TEXTO PARA DISCUSSÃO

No. 472

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DEPARTAMENTO DE ECONOMIA
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PUC-RIO

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THE EXTERNAL CONTEXT, 1928-1982

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FEVEREIRO 2003

Latin America: the external context, 1928-1982[1]

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This chapter covers the time span between the great debt crises that began in 1928, when the Wall Street boom and the Fed's contractionary monetary policy started to crowd out new loans to Latin America, and 1982, when the Mexican debt crisis brought an end to the second cycle of voluntary international lending to Latin America that had started about fifteen years before. Between these major balance of payments crises what happened in Latin America was strongly influenced by events in the world economy, but there was also a long-term trend making these economies much less outward-looking than they had been before the end of the 1920's, and even more, before 1914.

Fast recovery from the depression of 1928-1933 – far from "great" for most of Latin America – followed the upturn in the developed economies, especially the United States, after 1933, and was interrupted by the recession of 1937 in the United States, and then by the effects of the war on the progressive contraction of export markets until 1942. Good export performance and import compression in the remaining war years paved the way for a repayment of old foreign debt. But after the initial post-war period most of Latin America faced the constraints imposed by dollar shortage as reserves in dollars were restricted and import prices rocketed. European exports were badly affected by reconstruction demand and the United States was by far the major supplier of imports, even if restricted by the pressures of domestic demand. A boom in Latin American export prices in the late 1940s and as a result of the Korean War, however, eased the impact of the dollar shortage. World financial markets remained closed for Latin America until the mid-1960s. Foreign finance came mainly from loans by multilateral banks, the World Bank from the late 1940s and the Inter-American Development Bank after 1960, and also from credits extended by suppliers of capital goods.

In the second half of the 1950s, as economic conditions in Europe returned to normalcy, there was a reduction in the importance of United States direct investment in Latin America and also of trade links with the United States Europe recovered some of the ground lost during the 1930's and the war both in Latin American markets and in relation to foreign direct investment flows towards Latin America. In the early 1960s, the Cuban menace, as seen by the United States, prompted a substantial increase in loans by the United States government to Latin America. After 1966-1967, voluntary private lending to Latin America was resumed in the wake of the expansion of dollar deposits in Euro-markets as a result of United States legislation controlling domestic interest rates and the Soviet Union interest in holding dollar deposits that were not vulnerable to interference by the United States. Foreign debt remained low since the Second World War – mainly due to the lack of interest by lenders – but increased rapidly after the mid-1960s.

The 1973-74 oil shock badly affected the position of oil importers as oil prices increased 4-fold. But it was always possible to finance the transition through further indebtedness as the soft macroeconomic policies adopted in the United Sates which allowed nominal rates of interest to remain below world inflation until almost the end of the decade. Latin American oil exporters were also unfavorably affected by wrong policies in answer to the oil boom that led to heavy capital flight. A second oil shock in the decade led to a further 3-fold increase in oil prices after 1978. This time macroeconomic policies in the United States were far from accommodating and monetary restriction led to real rates of interest including country spreads beyond 20%. For the heavily indebted Latin American economies this was fatal and the Mexican default of 1982 was rapidly generalized.

The chronological organization of this chapter reflects major changes in the world economy. It is divided into six sections: the impact of the depression on Latin America (1928-1933); recovery (1933-1937) and further shocks following the 1937 recession in the United States and the beginning of World War II; dollar plenty followed by dollar shortage: 1942-1947; the golden age of import substituting strategy: 1947-early 1960s; macroeconomic instability, export diversification and growth: mid-1960s-early 1970s; two oil shocks and a new debt crisis: 1973-1982.

In the half century after the end of the 1920s there was a sharp reduction in the importance of the Latin America in the world economy as measured by its importance in global trade and capital flows. But it remained all the same extremely vulnerable to fluctuations in the world economy. Its importance in world trade had increased since the early 1880s until the early 1950s, but the fall afterwards was spectacular: from the peak 12.4% of world exports in 1950, mostly explained by the boom in commodity prices and the slow recovery of Europe, the Latin American share fell below 8% in 1960 and to the 5-6% range in the 1970s and early 1980s, compared to 9.8% in 1928. Of the larger economies, only Mexico and Venezuela increased their share of world exports between 1928 and 1982, from 0.74% to 1.13% in the first case and from 0.36% to 0.89% in the latter. In Brazil, the reduction -- from 1.45% to 1.01% -- was significant but no large country portrays better the Latin American withdrawal into autarchy than Argentina. Its share in world exports decreased by more than 80% in the same period: from 3.12% to 0.42% of world exports. Chile´s record was only slightly better. There was some diversification of Latin American exports. In the late 1920s only commodities were exported. In the early 1980s manufactured exports were substantial, not only in some of the bigger non-oil exporting economies, where they exceeded 30% of total exports in Brazil and 20% in Argentina and Colombia, but also in some of the smaller Central American and Caribbean republics as Costa Rica, Haiti and Guatemala.

It can be misleading to compare terms of trade over the long term for Latin America as a whole since there was a sharp difference between oil exporting economies and the average. For Latin America as a whole the terms of trade in the early 1980s were slightly above the 1928 level after having peaked in the early 1950s almost 30% above this initial level. Terms of trade of oil-exporters, however, improved almost 200% by 1982 in relation to 1928, while those of non-oil exporters fell by more than 20%.

To a large extent the history of the foreign debt crisis that followed after the late 1920s, when the first cycle of heavy indebtedness drew to a close, was repeated after 1980. The ratio between total debt and exports for Latin America in 1928, on the eve of the "great" depression, was around 1.5. More than half a century later, in 1980, on the eve of another major balance of payments shock, the ratio was back to almost 2.0. In both cases, in the economies worst hit by the sharp fall in exports and fast rise of debt, the ratio exceeded 5.0 and led inexorably to the temporary reduction of full service, defaults and the renegotiation of contractual conditions.

The Latin American share of United States global foreign direct investment in 1929 was 46.7%. Estimates for the geographical distribution of British investment are rather unreliable before 1938, but 21.8%, which was the Latin American share in 1938, can be considered as a lower bound for an estimate for 1929. So Latin America in the late 1920s had attracted at least 37% of global foreign direct investment.[3] In 1980 the stock of foreign direct investment in Latin America had decreased to 8.9% of the global stock. There was a similar contraction affecting other investment. The Latin American share of the stock of dollar and sterling public foreign loans in 1929-1930 was no less than 46% of the total.[4] In 1981 the Latin American share of world debt had declined to 12%.[5]

1. The uneven impact of the depression: 1928-1933

Most Latin American economies, and certainly all the bigger ones, faced a major external shock before 1931. It was the Wall Street boom rather than the 1929 crash that marked the beginning of what was to become the "great depression" in Latin America. The massive external shock that hit Latin America affected the balance of payments, first through the capital account, and then the current account, as the value of exports fell rapidly due to the contraction of trade volumes and of export prices. In many economies, such as Argentina and Brazil, the significant inflow related to foreign loans had come to a total halt by mid-1928. The short-lived recovery of inflows in 1930 was in some cases, such as the large Brazilian coffee realization loan, mainly related to the consolidation of short-term debt.

It is not easy to single out the economy which suffered most from the external shock as the fall in export prices and volumes varied substantially between different economies. Moreover, the capacity to expand export volumes also varied considerably so that economies with a sharp deterioration in their terms of trade could partly compensate it with a significant increase in export volumes and dampen the reduction in the capacity to import. The reduction of Chile's exports was by far the most significant amongst the bigger economies: in 1932 the U.S. dollar value of Chilean exports had fallen to the almost unbeliveable level of one eight of its 1929 peak. In most other bigger economies -- Argentina, Brazil, and Mexico – the fall in the value of exports generally started in 1928, reached a trough in 1932 when the fall was in the 62-68% range in relation to their peak.[6] In Peru, the reduction was similar but the export peak was reached in 1929. The fall was slightly less significant in Colombia (55% in relation to the 1928 peak). In Central America, exports started to fall already in 1926 in countries such as El Salvador and Nicaragua, but in the others the peak was also in 1928. The trough was generally also in 1932, with the exception of Honduras where exports remained roughly stable until 1934. Reduction was slightly smaller than in the big economies in Costa Rica (55%), but even higher in Guatemala and El Salvador.

