DEBT and Democracy in Latin America

edited by
Barbara Stallings
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Westview Press

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Westview Press
BOULDER, SAN FRANCISCO, & LONDON

Published in 1989 in the United States of America by Westview Press, Inc., 5500 Central Avenue, Boulder, Colorado 80301, and in the United Kingdom by Westview Press, Inc., 13 Brunswick Centre, London WC1N 1AF, England

Library of Congress Cataloging-in-Publication Data
Debt and democracy in Latin America.
Includes index.
1. Debts, External—Latin America. 2. Latin America—Economic conditions—1982– . 3. Latin America—Politics and government—1980– . I. Stallings, Barbara. II. Kaufman, Robert R.
HJ8514.5.D445 1989 336.3′435′098 88-28009
ISBN 0-8133-7547-9
ISBN 0-8133-7548-7 (pbk.)

Printed and bound in the United States of America

The paper used in this publication meets the requirements of the American National Standard for Permanence of Paper for Printed Library Materials Z39.48-1984.

10 9 8 7 6 5 4 3

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Acknowledgments

Many people have helped at various stages in the preparation of this book. We would like to thank the contributors as well as the group of scholars who joined them early on to discuss some of the issues developed in the book. The latter group included René Cortázar, Kevin Middlebrook, Carlos Rico, Thomas Skidmore, and Toru Yanagihara. In addition, we are grateful to Eric Hershberg and Barbara Forrest of the Ibero-American Studies Program of the University of Wisconsin-Madison for their administrative assistance. We are also highly indebted to Jayni Edelstein and Kate Hibbard, who ably undertook the time-consuming tasks of typing and copy-editing the manuscripts.

Financial support was received from the Cyril B. Nave Bequest, the Hewlett Fund, the Anonymous Fund, and the University Lectures Committee (all of the University of Wisconsin-Madison) and from the Latin American Studies Center of the University of Wisconsin-Milwaukee.

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Introduction

Barbara Stallings and Robert Kaufman

Future historians trying to characterize Latin America during the 1980s are likely to focus on two main processes. In economic terms, virtually all Latin American countries were struggling with balance-of-payments deficits, high inflation, and stagnating production. These problems resulted from many adverse factors, both domestic and international, but the heavy burden of debt service payments certainly loomed large among them. On the political side, the 1980s saw many Latin American nations moving away from authoritarian regimes and toward democracy—or at least toward greater openness and increased space for oppositional activities.

The link between these two processes is controversial. Did the economic crisis trigger the political change? Will the same crisis destabilize the very democracies it brought about? Will the type of regime influence the selection of policies to deal with the economic problems? Will it affect governments' ability to implement chosen policies? It is not coincidence that these questions are controversial, for they are very difficult to answer. Nevertheless, they are sufficiently important—both for the practical future of Latin America and for political-economic theory—that an attempt must be made. This book does just that. Through a series of general essays and case studies, it investigates the two-way relationship between debt and democracy in the 1980s. That is, we examine the evidence about how regime type influenced the choice of policy to deal with foreign creditors and related economic issues. We also reverse the question and look at how debt problems have affected the transition to, and the consolidation of, democratic political systems.

In most of our chapters, two sets of terms are central to the analysis. One is the distinction between democracy and authoritarianism. For our purposes, a regime can be considered democratic to the extent that incumbent governments must win and retain power through competitive elections, tolerate opposition challenges to their incumbency, and deal with relatively independent interest groups. Authoritarian regimes are those that do not permit competitive elections and restrict the space allowed to either oppositional or interest group activity. We also distinguish between orthodox and heterodox policy packages to deal with the economic problems confronting Latin America. The term orthodox refers to market-oriented approaches (often associated with the International Monetary Fund) that emphasize fiscal and monetary restraint, reduction in the size of the state sector, liberalization of trade restrictions, and collaboration with creditors. Although heterodox approaches do not reject all elements of this package, they generally advocate a more active state role in investment and economic regulation, are more willing to risk confrontation with creditors, and attach a higher priority to issues of distribution and employment.

