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Ideas for

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Development

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in the Americas

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All that Glitters May Not Be Gold



Inter-American Development Bank
Research Department

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The past five years have been exceptionally good times for Latin America. Although some observers point to a very favorable external environment—strong world growth, high commodity prices and benign financial conditions—most analysts largely attribute this strong performance to the region's improved fundamentals. According to this view, stronger fundamentals will not only allow the region to sustain high levels of growth, but also make it less vulnerable to adverse external shocks and financial crises, a combination that has often derailed Latin America's economic expansions. "This time is different" is a view that is rapidly gaining support, especially since the region seems to have dodged the recent subprime bullet.

But all that glitters may not be gold. Considering the region's seven largest countries—Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela (henceforth LAC-7)—fundamentals may not be as sound as they appear at first sight. After all, fragilities are often both generated and easily missed in good times. A closer look at the region's growth performance, fiscal policy, public spending composition, public debt management and external position reveals some cracks in this otherwise rosy picture. Without intending to be a spoilsport, this issue of IDEA presents an alternative perspective in order to avoid complacency and to precipitate a healthy, constructive debate.

Once the veil of the external bonanza is lifted, a host of vulnerabilities are apparent.

Is this boom different from previous growth spurts? In the last five years Latin America has enjoyed a revival of external capital inflows, a boom in asset prices, a strengthening of domestic currencies, and solid growth. Since the fourth quarter of 2002, regional growth has been close to 6% per year—the highest rate since the 1970s, and far above the region's lackluster long-run average growth of 3%. It even exceeds the rate posted during its last expansionary cycle, 1991–97, when growth averaged 4.6% per year.

Moreover, until recently the current expansion has been associated with remarkably subdued inflation rates. With few exceptions, inflation has remained under control, averaging around 5% for LAC-7 as a whole. In sharp contrast, inflation averaged 21% per year during the 1991–97 boom.

Latin America's recent positive performance owes a great deal to sound macroeconomic and financial policies. Thanks to major improvements in the fiscal position, the region's overall surplus was 1.5% of GDP in 2007. With the exception of Brazil, LAC-7 countries are currently in balance or have a fiscal surplus. On the other hand, at the peak of the previous expansionary period LAC-7 exhibited a fiscal deficit of 0.9% of GDP, and all countries except Chile had a fiscal deficit.

A better fiscal position, strong growth and a substantially appreciated real exchange

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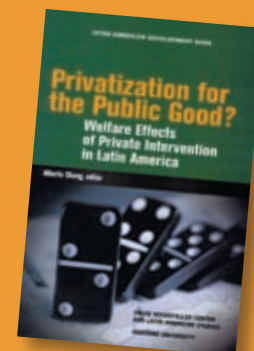
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All that Glitters May Not Be Gold

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rate have significantly eased public debt levels from 51% of GDP in 2003 to 35% of GDP in 2007. Although public debt levels are similar to those prevailing prior to the 1998 crisis, debt composition has improved considerably while maturities have lengthened.

The region has also dramatically reduced its exposure to external financial vulnerability. Instead of the large current account deficits and heavy dependence on external financing characteristic of past expansions, today's expansion has been accompanied by improvements in the current account. In fact, LAC-7 posted a current account surplus of 2.2% of GDP in 2007, compared to a deficit of 3.0% of GDP in 1997. Since Latin America's economies are now net savers rather than borrowers, their exposure to Sudden Stops in capital flows is mitigated. This reduces vulnerability to standstills in international liquidity that could compromise current account deficit financing and result in real exchange rate melt-downs and traumatic macroeconomic adjustments. The region's net foreign liability position has been bolstered even more by an unprecedented build-up of international reserves to \$400 billion, more than twice the region's reserves at the onset of the 1998 crisis and a large war chest in the event of a global liquidity crunch.

