International Political Economy (SOCS-SHU 222)

DEVELOPING COUNTRIES AND INTERNATIONAL FINANCE I: THE LATIN AMERICAN DEBT CRISIS

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https://www.youtube.com/watch?v=xPw98dwbPO0

Developing Countries and International Finance I:

The Latin American Debt Crisis

READING ASSIGNMENT:

Oatley Chapter 14

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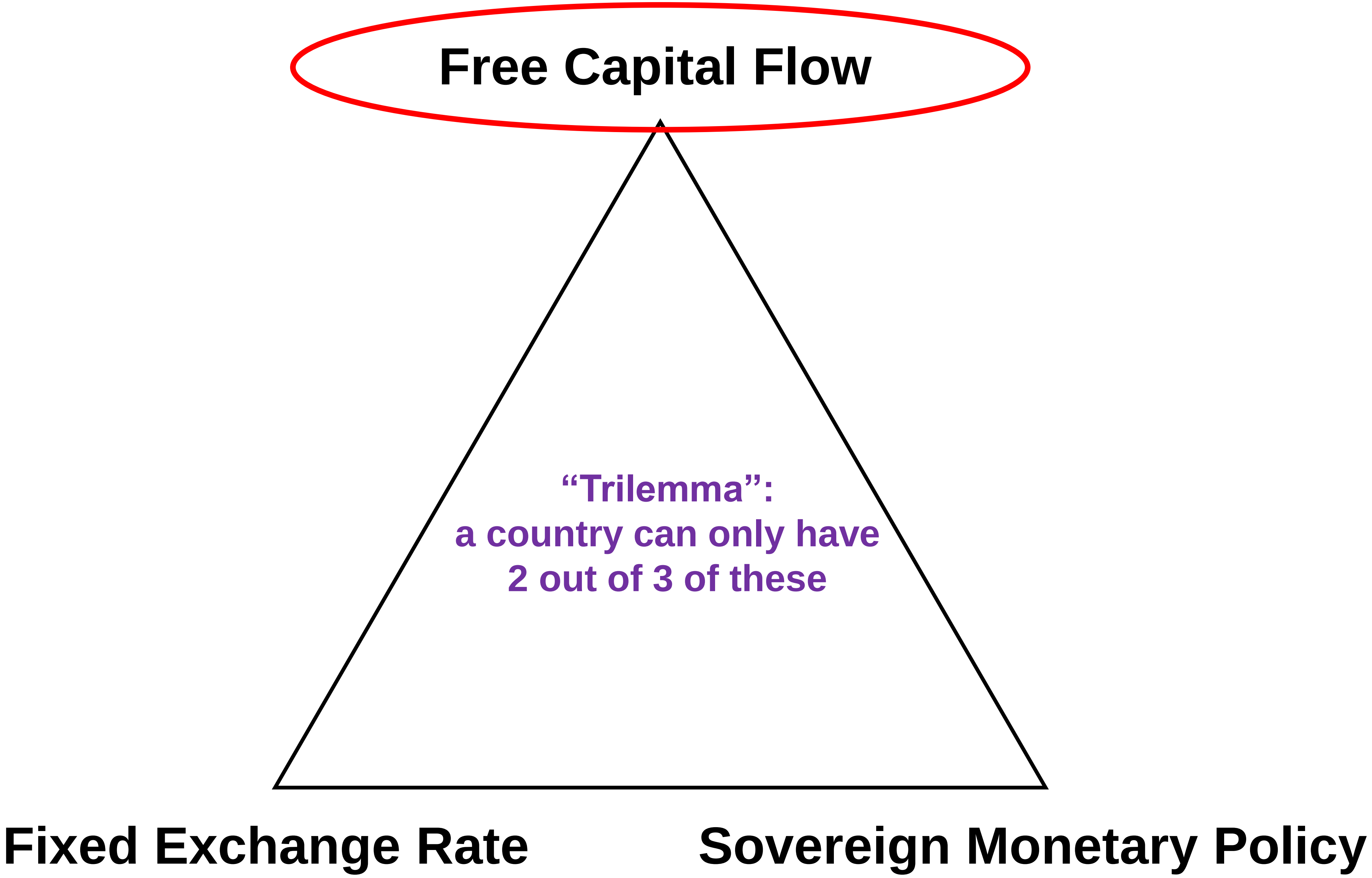
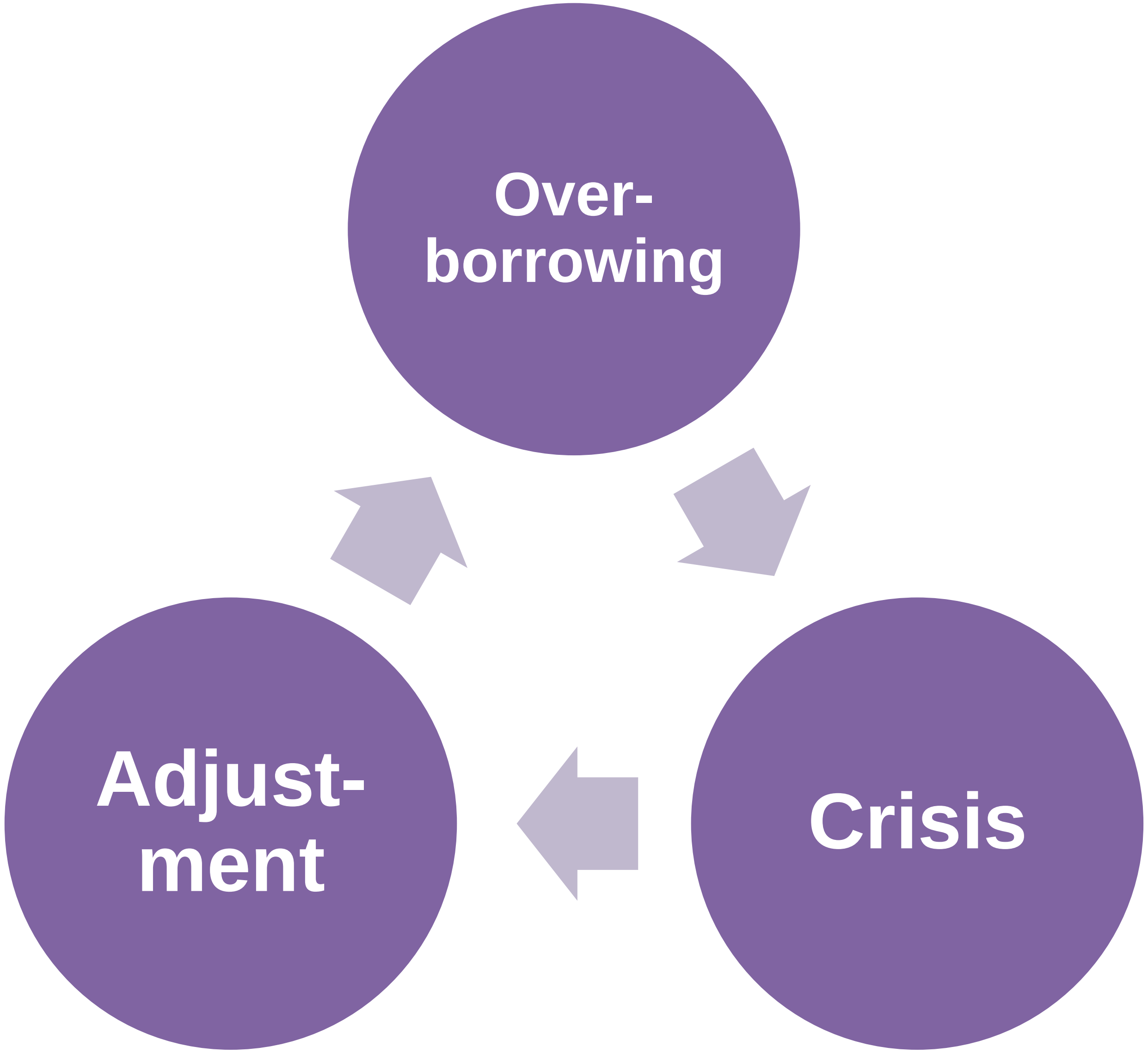

