CHAPTER 14

Developing Countries and International Finance I: The Latin American Debt Crisis

Developing countries have had a difficult relationship with the international financial system. At the center of these difficulties lies a seemingly inexorable boom-and-bust cycle. The cycle typically starts with changes in international capital markets that create new opportunities for developing countries to attract foreign capital. Wanting to tap into foreign capital to speed economic development, developing countries exploit this opportunity with energy. Eventually, developing countries accumulate large foreign debt burdens and are pushed toward default. Looming default frightens foreign lenders, who refuse to provide new loans and attempt to recover many of the loans they had made previously. As foreign capital flees, developing countries are pushed into severe economic crises. Governments then turn to the International Monetary Fund (IMF) and the World Bank for assistance and are required to implement far-reaching economic reforms in order to gain those organizations' aid. This cycle has repeated itself twice in the last 25 years, once in Latin America during the 1970s and 1980s, and once in Asia during the 1990s. A similar, though distinct, cycle occurred in sub-Saharan Africa. The political economy of North–South financial relations focuses on this three-phase cycle of overborrowing, crisis, and adjustment.

Each phase of the cycle is shaped by developments in the international financial system and inside developing societies. Developments in the international financial system, including changes in international financial markets, in the activities of the IMF and the World Bank, and in government policies in the advanced industrialized countries, powerfully

affect North–South financial relations. They shape the ability of developing countries to borrow foreign capital, their ability to repay the debt they accumulate, and the economic reforms they must adopt when crises strike. Events that unfold within developing countries determine the amount of foreign capital that developing societies accumulate and influence how governments and economic actors in those countries use their foreign debt. These decisions in turn shape the ability of governments to service their foreign debt and therefore influence the likelihood that the country will experience a debt crisis.

This chapter and the next examine the evolution of this cycle in North–South financial relations. We begin with a short overview of international capital flows in order to understand why they are important for developing societies and how developing societies gain access to foreign capital. We then briefly examine the relatively stable immediate postwar period during which capital flows to developing countries were dominated by foreign aid and foreign direct investment (FDI). The rest of the chapter focuses on the first major financial crisis of the postwar period: the Latin American debt crisis of the 1980s. We examine how it originated, how it was managed, and its consequences, political and economic, for Latin America.

FOREIGN CAPITAL AND ECONOMIC DEVELOPMENT

If a cycle of overborrowing, crisis, and adjustment has characterized the history of capital flows from the advanced industrialized countries to the developing world, why do developing countries continue to draw on foreign capital? Why do they not simply refrain from borrowing that capital, thus bringing the cycle to an end? Developing countries continue to draw on foreign capital because of the potentially large benefits that accompany its apparent dangers. These benefits arise from the ability to draw on foreign savings to finance economic development.

Investment is one of the most important factors determining the ability of any society to raise per capita incomes (Cypher and Dietz 1997, 239). Yet, investment in developing societies is constrained by a shortage of domestic savings (Bruton 1969; McKinnon 1964). Table 14.1 illustrates average savings rates during the last 40 years throughout the world. The most striking difference that the table highlights is between the high-income Organization for Economic Co-operation and Development (OECD) countries and the world's poorest countries. On average, the high-income countries saved slightly more than one-fifth of their national

income each year between 1970 and 2006. In contrast, the least developed countries have saved less than 15 percent of their national income per year. Even when a developing country has a high savings rate, as in East Asia and the Pacific and in Latin America, the low incomes characteristic of a developing society mean that the total pool of savings is small. The scarcity of savings limits the amount, and raises the cost, of investment in these societies.

TABLE 14.1

Average Savings Rates as a Percent of Gross Domestic Product, 1970–2006

High-Income OECD Countries	21.7
Least Developed Countries	13.4
East Asia and the Pacific	34.5
Latin America and the Caribbean	19.9
Sub-Saharan Africa	16.9
South Asia	21.2

Note: OECD = Organisation for Economic Co-operation and Development.

Source: World Bank, *World Development Indicators 2008 CD-ROM* (Washington, DC: World Bank Publications, 2008).

Foreign capital adds to the pool of savings available to finance investment. Many studies have found a one-to-one relationship between foreign capital inflows and investment: one dollar of additional foreign capital in a developing country produces one dollar of additional investment (see, e.g., Bosworth and Collins 1999; World Bank 2001a). Higher investment in turn promotes economic development. Indeed, a considerable body of research suggests that developing countries that have participated in international financial markets during the last 30 years have experienced faster economic growth rates than economies that remain insulated from international finance (see IMF 2001; World Bank 2001a). Although foreign capital does not always yield higher growth (see, for example, Rodrik 1998), a country that draws on foreign capital has the *opportunity* to reach a higher development trajectory. Many other factors, some of which lie inside developing countries and others that inhere in the international financial system, shape the extent to which a developing

country can take advantage of this opportunity.

Foreign capital can be supplied to developing countries through a number of channels. The broadest distinction is between foreign aid and private capital flows. **Foreign aid**, or official development assistance, is foreign capital provided by governments and by multilateral financial institutions such as the **International Bank for Reconstruction and Development** (IBRD), known more commonly as the World Bank. In addition to the **World Bank**, a number of regional development banks, including the Inter-American Development Bank, the African Development Bank, and the Asian Development Bank provide concessional loans to support development. These more established institutions were joined in 2016 by the Asian Infrastructure Investment Bank (AIIB). The AIIB is an initiative of the Chinese government intended to foster the construction of transportation, energy, and telecommunciations infrastructure in Asia. The U.S. did not join the AIIB and tried (unsuccessfully) to convince its European allies to remain outside as well. The AIIB thus may be yet another manifestation of the shift in economic power from North America to Asia.

The largest share of foreign aid is provided as bilateral development assistance—that is, foreign aid granted by one government directly to another government. In 2016, the advanced industrialized countries together provided $143 billion of bilateral assistance to developing countries. The World Bank and other multilateral development agencies provided an additional $61 billion. The United States provided the most aid in absolute terms in 2016, about $33.6 billion (Figure 14.1). Japan, France, Germany, and Great Britain were the four next largest donors in absolute terms. China has emerged as an important source of aid, providing slightly less than $9 billion per year. The rankings change considerably when we measure aid as a share of the donor country's national income (Figure 14.2). By this measure, the smaller northern European countries are the most generous, dedicating between 0.6 and 1 percent of their total national incomes to foreign aid. The United States emerges as one of the least generous of the high-income countries, dedicating only 0.2 percent of its national income to foreign aid.

