The Evolving Role of the World Bank

The Latin American Debt Crisis
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Sebastian Edwards

The World Bank
Washington, DC
The World Bank Group

The World Bank Group is a family of multilateral development institutions owned by and accountable to member governments. These governments exercise their ownership function through Boards of Governors on which each member country is represented individually. All the powers vested in the Board of Governors, with a few exceptions, have been delegated to Boards of Executive Directors, who are appointed or elected by member governments. The President of the Bank Group is appointed by the Executive Directors.

The World Bank Group today includes five international organizations:

The International Bank for Reconstruction and Development (IBRD), the original institution in the group, opened its doors for business in 1946. Today, it is the largest source of market-based loans to developing countries and is a major catalyst of similar financing from other sources. It lends to governments or to public or private entities with government guarantees. It is funded mainly through borrowings on the international capital markets.

The International Finance Corporation (IFC) was established in 1956 to support private enterprise in the developing world through the provision and mobilization of loan and equity financing and through its advisory activities relating to, among other things, capital market development and privatization. IFC is also a major catalyst of both local and foreign private investment. Its lending and equity investment activities are based on the principle of taking market risk along with private investors. Under the terms of its Articles of Agreement, it cannot accept government guarantees.

The International Development Association (IDA) was created in 1960 to provide finance on concessional terms to low-income countries that lack creditworthiness for IBRD borrowing. IDA is primarily funded from grants it receives from donors in periodic replenishments.

The International Centre for Settlement of Investment Disputes (ICSID) was added to the World Bank family in 1966 to provide conciliation and arbitration services for disputes between foreign investors and host governments that arise directly out of an investment.

The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 to provide noncommercial investment risk insurance and technical services that help promote investment flows. It also disseminates information on investment opportunities.

As is now common practice, the “World Bank” or simply the “Bank” are used interchangeably to mean both IBRD and IDA. The “World Bank Group” refers to IBRD, IDA, IFC, ICSID, and MIGA.
Foreword

The world has changed dramatically over the last five decades and so has the World Bank. The Fiftieth Anniversary of the World Bank has provided us with an opportunity to reflect on and learn from the Bank’s experience and to apply the lessons to the Bank’s future agenda.

This series of essays is devoted to improving understanding of the evolving role of the World Bank. Each essay analyzes the Bank’s approach to the major development challenges its borrowing countries have faced, starting with the reconstruction and development needs of Europe and Japan in the 1940s and 1950s and ending with the transition of Central and Eastern Europe and the former Soviet Union. One essay examines the evolution of the Bank’s relations with the world’s capital markets as it mobilizes private savings for development. An overview paper provides a picture of the fifty-year period as a whole.

The story that emerges is one of an evolving and learning institution that has built on its successes and its mistakes. The Bank has responded with vigor and energy to the challenges confronting its borrowers. In this process, it has made a significant contribution to the impressive developmental gains recorded in these past fifty years. In responding to those challenges, the Bank itself has changed, learning from its experiences, deepening its understanding of the development process, and recasting its analytical and financial support to help its borrowers better.

The Bank will continue to nurture its tradition of self-evaluation and learning. These essays will, I hope, contribute to a better-informed debate on the Bank’s future role. They complement the recently issued paper, *The World Bank Group—Learning from the Past, Embracing the Future*, which sets out the future directions for the Bank Group.

Armeane M. Choksi
Vice President, Human Resources Development and Operations Policy, and
Chairman of the Bank Group Committee on the 50th Anniversary
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When the debt crisis erupted in August of 1982, most analysts thought that Latin America was facing a liquidity problem. Thus in the early years of the crisis, countries improvised to generate massive resource transfers to the industrialized world. Argentina, Brazil, and Peru experimented with heterodox plans (which ignored the need for fiscal discipline) to reduce inflation. These were the last massive adjustment efforts based on the traditional Latin American structuralist approach to economic development. Their rapid failure ignited deep soul-searching among political leaders and intellectuals in the region.¹

