



# Protectionism and Latin America's historical economic decline

Sebastian Edwards\*

*Anderson Graduate School of Management, UCLA, Los Angeles, CA 90095, United States*

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## 1. Introduction

Most economic historians agree that the Smoot-Hawley Act of 1930 contributed significantly to the Great Depression. By greatly reducing the flows of international trade this legislation managed both to amplify the recessionary forces, and to export the slowdown from the United States and other advanced nations, such as the United Kingdom and Germany, to the rest of the world. In the aftermath of the global financial crisis of 2008 many analysts have been concerned about protectionism. Although no one expects a re-edition of the 1930s, there has been talk that some of the trade reforms of the last decades may be rolled back. This protectionist talk has been particularly pronounced in Latin America, where a number of anti-globalization politicians – including Hugo Chavez from Venezuela and Evo Morales from Bolivia – have strongly criticized globalization and put in place new import tariffs and imposed other forms of trade restrictions.

Globalization critics and skeptics base their views on trade openness and the emerging countries on three points: first, they have argued that a greater degree of trade openness does not generate higher growth, or a faster pace of innovation and total factor productivity growth. Second, according to them, a lower degree of openness helps developing countries' shift their product mix towards greater value added content. And third, they have argued that globalization makes income distribution more unequal and tends to worsen social conditions. Globalization critics tend to look at the past through nostalgic lenses. For instance, some authors have argued that the era of import substitution industrialization was a success in Latin America. For instance, according to English

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\* Tel.: +1 310 206 6797; fax: +1 310 206 5825.

*E-mail address:* [sebastian.edwards@anderson.ucla.edu](mailto:sebastian.edwards@anderson.ucla.edu).

economist [Thorp \(1998\)](#), “Latin American economic performance during the three decades that followed the Second World War was outstanding.”

Many times, however, the passage of time distorts analysts’ perspectives. In this paper I provide a new assessment of how the economies of Latin America fared during the decades of protectionism and import substitution stabilization. The picture that emerges from this analysis is clear: protectionism was extremely costly in the Latin American region. In most countries growth was lower than in the advanced nations or the East Asian countries, the industrial sector was highly inefficient, a dual labor market developed, and social conditions did not improve. Indeed, the historical record suggests strongly that protectionism was one of the most important causes – if not the most important one – of Latin America’s relative decline during the second half of the 20th century.

## **2. Latin America’s gradual economic decline**

According to data assembled by [Maddison](#), in 1492, when Europeans arrived in the Americas, the indigenous communities that lived in what today we call Bolivia and Peru had a higher standard of living than those in North America. [Maddison \(2007\)](#) also estimates that in 1700 the average income per capita in Latin America was roughly the same as in the United States. Since then, however, the nations of Latin America have consistently lagged behind the advanced countries, including the United States and Canada. In the year 2000 average income per capita in Latin America was roughly 20 percent that of the United States.<sup>1</sup>

In a recent study [Prados de la Escosura \(2007\)](#) has presented new comparative data on the evolution of Latin America’s income per capita since the mid-19th century, relative to that of what we today call “advanced nations.” One of [Prados de la Escosura](#)’s many comparisons centered on the average income per person in Latin America’s five richest countries in the mid- and late-19th century – Argentina, Brazil, Chile, Mexico, and Uruguay – and a group of seven nations that currently belong to the Organization of Economic Cooperation and Development (OECD), including the United States.<sup>2</sup> According to this analysis, in 1820 average income per capita in these five Latin American countries was approximately 40 percent that of the advanced nations. By 1870, and as a consequence of the disastrous post-independence years, the ratio of Latin America’s and the advanced countries’ income per capita had declined to 27 percent. In 1929, this ratio was still 27 percent. In 1933, at the end of the Great Depression, it continued to be 27 percent, as it was in 1938, just before the region adopted wholesale protectionist policies to encourage industrialization. By 1960 the ratio had declined to 22 percent; by 1970 it was even lower, at 21 percent, and by 1990 it was only 17 percent of the advanced countries income per capita. A comparison using Latin America’s seven richer countries – this adds Cuba and Venezuela to the previous group – and fourteen advanced nations produces a similar result. In this case the ratio of Latin American to rich nations’ income per capita goes from 30 percent in 1929, to 20 percent in 1960, to 19 percent in 1990. Moreover, when [Prados de la Escosura](#)’s data are used, the stability of the income gap between the United States and Latin America for the post-1938 period disappears:

<sup>1</sup> See [Maddison \(2007\)](#). Also, see [Fukuyama \(2008\)](#) and the essays collected there.