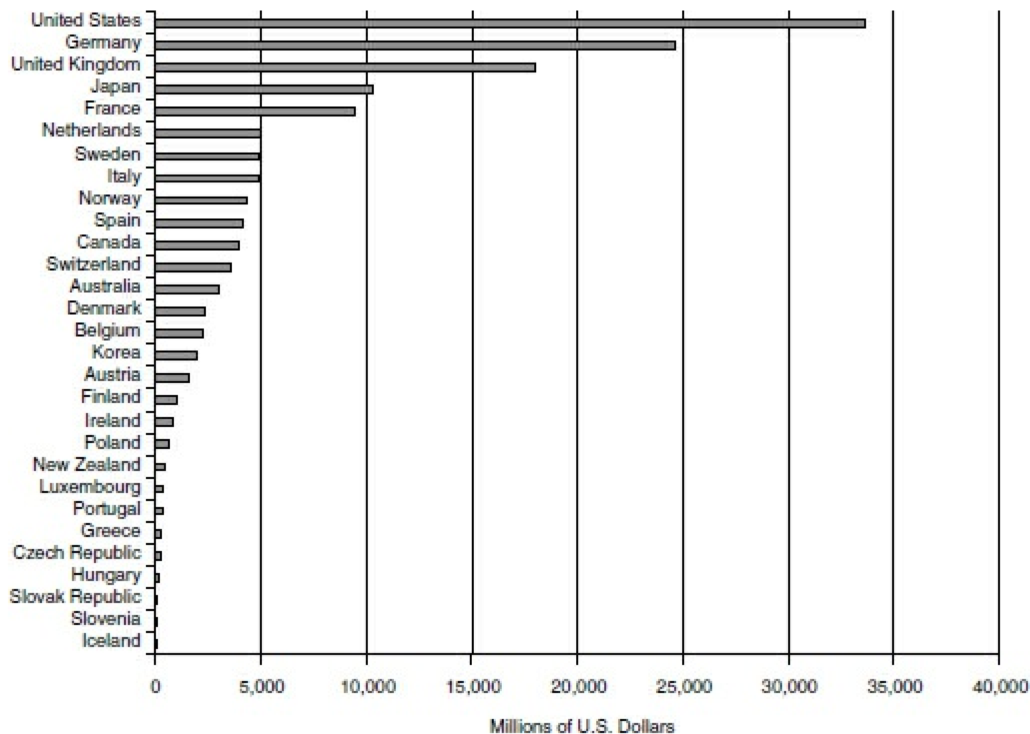

FIGURE 14.1

Foreign Aid Expenditures, 2016

Source: Official and private flows, OECD International Development Statistics (database).

Private capital flows transfer savings to the developing world through the activities of private individuals and businesses. Private capital can be transferred to developing countries in a number of ways. Commercial banks transfer capital by lending to private agents or governments in developing societies. Private capital is also transferred when individuals and large institutional investors purchase stocks traded in developing-country stock markets. Private capital can also be transferred through bonds sold by developing-country governments and businesses to individuals and private financial institutions in advanced industrialized societies. Finally, multinational corporations (MNCs) transfer capital each time they build a new or purchase an existing factory or other productive facility in a developing country. The relative importance of each type of private capital flow has varied across time, as we shall see as we move through this chapter and the next.

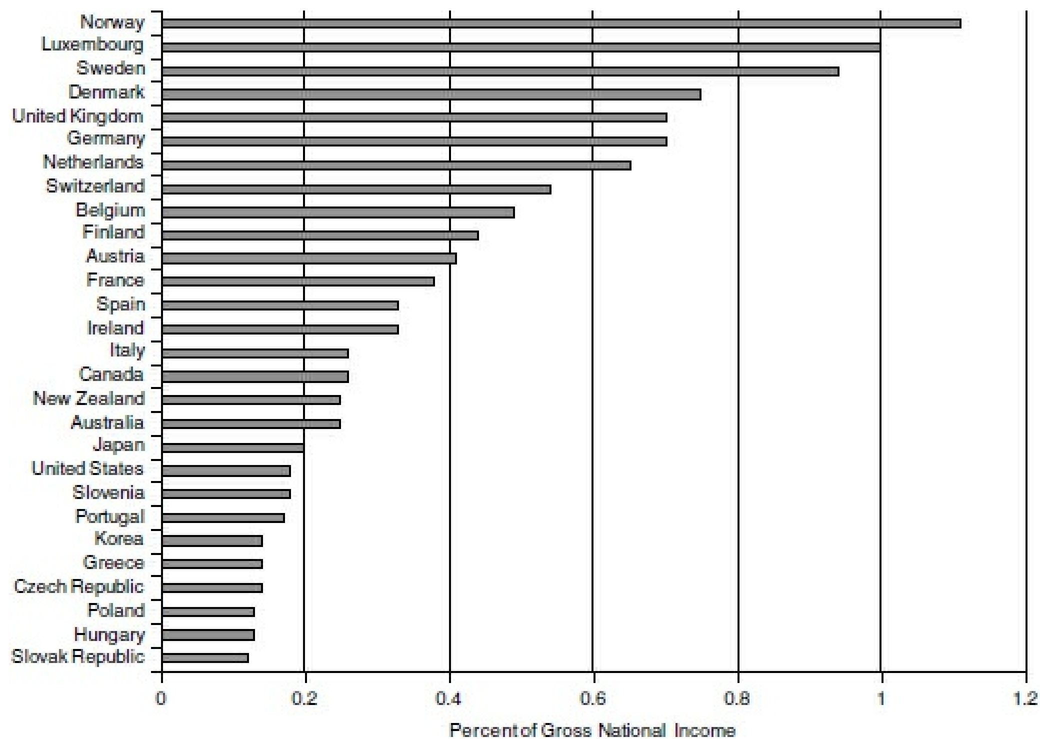

FIGURE 14.2

Foreign Aid Expenditures as a share of National Income, 2016

Throughout the postwar period, private capital flows have been larger than foreign aid flows. In general, private capital flows typically constitute somewhere between two-thirds and three-quarters of all capital flows to the developing world. Yet, developing countries vary substantially in their ability to attract private capital inflows; thus, some countries rely much more heavily than others on foreign aid. These different abilities to attract private capital reflect private lenders' need to balance return against risk when investing in developing societies. On the one hand, because savings are scarce, the return on an investment should be substantially higher in developing societies than in the advanced industrialized world. Consequently, private lenders should earn a higher return on an investment in a developing country than on an equivalent investment in an advanced industrialized country. This pulls in private capital. On the other hand, foreign investment is risky. Private lenders face the risk of default—the chance that a particular borrower will be unwilling or unable to repay a debt. Private lenders also face political risk—the chance that political developments in a particular country will reduce the value of an investment. Political risk arises from political instability—coups, revolution, or civil war—and, less dramatically, from the absence of strong legal systems that protect foreign investment. Large risks substantially reduce an investment's expected return. This risk acts to push private

capital away from a country. Indeed, such risks are one of, if not the principal reason why sub-Saharan Africa attracts so little private capital.

More recently, remittances have emerged as an increasingly important third source of capital for developing countries. Remittances are transfers of income earned by migrant workers from jobs in their host countries back to family and friends in their country of origin. Migrant workers typically transfer money back home in small amounts—a couple hundred dollars a month—using international money transfer companies such as MoneyGram, Western Union, and Ria. The countries that receive the largest remittance inflows are those that have the largest number of workers living overseas. Not surprisingly, China and India receive the largest volume of remittances (roughly $65 billion in 2016), and they each receive more than twice as much as each of the next largest recipient countries (the Philippines, Mexico, and Pakistan). The overall volume of remittances has increased dramatically during the last 30 years. The World Bank estimates that total remittances rose from less than $50 billion in 1990 to almost $600 billion by 2017 (World Bank 2017b). This level is four times as large as combined foreign aid flows from the Development Assistance Committee (DAC) countries—the major donor countries. Existing research indicates that remittances are a less volatile source of foreign capital than private capital flows, are often pro-cyclical rather than counter-cyclical, and because remittances flow to individuals rather than to governments or private firms, they have a greater impact on households than other types of capital flow (see, e.g., Grabel 2009).

