CHAPTER 4

The Politics of Capitalism and Socialism Through the Twentieth Century

LEARNING OBJECTIVES

- Explain the key differences between capitalism and socialism.
- Evaluate the effects of economic dependence on the United States.
- Identify the variety of responses in Latin America to economic underdevelopment.

In 1890, Carlos Pellegrini became president at a difficult time in Argentine history. Economic policy had long emphasized foreign investment and loans, and so both national and local governments were spending far more than they brought in. In fact, the previous president had just been forced out because of the economic crisis. Working with economic elites, he diversified the Argentine economy and boosted exports. Within a few short years, the economy had revived because of, as he put it, "peace and work."[1] Yet that prosperity didn't last long, as those same elites began to fight amongst themselves and as a result were responsible for economic decline and national political violence. Argentina's rising star was plummeting.

At the threshold of the twentieth century, most of Latin America depended largely on primary products and foreign capital. In the case of Argentina, the focus on cattle (and the wonders of refrigeration to transport beef around the world) spurred growth that left the impression the country would soon move into the ranks of the developed world. On the other side of the spectrum, countries such as Guatemala relied on foreign companies to manage the fruit industry. That created wealth, but it remained in the hands of foreign companies and a small domestic elite.

Overall, manufacturing output in Latin America was low, such that even in a relatively highly developed economy such as Argentina's, it represented only 16.6 percent of gross domestic product (GDP) by 1913. The majority of exports across the region were processed foods and textiles. Export partners were diverse. In 1913, only 29.7 percent of exports went to the United States, followed by the United Kingdom (20.7 percent), Germany (12.4 percent), and France (8.0 percent).[2]

This picture, however, would soon become much more complicated with the introduction of new political and social actors, who brought with them new ideas about how economies should be organized. Eventually, it also brought pressures to industrialize. Of course, these developments would have important political implications. This chapter will analyze the changes that were taking place, while also explaining the economic concepts that will help us make more sense of the types of policies that were pursued in the twentieth century.

Throughout the century, much political, economic, and social conflict revolved around the divergence of international and national influences. Ideologies such as Marxism, which originated elsewhere, were adapted to local conditions but faced stiff resistance that in many cases descended into violence. The United States in particular watched the region with great interest, pushing for more open economies, foreign investment.

International Influences: Capitalism and Socialism

In previous chapters, we've discussed "economic development" but not its ideological underpinnings. Throughout the nineteenth century, that development was capitalist. **Capitalism** entails a small role for the state in the economy. Instead, the economy relies on signals from the market, which refers to the sum total of all the buying and selling that occurs. If there is high demand for a given product, then its price may rise, and more producers will try to gain a share of that market. As production increases, prices will likely decrease. In a truly capitalist economy, the state's role is just to ensure a basic level of stability, but otherwise it should not become involved, because interference will distort supply and demand.

The Foundations of Capitalism

The key to capitalism is incentive. Any individual (or firm) should be able to fulfill his or her goals by finding the right market. Those who are entrepreneurial will always be looking for innovations that will make a profit. From this perspective, innovation benefits society as a whole. Advances in technology, infrastructure, health, and other areas occur because individuals and companies saw the possibility of profit.

Nineteenth-century Latin America was indeed very capitalist, but the state still played a role, albeit an often corrupt one. Government officials are always

involved in the nuts and bolts of business, such as granting licenses, approving construction or land purchases, and resolving disputes. Corruption, in the form of payoffs, was an all too common accompaniment to doing business. It opened the door for monopolies to form, where competition is squeezed out by large companies, such as in the Central American fruit industry. In an oligarchic environment, inequality was extremely high, and that would change very little. Currently, Latin America has higher rates of inequality than any other region of the world.

The politics of capitalism in the early twentieth century revolved around stability, and this generally precluded democracy. Foreign capital required a conducive business atmosphere. That meshed perfectly with local political and economic elites (including the military), whose livelihoods were tied directly to maintaining the status quo. With regional variation, the traditional oligarchy was careful to quash labor organizers and peasant leaders. Political activism at the local level was therefore difficult to generate and maintain. In her novel *The House of the Spirits*, Isabel Allende provides a vivid depiction of hacienda life in early-twentieth-century Chile, where the "patrón" controlled virtually every aspect of a worker's life, even paying them with his credit rather than cash. He taught them the basics of reading and writing to increase their productivity, but "he was not in favor of their acquiring any additional learning, for fear they would fill their minds with ideas unsuited to their station and condition."[3] Although the stock market crash of 1929 and the resulting global depression tends to get most of the attention, the first decades of the twentieth century were difficult economically in most Latin American countries.

World War I upset trade in the Western Hemisphere. This was especially true for countries, such as Argentina, Chile, and Uruguay, which had strong European ties. European investors abruptly pulled out, European capital evaporated, and export markets disappeared. Indeed, it is for this reason that the United States became such a major economic player in this time frame. But trade in general was threatened by German submarines in the Atlantic (which torpedoed Argentine, Bolivian, Brazilian, Peruvian, and Uruguayan ships). The war's aftermath saw a brief boom (1919–1920) followed by a crushing depression (1921–1922).

The Foundations of Socialism and Communism

Economic disruption helped fuel nascent Socialist and Communist parties. The dawn of the twentieth century saw the rise of competing ideologies in Latin America. Of these, **socialism** and **communism** are the most relevant. Karl Marx first published *The Communist Manifesto* in 1848, so these ideologies were hardly new, but they only gained real significance in Latin America when urbanization and industrialization created a new and politically active working class.

There is tremendous confusion about what socialism and communism mean. In part, this is due to the fact that even advocates define them in different ways. Marx would not have labeled most "communist" countries of the

twentieth century (e.g., Cuba) as such at all. It is also because opponents emphasize their most negative features in an effort to demonize them. Finally, there are many different possible variants that elude easy labels.

The essence of socialism is that the state plays a central role in the economy. The ideological foundation is the assertion that capitalism fosters certain problems—most notably poverty—and cannot solve them. But capitalism also does not guarantee education, health care, or retirement benefits. Under a purely capitalist system, those benefits would only emerge if they were profitable and a private company sought to provide them. In addition, capitalism distributes wealth unequally, so that a relatively small proportion of society gains the lion's share. In socialism, the state takes total or partial ownership over a wide variety of enterprises, paying for it with a higher rate of taxation than in a capitalist economy (or owning it completely). The overall goal is cooperative control over the means of production, and then equitable distribution of resources. Down to the local level, individuals are shielded from market disruptions typical of capitalism.