<sup>2</sup> The six OECD countries are Australia, Denmark, France, the Netherlands, Sweden, the United Kingdom, and the United States. Strictly speaking these comparisons are for gross domestic product per capita. All averages are weighted by the countries’ population. I chose to concentrate on this particular comparison because it is the one that goes further into the past—all the way to 1820. However, other comparisons presented by [Prados de la Escosura](#) provide an almost identical picture of Latin America’s relative economic performance over the very long run.

according to Prados de la Escosura's most recent estimates this income ratio was 25 percent in 1938, 19 percent in 1960, 21 percent in 1980, and 16 percent in 1990. Latin America's relative income decline in the 1980s is universally recognized as corresponding to one of the region's darkest times, an era appropriately called the "lost decade."

The data at the individual country level confirms the story for the regional average, presented above. According to Prados de la Escosura's, in the 1938–1980 period almost every country in the region grew at a slower pace than either the OECD seven richest or the OECD fourteen richest countries. This was the case of Argentina, Chile, Colombia, Costa Rica, Cuba, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Peru, Uruguay and Venezuela. During this period only Brazil outperformed the OECD nations; Mexico grew almost at the same pace as these rich countries.

### 3. Protectionism, import substitution and inefficiency

The low degree of openness to international competition was the result of the increasingly protectionist policies implemented since the late 1930s as a way of encouraging industrialization. One of the most influential promoters of this policy was Argentina's Raul Prebisch, who as head of the United Nations Economic Commission for Latin America – universally known by its Spanish acronym Cepal – led a small group of economists that argued that, unless Latin America industrialized rapidly, it would be left behind. The reason for this, they pointed out, was that in the decades to come international prices for Latin America's exports – mostly commodities such as oil, copper, wheat, iron ore, and soybeans – would decline significantly, while prices of imported manufactured goods would increase steadily.

In most countries the industrialization process had gathered force during World War II, when imports of manufacturing goods from the United States and Europe dried up. During this time the region's nascent industrial sector expanded almost exclusively on the basis of substituting those imports that were not available due to the war effort.<sup>3</sup> During the second half of the 1940s, and as international economic relations began to normalize, Latin America's authorities faced a dilemma: Should industrialization continue to be based on the substitution of imports of consumer goods? Or, should it be tied to an expansion of exports? The former strategy required protecting national industries through even higher import tariffs and other forms of trade restrictions. The latter involved adding value to commodity exports, and maintaining a highly competitive value of the domestic currency. These two approaches differed in terms of the role given to foreign capital – the import substitution model restricted it, while the export-oriented alternative encouraged it – and had very different implications for the distribution of income. In most countries, the import substitution model implied transferring income from the countryside and the provinces, where most export activities were located, to the nascent industrial sector and to the large cities.

During the second half of the 1940s and early 1950s in country after country the authorities opted for the import substitution model. This reflected a shift in political power that had occurred since the Crash of 1929 and the Great Depression. Exporters had lost influence, while the state – and with it, civil servants and bureaucrats – had gained considerable power, as had the new urban industrialist class and labor unions. The technical bases and underpinnings for the protec-

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<sup>3</sup> Import substitution entailed that resources were devoted to develop activities in which Latin American countries had no *comparative advantage*. Obviously, this is one of the ingredients in the inefficiency of many nascent industries.

tionist policy drive were provided by the new ideas developed by Raul Prebisch and his Cepal colleagues.<sup>4</sup>

