regard than the Brazilians, whose B-A regime created a host of large state enterprises at the same time that the Chileans were selling state enterprises inherited from the Allende regime.

Second, each of the B-A regimes was dedicated to controlling inflation and correcting the balance of payments. In large measure, these regimes came into power because of economic crises, reflected by rising or repressed inflation and foreign exchange shortages, that civilian governments had been unable to control. The military response to these two problems was to cut government deficits by such measures as raising taxes, reducing the expansion of the money supply, suppressing wage demands in order to reduce cost-push pressures on prices, and devaluing the currency to make exports more competitive and to correct the balance-of-payments deficit. In short, what these B-A regimes did was to impose a classic, orthodox stabilization program of the sort generally demanded by the International Monetary Fund.

Subsequently, when the immediate balance-of-payments and inflation crises were overcome, the long-run economic characteristics of the regimes became clearer. The two most important were a greater orientation toward both exports and agriculture. The regimes tended to reverse the more extreme import-substitution policies—domestic industrial promotion at the expense of agriculture—that had been followed by their predecessors. They lowered tariffs and established the crawling-peg exchange rate so that exporters would not have to worry about overvaluation. They also established a variety of subsidies for exports, both industrial and agricultural. Finally, they all held out a welcome mat for foreign direct investment, which they hoped would join in a constructive partnership to develop their countries and, not incidentally, help shore up the kind of political and social order they were hoping to establish.

10. Anatomy of the Debt Problem

Rudiger Dornbusch

To stabilize their economies and spur renewed growth, the military regimes of the 1970s, particularly after the 1973 oil embargo, turned increasingly to foreign banks for loans. This policy led to a rapid and excessive buildup of foreign debt, which, as MIT economist Rudiger Dornbusch states, together


Dilemmas of Development

with poor management and the onset of world recession, precipitated the debt crisis of the 1980s.

The Latin American debt crisis now is six years old and growing. When Mexican debts trade at 50 cents on the dollar, and those of Peru at less than a dime, the debt crisis is obviously unresolved. Far from improving their creditworthiness, the debtors are falling behind. Debt ratios are far above the 1982 level, and debtor countries’ economies are showing the strains of debt service in extremely high inflation, a deep drop in income, and an unsustainable cutback of investment. The debtors cannot afford to pay, nor can they afford to walk out on the system.

On the side of creditors, reserves are built up to provide a cushion against potential losses. In the meantime, creditor banks are unanimous in their reluctance to continue lending in a situation where the debts are obviously deteriorating. Increasingly, the World Bank is filling the gap left by the debtors’ inability to pay and the banks’ unwillingness to lend. Former Treasury Secretary Baker’s “muddling through” remains the Reagan administration’s strategy, a treadmill of pretense and make-believe in which both debtors and creditors are falling behind. There is a major public interest in changing the course and breaking the deadlock...

Origins of the Debt Crisis

Debt crises are common in a broader historical perspective. The last worldwide crisis was that of the 1930s when all of Latin America, with very few exceptions (most notably Venezuela and Argentina), went into moratorium for many years. Even as the 1930s defaults got fully under way, Winkler wrote:

The fiscal history of Latin America is replete with instances of government defaults. Borrowing and default follow each other with perfect regularity. When payment is resumed, the past is easily forgotten and a new borrowing orgy ensues. This process started at the beginning of the past century and has continued down to the present day. It has taught us nothing.

The cleanup of debtor-creditor relations occurred in the 1950s. Borrowing resumed in the 1960s when first Mexico and then all of Latin America made new forays into the world capital market.

Sporadic debt difficulties occurred throughout the 1970s, but the systemwide problems only emerged in 1982 when Mexico, and soon most of Latin America, had to reschedule its external debt. Three factors account for the generalized debt problem: poor management in the debtor countries, the world macroeconomy that took a singularly bad turn, and initial overdrafting.
In the late 1970s exchange rates in most Latin American countries were massively overvalued. This was a popular policy because it helped limit or bring down inflation with recession. But the cure was very short lived, since the resulting loss of competitiveness soon led to large trade deficits and capital flight. The extent of overvaluation is apparent from some data for the period 1977 to 1981. Argentina experienced a real appreciation of 85 percent, Brazil 36 percent, Chile 57 percent, and Mexico 30 percent. The resulting trade imbalance was financed by borrowing in world capital markets. Moreover, when capital flight became important, especially in Argentina and Mexico, external loans financed this exodus of private capital. It was a curious spectacle when a central bank borrowed in New York to obtain the dollars that it sold to private citizens who in turn deposited them in Miami.

There is considerable uncertainty about the precise extent of capital flight. One recent study, published by the Institute of International Economics, gives estimates for various countries over the period 1976-1982. It shows Argentina with capital flight of $22.4 billion, Brazil $5.8 billion, Mexico $25.3 billion, and Venezuela $20.7 billion. To put these data on capital flight in perspective, it is important to judge them relative to the stock of debts outstanding. In the case of Argentina, for example, the 1982 stock of external debt was $44 billion. Thus, capital flight accounted for no less than half of the accumulated debt.

The second element in the debt crisis was the sharp deterioration of the world economy. Under the impact of tightening U.S. monetary policy, with other industrial countries following suit, world interest rates skyrocketed, economic activity declined, and real commodity prices plummeted. Table 1.1 shows the relevant data.

Each element in world macroeconomic development was unfavorable for debtors. Higher interest rates implied increased debt service burdens, while lower commodity prices and reduced activity in center countries implied a sharp drop in export earnings. Thus, between increased debt service and reduced export earnings, a large foreign exchange gap resulted. Table 1.2 shows the deterioration in debt and debt service ratios between 1979 and 1982.