Developing societies import foreign capital, therefore, because it makes it possible to finance more investment at a lower cost than they could finance if they were forced to rely solely on their domestic savings. And although developing countries can import some capital through foreign aid programs, such programs are limited. Thus, if a developing society is to import foreign savings, it must rely on private capital. The desire to import foreign savings and the need to rely on private capital flows to do so creates difficulties for developing societies, for private capital never flows to developing societies in a steady stream. Instead, financial markets shift from excessive concern about the risk of lending to developing societies to exuberance about the opportunities available in those societies and then back to excessive concern about the risk. As a consequence, a country that is unable to attract private capital one year is suddenly inundated with private capital the next, and then, just as suddenly, is shut out of global financial markets as private investors cease lending. The consequences are often devastating. We turn now to look at the first revolution of this cycle.

COMMERCIAL BANK LENDING AND THE LATIN AMERICAN DEBT CRISIS

The composition and scale of foreign capital flows to the developing world changed fundamentally during the 1970s. In the 1950s and 1960s, foreign aid and FDI were the principal sources of foreign capital for developing countries, and neither was abundant. Only the United States had resources for foreign aid, and these flows were quite limited. World Bank lending was also limited. It perceived its mission as providing loans at “close-to-commercial rates of interest to cover the foreign exchange costs of productive projects” (Mason and Asher 1973, 381). And most of its lending in this period also financed postwar reconstruction in Europe (Mason and Asher 1973).

Development aid increased a little beginning in the late 1950s. The World Bank created the **International Development Association** (IDA) and began to provide concessional loans to many of its member governments. At the same time, a number of **regional development banks**, such as the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank, were created to provide concessional lending on the model of the IDA. Advanced industrialized countries also expanded their bilateral aid programs during the 1960s. As a consequence, the amount of aid provided through multilateral development agencies increased fourfold between 1956 and 1970, whereas bilateral development assistance more than doubled during the same period (see Table 14.2). By the end of the 1960s, official development assistance to developing countries was almost twice as large as private capital flows.

The expansion of foreign aid programs during the 1960s reflected changing attitudes in advanced industrialized countries. These changing attitudes were in turn largely a product of the dynamics of decolonization. World Bank officials recognized that governments in the newly independent countries would have great difficulty borrowing on private capital markets and would be unlikely to qualify for lending under the World Bank’s normal terms. The World Bank therefore began to reconsider its resistance to concessional lending. American attitudes toward foreign aid changed in response to political consequences of decolonization. American policymakers believed that the rising influence of developing countries in the United Nations would eventually lead to the creation of an agency that offered development loans at concessional rates. The creation of such a UN agency could undermine the World Bank and

weaken American influence over development lending. U.S. officials began to support a concessional lending agency within the World Bank, therefore, in order to prevent the creation of a rival within the United Nations, where developing countries had greater influence.

TABLE 14.2

Financial Flows to Developing Countries, Millions of U.S. Dollars, 1956–1970

Official Development Assistance	**1956**	**1960**	**1965**	**1970**
Official Government Aid	2,900.0	4,236.4	5,773.1	6,587.4
Multilateral Organizations	272.5	368.5	312.9	1,176.0
Organization of the Petroleum Exporting Countries (OPEC)				443.5
Private Finance	**1956**	**1960**	**1965**	**1970**
Foreign Direct Investment	2,500.0	1,847.9	2,207.4	3,557.2
Portfolio Flows	0.0	408.2	836.0	777.0

Source: Wood 1986, 83.

At the same time, during the late 1950s and early 1960s, American policy-makers increasingly came to view foreign aid as a weapon in the battle against the spread of Communism throughout the developing world. Nowhere was this more evident than in the Kennedy administration's "Alliance for Progress," which was designed to use U.S. government aid to promote socioeconomic reform in Latin America in order to prevent the spread of Cuban-style socialist revolutions throughout the region (Rabe 1999). These changes in attitude contributed to the tremendous growth of foreign aid programs during the 1960s.

The paucity of private lending to developing countries changed fundamentally during the 1970s. On the one hand, commercial banks found themselves awash with deposits in the wake of the 1973 oil shock. The oil shock generated large current-account surpluses in the oil-exporting countries. Saudi Arabia's current-account surplus jumped from $2.5 billion in 1973 to $23 billion in 1974 and then averaged about $14 billion during the next 3 years. These surpluses, called **petrodollars**, provided the financial resources that developing countries needed to cover

their greater demand for foreign capital. Commercial banks intermediated the flows, accepting deposits from oil exporters and finding places to lend them. The process came to be called **petrodollar recycling**.

It turned out that the growing supply of loanable funds was matched by a growing demand for foreign capital in developing countries. Higher oil prices cost developing countries about $260 billion during the 1970s (Cline 1984). Because most developing countries were oil importers, higher prices for their energy imports required them to reduce other imports, to raise their exports, or to borrow from foreign lenders to finance the larger current-account deficits they faced. Cutting imports was unattractive for governments deeply committed to ISI strategies. Increasing exports was also difficult, as import substitution had brought about a decline in the export sector in most countries. Consequently, the higher cost of oil widened current-account deficits throughout the developing world.

ISI also generated a growing demand for foreign capital. In Latin America, governments were responsible for between one-third and one-half of total capital formation (Thorp 1999, 169). Governments created state-owned enterprises to drive industrialization, and they provided subsidized credit to targeted sectors. These strategies led to an expansion of government expenditures in connection with the initial investment and then in connection with continued subsidies to the unprofitable state-owned enterprises they created (Frieden 1981, 420). Government revenues failed to grow in line with these rising expenditures. As a consequence, budget deficits widened, reaching on average in Latin America 6.7 percent of gross domestic products (GDP) by the end of the 1970s. In some countries, deficits were even larger. Argentina's budget deficit rose to over 10 percent of GDP in the mid-1970s and remained above 7 percent of GDP until the early 1980s. Mexico's budget deficit increased in the early 1970s and then exploded—to more than 10 percent of GDP—in the early 1980s. Governments needed to finance these deficits, which generated a demand for foreign capital.

Commercial banks looking for places to lend and developing-country governments looking for additional funds found each other in the mid-1970s. Commercial banks loaned directly to governments, to state-owned enterprises, and to government-owned development banks. The result was rapid accumulation of foreign debt (see Table 14.3). In 1970, the developing world as a whole owed only $72.7 billion to foreign lenders. By 1980, total foreign debt had ballooned to $586.7 billion. Most was owed by a small number of countries. The 40 most heavily indebted

developing countries owed a total of $461 billion in 1980, close to 80 percent of the total. Latin American countries were among the largest borrowers. The foreign debt of the seven most heavily indebted Latin American countries—Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela—increased by a factor of ten between 1970 and 1982. By the early 1980s, these seven countries accounted for about 80 percent of all Latin American debt and for about one-third of all developing-world foreign debt.