Since 1987–88, economic thinking in Latin America has been transformed. Protectionism and interventionism have given way to openness, market orientation, and competition. Four main causes exist for this transformation: the realization that the traditional, government-led development policies failed to create a modern economic system; the example of East Asia, with its high growth; the fall of Eastern Europe and the realization that socialism had led to generalized failure and frustration; and the policies of the multilateral institutions—especially the International Monetary Fund (IMF) and the World Bank—that conditioned their funds on the implementation of major reforms.²

Since 1987–88, economic thinking in Latin America has been transformed. Protectionism and interventionism have given way to openness, market orientation, and competition.
The initial reaction by the creditor countries was that the debt crisis could be solved with a combination of macroeconomic adjustment, debt rescheduling agreements, and structural reforms. All this resulted in a new Latin American consensus driving the region's reforms. This consensus, shared by most policymakers and analysts in the region, is based on four basic tenets. First, macroeconomic stability is fundamental for achieving sustainable growth with equity. Second, the Latin economies' massive (and largely unilateral) trade liberalization should help to transform exports into the region's "engine of growth." Third, massive privatization and deregulation should increase the role of markets and competition in development. Fourth, policymakers and political leaders recognize that, to consolidate reforms, the issues of poverty and inequality must be addressed. To this end, new programs targeted at the poorest and at social sectors are being devised in many countries.

The World Bank played an important role in the way Latin America dealt with the debt crisis and has helped to shape its reforms. The Bank's analytical work facilitated dialogue and contributed to the design of specific policies. Bank resources helped cushion the severity of the crisis, especially during its early years. And Bank conditionality provided discipline and financial credibility to the reform process.

Initial Approaches to the Crisis

With the sudden halt of foreign capital in 1982, every country in Latin America was forced to finance debt payments through large trade surpluses. The initial reaction by the creditor countries was that the debt crisis could be solved with a combination of macroeconomic adjustment, debt rescheduling agreements, and structural reforms.

This approach was promoted by the United States government and coordinated by the IMF and the World Bank. The official approach called for "new monies" (up to $20 billion) to be lent to countries engaged in structural reforms. The banking community endorsed this view, although it argued for shifting the burden of new financing to multilateral and official...
institutions: "...realism demands an increased share of new money to be furnished by official sources during the next several years." Debt-restructuring operations, IMF-sponsored programs, and World Bank structural adjustment loans were the most important elements of the early official strategy. Between 1983 and 1988, Latin American nations engaged in twenty-nine debt restructuring operations with private banks.

The 1984 issue of the IMF's World Economic Outlook and the World Bank's World Development Report included optimistic projections, predicting a steady decline in the debt-export ratio of Latin American countries. Things did not work out that way. In the following years, analysts came to recognize that the magnitude of the problem had been seriously underestimated.6

Although the multilateral institutions had failed to grasp the size of the debt crisis during its early years, they did contribute significant resources to Latin America so that debtor nations could reduce the magnitude of their resource transfer to the rest of the world. Between 1980 and 1986, the World Bank more than doubled its net disbursements to Latin America, increasing them from $1.2 billion to almost $2.8 billion. In the same period, the net resource transfer from the Bank (net disbursements less interest) increased from $600 million to almost $1.1 billion. The IMF channeled even larger resources into the region at the start of the crisis. While IMF net transfers to Latin America and the Caribbean had been negative $173 million in 1980, they reached almost $6 billion in 1983.

From the early stages of the crisis, the World Bank was concerned with helping to engineer a smooth, sustainable adjustment to promote macro-economic stability; to restore growth, including a minimum increase in consumption; and to reduce the debt overhang. Within this framework, ensuring consumption growth during transition was necessary.
considered crucial from both economic and political standpoints. Without it, countries would lack the will to undertake reforms and would tend to stagnate.