Socialism can easily coexist with democracy, and often does. **Democratic socialism** is standard in much of the European Union. Citizens have the opportunity to vote and there is considerable debate in legislatures about what types of socialist policies to pursue. The degree of socialism therefore waxes and wanes with time according to different variables, such as which party is in power and how the economy is doing. Of course, there are also countries that are both socialist and dictatorial. In Latin America, Cuba has been the most prominent example by far. Marxist government force policies on the population from the top down, arguing that state control is necessary to block counterrevolutionary forces and ensure that everyone receives equal benefits. The economy is centrally planned (though, as we will see, in Cuba that has changed in recent years).

Inequality is a central issue for these ideologies, and we can measure it. The most common measure is the **Gini coefficient**, which is a value between zero and one. Perfect equality (where everyone has the same amount of wealth) would mean a coefficient of zero. Total inequality—which in theory means that one individual has all the wealth and the rest of the population has nothing—would result in a coefficient of one. Latin America currently has the highest regional Gini coefficient of any region in the world, usually around 0.50 (for comparison, the United States is commonly about 0.45).[4]

Because of their emphasis on redistribution of wealth, countries with socialist economies tend to have lower Gini coefficients. The relationship between socialism and economic equality is the reason why governments seeking to alleviate inequality increase the state's role in the economy. As Latin America is the most unequal region in the world, the political battles over socialism are all the more intense. Historically, a large proportion of the population feels left out, and so at various times political leaders have successfully mobilized them to roll back capitalism. Not surprisingly, such efforts are not always peaceful. Opponents argue that socialism takes resources away from productive parts of the economy, such as business, and then just gives them away, thus increasing poverty in the long term.

Perhaps the most difficult concept is communism. Marx considered communism the natural and inevitable evolution of industrialized countries. Industrialization would foster class conflicts, and over time these would bring down the global capitalist system and transform it into a socialist one. What we usually refer to as communism, however, is really Marxism-Leninism. The Russian revolutionary Vladimir Lenin argued that Marx's slow march toward communism could be sped up through revolution. Furthermore, Lenin contested Marx's assertion that countries must undergo industrialization to achieve communism. Instead, Lenin argued, peasants could be mobilized and the country could become industrial after the revolution succeeded. They would overthrow the old capitalist system by force and a communist party would be required to install a new system that would remove all class distinctions and create a society based on equality. Marx coined the famous phrase "from each according to his ability, to each according to his need." Communism would make that possible, and the Communist party would act as the director.

In Latin America, the attraction of Marxism-Leninism was its promise to liberate the poor and destroy the traditional elite bases of power. It gained momentum as European immigrants helped to diffuse ideas such as socialism, anarchism (a rejection of government), and syndicalism (which offers a collectivist view of working, where traditional politics is rejected and everyone works together in a democratic setting). Communist parties would not be organized until the 1920s (the first was in Mexico) after the Russian revolution of 1917 put the principles of Marxism-Leninism into practice.

The Dynamics of Dependence

Latin American governments therefore walked a delicate line but still faced the essential problem of dependence. Dependence on primary products is problematic for several reasons. In Chapter 1, we outlined dependency theory, which emphasizes how developed countries are in a position of considerable advantage. In many ways, Europe and the United States grew economically at the expense of the less developed world, exploiting their natural resources and then reaping the profits.

But there are other problems. Prices tend to be much more volatile than for industrial goods. For example, the metal, rubber, leather, and other components of a car go up and down all the time, whereas the price of, say, a new car stays very stable and usually rises over time. Food products may shoot up when there is a drop in supply (say, because of natural disasters that destroy crops) but then plummet when harvests are plentiful in other countries and supply exceeds demand. Latin American countries have consistently suffered from weak terms of trade. This means the revenue from exports has not been enough to pay for what the country needs to import. Such a situation leaves a country very vulnerable to economic shocks and leads to debt. Economic alternatives in the mid-twentieth century centered largely on creating buffers from global supply and demand, with an active state role.

The question of dependence relates directly to the debate over "structure" and "agency." Economic arguments that place Latin America within the context of its place in the international system are called *structural*. This refers to the fact that economic outcomes (income inequality, for instance) can best be understood by examining the structural conditions of a country. Does it generally export raw materials? Does it generate any manufactured products of its own? Does it rely on foreign sources of capital? As economic structures are deeply rooted and difficult to change, most structural arguments maintain that change requires drastic action to overcome well-entrenched obstacles.

Structural arguments stand in contrast to those that emphasize "agency," which refers to the ability to make decisions and influence one's destiny. Free-market theories going back to eighteenth-century philosopher Adam Smith hold that individuals (or firms or even governments) can improve their situations through good planning, hard work, and an entrepreneurial spirit. Their individual decisions will lead to better collective outcomes as well, because everyone will be working as hard they can, thus creating more wealth overall.

For much of the twentieth century, the "structure" versus "agency" debate boiled down to the basic question of how large a role the state should play in the economy. Structuralists see an expanded role as necessary because only the state has the power and resources to resist broad global forces. This argument has reemerged in recent years. In 2009, Venezuelan President Hugo Chávez gave U.S. President Barack Obama a copy of famed Uruguayan intellectual Eduardo Galeano's *Open Veins of Latin America*, which offers a scathing analysis of the structural inequalities that have contributed to underdevelopment. The gesture was a signal of agency, as Chávez was clearly indicating that individual leaders can counteract structural constraints.

Anti-mperialist and revolutionary ideology was also evident in a sprinkling of different political parties, but for the most part Marxism took years to germinate in Latin America and did not flower until the Cold War. The United States and other anti-Communist governments eyed the Soviet Union—dominated at that time by Josef Stalin—warily, but the Soviets were focused on internal developments such as industrialization and so did not yet pose an immediate threat to the United States. World War II changed that. The Soviet Union suffered terribly (upward of 23 million dead) but emerged victorious with a large, strong military and a commitment to self-protection. Most prominently, that meant developing a nuclear weapons program and controlling border countries. But it also involved listening to Latin American communists, directing their activities through the Communist International (Comintern) and helping them when possible. Contrary to popular opinion, the Soviets did not sponsor revolution in Latin America. Yet when conditions were favorable, they stepped in with aid, advisors, and weapons (in the case of Cuba, that even meant nuclear missiles).

