Latin American Debt Crisis of the 1980s

The Latin American debt crisis was a financial crisis that began in the 1980s when Latin American countries found themselves unable to repay massive foreign loans which they had taken on in the preceding decades. This resulted in a severe economic, political and social crisis which would take years to resolve.

In the 1960s and 1970s, many Latin American countries, especially Brazil, Mexico and Argentina, borrowed large sums of money to fund industrialisation and infrastructure projects. This resulted in strong economic growth, which averaged between 5-6% p.a. [i]

With low domestic savings rates, growth was funded primarily by overseas lenders, initially by the World Bank and then by commercial banks.

During the 1970s, the world was hit by two oil price shocks, both of which had major impacts on the global economy. The first shock occurred in 1973 when OPEC (the Organization of the Petroleum Exporting Countries) imposed an embargo on the sale of oil to major western nations in retaliation for U.S. support for Israel in the Yom Kippur War. The price of oil quadrupled from US$3 to nearly $12 per barrel, causing inflation to rise and sending the world into recession. The world's economy eventually recovered, but it led to a major transfer of funds from oil-consuming to oil-producing nations.

With encouragement from the U.S. government, the major money-center banks became willing intermediaries between the two groups, providing exporting countries with what they believed to be a safe, liquid place for their funds and then lending those funds to Latin America. [ii]

Between 1975 and 1982, Latin American debt to commercial banks increased at a cumulative rate of 20% p.a. As a result, Latin American external debt quadrupled between 1975 and 1983 from $75 billion to more than $315 billion, or to 50% of the region's GDP. Debt servicing costs grew even faster as global interest rates surged, growing from $12 billion to $66 billion between 1975 and 1982. [iii]

In 1979, the world suffered a second oil shock in the wake of the Iranian Revolution, when the price of crude oil more than doubled to $39.50 per barrel.

The rapid jump in oil prices and interest rates had an immediate effect on the economies of the debt-laden Latin American nations. Many countries were highly dependent on foreign oil, and they were forced to seek out additional loans just to keep the oil flowing. Increasing interest rates also made it harder to maintain debt repayments, while the contraction in world trade caused commodity prices (Latin America's largest exports) to collapse. Finally, many of their debts were denominated in U.S. dollars. Falling exchange rates not only fed through into inflation, but they increased debt repayments, putting these nations under immense pressure. [iv]

The crisis was triggered in 1982 when Mexico advised lenders that it would be unable to service its debt, which at that point totalled $80 billion. Other countries quickly followed suit. Ultimately, sixteen Latin American countries rescheduled their debts, as well as eleven Lesser Developed Countries (LDCs) in other parts of the world. [v]

In the wake of Mexico's default, foreign lenders significantly reduced or halted new lending to Latin America. As many of Latin America's loans were short-term, a crisis ensued when lenders refused to roll-over the debts. Billions of dollars of loans that would previously have been refinanced, became due for immediate repayment. [vi]

As the crisis spread, the U.S. took the lead in coordinating rescue efforts. Under the program, commercial banks agreed to restructure the countries' debts, and the IMF and other official agencies lent the LDCs sufficient funds to pay the interest, but not principal, on their loans. In return, the LDCs agreed to undertake structural reforms of their economies and to eliminate budget deficits. The hope was that these reforms would enable the LDCs to increase exports and generate the trade surpluses and dollars necessary to pay down their external debt. [vii]

Although the actions averted an immediate crisis, the problems continued to fester. Instead of eliminating subsidies to state-owned enterprises, many LDCs cut spending on education and health, freezing wages and laying off workers. This only exacerbated the crisis, as LDCs continued to drown under the weight of debt.

At the same time, U.S. banking regulators allowed lenders to delay recognizing their bad loans, fearing that many banks would have been deemed insolvent if they were forced to write down their debts to LDCs. These actions, however, only delayed the problem. By the end of the decade it became clear that much of the debt would not be repaid. Between 1989 and 1994, private lenders forgave $61 billion in loans, about one-third of the total outstanding debt. In exchange, the eighteen countries agreed to domestic economic reforms that would enable them to service their debt. [viii]

The 1982 debt crisis was the most serious economic crisis in Latin American history. Incomes and imports dropped; economic growth stagnated; unemployment soared; inflation reduced the buying power of the middle classes; while GDP per capita in Latin America fell by almost 9% between 1980 and 1985. [ix] In the ten years after 1980, real wages in urban areas dropped between 20 - 40%. [x]

The lending strike by western banks also created problems in that it rendered several half-finished projects useless, contributing to infrastructure problems in the affected countries. [xi] Additionally, investment that might have been used to address social issues and poverty was instead used to repay debt. [xii] Between 1982 and 1985, Latin America paid back $108 billion, [xiii] diverting much needed funds from further economic development.

