Winners and Losers in the
Latin America Debt Crisis:
The Political Implications

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Latin American debt has been politicized since the financial crisis began in 1982. It is easy to understand why international debt has become an international political issue, for the renegotiation of cross-border loans inevitably involves governments. Continued bargaining over the terms of debt service among debtor states, creditors, and creditor states confirms expectations that this international political interaction will reflect the wide variety of material interests and institutional forces at play.

Foreign debt has also become an extremely important political issue within Latin American countries. It has been central to Latin American domestic politics since 1982, affecting such significant processes as democratization, oppositional protests, and repression in a variety of countries. Indeed, domestic political strife over the external debt has often spilled over into the international bargaining process, as countries have found their international negotiating stance constrained by domestic pressures.

Recent experience demonstrates the weakness of existing approaches to Latin American political economy. The modernization tradition, which argued for a positive relationship between economic development and political democracy, was largely discredited by the wave of authoritarian coups that swept Latin America in the late 1960s and early 1970s. The most common alternative, the “bureaucratic authoritarian” approach that suggested a causal link between economic crises and political authoritarianism in countries at middle levels of economic development, has been undermined by the wave of democratization that, in the midst of serious economic distress, swept the region in the early 1980s.

This essay suggests an alternative based on the broader political economy literature. The approach explores how socio-economic actors, in pursuit of their material interests, interact with existing institutions. The result is not a constant assertion that economic growth leads toward or away from democracy, but rather a mode of analysis that allows us to understand the relationships among economic interests, political behavior, and social outcomes.

The essay summarizes the domestic political impact of the debt crisis in the five largest Latin American debtor nations: Argentina, Brazil, Chile, Mexico, and
Venezuela. It emphasizes how the domestic distributonal effects of the financial crisis have been reflected in the domestic political arenas of the major Latin American debtors. A simple analytical framework focusing on the impact of the crisis on different social groups, the distinction between liquid and fixed asset-holders, and the availability of a sympathetic government or attractive oppositional coalition partners is used to explain the responses of different economic agents to financial distress. The evidence mustered is not exhaustive or systematic, but meant to illustrate the analytical points being made. First is a general survey of the distributional effects of international financial relations. The next two sections of the essay discuss these distributional effects during the borrowing process and the financial crisis respectively. The final section explores the political implications of these distributional effects during the debt crisis.

**International Finance and Domestic Interests**

Foreign debt is often a source of domestic political conflict, for it can raise important distributonal issues. An inflow of capital as debts are contracted, or an outflow of capital as debts are repaid, affects different economic agents variably. Some do especially well during an expansion in borrowing, while others do especially poorly during a contraction in new borrowing or reversal of financial flows. The possibility of an unequal distribution of gains and losses in borrowing booms and financial crises makes foreign debt potentially controversial within borrowing countries.

Beyond market forces, government policy can also affect who wins and who loses in borrowing and financial crises. During financial expansions the government may channel foreign loans to favored firms, while during times of crisis it may use taxpayers' money to bail out the indebted enterprises. External finance may be used to allow industrialists to purchase cheap capital goods from abroad, while a financial cut-off may be dealt with by repressing industrial wages to increase exports. In such instances, the relative distribution of costs and benefits in both boom and bust is amenable to government policy, and is thus the focus of political conflict. To clarify the issues involved, we first consider the economic impact of a capital inflow (or outflow) in the absence of government policy, and then consider how government policy can affect this economic impact.

We begin our analysis at the point where financial resources start to flow into the country, which affects three important economic variables: the availability of capital, foreign currency, and government finance. This is of course only part of the story—the pattern of borrowing presumably responds to the prior structure of domestic socio-economic and political interests—but it is ambitious enough for our purposes. We take as given the structure of economic interests, political institutions, and government policy when borrowing begins.

Inasmuch as foreign finance increases the supply of capital available for domestic investment, it lowers domestic interest rates. A capital inflow thus makes borrowing cheaper and saving less attractive. When the capital inflow is channelled through domestic financial intermediaries, as occurs frequently, it benefits the national financial sector as well. Of course, here as elsewhere the capital inflow has a number of crosscutting effects. Borrowers eventually have to service their debts, and savers who are also consumers may benefit in the long run if the capital inflow leads to higher levels of productivity and thus lower prices. Nonetheless, the principal short-term result is straightforward: borrowers benefit from the increased supply and lowered price of capital.

