REVIEW ESSAYS

THE POLITICAL ECONOMY OF THE LATIN AMERICAN DEBT CRISIS*

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DEBT-EQUITY SWAPS AND FOREIGN DIRECT INVESTMENT IN LATIN AMERICA. By Joel Bergsman and Wayne Edisis. (Washington D.C: World Bank, 1988. Pp. 34. $5.00 paper.)

LA CRISIS DE LA DEUDA LATINOAMERICA FRENTE A LOS PRECEDENTES HISTORICOS. By Gonzalo Biggs. (Buenos Aires: Grupo Editor Latinoamericano, 1987. Pp. 192.)

LOST PROMISES: DEBT, AUSTERITY, AND DEVELOPMENT IN LATIN AMERICA. By William L. Canak. (Boulder, Colo.: Westview Press, 1989. Pp. 244. $37.00 cloth, $16.00 paper.)

THE DEBT THREAT. By Tim Congdon. (New York: Basil Blackwell, 1988. Pp. 246. $24.95.)

THE LOAN PUSHERS: THE ROLE OF COMMERCIAL BANKS IN THE INTERNATIONAL DEBT CRISIS. By William Darity, Jr., and Bobbie L. Horn. (Cambridge, Mass.: Ballinger, 1988. Pp. 203. $34.95.)

A FATE WORSE THAN DEBT: THE WORLD FINANCIAL CRISIS AND THE POOR. By Susan George. (New York: Grove Press, 1988. Pp. 292. $17.95.)

MANAGING WORLD DEBT. Edited by Stephany Griffith-Jones. (New York: St. Martin's Press, 1988. Pp. 386. $49.95.)

BETWEEN BAILOUT AND BREAKDOWN: A MODULAR APPROACH TO LATIN

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AMERICA'S DEBT CRISIS. By William Guttman. (Washington D.C.: Center for Strategic and International Studies, 1989. Pp. 56. $6.95.)

FOREIGN INVESTMENT, DEBT, AND ECONOMIC GROWTH IN LATIN AMERICA. Edited by Antonio Jorge and Jorge Salazar-Carrillo. (New York: St. Martin's Press, 1988. Pp. 250. $60.00.)

LATIN AMERICAN DEBT. By Pedro-Pablo Kuczynski. (Baltimore, Md.: Johns Hopkins University Press, 1988. Pp. 258. $32.50 cloth, $12.95 paper.)

TWO CRISES: LATIN AMERICA AND ASIA, 1929–38 AND 1973–83. By Angus Maddison. (Paris: Organization for Economic Cooperation and Development, 1985. Pp. 105. $14.95 paper.)

LATIN AMERICA'S DEBT CRISIS: ADJUSTING TO THE PAST OR PLANNING FOR THE FUTURE? Edited by Robert A. Pastor. (Boulder, Colo.: Lynne Rienner Publishers, 1987. Pp. 176. $20.00.)

NEW APPROACHES TO THE LATIN AMERICAN DEBT CRISIS. By Jeffrey D. Sachs. Princeton Essays in International Finance no. 174. Princeton, N.J.: International Finance Section, Princeton University, 1989. Pp. 50. $6.50.)

DEVELOPING COUNTRY DEBT AND THE WORLD ECONOMY. Edited by Jeffrey D. Sachs. (Chicago: University of Chicago Press, 1989. Pp. 334. $13.55 paper.)

WORLD DEBT: WHO IS TO PAY? By Jacobo Schatan. (London: Zed Books, 1987. Pp. 126. $35.00 cloth, $9.95 paper.)

BANKER TO THE THIRD WORLD: U.S. PORTFOLIO INVESTMENT IN LATIN AMERICA, 1900–1986. By Barbara Stallings. (Berkeley and Los Angeles: University of California Press, 1987. Pp. 434. $45.00 cloth, $12.95 paper.)

DEBT AND DEMOCRACY IN LATIN AMERICA. Edited by Barbara Stallings and Robert Kaufman. (Boulder, Colo.: Westview Press, 1989. Pp. 232. $29.00 cloth, $14.95 paper.)

THE FAILURE OF THE INTERNATIONAL DEBT STRATEGY. By Knud Erik Svendsen. (Copenhagen: Centre for Development Research, 1987. Pp. 123.)

REKINDLING DEVELOPMENT: MULTINATIONAL FIRMS AND THIRD WORLD DEBT. Edited by Lee A. Tavis. (Notre Dame, Ind.: University of Notre Dame Press, 1988. Pp. 369. $26.95.)

LATIN AMERICA AT THE CROSSROADS: DEBT, DEVELOPMENT, AND THE FUTURE. By Howard J. Wiarda. (Boulder, Colo.: Westview Press, 1987. Pp. 114. $19.95.)

VOLUNTARY APPROACHES TO DEBT RELIEF. By John Williamson. (Washington D.C.: Institute for International Economics, 1988. Pp. 63. $10.95 paper.)

Eight years after Mexico announced that it was unable to service its foreign debts, the Latin American debt crisis remains one of the central problems confronting the international economy. The Brady Plan, an-

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nounced in 1989, marks a new phase: for the first time, the U.S. government has thrown its weight behind debt relief rather than debt refinancing. This change in the stance of U.S. policy reflects the changed realities. The dangers of widespread bank insolvencies and world financial collapse as a result of Latin American defaults have receded, but most Latin American economies continue to stagnate or even deteriorate. As Jeffrey Sachs, an advisor to a number of Latin American countries, observes: "Despite many years of emergency treatment, Latin America's debt crisis continues to deepen. . . . Many countries are now suffering from an alarming mix of hyperinflation and hyperdeflation that has not been witnessed on such a wide scale since the disastrous experience of Central Europe in the 1920s. In many countries, economic instability is so acute that it is breeding political instability and threatening democratic governments" (*New Approaches to Latin America's Debt Crisis,* p. 1).

The underlying causes of this economic disaster in Latin America and the appropriate policy responses by debtor and creditor governments are still being debated, and the Brady Plan is unlikely to be the final word. In recent years, a vast literature on Latin American foreign debt has emerged from a wide variety of disciplines and perspectives.[1] This review essay will assess and contrast some of these contributions (most of which appeared between 1987 and 1989) in an effort to understand the sources of the disagreements and continuing difficulties. The essay will begin with a review of historical antecedents of the present debt crisis and will then analyze the causes of the current crisis. The following two sections will assess economic management of the crisis since 1982 and examine the ways in which interaction between politics and economics have influenced the strategies and outcomes. The last main section will examine alternative proposals for reforming economic policies and financial markets.

HISTORICAL ANTECEDENTS

Various observers have noted the parallels between the current situation and earlier debt crises and have attempted to examine the past so as to elucidate the present. Foreign creditors have been lending to Latin America for more than one hundred and fifty years. Historical experience has clearly invalidated Walter Wriston's infamous statement that sovereign lending is safe because nations do not go bankrupt. One wonders what other lessons Latin American debtors and creditors could have learned from history. A number of intriguing questions can be posed. How does the nature of the lending boom in the 1970s and the collapse in the 1980s compare with earlier periods, particularly the 1920s and 1930s?

1. Several review essays on Latin American debt and adjustment have recently appeared in *LARR*. See Sachs (1988), Edwards (1989), and Sheahan (1989).

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Are fluctuations in international capital flows driven by bank "loan pushing" or by debtor "demand pulling"? What were the causes of the defaults, and how were those defaults handled in negotiations between creditors and debtors? How does the Latin American experience compare with that of other debtor nations? Perhaps most important, does a long historical view of international lending indicate that it has been mutually beneficial to debtors and creditors, as economic theory suggests it can be? If not, what are the systemic sources of failures of international credit markets, and what can be done about them?

Patterns of International Lending and Default

In *Banker to the Third World,* Barbara Stallings presents a comprehensive assessment of U.S. lending to Latin America between 1920 and 1980, with particular emphasis on comparing the 1920s with the 1970s, the two periods of substantial portfolio capital flows. Stallings draws on the literature on British capital exports in the nineteenth century as a source of hypotheses for examining the U.S. experience. She details the economic and political forces at work in the evolution of international lending. In particular, she attempts to sort out the relative role of the U.S. supply of loans versus the Latin American demand for borrowing. The strengths of *Banker to the Third World* are its comprehensive data series, many of them assembled for the first time, and a carefully nuanced empirical analysis of these data. The main weakness is that some of the analytical sections are not as clear as they could be, although the overall framework is sound.

Stallings emphasizes the following supply factors: politics, institutional innovations, savings rates, and attitudes of bankers. On the demand side, she focuses on "structural linkage," "process linkage," fiscal deficits, growth, and demand for credit by other regions. Unfortunately, some of these concepts are not completely elucidated, especially "structural" and "process" linkages. The idea of structural linkages is based on the well-known two-gap theory of shortages of foreign exchange and capital in developing countries, but Stallings's discussion is a little confusing. For example, she writes, "Both structural linkages imply a potential need for foreign capital. The capital goods linkage will actually require a foreign capital inflow only if a current-account deficit exists" (p. 167). But a current-account deficit can only exist if financing is available, and consequently, her distinction is not helpful. The concept of "process linkage" is vague as well. It would also be helpful to situate the bilateral financial relationship between the United States and Latin America in terms of the worldwide flow of funds. In these areas, *Banker to the Third World* suffers from not having a more clearly articulated analytical frame-

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work, although the basic distinction between demand "pull" and supply "push" factors is sound and useful.

Stallings attempts to sort out the effects of supply and demand factors in a variety of overlapping ways and arrives at balanced and convincing conclusions. She examines long-run trends and short-term fluctuations and provides statistical analyses as well as case studies. She notes that a number of authors such as Charles Kindleberger, Hyman Minsky, and most recently William Darity and Bobbie Horn (reviewed in this essay) stress the role of supply factors, particularly the irrational swings between optimism and pessimism in the financial markets. Stallings's analysis reveals the importance of these supply factors but also includes the central role of demand. She characterizes the period between 1900 and 1930 as experiencing increases of both supply and demand for loans, with the demand shift being somewhat greater, whereas between 1954 and 1980, supply and demand both shifted substantially, with the supply increase becoming dominant. Stallings arrives at these conclusions by examining the variations of the interest premium on Latin American loans compared with domestic U.S. loans and the size of capital movements, using a simple but useful supply and demand framework. She offers a detailed statistical analysis of capital flows in the 1920s and 1970s, providing additional evidence that Latin American borrowers were more credit-constrained in the 1920s than in the 1970s. The rise in loan supply in the 1970s is attributed primarily to innovations in the financial markets (the Eurocurrency markets discovered Latin America) and the OPEC surplus of savings. Stallings also provides a detailed study of Peru, which corroborates and complements her statistical analysis. She shows how the August Leguía government was avid for loans and actively sought out the bankers in the early 1920s, with the bankers taking the offensive in "pushing" loans from 1924 to 1928. A similar pattern emerged in the late 1960s and 1970s, with Peru initially credit-constrained followed by a period of bankers competing to provide additional loans to Peru. Stallings notes, "At least in the Peruvian case, the idea of passive governments being 'forced' to accept loans so that the banks could make profits is quite misleading. In both the 1920s and 1970s, Peruvian governments wanted to borrow for both political and economic reasons" (p. 290).

