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## **The great depression in Argentina, Brazil and Uruguay: revisiting vulnerabilities and policies**

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## **II. The conceptual framework**

The interwar period was a complex and difficult time for the world from the political point of view. During this time, the world was not only affected by the economic collapse of 1929, but also by the political context left after the defeat of Germany during the First World War, and the subsequent processes of economic collapse, hyperinflation and unemployment. The eventual rise of authoritarianism that ended in the Second World War was the end result of this process. Also in our case studies the political situation was variable, and the interest groups and the great powers played an important role beyond economics. In every study that involves real life, economics and politics are inseparable, and if there is a period of time in which this perception is clearest, it is precisely the interwar period. And for that reason it is more than advisable to depart from some concepts borrowed from the literature that focus on the international political economy.

In working with this complex period of time, we need to engage in this thesis with concepts borrowed from economic science and from the discipline called international political economy. On the one hand, following Tugores (2005) there are transmission channels in the world that explain the interdependencies across countries in varying degrees. Even though the effects of the transmission from one country to another depend on the characteristics of each one, there are channels associated to them in any point of time.

Beyond this economic analysis, economic historians have researched those interdependencies for each time period and in particular have identified channels relevant to the experience of the interwar period. Those include the specific features linked to the ideology of the time. As explained by authors such as Barry Eichengreen, Peter Temin and Charles Kindleberger, the functioning of the gold standard was as a key contributing factor of the depression. The fixation of the values of national currencies in terms of gold, the absence of international coordination, the asymmetry between countries experiencing balance of payments deficits/surpluses, the deflationary forces underlying the gold standard system and the monetary policy of major powers, were all dogmas of the prevailing ideology at the end of the twenties that help to explain the severity of the subsequent worldwide contraction. Eichengreen (1992) also identifies a specific model to the historical gold standard, linked to the behaviour of short-term capital movements that rendered banking systems in smaller countries more vulnerable than those in large ones. And Irwin (2012, pp. 43-46) highlights the difficult trilemma of economic policies faced by the countries under the gold standard in maintaining the gold parity, independent

monetary policy and open trade. An outcome of this trilemma is the fact that after the collapse of 1929 many countries resorted to the direct regulation of foreign trade. In this scenario, most countries had adopted the new measures only as emergency or transitory ones, or as a defence against the similar ones of other countries. But as they became accustomed to the new measures and as the prospect of their early abandonment by other countries became less and less promising, there was a widespread trend towards them as more or less permanent.

The work of the League of Nations (1943, pp. 83-85) provides a good summary of the risk factors underlying the international economies of the twenties and the interaction among these channels in a political context that paved the way for a worldwide perfect storm. Certainly, the First World War left many distortions and the policies adopted by governments aggravated the situation. After the war, some countries had returned to the gold standard at old parities no longer appropriate to their existing trade status and their internal price structure, and without adequate reserves in gold or in foreign exchange assets (exchange rate competitiveness). International credit was provided to a larger extent than before 1914 on a short-time basis, although used at least as largely as before 1914 for long-term purposes. The US, which was then the predominant source of international credit, was an inexperienced lender. Many of its loans had been made for purposes not adapted to creating the means for servicing the debt and at interest rates burdensome to the debtors (external debt). Recollections of extreme inflation and exchange depreciations made investors and banks more sensitive to signs of monetary pressure than they had been before 1914, with the result that much of the international lending was liable to sudden cessation or withdrawal upon the appearance of any symptoms of impending difficulties (financial contagion). The German reparation obligations and the inter-allied loans constituted large blocks of international debt obligations which were then rigid and unresponsive to changes in the basic trade or financial position of the debtor countries. Increased rigidities in price and cost structures, resulting from social security programmes, from the growth of collective bargaining and from the extension of monopolistic organization of private business under governmental sanction or tolerance, had lessened the adaptability of the national economies of the industrial countries to downward price-changes in world markets and to international balance of payment pressures (political economy). Overextension of cereal production had reduced the prices of grains in the world market to levels unremunerative for the grain-exporting countries (Mother Nature).

This short introduction is an advance of the elements that we explain in full in the following chapters. It is included for the benefit of the reader, who is expected to read the remainder of this conceptual chapter with an eye on the thirties. From now on we develop three sets of general concepts that we find useful for our historical research, following a structure consistent with the elements that we identified in our introductory chapter in Figure 1. Firstly, we address the transmission channels of an economic downturn and the involved vulnerabilities associated to them that can be identified for any given event in time. These concepts help us to analyse the available information about economic flows and interdependencies. Then, we expand to different perspectives surrounding the concepts of power and interdependence extracted from the specific field of political economy, in order to put the economic facts in political and

international context. In addition, we describe the mechanics of the gold standard, which constitutes an important source of vulnerability for the case countries. Finally, we introduce notions from structuralist perspectives, specifically Latin American structuralism and the world-system analysis of Immanuel Wallerstein. In doing this, we seek to make use of concepts such as dependence between core, semi-periphery and periphery, which are key elements of analysis of the political economy underlying the relationship of ABU with the great powers at the core.

### **i. Channels of economic transmission**

Economic literature is full of analyses about the way in which international crises jump from one corner of the world to another. In the context of an integrated world, Tugores (2005, pp. 323-353) details and defines that interdependencies fundamentally work through the channels of income or trade, interest rates and exchange rates (competitiveness and prices). In particular for the Latin American scenario in two working documents written for ECLAC in the context of the Financial Crisis of 2008, Kacef (2009, pp. 12-18) distinguishes mainly the real (terms of trade, aggregate demand, remittances and tourism) and the financial (external debt and international reserves) channels of crisis transmission. And Ocampo (2009, pp. 16-25) identifies worker remittances, international trade and capital flows. Fanelli & Jiménez (2009, pp. 31-62) focus on the following channels: the capital flows, foreign direct investment (FDI) and remittances. Porzecanski (2009, pp. 8-9) works on the credit channel, the international trade and through investor and lender herd behaviour and contagion effects. Titelman et al. (2009) adds that the available evidence shows that the deep and protracted effects are strongly associated with the extent to which countries face restricted access to external finance and contractions in international trade flows.

We now describe the different transmission channels that we find most relevant for the Latin American economic performance in any given period of time. Unless otherwise mentioned, we depart from a classification and analysis similar to that of Tugores (2005, pp. 323-353), because in essence it coincides with the main books on these topics in the framework of international economics, and we expand as necessary with the aforementioned authors.

#### **Income or trade**

Based on the simplifying assumption that in the international economy, there only coexist two countries (A and B) whose economies are open, an economic downturn in Country A will eventually transmit the economic contraction to Country B. This is because a decline in income in Country A means that households, businesses and the public sector buy fewer consumer and investment goods, either locally produced or imported. Therefore, as imports from Country A are exports from Country B, there will be a decline in exports in B, and in turn, a decline in domestic demand and economic activity in that country. The degree of transmission of the economic contraction via trade from Country A to Country B depends on how significant is the share of good and services of B exported to A in the total exports of B, that in turn depend on the behaviour of prices and quantities exported.

In practice, commodities represent a considerable proportion of the export basket of many Latin American countries, and as a consequence also an important source of revenue for them. Thus, the volatility in commodity prices normally jeopardizes seriously the soundness of one of the main engines of regional growth. A recession in developed markets and the significant slowdown in emerging economies results in a curtailed demand of exports from the peripheral countries. The fall in commodity prices following the global slowdown results in a deterioration in the terms of trade for primary producing countries, although with different effects in each one. The decline in exports of goods has a greater impact on the growth of the most open economies, of doing more business with core countries and of selling a higher proportion of manufactured goods to developed markets, because it is harder to quickly find alternative markets for those products.

In particular, in the next chapters we explain that the contraction in prices of agricultural products was a significant contributor to the decrease of the output and the international transmission of the Great Depression to our case countries.

### **Interest rates**

The mechanism of transmission of a downturn through the interest rate shifts in an integrated world is driven by the preference of investors who have the ability to move their funds internationally seeking high interest rates. Under the assumption of perfect capital mobility and perfect substitution between assets/debts denominated in different currencies, a higher interest rate in Country A than in Country B would attract capital to Country A from Country B. This situation would occur until the latter is able to also raise its interest rate so that there is no more profitability obtained from that flow.

However, the previous causality may not occur when: a) there are limitations to the mobility of capital, as for example occurs in the case of the ‘exchange controls’ applied during the Great Depression; b) imperfect substitution among assets/debts expressed in different currencies, because investors prefer a particular portfolio composition or because there is some risk associated with the securities denominated in a particular currency; and c) there are expectations of appreciation or depreciation. With regard to the latter, it happens that if the interest rate increases in Country A, but at the same time investors expect that the country’s currency might depreciate, there will be no incentive to move funds to that country.

As we explain later, the membership of the gold standard enshrined a general unwillingness of central banks to lower discount rates to prevent gold from flowing away to the US or France. Specifically, as capital was mobile and exchange rates were fixed, higher interest rates in the US meant higher interest rates in the rest of the world as a result of interest arbitrage. Consequently, the restrictive turn in monetary policy in the US during 1928-1929 provoked an even more contractive policy turn elsewhere. In other words, the downturn was fuelled further through the interest rate channel due to deliberate public policies in those core countries.