Free Capital Flow
“Trilemma”:
a country can only have
2 out of 3 of these
Fixed Exchange Rate
Sovereign Monetary Policy

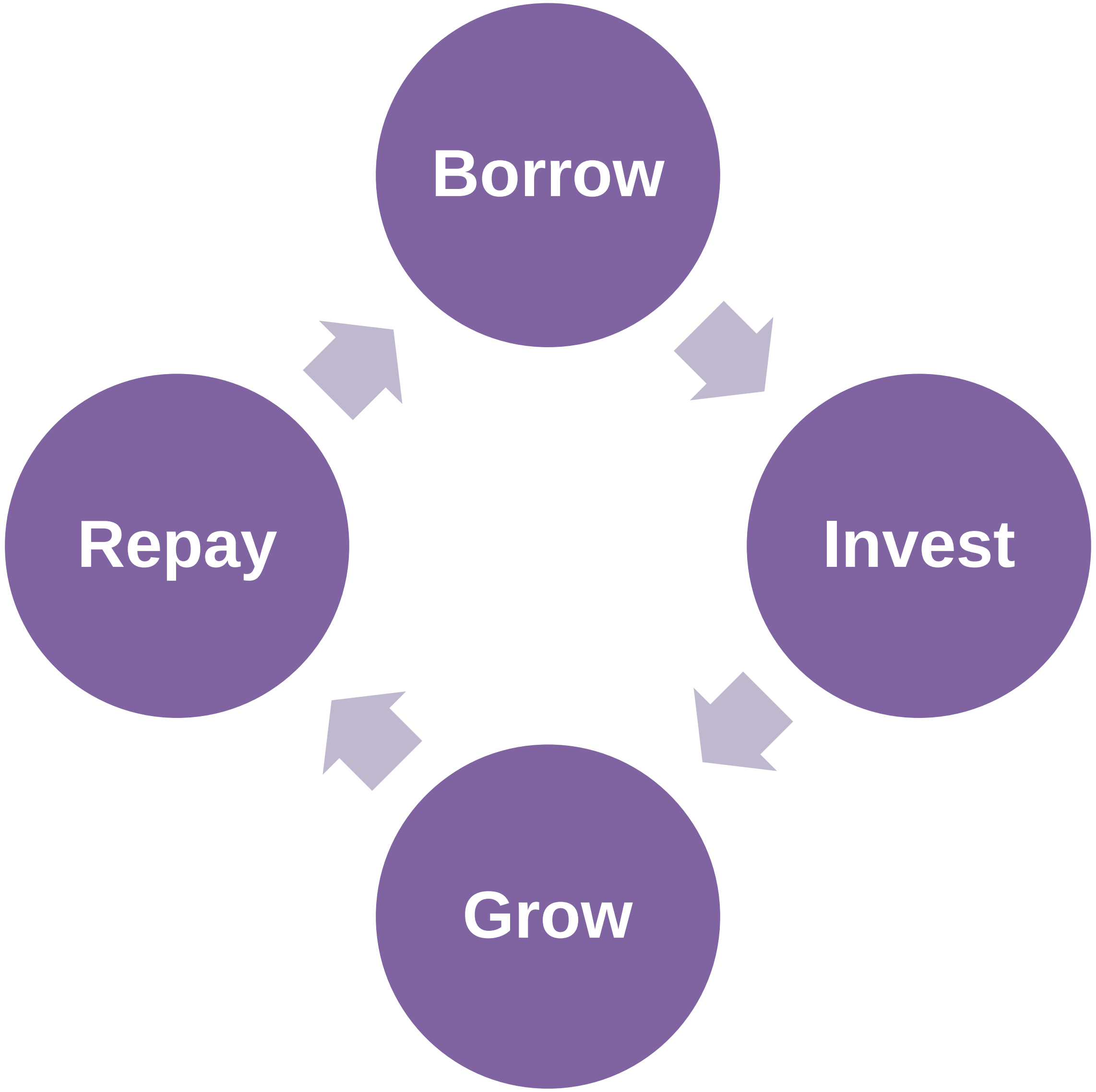
Why would you want…

- Free Capital Flow?
    - Draw on the savings of the rest of the world
    - Investment opportunities abroad
- Fixed Exchange Rate?
    - Reduce uncertainty in trade
- Sovereign Monetary Policy?
    - Address inflation/unemployment


Over-
borrowing
Crisis
Adjust-
ment

Why Borrow

- Investment -> Economic Growth
- Where does money for investment come from?
