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*Latin American Research Review*, Vol. 23, No. 3 (1988), 170-179.

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*Latin American Research Review* is currently published by The Latin American Studies Association.

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## RECENT STUDIES OF THE LATIN AMERICAN DEBT CRISIS

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- TOWARDS RENEWED GROWTH IN LATIN AMERICA.* By BELA BALASSA, GERARDO BUENO, PEDRO-PABLO KUCZYNSKI, and MARIO HENRIQUE SIMONSEN. (Washington, D.C.: Institute for International Economics, 1986. Pp. 216. \$15.00.)
- INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE.* By WILLIAM CLINE. (Washington, D.C.: Institute for International Economics, 1984. Pp. 336. \$30.00.)
- EXTERNAL DEBT AND DEVELOPMENT STRATEGY IN LATIN AMERICA.* Edited by ANTONIO JORGE, JORGE SALAZAR-CARRILLO, and FRANK DIAZ-POU. (New York: Pergamon Press, 1985. Pp. 269. \$35.00.)
- THE POLITICS OF INTERNATIONAL DEBT.* Edited by MILES KAHLER. (Ithaca, N.Y.: Cornell University Press, 1986. Pp. 272. \$9.95.)
- DEBT AND DEVELOPMENT IN LATIN AMERICA.* Edited by KWAN KIM and DAVID RUCCIO. (Notre Dame, Ind.: University of Notre Dame Press, 1985. Pp. 226. \$24.95.)
- DEBT AND DANGER: THE WORLD FINANCIAL CRISIS.* By HAROLD LEVER and CHRISTOPHER HUHNE. (Boston: Atlantic Monthly Press, 1985. \$16.95.)
- NEOCONSERVATIVE ECONOMICS IN THE SOUTHERN CONE OF LATIN AMERICA, 1973-1983.* By JOSEPH RAMOS. (Baltimore: Johns Hopkins University Press, 1986. Pp. 200. \$25.00.)
- TILL DEBT DO US PART: WHO WINS, WHO LOSES, AND WHO PAYS FOR THE INTERNATIONAL DEBT CRISIS.* By ALFRED WATKINS. (Washington, D.C.: Roosevelt Center for American Policy Studies, 1986. Pp. 87. \$8.50.)
- POLITICS AND ECONOMICS OF EXTERNAL DEBT CRISIS: THE LATIN AMERICAN EXPERIENCE.* Edited by MIGUEL WIONCZEK, with LUCIANO TOMASSINI. (Boulder, Colo.: Westview Press, 1985. Pp. 300. \$49.00.)

Medical doctors joke that dermatologists have the ideal specialty: their patients never call in the middle of the night, they never die, and they never get better. Soon economists will be saying the same thing

about their colleagues specializing in the Latin American debt crisis. Latin America has now endured more than five years of debt crisis without the finality of total collapse but also without getting better. Like dermatologists, an array of economic and political specialists have been monitoring the progress of the disease, making diagnoses, prescribing treatments, and even making occasional house calls. One result of these efforts has been a remarkable outpouring of books, conference volumes, and journal articles on the topic. This outpouring, like the crisis itself, shows no signs of abating as the crisis enters its sixth year.

The sheer quantity of writings is now so great that it would be fruitless to attempt a comprehensive review of studies of the debt crisis. Instead, I shall merely sample some of the recent output to indicate the lines of analysis that have proven useful or not so useful and to underscore some areas that researchers have so far neglected.

The debt crisis poses an enormous range of issues in economic, political, and financial analysis. These issues include the macroeconomic and financial links between the creditor and debtor nations; the macroeconomic effects of the debt crisis on the debtor countries; the effects of the crisis on international commercial banks and the risks posed to the international financial system; the role of debtor country policies in the onset of the crisis and the political underpinnings of those policy choices; the nature of bargaining and international relations among the banks, the creditor governments, and the debtor governments; the role of international financial institutions (such as the International Monetary Fund and the World Bank) in resolving the crisis; and the distributional implications of alternative ways out of the crisis. The various studies under review tend to focus on subsets of these issues. Interested readers must therefore canvas widely just to touch on all the major themes.