Together, these facts points to a Latin America that is more poised to engage in sustained growth and less vulnerable to external shocks than at any other time in recent history. Even the market seems to have adopted the "this time is different" view: credit ratings have improved significantly during the current expansion and the region as a whole is only a notch

below investment grade status. More importantly, recent turmoil in US financial markets has had only mild repercussions in Latin America's bond markets.

What is the downside to this story? Research shows that once the veil of the external bonanza is lifted, a host of vulnerabilities become apparent. This issue of IDEA draws upon a study presented at the IDB's annual meetings in Miami, FL. to look at whether Latin America's recent growth really is extraordinary, whether its twin fiscal and current surpluses are actually that large and whether the subprime crisis is a useful measure of the region's strength. Taking this devil's advocate's position points to a policy agenda that could help the region continue to grow and remain crisis-free.



The complete study from which this newsletter draws is titled: **All That Glitters May Not Be Gold: Assessing Latin America's Recent Macroeconomic Performance**. It can be accessed on the Research Department web-site at: <http://www.iadb.org/res/glitter.cfm>

This issue of IDEA was prepared by Alejandro Izquierdo and is based on a research paper prepared with Ernesto Talvi with contributions from Luis Catao, Eduardo Cavallo and Andrew Powell.

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The Truth about Growth

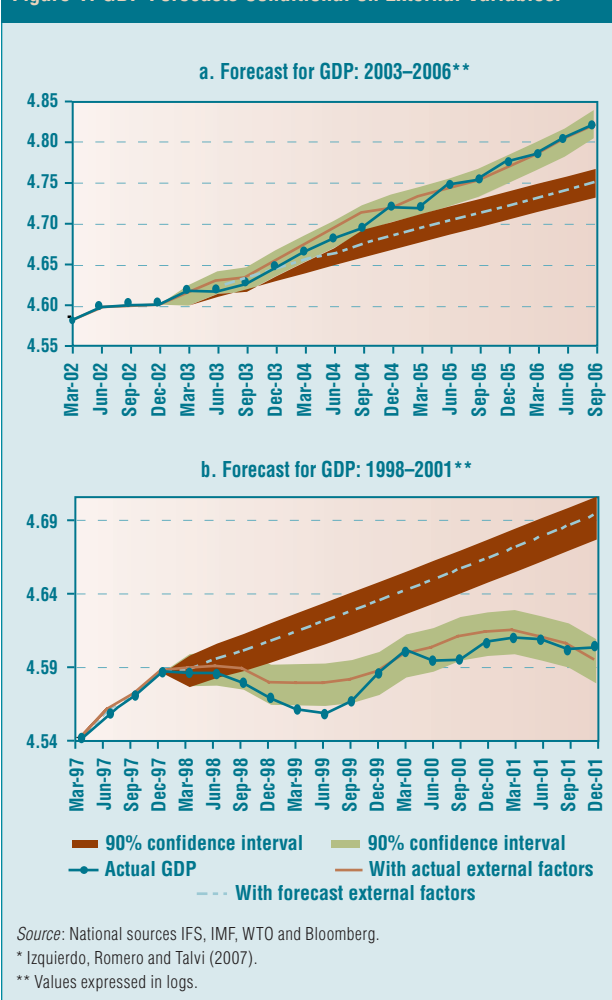
With growth averaging near 6% since the end of 2002, Latin America's recent expansion has been remarkable—or has it? Looked at from various angles, the region's growth performance is perhaps less spectacular than it appears at first glance. At the very least, the idea that better economic management at home is responsible for most of this growth spurt is highly suspect. And if the bulk of this expansion is not home-grown, then how can countries count on future growth?

