Coffee Crisis

The Case for a Regulated Market

John M. Talbot

John M. Talbot is Assistant Professor of Sociology at Colby College in Waterville, Maine.

You may not realize it, but there is a severe crisis in the world coffee market. While the price of your latte, your pound of Starbucks, or your can of Maxwell House may not have gone down much, the world market price for green (unroasted) coffee has fallen by two-thirds since 1997. For the estimated 10 million small farmers around the world who produce about 70 percent of the world's coffee, the results have been devastating. Thousands of coffee farmers in Guatemala, Honduras, and Nicaragua have abandoned their farms and headed to the cities in search of food, or headed north with hopes of finding work in Mexico or the United States. At the end of July 2001, coffee farmers in Colombia blockaded major highways across the country, warning that unless their debts were cancelled, 80,000 of them would lose their farms because they would default on their loans. In Kenya, farmers who have been losing money on coffee production have replaced their coffee trees with subsistence crops.[1]

The proximate cause of the crisis is a glut of coffee on the world market, but the roots of the crisis go back much farther, to U.S. and World Bank policies in the 1980s that produced a situation of chronic oversupply. Since the mid-1990s, this oversupply has been exacerbated by the emergence of Vietnam, which surpassed Colombia last year to become the world's sec-

ond largest coffee producer. The coffee glut is likely to continue for another few years, until supply is brought back into balance with demand through the ruin of hundreds of thousands of small coffee growers and the devastation of the economies of a number of countries that still depend heavily on coffee exports.

This article traces the roots of the current crisis and proposes a solution. The main argument is that the free market does not work for coffee. Due to the economics of coffee production, an unregulated world coffee market produces wide price fluctuations, which create brief windfalls followed by devastating periods of low prices like the current one. The solution to this problem lies in creating a regulated market that can maintain a rough balance between supply and demand.

A Brief History of Coffee. The origins of coffee as a beverage are unclear, but by the fifteenth century, the Arabs in what is now Yemen cultivated and drank it. From there, it spread through the Arab world to Constantinople, where European travelers first tasted it. By the early 1600s, it had been introduced into Europe, and coffee houses spread rapidly through Italy, France, England, and the rest of the continent. An Indian pilgrim to Mecca, who smuggled out a few seeds and planted them in Mysore, eventually broke the Arab monopoly on coffee cultivation. Later, the Dutch took a few seedlings from southern India and planted them in Java. A Dutch botanist carried several seeds from these trees in Java and grew a few coffee trees in a greenhouse in Amsterdam, one of which was presented to Louis XIV as a gift. The Dutch sent some seedlings from Amsterdam to their colony in Surinam, and the French sent some seedlings to their colony in Martinique. From trees propagated in Surinam, some seeds were later sent to Brazil, where the first coffee was planted in 1727.

From the one tree that survived the trip to Martinique, coffee gradually spread through the Caribbean and the rest of Latin America. Most of the arabica coffee trees now growing in Latin America are direct descendants of a few seeds from Java. Around 1900, some seeds from the Caribbean were planted in East Africa, where coffee is thought to have originated. Robusta coffee, a different species that produces lower-grade coffee, was also spread by French and Dutch colonists through Central and West Africa and South and Southeast Asia.[3]

The legacy of colonialism is clear from this history. Coffee spread around the world because colonists searching for ecological niches that would produce good coffee carried it to more than fifty countries. As Sidney Mintz has shown, sugar, along with coffee, tea, and cocoa, became important sources of colonial power for Britain, as well as essential consumption items for the growing industrial working class.[4] In Britain and other European powers, coffee and tea gradually replaced beer and wine as working-class beverages. Tea won out as the preferred beverage in Britain, due in large part to the British East India Company monopoly and the fantastic revenues that the British colonial state was able to derive from the trade.[5] This in turn led to the United States becoming a coffee-drinking country when the British attempt to extract revenues from the tea trade to its American colonies spurred the colonists to revolt. When the coffee-producing countries achieved independence, they were already locked into roles

as suppliers of green coffee to their former colonial masters.

