

The Latin American Debt Crisis of the 1980s and its Historical Precursors

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April 8, 1999

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I. Introduction

Since its independence from Spain and Portugal in the 1820s, Latin America has relied heavily on international capital to finance its development. Foreign capital allowed the nations in Latin America to expand, develop, and protect themselves, it also placed a heavy debt burden on their still emerging economies.

While this burden has been bearable during economic expansions, during the times of economic stagnation which inevitably follow the boom, Latin American nations have often been unable to service their debt obligations. The combination of trade and fiscal imbalances during recessionary periods has led much of Latin America to default on its loan obligations several times over the last century and a half. A boom and bust cycle has thus emerged from Latin America's economic history, and it one of its most striking features is the debt crisis that arises after a long period of economic expansion.

The experience of most Latin American nation in the 1980s was similar in this regard. After a twenty-five year economic expansion tailored off in the 1970s, Latin America experienced a severe credit crunch, debt crisis, and a prolonged economic recession. The size, complexity, and depth of the crisis in 1982, however, seems far greater than those of crisis past.

II. Origins of the Crisis

An economic analysis of the 1980s debt crisis would be impossible without a perspective from the collapse of the Bretton Woods system in 1971. The Bretton woods system which was established after World War II, created international economic stability through first-world government control over a system of fixed exchange rates locked into a gold standard. As national governments, unable to maintain the gold standard, moved towards managed floating exchange rates in the early 1970s, this system broke down. The result was an expansion of the reemerging international capital markets and an increase in the

activity of international commercial banks. This shift towards a global financial market was accentuated by the monetarist policies of the United Kingdom and the United States during the late 1970s.¹

While the collapse of the Bretton Woods set the stage for financial globalization, it was the oil shocks brought about by the Organization of Petroleum Exporting Countries (OPEC) which played a critical role in enabling Latin America access to and a need for massive loans. When the OPEC cartel abruptly quadrupled the price of crude oil in 1973, a great supply of and demand for capital was created. OPEC nations experienced a huge increase in capital inflow due entirely to earnings from high priced oil exports, while non-oil producing nations experienced an increase in capital outflow as the cost of a crucial import quadrupled. This new and abundant supply of capital in OPEC nations was far in excess of their ability to consume or invest it, and the surplus was consequentially deposited with international commercial banks.²

The recession in developed nations, caused in part by the oil shocks, made investing in developing nations very attractive for international banks awash in Petrodollars. Furthermore, oil-importing nations in Latin America increasingly needed capital, in part to finance the external deficits associated with oil-inflation. This so called Petrodollar recycling program allowed lesser developed nations to purchase oil even as its price skyrocketed, and was actively promoted by the United States.³

At the same time, multilateral development organizations, such as the World Bank, were shifting their lending away from Latin America towards poorer nations. During the 1950s and 1960s most capital flows to Latin America were “government to government, or intermediated by official international agencies like the World Bank.”⁴ In 1961 more than half of Latin America’s foreign debt was owed to foreign governments or international agencies. However, by 1970 only 36% of foreign debt was owed to

¹ Institute of Latin American Studies. The Debt Crisis In Latin America. p.14,42

² Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.7

³ Cardoso, Eliana and Helwege, Ann. Latin America’s Economy. p.116 and Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.54 and U.S. Senate Joint Economic Committee Website

⁴ Brock, Philip and Connolly, Michael ed. Latin American Debt and Adjustment. p.100

official sources. Latin America's foreign debt continued to shift towards commercial banks and by 1982 only 12% of its foreign debt was owed to international agencies and foreign governments.⁵

Loans from the International Monetary Fund (IMF), the World Bank, and the Organization for Economic Cooperation and Development (OECD) nations usually imposed rigid terms to their financing and aid vehicles. They also tended to be long term and to carry relatively low interest rates. When these loans dropped off in the Americas, commercial banks took their place, and these imposed far fewer restrictions on their loans but generally negotiated for shorter maturities and higher interest rates.⁶

This drastic change in the source and composition of loans to Latin American in the 1970s, from long-term official loans with low interest rates to short-term commercial loans with variable high interest rates was a major factor which led to the debt crisis of the 1980s. Domestic and demand-side factors, however, played equally prominent roles in bringing about the Latin American crisis.