Stallings concludes that history reveals a pattern of shortsightedness by both borrowers and lenders, with a surprising lack of historical memory of previous difficulties. In the 1920s and 1970s, lending to Latin America began cautiously but escalated into a full-scale speculative boom, with great carelessness exhibited by bankers as well as borrowers. *Banker to the Third World* is very useful in showing how all parties to the loans are responsible for the pattern and magnitude of international lending, including those who establish the contexts in which loans are arranged and renegotiated, namely policymakers in creditor countries. History reveals

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the manifest irrationality of the boom and busts cycles of international lending to Latin America, but attempts to find a single scapegoat for debt-servicing difficulties are usually oversimplified.

Although Stallings uses the British capital exports of the nineteenth century as a source of hypotheses, she does not provide a detailed comparison of the British and American experiences. Stallings cannot be faulted for this omission because her objective is more narrowly defined, but the contrasts seem to be quite dramatic (Fishlow 1985). The magnitudes of borrowing and lending in relation to economic magnitudes such as the gross national products of the debtor and creditor governments were much greater in the nineteenth century than during the 1970s and 1980s. Also, Fishlow (1985) argues that nineteenth-century debt-servicing difficulties were handled more equitably and rationally then than in the 1930s and 1980s. The earlier British experience seems to suggest that the catastrophic experiences of Latin America in the twentieth century reflect particular conditions rather than the intrinsic flaws of private international lending.

Historical precedents are discussed further in two chapters of *Developing Country Debt and the World Economy*, edited by Jeffrey Sachs (other parts of which will be reviewed subsequently). These two chapters typify the excellent quality and originality of the research in this collection, which contains abbreviated versions of longer articles published separately in *Developing Country Debt and Economic Performance* in three volumes, not all of which had appeared at the time this review was undertaken. The abbreviated versions are detailed and self-contained enough that many readers will not need to refer to the longer versions, although specialists will wish to consult the longer versions of articles of interest to them. Peter Lindert and Peter Morton examine the repayment record of sovereign debt over wide geographical and time spans. They note that some regions seem more prone to default than others. Latin America and Eastern Europe have long histories of repeated defaults, while Western Europe and Asia east of the Persian Gulf have almost never defaulted. Lindert and Morton examine the rates of return realized by British and American investors on their bond holdings in selected Latin American and other countries from 1850 to 1970. It is interesting to observe that historical average rates of return on foreign investments tended to exceed domestic rates on U.S. and British government securities, even for some Latin American countries with histories of default. This evidence suggests that foreign investors were at least partially compensated for the riskiness of international lending. Even more surprising, bonds issued between 1850 and 1914 had lower rates of return than those issued between 1915 and 1945, despite the experience of the Depression.

Lindert and Morton also examine the degree to which defaulters were punished by subsequent credit embargoes and trade restrictions.

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They find no evidence of any differential treatment of defaulters relative to nondefaulters. Barry Eichengreen's chapter focuses on foreign lending by the United States between 1920 and 1955. He observes that reputation appeared to be significant in the pricing of foreign bonds but finds little evidence that risk premia reflected economic performance. Furthermore, like Lindert and Morton, he finds no evidence of discriminatory treatment of defaulters through loss of future access to credit. Following the defaults of the Depression, all sovereign borrowers had reduced access to new credits, not just those that had defaulted.[2] The results found by Eichengreen and Lindert and Morton support the view that there are elements of systemic irrationality in the booms and busts of foreign lending. One example is the pattern of repeated defaults by some countries and the failure of creditors to punish selectively, although the situation was by no means entirely negative from the standpoint of long-run rates of return on foreign loans.

Adjustment to Crises

Angus Maddison's *Two Crises* provides a masterful overview of the periods from 1929 to 1938 and 1973 to 1983, focusing on the experiences of Latin America and Asia in a turbulent world economy. In less than one hundred lucid pages, Maddison characterizes the overarching features of these periods and describes the experiences of a number of individual countries. He shows that the external shocks hitting the developing countries were much harsher in the earlier period. The Depression of the 1930s was transmitted violently from industrial to peripheral countries, while the major shocks of the 1970s were the oil price increases, which emanated from the periphery itself and benefited at least some oil-exporting developing countries. The decline in industrial country output was much greater in the 1930s than in the later period, making the drop in external demand for developing countries' exports also correspondingly greater.

Contrary to the current conventional wisdom about the merits of outward orientation, Maddison demonstrates that inward-looking policies served Latin America well in the 1930s.[3] Almost all Latin American countries defaulted on their foreign debts and adopted import-substitution industrialization policies during the Great Depression. Although perhaps partially unintended, a number of countries adopted de facto Keynesian policies to stimulate aggregate demand through government spending,

2. The failure of creditors to impose selective sanctions can be understood in game-theoretic terms. Creditors may not find it in their own interest to carry out sanctions even if they threaten to do so. Furthermore, group coordination problems may arise in enforcing punishment. See Krugman (1985) for a general discussion of this point.

3. Díaz Alejandro (1983) makes the same point.

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even though Keynes's *General Theory* advocating such policies had not yet been published. For example, Brazil's coffee price supports served to stabilize real incomes of producers and had Keynesian multiplier effects on the rest of the economy. By contrast, those countries in Asia that were European colonies (like India and Indonesia) fared poorly due to the deflationary policies and full debt servicing that were imposed by British and Dutch colonial authorities. Japanese colonies like Korea and Taiwan benefited from the more expansionary approach favored by Japan.

As will be discussed later in this review, the favorable experience of Latin America relative to Asia in the 1930s was reversed in the 1970s and 1980s. Maddison points out that economic policy was far from homogeneous in Latin America in the 1970s, but he notes some shared weaknesses deriving from the "common institutional heritage which includes a very unequal distribution of landed property, weak fiscal structures which often rely on inflation as a revenue instrument, and a tradition of military-bureaucratic authoritarianism which strengthens belief in government control rather than the price mechanism" (p. 53). The extreme swings of economic policy have undermined long-run credibility of Latin American governments. By contrast, Asia's outstanding performance throughout the 1970s and 1980s reflect enlightened and farsighted economic policies that focus on raising investment and improving efficiency through opening to international trade.

Unfortunately, Maddison does not attempt to resolve a fundamental question raised by his analysis: why was Latin America's economic performance relatively good in the 1930s and so poor in the 1980s? In particular, if default and inward orientation were appropriate policy responses in the 1930s, why were they not appropriate in the 1980s? In view of the great costs of austerity in Latin America and the successful experience with default in the 1930s, the default option is again arguably the best choice from the standpoint of the standard of living of Latin Americans. Although Maddison argues briefly that outward-oriented policies are more feasible and desirable in the 1980s, a full analysis of this issue is missing from his otherwise excellent book.[4] This omission probably reflects the fact that *Two Crises* was written in 1984, before the chronic nature of the debt crisis became fully apparent. Indeed, readers can see with the hindsight of the 1990s that Maddison was somewhat overoptimistic in his concluding chapter about the resolution of the debt crisis. Nonetheless, he has provided an extremely useful overview of a large span of history and geography.

In *La crisis de la deuda latinoamerica frente a los precedentes históricos,*

4. The failure of Latin American debtors to negotiate more favorable deals remains one of the puzzles of the 1980s and is atypical of the history of international lending, as is discussed subsequently.

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Gonzalo Biggs looks at historical precedents of the current crisis from an unabashedly Latin American perspective. He argues powerfully that the current situation is historically unique in terms of the unfair burden of adjustment and the consequent costs to the debtors. As will be discussed subsequently in this review, a near consensus has emerged that the resource transfers exacted from the debtors between 1982 and 1987 were excessive and unsustainable. The originality of Biggs's treatment lies in his analysis of the current crisis in light of the past: "The summary examination of historical precedents . . . demonstrates that in absolutely all international financial crises, the creditors and their governments had to assume an important part of the losses on their loans and investments. The sole exception to this rule has been the current Latin American experience . . . " (p. 28, my translation).

The fundamental reason for this outcome, according to Biggs, has been the unyielding stance of creditor governments, especially the United States, in support of their own financial institutions. Under the smoke screen of free-market ideology, creditor governments have adopted energetic policies whenever their own interests or those of the banks were threatened. Biggs argues that such policies are morally indefensible because the banks and creditor governments bear a large share of the responsibility for the current situation. He goes so far as to suggest that an ulterior motive of U.S. policies favoring liberalization and privatization has been to undermine the sovereignty of Latin American governments.

Biggs's historical overview distinguishes two types of defaults: repudiations for political reasons and inability to pay due to economic hardships. He argues that an unwritten historical rule is that creditor sanctions are justified in the case of political repudiations but not in the case of economic defaults, although he notes that considerations of power have often superseded these norms. The cases of economic default covered by Biggs include the Latin American defaults of the 1820s and the 1930s as well as German reparations and Allied war debts in the interwar period. The political repudiations consist of the Mexican imperial debt in the 1860s, the Southern states of the United States between 1842 and the 1870s, and the Russian imperial debt. Each case is documented, discussed concisely, and compared with the current situation.

Biggs analyzes the evolution of the roles of Latin American governments and international law in conflicts with foreign creditors. In the early years of independence, Latin American governments responded weakly to foreign government interventions in their domestic affairs. Paraguayan diplomat Carlos Calvo initiated a decisive break around 1870, however. The Calvo doctrine asserted that Latin American governments were not responsible for the losses of foreign creditors due to internal disturbances and civil wars in Latin America and that "European governments must apply the same norms in their relations with Latin American

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governments as they do among themselves" (p. 76). The Calvo doctrine was widely adopted in Latin America, and Biggs praises Calvo effusively as one of the great figures in nineteenth-century international relations. Biggs speculates that some interventions of the World Bank and the International Monetary Fund would have been rejected by Calvo as violations of Latin American sovereignty. Luis María Drago, Argentine foreign minister at the turn of the century, carried Latin American independence a step further by asserting the illegitimacy of using force to collect foreign debts. The Hague court ruled against Drago in 1904, but Biggs argues that the Drago doctrine was influential nonetheless and ultimately led to a change in U.S. policies toward Latin America in 1907. Biggs observes with regret that agreements on norms governing conflicts between creditors and sovereign debtors have never been codified, the most rigorous attempt being that of the Preparatory Committee of the League of Nations in 1929. The essence of the principles enunciated by this committee is that default could be justified in circumstances of financial necessity or public interest as long as foreigners did not receive adverse discriminatory treatment (p. 89).

Biggs goes on to analyze particular crises in detail. Because of space limitations, my comments will be limited to the cases of the U.S. Southern states and the Latin American defaults of the 1930s. Biggs takes some delight in pointing out that the repudiations of some Southern states were not caused by the U.S. Civil War but were instead the most egregious examples to date of political defaults, flagrantly violating the principles of conduct just discussed. As in the case of the Soviet Union's repudiation of the Czarist debt, foreign bondholders still have not relinquished their claims because of the overtly political nature of the repudiations of the U.S. Southern states. Biggs argues that many of the U.S. states justified their defaults with legal technicalities, a recourse that Latin America never would be able to get away with today. He cites the Council of Foreign Bondholders' scathing comments on the case of Mississippi, where "the repudiation took place in conditions of peace and normalcy, and, apparently, has been accepted by the citizens of one of the most prosperous communities of the world" (p. 107). Biggs notes the repeated refusals of the U.S. federal government to assume any responsibility for the delinquent debt of the states, in contrast with the current situation in Latin America, where governments have often taken responsibility for private-sector foreign debts as a result of pressure from U.S. creditors.