As external borrowing increases the domestic supply of foreign currency, it cheapens foreign exchange relative to the domestic currency. Without getting into thorny analytical debates about currency “overvaluation,” we can safely say that in most instances the borrowing country’s currency is stronger than it would otherwise be; domestic prices rise relative to world prices. This benefits those who purchase imports and harms exporters, although the ultimate result depends on the structure of protection. In the usual Latin American context, in which there are many barriers to the import of finished goods, cheap foreign exchange generally helps protected domestic producers who use imported capital goods or inputs.

When foreign capital is used to cover the public sector deficit, it has distributional effects analogous to those of more general government spending. Some benefit by the public programs made possible by external public borrowing; others benefit by the short-term reduction in taxation that public borrowing allows. When, as is common, public borrowing is done by parastatal firms, the position of three groups is improved: employees of the firms whose debt allows increased wages or payrolls, suppliers of the firms that use debt to increase orders, and customers of the firms where debt leads to increased output and lower prices for the firms’ products.

Of course, the differentiated effects of a capital inflow are reversed in the case of a capital outflow or a cessation of new lending. When a country with previous access to foreign capital is cut off, the supply of capital is reduced and domestic interest rates rise. Foreign exchange dries up and the currency depreciates, while the public spending–revenue gap must be closed without recourse to foreign funds. The society also has to mobilize domestic resources and foreign exchange to maintain service payments on the external debt. National savings, exports, and government revenue have to increase, or investment, imports, and government spending must decrease, or some combination of these. As foreign finance disappears and domestic interest rates rise, borrowers lose and savers gain. As foreign exchange becomes scarce and the currency depreciates, consumers of imported goods suffer and exporters benefit. As it becomes harder to finance the public deficit, spending is cut and employees, suppliers, and consumers of the public sector suffer the consequences.

Government policy can affect the distribution of foreign finance and thus the costs and benefits of a country’s international financial position. When loans flow in, the government can channel capital and foreign exchange to favored sectors of the economy, thus concentrating the availability of cheaper capital or imports on a
few government-backed borrowers. It is precisely this ability of government policy to affect the impact of international financial flows on different groups in society that makes these flows politically controversial. On the basis of these general observations, we can move on to discuss the Latin American experience, both while finance was readily available and once the financial crisis hit.

Politics and Economics in the Borrowing Process

The economic effects of Latin American borrowing were the result of both market factors and government policies; they thus varied from country to country. We can nonetheless identify general patterns among the economic actors who were especially assisted by foreign borrowing; that is, those on whom the positive effects of the capital inflow were concentrated. It should be kept in mind that our analysis uses the borrowing period as a somewhat artificial starting point, especially since many of the effects discussed here were the result of government policies already in place when borrowing began.

In virtually all borrowing countries, the financial and commercial sectors grew very rapidly. The banking system was a major conduit for funds in all countries, and its role as intermediary between foreign lenders and domestic borrowers was extremely lucrative. By the same token, the greater availability of foreign exchange increased foreign trade, thus helping the commercial sector.

Other consequences of external borrowing depended on the specifics of national government policy. In Brazil, Mexico, and Venezuela, the significant portions of foreign borrowing that went to finance parastatal investment improved the position of the parastatals themselves, as well as that of the suppliers and customers of the parastatals. This included construction firms and capital goods producers which received lucrative orders to supply the huge parastatal petrochemical, hydroelectric, mining, and steel projects. It also included the consumers of industrial inputs produced and sold at subsidized prices by these new parastatal investment projects. At the same time, domestic industry was accorded significant protection from foreign competition, even as it was generally able to purchase relatively inexpensive foreign capital goods. In all three countries, therefore, the public industrial corporations and the private firms tied to them grew very substantially.

