poor, various interventions aimed at increasing the satisfaction of basic needs, as well as at structural changes in the sociopolitical setting, are required.

Because adjustment policies often involve difficult policy choices such as how to distribute the burden of adjusting to adverse external shocks, any meaningful program should be based on social consensus if it is to be successfully implemented. This would imply designing programs together with all affected social groups. This could lead, for example, to the formulation of incomes and price policies that affect wages and include other incomes such as profit and rental. As part of a broader developmental policy, social consensus could be sought to exempt the poorer wage groups from declines in their incomes in times of contraction by setting a floor to minimum wages and guaranteeing access to essential services to safeguard a minimum level of living.

3 LOSERS PAY REPARATIONS, OR HOW THE THIRD WORLD LOST THE LENDING WAR

John F. Weeks

In the late 1970s, the economics of Latin America and Africa entered into an economic depression worse than that of the 1930s, plunging the populations of these countries to levels of poverty and unemployment of a decade before. A disturbing aspect of this profound economic and social crisis is that most of the concern of the international community has focused on what in human terms is a minor side effect of this catastrophic depression—the inability of governments to service their foreign debts. In any rational world, the financial side of the crisis would be the least of our worries, a problem easily dealt with through a moratorium on payments, "forgiving" part of the debt, or general default, as in Latin America in the 1930s.[1] But on the contrary, the solution to the narrow financial issue, whose resolution directly affects relatively few people and to an extent merely involves manipulation of accounting categories in a world of ledger entries and reserve ratios, has become the prior condition

1. "Those who tremble at the prospect of widespread fault will find their fears reinforced by the World Bank. The biggest and most lasting casualty of a conflictual breakdown of loan agreements would be the confidence indispensable to future economic and financial relations and the broad perception of a shared common interest in making the international economy work. At stake may be not only future financial flows to developing countries, *but the preservation of the whole international framework*" (World Bank 1987b: x). Emphasis added.

On the Richter scale of apocalyptic polemics, the last phrase must register quite high, and one can perhaps speculate on the discretion involved in invoking such visions of doom.

for amelioration of starvation, deprivation, and the general degradation of human existence that accompanies a sudden descent into abject poverty.[2]

We are indeed in a world turned upside down, a world in which those who stress the urgency of material problems such as poverty and unemployment are considered hopeless romantics, and those who restrict themselves to the rarefied world of high finance are hard-headed realists. There is good reason for this inversion of reality. At one level, we live in a world in which finance does in fact take priority over material life. The representatives of the international financial system speak with a certain truth when they say that default on debt, particularly by the Latin American governments, could destabilize the world monetary system, though the long-term cost of this for the peasants and wage earners of the Third World might be less than that of orderly debt servicing.[3]

While at one level we can grasp the irrationality of a world gone mad in which finance counts for all and the human condition for little, we necessarily must enter into that world lest we ourselves be judged as unbalanced, and our suggestions discarded as the ravings of deranged romantics. It is the purpose of this paper first to review the process by which Third World countries accumulated large external debts over the last fifteen years. Second, I consider why the accumulation of debt has resulted in a protracted crisis. Finally, I critique structural adjustment programs in light of the preceding discussion.

THIRD WORLD DEBT AND RESERVE CURRENCIES

It is obvious that the great impetus to developing country debt was the dramatic increase in petroleum prices during 1973-1979, which redistributed world income from oil importers to oil producers. But before considering why governments of underdeveloped countries reached a point of over-indebtedness, one must ask a prior question: Why is it underdeveloped countries that are in this situation and not developed ones? A quite plausible argument can be made that a number of advanced industrial countries were more sensitive to the increase in oil prices than were underdeveloped countries.[4] Japan and the Federal Republic of Germany, the second and third industrial powers in the

2. On human suffering, see Jolly and Cornia (1984).

3. Commenting on default as a policy alternative to full debt service, Robert Devlin writes: "It is not at all obvious that the debtor countries [in Latin America] would have been worse off with full or partial conciliatory defaults and acceptance of the risk of costly sanctions . . ." (Devlin 1987: 93). In an insufficiently noted paper, Carlos Diaz-Alejandro demonstrates that debt default in the 1930s had a net positive effect on Latin American economic development (Diaz-Alejandro 1985).

4. Certainly the decline in oil prices in recent years has benefited industrial countries more (World Bank 1987b: xi).

western world, produce no oil, and because their economies are so industrialized they are much more dependent upon oil than even Brazil and Korea. Yet Brazil and Korea have huge absolute and per capita foreign debts, while the FRG and Japan do not. Clearly something more than a rise in oil prices was involved.

First and most important, the monies of the western industrial countries serve as de facto reserve currencies, the currencies in which other countries, namely underdeveloped countries, must conduct their trade (even among themselves) and hold in hoards to clear trade imbalances. This has a profound effect on the balance of payments of the western industrial countries. If Brazil runs a persistent deficit in its international payments, it must sooner or later seek private bank financing or go to the IMF in hopes of striking a bargain on a standby agreement. Further, when borrowing from private banks the government is partly financing its deficit via the deficits run by reserve currency countries. The "hard currencies" that banks lend to Brazil do not accumulate in those banks by magic.

This interactive relationship, in which the currencies of western countries are sustained in part by the borrowing of governments of underdeveloped countries, was quite obvious during the boom in petroleum prices. During the 1970s, the major oil-producing countries ran enormous surpluses on their trade accounts. These were matched by deficits suffered by oil importers, both developed and underdeveloped. The so-called "recycling" of petrodollars involved in part the financing of western economy deficits by Third World governments' borrowing.[5] Far from facing a situation in which they had to borrow to finance their trade deficits, the governments of the western countries found themselves in the enviable position that their financial systems were net lenders. Their currencies returned to them as hoards held by oil exporters and, to a lesser extent, direct investments in physical assets. Rather than creating a financial squeeze in the western economies, the worldwide trade deficits of non-oil producing countries stimulated a financial boom.