The most influential early study of the crisis was William Cline's 1984 book, *International Debt: Systemic Risk and Policy Response*, itself an extension of a shorter 1983 study. In many ways, this book is a masterful work, even though its analysis is seriously flawed and its forecasts have proved to be far off the mark. Cline was the first to attempt a thorough macroeconomic analysis of the crisis, focusing on the origins of the crisis as well as on prospects for recovery. The book covers the onset of the crisis, the implications and risks for large U.S. commercial banks, the prospects for the largest indebted countries, and the appropriate role of international institutions. Cline's basic conclusion was that the "problem of international debt is likely to recede as international economic recovery proceeds, and it remains appropriate to manage the problem as one of liquidity, not insolvency, and on a case-by-case basis" (p. 199). His projections showed a sharply falling debt-to-export ratio

for the largest debtor countries by 1986, and on this basis, Cline predicted that debtor countries would quickly return to normal market borrowing.

*International Debt* gave important intellectual support to the U.S. strategy for managing the debt crisis. That strategy's three central features have remained more or less constant since the outbreak of the crisis in Mexico in mid-1982. First, debtor countries have been pressured to continue to pay all interest due on their commercial bank debts, while principal repayments may be postponed through re-scheduling agreements. No principal is to be forgiven. In effect, the time path of debt repayments can be pushed further into the future, but the total amount of repayments due is maintained in present value terms. Second, the commercial banks have been called upon to refinance some of the interest due through "concerted loans," in which each of the creditor banks relends the debtor country a proportion of the existing interest due. These loans are also sometimes called "involuntary loans" because each individual bank would like to avoid the obligation to extend new loans, but collectively the banks recognize that new loans are in their joint interest because these loans keep debtor countries afloat.

Third, the official community has been called into action to enforce these arrangements and to bolster them through various incentives. Most important, the International Monetary Fund has become the choreographer of the overall arrangement. The IMF negotiates an adjustment program with the debtor country, generally in the form of an IMF standby agreement. The adjustment program defines the extent of austerity that is theoretically required in the debtor country so that it can meet its interest-servicing bill. At the same time, the IMF helps the banks and the U.S. government to determine the amounts of new concerted lending that will be requested from the commercial banks. An IMF agreement is almost always a prerequisite for several further steps: a rescheduling agreement with the commercial banks; a rescheduling agreement between the debtor country and the official bilateral creditors, which takes place in the Paris Club; and new official lending from the IMF, the World Bank, and the export-credit agencies of industrial countries.

The United States adopted this strategy because of the perceived need to protect U.S. commercial banks and thereby stabilize the international financial system. In 1982 and 1983, the total capital of banks in the United States, Europe, and Japan fell far below their loans outstanding in Latin America. Consequently, widespread defaults could have undermined the international banking system. The policy priority of the United States was therefore natural: to prevent defaults and other forms of debt write-offs, at least until the commercial banks could

rebuild their capital base relative to their exposures in the problem debtor countries, as they have done in the past several years. Debt relief for Latin American countries was viewed as highly risky to the international financial system, no matter how realistic or desirable from the point of view of the debtor countries.

Cline's study bestowed an intellectual blessing on this approach by arguing that debt forgiveness was not necessary, that a postponement of principal repayments would be enough to tide the debtor countries over their difficulties. In practice, most of Cline's forecasts have gone seriously awry. Debt-export ratios in the major countries rose between 1982 and 1987, rather than falling as forecasted. Growth in the debtor countries was seriously hampered by the net outflow of resources from the region, with negative per capita growth rates in most of Latin America since 1982. Macroeconomic stability in Latin America proved to be elusive. By 1987 the three largest debtor countries—Argentina, Brazil, and Mexico—as well as Peru were suffering inflation rates well above 100 percent per year. Bolivia experienced a true hyperinflation (with inflation reading 20,000 percent in 1985). Not surprisingly under these circumstances, the commercial banks had not resumed normal lending to the debtor countries by 1987.

Many of the contributors to the conference volumes edited by Miguel Wionczek and by Antonio Jorge and coeditors expressed considerable skepticism about the prevailing debt strategy in general and about Cline's widely discussed analysis in particular. Wionczek's *Politics and Economics of External Debt Crisis* is based on a conference held in late 1983, and the Jorge team's *External Debt and Development Strategy in Latin America* resulted from a conference in early 1984. Both volumes are divided between global analyses and country case studies.

With the onrush of events, both volumes are already dated, although they remain of interest to the specialist for several reasons. First, the fact that many of the essays take issue vigorously with the official debt-management strategy shows that criticism of creditor policies is not merely a matter of hindsight. Second, the essays point up many of the methodological weaknesses of approaches like that of Cline. Third, the detailed country studies remain valuable sources of information about the buildup of the crisis in many individual countries. In general, the Wionczek volume offers the more substantial and therefore longer-lasting contributions. The Jorge volume is interesting mainly for its unusually close focus on the Central American and Caribbean debtor nations, which are typically neglected in studies of the debt crisis because of their small size.