First of all, who should Latin America thank for its recent economic performance? Empirical evidence strongly suggests that external factors such as world growth, commodity prices and international financial conditions for emerging economies (EMs) play a key role in economic fluctuations in the region. Recent experience is no exception and is, in fact, an exaggerated example of this tendency. During the current expansion through year-end 2007, the region enjoyed unusually favorable external factors when compared to those prevailing during the previous expansion of 1991–97: world growth was 1.4 percentage points stronger, commodity prices 76% higher, and Emerging Market Bond Index (EMBI) spreads about 400 basis points lower than during the 1991–97 expansion. In this context, it is clear that while improved fundamentals may have helped LAC-7 economies, they owe much of their recent boom to external factors. In fact, what was exceptional was the external environment, not necessarily domestic growth. As Figure 1 illustrates, had these external conditions been known, forecasts for growth would have been close to the 5.6% observed rate (see red line of panel a). And if external factors had followed historical trends, average growth would have been predicted at only 3.8% (see

light blue dotted line of panel a)—almost 2 percentage points less than the observed growth rate—a much less impressive number when compared to the 3% historical rate.

But what if the external environment were to remain favorable for the foreseeable future? Chances are growth rates would slow down significantly, because some of the improvements in external variables may have level effects rather than growth effects. For example, it has been argued that the large increase in commodity prices faced by the region reflects changes in the world economy due to the emergence of China as a global player. Therefore, high commodity prices are here to stay and no declines are to be expected in the near future. Yet, even if this were the case and commodity prices were to remain high, their impact would not necessarily lead to sustained growth, but rather have a level effect on GDP. Firms may adjust their production scale by choosing a higher capital stock matching higher commodity prices, but once optimal production levels consistent with new prices have been reached, a slowdown would occur. To the extent that adjustment costs exist, convergence to new production levels could show up as higher GDP growth for a while, but

Figure 1. GDP Forecasts Conditional on External Variables:



growth rates should be high only temporarily until convergence to desired new and higher output levels is attained.

Viewing Latin America's growth rate compared to other emerging regions is another sobering experience. While 5.6% growth may appear exceptional, it still puts Latin America behind every other emerging region, including Africa (see Figure 2). Admittedly, some regions may have reaped greater benefits from the external shocks, most notably in

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The Twin Surpluses: Cause for Comfort?

At first glance, the countries of the region appear to be in the enviable position of displaying “twin surpluses” in both their fiscal balances and current accounts. Because of the current expansion, Latin America now enjoys an observed fiscal surplus in excess of one percent of GDP and is a net lender to the rest of the world. A closer examination, though, presents a more troubling scenario.

Fiscal Surplus

Since the current expansion has been associated with strong output growth, high commodity prices and a resulting increase in revenues, improvements in the observed fiscal position reflect a favorable macroeconomic environment rather than fiscal restraint. While a more accurate portrayal of fiscal poli-

cy during the current expansion would extract the effect of cyclical variations and compute the structural fiscal balance, traditional ways of computing the structural fiscal balance do not consider the commodity price fluctuations or macroeconomic volatility that affect Latin America. For this reason, an alternative exercise that addresses these issues is to “implicitly adopt” the methodology followed by Chile since 2001, which at the same time follows a cautious approach to measuring booms.

Applying this approach leads to the surprising—and distressing—conclusion that the region’s structural fiscal balance may have *deteriorated* rather than improved during the current expansion. This should be surprising, given that total public expenditures have risen along with revenues. Figure 3 shows

that, on average, the region’s seven largest economies have spent 77% of the revenue bonanza since 2002.

Pro-cyclicality in government spending would not be a serious problem in and of itself if the revenue bonanza were being used mainly to increase investment spending. Public investment spending may not only increase future output, but may also represent a flexible budget item that can be adjusted in times of revenue shortfalls and limited access to international capital markets.

Investment expenditure in LAC-7, however, represents only 13% of primary spending—half the level in emerging Asia. While public investment is increasing in absolute terms, this low percentage of capital spending as a

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The Truth about Growth ► *from page 3*

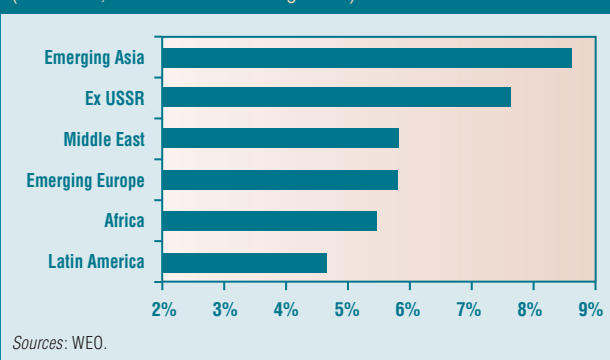
terms of trade. Still, it puts Latin America’s achievement in perspective and puts a damper on the region’s exuberance.