Nonetheless, the very possibility that Marxism could take hold in Latin America horrified many, especially after World War II when the Soviet Union expanded its hold over Eastern Europe and developed a nuclear weapons program. The United States worked quickly to counter the threat, encouraging the ratification of the Inter-American Treaty of Reciprocal Assistance (more

commonly known as the Rio Treaty) in 1947. It stated that an attack from outside the hemisphere on one country would be considered an attack on all. As communism originated outside the Western Hemisphere, by definition it would trigger the Rio Treaty even if no outside powers were involved.

Opposition to unrestrained capitalism was therefore growing but only slowly and in no unified form. By the 1920s, however, skepticism grew about the power of primary products to bring prosperity. As countries become wealthier, their demand for primary products does not increase significantly. Around the world, people with more money may well buy more cars, but they will not eat more bananas. Thus, a country such as El Salvador, where by 1938 coffee still constituted 92 percent of total exports, could go no further. That fostered restlessness from below.

The 1929 stock market crash accelerated popular support for alternatives to capitalism, for three reasons. First, it obviously entailed severe economic deprivation, and the struggle to stay afloat opened the door to new and perhaps even radical ideas. On the ground, people did not have enough money to buy basic goods. Second, the Russian revolution of 1917 provided a concrete example of how a dictatorship could be overthrown and replaced by a government that claimed goals of equality. No matter how different the circumstances, or how weak the actual commitment to equality Soviet rulers demonstrated, the revolution was real. Activists therefore found it easier to attract support. Third, the 1930s and 1940s was a period of political flux in Latin America. As noted in Chapter 3, Latin American governments during that period were fragile at best, and elite preferences still tended to dominate. The friction between efforts to try new economic models from below and resistance from above was the precursor to the much more violent ideological wars that appeared in the 1950s and 1960s.

Economic Alternatives: International and National Influences

There has always been confusion about the relationship between national and international influences, engendered by Cold War assumptions. From the perspective of most Latin American economic and political elites, as well as the U.S. government, leftist ideology was fundamentally foreign. Thus, what many advocates considered to be nationalist policies based on placing more land or natural resources in domestic rather than foreign hands was immediately viewed as an orchestrated effort by communists (ultimately controlled by the Soviet Union) to take over the region. While reformer Jacobo Arbenz was in power in Guatemala, the United States pushed for a resolution proclaiming communism to be an external threat to the hemisphere, which would then trigger action through the Rio Treaty. Secretary of State John Foster Dulles was unable to garner enough votes, but the assessment would become embedded in U.S. foreign policy. There would be only a few exceptions, where (like in Peru from 1968 to 1975) land reform was accepted as long as the government clearly opposed communism.

The Impact of Nationalization

The emphasis on national origins of economic reform was particularly complex with regard to nationalization. For many years, natural resources in Latin America were controlled and operated by foreign firms. This arrangement brought in the necessary capital and resources but began to grate on nationalist sensibilities. Profits, of course, flowed outward, whereas those who worked in the mines or the fields were routinely treated poorly. The local population was repressed and mistreated.

One of the most famous cases of nationalization was Mexican President Lázaro Cárdenas's seizure of the oil industry—dominated by U.S. companies—in 1938 after the companies refused a government order to accept worker demands. Avoiding foreign intervention required skilled maneuvers, which included strong criticism of foreign companies while also giving clear signals that the Mexican government had no plans for widespread nationalization and expected U.S. private capital to play an important role in the economy. He phrased the nationalization decree carefully, even referring to how it would benefit foreign investment generally: "It is the social interest of the working class in all the country's industries that demands it. It is the public interest of Mexicans and even of foreigners living in the Republic who require peace and the dynamics of petroleum for work." Cárdenas sought to convince the administration of Franklin Delano Roosevelt that oil was a unique national asset and that nationalization was not part of an ideological program aimed at foreign capital. There was some retaliation, as the United States refused to buy Mexican silver and some countries boycotted Mexican oil, but those petered out as the Cold War got underway, and PEMEX became a large company.

ANALYZING DOCUMENTS

The decision by President Lázaro Cárdenas to nationalize the oil industry had a major impact on both the Mexican economy and nationalism. He focused on how oil was too vital to the economy to be controlled by foreign investors, and to this day any proposal to privatize the national oil company, PEMEX, is extremely controversial.

Speech by President Lázaro Cárdenas Regarding Oil Expropriation

[T]he oil companies, despite the calm attitude of the Government and the considerations they have been given, have persisted in following, both in and out of the country, a dirty and skillful campaign that the Federal Authorities told one of the directors of the companies about two months ago, who denied it. The result has been that the companies are attempting to seriously damage the economic interests of the nation, seeking by these means to nullify the legal dictates of the Mexican authorities.

...

And in this delicate situation, the Public Power finds itself besieged by the social interests of the nation that would be the most affected, since insufficient petroleum production for the diverse activities of the country, which includes those as important

as transportation, or even production that is zero or made too expensive by difficulties, would create in a short time a situation of chaos that is incompatible not only with our progress, but peace itself in the nation. It would paralyze banking, commercial life in many of its aspects, public works of general interest would be made almost impossible and the existence of the Government itself would be placed in grave danger, since losing the State's economic power would also mean losing political power, thus producing chaos.

It is evident that the problem the oil companies have presented the Executive Power with their refusal to obey the ruling from the High Court is not a simple case of carrying out a judgment, but rather a definitive situation that needs to be resolved with urgency.

It is the social interest of the working class in all the country's industries that demands it. It is the public interest of Mexicans and even of foreigners living in the Republic who require peace and the dynamics of petroleum for work.

It is the very sovereignty of the nation, that would be left exposed to the maneuvering of foreign capital which, forgetting that previously they had been part of Mexican enterprises, under Mexican law, attempts to avoid orders and the obligations placed on them by the country's authorities.

This consists of a clear and evident case that obliges the Government to apply the Expropriation Law with vigor, not only to subject the oil companies to obedience and submission, but because having broken the work contracts between companies and workers and leaving them thus, for the Government not to occupy the companies' institution would bring on immediate paralysis of the oil industry, creating incalculable evils for the rest of industry and the general economic of the country.