For those romantics who might question a monetary system in which a major shock (oil prices, for example) hits underdeveloped and developed countries alike, but stimulates potential crisis in the former and a boom (financial at least) in the latter, an apologetic answer is at hand. Were it not for stable reserve currencies (of individual countries or in the form of Special Drawing Rights from the IMF), world trade would be chaotic, we are told. While the arrangement may not be precisely to the liking of the government of each country, it is hardly realistic to think that international payments could be

5. See Chapter 13 by Representative Bruce Morrison for a discussion of the public policy implications of the recycling of petrodollars.

cleared with currencies as unstable and legally restricted as those of, say, Latin American countries.

This, however, is a transparently fallacious argument. To the extent that the dollar, mark, pound, et cetera, are more stable than the currencies of Latin American countries, this is in part *because* they have a reserve status, not vice-versa. If in Bretton Woods at the end of World War II the criterion for reserve status had been stability, no rational person would have selected the pound sterling as a medium of international payments. Not only was it severely devalued after the war, it was sharply restricted as to the conditions for its convertibility (though most of these restrictions were later dropped). The pound was selected for geopolitical reasons, not the least of which was the existence of Britain's colonial empire, in which the pound played a central role. The role of the dollar in clearing trade accounts in Latin America has an analogous origin. Specifically with respect to the U.S. dollar, little claim can be made for its stability in recent years. Indeed, a significant part of the instability of Latin American currencies can be traced directly or indirectly to the instability of the dollar, a point I consider below when treating interest rates.

Thus, we can conclude that a major reason the oil price boom manifested itself in developing countries in the form of heavy debt burdens, but did not do so in the western economies, is because of the organization for the international monetary system. It should come as no surprise that from 1976 to 1982, 108 of the 114 standby agreements reached with the IMF involved governments of underdeveloped countries (Killick 1984a).[6] But there is a further reason that the western industrial economies fared better with regard to the oil price increases, namely the flexibility of these economies.

After the first rise in oil prices, many commentators predicted that the debilitating effects would be overcome by conservation measures in response to relative price changes, both through lower use of petroleum due to income effects and the substitution of alternative fuels for oil. In the industrial countries these predictions have largely been fulfilled, but not in the countries of the Third World. While there are notable examples of development of alternative fuels, such as the production of combustible fuels from sugar, "conservation" in the Third World was primarily achieved by lowering the level of economic activity, or not at all. There is a good reason for this: the development of alternative energy sources requires investment. Foreign investment flows to developing countries declined substantially over the last ten years, and

6. For an analysis of the 1947-1979 period, when borrowing by developed countries was more important relatively, see Officer (1982).

government investment has been constrained by the same balance of payments pressure that was the impetus for conservation. The possibility that existing plant and equipment could be used for alternative energy sources was virtually nil.

Further, in the industrial countries reduction in use of petroleum came not only in use of fuel but also in use of petroleum-based inputs, as natural fibers and nonmetallic minerals became relatively cheaper. Such substitution requires a developed production structure, which most developing economies do not have. For example, Nicaragua was an exporter of raw cotton; the increase in petroleum prices made cotton a cheaper input for clothing than synthetic fibers, yet there was not a single plant in Nicaragua in the 1970s to render raw cotton into thread (Weeks 1985a: chapter 7). Adjustment to the rise in petroleum prices required new investments at every level of production in developing countries, new investment which for the most part was not forthcoming.

The answer to the question of why underdeveloped countries in particular accumulated large debts: It was the necessary consequence of their relationship to the international monetary system and the underdeveloped nature of their economies. Given this, is it nonetheless the case that governments borrowed beyond their means and banks lent beyond the point of financial responsibility? One can only pose that question by ignoring the events that followed the increase in oil prices, or by treating those events as predictable. If there has been any event since the end of WWII that can be described as a transitory, "once-and-for-all" change, it was the increase in oil prices. Given the tremendous price increases in 1973 and 1974, it was only reasonable to assume that at some point in the not too distant future an oil glut would result. Many observers predicted this and, notwithstanding the sharp price rise in 1979, these predictions proved correct, perhaps beyond the dreams of those who had made them. In the mid 1970s, it was reasonable that both governments of underdeveloped countries and private bankers would view the large trade deficits of Latin American countries as transitory, which with respect to oil prices they were. Further, many developing countries of the region had experienced rapid growth just prior to the price increases, and there seemed no reason to think that such would not be the case once the effect of the oil shock had run its course.

Three other factors indicated reason for optimism. First, the prices of many nonoil primary product prices experienced a moderate boom, so even the short-run repayment situation seemed favorable. Second, increased oil prices had a depressing effect on the rate of growth of the western industrial economies (particularly in the United States), and a reasonable prediction was that once adjustment had occurred, their rate of expansion would be rapid. This in turn

would presumably increase the demand for primary products, facilitating the repayment of the debts that were being contracted. And third, the debts were negotiated in a period of inflationary pressure at real interest rates that were quite low.[7] Few experts seriously believed that international inflation would fall dramatically within the space of a decade, particularly if the recovery of the western industrial countries occurred as anticipated. Therefore, the future interest burden appeared manageable. In light of these reasonable expectations, a Third World government would have been foolish *not* to borrow, for not to do so would have implied as an alternative a program of domestic deflation that prevailing expectations predicted to be unnecessary. After all, one of the major functions of credit, for individuals, firms, and governments, is to "smooth out" short-period fluctuations along a long-term trend.

Some of these expectations were fulfilled, namely a dramatic shift to a petroleum market characterized by excess supply. However, the other expectations—buoyant primary product prices, continued inflationary pressures, and economic growth of developing countries with a strong export record—all derived from the anticipation of economic growth in the western industrial countries. Instead of growing as projected, the U.S. economy entered into its worst depression in half a century, with its performance in 1981 to 1983 nothing short of disastrous in terms of unemployment and falling real wages. Instead of rising, primary product prices fell, and petroleum-importing developing countries began to run deficits even on their nonoil imports. Worse still, while the sharp decline of the U.S. economy had the effect that any Keynesian would predict—lowering the rate of domestic inflation—nominal interest rates rose to historically unprecedented levels.[8] Why real interest rates rose I consider below.

