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Barbara Fritz

Development or Growth-cum-Debt?

Reflections on Latin America's Economic Strategy in a Time of International Financial Instability

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Garystraße 21, 14195 Berlin

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Reflections on Latin America's Economic Strategy in a Time of International Financial Instability[*]

Abstract: This article analyses the impact on the Latin America economies of international financial instabilities. It inquires into the implications specifically of the Asian crisis for the exchange-rate-anchor based stabilisation and development strategy adopted by most countries in Latin America during the 1990s. As this strategy necessitated profound structural reform, governments and representatives of international financial institutions alike view it as an instance of "cruel injustice" that despite its efforts Latin America should fall victim to the Asian crisis. In marked dissent from this view, the present paper argues that the model adopted was based on an explicit overvaluation of national currencies which was bound to lead to a weakening of international competitiveness and a dramatic deepening of Latin America's debtor position. Dependency on permanent capital imports has increased the vulnerability of national economies and impeded the formation of a sustainable development model. The Asian crisis was not the cause of this impasse; it has merely revealed the inherent weakness of the model which turns out to be little more than the old strategy of growth-cum-debt in a new guise.

1. The Waves of the Asian Typhoon: Fallout in Latin America

Having painfully re-spun the image they held in the 1980s as a region permanently beset by crises, in the early 1990s Latin American countries embarked on a course of wide ranging structural adjustment including such measures as fighting inflation, market deregulation and liberalising capital markets and foreign trade. By the time the Asian crisis erupted, in Latin America these policies – commonly held to be neoliberal in nature – were bearing their first fruit: the average inflation rate which by the end of the 1980s hit the four figure mark had shrunk to below 10 percent; government deficits (with a few exceptions) were well within the criteria laid down by Maastricht for the European Currency Union; and, with the new perception of the region as an area of emerging markets, capital inflows had markedly increased. The consequences of the 1994/1995 Mexico crisis prompted most governments to embark on substantial reforms of their banking sectors. By 1997, with an overall increase of 5 percent in gross domestic product (GDP), Latin America could count itself among the regions with the highest economic growth.

Yet in spite of all these promising indicators, Latin America was very severely hit by the international financial crisis unleashed by the crash of Asian economies. Despite impressive growth rates in the period prior to the crash, real GDP growth plummeted to 2,2% (1998) and was expected to fall as low as 0,1% (1999). In some countries state budgets registered dramatic reductions in revenues and the regional current account deficit rose from 3,1% of regional GDP in 1997 to 4,5% in 1998 and only reverted back to 3,2% in 1999.

Empirically this downswing may be ascribed to two phenomena (CEPAL 1998b). First, spill-over effects led to capital flights, triggered by a general panic about estimates for so-called emerging markets and by porfolio re-allocations to cover losses in other regions. These effects were mirrored in the deterioration of the ratings given by the international agencies and the increase in spreads on emissions for Latin American countries on international credit markets. The clearest sign of the change of climate was the slump on Latin American stock markets: at the cusp of the Russian crisis, in september 1998, shares lost up to 50 percent of their value as against the start of the year. A large number of states suffered from dramatic capital haemorrhaging and had to ward off speculative attacks. Some economies faced devaluation. During the first months of the crisis borrowing on international finance markets came to a standstill and even today access to international credit markets remains restricted compared to the volume in the mid 90s. Even Chile, that Latin American showcase renowned for its capital import controls, was hit by a speculative attack in 1998 and forced to abandon its capital market restrictions.

Second, the international crises caused a clear demand fall-off in the region. Even if the overall volume of Latin American exports to Asia or Russia isn't all that high, some countries were harder hit than others by the reduction of exports to crisis-ridden areas. Chile, for instance, unloads a third of its main export product, copper, on south-east Asian markets. This demand fall-off should be coupled with the much weightier factor of the general slump in basic commodity prices since 1998 caused by the Asian recession and ensuing attempts to compensate for devalued currencies by maximising exports. Compared to 1997, Latin American terms of trade suffered a reduction of 18,3% in 1998, and a further 15,3% in 1999. This proved a body blow for oil exporting countries like Mexico and Venezuela and copper exporters like Chile but it also had a significant impact on all Latin American economies which, due to the relatively high proportion of raw material used in their production, had to accept significantly less favourable terms of trade.

Third, and this is valid basically for the bigger, more industrialized countries of the region, competion for market slots for (semi-)industrialised products in, for example, the US-American market, became much stiffer after the drastic devaluations undergone by Asian currencies. As countries scrambled to obtain trade surpluses, intra-regional trade too suffered severe restrictions leading to a notable impact on regional integration projects such as the Mercosur (*Mercado Común del Cono Sur*).

2. Political Reactions: Crisis Management and nothing more?

One of the prime reasons why the consequences of the external shock – capital flight, reduced government revenue, falling exports – were so hard on Latin American countries is that they impacted directly on the so-called fundamentals which foreign investors use as a benchmark when calculating risks and chances for a particular country. This made it vital for governments to embrace direct economic adjustment policies in an effort to signal to the markets that even under the most adverse conditions they were ready and willing to pursue the course they had embarked on.

In terms of a response to the crisis, this necessitated first and foremost a tightening of monetary and fiscal policies coupled with a switch-over to a more active trade policy in so far as this was compatible with the norms of the WTO (see table 1). Obviously all Latin American countries did not enter on this new round of structural adjustment with the same degree of rigour. Despite drastic losses in revenue due to the slump in oil prices, Ecuador and Venezuela, for instance, were rather sluggish in striving to balance the budget whilst, on the other hand, Mexico succeeded in pushing through no less than three austerity packages during 1998 and introduced a short-term increase in the domestic interest rate of 100 percent in an effort to achieve its set budget target and to re-balance its external account – and all this despite drastic losses in the oil revenue sector which constitutes 40 percent of the government budget. Similar measures were adopted by Argentina, Chile and Columbia.