Like Maddison, Biggs notes that the economic policies adopted in Latin America in the 1930s differed greatly from those of the 1980s, with defaults and inward-oriented economic policies chosen during the earlier period. In contrast with the 1980s, Latin American countries unilaterally suspended their debt servicing, although they did not repudiate their debts. The crucial factor was that creditors did not retaliate. Biggs ascribes

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the absence of creditor sanctions to a variety of political and institutional factors, including the lack of cohesion among individual bondholders and the U.S. government's refusal to act as an agent for private creditors. President Franklin Roosevelt took a much more enlightened attitude toward Latin America than did the Reagan administration in viewing expansion of trade as a way to improve relations. Subsequently, debtors and creditors arrived at agreements that reduced debt-service obligations substantially. Biggs also notes that debtors were able to reduce their debts through buybacks at large discounts on the secondary market. In the 1980s, in contrast, creditors have been able to take the initiative in the negotiations, and until the Brady Plan, full-interest servicing has been demanded, despite the fact that Latin American interest payments relative to gross national product (GNP) and exports are greater than the debt service owed in the 1930s.

In summary, Biggs has amply documented his case that the current debt crisis is historically unprecedented in its magnitude, in the lack of creditor concessions, and hence in the costs imposed on the debtors. *La crisis de la deuda latinoamerica* is a significant and timely book.

SOURCES OF THE PRESENT CRISIS

International economics textbooks demonstrate how international lending can be mutually beneficial to all parties involved. International lending can be regarded as intertemporal trade, a form of international exchange where the borrower "purchases" present consumption in exchange for future consumption. That is, international capital flows allow a more efficient global allocation of resources over time. The creditor countries receive a higher return on their saving than they would if they were confined to domestic investment, whereas a borrowing country is able to obtain funds for investment at lower costs or to smooth fluctuations in consumption in response to transitory adverse economic shocks.[5] A case could be made (and indeed was made in the 1970s) that international lending to developing countries like those in Latin America fits this optimistic characterization.[6] Latin American and other newly industrializing countries could fruitfully borrow for both reasons: high investment opportunities associated with structural change and financing of temporary economic shocks.

Clearly, however, the optimistic view of lending to Latin America has not been borne out by the experience of the 1980s. What went wrong? Was the problem unforeseen shocks or deep systemic flaws? Who was responsible—greedy banks, irresponsible Latin American governments,

5. For example, see Krugman and Obstfeld (1988), chap. 7.
6. See Sachs (1981) for such a view.

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or the destabilizing influences of OPEC, Paul Volcker, and Ronald Reagan? These questions continue to be hotly debated, as occurs in *Latin America's Debt Crisis,* edited by Robert Pastor. While most of the contributions in this volume are too short to constitute a full analysis and much of the discussion of remedies is dated, the Pastor volume presents a wide diversity of views on the causes of the debt problem and what to do about it. The contributors include policymakers and analysts from both debtor and creditor countries and representatives of commercial banks. A substantial range of views by eminent policymakers is represented, including former U.S. President Carter, David Mulford of the U.S. Treasury, U.S. Senator Bill Bradley, and former Mexican Finance Minister Jesús Silva Herzog. As Richard Feinberg points out in an excellent summary of the papers, the "institutional location or political position of analysts tends to be a good predictor" of their views of the causes of the debt problem (p. 125). The bankers, like Terence Canavan of Chemical Bank, argue that the loans were not foolish and that unforeseeable external shocks caused the problems. Meanwhile, policymakers from developing countries like Manuel Azpúrua of Venezuela, although agreeing that external shocks were important, argue that "instability of international money markets" played a large role in inducing excessive lending (p. 78). Eduardo Wiesner, formerly of the IMF, and Mulford cite the excessive role of the state sector in Latin America as a central problem. Pastor is to be commended for assembling such a distinguished and diverse group of commentators. The brevity of the articles is useful for those wishing for a quick summary, but *Latin America's Debt Crisis* would have achieved more lasting value if the contributions had been more systematic.

The Role of the Banks

Commercial bank lending to developing countries and especially Latin America in the late 1960s and 1970s represented a dramatic change in the international economy in that the flow of private financial capital to the Third World had been very low since the debacle of the 1930s. Several authors remind readers that it is often forgotten that the "recycling" of the OPEC surplus was widely praised and encouraged in the 1970s. Analysts sympathetic to the nationalism of developing countries, such as Edmar Bacha and Carlos Díaz Alejandro (1982), argued that private-bank lending had attractive characteristics from the debtors' viewpoint, compared with direct foreign investment and official loans, which tend to be more intrusive politically.

In hindsight, some authors have come to view the banks as the main culprits. A notable example of this view is *The Loan Pushers* by William Darity, Jr., and Bobbie Horn, whose clever title reveals the authors' biases. Darity and Horn contend that the lending booms of the

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1920s and 1970s were driven by the supply of loans rather than by the demand for credit, although the authors qualify this view in some respects. They do not marshall much new evidence to indict the banks as loan pushers and countries as defenseless addicts, however. Most of the book consists of a survey of alternative theories of banking and finance, ranging from the rational expectations view popular among neoclassical economists to the Minsky-Kindleberger view of speculative cycles to Marxist theories of imperialism. Darity and Horn themselves favor a rather unclear notion of the debt crisis as somehow reflecting the "combative transition from capitalism to the managerial estate" when finance comes to dominate capitalist economies (p. 149).

Darity and Horn make their case that financial markets can be prone to irrationality, and their survey offers a useful introduction to some important theories. For example, the view of Jack Guttentag and Richard Herring that banks are subject to "disaster myopia" seems convincing considering the surprisingly low loan spreads (often less than 1 percent) charged to Latin American and other borrowers. Unfortunately, Darity and Horn oversimplify the role of the banks by characterizing them as "loan pushers." It seems clear that lenders paid insufficient attention to the uses of funds by borrowers and their economic policies, due in part to insufficient information and inexperience, but part of the responsibility for this situation is the lack of supervision by regulators, who often encouraged this "recycling." Also, as discussed earlier, Stallings has shown that it is misleading in theory and in practice to look only at the supply side of the market for loans.

William Guttman, whose *Between Bailout and Breakdown* will be discussed further on, offers a less critical view of the role of the banks. He notes that "the mantle of 'villain' has surprisingly been placed on the international banking system. The surprise results not from the blamelessness of the banks but from their role as mere transmitters—not generators—of global shock" (p. 5). He observes that banks sought to protect themselves from risk through a variety of institutional mechanisms such as syndication, floating rate loans, and short maturities. Unfortunately, some of these features, which are perfectly rational from the point of view of an individual bank, increase the vulnerability of the system as a whole to certain types of global shocks, such as world recession and high real interest rates induced by tight monetary policies in the creditor countries (precisely what transpired). It can be argued, however, that the banks should have been aware of the possibility of global shocks—after all, a world recession caused by oil shocks and contractionary monetary policy had happened only a few years earlier in 1974–75. In this light, the second oil shock and the Volcker deflation cannot be regarded as complete surprises.

The international debt debacle is not evidence that international

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lending by private agents is inherently undesirable. Rather, it proves that financial markets are prone to crisis in the absence of regulation and sound macroeconomic policies in the debtor and creditor countries.

Mismanagement in Latin America

There can be little doubt that mismanagement in Latin America played an important role in the origins of the crisis, although this point too is often exaggerated with the benefit of hindsight. As Díaz Alejandro (1984) aptly pointed out, few observers can credibly claim to have foreseen the effects of the continent-wide policy mistakes, and economic policy was far from homogeneous across Latin America. Nonetheless, Sachs (1985) conclusively showed that Latin American mismanagement played an important role because the magnitude of the adverse external shocks of the 1980s were at least as great in East Asia, where countries (other than the Philippines) achieved far superior economic performances and avoided any interruptions in their debt servicing.

A number of books under review here undertake critical reexaminations of Latin American economic policies and structure in attempts to determine the roots of mismanagement. Pedro-Pablo Kuczynski's *Latin American Debt* presents an excellent overview of the origins and evolution of the debt crisis, although it may be too cautious and orthodox for some tastes. He points to a number of features of the political economy of Latin America that led to the current situation. Underlying historical, geographical, cultural, and social forces contributed to economic outcomes. Kuczynski cites the existence of sizable internal markets in large Latin American countries that made outward orientation less pressing than in East Asia. The Spanish colonial legacy of granting monopolies partly explains the excessive role of the state and its reliance on patronage. Another factor was the combined experience of the Depression and World War II, which strengthened the case for an inward-looking approach to development. Also, the greater influence of U.S. culture on consumption patterns in Latin America (compared with most other developing countries) when added to the growing political power of the urban middle class increased the bias toward urban industrialism and against agriculture in Latin America, as compared with Asia. The influx of labor to urban areas along with slow employment growth in private manufacturing has resulted in "great pressure on the government to provide employment either directly or through state enterprises" (p. 16).

Kuczynski reviews Latin American performance in the 1960s and 1970s and notes a mixture of favorable and unfavorable dimensions. The negative features were an excessive bias toward industry that resulted in a neglect of agriculture and an unusually skewed distribution of income. He points out that Latin America nevertheless emerged from the 1970s with

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"healthier, longer-living, better-educated populations than twenty years earlier" (p. 27). During the 1970s, a number of stresses led to a slowdown in growth. First, increased reliance on foreign capital was not accompanied by increased efficiency of capital investment but resulted from a variety of factors like public-sector deficits and erratic monetary and exchange-rate policies. Second, protectionism became increasingly costly as the import-substitution policy was pushed too far and inefficiency resulted. Inefficiency was also exacerbated by the uncontrolled expansion of state enterprises. Third, the violent lurches of macroeconomic policies between populism and orthodoxy have hardly been conducive to stability. Fourth, nationalistic opposition to direct foreign investment led to greater reliance on bank loans for financing current-account deficits. One symptom of these cumulative stresses was capital flight, which increased sharply at the end of the 1970s.

Kuczynski devotes particular attention in *Latin American Debt* to what he regards as the excessive role of government, especially public enterprises. The underground economy has boomed in many countries in response to extremely onerous regulations. He castigates the role of state enterprise as a major contributor to public-sector deficits and external borrowing. While acknowledging that some efficient state enterprises exist, Kuczynski maintains that the majority are bloated, inefficient, and unprofitable. They continue to operate because of political pressures rather than economic efficiency. He cites a number of anecdotes to illustrate this view but produces little hard evidence, making the indictment of the size of the public sector not altogether convincing. Indeed, Sachs (1985) argued that the size of the public sector has not differed markedly between East Asia and Latin America, and consequently it may not be the size of the public sector per se but rather its efficiency and insulation from special-interest pressures that is crucial. Nonetheless, Kuczynski is surely right in suggesting that the role of the public sector in Latin America must be redirected.