Were these problems not enough, the glut on the petroleum market proved a mixed blessing indeed to the developing countries, if it was a blessing at all. While high oil prices had generated trade deficits, they had also generated the liquidity by which those deficits could be financed in the short run—the "recycling" of petrodollars discussed above. But the new trade deficits, created by the depression in the U.S. economy, had no such benevolent side effect. Once oil-producing countries no longer enjoyed large trade surpluses, the supply of world liquidity contracted dramatically. In retrospect, the years of high petroleum prices made for an environment considerably more favorable for

7. For example, Devlin calculates that interest rates deflated by changes in the world price of Latin America's exports averaged -4.8 percent for 1973 to 1979 (Devlin 1987: 91).

8. Devlin calculates an average real interest rate for Latin American debtor countries of 17.4 percent for 1981 to 1986 (Devlin 1987: 91). The World Bank calculation for all developing countries for the same period is about 15 percent (World Bank 1987b: xii).

the growth of developing economies than do present circumstances. For oil-producing countries, it was obviously a time of boom. For nonoil producers, the higher cost of petroleum was partly offset by easy access to liquidity and the concessionary oil sales by Mexico, Venezuela, and the Gulf States.

Less tangibly, but of great importance, during the 1970s the relationship of developing country governments to the world financial community was quite different from what it had been before or is likely to be in the foreseeable future. From the end of WWII until the oil boom, short-term balance of payments support was usually obtained only from the IMF or bilaterally. Both sources involved governments entering into economic and/or political commitments that they might otherwise not have chosen. With liquidity in effect no longer scarce during the years after 1973, private banks with money to lend lacked the market power to impose conditions on the borrowing governments, due to the competition among banks.

By contrast, the developing country governments found themselves in the worst of possible worlds in the 1980s—low export prices, tight liquidity, unprecedented real interest rates, and a staggering debt burden carried forward from the previous decade. And the situation has proved worse still. In the past, the recovery of the U.S. economy has been associated with an improvement in primary product prices. In 1983, the United States economy began to revive, growing rapidly in 1984 and early 1985 (via enormous depression-induced idle capacity and excess demand stimulated by massive budget deficits, as any Keynesian would predict). However, the response of primary product prices has been sluggish at best, suggesting support for the famous Prebisch-Singer hypothesis that primary product prices tend to fall relative to prices of manufactures in the long run.

The recovery of the U.S. economy has brought no relief for hard-pressed Third World governments. The export demand was sluggish for Latin American countries, whose economies were particularly dependent on the U.S. markets.[9] Given the contrast between the medium-term expectations by governments and bankers in the 1970s and subsequent economic events, attributing an unmanageable debt burden to the irresponsibility of the contracting parties is absurd. In effect, it seeks to cast blame and divert attention from the institutional and economic context in which the debts were contracted and the market interventions by creditor governments and multilateral agencies to force payment.

9. Mexico and Brazil increased their exports to the United States by about US$5 billion on an annual average, 1982-1985 compared to 1980-1981. However, for the rest of the hemisphere the increase was barely US$1.5 billion. In the case of Central America, half the increased exports to the United States represented trade diversion (Weeks 1988).

One of the most debilitating aspects of the economic environment of the 1980s for debtor governments has been the extraordinarily high real interest rates, which, it is generally agreed, are the result of the policies of the government of the United States. In the last four years, developing country governments have faced interest rates in relation to export prices (the relevant comparison) that were multiples of what was experienced from 1950 to 1980. The usual explanation of these high interest rates is the astounding size of the operating deficit of the federal government budget in the United States—more federal debt accumulated in the first four Reagan budgets than in the 200 years since the American Revolution. There is a certain bitter irony about these deficits, which no doubt is not lost on Latin American politicians and policymakers. As we shall see in a subsequent section, the policy packages being pressed upon Latin American governments by the multilateral agencies with the enthusiastic encouragement of the current U.S. administration place heavy emphasis on "fiscal responsibility," reducing state expenditures to cut the gap between those expenditures and state revenues. Were the IMF to impose the same discipline on the most profligate government in the world, one might take the commitment to fiscal austerity a bit more seriously.

However, the hypothesis that interest rates are high because of the size of the federal deficit ("crowding-out") is based on dubious application of closed economy monetary theory. It obscures a much more fundamental difficulty of the U.S. economy that will not be eliminated by cutting the deficits. Over the last two decades, the U.S. economy has become increasingly import-using, with the share of imports in GNP more than doubling since the 1950s and early 1960s. On the other hand, export performance has been quite poor, resulting in enormous annual trade deficits. In most developing countries, as local policymakers know to their chagrin, the result of a huge trade deficit would be to force a program of severe austerity on the population. In contrast, the U.S. economy enjoyed a recovery beginning in 1983, though trade deficits continued to grow. This was possible because of high interest rates, which drew in short-term capital from abroad to finance the excess demand for imports. Thus, far from being a factor restraining economic expansion in the United States, as some argue, the high interest rates are the necessary condition for economic expansion. Lower interest rates would make the trade deficit unmanageable (even though the dollar is a reserve currency), forcing deflationary policies on the current administration to reduce the import bill.

In other words, the growth of the United States economy in the 1980s was based on attracting short-term capital, which intensified the international liquidity shortage for Third World governments. It was largely circumstantial that the capital inflow served to finance a government deficit. Were the United States fiscal deficit to be substantially reduced, high interest rates would still be necessary to finance the large import bill, whose basic cause is the lack of competitiveness of domestic production compared to production in Western Europe and Japan. To the extent that there is a "crowding-out" phenomenon, it is borrowers in Latin America and other parts of the underdeveloped world that are being "crowded," not the private sector in the United States.