Initially, foreign debt fueled economic growth. The positive impact of commercial bank lending is quite clear in aggregate statistics for the period. In Latin America as a whole, economic growth averaged 5.6 percent per year between 1973 and 1980. Some Latin American countries grew even more rapidly. In Brazil, one of the largest borrowers, the economy grew by 7.8 percent per year between 1973 and 1980; Mexico realized average growth of 6.7 percent over the same period.

Behind this robust economic growth, however, lay some worrying trends. Debt problems emerge when foreign debt grows more rapidly than the country's ability to service its debt. A country's **debt-service capacity**—its ability to make the payments of interest and principal required by the terms of the loan—is a function of how much it needs to pay relative to its export earnings. Thus, as a country increases its foreign debt, it must also expand its export earnings to service the debt comfortably. Exports failed to keep pace with debt service throughout Latin America. Governments invested foreign capital in nontraded-goods. Mexico, Argentina, and Venezuela, for example, created massive hydroelectric projects that added nothing to export revenues (Thorp 1999, 209). Governments borrowed to buy military equipment, to pay for more expensive oil, and to subsidize consumer goods. Even when foreign capital was invested in the traded-goods sector, ISI's focus on capital-intensive projects failed to generate exports. As a consequence, debt service grew faster than export revenues, causing debt-service ratios to rise sharply (Table 14.4). By 1978, debt service was consuming 38 percent of Latin America's export revenues. Debt-service ratios were even higher in Brazil, Chile, Mexico, and Peru.

Rising debt-service ratios rendered Latin American countries vulnerable to international shocks. Three major shocks hit Latin America in 1979 and the early 1980s. First, interest rates began to rise in the United States as the U.S. sought to reduce inflation. Rising American interest rates were transmitted directly to Latin America, because two-thirds of Latin American debt carried variable interest rates. Higher interest rates thus increased debt-service costs. Second, recession in the advanced

industrialized world reduced the demand for Latin American exports and reduced their terms of trade (Cline 1984). Latin America's export revenues thus declined. By 1980, therefore, Latin American governments were facing larger debt-service payments and declining export earnings. As if this wasn't enough, oil prices rose sharply again in 1979, imposing a third shock.

TABLE 14.3

Developing-Country Foreign Debt, Billions of U.S. Dollars, 1970–1984

	All Developing Countries[1]	30 Most Heavily Indebted Countries[2]	7 Most Heavily Indebted Latin American Countries (See also remaining columns)	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
1970	72.7	65	28	5.8	5.7	3.0	2.2	7.0	3.2	1.4
1978	391.7	317	142	13.3	54.6	7.4	5.1	35.7	9.7	16.6
1979	480.8	377	174	21.0	61.3	9.4	5.9	42.8	9.3	24.1
1980	586.7	461	214	27.2	71.5	12.1	6.9	57.4	9.4	29.3
1981	703.2	539	261	35.7	81.5	15.7	8.7	78.2	8.6	32.1
1982	809.9	606	294	43.6	93.9	17.3	10.3	86.1	10.7	32.2
1983	880.1	661	316	45.9	98.5	17.9	11.4	93.0	11.3	38.3
1984	921.8	686	328	48.9	103.9	19.7	12.0	94.8	12.2	36.9

Notes:
[1] Developing Countries comprise all 157 low- and middle-income countries as defined by the World Bank.
[2] Most Heavily Indebted Countries comprise Algeria, Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Egypt, India, Indonesia, Jamaica, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, South Korea, Sudan, Syria, Thailand, Turkey, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia.

Source: World Bank, *World Development Indicators 2001 CD-ROM* (Washington, DC: World Bank Publications, 2001).

TABLE 14.4

Debt-Service Ratios in Latin America [(Payments of Principal plus Interest)/Export Earnings], 1970–1984

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	All Latin American Countries
1970	n.a.	n.a.	n.a.	28	n.a.	n.a.	4	n.a.
1978	42	58	54	12	n.a.	50	9	38
1979	23	63	44	14	66	34	19	38
1980	37	63	43	16	44	45	27	36
1981	46	66	65	22	46	59	23	40
1982	50	82	71	30	51	49	30	47
1983	70	55	54	38	45	34	27	41
1984	63	45	60	30	45	30	25	39

Source: World Bank, *World Development Indicators 2001 CD-ROM* (Washington, DC: World Bank Publications, 2001).

Many governments responded to these shocks by borrowing more. As a result, foreign debt jumped after 1979, rising to $810 billion by 1982. Debt-service ratios also rose sharply (see Table 14.4). For Latin America as a whole, debt service consumed almost 50 percent of all export earnings in 1982. Brazil's position was the most precarious, as debt service consumed more than 80 percent of its export revenues in 1982. These debt problems became an active debt crisis in August of 1982, when Mexico informed the United States government that it could not make a scheduled debt payment (see Kraft 1984). Commercial banks immediately ceased lending to Mexico. Fearing that Mexico's problems were not unique, they stopped lending to other developing countries as well.

The abrupt cessation of commercial bank lending forced governments to eliminate the macroeconomic imbalances that their commercial bank loans had financed. Current-account deficits had to be eliminated because governments could not attract the capital inflows required to finance them. Budget deficits had to be reduced because governments could no longer borrow from commercial banks to pay for them. Rapid adjustment in turn caused economic activity to fall sharply throughout Latin America (Table 14.5). The most heavily indebted countries suffered the worst. Argentina's economy shrank by 6 percent in 1981 and then by another 5 percent in 1982. Brazil's economy shrank by 4 percent in 1981 and then by another 3 percent in 1983. Mexico's economy shrank by 1 percent in 1982 and by another 3 percent in 1983. The end of capital inflows, therefore, ended the economic boom of the 1970s abruptly.

TABLE 14.5

Economic Growth Rates (Percent) in Latin America, 1979–1983

	Latin America	Argentina	Brazil	Chile	Mexico	Peru	Colombia	Venezuela
1979	7	10	7	9	10	6	5	1
1980	9	4	9	8	9	3	4	–4
1981	–1	–6	–4	5	9	7	2	0
1982	–1	–5	1	–10	–1	–1	1	–2
1983	–2	4	–3	–4	–4	–12	2	–4

Source: World Bank, *World Development Indicators 2009 CD-ROM* (Washington, DC: World Bank Publications, 2001).

Commercial bank lending therefore proved a mixed blessing. On the one hand, it allowed many developing countries to finance the large current-account deficits generated by the oil shock. In the absence of these loans, governments would have been forced to reduce consumption sharply to pay for energy imports. Commercial bank loans also allowed developing countries to invest more than they could have otherwise. Private capital flows therefore relaxed many of the constraints that had characterized the foreign-aid-dominated system of the 1950s and 1960s. On the other hand, the rapid accumulation of commercial bank debt rendered developing countries vulnerable to shocks imposed by developments in the U.S. and Europe. The management of this debt crisis dominated North–South financial relations throughout the 1980s.

MANAGING THE DEBT CRISIS

By 1982, the 30 most heavily indebted developing countries owed more than $600 billion to foreign lenders. Few could service that debt. As they defaulted, they turned to governments in the creditor countries for help. As a result, the Latin American debt crisis came to be managed within a framework that reflected the interests of the creditors. This regime was based on a simple, if somewhat unbalanced, exchange between the creditor and debtor governments. Creditor governments offered new loans and rescheduled the terms of existing loans in exchange for policy reform in the indebted countries.