In the Southern Cone, neo-liberal policies meant that external finance went largely to the financial and commercial sectors. Despite the general availability of cheap imported capital equipment and inputs, trade liberalization made the countries’ most uncompetitive industrial firms particularly unattractive to external lenders. Meanwhile, concurrent booms in consumer goods, financial, and real estate markets made firms in these sectors especially attractive. Chile is the most striking case: the public sector did almost no borrowing, and most of the country’s external debt was accumulated by diversified conglomerates based in financial, commercial, and real estate activities. In Argentina the pattern was similar, although some military-controlled public corporations were major borrowers there.

Foreign borrowing led to little domestic political conflict in Latin America before the financial crisis. This is easy to understand, since an inflow of foreign resources has far more visibly positive effects than negative ones. Whatever unfavorable impact a capital inflow may have had on savers and exporters was generally overshadowed by the general prosperity it brought. The borrowing phase of recent Latin American financial experience was in fact one of relative well-being, as debt went to finance an expansion of consumption or investment or both.

Although debt-financed consumption or investment booms were generally uncontroversial, two criticisms of Latin American borrowing were voiced in some quarters even before 1982. One explicitly political objection came from opponents of the many authoritarian regimes then in power, who viewed foreign borrowing as a contribution to strengthening the status quo. The most obvious examples of this first criticism were in the Southern Cone, where policies of financial liberalization and resultant borrowing sprees were closely tied to the anti-labor bent of the military dictatorships and their supporters. The left and much of the labor movement in Chile and Argentina were just as hostile to foreign borrowing as they were to the regimes’ neo-liberal policies.

The second pre-1982 criticism of external debt was explicitly economic, focusing on the role of foreign borrowing in validating or reinforcing undesirable domestic resource transfers. The most egregious target of such criticisms was the linked financial and currency speculation that went on in most countries, especially after 1979. As international interest rates rose in 1981 and 1982 and domestic interest rates followed suit, financial investors reaped very large profits. At the same time, as currencies became increasingly overvalued, the availability of a “one-way bet” against the national currency led financial investors in many countries to buy dollars and transfer their portfolios to Miami, London, or New York. Moreover, the major currency overvaluations of the early 1980s were generally possible because national monetary authorities could borrow heavily abroad and resell borrowed dollars at home at bargain basement prices.

Despite some complaints about the distributional effects of foreign borrowing—especially in the Southern Cone—the prevailing affluence among the upper and middle classes, and of parts of the working classes, muted most of the discontent that existed. The external debt did not become a major domestic political issue until the financial crisis began in 1982.

Distributional Effects of the Debt Crisis

The sudden disappearance of external sources of finance in 1982, exacerbated by the need to make service payments on large accumulations of external debt, had important macroeconomic consequences for countries that relied on foreign loans to finance investment and/or to cover their trade and budget deficits. Access to foreign capital dried up, which drove interest rates substantially higher everywhere. The reduced supply of foreign exchange led to rapid currency depreciation and a
major compression of imports. The public sector’s inability to finance its deficit abroad forced it to borrow more at home, driving interest rates up still further. It also forced the public sector to reduce its expenditures (other than debt service) and increase its revenues.

The debt crisis was disastrous for virtually everyone in Latin America. In one sense, of course, the crisis hit the poor hardest, since they had the least reserves to cushion the impact of the worst depression in modern Latin American history. While this is an important fact to keep in mind, it is far too undifferentiated to be of much explanatory power in understanding the political fallout of the crisis. Poverty is endemic in Latin America, the poor are always in conditions of relative deprivation, and most of the region’s political systems have long succeeded in systematically excluding the poor from effective political activity.

Leaving aside the undifferentiated mass of the impoverished, the effects of the debt crisis fell unevenly on other economic agents. Those who bore the exchange risk for major foreign debts were probably the hardest hit. In some countries this was the domestic financial system itself, but in most cases local banks had passed the exchange risk on to local borrowers, and the massive crisis-driven devaluations bankrupted virtually all such ultimate borrowers. In one fell swoop many of Latin America’s leading private firms were made insolvent, with dollar liabilities often many times larger than their assets.