BANK MARKET POWER AND THIRD WORLD DEBT

During the 1970s and early 1980s, developing countries accumulated external debts to a previously unprecedented level. However, this accumulation need not have resulted in a prolonged crisis of debt management. Given the economic environment, a payments crisis was inevitable for governments of developing countries, but properly functioning financial markets provide a variety of means to resolve even the most severe payments difficulties. The accumulation of unmanageable debt in the private sector is hardly uncommon, and the response in financial markets is bankruptcy or some form of devaluation of debt paper. The purpose of this section is to consider why world financial markets did not respond quickly and smoothly to eliminate the payments crisis.

It is useful to begin with a thought experiment that demonstrates the efficient response of financial markets to a payments crisis. Following common practice, let it be assumed that private banks in the 1970s carried out their lending on the basis of rational calculations of costs and benefits. Further, as is the current vogue, let it be assumed that economic agents made their predictions of the future on the basis of rational expectations. That is, they formulated their lending policy on the basis of a correct and complete model of the world economy, such that those predictions corresponded to the mean outcome of a set of alternatives each characterized by random shocks. In formulating policy, banks presumably set the lending rate to incorporate the probability of varying degrees of default and rescheduling. On the reasonable assumption that banks treated the world economy as characterized by uncertainty and risk, the lending rate and terms of loans were set above what would have prevailed in a world of perfect foresight. It should be added that market power on the part of banks, an issue that looms large below, would not affect the evaluation of probable outcomes. If capital markets are efficient, then at a minimum the average terms of loans incorporated the possibility of outcomes unfavorable to creditors even had expectations not been rational. To assume otherwise requires one to justify systematically irrational behavior,

which among other things would imply a general lack of faith in the efficiency of market outcomes.[10]

The implication of this thought experiment is that while the economic environment of the 1980s was radically different from that of the 1970s, the new conditions were ones that rational agents would have anticipated and that efficient markets would accommodate. Once the payments crisis began, one would expect that competitive financial markets would produce secondary trading in Third World debt paper, with bond values falling to a level that would adjust the actual debt service toward the long-term equilibrium level. If private trading was efficient there would be no reason to expect the competitive market outcome to be disruptive to the international financial system. This unfortunate occurrence (from the point of view of banks) would be read as but one of many possible outcomes, to be balanced against past and future outcomes when banks benefited from favorable random shocks. To assume that banks and the international community would be thrown into shock by the commonplace and mundane vehicles of secondary trading in debt paper and loan default is to attribute an irrationality to economic agents in this case that economic theory refuses to entertain in any other line of inquiry.

Economic theory tells one that secondary trading in debt paper would be stabilizing. While the devaluation of loans might result in bankruptcy of lenders, there is nothing in the theory of the firm that suggests that bankruptcy is anything more than an aspect of the efficient working of markets. On the debtor side of the ledger, default and discount sales of debt would reduce debt service to a manageable level, which as a side effect would strengthen the balance sheets of remaining international banks.[11] Once debt had been discounted and defaulted to a manageable level, debtors would again be creditworthy and competition among lenders would bring forth new loans if such were required. If one is skeptical about this sanguine scenario, then one is in effect rejecting the general conclusion of mainstream economics that markets produce efficient outcomes, with the implication that policy should be based on political and power considerations rather than criteria of economic efficiency.

In light of what theory suggests as the obvious market solution to the payments crisis, this question necessarily arises: Why did not efficient secondary markets in Third World debt paper develop? The answer to the question is that the monopoly power of the primer international banks prevented the emergence of such a solution. A brief comparison to the 1930s is

10. In Chapter 16, Darity argues that banks in fact may not have incorporated a risk premium.

11. During the lending boom it was common practice for borrowing governments to contract not to repurchase their debt on a secondary market. Such a pledge could easily be circumvented.

relevant here. In the 1930s, the governments of Latin America escaped from an unmanageable debt burden through default and secondary market discounts of their debts. The decentralized character of debt-holding meant that creditors could neither combine to distort the operation of the market mechanism nor combine and conspire to enforce punitive sanctions against debtor governments.[12] The experience of the 1930s, along with economic theory, suggests that the fear that "the whole international economic framework" (to use the World Bank phrase) might crumble in response to the efficient operation of financial markets is not inherent in default and discounting, but the result of the monopoly power of international banks. That the market distortions preventing the spread of secondary trading in debt are the result of a cartel of banking interests is generally recognized, and World Bank authority can be cited:

> . . . [M]any banks remain concerned that an expanding secondary market in developing country debt will call into question the valuation of loans. . . .U.S banks, in particular, have been reluctant to trade in the secondary market for this reason, and have thus restrained its growth.[13]

It is hardly surprising that banks would be reluctant to encourage the development of secondary markets, because their efficient operation would be precisely to discount debt ("call into question the valuation of loans"). It remains the case that action by banks to prevent the emergence of such trading represents perhaps the most serious market distortion associated with the debt crisis. One can identify several inefficient consequences of this market distortion. First, it has prolonged the payments crisis, which might well have been several years behind us had secondary markets operated efficiently. As a consequence, inefficiencies in the banking systems of the developed countries have been perpetuated, the growth of world income has slowed, and there has been a substantial increase in the tension between governments of developed and developing countries.[14] Second, the exercise of monopoly power has effected an arbitrary redistribution of income from debtors to creditors. The redistribution is arbitrary in that it bears no strict relationship to efficient market outcomes. As argued at the outset of this section, either the lending policy of banks reflected a rational expectations prediction of probable outcomes or borrowing costs incorporated the risk of default and discounted

12. For a brief but illuminating discussion of the 1930s, see Devlin (1987: 92-93); and also Diaz-Alejandro (1985).

13. World Bank (1987b: xxxiii).

14. One might also speculate about the Third World governments that have fallen, the increase in the incidence of malnutrition, the children that have gone uneducated, and the public investment in social infrastructure that has been cancelled.

refunding of debt. In either case, the distorted management of financial markets to achieve full repayment under original conditions represents an attempt by banks to recover not only the normal rate of return, but also a monopoly rent. This can be demonstrated by way of a hypothetical example. Assume over n time periods competition among lenders sets normal loan conditions. In some time periods the lenders will do abnormally well (for example, full repayment at a real interest rate above what was predicted); in other time periods the lenders will do abnormally poorly (high default rates or real interest rates well below predicted levels). However, if shocks are random and expectations rational, the mean outcome will correspond to the normal rate of return under conditions of long-run equilibrium. When lenders seek to avoid losses during the unfavorable periods they are in effect violating the operation of competitive markets and unilaterally altering the rules of the game.