For these reasons the corresponding decree has been expedited and it has been ordered that its rules be followed, and this manifesto informs the people of my country the reason why everything has proceeded in this way and asks of the entire nation the moral and material support necessary to confront the consequences of a decision that we neither desired not sought of our own accord.

Discussion Questions

- Why are so many governments sensitive to international control over national natural resources?
- What seems to be Cárdenas's concern about how national law is respected by international investors?

Source: Colosio Foundation Web site, http://web.archive.org/web/20090523073516/ http://comunidad.fundacioncolosio.org/_Discurso-del-Presidente-Lzaro-Crdenas-con-motivo-de-la-Expropiacin-Petrolera-/blog/44696/24409.html?b=

A similar dynamic held in Bolivia, where mines were nationalized in the 1950s as part of a broad program of reform by the Revolutionary Nationalist Movement (MNR). The government of Víctor Paz Estenssoro was careful to emphasize his anticommunist credential and stay within the U.S. "camp" by resisting internal pressures not to compensate the former owners. We will come back to the consequences for Bolivia in Chapter 8.

But these were the exceptions. Most often, elites as well as U.S. policy makers considered nationalization—even with full compensation—to be associated with communist infiltration. Later, after the Cold War erased the threat of communism, state seizure of private industry would still be viewed as potentially threatening but not nearly to the same degree.

Economic Reform Within Latin America

World War II had several important economic impacts on Latin America. It sparked a boom in raw materials, which the Allies needed for the war effort, and increased reserves in many countries. It also fostered nascent industrialization (though the capital goods were largely imported from the developed world), and especially in South America, industrial trade between countries began. After the war concluded, Latin American political leaders looked to the United States to provide aid and some measure of price stability for primary products, something along the lines of a Marshall Plan that contributed to rebuilding Europe after the war. The administration of Harry S. Truman was not interested "because the problems of the countries in this hemisphere are different in nature and cannot be relieved by the same means and the same approaches."[5]

Faced with uncertainties, Latin America looked for alternatives. Created in 1948, the Economic Commission for Latin America and the Caribbean (known as both ECLAC and CEPAL [its Spanish acronym]) became the center of debate over economic reform. Its most influential director, the Argentine Raúl Prebisch, held the position from 1950 until 1963 and spearheaded a regional push for import substitution industrialization. The policy was not new, as it dated back to the 1930s, and the struggle to overcome the global depression by enacting protectionist tariffs aimed at limiting imports (see Box 4.1). Under Prebisch's leadership, however, it gained intellectual weight and broader support.

BOX 4.1

Raúl Prebisch and the Import Substitution Model: Using National Resources to Overcome International Structural Constraints

International: Created in 1948, the United Nations' Economic Commission for Latin America and the Caribbean developed a structural economic view of Latin America. The driving idea was that the global capitalist system left Latin America at a disadvantage. There was, the argument went, no way to create and then nurture industry because it would be immediately overwhelmed by competition from the more developed world, particularly the United

States. Countries at the "core" of the international system to a significant extent controlled prices and prevented the "periphery" from moving forward. This idea of unequal exchange dated back to European theorists from the nineteenth century.

National: Therefore, the only way to develop was through targeted protection of specific industries. Unlike the more blanket protectionism so often used in the 1930s, the new policy would bring the state together in cooperation with industry only in certain sectors. This would spur on development but also would satisfy the growing (and restive) urban population, which was clamoring for work.

It was called *import substitution industrialization*. Domestic industry would gradually substitute for imports. It would do so by imposing tariffs, which were intended to be temporary. Once the industry was mature, it would be ready to compete in the global market, at which time further protection would no longer be necessary. The state's role was critical, because only it had the resources and power necessary to foster industrialization in the face of international competition.

ISI would indeed bring growth, but by the late 1970s it was widely viewed as "exhausted." From an economic perspective, there was a problem of both incentive and efficiency. The state became deeply involved in creating industrial employment, which in turn became a source of political support. Workers and unions were politically active and tied to ruling political parties, which in turn were unwilling to make economic decisions that might jeopardize that support. Industries therefore continued even if they were not becoming competitive.

Given the continued flow of capital from the state, companies had little incentive to change course or respond to market demand, which entailed restructuring and risk. Meanwhile, given the reasons just mentioned, policy makers had no incentive to force such changes given the strong potential for political backlash. Governments were therefore saddled with inefficient industries, and they borrowed abroad as a result. That borrowing became a cause of the catastrophic economic crash of the 1980s.

Local: The model's main successes were also limited to countries with large and wealthy enough domestic markets to purchase the domestically produced goods. Brazil, for example, produced cars (actually in collaboration with foreign companies), which would have been impossible in most other countries. Plus, in Brazil (and other prominent examples include Argentina, Chile, and Mexico), economic growth under ISI provided an industrial foundation for future economic development.

Discussion Questions

- Why do Latin American governments want to sell industrial rather than primary goods to international markets?
- Why might local and national markets be so important for at least partial success for the model?

CEPAL was but one of several important international financial institutions that emerged in the postwar years. After World War II, the United States was instrumental in the creation of the **World Bank**, the **International Monetary Fund (IMF)**, and the Inter-American Development Bank (IDB). Originally, the World Bank's purpose was to fund and coordinate development projects, and it began lending in 1947. The IMF was intended to create monetary stability through a system of financing.

These institutions became more central after the Cuban revolution in 1959. They acquired foreign policy relevance to the United States, which considered them a bastion of capitalist assistance to the developing world that could stem the tide of communism. Under President John Kennedy, the United States also launched the Alliance for Progress in 1961, which had the same goal. Throughout the 1960s, the United States sent over a billion dollars a year in economic assistance to Latin America, focusing intently on those countries (e.g., Chile) that had strong leftist parties. The intended goal of alleviating poverty did not come to pass, and the political left continued to make important advances. In general, the Alliance for Progress did not entail any structural changes to Latin American economies, so inequality and poverty remained persistent and widespread.

Our discussion thus far might lead one to believe that the search for economic alternatives was led only by the left, but this is not the case. In fact, in South America right-wing dictatorships were also seeking new models that often included a central role for the state. This is particularly striking because modernization theory would assert that countries such as Argentina, Brazil, and Chile should be moving briskly toward democracy. Modernization theory was challenged by scholars such as Guillermo O'Donnell, who noted the serious problems that arose when the ISI model began to stagnate.