During the mid 1970s many nations in Latin America, including Chile, Uruguay, and Argentina, voluntarily embraced monetarism as a path of development and introduced substantial economic reform. This reform involved the liberalization of foreign trade, domestic financial markets, and international capital flows and the privatization of public industries. Exchange controls, capital controls, and other economic restrictions were dismantled and simplified without any increase in regulatory oversight.⁷

Chile abolished import licenses and reduced tariffs from an average of over 100% to a uniform rate of 10%. In 1976 Argentina uniformly reduced the reserve ratio to 45% and financial institutions were given the right to set interest rates freely. Uruguay and Chile also freed interest rates on loans and deposits during the 1970s. Furthermore, restrictions on the repatriation of profits were dismantled in Argentina, Chile, and Uruguay, as were the rules and restrictions on the negotiation of foreign loans.⁸

⁵ and Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.7

⁶ Institute of Latin American Studies. The Debt Crisis In Latin America. p.42 and Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.7

⁷ Phylakatis, Kathleen and Pradhan, Mahmood. ed. International Finance and the Less Developed Countries. p.98

⁸ Phylakatis, Kathleen and Pradhan, Mahmood. ed. International Finance and the Less Developed Countries. p.100

The result of these financial reforms was to free the flow of capital to and from the Americas. Private industry and domestic banks could borrow internationally with little or no regulation and capital could leave Latin America with relative ease.⁹

Latin American nations welcomed their new and unlimited access to foreign capital. Between 1975 and 1982, Latin American debt to commercial banks increased at a cumulative annual rate of 20.4%. This heightened borrowing frenzy led Latin America to quadruple its external debt from \$75 billion in 1975 to more than \$314 billion in 1983, or 50% of the region's gross domestic product (GDP). Debt service (interest payments and the repayment of principal) grew even faster reaching \$66 billion in 1982, up from \$12 billion in 1975.¹⁰

A good part of Latin American debt went to finance the growing trade imbalances towards the end of the 1970s. Non oil-importing nations faced expensive oil imports, and while most commodities enjoyed an increase in prices, foreign capital was needed to make up the difference. Financing needs, however, increased as the growing interest payments on the debt contributed to worsening current account deficits. And while exports only grew at an average rate of 12% per year, the service payments on debt were growing 24% a year, creating a widening gap between income earned from exports and expenses associated with debt service.¹¹

Latin American nations in turn borrowed more from abroad to finance their interest-heavy current account deficits. Even as debt service exploded, however, Latin America still experienced a net capital inflow of between 17% and 20% annually up until 1982. As borrowing continued, the real exchange rate appreciated due to the massive net inflow of capital. Furthermore, many nations in Latin America looked to keep the real exchange rate strong as a measure against inflation. The real exchange rate appreciated continuously through the late 1970, making international interest rates, which were relatively low in nominal terms due to the large international supply of capital, to actually be negative in real terms. This

⁹ Institute of Latin American Studies. [The Debt Crisis In Latin America](#). p.126

¹⁰ Institute of Latin American Studies. [The Debt Crisis In Latin America](#). p.69

provided a feedback mechanism which led many Latin American countries into a vicious cycle of growing indebtedness, leaving the continent in a precarious position leading into the global recession in the early 1980s.¹²

III. The Crisis of the 1980s

The rapidly changing domestic and international financial conditions in the 1970s created an unsustainable economic environment in Latin America which sowed the seeds of the crisis in the 1980s. These changes enabled and encouraged Latin American businesses and governments unprecedented access to cheap foreign capital in the form of short term loans, which accumulated to record amounts by the 1982. The debt crisis itself was precipitated by a number of inter-related exogenous shocks which toppled Mexico and several other Latin American economies, already overburdened with an increasing percentage of the world's outstanding debt.