The foregoing analysis suggests a major item for the agenda of public policymakers in developed countries and multilateral agencies: If one adheres to the principle that market outcomes are efficient, then the distorting effect of the bankers' cartel should be eliminated;[15] and at the very least responsible agencies and governments should not aid and abet the distortions. The issue can be put another way: Secondary trading in debt paper might not have solved the payments crisis, but it is a solution offered by the market mechanism. Given that representatives of creditor governments and multilateral agencies have professed great faith in the magic of the market, why was this possible solution not seriously pursued?

THE ALLIANCE OF THE INTERNATIONAL BANKS AND THE "BRETTON WOODS TWINS"

Anyone who has followed World Bank publications in recent years will know that the Bank has come to place increasing stress upon the importance of the private sector in the process of growth and development in the Third World, to the extent of recommending privatization of state property. The IMF can of course be commended for its consistency on this issue throughout its existence. One can presume that such emphasis reflects a theoretical and empirical judgment that market outcomes are generally efficient. Therefore, it is rather puzzling that with regard to Third World debt both of these institutions have discouraged policies that would allow market processes to operate effectively.

15. Combination and conspiracy to restrict the size of the secondary market is not inconsistent with disarray among the banks on other issues, as described by Sacks and Canavan in Chapter 5.

Creditors have used monopoly power to insulate themselves against market discipline in a number of important ways, none of which the Bretton Woods multilaterals have shown disposition to criticize. Indeed, cooperation of the multilaterals was probably a key element in the success of monopoly intervention in the financial market. First and perhaps most important, the international banks have been impressively successful in maintaining discipline in their own ranks against the pressure of market forces while preventing any symmetric solidarity among debtor governments. In a strategy any general would envy for an armed conflict, the banks have managed to concentrate their forces in a protracted series of case by case battles against scattered and disorganized debtors. More than incidental to this strategy of avoiding a pitched battle against the combined opposition has been the role of the IMF as an advance force to define the scope of conflict. The combination of the case by case review of debtor government financial needs and serving to confirm creditworthy status has made the IMF central to the exercise of bank monopoly power. This role of the IMF as the broker for the bank cartel began on an ad hoc basis, and its impressive success in preventing official default led to its emergence as official Fund policy in mid 1982, when Managing Director J. deLarosiere announced that the multilateral would serve as a catalyst for organizing debt rescheduling on a case by case basis.[16]

Second, the multilaterals have been instrumental (or at least acquiescent) in bank pressure to force debtor country market intervention to nationalize (socialize) private sector debt, a policy most important in Latin America. A substantial proportion of the money owed by the most indebted countries was contracted by private economic agents. One can presume that this portion of the debt was agreed upon with rational calculations of profit and loss by both sides of the exchange under the rules of governance of market trading. Therefore, it is a quite brazen exercise of monopoly power by international banks to demand debtor government intervention to "guarantee" private debt.

"Guarantee" in this case is a misnomer, for what is involved is state intervention to protect private agents from the judgment of market outcomes. Clearly there can be extenuating circumstances. If a private debtor operates in a country with severe exchange controls such that hard currency is available only through an administrative process, then the state has de facto socialized private debt and should do so officially. However, the most celebrated case of cartel pressure to force socialization of foreign debt, that of Chile, involved no such

16. It is difficult to find neutral observers with regard to the payments crisis, but a quite balanced discussion of the role of the IMF is contained in ECLAC (1985). An excellent analytical treatment is found in Darity and Horn (1988: chapter 9).

extenuating circumstances. When the government of Chile announced that the private sector's foreign debt was the responsibility of those who contracted it, capital controls were sufficiently lenient to leave little complaint about the convertibility of the national currency.[17] Yet the government of Chile immediately came under tremendous pressure from the international financial community, including threats of sanctions. Both the IMF and the World Bank were at that time counseling governments throughout the Third World to limit the scope of government intervention and rely more on private initiative in resource allocation. Therefore, it is surprising that these two multilaterals did not use their great influence to support this privatization move by the Chilean government. What seems to be involved here is a double standard. In as far as privatization and deregulation facilitate private profitability, governments should limit their intervention in markets. However, when market outcomes dictate private losses, government intervention is not only tolerated but forced upon debtor countries. This asymmetric position—for example, enthusiasm for privatization of virtually any state activity but pressure to socialize the foreign debt—casts doubt upon the allocative efficiency arguments offered by the World Bank and the IMF.[18] Markets achieve their allocative magic through penalizing losers with losses as well as rewarding winners with profits. Deregulating to stimulate the latter while socializing to discourage the former generates major market distortions. The "practical" argument one hears to justify socializing developing country foreign debt is that not to do so would result in a serious loss of confidence on the part of the international banks. This may well be so. If it is, it implies that market processes are destabilizing and not to be trusted for resource allocation. To continue with the present example, if the Chilean private sector cannot be trusted with the responsibility of its external debt, should it be entrusted with the over 500 firms denationalized since 1973?