The identity of those hit hardest by crisis-induced devaluations depended on the major borrowers in the financial expansion. In Brazil, where the devaluation was only moderate and most of the borrowing had been done by the public sector, the impact on the private sector was less severe than in Chile, where the devaluation was massive and the vast majority of the borrowing had been done by private firms. Mexico and Venezuela both had important private-sector borrowers that were bankrupted by the crisis, but the public sector still accounted for most external debt. In Argentina the mix was about half and half. In these last three countries, the devaluations were substantial, and the impact was felt throughout both the private and public sectors.

Another important group of economic actors who shared the brunt of the crisis in many countries was the network of firms tied to the public sector. The crisis forced a major curtailment on public investments expanded by borrowing, which hit hard at the parastatal’s former suppliers. This was very much the case in Brazil, Mexico, and Venezuela. By the same token, where debt-financed parastatales had offered subsidized inputs to private industry, the crisis forced them to raise prices to maintain debt service. The resultant increase in utility rates, energy prices, transportation costs, and the cost of basic industrial inputs again hurt important industrial sectors in Brazil, Mexico, and Venezuela. Both of these outcomes—reduced parastatal orders and reduced public-sector subsidies to industry—were far less significant in Argentina and unimportant in Chile, which had fewer orders and subsidies to begin with.

Other beneficiaries of government spending were also affected by the crisis in...
them different incentives to divert resources from economic endeavors to political activity. Throughout Latin America, investors whose assets were very mobile could easily exit from the local economy and thus had less incentive to exert political pressure on the government. Other groups whose assets were relatively immobile had no choice but to engage in political activity to protect their interests.

There is a continuum in the political behavior of economic actors from complete reliance on the market to total dependence on government favors. The endpoints are unrealistic—few firms devote none or all of their resources to political pressure—but there is substantial variation. Whether social actors exit the system or give voice to their demands is a function of the economic position of the actors themselves—the economic feasibility of each option—and of the domestic political environment—the expected results of protest. Leaving aside for now the likelihood of the success of political pressure, there are clear reasons why different sorts of investors with different kinds of assets will respond differently to identical economic events.8

Some economic actors can easily move their assets among sectors and jurisdictions, and thus respond rapidly to changes in economic conditions without loss of revenue. Those whose savings are in very liquid domestic financial instruments can easily respond to national economic difficulties and uncertainty by shifting their savings to Miami, where both the currency and the underlying economic and political environment are presumably more stable. Financial institutions can similarly shift their short-term assets from Mexico City to London. Investors with easily-marketable assets, such as gold, can readily liquidate their holdings.

Other investors, however, have assets tied to activities that cannot easily be liquidated without a significant capital loss. Capitalists may have production facilities with which they are very familiar, informal contracts from which they alone can benefit, expertise that can only be used in certain lines of production, or other sector- or site-specific assets that bind them to the local economy. Managers or employees may have skill, language, or personal ties that make it very difficult to move. Investors with assets that cannot easily be sold at the price they are worth to the investors, and who would have to take a major loss to liquidate their holdings, are relatively immobile economically.

The former investors, whom we shall call liquid asset holders, are far more likely to take their investments elsewhere in times of crisis than the latter investors, whom we shall call fixed asset holders. In response to serious domestic economic difficulties, which lower local rates of return or introduce unacceptable risk into local economic activities, liquid asset holders will tend to change their portfolios or even to flee the jurisdiction, while fixed asset holders will tend to stand and fight to protect the value of their assets.

In all of Latin America, important economic groups with liquid assets responded to the debt crisis with a combination of hedging and capital flight. Some went to extremely short-term deposits (often overnight accounts) indexed to the inflation rate or the dollar, or otherwise relatively protected against domestic instability. Others bought consumer durables, dollars, or gold, which could easily be sold at predictable prices in case of further trouble. Still others took their assets elsewhere, to establish dollar accounts or buy condominiums in Miami, San Diego, New York, London, or Geneva.