  - Low savings domestically
  - Draw on the savings of the rest of the world (developed countries)


Borrow
Invest
Grow
Repay

Different Types of Foreign Capital

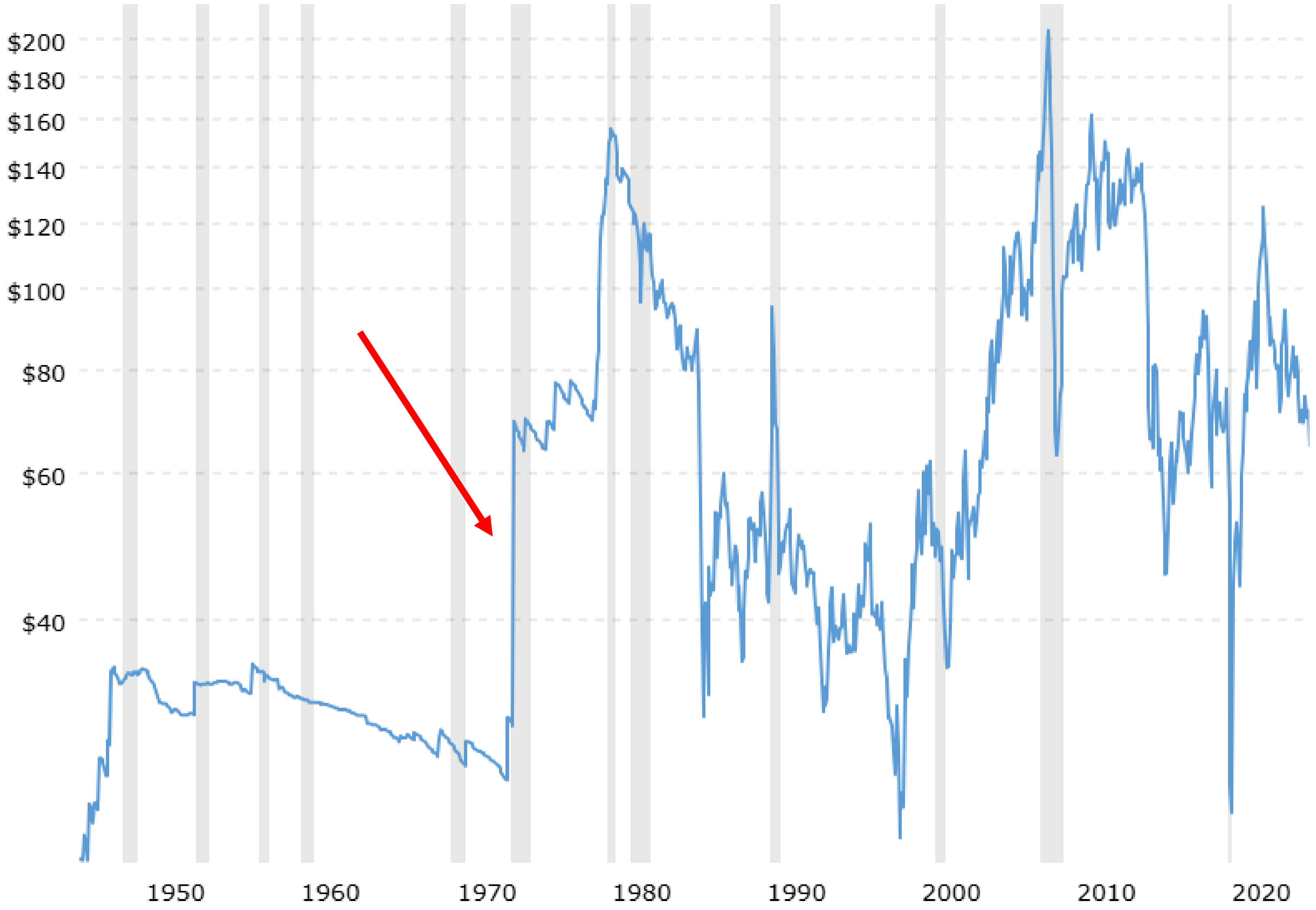
- Foreign Aid (Official Development Assistance)
  - Bilateral: USAID, OECD Development Assistance Committee (DAC), etc.
  - Multilateral: World Bank, etc.
- Private Capital
  - Commercial loans to firms or governments
  - Stocks from stock markets
  - Bonds sold by governments and firms
  - FDI by multinational corporations
- Remittances*