Without a doubt Brazil was the country on which the crisis had the severest impact. As it is by far the biggest economy in the region, this entailed serious negative consequences for its neighbours as well. Prior to the balance-of-payment crisis in January 1999, it had twice successfully warded off speculative attacks on its currency. In November 1997, when capital was leaving the country in the context of the burgeoning Asian crisis, the government doubled the interest rate from 20 to 40% p.a. and embarked on a radical fiscal adjustment programme. But in 1998, in part because of the negative fiscal effects of the highly restrictive monetary policy and in part due to the relaxing of the austerity policy, the public deficit rose. With significant external imbalances and in a climate of growing uncertainty due to the ongoing Asian crisis and its spill-over to Russia, this caused a strong and continuous bleeding of foreign exchange beginning in September 1998 and which neither yet another monetary and fiscal tightening nor the approval of a US$ 40 billion IMF rescue package in November of the same year could stop. The maxi-devaluation, finally forced through in early 1999, was passionately fought up to the last moment because it signified the abandonment of the strategy of stabilisation and development pursued up till then.

Table 1
Economic policy measures in Latin America as an answer to the south-east Asian Crisis

Country	Fiscal adjustment	Monetary tightening	Trade measures
Argentina	X		X
Brazil	X	X	X

Chile	X	X	
Colombia	X	X	X
Ecuador	X		X
Mexico	X	X	
Paraguay		X	
Peru			possible
Uruguay			possible
Venezuela	X		

Source: CEPAL (1998b), p. 21.

In the view of the CEPAL, the United Nations Economic Commission for Latin America and the Caribbean, the Latin American response to the crisis was one of unprecedented speed and efficiency:

> (...) the measures that have been adopted are much more stringent than would have been justified by conditions in each economy, as they have basically been put in place in response to foreign speculation. As a result of the financial contagion the Latin American countries will have to bear heavy costs, which have no domestic justification and are, thus, economically and socially inefficient. (CEPAL 1998c, p. 18)

The chief economist at the World Bank, Joseph Stiglitz, also held the fallout of the crisis on Latin American to be a "particularly cruel injustice: Brazil and the other Latin American states have not merited suffering through the difficulties of others. (...) These economies all have first class basic data. Their future perspectives are splendid".

Even though in reality all countries do not fit that neatly into this glowing appraisal, Stiglitz's statement still highlights the central question which this article will now examine in more detail: whether the development model adopted by Latin American countries in the 90s really does hold the key to these splendid future perspectives which were only temporarily obscured by the international financial crisis or whether this external crisis has not in fact operated more as a sun than a cloud shedding a pitiless light on the model and revealing its inherent weaknesses and dilemmas?

3. Similarities and Dissimilarities between Latin America and Asia

In seeking an approach to this question, a comparison of the 1994/1995 Mexican crisis and the Asian crisis from 1997 onwards is illuminating. This is indeed the common approach adopted by economic literature searching for new explanations of balance-of-payment crises that exclude inconsistent national factors such as significant public deficits as the catalyst of speculative attacks.

In the view of Ortiz (1998), there are far reaching parallels between the two regions: both their crises were preceded by low inflation and a low public deficit; both finally enjoyed the status of an emerging market with a consequent ever higher import of capital, in the case of Mexico after profound structural reform, in the case of Asia during a period of sustained economic growth. In both regions their new found status resulted in a rise in domestic demand, a sharp rise in stock markets, the expansion of credit in the domestic banking sector and a clear rise in the current account deficit. The abrupt reversal of these capital in-flows then resulted in liquidity problems in the banking sector and a balance-of-payments crisis.

However, the key feature which binds Asia and Mexico together in this scenario and which is vital for its coherence is the pegging of the exchange rate to the US dollar. (And this is equally valid for Mexico in the period preceding the monetary crisis and for the vast majority of Latin American countries.) Ortiz is happy to highlight these parallels, but he is also skilled in skirting round the crucial difference. It seems certain that the need to cope with an inflation rate that was internationally very low during the whole of the 90s – a key factor underpinning economic policy-making throughout the world - will have furnished a powerful argument in favour of an exchange-rate anchor in both regions. An exchange–rate anchor allows the import of monetary stability for the "anchored" currency. It produces the same low inflation rate as a prolonged tightening of national monetary policy would do but without repressing the creation of national income.

At the same time, the nominal fixing of developing countries' currencies can be seen as a response to the general need to demonstrate the quality of their historically weak currencies as a store of value. This requires not only a stabilisation on the domestic front through a low inflation rate but also an outwardly geared nominal stabilisation of the exchange rate. Such an outwardly oriented currency stabilisation can, but must not necessarily be, realised by a nominal fixing of the exchange rate. However, it is important to note that for a developing country such a precondition is absolutely incompatible with a real valuation of its currency as real valuation stemming from an inflation differential vis-à-vis the anchor currency inevitably creates devaluation expectations. In contrast to real valuation, economic development in the sense of a strengthening of national currency needs a stable and undervalued currency because only such a currency can create the conditions for a country to become a creditor economy.

