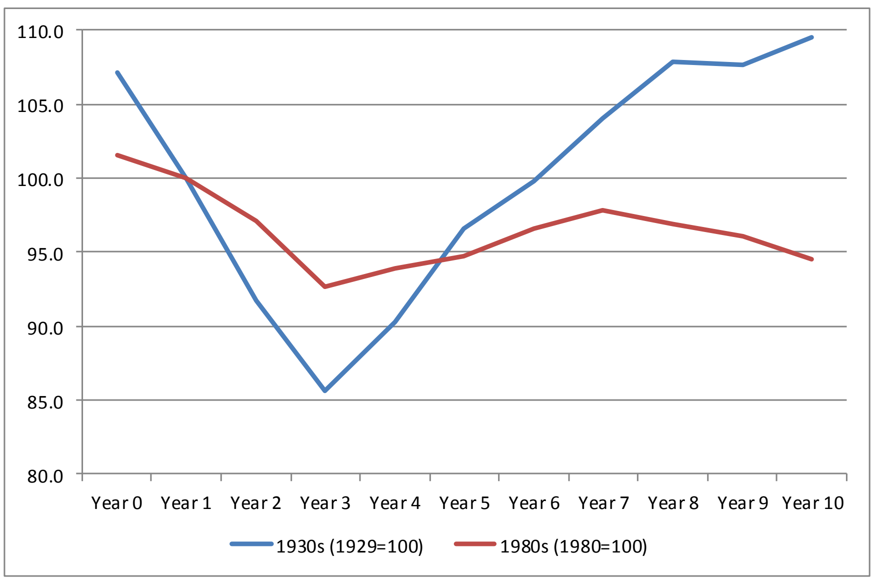
The net effect of all this is that, even though the initial shock on Latin America's GDP was stronger during the Great Depression, the recovery was steep, and since 1937 Latin America was able to surpass the pre-crisis per capita GDP. In contrast, during the 1980s, this only occurred in 1994 –i.e., almost a decade and a half later (Figure 7). The contrast is even sharper when we compare the period of recovery after the crisis: whereas in 1932-39, GDP growth was 5.5% per year, between 1983 and 1990 it reached only 2.3%.

The recession in the early 1980s was initially severe. The region's per capita 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. In 1984-87 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 large amounts of official external financing (Chile and Costa Rica).

Figure 7
A Comparison between the Crises of the 1930s and 1980s: GDP and per capita GDP
A. GDP



B. Per capita GDP



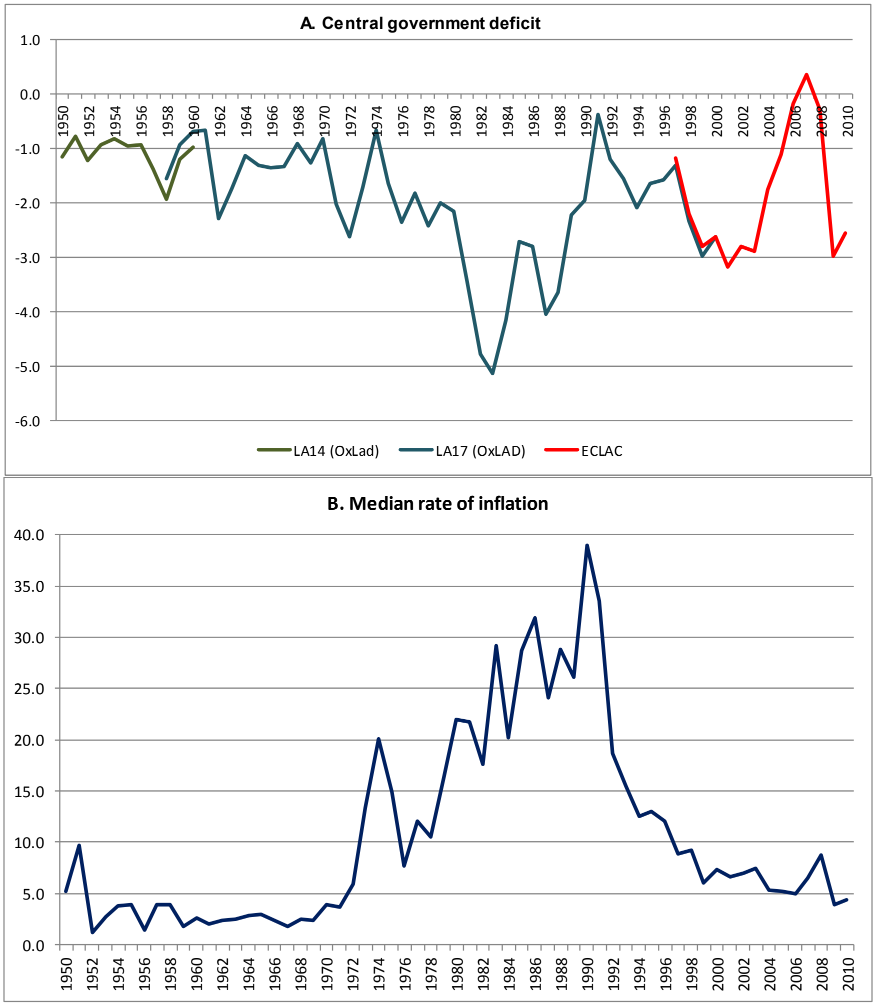
Note: Excludes Bolivia, Panama, Paraguay and the Dominican Republic in the 1930s.
Source: Estimated on the basiss of Bértola y Ocampo (2012), Statistical Appendix.

