

# The 1980s: The Debt Crisis & The Lost Decade

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We will end Part One with a look at the debt crisis of the 1980s. That event was significant in many ways. First, as you will learn from the first two parts of the section, it gave the IMF a highly visible role in crisis management, not unlike its current role in the Asian financial crisis. Although many observers have criticized the Fund (and the World Bank) for its handling of the debt crisis, no one would disagree that the institution helped bring about a system (however muddled) that eventually resolved the acute phase of the crisis. The Fund was able to do this by bringing together commercial banks, debtor countries, and other entities involved in the crisis.

The debt crisis also illustrated the deep involvement of the IMF in development issues. With the collapse of the Bretton Woods System of fixed exchange rates, the Fund, some say, became an institution without a purpose. The debt crisis gave the IMF a reason for existing. Along with the World Bank, the IMF required debtor countries to implement market-based reforms in exchange for financial assistance. This marked a widespread "market friendly" movement in Latin America and elsewhere. Indeed, the reforms recently adopted in the wake of the Asian financial crisis are linked to reforms that began in the 1980s.

The IMF and World Bank adjustment programs have been very controversial, of course. The third part of this section will address the social costs resulting from the debt crisis. In light of the halt in Latin America's economic growth after the onset of the debt crisis, virtually everyone agreed that the label "lost decade of development" was accurate. Even today, the region's poverty rates have not uniformly fallen to pre-crisis levels (which were high to begin with).

Are the IMF and the World Bank to blame for the lost decade? Studies have yielded mixed analysis. Some produce clear evidence that IMF/World Bank adjustment programs have hurt the poor and widened the gap between the rich and the poor. Other studies provide evidence to the contrary. The mixed results have allowed the IMF and World Bank to insist that the short-term pain is worth the long-term gain.

## *A. An Overview of the Debt Crisis*

Let's begin with a brief overview of the debt crisis and the measures taken to resolve it.

### **1. Petrodollar Recycling by Commercial Banks to Developing Countries Gave Rise to the Debt Crisis.**

Most observers believe the "petrodollar recycling" of the 1970s gave rise to the debt crisis. During that period, the price of oil rose dramatically. Oil-exporting countries in the Middle East deposited billions of dollars in profits they received from the price hike in U.S. and European banks. Commercial banks were eager to make profitable loans to governments and state-owned entities (as well as private companies) in developing countries, using the dollars flowing from the Middle Eastern countries. Developing countries, particularly in Latin America, were also eager to borrow relatively cheap money from the banks.

### **2. Decreased Exports and High Interest Rates in the Early 1980s Caused Debtor Countries to Default on Their Foreign Loans.**

The frenzied lending and borrowing came to a halt with the global recession in the early 1980s. The significant drop in debtor countries' exports, combined with a strong dollar, (i.e., the value of the dollar increased relative to the value of other currencies) and high global interest rates, depleted foreign exchange reserves that debtor countries relied upon for international financial transactions. Debtor countries consequently began to feel the strain of having to make timely payments on their foreign debt, which became much more expensive to pay off because the loans carried floating interest rates that increased along with global rates. These problems were compounded by massive capital flight—outward transfers of money by private individuals and entities in developing countries.

In August 1982, Mexico stunned the financial world by declaring that it could no longer continue to pay its foreign debt. Not long after Mexico's declaration came similar announcements from other Latin American debtor countries, such as Brazil, Venezuela, Argentina, and Chile. The prospect of massive defaults posed grave problems for creditor countries, such as the United States. Government regulators discovered that commercial bank creditors, particularly the big U.S. ("money center") banks, had dangerously low levels of capital that could be used to absorb losses resulting from massive loan defaults. Policymakers were also worried that there was no central authority or forum that could oversee an orderly resolution of the crisis, such as a global bankruptcy system.

### **3. Case-by-Case Debt Restructuring Negotiations Saved the International Financial System from Collapse.**

Yet the principal players in the crisis — governments, banks, the IMF and the World Bank — averted a collapse of the international financial system by resorting to case-by-case debt restructuring negotiations, popularly known as the "muddling through" approach. The approach entailed engaging in a series of work-outs with hundreds of commercial bank creditors throughout the world via Bank Advisory Committees or Steering Committees, which were composed of banks with the greatest exposures to debtor countries. (Work-outs for government-to-government lending took place under the auspices of the Paris Club, a forum open only to sovereign states.)