But the need to stabilise was of a fundamentally different nature in Asia and in Latin America. Whereas Asia started with comparatively low inflation rates (approx. 10 – 20%), balanced public budgets and comparatively low external deficits and debts, Latin America was emerging from a situation of despair. Suffice it to say that for Latin America exchange-rate based stabilisation seemed to be the only practical way in conformity with the markets to end the inflationary erosion of its currencies without renouncing development. Just why the "best of all possible worlds", the short-term fusion of monetary stability and growth, was possible but, with the highly restrictive conditions of success, not viable in the long-term will now be the topic we turn to.

4. Latin America's Start in the 90s: Chronic Inflation and the Need to Fight it

The Latin American start-up scenario differed totally from that of the Asian "success story". For Latin America the 1980s - commonly known as the "lost decade" - marked the definitive collapse of the Industrialisation by Import Substitution model which had dominated economic policy-making in the region from the 1950s onwards. The outbreak of the debt crisis in the early 1980s was marked by a sharp climb in the inflation rate on currencies which had been substantially weakened in the preceding decades by the *desarrollista* state. The orthodox stabilisation programmes introduced under IMF supervision in most cases duly failed or were cancelled because they were tackling not what they were designed to tackle - the expected result of a short-term stabilisation crisis along with gradually falling inflation rates - but rather a "worst of all worlds" scenario: dreaded stagflation, i. e. an economic crisis combined with continuing high inflation rates. Whilst mainstream crisis readings prescribed this failure to an inadequate implementation of an essentially correct economic policy, Latin American authors striving to explain the phenomenon were formulating a heterodox theory of chronic inflation which called for alternative stabilisation approaches.

In their view a process of chronic inflation is distinct from the type of inflation which orthodox stabilisation programmes were designed to cope with. The latter assume a short-term imbalance in monetary policies, the result of a money supply being created to finance an expansive fiscal policy whilst the domestic currency is overvalued due to inadequate adjustment of the nominal exchange rate. The heterodox diagnosis, on the other hand, even though it cites public deficits as one of the possible reasons for the start of chronic inflation processes, pinpoints the crucial cause of long-term inflation in the "inflation memory" of market actors, in other words in inertial components transposed from one period to the next and institutionalised via wages and prices indexation mechanisms. In a similar vein inflation can also be interpreted as the outcome of a social distribution conflict permanently culminating in a pseudo-solution of nominal wage and price rises and further fuelled by oligopolistic price formation processes in sealed markets. This leads to the formation of an inflation socket which, if combatted by orthodox money supply control policies, leads to extremely high economic and social costs but even then is likely to result in stagnation.

Due to the gradual erosion of the domestic currency as a means of payment, such chronic inflation is usually accompanied by culminative dollarisation which then tends to accelerate inflation and, given a reduced monetary base, further undermines the co-ordination function of the central bank, thus weakening the stabilising effects of a rigorous monetary policy. However, the degree of dollarisation varies from country to country: Bolivia, Argentina and most of the Central American countries are generally considered to be more or less dollarised whilst during the 80s Brazil developed a very specific monetary regime of quasi-dollarisation that impeded the process.

Now since the money supply in a situation of chronic inflation could not be used as a nominal anchor, in their search for alternative approaches heterodox economists identified the wages and prices level as the nominal anchor through which price stability could be achieved. So a freeze on wages and prices was the nub of heterodox stabilisation programmes in the mid 80s, programmes which were implemented in a wide range of Latin American countries, all with very little success. The operational difficulties such measures encountered are easily imaginable. Furthermore, with the advantage of hindsight heterodox economists did recognise that insufficient account was taken of continuous fiscal deficits, one of the central components of the orthodox view of inflation. However, in their view which differed from that of mainstream thinking, such fiscal deficits were to be understood not as mere products of lax fiscal policies but rather, first and foremost, as the fruit of the longstanding and profound deterioration afflicting Latin American economies and public sectors (Fanelli et al. 1994, p. 108 ff.).

However, another kind of stabilisation programme, only possible in the late 80s or early 90s, finally won general acceptance. Although the use of the exchange rate as nominal anchor had been seriously considered by heterodox economists at least on the theoretical level from the very beginning, it only became feasible when, with their gradual return to international financial markets, the countries had enough foreign currency reserves to defend a fixed or quasi-fixed exchange rate – a necessary but by no means sufficient condition for the success of their stabilisation programmes. However, as long as Latin America struggled under its heavy debt burden and was forced to use the exchange rate to maximise currency in an effort to service foreign debt, hard currency accumulation by the central bank was simply not on the agenda.

5. Pros and Contras of Exchange Rate Anchors in Chronically Inflated Economies: Argentina, Brazil and Mexico

The rigidity applied to the pegging of the exchange rate in Latin America was subject to a wide degree of variation, just as it was in Asia up to the outbreak of the crisis. The best known cases of the use of exchange rate anchors are the three largest countries of the continent, Argentina, Brazil and Mexico that together make up two thirds of Latin America's GDP. Of the three Argentina has been the only one able to maintain its fixed exchange rate during the turbulence of the past years. A number of other Latin American states pursued this strategy in a somewhat more diluted form.

From an orthodox viewpoint the total fixation of the exchange rate together with the ensuing de-activation of monetary policies has the advantage of being rule-based. However, a more moderate approach adopting a quasi-fixation that includes an element of crawling peg is able to soften (or lengthen the time available for) the adjustment measures that become necessary in this context. However, the more the peg is loosened, the more the monetary policy must take over the stabilisation function. This is apparent in the difference in interest levels between Argentina and Brazil (see below). Decision-making as to which degree of pegging should be employed is dependent on a large number of factors ranging from the specific monetary and fiscal regime to the nature of society and balance of political forces in any given country. For a better overview we shall now characterise stabilisation programmes with exchange-rate pegging in a number of selected countries.