### **Exchange rates: competitiveness and prices**

This transmission mechanism implies that whenever Country A devalues its currency in order to increase its competitiveness, its export goods become cheaper, but at the same time Country B loses competitiveness because its export goods become more expensive. This mechanism is called ‘beggar thy neighbour’ and is a commonplace in our analysis of the thirties. Whenever there is a decline in global demand, domestic demand can only be increased at the expense of other countries, which could retaliate with subsequent devaluations of equal or greater magnitude, fostering a spiral of competitive devaluations that check each other. The resulting conflicts often prompt the enactment of trade barriers that in turn might exacerbate clashes of greater consequence. The corollary could be a collapse of international trade, as was the case during the thirties. Furthermore, the macroeconomic difficulties created by competitive devaluations are always tough to manage, especially if the country is small and the imports have a great influence in domestic prices.

An associated concept is the real exchange rates, which are the relative prices of tradable to non-tradable products. They have a potentially strong impact on the incentive to allocate resources (e.g. capital and labour) among the sectors producing tradable and non-tradable goods. And they are also a measure of real competitiveness, as they capture the relative prices, costs, and productivity of one particular country vis-à-vis the rest of the world<sup>42</sup>. In addition, when Country A devalues, there is a rising cost for its imports and, provided that imported goods represent a significant fraction of household spending of that country, then inflation is likely to rise. Conversely, as devaluation in Country A is actually a revaluation in Country B, imported goods in the latter become cheaper and this situation involves a lesser pressure on its inflationary process.

During the Great Depression, instead of inflation, the biggest problem was the reduction of prices or deflation. Barry Eichengreen, Peter Temin and Charles Kindleberger, among others, refer to the deflationary forces underlying the gold standard system and the monetary policy of major powers that help to explain the severity of the contraction worldwide.

### **Capital flows contagion**

In the context of a crisis imported from abroad through the financial channel, experience proves that the portfolio investment inflows to a region that is a net recipient of foreign capital normally suffer a slowdown or even a significant reduction prior to the formal recognition of a state of an economic recession. As the financial markets of developed countries get into liquidity problems, the international interbank market transfers the internal credit squeeze elsewhere in the world. In addition, stock markets plummet and currencies depreciate sharply, partly as a result of previous speculative positions based on expectations of appreciation of local currencies. Companies with foreign currency debt suffer a negative impact on their balance sheets following the probable devaluation of currencies in the region. The increasingly difficult

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<sup>42</sup> See Auboin & Ruta (1984, p. 3).

conditions of access to credit are of particular concern for large local companies that often seek financing in international markets. The liquidity problems of the internal market also put into difficulties small and medium businesses that need access to financial resources. This hypothetical picture can be more complex if the liquidity problems in the core countries boost a banking crisis that can spread abroad and force a full stop in the interbank lending system.

As global economic growth slows, so does the entry of foreign direct investment. The slowdown in developed countries reduces the need for this kind of investment in the search for efficiency and resources elsewhere; while the slowdown of the peripheral economies reduces the incentives for foreign direct investment aimed at finding markets. In addition, the liquidity squeeze limits the ability of firms to finance mergers and acquisitions, which are the most important modalities of foreign direct investment in many economies, in particular the Latin American ones.

Porzecanski (2009, pp. 8-9) analyses further this channel and concludes that in the credit channel, a tightening of liquidity conditions in for example the US, Europe or Japan, likely accompanied by a wave of risk aversion that spills over across borders and, if sufficiently serious and prolonged, can lead to a ‘sudden stop’ of capital to governments, banks and corporations in other industrialized and developing economies. In particular, he mentions the possibility that investor, lender herd behaviour and contagion effects can play an important role in the transmission of a crisis. A tightening of liquidity or surprise changes in economic, political or financial conditions tends to trigger sudden portfolio adjustments, whereby investors and lenders attempt to exit from certain asset classes, markets, industries and countries. And the best decision is to turn to others perceived to be safer or more appropriate, regardless of long-term economic fundamentals. Herding is presumed to be caused by problems of asymmetric information and by pressure on professional investors not to underperform their competitors, thereby encouraging them to follow each other in and out of asset classes or geographic or product markets. Contagion effects can occur when a shock in one asset class or country encourages lenders and investors to anticipate a similar event in comparable asset classes or countries. Or when a shock in one asset class or country forces lenders and investors –especially the most leveraged ones– to take offsetting measures elsewhere, regardless of different long-term fundamentals, for example when faced with deposit withdrawals or investor redemptions.

After the aforementioned explanations, it is important to recall that even before 1929 capital exports began to fall steeply from the US, reducing in this way a key source of growth for the rest of the world during the twenties. Moreover, the failure of the Bank Vienna Credit Anstalt in 1931 initiated a banking panic that spread to the rest of Europe and added to the banking panics in the US, making the availability of capital even more difficult. The shortage of capital was a key factor that we address further in the rest of this work.

### **Worker remittances**

Remittances have always been an important source of foreign income worldwide, helping to improve the welfare of low-income families. Nowadays, remittances are a significant source of



hard currency for many Latin American countries. Their migrant families work in the US and European countries and send back home billions of dollars each day that contribute to economic activity and the country's development, and improve the situation of low-income families. Consequently, a weak labour market has a negative impact on remittances sent by migrant workers to their families in their countries of origin.

However, the direction of the international flow of remittances was certainly the opposite during the thirties as compared with today. According to Obstfeld & Taylor (2004, pp. 127-128) from 1831 to 1931 the freedom in labour markets is simply unimaginable today. As about 50 million emigrants left Europe for the New World, most of them going to the US, but large numbers also headed for the British dominions, Argentina, and other parts of South America. In most countries, this massive flux of people took place with absolutely no governmental interference. Labour, whether skilled or unskilled, could seek almost freely the best returns or the most desirable location, unhindered by quotas, immigration inspectors, and the like. There were registers of movements kept, but no formal exclusions in most receiving countries. Some receiving countries, including Australia, Argentina, and Brazil, from time to time even subsidized the passage of immigrants in an attempt to boost population inflows. Those millions of immigrants from Europe living and working in Latin America were probably an important source of remittances from America to Europe. Thus, the global crisis after 1929 almost certainly meant a reduction of such remittances, contributing to the downturn in core countries, and easing in a way the drain of hard currency and gold of the time.

### **Transmission channels and country vulnerability**

The transmission channels already mentioned interact in a context of external pressures that do not operate symmetrically. Escaith and Gouguet (2009) argue that a credit crunch in one or more of the leading industrialized countries, whether induced by monetary policy or not, reduces the pace of domestic investment and consumption. In a commercially integrated world, this slowdown in domestic demand likely generates a drop in merchandise import volumes, commodity prices, tourism spending overseas, and workers' remittances normally sent abroad. Since many commodities are also financial assets held by investors with access to credit, and not just or mainly by end-consumers and producers, they are quite sensitive to developments in the credit channel as well. And the credit and trade channels are interrelated in other ways: foreign trade is facilitated by the availability of lines of credit, and credit crunches that disrupt selected productive activities can dislocate worldwide production processes and trade flows. The cycles in the economies also matter. Ocampo (2009, p. 26) considers that during the positive phases of the business cycle, a number of vulnerabilities arise, basically private or public deficits that generate high levels of debt which are the counterpart in the current account of the balance of payments, also fed by an overvaluation of national currencies.

However, each country is asymmetrically vulnerable to the transmission through those channels, depending on the specific characteristics of each economy, as becomes clear in the event of a global contraction. Accordingly, each country needs to deal with the consequences of such asymmetric transmission with non-symmetrical counteracting responses. Certainly, vulnerability

is an important concept in our research. It is a complex concept that includes many elements that can be analysed from an economic or international relations perspective. One strictly economic analysis would say that some of the main risk factors that make a country more vulnerable to the transmission of a crisis are: excessive trade specialization, less diversification of export markets, inflexibility of prices, a system of fixed exchange rate, structural duality, high dollarization of the economy, high public debt, excessive regional concentration of exports, high trade and financial openness, a weak banking system and a disadvantageous business climate that negatively affects foreign direct investment<sup>43</sup>. Specifically, these authors mention that the shocks associated with an international crisis take the form of a sudden stop in capital flows which affects every country in ways that depend on the status of risk factors generally cited in the literature.

The first of these risk factors is the degree of both public and private debt dollarization. Since sudden stop episodes provoke major changes in the real exchange rate, debtors with foreign exchange denominated liabilities usually experience a sharp rise in their debt/assets ratio, increasing financial leverage and systemic financial fragility. Thus, the greater the depreciation induced upward correction in the value of the debt as a percentage of assets, the steeper is the rise in leverage and fragility. The second factor is the ratio of public debt to output. This is important because the greater this ratio is, the more pronounced the effects under examination here are. Note that even if the public debt is denominated in local currency, a reversal of capital flows increases interest rates, and correspondingly increases the funds required to meet interest expenses. A third risk factor is associated with the level of economic openness. It is understood that a country is more open to the extent that international trade has more weight on the level of domestic economic activity and the more open a country is, the more important the transmission channel via trade is. The more open the economy, the greater the size of its tradable sector, and hence the smaller the effect of the increased leverage produced by the real depreciation<sup>44</sup>. This

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<sup>43</sup> See Fanelli & Jiménez (2009, pp. 50-55).