The book is divided into four sections. The first provides an overview of the issues from economic, political, and historical perspectives. To begin, Rudiger Dornbusch's chapter provides the essential background for a discussion of the debt issue. He explains the origins of the debt crisis, including both external and internal factors. Then he goes on to analyze the current problems, focusing on debtor countries' need to grow, banks' need to maintain their solvency, and creditor governments' difficulties in reconciling the two. The outcome up until now has been a strategy of "muddling through." Finally, Dornbusch presents three alternative solutions to the crisis. One is lowering interest payments by capitalizing interest when payments exceed a certain level. A second is the establishment of a "debt facility" or agency that would buy part of the banks' Third World debt at a discounted value and pass on the benefits to the debtors. Third, Dornbusch explains his own preferred solution, which focuses on a "responsible" unilateral decision by debtor nations to reduce debt service in the context of a program to revive growth. The argument in favor of the third strategy is that both debtor and creditor countries will benefit in the long run.

The chapter by Jeffry Frieden turns to the political aspects and implications of the debt crisis. Focusing his analysis on the five largest debtors—Argentina, Brazil, Chile, Mexico, and Venezuela—Frieden identifies the economic interests of different social groups, both during the period of heavy borrowing in the 1970s and early 1980s and after lending ceased in 1982. One of his crucial distinctions is between groups that can easily move their assets and those whose assets are geographically fixed. These economic characteristics are linked to political activities once a crisis sets in. Frieden suggests that those with fixed assets are most likely to engage in political struggle to protect their property. The question then becomes whether they will try to pressure the government from inside or join the opposition. This choice is said to be determined by a group's political weight, its ties to the government, and the existence of a potent opposition whose goals are compatible with those of the group in question.

As the final part of the overview section, Paul Drake's chapter looks back to the debt crisis of the 1930s to draw some historical comparisons with the current situation. In particular, he asks about the effect of economic crisis on the political system. In both decades, he finds a large number of regime changes. The difference is that the change in the 1930s was from democracy to dictatorship, while the reverse occurred in the 1980s. Drake's conclusion is that the sharp negative impact of a debt crisis tends to undermine *whatever* type of regime is in power at the time. Once that change occurs, however, the economic situation has less of an influence on politics. On an optimistic note, he contradicts conventional wisdom and suggests that democracies may have some resources that dictatorships lack, especially their greater legitimacy, in order to resist the negative effects of crisis.

The second section of the book examines three crucial sets of actors in the current crisis. All three—U.S. creditors, Latin American business, and Latin American labor—play political as well as economic roles in the process. Riordan Roett's chapter begins this section with a study of various actors in the United States and their interactions with Latin American governments. He traces out U.S. actions, and European and Japanese lack of action, since the debt crisis began in 1982. He concurs with Dornbusch in describing the approach of the Reagan administration as "muddling through" and portrays recent congressional initiatives as a reaction to the failure of the Reagan strategy. He also contrasts the position of the Latin American presidents to that of the U.S. executive branch. Differing with Drake, Roett strongly endorses the Latin American position that the debt crisis is a major threat to democracy.

A second important set of actors consists of local businesspeople in Latin America. In a chapter that reinforces the major elements of Jeffry Frieden's model, Sylvia Maxfield discusses the economic and political characteristics of business. Concentrating on the three largest debtors—Argentina, Brazil, and Mexico—Maxfield notes that the debt-led growth of the 1970s and early 1980s was especially favorable to the financial sector and large business firms in general. Even these groups, however, felt excluded from economic policy making by the authoritarian regimes in power. When economic problems arose because of the debt crisis, they thus supported the democratic opposition, hoping to increase their own power. Nevertheless, the continuing economic problems have deterred private sector investment, and Maxfield concludes that without such investment, the prognosis for democracy is not auspicious.

In a complementary analysis, which also focuses on Argentina, Brazil, and Mexico, Ian Roxborough discusses the politics of labor during the 1980s. Organized labor, he finds, has not been able to defend itself against wage declines and increased unemployment. Divisions within the labor movement have exacerbated the problem. In the meantime, the three governments have had no consistent policy. The possibility of negotiating a "social pact" among labor, business, and the government has been on the agenda in all three countries, but has not been successfully implemented anywhere. Failing that option, governments have "muddled through," varyingly trying to win support from the labor movement, to divide it, and/or to repress it. Overall, labor has fared poorly, a clear loser despite its organizational potential.