The United States quickly became the world's largest coffee-consuming country, and Latin American countries, led by Brazil and Colombia, became the world's major suppliers. Following World War II, as Europe rebuilt and the U.S. and Japanese economies grew rapidly, the demand for coffee increased. As a result, coffee production expanded in Africa, Asia, and Latin America. By the late 1960s, this expanded production exceeded demand, and prices fell. The United States, faced with the threat of communism spreading through Latin America, and Europe, faced with a similar threat from anti-colonial movements in its African and Asian colonies, agreed to participate in a plan to regulate the market. This plan followed the outlines laid out by the Havana Charter—signed, but never ratified, by the United States as part of the effort to set up a multilateral post-war world order led by the United Nations.[1]

The plan was embodied in the International Coffee Agreement (ICA), an agreement between coffee-producing and coffee-consuming countries first signed in 1962. The ICA set up a system of export quotas to manage the market. To keep world market prices within an agreed-upon range, the agreement designated an overall quota for total world exports and divided it among the coffee-exporting countries. The quotas were periodically adjusted as market conditions changed. The coffee-importing countries enforced the quotas by collecting certificates of origin for all imported coffee and rejecting any over-quota imports.

A series of four ICAs were in force for most of the period from 1962 to 1989, during which time they stabilized, and probably raised, world market prices.[2] The governments of both producing and consuming countries saw the agreements as a form of economic aid from the developed consuming countries to the less-developed producing countries. By 1989, however, when the fourth ICA was due to expire, the Cold War rationale that had supported the ICAs was crumbling. The outgoing Reagan and incoming Bush administrations considered the ICAs inconsistent with the free-market policies of the Washington Consensus. U.S. intransigence caused the negotiations for a fifth ICA to break down, and the regulated market expired in July 1989.

When the coffee-producing countries achieved independence, they were already locked into roles as suppliers of green coffee to their former colonial masters.

Meanwhile, several other developments had converged to create a chronic oversupply of coffee. First, beginning in the late 1970s, Colombia and the Central American countries, with funding from USAID, began to "technify" their coffee production. They replaced the traditional way of growing coffee—under shade and inter-planted with food crops—with new high-yield varieties of coffee planted in monocultures under direct sunlight. Like

other Green Revolution crops, this new coffee required high levels of fertilizers and pesticides. While this method had some damaging ecological consequences, it sharply increased coffee production. Second, in 1975, a major frost in Brazil, the largest producing country, caused a severe coffee shortage that raised world market prices to record highs by 1977. During this extended period of high prices, coffee growers planted millions of new coffee trees, but since coffee trees take three to five years to bear fruit, they had no immediate effect on coffee prices.

By the early 1980s, the combination of these factors had created a world level of production that exceeded total world demand. Enforcement of ICA quotas, however, averted a price crash. Countries that were producing consistently above their quota levels were forced to store the excess production. The third development contributing to oversupply was the debt crisis of the 1980s, which resulted in World Bank- and IMF-imposed structural adjustment programs in many developing countries. One component of these programs was strong pressure on countries to increase their exports to ensure a source of revenue that would allow them to service their debts. Despite existing quotas, some countries increased their coffee production, hoping that expanded production would help them gain a larger quota share. Other countries began to produce coffee as a new source of export revenues. This only added to the oversupply situation.

Upon the expiration of the ICA in 1989, a flood of stored coffee was released onto the world market, and prices fell by 50 percent within six months. Prices stayed low through 1992, and producing countries lost an estimated $10 to 12 billion in export revenues over this period. Low coffee prices caused widespread economic devastation, leading in some cases to political and social chaos. In Rwanda, where coffee accounted for 80 percent of total exports, for example, the resulting economic crisis was a key factor in igniting ethnic tensions that led to the genocide. In Chiapas, Mexico, low coffee prices helped spur the Zapatista uprising. And in the Colombian coffee growing regions, which had always been relatively prosperous, guerrilla groups began to gain a foothold for the first time as small coffee growers were driven to economic ruin.