Selowsky and van der Tak (1986) argued that this type of adjustment could not be achieved overnight. During the early stages, debtor countries needed additional foreign resources to gain time to implement the domestic reforms required to accelerate growth and reduce the debt burden. One aspect of the Selowsky–van der Tak analysis was that, in some circumstances, initial conditions were so severe that the only way to restore a viable debt-output ratio was for the creditors to forgive debt. In the late 1980s, this line of argument began to make headway among officials in creditor countries as it became evident that some debt reduction would benefit both debtors and creditors.

The Brady Plan and the Bank

In early 1989, lack of progress in two of the large debtors—Argentina and Brazil—prompted a change in the official debt strategy. In March, U.S. Secretary of the Treasury Nicholas Brady announced a new initiative based on voluntary debt reduction. He proposed to exchange old debt for new, long-term debt with a lower face value. The conversion ratio and new instruments were to be negotiated between the debtor countries and their creditors.

To make this new approach attractive to creditor banks, industrial nations and multilateral institutions—including the World Bank—agreed to provide a substantial amount of resources ($30 billion or so) to guarantee “Brady” concessional bonds. Typically, principal payments on these new securities were backed by thirty-year, zero-coupon U.S. Treasury Bills, with interest payments subject to rolling three-year guarantees.

To be eligible for Brady Plan negotiations, countries had to show some history of and willingness to engage in serious economic reform. This was
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seen as a way to reward countries committed to modernization reforms. It was also expected that in some countries this requirement would lift the debt overhang burdens associated with extremely high payments.

The World Bank has supported Brady deals through a number of mechanisms. Together with the IMF, the Bank has been instrumental in helping countries design the steps required prior to reform. The Bank's involvement in the design of reforms has been indirect—through its Economic and Sector Work (ESW), and direct—through its adjustment loans. The World Bank has also supported Brady agreements by waiving negative pledges in their loan agreements, allowing them to use U.S. Treasury zero-coupon bonds as guarantees. The Bank has also provided fresh loans to most countries involved in Brady agreements.

In 1989, Mexico and Costa Rica became the first countries to reach broad agreements with creditors to reduce debt under the Brady Plan. Venezuela and Uruguay followed in 1990 and 1991, and Argentina and Brazil both signed draft agreements in 1992 (see Table 1). In this table, the first column contains the total value of the debt covered by each agreement. In the cases of Argentina and Costa Rica, it includes both principal and arrears. The debt subject to each arrangement was quite large. In the case of Mexico, almost $49 billion was exchanged for concessional bonds—a figure substantially higher than the $6.7 billion converted under the Mexican 2008 bond scheme.

The next three columns in Table 1 illustrate the amount of debt eligible for conversion under three different options. One conversion option is a debt buyback, in which old debt is canceled by a cash payment at a fraction of the original liability. In Costa Rica, $159 million was used to retire old debt with a face value of $991 million. This operation

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**Table 1** Debt and Debt-Service Reduction (DDSR) in Selected Latin American Countries  
(Millions of dollars)

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of DDSR agreement</th>
<th>Face value of eligible debt</th>
<th>Buy-back (discount)</th>
<th>Discounted bonds (discount)</th>
<th>Par bond (interest rate)</th>
<th>New money (interest rate)</th>
<th>Total debt (Dec 1991)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1992b</td>
<td>23,160c</td>
<td>n.d.</td>
<td>n.d.</td>
<td>n.d.</td>
<td>0</td>
<td>56,273</td>
</tr>
<tr>
<td>Brazil</td>
<td>1992b</td>
<td>44,000c</td>
<td>0</td>
<td>n.d.</td>
<td>n.d.</td>
<td>n.d.</td>
<td>118,148</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>1989</td>
<td>1,602a</td>
<td>991</td>
<td>0</td>
<td>579</td>
<td>0</td>
<td>3,966</td>
</tr>
<tr>
<td>Mexico</td>
<td>1989</td>
<td>48,089</td>
<td>0</td>
<td>20,851</td>
<td>22,427</td>
<td>4,387</td>
<td>98,263</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1991</td>
<td>1,610</td>
<td>633</td>
<td>530</td>
<td>0</td>
<td>448</td>
<td>3,049</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1990</td>
<td>19,098</td>
<td>1,411</td>
<td>1,794</td>
<td>10,333</td>
<td>6,060</td>
<td>34,081</td>
</tr>
</tbody>
</table>

