Recent economic disturbances in Latin America—particularly the currency crises in Mexico in 1994–95 and Brazil in 1998–99—have prompted significant research and debate over financial sector reforms and appropriate monetary and fiscal policy for the region. The recent discussion over dollarization is but one of many such debates. It is important, however, that the ongoing policy discourse be informed by a broader understanding of the region’s economic history.

The current rethinking of economic policy in Latin America is only the latest chapter of a much longer story. Well before the recent episodes of financial turmoil, Latin American economies had already proven vulnerable to external economic shocks, which have taken the form of changes in commodity prices, movements in international interest rates, and fluctuations in the volume and direction of capital flows. These factors have interacted with (and in some cases, prompted) frequent changes in the region’s economic policy orientation. This mix has resulted in high volatility of key indicators, including inflation, fiscal and external balances, and gross domestic product (GDP) growth rates. This article provides a survey of the evolution of economic policy and performance in Latin America in the post–World War II period. It highlights the impact of and reaction to certain economic shocks the region experienced, including the declining terms of trade in the early postwar period, the oil shocks of the 1970s, the debt crisis of the 1980s, and the more recent emerging markets crises of 1997–99.

Prebisch and Import Substitution

The notion that export-led development was the wrong choice for Latin America took hold in the immediate aftermath of World War II. The international recession of the 1930s, the economic turmoil caused by the global conflicts, and protectionist policies by developed nations such as the U.S. Smoot-Hawley tariff in 1930 led to weak demand for primary commodities and consequent contractions for Latin American economies, which have traditionally been heavily dependent on primary exports. The perception of a global division of labor, with the north producing manufactured items and the south providing primary goods, seemed inimical to Latin America’s long-term develop-
ment because of adverse terms of trade fluctuations and to the apparent concentration of technology in the manufacturing industries of the north. This north-south or “center-periphery” dichotomy, forcefully articulated by Raul Prebisch of the United Nations’ Economic Commission for Latin America and the Caribbean (CEPAL), came to dominate regional economic thought during the early postwar years.

Economic policy making in Latin America was guided by the principle that the international environment presented an obstacle to the region’s economic expansion and that policy should be adjusted to deal with external constraints on growth. Prebisch (1963) argued that domestic industrialization would foster the spread of technology, increase employment, and enhance the productivity of the labor force, thus reducing the region’s vulnerability to international economic forces. This argument served as the underlying rationale for the region’s import-substitution industrialization (ISI) policies, which sought to enhance industrial development through the protection of domestic markets via tariffs, quotas, and other restrictions and with targeted subsidies to local producers.

In its early period, import substitution was able to foster heavy industries in some of the larger countries of the region and created a modest base for the growth of domestic manufacturing. As a result, Latin American GDP grew at an average annual rate of 5.1 percent from 1951 to 1960 (Wilkie 1995). However, the strategy began encountering bottlenecks in the late 1960s. First, the production of advanced durable goods often required intermediate capital inputs not available domestically. This need for foreign inputs aggravated the very problem that the region was attempting to avoid: external dependence. Also, in order to exploit economies of scale, complex goods often required larger markets than those available internally.

Import substitution also resulted in the creation of capital-intensive industries, thus failing to generate a substantial demand for labor. Although some high-productivity manufacturing jobs were created, the expected connection between manufacturing, technology, and increased labor force productivity with subsequent higher wages and living standards failed to materialize. But despite the strategy’s shortcomings, the regional economy experienced even higher growth rates in the 1960s, expanding by an average annual rate of 5.75 percent from 1961 to 1973 (Wilkie 1995). The results appeared favorable enough that the trend of protectionism and government intervention in Latin America continued during the 1970s.

To continue the growth process, many Latin American countries began importing heavily, relying on capital inflows greatly facilitated by the “petrodollars” from the oil shock of 1973 to complement internal savings in the financing of investment. The significant liquidity available in the international system made cheap foreign financing readily available during the 1970s. Between 1975 and 1982, Latin America’s long-term foreign debt increased from $43 billion to $176 billion (Edwards 1993). In keeping with the top-heavy nature of ISI, state enterprises and the state in general received the lion’s share of funds as the inflows financed ever-increasing public sector deficits (Kuczynski 1988).

A favorable international environment of low real interest rates and strong demand for Latin American primary exports helped the region’s governments service their growing debts with little difficulty from 1975 through 1979.

