LATIN AMERICAN POLITICAL ECONOMY

Financial Crisis and Political Change

edited by
Jonathan Hartlyn
and Samuel A. Morley

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About the Book and Editors

Faced with an explosion of foreign debt, falling export prices, and rising real interest rates, Latin American countries have experienced in recent years a dramatic worsening in their economic prospects and policy options. This volume of original essays considers the major historical and contemporary determinants of the development crisis facing Latin America from a political economy perspective and compares the effects of and responses to the crisis in a number of countries. Contributors examine the importance of external and internal factors in the debt crisis, discuss the internal policy errors that led to recent financial "blowups" in Mexico, Brazil, Argentina, and Chile, and relate earlier experiences of populist and postpopulist politics to general patterns of economic policymaking in Latin America. The next part is devoted to individual country studies. The "spectacular failures" of Peru and the bureaucratic-authoritarian regimes of the Southern Cone are contrasted to the moderate successes of Mexico and Colombia, and the cases of socialist Cuba and Nicaragua are examined. Each of the country studies discusses the economic and policy record that has led to the current crisis and describes the political and economic context in which policy choices were made.

At the end of the book comments by eminent scholars are included to provide a broader context in which to consider the issues raised. Alternative, or even opposing, points of view expressed in the commentaries encourage discussion of the often difficult questions and problems posed by the contributors. Taken together, the essays and the commentaries offer an unusually current and comprehensive view of what is happening in Latin America. They allow the student and scholar to compare policy responses in different countries, understand the political and economic constraints facing policymakers, and evaluate prospects for the future.

Jonathan Hartlyn is assistant professor of political science, and **Samuel A. Morley** is professor of economics at Vanderbilt University. Both have written extensively on economic and political problems in Latin America.

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1 Introduction

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Latin America is currently confronting its worst financial and economic crisis since the Great Depression. Despite a wide variety of policies and economic conditions, every country on the continent has a balance-of-payments problem and a crippling level of external indebtedness, and each has been forced into recession as it struggles to meet the interest payments on its debt. This grim economic picture is a new phenomenon. Prior to the 1980s, the post–World War II period had been a prosperous one for Latin America. On average, from 1950 to 1980, per capita income on the continent grew by 2.4 percent per year, and from 1960 to 1980, life expectancy increased by ten years, in a context of very rapid population growth. Not surprisingly, Latin America was considered by many economists to be an example of successful long-run development.

If the 1980s have been devastating to Latin America in an economic sense, they have at the same time witnessed a retreat from military authoritarianism. Since 1980, military regimes have relinquished power in Argentina, Uruguay, Brazil, Peru, Ecuador, El Salvador, Panama, Honduras, and Bolivia. In a way, this situation is ironic. Social scientists used to think that economic growth would lead to improved social conditions that would be conducive to democracy. But during the 1960s and 1970s, many civilian regimes, including those in the most advanced countries, were overthrown by military coups. The growth-democracy view was replaced by the conviction that the conditions required for economic growth—particularly wage restraint, profit incentives, and high levels of saving and investment—could not be guaranteed in a democracy but would require instead a long period of institutionalized military rule. Yet recent events have demonstrated that the military regimes in Argentina, Brazil, Chile, and Uruguay have shown themselves to be no better, and in most cases worse, than the civilian regimes they replaced in generating satisfactory and noninflationary long-run growth rates. Their poor economic performance is one of the main factors why the military has stepped down from power in so many countries. It is, of course, too early to tell whether the successor civilian regimes will be able to resolve the severe economic problems that the military regimes left behind, or whether the civilian regimes will be able to consolidate themselves politically.

A natural and common theme of the chapters in this book is the question of what went wrong. How did so many countries, employing such a variety of economic strategies, end up in a similar mess? What mistakes did they make, and why did they make them? Was economic theory deficient or poorly implemented? What role did external events—largely beyond the control of Latin policymakers—play in causing the current crisis? Did political pressures force governments knowingly to adopt unwise economic policies? Did certain kinds of regimes, notably those less subject to populist pressures or those less linked to the international financial system, perform better?

These issues are important ones. Practically all the countries in Latin America are aligned with the West and have bet their economic futures on its capitalist market economy and its international trading and financial system. Prior to 1980, that decision looked like a wise one. Latin America and Asian countries such as Taiwan and Korea were economic success stories. In the current crisis conditions, there will inevitably and appropriately be many people in Latin America who will question the wisdom of the development choices that were made and the advisability of continuing unchanged along the same course. We in the United States would be wise to try to understand the grave difficulties of our southern neighbors and their thoughts about how the crisis happened and what they should do about it. We hope these pages will help develop such awareness and comprehension.