Private Capital —— Why Lend?

- Higher expected returns
  - Lower savings and lack of capital in developing countries
- But also, higher risks
  - Risk of default
  - Political risk: political stability, property rights protections, etc.

Latin American Debt Crisis

Crude Oil Price



“Petrodollar Recycling”

- Oil shock → huge surpluses for oil-exporting countries (petrodollars)
- Petrodollars deposited in Western commercial banks
- Banks sought returns → lent heavily to developing countries
- How money moves:
  - Oil importers paid to →
  - Oil exporters deposited in →
  - Commercial banks lend to →
  - Oil importers

ISI and the Demand for Foreign Capital

- Governments drove industrialization via state-owned enterprises
- Rising public spending → growing budget deficits
- Deficits reached 6–10% of GDP by late 1970s
- External borrowing used to finance ISI
- ISI policies deepened reliance on foreign capital

Rapid Accumulating of Foreign Debt

- Supply: Petrodollar Recycling
- Demand: ISI policies require foreign capital
- Result: Heavily indebted Latin American countries
  - Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela
  - Foreign debt in 1970: $28 billion
  - Foreign debt in 1980: $214 billion

From Growth to Crisis

GDP growth (annual %) - Latin America & Caribbean

World Bank national accounts data, and OECD National Accounts data files.