**Conversion options**

- **a.** Including IMF and net short-term debt.  
- **b.** Agreement in principle with creditor banks; not yet finalized.  
- **c.** Estimated. In addition, there are $8.6 billion in arrears, including imputed interest.  
- **d.** Interest rate increases from 4 percent the first year to 6 percent in the 7th year; 6 percent from then on.  
- **e.** Estimated. In addition, there are $6 billion in arrears, including imputed interest.  
- **f.** There are several par bonds offered, with different maturities periods, interest rates, and collateral:  
  - **A.** 30/30 years, rate 4 percent to 6 percent first 7 years, 6 percent from then on, full collateral principal, 12-month interest.  
  - **B.** 15/5 years, rate 4 percent to 5 percent first 6 years, LIBOR + 13/16 from then on, 12-month interest collateral for 6 years.  
  - **C.** 20/10 years, rate LIBOR + 13/16 but interest above the rate in bond B is capitalized, no collateral.  
  - **D.** 20/10 years, rate 8 percent interest above the rate in bond B is capitalized, no collateral.  
  - **E.** 18/10 years, rate LIBOR + 7/8, no collateral.  
- **g.** New money equivalent to 18.18 percent of debt tendered for debt conversion bonds (see f, option E).  
- **h.** Including past-due interest.  

*Source: World Bank.*
The Brady-endorsed debt reduction packages helped Latin American countries by reducing debt burdens and allowing them to concentrate on implementing reforms. The second option is using discounted bonds to retire the original debt. Creditors receive a 35 percent discount, but the exchange between old debt and new bonds takes place at a ratio below one-to-one. The actual conversion ratio has varied from country to country, and new bonds carry a market interest rate. The collateral on foreign debt still represents long-term (usually thirty-year) estimated that such debt relief would reduce the size of the internal debt to creditors by $4 billion a year between 1989 and 1994.

The third option consists of exchanging old debt for new bonds with the same face value—so-called par bonds. The recent conversion ratio has varied from country to country. Argentina, Brazil, and Venezuela could obtain only a 30 percent discount. Creditors receive example, the World Bank has followed until now a combination of multilateral support, economic reform, and market-based debt reduction—have worked well enough.

Most countries in the region are still suffering from the consequences of the debt explosion of the 1970s and early 1980s. Interest payments on foreign debt still represent high percentages of GDP in a few countries. In Mexico, for instance, the debt is so large (more than three times GDP in Nicaragua) that the prime example) that
massive debt reduction agreements will be required to achieve a longer-run solution.

Despite these continuing problems, many countries feel that the debt crisis is behind them. Recently, the price of some countries' debt in the secondary market has increased, and after almost ten years of negative net resource transfers, Latin America had positive transfers from the rest of the world in 1991. Net capital inflows into the region increased dramatically in 1992, passing $20 billion. To a large extent, this turn-around of net resource transfers reflects the fact that many of the countries in the region (Argentina, Chile, Colombia, and Mexico) have regained access to voluntary capital market financing. This alone is an indication that, in some Latin countries, the debt crisis is almost over (see Figure 1).

Paradoxically, the recent increase in capital flows into Latin America has generated serious problems related to real exchange rate behavior. As capital comes into these countries, foreign exchange becomes overabundant, appreciating the real exchange rate. This results in a loss of international competitiveness and pressures politicians to implement policies that compensate exporters.
The Power of Ideas

Some authors (notably Williamson 1990) have suggested that the new approach towards development policy in Latin America was imposed from the outside by the U.S. Treasury, the World Bank, and the International Monetary Fund—the so-called Washington consensus. But while these institutions played roles in forging new views, it is an exaggeration to give them top billing. Fundamental soul-searching began in Latin America early on, when its traditional programs failed and following the Chilean experience. Still, the multilateral institutions exercised important influence in forging the new convergence of doctrinal views in Latin America. These institutions—and chiefly the World Bank— influenced policy in Latin America partially through empirical research, analytical work, conditional lending practices, and policy dialogue.