To a certain extent this should come as no surprise. In spite of exceptional external conditions, Latin America’s private investment and productivity during the current expansion have not performed much better than during the first four years (1991–1994) of the previous expansion period. The prospect of future economic growth is an important determinant of the profitability of investment opportunities. If economic agents expect sustained economic growth, the forces of private investment should be unleashed and spur on exceptional investment growth. This simply has not occurred. At the same time, IMF (2006) data indi-

cate that, if anything, total factor productivity growth in LAC-7 has been lower in the current 2003–2006 expansion period than in the period 1991–1994 (2.5% vs. 2.7% annually, respectively), and it is still the lowest among emerging regions, averaging less than 1% per year since 1990.

In sum, Latin Americans can be happy about the growth they’ve enjoyed since 2002 but they should think twice before patting themselves on the back. As usual, external factors seem to be driving the expansion and even if world

Figure 2. Growth in Emerging Markets: A Comparative Perspective
(Real GDP, 2003–2007 annual growth)



conditions should remain favorable, the prospect that economies will keep up the pace is questionable. Anyway, Latin America’s growth is only exceptional compared to its own past performance; compared to the rest of the developing world, it still brings up the rear.

Figure 3. Fiscal Revenues and Expenditures*
(Adjusted Revenues following the “Chilean Fiscal Rule”)

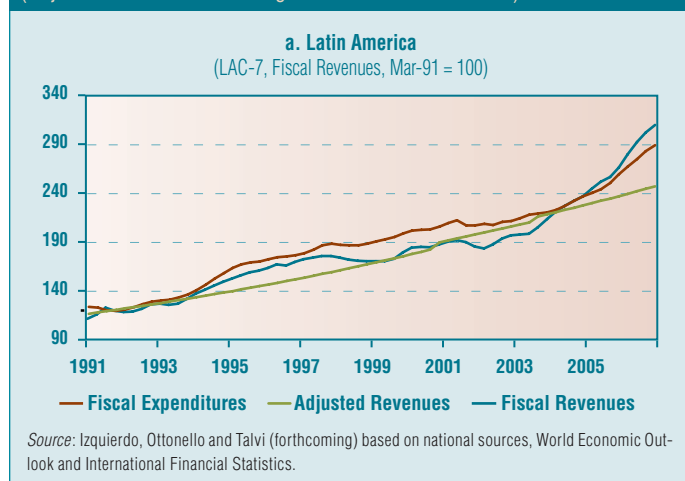
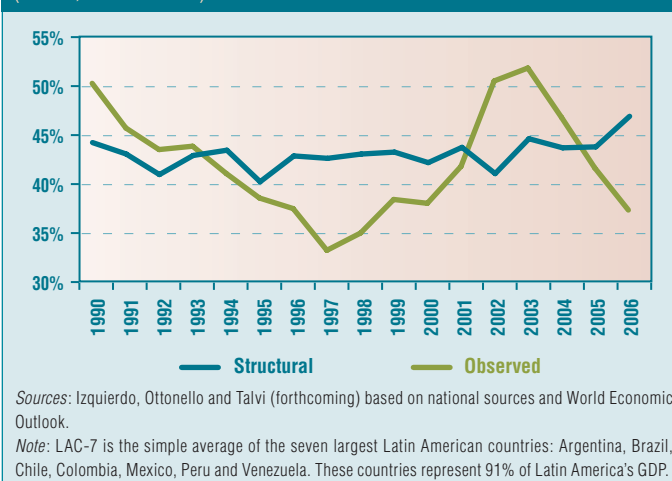


Figure 4. Observed and Structural Public Debt
(LAC-7, in % of GDP)



share of primary spending means that the region is both failing to take long-term advantage of the current boom and leaving itself with little flexibility in the face of adverse external shocks.