In comparison, during the 1930s the initial recession was even stronger, but was followed by an early and, as we have seen, strong recovery. The renewal of growth was based in a variable mix (according to the country) of import substitution of agricultural and manufacturing goods and the expansion of the domestic demand based on expansionary macroeconomic policies that were made possible by default on the external debt (see below). Among the larger economies, Brazil, Colombia and Venezuela (supported in the latter case by continuous expansion of its oil exports) did best. Argentina is a weaker story, as it had a less severe external shock but grew much less than Brazil, possibly reflecting the effects of continuous debt service. In turn, Chile and Cuba had by far the strongest external shocks, which explain their weak performance. In any case, for the region as a whole, growth slowed down significantly in relation to the 1920s: 2.2% in 1929-39 vs. 4.9% in 1921-29.

The social costs of the 1980s debt crisis were huge. The poverty rate climbed sharply between 1980 and 1990 (from 40.5% to 48.3% of the population). It would only return to 1980 levels in 2004, thus indicating that in relation to poverty there was not a lost decade but a lost quarter century. 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 several 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 (Bértola and Ocampo, 2012, ch. 1).

Large fiscal, monetary and exchange rate adjustments stressed what were already weakened economic structures. The recession led to an initial increase in the budget deficit but a draconian fiscal adjustment brought the central government deficit back to 1-2% of GDP by the early 1990s (similar, in fact, to the levels that had prevailed in the region up to the mid-1970s) (Figure 8.A). This implied an average cut in central government spending of five to six percentage points of GDP, depending on which years are used for the comparison (Bértola and Ocampo, 2012, Figure 5.7.A).

Figure 8: Public Sector Finances and Inflation (simple averages)



Sources: A. OxLAD and ECLAC. The data for LA17 from OxLAD exclude Bolivia and Cuba; that for LA14 also excludes Nicaragua, Paraguay and Uruguay. The data from ECLAC exclude Cuba, El Salvador, Guatemala, Paraguay and Panama. B. IMF, International Financial Statistics.

This involved a particularly sharp reduction in central government investment, to which we must be added the cut in investment by the public sector firms and the private sector. The investment rate fell six percentage points from its 1975-80 peak (see Table 1) and, in fact, has not yet returned (as of 2012) to that peak. A closer look at the data indicates that this is due to Brazil and Venezuela; so, if we exclude these countries, the investment rate came back to the peak at the end of the 2003-08 boom. For this reason, in this area there was also at least a lost quarter century. Forcing governments to cut back on infrastructure investment as part of the adjustment program also stunted long-term growth (Easterly and Servén, 2003).