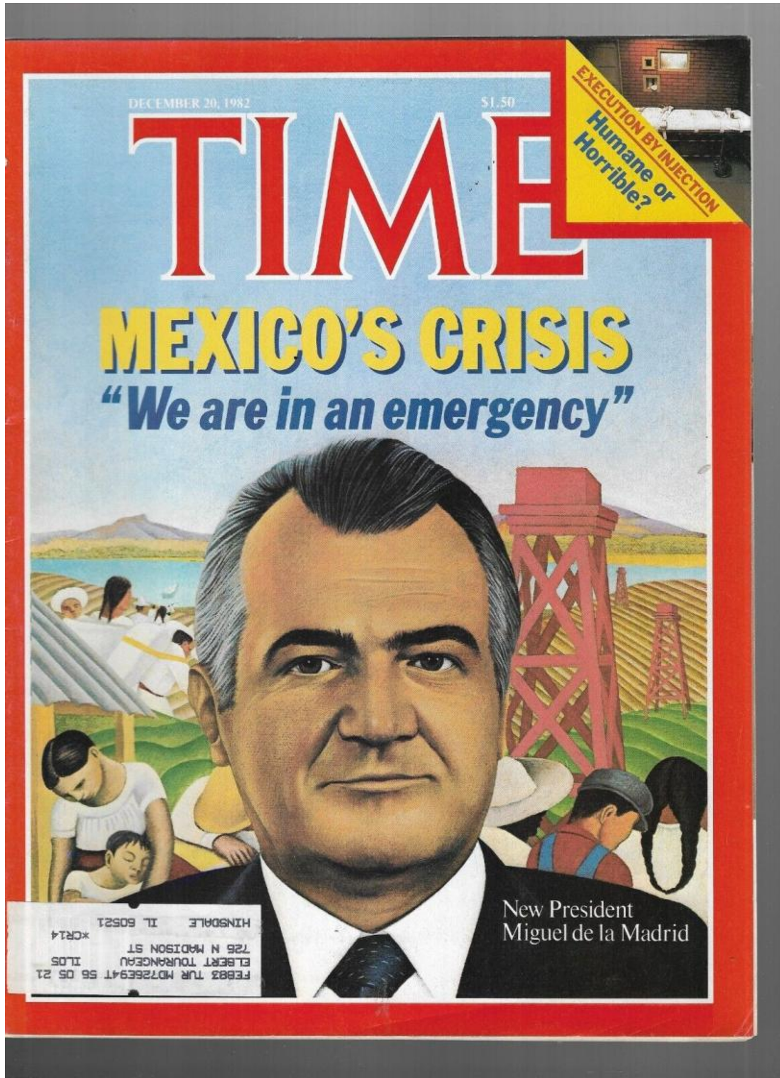
- Initially, foreign debt fueled economic growth
- But foreign debt grows too rapidly
- While exports failed to keep pace
- Result: Rising debt-service ratios

Triple Shocks

1. Rising interest rates in the United States
    - ↑ interest payments, ↑ debt-service costs
2. Recession in the industrialized world
    - ↓ demand for Latin American exports
    - ↓ export revenues
3. Rising oil prices
    - ↑ expenses on oil imports

1982 Debt Crisis

- August 1982: Mexico defaults
- Global panic: commercial banks cut off lending to all developing countries
- Immediate consequences
  - Budget deficits could no longer be financed
  - Forced fiscal austerity & reduced consumption
  - Economic collapse across Latin America



Managing the Debt Crisis

The International Monetary Fund (IMF)

- Established in 1944 at Bretton Woods to ensure global monetary stability
- Acts as a lender of last resort to countries in balance-of-payments crisis
- Offers loans with “conditionality”: borrowing requires implementing economic reforms

The Basic Deal

- By 1982, developing countries owed more than $600 billion; many defaulted
- Creditor governments stepped in:
  - new loans + rescheduling in exchange for policy reform.
- Belief: Crisis = short-term liquidity problem, not solvency

Macroeconomic Stabilization: IMF’s Playbook

- Focus on eliminating current-account deficits
- Budget cuts → lower domestic demand → fewer imports
- Currency devaluation → boost exports
- Goal: Shift to trade surplus, reduce need for new capital

From Stabilization to Structural Adjustment

- By mid-1980s, liquidity diagnosis shifted: crisis = structural
- Core belief:
  - ISI economies too inward, inefficient
  - Governments too heavily involved in economic activity
- Structural Adjustments:
  - Trade liberalization
  - FDI liberalization
  - Privatization
  - Deregulation

Who Bore the Burden?

Creditors

- Power from ***conditional lending***
- Challenge: free-rider problem
- Solution: the IMF to ensure unified terms

Debtors

- Power from ***collective default***
- Challenge: prisoner’s dilemma
- Incentives to negotiate separately

Outcome: Creditors set the rules; debtors bore the adjustment costs.

Thank You!

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Take-away

- Foreign capital and development
- Debt-service capacity and overborrowing
- Petrodollar recycling
- ISI strategies and demand for external finance
- Latin American debt crisis
- IMF conditionality
- Structural adjustments
- Economic reforms