Depending on the specific country, there were sharp contrasts in the behavior of prices and quantitities to explain export trends. The volume of Brazil's exports increased by more than 50% in 1928-1933, and in Colombia had also started to increase in 1932. But in economies such as Mexico and Chile export volumes fell substantially: by 37% in Mexico, and by no less than 73% in Chile. Export volumes also fell in Argentina but recovered shaply and hovered around 15-20% below the 1927 peak until the end of the 1930s. Terms of trade fell almost everywhere in Latin America between 1928 and 1932-33: less in Mexico (20.8%), around 35% in many economies (Argentina, Brazil, Colombia, Costa Rica), 45-50% in Guatemala and Nicaragua, and 60% in Chile (1926-1933).

All Latin American economies were commodity exporters and remained so at least until the 1960s. Exports were generally concentrated in a small number of commodities. In all Latin America the leading commodities accounted for more than half total exports and in ten countries one product answered for half total exports.[7] Only Brazil was clearly a price maker in the relevant international commodity market and other Latin American coffee exporters were to a very large extent free riders of the unilateral Brazilian coffee 'valorization' policies more or less continuously adopted since 1907. Exports/GDP ratios in 1928 were relatively high in the small Central American economies (56.5% in Costa Rica), mid-range in Argentina (29.8%), Chile (35.1%), Mexico (31.4%) and Peru (33.6%), lower in Colombia (24.8%) and lowest in Brazil (17%).

In the longer term there was some diversification of Latin American exports, notably the increase in the share of oil in total exports in Venezuela and Mexico. In Brazil, the share of coffee in total exports fell from 71.5% in 1928 to 45% in the late 1930s due to increased exports of other commodities, especially cotton, but also because coffee prices fell in relation to other export prices. With the recovery of coffee prices in the late 1940s this apparent export commodity diversification was rapidly reversed.

After the seriousness of the external shock was evident, money doctors flowed to Latin America, still following the traditional division of spheres of influence that had been defined in the 1920s. Experts from the United States, and prominently Dr Edwin Kemmerer, visited the West Coast of South America and the Caribbean, while in the East Coast the British remained in control. In the case of Brazil this was somewhat surprising, given the much more important commercial links with the United States than with the United Kingdom and the rapidly rising inflow of capital from the United States in the 1920s. But the Hoover administration bungled foreign policy allowed a politically motivated extension of British financial influence that was to last until the mid-1930s.

In 1930 Kemmerer visited Colombia and recommended many economic policy measures purporting to be improvements on his own former recommendations. Central banking, banking legislation, taxation, almost nothing seemed outside the scope of the mission. In Peru, the gold exchange standard was adopted on April 1931, and as late as September 1931 a new central bank was created. But by May 1932 it joined the rest of Latin America in the road to unconvertibility and default. There was a remarkable coincidence between the Kemmerer proposals, say in Peru, and what Sir Otto Niemeyer proposed when tendering advice to the new Brazilian government in 1931. The Niemeyer report on Brazilian finances published in July 1931 stressed singularly irrealistic, and retrospectively, ill-timed proposals that Brazil should raise a sizeable loan in the London market so as to make possible a return to the gold standard. Two months after the report was published the pound sterling went off gold.

In spite of the advice of money doctors, the standard answer by Latin American economies to the external shock ended up by abandoning orthodoxy. The date of Britain's abandonment of the gold standard was crucial. Many countries that had played a waiting game until then decided to shift their policies as it became clear that there was no hope of raising new loans in London. These policies included the abandonment of the gold exchange standard followed by formal devaluation, the introduction of foreign exchange controls, which effectively rationed access to foreign exchange cover, and then some kind of adjustment of payments related to the foreign debt service.

The introduction of controls and sustained overvaluation of the domestic currency was rationalized by two lines of argument. One, valid for all economies, was to make less painful the impact of devaluation on public finances, as there was a lack of simmetry between the strength of the effects of devaluation on expenditures and revenues that transformed external shocks into fiscal shocks. The other argument, valid for those countries with a significant share in specific commodity markets, such as Brazil, dominant in the coffee market, a price maker and not a price taker, was that devaluation could be self-defeating as it would provide incentives to the concentration of sales in the short-term which would depress world prices of such commodities.

However, while most Latin American economies, with the important exception of Central America, ended up by abandoning the gold standard before the 1933 devaluation in the United States, the timing of doing so varied considerably. Argentina abandoned the gold standard quite early, closing its *Caja de Conversión* in December 1929. Brazilian foreign reserves vanished by mid-1930, after two years of stubbornly maintaining convertibility while waiting for a favourable change in the international environment. Mexico abandoned the gold standard after a protracted fight to stay in the gold standard and a massive monetary contraction in May-July 1931. After a period of flotation, the Mexican peso was pegged to the U.S. dollar in May 1932 and remained so until 1938. Chile went off gold *de facto* in July 1931, even if this was explicitly recognized only in mid-1932.

Many countries adopted exchange controls as early as 1930. Foreign exchange scarcity was met initially by a mixture of moratoria and *ad hoc* decisions without a formally defined set of rules. But after the devaluation of sterling formal controls followed. By October 1931, for instance, foreign exchange controls were introduced in Brazil, at the same time as in Argentina and Colombia. This took a form similar to that of many arrangements in Latin America and elsewhere. Foreign exchange was to be compulsorily sold to the government agent at a fixed rate and, after government demand was met, the residual exchange cover was distributed according to "essentiality" criteria to the private sector. With different formats some form of exchange control was to remain in place in countries such as Brazil for more than sixty years, if a short period of liberalization after the World War II is excluded. Nominal devaluation of the official (overvalued) exchange rate against the U.S. dollar was of 66% (mil-réis/U.S. dollar) in 1929-32 and real devaluation of 42% against the dollar was of a middle-of-the-road magnitude of devaluation if compared to other Latin American economies. Chile established exchange control immediately following its foreign debt default in mid-1931. Devaluation reflected the seriousness of the shock: nominal devaluation in the same period was of 339% against the U.S. dollar, a real devaluation of 60%. In the other extreme of the spectrum, real devaluation in Mexico was more modest at 23%, very similar to that of Argentina, where the nominal devaluation against the dollar was of 62%, but domestic deflation was rather modest. Argentina faced much pressure to treat British credits preferentially based on the British structural trade deficit with Argentina. This became explicit policy with the Roca-Runciman Anglo-Argentinian agreement of 1933.[8] The Colombian peso remained pegged to the dollar until 1933. But only in some economies in Central America and the Caribbean -- Cuba, Dominican Republic, Honduras, Panama -- where the dollar was *de facto* or *de jure* in circulation, there was no exchange control.

In most Latin American economies the magnitude of the external shock made unavoidable some kind of default or unilateral refinancing of the whole or part of the foreign debt service, especially so as it became clear after 1930 for most countries that no new loans could be floated abroad. Mexico was an especially early case as it defaulted in 1928. Attempts to renew service at much reduced levels failed and it remained in default until 1942. In mid-1931 Chile also defaulted, and Brazil and Colombia entered into three year funding loans which provided for automatic refinancing of interest due on at least a part of their foreign loans. As the crisis persisted, Colombia defaulted partially in 1932, and totally in 1933. Argentina's stance on the foreign debt was the most important exception among the bigger Latin American economies as service was maintained in full, with only minor problems affecting provincial loans. Venezuela by 1930 had redeemed its foreign debt and some of the smaller Central American and Caribbean economies also avoided default: Honduras, the Dominican Republic and Haiti.[9] Venezuela is a rather special case amongst the larger Latin American economies as it adopted a foreign exchange regime based on a floating Bolivar after 1932 in a context of its rising dollar oil revenues. By 1937 the Bolivar had appreciated 50% against the U.S. dollar.

The massive external shock suffered by most of Latin America resulted in de-stabilizing fiscal consequences as there was an imbalance between the impact of foreign exchange devaluation on revenue side and that on expenditure side. The sharp contraction of imports tended to reduce the contribution of the all-important import duties to total revenue. A significant share of expenditure was indexed to the foreign exchange rate, especially so before default and/or renegotiation of the foreign debt service. Moreover, the interruption of voluntary foreign lending to Latin America restricted deficit financing to domestic sources. In many economies continuous access to the international financial markets was an essential condition to fully service the foreign debt and even this had frequently required periodical reschedule of payments in the past. The depression would make explicit the inconsistency between keeping full service flows and the capacity to generate foreign exchange cover.

The crisis implied the interruption of capital flows to most Latin American economies. In some cases private voluntary lending returned only in the late 1960s in the middle of the Euro-dollar market boom. Total public foreign debt in Argentina declined since 1914. In the late 1920s it was of U.S.$ 745 million compared to U.S.$ 1230 million in Brazil and U.S.$ 449 million in Chile. Debt-export ratios in these big Latin American debtors which where regularly raising new loans in the late 1920s varied between 0.9 in Argentina and 2.5 in Brazil. After the external shock, these ratios increased in Argentina to something around 2.0 while they shot up to 5.5 in Brazil and 11.5 in Chile in 1932 as exports slumped.