As these events were unfolding, World Bank policies made the problem even worse. The Bank had generally not pressured countries to liberalize their coffee sectors during the 1980s, even when it was forcing the liberalization of other sectors of their economies. The Bank left the coffee sectors alone because of the ICA, which required producing states to regulate their coffee sectors in order to meet their obligations under the quota system. After the ICA collapsed, however, the Bank moved to end state intervention in coffee production. In some countries, where state marketing boards had skimmed a large percentage of the world market price, liberalization was initially good for growers, who now received higher prices for their coffee. These growers responded by planting more coffee, however, adding to the oversupply. Unfortunately, liberalization also removed the buffers that had protected small coffee growers from the wildly fluctuating prices of the world market.

In 1994, two frosts in Brazil created a temporary coffee shortage, interrupting the period of overproduction and low prices. This led to higher world market prices and increased coffee planting. By 1994, Vietnam, which had been a mar-

ginal coffee producer until the late 1980s, was already the second largest Asian producer, behind Indonesia. As the frosts drove prices up, Vietnamese growers responded with a massive increase in coffee planting. When this coffee began to hit the world market in 1997–8, coffee prices went into a downward spiral.

The Case for a Regulated Market.

Economists argue that a free, unregulated market ensures that commodities will be produced as efficiently as possible. The market rewards efficient, low-cost producers and eliminates inefficient, high-cost ones; consumers benefit from low prices. While the ICA quotas were in effect, economists argued that they were distorting the market, holding world market prices above their "equilibrium" level, rewarding inefficient producers, and leading to misallocation of productive resources. The quotas were responsible for the chronic oversupply situation, they proclaimed. If this were true, then twelve years of an unregulated market since 1989 should certainly have eliminated the inefficient producers and brought supply back into balance with demand. Why hasn't this happened? The chronic oversupply, as we have seen, was caused not by the quotas, but by U.S. and World Bank policies. The free market argument doesn't apply to the world coffee market, for two reasons.

First, the argument assumes factor mobility; it assumes that capital and labor can be moved easily out of inefficient sectors into more productive activities, so that supply responds quickly to price signals. Coffee, however, is a tree crop. Coffee trees do not bear fruit for three to five years after planting, so supply responds very slowly to price. In the absence of market intervention, this results in recurring price cycles. If world market coffee prices are high, growers plant more coffee, but this has no immediate impact on the market. Since prices remain high, growers plant even more coffee, sowing the seeds of a glut on the market three to five years later. As this new coffee comes onto the market, prices fall because of oversupply. Coffee trees, however, continue to produce, and since growers have sunk capital in these new trees, they continue to pick the coffee. Oversupply and low prices thus persist for several years, until prices fall below the costs of production. Growers then stop maintaining their trees, and production declines slowly. As prices remain low, and growers are unable to pay back loans, they may lose their land, abandon their farms, or plant other crops. Eventually, this lowers supply, raising coffee prices. Supply, however, tends to fall too low, because more trees are taken out of production than is necessary to balance supply and demand. Thus, new shortages arise, initiating a new cycle.

The decline in production during the low-price phase of the cycle does not involve the simple movement of labor and capital out of coffee production, as suggested by the economists' abstract models. The prolonged periods of low prices wreak havoc on the lives of small coffee-growers and their families, many of which have produced coffee for generations. Because 25 million people—small farmers and their families—depend directly on coffee production, low prices can also cause economic disaster in developing countries heavily dependent on coffee exports.[8] This happened in the early 1990s, and it is happening again during the current coffee crisis.

The second reason that the free market argument doesn't apply to coffee is

that an oligopoly of giant coffee companies dominates the major consuming markets, and uses its market power to distort prices. Five large coffee traders account for over 40 percent of all coffee imports into the major markets: the United States, the European Union, and Japan. Four giant conglomerates control over 60 percent of coffee sales: Nestle, Philip Morris (Maxwell House), Sara Lee (Superior, Chase and Sanborn, MJB, Hills Bros., and Chock Full o' Nuts), and Procter and Gamble (Folgers). Consolidation of market control by these companies is the reason that, while the world market price for green coffee declined by 18 percent between 1975 and 1993, the retail price of coffee in the United States rose by 240 percent. While green coffee prices have fallen by two-thirds since 1997, retail coffee prices in the United States have decreased by only about one-quarter. The unregulated market has given us the worst of both worlds: high coffee prices for consumers, and economic crisis for coffee growers.