Howard Wiarda's analysis of the origins of the debt crisis in *Latin America at the Crossroads* is similar to Kuczynski's, although Wiarda's style is more lively and less rigorous. Wiarda and Kuczynski differ in their assessment of the management of the debt crisis, however, as will be discussed further on. Wiarda points to the same mix of external and internal factors, and his diagnosis of Latin American policy mistakes also stresses the excessive role of the public sector. *Latin America at the Crossroads* is written in an exuberant style that manifests the author's genuine concern for Latin America, but its arguments are not always carefully reasoned and documented. Although the work was published in 1987, most of the tables present only data through 1983 or even earlier. Like Kuczynski, Wiarda favors deregulation and privatization but at a moderate pace: "Cutbacks need to be made . . . but . . . need to be prudent and

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guarded so that . . . they do not undermine and destabilize the very countries we are seeking to support" (p. 19). Wiarda sensibly calls for less ideological approaches to economic policy and expresses some optimism that such changes may be forthcoming.

In contrast to the moderate right-wing views of Kuczynski and Wiarda, two other books adopt a left-wing approach to the Latin American foreign debt: Susan George's *A Fate Worse than Debt* and Jacobo Schatan's *World Debt: Who Is to Pay?* Perhaps surprisingly, these two analysts place substantial blame on the debtors themselves, although they also fault external influences. The approaches of George and Schatan provide a welcome contrast to more orthodox ones, especially in their stress on the distributional and environmental concerns often neglected in narrower economic analyses. Unfortunately, however, both books are far too sweeping in their judgments, lack analytical rigor, and make numerous elementary errors in economic analysis. For example, George blames high U.S. interest rates on "demented" military spending, disregarding the more important roles of tax reductions and tight monetary policies. She adopts a rather extreme view of the IMF as an instrument of the major industrial countries, although she later acknowledges that the United Kingdom and Italy "at one time" had IMF stabilization programs too. Schatan refers to Latin American strategy as "export-led industrialization" while George disparages "exportomania," when most countries relied on import substitution rather than export promotion as their primary strategy. Schatan's claim that banks gain from high interest rates fails to recognize that banks profit from the spread between loan and deposit rates, not the overall level of rates. These lapses are regrettable because the fundamental message of these books, especially George's, should be taken seriously. Environmental protection in developing countries, now increasingly appreciated outside left-wing circles, is strongly stressed in both books. George makes a cogent case for altering IMF stabilization programs to give greater weight to distributional concerns, as will be discussed later.

George regards the misuse of the borrowed funds not as an accident but as the result of a fundamentally flawed model of development, the "mal-development model." In her view, this model "calls for industrialization at all costs" (p. 16) and results in corruption, "gilding of technological lilies," and environmental degradation that benefits only the elites of these countries. George argues with passion that development strategies and the adjustment to the debt crisis have engendered adverse distributional consequences, although her evidence is mostly anecdotal. She adopts the structuralist view that success in international trade is impossible for developing countries in view of depressed commodity prices and protectionism in the rich countries, but this view has been falsified by the East Asian experience, which she does not discuss.

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Schatan goes even further than George in his critique of the established order in Latin America, noting that it displays a "marked component of irrationality" (p. 44). Like those taking more orthodox approaches, he cites exchange rate and monetary policies as important factors, but he argues that the more fundamental problem is that Latin American consumption patterns are modeled on wasteful Western patterns, which meet superfluous and false needs. Much of *World Debt* is a diatribe against consumerist society, which the author contends is an underlying cause of the debt problem through its effects on spurring imports. Schatan carries out a dubious exercise purporting to show that most Latin American imports are unnecessary—they are either useless or could be produced domestically. The latter category disregards the basic principle of comparative advantage, which holds that it is preferable to import rather than to produce domestically if the real resource cost is lower. Schatan classifies imports according to their degree of intrinsic uselessness: 100 percent useless televisions and watches, 33 percent useless vehicle parts, and so on (p. 81). He may have a point in decrying the materialistic ethos inappropriate for a poor country. But this line of thinking leads him to rather totalitarian prescriptions, such as "it should not be very hard for a given community to distinguish between necessary and redundant articles" (p. 66). It seems unlikely that many Latin Americans or anyone else would wish to live in a society that decides that televisions and watches should be banned. Moreover, in this reviewer's opinion, it is not so much materialism itself but rather the extreme inequality of income and wealth that leads to the highly skewed consumption pattern that justifiably disturbs Schatan.

Developing Country Debt and the World Economy contains a number of country studies of Latin America and Asia that shed light on the quality of economic management. Each of the four Latin American cases (Mexico, Argentina, Bolivia, and Brazil) demonstrates how policies in the 1970s contributed to current difficulties. The country studies are extremely useful, although they cover developments only through 1987. The contrast between South Korea and the Latin American countries is particularly illuminating.

In a precisely argued and well-documented chapter on Mexico, Edward Buffie and Allen Sangines Krauss question some conventional views of recent Mexican economic history. It is often alleged that the structural failures of the period of "stabilizing development" of the 1950s and 1960s set the stage for Mexico's subsequent difficulties. But Buffie and Sangines show that little hard evidence can be found of low growth in employment, a worsening income distribution, and fiscal excesses during this period. They locate the roots of the current Mexican crisis instead in the policies of the administrations of Luis Echeverría and José López Portillo in the 1970s. Buffie and Sangines convincingly argue that during

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this period fiscal and monetary policies became wildly overexpansionary. These irresponsible macroeconomic policies, combined with controlled interest rates and a fixed exchange rate, led to capital flight. The 1976 stabilization was abandoned because the oil boom was accompanied by a near complete relaxation of fiscal control. Despite "the exceptional opportunity to embark on an era of high and stable growth" afforded by the oil wealth, "Mexico obtained remarkably little for the $59.7 billion of debt taken out during the López Portillo years" (p. 155). Buffie and Sangines go on to argue that the import-compression policies followed by the administration of Miguel de la Madrid in the 1980s have been too draconian in view of the essential role in production of imports of capital and intermediate goods.

Rudiger Dornbusch and Juan Carlos de Pablo demonstrate that in Argentina too, "domestic events were the dominant factor," although adverse external forces were certainly important (p. 44). In particular, the disastrous policies pursued under José Alfredo Martínez de Hoz in the 1970s represented a continuation of the swings between populist and orthodox extremes that have characterized Argentine economic history. The results of these perennial conflicts have been slow growth, inflation fed by fiscal deficits, and exchange-rate instability. Especially significant in the late 1970s was the overvaluation of the exchange rate, induced in an attempt to force down inflation. The overvaluation was particularly insidious in that the initial effects were quite benign, raising real incomes while lowering inflation, but the ultimate effects were capital flight and financial collapse. The legacy of mismanagement in Argentina leaves the country with difficult choices between debt servicing, domestic investment, and consumption. It is impossible to sustain all three, according to Dornbusch and de Pablo. So far, investment has been squeezed. Unfortunately, debt relief may not be enough to ensure recovery because a fundamental reordering of economic policy is necessary.

Juan Antonio Morales's and Jeffrey Sachs's study of Bolivia searches for the underlying political structures that have led to economic distortions. Like Argentina, Bolivia has a long history of political instability and conflict. For various historical reasons, the state came to play a central role in Bolivian economic development, but the conflicts between social groups and the weak capacities of the government have led to inconsistent economic policies. In particular, the government has sought to evade conflicts over the distribution of income through fiscal and monetary expansion, resulting in high inflation. Efficiency has been the victim of "deep politicization of almost all instruments of economic policy" (p. 65). The most recent example was the boom in the 1970s fueled by foreign borrowing, which exacerbated the underlying weaknesses by relaxing fiscal constraints and increasing inequality. When capital inflows abruptly stopped, Bolivia resorted to increasing the money supply to finance the

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fiscal deficit, resulting in a vicious circle of rising inflation and declining real tax revenues. The hyperinflation was halted in 1985 by a stabilization policy, which Morales and Sachs praise for combining orthodox fiscal restraint and price liberalization with heterodox debt relief.[7] In their view, longer-term structural adjustments remain the crucial requisite for sustained growth: the role of the state must be redirected toward reducing income inequality through higher taxes on the rich and greater public spending on rural development, while allowing a greater role for market forces in allocating resources.

Brazil's main error in the 1970s was excessively expansionary policies in the face of adverse external circumstances, according to Eliana Cardoso and Albert Fishlow. The availability of foreign finance allowed Brazil to maintain high growth, although at the cost of a sharply increasing foreign debt. Although capital inflows financed investment rather than consumption, reliance on foreign debt had placed Brazil in a precarious position by the time the second oil shock hit. The subsequent failure of the Cruzado Plan can also be ascribed to excessive stimulus of domestic demand, as will be discussed further on. Regrettably, the model of external debt, budget deficits, and inflation in this chapter is too abbreviated to be comprehensible.

As Susan Collins and Won-Am Park show in their chapter on South Korea in *Developing Country Debt and the World Economy,* the textbook argument for debt accumulation to finance investment and adjustment can be valid. South Korea's ratio of foreign debt to GNP in the early 1980s was comparable to those of Brazil and Mexico, and yet by the second half of the 1980s, Korea succeeded in combining a rapidly growing economy with reductions in its external debt through current-account surpluses, which were achieved through astonishing export growth. While the sources of Korea's successes in the 1980s are still being debated, they do show that at least part of the Latin American failures are internal in that Korea and Latin America faced similar external environments. Government intervention was heavy, but unlike that in Latin America, Korean policymakers focused on long-term efficiency and growth. The crucial difference between Korea and many of the Latin American debtors seems to be the effectiveness of policy rather than the size of government.

The World Economy

Virtually all the authors of the books reviewed here agree that the world economy has played a destabilizing role and contributed to the severity of the debt problem, although they sometimes differ considerably

7. Sachs was an advisor to the Bolivian government and helped to design the stabilization program.

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in the importance they attach to external shocks and the ways in which these shocks were transmitted to developing countries. Kuczynski refers to the "two blades of the financial scissors"—falling commodity prices and rising foreign interest rates—which cut deeply into the Latin American balance of payments (p. 73).

Little doubt exists that high real interest rates in the 1980s dealt a major unanticipated blow to Latin American countries with a large volume of floating interest-rate debt. The deleterious effect of high real interest rates is Tim Congdon's major theme in *The Debt Threat*. He takes an alarmist view of the growth of indebtedness, attempting to dramatize what he regards as an extremely dangerous situation. Congdon argues that high real interest rates are causing unsustainable debt problems throughout the world for the U.S. government, the private sector, and the developing countries. His argument is that ratio of debt to GNP grows unsustainably if the real interest rate exceeds the growth rate of real GNP. With currently high real interest rates, therefore, debts are set to grow unsustainably. High real interest rates are due in turn to fiscal profligacy, according to Congdon, who muses nostalgically about the "old-time fiscal religion" of balanced budgets. He vitriolically attacks the "voodoo economics" of Keynes and Reagan, whom he lumps together as apostles of fiscal irresponsibility. In his zeal against fiscal deficits, Congdon fails to emphasize sufficiently other important causes of high real interest rates, especially the tight monetary policies pursued in the United States and elsewhere. He also fails to recognize that the Reagan fiscal expansion played a constructive role in ending the world recession of the early 1980s. Congdon advocates budget surpluses—even for West Germany and Japan, with their large trade surpluses. In short, he seems to have overstated the adverse effects of budget deficits and the benefits of surpluses at all times. It is nevertheless true that the mix of tight monetary policy and expansionary fiscal policy in the United States has created many negative consequences for the United States as well as for Latin American debtors, whose debts are mostly dollar-denominated at floating interest rates. Congdon's chapters on Latin American debt are often insightful but somewhat rambling, and they do not strongly support his main thesis that high real interest rates are the sole root of the problem.