Hirschman (1984), one of the most prominent supporters of the import substitution strategy, argued that in order for it to succeed, two conditions were required. First, the protectionist measures had to be strictly temporary, and had to be reduced through time. More generally, import tariffs and other restriction on trade should be, at the same time, sufficiently high as to protect the targeted industry, and low enough as to act as a “pressure mechanism” that forced producers to improve productivity and to become efficient.<sup>5</sup> And second, only selected industries should be protected. This recommendation was part of Hirschman’s conviction that a healthy and successful growth process was always “unbalanced,” and that some industries and sectors were supposed to grow faster than others for prolonged periods of time. Hirschman contrasted his “unbalanced growth” view with what he considered to be blunt and unsophisticated efforts to generate, through the implementation of huge development plans, the indiscriminate creation of large state-owned manufacturing firms, and massive and indiscriminate protection, a “big push” towards industrialization.

According to Hirschman’s views – which became very popular in academic circles and among policy makers from around the world – trade restrictions should be used to protect and encourage those sectors with strong “forward and backward linkages.” That is, protection should be provided only to those industries whose expansion would, at the same time, feed into other promising economic sectors, and demand large amount of inputs and materials from other deserving industries. The goal of all of this was to encourage industrialization in a rapid and effective way. At the time steel was usually mentioned as an example of an industry with significant forward and backward linkages. On the one hand, steel mills required iron ore and coke coal, and on the other the finished product could be used in the manufacturing of automobiles, white goods and in construction.

Hirschman had come to these views after many years of working in the field as an economic advisor to governments and development agencies—in Europe with the Marshall Plan, and in Colombia from 1952 through 1957. In spite of its appeal, the proper implementation of this protectionist model required a remarkable amount of fine tuning and very precise and detailed knowledge of the economy; indeed, it required the type of knowledge that no government official – not even the best trained, most cable and well informed ones – was likely to have, or ever acquire. Which industries had the greatest linkages? By how much should they be protected? and For how long? What was the combination of import tariffs, quotas and licenses that would provide the adequate “pressure mechanism” to force firms to become efficient? And, more important than all of the above, how to make sure that policy makers were not captured by industrial lobbyists that claimed that their specific sector had extremely high linkages and was utterly deserving of protection? As Diaz Alejandro (1984) put it, the problem with Hirschman’s linkages approach was that its policy implications were extremely complex and were likely to become “dangerous in the sloppy hands of mediocre followers.”<sup>6</sup>

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<sup>4</sup> Prebisch joined Cepal in 1949, when his ideas on the need to industrialize were already formed in his mind. See Prebisch (1984). The most influential Cepal publications at the time were “*Economic Survey of Latin America*” (1950) and “*The Economic Development of Latin America and its Principal Problems*” (1950).

<sup>5</sup> Hirschman argued that inefficiency would be avoided if the productive process and the institutional setting “lacked latitude” for errors. He argued that a difficult question was how to ensure this “lack of latitude.” With time he came to argue that three mechanisms were usually at work: “voice”, “loyalty” and “exit.” He associated the latter with economic competition. See his discussion in Hirschman (1984).

<sup>6</sup> Diaz Alejandro (1984), p. 113.

And sloppy hands, indeed, they were. Instead of being selective, protection became general and massive. It affected industries with a high degree of linkages, low linkages, and no linkages at all. It took the private manufacturing sector no time to capture policy makers and to convince them that their particular industry was exceptional, had great promise, contributed to the process of technological transfers from the advanced world, and deserved to be protected by tariffs, quotas and even straight prohibitions. In addition, a “reactive lobby” emerged; a lobby whose only goal was to obtain tariff exemptions and permits to import otherwise protected goods at no tariff or at a very low one. Of course, those that managed to become sole importers at low (or zero) import duties made fortunes in very short periods of time. Tariff books throughout Latin America became huge monsters that detailed import tariffs for tens of thousands of goods, described the extent of restrictions and regulations, presented sliding duties’ schedules, detailed the coverage of prior licenses and the levels of surcharges, and specified a number of exemptions.