Albert Fishlow's contribution to the Wionczek collection offers a powerful critique of Cline's methodology and optimism, a view that has been validated by subsequent events. Fishlow's study suggests that the

major analytical weakness of Cline's analysis is his "black box" treatment of the debtor countries themselves. In Cline's formal models, export growth from Latin America depends only on the growth in the industrial countries, and not on the export capacity in Latin American industries. Also, the fact that the debt-servicing burden deprives Latin American nations of resources for investment plays no part in Cline's approach but is given center stage in Fishlow's argument. Fishlow also stresses the macroeconomic and political instabilities that are likely to arise from the heavy burden of debt servicing, and he doubts (with foresight) that the new democracies in Latin America will be prepared to suffer long such instabilities for the sake of foreign creditors.

The separate case studies in the two volumes peer further into the "black box" of the debtor countries and thereby deepen skepticism over the optimistic assessments of the official debt-management strategy. The case studies all make clear that the debt crisis arose not only from global macroeconomic shocks (such as the oil price increases, the world recession in 1980–1982, the emergence of high real interest rates after 1980) but also from internal political and economic conditions in the debtor countries. Underpinning the crises are weak financial systems, the absence of adequate controls over budgetary expenditures, and deep political and social rifts in the countries that prevent an adequate burden-sharing when the countries are hit by external shocks. These political and economic fragilities, which hampered economic development in the 1970s, have been intensified by the need to repay foreign debts in the 1980s; in view of the countries' histories, it is therefore not surprising that many of the economies have nearly collapsed under the debt-servicing burden.

In 1983 and 1984, the optimistic scenarios looked possible, if not probable. The major debtor countries were dutifully servicing their interest payments, and the industrial countries were growing reasonably rapidly, led by a strong U.S. recovery. In early 1985, the *New York Times* reported that the debt crisis was considered all but over (4 Feb. 1985, p. D1). In a few short months, however, this optimism was shattered. In the external arena, prices of commodities in the debtor countries fell sharply, once again jeopardizing their export prospects. More predictable, although less understood, was the fact that the internal economic and political costs of debt servicing continued to mount. Debt-strapped governments resorted increasingly to creating money in order to cover government expenditures, with the result being that inflation rose sharply throughout Latin America. The economic pain of debt servicing strengthened the calls within the debtor countries for a unilateral suspension of debt payments.

The dam burst with Peru. Newly elected President Alán García announced in July 1985 that Peru would unilaterally restrict debt pay-

ments to 10 percent of export earnings. This challenge ricocheted around the world, ultimately prompting U.S. Treasury Secretary James Baker to announce his new "Baker Plan." The "plan" turned out to be little more than rhetoric, but it had one important effect. It acknowledged that the debt strategy should be deemed successful only if it allowed for renewed growth in the major debtor countries. The search was now on for "growth-oriented" adjustment.

The Baker Plan called for intensifying the debt strategy along two lines. The commercial banks were to extend about twenty billion dollars' worth of "new" money loans between 1986 and 1988 to the fifteen countries with the largest debts. These countries were supposed to commit themselves to making renewed structural adjustments, usually in the direction of free-market policies, which were supposed to spur economic growth. The sum of twenty billion dollars was a meager target, and obtaining even that much in practice has proved to be nearly impossible. Twenty billion represented less than 3 percent growth per year in the banks' exposure (total loans) to the region, even though the countries were paying about 9 percent per year in interest alone. Thus the "new money" was not new money at all—it was merely a refinancing of about one-third of the interest due on the debt.

Even more controversial were the structural adjustments that the debtor countries were being pressed to undertake. Several of the books under review, especially those by Balassa and coauthors, Ramos, and the essays edited by Kim and Ruccio, add important background information and analysis to the debate over these policy measures. *Towards Renewed Growth in Latin America*, by Bela Balassa, Gerardo Bueno, Pedro-Pablo Kuczynski, and Mário Henrique Simonsen, clearly supports the Baker Plan's proposals for adjustments in the debtor countries. In their review of the Latin American crisis, these authors conclude that the Latin American economies need to pursue three avenues of adjustment: first, greater outward orientation of their economies; second, a significant increase in savings rates by deregulating interest rate ceilings, creating tax incentives, reducing budget deficits, and improving incentives for the reversal of capital flight; and third, a sharply reduced governmental role in economic life.