The tree-crop price cycle has characterized the unregulated world market. While the market was regulated by the ICAs, however, the highs and lows were smoothed out. The quotas generally forced producing countries to store some of their production; during temporary shortages, this coffee could be immediately released to dampen price increases. During times of oversupply, prices were maintained at a level that allowed small growers to stay in business. Looking back over the past fifty years, it is clear that regulated markets have benefited coffee-producing countries and individual coffee producers. Market regulation has stabilized prices, providing a more steady income for producers. The percentage of the retail price of coffee that has returned to the producing countries and the percentage that has returned to the growers have both, on average, been higher under regulated markets than under deregulated ones. In short, regulated markets have meant *fairer* prices for coffee producers.

Coffee can only be profitably grown in certain ecological zones that lie between the Tropics of Cancer and Capricorn. Most of its consumers live in the temperate developed world, and cannot grow their own coffee. Coffee is grown in so many countries because Europeans, who developed a taste for the bean, planted it across their colonial empires. These regions were integrated into the world economy as coffee suppliers, but they have found it exceedingly difficult to break out of this role. I argue that, given this history, coffee drinkers in the developed world have a responsibility to see that coffee growers are fairly compensated for their efforts. The free market clearly has failed to achieve this, and a regulated market is needed.

Outline for Renewed Regulation.

The most important goal of a new regulatory regime for coffee would be to end the oversupply situation and stabilize supplies. World demand for coffee is relatively stable and unresponsive to price. The problem is to bring potentially volatile production into rough balance with stable demand, and production controls are the best long-term solution. Export controls worked relatively well in the 1960s, but in the 1980s, they couldn't prevent the overproduction driven by U.S. and World Bank policies. Ideally, total world production would be set at a level slightly above total consumption, so that some coffee could be stored to cover shortages when the next natural disaster strikes. Excess production could be

managed through a system of export controls or a centrally-managed coffee stockpile. Although export controls did not work in the 1980s, they would be effective in combination with production controls. Once the controls are in place, production could be gradually increased to keep pace with slowly increasing world consumption.

Allocating production among producing countries would be the most politically challenging task in a new ICA. It would be difficult precisely because coffee is a key crop and source of livelihood for so many people in developing countries, and each government would want to maximize its economic benefits by having a larger quota. Production controls would necessitate a cutback of production in participating countries, and financial assistance to manage the transition. Cutbacks in coffee production should not take the form of "diversification" into other related crops, such as cocoa or tea, which are also in oversupply on world markets as a result of World Bank and IMF pressures to expand exports during the 1980s and 1990s. Rather, production controls should probably be extended to some of these crops as well.

ICA members would have to agree upon a price range for the world market price of coffee that would be both reasonable for consumers and fair for producers. Since world demand can be predicted fairly accurately, total world production and exports could be set so that the market balances supply and demand at a price that allows coffee growers to recover their costs and earn a reasonable profit. Growers could then be encouraged to invest this profit in improving the quality of their coffee and in adopting ecologically-sustainable production practices.

The higher prices for producers that would result from controls could be taxed to provide an adjustment fund so that production of different types of coffee could be changed in response to changes in demand for these types. New countries that wanted to start exporting coffee could buy a share of the global quota by contributing to this fund, and this money could be used to phase out comparable production elsewhere. The major consuming countries would all have to participate in and enforce this regime so that very little coffee could be sold outside it.

Most of the ideas proposed here have been included in some form in some previous ICAs; others, like production controls, have been discussed in previous negotiations. Are the major consuming countries likely to agree to re-regulate the world coffee market? The European states and Japan were prepared to agree to a new ICA in 1993, but the United States again blocked an agreement. Japan and the European countries generally provide much higher levels of official development assistance relative to GDP than does the United States. Recognizing the seriousness of the current crisis, they would probably agree to a new regime to aid producing countries. The United States, and the transnational coffee giants that have considerable influence over U.S. policy, would be the major obsta-

Regulated markets have meant *fairer* prices for coffee producers.

cies. Nevertheless, a combination of collective pressure from coffee-producing states, as well as from U.S. citizens, could convince U.S. policymakers to acquiesce to renewed regulation.