While the dangerous accumulation of foreign debt by countries in Latin America occurred over a span of years, the debt crisis began when the international capital markets became aware that Latin America would not be able to payback its loans. This occurred in August of 1982 when Mexico's Finance Minister, Jesus Silva-Herzog, declared that Mexico would no longer be able to service its debt. A look into the causes of Mexico's debt default will illuminate why other Latin American nations collapsed soon after.¹³

Unlike most other Latin American debtor nations, Mexico was an oil producing nation and therefore benefited from the oil shocks in the 1970s. Because of its large natural resources endowment, Mexico was able to exploit the high oil prices and increased its oil exports from \$600 million in 1976 to \$14 billion in 1981. Non-oil exports, however, deteriorated rapidly during this period while imports grew 30% per year, contributing to a current account deficit of \$12.5 billion by 1981. Some of the factors

¹¹ Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.54

¹² Institute of Latin American Studies. The Debt Crisis In Latin America. p.70,129

¹³ Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.9

which led to the current account deficit include the liberalization of trade, which reduced import controls, and the revaluation of the real exchange rate between 1978-81, which made Mexican exports more expensive abroad and imports less expensive.¹⁴

To finance the widening current account deficit, Mexico's public and private sectors relied on foreign debt. As a result, increasing interest payments abroad accompanied the deterioration in the trade balance, resulting in a higher current account deficit.^b Furthermore, the increases in debt consisted mainly of short-term loans, such that more than 50% of Mexico's net foreign debt was subject to interest rate changes by 1981.¹⁵

When the second oil shock occurred in 1979, doubling the price of oil, the United States and other OECD nations responded by dramatically raising interest and imposing tight monetary control. But the Mexican government continued to increase its public spending even as debt service became much more expensive. "High and increasing oil prices were taken to be a permanent feature of the international economy, while the increase in interest rates was interpreted as a temporary phenomenon."¹⁶ by the Mexican government.¹⁷In reality the opposite was true. By 1981, oil prices began softening due to the recession in the United States. But interest rates did not fall significantly from their 1980 peak of 19%.

The Mexican private sector, however, took its cue and began shifting its assets abroad in the wake of the changes in the international economy. More than \$20 billion from the private sector fled the country between 1981 and 1982, even after borrowing heavily in 1979. Capital flight continued well into 1982 and was compounded by continuously falling oil prices, pushing Mexico towards a financial crisis.

¹⁴ Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.73

^b The current account includes the balance of trade, external interest payments, and income earned abroad.

¹⁵ Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.73

¹⁶ Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.75

¹⁷ Cardoso, Eliana and Helwege, Ann. Latin America's Economy. p.116

The government finally reacted in 1982, raising import controls, cutting spending, and devaluing the peso, but the damage had already been done.¹⁸

The peso depreciated 80% in February of 1982 while capital flight continued, leading to debilitating stagflation. At this point, more than half of Mexico's foreign debt was due for repayment or refinancing within a year. By August, Central Bank reserves were almost exhausted, international banks refused to lend to the Mexican government, and the government announced its inability to service its debt. The United States, other OECD nations, and the IMF put together bridge \$190 billion in bridge loans and other short term financing to keep Mexico from overtly defaulting before formal debt restructuring could be completed.¹⁹

In the wake of Mexico's default, most commercial banks reduced significantly or halted new lending to Latin America. As much of Latin America's loans were short-term, a crisis ensued when their refinancing was refused. Billions of dollars of loans that previously would have been refinanced, were now due immediately.²⁰

As with oil prices, most commodity prices dropped of steeply in the early 1980s, putting heavy pressure on Latin American countries which traditionally had focused on exporting primary goods. Furthermore, commodities. The result was a decrease in export revenues and a deterioration in the terms of trade.