What conclusions emerge from these various interpretations of the origins of the debt crisis? While the emphasis can be debated, it would be hard to disagree with Silva Herzog that "We were all responsible" (in *Latin America's Debt Crisis*, p. 33). Furthermore, the interactions of the three forces considered—the excessive magnitude and systemic dangers of bank loans, the structural weaknesses and policy blunders in Latin America, and the instability of the world economy—added up to more than the sum of the parts and contributed to the disastrous outcomes. The country studies in *Developing Country Debt and the World Economy*, however, con-

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stitute persuasive evidence that the dominant factor was internal mismanagement in Latin America. The banks were undeniably imprudent, and the instability of the world economy increased the riskiness of foreign indebtedness, but the availability of bank credit represented an opportunity for development that was misused in Latin America.

THE BURDEN OF ADJUSTMENT

Unlike the experience of the 1930s, outright defaults have mostly been avoided in the "cooperative" strategy engineered by the International Monetary Fund and the U.S. government. The cooperative approach has been predicated on a combination of austerity in the debtor countries, new loans from commercial banks and international agencies, and a stable world economy. Many of the studies reviewed here praise these efforts in forestalling a financial collapse. But increased attention has been devoted to what almost all authors regard as highly unbalanced outcomes. The uneven burden has two components: first, between debtor and creditor countries, and second, among social groups within the debtors. The distribution between creditors and debtors has been inequitable in that the debtors have suffered sharp declines in standards of living in the process of achieving the substantial trade surpluses that have enabled them to continue paying most of the interest due on their debts with little net new lending. Although it is wrong to argue that banks have actually profited from the crisis in that their equity prices have been very depressed relative to those of other corporations, until recently banks have been unwilling to grant either net new loans or debt relief, with the result being that actual earnings have remained high. It is widely asserted that the poor in the debtor countries have suffered far more from austerity than the elites. While a near consensus exists that the distribution of burdens was unbalanced in these senses, substantial disagreement remains as to the interpretations of these outcomes.

Interpretations of the Official Strategies

Kuczynski again takes a rather orthodox view in arguing that the initial policies of "devalue, deflate, and deregulate," which were promoted by the IMF and the Reagan administration, were inevitable and appropriate because they were the only way for the debtors to restore equilibrium quickly to the balance of payments. He recognizes, however, that the cost to the debtors has been steep in terms of output, investment, and standard of living. Part of the problem has been the unwillingness of the banks to extend new loans. Kuczynski also ascribes the stabilization policies' failure to restore growth to three sources: the difficulties of curbing public-sector deficits when debt-servicing costs escalated due to

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interest-rate increases and devaluation, the ability of state enterprises to escape controls, and the "stagflationary" effects of devaluation and price deregulation.

Knud Erik Svendsen is more critical of the creditor countries' approach to Latin American debt in *The Failure of the International Debt Strategy.* Like most others, he recognizes the achievement of preventing a collapse of the international banking system, but he argues that this outcome could have been obtained in ways less detrimental to the debtor countries, although he does not spell out these alternatives. Svendsen maintains that the "muddling through" strategy promoted by the Reagan administration is a misnomer because it was actually a coherent strategy, albeit a misguided one. He argues that the dominant perspective during the first few years of the crisis was to regard the problem as a temporary liquidity crisis in which the creditworthiness of the debtors could be restored through a combination of recovery in the developed countries, austerity in the debtors, and concerted lending. Svendsen sharply criticizes the dominance of right-wing ideology in shaping the policies of the IMF, which in turn reflects the influence of the United States. He contends that given the state of the world economy and the recessions in the debtor countries, the IMF should have adopted a more flexible approach (also unspecified). He argues further that the IMF is poorly placed to deal with long-term structural difficulties. It is not completely clear from Svendsen's brief analysis, however, whether he regards the misguided debt strategy as a good-faith error or a deliberate attempt to extract resources from the debtors.

Svendsen makes the interesting argument that the Nordic countries of Europe, with their tradition of concern for developing countries, should have come forth with alternatives to the orthodox strategy. Although he discusses the experience of Scandinavian aid to Tanzania, the upshot of his argument remains unclear. He concludes by urging new approaches but is vague here too.

Wiarda is also critical of the management of the crisis, although for a different reason. He argues that the current situation is an impossible one: debtors are unable to repay, but it is in everyone's interest to maintain the illusion that the situation is "manageable." Hence Wiarda regards all efforts to avert default as a form of successful obfuscation, "one of the great 'smoke and mirrors' operations of all time" (p. 30). Wiarda's view that debt relief would have to be part of the solution in the long run has proven to be prescient. He correctly anticipated in 1985–86 that the banks and taxpayers would be called on to pay for debt relief in the next few years. Wiarda's cynical evaluation of the international strategy, however, seems exaggerated. William Cline (1983) and Paul Krugman (1985) have demonstrated a theoretical rationale for a combination of concerted lending with debtor-country adjustments. The essence of their arguments is

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that new loans take on the character of a public good during a debt crisis because each creditor in isolation prefers to reduce exposure but an attempt by all creditors to do so is likely to force an illiquid debtor into complete default. Here Wiarda, along with many other non-economists and even some economists, errs in assuming that inability to repay a debt fully is the same as insolvency. Ongoing concerns like the U.S. government and private corporations are not expected to "repay" but merely to service their debts in a timely fashion. In fact, it can be argued that part of the problem is that in view of the large resource transfers creditors have received in recent years, the debtors have in effect been servicing their debts too rapidly rather than too slowly. Later in *Latin America at the Crossroads*, Wiarda seems to modify his analysis by acknowledging that "a great deal can be said in favor of such a pragmatic, largely ad hoc way of dealing with the crisis" (p. 92).

George presents a vehement radical critique of the debt strategy, but without the usual opaque Marxist jargon. She candidly acknowledges that "when I started doing research on the debt crisis, I was prepared to assign the role of global ogre to the IMF" (p. 47). She emerged with a more sophisticated view of the IMF as a less powerful organization than she initially assumed. George argues nonetheless that the IMF acts as an agent for governments and banks in the rich countries and elites in the developing countries. She decries the shortsightedness of the stabilization policies from distributional and developmental points of view, arguing that cuts in subsidies for basic necessities lead to deterioration of human capital and undermine economic potential in the long run. The IMF's response that it is neutral vis-à-vis the distributional and social consequences of stabilization policies is, in her view, "politely put, rubbish" (p. 53). George argues persuasively that the fundamental inequities involved originate with political power. Elites with accounts in foreign banks who have benefited enormously from the foreign debt accumulation are not sharing the burden of adjustment, while the poor are shouldering an unfair portion. International cooperation would make it possible to identify much of the capital flight and tax evasion that has taken place, and the failure of the international community to do so reflects the power of the elites in both North and South in protecting their interests. Unfortunately, George has not fully documented her assertions about the increasing inequality and poverty that have resulted from the management of the debt crisis, although her view is widely shared and plausible. Such a task is admittedly difficult in view of the paucity of data. The strength of *A Fate Worse Than Debt* comes from the genuine moral indignation that George conveys and her lively personal style, even though the work is weakened by lack of rigor in its arguments.[8]

8. For a more rigorous radical critique of the IMF, see Pastor (1987).

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Several chapters of *Developing Country Debt and the World Economy* assess the period from 1982 to 1987. Sebastián Edwards maintains that structural adjustment in the debtor countries was not nearly as orthodox as is commonly alleged. Citing evidence for 1986, he contends that the trade surpluses have been smaller than net interest payments, indicating that capital flows have remained substantial. Furthermore, according to Edwards, economic adjustment has often "been inflationary with high and persistent fiscal deficits, and with increasingly distorted external sectors" (p. 253), hardly what a strict monetarist would recommend. It could be argued in response that inflation and the fiscal deficits are partially the consequence of devaluations and liberalizations, which have had stagflationary effects, rather than the result of lax macroeconomic policies. Edwards advocates a gradual trade liberalization as the centerpiece of long-term structural adjustment. He stresses that credibility is essential to the success of such a program. Paul Krugman's chapter observes that "to a first approximation the debtors have made resource transfers equal to interest less official inflows," so that "debtors have been forced to run massive trade surpluses" (p. 285). Disagreement with Edwards on this point comes from the fact that Edwards cites data for 1986, when the trade surplus was unusually small relative to interest payments. Krugman reviews the argument for defensive lending mentioned above and asks why bank lending has been so small. He concludes that the most plausible answer is that banks were able to shift almost the entire burden of adjustment onto debtors. This conclusion raises the question of why banks were able to achieve such successful bargains, one that will be addressed further on. Finally, Dornbusch's chapter in *Developing Country Debt* examines the behavior of the world economy between 1982 and 1987 in terms of its effect on debtor countries. While world output growth has recovered well, commodity prices have not fully recovered in real terms, and real interest rates have remained high. In summary, these features of the world economy as well as the low level of capital inflows into debtor countries have resulted in a rather unfavorable setting for the resumption of growth in Latin America.

Effects of Austerity

In view of the declines in per capita income in Latin America and the widespread opinion that the poor have borne the brunt of this decline, it would be useful to have more complete information on the effects of austerity on the welfare of Latin Americans. William Canak aims to fill this void with *Lost Promises: Debt, Development, and Austerity in Latin America,* which includes contributions from disciplines ranging from sociology, political science, and economics to geography. Unfortunately, few of the contributions provide detailed evidence or careful analysis. Two

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interesting articles on the politics of heterodox stabilization policies will be discussed in the following section. The article by Ralph Hakkert and Franklin Goza on the demographic consequences of austerity is carefully substantiated. They point out that many of the alleged effects of the debt crisis on mortality are not supported by hard evidence for the countries they examine. They nonetheless conclude that some adjustments are likely to have adverse long-term consequences, such as children dropping out of school. Alejandro Rofman argues sensibly that regional development strategies will have to be scaled down in view of the shortage of capital and the failure of past capital-intensive approaches. Other articles are less persuasively argued, provide little concrete information on the effects of austerity, or have no bearing on the central theme of *Lost Promises*. Given the paucity of hard information, generalizations about the adverse effects of austerity are difficult to assess.

POLITICAL ECONOMY

The origins of the current economic crisis in Latin America lie to a large extent in the mismanagement of domestic economic policies in the period leading up to the crisis, as discussed. This conclusion raises the question of why so many countries erred so grievously. As seen in the previous section, the severity and length of the downturn have resulted from unequal sharing between creditors and debtors of the burden of adjustment to the debt crisis, a situation that Biggs has shown to be historically unprecedented. But why were debtors so compliant? It has been increasingly recognized, even by economists, that the interaction between politics and economics is central to understanding both the bargaining between debtors and creditors and the choice of economic policies by Latin American governments.