In most of Latin America GDP in the 1920s peaked in 1929. The most important exception among the bigger economies is Mexico where the peak was in 1926. In some of the smaller economies, the peak GDP was either earlier on as in Costa Rica in 1928 or later: 1930 (Venezuela and El Salvador) and 1935 (Honduras). The trough was in 1932 for practically all Latin American economies. But in Brazil and Colombia not only the fall in GDP was limited (5.3% and 2%, respectively), but recovery started in 1931 as a result of expansionary policies adopted in the wake of the dramatic fall of coffee prices to a third of their peak level in U.S. dollars. By contrast, GDP fell 13.7% in Argentina and 21.1% in Mexico in 1929-1932 (in the latter case in addition to a fall of 3.7% in 1926-1929 from the 1926 peak). Chile had the worst record in Latin America as GDP fell 44.1% in the same period. In some Central American republics (Honduras, Guatemala) the fall of GDP from peak to trough exceeded 20% and others, such as Nicaragua, 30%, but in Costa Rica it fell only 8.7%.[10]

While the response to the external shock in almost all Latin American economies involved an attempt to shift demand from imports to domestic consumption, the extent to which such policies were successful varied considerably from country to country among other things because there was more scope for an effective answer of domestic producers in specific countries than in others. There was, for instance, idle industrial capacity in Brazil after a decade marked by an investment boom followed by recession in the mid-1920s and then by *plata dulce* and a consequent import boom. But much less so in Argentina, where a large share of existing industrial plant in the late 1920s was complementary to exports rather than of the import substituting kind.

Fast recovery in countries such as Brazil, Colombia and Mexico was based on expenditure-switching induced by foreign exchange devaluation and the imposition of import controls and also expansionary fiscal and/or monetary policies. In Brazil, from October 1931 coffee price support based on stockpiling and destruction of coffee production was partly funded by transfers from the central government. This has been claimed as Keynesianism *avant la lettre* but in fact was a only a recurrent feature of the Brazilian traditional answer to fiscal shocks induced by external shocks through public expenditure financed by printing money. What was peculiar in the policies of the 1930s was the destruction of coffee of the equivalent of three world yearly coffee crops between 1931 and the early 1940s. This contributed to support coffee prices due to Brazil's weight as a producer even if coffee prices fell rapidly to a third of their peak in the late 1920s and remained hovering barely above this level for the rest of the decade. Without such intervention the fall would have been even more dramatic. In Mexico, a shift in policies occurred in 1932, when expansionary monetary and fiscal policies were adopted. In Colombia, the public deficit rose from 5% of central government expenditure in 1928 to nearly 20% in 1931. Colombia as well as other coffee exporters in Latin America was favoured by the "artificial" recovery of coffee prices prompted by Brazilian policies of supporting coffee prices.

2. Recovery (1933-1937) and further shocks (1937-1942)

As the world economy started to recover after 1933, intervention in the foreign exchange market was made more flexible in many economies of Latin America. The

Argentinian experiments with different systems of intervention in foreign exchange markets were very influential in other countries. Stage 2 of exchange control in Argentina involved a segmentation of the foreign exchange market in official and free market rates which allowed the government to have access to cheaper exchange to cover its requirements in foreign currency and to treat imports from Britain more favorably on a discretionary basis by allowing their payment at the official (less devalued) exchange rate. A similar system was adopted in Brazil after 1934, which while non-discriminatory, included the possibility of offering a more devalued exchange rate for exporters of non-traditional exports, while coffee exporters were restricted to the official market. This is typically what happened elsewhere in Latin America as exchange controls became looser as a result of the relaxation of external constraints.[11]

In Argentina , Brazil and Chile the exchange rate was allowed to revalue against the dollar when the dollar went out gold in 1933. Assessment of real devaluation in 1932-1937 is extremely difficult because of the multiplicity of exchange rates but there is no evidence of major further real devaluation or its reversal. Many Central American and some Caribbean republics tried to remain pegged to the dollar in the 1930s. In Central America only Guatemala and Honduras suceeded. Costa Rica and El Salvador devalued rather early and Nicaragua in 1936, just before the onset of the recession in the United States.

Exports recovered strongly between 1932 and 1937 almost everywhere in Latin America but still remained considerably below peak pre-depression levels. In Argentina, rising export prices, due to droughts in many agricultural competitors in the world market, made possible a recovery of exports to a level 2.3 times above 1932 (but still more than 25% below the 1928 peak). Growth was lower but still substantial elsewhere: Brazil (1.9 times), Chile (5.3 times, from an extremely low value), Mexico (2.5 times), Peru (2.4 times). It was still lower in Central America: from Honduras (0.6 times) and Costa Rica (1.3) to Nicaragua and Guatemala (1.5-1.7). Only El Salvador was an exception (2.8 times). Terms of trade improved in most economies, especially in those economies such as Chile with the most significant fall in export prices during the 1928-1932 period. But they continued to fall in countries such as Brazil and Costa Rica. In Brazil this was compensated by a very substantial expansion of export volumes that almost doubled in this period.

The international economic policies of developed economies were a major factor to determine the trade and balance of payments performance and the extent and timing of recovery and growth of different Latin American economies. Its effects depended crucially on the geographical orientation of their trade. Economies which usually generated a surplus in their trade with the United Kingdom were vulnerable to pressure as British foreign economic became increasingly less multilateralist. In 1932, the agreements reached in the Ottawa conference reinstated discriminatory access to the British market in the form of Imperial preferences, a policy that had been abandoned in the late 1840s. "Imperial" products would enjoy preferential access to the British market and traditional Argentinian exports were consequently diverted.[12] Moreover, the British government was willing to abandon its long-established stance of defending multilateralism and in countries such as Argentina, where Britain had a structural trade deficit, was prepared to insist on extracting preferred treatment based on discriminatory policies. British policy in Argentina was based on promotion of the slogan "buy from those who buy from us."[13] It resulted in the Roca-Runciman agreement of 1933 and the Eden-Malbrán agreement of 1936 that assured preferential treatment for Britain concerning both the implementation of foreign exchange control regulations and the reduction of import duties om goods of special British interest.[14] The British share of the Argentinian market correspondingly increased in the mid-1930s in comparison with those of the United States and Germany. This British policy, however, only applied in those countries where Britain had leverage as a result of its trade deficit. In other Latin American economies, with which the United States had a structural trade deficit, the proposed British slogan was "buy from those who sell you the best".

Those countries that had a traditional surplus in their trade with the United States where in a much better bargaining position than those depending on the British market. Trade policy adopted by the United States in the 1930s evolved from the self-defeating emphasis on "beggar thy neighbor" policies, as implied by the Smoot-Hawley tariff of 1930, to a clear commitment to multilateralism and the promotion of more open trade policies worldwide as a main pillar of the Reciprocal Trade Act of 1934. The United States used its leverage with Latin American countries such as Brazil and Colombia to negotiate new trade agreements and tried with limited success to open up such markets. Cuba and Haiti were also included in a second wave of trade agrements.[15] But the United States showed considerable restraint in exerting its bargaining power to gain priviledged access to scarce foreign exchange cover or to counter the expansion of compensation trade with European competitors, especially Germany, or to extract preferential treatment for the service of dollar loans.

The introduction of new foreign economic policies in Nazi Germany, following Schacht's New Plan of 1934, resulted in the substantial expansion of trade between some Latin American economies and Germany under compensation agreements through which balanced bilateral trade was conducted in unconvertible marks. Between 1934 and 1938 there were growing frictions between Germany and the United States due to the real or alleged diversion of United States exports as a result of the bilateral trade arrangements promoted by the Nazi authorities. In many Latin American economies there was scope for the expansion of German exports through bilateral policies, given the traditional German trade deficit and this in fact ocurred both in Central America[16] and to a certain extent in Brazil. Imports from Germany displaced United States products in Central America but in Brazil it was the British share of the market that shrank. The spectacular increase in Brazilian cotton exports to Germany to about 20% of German imports, added to the fact that there was a sharp fall in cotton exports by the United States to Germany, was perhaps the most quoted instance of the alleged distortions related to compensation trade.[17] The standard resource misallocation arguments, however, are of doubtful relevance when there is excessive long-term reliance on a single commodity crop and no full employment.[18]

In many countries commercial arrears acummulated as, at the fixed exchange rates, the foreign exchange market did not clear and there was excessive demand for cheap exchange cover. Negotiations concerning the thawing of commercial arrears were fairly common in Latin America throughout the 1930s. The accummulation of arrears provided leverage for Latin American countries in the process of extracting mid-term financial accommodation mainly in New York and London to finance the reduction of arrears.