Why Do Democracies Break Down? Economic Factors at the National Level

As mentioned, the most developed South American countries suffered military coups in the 1960s and early 1970s. A prominent and widely discussed middle-range theoretical response came from Guillermo O'Donnell, who coined the term *bureaucratic-authoritarian* to label these new modern dictatorships. According to O'Donnell, in the South American cases modernization was also accompanied by exclusion. If the popular sectors (e.g., labor) started making demands at a time when they could not be met economically (i.e., the policies of industrialization were coming to a halt), and those demands were then ignored or suppressed, modernization might actually compel elites to support a dictatorship. He asserted that the "easy" stage of import substitution industrialization was ending. It had been characterized by "horizontal" industrial growth, meaning they were aimed at satisfying domestic demand for finished goods. However, this demand was being met by foreign, not national, producers.

Rising political and economic demands prompted the upper class, those with money and land, to ally themselves with the armed forces to reestablish what they viewed as order, usually meaning stamping out unrest at the local and national levels. Such a dictatorship would be not only authoritarian—non-democratic—but also bureaucratic, because it would have all the trappings of a modern state, including a functioning bureaucracy, trained experts (**technocrats**), and a professional military.

O'Donnell's work contradicted assumptions about modernization. Still, it received its criticisms. Different countries—such as Argentina, Brazil, Chile, and Uruguay—that at first glance seemed to support his hypothesis were pursuing different economic policies and had widely varying political characteristics. In addition, why did some more developed countries such as Mexico manage not to succumb to dictatorship? In other words, O'Donnell's primarily national argument had some holes. Nonetheless, his hypotheses forced a rethinking of the relationship between modernity and democracy as well as between economic policy and political outcomes. These are puzzles that we need to explore.

There are other reasons for ISI's decline. One serious problem was that governments kept their exchange rates overvalued as a way to encourage the cheap import of industrial goods required to equip factories. Therefore, the finished product was handicapped because it was expensive for buyers in other countries, while the internal market was too small to fill the gap. Plus, governments were not willing to allow inefficient industries to go under. Rather than face the potentially explosive results of greater unemployment, they continued to subsidize regardless of performance. Economic elites benefited greatly from state assistance, but ISI did not spark much improvement for the lot of the majority. High growth rates only led to more inequality, which in turn produced unrest. It is worth mentioning, however, that ISI did create an industrial base that contributed to economic growth in the long term.

The short-term economic challenges were becoming evident in the 1960s, in the wake of the Cuban revolution and amidst massive protests worldwide against the status quo. The Brazilian coup was the first of a decade-long wave of military overthrows of civilian governments across Latin America. By no means, however, did military government automatically mean the state reduced its presence in the economy. In the Brazilian case, by 1973 (almost a decade after the coup) the state still owned 100 percent of railways and port services, 99 percent of water, gas, and sewers, 97 percent of telegraph and telephone, and over 50 percent of a wide range of other economic sectors.[6]

Thus, in some of the largest and most dynamic economies of Latin America, such as Argentina, Brazil, and Chile, modernization in the 1960s and 1970s contributed to authoritarian rule. Yet despite the shift away from democracy, with the exception of Chile, the economic models did not change drastically. A prominent role for the state was posed in nationalist terms, sidestepping the fact that these anti-Communist governments were in fact retaining important socialist policies. Even in Chile, which moved more toward pure capitalism than any other government, the copper industry remained largely in the state's hands for nationalist reasons (and much of it remains there now).

International Factors in the Late Twentieth Century

Clearly, the import substitution model was started to show cracks, but it received a boost in the early 1970s. The countries of the Organization of the Petroleum Exporting Countries (OPEC) unified and established various measures to increase the price of oil. Those governments, primarily in the Middle East but also including Ecuador and Venezuela, soon were awash in dollars. Their response was to invest that money in foreign banks, which in turn needed to loan it out. Governments across the region embarked on large projects and kept many state-run businesses afloat that otherwise would have gone bankrupt. The good times rolled, at least for a short while. Concerns about risk were disregarded, and Latin American governments were able to pile new debt onto old.

The Debt Crisis

Meanwhile, throughout the 1970s interest rates in the United States and Europe began to climb as a way to combat inflation—the way to get people to stop spending money is to entice them to save with high interest rates. For Latin America, it resulted in loan terms that required an ever greater share of their payments to be interest rather than principal. In 1979, debt payments constituted 11.1 percent of the exports of goods and services, and by 1982 that had grown to a whopping 24.2 percent.[7] But it also meant an increase of imports, which in turn led to trade deficits. As competitiveness dropped, investors started getting nervous, and capital flight ensued.

When the global economy contracted in 1981, the ride was officially over. Lenders began questioning the wisdom of approving new loans to much of the developing world, yet without new loans it was not possible to pay off past existing loans. The inevitable conclusion was nonpayment. Beginning in 1982 with Mexico, Latin American governments announced they were defaulting.

At that point, the United States and the IMF took center stage, as the latter became a clearinghouse for any loans. Treasury Secretary James Baker pushed for structural adjustment in 1985 for the larger debtor countries. The assumption of the Baker Plan was that increased exports could spark the economic growth necessary to reduce debt. As the plan called for banks to increase lending to spur industry, it actually also increased debt. Continued failure to repay ended the plan after less than two years. In 1989, Treasury Secretary Nicholas Brady developed what became known as the Brady Plan, which replaced old Latin American bonds with new, dollar-denominated bonds. The idea was that investors would feel more confident with choices of new bonds (the values of which were negotiated) that had more protections and that could be traded if companies felt they were too risky. Unfortunately, no solution reduced Latin American debt. For the most part, it was restructured but still increased.

Along with U.S. policy makers, the IMF had the leverage to compel Latin American governments to enact its desired economic reforms. Refusal would

mean no new loans, because banks would not come calling without an IMF stamp of approval. Lenders dealt with each country on a case-by-case basis, determining exactly what types of market reforms would be necessary to resume a flow of credit. In practice, this meant reversing many aspects of the state's role to achieve greater economic efficiency and tackle debt.