Negotiations between Creditors and Debtors

The highly unequal distribution of the burden of adjustment is difficult to understand on the basis of economic considerations alone. Why have the Latin American debtors been willing to run large trade surpluses in order to continue paying most of the interest on their debts without any sign of a resumption of voluntary lending by the banks or increased foreign aid from the Organization for Economic Cooperation and Development. Economic theories of optimal default as well as the historical precedents would seem to suggest that countries should either strike a better bargain or engage in unilateral actions along the lines of Peru's limiting debt service to 10 percent of exports. Why have the debtors been so compliant and failed to form a united debtors' cartel to strengthen their negotiating stance?

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Managing World Debt, edited by Stephany Griffith-Jones, attempts to answer these questions by using applied bargaining theory. This volume contains two types of contributions: country studies as well as overviews of the analytical foundations and empirical findings. This collection is another example of an excellent idea with flawed execution. The concept of bargaining seems a fruitful one, as laid out in Griffith-Jones's introductory chapter, and some important insights emerge. For example, Griffith-Jones argues that creditors were able to outmaneuver debtors by taking the initiative in making proposals and establishing precedents in their favor. Unfortunately, the analytical chapters that follow are somewhat vague, and most of the country studies do not provide the type of information and analysis needed to employ the bargaining approach. As Carlos Fortin observes in his overview chapter, the country studies "do not go into the pressure group and public opinion politics surrounding the negotiations" (p. 326). Instead, many of the country studies provide general information that does not bear directly on the negotiations. Exceptions to this generalization are Angel Gurria Trevino's detailed chronology and analysis of the Mexican negotiations and Ricardo Ffrench-Davis's informative discussion of the Chilean case. Other country studies on Peru, Costa Rica, and Venezuela are not clearly written and argued, perhaps because English is not the authors' native language. For example, one encounters confusing sentences such as "Public investment [in Peru] totalled 9 percent in the 1981–84 period" (p. 173). Did investment grow 9 percent over this period, annually or cumulatively, or did it average 9 percent of GNP? One finds numerous typographical and editing errors throughout the volume, and a crucial table is missing from Ffrench-Davis's chapter, in which Table 4.7 has been replaced by Table 4.5 (p. 123).

In view of the weaknesses of the country studies, the empirical underpinning of this project, it is not surprising that the overview chapters are rather short on specifics. Diana Tussie's chapter on the important question of coordination among the debtor countries argues that cooperation has increased over time since the Cartagena summit in 1984. Despite the lack of concrete actions, she maintains that Cartagena has served "to coordinate bargaining tactics for mutually reinforcing effects. As such, its credibility is intact" (p. 305). Yet little evidence is offered for this optimistic conclusion (from the debtors' viewpoint), and subsequent events have not indicated any trend toward cooperation among debtors, although Tussie may be right in arguing that the threat of debtor cooperation has spurred creditors to make concessions. Griffith-Jones's conclusion provides additional interesting insights. She argues that the stronger financial position of banks may tip the balance of power toward the debtors in subsequent negotiations because the banks can no longer credibly cite their precarious situation as a basis for further concessions

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from the debtors. Griffith-Jones advocates tougher bargaining by debtors, including unilateral actions, but she cautions against radical rhetoric because international financial markets respond to perceptions as much as reality. She also makes some implausible judgments, such as arguing that debtors were compliant because they were afraid of destabilizing the international banking system, rather than because they feared retaliation. The trouble with these opinions is that they are not grounded in either theoretical analysis or empirical observation.

Managing World Debt does lead to some understanding of bargaining outcomes. Kuczynski provides additional insights. He points out that the costs of default were perceived as large by newly democratic countries seeking to establish their legitimacy through responsible behavior. It may be that middle-class Latin American citizens view default as a sign of backwardness. The outspoken stances taken by Alan García and Fidel Castro in favor of unilateral actions by the debtors may actually have backfired by turning more moderate governments toward cooperation. Silva Herzog suggests in *Latin America's Debt Crisis* that one reason for the continued debt servicing in such dire circumstances is simply that debtor governments felt morally obliged to do so and made great efforts to act responsibly to establish their legitimacy, even though economic self-interest would have dictated a less cooperative approach. Díaz Alejandro (1984) argued several years ago that the internal politics of debtor countries are an important part of the story and suggested that individual policymakers, not abstract "countries," make decisions about whether to service foreign debts. He also pointed out that many of these policymakers have much to lose from default in that they and their friends are the ones with large accounts in foreign banks.

Political Regimes and Economic Policies

The links between economic policy and political regimes run in both directions. Authors like Sachs (1985) have sought political explanations for the divergent economic courses pursued by various countries, notably in Latin America and East Asia. Others have focused on the effects of economic outcomes on political choices. In this regard, it is often argued that continuing economic difficulties in Latin America threaten democracy. Wiarda, for example, states that "the transition toward expanded democracy that we have recently seen in Latin America is almost certain to be halted or reversed" (p. 59).

Both directions of the relationship between politics and economics are investigated in depth in *Debt and Democracy in Latin America,* edited by Barbara Stallings and Robert Kaufman. This coherent volume contains many excellent individual contributions. What emerges from these studies is a complex relationship between the debt crisis and political change.

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Debt and Democracy is divided into four subsections: overview, key actors, country studies, and conclusions. The highlight of the overview section is a fascinating article by Paul Drake, comparing the political-economic interactions in the 1920s–1930s with those in the 1970s–1980s, which complements the books by Maddison and Stallings already reviewed. In both periods, economic shocks were associated with profound political upheavals. In the 1930s, however, a general shift occurred from democracies to dictatorships, whereas the 1980s have witnessed a move in the opposite direction. Many interesting features of the earlier period are brought out in Drake's informative essay, such as the roles of the U.S. government and Professor E. W. Kemmerer of Princeton University, "a sort of one-man IMF." Drake speculates that the relative longevity of democracies in the 1980s may reflect their greater legitimacy and flexibility. The chapters by Dornbusch and Jeffry Frieden also offer interesting perspectives. Dornbusch advocates forced reinvestment of external interest payments in the debtor countries because he views the problem for major debtors like Argentina as a "short-run inability . . . to pay, not a basic insolvency" (p. 21). In his view, the crisis has been aggravated by creditors' insistence on excessive resource transfers. Unfortunately, the argument that debtors are illiquid rather than insolvent is not adequately substantiated here. Frieden argues that a major factor in determining the political behavior of agents is whether their assets are liquid or fixed. Those with liquid assets are able to exit the domestic political scene under adverse conditions and tend to favor conciliation with foreign creditors.

The section of *Debt and Democracy* on major actors deals with U.S. policy (by Riordan Roett), national business (Sylvia Maxfield), and organized labor (Ian Roxborough). Roett provides a knowledgeable overview of U.S. policy but is sometimes unduly rhetorical in his repeated assertions that the debt is an important political issue for the United States. Maxfield argues that the financial boom spurred by access to international markets led to segmentation and distortions in domestic financial markets, with large firms enjoying preferential access at the expense of smaller firms. Private investment has suffered from the financial boom and bust. Roxborough presents data on real wages and unemployment. He stresses the decline in real wages, but his figures actually show a rather mixed pattern, with real wages above their 1980 levels for Argentina, Brazil, Colombia, and Uruguay and sharp declines in other cases, notably Mexico. Roxborough scrutinizes labor policies in Brazil, Argentina, and Mexico. While Mexico has followed a fairly consistent orthodox policy of austerity, Brazil and Argentina have changed policies frequently in response to political pressures.

Perhaps the strongest part of *Debt and Democracy* is the group of country studies, which cover Mexico, Brazil, Costa Rica, Peru, and Chile. Particularly interesting are Kaufman's study of Mexico, Joan Nelson's

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study of Costa Rica, and Carol Wise's chapter on Peru. Kaufman interprets the recent history of Mexican policies as political choices between heterodoxy and orthodoxy and points out the flaws in both, although he seems to lean toward more heterodox strategies. The de la Madrid administration has stuck consistently to an orthodox approach of deflation and liberalization, despite terrible costs and without any seeming benefits in restored creditworthiness. Kaufman contends that this choice was not based on rational economic logic but was conditioned by political forces, notably the influence of Mexican right-wing business. He calls for "significant changes in conventional economic wisdom" (p. 124). Nelson's analysis of Costa Rica elucidates the strengths and weaknesses of democracy in carrying out effective economic policies. She shows how a regime with political legitimacy (the Luis Alberto Monge administration in 1982) was able to carry out effective stabilization policies of fiscal contraction and devaluation but in a way that cushioned the effect on the weakest elements of society. Longer-term structural reforms, however, are more intractable politically in a democracy because they require more time and tend to be gradually undermined by special-interest groups. Wise's study of Peru demonstrates with depressing effectiveness that the scope for government policy is very limited in a situation marked by "backwardness within the government bureaucracy, enshrouded in personalistic politics and petty patronage . . . [to a degree] unusual even in Latin America" (p. 165).

In their concluding chapter, Kaufman and Stallings attempt to synthesize the country studies by distinguishing three types of regimes: authoritarian regimes, established democracies, and transitional democracies. Authoritarian regimes can enforce tough austerity without responding to popular suffering and pressure. Established democracies, such as Costa Rica, have the flexibility to pursue more mixed strategies that can combine orthodox fiscal restraint with heterodox concern for income distribution. Transitional democracies tend to adopt the weakest and most inconsistent economic policies, reflecting their lack of political legitimacy. The results are often shortsighted populist policies that result in external payments crises and explosive inflation. While Kaufman and Stallings's generalizations are plausible, they cannot be taken as conclusive because of the small sample of countries and the complexity of each individual country's experience, which is richly documented in this volume.[9] Kaufman and Stallings also reiterate Drake's conclusion that democracy may prove to be more resilient in the face of adverse economic circumstances than many analysts seem to believe.

9. Remmer (1986) cautions against overemphasizing the regime variable when analyzing the effectiveness of stabilization policies.

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Inflation, Orthodoxy, and Heterodoxy

As discussed above, political pressures surrounding the distribution of income in Latin America lead to persistent fiscal deficits, often financed by money creation, resulting in chronic inflation or even hyperinflation. Populist excesses are then followed by extreme retrenchment of fiscal and monetary policies. It is well known that orthodox policies of demand contraction have been successful in improving external balance but that reduction of inflation has been painfully slow even under conditions of severe recession.[10] The declines in output and employment associated with orthodoxy have given rise to the search for alternative ways of controlling inflation while avoiding recession. Two imaginative alternatives that initially appeared quite promising were the Plan Austral in Argentina and the Plan Cruzado in Brazil.