U.S. consumers have already responded overwhelmingly in surveys that they would be willing to pay more for clothing if they were guaranteed that it wasn't made in sweatshops.[14] They may also be willing to pay more for coffee if they could be assured that their money was going to support small farmers and their families. Sales of Fair Trade coffee, for which coffee growers are guaranteed a minimum price (now about two and a half times the world market price), have been growing rapidly since it was introduced in the United States in 1998; it already has a small but significant market share in Europe. Consumer pressure has forced Starbucks and Sara Lee to begin offering Fair Trade coffees. Pressure by consumers and citizens who understand the devastating effects of the current crisis could change U.S. government policy to support a new ICA. Something must be done to help the millions of coffee growers and coffee workers whose lives are being destroyed by the free market, and to prevent the social disintegration that is likely to follow.[15]

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Reaching for the Light

Andres Velasco, interviewed by Carol Lancaster

In the face of the recent global economic slowdown, Latin American countries have found it increasingly challenging to attain economic growth. The economic effects of the U.S. recession have rippled throughout the region, which was already plagued by fiscal problems, financial contagion stemming from Argentina's crisis, and ongoing problems with corruption and poverty. These recent events come after a decade of Washington Consensus reforms whose results have been mixed at best. As a consequence, the debate has intensified as to how Latin American countries should confront both new and old economic development problems. While countries such as Chile and Costa Rica have had visible successes, crises throughout the region illustrate the continuing challenges facing policymakers in the region and in international financial institutions.

The *Georgetown Journal of International Affairs* had the pleasure of interviewing Dr. Andres Velasco, Sumitomo Professor of Finance and Development at Harvard University's Kennedy School of Government, to discuss the impact of structural reforms in Latin America, the regional economic outlook in the face of an Argentine default, and the effectiveness of the IMF in promoting economic growth and preventing financial collapse in developing countries. Dr. Velasco, a native of

Andres Velasco is Sumitomo-FASID Professor of International Finance and Development at Harvard University's John F. Kennedy School of Government. He is affiliated with the National Bureau of Economic Research in Cambridge and the Center for Applied Economics at the University of Chile.

Carol Lancaster is Director of the Master of Science in Foreign Service (MSFS) program at Georgetown University. Her prior positions include Deputy Administrator of the U.S. Agency for International Development and Deputy Assistant Secretary of State for African Affairs.

Chile, offered his insights into the causes of recent financial crises and suggested innovative policies that may help avoid them in the future.

[illegible]: The slowing world economy and the U.S. recession have been deepened by the September 11 attacks. Until then, consumer spending had been the main factor keeping the U.S. economy afloat, but consumer confidence levels have decreased since the attacks. In addition, commodity prices are low, external demand for Latin American exports is low, portfolio and foreign direct investment in Latin America have decreased, and Argentina is embroiled in crisis, potentially causing financial contagion throughout the region. In this context, what is the near-term economic outlook for Latin America?

[illegible]: The outlook for Latin America in the next year or so is dismal. This is because of three factors. The first is instability and uncertainty arising from Latin America itself, most notably from Argentina, but also from Brazil.

The second is the downturn in the world economy that will hit Latin America hard. The downturn in the world economy will not be long lived—it could be over by the end of 2002. Nonetheless, the next twelve months or so will be tough for the region, especially for coffee producers, who have been bruised by the entry of new large-scale producers like Vietnam.

The third factor hitting Latin America today is the sharp fall in capital flows to the region. This did not begin with September 11, but with the Asian crisis of 1997–8.

When you put it all together—local uncertainty, a downturn in the world economy with weak commodity prices, and a longer-term trend of smaller capital inflows—the outlook is pretty grim indeed.

[illegible]: What impact will Argentina's default have on other emerging markets? Will it cause financial contagion, or has the market learned to differentiate between countries and regions?

[illegible]: I think that we will have an aftershock, but not a huge one. Why do I say that? Why is Argentina likely to be different from Mexico? Mexico suffered a quick, sudden, and unanticipated shock, while Argentina's crisis has been in slow motion. People have come to expect it, and the financial world and Latin American governments have spent the last six, ten, or twelve months preparing for an Argentine crisis. The prices of currencies and interest rates have long reflected the expectation that Argentina would go belly up.