Trade Policy Reform

The World Bank did have an intellectual influence in shaping the reform process, due in great part to the central role it gave to trade liberalization. Several Bank studies showed empirically that less distorted economies outperform those that impede the development of markets. Early studies by Balassa (1982, 1985) and Feder (1983) suggested that countries that pursued outward-oriented policies encouraging exports grew faster than countries that followed protectionist strategies. In a more comprehensive work, Agarwala (1981) argued that distortions in addition to trade protectionism also slowed growth. A series of Bank studies pointed out that careful deregulation of the financial sector would result in a more efficient allocation of investment—and eventually more rapid growth.

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World Bank-sponsored economic and sector work has also been influential in determining the mechanics of liberalization attempts. For example, a series of studies presented at a 1983 conference addressed issues related to the sequencing and timing of reforms. Even at this early stage, most essays warned policymakers of the dangers associated with temporary real exchange rate appreciations during the transition toward market orientation. It was also pointed out that, under most circumstances, the appropriate sequencing of liberalization required an early elimination of the fiscal deficit followed by trade reform, and later, by capital market liberalization. The same conference dealt with the crucial role of credibility to reform success, an idea that has gained popularity in the past few years.

In the 1980s, the World Bank undertook a monumental nineteen country comparative study on trade liberalization (Michael, Papageorgiou, and Choksi, 1991). The project analyzed the characteristics and consequences of different trade regimes and investigated the most appropriate ways to implement liberalization. Issues related to sequencing, speed, and transitional costs were analyzed and compared. By and large, the results supported the view that countries with more intense, sustained liberalizations have outperformed those with failed liberalization attempts. Moreover, avoiding real exchange rate overvaluation was the single most important factor in the success of trade liberalization. Findings from this and other World Bank research were disseminated widely in Latin America through conferences and talks. This helped regional leaders become aware of historical regularities and, in some cases (such as Brazil, Mexico, and Colombia) had an important impact on decisions to implement trade reforms.

Studies sponsored by the World Bank also investigated the link between distortions (in particular, trade restrictions) and the creation of employment. In summarizing the experiences of eleven countries, Balassa (1982)
points out that, since primary activities and manufacturing for exports are more labor intensive, "reducing tariffs will tend to benefit employment." The most ambitious study on the labor market effects of trade liberalization reforms is Michaely, Papageorgiou, and Choksi (1991), which found that, in most successful structural reforms, medium-run net effects on employment have been positive. This finding has had an important role in the recent acceleration of trade liberalization reform in a number of countries—including Argentina, Colombia, and Nicaragua. As political leaders discover that the political costs of reform (in terms of unemployment) are not as high as once thought, they are willing to move more swiftly.

An illustration of the influence and persuasive powers of the multilateral institutions is the World Bank's role in the design of the Mexican reforms. Early on there was opposition to trade liberalization in some Mexican circles—especially those associated with the Secretary of Commerce and Industry. But World Bank-sponsored policy discussions, including public seminars in Mexico, helped create broader support for these measures, strengthening the position of then secretary of Budget and Planning Salinas and of Central Bank governor Mancera within the Mexican government. In 1985, almost two years after work had begun in this area, the World Bank approved a loan for Mexico to build a policy basis for the country's trade liberalization. The World Bank also helped create early awareness in Mexico of the need to implement public sector reforms and embark on a major privatization program.