<sup>44</sup> However, as Montalbano (2011, p. 1489) states, the trade theory does not provide a full understanding of the links between trade openness, shocks, and uncertainty. Most empirical works establish a consistent and significant positive correlation between trade liberalization, growth and poverty reduction (Edwards, 1993; Frankel & Romer, 1999; Sachs & Warner, 1995; Dollar & Kraay, 2002, 2004; Cline, 2004; Winters, 2004). The drawbacks to trade openness are acknowledged basically in terms of short and medium run adjustment costs. The hypothesis of a direct link between developing countries' instability and trade openness has several roots: (i) the apparent asymmetry between the process of increasing specialization and the presence of random, undiversifiable shocks in the export markets of open economies (Koren & Tenreyro, 2007; Razin & Rose, 1992); (ii) the tendency of commodity prices -which are at the core of the specialization process in developing countries- to be more volatile than those of manufacture goods (Malik & Temple, 2009); (iii) the possible inconsistency between the shocks prevailing in open markets and traditional coping mechanisms and local market structures (Dercon, 2001); (iv) the occurrence of boom-bust cycles of investment induced by trade openness in countries characterized by inadequate infrastructures and shortages of skilled labour (Razin et al., 2003); (v) the role of trade liberalization in altering households' optimal portfolios, coupled with greater variability in new portfolio options (Winters et al., 2004); and (vi) higher risk of policy mismanagement in response to an entirely new set of incentives induced by trade openness in contexts where political institutions are weak (Acemoglu et al., 2003; Fata's & Mihov, 2003, 2005; Gavin & Hausmann, 1996; Rodrik, 1999). Loayza et al. (2007) underline as well that developing countries not only face more volatility than industrial countries but suffer larger volatility effects, because of the intrinsic instability of the developing process (mainly linked to the weakness of their financial systems and the main characteristics of their specialization process of production); the concrete risk of policy mismanagement (e.g., as in the case of pro-cyclical and/or

is true for both the public and private sectors. If a major portion of public sector revenues derives from the tradable sector, either because this is the tax base or because the revenue includes dividends from public enterprises that export, there is less vulnerability associated with the foreign exchange denominated public debt. Thus, in assessing the fiscal effects of a sudden stop, one must consider the characteristics of the assets that serve as collateral for such debts. Fanelli (2008) adds that another reason for the relation between the openness of an economy and its vulnerability is that, *ceteris paribus*, the smaller the tradable sector is as a percentage of the economy, the greater is the proportion of domestic absorption that must be sacrificed to gain an extra dollar through reduced imports. This is the typical form of short-term external adjustment. Thus, a lack of openness may ultimately exacerbate the economic slowdown if authorities compensate for the sudden stop of financial flows by reducing imports<sup>45</sup>. An economy's financial openness also has an effect on vulnerability: the greater the financial openness, the greater the capital flows, and hence the more risks the economy faces if flows are reversed.

Regarding our work, we acknowledge that there are many modern attempts to provide a comprehensive definition of vulnerability, including the 'social risk management' of the World Bank and the 'sustainable livelihood vulnerability' adopted by many international development agencies, such as UNDP, Oxfam, CARE<sup>46</sup>. However, the lack of statistical information regarding national accounts, household income, poverty, etc. during the thirties, forces us to keep our analysis constrained to the basic aggregated macroeconomic data available. While the statistical evidence presented in this thesis gives us insight about economic vulnerabilities by the thirties, our literature review and field research allows us to have clues about how those vulnerabilities translate into political leverage against the smallest powers.

## **ii. Beyond economics: power and interdependence**

One of the basic concepts that arises from time to time in our research is the concept of power that is deeply rooted in all our work. However, as mentioned by Guzzini (2000, p. 53), power is

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erratic fiscal and monetary policies), and the presence of weaker mitigating and coping mechanisms. Winters (2002) provides a first analysis of the conditions under which foreign shocks can have specific impacts on households in developing countries, via the main transmission channels of trade openness: when foreign shocks are greater than domestic ones (e.g. when world markets are more variable than local ones); when trade liberalization affects governments' ability to operate price stabilization policies and when trade reforms change the emphasis among the different activities engaged by households (e.g. in the case of farmers, switching from subsistence to cash crops). He concludes that international trade has a priori ambiguous implications for macro stability. A separate but related issue is the role of international trade as a key determinant of business cycle transmission across countries (Anderson et al., 1999; Baxter & Kouparitsas, 2005; Canova & Dellas, 1993; Clark & van Wincoop, 2001; Calderón et al., 2007; Imbs, 2004; Kose & Yi, 2001, 2006; Otto et al., 2001).

<sup>45</sup> Whenever there is a sudden stop event on capital flows, risks are exacerbated by a poorly regulated and supervised banking system, excessive short-term bank deposits and loans, and fixed exchange rate regimes. As financial assets are short-term, it is easier for investors to flee to higher quality at signs of weakness in the banking system. This generates a process of deleveraging that makes banks illiquid and leaves businesses without credit for investment or working capital. The latter tends to add supply problems to aggregate demand problems. Also, capital flight increases the likelihood that authorities will be forced to devalue the currency to protect constantly falling reserves. In a number of countries, this pattern of vulnerability ultimately provokes twin crises: exchange-rate and financial (Fanelli, 2008).

<sup>46</sup> See Montalbano (2011, pp. 1491-1492), among others.

one of the most under-researched concepts in international relations and in international political economy. But probably the simplest definition is the most easily understood. In this regard, taking a definition from the realist Hans Morgenthau, power is the man's control over the minds and actions of other men<sup>47</sup>. And Baldwin (1989, p. 7) defines power as the capacity to get somebody else to do what he or she would not have done otherwise.

Power explains not only the international relationship of ABU with the US, the UK, Germany and other major powers, but also among themselves. Political realism in its original version affirms that interests are defined in terms of power, politics is governed by laws based on human nature and moral principles do not apply to states<sup>48</sup>. States tend to accumulate power and have at their disposal the three elements necessary to represent a credible treats to the biggest powers: a people predisposed against another people, an army capable of entering combat and political leadership that sets the goals<sup>49</sup>. In the end, the ultimate goal of the State is national survival<sup>50</sup>. However, even the weakest power has the power to ensure its existence through alliances with other lesser powers<sup>51</sup>. From a less basic perspective, Waltz (1988) proposes an international policy framework characterized by coordination relationships, because formally and functionally states are equal to each other, so that none of them has the authority to command or obligation to obey. This generates a system by definition decentralized and anarchic. Within it, although states are not differentiated by functions, they possess different capacities to fulfil them. In this regard, for example, the US retains indisputably the largest capacities, especially in the Western Hemisphere.

Another concept closely linked to realism is economic nationalism, very important for our period of analysis. Both economic nationalism and political realism stress the primacy of the State and national security, but differ in that the former is an economic position that builds on the realist doctrine and affirms that economic activities are and should be subordinate to the goal of State building and the interests of the State. The economic nationalists tend to seek industrialization, because they believe that industry leads to development, ensures self-sufficiency, grants political autonomy and is the basis of military power<sup>52</sup>.

The role of the biggest powers leads to the analysis of the hegemonic power. Charles Kindleberger (1973) was the first researcher to argue that the integrated world economy of our times requires a hegemon at its centre to function in an orderly and productive way. One way of describing the context of a hegemonic power is when a powerful nation, called a leader or a hegemon, bears the cost of providing the public goods in order to maintain a system of fair trade and induce political stability. He also defines the basic requirements of such a hegemonic system. A capitalist or market system is apt, as experience has shown, to suffer cyclical booms and slumps and to fail periodically to match its demands and supply. The hegemon thus has to

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<sup>47</sup> See Gilpin (1975, p. 22).

<sup>48</sup> See Donnelly (2000, p. 16).

<sup>49</sup> See Brown (1997, pp. 112-113).

<sup>50</sup> See Morgenthau (1978, pp. 4-15).

<sup>51</sup> See Brown (1997, p. 116).

<sup>52</sup> See Gilpin (1987, pp. 31-33).

function in three ways in order to preserve order in the system. Whenever necessary it must offer a vent or outlet for surplus production; it must act as a lender of last resort to maintain monetary liquidity; and it must generate an outflow of capital or credit to keep the system expanding<sup>53</sup>.