Public Debt Management

It would additionally be mistaken to take too much comfort in the decline of public debt as a share of GDP; such a decline is typical during expansions.

When cyclical behavior is filtered out of the calculation, structural ratios of debt to GDP have been rising slightly throughout the current expansion and are now hovering around 50% of GDP, a relatively high level according to IMF criteria for emerging markets (see Figure 4).

Favorable changes in debt composition during the current expansion—i.e., less dollarization, longer maturities, and a larger proportion of debt at fixed interest rates—might conceivably allow Latin America to sustain higher levels of debt. These changes, however, are themselves dependent on the very favorable external environment. It is easier to issue debt in domestic currency when exchange rate appreciation expectations are in place or to issue long-term debt at fixed rates when markets expect interest rates to fall.

If expectations regarding the direction of interest rates and the exchange rate were to change, debt composition could again tilt very quickly toward riskier debt, as occurred in Mexico in 1994 and Brazil in 1998.

The Current Account Surplus

Latin America's current account surplus creates the impression that the region does not depend on volatile external financing to propel the current expansion, making financial crises less likely.

The question is whether a current account surplus position is likely to insulate the region against a global liquidity crunch. After all, a current account surplus implies the region is a net lender to the rest of the world, and net lenders can finance themselves by simply refusing to lend.

Although this argument seems compelling, it may neglect two relevant issues. First, it is important to separate stocks and flows. A country with a current account surplus might still find it difficult to roll over existing stocks of debt during a global liquidity crunch.

Second, a current account surplus does not guarantee that every sector in the economy is a net lender. This observation is especially relevant for Latin America, which in the last five

years has enjoyed a sizable improvement in its commodity export prices and terms of trade.

Although net capital inflows have been very small throughout the current expansion cycle, they have been accompanied by a surge in gross capital inflows as well as equally large gross outflows. In short, some sectors have increased their exposure to foreign lending while other sectors—especially those that benefit from improving terms of trade—have shipped their savings abroad.

What would happen if turmoil hits international financial markets for EM and capital stops flowing to net borrowers? Previous experience in Latin America suggests that those in the private sector who accumulated surpluses abroad are unlikely to be willing to repatriate international liquidity to bail out the rest of the economy when foreigners are running for the exits. Even countries with commodity stabilization funds, such as Chile, might have political and practical difficulties allocating those funds on short notice.

While the current expansion has clearly benefited both governments and the population at large, it would be unwise to become complacent in the face of the twin surpluses, which hide potentially relevant vulnerabilities.

Surviving the Subprime Crisis: Who Deserves the Credit?

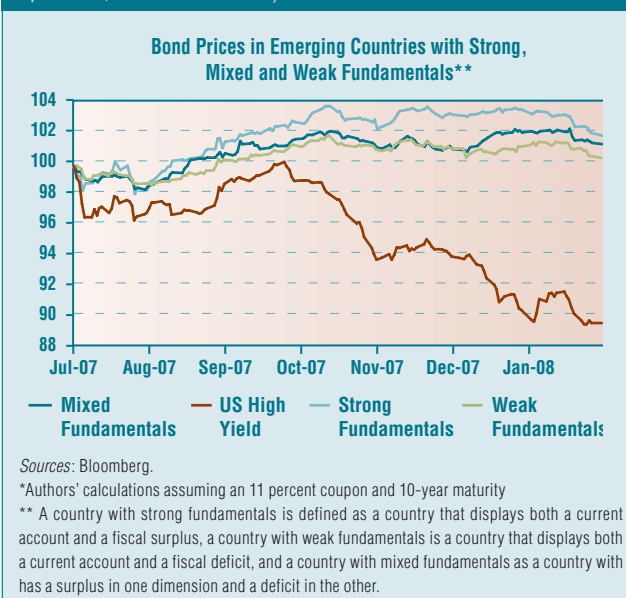
Since mid-2007, the US subprime mortgage market crisis has expanded to a wide variety of assets including the US HY bond market, and the end of this crisis is nowhere in sight. Moreover, the subprime crisis and the associated credit crunch are now contributing to a real fear of a recession in the US economy. In the past, crises in the U.S. have spelled disaster for Latin America but to date the region has remained relatively unscathed. Does this mean the region has finally found a way to protect itself from outside shocks? Are Latin American economies fundamentally sounder? Do the region's governments deserve a pat on the back? Or is there something else going on that is breeding a false sense of security?