State-owned enterprises were privatized, meaning they were sold to private companies, which brought in revenue. Governments were very hesitant to do so, but by the late 1980s privatization became commonplace. Trade barriers, such as tariffs, were dismantled so that domestic business would either sink or swim according to whether it was competitive globally, not whether the state was protecting it. Latin American countries joined the General Agreement on Trade and Tariffs (GATT, created in 1947), which became the World Trade Organization (WTO) in 1995. Their purpose was to set rules for free trade, which included reduction of tariffs. Public spending was cut, and so were the subsidies that kept prices for specific goods (including food) artificially low.

All these measures taken together became widely known as the *Washington Consensus*, which emphasizes the international influence. Their ultimate sources were headquartered in Washington, DC, and they were pushed hard by the U.S. government, which, not coincidentally, is also centered in Washington, DC. To be sure, there were plenty of Latin American leaders who supported these policies, but many others were not pleased at how the Washington Consensus was forced onto them.

The market-driven approach had varying results. From a macroeconomic perspective, the reforms successfully addressed some of the most pressing challenges. As so much money was being taken out of the economy, inflation dropped, which stabilized prices. Inflation had been a serious problem, especially for the poor, because wages did not keep up. In some cases, governments had resorted to printing more money, which ultimately had the effect of making inflation worse.

But debt did not go away. In fact, it often increased. Plus, as governments still had to pay off interest, government spending as a percentage of GDP actually increased despite all the cuts in services. For example, by 1987 more than 50 percent of Mexico's central government expenditures went to interest payments.[8] Debt repayment is a constant problem.

Chile as an Alternative Model

Unlike the rest of Latin America, Chile already had market-oriented policies in place before the debt crisis. Several years after the 1973 coup that ended the country's experiment with socialism, the dictatorship put the economy into the hands of a young group of economists, many of whom had studied in the United States (they became known as the *Chicago Boys* because of their ties to the University of Chicago). They had been meeting informally to discuss Chile's economic future and soon after the coup made sure that a copy of their diagnosis and prescriptions got into the hands of the new military government. The

report became known as *El Ladrillo*, or *The Brick*, because of its size. It argued that state intervention was at the heart of Chile's economic stagnation and that only dramatic shifts toward free-market capitalism would open up its potential. The report harshly criticized the "asphyxiating statism" followed by the government of Salvador Allende and became the intellectual model for economic reform in Chile and later for other countries as well.

ANALYZING DOCUMENTS

The Chilean economic model that emerged in the mid-1970s had a strong international influence. The Chicago Boys found inspiration in the United States and used ideas found there to address what they considered a disastrous national economic model. They also believed that negative international factors—such as the popularity of Marxism—had brought the country to the brink of economic ruin.

El Ladrillo

Introduction

This report is the result of long study by a group of distinguished economists from high academic levels, whose object was to define a collection of coherent and interrelated policies that would resolve the deep economic crisis the country is experiencing, and at the same time to propose the basic elements of a global political economy that would make accelerated economic development possible.

The group began its activities in a totally informal manner, with the object of exchanging opinions among professionals of the same academic level about the grave results that could be foreseen regarding the harmful political economy initiated by the Popular Unity government. It became evident that we shared the basic diagnostic elements, and that it fell to us, as professionals and as citizens, the unavoidable responsibility of adding our intellectual contribution to the effort to reconstruct the country and to liberate it from the chaos in which it finds itself.

. . .

Chapter I—Diagnosis

This anxiety to obtain a more rapid economic development and the failure of successive programs intended to generate it have opened the door for the triumph of Marxist demagoguery that presented itself with the halo of an untested scheme and which promised substantial improvements in the quality of life for the vast majority of Chileans, where no one but the very rich would have to make sacrifices. According to this scheme, it was enough to expropriate the large monopolies and *latifundia*, and transfer their surplus to social investment and the redistribution of wealth, in order to achieve accelerated economic development in an atmosphere of price stability (the end of inflation) and justice in the distribution of income. Less than three years have been enough to demonstrate the complete failure, constantly more evident, of the Marxist recipe. . . .

Another characteristics, in large part associated with the first, has been the growing and asphyxiating statism that myopically has created a vicious cycle of stagnation-statism. In effect, since the end of the 1930s, Chile has been following a line of state intervention with which it has hoped to resolve the crisis of growth.

. . .

One of the most pernicious aspects of the statist tendency has been the growth formula that has been tried: "excessive industrial protectionism to induce the substitution of imports" that has had the contrary effect to that desired, and has resulted in a concentration of our productive resources in the service of restricted internal markets, which because of their small size are condemned to a slow rate of development.

Discussion Questions

- For the authors of *El Ladrillo*, what role should the state have in national development?
- What does their view seem to be about the benefits of international markets?

Source: Ladrillo, 15–16, Centro de Estudio Públicos, http://www.cepchile.cl/dms/lang_1/cat_794_inicio.html

This model was not followed anywhere else in Latin America at the time, but it can be seen as a precursor to the Washington Consensus. Nowhere else was there the same combination of a dictatorship (which ensured that labor remained fully controlled), ideological unity, and a generalized feeling that the previous statist economic policies had failed. As inflation was tamed and foreign investment flowed in, Chile was often held up as an example of what other Latin American countries could achieve. The "Ladrillo" tenets would spread.

As the Cold War came to a close, a new debate over political economy emerged. Had the world, to use a rather tired but common phrase, reached the "end of history" in which Marxism and command economies been permanently discredited? Was there no other model than that of capitalism? In Latin America, the initial answer seemed clear. The state-led development strategies of past decades had contributed to the debt crisis of the 1980s, and market reforms were slaying hyperinflation and increasing rates of economic growth. Once the state began to retreat from the economy, private industry moved in.

Another Alternative: Mixed Economies

One problem was that many countries experienced serious and sometimes very violent protests against policies of privatization. As a result, a number of scholars and policy makers, many associated with CEPAL, began proposing a balance between markets and state intervention in the economy. It became known as the *third way* (between capitalism and socialism) or sometimes as *neostructuralism*. One scholar has labeled it the "political economy of the possible."[9]

No matter what it is called, the idea is that an export-driven model of development is the best engine for growth. However, it also recognizes that capitalism is attuned to supply and demand rather than to people. Therefore, advocates seek to include an ethical dimension to economic policies, using carefully targeted government spending to provide a safety net for the disadvantaged.

Advocates argue that economic growth alone is not the answer to a country's problems and that poverty must also be reduced to take full advantage of its human resources.