While the Argentine crisis is serious business and I do not want to minimize its importance, I do not think that we will wake up tomorrow and find a meltdown of markets in the region.

[illegible]: What do you expect to be the engine of growth for Latin American countries in the next five years? How will they find capital? What will pull them out of the economic downturns?

[illegible]: There is no single answer to this question. For some countries, exports will clearly be the way out. That is happening already in countries closer to the United States. In countries that participate in NAFTA or the Caribbean Basin Initiatives, there has

been an export revolution. Mexico is the prime exponent of this, but the Dominican Republic is not too far behind, and Costa Rica—with Intel and a few other high-tech companies—is also an example. As the U.S. economy grew quite quickly, there was almost boundless demand for new exports from some of these countries. It is important to note that these are not just commodities or low-tech goods. Many are brand new products that these countries had never sold before. For example, Mexico has a booming auto industry and Costa Rica has a software industry. Neither was there a decade ago. For most of the countries in the region, without a question, exports are the way out.

For some of the larger, more inward-looking countries such as Brazil and Argentina, exports will play a role, but less of one. The medium-term question is, can the countries in South America go through an export revolution like the one that we have seen in Mexico or the Dominican Republic? Chile has gone part of the way, but other countries have not. And even Chile is finding it hard to make the transition from exporting things like fishmeal, forest products, and fresh fruit to things that have more value added.

Moving on to the issue of income inequality in Latin America: Since Latin American countries adopted neoliberal reforms in the 1980s and 1990s, income distribution in Latin America has increased and the region now has the highest income inequality in the world. What role do you think neoliberal reforms played in this expansion of income inequality?

Is it true that Latin America is a highly unequal region? Yes, it is. Is it the most unequal region in the world? This depends on how you measure it. Africa is more unequal according to some definitions, but not according to others. Not all Latin American countries are similarly unequal. Latin America is heterogeneous in many respects, and income inequality is one of them. A country like Uruguay is pretty egalitarian, while Brazil and Guatemala are not. We should be careful before we talk about Latin America as a single entity in this respect.

While Latin America is unequal, it is not correct to assert that the region has become sharply more unequal recently. It is even more of a stretch to claim that recent changes in inequality are the direct effect or consequence of neoliberal reforms.

There are three things to keep in mind in this respect. First, income distribution changes very slowly across the world. This is true for Latin America, the rich countries, Asia, et cetera. The Gini coefficient, which is the most common index of income inequality, has hardly moved in Latin America for the last fifteen to twenty years. It went up slightly in the 1980s during the debt crisis, and fell slightly in the early 1990s as countries were beginning to recover. The Gini coefficient has probably risen slightly over the last five years, when growth has slowed again; but, again, these are tiny changes. It is hard to make assertions about a big trend in one direction or the other.

Second, income inequality has slightly worsened in the world over the last fifteen years. This has very little to do with

neoliberal reforms or trade, but probably has to do with technological change. The advent of new technologies tends to reward those with skills to the detriment of those that do not have the skills. There has been a slight worsening of income disparity, particularly of the gap between skilled and unskilled labor throughout the world—even in the United States. Despite this trend, Latin America has not done too badly. It has basically stood still.

Third, where do the neoliberal reforms come into play? The truth is that there is not much evidence to this effect, and what evidence exists is highly mixed. Some reforms, such as the sharp decrease in inflation, are good for income equality since inflation is a tax that the rich can evade but the poor cannot. Other policies, like privatization, may have been bad for equality, not so much of income but of wealth. It is probably true that some measures of wealth distribution have become more concentrated, but we do not have the data to prove it.

To summarize, we should be careful before coming to extreme conclusions. Latin America is unequal, but it is not necessarily becoming more unequal. If Latin America begins to grow again, there is reason to believe that inequality can diminish.

If Latin America begins to grow again, there is reason to believe that inequality can diminish.

In your article entitled "Time to Repave," you suggest that "the IMF is too small and slow to offset the tens of billions of dollars that traders can move with the strike of a key." Is there any way to make the IMF more effective, or is it by nature too slow to keep up with the market? How effective do you think the IMF has been in promoting economic growth and preventing economic collapse in the region?