Under this approach, commercial banks agreed to (i) provide new loans to debtor countries, and (ii) stretch out external debt payments. In return, debtor countries agreed to abide by IMF and World Bank stabilization and structural adjustment programs intended to correct domestic economic problems that gave rise to the crisis. IMF stabilization programs typically included drastic reductions in government spending in order to reduce fiscal deficits, a tight monetary policy to curb inflation, and steep currency devaluations in order to increase exports. World Bank structural adjustment programs focused on longer-term and deeper "structural" reforms in debtor countries.

### **4. "Debt Fatigue" Appeared in the Mid-1980s.**

After a few years of repeated restructuring deals, "debt fatigue" began to appear. New loans to debtor countries plummeted as commercial bank creditors contemplated the possibility that debtor countries were facing insolvency rather than a temporary drop in their ability to pay back the foreign debt.

In October 1985, U.S. Treasury Secretary James Baker proposed a strategy, dubbed the Baker Plan, that attempted to alleviate the debt fatigue. The plan was designed to renew growth in fifteen highly indebted countries through \$29 billion in new lending by commercial banks and multilateral institutions in return for structural economic reforms such as privatization of state-owned entities and deregulation of the economy. The strategy failed, however, because the projected financing did not materialize and, to the extent it did, the new lending merely added to debtor countries' already crushing debt burden. During this period, Latin American debtor countries were making massive net outward transfers of resources.

In light of what appeared to be an intractable problem, government officials, academics, and private entities began to propose plans that would provide debtor countries with debt *relief* rather than debt *restructuring*. In the meantime, various debtor countries suspended debt payments and fell out of compliance with, or otherwise refused to adopt, IMF adjustment programs. This eventually prompted the big creditor banks to admit publicly (by adding to "loan loss reserves") that many of the loans to debtor countries would not be repaid.

### **5. The Brady Initiative in 1989 Focused on Debt Reduction Strategies.**

The Brady Initiative, announced in March 1989 by U.S. Treasury Secretary Nicholas F. Brady, marked a change in U.S. policy towards the debt crisis. Given the persistently high levels of foreign debt, the Initiative shifted the focus of the strategy from increased lending to voluntary, market-based debt reduction (reduction of outstanding principal) and debt service reduction (reduction of interest payments) in exchange for continued economic reform by debtor countries.

Debtor countries obtained significant (but not massive) debt relief under the Brady Initiative through: (i) direct cash buybacks; (ii) exchange of existing debt for "discount bonds" (bonds issued by the debtor country with a reduced (discounted) face value but carrying a market rate of interest); (iii) exchange of existing debt for "par bonds" (bonds that carry the same face value as the old loans but carry a below-market interest rate); and (iv) interest rate reduction bonds (bonds that initially carry a below-market interest rate that rises eventually to the market rate). Commercial bank creditors that did not wish to participate in a debt or debt service reduction option could choose to give debtor countries new loans or receive bonds created from interest payments owed by debtor countries. Debtor countries sweetened the deals by providing "enhancements," such as principal and interest collateral (U.S. Treasury bonds).

### **6. Brady Deals Combined with Economic Reforms and Increased Flows of Capital to Debtor Countries Led Some Observers in the Early 1990s to Declare that the Debt Crisis was Over.**

Commercial bank creditors agreed to Brady deals with a good handful of countries, including Argentina, Costa Rica, Mexico, Nigeria, the Philippines, Venezuela, Uruguay and Brazil. In the meantime, Latin American countries implemented substantial economic reforms. In 1991, the region registered capital inflows that exceeded outflows for the first time since the onset of the debt crisis. This led some observers to proclaim that the debt

crisis was over for major Latin American debtor countries.

### ***B. Stabilization and Adjustment Programs***

Here we provide more detail regarding IMF stabilization programs and World Bank structural adjustment programs.