In fact, "pure" neoliberalism is no longer common in Latin America. Policy makers of all ideological stripes agree that at times the state must take an important economic role, especially in times of crisis. The basic ideas of the famous economist John Maynard Keynes are widely held. Keynesian economic policy asserts that free markets can be inefficient, which leads to negative economic outcomes. As a result, the state should intervene (e.g., through spending) to encourage growth and unemployment. In the wake of the global economic crisis of 2008, many Latin American governments implemented stimulus packages to boost employment and growth.

In subsequent chapters, we will see how such policies have functioned in practice. The most widely cited contemporary examples are Brazil and Chile, where governments have followed market-driven policies while also working to alleviate the negative effects of capitalism through targeted social programs and spending, which show Keynesian tendencies. We will get a grip on their political ramifications and examine the ways in which they are perceived at different levels.

The Local Level: Formal and Informal Economies

These macro-level factors have real micro—that is, local—impacts as well. Understanding the state's involvement in the economy also requires examining the local level, where there is a lot of economic activity that doesn't get noted in the official, national-level statistics. In addition to the formal, there is an **informal economy**. This refers to people who perform work and earn money that is not sanctioned or recorded by the government. There are countless examples, from very small (selling items on the street) to very large (including narcotics) transactions. Yet most are local, composed of individuals seeking small-time work. It may consist of anywhere between one-third and one-half of the economically active population.[10] Many people participate in both, using the informal to augment formally earned income.

The informal economy is a direct result of state failure at the national level. The most common argument is that the government could not generate enough decently paying jobs, thus forcing many people to search for alternate sources of income. This is particularly true in time of deep economic crisis, such as the aftermath of the debt crisis. However, others have argued that overly complex and burdensome state regulations make life too difficult for would-be entrepreneurs, who opt for the freedom of less formal work. Regardless of economic policy, it is also a consequence of rapid urbanization. In the past several decades, millions of people migrated from rural to urban areas, as the former could no longer sustain a growing population.

The informal economy is both there and not there, though of course government officials are well aware of its existence. Vendors may be selling things and quickly disappear when strolling police approach. The police know they

are all around. Sadly, there are many instances of corruption, where people must pay not to be officially noticed by the state. The sales—and certainly the kickbacks—are not reflected in official tallies. But the state cannot afford to crack down too heavily, because it would face an enraged population no longer able to make a living.

Informality falls heavily on the shoulders of women. A lack of income pushes women into the informal workforce as a way to make enough money to provide for a family. Women still have to do all their traditional tasks but then are expected to add that additional labor. For example, they may sell food, or provide childcare, or otherwise perform services for others that are not official and are not taxed. Needless to say, it is a tremendous hardship.

This dual economy poses a serious obstacle to economic development. The state does not officially capture any of the benefits (e.g., taxation), the jobs tend not to create stable enterprises, it decreases faith in the rule of law, and it increases inequality because the informal economy is composed overwhelmingly of the poor and does not offer much upward mobility. Therefore, it can be both crucial to survival and problematic for a life that goes beyond simply surviving.

Dollarization: The Ultimate International Influence

Faced with extremely high—roughly 50 percent or more a month—inflation (called **hyperinflation**) in the 1980s, some Latin American policy makers looked to a solution that would ensure a stable currency indefinitely. **Dollarization** means making the dollar the official currency. It is a radical solution because it takes much of a country's fiscal policy out of its hands. For example, printing money (called *seignorage*) is no longer possible. Indeed, part of dollarization's rationale was to prevent that very action because it contributes to inflation. This has major impacts on the local level, because people who don't have money suffer badly when inflation hits. A loaf of bread and other basic goods could go up drastically from day to day and that generates a lot of resentment and often leads to protests.

There are historical precedents for dollarization. By virtue of a very large U.S. presence and the widespread use of dollars, Panama became dollarized in 1904. A Cuban law passed in 1914 allowed the dollar to circulate along with the peso; even by 1931, over 80 percent of Cuban economic exchanges were in dollars.[11] At various times, governments have pegged their currency to the dollar (e.g., Honduras, the Dominican Republic, and Haiti during the 1930s) to avoid exchange rate shocks. As we will discuss more in later chapters, Ecuador made the full switch in 2000 and El Salvador in 2001. For Ecuador, economic crisis in the late 1990s combined with heavy debt to raise the specter of default, inflation, and capital flight, so President Jamil Mahuad eliminated the "sucre" currency and adopted the dollar. In El Salvador, the decision was made preemptively as there was no immediate economic crisis to overcome.

Dollarization does lead to macroeconomic stability (with low inflation and interest rates) and consequently encourages a continuous flow of investment. Exchange rate volatility is no longer a problem because the dollar is much steadier.

But it does not necessarily have a major impact on debt or budgetary discipline. It also makes the economy even more heavily dependent upon policy decisions made in the United States as well as the performance of the U.S. economy. If major trading partners devalue against the dollar, they automatically also do so against dollarized economies. In Chapter 12, we will examine the problems that Argentina faced when its peso was pegged to the dollar.

At the same time, it is notable that Rafael Correa, elected president of Ecuador in 2006 (and who also holds a Ph.D. in Economics), has not called for an end to the policy, despite his strong criticisms of capitalism and the United States. Similarly, when Mauricio Funes of the leftist FMLN party was elected president of El Salvador in 2009, his platform did not include any challenge to dollarization. The combination of its stabilizing properties and the difficulty of reversing it tend to leave it off the table. No matter what ideology a president has, he or she values macroeconomic stability.

An International Constant: The Exchange Rate

An important final point to make is that with all the booms and busts and ideological evolution, an economic constant is the **exchange rate**. No matter what the ideological orientation, policy makers must make decisions about the value of their currencies. At a very basic level, at times they must decide whether the current value compared to other countries is benefiting or hurting them economically.

The exchange rate refers to the value of one country's currency in relation to another. Policy makers are always greatly concerned about how their currency relates to the dollar, because business around the world is often conducted in dollars. However, it is also critical for any countries that trade a lot of goods with each other. Anyone who has traveled internationally has firsthand experience with the exchange rate, because when you arrive in a country, typically one of your first actions is to take your money (let's say, Mexican pesos) and exchange it for the money of the country you are visiting (e.g., the Brazilian real). If day after day, your pesos get you more and more reais (the plural for real), that means the Mexican peso is strong, and the real is weak.