There is a further market distortion created by socialization of the foreign debt. As argued above, presumably the lending conditions of the contracted debt incorporated a risk element to compensate banks for the possibility of default. Once all governments are forced to socialize the debt and repay in full, the risk element has been eliminated. Part of the debt service then represents a

17. For a discussion of controls on capital flows in Chile in the mid 1980s, see Arellano and Ramos (1987).

18. Interestingly enough, when discussing how privatization increases the return on investment in developing countries, Chile is noted as a positive example. "Several countries, notably Chile, have begun to return government-controlled companies to the private sector in order to improve competitive conditions and reduce budgetary outflows" (World Bank 1987b: xii). It is a surprising oversight that the passage does not refer to the government's forced nationalization of approximately 2 percent of GDP (the relative size of private debt servicing).

pure monopoly rent and a misallocation of national resources to unrequited foreign transfers. One looks in vain in the reports of the multilaterals for reference to this major market distortion. A third source of market distortion regarding the payments crisis should be mentioned: capital flight. There seems to be a consensus that the international banks, aided by creditor government policies, have actively sought to attract private deposits from wealthholders in Third World countries.[19] Rodriguez characterizes this process as "criminal":

> . . . [F]oreign banks and governments have created various incentives to stimulate capital flight, and thus tax evasion from Latin American countries A behavior considered criminal . . . in the advanced countries is actively prompted by the members of the . . . OECD, especially the United States.[20]

Perhaps the most surprising aspect of this inconsistent policy by the multilaterals is the heavy stress placed on the disruptive effect of nonpayment. The emphasis given to apocalyptic consequences of default and debt discounting is a relatively recent phenomenon, one which contrasts sharply with previous views. For example, in the influential Pearson Commission Report, one is told "debt relief should be recognized as a legitimate form of aid," and the contemporary Rockefeller Report took a similar view (Pearson 1969: 18; Rockefeller 1969).[21] One should entertain the possibility that the predictions of catastrophe emanate more from the boardrooms of the international bank cartel than from the inherent workings of the international financial system.

STRUCTURAL ADJUSTMENT: THE LENDING WAR ON THE DOMESTIC FRONT

Since its creation, the International Monetary Fund has functioned as an institution concerned with short- and medium-term monetary and balance of payments adjustment. As such, its role has not been to promote economic development, though its defenders might argue that the policies of the Fund have a favorable effect on development. The task of promoting development was assigned to the International Bank for Reconstruction and Development (World Bank), and the Inter-American Development Bank was established to

19. "[M]any foreign private banks and financial institutions were accomplices of capital flight as competitive pressures induced them to actively solicit deposits from private economic agents in [Latin America]" (Devlin 1987: 90). The word "competitive" should be interpreted in the context of oligopolistic competition.

20. Rodriguez F. (1987: 139).

21. A detailed treatment for debt refunding in this century is found in Bitterman (1973).

play the same role on a regional level. Until recently, the approach to lending by the Fund on one hand and the World Bank and the IDB on the other reflected the two different roles. The Fund provided balance of payments support, and in doing so felt justified in the dubious practice of imposing conditions on its loans that involved policy decisions we normally take to be the responsibility of governments.[22]

This role of the IMF—laying down macroeconomic conditionality—has always been controversial, and is generally avoided by the World Bank and the IDB. Restricting themselves primarily to program and project lending, these two institutions did not in the past tend to set macroeconomic conditions, though continued lending to a government was always conditional upon "creditworthiness." Creditworthiness basically referred to the likelihood of a government's being able to repay a loan, but the criterion was applied with considerable flexibility, consistent with its vagueness. Country reports by these two institutions included macroeconomic policy suggestions, but an official of a Latin American country who went to Washington to negotiate a loan with the World Bank or the IDB would not anticipate being presented with a shopping list of policy changes that would be the precondition for financing of a highway, rural development project, or social development scheme. The technicians of the World Bank and the IDB were primarily concerned for it to be demonstrated that the money would be used for the stated purpose and reach the proposed beneficiaries. Such an approach was particularly the case with the IDB, whose executive officers took the view that their institution had been created by the governments of the hemisphere, after all, and it would be inappropriate to dictate policy to the organization's ultimate constituency.

Given this orientation of the World Bank and the IDB, it is not surprising that the two organizations took a considerably more eclectic view than the IMF of the possible economic policy regimes that might be consistent with successful economic development. Within the halls of these institutions one found a response to the shifts in current thinking about the nature and goals of development that was notably absent in the IMF. For example, a considerable amount of theoretical and empirical work was done in the World Bank on what came to be called the "basic needs approach" to economic development (though official World Bank policy never endorsed such an approach). The eclecticism of these institutions gave a degree of freedom to borrowing governments that they would not have enjoyed a few hundred yards away at the IMF. In

22. By custom, governments are considered to some degree to represent their populations, so it is appropriate that they alone should take the momentous decisions that affect the welfare of their populations and be held responsible for taking them.

particular, the fact that a government might be unwilling to agree to conditions set down by the IMF for a standby loan did not necessarily prejudice its chances of obtaining project or program funding from the World Bank and the IDB.

This situation has undergone rapid change in the last five years, to a point that soon the division of labor between the Fund and the Bank may be more apparent than real. The vehicle for this shift in World Bank basic policy is the structural adjustment loan (Wright 1980; Landell-Mills 1981).[23] Structural adjustment loans are very close cousins of the IMF standby lending, with the same type of conditionality. The shift in emphasis from project and program lending to lending based on macroeconomic conditionality would seem to be the wave of the future in the World Bank. The similarity in outlook between the IMF and the World Bank, with the IDB moving in the same direction, is even more clearly demonstrated in the unprecedentedly close cooperation among the three institutions in recent years. This is shown in two developments. More overtly, emergency loan packages have been put together among these institutions for several countries, a notable case being the Costa Rican crisis of 1981-1982. It might be thought that cooperation can only be a good thing in these matters so that efforts are coordinated. This would certainly be the case in a perfect world in which the borrowing government and the lending institutions shared the same goals and assessment of current economic difficulties. But as shown in the previous section, this cooperation has become an integral part of monopoly intervention to block market outcomes.