The precise mix of such asset movements was largely a response to national economic conditions as well as geographical and historical factors. Table 2.1 presents estimates of capital flight in the five major Latin American borrowers. In Brazil, there was only a moderate currency overvaluation, a long tradition of capital controls, and general confidence in the country's long-term prospects. Liquid asset holders there generally got into real estate, index-linked Treasury securities, or physical dollars they kept inside the country. In Chile, the principal economic actors had substantial liquid assets, and resubmitted them in response to the crisis. Few engaged in capital flight, despite the massive peso overvaluation. The reasons for this are not entirely clear. Investors may simply have believed the dictatorship's continual insistence that there would be no devaluation, or astronomical domestic interest rates may have offset devaluation expectations.

Recourse to capital flight was most common in Mexico, Venezuela, and Argentina. In Mexico and Venezuela, with long traditions of easy movement to and from the United States and few or no capital controls, many investors already had U.S. bank accounts. The principal response of liquid asset holders in these countries was to buy dollars and take them overseas. To some extent, relatively inexperienced or trusting Mexican middle-class savers established legal dollar accounts inside Mexico; they were rewarded for their inexperience and faith by having their accounts frozen and converted to pesos at an artificially low rate once the crisis struck. Argentina's chronic economic and political instability since World War II had made many investors wary of fixed assets, so flight into overseas dollar accounts was widespread in Argentina.
While liquid asset holders responded primarily by protecting their assets—shifting their investments into new instruments or taking them abroad or both—they also engaged in some political action. Their primary concern was to ensure the continued liquidity, availability, and profitability of their assets. Thus they lobbied against exchange controls, for freer financial markets, and for government support for failing financial institutions. Although such demands for economic liberalization were limited in the initial phases of the crisis, since investors with such interests were relatively protected against the worst effects of the financial turmoil, pressures from market-oriented liquid asset holders have mounted over time.

In all countries liquid asset holders, many of whom now hold internationally-diversified portfolios, have come to support more orthodox macroeconomic measures, financial and commercial liberalization, and a more cooperative stance toward international financial institutions. The most visible such movement has been the increased support for the right-wing Partido Acción Nacional (PAN) by a portion of the Mexican business community, especially those in the North and/or those tied to trade and finance. Whether through Mexico’s PAN, Venezuela’s Grupo Roraima, or through other means, liquid asset holders have exerted some political pressure on the government. Nevertheless, because they concentrated most of their resources on economic diversification rather than political activity during the first stages of the crisis, their initial political successes were quite limited.

All of this explains why the foremost political pressures on Latin American governments in the aftermath of the financial crisis came from sectors that could not easily shift their economic activities and so were forced to fight for state support. The most prominent such group was made up of industrial capital and labor. Everywhere in Latin America the industrial sector was the strongest opponent of debt crisis-induced domestic austerity measures.

Our first step was to explain why some social groups engaged in intense political activity as the financial crisis hit. Our second step is to explain why this activity took different forms. Within the political arena, we are primarily interested in explaining a group’s choice between exerting political pressure on the government and engaging in oppositional activity. The sort of political activity chosen depends on the likelihood that such activity will matter, which is largely a function of the institutional and political environment faced by social actors. Firms, sectors, and groups are most likely to make demands on governments perceived to be responsive. By the same token, they are most likely to support an opposition that has both the willingness to endorse their demands and some prospect of taking power.

The sort of political action engaged in by a social group thus depends on its assessment of the likelihood of success of the various options. This in turn is a function of the strength of the group, its ability to ally with other groups, its existing ties to the government, and the strength and availability of an oppositional alternative. We can highlight this process by focusing on how and why industrial capitalists, the most important group of fixed asset holders in industrializing societies, chose to exert pressure on the government or defect to the opposition.

The ability of industrialists to obtain the policies they sought without defection from the government was largely due to the economic importance of domestic industry, the degree to which industrial labor and management were able to unite in support of common demands, and the existence of close ties between industrialists and the government. A turn toward oppositional activity depended both on an inability to meet these conditions and on the availability of an acceptable opposition partner with reasonable chances of eventual success.