The international environment eventually became less accommodating. The second oil shock in 1979 resulted in higher petroleum prices and declines in the prices of other primary commodities. Meanwhile, to combat inflationary pressures, U.S. monetary authorities raised interest rates, significantly increasing Latin America’s debt-service burden. Because much of the debt Latin American governments had assumed was in the form of variable-rate loans, interest payments on the region’s foreign debt rose significantly, from less than $9 billion in 1978 (17 percent of regional export earnings) to $30 billion in 1981 (42 percent). The region’s current account deficits more than doubled in the 1979–81 period (Inter-American Development Bank 1985). These factors, in conjunction with a pattern of capital flight from Latin America during the late 1970s, eventually triggered the regional debt crisis of the 1980s.

### The Lost Decade and the Return to the Market

In 1982 Mexican authorities declared themselves unable to continue servicing the country’s external obligations; other economies in the region quickly followed suit. Borrowing from abroad plummeted from $48 billion in 1981 to $16 billion in 1983, and capital

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1. This article builds upon Birdsall and Lozada (1998).
inflows virtually disappeared by mid-decade (Inter-American Development Bank 1985).

Faced with a sudden and drastic decline in capital inflows, many Latin American countries restricted imports, imposed higher tariffs, created multiple exchange rates, and levied inefficient taxes in hope of mitigating ballooning external and domestic deficits. As deficits persisted and foreign funding continued declining, governments turned to their central banks for financing, provoking inflation. In the mid-1980s, some countries experimented with heterodox strategies, attempting to combat “inertial” inflation through price freezes as well as exchange rate and wage controls. These approaches ultimately exacerbated the inflationary spiral, mainly because they neglected to recognize the fundamental role of fiscal discipline in achieving price stability. Inflation reached nearly 7,500 percent in Peru during 1990, and several other countries— notably Argentina, Bolivia, Brazil, and Nicaragua— experienced bouts of hyperinflation at some point during the decade. These policy changes contributed to poor economic growth rates during the decade. After averaging 5.9 percent during the 1970s, annual GDP growth rates dropped to 1 percent from 1980 to 1990 and were negative on a per capita basis during that period (Inter-American Development Bank 1996).

By the late 1980s a new consensus on economic policy was slowly emerging. Policymakers began to recognize that the state-led, protectionist development model employed over the previous decades had finally exhausted itself. The visible success of Chile, an early adjuster, the collapse of the statist economies of Eastern Europe and the Soviet Union, and the then-rapid growth of East Asian economies all contributed to increases in Latin America in the 1990s: “The progress of the Latin American region and among multilateral institutions. The Inter-American Development Bank and the World Bank both emphasized the primacy of domestic policies early in the 1990s: “The progress of the Latin American economies during the coming years is likely to be driven more by the success of domestic reform processes than by the performance of the world economy” (Inter-American Development Bank 1992); “t h e future of the developing countries is largely in their own hands. . . . The right strategy for the developing countries, whether external conditions are supportive or not, is to invest in people, including education, health, and population control; help domestic markets to work well by fostering competition and investing in infrastructure; liberalize trade and foreign investment; avoid excessive fiscal deficits and high inflation” (World Bank 1991).
Positive medium-term results vindicated Latin America’s market reforms. Stabilization efforts resulted in a significant decline of regional inflation (Table 1). By 1997 most countries in the region had only single-digit inflation, and the median rate had dropped to 9 percent, the lowest in any year since 1977 (Inter-American Development Bank 1998). Similarly, regional economic growth recovered during the first half of the 1990s and reached 5.1 percent in 1994. Although in some countries, such as Argentina, El Salvador, and Peru, strong growth was partially enabled by the renewed employment of previously underutilized productive capacity, in most countries the rapid growth of the early 1990s was fueled by new investments and productivity gains (Inter-American Development Bank 1996).

### Capital Flows and Financial Contagion

Much of the new investment in the region was facilitated by foreign capital inflows, which made a strong comeback to the region during the 1990s. After virtually disappearing from 1983 to 1990, financial flows to Latin America grew dramatically, reaching 4 percent of regional GDP in 1991 and 6 percent in 1993 and 1994. Chart 1 shows the evolution of capital inflows to the region from 1988 through 1997.