Without the banks’ eagerness to lend, the debt crisis would obviously not have occurred in the first place. In hindsight, why did banks not use more caution? That question is asked in the aftermath of each wave of default, and the answer has not yet been found. The most plausible explanation is that of Guttentag and Herring, who argue that banks have “disaster myopia”—they underestimate the true probability of infrequent events. The combination of overindebtedness and a sharp world deterioration is one

---

**Table 1.1**

Aggregate World Macroeconomic Indicators, 1970–1987

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Commodity Prices (1980=100)</td>
<td>115</td>
<td>100</td>
<td>96</td>
<td>89</td>
</tr>
<tr>
<td>LIBOR* (%)</td>
<td>8.0</td>
<td>14.4</td>
<td>16.5</td>
<td>13.1</td>
</tr>
<tr>
<td>Inflation* (%)</td>
<td>11.4</td>
<td>13.0</td>
<td>-4.1</td>
<td>-3.5</td>
</tr>
<tr>
<td>Growth Rates* (%)</td>
<td>3.4</td>
<td>0.0</td>
<td>-7.0</td>
<td>-3.3</td>
</tr>
</tbody>
</table>

*Measured in terms of manufactured export prices of industrial countries

---

**Table 1.2**

Debt and Debt Service Ratios,* 1979–1982

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>165</td>
<td>152</td>
<td>186</td>
<td>241</td>
</tr>
<tr>
<td>Interest and Amortization*</td>
<td>27.9</td>
<td>25.4</td>
<td>32.9</td>
<td>40.3</td>
</tr>
<tr>
<td>Interest*</td>
<td>11.1</td>
<td>13.1</td>
<td>18.6</td>
<td>24.2</td>
</tr>
</tbody>
</table>

*Countries with recent debt service problems

---

The banks’ role in the debt crisis went beyond the initial overlending. An essential element was the halt on all lending once the debt service difficulties of lenders became apparent. Each bank’s attempt to pull out of further lending, seeking recovery of principal at the expense of other creditors,
had all the appearances of a bank run. Suddenly, debtors could no longer roll over their interest payments and borrow to finance current account imbalances; they had to adjust. The main feature of the debt crisis was precisely that abrupt halt to all lending. Debtors frozen out of the world capital market learned firsthand the old banking truth: "It is not speed that kills, it is the sudden stop."

11. The United States Responds: The Brady Plan and the Enterprise for the Americas Initiative • Peter Hakim

In March 1991, Peter Hakim, staff director of the Inter-American Dialogue, appeared before the Subcommittee on Foreign Operations of the House Appropriations Committee. After assessing the dire economic straits confronting Latin America as a consequence of debt and depression, he described two U.S. initiatives designed to help resolve the crisis. The Brady Plan, designed by President George Bush's secretary of the treasury to alleviate the debt crisis, was essentially called for debt relief by Latin America's principal creditors. Hakim criticized the plan (for being too little and of benefit only to the better-off rather than to the weakest countries in the region) and then made specific suggestions for its strengthening. As for the Enterprise of the Americas, it proposed further debt relief from the U.S. government, the establishment of a $100-million investment fund, and the creation of a free-trade zone throughout the Americas that would give Latin America greater access to U.S. markets for its goods.

I want to thank the subcommittee for this opportunity to testify on the two most important U.S. policy initiatives toward Latin America in recent years. The first is the so-called Brady Plan, launched just two months after President Bush took office in 1989 and offering a new strategy for dealing with Latin America's accumulated debt burdens. The second, the Enterprise for the Americas Initiative, was announced by President Bush last June and called for a combination of measures to help strengthen Latin America's economies and foster more productive long-term economic relationships between the United States and the region. The proposed free-trade agreement with Mexico is vital to this second initiative.


Dilemmas of Development

Let me start by emphasizing several crucial points: First, Latin America's deep economic and social problems are still a long way from solution. Since 1982, Latin America has been mired in its worst depression ever, one that has affected virtually every country in the region. And the cumulative effects of that depression now pose severe obstacles to economic recovery in all but a very few countries. Some figures will reveal Latin America's economic straits:

• The region's debt burdens are enormous. Its aggregate debt exceeds $420 billion, $100 billion greater than in 1982 when the debt crisis first struck. Interest payments on that debt, amounting to some $35 billion a year, deprive the region of the resources it needs for investment and crucial imports; they also keep budget deficits high, fuel inflation, and sap private investor confidence.

• Latin America is plagued by record levels of inflation. Average inflation for the region as a whole last year was 1500 percent, ten times what it was in 1980.

• Eight years of low investment have left most Latin American nations with deteriorated physical plants, outdated technologies, and a lagging ability to compete internationally.

• More people than ever are trapped in poverty. Unemployment stands at historic highs in many countries; wages have deteriorated badly, by 50 percent or more in some places; and the quality of housing, health care, and education has steadily worsened.

Second, Latin America's economic hardships present a grave danger to the region's still fragile democratic institutions. Latin America has made impressive strides toward democratic rule in recent years. Every country in the region, except Fidel Castro's Cuba, is now governed by elected civilian leadership. Yet the practice of democracy remains very uneven throughout the region and, in fact, is floundering in many countries. No easy relationship can be drawn between economics and politics in the region, but economic distress has consistently undermined the credibility of democratic leaders and is frustrating the development of vibrant democracies. In some places, persistent economic crisis may yet lead to a return to authoritarian rule.

Third, I believe that Latin America, with its population of 400 million people, is important to the economic well-being of the United States. Even