Chile illustrates in a stark way the excesses of protectionist policies during the years of the import substitution industrialization model. In the mid-1960s, and after more than two decades of protection, import tariff and duties continued to be extremely high in the manufacturing sector. This resulted in domestic prices being much higher than what Chilean consumers would have paid if they had freer access to the global market place. It also allowed Chilean producers to be less efficient than if forced to compete with foreign suppliers. In the mid-1960s, for instance, a Chilean consumer paid for a pair of pants 52 percent more than what he would have paid in the international market place; wool coats were 23 percent more expensive, and shoes 20 percent dearer. In 1965, and as already noted, bicycles cost 300 percent more than in the advanced nations. This basically put them out of reach of average blue-collar workers. Worse yet, the quality of locally produced goods was much lower than that of goods produced in other regions: shoes wore off more rapidly, white and electronic goods malfunctioned often, and bicycles broke down frequently—I know this first hand, since, as a kid, I owned a bike made in Chile.<sup>7</sup>

There are more examples: imported textiles were subject to duties ranging from 80 to 120 percent. Dyed textiles paid a 92 percent tariff, while those made of combed wool paid “only” 80 percent duties. Automobile tires were subject to a 125 percent import tariff, which increased their domestic cost to consumers by at least that much, relative to international prices. Drills paid a 75 percent tariff, heaters 244 percent, electrical motors 162 percent, radios 340 percent, vacuum cleaners 85 percent, and refrigerators 136 percent. I could go on and on, but I think that there is no need for it, as these examples already convey the clear message of how surrealistic things had become in the industrial policy and protectionist spheres.

Incredibly, import tariffs, quotas and licenses were not the whole story. In the mid-1960s the importation of a number of goods was also subject to a 10,000 percent prior deposit at the Central Bank of Chile. These deposits, which earned no interest, were made at the time the import process began, and had to remain at the Central Bank until the goods in question had cleared customs. Needless to say, with a rate of inflation in excess of 30 percent per year, the prior deposit added considerably to the cost of importing foreign goods.

Producers of these and other industrial products were the big winners of Chile’s import substitution industrialization policy. However, there were also losers. These were concentrated among exporters – wineries, mining companies, and fresh fruit producers, to name just a few – that had to pay heavy tariffs on their imported inputs and on capital goods and machinery, but received no government incentives when they sold their products abroad. A few examples illustrate this

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<sup>7</sup> These data on the extent of protection are from De la Cuadra (1974) and Edwards (1975).

point: furniture manufacturers had to pay average import tariffs of 20 percent on their inputs, wine producers paid 90 percent, wheat producers 32 percent, and corn farmers paid an average import duty on imported inputs of 28 percent.

Exporters were additionally penalized because, as a result of a high degree of overall protection and the concomitant low degree of openness of the economy, the domestic currency strengthened significantly, and artificially, in value. This meant that for each dollar of goods sold abroad, exporters received fewer units of domestic currency – Escudos at that time – than what they would have obtained under freer trade. It has been estimated that in the late 1960s the degree of currency overvaluation induced by protectionism in Chile was equivalent to a very substantial tax on exports, ranging from 24 to 32 percent of the value of the goods exported.<sup>8</sup>

From today's perspective the irrationality and arbitrariness of Chile's 1960s import tariffs is striking and difficult to understand. Indeed, these levels of protection hardly constituted what Hirschman had called a "pressure mechanism" to force producers to be efficient.

Instead of declining, as Prebisch, Hirschman and others had predicated, the degree of protectionism in Chile – and in most of Latin America, for that matter – increased through time. For example, by late 1969 import duties on combed wool textiles had increased to 120 percent from 80 percent 4 years earlier, and tariffs on men's shirts and coats had increased to 120 percent, from no tariff and 23 percent, respectively. Also, export sectors continued to be penalized, both through high costs of inputs and machinery, and an artificially high value of the local currency, the Escudo.