In the chapters that follow, the authors (all but one of whom are from the country about which they write) review their country's economic and political history and look for answers to current problems in the policies and politics of the past. In addition, the four overview essays in Part 1 compare different country experiences and draw some important policy conclusions, and the commentaries in Part 3 give additional perspective on the issues raised in the essays. A short summary of each chapter follows.

Part 1

The four chapters in Part 1 provide comparative perspectives. In the first, Jonathan Hartlyn and Samuel Morley give an overview of different political regimes and their economic performances, and in the second, they analyze the performance of the bureaucratic-authoritarian (B-A) regimes in Argentina, Chile, and Brazil. They argue that the poor economic performance of these regimes was no better than the performance of the civilian regimes they replaced or of the other Latin American civilian regimes of the 1970s. They present three major factors whose interaction helps explain this phenomenon. First, even disregarding the social cost to vast population sectors in these countries, the version of international monetarism applied by the regimes—especially their decisions to prefix the exchange rate and drive up internal interest rates—had disastrous results. Inflation did not decline as predicted, and the increasingly overvalued currency hurt industry particularly. The difficulties of the policies were hidden by a massive influx of foreign funds until world interest rates increased suddenly and sharply. The second factor that helps explain the disastrous performance of these regimes was the absence of any international constraints to their policies as, until the dramatic change in 1981–1982, foreign commercial banks were eagerly lending to a variety of countries and were particularly attracted to these political regimes.

The third factor, of particular relevance for Chile and Argentina, was the total absence of a domestic political constraint, which almost certainly allowed the regimes to apply their radical free-market policies far longer than they would otherwise have been able to do. In Chile and Argentina, the presumed "benefits" of the invulnerability of military regimes to political pressures were far more disastrous economically than the vulnerability of civilian regimes. The Brazilian B-A regime, no longer able to justify its existence on the basis of a populist "threat," sought foreign loans in an attempt to continue strong growth and thus legitimacy during its uncertain process of political liberalization. Chapter 3 ends with a brief consideration of the relationship of these B-A regimes to broader historical processes that suggest these regimes have appeared in Latin American countries with "pendular" economic and political patterns. In contrast, governments in other countries have pursued more "moderate" patterns.

In Chapter 4, Albert Fishlow compares the adjustments of various countries to the oil shocks of 1973 and 1979. For 1973, two broad patterns stand out. One was a reliance on external finance and import substitution or export promotion to sustain relatively high rates of growth; the other was acceptance of lower income growth rates to curb imports along with efforts to increase exports. Brazil, Korea, and Mexico—each relatively large and with a history of successful import substitution and/or export promotion—followed the first broad pattern. Chile, Taiwan, and Singapore—being smaller and having more open economies—followed the second.

Albert Fishlow then turns to an analysis of the current crisis and its roots in the 1979 oil shock. Up to 1980, the adjustment to the shock appeared to be satisfactory. However, conditions swiftly deteriorated as a worldwide recession drove down the demand for Latin exports and cut off the supply of credit as sharply higher interest rates raised the cost of foreign debt. The result was a balance-of-payments crisis that forced every economy on the continent into a severe contraction.

Although the results were similar across countries, Albert Fishlow shows that the causes of the crisis were quite different in each country. In Mexico, excess aggregate demand, fed by rapid expansion of the public sector and the oil bonanza, was the key culprit. In Brazil, rising oil prices and the "scissors effect" of high interest costs and a falling export demand explain nearly all of that country's subsequent balance-of-payments problems. In contrast Chile's domestic policy errors, which encouraged a rapid accumulation of foreign debt without a comparable increase in total saving, were responsible for its balance-of-payments crisis of 1982 and beyond.

Austerity programs are being applied just as many countries are seeking redemocratization. Despite the appeal of populist solutions, Fishlow argues that there is a widespread realization in Latin America that export promotion and greater internal sacrifice will be necessary to improve the situation. These measures can be accepted, but only if there is an equal sense of flexibility on the part of the external lenders, particularly a willingness to extend debt repayment schedules, allow increases in imports to developed countries, and explore ways to lower the interest burden.

In Chapter 5, David Felix analyzes the financial "blowups" that resulted from the neoliberal policies followed by the bureaucratic-authoritarian regimes in Argentina, Chile, and Uruguay and the state-directed policies adopted in Brazil and Mexico. Despite their promise and early success, all of these five economies have been overwhelmed by economic crisis since 1982. David Felix seeks to explain why. He asserts that in the neoliberal economies, the main cause was the prefixed exchange rate and excessive capital inflows in the 1979–1981 period. Basically, the capital inflows permitted an increasingly serious overvaluation of the exchange rate, which caused large current account deficits and a shift away from the domestic production of tradable goods. Firms were confronted by a killing combination of high real interest rates and low-priced foreign goods, and many went deeply into debt, much of which was denominated in dollars and was unserviceable when the exchange rate overvaluation was finally corrected. The result was a downward spiral of bankruptcies, falling output, and reduced employment. A full-fledged financial collapse was averted only by belated government intervention.