Recovery in Latin America after 1932 was particularly strong (in the 6-7% yearly rate range in 1932-39) in Brazil, Chile, Costa Rica, Mexico and Venezuela as well as in some of the Caribbean and Central American economies such as Cuba and Guatemala. It was more laggard (3.7-4.8% range) in most other economies including Argentina (4.4%). It simply did not occur in Honduras and Uruguay. In relation to the peak in the 1920s growth performance was outstanding in Brazil, Colombia and Costa Rica and curiously enough had nothing to do with the behavior of prices of coffee, their common major commodity export, whose prices remained very depressed during the whole period.

Taking 1929 as a reference the decomposition of GDP growth by sources of growth over the decade indicates that in almost every Latin American recovery was linked to a favourable impact of home demand and reduced import coefficients. Only in a handful (Brazil, Colombia, El Salvador, Honduras, Venezuela) export promotion had any importance. If only industrial production is considered, the importance of import substitution is considerably enhanced and import-substitution in agriculture especiallly important in Central America.

Balance of payments difficulties unfavorably affected both the flow of profit remittances by foreign firms operating in Latin America (due to exchange control) and the capacity to maintain profitability in face of persistent devaluation. Providers of public services this was aggravated by the political difficulties involved in seeking readjustment of public prices to compensate for exchange devaluation. British total investment in Latin America, which was heavily concentrated in public utility services and especially in railways, contracted modestly, perhaps about 7%, from a total of £876 million between 1928 and 1939.[19] But even investments of the United States in Latin America, which were much less concentrated in public utility services (25.6% of the total in 1929), declined from U.S.$ 3,462 billion (book value) in 1929 to U.S.$ 2,705 million in 1940. United States foreign direct investment in 1929 was heavily concentrated in agriculture (23% of the total, mostly in Cuba, Central America, the Dominican Republic and Haiti)), mining (21%, mostly in Chile and Mexico), oil (17%, mostly in Mexico and Venezuela) and utilities (25.6%, mainly in

Cuba, but also in most other economies). Most of the reduction was in Cuba (agriculture), Mexico (oil), and Central America and the Caribbean (agriculture and utilities). Only in Argentina, Brazil, and Venezuela stocks of foreign direct investments of the United States increased modestly (about 20%), but it was only in Brazil did investment in manufacturing increase (by more than 50% to reach U.S.$ 70 million in 1940).

Improvement in the foreign exchange constraints faced by Latin American economies after 1933 contributed to make possible a revision of the foreign debt policies adopted immediately after the external shock. But there was still a wide spectrum of policies implemented by different Latin American countries. Argentina continued to service the foreign debt. Brazil replaced its funding arrangements with a new arrangement that reduced contractual service by two thirds. There was some interest payment relief, but most of the reduction was due to postponement of amortization. But for the first time this included non-Federal foreign debt that was not a direct responsibility of the government. Federal involvement in negotiations that included non-Federal debt had become unavoidable because of Federal intervention in the foreign exchange market. Chile unilaterally decided in early 1935 upon a renewal of public foreign debt payments. Debt service was to be related to the country's capacity to pay. Yearly service fell to 10% of its contractual level. Between 1935 and 1948 partial payments amounted to about 20% of contractual interest. Substantial amounts of the Chilean dollar debt were redeemed in 1935-1939 at slightly more than 10% of its face value. Peru defaulted in 1931 and paid a small part of the service on the old sterling guano loan until 1937. Only in 1947 Peru would make a comprehensive offer on defaulted foreign debt. The position in other economies was still worse. Mexico remained in default and Colombia defaulted entirely in 1935.

External debt default was also the standard answer in most of Central America where it continued in most countries until after the Second World War with the exception of Nicaragua and Honduras. Haiti and the Dominican Republic also serviced their foreign debts in full during the 1930s and 1940s.

The sharp 1937 recession in the United States unfavourably affected GDP growth in some Latin American economies. Mainly as a result of a contraction in exports, GDP in the late 1930s fell or was practically stagnant in most of Central America, and also in Argentina and Chile. Argentina had an export boom in the mid-1930s as wheat and maize prices increased with successive crop failures in the United States.[20] But even then its growth performance, although better than that of stagnant Chile, was considerably poorer than those of Brazil and Mexico. The downturn in the United States served as a pretext for a shift in policies in some Latin American economies, as their balance of payments deteriorated, away from the liberalization that had started in 1934, especially in South America. In Brazil, the Federal government defaulted on the public foreign debt, suspending the much-reduced scheduled payments agreed in 1934. In Argentina, the dual exchange rate regime of 1933, already much refurbished to assure preferential treatment to British goods, was discontinued and an universal import licensing system introduced in late 1938.[21]

The international political situation crisis in 1938 and the beginning of World War II caused an additional external shock in many countries as from September 1939 markets in Germany and Central Europe were practically closed by the British economic blockade. Trade with the United Kingdom and France as well as with European countries that remained neutral, and increasingly with other American economies including the United States, was affected by German submarine activities. By mid-1940 most Western European markets were lost and after 1941 also the Asian markets, of which Japan was the most important. The impact was more relevant, of course, on economies that had been relatively less dependent on the United States markets before the war as those in the Southern Cone of South America and in Central America, such as Costa Rica.

Coffee prices fell substantially after 1937. In 1940, Brazilian terms of trade had decreased a further 30% since 1937 (when they were already 45% below 1928). There was a strong political motivation in the United States to foster an Inter-American Coffee Agreement that sustained coffee prices and improved balance of payments conditions in Central America, Brazil and Colombia.

Very early in the war it was perceived in London that in many neutral countries there would be surplus stocks of commodities available at depressed prices. Neutrals could be persuaded to accept payments into special accounts that could be drawn only to settle claims in sterling. Due to stiff export control in the United Kingdom drawings were mostly limited to the settlement of financial obligations related to the foreign debt service and foreign direct investment profit remittances. After 1941, unconvertible Latin American sterling balances accummulated rapidly in London and were a significant share of the relatively large reserves accumulated by Latin America during the war.

The composition of exports increasingly reflected the new demands related to the war effort. Exports to the United States and the United Kingdom were determined by official procurement and pre-emption of enemy supply. But it took some time to adjust supply to the new demands. Supply restrictions in the developed economies determined the behaviour of imports, sharply restricted in most of Latin America with the exception of Mexico. The scarcity of imports, together with the relatively strong bargaining power of some Latin American economies, made possible a qualitative change in the import substitution efforts. In Brazil, a public-owned relatively small integrated steel mill was financed by the United States adding up to initiatives in Bolivia and Mexico, with the nationalization of oil, and Chile, with Corfo, to mark a new era in the direct involvement of the state in the production of goods. Import scarcity was so pressing that it temporarily became policy of the United States to foster import substitution. As peace approached this policy would be abandoned.

Some Latin American economies that had been in partial or total default in the late 1930s resumed reduced debt service in the early 1940s. But the beginning of a general process to reach permanent debt settlements on outstanding debt which was made possible by the fast accummulation of foreign reserves had to wait for the late war period or the immediate postwar.

3. Dollar plenty and dollar shortage: 1942-1947

After 1942 there was a fast accummulation of foreign reserves in most Latin American economies. This was the combined result of the significant expansion of exports, at an yearly rate above 10% between 1939 and 1945, and the contraction of imports, due to supply difficulties -- including export control -- in some of the previous leading suppliers. Expanded exports were often the result of higher export prices rather than of expanded export volumes. Among the larger economies, Venezuela is the main exception as export volumes expanded by more than 8% yearly. The contraction of traditional export markets led to a diversion of Latin American exports, especially manufactures, by the industrially more advanced economies such as Argentina and Brazil, to non-traditional markets in Latin America and even beyond, as for instance to South Africa. Mexico expanded its exports to the

United States dramatically: manufactured exports reached almost 38% of total exports in 1945 and external demand was about three times more important than domestic demand as a source of industrial growth during the war. In most Latin America import volumes stagnated or contracted -- in some case sharply as in Argentina where they fell by more than 16%. The major exception was, once again, Mexico where imports expanded at a rate of more than 22% on average during the war.

In many economies the exchange rate regime during the war was based on a fixed nominal exchange rate. In some cases a multiple exchange rate regime was adopted, maintaining a more appreciated official rate, applied to government transactions, and also a more devalued financial rate. Since war inflation was substantial in most Latin America there was a sharp erosion of export profits during the war, especially in the case of products that were included in the war-time price control in the United Sates. Distortions provoked by exchange rate overvaluation continued after the war. In many economies fear of inflation rationalized decisions not to devalue, in spite of the high war inflation. Wildly overvalued exchange rates were fixed under the rules of the new International Monetary Fund amid optimistic views on structural changes that, it was alleged, had favorably affected the balance of trade of Latin American economies.