Brazil provides another example. In 1987, the Government of Brazil announced its intention to implement gradual trade reform. It did not contemplate reducing nontariff barriers (NTBs) in an aggressive fashion. The World Bank considered the program too timid, and discussed it with the authorities. To increase the Brazilian public's awareness of the benefits of opening the economy, the Bank organized
seminars and conferences. This exchange of ideas generated reports that were discussed with Brazilian officials and intellectuals. As a result, the Collor government was in a position to act rapidly on reform in 1990, when most NTBs were eliminated and the tariff reduction program was instituted.15

Reform in Central America

The multilateral institutions also played a role in shaping economic reforms in Central America. Through reports, meetings, conferences, and discussions, a new generation of political leaders was persuaded to shift from the old interventionist policies toward market-based reforms. For example, early involvement of the World Bank and the IMF in Costa Rica helped set the stage for reform and paved the way for an early deal with private banks on debt reduction. The World Bank and the IMF were also intimately involved in launching the April 1991 Nicaraguan stabilization program, which put an end to hyperinflation. The macroeconomic adjustment efforts undertaken by the countries of Central America have been largely successful. Honduras, Nicaragua, and Panama, for example, were the only three countries in Latin America with single-digit inflation in 1992.

Social Programs

As a result of the Bank’s advice and financial support, some countries have implemented emergency social-investment funds geared to community-based projects that provide work to the unemployed while solving basic infrastructure problems. Those projects have worked successfully in Bolivia and Jamaica and are now being implemented in Nicaragua. The World Bank’s support of Mexico’s Programa de Solidaridad has helped make that program a successful instrument for efficiently dealing with poverty and social problems. The World Bank’s position on the importance of nutritional programs directed at children, pregnant women, and other vulnerable groups has also been accepted by most
political leaders in the region and is increasingly included in social programs.16

The Role of Conditionality

Multilateral lending programs also played an important role. By conditioning the release of funds on the implementation of certain basic reforms, the multilateral institutions forced Latin American authorities to develop comprehensive and consistent reform programs. Conditionality within World Bank programs has covered highly diverse areas, including trade reform, privatization, and financial liberalization (see Table 2).

Some nations initially resisted some of the conditions, but as time passed and adjustment proceeded, many countries began to move more rapidly than required to by the multilateral agencies. Mexico's privatization program, for instance, greatly exceeded the original World Bank goals. Likewise, the extent and speed of trade liberalization reform in Colombia went beyond what the multilaterals had originally requested.17

An Era of Reform

Although it is difficult to pinpoint the beginning of economic reform in each country, it acquired full and generalized force in Latin America in the late 1980s and early 1990s, after attempts to use traditional structuralist policies to solve the crisis had failed. Each country, of course, faced different initial conditions at the time reforms were initiated. Some faced rapid inflation and highly distorted incentive systems; others began with more moderate and manageable conditions. The economic role of the state also varied, as did the importance of state-owned enterprises. Although the intensity and scope of the reforms have differed, it is possible to classify them into four broad groups according to their approximate time of initiation: early, recent, very recent, and future-reformers.

Generally speaking, early reformers are further along in the process of transformation and have made progress in many areas. Chile represents a

Table 2 Conditionality Content of World Bank Programs

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade liberalization</td>
<td>79</td>
</tr>
<tr>
<td>Exchange rate action</td>
<td>45</td>
</tr>
<tr>
<td>Tax and fiscal policy reform</td>
<td>67</td>
</tr>
<tr>
<td>Financial reform</td>
<td>51</td>
</tr>
<tr>
<td>Public enterprises reform and privatization</td>
<td>65</td>
</tr>
</tbody>
</table>

Note: Refers to all adjustment loans (mostly SALs and SECA Ls) during 1982–89. See World Bank (1990) for details.
case of its own, having initiated reforms in 1975, almost a decade before anyone else. Mexico initiated reforms in 1985 and has also moved broadly and deeply, building new institutions to help consolidate the new economic system.

Recent and very recent reformers vary in intensity and scope. Some countries, such as Argentina, have dealt with many sectors rapidly and simultaneously. Others have moved selectively on structural reforms or have not been able to enact credible macroeconomic programs.

In almost every Latin American country, the early post-debt crisis years (1982–87) saw severe declines in per capita GDP. After 1987, per capita GDP generally began to recover. Interestingly, growth has shown a stronger trend among advanced reformers than among those countries that delayed adjustment. In 1992–93, most Latin American countries, with a few exceptions, experienced respectable to strong growth.