With the establishment of a Currency Board and the fixing of the exchange rate by law (with a certain relaxation of its convertibility obligations over time), Argentina is an example of a country set on a highly rigorous course. This may be in part explained by the extremely high degree of dollarisation to which the economy was subject as well as by social trauma resulting from the country's experience of hyperinflation. Linking the money supply to capital imports and introducing the US dollar as the second legal means of tender meant the full liberalisation not merely of the commodity markets but, more especially, of the capital markets themselves.

By contrast Mexico, which had never known such a high inflation rate and which with its one-hegemonic party system is highly corporatist, opted with its 1988 "Pacto de Estabilidad" (Pact for Stability) for a less rigorous form of currency pegging together with a more or less active monetary policy. With its negotiated wages and (at least on paper) price fixing agreements in concert with a promise to liberalise foreign trade markets, this package was strongly coloured by heterodox components. The passive crawling peg the programme included introduced mini devaluations to be announced regularly and kept below the inflation differential to the anchor currency. The comprehensive liberalisation of foreign trade markets also included in the programme was a timely factor that should be seen in the context of Mexico's entry to the North American Free Trade Association (NAFTA).

Table 2
Exchange-rate based stabilisation programmes in Argentina, Brazil and Mexico

	Programme	**Period**	**Exchange-rate regime**
Argentina	Plan Cavallo	since 1991	Currency Board with fixed parity of 1:1
Brazil	Plano Real	1994 - 1998	quasi-fixed exchange rate (formally: crawling band)
Mexico	Pacto de Estabilidad	1988 - 1995	quasi-fixed exchange rate (formally: pre-fixed passive crawling peg)

In comparison to Argentina and Mexico, the *Plano Real* approach adopted by Brazil appears much more a mix of relaxed exchange rate pegging and active monetary policy.

This mix may be explained by reference to Brazil's particular monetary regime marked by quasi-dollarisation and the relatively narrow orientation of the big continental economy to the world market, even though the stabilisation programme gave a boost to the external liberalisation process. However, even a relatively comprehensive liberalisation of capital flows did not affect the dollarisation of the domestic banking sector which remains limited even today. Indeed, one of the reasons why monetary policies were of such crucial importance is that they had to counter-balance relatively high and visible fiscal problems in this way .

At this point we shall focus on some of the arguments put forward in favour of exchange-rate based stabilisation and development programs. Four central kinds of argument may be identified and we shall discuss their repercussions in the light of the Asian crisis.

5.1 Avoiding a Crisis of Stabilisation?

Exchange rate fixing or quasi-fixing with a view to importing stability from abroad holds out a number of short-term key advantages, particularly for countries with chronic inflation. First and foremost it offers short-term relief from the dilemma of orthodox anti-inflation policies which can provide stability if applied over a long enough period but no development. In place of the permanent repression of the domestic market through monetary policy the new nominal anchor usually achieves a relatively quick reduction of inflation, giving birth to a demand-driven consumer boom. Thus the initial phase at least heralds in "the best of all possible worlds" – stabilisation *without* adjustment costs (see table 3).

But this initial upsurge in economic growth usually comes to an end at some point or has at least to be interrupted. Even when the use of the exchange rate as an anchor to combat three- or four-digit inflation rates can lead to astonishingly quick results, in the first years there is still an inevitable residual inflation, due to initial stickiness in wages and prices, which soon leads to a valorisation of the real exchange rate. Not even the addition of a crawling-peg component could completely counterbalance such a valorisation tendency because, if it compensated for the full real valorisation of the exchange rate, it would completely neutralise the stabilisation effect of the exchange rate anchor. And valorisation has a direct negative impact on the current account (see table 4).

Under these circumstances the current account deficit may easily reach a level where at a certain moment it is perceived as "unsustainable", precipitating a reversal in capital flows and thus a balance-of-payments crisis with attendant correction of the exchange rate and return to orthodox monetary policies. This is the common explanation advanced to cover both the Asian crisis and the 1994/1995 Mexican crisis.

Table 3
Effects of the exchange-rate based stabilisation and development programmes: Growth and inflation rates

	Inflation (consumer price index)				**Growth (in % of GDP)**			
	One year before	**Three years after stabilisation**			**One year before**	**Three years after stabilisation**		
Argentina	(1990) 1.344	(1992) 18	(1993) 7,4	(1994) 3,9	(1990) 0,1	(1992) 9,5	(1993) 5,7	(1 7

Brazil	(1993) 2.489	(1995) 22	(1996) 9,1	(1997) 4,3	(1993) 4,5	(1995) 3,9	(1996) 3,1	(1 3
Mexico	(1987) 159	(1989) 20	(1990) 30	(1991) 19	(1987) 1,5	(1989) 3,3	(1990) 4,4	(1 3

Source: CEPAL 1998: Balance preliminar de la economia de América Latina y el Caribe 1997: Apéndice Estadístico (http:// www.eclac.cl/espanol/Publicaciones/bal97/cuadros).

Table 4
Effects of the exchange-rate based stabilisation and development programmes: exchange rate behaviour
(real effective export index)

	One year before the stabilisation	**Two years after the stabilisation**	
Argentina	(1990) 100	(1992) 77,5	(1993) 74,4
Brazil	(1993) 100	(1995) 61,7	(1996) 58,4
Mexico	(1987) 100	(1989) 76,3	(1990) 74,0

Source: IMF, International Financial Statistics Yearbook, and CEPAL: Notas sobre la economía y el desarrollo (from: Fishlow 1997).