Latin American foreign reserves rose substantially during the war but in certain economies, and especially so in Southern South America, a large share of them were unconvertible. By far the more important case affected sterling balances as the terms of the United States-United Kingdom loan agreement of 1945 resulted in an implied British commitment to make them unconvertible into scarce dollars. Their reduction was a complex matter and involved massive purchases of British assets by

Latin American governments at prices open to controversy. Argentina, moreover, redeemed its substantial non-Federal external debt and converted it into internal debt.

The combination of explosive post-war imports – in Latin America as a whole they increased 75% in volume in 1945-48 – with a sharp reduction in convertible reserves led, in spite of some improvement in the terms of trade, to balance of payments problems in most Latin American economies. There was a concentration of imports in the dollar area as Europe could not supply eagerly demanded imports. The lack of dollar reserves was combined with trade deficits with the United States as there were no alternative sources of supply for most industrial products. This led to an acute dollar shortage in many parts of Latin America. Peak exports were reached in 1947 in Mexico, in 1948 in Argentina, in 1949 in Chile, in 1951 in Brazil. In many of these economies foreign exchange regimes based on the overvaluation of the foreign exchange and import controls continued to be adopted.

The roots of ingrained anti-export bias can be detected here. They are also mixed up with nationalism. For those economies that could consume what they exported it became tempting to reduce incentives to export to economies that could not pay in cash and to court the masses by increasing real wages and allowing increased domestic consumption of exportables. Post-war payment difficulties in Europe, compounded by the persistent protectionism affecting temperate agriculture, inexorably constrained the exports of those Latin American economies specializing in food and agricultural raw materials. Perón's Argentina is perhaps the best example of such a shift in the direction of autarchical policies.

With the improvement in the foreign reserve position during the war many Latin America governments became anxious to reach permanent foreign debt settlements with their bondholders in substitution of the sequence of short-term arrangements that had generally marked the 1930s and early 1940s. Some Central American economies such as Nicaragua and Honduras redeemed part of the foreign debt. The Mexican debt agreement of 1942 involved liquidation of principal and interest arrears in the region of U.S.$ 500 million for only 10% of nominal values. The Brazilian agreement of 1943 halved the value of outstanding public foreign debt of almost U.S. 900 million and consolidated it under the guarantee of the Federal government. But other economies waited longer to negotiate and extracted still better terms from bondholders. Chile, for instance, only reached agreement with bondholders in 1948, after a long history of default or extremely low service payments combined with debt redemption at low prices. Mexico also settled its pending obligations with the foreign oil companies that had been taken over in 1938.

British foreign direct investment practically disappeared from many Latin America economies in the immediate post-war period. Sterling balances were used to buy existing assets. Total foreign direct investment of the United States in Latin America, on the other hand, expanded modestly in the war from U.S.$ 2.7 billion in 1940 to U.S.$ 3 billion in 1946. Expansion in Venezuela, Central America, Brazil, Colombia and Chile was substantial and there was contraction in Argentina and Mexico. About half the investment was in Cuba, Chile and Venezuela, mainly in agricultural activities and mining. Brazil was by far the most important recipient of United Sates foreign direct investment in manufacturing (U.S.$ 126 million), but the expansion in Mexico was much faster.

4. The golden age of ISI: 1947-early 1960's

There is some irony in the fact that foreign exchange overvaluation adopted in some countries, at least partly justified by the fear of inflationary pressures and adverse fiscal consequences, resulted in a powerful inducement to substitute imports under the umbrella of absolute protection provided by stiff import controls. Other arguments in favour of overvaluation in economies with a big share in specific world commodity markets hinged on the intent to maintain high world commodity prices. Such commodity price support efforts were complemented in some cases by international agreements of which the most important was on coffee, as Brazil found onerous to continue with its long-standing unilateral price support policies. In the long term such policies acted as a powerful inducement to the rise of the coffee output of emerging higher cost competitors. Import controls were introduced in 1947 in some of the big economies such as Brazil and Mexico. Multiple exchange rate regimes based on a differential treatment of buyers and sellers of foreign exchange eventually became widespread in those economies opting for the import substitution strategy: Argentina, Brazil and Chile. In contrast, in Mexico, as in Colombia, this strategy was combined with sustained incentives to exports, and there was a sequence of devaluations in the early 1940s and mid-1950s.

Export pessimism played an important role in the rationalization of sustained import substituting policies especially in the context of inconvertibilty in Europe and shrinking markets for the non-traditional exports that had boomed during the war. But as the world economy recovered from the war there was an expansion of Latin American exports to Europe. In the early 1960s the United States and Europe had similar shares of 35-38% of these exports whereas in 1951 the United Sates had bought about 47% of total Latin American exports compared to 28% by Europe. The importance of intra-Latin American increased: its share of 9%, both in 1928 and 1951, reached 15% in 1963.

In the wake of policies with a strong anti-export bias, the share of exports in total world exports fell in most of Latin America in the 1950s. In some economies as Argentina and Brazil postwar nominal export peaks would not be reached again before in almost twenty years. A marked feature of Latin American development in this period was that even in the economies going through a fast process of structural change, with a sharp increase in the share of industry in GDP, the share of commodity exports in total exports remained quite high.

Import substitution was not sufficient to assure economic growth. While in Brazil and Mexico growth in the 1950s and 1960s at around 6% yearly was relatively fast and above the Latin American average of 5.2%, in the other economies commited to import substitution, Chile (4.2%), Argentina (3.6%) and Uruguay (1.7%), the results were much less impressive. The conventional decomposition of sources of growth indicates that the contribution of import substitution to growth until the mid-1960s was substantial in Brazil (26% of industrial output 1949-62) and Colombia (30% in 1956-67), but tended to be modest in other high flyers such as Mexico, and even then positive only in the second half of the 1950s.

As part of the new strategy new policies towards direct foreign investment were introduced in the mid-1950s. These were designed to attract foreign direct investment through credit subsidies, fiscal rebates, foreign exchange preferential treatment and a combination of absolute protection and restricted right of establishment. This new spurt of foreign investment was initially geared to domestic markets. Multinationals would become relevant exporters of manufactures only after the late 1970s. In most countries entry was restricted in many sectors and the state gained ground as a producer of goods and services both in the provision of public services which had been traditionally supplied in the past by foreign firms and in the industrial sector often in joint ventures with foreign investors and domestic private interests.

In contrast with the larger Latin American economies, in most smaller economies and also in Peru, policies were outward-looking and sought export diversification rather than import substitution. Some of these, such as Costa Rica, the Dominican Republic and Panama, had a good growth performance in the 1950s and 1960s. By 1960, only a few of the Caribbean economies had managed to diversify exports and became exporters of services: the Bahamas (financial services and tourism), the Virgin Islands and the Netherlands Antilles (oil refining) and Trinidad and Tobago (oil). Some of the smaller economies were heavily dependent on financial transfers. The insertion of Cuba in the world economy after 1960 was very much determined by the United States embargo that made it almost exclusively dependent on trade with the Soviet bloc, and especially with the Soviet Union. Oil was a special case among commodities and explained the star performance of Venezuela growing at more than 7% yearly in the 1950s and 1960s. As some of these economies faced difficulties in expanding their exports, import substitution gained ground in the 1960s, but given market size restrictions the process was more inefficient than in the larger economies and failed to provide a sustainable alternative strategy.

Protectionism in the developed economies affected Latin American exports, especially so the exporters of temperate agricultural commodities and textiles and apparel. But Latin American was laggard in searching for multilateral remedies for such policies. Only Brazil and Cuba, and Chile slightly later, joined the General

Agreement on Tariffs and Trade at the origin in 1947. Large Latin American economies only became contracting parties much later: Argentina in the 1960s, Mexico and Colombia in the 1980s. For Latin America, as for most developing economies, the General Agreement of Tariffs and Trade was, in the language of the day, “a rich men’s club”. Tariff lines of Latin American economies were mostly unbound, that is there were no undertakings on tariff ceilings multilaterally agreed. Quantitative import restrictions based on on balance of payments difficulties (article XVIII:B of the GATT) were the rule and made absolute protection not only possible but frequent, generally combined with exchange overvaluation. Preferential treatment painfully granted by the developed economies in the aftermath of the 1964 United Nations Conference on Trade and Development, under the Generalized System of Preferences, were minor and subject to discretionary withdrawal.