I think the IMF could be more effective. But to be more effective, the discussion over its role has to be reoriented. Washington has been obsessed recently with the wrong question: too much lending by the IMF, which allegedly encourages moral hazard. Many politicians are saying that the IMF is too ready to bail out countries, encouraging those countries to misbehave. This is exactly the wrong reading of the situation.

First of all, there is very little evidence that the countries' problems have been induced by moral hazard. You would have to be pretty crazy to be the leader of a country, and bankrupt your country or risk bankrupting it simply because you think the IMF or U.S. Treasury will come to the rescue.

Secondly, if too much lending and too many bailouts to bond holders were the problem, then you would see a lot of bond lending in emerging markets. But nowadays that is not what you see. Whatever little capital is still flowing to Latin America is direct investment, not bond lending.

Rather than too big and too lax, the IMF is too small and too slow. Many of the crises today are crises of confidence, based on self-fulfilling pessimism. Investors begin to bet against countries

and currencies. Interest rates go up, the currency depreciates, and the country finds itself in dire straits. Sooner or later, the pessimism is vindicated and the country enters a crisis.

Many of these crises of confidence could be avoided if we had at the international level what most countries have at the domestic level—that is, a lender of last resort that can step in during crises of confidence and offer liquidity. That is what the Federal Reserve Bank did in the summer of 1998, when Long-Term Capital collapsed, and after the September 11 attacks. What the Fed does on the domestic level, however, nobody does at the international level. So, it is no surprise that we see all these crises.

But is the Argentine crisis just a matter of self-fulfilling pessimism? Isn't Argentine policy also to blame?

Again, I think that much of the international discussion has been misguided. If you read the international press for the last six months, the focus has been on Argentina's alleged fiscal misbehavior. The perception has been that Argentina has borrowed too much, that it has too large a deficit, and that this is the root of Argentina's problems. I think this is perfectly wrong. Argentina does have a deficit, but the deficit is mostly there because of the humongous interest payments Argentina has been forced to make. At those interest rates, even Switzerland would go broke.

What is the solution for Argentina? More loans at cheaper interest rates are part of the story. But changes in other areas are also key. I am obviously thinking of the exchange rate. For the last decade, but especially for the last three years, Argentina has done everything in the book to try to regain competitiveness without touching the one to one parity to the dollar. Looking back, there can be no question that those strategies failed. So, I think it is now time to move from plan A to plan B, and plan B involves the abandonment of the parity.

My colleague Ricardo Hausmann at the Harvard Kennedy School of Government has suggested that Argentina should float its currency, and should also convert its international and domestic debt from dollars to pesos. I think that is a very good idea; it is one element that could put Argentina back on the road to recovery.

So you think Argentina should devalue instead of dollarizing?

I think Argentina should float its currency.

Since middle-income countries are capital-scarce, it seems logical that they borrow capital from abroad to develop their national economies. If they do so, however, they may become prisoners to the wishes of the international capital markets. How can capital-scarce middle-income countries avoid this catch-22?

That is a good question. There is no one answer. Let me mention a few possibilities. First, we need better rules internationally, or we need internationally some of the same institutions that we have domestically, one of which is the lender of last resort.

Second, we need other kinds of debt. Today, the bulk of loans to emerging markets are denominated in dollars. This leaves borrowers with very little flexibility. Most importantly, they cannot use the exchange rate to adjust when they suffer a bad shock, because with

dollar loans, the devaluation means a sharp increase in the repayment value of those loans. It would be better for borrowers and lenders if loans to emerging markets were denominated not in dollars, but in either domestic currency or perhaps units of their exports. It would be much better if Venezuela could borrow oil bonds instead of dollar bonds, or if Chile could borrow in copper bonds, or if Colombia could borrow in coffee bonds. Think of this last example. Today, the price of coffee is low; Colombia would not have to pay a lot of dollars on its debt. If tomorrow the price of coffee goes up, then Colombia pays more dollars on its debt. This means that when times are good, Colombia pays a lot, and when times are bad, Colombia pays little. That makes Colombia a much safer place.