Emerging economy asset prices have traditionally been very closely correlated to asset prices in the US. However, during the current subprime crisis, correlations have been much lower than expected. While EMBI spreads and emerging economy CDS spreads have widened, the movement is minimal compared to the tumult seen in previous crisis episodes. Indeed, while US HY bond prices fell by 11% between July 2007 and March 2008, an index of Latin American bonds remained unchanged. But before toasting to Latin America's new-found strength, a glance around the world raises some interesting questions. Surprisingly, both EMBI bond prices in Emerging Asia and Emerging Europe responded to the subprime crisis in much the same way as Latin America's bond prices. This result, if only driven by fundamentals, would imply that Latin America's fundamentals and those in other regions are quite similar.

A closer look at the fundamentals revealed some interesting results. A set of countries included in JP Morgan's EMBI were classified into three groups: countries with strong, mixed and weak fundamentals. A country with strong fundamentals is defined as one with both a current account and a fiscal surplus; a country with weak fundamentals displays both a current account and a fiscal deficit; and a country with mixed fundamentals has a surplus in one dimension and a deficit in the other. Averages range from a current account surplus of 7.4% of GDP and a fiscal surplus of 4% of GDP for the group with strong fundamentals, to current account and fiscal deficits of 3.9% and 3% of GDP, respectively, for the group with weak fundamentals. To obtain some sense of the dispersion among this set of EMs, consider the cases of Chile and El Salvador that belong to the strong and weak fundamentals group, respectively. While Chile enjoys a current account surplus of 3.6% of GDP and a fiscal surplus of 7.7% of GDP, El Salvador has a current account deficit of 4.7% of GDP and a fiscal deficit of 2.9% of GDP.

The behavior of bond prices of these three groups of emerging countries is illustrated in Figure 5, and is exactly as would have been expected: since July

Figure 5. Emerging Markets' Reaction to US Subprime Crisis
(US High Yield and Emerging Markets Bond Index, Bond Price Equivalent, 23-Jul-07 = 100*)



2007, bond prices of countries with strong fundamentals have increased by more than those of countries with weak fundamentals (2.2% vs. 0.7%, respectively), while bond prices in countries with mixed fundamentals increased somewhere in between (1.6%). However, the differences in bond price performance among the three groups of emerging countries are not only small in absolute terms, but they also pale in comparison with the fall in the US HY bond market (11%). If countries in Latin America covered by the EMBI were to be classified into these same three groups very similar results would be obtained.

Thus, while fundamentals do help in determining a country's bond price reaction to the subprime crisis, they do

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Act Now, Benefit Later

Because all that glitters may not be gold, Latin American countries could benefit if they took advantage of the external bonanza to further improve their macroeconomic fundamentals. Clearly, most countries have made important progress in recent years and macroeconomic management has improved noticeably. However, jitters over the future of the world economy call for a cautionary approach to policy. Policymakers should resist the temptation to ride favorable tailwinds alone; instead, they should work resolutely to achieve goals that take into account cycles in the international economy, commodity prices and world financial conditions.