The Latin American debt crisis is interesting for several reasons. Firstly, major commercial banks were forewarned of the growing risk of lending to LDCs and yet continued to lend in any event. In 1977, then-Fed Chairman Arthur Burns criticized commercial banks for assuming excessive risk in their Third World lending. Despite such warnings, by 1982, the nine largest U.S. money-centre banks held Latin American debt amounting to 176% of their capital. Their total LDC debt was nearly 290% of capital. [xiv]

Secondly, the new boom in external financing for Latin America was part of broader changes in international capital markets that began in the 1960s (when it was dubbed the "Eurodollar market"). A growing number of formerly national banks began to expand globally, increasing competition in global markets. They also led consortia of smaller banks, many with limited international experience, who trusted almost implicitly in the credit evaluations of the large banks that led the consortia. The way they raised funds - by pegging the interest rate to the interbank market – also shifted risk from lenders onto borrowers. [xv]

Secondly, the IMF came in for strident criticism for the strict conditions they imposed on the LDCs in return for debt relief. These conditions imposed the greatest hardship on those who could least afford it – the poor and middle classes.

Finally, it led to the development of what became known as the Washington Consensus, an orthodoxy which would come to symbolize the worst of capitalism, whilst dividing the economics community.

The Washington Consensus was a set of ten policy prescriptions considered to represent the consensus by the Washington-based global financial elite - namely the U.S. government, the IMF, World Bank, the think tanks and leading western economists – on how to handle the Latin American financial crises. The concept and name were first proposed by English economist, John Williamson. [xvi]

The policy prescriptions included the need to impose fiscal discipline and avoid large budget deficits; redirect government money away from subsidies towards pro-growth, pro-poor services such as health, education and infrastructure development; broaden the tax base; ensure interest rates are positive (but moderate) in real terms and determined by market forces; facilitate competitive exchange rates; remove trade barriers and liberalise foreign direct investment; open domestic markets up to competition; privatize state enterprises and ensure legal security for property rights. [xvii]

The general ideas derived from the Washington Consensus had a huge influence on the economic reforms of many countries. Yet, the way these countries interpreted such ideas varied substantially and their actual implementation varied even more so. [xviii]

Discussion of the Washington Consensus has long been contentious. Partly this reflects a lack of agreement over the term itself, but there are also philosophical differences over the merits and consequences of the policy prescriptions themselves. [xix]

In his insightful 1999 article entitled *Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?* Moises Naim cites several examples of opposing views in relation to the effectiveness of the measures taken to handle the Latin American and subsequent financial crises in Asia and Russia. Importantly, these were not debates between passive bystanders, but rather involved Nobel laureates in economics as well as insiders working in government and global financial institutions such as the IMF and World Bank. [xx]

The first area of disagreement focused on the pace and sequence of reforms. Some “experts” argued for an expansive, big bang approach to economic reform i.e. shock therapy, while others argued for a slower, more sequenced pace.

Mainstream economist, Joseph Stiglitz publicly denounced the IMF's handling of the subsequent financial crises in Asia and Russia. This led Anders Aslund, a Russian expert at the Carnegie Endowment in Washington to tell *The Economist* that "without knowing anything [Stiglitz] mouths any stupidity that comes to his head." [xxi]

Ricardo Hausmann, the Chief Economist of the Interamerican Development Bank [IDB] enthusiastically recommends that countries shed their currencies in favor of the U.S. dollar, a policy that would shield them from the ills brought about by international financial volatility. This opinion was quickly condemned by other economists and even disowned by the President of the IDB. [xxii]

Nobel laureate, James Tobin called for a tax on currency transactions to "put sand in the wheels of international finance" and tame volatility while Nobel laureate Milton Friedman argued that the problem is perhaps too much sand in the wheels of global finance and called for, among other measures, the abolition of the IMF. Others such as financier, George Soros suggest that the world is in dire need of a new financial architecture.

In terms of the debate on the liberalization of a country's capital account, Alan Binder, a former Vice-Chairman of the U.S. Federal Reserve Board, suggested that "the hard-core Washington Consensus—which holds that international capital mobility is a blessing, full stop—needs to be tempered by a little common sense." [xxiii] Proponents of capital controls, however, do not share the same common sense about what kind of measures work best. Some of the most radical proponents, like Paul Krugman, recognize that "there is virtually unanimous consensus among economists that exchange controls work badly." [xxiv]

Outside of pure economic arguments between so-called economic experts, the term Washington Consensus has become associated with criticisms of neo-liberalism and debate over the expanding role of the free market, constraints upon the state, globalisation, demands by the IMF for trade liberalisation and privatisation, and finally the role of the U.S. in global affairs. Many of these arguments are based on ideological rather than economic arguments, which I will address in later chapters.