Macroeconomic Stabilization

Macroeconomic stabilization, including the reduction of the debt burden, has been the centerpiece of reform. Recognition by industrialized nations that the crisis was more than a liquidity crunch was a fundamental step toward stabilization. In general, voluntary debt reduction agreements—the Brady deals—were undertaken only after the country in question had made significant progress in reducing fiscal imbalances, curbing inflation, and achieving macroeconomic stability.

Policy questions related to sequencing and speed were often addressed by policymakers designing stabilization programs: Should macroeconomic adjustment precede structural reform, or could both be undertaken simultaneously? Should gradual stabilization be attempted, or would abrupt policies be more appropriate? In some countries, fixed nominal exchange rates have been used as anchors in the anti-inflationary effort. But this has been a controversial policy. While a number of analysts
argue that fixing the exchange rate provides credibility to a stabilization program, others point out that fixed rates contribute to real exchange rate overvaluation during the transition to lower inflation, undermining the sustainability of the stabilization effort.\textsuperscript{22}

\textit{Trade Liberalization}

Trade liberalization is the core of structural reform. Throughout Latin America, it has reduced import tariffs from an average of 70 percent to near 12 percent and has almost eliminated nontariff barriers in a short period. As a result, the Latin countries have experienced rapid productivity improvements and significant expansion in exports. Recently, this unilateral opening process was supplemented by efforts to create (or revitalize) regional trading blocks—such as MERCOSUR, the Andean Pact, the Central American Common Market, and CARICOM.\textsuperscript{23} And most countries have expressed interest in joining the North American Free Trade Area (NAFTA).\textsuperscript{24} A competitive real exchange rate—and, in particular, the avoidance of overvaluation—has played a key role in the success of trade reforms. The pressure that massive capital flows have recently exercised on real exchange rates throughout the region, therefore, has been a cause of concern among policy analysts.

\textit{Reorienting Government}

A salient feature of the recent Latin reforms, and one that distinguishes them from past efforts, is the emphasis on reducing the size of the state through massive privatizations. In many countries, privatization has been linked to debt reduction schemes based on debt-equity swaps. As a result, foreign firms have played an important role in reshaping Latin America's manufacturing and financial sectors. This development constitutes a marked change from a traditional history of mistrust of foreign firms. Although privatization has taken different forms in different countries, in many it has created thousands of new shareholders. While Latin American policymakers have also discovered that a

\textit{Trade liberalization is the core of structural reform. Throughout Latin America, it has reduced import tariffs from an average of 70 percent to around 12 percent and has almost eliminated nontariff barriers in a short period.}
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modern regulatory framework is needed for the efficient functioning of a newly privatized sector, progress in this area has been uneven throughout the region,25 and labor market deregulation has shown little improvement. In most countries labor market duality continues to exist, and labor distortions negatively affect the public welfare and international competitiveness.26

Financial Sector Deregulation

For years, most Latin American countries controlled capital markets, quantitatively allocating credit and keeping interest rates below inflation.27 But financial sector deregulation has been an important component of most countries' reforms. Interest rates have been freed, and the creation of new financial institutions has been encouraged. Some important policy debates in this area have dealt with the optimal timing of financial reform, the role of capital market supervision, and the opening of the capital account. But despite reforms of Latin America's capital markets, investment and savings remain low in most countries. Explaining the behavior of private savings is rapidly becoming one of the most pressing issues in Latin American analysis.