Chile's experience with protectionism during the import substitution industrialization era was hardly unique. In a 1971 study, Balassa estimated that Brazilian and Mexican average import tariffs on manufacturing and consumer goods were as high as in Chile. Moreover, according to his estimates, at that time import tariffs in Latin America were significantly higher than in Malaysia and other East Asian nations. In 1994, English economist Bulmer-Thomas showed that in the 1960s average import tariffs were 131 percent in Argentina, 168 percent in Brazil, 138 percent in Chile, 112 percent in Colombia, and 61 percent in Mexico.<sup>9</sup> In contrast, average import tariffs in the European Economic Community stood at 13 percent. And, according to data compiled by the Fraser Institute, in 1980 Latin America was one of the most protectionist regions in the world; import tariffs across all countries and sectors – including those export sectors with no import tariffs – were, on average, 42 percent. For comparison, at that time average import tariffs were only 15 percent in the so-called East Asian Tigers nations.<sup>10</sup>

Starting in the mid-1940s, in most Latin American countries the state grew at a rapid pace. According to the prevailing views, it was not enough to encourage industrialization through massive protectionist policies; in order to build a substantial manufacturing base, it was also necessary to create large state-owned enterprises in what were defined to be "strategic sectors," including sectors with considerable backward and forward linkages. Two interrelated ideas were behind this drive for an active role of the state in the production sphere: first, it was thought that the private sector would be unable to obtain the financial resources required for investing in very large companies in the steel, energy, mining, and oil sectors. This was not a completely unfounded point; what the proponents of the government-led development strategy failed to note, however, was that the private sector inability to obtain the required financing was the direct consequence

<sup>8</sup> See Edwards (1975).

<sup>9</sup> See Balassa (1971) and Bulmer-Thomas (1994).

<sup>10</sup> Krueger (1978) and Sheahan (1987) also provide data that show that other countries in the region had levels of protection similar to those in Chile.

of poorly developed credit markets, and of legislation that failed to protect the rights of minority owners and share holders. Second, these sectors were considered to be too important to be left to foreign investors. Indeed, since the expropriation of oil fields and the creation of giant state-owned oil company Pemex in 1938, many nationalistic political leaders throughout the region argued that Mexico provided the right model to follow.

A number of institutions were created across Latin America as a way of promoting state-owned companies. These included Corfo (Corporación de Fomento de la Producción) in Chile, created in 1939; BNDES (Banco Nacional de Desenvolvimento Economico e Social) in Brazil, founded in 1956; and Argentina's Banco Industrial, from 1944. In Mexico, Nacional Financiera was created in 1934, with the aim of financing large investment projects in infrastructure and basic industries. With time the number of state-owned enterprises grew significantly. Some, such as Petrobras in Brazil, were created from scratch, some were the result of nationalization processes – Pdvsa in Venezuela and Chile's copper giant Codelco are two prominent examples – and other were acquired by the state as a result of bail-outs of private sector enterprises that had been poorly managed and run into financial trouble. In the late 1970s, heavy industry, telecommunications, water supply, and mining, among other sectors, were dominated by the state throughout most of the region. Also, in some countries the state had a strong presence in the financial sector, and owned or controlled banks, financial concerns and insurance companies. Many of these firms were run with political criteria, developed a bolted payroll, and became highly inefficient. By the early 1980s the vast majority of them were losing money, and contributed significantly to public sector deficits and, thus, to inflationary pressure. In 1990 there were more than 300 state-owned enterprises in Argentina, more than 700 in Brazil, and more than a 1100 in Mexico.<sup>11</sup>

#### **4. Protectionism, informality and unemployment**

Starting in the late 1940s unemployment and informality became increasingly pressing problems throughout Latin America. This was the direct consequence of the development model based on protectionism, heavy government regulations, and artificially strong domestic currencies. These policies helped create highly segmented, or dual, labor markets. Some urban workers were able to get jobs in the modern, and highly protected, manufacturing sector. To the extent that these companies were sheltered by high barriers to international competition, they could pay relatively high salaries, as well as retirement and health benefits. However, an informal or unprotected sector co-existed side by side this modern labor market. Informal workers often had the same skills as those employed in modern firms; they just were not fortunate enough as to obtain one of the highly coveted high paid jobs. Informality was concentrated in very small firms, the service sector—repair shops, food stalls, and menial jobs. These workers received significantly lower salaries than formal workers and got no benefits.