The debt regime was based on the creditors' strongly held belief that developing countries eventually could repay their debt. Creditors initially diagnosed the debt crisis as a short-term **liquidity problem**. The creditors believed that high interest rates and falling export earnings had raised debt service above the debtor governments' current capacity to pay. Once interest rates fell and growth resumed in the advanced industrialized world, developing countries could resume debt service.

This diagnosis shaped the creditors' initial response to the crisis. Because they believed that the crisis was a short-term liquidity problem, they prescribed short-term remedies. They required the debtor countries to implement macroeconomic stabilization programs. **Macroeconomic stabilization** was intended to eliminate the large current-account deficits

in order to reduce the demand for external financing. The centerpiece of the typical stabilization program was the reduction of the budget deficit. Balancing the budget has a powerful effect on domestic economic activity, reducing domestic consumption and investment, and thereby the demand for imports. Moreover, the resulting unemployment would reduce wages, making exports more competitive. Exchange-rate devaluation would further improve the balance of trade. The smaller current-account deficits that would follow would require smaller capital inflows. In the ideal world, stabilization would produce current-account surpluses.

In exchange for macroeconomic stabilization, creditor governments provided new loans and rescheduled existing debt to offset the liquidity shortage. New loans were made available by the IMF and by commercial banks through a process called concerted lending. In 1983 and 1984, the IMF and commercial banks provided a total of $28.8 billion to the indebted governments (Cline 1995, 207). Developing countries were also allowed to reschedule existing debt payments. Debt owed to commercial banks was rescheduled in the **London Club**, a private association established and run by the large commercial banks. Rescheduling agreements neither forgave debt nor reduced the interest payments attached to the debt. They merely rescheduled the payments that debtor governments had to make, usually offering a grace period and extending the maturity of the debt. Access to both, however, was conditional on prior agreement with the IMF on the content of a stabilization package.

A Closer Look

The International Monetary Fund

The IMF is based in Washington, DC. It has a staff of about 2,690, most of whom are professional economists, and a membership of 184 countries. The IMF controls $311 billion that it can lend to member governments facing balance-of-payments deficits. Two ruling bodies—the Board of Governors and the Executive Board—make decisions within the IMF. The Board of Governors sits at the top of the IMF decision-making process. Each country that is a member of the IMF appoints one official to the Board of Governors. Typically, the country’s central-bank president or finance minister will serve in this capacity. However, the Board of Governors meets only once a year; therefore, almost all IMF decisions are actually made by the Executive Board, which is composed of 24 executive directors, each of whom is appointed by IMF member governments. Each of eight countries (the

United States, Great Britain, France, Germany, Japan, China, Russia, and Saudi Arabia) appoints an executive director to represent its interests directly. The other 16 executive directors represent groups of IMF member countries. For example, Pier Carlo Padoan (an Italian) is currently the executive director representing Albania, Greece, Italy, Malta, Portugal, and Spain, whereas B. P. Misra (from India) is currently the executive director representing Bangladesh, Bhutan, India, and Sri Lanka. The countries belonging to each group jointly select the executive director who represents them. A managing director appointed by the Executive Board chairs the Board. Traditionally, the managing director has been a European (or at least non-American).

Voting in the Board of Governors and the Executive Board is based on a weighted voting scheme. The number of votes each country has reflects the size of its quota in the stabilization fund. The United States, which has the largest quota, currently has 371,743 votes (17.14 percent of the total votes). Palau, which has the smallest quota, currently has only 281 votes (0.01 percent of the total votes). Many important decisions require an 85 percent majority. As a result, both the United States, with 17 percent of the total votes, and the EU (when its member governments can act jointly), with more than 16 percent of the total vote, can veto important IMF decisions. As a block, developing countries also control sufficient votes to veto IMF decisions. Exercising this developing-country veto requires a level of collective action that is not easily achieved, however. In contrast with other international organizations, therefore, the IMF is not based on the principle of "one country, one vote." Instead, it is based on the principle that the countries that contribute more to the stabilization fund have a greater say over how that fund is used. In practice, this means that the advanced industrialized countries have much greater influence over IMF decisions than developing countries.

The IMF lends to its members under a number of different programs, each of which is designed to address different problems and carries different terms for repayments:

- Standby arrangements are used to address short-term balance-of-payments problems. This is the most widely used IMF program. The typical standby arrangement lasts 12 to 18 months. Governments have up to 5 years to repay loans under the program, but are expected to repay these credits within 2 to 4 years.

- The Extended Fund Facility was created in 1974 to help countries address balance-of-payments problems caused by structural weaknesses. The typical arrangement under this program is twice as long as a standby arrangement (3 years). Moreover, governments have up to 10 years to repay loans under the program, but the expectation is that the loan will be repaid within 4.5 to 7 years.
- The Poverty Reduction and Growth Facility (PRGF) was established in 1999. Prior to that year, the IMF had provided financial assistance to low-income countries through its Enhanced Structural Adjustment Facility (ESAF), a program that financed many of the structural adjustment packages during the 1980s and 1990s. In 1999, the PRGF replaced the ESAF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper, which is prepared by the borrowing government with input from civil society and other development partners, including the World Bank. The interest rate on PRGF loans is only 0.5 percent, and governments have up to 10 years to repay loans.
- Two new programs were established in the late 1990s in response to financial crises that arose in emerging markets. The Supplemental Reserve Facility and the Contingent Credit Line provide additional financing for governments that are in the midst of or are threatened by a crisis and thus require substantial short-term financing. Countries have up to 2.5 years to repay loans under both programs, but are expected to repay within 1.5 years. To discourage the use of these programs, except in a crisis, both programs carry a substantial charge on top of the normal interest rate. [H17039]

By 1985, the creditor coalition was revising its initial diagnosis. Latin American economies failed to recover as growth resumed in the advanced industrialized world. Although creditors still believed that countries could repay their debt, they concluded that their ability to do so would require more substantial changes to their economies. Stabilization would not be sufficient. This new diagnosis generated a second, more invasive, set of policy reforms known as **structural adjustment**. Structural adjustment rested on the belief that the economic structures developed under ISI provided too little capacity for export expansion. Governments were too heavily involved in economic activity, economic production was too

heavily oriented toward the domestic market, and locally produced manufactured goods were uncompetitive in world markets. This economic structure stifled entrepreneurship, reduced the capacity for economic growth, and limited the potential for exporting. Structural adjustment programs sought to reshape the indebted economies by reducing the government's role and increasing that of the market. Reforms sought substantial market liberalization in four areas: trade liberalization, liberalization of FDI, privatization of state-owned enterprises, and broader deregulation to promote economic competition.

Structural adjustment programs were accompanied by additional lending by the World Bank, new IMF programs, and commercial banks. Commercial banks were asked to provide $20 billion of new loans over a 3-year period to refinance one-third of the total interest coming due in the period. Multilateral financial institutions, particularly the World Bank, were asked to provide an additional $10 billion over the same period. In all cases, fresh loans from commercial banks hinged upon the ability of debtor governments to gain financial assistance from the IMF, and loans from the IMF and World Bank were contingent upon the willingness of governments to agree to structural adjustment programs.