The drop in exports earnings was compounded by the sudden increase in interest rates brought about by the United States' newly tightened monetary policy. Like Mexico, most other Latin American nations held short term loans, which put interest-rate risk on them rather than on the lending banks, and

¹⁸ Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.77

¹⁹ Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.79,80

²⁰ and Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.9

experience a tripling of the interest rate between 1977 and 1981. As a result, none of the debtor nations could conceivably pay back the billions that were now being demanded by international banks.²¹

The situation was further aggravated by widespread capital flight throughout the Americas. By 1984, non-government Latin American assets in the U.S. had reached \$160 billion. The massive outflow of capital in the early 1980s served to depreciate the exchange rates in Mexico, Brazil, Chile, and Argentina, thereby raising the real interest rates in these nations.²²

As a result of Mexico's defaults and other economic pressures, the flow of external credits to Latin America decreased dramatically after 1982, and creditors began demanding payment. Because of the staggering accumulation of debt over the previous 10 years, and the recent increase in the real and nominal interest rates, the interest payments on debt were enormous. In 1984, the interest due on debt as a ratio of gross national product (GNP) of the region reached 5%.²³

Shut off from international credit and forced to transfer huge resources abroad, not a single debtor nation in Latin America was able to pay the total amount of the interest for single year. The portion of the interest which nations were not able to pay off was generally added to the principal, "increasing the previous amount of the debt; the amount of the interest payment rises yearly, and with it the burden on the debtor countries."²⁴

To pay off their debts, Latin America went through a long and painful process of adjustment which began with a shift in the trade balance. As a whole, Latin America went from a trade deficit of \$2 billion in 1981 to a trade surplus of \$31 billion in 1983, most of which was transferred abroad in the form of interest payments. Latin American nations also adopted tight fiscal and monetary policy, and in many

²¹ and Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.56 and Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.76

²² Thorp, Rosemary and Whitehead, Laurence. ed. Latin American Debt and the Adjustment Crisis. London: Macmillan Press, 1987. p.18

²³ Institute of Latin American Studies. The Debt Crisis In Latin America. p.113

²⁴ Institute of Latin American Studies. The Debt Crisis In Latin America. p.114

cases nationalized the masses of debt accumulated by the private sector. Latin America became a net-exporters of capital between 1982-1985, pumping out over \$106 billion in interest payments.²⁵

Nonetheless, most nations in Latin America were forced to renegotiate the terms of their debt with creditors, as it became obvious that they were unable to make their debt service payments. The IMF stepped in to coordinate international credit and debt renegotiations which lasted well into the late 1980s. As a precondition to loans and debt restructuring, the IMF required debtor nations to sign agreements which allowed the IMF to dictate contractionary domestic economic policy.²⁶

The long-term effects of the crisis have included a major recession. Real GDP growth for the region was only 2.3% between 1980 and 1985, but in per capita terms Latin America experienced negative growth of almost 9%.²⁷

IV. A Historical Perspective

The debt crisis which Latin America faces in the 1980s is not a new phenomenon. The continent has experienced a series of debt crisis since independence. A review of Latin American history since 1820 reveals a pattern of long expansions followed by sharp protracted recession, culminating in a debt crisis and years of debt negotiations.

Upon achieving independence, most nations in Latin America adopted free trade policies. The primary objective of liberal policy was to gain revenue for the young governments via import and export taxes. But a secondary, and unintended, effect was to provide a major opportunity for North American and British merchants, who quickly became major exporters, investors, and financiers to the nascent countries.²⁸

²⁵ Institute of Latin American Studies. The Debt Crisis In Latin America. p.115

²⁶ Institute of Latin American Studies. The Debt Crisis In Latin America. p.70

²⁷ Pastor, Robert A. ed. Latin American Debt Crisis: Adjusting to the Past or Planning for the Future. p.35