The general openness of the government to various social demands and the availability of an attractive opposition were indeed important factors in the political behavior of the Latin American private sector after 1982. In Chile, ties between domestic industrialists and the military regime were weak. Leaders of industry had little say in or sympathy for the government’s neo-liberal economic policies after 1973. Indeed, industry had been substantially weakened by neo-liberal policies, as manufacturing value added dropped from 25 percent of gross domestic product (GDP) in 1970 to 19 percent in 1982. In addition, labor-management relations were extremely hostile, so that industrial capital and labor could not unite to pressure the government. Industrial pressure on the Chilean government was weak, and the industrial sector had almost no success in obtaining government support. The government was willing to assume some responsibility for the financial catastrophe, but mostly in support of the heavily-indebted conglomerates whose position affected the country’s overall international creditworthiness. After some initial vacillation, however, the dictatorship was generally indifferent to the pleas of the domestic industrial sector.

Despite their inability to influence government policy, Chilean industrialists engaged in little political protest. This was primarily because the existing opposition to the military did not enjoy the confidence of the private sector. The left, of course, was a traditional enemy, but even the Christian Democrats and the right were discredited in the eyes of the business community by their pre-1970 behavior. The moderate Chilean opposition complained bitterly that the private sector was cowardly, and at the same time attempted to tie itself to business discontent by assuring investors that the opposition would respect property rights and otherwise encourage private enterprise. Few businessmen were convinced. Another factor was the apparent willingness of the regime to use brute force to repress most opposition; there seemed little likelihood of anyone dislodging Pinochet. The opposition’s ambiguous economic preferences and poor prospect of taking power meant that the business sector, discontented as it might be, remained politically passive. The exception that proved the rule, of course, was the brief participation of business groups in the opposition demonstrations in 1983-84. The government’s success in co-opting business was a key factor in the failure of the protest movement.

In Argentina, industrialists had more options. Although Argentine deindustrialization was almost as significant as in Chile—manufacturing value added went from 27 to 23 percent of GDP between 1970 and 1982—the sector maintained ties with some military factions. At the same time, Argentine labor-capital relations, al-
though not fully cooperative, were better than in Chile, and most of the opposition was less suspect. The industrial sector thus used a combination of pressure on the dictatorship and defection to the opposition. The 1981 Viola presidency reversed the anti-industrial course of previous economic policy and bailed out many private firms, raising the hopes of the industrialists. When Viola was eased out by hard-line officers, however, industrialists lost faith in the military. After the Falklands/Malvinas disaster discredited the hard-liners still further, it seemed a safer bet to dissent from the military, and much of the industrial sector openly opposed the country's military-run neo-liberal policies. The industrial sector in fact received support during both the 1981 Viola presidency and after Raúl Alfonsín's accession to power.

In Brazil, Mexico, and Venezuela industrial production led the pre-1982 economic expansion, and the industrial sector was both economically and politically influential. The three countries differed primarily in government responsiveness to industrial demands.

In Mexico and Venezuela the industrialists were economically crucial, and labor-management relations were such that unified sectoral demands could be made. In both countries, the industrial sector worked through the existing political structures of the ruling party, and it received substantial support. Government assistance given in response to industrial pressure ranged from subsidized loans to trade protection. Perhaps the most important aid to industry took the form of schemes allowing industrial firms with overseas liabilities to service their foreign debts at a preferential exchange rate rather than at the vastly more expensive market rate, thus effectively transferring most of private industry's debt burden to the government. After the initial shock of the crisis, Mexican policy did gradually move toward liberalization, but by then much of the industrial sector had been cushioned against some of the most severe effects of the financial distress, whether by access to loans at subsidized interest rates or to artificially inexpensive foreign currency for debt service payments.

In Brazil there was a both a history of government sympathy for the industrial sector and a vibrant opposition. Brazilian industry had grown extremely rapidly during the borrowing period, and both labor and management in modern industry were well-organized. Brazilian industrialists thus reacted to the crisis in two ways. First, they protested vehemently to the military government about the policies being undertaken. When their protests went more or less unheeded, the industrialists defected to the opposition, either leaving the official party for the new Liberal Front or joining the leading opposition party, the Partido Movimento Democrático Brasileiro (PMDB). Eventually the military and its civilian supporters were replaced by a broad anti-austerity PMDB-Liberal Front movement of the modern industrial sector, the urban middle class, and parts of the working class.¹⁰

All of these cases are far more complex than this rudimentary summary allows. The structure of labor-management relations, private sector ties with the military, the traditional party system, and a host of other considerations need to be investi-

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gated in much more detail and factored into an accurate account of the crisis. Our purpose has been only to sketch the implications and demonstrate the potential usefulness of an approach that directs attention to the economic position of social actors and, given this economic position, to the choices they made within their economic and political environment.