This debt regime pushed the costs of adjustment onto the heavily indebted economies. Table 14.6 illustrates the economic consequences of the crisis for Latin America as a whole. Investment, consumption, and economic growth in the region all fell sharply after 1982. Indeed, by the end of the decade most still had not recovered to their 1980 levels. The economic crisis hit labor markets particularly hard; unemployment rose and real wages fell by 30 percent over the course of the decade. Real exchange rates were devalued by 23 percent, on average, and by more substantial amounts in Chile (96 percent), Uruguay (70 percent), and a few other countries (Edwards 1995, 29–30). This adjustment brought a small increase in exports, a sharp reduction in imports, and an overall improvement in trade balances. From an aggregate $2 billion deficit in 1981, Latin America as a whole moved to a $39 billion trade surplus in 1984 (Edwards 1995, 23).

TABLE 14.6

Economic Conditions in Latin America, 1980–1990

	1980–1981	1982	1983	1984	1985	1986–1990
GDP[1]	100.0	95.6	91.3	92.2	92.7	94.1
Unemployment[1]	77.0	74.0	70.3	70.4	69.9	71.6
Investment[1]	24.4	19.6	14.9	15.2	16.1	15.9
Unemployment[2]	6.7				10.1	8.0
Real Wages[3]	100.0				86.4	68.9
Imports[4]	–12.3	–9.7	–7.5	–8.0	–7.9	–9.2
Exports[4]	12.5	12.6	13.6	14.5	14.2	15.2
Net Transfers[4]	12.2	–18.7	–31.6	–26.9	–32.3	
Fiscal Deficit[5]	3.7	5.4	5.2	3.1	2.7	
Inflation	53.2%	57.7%	90.8%	116.4%	126.9%	

Notes:
[1] GDP, Consumption, and Investment rates as a percentage of 1980–1981 gross domestic product (GDP).
[2] Unemployment rate of open unemployment as a percentage of total labor force.
[3] Real Wages as index of real wages in unemployment.
[4] Imports, Exports, and Net Transfers in $U.S. billions.
[5] Fiscal Deficit as a percent of GDP.

Sources: Thorp 1999; Edwards 1995, 24; Edwards 1989, 171.

Latin American governments used these current-account surpluses for debt service. Net transfers, which measure new loans minus interest-rate payments, provide a measure of the scale of this debt service. In 1976, net transfers for the 17 most heavily indebted countries totaled $12.8 billion, reflecting the fact that these countries were net importers of capital. Between 1982 and 1986, net transfers for these same 17 countries averaged negative $26.4 billion per year, reflecting the substantial flow of funds from the debtor countries to banks based in the advanced industrialized countries (Edwards 1995, 24). Thus, domestic economic adjustment generated the resources needed to service foreign debt.

The puzzle in the management of this crisis concerns the ability of creditors to push such a large share of the adjustment costs onto the debtor governments. That is, why were creditors so much more powerful than debtors? The short answer is that creditors were better able to solve the free-rider problem than debtors. As a result, creditors could maintain a common front that pushed the costs onto the debtor governments.

Creditor power lay in the ability to condition lending to policy reform. In order to exploit this power, the creditors had to solve a key free-rider problem (see Lipson 1985). Each individual creditor recognized that debt service in the short run required additional financing and in the long run depended on structural reforms that governments would not implement without additional financing. But each individual creditor also preferred

that other creditors provide these new loans. Thus, each creditor had an incentive to free ride on the contributions of the other members of the coalition.

Commercial banks had an incentive to free ride on IMF lending. Loans from the IMF would allow the debtor governments to service their commercial bank debt. If the IMF carried the full burden of new lending, commercial banks would be repaid without having to put more of their own funds at risk. Within the group of commercial banks involved in the loan syndicates, smaller banks had an incentive to free ride on the large banks. Smaller banks had much less at stake in Latin America than the large commercial banks had, because the smaller banks had lent proportionately less as a share of their capital. Consequently, default by Latin American governments would not necessarily imperil the smaller banks' survival. Thus, whereas the large commercial banks could not walk away from the debt crisis, the smaller banks could (Devlin 1989, 200–201). Smaller banks could refuse to put up additional funds knowing that the large banks had to do so. Once the large banks provided new loans, the small banks would benefit from the resulting debt service.

The IMF helped creditors overcome this free-riding problem. To prevent large commercial banks from free riding on IMF loans, the IMF refused to advance credit to a particular government until commercial banks pledged new loans to the same government. This linkage between IMF and private lending in turn encouraged the large commercial banks to prevent free riding by the small commercial banks. Because the large commercial banks were unable to free ride on the IMF, they sought to compel the small banks to provide their share of the new private loans. Large banks threatened to exclude smaller banks from participation in future syndicated loans—a potentially lucrative activity for the smaller banks—and threatened to make it difficult for the smaller banks to operate in the interbank market. American and European central-bank officials also pressured the small banks. Free riding thus became costly for the small banks.

Policy Analysis and Debate

International Monetary Fund Conditionality

Question

Should the IMF attach conditions to the credits it extends to

developing countries?

Overview

IMF conditionality has long been a source of controversy. Critics of the practice argue that the economic policy reforms embodied in IMF conditionality agreements force governments to accept harsh austerity measures that reduce economic growth, raise unemployment, and push vulnerable segments of society deeper into poverty. Moreover, the IMF has been accused of adopting a “one size fits all” approach when designing conditionality agreements. It relies on the same economic model in analyzing each country, and it recommends the same set of policy changes for each country that comes to it for assistance. Consequently, critics allege, IMF policy reforms are often inappropriate, given a particular country’s unique characteristics.

The IMF defends itself by arguing that most developing-country crises share a common cause: large budget deficits, usually financed by the central bank. Such policies generate current-account deficits larger than private foreign lenders are willing to finance. Governments turn to the IMF only when they are already deep in crisis. Because most crises are so similar, the solution to them should also be similar in broad outline: governments must bring spending in line with revenues, and they must establish a stable base for participation in the international economy. And though the short-term costs can be high, the economy in crisis must be returned to a sustainable path, whether the IMF intervenes or not. Should the IMF require governments to implement policy reforms as a condition for drawing from the fund?

Policy Options

- Continue to require conditionality agreements in connection with IMF credits.
- Abandon conditionality and allow governments to draw on the IMF without implementing stabilization or structural adjustment measures.

Policy Analysis

- To what extent are the economic crises that strike countries that turn to the IMF solely a product of IMF conditionality

agreements?

- To what extend does conditionality protect IMF's resources? What would happen to these resources if conditionality were eliminated?

Take A Position

- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How would you defend your recommendation against these criticisms?

Resources

Online: Do an online search for "IMF conditionality." Follow the links to some sites that defend conditionality and to some that criticize the practice. The Hoover Institution maintains a useful website that examines IMF-related issues. Search for "Meltzer Commission" to find some strong criticisms of the IMF's activities. The IMF explains and defends conditionality in a fact sheet. (Search "IMF facts conditionality.")

In Print: Joseph Stiglitz, "What I Learned at the World Economic Crisis," *The New Republic*, April 17, 2000, and *Globalization and Its Discontents* (New York: W.W. Norton and Company, 2002); Kenneth Rogoff, "The IMF Strikes Back," *Foreign Policy* (January–February 2003): 38–46; Graham R. Bird, *IMF Lending to Developing Countries: Issues and Evidence* (London: Routledge, 1995); Tony Killick, *IMF Programmes in Developing Countries: Design and Impact* (New York: Routledge, 1995).