Financial difficulties were also central in Mexico's road to crisis. The shift to "shared development" under Luis Echeverría Alvarez in 1970 and the oil bonanza under José López Portillo dramatically increased public sector deficits and borrowing requirements. Inflation increased, and there were massive current account deficits and large increases in public foreign borrowing, much of which was offset by private capital flight. When oil prices began to decline in 1981, foreign credit dried up, and Mexico was forced to accept a severe stabilization policy.

Brazil's story is different. Like Fishlow, Felix does not believe financial crisis and capital flight are the main culprits in this case. In the 1970s, Brazil followed a capital-intensive growth strategy that was largely financed by external borrowing, not internal saving. After the second oil shock hit, large balance-of-payments deficits resulted from the scissors effect of high interest rates, lower export receipts, and high oil prices. When further international credit was shut off in 1982, Brazil was forced to accept a stringent International Monetary Fund (IMF) stabilization plan.

Part 2

Part 2 examines "spectacular failures" and "moderate successes" in a number of country case studies, the first of which is the tragic case of Argentina. Marcelo Diamand argues that for decades, Argentine economic performance has been harmed by government economic policies that have swung like a pendulum between the orthodox and the populist, neither of which is capable of generating sustained growth in an economy that has an unbalanced productive structure. Argentine industry is intrinsically neither more nor less efficient than industry in other countries. Its problem is that it coexists with the most productive agricultural sector in the world and cannot compete internationally at the exchange rate determined by the agricultural sector.

In the past, populist, Keynesian-type policymakers took office after a bout of orthodox stabilization left the country with a high level of foreign reserves. The populists expanded demand, and the country enjoyed a period of rapid economic growth. But there was little effort to increase exports—indeed, agricultural prices were generally held below production costs because of the political importance of food prices—and the country soon exhausted its foreign exchange reserves. The government then turned to foreign exchange controls, which caused capital flight, shortages of essential imports, and finally a balance-of-payments crisis with rising inflation.

The crisis brought to power an orthodox-minded government whose program typically consisted of a contractionary monetary and fiscal policy coupled with an abrupt devaluation. The balance of payments improved temporarily simply because of the recession, but there was little resource switching into traded goods because industrial products were not even close to the margin of competitiveness. Meanwhile, the rising relative price of traded goods and declining real wages caused workers and the industrial sector to fight back, leading to a period of rising inflation that eroded the initial change in relative prices. In recent years, the orthodox governments have also relied on high interest rates and foreign borrowing to compensate for the failure to improve the balance of trade. Capital inflows have permitted devaluations to lag behind internal inflation, but the cost has been a widening of the current account deficit, mounting foreign debt, and widespread bankruptcy of domestic industry due to the overvalued exchange rate.

Diamand argues that the new Alfonsín government should design a new program based on the following principles: (1) the promotion of industrial exports through a system that amounts essentially to multiple exchange rates; (2) the promotion of agricultural exports by a devaluation accompanied by a tax on land; (3) selective import substitution; and (4) the avoidance of excessive dependence on short-term financial capital to solve foreign exchange problems.

The Bolivar Lamounier and Alkimar R. Moura chapter is an account of the relationship between the way in which Brazil confronted its principal economic challenges, the two oil shocks of 1973 and 1979, and its main political problem of how to move from the highly repressive structure inherited from the Medici administration to a more representative and open political system. In partial contrast to Albert Fishlow and David Felix, the authors of this chapter argue that the country should have accepted an economic slowdown and a real adjustment to less favorable conditions well before 1980.

They decisively reject the hypothesis that the delay in adjustment was dictated by populist political pressures. Despite the political liberalization that occurred under Ernesto Geisel (1974–1979), opposition leaders posed no effective threat to the technocrats directing policy. Rather, government leaders underestimated the seriousness of the external constraints in part because they were sensitive to the political importance of maintaining high rates of economic growth, their principal source of continuing legitimacy.

Politically, the process of liberalization was too gradual and hesitant. Never willing or able to create a viable political party of the center, the Geisel government failed to form a solid basis of support for a more realistic policy of adjustment to external shocks. In 1979, an amnesty for political prisoners, the return of political exiles, and other liberalizing measures created the impression that the country was in a clear transition