But the critique that this was a politically motivated delay of the necessary devaluation of the exchange rate that led finally to the crash ignores two fundamental problems. First, in the case of Latin America in the 90s, much of economic policy credibility was bound up with a commitment to maintain the exchange rate. Loosening it, so governments feared, could cause a loss of confidence that would lead, under certain circumstances, to a significant capital flight and thus to a similar kind of currency crisis with all its high economic and social costs. Second, and more importantly, devaluation of the national currency leads not only to an inflationary pressure that has to be repressed by raising the internal interest rate, it also causes valorisation of the external debt in national currency for the debtors. For this reason, the probability of a banking crisis and the consequent weakening of the quality of national currency in a maxi-devaluation is high.

Mainstream literature establishes limits for what it calls a "sustainable" external deficit. But whether a given external deficit is viewed by the market as "sustainable" or not depends to a large extent on external conditions. When external conditions worsen, a country with an expressive current account deficit that beforehand seemed easily financeable sees itself obliged to repress internal demand by a significant raise in its interest rate. With a fixed exchange rate this is the only way to attract the necessary amount of capital imports and to effect a short-term reduction in the volume of imports for a quick improvement in the trade balance. This kind of repression is what Argentina and

Brazil have had to do several times in the course of the past years, first as a consequence of the Mexican "tequila effect" and subsequently in the wake of the the protracted Asian crisis. This has resulted in a market-driven Stop-and-go process. It is vital to note here that this Stop-and-go process does not - as was the case in the past - emanate from alternation between an orthodox monetary policy and a populist policy of easy growth once the monetary policy has failed in its goals of stability with growth. This time the result is an unstable growth rate stopping and starting according to the amount of international liquidity available.

5.2 Incentives to Fiscal Austerity?

The pegging of the exchange rate to a hard foreign currency nurtured a vision, as it were, of tailoring domestic monetary and fiscal policy-making to the constraints of an external strait-jacket. The climate of opinion both abroad and in Latin America itself tended ever more to the view that the political elite of the region was either unwilling or unable to pursue a consequent austerity policy. Against this backdrop, the pegging of the exchange rate was seen as the motor which, with the aim of the quickest possible convergence of the domestic inflation rate with that of the anchor country, would drive for adjustments in monetary and fiscal policy to prevent too strong a valuation of the exchange rate and thus an explosion of balance of payments problems. The de-politicisation of fiscal policy-making and the trend to relocate monetary policy decision-making from the domestic level to that of the anchor country were seen as factors that would put a definitive end to traditional, politically motivated stop-and-go policies in Latin America. It was expected that this form of voluntary tying would substantially enhance the credibility of national policy-making, in particular vis-à-vis international investors.

All this meant that fiscal policy-making was faced with extremely severe adjustment demands. But first of all, with an historically given level of taxation that is largely impervious to change, public finance depends mainly on the state of the economy, not on political will. While in an expansionary phase it may be easy to cope with the goal of a balanced budget by endogenously raising revenues, this becomes much more difficult in the case of a shrinking economy with declining fiscal incomes. Moreover, high demands placed on fiscal policy hit a raw nerve in Latin American economies. On the one hand national elites display a long tradition of resistance against taxation by the nation state, and the heterogeneous societies of Latin America contain a high proportion of informal, non-monetised activities that by their very nature elude taxation. On the other, the state is subject to many high expectations, all a potential drain on its budget. To the old patterns of clientelistic claims that have weathered changes in political regime there must now be added the calls by socially marginalised groups for a "settlement of the social debt" by newly democratised states, a further burden on state expenditure but one that, in view of glaring economic inequalities, is highly legitimate.

Against this backdrop, whilst at first view states like Argentina and Mexico might seem to have achieved a measure of success in balancing public expenditure through structural reforms, the nature of their success nevertheless still remains highly precarious. As the CEPAL noted:

(...) myriad economic problems and crises – in many cases limited in intensity and ultimately brought under control, but crises nonetheless – have created an overall impression of fragility and suggest that fiscal balance and its contribution to general macroeconomic equilibrium are still constantly at risk [CEPAL (1998a) p. 6 f.).

It is hardly surprising then that once-for-all gains from privatisation programmes have assumed such crucial importance in all Latin American states and that some countries like Argentina have postponed problems by simply pushing them aside onto subsidiary federal levels. A further factor to be taken account of in Mexico and Brazil during the application of the exchange-rate anchor is the quasi-fiscal deficit due to the cost intensive sterilisation of high capital imports by the central bank, a deficit resulting from the interest differential between domestic and international financial markets. The drop in government revenue in Mexico due to the slump in raw commodity prices as a result of the international financial crisis points in the same direction as well. And last but not least, the banking crises which imploded in all three countries in the wake of the Mexican crisis have placed a heavy strain on the public budget.

Even so, efforts at fiscal reform enjoyed differing degrees of success from country to country (see table 5). Mexico and Argentina indeed had low deficits in spite of the reservations named above, whilst Brazil saw a continuous rise in its public funding requirements after stabilisation was achieved. It was the nominal deficit to the tune of 7 percent at the time of the Russian crisis that acted, alongside the worsening of the external deficit, as the catalyst for the large-scale flight away from the Brazilian currency that culminated later in the currency crisis which the IMF rescue package was powerless to prevent.