The international financial markets remained to a large extent closed to Latin America until the late 1960s. Financial flows were mostly official, such as World Bank and Inter-American Development Bank loans, and suppliers’s credits. World Bank loans to Latin America up to 1960 added up to U.S. $ 1,246 million, about 21.5% of total loans approved. This was a lower share of total capital flows than Latin America had been able to attract in the golden pre-1929 years, but in the initial post-war period there was stiff competition from economies in the process of reconstruction in Europe and Asia. The rather modest increase in financing of development projects by the United States during the second Truman administration was reversed by the Republican administration. A more substantial one occurred with the Alliance for Progress in the early 1960s in reaction to developments in Cuba. Foreign direct investment flows for Latin America as a whole in the 1950s were almost 60% of total capital inflows. This would be dramatically reversed in the 1960s and afterwards.

European integration launched by the Treaty of Rome had an important demonstration effect in Latin America. Several integration initiatives took place in the early 1960s, but on the whole they failed to provide the expected stimuli to growth. The emphasis, based on Raul Prebish's influence, was on obtaining market sizes compatible with further deepening of import substitution. In 1960, a Latin American Free Trade Association (LAFTA) was formed, including all of South America and Mexico with a free trade area as a target for 1972. A Central American Common Market was also created. Later, in the end of the 1960s, an Andean Common Market and a Caribbean Free Trade Area (CARIFTA, later CARICOM) were formed. There was some reduction of trade barriers in the early 1960s in LAFTA, but opposition by protectionist lobbies managed to freeze trade liberalization afterwards and no advance was made on a common tariff. Facilities to finance reciprocal trade were created. The so-called complementary agreements allowed trade liberalization restricted to a sub-set of members and mainly affected intra-firm trade. In 1968, the time limit to establish a free trade area was extended to 1980. While not a great success, LAFTA was one of the factors that explained the expansion of regional trade from 10% to 20% of total trade in its first twenty years, together with increased oil prices and the rise of subsidized manufactured exports in some of the big Latin American economies. In 1980, as the Treaty of Montevideo expired, LAFTA was replaced by LAIA (Latin American Integration Association) and the initial ambitions of full integration buried.

5. Macroeconomic instability, export promotion and growth: mid-1960's-early 1970's

From the mid-1960s export promotion policies became a pillar of foreign economic policy not only in most of the larger Latin American economies -- Argentina, Brazil, Colombia and Mexico -- but also in some of the smaller economies as Honduras and the Dominican Republic. These policies were based on the provision of massive fiscal and credit incentives. This partial re-orientation of the previous strategy based on import substituting industrialization was much less radical in certain countries than claimed at the time. It is indeed difficult to classify the foreign economic policy strategy of most of the bigger Latin American economies, at least until 1973, as truly "outward looking". It seems more reasonable to think of a "cross-eyed" strategy, incorporating inertial elements of inwardness and new elements of outwardness geared to export promotion and attraction of foreign direct investment. In economies such as Brazil, reduction of the protection of domestic markets proceeded very slowly, even in the golden years before 1973. Perhaps the more important feature is that government policy remained firmly based on a pick-the-winner framework. The main adjustment in relation to the full-throttle import substitution strategy, adopted in the past, was that "winners" now could be selected because of a good hunch concerning either their prospects for substituting imports, or expanding exports, or both. Subsidiaries of multinationals previously heavily protected against foreign competition, started to receive substantial subsidies related to export performance.

In many Latin American economies there was an overhaul of foreign exchange regimes in the 1960s. Explicit multiple exchange rate regimes were abandoned and crawling peg rules adopted – in 1964 in Argentina, in 1967 in Colombia, in 1968 in Brazil – so as to assure that the nominal exchange rate was adjusted in line with the difference between domestic inflation and world inflation. Mexico was once again the main exception, having adopted a fixed exchange rate and with a much steadier macroeconomic performance than all other large economies. But the general refurbishment of foreign exchange regimes did not mean that exchange rate overvaluation did not remain widespread and foreign exchange restrictions the rule. It can even be said that the proliferation of export subsidies and import duties rebates, distributed on a discretionary basis, to a large extent replicated the past distortions related to multiple exchange rate regimes.

There was a world trade boom between 1967 and 1973 with an expansion of exports of 17.9 % yearly. Latin America´s performance was not bad, with its exports expanding at a rate only 1.5% below the world average. The share of thr United States in Latin American exports decreased very little in the decade following 1963, but the Western European recovery in the 1950s was reversed with its share falling from 35% to 29% of total exports. This was compensated by a modest increase in the market shares of intra-Latin American trade (from 15% to 18% of total exports), other developing economies (2% to 4%) and the socialist economies (5% to 6%). The share of manufactured exports in total exports increased from 9% in 1960 to 21% in 1973 and new commodities such soya beans were added to the traditional list.

In the time span extending from the early 1960s to the first oil crisis of 1973, most big economies in Latin America – Mexico is a major exception – suffered a major macroeconomic slowdown, generally accompanied by a balance of payments crisis and a sharp acceleration of inflation. Argentina led the way in 1962-63, Brazil followed in 1963-67, and Chile went through the very difficult years of the socialist government between 1970 and 1973. Between 1960 and 1973, the GDP of Brazil and Mexico increased by more than 7% yearly, significantly above the average of 5.9%.

But this hides in the case of Brazil a rather unstable record: an exceptionally good performance up to 1962 and after 1967, with a recession in between. Colombia was the best performer (5.6%) amongst the large group of below-the-average economies, and the growth of GDP of Venezuela, Peru and the group of smaller economies was in the 4.7-5.4% range. The worst performers were Argentina and Chile where GDP increased 4% and 3.4% yearly, respectively, even if in the former case the decade after 1963 is known as the *primavera económica*.[22] There was macroeconomic instability in all the ABC economies: the difference was that the Brazilian average growth was much higher than in Argentina and Chile.

Relations of some of the bigger economies of Latin America with the International Monetary Fund had been difficult in several episodes between the late 1940s and the early 1960s. Drawings by most Latin American economies were frequent, notably by Argentina (1957, 1959, 1960-63), Brazil (1949, 1951-1953, 1958, 1960-61, 1963), Chile (1947, 1953, 1957-59, 1961, 1963) and Mexico (1947, 1954, 1959, 1961). The Latin American share of total drawings from the International monetary Fund was rather high (between 34% and 80.9%) in 1951-54 – even if in some years total drawings were rather low – and again in 1957-60 (between 20.9% and 63.8%) as well as in 1963 (69.5%). In 1961, Latin American drawings were substantial but were dwarfed by drawings by the United Kingdom. But these were passing problems and renewed access to financial markets from the mid-1960s reduced the importance of access to the International Monetary Fund until the 1982 crisis. By 1973 inflation and its adverse effects on the balance of payments were under control in most of Latin America, with the exception of Argentina and Chile. In Argentina, perhaps more markedly and for a longer period, and in more frequent episodes, than in any of the other larger economies, there was high inflation substantially above the levels reached in other economies in the early 1950s, and beyond 100% later in the decade. It was on average near 30% a year in the decade ending in 1973.

The foreign debt of many Latin American economies increased rapidly after the late 1960s, even if at the origin their level tended to be modest due to the forced abstinence before 1967. Voluntary lending, which had ceased since the late 1920s for most Latin American economies, was again possible after 1966 as the eurodollar market expanded. The yearly inflows of foreign direct investment into Latin America doubled between the first and the second half of the 1960s to reach around U.S.$ 0.5 billion. The rate of inflow increased even more in the early 1970s: in 1971-1973 U.S.$ 3.4 billion of foreign direct capital entered Latin America, more than in the whole 1960s. Much of it was attracted to participate in joint ventures, generally with the involvement of the public sector and domestic firms as part of interventionist public policies. But the share of foreign direct investment in total inflows of foreign capital decreased sharply: in the 1950s it was almost 60%, in 1973-74 it had been reduced to slightly more than 22%. Loans raised in the Eurodollar market were concentrated in the larger economies of Latin America and official lending continued to dominate the debt position of the smaller economies.

6. Two oil shocks and a new debt crisis: 1973-1982

Oil prices were multiplied by four in 1973-1974 and then again by three in 1978-79. The impact on the balance of payments of Latin American oil importers was severe following the first oil shock and crippling following the second oil shock.[23] This, in the latter case was because to the direct impact of oil price increases was added the substantial rise in interest rates in the wake of the shift in the economic policies of the United States away from the inflationary accommodation that had followed the first oil shock.