The conduct of this hegemon can be guided by very different forces. It could be a benevolent leader with free trade preferences that is necessary in the international system to overcome the free rider problem enshrined in the prisoner's dilemma. This means the incentive that individual states have not to bear the costs of such public goods, because once they are provided by one State, they also benefit others without extra cost, and thus the latter do not have the incentive to bear the costs<sup>54</sup>. Alternatively, from a very different perspective, Cox (1983, pp. 171-172) states that hegemony in the global system is a form of class rule, and not primarily a relationship between states as it is in neorealist theory. Moreover, hegemony is not primarily economic, political or social structure, but all three together. The liberal world order of the nineteenth century (*Pax Britannica*) was in fact the expression of the internal hegemony of the financial and commercial aristocracy in Britain. It was a social hegemony that projected outward through its control over the British State and its overwhelming military power and through the promulgation of its liberal internationalist concept of control around the globe. Accordingly, the reconstructed liberal world order of the decades after Second World War (*Pax Americana*), reflected and reproduced on an enlarged scale the hegemony of the corporate liberal bourgeoisie in the US and Western Europe<sup>55</sup>. Kindleberger (1973, pp. 291-292) argues that Britain played the hegemonic role more or less successfully in the three or four decades before First World War, and the US played it in the two decades following Second World War. Between the wars, however, Britain was unable and the US was unwilling to do so. The result was that the world suffered the worst depression in its history.

However, Keohane (1984) criticizes the theory of hegemonic stability, as it presupposes that the existence of a hegemonic state is necessary and sufficient to achieve greater international cooperation. The hegemonic powers must have control of raw materials, sources of capital, markets and keep competitive advantages in the production of high-value added goods. The leader must also have the political will to create and enforce the rules of the system. By analysing the hegemony of Great Britain in the nineteenth century, he notes that although it was a hegemon, it was not necessarily able to impose the rules on the rest of the world. Meanwhile, the United States in the early twentieth century had accumulated power, but it did not have the political will to impose it on the rest of the world. The concentration of power alone is insufficient to create an international economic order, in which cooperation can flourish. Consequently, he defines hegemony as the ability or willingness of a single State to create and enforce rules, without that meaning necessarily stronger weight of cooperation among states.

Instead, Keohane (1984, pp. 57, 85–109) proposes a neo-liberal theory of international cooperation. This theory embraces three elements of neo-realism: the importance of

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<sup>53</sup> See Strange (1985, p. 256).

<sup>54</sup> See Carlson (2000, p.120).

<sup>55</sup> See Overbeek (2000, p. 176).

international anarchy in shaping State behaviour, the State as the most important actor in world politics and the assumption of states as essentially self-interested. However, neo-liberalism draws very different conclusions about the potential for sustained international cooperation. States have to pursue their interests under conditions of anarchy, but anarchy alone does not determine the extent or nature of that cooperation. Whenever economic and political interactions between states are minimal, there are few common interests to spur cooperation. After the Second World War, states came to share a wide range of interests, from the management of international trade to global environmental protection. The existence of mutual interests is a prerequisite for international cooperation, but neo-liberals insist that the existence of such interests does not itself explain the extent and nature of cooperative relations between states. Even when states have interests in common, the lack of a central world authority often deters them from incurring the reciprocal obligations that cooperation demands. That is why states construct international institutions, or regimes, to overcome obstacles to cooperation. Defined as 'sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations', international regimes are said to raise the cost of cheating, lower transaction costs and increase information, thus facilitating cooperation under anarchy<sup>56</sup>.

Another alternative view, which we share, is the concept of power used within the notion of complex interdependence among unequal powers developed by Keohane & Nye (1988)<sup>57</sup>. For them, power derives from relations of vulnerability interdependence defined by the high cost to be paid for substituting these resources<sup>58</sup>. Complex interdependence is possible because the growth and deepening of associations amongst nominally independent states would eventually generate a world characterised by multiple channels of connection amongst societies. Wherever complex interdependence prevails, the use of force amongst states diminishes its utility as an instrument in international relations<sup>59</sup>. The security threat was decreasing in importance in the international agenda in the twentieth century, because the survival of the human race is threatened by environmental hazards, as well as by military actions. There cannot be three conditions simultaneously: that all environmental economic schemes are in danger, that all states are vulnerable, and that there is only one solution to the problem that leaves no doubt about how to fix it. The notions of balance of power and national security are very poor for the analysis of the problems of economic and ecological interdependence Keohane and Nye (1988). Thus, states create and become members of international institutions, so that they can significantly broaden their conceptions of self-interest in order to widen the scope for cooperation. Compliance with the rules of these organizations not only discourages the narrow

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<sup>56</sup> See Reus-Smit (2005).

<sup>57</sup> However, as Jones (1995, pp. 4-5) indicates, one could talk about human interdependence as a term often employed to emphasise the degree to which individual human beings do not, and cannot, live in isolation from their fellows; 'International interdependence' to embrace those forms-of interdependence that exist amongst constituted states; and 'global interdependence' that proceeds beyond the world of inter-state relations to a vision of a world community.

<sup>58</sup> See Guzzini (2000, p. 59).

<sup>59</sup> See Keohane & Nye (1988, pp. 12-13).

pursuit of national interests. This suggests that the international system is more normatively regulated than realists would have us believe<sup>60</sup>.

This analysis entails 'vulnerabilities' and 'sensitivities' in international relations. Sensitivity involves degrees of responsiveness within a policy framework. Or in other words how quickly do changes in one country bring costly changes in another and how great are the costly effects<sup>61</sup>. Sensitivity is often used to denote an 'objective' quality of the dependence of any one society upon any other(s). Such 'objective' sensitivity is thus a measure of the exposure of the sensitive economy to costs imposed by external developments before there has been the time and opportunity to introduce policies that might reduce, or even eliminate, such costs<sup>62</sup>.

Vulnerability is an actor's liability to suffer costs imposed by external events even after policies have been altered<sup>63</sup>. Following Jones (1995, pp. 6-8) vulnerability could be restated as the simple unavailability of a policy option that would protect an actor from any future costs generated by the given external event. The vulnerability dimension of interdependence rests on the relative availability and costliness of the alternatives that various actors face. Reference to dependencies has been no mere casual departure from the use of the terms 'sensitivity interdependence' and 'vulnerability interdependence' in Keohane & Nye's work.

Interdependencies are instances of mutual dependencies. However, it is possible for one bilateral relationship to involve relatively trivial sensitivity dependence in one direction, but a critical dependence, of high vulnerability, in the other. Asymmetry and imbalance could be particularly pertinent to the potential for relative power and influence between the participants. This is a clear message that we present from time to time in our work.

Beyond the analysis from the point of view of the theory of international relations, the works of researchers from international political economy are also useful. One of the first scholars to elaborate on the relationship between economics and politics in a systemic way, Robert Gilpin adheres to the State centric principles, in which states apply strategic practices in trade and industry that resemble renewed 'beggar thy neighbour' policies. Given the continuous external threats, states have to strengthen their relative position in terms of power, and for this reason international economic cooperation among states is limited<sup>64</sup>. In Gilpin's view, the relationship between economics and politics is reciprocal. On the one hand, politics largely determines the framework of the economic activity and channels it in directions intended to serve economic interests of dominant groups. Further, the State is made of politicians, decision makers and public servants, who are ultimately, influenced by other individuals, such as journalists, lobbyists and voters<sup>65</sup>. On the other hand, the economic process tends to redistribute power and wealth, transforming the relationships among groups<sup>66</sup>. Given the fact that individuals, groups

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<sup>60</sup> See Burchill (2005, p. 64).

<sup>61</sup> See Keohane & Nye (1988, p. 12).

<sup>62</sup> See Jones (1995, p. 97).

<sup>63</sup> See Keohane & Nye (1988, p. 13).

<sup>64</sup> See Deugd & Hoen (2010, pp. 13-14).

<sup>65</sup> See Ibid., p. 75

<sup>66</sup> See Gilpin (1975, p. 22).

and states are differently endowed and differently situated to take advantage of the opportunities created by the market economy, growth and wealth tend to be uneven, favouring one State or another. Furthermore, there is an economic interdependence among states that creates power relationships among groups and societies. It also creates vulnerabilities that can be exploited and manipulated, with an extreme example being the power to interrupt commercial or financial relationships with any country. The natural consequence is that every country tends to enhance its own independence and reduce the dependence on other states<sup>67</sup>.

Alternatively, Susan Strange, considered the founder of international political economy, uses an eclectic definition of power. Her approach focuses always on a quest of answering the question: 'who benefits?'. In her view, there are bargains within and between states. Some of those bargains are linked to a kind of 'relational power', meaning the ability to make another do what you want it to do. She also identifies so-called 'structural power' that nations gain through the organization of the use of force (security), the allocation of economic factors (production), the organization of access to money flows (finances) and access to information and technology (knowledge)<sup>68</sup>. For example, by answering who has money, who lends money to whom, who lends money for what purpose, who lends money in which conditions, in fact it is possible to know who controls credit, and in short who has structural financial power. Something similar could be done to the other possible structures (security, production and knowledge). This power allows the actor to shape the structure of the international political economy in which other actors' political institutions, economic enterprises, scientists and professionals have to operate in. It is the power to set the rules of the game for others. The international political economy is characterized by overlapping structures, and individual actors hope to gain from the specific location that they occupy within their structural environment, whereas others stand to lose from their location. Actors have vested interests in ensuring that this framework of overlapping structures remains that way to their advantage<sup>69</sup>.