Heterodox stabilization policies involve an attempt to influence expectations and contracts directly instead of through contractionary pressure. Two chapters in *Debt, Austerity, and Development,* those of William Smith on Argentina and Brazil and Paul Singer on Brazil, provide excellent discussions of the experiments with heterodoxy in Brazil and Argentina. Despite promising beginnings, the experience of the Austral and Cruzado plans turned out to be little short of disastrous. Repeated failures have undermined credibility further. As Smith comments, "Argentina 5, Brazil 3. Unfortunately, this score is not the outcome of a soccer game between two traditional rivals, but the number of heterodox shocks each country has experienced, as of early 1988, since returning to democracy" (p. 155).

Smith and Singer both point to the underlying political conflicts to explain the failures of both orthodoxy and heterodoxy. Smith views the basic stabilization problem as a prisoner's dilemma between labor and capital. Because each group has an incentive to free ride on the other's concessions, the result tends to be noncooperative. Singer stresses the dependence of all parties in Latin America on assistance from the government—to the point that the state becomes dependent on patronage for support. Both authors emphasize the role of indexation and contracts in making inflation difficult to eradicate. Indexation accounts for the failure of orthodox deflation by perpetuating inflation automatically, regardless of the amount of slack in the labor and goods markets. Heterodoxy therefore appears to be a sensible alternative. It involves breaking inflationary expectations and inertia by abolishing indexation through a currency reform and through more controversial wage and price controls. Most economists recognize, however, that fiscal and monetary restraint to keep aggregate demand under control are also necessary to prevent new

10. See, for example, Díaz Alejandro (1981) and Kiguel and Liviatan (1988).

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inflationary pressures, given that fiscal deficits are often the underlying cause of inflation. The initial successes of the Austral and Cruzado plans along with irresponsible behavior of the policymakers led to dismal failures. The administrations of Raúl Alfonsín and José Sarney both failed to follow through with demand restraint after the inflationary spiral was broken. With public-sector deficits still out of control, a resurgence in inflation was inevitable. As Singer notes, "political authorities viewed the heterodox shock as a sort of magic . . . and concluded that the shock freed them from the constraints imposed by high inflation" (p. 44). Smith adds that policymakers need to "parlay the initial euphoria . . . into measures such as exchange reforms, elimination of public sector 'sacred cows,' and progressive taxation" (p. 156). The failures of the Alfonsín and Sarney administrations to take a longer perspective during the initial periods represent tragic errors. Were those errors avoidable? Smith and Singer seem to suggest that the failures were inevitable given the political pressures brought to bear on governments in the polarized Latin American environment. They argue for more democratic and open negotiations in which various interest groups can bargain and agree to support the program. It can also be plausibly argued, however, that the failures result from simple incompetence on the part of the new governments: in the aftermath of elections and reductions of inflation, when their popularity was high and the public was willing to make sacrifices in the national interest, Alfonsín and Sarney could have initiated some longer-term structural reforms while restraining growth of domestic demand.[11]

NEW DIRECTIONS

Virtually all the studies reviewed here make recommendations for reform. Proposals for change focus on three dimensions: macroeconomic and trade policy in the creditor countries, reforms in the debtor countries, and financial initiatives such as debt relief and ways of resuming capital flows from creditors to debtors. These proposals are interdependent. For example, reform in the debtor countries can be facilitated by creating a supportive environment of global macroeconomic stability and reducing the burden of debt-servicing. Furthermore, new capital flows are more likely to materialize if debtors do undertake serious reforms. To a large extent, the proposals can be inferred from the earlier discussion, and in such cases, I will not repeat my analysis. Following a brief discussion of other policy reforms, this section will emphasize new financial initiatives.

A near consensus holds that macroeconomic policies in the developed countries should become more stable and should endeavor to lower

11. Nelson (1984) argues that new governments initially enjoy a grace period when the public will rally behind them.

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real interest rates through altering the mix between fiscal and monetary policies while maintaining a high rate of output growth. Protectionist pressures against manufactured exports of developing countries hinder their diversification of exports and must be contained. It would also be desirable to improve the terms of trade for the debtors, which means higher real commodity prices. Some commentators, such as Larry Sjaastad in *Foreign, Investment, Debt, and Growth* (yet to be reviewed) and Fred Bergsten in *Latin America's Debt Crisis,* have pointed to the appreciation of the U.S. dollar as the source of commodity price deflation in the first half of the 1980s. This view, however, has been falsified by the failure of most commodity prices to rise commensurately with the subsequent sharp depreciation of the dollar. Currency stability may matter nonetheless in facilitating steady growth and open markets in the developed countries, factors that are crucial for the export prospects of the developing countries.

There is also agreement that debtor countries need to improve macroeconomic performance, although here the nature of the policy errors and hence the requisite adjustments are more controversial, as has already been discussed. The role of conditionality in spurring these reforms is also contested. Analysts with conservative points of view emphasize the importance of liberalizing and reducing the size of the public sector (Kuczynski, Wiarda, and Guttman), although moderate proponents favor a gradual approach, as has been shown. This view coincides with IMF and World Bank notions of structural adjustment embodied first in the Baker Plan and now in the Brady Plan. Participation in these plans has been made contingent on adopting market-oriented reforms like those pursued by Mexico.

Senator Bradley, in *Latin America's Debt Crisis,* launches a scathing attack on the Baker Plan, calling it a "kind of supply-side imperialism" based on right-wing ideology rather than economic logic. Bradley proposes instead to give the debtors more leeway in formulating their own policies of structural adjustment. This view is echoed by Fishlow in the same volume. In his opinion, the Baker Plan assumes that Latin American governments "will follow the right policies only under external tutelage and [on] a short leash" (p. 105). Fishlow dismisses the view that Latin American nations are a bunch of "basket cases" incapable of intelligent behavior. He also argues that the new democracies must learn for themselves how to conduct rational economic policies. In his view, which is amply supported by Carlos Díaz Alejandro (1981), Alejandro Foxley (1983), and John Sheahan (1987), extreme free-market orthodoxy has created highly negative consequences in Latin America, notably in the Southern Cone, fostering both inequality and poor growth. According to Fishlow, long-run reforms should include four features: a better balance between private and public sectors, a reversal of the bias toward open capital markets and closed trade, an eclectic combination of import sub-

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stitution and export promotion in trade policy, and a frontal attack on inequality.

George favors a radical sort of conditionality, under which debt relief would be granted in return for democratic and egalitarian reforms arrived at through more decentralized negotiations.[12] She presents a collection of possible reimbursements "in kind," such as improving health and education for the poor, reforesting, and developing alternative energy sources (pp. 242–43). George's conditionality would be highly intrusive, however, perhaps even more so than the orthodox variety, which she recognizes as necessary for altering long-standing distortions and entrenched interests. While George's ideas may seem hopelessly utopian, they have the merit of awakening readers to the reality that the many features of conditionality embodied in IMF orthodoxy and the Baker and Brady plans have distributional and political biases that can be legitimately questioned.

I turn now to examining new financial initiatives that aim to relieve the stresses on the debtor countries. Unfortunately, many of the discussions of financial initiatives have become somewhat dated, given the rapid progression of events—particularly the Brady Plan, which was put forth after all of these books were written. Nonetheless, the situation is still fluid, and many questions about the Brady Plan still remain unresolved, making it well worth examining alternative views. As was discussed in the section on the burden of adjustment, the books reviewed here agree that the magnitude of the net resource transfer from Latin America to its creditors is excessive and unsustainable. The resource transfer can be reduced through either new capital flows or lower debt service. Most authors view the resumption of large-scale bank lending as highly unlikely in the foreseeable future. Hence the focus has increasingly shifted to direct investment and official lending, which will be examined subsequently. In the short run, however, increased inflows of direct investment and official lending cannot be expected to affect the balance of payments appreciably, and as a result, reductions in debt servicing have come to the forefront of the debate.

Debt-Relief: Voluntary or Comprehensive?

A number of writers argue strongly against comprehensive approaches in which debt relief is carried out by a supranational agency that purchases debt at a discount, along the lines originally suggested by Felix Rohatyn and Peter Kenen in the early 1980s. John Williamson, in *Voluntary Approaches to Debt Relief,* agrees that a case can be made for debt relief but

12. Most of George's discussion of "creative reimbursement" refers to Africa, but she goes on to argue that it is relevant for Latin America too.

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contends that comprehensive approaches pose a number of serious difficulties: it will be difficult to induce banks to participate because each individual bank will seek to obtain a free ride on the debt reduction of other banks; any agency will face difficult decisions about which countries' debt to buy at what price; such a strategy smacks of moral hazard and inequity because scarce public funds would be used to bail out countries suffering from their own mismanagement; and in any case, a Marshall Plan for Latin America is simply not realistic politics. Williamson argues nevertheless that voluntary debt relief is both feasible and desirable, even for creditors. Debt relief is desirable because of the inefficiencies caused by the debt overhang (the "debt-relief Laffer curve" effect, coined by Krugman), whereby large debt-servicing requirements act like a tax on sound economic policies in that creditors rather than the debtor reap most of the benefits from improved economic performance. Furthermore, voluntary debt relief allows various debtors and creditors to express their expectations about the market value of the debt and is thus more efficient than having a supranational agency impose its valuation arbitrarily on all market participants. Williamson recognizes that some economists have shown that buybacks are undesirable under some conditions, but he dismisses this finding as unimportant in practice.

Williamson goes on to describe the pros and cons of particular types of market-based debt reduction, including buybacks, exit bonds, and swaps. Unfortunately, this discussion is too cursory. A nonspecialist seeking a clear introduction to these arcane financial transactions will be disappointed, while specialists will wish for a more in-depth theoretical and empirical analysis of these instruments. For example, only two pages of *Voluntary Approaches to Debt Relief* are devoted to debt-equity swaps. Williamson concludes on the basis of simulations that voluntary debt relief can be beneficial but may be insufficient to dent resource transfers sufficiently, in which case he advocates increased official lending or capitalization of interest.

Guttman and Kuczynski arrive at broadly similar assessments. In *Between Bailout and Breakdown*, Guttman stresses the same basic trade-off that Williamson discusses: debt relief is a public good, but it poses problems of moral hazard and inequity. Like Williamson, he favors a variety of small voluntary initiatives. Guttman's lucid and comprehensive discussion presents a long catalogue of initiatives for multilateral organizations, private financial institutions, creditor governments, and debtor governments, but it provides little detailed analysis and evaluation. Kuczynski advocates interest deferral but not forgiveness, as well as increased lending by multilateral agencies. He stresses the last approach as a way of relieving the stresses on debtors with "minimum funds from the taxpayer" (p. 196), and he favors large increases in disbursements and callable capital for multilateral development banks. Kuczynski maintains

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that the costs to taxpayers are likely to be minimal in view of the low default rates on previous loans from these agencies, but this view can be questioned, given the increasingly serious problems of arrears at both the World Bank and the IMF.