Conclusion

This chapter has presented a framework for analyzing the political effects of the Latin American debt crisis. International financial relations have differential consequences, and their political implications follow from their distributional effects. These distributional effects are filtered through two prisms. The first is economic, and determines the probable response of economic agents to economic difficulty, especially the likelihood that they will have recourse to the political arena. The second is political, and determines the form of the political response, especially the likelihood that a group's political activities will occur within the existing government's support apparatus, rather than taking the form of oppositional protest.

The first step in understanding the politics of the debt crisis, then, is accurately to characterize the economic interests of the various social forces at work. We have argued that there is a crucial difference between liquid and fixed asset holders, since the former can easily leave the domestic economic environment, while the latter are tied to it and thus driven to the political arena in times of distress. As the debt crisis hit, the response of the two broad groupings of investors was substantially different: one engaged primarily in asset diversification (such as real estate speculation or capital flight), while the other moved primarily into political action.

The second step is to specify the political environment faced by various social forces. We have explored the circumstances in which a group's political activity takes the form of "loyal" pressure on the government, and those in which the group resorts to political opposition. This set of choices is determined by the group's economic importance, its ability to unite with other forces, its ties to the government, and the availability of an opposition attractive to the group in question.

The discussion in this chapter is preliminary and suggestive, rather than detailed and definitive. It does, however, indicate the possibility of going beyond ad hoc description and abstract theorizing to analyze the sources of domestic political conflict in Latin America. The essay demonstrates the utility of the approach put forward and holds out the prospect that further investigation and analysis will help us explain Latin American political behavior, both in the debt crisis and more generally.
Notes

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4. In the simplest sense, “overvaluation” results when an inflow of resources leads to an increase in the demand for non-traded goods, whose prices thus move upward. Inasmuch as traded goods prices are constrained by international competition and the exchange rate is set by the traded goods sector, the exchange rate will tend to drift toward “overvaluation” as it rises more slowly than domestic inflation. See, for example, Arnold Harberger, “Economic Adjustment and the Real Exchange Rate,” in Economic Adjustment and Exchange Rates in Developing Countries, ed. Sebastian Edwards and Liahua Ahamed (Chicago: University of Chicago Press, 1987). The well-known and controversial literature on the “Dutch disease” discusses a special case of this phenomenon.

5. In a more nuanced vein, the benefits accruing to the financial and commercial sectors, and to the non-traded goods sectors more generally, depended on the degree to which financial resources flowed to these sectors or “leaked” into them in large amounts. To the extent that government policy limited borrowing to producers of traded goods and forced borrowers to use borrowed funds directly for imports, there was little overvaluation and thus little switching of domestic expenditures from domestically-produced traded goods to foreign and non-traded goods. Where government policy allowed significant amounts of borrowed funds to be used for non-traded goods purchases, the resultant overvaluation exacerbated the first-order effect by cutting into the domestic demand for domestically-produced traded goods.

6. This implies, of course, that agents were not accurately forecasting the future costs of current borrowing. Given the catastrophic and relatively sudden nature of the crisis, this is hardly a controversial assertion. For an argument that even “prudent planners” would have been swamped by the events of 1982-1983, see Carlos Díaz-Alejandro, “Some Aspects of the 1982-1983 Brazilian Payments Crisis,” Brookings Papers on Economic Activity 2 (1983).


8. In what follows we focus almost exclusively on real capital; the argument could easily be extended to include human capital, and thus the specific skills of workers. The political implications of the inclusion of human capital are clear and significant. It should also be noted that the following discussion assumes that investors’ portfolios are not completely diversified. This is a reasonable assumption, especially in Latin America, where capital markets are extremely underdeveloped and almost all firms are family-owned.


Suggestions for Further Reading


Frieden, Jeffry A. “Classes, Sectors, and Foreign Debt in Latin America.” Comparative Politics (forthcoming).