Table 5
Fiscal Balances[a]
(in percent of GDP)

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Argentina[b]	-1,6	-0,1	1,4	-0,2	-0,5	-1,7	-1,8
Brazil[c]	1,4	-2,1	0,3	1,4	-4,9	-3,8	-4,3
Mexico	-0,4	1,6	0,7	-0,3	0,0	-0,1	-0,8

Source: CEPAL; Banco Central do Brasil; Deutsche Bank Research;

[a] surplus (+) or deficit (-) of the non-financial public sector in national currency in current prices (nominal concept)

[b] Central state without provinces and municipalities

[c] operational deficit (inflationary effects eliminated)

However, in this matter of public financing Brazil once again proves to be a highly complex case. Obviously its growing public deficit may be partially explained by less than rigorous fiscal policy-making and by the unwillingness of both government and parliament to grapple with far reaching reform. Nevertheless in this context it would be difficult to underestimate the importance of the deterioration of the budget situation as evidenced by the transition from extremely high to extremely low inflation rates, especially in the light of the key role played by the quasi-fiscal deficit. In turn it may be explained by the fact that not only private sector contracts but public finances themselves had undergone a comprehensive process of accommodation to the conditions imposed by high inflation. Thus stabilisation resulted in a kind of reversed Olivera-Tanzi effect – a potentially high deficit, suppressed to the end of inflation by only paying out nominal amounts when their real value had sunk enough, first became evident after stabilisation had taken effect (see Bacha 1984).

5.3 Using The Exchange Rate Anchor as a Development Strategy: Compatibility with the Liberalisation Paradigm

The third point to be discussed is that the strategy of pegging the exchange rate is thoroughly compatible with the paradigm of economic liberalisation. Fixing the exchange rate necessitates the liberalisation of capital markets as this is the only way to guarantee the influx of foreign currency vital to defend it. In a similar vein the lowering of trade barriers is also requisite in order to allow increased imports to place more pressure on domestic companies and thus discourage them from raising their prices whilst encouraging them to achieve higher productivity. All this is in line with the commonly held view that the Latin American crisis was primarily caused by below par standards of production efficiency due to highly protectionist policies of import substitution.

The influx of foreign capital, drawn in by the no-risk scenario signalled by the fixing of the exchange rate, is both a support of and reinforcement to the real valorisation of the domestic currency. In conjunction with the liberalisation of trade which was being carried out at the same time, the double competitive shock of overvaluation and tariff reduction produced a number of quantitative effects with a dramatic rise in imports unaccompanied by a corresponding increase in export growth. This is why the major part of the continent belongs to the category of countries with the highest growth rates *only* in the import sector whilst Asian countries, before the outbreak of the crisis, had high growth rates in both import and export sectors (see tables 6 and 7). The loss of its competitive edge is also a reflection of the fact that Latin America is the only region in which the USA, with its huge external deficit, is capable of generating an export surplus.

Table 6
Effects of the exchange-rate based stabilisation and development programmes:
Trade balance and current account
(in million US-Dollar)

	Trade balance				**Current account**		
	One year before stabilisation	**Three years after the stabilisation**			**One year before stabilisation**	**Three years after the stabilisation**	
Argentina	(1990) 8.628	(1992) -1.396	(1993) -2.364	(1994) -4.139	(1990) 4.552	(1992) -5.487	(1993) -8.003
Brazil	(1993) 14.329	(1995) -3.157	(1996) -5.554	(1997) -8.364	(1993) 20	(1995) -18.136	(1996) -23.602
Mexico	(1987) 8.786	(1990) -881	(1991) -7.279	(1992) –15.934	(1987) 4.247	(1990) -7.451	(1991) -14.888

Source: IMF, International Financial Statistics Yearbook 1999

The loss of competitiveness suffered by Latin America is also mirrored in the qualitative changes undertaken in domestic production structures. A number of sectors are in the throes of a fully blown de-industrialisation process which may only be partially explained as the necessary antidote to an import substitution strategy based on the self sufficiency of national industrial production. Much less evident, but probably of much greater import, is the weakening of industrial depth, in other words the growth of assembling or *maquiladora* industries as a knee-jerk reaction of national producers to conditions of increased competitiveness. Similarly we are also witnessing another upturn in the role played not merely by raw materials but by raw material processing industries as well.

Table 7

Countries or areas with the fastest trade growth[a]

(in current dollars; annual averages for the period 1990-1996)

Exporting countries	Percentage growth in exports	Importing countries	Percentage grow imports
Malaysia	18	Argentina	34
Philippines	17	Poland	22
China	16	Malaysia	18
Thailand	16	Philippines	18
Singapore	15	China	17
Mexico	15	Brazil	17
Ireland	13	Columbia	16
Kuwait	12	United Arab Emirates	15
Rep. of Korea	12	Chile	15
Indonesia	12	Mexico	14
Argentina	12	Singapore	14
India	11	Rep. Of Korea	14
Spain	11	Thailand	13
		Indonesia	12
		Turkey	11
		Israel	11
		Taiwan (China)	11

Source: World Trade Organization (from: Cepal 1998b, p. 48)

[a] Countries whose exports or imports exceeded US$ 10 billion in 1996 and grew at a rate at least one and a half times the world average figure of 7% during the period 1990-1996.

This trend opens the way to a much greater vulnerability vis-à-vis fluctuations in raw commodity prices in the wake of international financial crises. But just as tellingly it also prepares the ground for a situation in which competitiveness can only be achieved at the cost of low wages. Testimony to this is offered by the fact that the real discernible upswing in productivity growth depends in the main not on new investment but rather on rationalisation processes or the hiving off of jobs to subcontractors. Taken as a whole, these tendencies culminate in a drastic increase in unemployment, the rapid spread of the informal employment sector and in an overall deterioration of job quality with yet a further exacerbation of income distribution patterns, already some of the most polarised in the world and yet a further erosion of already highly fragmented social systems.