Following these six general essays, the third part of the book features a series of case studies on Mexico, Brazil, Peru, Costa Rica, and Chile. The first country study is Robert Kaufman's analysis of Mexico. Mexico has a peculiar political system. Some label it "quasi-democratic;" others call it "quasi-authoritarian." The delicate balance between the dominant party's labor and business constituencies had been based on a high-growth economy that, in turn, relied heavily on foreign capital. The 1982 crisis threatened that balance, and the de la Madrid government had to make more difficult choices than his predecessors. In the process, opposition parties of left and right have been strengthened, but the implications for democracy remain to be seen.

Brazil shares many economic characteristics with Mexico, but it has a quite different political history. Eul-Soo Pang's chapter describes the political maneuvering among the various political parties as Brazil's military began the process of withdrawal from government. The new democracy was saddled with two sets of problems: an economic crisis that left few resources to meet pent-up demands, and a political crisis after Tancredo Neves' death that left the government searching for legitimacy. Unlike Mexico, Brazil followed a heterodox economic approach, both in regard to macroeconomic policy and debt negotiations. Now that both have failed, a more orthodox period may result, but Pang points to the lack of unity and direction as a powerful deterrent to resolving the political-economic crisis.

The other new democracy among the five cases is Peru, which is discussed by Carol Wise. Under the presidency of Alan García, Peru has taken the most radical stand on the debt issue and proposed a more thorough-going heterodox economic policy package than Brazil. The economic package has failed almost completely now. In part, this was due to the exhaustion of foreign exchange reserves, but Wise points to other reasons as well. One is the underdevelopment of the Peruvian state apparatus, both in terms of institutions and personnel. Another was the infighting and otherwise inefficient management by the political and economic teams around García. A third was the suspicion of groups not associated with the government but whose support was needed—especially business but also labor, other political parties, and the military.

A more established democracy, Costa Rica, is the subject of Joan Nelson's chapter. Although one of the smallest of the countries in Latin America, Costa Rica has a fairly modern economy and an advanced social infrastructure as well as a 40-year functioning democracy. Nelson reports surprising success on the part of the Monge government in dealing with the short-term economic crisis in 1982-83, but less success in pushing forward with structural changes to perpetuate the short-term achievements. She finds that democracy had both positive and negative effects on dealing with the crisis situation (e.g., the slowness with which consensus building had to proceed, but the public support once it occurred). Turning the question around, she asks if the crisis damaged the democratic political system. The answer is no, in part because of the way the situation was handled. Especially important were the provisions to distribute the cost of stabilization more evenly than in some other countries.

Finally, Barbara Stallings examines the experience of the Pinochet government in Chile. Chile suffered the worst economic crisis in Latin America in 1982, and the following year political protests were on the verge of dislodging Pinochet. The government managed to weather the storm, however, and its orthodox economic policies have produced success in terms of growth and inflation, but they have also led to increased inequality and hardship. Stallings suggests that these conflicting economic trends will be crucial factors in determining the outcome of the plebiscite scheduled for late 1988, which will decide whether the military will rule for another eight years. Political variables will also play an important role in this new phase of the ongoing struggle for democracy in Chile.

The last section of the book is the concluding chapter by Kaufman and Stallings. It brings together the themes discussed in the preceding chapters in a comparative analysis that draws not only on the five cases presented in the book but also several others. It asks three main questions. The first is whether political regime characteristics have had much effect on choice of economic policy during the crisis period of the 1980s. Unlike some previous literature—which focused on earlier, more affluent periods—this analysis finds that regime was an important variable in the 1980s. Nevertheless, it must be used in combination with other variables such as state capacity, role of domestic groups, and international factors. Second, the essay looks at the impact of political regime on economic outcomes. Here again there is some evidence of a link. For example, authoritarian regimes have better performance on outcomes like inflation and budget deficits, while transitional democracies do especially poorly. Conversely, authoritarian regimes tend to have a contraction of real wages, while real wages go up rapidly just after democracies return. Not all evidence, however, fits so neatly. Finally, the essay considers the effect of economic crisis on the survival potential for the new democracies. While admitting that the economic problems facing these governments are daunting, the authors basically agree with Drake that many factors other than economics will help determine the fate of the new democracies, and some may provide them with greater strength than their authoritarian predecessors.