Several factors contributed to this surge of capital inflows. Reductions in inflation, as well as the privatization and deregulation of internal markets, provided domestic and international investors with new high-return opportunities in a less volatile economic environment. The lure of high returns and opportunities for risk diversification supported this increased participation of emerging economies in global capital markets. Finally, an environment of low interest rates in the United States during the 1990s likely rendered the high returns in emerging markets even more attractive.

Furthermore, technological advances greatly increased the pace and efficiency with which capital can flow into and out of emerging markets. High-tech innovations in the global financial system have facilitated the virtually instantaneous dissemination of information among market actors, thus dramatically reducing transaction costs and enabling the development of new financial instruments. The integration of emerging economies into this system allows market forces to swiftly reward positive economic performance or policies as well as to expose and punish underlying economic mismanagement or inconsistencies.

Capital inflows in the context of increasingly integrated financial systems present distinct benefits to emerging economies. Primarily, they can boost economic growth by decoupling investments in the local economy from the availability of domestic savings. Financial integration also supports growth by shifting the investment mix in a given country toward higher-return projects because it improves investors’ ability to diversify away some of the risk normally involved in high-return investments (World Bank 1997).

However, increased capital flows and financial integration also present substantial risks (Chang 1999). High levels of capital inflows, common in the early stages of financial market integration, increase the potential costs of sudden reversals. Rapid outflows are usually triggered by a loss of confidence in a country’s ability to earn enough to pay its foreign-denominated debt although they might also occur, at least temporarily, in other economies that do not necessarily share the vulnerabilities of the originating nation. Problems in a particular emerging economy might trigger a temporary withdrawal from several or all economies considered to be in the same asset class. Some argue that such outflows may be compounded by a so-called herding effect, by which institutional investors and fund managers tend to follow the behavior of their peers so that their particular portfolio record will not appear worse than that of the industry as a whole.

### Table 1: Annual CPI Inflation in Selected Latin American Economies (1991–99)

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<tbody>
<tr>
<td>Argentina</td>
<td>171.7</td>
<td>24.9</td>
<td>10.6</td>
<td>4.2</td>
<td>1.6</td>
<td>0.0</td>
<td>0.3</td>
<td>0.7</td>
<td>-1.0</td>
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<tr>
<td>Brazil</td>
<td>440.9</td>
<td>1,008.7</td>
<td>2,148.5</td>
<td>2,668.6</td>
<td>23.2</td>
<td>10.0</td>
<td>4.8</td>
<td>-1.8</td>
<td>6.6</td>
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<tr>
<td>Chile</td>
<td>22.0</td>
<td>15.4</td>
<td>12.7</td>
<td>11.4</td>
<td>8.2</td>
<td>6.6</td>
<td>6.0</td>
<td>4.7</td>
<td>4.0</td>
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<tr>
<td>Colombia</td>
<td>30.4</td>
<td>27.0</td>
<td>22.6</td>
<td>23.8</td>
<td>19.3</td>
<td>21.6</td>
<td>17.7</td>
<td>16.7</td>
<td>12.4</td>
</tr>
<tr>
<td>Ecuador</td>
<td>48.7</td>
<td>54.6</td>
<td>45.0</td>
<td>27.3</td>
<td>22.8</td>
<td>25.5</td>
<td>30.5</td>
<td>43.4</td>
<td>55.5</td>
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<tr>
<td>Mexico</td>
<td>22.7</td>
<td>15.5</td>
<td>9.7</td>
<td>6.9</td>
<td>52.0</td>
<td>27.7</td>
<td>15.7</td>
<td>18.6</td>
<td>14.4</td>
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<tr>
<td>Peru</td>
<td>409.5</td>
<td>73.6</td>
<td>48.6</td>
<td>23.7</td>
<td>10.2</td>
<td>11.8</td>
<td>6.5</td>
<td>6.0</td>
<td>5.7</td>
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<tr>
<td>Venezuela</td>
<td>34.2</td>
<td>31.4</td>
<td>38.1</td>
<td>60.8</td>
<td>56.6</td>
<td>103.2</td>
<td>37.6</td>
<td>29.9</td>
<td>25.3</td>
</tr>
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f = forecast

Source: Inter-American Development Bank data and Latin American Consensus Forecasts
Underperformance is often penalized more than overperformance is rewarded, especially if emerging market fund managers are required to meet the performance of the median fund in their category or market (World Bank 1997).