The IMF's stabilization programs applied short-term "emergency" measures intended to reduce domestic demand for goods and services (IMF stand-by arrangements). The World Bank engaged in policy-based lending through structural adjustment loans (SALs) and sector adjustment loans (SECALs), medium- to long-term loans that supported structural changes to improve supply and prevent the recurrence of a crisis. The distinction between IMF and Bank programs often blurred in practice, however, because of the close collaboration between the two institutions and the complementary nature of their programs. Both programs carried "conditionality," releasing funds in installments and requiring recipients to meet performance criteria for each installment.

#### **1. IMF Stabilization Measures Tried to Cool Down Overheated Economies.**

The idea behind stabilization is that a drop in demand will result in a reduction of the current account deficit (more imports than exports), which the IMF believed was one of the major causes of the financial crises in debtor countries. In most cases, governments reduced demand by cutting public expenditures, devaluing the country's currency, and reducing the money supply. The expenditure-cutting included drastic cuts in infrastructure (e.g., roads, bridges, and dams), freezing state employees' wages or laying off state employees, reducing consumer subsidies, and cutting health and education expenditures. Central banks devalued the currency in part to reduce imports and increase exports. Authorities reduced the money supply to check inflation.

#### **2. World Bank Structural Adjustment Measures Promoted Market-Based Reforms to Increase Efficiency.**

World Bank structural adjustment programs complemented stabilization efforts by seeking to increase economic efficiency, which, in turn, would increase the domestic supply of goods and services. Although such programs differed among countries, they shared two themes: liberalization of domestic and foreign trade, and privatization of often large and inefficient public enterprises. Domestic liberalizations included abolishing price controls, freeing interest rates, ending credit rationing, and establishing a capital market. Liberalization of external trade typically included reduction of high tariffs, elimination of

quotas on imports and import licenses, abolition of export duties and licenses, devaluation of the currency, and product diversification. Public enterprises were also subject to market discipline via privatizations, reduction or abolition of subsidies, and other streamlining measures.

### ***C. The Social Costs of the Debt Crisis: The Lost Decade of Development***

A great number of observers criticized the IMF and the World Bank for their handling of the debt crisis. Indeed, the criticisms of that crisis resemble much of what we have heard about the Asian financial crisis: the IMF and World Bank stabilization and structural adjustment programs (SSAPs) imposed great costs on the poor and vulnerable in developing countries while "bailing out" foreign players such as banks and investors.

#### **1. The Debt Crisis Brought Debtor Countries' Economies to a Halt and Wiped Out Gains in Social Welfare.**

It is not hard to find evidence showing that the poor, women, children and other groups (indigenous peoples) suffered disproportionately as a result of structural adjustment programs during the 1980s. As Latin America's economies stagnated (experiencing zero or negative economic growth), per capita income plummeted, poverty increased, and the already wide gap between the rich and the poor widened further. The debt crisis seriously eroded whatever gains had been made in reducing poverty through improved social welfare measures over the preceding three decades. These developments led policymakers to label the 1980s "the lost decade of development."

#### **2. Post-Crisis Studies have Shown that Stabilization and Structural Adjustment Programs have had Mixed Effects on Poverty and Income Distribution.**

Post-crisis studies of the impact of SSAPs have helped policymakers evaluate whether such programs have had a negative impact on poverty and income distribution. The studies show that SSAPs have had mixed effects. Some studies indicate that SSAPs have adversely affected the poor and increased the gap between the rich and the poor in developing countries. This is because SSAPs have resulted in lower wages for laborers and increased unemployment. Funds earmarked by governments or the World Bank for "social safety nets" have fallen short of the amount required to prevent overall increases in poverty.

As one might expect, other studies have shown that SSAPs are not as detrimental as critics have claimed. Some have pointed out that the impact of SSAPs varies from country to country--they are not uniformly detrimental across developing countries. Others have shown that the plight of the poor can be improved after the implementation of SSAPs. For example, an overvalued exchange rate can reduce agricultural exports by making them more expensive for foreign consumers, thereby impoverishing people in the agricultural sector. A devaluation may improve those exports by making them less expensive and may indirectly increase the income of the rural poor. Still other studies have shown that avoiding adjustment or implementing adjustment policies that depart from IMF/World Bank criteria have resulted in skyrocketing inflation, which disproportionately hurts the poor who use most of their income for consumption.