As protectionism grew, so did the extent of informality. In 1950 informal workers represented, on average, 9 percent of the regional labor force. Informality was particularly high in Chile (14 percent), Venezuela (11 percent) and Guatemala (11 percent). Two decades later, in 1970, the overall degree of informality had climbed to 12 percent of the Latin America's labor force. Peru now led the region with 17 percent, followed by Mexico and Bolivia with 15 percent of informality. In 1989 more than one half of non-agriculture jobs were in the informal sector (52 percent). Of those employed in the formal sector, one third worked for the government, and had a dubious level

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<sup>11</sup> See Edwards (1995).

of productivity. This dismal state of affairs captured forcefully the severe limitations of the import substitution protectionist model followed by most Latin American countries without interruption since the late 1930s.<sup>12</sup>

Massive migration from the countryside into the cities was another consequence of the import substitution policies. The existence of high paid jobs in the modern sector acted as a strong magnet. The fact that these jobs were few and hard to get, did not dissuade poor rural families that could barely survive in a stagnated agricultural sector that was plagued by economic problems, including unproductive land holdings, and artificially strong domestic currencies that reduced crop prices and exports' competitiveness.

Those rural migrants that failed to find jobs in the modern and protected segment of the economy engrossed the army of the unemployed and of those toiling in the informal sector. They had no benefits, earned very low wages, and were trapped in a perpetual circle of poverty and desperation. Just as the family of Jesús Sánchez – the destitute Mexican family depicted in Oscar Lewis' "The Children of Sánchez" – they lived in slumps; they lived in *villas miserias*, *favellas*, *pueblos jóvenes* and *poblaciones callampas*. They were the victims of violence and crime, their children did not attend school – or, if they were lucky enough, they would barely complete 2 or 3 years of formal schooling – and would die if they got seriously ill.

With time these slums became cities of their own. The dwellings that had started as mere mud huts became sturdier. Slowly, and often with the help of relatives and neighbors, a cement floor was installed. Then it was a solid wall or two, and a few years later it could even be a dining room, or a second story. Governments often tried to improve conditions; they would install electrical connections, and potable water and sewages would be made available. After a number of years – a number of decades are more likely – some of these poor families had a small capital invested in their houses. However, as Soto (2000) has pointed out in his book "The Mystery of Capital," there is tragedy and irony in this story. In spite of all the suffering and all the effort, these families lacked titles to their homes; and without a title they were not eligible for small loans, and without financing they could not start a small business. It was just not possible; even if they wanted to do it, even if they had the ability and the entrepreneurial spirit, they just could not do it.

In 1970 – three full decades after the initiation of the import substitution development strategy – 40 percent of all Latin America's families still lived below the poverty line; in the rural sector the incidence of poverty was an astonishing 62 percent.<sup>13</sup>

## 5. Protectionism, oil shocks and the debt crisis

In 1973 the international price of oil increased by more than 200 percent – from approximately 4 dollars per barrel to little over 12 dollars per barrel –, and in 1979 it increased by another 125 percent to approximately 32 dollars per barrel. These major price changes shaped in a fundamental way the path followed by the Latin American countries during the last quarter of the 20th century.

As expected, the large increase in oil prices affected oil exporters and importers in very different ways. The former – and, in particular Mexico and Venezuela – embarked on ambitious development plans aimed at rapid industrialization; Mexico's President José López Portillo, said "we will administer abundance." Most of this effort was led by the public sector, and consisted of

<sup>12</sup> See Thorp (1998), Tables 6.3 and 6.4.

<sup>13</sup> See Sheahan (1987), Table 2.4. These data come originally from Cepal.

gigantic and, as it turned out, inefficient investment projects that were laden with corruption.<sup>14</sup> As a way of leveraging the oil monies, governments in the oil exporting countries borrowed heavily from the rest of the world, and rapidly accumulated very large external debts.