Poverty Reduction

Latin America has a long tradition of poverty and inequality, and many social indicators have further deteriorated since the eruption of the debt crisis. There is now a general recognition that economic growth and education are the main long-run determinants of reduced poverty. Yet both take considerable time to effect change. As a result, many governments and multilateral institutions have decided to implement programs directed at alleviating poverty and inequality, an approach that contrasts acutely with traditional practices. Instead of providing blanket subsidies through price controls and other distortions, targeted subsidies are being directed toward the most vulnerable segments of society.28 It is argued that, to help the poor and avoid a return to populist practices, it is necessary to tackle social problems effectively and to develop new institutional settings that ensure...
stability and protect the economy from short-term, myopic political impulses. Many have pointed out that this type of reform will not only help maintain the path toward growth and prosperity but is also likely to strengthen the region’s nascent democracies.32

The Future of Reform

Despite the real progress made by most Latin American countries, problems persist. Physical infrastructure has deteriorated severely, and in many countries poverty has increased. Inflation continues to be high, and even where it has been cut dramatically it often remains in the double digits. In some countries, economic reforms have not been accompanied by the modernization of political institutions, which can lead to political unrest. Serious crises have already arisen in Brazil, Guatemala, Haiti, Peru, and Venezuela. Additionally, large capital inflows have recently financed increasingly large current account deficits in many countries, generating sizable pressures for real exchange rate appreciation.

Latin America faces tremendous challenges in the years ahead. If the reforms of the 1980s and 1990s are to be sustained, policymakers will need to address such pressing issues as maintaining prudent macroeconomic management, alleviating poverty, reducing inequality, increasing domestic savings, and creating the solid economic, social, and political institutions that are the foundation of long-term growth.

The World Bank should continue to play an important role in the region’s development in the years to come, helping to consolidate its reforms. In some countries the Bank will play its traditional role, in others it will provide technical assistance, in still others it will help create modern institutions. Throughout Latin America, the Bank will be active in social and infrastructure projects, for it is clear that now is not the time to scale down Bank involvement in the region. In grappling with problems of equity and growth, Latin America needs to be able to rely on the Bank’s experience and strength.

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Notes


3. Some analysts have referred to this process as the "Washington Consensus," and have suggested that the new policies were imposed on Latin America by the U.S. Treasury, the IMF, and the World Bank. This interpretation is overly U.S.-centrist and clearly misses the internal Latin American political dynamics.

4. For details on the social consequences of structural reforms and labor market behavior during adjustment, see Edwards (1993b).


6. See the 1986 issue of the IMF's World Economic Outlook.

7. Work undertaken at the IMF under the leadership of Jacob Frenkel was highly influential in this area.


9. A nontrivial proportion of the capital inflows have been reverse capital flight. See Calvo, Leiderman, and Reinhardt (1992).

10. See Fishlow (1991) and Edwards (1993a) for some methodological criticisms of these studies.

11. See, for example, Hanson and Neal (1985).

12. Lai (1985), however, argued for an early liberalization of capital controls.

13. The countries covered were Argentina, Brazil, Chile, Colombia, Greece, Indonesia, Israel, Korea, New Zealand, Pakistan, Peru, the Philippines, Portugal, Singapore, Spain, Sri Lanka, Turkey, Uruguay, and Yugoslavia.

14. For a discussion of the way in which the World Bank influenced policy making in Latin America during the reform process, see Hicks (1992).

15. Ibid.

17. Miguel Urrutia, current Governor of the Central Bank of Colombia and former Planning Minister, documented the World Bank's role in forging the Colombian trade liberalization program in Colombia Williamson (1994).


19. It is important to note, however, that despite recent growth, by 1991 only thirteen countries in the region had income per capita that exceeded that of 1980: Colombia, Chile, Paraguay, Bahamas, Barbados, Belize, Jamaica, Antigua, Dominica, St. Kitts and Nevis, St. Vincent and Grenadines, and St. Lucia.

20. The recently approved Brazilian deal is a departure from this norm.


22. On this debate see Edwards (1993c), Bruno (1991), and see also Edwards and Losada (1994). A number of recent analyses have related inflation and the fate of stabilization policies to political economy developments. See, for example, Cukierman, Edwards, and Tabellini (1992).


25. See, for example chapter 6 of Edwards (1993c).

26. For an analytical discussion of some of these issue see Edwards (1988b).

27. McKinnon (1991) documents that the ratio of loanable funds to GDP in Latin America was significantly lower than that of Asia during 1960-85.


29. On these issues see the detailed discussion in chapter 8 of Edwards (1993c).
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References


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