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 experienced 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 entered into the era of triple-digit inflation in the midst of serious political crises (Chile and Argentina). Nonetheless, as already pointed out, the inflationary spirals of the 1980s were an *effect* rather than a cause of the debt crisis. The worst cases were, of course, 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%. The median rate of inflation soared to nearly 40% in 1990 (Figure 8.B) and the mean inflation (not shown in the graph) to over 1,000%) 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.[17]

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 banking systems. These domestic transfers could be made more easily in countries where the State had direct access to hard-currency export earnings (mainly through State-owned firms in the oil and mineral sectors) 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).

[17] 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.

The domestic transfer problem also 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.[18]

The experience of the 1930s is different in many respects. The external collapse generated balance of payments and fiscal tensions, that led to protectionist policies (following in this regard a global trend) as well as, initially, strong fiscal adjustments, following the gold standard "rules of the game".[19] However, the magnitude of the shock led some countries to abandon the gold standard early on, and the remaining of them after Great Britain did so in September 1931. This led to the broad-based use (and, later, abuse) of exchange controls and multiple exchange rates, following in both cases European practices. The countries that avoided an exchange rate depreciation and/or exchange controls were generally small countries under strong U.S. influence, some of which used the dollar as a domestic means of payment; Cuba and Panama are the most important examples in this regard. Among the larger economies, Venezuela was the only exception to exchange rate depreciation.[20]

The end of monetary orthodoxy, together with the fiscal relief generated by the external debt default facilitated the adoption of expansionary monetary policies, which facilitated the domestic demand expansion, staring in 1932. This was clearer in the case of monetary than in that of fiscal policy, given the still infrequent use of central bank financing of government deficits. The expansionary monetary policies were furthermore accompanied by state intervention in the credit market to facilitate the expansion of lending –including long-term lending— which included the creation of several commercial and development state-owned banks. Exchange rate depreciation also had

[18] For a discussion of the various dimensions of the domestic transfer problem, including the fiscal transfers mentioned above, see Frenkel and Rozenwurcel (1990).
[19] See, in relation to the Great Depression in Latin America, Diaz-Alejandro (2000), the volume edited by Thorp (2000) and Bulmer-Thomas (2003, ch. 7).
[20] This country effectively appreciated its currency as it did not change the price of gold when the U.S. did so in January 1934. It introduced later on preferential exchange rates for coffee and cocoa.

some expansionary effects, as they were undertaken when countries were running trade surpluses; they also cut short the deflation that characterized the early years of the crisis.

VI. Conclusions

The analysis presented in this paper shows that the great difference between the 1980s and the Great Depression must be found, not in the magnitude of the trade shock, and nor in the massive and prolonged capital account shock, which were in fact worse during the 1930s, but in the international response to the crisis and, particularly, in the bad management of the external debt crisis, which plunged Latin America into its worst crisis in history.

Indeed, despite a stronger trade shock and a collapse of the international financial system that would last more than three decades, the performance of the Latin American economies was better during the Great Depression. The basic reason for that was the management of the debt crisis through a fairly generalized default. In contrast, during the 1980s, Latin America faced strong pressures to avoid default and rather faced a creditors' cartel supported by the U.S. The lost decade must therefore be seen as the result of the way the U.S. banking crisis was managed, which clearly benefited U.S. banks at the cost of Latin America. Some solutions, particularly the Brady Plan, would arrive relatively late in the process, when the region had in fact overcome the worst of the crisis. It also gave smaller relief than when the external debts were renegotiated in the 1940s and 1950s. As a result of the management of the crisis, the 1980s were years of strong contractionary macroeconomic policies, whereas the way the crisis was managed after external debt default in the 1930s opened the space for expansionary policies.

Curiously, the crisis of the 1980s counted with a more elaborate international institutional financial architecture, but that did not turn out to be advantageous for the region, as it forced Latin America to service its external debt beyond its capacity and forced it into unduly contractionary macroeconomic policies. The main lesson from this is not that an institutional architecture is not required, but rather that there is a need to develop an international debt workout mechanism. Furthermore, and most important, it is essential that international financial institutions should never be used to support the interests of the creditor countries.

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