Strategies to face the shocks varied considerably across Latin America. Some economies deepened their commitment to export promotion. Such was the case of the big three Latin American economies – Argentina, Brazil and Mexico – and also of Colombia and some of the smaller economies as Haiti and the Dominican Republic. In certain cases, such as that of Brazil, export promotion continued to be combined with import-substituting industrialization as it was explicit government policy to further reduce dependency on imports as a reaction to the oil shock This was import substitution *in extremis*, as with imports representing only 11.9% of the supply of industrial products in 1974 it was unlikely that import substitution could serve as a bootstrap to assure growth. And indeed in 1974-1979 the contribution of import substitution to manufacturing output growth in Brazil was only 10.1%, similar to that of exports. Protection of the domestic market was again raised through a combination of tariff increases, lists of prohibited imports, national similarity rules and import deposits. At the same time approved new projects would enjoy complete exemption of import duties. Residual import substitution mostly affected intermediate and capital goods. High protection of domestic production of capital goods resulted in expensive and non-state-of-the-art import substitution with long-term adverse consequences on the competitiveness of exports.

Fiscal incentives to exports in Brazil – including export tax credits, income tax reduction, draw back and import duty reductions related to export performance – reached a peak average rate in excess of 15% in the late 1970s. Average financial incentives were in the late 1980s of the order of 11.5%. So total subsidies – some legal, others illegal under the rules of the General Agreement on Tariffs and Trade – comfortably exceeded 25% of the value of exports.

The return of Latin America to the world financial markets in the second half of the 1960s was possible because of the rapid expansion in the availability of funds in the Euro-dollar market. This was a borrower market and almost any developing economy could tap it. After 1973, the increase in oil prices further stimulated the increase in foreign indebtedness as the main element in the "adjustment" policies of many economies in Latin America. Expansionary macroeconomic policies in the United States made this possible as the resulting low nominal interest rates *cum* high inflation made some economists underline the rationality of borrowing at negative real interest rates but abstained to mention that, in contrast with pre-1930 foreign debt, interest rates were now linked to short term rates in the market.[24] Bonds were only a small proportion of the total debt of Latin American economies. So an eventual default would hit commercial banks and not bondholders as had been the case in the debt crisis of the end of the 1920s. Even oil exporters resorted to a perverse combination of foreign exchange overvaluation, new foreign loans and capital flight. Debt crises would require the bail-out of banks in lender economies rather than result in losses by "widows and orphans".

Export promotion policies were often combined with a rather risky strategy concerning the rate of expansion of foreign debt that can be described as an attempted *fuite en avant*. The idea was that it made sense to avoid a recessive adjustment and use access to foreign finance, at negative real interest rates, to foster another spurt of import substitution. Open or potentially high inflation made tempting to toy with foreign exchange overvaluation and public finances deteriorated with a sharp fall in public savings. Bad macroeconomic policies were closely linked to dependence on continued access to world financial markets and in consequence a rapidly rising foreign debt.

But there was a sharp deterioration of the international environment in the wake of the second oil shock of the 1970s as the United States adopted a totally different macroeconomic stance if compared to the soft post-1973 policies. A stringent monetary policy led to a sharp increase in nominal interest rates coupled with low inflation. This increase in nominal interest rates after 1978 led to a soaring increase in foreign debt service as a proportion of exports for Latin America as a whole from 26.6% in 1975 to 59% in 1982. Foreign direct investment flows were dwarfed by flows related to loans: the share of loans in total flows continued to increase and remained close to 85% in 1974-1981. The contribution of foreign direct investment and official capital flows, which had made up three quarters of the total inflows of foreign capital into Latin America in the 1960s, fell to only a third by 1980. Interest of the banks was concentrated in the bigger economies. In the smaller Latin American economies official debt remained more important than private flows even after these *plata dulce* years. Propped by import substitution and export promotion Brazil´s GDP increased at 5.7% yearly between 1973 and 1981, extending a very long period of high growth since the early 1940s with only relatively minor reversals such as that of 1963-65. But, by 1981 recession arrived as policies became contractionary in an attempt to fight inflation that was accelerating to more than 100% yearly and to cope with balance of payments difficulties.

The other above-the-average performer among the larger Latin American economies in the 1973-1981 period was Mexico, which also started the 1970s with a strategy based on export promotion. Mexico´s adherence to a standard export promotion strategy was, however, brought to a close by the discovery of large oil fields in 1976 when its economic strategy was narrowed down to the promotion of oil exports. The deterioration of Mexico´s macroeconomic performance was more or less in line with that of Brazil. Between 1971 and 1976 the foreign debt quadrupled to reach U.S.$ 27.9 billion. Incentives to capital flight increased with the overvaluation of the peso and persistently low domestic interest rates. At the end of 1976 inflation surged to 60% a year and a stabilization program was agreed with the International Monetary Fund with the usual mix of monetary and fiscal austerity and trade liberalization. But good intentions were dropped when the possibilities opened by the new oil riches became clear. Economic policy was deeply affected. Public expenditures soared and the nominal deficit rose to 17.6% of GDP in 1981. Imports of inputs and capital goods more than doubled in 1978-1980; those of consumption goods trebled. By 1981 the foreign debt had risen to U.S.$ 81 billion. It has ben estimated that capital flight answered for between 38 and 53% of the debt accummulated in 1977-1982. Oil prices peaked in 1981 and started to fall. There is some irony in the fact that the balance of payments crisis of 1982 affected both oil importers and oil exporters in Latin America with more or less the same intensity.

Smaller economies that had reacted to the new environment in the 1970s trying to promote exports, and especially exports of manufactures, included Colombia, the Dominican Republic and Haiti, all of which had growth performances above the Latin American average. Colombia was also favourably affected by the sharp rise in coffee prices that trebled in 1975-77 due to a big Brazilian frost.

Another group of Latin American economies avoided import substitution, export promotion of manufactures as well as the outward-looking policies adopted in Argentina, Chile and Uruguay. They concentrated efforts on policies to promote non-industrial exports. This included economies specializing in primary commodities and those concentrating efforts on services as was the case of Paraguay and Panama. In Paraguay activity was boosted, with GDP growing at more than 8% yearly in the 1970s, by the building of the two big bi-national hydroelectricity plants of Itaipú and Yaciretá as well by increased soya exports. Panama, with much less success in terms of sustained growth, established an off-shore financial centre whose activities peaked in 1982 . Of the Latin American oil and gas producers – Venezuela, Ecuador and Bolivia – only Ecuador had a good performance in the wake of the rise in oil and gas prices, with GDP increasing 9.7% yearly in the 1970s. In all these economies the oil sector came to be controlled by state-owned enterprises, including in Venezuela where the oil industry was nationalized in 1975. Some of the Central American economies were favorably affected by the coffee price boom after 1975, especially Costa Rica and Guatemala, where GDP increased 5.7% yearly in the 1970s. But political instability became widespread, particularly affecting Nicaragua after 1979.

Three Southern Cone economies – Argentina, Chile and Uruguay – adopted policies which gave absolute priority to price stabilization. These policies emphasized the need to reduce traditional anti-export bias, to open up the protected domestic markets and to remove controls on the balance payments, including the capital account. They were generally adopted after political coups by military regimes, starting with the deposition of Allende´s government in Chile in 1973 and following the demise of Peronism in 1976 in Argentina. In almost every episode, initial real foreign exchange devaluations coupled with trade liberalization, generally starting at extremely high levels of protection, ended up in exchange overvaluation due to the failure of experiments to break inflationary expectations by pre-announcing future exchange rate devaluations below the rate of inflation. This discouraged exports, promoted import booms and a rapid rise in foreign indebtedness and capital flight.

Peru abandoned its experiment rather early, following balance of payments problems created by an import boom. But experiences in the Southern Cone were more sustained and deeply affected the level of activity. The growth performance of these economies in 1973-1981 was much below the Latin American average, with GDP growing both in Argentina and Chile barely above 2% and Uruguay at 3.5% yearly.

Multilateral trade negotiations in the 1970s brought no especially favorable developments to the Latin American economies. The Tokyo Round in the General Agreement on Tariffs and Trade did not improve significantly market access for agricultural or textile and apparel products. The United States shifted away from its traditional post-war defense of non-discrimination to an emphasis on reciprocity. The new General Agreement on Tariffs and Trade codes covered issues of specific interest of the developed economies such as subsidies. The more industrialized Latin American economies became targets of the new policy of the United States that sought to bring subsidies favouring exports of manufactures under stricter control. Generous fiscal rebates that were illegal under the Genearal Agreement on Tariffs and Trade rules were adopted in countries such as Brazil were discontinued under pressure by the United States. Exports of manufactures by Latin America continued to increase in the 1970s. In some of the big economies such as Brazil they exceeded 30% of total exports. They also increased in some of the smaller successful exporters of industrial products as Guatemala and Haiti. The United States absorbed around 36% of Latin American total exports and the European share continued to decline to reach 21%. Exports to Latin America itself increased from 18% to 21% and to the other developing countries from 4% to 7%. This was a reflection of the increased share of manufactured exports in total exports, since they were mainly directed to Latin

America, and also to the proliferation of countertrade deals involving Latin American countries and suppliers of oil, mainly in the Middle East.