The ability to solve the free-riding problems produced a united front that effectively controlled financial flows to Latin America. The IMF and the commercial banks advanced new loans to Latin American governments (although the commercial banks did so quite reluctantly), and all accepted a share of the risks of doing so. This united front allowed the creditors to reward governments that adopted a cooperative approach to the crisis with new financing, and to deny additional financing to governments that were unwilling to play by the creditors' rules.

Governments in the debtor countries were unable to exploit their potential power. Debtor power lay in the threat of collective default. Although each of the large debtors owed substantial funds to American

banks—in 1982, for example, Mexico's debt to the 9 largest American commercial banks equaled 44.4 percent of those banks' combined capital—no single government owed so much that a unilateral default would severely damage American banks or the American economy (Cline 1995, 74–75). Collective action could provide power, however. If all debtor governments defaulted, the capital of the largest American commercial banks would be eliminated, creating potentially severe consequences for the American economy. A credible threat to impose such a crisis might have compelled the creditors to provide more finance on easier terms, to demand less austerity, and perhaps to forgive a portion of the debt.

Yet, debtor governments never threatened a collective default (Tussie 1988). Latin American governments held a series of conferences early in the crisis to discuss a coordinated response. Governments used these conferences to demand that the creditors "share responsibility in the search for a solution," and they demanded "equity in the distribution of the costs of adjustment," but they never threatened a collective default (Tussie 1988, 291). Argentina was the only country to adopt a non-cooperative stance toward the creditors' coalition, and it tried to convince other Latin American governments to follow suit. Those governments, however, were unwilling to take a hard line; in fact, they encouraged Argentina to adopt a more cooperative stance (Tussie 1988, 288). Thus, instead of threatening collective default, debtor governments played by the creditors' rules.

Debtor governments never threatened collective default because they were caught in a prisoner's dilemma. Even though the threat of collective default could yield collective benefits, each government had an incentive to defect from a collective threat in order to seek a better deal on its own. The incentive to seek the best deal possible through unilateral action, rather than a reasonably good deal through collective action, arose because each debtor government believed that it possessed unique characteristics that enabled it to negotiate more favorable terms than would be available to the group as a whole. Mexico, for example, believed that it could exploit its proximity to the United States and its close ties with the U.S. government to gain more favorable terms. Brazil, which by 1984 was running a current-account surplus, believed that it could use this stronger position to its advantage in negotiations with its creditors (Tussie 1988, 288).

The bilateral approach that the creditors adopted reinforced these fears of defection. Because creditors negotiated with each debtor independently, they could adopt a "divide and conquer" strategy. They could offer "special deals" to induce particular governments to defect from any debtor

coalition that might form. If one government did defect, it would gain favorable treatment, whereas the others would be punished for their uncooperative strategy. Punishment could include fewer new loans, higher interest rates and larger fees on rescheduled loans, and perhaps more-stringent stabilization agreements. Thus, even though coordinated action among the debtor countries could yield collective gains, each individual government's incentive to seek a unilateral agreement dominated the strategy of a collective threat of default.

The debt regime pushed the adjustment costs onto debtor governments, therefore, because creditors were able to overcome free-riding problems and develop a coordinated approach to the debt crisis, and debtors were not. The creditors used their power to create a regime that pushed the costs of the debt crisis onto the heavily indebted countries. The regime was based on the dual premises that all debt would be repaid in the long run, but debt service would require the indebted governments to implement far-reaching economic policy reforms. Conditionality thus provided a powerful lever to induce developing countries to adopt economic reforms: few developing countries could afford to cut themselves off completely from external financial flows. After 1982, these governments found that the price of continued access to international finance was far-reaching economic reform.

THE DOMESTIC POLITICS OF ECONOMIC REFORM

Although the creditors established the structure for managing the debt crisis, used conditionality to promote economic reform, and set the parameters on the range of acceptable policies that could emerge from the reform process, the pace at which debtor governments adopted stabilization and structural adjustment programs was determined by domestic politics. Domestic politics caused most governments to delay implementing stabilization and structural adjustment programs.

Economic reform required governments to impose costs on powerful domestic interest groups. The need to impose these costs generated distributive conflict that delayed economic stabilization. Distributive conflict revolved around which domestic groups would bear the costs associated with balancing the budget. Governments had to choose which programs would be cut. Would the government reduce subsidies of food or energy, or would it reduce credit subsidies to industry? In addition, governments had to decide which taxes to raise and who would pay them.

The need to make these decisions generated a war of attrition between veto players. Each veto player pressured to reduce expenditures on programs from which it did not benefit and to tax other groups. Each blocked efforts to cut its preferred programs or tax it at a higher rate (Alesina and Drazen 1991). This war of attrition drove the politics of stabilization throughout the early 1980s. The interest groups that had gained most from import substitution stood to lose the most from stabilization and structural adjustment. Import-competing firms that had benefited from government credit subsidies would be hit hard by fiscal retrenchment. State-owned enterprises would be particularly hard hit, as they would lose the government infusions that had covered their operating deficits during the 1970s. Workers in the urbanized nontraded-goods sector who had benefited from government subsidies of basic services, such as utilities and transportation, and essential food items would also be hit hard by budget cuts. Public-sector employees would suffer as well, as budget cuts brought an end to wage increases and forced large reductions in the number of government employees.

Unwilling to accept the reduction in income implied by fiscal austerity, interest groups blocked large cuts in government expenditures. In Brazil, for example, the military government attempted to implement an orthodox stabilization program in the early 1980s, but “both capitalists and labor in modern industry … demanded relief from austerity. So too did much of the urban middle class including government functionaries whose livelihood was imperiled by attacks on public spending” (Frieden 1991b, 134). These groups shifted their support to the civilian political opposition, which took power from the military. Once in office, the new civilian government abandoned austerity measures. The Brazilian case was not unique: the import-substitution coalition was well positioned to block substantial cuts in government programs in most heavily indebted countries.

The inability to reduce government expenditures resulted in high inflation throughout Latin America. Many governments financed budget deficits by selling bonds to their central banks. Printing money to pay for government expenditures sparked inflation. Annual average inflation in Latin America rose from about 50 percent in the years immediately preceding the crisis to over 115 percent in 1984 and 1985 (Table 14.6). Worse, these regional averages hide the most extreme cases. In Argentina, inflation averaged 787 percent per year during the 1980s. Brazil fared a little better, enduring average rates of inflation of 605 percent throughout the decade (Thorp 1999, 332). Bolivia’s experience was the most extreme, with inflation rising above 20,000 percent in late 1985.

Even rapid inflation was insufficient to induce governments to cut expenditures. In Argentina, Brazil, and Peru, governments responded to high inflation with **heterodox strategies** (see Edwards 1995, 33–37). Advanced as an alternative to standard IMF stabilization plans, heterodox strategies attacked inflation with government controls on wages and prices. The Argentinean and Brazilian plans illustrate the approach. In both programs, the government froze prices and wages in the public sector. Each government also introduced new currencies and established a fixed exchange rate. Initially, the programs appeared to work, as inflation dropped sharply in the first 6 months. Early successes were reversed, however, because neither government was willing to reduce government expenditures. In less than a year, inflation rates rose again and the programs were scrapped (Edwards 1995, 37).