The impression that the Washington Consensus was a set of rigid, almost unalterable, set of theoretical propositions about which the powerful and the knowledgeable had no doubt was widespread. In fairness to Williamson, it seems that he was the innocent victim of the success of his very useful summary, which he subsequently argued was not a rigid policy framework, but rather a set of guidelines. [xxv]

The above discussion is important for several reasons. Firstly, it highlights that there is no agreement amongst leading mainstream economists on how an economy functions, and if a crisis does occur, what is the best way to resolve it. This then leads to the next logical realization. If economists can’t agree on something as fundamental as how an economy works and how crises develop, then why should the public have any faith in what they say.

Secondly, it highlights that despite repeated warnings that LDC debt levels were unsustainable, banks continued with their reckless lending until crisis struck. But then having created the problem in the first place, western powers then engaged the IMF to bail the money-centre banks out, while imposing onerous conditions on the creditors, conditions that brought immense suffering to the poor.

[i] The Conference Board. 2016. The Conference Board Total Economy Database™ (Original version), November 2016, http://www.conference-board.org/data/economydatabase/

[ii] https://www.federalreservehistory.org/essays/latin_american_debt_crisis

[iii] Institute of Latin American Studies, The Debt Crisis in Latin America, p 69

[iv] García Bernal, Manuela Cristina (1991). "*Iberoamérica: Evolución de una Economía Dependiente*". In Luís Navarro García (Coord.), Historia de las Américas, vol. IV, pp 565–619. Madrid/Sevilla: Alhambra Longman/Universidad de Sevilla. ISBN 978-84-205-2155-8

[v] https://www.federalreservehistory.org/essays/latin_american_debt_crisis

[vi] https://en.wikipedia.org/wiki/Latin_American_debt_crisis

[vii] Devlin, Robert, and Ricardo Ffrench-Davis. "The Great Latin America Debt Crisis: A Decade of Asymmetric Adjustment." *Revista de Economia Politica* 15, no. 3 (July-September 1995): 117-42

[viii] https://www.federalreservehistory.org/essays/latin_american_debt_crisis

[ix] García Bernal, Manuela Cristina (1991). "Iberoamérica: Evolución de una Economía Dependiente". In Luís Navarro García (Coord.), Historia de las Américas, vol. IV, pp. 565–619. Madrid/Sevilla: Alhambra Longman/Universidad de Sevilla. ISBN 978-84-205-2155-8

[x] Felix, David (Fall 1990). "*Latin America's Debt Crisis*". World Policy Journal. **7** (4): 733–771

[xi] "*Encyclopædia Britannica Online School Edition"*. Encyclopædia Britannica. Retrieved 21 May 2012

[xii] Ferraro, Vincent (1994). *World Security: Challenges for a New Century*. New York: St. Martin's Press

[xiii] García Bernal, Manuela Cristina (1991). "Iberoamérica: Evolución de una Economía Dependiente". In Luís Navarro García (Coord.), Historia de las Américas, vol. IV, pp. 565–619. Madrid/Sevilla: Alhambra Longman/Universidad de Sevilla. ISBN 978-84-205-2155-8

[xiv] Sachs, Jeffrey D. "International Policy Coordination: The Case of the Developing Country Debt Crisis." In *International Economic Cooperation*, edited by Martin Feldstein, 233-78. Chicago: University of Chicago Press, 1988

[xv] http://sas-space.sas.ac.uk/6500/1/Bertola%20and%20Ocampo%20paper.pdf

[xvi] Williamson, John: *What Washington Means by Policy Reform*, in: Williamson, John (ed.): Latin American Readjustment: *How Much has Happened*, Washington: Institute for International Economics 1989

[xvii] Williamson, John: *What Washington Means by Policy Reform*, in: Williamson, John (ed.): Latin American Readjustment: *How Much has Happened*, Washington: Institute for International Economics 1989

[xviii] https://www.imf.org/external/pubs/ft/seminar/1999/reforms/Naim.HTM

[xix] https://en.wikipedia.org/wiki/Washington_Consensus

[xx] https://www.imf.org/external/pubs/ft/seminar/1999/reforms/Naim.HTM

[xxi] September 18, 1999 p 81

[xxii] Foreign Policy Magazine, Fall 1999

[xxiii] Alan Blinder "Eight Steps to a New Financial Order" Foreign Affairs September\October 1999 p57

[xxiv] See Paul Krugman's article in Fortune Magazine, Sep 7, 1998 "Saving Asia: it's time to get RADICAL" pp. 75-80 and also his book The Return of Depression Economics [New York, WW Norton, 1999] pp145-146

[XXV] https://www.imf.org/external/pubs/ft/seminar/1999/reforms/Naim.HTM