Oil importing countries tried to cushion the sudden worsening in their terms of trade – or prices of exports relative to those of imports – by borrowing liberally from abroad. As their oil-exporting neighbors, they accumulated foreign debt at a pace that turned out to be unsustainable. Many countries that for decades had maintained price stability – mostly the countries of Central America – began to rely on money printing to finance rapidly increasing government expenditures. As a result, inflation increased, exports loss competitiveness, and international reserves held by the central banks declined rapidly.<sup>15</sup> Most countries responded to this situation by implementing exchange and capital controls, and by restricting the purchase of hard currency by local firms and individuals. Businessmen and families traveling abroad were allowed to purchase nominal amounts of foreign exchange that did not cover the costs of hotels or subsistence. As trade deficits became larger, a number of countries adopted multiple exchange rate regimes, where different transactions, including the exportation of different varieties of the same good, were subject to different exchange rates. These systems were highly inefficient and encouraged corruption and black markets, and eventually forced the countries that adopted them – including the Central American nations – to devalue their currencies and abandon their decades long fixed exchange rate regimes.

On the evening of 12 August 1982, Mexico's Finance Minister Jesús Silva Herzog, a respected economist known for his charm and thunderous baritone voice, flew to Washington, DC. The purpose of the trip was to inform his American counterparts that, in spite of the high price of oil, Mexico – on of the world's major oil exporters – would be unable to make interest payments on its debt that were due the following Monday.<sup>16</sup> His first meeting during the morning of Friday the 13th, was with Jacques de Larosiere, a Frenchman that at the time headed the IMF. Fund officials had recently returned from Mexico City and were already preparing a sizable loan that, they hoped, would help stabilize Mexico's finances. The meeting with de Larosiere was short and to the point; the two officials agreed that the sooner the IMF funds were made available the better. They also concluded that Mexico would need additional financing, and that some of it had to become available immediately. Silva Herzog's next stop was at the Federal Reserve, where Chairman Paul Volcker rapidly grasped the impact that a Mexican default would have on world financial markets. He said that the Fed would work with other national and international institutions in an effort to find a solution to Mexico's problems. During the next few weeks Volcker would play a key role helping arrange a bridge loan from the Bank of International Settlements – an international institution headquartered in Basel whose goal is to coordinate central banks from around the world – and organize the G-7 response to this unexpected turn of events. In spite of the efforts made by Volcker, and by Secretary of the Treasury Donald Regan and other officials from the advanced countries, it was not possible to avoid the Mexican default.

<sup>14</sup> López Portillo was born in 1920 and died in 2004. Many of his obituaries remembered both his promise to “administer abundance” and the corruption that plagued his administration. See, for example, the obituary published by Spain's *El Mundo*, in: <http://www.elmundo.es/elmundo/2004/02/18/obituarios/1077065549.html>.

<sup>15</sup> The currencies of El Salvador, Guatemala, Honduras, and Nicaragua were for decades pegged to the U.S. dollar. Costa Rica was an exception in Central America, and suffered from periodic currency crises.

<sup>16</sup> The account of the first days of the crisis presented here draws on Kraft (1984) and Boughton (2001), as well as on my discussions with Mexican and other officials involved in the negotiations.

The causes behind the 1982 Mexican crisis read like a catalog of Latin America's economic excesses and policy mistakes of the import substitution era. Surrealistic government regulations and controls, coupled with generalized protectionism, had greatly distorted the price system. This, in turn, resulted in a significant misallocation of productive capital. Instead of financing capital projects in areas where the country had competitive advantages, huge investments were made in inefficient and gigantic initiatives with low or no economic return. Monies were also wasted in corruption and in mammoth infrastructure projects that did not contribute to improving efficiency, making exports more competitive, or accelerating economic growth. Massive government expenditures put pressure on prices and inflation, and resulted in the rapid accumulation of foreign debt. The collapse of the Mexican peso in 1982 – in 1 year it lost almost 75 percent of its value – was a traumatic event that marked the beginning of Latin America's darkest hour, the "lost decade."

During the next 7 years income per capita in most Latin American countries barely grew, social conditions worsened quickly, and some countries suffered serious bouts of hyperinflation. In 1989 the rate of inflation in Argentina exceeded 3000 percent; in Bolivia it was almost 12,000 percent in 1985, and in Brazil it climbed to almost 3000 percent in 1990. Worse yet, during most of the "lost decade" many countries in the region were governed by military dictators that violated human rights, prohibited dissent, and persecuted political opponents.