The functioning at a subnational level is important. For example, the political economy pressures associated with the collapse of public finances can be significant and depend in great measure on the political environment. For example, when a sudden halt in foreign capital arises the relation between central and subnational governments is affected. When the economy is subjected to a financial shock, subnational governments have more difficulty obtaining credit (if they are permitted to borrow) in a context of declining collections. Thus, they lobby for more transfers, and this affects the discretionary component of central government spending or the tax component if there are demands to increase taxes in order to finance the transfers<sup>70</sup>. Also, vested interests, for example, could have guided the conduct of interest groups working in the background of the internal politics of our case studies and help to explain the regime changes of the time (e.g. coups of José Uriburu in Argentina, Getulio Vargas in Brazil and Gabriel Terra in

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<sup>67</sup> See Gilpin (1987, p. 23).

<sup>68</sup> See Deugd & Hoen (2010, p. 14).

<sup>69</sup> See Ibid., p. 81.

<sup>70</sup> See Fanelli & Jiménez (2009, p. 53).



Uruguay) and the specific policies applied by governments to fight the Great Depression (protectionism, devaluation, debt payment cessation, etc.).

Finally, we are interested in the role of economic commodities and power. Following Wallenstein (1978, pp. 47-54), economic commodities can be used as means of influence, to punish enemies and reward friends, if the following four factors are present: scarcity, supply concentration, demand dispersion and action independence. Regarding scarcity, if demand is high and supply limited, the value of a given commodity increases in price and if the consumer is prepared to pay a high price in monetary terms, he or she might also be prepared to pay a high price in political concessions. Meanwhile, supply should be in the hands of a few producers and/or sellers, who can create a cartel or even a monopoly of supply for a long duration. Demand dispersion favours the utility of a given economic good as a weapon, assuming scarcity and supply concentration. In the case that many buyers compete, the monopolistic seller can take advantage from the competition among consumers, and increase prices or make conditional deals. However, the situation of only one buyer is strongly different. The buyer, being the only or the major consumer can exert pressure by threatening not to buy, particularly if unacceptable or unrelated conditions are tied to a deal. Finally and crucially, action independence is also required, meaning that the seller/producer must himself control his assets to be able to use them instrumentally and have a capability to take action as defined by him. For instance, if a seller/producer for his production of a given commodity is dependent on imports or on financial assistance, his action independence is relatively low, compared to the situation of basing the production on internal or autonomous resources. The four conditions listed have to be present simultaneously to give the structural possibility of turning an economic asset into a political instrument. The issue of the relative power of poor countries with some leverage in certain commodities vis-à-vis core countries' markets arises from time to time in this thesis. More specifically, even though each of the ABU had strong leverage in certain agricultural products, either the concentration of the demand or the lack of independence diminished their economic power, resulting, for example, in a doubtful capacity to impose a more positive outcome in commercial negotiations.

### **iii. The mechanics of the gold standard**

The gold standard was restored in many countries after the First World War, although in a different setting than the classic and pure gold standard applied before the First World War. It is more precise to say that the system restored after the Genoa International Monetary Conference of 1922 can be more accurately described as the 'gold-exchange standard'. As James (2001, pp. 34-36) explains, under this version of the gold standard, reserves could be held in the form of commercial or treasury bills, rather than in unproductive and non-interest-bearing gold. The operation of the gold-exchange standard, along with the creation of independent central banks, ensured control of the fiscal policy and included enough ambiguity to secure its political acceptability. In the remainder of this thesis we refer to the gold standard as the system proper of the interwar era, established after the Genoa Convention.

There are many reasons for the return of countries to the gold standard. During the twenties the system stabilised exchange rates worldwide, which in turn encouraged unprecedented levels of foreign investment. Countries like Britain and France contributed to the expansion of the international economy with their investments that accounted for a quarter to a third of their savings abroad, and consequently had strong reasons to support the gold standard<sup>71</sup>. But beyond the national interest, there were deep psychological reasons. The gold standard was for many countries more than a policy. It was a dogma that influenced policies potentially in the wrong direction. The memory of stability of previous decades under the gold standard, and the fresh reminder of episodes of hyperinflation in Europe after the First World War led many countries to believe that the return was necessary to ensure stability worldwide. There was a state of mind at the end of the twenties that defended the gold standard beyond questioning its costs, and for that reason many researchers blame the magnitude and transmission of the depression on this system. For Austria, Germany and other countries with a recent history of high inflation and hyperinflation, the gold standard promised assurance against the recurrence of unsound fiscal policies. In Britain the restoration of the pre-war parity was also linked to identity issues related to the UK's decline and America's ascendance<sup>72</sup>. For exporters of primary products prone to volatile terms of trade movements, the model of the League of Nation's Stabilization loans and the core program recommended by influential advisors such as Edwin Kemmerer<sup>73</sup>, promised, in exchange for the strict adherence to gold and tight fiscal control, the compensating benefits. That was what Bordo & Rockoff (1995) called the 'good housekeeping seal of approval' that facilitated access to the financial markets in London and New York and contributed to the task of attracting foreign direct investment<sup>74</sup>.

Barry Eichengreen, Peter Temin and Charles Kindleberger, among others, consider the gold standard system as a main driver of the Great Depression. Following Temin (1993, p. 88), the gold standard was characterized by: first, the free flow of gold between individuals and countries; second, the maintenance of fixed values of national currencies in terms of gold and therefore each other; and third, the absence of an international coordinating or lending organization like the International Monetary Fund (IMF). Together, these arrangements implied two more features. Firstly, there was an asymmetry between countries experiencing balance of payments deficits and surpluses. A country running a deficit had to export gold, while a country running a surplus could import gold. Consistently running a deficit threatened running out of gold (or foreign reserves) which meant that the country would no longer be able to maintain the fixed value of its currency. Defaulting on this commitment meant the cessation of foreign loans and, in the early interwar period, an invitation to hyperinflation. By contrast, running a surplus had a light penalty, namely the foregone interest from holding greater reserves, and possibly

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<sup>71</sup> See Eichengreen & Temin (2000, p. 187).

<sup>72</sup> See Wolf & Yousef (2006, pp. 6-7).

<sup>73</sup> Edwin Walter Kemmerer (1875-1945) was a US financial adviser whose acceptance of an invitation to provide financial advice would be sufficient to improve prospects for a country's future (Thorp & Londoño, 2000, p. 72).

<sup>74</sup> See also Blattman et al. (2004).

some inflation if the additional gold reserves were allowed to increase the money supply<sup>75</sup>. Secondly, the adjustment mechanism for a deficit country was deflation rather than devaluation, or in other words, a change in domestic prices instead of a change in the exchange rate. Lowering prices and possibly production as well would reduce imports and increase exports, improving the balance of trade and attracting gold or foreign exchange. In turn, deflation meant a strong strain on the world economies.

According to Bernanke & James (2000, pp. 84-89), there are at least three channels by which deflation may induce a contraction of economic activity. The first channel is through real wages. If wages possess some degree of nominal rigidity, then falling output prices will raise real wages and lower labour demand. Downward stickiness of wages (or of other input costs) will also lower profitability, potentially reducing investment. The second is through the real interest rates. The deflation might have raised *ex ante* the real interest rate, shifting the aggregate demand. Finally, as debt instruments are typically set in money terms, a deflation weakens the financial position of borrowers, both nonfinancial firms and financial intermediaries, paving the way for a potential financial crisis. Eichengreen (1992) identifies a specific model to the historical gold standard, linked to the behaviour of short-term capital movements. He notes that shocks to the gold standard in the largest industrial countries were offset by short-term capital movements. If the long-term capital outflow from London suddenly increased, the recipients would hold much of their new balances in London, creating a short-term capital inflow offsetting the outflow. Shocks to the currencies of other countries however were magnified by short-term capital movements. If Argentina experienced a fall in exports, capital flows to Argentina were likely to fall as well. This transmission channel explains why banking systems in smaller countries were more vulnerable than those in large ones and how weaker countries experienced more disruption than stronger ones. Wolf & Yousef (2006, p. 8) point out that specie shortages prompted increasing reliance on convertible foreign currency reserves at the cost of enhanced fragility if the convertibility promise of the reserve currencies were to come into doubt. Finally, the gold standard was a big constraint for governments in the face of downward outflows of gold, and especially when the gold and foreign reserves became dangerously scarce.

#### **iv. Structural constraints**

There are many ways in which researchers have come to the conclusion that there are structural constraints that limit the liberty of actors to take decisions and to act freely in the world system. In this regard, we have chosen to use some of the concepts within Immanuel Wallerstein's world-system analysis of the seventies and eighties. However, this method of analysis has

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<sup>75</sup> Bernanke & James (2000, pp. 74-78) add to the asymmetry argument, the pyramiding of reserves, meaning the holding of convertible foreign exchange reserves as a partial or nearly complete substitute for gold, and the insufficient powers of the central banks to conduct open market operations.

connections to the deeply influential analysis of Latin American structuralism led by Raúl Prebisch of the fifties and sixties<sup>76</sup>. In this section we present both perspectives.