What is striking about the Balassa volume, as well as the rhetorical fervor behind "growth-oriented" adjustment in the Baker Plan, is the nearly religious belief that a dramatic freeing of markets and reduced government regulations are the keys to rapid and sustained recovery. This conviction is all the more remarkable in view of the findings of Joseph Ramos in his elegant study, *Neoconservative Economics in the Southern Cone of Latin America, 1973–1983*. Ramos's careful study makes two major points. First, the advocacy of free-market economics is not new to Latin America and indeed has been tried on many occa-

sions, most recently in the Southern Cone countries of the 1970s. Second, the experience with radical free-market reforms has not been highly favorable. Each of the Southern Cone experiences ended in debacle, for reasons that Ramos carefully teases out of the data. The Balassa team unfortunately neglects this historical experience in its advocacy of free-market reforms.

Ramos's *Neoconservative Economics in the Southern Cone* is remarkably balanced, avoiding many of the ideological traps that tend to weaken books like the Balassa collection and similar volumes on the opposite side of the debate. For some in Latin America, liberalization is wrong per se because it is associated with authoritarian regimes such as that of Pinochet in Chile. Ramos clearly has no sympathy with such regimes, but he succeeds in avoiding the easy temptation to damn such policies only because of the ugly visage of some of their sponsors. While he takes up the policies in their social context, Ramos considers the alternative policies on their merits to see what is actually good or bad about specific policy options.

Ramos's analysis suggests that many of the reforms carried out in the Southern Cone pointed broadly in the right direction but erred seriously with regard to the pace, extent, and specific forms of implementation. As a central example, Ramos offers evidence supporting the idea that the Latin American trading regimes are excessively biased against exports. In his view, an important need exists for promoting exports and making tariffs lower and more rational. He also shows that the Southern Cone policies promoting nontraditional exports had favorable effects. New export industries in fact emerged, and older industries used to producing for the domestic market reoriented their production to the external market.

In the end, however, these policies failed. According to Ramos, they failed because the liberalizations were inconsistent with the rest of the macroeconomic policies, which were geared toward fighting inflation. The budgetary and exchange-rate policies needed to promote exports (fiscal subsidies, public investment spending, and an undervalued exchange rate) were the opposite of the policies used to fight the very high rates of inflation in the region (budget austerity and an overvalued, or at least pegged, exchange rate).

This lesson is particularly important today in view of the fact that the major debtor countries are wracked by triple-digit inflation. It would be dangerous, if not impossible, for them to embark on dramatic export-promotion policies at the same time that they are desperately trying to restore price stability. Because the debt itself is the major factor today in macroeconomic instability, the historical record suggests an appropriate ordering for reform in the region. An easing of the debt

burden should come first, followed by comprehensive fiscal reform and macroeconomic stabilization, and then gradual policies that promote exports.

Ramos demonstrates much less approval of several other aspects of liberalization that have been stressed by the Balassa team and highlighted in the rhetoric of the Baker Plan. Financial liberalization, including free internal interest rates and unregulated international movements of capital, has a poor track record. In the Southern Cone, these policies contributed to the concentration of wealth, increased precariousness of the financial system, and eventually, financial panics. Similarly, the privatization of public firms, high on the agenda of the Baker Plan, had adverse consequences on income distribution due to the manner of implementation in the Southern Cone countries.

The whole issue of income distribution is neglected in the Balassa volume and in the Baker Plan itself. This omission is a serious analytical flaw. As Ramos demonstrates, the recommended policy changes can have major distributional consequences in the short-to-medium term that may be highly deleterious and politically destabilizing. Real wages in all of the Southern Cone countries plummeted after the liberalization programs were adopted, while profit shares rose. It remains unclear whether such a decline in real wages is an inevitable feature of such programs or resulted instead from the particular means of implementation and the specific goals of the military regimes in power at the time. Second, the very reasons for many of the "illiberal" features of the Latin American economic landscape (large public sectors and protected markets) can be found in earlier political struggles over income distribution. For example, Perón's protection of domestic industry at the expense of agricultural exports was an explicit attempt to transfer income to an urban industrial class of workers.

The debate on income distribution in Latin America remains fierce, in part because income distribution in the region remains among the most unequal in the world. Most of the essays edited by Kwan Kim and David Ruccio in *Debt and Development in Latin America* are meditations on the links among the debt crisis, public policies, and income distribution in the region. The structuralist approach of most of the contributors moves the battles over income distribution to center stage. Unfortunately, the precision of analysis in this collection is generally low. One finds no attempts at any formal modeling and few references to such models. The trade-offs between equity and efficiency are not explored, and the few attempts at quantification are extremely modest. Yet the essays are worth reading (especially those by Alain DeJanvry and E. V. K. FitzGerald) because the issues linking distribution and economic adjustment are significant, too often neglected, and admit-

tedly complex. The contributors to this collection provide at least a stimulus to further thinking, if not highly satisfactory answers in their own essays.