In particular, the current upsurge in international liquidity thanks to the US Fed's aggressive intervention may further blur the picture. Lower exposure of EMs to subprime assets and relatively attractive yields make them good candidates—at least in the short run—for additional capital inflows. Thus, Latin America's gold may glitter even more as macroeconomic indicators improve even further—at least temporarily—in spite of the shaky US economy. Such complacency may be particularly misplaced because eventually, interest rates in the US may jump substantially as the Fed fights the inflationary consequences of its current actions.

The set of policies discussed here is not exhaustive and detailed policy prescriptions are better left at the individual country level, but some broad policy principles could help countries steer through what are sure to be rougher waters in the future. To begin with, fiscal rules should be strengthened even further. Targeting structural rather than observed budget

surpluses, as Chile does, would be a considerable improvement. By adjusting revenues to account for cyclical fluctuations in both the economy and commodity prices, structural budget rules would go a long way toward preventing pro-cyclical government spending. They would also help reduce debt more rapidly in times of plenty, thereby limiting exposure and leaving countries better prepared to weather the rainy days. In this vein, countries would be wise to set specific structural fiscal targets that aim to reduce *structural* public debt and, therefore, underlying financial exposure. Many countries in the region still have unsafe levels of public debt. Cutting them down to safe levels is particularly important, since relying too heavily on changes in debt composition to limit the riskiness of debt can be an insufficient strategy given the speed at which debt composition can change on the eve of a crisis. Good management in terms of debt composition geared toward safer debt is welcomed but should be pursued in tandem with debt reduction strategies.

Fiscal rules could also be strengthened to ensure adequate levels and quality of public investment. Public investment is not only a key complement to private investment, it is also relatively more flexible than current expenditures—many times synonymous with entitlements—and thus helpful in coping with budget cuts in times of distress. Public investment as a share of primary expenditures has slipped significantly in the region to a meager 13%, half that of Asian countries and well below the levels of the early 1990s. Boosting the share of expenditure channeled to investment is both good short-run macroeconomic

Jitters over the future of the world economy call for a cautionary approach to policy.

policy and good long-run growth policy.

On another front, regulation and supervision of the banking system matters, particularly during a credit boom. The rapid increase in domestic bank credit should be a source of concern for the region. In the past, credit booms have been too often followed by financial busts. In the boom period, competition between lenders becomes paramount and proper risk assessment may be sacrificed in order to maintain market share. Moreover, during a boom, since new credits are deemed good credits, banks' delinquency ratios decline. Although regulation and supervision have improved and financial systems have been strengthened by the entry of foreign banks, since some financial systems are growing from a small base, rapidly growing household, and in some cases, corporate debt remains a significant concern. Indeed, recent events have shown that sophisticated banks from developed countries supervised by regulators with wide powers and excellent resources—much more than their Latin American counterparts—do not guarantee that problems can be avoided.

The key point is that it is in this boom phase that regulation and super-

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Act Now, Benefit Later

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vision should be strengthened. Once the boom is over and credit growth subsides is when problems appear and when it is frequently too late to prevent financial distress. Countries should be ensuring that banks' capital ratios and provisions are growing pro-cyclically and as a percentage of assets, not just in dollar amounts. Moreover, in sectors where credit growth is very strong (consumer credit being one example) supervisors should ensure that banks' risk management processes take a very cautious view of clients' risks and ensure that competitive pressures do not push them to take shortcuts in the risk management process.

As far as building up international reserves, the best policies to insure against external shocks would call for contingent contracts or contingent credit lines, rather than self-insurance via reserve accumulation. Yet, in the absence of a strong supply of this type of arrangements, building a strong international reserve position to avert Sudden Stops in international financial flows is an important (albeit second best) policy objective. However, the way reserves are accumulated is relevant when assessing their insurance value. Clearly, it would be best to increase international liquidity by accumulating resources that do not have a liability counterpart (e.g., stabilization funds) rather than through sterilized or unsterilized intervention. Although the region enjoys greater exchange rate flexibility than in the past, the bulk of reserves were amassed by issuing monetary liabilities that accompanied reserve accumulation. Arguably, acquiring reserves through exchange rate market intervention, although costly, could work as an insurance policy, given that central banks would have "reserves in hand" in the event of a crisis. Howev-

er, monetary liabilities may still pose a serious threat under pressure from large adverse external shocks; if these liabilities claim the reserves just when they are most needed, their insurance value will be minimal.