The risks associated with increased capital flows to an emerging economy can be exacerbated when the inflows are intermediated through an underdeveloped or inadequately regulated local financial system, which might already be experiencing a lending boom such as often happens in the early stages of a poststabilization economic recovery. Unless lending practices are rigorously supervised, it is likely that funds are made available to individuals or entities that may be unable to meet their payments in face of a sudden economic downturn or interest rate hike (Birdsall, Gavin, and Hausmann 1998). Unfortunately, such financial fragilities may become apparent only after the economy or the capital inflows or both begin to decelerate.

The Mexican Crisis. This last scenario describes some elements of the Mexican financial crisis of 1994–95. Along with the country’s stabilization efforts begun in the late 1980s, authorities had introduced financial sector reforms that included the liberalization of interest rates and the privatization and deregulation of the banking system. These conditions combined to unleash a bank lending boom in the early 1990s. At the same time that capital flows to Mexico grew to an annual average of 8 percent of GDP from 1990 to 1993, bank credit to the private sector rose from less than 10 percent of GDP in 1989 to about 40 percent by 1994 (Birdsall, Gavin, and Hausmann 1998).

Domestic disturbances—both economic and political—prompted a severe devaluation of the Mexican peso in late December 1994; on December 20–21 alone the central bank spent approximately $4 billion in foreign reserves attempting to defend the currency (International Monetary Fund 1995). Authorities were eventually compelled to move to a market-determined exchange rate regime. The crisis was heightened by the fact that substantial stocks of dollar-denominated, short-term government debt was coming due just as international capital markets were least willing to finance Mexico. The impact on the banking sector was significant as inflation, high interest rates, reduced economic activity, increased debt burdens, and deteriorating loan portfolios contributed to the deterioration of banks’ capital ratios. The government was eventually compelled to intervene through a series of bailout packages and banking system reform initiatives. Although economic growth in Mexico resumed strongly in 1996 and 1997, the crisis exacted a high price in 1995 when unemployment and bankruptcies rose dramatically and Mexican GDP contracted by 6.2 percent (Inter-American Development Bank 1997).

The Mexican crisis also had regional contagion effects, triggering capital reversals in other Latin American economies in the region, most notably Argentina, which came under pressure because of its “convertibility program,” a fixed exchange rate regime that pegs the value of the local peso to the U.S. dollar and prohibits the issuance of any new currency not backed by international reserves. Over a period of three months in early 1995, approximately 18 percent of

### Chart 1: Investment Flows into Latin America (1988–97)

Source: Inter-American Development Bank
deposits in the Argentine banking system were pulled from the country, much of it going to neighboring Uruguay. Although more than two-thirds of these deposits had returned by the end of 1995, Argentina also suffered a severe recession in 1995, with GDP declining by 4.4 percent (Inter-American Development Bank 1997).

**Effects of the Asian Crisis.** If the Mexican crisis showed that Latin American economies are susceptible to contagion effects, merited or otherwise, stemming from crises occurring elsewhere in the region, the Asian crisis of 1997–98 demonstrated that contagion from one crisis can threaten geographically distant economies in both developed and developing areas.

The impact of Asia’s financial difficulties on Latin America was most visible through financial market contagion. As developments in Asia unfolded, capital flows into Latin America also slowed, declining sharply in late 1997 and 1998. After surpassing $100 billion in 1996 and 1997, private capital inflows to Latin America declined to $85 billion in 1998 and are forecast to diminish further in 1999, to $66 billion (Institute of International Finance 1999). Most of the flows in 1998 took the form of foreign direct investment as portfolio investment turned sharply negative. Stock indexes throughout the region lost ground during the fourth quarter of 1997 and much of 1998 with the Russian debt default in August of that year also contributing to the slump. (Chart 2 displays the performance of major Latin stock indexes from October 1997 through 1998.) Confidence in the Brazilian market during 1998 and early 1999 eroded to the point that capital flight compelled authorities to devalue and eventually float the real in January 1999.