²⁸ Marichal, Carlos. A Century of Debt Crises In Latin America. p.17

Governments eagerly overspent on imports, and later on silver and gold mines to pay for the rising trade imbalance associated with the increase in imports. To attract foreigners to develop the mines, Latin American governments reduced taxes, thereby creating fiscal imbalances as well. Furthermore, financing the large armies and navies in Argentina, Chile, Bolivia, Columbia, and Venezuela required deep pockets. By 1822, unable to balance their fiscal or trade accounts, Latin American governments turned to foreign bankers for financial assistance. The first major accumulation of debt in Latin America, therefore, was a direct response to the deterioration of fiscal and trade balances as well as spending on public projects and defense.²⁹

The debt crisis of 1825 which followed several years of economic expansion was caused mainly by a combination of exogenous factors. Some contributing factors included the sharp decline in commodities prices, the tightening of credit internationally, and a financial panic abroad. As a result of these pressures, almost every government in Latin America defaulted on its debt by 1827. Political instability, military conflicts, and declining exports prevented any nation in Latin America to resume payments on its debt until 1844.³⁰

The first debt crisis in Latin America's young history provides an interesting contrast to the crisis of the 1980s. Both crisis were strongly influenced by recessions abroad, and their accompanying higher interest rates and falling commodities prices. And loans in both periods were primarily provided for by international banks. The use of the loans, however, varied significantly, as loans the 1970s were used mostly by the private sector. Furthermore, while some nations in the 1820s were able to rely on domestic credit, this was not an option for Latin American governments in the 1980s as capital flight mounted.

The global economy experienced a sustained period of growth between 1850 and 1873, led by transportation breakthroughs, the United States gold-rush, and unprecedented growth in North America.

²⁹ Marichal, Carlos. A Century of Debt Crises In Latin America. p.27,41

³⁰ Marichal, Carlos. A Century of Debt Crises In Latin America. p.44,55,57

As a result, Latin America experienced a long phase of expansion, during which primary product exports from across the continent surged.³¹

A wave of restructuring and economic reform ensued, leading to Latin America's return to the international credit markets. Once again governments led the way, borrowing more than \$75 million in the 1870s alone to finance public works, infrastructure projects, and modernization programs. Peru, Brazil, Chile, Argentina, and Mexico also borrowed money to finance wars and other military events, including invasions from Spain.³²

By 1873, however, another financial crisis in the North Atlantic brought Latin America's growth to a halt and its loans into default. Stock exchanges crashed across Europe and the U.S., leading to crisis in developing nations around the world. Commodity prices dropped abruptly, leading to a 37% decrease of exports between 1872 and 1868. Latin America dipped into a severe recession, and many countries, lacking the export earnings to maintain interest payments, defaulted on their loans.³³

Like the debt crisis of 1827, the debt defaults which followed the 1873 market crash was caused mostly by exogenous factors and an unsustainable international debt burden undertaken by Latin American governments. Similar also to the crisis of 1982, the extensive international borrowing by Latin American governments created a fragile economic environment which when subjected to financial panic from abroad, brought the governments into bankruptcy. The eager lending of European banks with relatively inexpensive capital helped the Latin American governments borrow well past their capacity, in some cases exceeding their export earnings by 200%. In 1873, however, the majority of the foreign debt was still owed by governments and was used mainly for public works and military activities.³⁴

The greatest financial crisis in the history of the world, the Great Depression, was preceded by a 20 year boom in both exports and loans in Latin America. Between 1904 and 1914, Latin American

³¹ Marichal, Carlos. A Century of Debt Crises In Latin America. p.68

³² Marichal, Carlos. A Century of Debt Crises In Latin America. p.95-6

³³ Marichal, Carlos. A Century of Debt Crises In Latin America. p.105

³⁴ Marichal, Carlos. A Century of Debt Crises In Latin America. p.107

governments amassed more than \$1 billion in new debt. Even as World War I broke out in Europe, Latin America managed to service its huge debt load, partly with investment from the United States. During the war, exports boomed and U.S. investment banks edged out European banks as the leading lenders to Latin America. More than \$1.5 billion of Latin American bonds were sold by U.S. bankers between 1925 and 1928.³⁵

During the beginning of the 20th century, private borrowing became a powerful source of debt for Latin America, accumulating more than \$7 billion by 1914. Between 1920 and 1929 more than \$5 billion had been transferred abroad to cover interest payments on private sector debt in Latin America.