1

The Latin American Debt Problem: Anatomy and Solutions

Rudiger Dornbusch

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 debtor countries' 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.

This chapter briefly reviews the origins of the debt crisis, then identifies the present dilemmas and recommends interest recycling as a policy that involves fair burden sharing and provides the best chance for all parties to come out ahead in what is presently a negative sum game.

Origins of the Debt Crisis

Debt crises are common in a broader historical perspective.[1] 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 underway, 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.[2]

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 system-wide 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 overlending.

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 without recession. But the cure was very shortlived, 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,[3] gives estimates for various countries over the period 1976-82. 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.

Table 1.1
Aggregate World Macroeconomic Indicators, 1970-87

	Real Commodity Prices (1980=100)[a]	Libor[b] (%)	Inflation[c] (%)	Growth Rates[d] (%)
1970-79	115	8.0	11.4	3.4
1980	100	14.4	13.0	0.0
1981	96	16.5	-4.1	-7.0
1982	89	13.1	-3.5	-3.3
1983-87	84	8.5	4.0	3.2

[a]Measured in terms of manufactured export prices of industrial countries
[b]London Interbank Offered Rate, base interest rate for most Latin American loans
[c]Rate of increase of industrial countries' unit export values
[d]Industrial production
Source: IMF and Economic Commission for Latin America.

Table 1.2
Debt and Debt Service Ratios,[a] 1979-82

	1979	1980	1981	1982
Debt[b]	165	152	186	241
Interest and Amortization[b]	27.9	25.4	32.9	40.3
Interest[b]	11.1	13.1	18.6	24.2

[a]Countries with recent debt service problems
[b]As percent of exports of goods and services
Source: IMF.

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.[4] The combination of overindebtedness and a sharp world deterioration is one such case. The combination makes for pervasive defaults, but it is a rare event.

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 first hand the old banking truth: "It is not speed that kills, it is the sudden stop."

Current Problems in the Debt Crisis

Debtor adjustment programs were expected to show, in time, an improvement in creditworthiness sufficient to warrant a return to voluntary lending.[5] That remains the official position, but the process is not on schedule, and few believe that the solution lies in the direction of more of the same. A return to voluntary lending is a very remote possibility if one observes the large discounts in the secondary market for LDC debts and banks' attempts to relinquish anything remotely connected to Latin America.

In fact, there is concern that conditions may deteriorate. Over the past five years the non-interest current account of Latin American debtors turned toward a large surplus, and as a result they managed to pay a significant share of their interest liabilities. At the same time, however, investment declined sharply. A cut in investment may be a reasonable response to the crisis for a brief period, but when it lasts year after year it can only lead to severe trouble. Policy makers in debtor countries are concerned that they will ultimately bear the costs for prolonging what they consider a totally unreasonable decapitalization of their economies. Surprisingly no populist government has yet come to power to dramatize this issue, but it is clear that in Brazil, Mexico, and Argentina, the issue is buried only a foot deep.

On the creditor side there is also a deterioration underway. Large banks that are organizing the lending cartel are increasingly disenchanted with Federal Reserve pressure to keep up lending. They would like to see a more substantial takeover by the taxpayers, either overtly or under the cover of expanded loans and guarantees from international agencies. The problem is aggravated by the increasing unwillingness of small banks to participate in new rounds of "involuntary" lending. Their withdrawal puts pressure on loan discounts and thus highlights the fact that loans are traded significantly below par. Dissension between European and New York banks is another factor weakening cohesion.

A final dimension of the crisis is the trade issue. This aspect has been emphasized by Senator Bradley in his proposal for limited, selective and targeted negotiation of debt relief in exchange for conditioned adjustment programs and trade concessions in the debtor countries. Debtor countries today run trade surpluses to earn dollars for debt service. They have achieved these surpluses by substantially depreciating their currencies to gain competitiveness, restricting imports, and expanding exports. At the same time, this large swing in their trade is perceived as a threat to a liberal world trade regime.

Four facts summarize the lack of success of the adjustment efforts so far. First, creditworthiness has been deteriorating. The ratio of debt to exports for problem debtors has risen since 1982 from 269 percent to 350 percent, and the ratio of debt to gross domestic product (GDP) of these countries increased from 44 percent to 54