### **The changing patterns of dependence: Latin American structuralism**

The object of this thesis is not the analysis of the long-term patterns of development in Latin America tackled in different theories, but it does provide a key framework for our research. Indeed, this issue is, and rightly so, crucial in the intellectual background of many of the most prolific Latin American researchers, and consequently is deeply rooted in the literature. Some of the analytical tools created to explain the reasons of development are useful for the research. This is particularly the case when analysing the patterns of dependence and vulnerabilities involved in exchanges with the main trading partners, as well as in the policies implemented by governments. Both arguments suggest that it is important to address the intellectual contribution of Latin American structuralism. After the Second World War, the Argentine economist Raúl Prebisch<sup>77</sup> suggested the existence of a number of structural barriers that slowed the economic growth of developing countries and was at the root of underdevelopment. His work, complemented by other researchers from the Economic Commission for Latin America and the Caribbean (ECLAC), such as Celso Furtado, Fernando Henrique Cardoso, Theotonio Dos Santos, Ruy Mauro Marini, Hans Singer, Osvaldo Sunkel and Rodolfo Stavenhagen, led to the construction of a new development theory. They based their findings on the great inequalities between the countries producing manufactures at the ‘centre’ and those producing basic commodities at the ‘periphery’. From their point of view, the world economy is not a place of relations among equals, but a place of asymmetries, reflected primarily in the structure of production. The industrialized countries organize the world trade according to their national interests, while the rest of the world, including Latin America, constitutes a heterogeneous

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<sup>76</sup> Wallerstein and Prebisch share certain theoretical premises; that does not mean that using the same concepts –e.g. ‘centre-periphery relationship’– implies necessarily the same. Beyond that Prebisch’s thinking influenced Wallerstein’s, the fact is that both of them only share the economic aspect of the relationship. While Wallerstein does not express with the same conceptual terms, he implicitly uses Prebisch’s keywords. That can be appreciated especially in the case studies of the hegemonic countries along the whole ‘historical capitalism’. In other aspects, they differ markedly, as Wallerstein expands the application of the centre-periphery dialectic to not just limit it to economic elements. Consequently, in Wallerstein, the economic aspect is what determines the membership or not of a country or region in the capitalist world-system hierarchy. And the political, social and cultural expressions of the centre-periphery relationship are merely reflections of the economic expression. Furthermore, for Wallerstein it is not merely the ‘centre’ and ‘periphery’, but there is another area that is the ‘semi-periphery’, which is in an intermediate zone between both which can be primarily defined as commercial intermediary between the ‘centre’ and ‘periphery’. Secondly, despite their differences in unit of analysis, for both the State is not considered the social system representing all of society; if so then there would be economic autarky among states and none could influence the other. Instead, for both, the unit of analysis is supranational; regional in Prebisch and the world-system in Wallerstein (although depending on the historical period). Thirdly, their intellectual influences are quite different. Prebisch was influenced mainly by the economic theory of Keynes, while the inheritance that influenced Wallerstein was much larger, from Karl Marx, through certain concepts of Prebisch and the ‘dependency theory’ to the historiographical French school *Annales* (in particular Fernand Braudel). Finally, it is a key element to take into account the origins of both intellectuals which determine to some extent the way that they appreciated the historical-social reality around them. Prebisch observed ‘from the periphery’ while Wallerstein did it ‘from the centre’, which makes their perceptions of underdevelopment qualitatively different.

<sup>77</sup> Raúl Prebisch promoted his theory based on his own experience as a public servant of the Ministry of Finance and the Central Bank of the Argentine Republic (BCRA) during the Great Depression.

group exporting its food and minerals to the 'centre'. The resulting dominant import-substitution policies of the 1950s and 1960s were the practical realization of the ideas of Prebisch (1959) and Singer (1964). And they were based on the famous Prebisch-Singer thesis on the declining terms of trade for primary products and the dynamic benefits of manufacturing. The emphasis on development planning in those same decades was greatly influenced by Rosenstein-Rodan's (1943) 'Big Push' framework, with its stress on increasing returns to scale and the need to kick-start growth through large-scale investments, and the planning model of Mahalanobis (1955), which argued that economic development could be accelerated by government encouragement of heavy industry.

For Prebisch, any given country in the periphery is structurally heterogeneous because it includes branches of production in which the productivity of labour is close to those allowed by the best available techniques or even closer to those prevailing in industrialized countries. This is a situation that coexists with others in which productivity is limited and associated to technologically backward activities. Technological progress is low in the peripheral countries, so that labour productivity, average income and accumulation are low. The inter-sectoral complementarity and vertical integration of production achieved by the periphery are only small or incipient. As technological change originates in the core countries and they also have higher consumption capacity, they are heavily concentrated in the most dynamic productive activities at the world level. Thus, while industrialized countries specialize in products of high income elasticity, the periphery concentrates on the production of goods of low income elasticity (raw materials and, increasingly, the manufacture of mature goods). The exchange that is generated between these two groups contains a key issue to explain the increasing impoverishment of Latin American economies. That is the deterioration of the terms of trade of commodities in relation to manufactures, which could be traced as a historical general trend starting at least since 1870. Countries find difficult to export manufactures and achieve successive increases in the value of total exports. There is also an ever increasing growth of imports, because of the low level of complementarity of domestic production and/or the demand for imports of goods located further back in the production chain.

This pattern explains the divergent growth rates and frequent balance of payments problems in the peripheral countries, including external gaps or bottlenecks. Indeed, there is a tendency towards a trade imbalance that arises from the joint effect of technological lag and strong external openness. That makes it difficult to maintain the domestic production of tradable goods that has to compete with high quality products coming from the centre, so that domestic production is eventually replaced by increasing imports of those goods. This is a key issue in our thesis, because this pattern of asymmetry is reflected in a cyclical vulnerability of Latin American countries to the shocks coming from the core countries. The vulnerability has been also changing over time, due to the increasing importance of the impact of financial shocks that have taken the leading role from those transmitted through trade<sup>78</sup>. The Brazilian economist

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<sup>78</sup> The literature of Latin American structuralism is vast. For a quick overview see for example Di Fillippo (2009), Galindo & Malgesini (1994), Gurrieri (2001), Ocampo (2001), O'Connell (2001), Ricupero (2004), Rodríguez (2001). For a deeper analysis the most important landmark contributions is Prebisch (1949), also

Celso Furtado, a follower of Prebisch, introduced a long-term historical perspective based on the Brazilian case, and concluded that the social and economic heterogeneities and low levels of economic diversification were consolidated throughout centuries of alternating cycles of growth and contraction. He also suggested that underemployment was a long-term problem in Latin America and initiated the Latin American debate on the relationship between development, wage-setting and income concentration in conditions of rural and urban underemployment. His main contribution was the analysis of the long-term trend of unemployment and poor income distribution<sup>79</sup>.

Originally, the development in the periphery depended on the export of foodstuffs and raw materials. Later, the industry started to grow, but its primary export specialization conditioned development. A country begins by producing simple consumer goods and only gradually progresses to the production of more technologically complex products, e.g. consumer durables, intermediate goods and eventually certain capital goods. Peripheral countries keep on changing over time, especially when the industry expands spontaneously and plays the leading role as a source of growth. However, they continue to be heterogeneous and specialized, while industrialized countries are more homogeneous and diversified. As technical progress is more rapid in industry than in primary production and also more rapid in industrial activities situated further back in the production chain, Latin American countries have to progress from the most basic degree of industrialization to more complex levels. Thus, a higher technological progress is achieved and the underemployment defined as the labour force applied to low productivity sectors is reduced.

The analyses of Prebisch (1949) and other ECLAC economists so far described constituted the beginning of the structuralist theory. The explanation is 'structural' as the socio-political structures influence and even shape the market. Industrialized countries have 'self-sustained' economies, while the underdeveloped countries do not. As people get rich, the core countries reduce consumption of raw materials and foodstuffs due to Engel's law<sup>80</sup>. And if we add to structural shortcomings the protection that the core countries extend to their agriculture and the technological innovation which continually reduce the share of raw material as input, the growth in the periphery depends less and less on itself. Instead, it increasingly depends on the core countries. The global market forces operate in a way that prevents this undesirable 'balance' from changing. As a consequence, only political decisions can change those politically driven trends. The goal is to achieve an 'inward-looking development' that incorporates knowledge, science and technology into the economic and social fabric, and the capacity to manage knowledge in the national space. And to do so, it is imperative to change the structure of peripheral countries by means of a process of industrialization that can spread technical

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known as 'The Manifesto'. An excellent review of the Latin American development theories is also Kay (1989).

<sup>79</sup> For an overview of the contribution of Celso Furtado, see for example Bielschowsky (2006) or Bresser-Pereira (2004). For a deeper analysis the most important landmark contribution is Furtado (1964).

<sup>80</sup> Engel's law states that when income increases, the proportion of income spent on foodstuffs has a contraction, even if the spending on foodstuffs increases, that is to say that the income elasticity of demand of foodstuffs is between 0 and 1.

progress. The main tool to fulfil this objective is the enactment of protectionist policies to induce import substitution in the periphery until disparities in the elasticity of demand are overcome and the international market approaches reciprocity in a level playing field. After 1950, Prebisch expanded his analysis to a 'mixed model', combining import substitution with the promotion of new exports, especially of industrial origin. And under this refurbished analysis, integration processes were an important complement to offset the negative effects of import substitution, namely the costs related to the absence of competition and the inefficiency coming from sub-optimal scale of industrial plants. In short, the structuralist theory advocates state intervention in the economy both for the defence of the infant industry to improve the distribution of income and the development of more balanced international economic relations.