5.4 Old Strategy in a New Guise: The Exchange-Rate Based Development Model as a Revival of Growth-cum-Debt

Especially in the Latin American context the anchoring of a national currency entails severe consequences inimical for sustained national development. At first sight the empirical basis does not seem to sustain the above finding. After all, Argentina is the only one of the three cases analysed here that has been able up to present to maintain its exchange-rate based stabilisation and development programme, a fact that could serve as an argument that its success is inextricably bound up with the rigid Currency Board regime Argentina submitted itself to. If this argument were accepted, it would reinforce the orthodox belief that in the long run a rule-based policy always brings better results than a policy guided by discretion. Within the same logic, the option of a loose exchange rate peg for Mexico and Brazil in conjunction with raised discretionary leeway for monetary policy-making can be interpreted as a sign of weakness or a "strait-jacket with a zipper", a constellation that undermines the credibility of economic strategy-making. Indeed, Argentina enjoyed the lowest interest rate levels even during times of high insecurity caused by the international financial crisis.

Table 8
Domestic interest rates, annualised
(in percentages)

		Argentina		**Brazil**	**Mexico**
1997	Jan	(1)	(2)		23,6
	Feb	7,9		22,4	19,8
	Mar	9,1		21,8	21,7
	Apr	8,4		21,3	21,4
	May	8,1		20,7	18,4
	Jun	7,9		20,7	20,2
	Jul	7,1		20,7	18,8
	Aug	8,0		20,7	18,9
	Sep	9,9		20,7	18,0
	Oct	7,2		20,7	17,9
	Nov	12,4		21,6	20,2
		13,5		43,4	
1998	Dec	11,7	11,3	40,9	18,9
	Jan	9,8	8,1	37,7	18,0
	Feb		8,2	34,5	19,5
	Mar		7,6	28,0	21,1

Source: National data, cited in: Cepal 1998b, p. 58

Argentina (1): Peso interbank rates, more than 15 days
Argentina (2): 30-day peso interbank rates (BAIBOR)
Brazil: Central bank rates
Mexico: 28-day treasury certificate (CETES) rates

But appearances are deceptive. In all three cases the fixing of the exchange rate and attendant overvaluation coupled with the need for an (at least relatively) tight monetary policy produces a sensible interest rate differential. This generates (and this holds true even for Argentina whose differential is by far the smallest) a strong incentive for national producers to borrow in foreign currency, hard pressed as they are by foreign competition to invest in new technologies. All three cases display a fast expansion of foreign liabilities during the application of the exchange rate anchor (see table 9). However it is none other than Argentina – that supposed success story! - that shows the highest growth of external debt in this period and thus the highest rate of indebtedness with its foreign liabilities more than doubling since the establishment of the Currency Board. Moreover, whereas in 1998 the debt to GDP ratio in Mexico was 36,9% and in Brazil a mere 23,8%, in other words less than one quarter, in Argentina it amounted to nearly half or 46,7% of GDP (IDB 2000).

Table 9

External debt[a]

(gross concept, in US-Dollar millions)

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**19**
Argentina	61.334	62.766	72.509	85.656	98.547	109.756	124.315	139.738	14
Brazil[c]	123.910	135.946	145.726	148.295	159.256	179.934	199.998	243.163	24
Mexico [d]	116.552	117.534	131.717	142.199	169.699	163.499	152.976	161.213	16

Source: CEPAL 2000: Balance preliminar de la economia de América Latina y el Caribe 1999, on the base of official data

[a] Includes the external debt of the public and the private sector, as also the debt with the IMF

[b] preliminary

[c] The increase of the debt from 1997 to 1998, registered in the official data of the Banco Central do Brasil suppose some changes in the statistical composition that could not be cleared by the CEPAL secretariat.

[d] without investments from non-residents in public bonds.

In fact, by the most consequent application of the exchange-rate based development model Argentina became the most heavily indebted country of the three and this despite having the lowest interest rate differential. This is an indication of the fact that confidence in the quality of the Argentinean *peso*, despite the convertibility guarantee, continues to be low, with no incentive for a deepening of credit relations in the national currency. So in spite of all the structural adjustment efforts undertaken in past years, the *peso* still continues to be viewed as prone to potential devaluation and thus as vulnerable to a speculative currency attack.

Through the creation of an ever greater demand for foreign currency to meet debt obligations, accumulation of foreign currency liabilities *per se* causes overvaluation leading to a deterioration in the trade balance. Thus its main effect is to deepen the debtor position of a country. This creates the strong possibility that, if these capital inflows are reversed, a maxi-devaluation of currency will become inevitable, as it is the only way available to cover external debt servicing. Accumulating foreign debt for short-period easy growth is putting a mortgage on a country's future.

The reiterated need confronting Argentinean policy to effect a brutal repression of the economy in order to adapt the quantity of national money to the availability of international currency without resorting to devaluation as the Currency Board demands, causes huge political and social problems. Moreover, however, it also impedes the formation of stable profit expectations. The result is that, at only 12% of GDP, the Argentinean investment rate now has reached an all time low. Consequences for economic policy-making linked to such a strategy are extremely far reaching. As neither exchange rate policies nor monetary policies can be used, adjustment measures in response to a change in macroeconomic conditions (such as a worsening of external conditions) must now be realised exclusively through wage and fiscal policy measures. However, the use of wage policy as a counterbalance to a loss of competitiveness results in a deterioration of the structure of income distribution whilst resorting to fiscal policy with the same goal in mind requires a reduced role for the state geared not to efficiency criteria but to external macroeconomic restrictions.