## **6. Concluding remarks**

As noted in the introduction, some authors have claimed that the period extending from the end of the Great Depression through 1980 – just before the eruption of the Mexican debt crisis of 1982 – was Latin America's golden age. The evidence discussed in this paper does not support this contention. It is true that growth per capita was high – higher, in fact, than during any comparable period since independence – but it was not as high as that experienced by those countries that today we call "advanced," or by the Asian Tigers, or other relevant comparison groups. In fact, from a comparative perspective, and with the exception of Brazil and perhaps Mexico, during the period 1938–1980 Latin America's growth was mediocre. This was not a period of catching up; on the contrary, for the vast majority of countries in the region it was a period of divergence, a period when their income gap relative to the wealthy countries and other emerging regions such as Asia increased, rather than declined.

According to data compiled by Prados de la Escosura's, between 1938 and 1980 only one country in Latin America – Brazil – posted a higher rate of growth of per capita income than the OECD's 14 richest countries (3.4 percent in Brazil vs. 2.9 percent in the OECD). Mexico grew as fast as the OECD, and Ecuador and Venezuela at a slightly lower rate (2.7 and 2.6 percent).<sup>17</sup> The rest of the region experienced average growth rates of income per capita ranging from 2.2 percent (Argentina and Costa Rica) and 1.2 percent (Honduras).

Some authors have argued that the good times were concentrated during the first 30 years of the import substitution model. According to this view, mistakes in the form of excessive protection and regulations, and an overstretched government were made after 1975 (Thorp, 1999). This, however, is stretching things considerably. It is true that between 1950 and 1973, a period sometimes referred to as the "first phase" of import substitution, per capita growth was positive – indeed at an average of 2.6 percent per annum, it was higher than any time before or since – but in spite of this, the income gap between Latin America and the advance countries did not decline. In his 2007

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<sup>17</sup> Notice that Mexico, Ecuador and Venezuela are oil-exporting countries. See Prados de la Escosura (2007).

book Maddison (2007) presents data that show that during that period income per capita grew in Western Europe at an average of 4 percent per year, significantly faster than in Latin America. In the so-called Western Offshoots – the United States, Canada, Australia and New Zealand – income per capita grew at an average rate of 2.5 percent per year, virtually the same rate as in Latin America, and in Asia income per capita expanded at 3.5 percent per year. Between 1950 and 1973 Latin America only grew significantly faster than Africa. And once the complete run of the import substitution model is considered – from the end of the Great Depression to the beginning of the reforms of the Washington Consensus’ reforms in 1990 – its record is extremely poor, indeed.

The lost decade of the 1990s was the culmination of Latin America’s affair with protectionism and a government-led economic strategy. These 10 years were devastating for the people of the region, and in particular for the poor and the disadvantaged. For the region as a whole, income per capita declined at an average rate of almost 1 percent per year. Income per capita in Argentina contracted at an annual rate of 2.3 percent. The reduction of income per person was 2.2 percent per year in Bolivia; it was 1.6 percent in El Salvador and 1.8 in Guatemala. In Mexico income per capita contracted at an average annual rate of 0.5 percent; the annual decline was 2.6 percent in Peru and 2.4 percent in Venezuela. During the 1980s income per person expanded in only five countries: Brazil, Chile, Colombia, Paraguay and Uruguay. But even in these nations, performance was mediocre; their income per capita grew at a dismal average rate of 0.8 percent per year. Average wages also declined dramatically during this period. For example, in Mexico, average wages in 1988 were 27 percent below their 1980 level; in Costa Rica they were 11 percent below 1980; in Peru, wages were 20 percent lower than in 1980; and in Venezuela average wages declined by 8 percent between 1980 and 1988.<sup>18</sup> Definitely, labeling the 1980s the “lost decade” is neither hyperbola nor exaggeration.

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<sup>18</sup> The income per capita data are from Cepal’s data bank: <http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp?idAplicacion=6&idTema=151&idioma=e>. The data on (inflation adjusted) wages are from Edwards (1995).

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