The thirties were seen by ECLAC as a particularly acute example of a more general cyclical characteristic of the capitalist world economy which allowed adjustment of income distribution and renewed accumulation<sup>81</sup>. Nowadays the message of ECLAC (2010) is that that development is impossible without a profound structural change that incorporates activities on the frontier of knowledge. It is required to address the consolidation of small and medium enterprises (SMEs); their links with large value chains; the ties between science and technology systems and production and education and synergy between the public and private domains. Democracy, social inclusion, leadership quality, democratic stability critical thought and sound macroeconomic fundamentals are also in the roadmap to development. There is also a growing awareness about the role of China in today's globalised world, which does not necessarily mean a positive change for the least advanced economies. There is probably a shift in the centre, but the basic dilemma remains. Latin America still imports complex manufactures and capital and exports foodstuffs and raw materials. The international division of labour between the old centre of the North Atlantic and the new Asia-Pacific centre and what remains of the periphery reproduces the trends of the past<sup>82</sup>. This is probably a key difference for our research, then and now. During the thirties the US was a rising power that used to assign to the Latin American nations - its backyard - a high priority in its strategic interests. But it was not alone. The Soviet Union, Germany and Japan contested its hegemony, and the prospects of a major conflict that would resolve for good and by force the open wounds of the First World War was in the horizon. The League of Nations<sup>83</sup>, as the first multilateral mechanism truly democratic and more or less universal had started to show its weaknesses in solving with idealism the conflicts that were rooted in national interest. After the Second World War the US was the only superpower capable of using military force effectively and to force regime changes. The relations with Latin

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<sup>81</sup> See FitzGerald (2000, p. 233).

<sup>82</sup> See Ferrer (2010).

<sup>83</sup> The League of Nations (1919–46) was an international organization which had the primary goal of preventing war. But it also dealt with issues relating to economic and financial cooperation, international working conditions and global health. According to Patricia Clavin, although it failed to avert the Second World War, the League represented a significant shift in the ideas about international relations and organization. Its history helped to underline the importance of economic and financial coordination and cooperation to the prospects of prosperity and peace. Moreover, this organization helped to incubate ideas that led to the World Bank and the International Monetary Fund, among others, that transformed the world after 1945 when the United Nations replaced the League of Nations. See [www.ox.ac.uk/oxfordimpacts](http://www.ox.ac.uk/oxfordimpacts), page visited in December 2012.

America were absorbed in the Cold War until the fall of the Berlin Wall in 1989. Then, the attack on the Twin Towers of New York in 2001 changed its strategic interest to the war against terrorism in Iraq and Afghanistan, so that Latin America lost priority in its strategic analysis. Meanwhile, China has been increasing its trade and investment interests in the Latin American region, disputing the place of the US and Europe. For example, as of 2009 China has displaced the US as the main trading partner of Brazil<sup>84</sup>. The issue of what is now the periphery and how its changing structures affect ABU is addressed throughout this thesis.

### **Wallerstein's world - system**

The world-system analysis within international political economy argues that the rise of capitalism and the nation-state in the sixteenth century was not a result of domestic forces, but of global market ones, which have determined national economic development or underdevelopment<sup>85</sup>. It was created by Immanuel Wallerstein from long-term research that begins in 1500. It holds that the modern Europe-centred world-system was the first capitalist system and that the transition from feudalism to capitalism happened for the first and only time in sixteenth-century Europe. Subsequent transitions in the mode of accumulation in the rest of the world have resulted from the global expansion and conquest by the formerly regional Europe-centred world-system. Wallerstein contends that it is only in the post-sixteenth century capitalist world-economy that powerful actors focus primarily on the goal of ceaseless accumulation<sup>86</sup>.

This analysis is holistic in the sense that it borrows the concept of 'world-system' from history, 'unequal exchange' from economy, 'social classes' from sociology and 'balance of power' from politics. It departs from the structural time or secular long-term trends that explain the emergence, development and demise of a world-system<sup>87</sup>. The capitalist world-economy is a system based on the drive to accumulate capital, the political conditioning of price levels of capital, commodities and labour; and the steady polarization of classes and regions around core and periphery<sup>88</sup>. It is based on the idea that there is a single on-going division of labour, yet multiple political and cultural systems<sup>89</sup>. There is a multicultural territorial division of labour in which the production and exchange of basic goods and raw materials is necessary for the everyday life of its inhabitants. It is therefore by definition composed of culturally different societies that are vitally linked together through the exchange of food and raw materials<sup>90</sup>.

The key assumption of this approach is the hypothesis of unequal exchange. This hypothesis contends that the central mechanism by which the global market acts to gather together the

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<sup>84</sup> According to figures obtained from Foreign Trade Database, BADECEL from ECLAC, in 2009 the US had a share of 10.4% in Brazilian exports, while China had a share of 13.4%. In 2010 that percentage grew to 15.5% whereas the US fell to 9.7%.

<sup>85</sup> See Simon (2011, p. 148).

<sup>86</sup> See Chase-Dunn & Grimes (1995, p. 393).

<sup>87</sup> See Wallerstein (2004).

<sup>88</sup> See Wallerstein (1980, p. 744).

<sup>89</sup> See Wallerstein (2004) and Evans (2007, p. 15).

<sup>90</sup> See Wallerstein (1974).



global surplus and channel it to the core is through price inequality. The political and military suppression of wages in the periphery allows the products of peripheral labour to be much cheaper than those of the core. In other words, an hour of labour in the periphery costs only a fraction of that in the core, so that a commodity produced there is much cheaper than the same commodity produced in the core. When core and periphery come together to exchange products in the world market, the exchange results in a net transfer of value from the periphery to the core. Hence the market masks a process of exploitation. It is a process backed up by the military power of the states in the periphery and, behind them, the military power of the core<sup>91</sup>.

Wallerstein builds on the notion of the centre-periphery, already mentioned within Latin American structuralism. Indeed, one of the most important structures of the current world-system is a power hierarchy between core and periphery in which powerful and wealthy core societies dominate and exploit weak and poor 'peripheral' societies<sup>92</sup>. There are core production processes that are relatively capital intensive and monopolized by a few producers in the market; and other peripheral ones that are relatively labour intensive and free market. Thus, countries that normally are developed and tend to rely on core processes are normally called core countries, and the rest peripheral ones. This division of labour between core-like and peripheral production processes leads to unequal exchange between the zones<sup>93</sup>. Within the current system, the so-called advanced or developed countries constitute the core, while the less developed countries are in the periphery. The core has remained composed of several states. They exhibit a phenomenon called hegemonic sequence, meaning the rise and fall of hegemonic core states. For example, this sequence includes the Netherlands in the seventeenth century, Britain in nineteenth century and the United States in the twentieth century<sup>94</sup>. Wallerstein's key insight lies with the realization that trading patterns prevailing at different points in history demonstrate the essential economic interdependence of the societies involved, whether or not they were united by a single political centre. The peripheral countries, rather than developing along the same paths taken by core countries in earlier periods as modernization theories hold, are instead structurally constrained to experience developmental processes that reproduce their subordinate status. It is the whole system that develops, not simply the national societies<sup>95</sup>.

There is another area in between core and periphery: the semi-periphery. The semi-peripheral states play a particular role in the capitalist world-economy. They act as a peripheral zone for core countries and they act in part as core area for some peripheral areas. It turns out that their ability to take advantage of the flexibilities offered by the downturns of economic activity is in general greater than that of either the core or the peripheral countries<sup>96</sup>. The semi-periphery includes economically stronger countries of Latin America: Brazil, Mexico, Argentina, Venezuela, and possibly Chile and Cuba. It includes the whole outer rim of Europe: the Southern tier of Portugal, Spain, Italy and Greece, most of Eastern Europe, parts of the northern

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<sup>91</sup> See Emmanuel (1972) and Raffer (1987).

<sup>92</sup> See Chase-Dunn & Grimes (1995, p. 389).

<sup>93</sup> See Wallerstein (2004).

<sup>94</sup> See Wallerstein (1974).

<sup>95</sup> See Chase-Dunn & Grimes (1995, pp. 389-390).

<sup>96</sup> See Wallerstein (1976, p. 462).

tier such as Norway and Finland. It includes a series of Arab states: Algeria, Egypt, Saudi Arabia and also Israel. It includes in Africa at least Nigeria and Zaire, and in Asia, Turkey Iran, India, Indonesia, China, Korea, and Vietnam. And it includes the old white Commonwealth: Canada, Australia, South Africa and possibly New Zealand<sup>97</sup>.