Loss of competitiveness due to lack of innovation is further exacerbated by the significant overvaluation of the currency and mirrored in the huge trade deficit and increased concentration on traditional export products. The repression of the Argentinean economy that was undertaken in response to the 1999 Brazilian crisis reveals the enormous structural weakness of the competitive position of the country: no less than one third of Argentinean exports were driven by the overvaluation of the Brazilian *real*, so that the Brazilian maxi-devaluation left Argentina with almost no alternative but to repress its own imports in order to compensate for export losses. As we can see, the basis of Argentinean economy, structured by convertibility, is of highly precarious nature.

Looked at this way, Argentina's choice of an extremely inflexible version of currency anchor becomes the problem, not the solution. To make matters worse, there seems to be no way out of the constellation of overvaluation and accumulation of external debt other than a big crash which would entail an enormous loss of confidence, given the central role played by fixed and guaranteed convertibility in the country during the past decade. The upshot here is that the above factors all disqualify the radical Argentinean version from serving as a model.

A devaluation would have, especially in the case of Argentina beset by high debts, truly disastrous consequences. However, some consolation may be gained by observing that the ending of the fixed exchange rate regime would mark the end of explicit incentives for the accumulation of foreign liabilities. This indeed was the case with Mexico whose stock of foreign debt stagnated after 1995 devaluation (see table 9). This is probably the only good reason for a maxi-devaluation, among the many good reasons for avoiding it at (almost) any cost.

6. Conclusion

If we take the implementation of liberalisation and structural adjustment measures as the benchmark of a successful development model, then it does indeed seem "unjust" that despite all the strenuous efforts undertaken by Latin America in the past years, it should be so badly hit by the fallout from the international financial turmoil. From this point of view it is only right and proper to draw attention to the speculative and destructive nature of unregulated international financial markets and to call for tighter control of the international financial system as, for example, the CEPAL does in its report on the international financial crisis (CEPAL 1998c). Yet however justified such a call might be, it fails to take account of the fact that the development model adopted by Latin American countries, geared as it was to liberalisation and the attraction of foreign capital, was inextricably bound up with the problem of overvaluation and therefore generated even stronger incentives to accumulate foreign liabilities. In this respect it was comparable to the crisis-beset countries of south-east Asia.

The attempt to base a sustainable development strategy for these two regions, Asia and Latin America, on fixed exchange rates was of the same colour in principle as the demand placed in general on developing countries to demonstrate the quality of their domestic currencies vis-à-vis the hard currencies of highly industrialised nations. In view of the dilemma Latin America was confronted with, after the "lost decade" of the 80s, of having to generate both stability and development at one and the same time, the pegging of national currencies did indeed appear to be the prime option at first view. However, in the context of an international multi-currency standard with flexible – or, to put it more accurately, with unstable – exchange rates, the attempt by weak currency countries to achieve this goal by the unilateral pegging of their currency to a hard currency could only lead to yet another dilemma.

Currency appreciation - a consequence of the unilateral pegging of the exchange rate and the attendant liberalisation of the capital market in order to generate new capital inflows – was further exacerbated in Latin America by the additional use of the exchange rate anchor as an instrument to combat high and chronic inflation processes. And from the early years of the 1990s it has led the continent into explicit overvaluation. The resulting deficits in both the trade and current account balance necessitated a constant inflow of capital. So when this inflow dried up, as has been the case several times in the recent past during recurrent financial crises, countries saw themselves constrained to repress the national process of income formation via monetary and fiscal policy in order to assure their international debt-paying ability. This resulted in a market-driven stop-and-go process according to the amount of international available liquidity.

Comparing the three Latin American cases studied here, Argentina, Brazil and Mexico, it becomes indeed evident that Mexico and Brazil have failed in their handling of the development strategy based on an exchange-rate anchor, and that, of all the countries which embarked on this course, Argentina alone has succeeded in warding off a balance-of-payments crisis and thus has managed to hold onto its exchange rate. Yet as far as the slump in national income is concerned, the economic adjustment stakes in Argentina are by no means any lower. And, even more to the point, the same comparison shows that whilst in all three cases the stock of external debt grew significantly during the application of the exchange rate anchor, it grew most of all in Argentina.

We may indeed endorse the view that the central problem facing Latin America’s economies today is one of financial volatility. But this is basically true for all debtor economies, in so far as countries which embark on an explicit course of foreign debt prove highly vulnerable to the changing moods of international capital markets. The key problem of the exchange-rate-peg development strategy is the high incentive it generates to contract liabilities in foreign currency.

In the end the Latin American development model of the 90s, based among other factors on the pegging of the exchange rate, turns out to be a case of the old strategy of "growth-cum-debt" in a new guise with no foreseeable outcome in sight as to how the process of debt accumulation could be transformed into one of debt reduction and sustainable development. When ability to pay was endangered through a change in international conditions, the prime aim of national economic planning geared to a restitution of order had to be to restore this payment ability, at whatever cost, even if it involved the partial annulment of previously implemented measures for structural adjustment. The traditional suspicion of weak Latin American currencies as being devaluation-prone was reinforced by a further suspicion as to the consequences of the renewed accumulation of foreign currency liabilities. This compounded suspicion was not a consequence of the international financial crisis of the late 90s; it was rather this crisis that brought this inherent weakness of the model fully into the light.

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