This is particularly the case with the IMF serving as the international financial system's gatekeeper and watchdog. In case after case in Africa, Latin America, and Asia, reaching a standby agreement with the IMF served as the necessary condition for obtaining World Bank structural adjustment loans as well as progress in renegotiating outstanding debt with private banks. The international financial community has indeed responded forceably to the Latin American debt crisis. It has closed ranks, established a common hard line, and developed a policy package that all governments must accept or face the real prospect of international financial boycott.[24]

Needless to say, the Reagan administration was extremely enthusiastic about this approach to the debt crisis, for the policy measures incorporated in structural adjustment programs are very close to the hearts of conservative politicians. However, there is a more fundamental reason for the return to importance of the pre-Keynesian theoretical and analytical framework. Given

23. See Chapter 9 by Epstein for the history of policy-based lending by the World Bank.

24. It should be stressed again that the cost of noncooperation with the Fund may be exaggerated. As Lissakers and Sacks and Canavan argue in chapters 4 and 5, no new lending would be forthcoming in any case.

the severity of the debt crisis, there is little, if any, possibility of Latin American countries achieving historic growth rates and repaying the debt.[25] Because the financial community in the 1980s ruled out any significant reform that would reduce the debt burden in the foreseeable future, policies for growth must yield to policies to facilitate repayment. This, however, is a difficult argument for the multilateral agencies to make explicitly—that the economic welfare of millions must be sacrificed (at least any significant improvement) to satisfy the welfare of the world's major private banks.

The conservative structural adjustment programs offer a way out of this difficult ideological situation. The central message of the structural adjustment programs is that the present difficulties of the Third World economies are the result of bad policy, and if correct policies are followed growth will result with no change in the present international economic environment. This is a powerful ideological message, an apparent exception to the general rule in economics that there is no such thing as a "free lunch." The argument is that if "distortions" are eliminated—economies opened to the international environment and "government taken off the backs of people"—exports will expand, investment will be forthcoming, and growth will follow. Though some developing country policymakers may have been under the impression that their economic difficulties arose in part from the instability of the world economy, the fact of the matter, we are told, is that the difficulties arose because their economies were insufficiently integrated into the world economy. It is this powerful ideological message, that throwing one's economy into the arms of the unregulated market will be the salvation of the Third World, that I now briefly consider.

While the word "structure" is vague when used in the term "structural adjustment," it suggests changes that involve basic alterations in an economy. "Changing the structure of production," for example, suggests more than just policies; it suggests also investments, technical innovations, and retraining of the workforce. However, in the contemporary context, the term means something quite different and much more limited—deregulation, denationalization, and reducing the size of the government sector. The basic change it suggests is primarily an ideological one—for Third World policymakers to abandon the path of economic nationalism and adopt the doctrine of laissez faire. This is offered as if its benefits are so obvious that only the ignorant would challenge them, despite the fact that no presently developed country developed by following laissez faire policies, with the exception of Great Britain.

25. Chapter 15 by Sunkel addresses this issue.

Let us consider the argument at face value. The basic structural adjustment package includes some or all of the following policy measures. The alleged benefits are given after each policy measure.[26]

1. Devaluation of the exchange rate: to reduce imports and increase exports.
2. Restriction of the growth of money wages (and, implicitly, lower real wages): to increase the rate of growth of employment, dampen inflationary pressures, and increase international competitiveness.
3. Cut government spending: to reduce the growth of the money supply (if there is a fiscal deficit) and "free" resources for private-sector initiative; domestic demand will fall, further releasing resources for export production.
4. Directly reduce the growth of the money supply by central bank action: to reduce inflationary pressures.
5. Deregulate markets, eliminating price controls, interest rate ceilings, and subsidies on commodities and services: to achieve a more efficient allocation of resources.

These policy measures reflect certain assertions of causality that have an almost religious status: "a fall in real wages will increase employment," "inflation results from excessive expansion of the money supply," and "a devaluation of the exchange rate will stimulate exports and discourage imports." These are only a representative sample. It should be noted that none of these are factual statements, nor are they theoretical inferences about which there is general agreement. On the contrary, even at the most theoretical and abstract level each of these apparently simple statements is a victim of intense controversy. If one surveys the literature on macroeconomic theory over the last twenty years, one discovers that none of these statements holds true except under very restrictive theoretical conditions. This cannot be stressed too much. Contrary to what some may argue, these statements do not reflect basic economic laws. They are nothing more than abstract conclusions derived from a highly controversial theoretical model whose internal, logical inconsistencies are well documented.

I shall take each of these statements in turn and demonstrate the theoretical controversy surrounding each. In the case of the first, the means (lower wages) achieves the end (more employment) on the argument that lower wages will induce capitalists to change from their current technique of production to one that is more "labor-intensive." This analysis of technique-switching is

26. The discussion that follows might be compared to the presentation in Chapter 6 by Liebenthal and Nicholas on the World Bank approach to adjustment policies.

theoretically valid only if the economy produces a single product. Thus, even in theory (to say nothing of the real world) it holds in conditions so restrictive as to be absurd.[27] The difficulty with the second statement (money supply/inflation) is that it cannot be established that there exists something called "the money supply" that is under the direct control of government authority (through the central bank) or indirect control (through government expenditure and taxation), except again under very restrictive assumptions.[28] With regard to devaluation, there are at least six separate approaches to its impact on imports and exports, the majority of which conclude that its result is *a priori* indeterminate. The monetarist approach tells us that devaluation has no permanent effect at all except in so far as it reduces the "real money supply."[29] All of this suggests that experts do not agree, to say the least.