It wasn't until the late 1980s that Latin America governments began to make painful economic adjustments. Governments reduced fiscal deficits and brought inflation under control. Macroeconomic stabilization provided a base upon which to begin structural reforms. Governments began to liberalize trade and privatize state-owned industries. Many governments also began to reduce their role in domestic financial systems and to liberalize capital accounts as well (Edwards 1995, 212).

Three factors induced governments to embark on economic reform. First, the economic crisis altered interest-group politics. Key members of the import-substitution coalition lost strength and faced higher costs from opposing reform. As a result, groups that had once been willing and able to block reform increasingly lost the capacity to do so. The economic crisis also caused "individuals and groups to accept [the fact] that their special interests need[ed] to be sacrificed … on the altar of the general good" (Williamson 1994, 19). Economic crisis thus created a new political consensus that the old order had failed and that reform was necessary. By weakening key interest groups and by forcing many of these same groups to redefine their interests, the severity of the economic crisis itself removed the political obstacles to reform.

Second, the United States initiated a new approach to the debt crisis in 1989. In March 1989, the United States encouraged commercial banks to negotiate debt-reduction agreements with debtor governments. Under this **Brady Plan** (named after Nicholas J. Brady, the secretary of the U.S. Treasury), debtor governments could convert existing commercial bank debt into bond-based debt with a lower face value. The precise amount of debt reduction that each government realized would be determined by negotiations between the debtor government and its commercial bank

creditors. To make the proposal attractive to commercial banks, the advanced industrialized countries and the multilateral financial institutions advanced $30 billion with which to guarantee the principal of these Brady bonds. This guarantee allowed commercial banks to exchange the uncertain repayment of a large bank debt for guaranteed repayment of a smaller amount of bond debt.

The Brady Plan strengthened the incentive to embark on reform by increasing the domestic benefits of reform. Large debt burdens reduced the incentive to adopt structural reforms because a significant share of the gains from reform would be dedicated to debt service. Commercial banks would thus be the primary beneficiary of reform. It is not hard to see why domestic groups would be reluctant to accept costly reforms. Reducing the debt burden ensured that a larger share of the gains from reform would accrue to domestic groups. As a result, the short-run costs of reform would be offset by long-run gains. This plan created a greater incentive to accept the short-term costs that stabilization and structural adjustment entailed.

Mexico was the first to take advantage of the Brady Plan, concluding an agreement in July 1989 (see Cline 1995, 220–221). The deal reduced Mexico’s net transfers by about $4 billion, an amount equal to about 2 percent of Mexico’s GDP. Reducing debt service allowed the Mexican economy to grow by 2 percentage points more than would have been possible without debt reduction (Edwards 1995, 81). By 1994, Brady Plan agreements covered about 80 percent of commercial bank debt and reduced debt-service payments by about one-third (Cline 1995, 232).

Finally, as the economic crisis deepened, governments became more willing to recognize that the East Asian model offered lessons for Latin America. The Economic Commission on Latin America (ECLA) played an important role in prompting this recognition (see Economic Commission for Latin America and the Caribbean 1985). The ECLA had begun to look closely at East Asia in the mid-1980s and was able to create a new consensus among Latin American governments that the East Asian model was relevant to Latin American development. As an ECLA study recommended in the late 1980s, “[T]he debt problem requires a structural transformation of the economy in at least two senses: the growth strategy needs to be *outward oriented* and largely based on a domestic effort to raise savings and productivity” (cited in Edwards 1995, 148). The ECLA’s transformation

> was like “Nixon in China.” When the institution that had for decades defended import substitution expressed doubts about its validity and

> recognized that there were lessons to be learned from the East Asian experience with outward-oriented policies, it was difficult to dismiss those doubts as purely neo-liberal propaganda.
>
> (Edwards 1995, 52)

The Latin American debt crisis was declared over in the mid-1990s (Cline 1995, 39). In hindsight, it is clear that the crisis was more than a financial one: it was a crisis of economic development. The accumulation of foreign debt during the 1970s reflected efforts to rejuvenate the waning energies of ISI. Moreover, the crisis itself, and the debt regime through which it was managed, transformed developing countries' development strategies. Governments abandoned state-led ISI in favor of a market-based and export-oriented strategy. As a consequence, developing countries fundamentally altered their relationship with the international economy.

CONCLUSION

The Latin American debt crisis illustrates the tragic cycle at the center of North–South financial relations. A growing demand for foreign capital generated in part by international events and in part by domestic developments combined with a growing willingness of commercial banks to lend to developing societies in order to generate large capital flows to Latin American countries during the 1970s. The resulting accumulation of foreign debt rendered Latin American societies extremely vulnerable to exogenous shocks. When such shocks hit in the late 1970s and early 1980s, governments found that they could no longer service their commercial bank debt, and commercial banks quickly ceased lending fresh funds. As the supply of foreign capital dried up, Latin American economies were pushed into crisis.

The Latin American debt crisis also forced governments in the advanced industrialized world to establish an international regime to manage the crisis. In the resulting debt regime, the IMF, the World Bank, and commercial banks provided additional financial assistance to the heavily indebted countries on the condition that governments implement stabilization and structural adjustment packages. This approach pushed most of the costs of the crisis onto Latin America. Moreover, the reforms it encouraged provoked far-reaching changes in Latin American political and economic systems. With a few changes that we will examine in the next chapter, this debt regime remains central to the management of developing-country financial crises.

Although the Latin American debt crisis is unique in many respects, in others it is all too typical. And though this crisis was the first of the postwar period, it would not be the last. In fact, crises have become increasingly common during the last 20 years, and the more recent ones share many of the central characteristics of the Latin American crisis and have been managed in much the same way. They have also generated much discussion about whether and how the international financial system should be reformed in order to reduce the number and severity of such crises. We examine these issues in Chapter 15.

KEY TERMS

Brady Plan
Debt-Service Capacity
Foreign Aid
Heterodox Strategies
International Bank for Reconstruction and Development
International Development Association
Liquidity Problem
London Club
Macroeconomic Stabilization
Petrodollar Recycling
Petrodollars
Regional Development Banks
Structural Adjustment
World Bank

SUGGESTIONS FOR FURTHER READING

For a detailed treatment of the relationship between development and the international financial institutions, see Eric Helleiner, *Forgotten Foundations of Bretton Woods: International Development and the Making of the Postwar Order* (Ithaca: Cornell University Press, 2016).

On the 1980s debt crisis, see Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton, NJ: Princeton University Press, 2016).

For the politics of IMF lending, see James Vreeland, *The International Monetary Fund: Politics of Conditional Lending* (New York: Routledge, 2007), and Erica Gould, *Money Talks: the International Monetary Fund, Conditionality, and Supplementary Financiers* (Palo Alto: Stanford University Press, 2006).

On the IMF and neoliberalism, see Sarah Babb and Alexander Kentikelenis, 2018. "International Financial Institutions as Agents of Neoliberalism," in D. Cahill, M. Cooper, M. Konings, and D. Primrose (eds.), *The SAGE Handbook of Neoliberalism* (Thousand Oaks, CA: SAGE Publications, 2018: 16–27).