Weakened currencies and recession in Asia during 1998 also affected Latin American trade balances. Chile in particular is heavily exposed to Asia with 34 percent of its 1997 exports destined to that region; Peru followed with 22.6 percent. Meanwhile, virtually all economies in the region depend significantly on primary exports—such as petroleum and copper—the prices of which experienced major declines in 1998, in no small part resulting from reduced Asian demand. (South Korea and Japan, for example, are among the world’s largest consumers of copper.) Latin American export revenues actually declined slightly in 1998, from $254 billion to $248 billion, and the region’s trade deficit increased from $31 billion in 1997 to $50 billion in 1998 (Institute of International Finance 1999). Partially as a result of the Asian crisis, Latin American regional GDP growth decelerated significantly in 1998, reaching only 2.0 percent after a 5.1 percent rate the year before. Early forecasts for 1999 suggest a mild recession for the year, with the regional economy contracting by 0.5 percent (Latin American Consensus Forecasts 1999).

**Policy Responses to Financial Contagion**

The effects of the Asian economic crisis have underscored Latin America’s ongoing vulnerability to external shocks through both trade and financial channels. The crisis highlighted the region’s limited export base and continued reliance on primary commodities as a source of foreign exchange, and the massive scale of capital inflows during the 1990s resulted in greater exposure of the region’s economies to international financial volatility. These effects have
jump-started further debates on appropriate economic policies for the region. Thus far, how have Latin American policymakers responded to the latest bout of external economic shocks?

Not surprisingly, the answer depends on each country’s starting point. Economies that had already introduced comprehensive, market-oriented reforms prior to the crises—such as Chile, Mexico, and Peru— have not introduced substantially different economic policies. All of them have recently implemented some degree of fiscal tightening to account for the impact of weaker commodity prices on export earnings (Institute of International Finance 1999). In other words, authorities in these economies have pursued procyclical fiscal policies, tightening the policy regime during an economic downturn. Under normal conditions, one would expect countercyclical fiscal policy, but because global capital markets tend to question emerging markets’ fiscal rectitude during contagion episodes, procyclical policies are often deemed necessary to restore market confidence (Hausmann and others 1996).

Other economies in the region, in particular Brazil, were more significantly affected by the Asian crisis because of their internal economic imbalances. In Brazil a nominal fiscal deficit that reached 6.1 percent of GDP in 1997 prompted market unease and subsequent capital flight (Central Bank of Brazil 1998). As a result, Brazil has begun a major fiscal adjustment process and has received substantial multilateral financial support for this effort. Ecuador and Venezuela, which as oil-exporting nations were especially vulnerable to declining commodity prices, are facing similar challenges.

In hindsight it appears that the economies that had carried out the most significant structural reforms earlier in the decade (or in the case of Chile, as far back as the 1970s and 1980s) were best able to insulate themselves from the global turmoil. Mexico and Peru are both expected to post moderate GDP growth in 1999 while economic activity in Chile is forecast to remain flat. Economies such as those of Brazil and Colombia, which have only partially implemented economic reforms, are expected to contract this year. Finally, non-reforming economies like Ecuador and Venezuela are forecast to experience sharply negative growth in 1999 (see Table 2) and thus still face serious policy challenges. Overall, countries that have undergone significant market-oriented reforms in the form of trade liberalization, fiscal adjustment, and privatization are posting relatively stronger performance than those that have not. (The only reformist nation in the region to suffer severe contagion effects as a result of the Mexican crisis of 1994–95 and the Asian crisis of 1997–98 was Argentina, which suffered from a perceived dual vulnerability: its fixed exchange rate regime and its high trade exposure to Brazil.)

## Conclusion

During most of the economic crises of the post–World War II period, governments in Latin America responded by introducing new economic policies representing a significant departure from the prior policy path. Post–Depression era declines in the terms of trade for primary goods served as the impulse for import substitution policies in the immediate postwar period and through the 1960s. The availability of international liquidity during the 1970s, in conjunction with the oil shocks and the subsequent international recession, helped spark the debt crisis of the 1980s. This crisis in turn led to the adoption of comprehensive market-oriented reforms in several Latin American economies during the late 1980s and the 1990s.

The adoption of market-oriented reforms did not render the region invulnerable from external shocks, as
the impact of the Asian crisis on Latin America amply demonstrates. But unlike the earlier crisis episodes, which prompted a sea change in the economic policy regime of several economies, the recent external shocks have led most governments to deepen, not depart from, the overall market-oriented framework. Although it took the region more than a decade to recover from the debt crisis of the 1980s, the recovery time from the recent crises is expected to be briefer: most forecasts suggest moderate economic growth for Latin America in 2000, following a regional downturn in 1999. Latin America is thus proving more resilient under the market framework of the 1990s than under the state-led economic policies of earlier decades.

REFERENCES