Although the State is not the unit of analysis of the world-system approach, it is interesting its role. Classes, ethnic groups and households struggle to increase, maintain or decrease the power of the State in order to change the particular group's ability to profit directly or indirectly from the operations of the world market<sup>98</sup>. The bourgeoisie is contradictory. On the one hand, it has to pursue its interest by maximizing profit without the constraints on geographical location or political considerations. On the other hand, it needs to utilize the state machineries to strengthen its position in the markets vis-à-vis competitors and to protect itself from the working classes. Something similar could be said about the proletariat. In any case, both classes tend to influence the State for their benefit, although the latter has only limited power to change the world-economy<sup>99</sup>. Thus, the State is the institutional intermediary in the establishment of market constraints to favour particular groups, and at the same time interacts with other states in the inter-state system. The setting of state policies is key since it means the adoption of rules governing the flow of the factors of production within and across frontiers. These critically affect the price structures of markets and the social relations of production, which critically affects the allocation of surplus value<sup>100</sup>. State policy intervenes ensuring and protecting the price rise of key commodities, and translating the windfall profits into particular kinds of imports<sup>101</sup>. It uses trade policy, property rights, working place legislation, externalisation of costs, industrial policy, fiscal policy and foreign policy to achieve this goal<sup>102</sup>.

In the core, states where the most efficient economic producers reside have less need to intervene in the world market economy than states where moderately efficient producers are located. The State is most active in states of moderate strength<sup>103</sup>. The presence in the core of a centralized and powerful state institutional political structure is therefore an indication of weakness rather than strength, because a self-aware and self-confident bourgeois class can agree to the necessary collective arrangements that require a strong ruler to impose. In the semi-periphery, the weakness of the owner-producers needs a greater degree of direct state involvement in the extraction of economic surpluses. Here, centralized and powerful state

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<sup>97</sup> See *Ibid.*, p. 465.

<sup>98</sup> See Wallerstein (1980, p. 745).

<sup>99</sup> See *Ibid.*, pp. 749-750.

<sup>100</sup> See *Ibid.*, p. 746.

<sup>101</sup> See Wallerstein (1976, p. 470).

<sup>102</sup> See Wallerstein (2004).

<sup>103</sup> State strength is determined by five independent measures of political strength. These include: the extent to which State policy directly aids owner-producers to compete in the world market economy (mercantilism); the extent to which states can affect the capacity of other states to compete (military power); the ability of states to mobilize resources to perform these competitive and military tasks at costs that do not eat into profits of their owner-producers; the capacity of states to create administrations that permit the swift carrying out of tactical decisions (or an effective bureaucracy); and, the degree to which the political rules reflect a balance of interests among owner producers such that a working hegemonic bloc forms the stable underpinnings of such a State (Wallerstein, 1980, pp. 113-114; Garst, 1985, p. 473).

institutional structures are an indication of strength<sup>104</sup>. However, the chronic impoverishment of the periphery prevents the typical peripheral State from being able to finance programs of public welfare or infrastructural improvement, so its popular legitimacy is low. Thus, it is always vulnerable to coups or popular insurrections<sup>105</sup>.

The division periphery - semi-periphery - core is not immutable. Since the exchange that occurs within the division of labour is based on the differential appropriation of the surplus produced, the positions among states are hierarchically ordered, so that it is not possible for all nations to be developed. In order to develop some countries, others must fall from the category of developed<sup>106</sup>. Despite structural barriers, some states have managed gradually to improve their infrastructure and to combine these improvements with policies that encourage the key industries that seem the most promising in the world market. Occasionally, such policies pay off in upward mobility. The most spectacular case of upward mobility has been the United States, a region that went from being peripheralized to a semi-periphery and then to core status after 1880, and finally achieved hegemony within the core after 1945<sup>107</sup>. The current decline of US hegemony is one of the salient features of sequential change in the contemporary system<sup>108</sup>.

Although counterintuitive, a downturn is more or less advantageous to all semi-peripheral countries<sup>109</sup>. There are long-term cyclical shifts in the capitalist world- system due to the acute disequilibrium in the world market between the immediate capacity for production of high cost, high-profit economic goods and effective demand. The long-term tendency to over-supply is inevitable in the pattern of separate decision-making processes by producers in a capitalist market. Over-supply leads to a shift in the terms of trade between the core and the periphery, a shift in the loci of profitable investment world-wide and the loci of employment opportunities. This in turn affects the wage structure in those parts of the world-economy based on fully proletarianized labour, as well the degree to which workers in other areas will continue to draw part or all of their income from sources other than wage-employment. When these shifts result in a strengthened world-wide effective demand, concordant expansion of the capitalist world-economy can once more take place. Subsequently the balance will shift acutely in favour of core producers. In other words, the percentage of surplus-extraction that ends up in the hands of producers located in the core steadily grows. When it becomes as important as to limit market demand, another crisis results<sup>110</sup>.

In moments of world economic downturn, semi-peripheral countries can usually expand control of their home market at the expense of core producers, and expand their access to neighbouring peripheral markets, again at the expense of core producers. The reason for this is relatively straightforward. As long as the products of core producers are relatively scarce, they can pick

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<sup>104</sup> See Garst (1985, p. 473).

<sup>105</sup> See Chase-Dunn & Grimes (1995, pp. 396-397).

<sup>106</sup> See Evans (2007, p. 16).

<sup>107</sup> Contemporary examples include Taiwan, Singapore, Korea, Hong Kong, and China, while Japan achieved an upward trajectory since 1880. See Chase-Dunn & Grimes (1995, pp. 396-397).

<sup>108</sup> See Ibid.

<sup>109</sup> See Wallerstein (1976, p. 466).

<sup>110</sup> See Wallerstein (1980, pp. 463-464).

and choose among semi-peripheral bidders for their investment in (semi-) manufactures and for their purchase of commodities. When the core producers face a situation of over-supply, they begin to compete intensely with each other to maintain their share in a comparatively shrinking world market for their finished goods (especially machinery). At that time, semi-peripheral countries can, up to a point, pick and choose among core producers not only in terms of the sale of their commodities but also in terms both of welcoming their investment in manufactures and of purchasing their producers' goods. They often result in shifts in regime where the previous regime is insufficiently flexible to respond to the changed world political situation. Also the ability of core powers to intervene illicitly in the state affairs of each semi-peripheral State decreases somewhat in moments of downturn in terms of production and trade patterns<sup>111</sup>.

Only a few semi-peripheral countries are able to translate that advantage into a real shift in economic position at any given moment in history. To do this, a semi-peripheral country must garner a heavy portion of the collective advantage of the semi-periphery as a whole to itself in particular. A semi-peripheral country rising to core status does so, not merely at the expense of some or all core powers, but also at the expense of other semi-peripheral powers. This is not development, but successful expropriation of world surplus<sup>112</sup>. The direct and immediate interest of the semi-peripheral State as a political machinery in control of the internal and international market is greater than in either the core or the peripheral states, since the semi-peripheral states can never depend on the market to maximize, in the short-run their profit margins<sup>113</sup>.

A world economic contraction does change the politics. Economic nationalism is widespread in world depressions in all those semi-peripheral areas that are sovereign (for example, Mexico, Brazil, Italy, South Africa in the 1930's; Canada in the 1880's, etc.). Protectionist measures can turn out to be merely obstacles whose very existence encourages the multinationals to determine new ways of hurdling them. Import substitution may simply involve substituting one kind of import dependence for another, thereby creating an even worse technological dependence. In such a case, world economic downturn merely accelerates a process that in the long-run was part of the built-in program of multi-national corporations<sup>114</sup>.

## **v. Conclusion**

Recalling our introductory chapter, our reasoning is illustrated in Figure 1. Our analysis of the Great Depression in ABU in our following chapters moves around a definition of complex vulnerability that incorporates most of the concepts described in this and the introductory chapters.

As such, it includes the short-term economicist notions of transmission channels of a crisis, with an emphasis on the trade transmission channel. We also incorporate the narrative of the historical context focusing on the issues regarding the complex interdependencies between our

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<sup>111</sup> See *Ibid.*, p. 464.

<sup>112</sup> See Wallerstein (1976, p. 466).

<sup>113</sup> See Wallerstein (1973, p. 3).

<sup>114</sup> See Wallerstein (2004).

semi-peripheral ABU and core countries. The comprehensive concepts of ‘power’ and ‘interdependence’ borrowed from the theory of international relations and international political economy helps us in this task. Finally, the ideology of the gold standard constitutes a specific source of vulnerability during the twenties and early thirties that we carefully have to take into account in our research.

Regarding the long-term conceptual framework, we take advantage of the reasoning of Immanuel Wallerstein’s world-system analysis that provides the useful distinction between periphery, semi-periphery and core. Furthermore, this analysis, from a structural view, addresses the fact that semi-peripheral states can take advantage of global downturns.

It is important to highlight that although Prebisch and Wallerstein are structuralists, Prebisch lacked a historical long-term view. Thus, he could not appreciate the structural problems that can only be noticed in a long-term historical perspective, which Wallerstein took into account. In that sense, Wallerstein took the French structuralism inherited from Braudel, who divided historical time in three strata: long, medium and short terms. As a consequence, Wallerstein in his historical analysis of world capitalism makes an exercise of structural history since he dedicated himself to observing the long-term economic cyclical trends, as well as the conjunctures. Hence, Wallerstein tackles both nomothetic analysis (social regularities) and idiographic (social singularities). Prebisch however essentially addresses the nomothetic through categories such as terms of trade, structural heterogeneity, etc., mostly without explaining how and why Latin America came to be as it was in those times.