In 1986 and 1987, the Baker Plan was increasingly viewed as insufficient. Macroeconomic instabilities in the region have continued to grow (particularly after the collapse of oil prices in early 1986), and frustrations in many debtor countries have boiled over. By mid-1987, a number of Latin American countries had taken the major unilateral step of suspending debt-servicing payments, including Bolivia, Brazil, Costa Rica, Cuba, the Dominican Republic, Ecuador, Honduras, Nicaragua, and Peru. Calls have multiplied for a deeper "political" solution to the crisis that would place more of the burden of adjustment on creditor nations. The last three books under review, those by Lever and Huhne, Watkins, and the collection edited by Kahler, belong to this latest stage of the crisis: the political debate over systemic solutions to the crisis.

*Debt and Danger* by Harold Lever and Christopher Huhne is a pithy and well-reasoned plea for a political solution. Lord Harold Lever has been one of Britain's leading economic policymakers in past Labour governments and has written with great prescience about the debt crisis and the inadequacies of the prevailing debt-management strategy. In the authors' view, taxpayers in the creditor nations will have to play the key role in reducing the debt burden. The terms for servicing the existing debt should be eased, and new lending to the developing countries should be fostered through official loan guarantees by the governments of industrial countries. *Debt and Danger* covers carefully yet crisply a broad range of issues that include the history of the crisis, patterns of crisis management, and alternatives for the future.

Alfred Watkins's short book, *Til Debt Do Us Part*, recounts the flaws in the current debt-management strategy and provides a brief survey of alternative directions for reform. Many of the reforms that he considers would place a large share of the burden on the bank shareholders, rather than on the taxpayers, as Lever and Huhne propose. This book is most intriguing in its attempts to answer the questions raised in its subtitle: *Who Wins, Who Loses, and Who Pays for the International Debt Crisis?* As a former U.S. Congressional staff member, Watkins is sensitive to interest-group politics. His book suggests the outlines of political coalitions in the United States that might favor or oppose alternative proposals for debt reform. The issue is not simply the banks versus the countries. Rather, the interests of the U.S. commercial banks in being fully repaid must be set against key sectoral and regional interests in the United States that would benefit from the faster economic recovery in Latin America resulting from debt relief. Such interests include U.S. farmers, who have lost export markets in Latin America and must now compete with increased agricultural production

in debtor countries, as well as U.S. manufacturing exporters (for example, producers of capital goods), who have lost major markets in the region.

As time passes, the political economy aspects of the debt crisis will come increasingly to the fore. The question of who would win and who would lose according to the many policy alternatives now under consideration has become a central, if not the central, feature of the debate. How will economic reforms in the debtor countries affect income distribution? How will bargaining power in the future shift debtor governments, creditor governments, and the banks? How should creditor governments balance their foreign policy goals (such as defending democracy in Latin America) against their inclination to bolster the bargaining power of their commercial banks?

These topics have been treated in many of the works already discussed, but they are taken up in an organized and insightful fashion in the essays in *The Politics of International Debt*, which is wholly devoted to the political economy of the debt crisis. Editor Miles Kahler provides a useful survey of the political economy issues in his introduction and conclusion. Fishlow, as usual, offers a provocative and insightful essay, in this case on the history of capital markets and debt crises in the nineteenth century. Stephen Haggard and Robert Kaufman provide useful essays on the internal politics of adjustment in the debtor countries, with Haggard's study setting forth remarkable data on the steep rate of failure of IMF adjustment programs during the past decade. Finally, Charles Lipson discusses the role of international institutions in managing the crisis. In all these essays, one finds much to debate, and they raise more questions than they answer. But this outcome is natural, given the originality of many of the analyses and the need for more work on issues relating to the political economy.

The debt crisis promises considerable further evolution, and inevitably, further studies. Several trends are evident, although their implications are not yet fully clear. The political debate within developing countries over debt servicing continues to evolve. Significantly, most of the leading commercial banks are no longer at fundamental risk from their exposures in Latin America, and they can now absorb substantial losses without risking insolvency. This change will surely shift the balance of negotiating power, probably in the direction of the developing countries, who can now threaten to suspend payments without the risk of toppling the international system. The lowered risk will also affect the concerns and priorities of creditor governments. In view of the fact that the banks can now afford to ease dramatically the terms of repayments to the debtor countries (through such means as exit bonds, sub-market interest rates, or other mechanisms), creditor governments might soon start to support such proposals.