What is the solution for Argentina? More loans at cheaper interest rates are part of the story.

Do you think denominating debt in terms of units of export commodities is a viable option in the medium-term?

I think so. It might not happen, however, without some help from above. By above, I mean the international lending institutions and probably the U.S. Treasury. Markets do not grow incrementally. You do not want to be the first to issue a particular security, because nobody may want to buy it. Buyers of bonds look for liquidity. If you do not want to hold the bond anymore, you want to be able to turn around and sell it to someone. It has to be a well-established market already. It is very hard to go from having no copper bonds, or no coffee bonds, to having a lot of them overnight. The same is true for Chilean peso bonds, for instance.

So, the World Bank, for example, could take the lead. The Bank has done a little bit in this regard, but not enough. For instance, it has issued bonds in indexed Chilean pesos. This helps create a market for indexed Chilean pesos, and if Chile wants to issue such bonds in the future, investors will be able to say, "Similar bonds have been in circulation for a long time. There is a market for them, and there is a benchmark interest rate with low risk. I know how to price these bonds, they are nice to trade, and I will buy some." Without that official push, that initial help, these markets may never develop.

Some experts argue that Latin America may be able to leapfrog stages of technological development to catch up with developed countries. Costa Rica may be an example of that. How important will technology be in the overall economic development of Latin America? And what is the likelihood that Latin America will leapfrog these technological stages? Is this a relevant issue?

Without question, technology has a role to play. Countries can move up the technological ladder. Mexico and Costa Rica have done it. But we should think of technology broadly. Technology is not simply information technology,

software, or high-tech goods. The most important role of technology is making current exports, or exports not much different from our current ones, more competitive.

Here is an example. We do not think of fruit exports as being technologically advanced. Nonetheless, one of the reasons why Chile is able to sell its peaches, nectarines, and grapes to every deli in Boston, Washington, and New York is that there have been massive technological advances in designing containers and methods for preserving the food while it is being transported across the world. New software has been developed to track the production of fruit, inventories, and shipments from fields to delis. There has also been genetic innovation in designing new varieties of fruits and vegetables by crossing old varieties. All of this is technology. It is not Silicon Valley technology, but it is technology nonetheless. I think that in the application of new technology to old products, we might find the most immediate payoff for Latin America and other middle-income countries.

Now the bonus question on Chile: As you know, Ricardo Lagos campaigned for the presidency on a platform based on "growth with equity." Does this third way exist? If so, what characterizes it and how successful has Lagos been in implementing it?

I am not particularly keen on first, second, or third ways. A better distinction is between those countries that do things well and those countries that do things poorly. Chile is a country that has done things well for the most part, not only in the last two years, but in the last eleven years since democracy returned. The combination of a market economy with openness to international markets and international trade, plus very prudent fiscal policies and a more targeted and aggressive set of expenditures aimed at health and education, all have largely paid off. Chile used to have 5 million poor when democracy returned in 1990. The poor are only 2 million today. Per capita income doubled in Chile over the 1990s. So, the overall thrust of Chilean policy over the last decade has been, without a question, the correct one.

Recently, things have become more difficult for two reasons. Reason number one is simply the world economy. Since 1998 or so, as I mentioned earlier, capital flows to Latin America have fallen sharply. This makes the life of small, open economies like Chile's much harder. Secondly, many of the reforms that Chile put into place in the 1980s and the early 1990s have paid off, but the additional growth that Chile got out of those reforms is beginning to run out. Reforms do not give you higher growth forever. They give you a spurt of growth that may last for four, five, six, or seven years, but probably no more than a decade. Chile now has to invent new policies and come up with new schemes to achieve the kind of growth and poverty alleviation that it achieved over the late 1980s and much of the 1990s. That is proving a tall order indeed.

Some progress has been made in some areas. Chile is in the midst of carrying out a very important judicial reform that will sharply cut the time it takes to get your average case tried. It has extended the school day and the school year, so children will spend a lot more time studying than they did

before. In other areas, such as health, things have been much tougher politically and technically. The Chilean congress and the Chilean government are struggling to design the appropriate reforms. But while Chile is moving a little more slowly today, I think it continues to move forward.