The inevitable crash which followed this export-led boom came during 1929. Foreign loans had dropped by an average 80% over the preceding three years, and foreign direct investment was almost negligible. After the stock market crash of 1929, commodity prices collapsed reeking havoc on almost every nation in Latin America. Political turmoil also followed the economic crisis, as revolutions and coups broke out in Guatemala, Honduras, the Dominican Republic, Argentina, Chile, Brazil, and Bolivia between 1930 and 1933. Latin American governments also declared debt defaults across the Americas continued through 1935.³⁶

As in previous crises, the most important factor leading to debt defaults in Latin America was the dwindling supply of foreign currency brought in by commodity exports. But there were significant differences between the 1930s collapse and previous debt crisis. The loans in previous crisis were used mostly for political, military, and strategic expenditures. The government debt outstanding in the 1930s, however, had been incurred in economic development and infrastructure projects.³⁷

Another major difference in the debt crisis of the 1930s and previous crisis was the extent and importance of the private sector. The crisis was marked by the collapse of numerous banks and business enterprises, much like the crisis of the 1980s. But while the 1930s saw the collapse of many regimes and

³⁵ Marichal, Carlos. [A Century of Debt Crises In Latin America](#). p.173

³⁶ Marichal, Carlos. [A Century of Debt Crises In Latin America](#). p.202

the violent overthrow of others, 1980s was relatively peaceful in Latin America for it had already experienced revolutions in the 1970s. Furthermore, some have even pointed out that the complexity of the debt crisis in the 1980s led to a peaceful transition from military regimes to democracies.

V. Conclusion

Several trends emerge from the history of Latin American debt crisis. Since 1820 there has been a consistent shift from government borrowing towards commercial borrowing, which by 1980 comprised most of Latin America's debt. The acquisition of debt to finance military expenditures, while persisting since 1820 has generally decreased as a proportion of total Latin American debt. Argentina, Brazil, Chile and Peru continued to borrow in the 1970s to establish a more sophisticated army, but the loans were small relative to the private sector.³⁸

Similarities between the 1980s crisis and its predecessors are mainly to be found in the general causes of the crisis. Most of Latin America's crisis followed a long period of economic expansion. All the Latin American debt crisis, excepting the great depression, have been preceded by fervent borrowing, peaking during the three years preceding default (1822-1825, 1870-1873, 1977-1980). The debt crisis consistently follow three inter-related exogenous shocks: a steep fall in commodities prices, instability in the financial markets of the first world, and recessions abroad. And in all four major Latin American debt crisis, commercial bankers in the United States and Europe were main sources of capital.

The differences between the debt crisis of the 1980s and its precursors are equally striking and more numerous. The 1980s crisis, while sparked by the official default of the Mexican government, was generally a crisis of the private sector. The majority of the debt was held in non-guaranteed private sector loans which were eventually nationalized to meet obligations. And while the IMF's role in preventing a total breakdown of debt payments and new loans was pivotal for the resolution of the 1980s crisis, this relatively young institution played no role in previous crisis. Furthermore, capital and trade liberalization

³⁷ Marichal, Carlos. A Century of Debt Crises In Latin America. p.206,230

in the Americas in the 1980s contributed significantly to the crisis, but has not been an issue historically.

³⁸ Marichal, Carlos. A Century of Debt Crises In Latin America. p.236

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