In *New Approaches to the Latin American Debt Crisis,* Jeffrey Sachs provides a powerful argument for comprehensive approaches and points out some flaws in the case for relying on market forces and official lending. Against those who advocate increased official lending, he points out that this approach is effectively a disguised subsidy from taxpayers to commercial banks. As noted above, banks have extended few net new loans and have even succeeded in lowering their exposure in real terms while continuing to receive most of the interest payments due. Under these circumstances, increased lending by official institutions amounts to a bailout of the banks because the official loans simply get recycled to the banks. It is therefore inconsistent to oppose the use of public funds to abet debt reduction on the grounds that taxpayers should not or will not come up with the money while advocating increased official lending, as Williamson, Guttman, and Kuczynski do. Sachs also counters the equity and moral hazard arguments against comprehensive debt reduction by observing that the hardships suffered by the Latin American debtors are such that few countries would wish to emulate their experience. Moral hazard can be further lessened by strict conditionality and a case-by-case approach to debt reduction. He rejects the voluntary approach to debt reduction on the grounds that debtors cannot bargain effectively in a situation where creditor governments tilt the balance of power in favor of the banks by favoring stiff sanctions against any unilateral actions by debtors to reduce debt service and by indirectly bailing out the banks. Sachs comments, "As soon as the commercial banks recognize that the official community is accepting the buildup of arrears by the debtor country, they will be much more disposed to search for long-term solutions to the debt" (p. 30). He also turns Williamson's free-rider argument on its head, countering that a comprehensive debt-reduction scheme is necessary to avoid the incentive for each individual creditor to refuse debt relief even though it is in the collective interest of creditors to grant relief. Sachs points out that domestic bankruptcy proceedings are a form of concerted debt reduction, which imposes an orderly settlement among creditors precisely to avoid the free-rider problem.

Sachs endorses the creation of an international debt facility to purchase debt at a discount. He stresses that such an agency need not involve a large outlay of funds from the public as long as it buys the debt at prices close to the secondary market discount. The international debt facility might even turn a profit to the extent that it would be able to capture some of the efficiency gains from reducing the debt overhang. The amount directly subscribed by individual creditor governments would be

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very small, particularly if the international debt facility is allowed to borrow a substantial portion of its funds in the open market (like the World Bank). Taxpayers would still face a contingent liability if the international debt facility loses money, but according to Sachs, a well-run international debt facility should be profitable. He nevertheless seems to neglect some of the operational and political difficulties in establishing and running such an international debt facility, which Williamson has stressed. Sachs's arguments for direct public subsidies for debt relief and, most important, a changed stance by creditor governments have been partially adopted in the Brady Plan, even though a de jure international debt facility has not been established. Sachs's approach has the merit of distributing the burden of adjustment more evenly and transparently than others in which subsidies are often disguised, as in official lending.

Against Sachs's approach, it could be argued that the banks and countries should arrive at debt reduction on their own, without direct or indirect public subsidies, which amount to "rewarding the profligate and punishing the poor" (Buiter and Srinivasan 1987). Yet all the books reviewed here recognize the major role played by mismanagement of macroeconomic policies in the developed countries in instigating the crisis. The laissez-faire argument ignores the point that the taxpayers of the creditor countries elected their governments and are therefore ultimately responsible for these administrations' mistakes. It also ignores the point that citizens in the rich countries, especially in the United States, stand to gain from recovery in Latin America.

Direct Investment

In the long run, it still makes sense for countries with growth opportunities to obtain capital from abroad. The consequence is a renewed interest in direct investment, both because inflows of portfolio capital are unlikely to resume on a large scale and because of the perceived advantages of direct investment. The possible advantages of direct investment over loans are twofold: direct investment provides risk sharing by the creditor (in bad times, dividends can be lowered), in contrast with contractually fixed interest rates for loans; and direct investment can provide valuable complementary inputs such as technology and management. Direct investment can have political and economic drawbacks too, such as reduction in economic sovereignty and possible distortions induced by multinational corporations (for example, such as anticompetitive practices and deceptive advertising).

Two conference volumes focus on the role of foreign direct investment in indebted developing countries: *Foreign Investment, Debt, and Economic Growth in Latin America*, edited by Antonio Jorge and Jorge Salazar Carrillo, and *Rekindling Development: Multinational Firms and World Debt*,

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edited by Lee Tavis. Unfortunately, the contributions to both these volumes are highly erratic in quality, most of them having little or nothing to do with the ostensible topic of the conferences. In *Rekindling Development,* only one essay deals with the relationship between direct investment and debt, a very useful contribution by Theodore Moran. He reviews the empirical evidence on multinational corporations and development and concludes that they tend to be beneficial when not sheltered from competition. Moran notes further that prior to the debt crisis, many developing countries were becoming more adept in their bargaining with multinational corporations. In view of the shortage of foreign capital in the wake of the debt crisis, Moran worries that many debtor countries have become overeager to attract such corporations and have retrogressed in their bargaining tactics. He sees as particularly dangerous the increased willingness to grant market exclusivity. Such an arrangement is appealing from a myopic point of view because it benefits the firm greatly and is off-budget to the government. The elimination of competition is extremely unwise, however. Instead of market exclusivity, Moran recommends aggressive efforts to attract initial entrants through subsidies and encouragement of subsequent competition. In the same volume, Paul Streeten discusses new forms of unbundling and joint ventures but makes no attempt to relate them to the particular situation of indebted countries. The other contributions, none of which are particularly original or informative, deal with various aspects of the debt crisis throughout the world.

Foreign Investment, Debt, and Economic Growth explicitly states its purpose as analyzing "the role foreign investment can play in the reactivation of the economies of the region" (p. 3). Most of the contributions have nothing to do with this subject, however, and some of those that do are weak. The volume contains interesting chapters on Central America, but they do not focus on the stated topic. Felipe Pazos presents a useful broad overview of the evolution of foreign direct investment in Latin America from 1950 to 1982. Helson Braga provides a thorough study of the evolution of Brazilian policy toward foreign direct investment, arriving at an assessment similar to Moran's in *Rekindling Development.* Braga recognizes the positive contributions that foreign direct investment can make in Brazil but argues against new incentive programs and dismantling regulations under the pressure of the debt crisis. Andrés Passicot's essay on the Chilean case discusses informatively the effects of the open-door policy toward foreign direct investment under General Augusto Pinochet. Despite the removal of nearly all restrictions, foreign direct investment inflows in Chile increased only slightly between 1974 and 1983 as compared with 1960 to 1971. Passicot ascribes this low responsiveness to three causes: a preference by foreign investors for debt rather than equity during most of the period, long memories of the less hospitable environ-

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ment of the past and questions about the sustainability of the Pinochet policies, and the serious recession in Chile during much of the period.

Joel Bergsman and Wayne Edisis focus on a narrower set of questions in *Debt-Equity Swaps and Foreign Direct Investment in Latin America.* They do not assess the desirability of foreign direct investment, which they take for granted, or even the full effects of swaps. Their modest objective is to understand some aspects of debt-equity swaps, particularly the issue of additionality—that is, whether the subsidies associated with swaps lead to increases in foreign direct investment or merely represent windfalls for investors who planned to undertake investment in the absence of the swap programs. Bergsman and Edisis also examine the extent to which the secondary market discount on the debt is captured by the debtor government or the foreign investor and the related question of the magnitude of the subsidy implicit in the swap. Much of the analysis is based on data obtained from interviews with investors who made use of swaps in Argentina, Brazil, Chile, and Mexico.

Bergsman and Edisis provide useful information and analysis of the implicit subsidy provided to investors. They find that investors reaped from 31 to 66 percent of the secondary market discount on the debt, amounting to effective subsidies of 25 to 50 percent. Unfortunately, their analysis of additionality is incomplete at best. To determine additionality, Bergsman and Edisis asked the investors whether they would have carried out the investment without the swap programs. Using this method, they determined that 100 percent of foreign direct investment by banks was additional, while 33 percent of foreign direct investment by nonbanks was fully additional with another 10 percent being partially additional. The problem is that this concept of additionality is highly flawed from a macroeconomic perspective and may greatly overstate overall additionality. The reason is that other investors may have stepped in to undertake the investment even if the particular investor in question would have pulled out in the absence of the swap program. Therefore Bergsman and Edisis's numbers can be considered an upper bound on additionality. In this light, additionality by nonbanks appears very low despite the rather large subsidies involved, controverting the authors' cautiously optimistic evaluation of swaps. Another problem is that they do not address the larger question of whether foreign direct investment should be subsidized in the first place, and if so, whether swaps are the optimal way to accomplish this end. As Jeremy Bulow and Kenneth Rogoff (1988) have pointed out, debt-equity swaps are in effect debt buybacks combined with subsidies for direct investment. The merits of swaps can only be assessed by examining the merits of each of these two components, both of which are fraught with complexity.

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CONCLUDING OBSERVATIONS

Latin America has compiled a long history of debt-servicing difficulties, as demonstrated by Stallings, Maddison, and Biggs. Important differences exist between the current crisis and past episodes, and the overall role of international finance in Latin American economic development has not been entirely negative, but it is clear that elements of systemic irrationality persist in Latin America's borrowing from abroad. Some interaction seems to occur between the shortsightedness of lenders and irresponsible policies in Latin America, two factors that combine to create fragile debt-driven booms that ultimately end in crashes when the external environment becomes unfavorable. While it is evident that external factors played an important role in fostering high levels of borrowing in the 1970s and then appeared to be the proximate cause of the crisis in the 1980s, this reviewer tends to conclude that the fundamental origins of the crisis are internal. Such a view also emerges from Kuczynski's work and especially the country studies in Sachs's edited *Developing Country Debt and the World Economy,* which document the importance of overexpansionary fiscal and monetary policies and exchange-rate misalignments. Access to international capital played a crucial role in magnifying the scope for policy errors by temporarily relaxing fiscal and balance of payments constraints.

Economists and political scientists have increasingly attempted to understand the political underpinnings of economic policies as well as the effects of economic outcomes on politics. Stallings and Kaufman's collection, *Debt and Democracy in Latin America,* is an excellent example of this approach. Two of the crucial political factors that emerge from *Developing Country Debt* and *Debt and Democracy* are the polarization among Latin American interest groups and the weakness of the state in mediating these conflicts, with the result being that economic policy becomes subordinate to conflicts over income distribution. These social conflicts tend to undermine orthodox as well as heterodox policies and to contribute to the general lack of government credibility.

While it is evident that internal political and social conflicts underlie the debt crisis and that reforms are necessary, the general consensus now is that the resource transfers extracted from the debtors since 1982 have been both unfair and counterproductive in the sense of inhibiting long-term recovery and structural change. The historical precedents analyzed by Biggs suggest that the pattern of adjustment in the 1980s has been extraordinarily favorable for creditors and equally costly to debtors. The case for debt relief is put forth with eloquence and conviction by Sachs in *New Approaches to the Latin American Debt Crisis.* Both Biggs and Sachs stress the crucial importance of the role of creditor governments in achieving balanced and farsighted solutions.

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Perhaps more controversially and less well-documented, the conditionality and adjustment embodied in the orthodox IMF approach and the Baker and Brady plans have been distributionally unbalanced in forcing great hardship on the less well-to-do members of Latin American societies while sparing the elites. Radical perspectives like that of George, despite evident flaws, point out that adjustment programs are not distributionally neutral and that alternatives to orthodoxy are possible. One can agree with conservative critics of Latin American economic policies that the role of the state in Latin America must be redirected and still continue to favor an important role for government. Despite the continuing setbacks, *Debt and Democracy in Latin America* offers some hope that the new democracies in the region can acquire the legitimacy and competence that will enable them to foster greater efficiency as well as equity.

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