The second oil shock of the 1970s, and the consequent steep increase in interest rates and the interruption of capital flows, made impossible to avoid a rescheduling of payments in foreign currency in the heavily indebted Latin American economies. After slightly more than half a century a new shock, very similar to that of the late 1920s, affected Latin America and was to have in the case of some of its economies even more significant and persistent consequences on the level of economic activity than in the past.

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[1] Chapter 7 of Victor Bulmer-Thomas, John H. Coatsworth and Roberto Cortés-Conde (eds.), *Cambridge Economic History of Latin America, Volume II. The Long 20th Century, Part 2. Inward-Looking Development*. This is the final version dated February 28, 2003. E-mail: marceloab@iadb.org.

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[3] Estimates of European investment from other origins are notoriously unreliable and certainly negligible for Latin America as a whole.

[4] This does not include French or other investments since estimates are of doubtful quality. In any case, French investment in securities was unlikely to be more than about 13% of the combined US dollar and sterling investments.

[5] Data on capital flows from Bank of England, *United Kingdom Overseas Investments 1938 to 1948*, (London, 1950); United States Department of Commerce. Office of Business Economics, *U.S. Investments in the Latin American Economy*, (1957); United Nations. Department of Economic and Social Affairs, *External Financing in*

Latin America, (New York, 1965); United Nations Conference on Trade and Development, *World Investment Report 2000. Cross-border Mergers and Acquisitions and Development*, (New York and Geneva, 2000); Robert Devlin, *Debt and Crisis in Latin America. The supply side of the story*, (Princeton, 1989), 14.

[6] All these comments are based on data in U.S. current dollars. The U.S. dollar/gold parity was changed in 1933 from 20.67 to 35 $ U.S/Troy ounce of gold.

[7] See Victor Bulmer-Thomas*, The Economic History of Latin America since Independence*, (Cambridge, Eng., 1994), 194. Five of these ten were coffee exporters (Brazil, Colombia, El Salvador, Guatemala and Nicaragua), two were sugar exporters (Cuba and the Dominican Republic) and the other three were exporters of bananas (Honduras), tin (Bolivia) and oil (Venezuela).

[8] See Virgil Salera, *Exchange Control and the Argentine Market*, (New York, 1941), ch 2 and 3.

[9] See Bulmer-Thomas, *Economic History*, 209.

[10] See Juan Braun, Matias Braun, Ignacio Briones, José Díaz, Rolf Lüders and Gert Wagner, "Economia chilena 1810-1995: Estadisticas Historicas," *Documento de Trabajo* 187, Pontificia Universidad Catolica de Chile, Instituto de Economia (Santiago, 2000), 25; Pablo Gerchunoff and Lucas Llach, *El ciclo de la ilusión del crecimiento. Un siglo de políticas econômicas argentinas*, (Buenos Aires, 1998), table 1; Victor Bulmer-Thomas, *The Political Economy of Central America since 1920*, (Cambridge, Eng., 1987), statistical appendix, table A.1.

[11] See Salera, *Exchange Control*, 96 and ff.

[12] See Ian M. Drummond, *British Economic Policy and the Empire 1919-1939*, (London, 1972), ch 3.

[13] Famously: "comprar a quien nos compra".

[14] See Salera, *Exchange Control*, ch 5 and Jorge Fodor and Arturo O'Connell, "La Argentina y la economia atlántica en la primera mitad del siglo XX," *Desarollo Económico*, 13 (1973), 44-55.

[15] See Henry J. Tasca, *The Reciprocal Trade Policy of the United States. A Study in Trade Philosophy*, (Philadelphia, 1938), ch 3 and 5.

[16] See Bulmer-Thomas, *Political Economy*, 79.

[17] See Howard S. Ellis, *Exchange Control in Central Europe*, (Cambridge, Mass., 1941),, ch 4, especially the section of exchange control as a "totalitarian institution". Clearing agreements were signed with most major Latin American economies and expansion of the German share in Central American imports was especially significant. Brazilian trade was also significantly affected by compensation agreements: the German share in total imports increased while the British decreased and Brazilian cotton exports to the US rose spectacularly. It is true, however, that US products bore the brunt of direct German competition. While British imports were displaced by German competitors, other US manufactures were displacing British traditional exports.

[18] See Larry Neal, "The Economics and Finance of Bilateral Clearing Agreements: Germany, 1934-8", *Economic History Review*, Second series, 33 (1979), 398.

[19] But these estimates by J. Fred Rippy*, British Investments in Latin America, 1822-1949. A case study in the operation of private enterprise in retarded regions* (Minneapolis, 1959) are notoriously deficient.

[20] See Arturo O'Connell, "Argentina into the Depression: Problems of an Open Economy," in *An Economic History of Twentieth-Century*, *volume 2: Latin America*

in the 1930s: The Role of the Periphery in World Crisis, Rosemary Thorp, ed. (Basingstoke, 200), 199.

[21] See Salera, *Exchange Control*, ch 8.

[22] GDP estimates vary substantially between different sources but this does not affect relative performances in the period. See, for instance, Angus Maddison, *Monitoring the World Economy, 1820-1992*, (Paris, 1995); Ricardo Ffrench-Davis, Oscar Muñoz and José Gabriel Palma, "The Latin American economies, 1950-1990" in *The Cambridge History of Latin America, Volume VI Latin America since 1930 Economy, Society and Politics Part I Economy and Society*, Leslie Bethell, ed. (Cambridge, Eng., 1994); Gerchunoff and Llach, C*iclo de la ilusión*, statistical appendix.

[23] Due to low oil prices in the 1960s there was little incentive to expand oil production in marginal oil producers. In the early 1980s the of oil imports in the total imports of more dependent economies would peak above 50%.

[24] Different country risks being reflected in different spreads in relation to be added to a basic rate such as the London Interbank Offered Rate (LIBOR)..

Bibliographic essay

This bibliographic essay is necessarily incomplete given space limitations, the long time span covered and the large number of economies involved. This is particularly true for the smaller economies. It should be complemented by the three bibliographical essays covering economic matters in post-1929 Latin America as a whole, included in *The Cambridge History of Latin America, Volume IX Bibliographical Essays,* Leslie Bethell, ed. (Cambridge, Eng., 1995) as sections VII.2, VII.3 and VII.4.

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From the late 1940s the *Economic Commission for Latin America* (later *and the Caribbean* was added to its name) is a major source of data and studies on the Latin American economies. To quote a few from the early years which were extremely influential: *Economic Survey of Latin America*, (New York, several years), but specially 1948 and 1949; *The Economic Development of Latin America and its Principal Problems* (Lake Success, 1950), among many. On Raúl Prebisch's contributions see, for instance, *La obra de Prebisch en la CEPAL*, 2 vols, Adolfo Gurriere, ed. (Mexico, 1982) and Arturo O'Connell, "The Return of the "Vulnerability"and Raul Prebisch's Early Thinking on the Argentine Business Cycle," *Cepal Review*, 75 (2001), 51-65. In the mid-1950s a series of extremely influential reports on the main Latin American economies were published by ECLAC under the general title of A*nálisis y proyecciones del desarrollo económico*. Articles published in the *Economic Bulletin of Latin America*, and later in the *Cepal Review*, have also been influential as, for instance, "The Growth and Decline of Import Substitution in Brazil," *Economic Bulletin for Latin America*, 9 (1964), 1-61. The *Statistical Yearbook for Latin America* is also useful. Some of the Inter-American Development Bank reports, *Economic and Social Progress in Latin America* and its predecessors, contain important material on international issues.

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The same comment that was made on Latin America as a whole needs to be repeated for specific Latin American economies. No attempt will be made here to cover evenly all the economies of the region. This bibliographic essay, which covers mostly the larger economies must be complemented by other country bibliographical essays as, for instance, those included in sections VII.16 to VII 43 of *The Cambridge History of Latin America, Volume IX Bibliographical Essays,* Leslie Bethell, ed. (Cambridge, Eng., 1995), especially: VII.49 on Bolivia, by Laurence Whitehead; VII.41 on Ecuador, by Enrique Ayala Mora; VII.34 on Paraguay, by Paul H. Lewis; and VII.33 on Uruguay, by Henry Finch.

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