Ten years ago this highly restrictive model of economic behavior upon which the structural adjustment medicine is based was in disfavor in the economics profession. In recent years, with the rise of right-wing politics in the United States and Great Britain it has come back into vogue. But its resurgence is not the consequence of finding solutions to its fundamental theoretical difficulties, but rather the result of a change in political climate that has made its ideological implications more functional. There is no compelling theoretical or intellectual reason to adopt the policy package. Nor is there much reason on empirical grounds. The experience of "market-oriented," "outward-looking" macroeconomic regimes in recent years has been mixed.[30]

The theoretical and empirical judgment on the conservative policy package is negative; there is little reason to think that these policies would generate growth any better than protectionist, nationalist-oriented policies. Why, then, is the policy package the new orthodoxy among the multilateral agencies? The answer is quite simple: This is not a growth package; rather, it is a policy package designed to minimize the possibility of loan default. With regard to debt repayment, its strength and appeal lie precisely in it not being a growth package.

27. The debate over whether lower wages induce more employment is part of the "capital controversy" in economic theory, and is treated in the context of short-run macroeconomic models in Weeks (forthcoming).

28. The hypothesis that the availability of money adjusts automatically to its demand has theoretical credentials at least equal to the hypothesis that there is a money supply determined independently of the demand for money.

29. The "monetarist approach to the balance of payments" denies that devaluation can alter domestic relative prices (Ghani 1984: 7-12).

30. See the analyses of Chile, Argentina, and Uruguay in Foxley (1982); see also Fishlow (1985: 133-142). The Fishlow article provides a thorough and balanced critique of the free market orthodoxy prevalent in the IMF.

The structural adjustment/liberalization package is essentially an output-reducing policy. If there is one economic relationship for which there is general agreement among economists and considerable empirical support, it is that if an economy is depressed sufficiently, there will come a point at which exports exceed imports. This remedy, which some critics have called "leeching" after the nineteenth century medical practice of applying leeches to the sick to extract "unhealthy blood," does not always work; and sometimes when it does work it requires a catastrophic decline in production to achieve its desired effect. However, it does work with great regularity, making it a least-risk choice for the financial community. The goal is to ensure that debts are repaid in full. If a balance of payments surplus (the necessary condition for debt repayment) is more likely to be achieved through depression or stagnation of economies than through growth (which is probably correct under present world market conditions), then depression or stagnation it must be.

The stabilization package is directly deflationary through its stress upon cutting government expenditure. Arguments about the inflationary impact of fiscal deficits are purely window dressing. For example, the IMF set for Costa Rica a government deficit target of less than 2 percent of GDP as conditionality at a time when the actual Costa Rican deficit was already one of the lowest in the hemisphere relative to national product.[31] Wage restraint has the same effect. Even more deflationary is the demand that economies be "opened." The consequence of this is to drive out of operation import substitution industries, thus reducing the demand for imported inputs. At this point, devaluation becomes functional. Without devaluation, the collapse of domestic industry might result in a flood of imports to replace commodities previously produced locally. Devaluation generates inflation in the prices of imports, as well as a regressive redistribution of income, which lowers aggregate demand. It might also be noted that liberalization policies have the side-effect of undermining regional economic integration, such as the Andean Pact and the Central American Common Market, a result consistent with preventing Latin American cooperation on debt issues.

The hypothesis that throwing oneself at the tender mercy of world market forces will result in debt repayment *and* prosperity is hardly convincing. Were it so simple, the governments of developing countries would have followed such a policy course long ago. The IMF has been singing the praises of the free market-liberalization strategy for forty years, and a mid 1980s policy paper reports that not only does this medicine work relatively painlessly, it also has

31. For a discussion of the Costa Rican case, see Weeks (1985b).

equitable distributional effects (IMF 1985b).[32] If this is true, one is left to wonder why few governments ever apply it except under duress. Either the patients are exceedingly stupid or the medicine is not the wonder drug it is advertised to be. Perhaps policymakers in Latin America have noted that governments have returned to the IMF for the same treatment up to nineteen times since the end of WWII with no obvious improvement in the health of their economies (Weaver and Wachtel 1984). Finally, one must be skeptical about a policy package that proposes deregulation with regard to one part of the economy (production and distribution), and massive government intervention with regard to another part (private external debt).

CONCLUSION

It has not been uncommon in world history for the victors in wars to demand reparations of the defeated, two notable examples being the Franco-Prussian War and World War I. These reparations represented unrequited transfers forced upon the vanquished, enforced by the threat of punitive sanctions. At the risk of entering into polemics similar to those invoked by the supporters of current international policy (with their visions of financial apocalypse), the current payments crisis can be likened to war reparations. Once the world economic environment turned dramatically unfavorable to creditors and borrowers around 1980, the issue became how losses would be apportioned. Because borrowers and lenders had contracted jointly, a joint sharing of losses would not have been inappropriate; indeed, theory suggests that a competitive market solution would have produced such an outcome. In place of this, the international banks embarked upon a conflict strategy designed to shift as much of the loss to debtors as would be possible. What then ensued was a financial war in which the debtors lost, often ignominiously, and were forced to declare something close to unconditional surrender. If the war analogy seems too farfetched, one might refer to various calculations of the debt service burden of developing countries compared to the reparations paid by France in the 1870s and Germany in the 1920s (Devlin 1987: 81-82; Fishlow 1985: 142). For African countries, one can note that the net flow of IMF funds has been a negative US$2.25 billion from 1985 to 1987 (United Nations 1986b and 1988b: 12). The

32. Recently the IMF seems to have in part accepted the argument of its critics that its programs harm the poor. It was reported in the *Wall Street Journal* on June 1, 1988, (p. 7), "A report from the International Monetary Fund acknowledges that poor people have been hurt by policies it has pressed on Third World countries with the support of the U.S." It was not possible to obtain a copy of this report before this volume went to press.

decision before the international community in the late 1980s is whether to continue to enforce reparations or to declare an end to conflict and pursue an enlightened and magnanimous policy toward the vanquished. Key to ending the conflict would be for the multilaterals to play a neutral role, rather than facilitating the monopoly intervention of international banks.