The nominal exchange rate is the amount that each currency can be exchanged for the other when governments do not intervene. The market, meaning the combination of supply and demand, determines the nominal rate. Very often, though, governments want to influence what goods will be worth to fulfill their economic goals. Governments sometimes have to deal with overvalued currencies. This is a situation in which the "real" value of the money has decreased, but the government has not yet changed the official exchange rate. The real value is the price of a domestic good compared to the price of a foreign good. How do we figure this out? The answer is by looking at purchasing power parity (PPP). The idea behind PPP is that the value of a good that is traded internationally—meaning it is exported and imported—can tell us the nominal exchange rate. You just look at the cost of a particular good—a toaster—in the United States, which might be $10. Then, using the official exchange rate, you

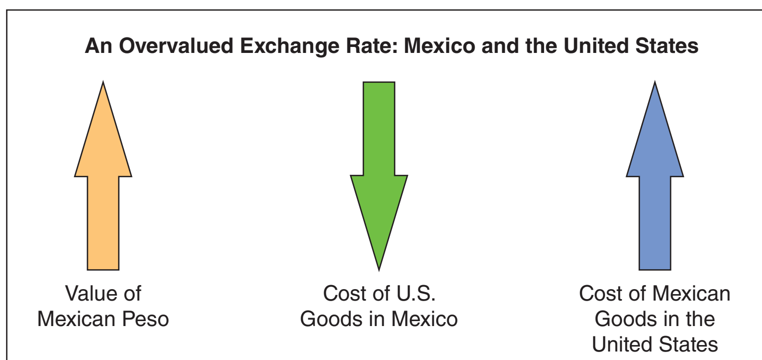

FIGURE 4.1 An Overvalued Exchange Rate: Mexico and the United States

calculate what $10 would exchange for Mexican pesos. That price in Mexican pesos is the nominal exchange rate.

So although the official exchange rate may be one peso to one dollar, the real exchange is something like 1.5 pesos : 1 dollar. Further, assume a company in the United States exports radios to Mexico, and they sell for $10 each. Using Figure 4.1, let's say a Mexican company makes the exact same radio. With an overvalued exchange rate, the imported radio costs $10, and the Mexican radio costs the equivalent of $15. What would a person in Mexico likely do? They would go to the bank, exchange their pesos for dollars, and then buy the radio from the United States. With an overvalued exchange rate, imported goods become cheaper, and that country's exports become more expensive to sell abroad. Many domestic businesses complain when this occurs, because, of course, they cannot compete well with the foreign goods coming into the country.

The problem with this scenario is that many people will be exchanging their pesos to get dollars. Speculators, in fact, will likely do so in large quantities. But even more importantly, the government sometimes must sell its dollars to maintain the overvalued exchange rate. Its dollar reserves then dwindle. If that process continues, a panic may ensue, which further reduces the currency's value and sparks a run on reserves. That sort of downward spiral is very difficult to reverse.

Now, why would a country keep its currency overvalued? One reason is to give local producers privileged access to important foreign raw materials, which become cheaper than they otherwise would be. That also helps if domestic industries need those imports for parts, machinery, and so on. However, sometimes it is an unintended consequence of having a currency pegged to another currency, discussed next.

Therefore, before long we would expect Mexico (or any other country in the same position) to **devalue**, which reduces the value of your currency relative to others. People will then stop running to exchange their money for

foreign money. Furthermore, that country's exports will become more competitive, which will then bring more foreign currency back into the country, thus restoring reserves.

But how does a government actually accomplish the changes in currency values? In the case of Latin America, it is essential for governments to maintain dollars in reserve. Dollars are the international currency of business (though in recent years some Latin Americans have called for an emphasis on the euro instead to decrease dependency on the dollar and, by extension, the United States) and so it is critical to keep them on hand to reassure investors. It is a sign of macroeconomic stability.

Conclusion

Although Carlos Pellegrini was in power well over a century ago, the types of challenges he faced have changed remarkably little over the years. International influence is particularly important for understanding the dynamics of political economy in Latin America, and governments have moved back and forth from market-led to state-led development. As the twentieth century progressed, the proposed alternatives to free-market capitalism multiplied. Given the stakes involved, challenges to capitalism created conflict, sometimes very serious. Some variation of socialism or communism enjoyed support from the working class in particular but was staunchly opposed by business and political leaders. However, government did periodically nationalize core natural resources for nationalist, rather than primarily ideological, reasons. Of course, such policies have important and often immediate impacts at the local level.

Development requires capital, and like other parts of the developing world, Latin America has experimented with virtually countless strategies to raise capital and maintain a stable economic environment for investment to flourish but also for the alleviation of poverty and inequality. These strategies have gone to different extremes, from free-market capitalism in Chile to a command economy in Cuba. In places such as Ecuador and El Salvador, it has entailed formal adoption of the dollar as national currency. The ideological divide that currently exists in Latin America revolves around the questions of capital accumulation and macroeconomic stability. The more things change, the more they stay the same. The chapters that follow will analyze how this played out in different countries.

Key Terms

- Capitalism
- Socialism
- Communism
- Democratic socialism
- Gini coefficient
- World Bank
- International Monetary Fund (IMF)
- Technocrats
- Informal economy
- Hyperinflation
- Dollarization
- Exchange rate
- Devalue

Discussion Questions

- In what ways is inequality an obstacle to national economic growth?
- Why does dollarization help with hyperinflation?
- Can you think of ways that capitalism in Latin America can lead to a larger informal economy?
- Why would the United States consider Latin American Marxism to be such a threat?
- In what ways can decentralization put more power in the hands of local politicians?

Further Sources

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Web Sites

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Inter-American Development Bank (http://www.iadb.org). Unlike other Web sites, the IDB Web site is focused not solely on economic indicators but rather on development projects that it sponsors across Latin America.

Latin American Economic Outlook (http://www.latameconomy.org/en/). This Web site is sponsored by the Organization of Economic Cooperation and Development. It includes a lengthy annual report on the economies of each Latin American country.

Latin Focus (http://www.latin-focus.com/index.htm). It is a Web site dedicated to maintaining updated links to news stories about the economies of Latin American countries, along with charts and tables on economic indicators.

The World Bank: Latin America (http://web.worldbank.org). The official Web site of the World Bank has a section on Latin America, which has a variety of data and publications. It includes detailed summaries of ongoing developments projects, which are organized according to economic sector.

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