Evidence suggests that private investment during the current expansion has not been particularly strong relative to past expansions. Certainly, the external environment cannot be blamed, as external factors have been much more favorable this time around. Looking inward, countries must create conditions conducive to increasing investment and raising productivity

so as to ensure that the current growth process is long-lasting and less dependent on international conditions.

Clearly, many Latin American countries have reason to be proud of the advances they have made in recent years, but the work is not finished. Most probably, none of the vulnerabilities discussed in this newsletter would alone be sufficient to precipitate a crisis of the type the region has suffered in the past. But a careful and balanced reevaluation of the region's strengths and weaknesses today, could avoid a crisis and ensure long-term growth in the future.

Surviving the Subprime Crisis

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not appear to be the key driving force behind Latin America's performance. If that were the case, countries with strong fundamentals should have performed much better during the current subprime crisis than countries with weak fundamentals.

So how did bond prices in every emerging region and in every country within these regions, regardless of the strength of its fundamentals, manage to decouple from the subprime crisis? One possible explanation relates to the source of the crisis. This event was related to subprime mortgages in the US, which is somewhat unrelated to the price of a sovereign emerging economy asset. Moreover, in its attempt to soften the effects of the crisis on the US economy, the Federal Reserve intervened massively and in all likelihood helped to isolate the crisis and prevent contagion into other asset markets, thus limiting collateral damage.

Latin America's ability to distance

itself from the subprime crisis stands in stark contrast with the behavior of EM spreads at the time of the Russian crisis, when spreads skyrocketed relative to US HY spreads. However, developments in the aftermath of the Russian crisis differed from the current subprime crisis in two respects. First, unlike the subprime crisis, which detonated at the center, the financial crisis of 1998 detonated at the periphery, more specifically in emerging market Russia. Moreover, the Federal Reserve did not pump up liquidity as aggressively, since US financial markets remained largely unscathed.

Thus, the credit for Latin America's survival of the subprime crisis would seem to lie less with the countries themselves as with the nature of the crisis. Differences both in the origin of the shock as well as in the hard-currency liquidity provision may better explain the behavior of EM spreads then and now.

New Publications

Available in English only unless otherwise stated.

BOOKS

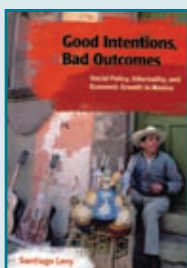


Bond Markets in Latin America: On the Verge of a Big Bang?

Eduardo Borenzstein, Kevin Cowan, Barry Eichengreen and Ugo Panizza,

Eds. Cambridge, Mass: MIT Press

Bond markets are an essential component of a well-functioning financial market and developing local bond markets is high on the policy agenda of Latin America. Latin American bond markets are growing, and may even approach a “big bang”-like surge, although significant challenges remain. This first comprehensive examination of the importance of local bond market development in Latin America provides conceptual and comparative assessments, case studies of six countries, surveys of firms and investors, and a cross-country economic analysis of the determinants of bond market development



Good Intentions, Bad Outcomes: Social Policy, Informality and Economic Growth in Mexico

Santiago Levy Algazi.

Washington, DC:

Brookings Institution Press.

This book studies the link between misguided social programs, low productivity and wages, and disappointing growth in Mexico. Although focused on Mexico, the issues considered are faced by most developing countries, in Latin America and beyond.

RESEARCH DEPARTMENT WORKING PAPERS

Gender Segregation in the Workplace and Wage Gaps: Evidence from Urban Mexico 1994–2004 (WP-636)

Sebastian Calonico and Hugo Nopo

This paper analyzes the evolution of gender segregation in the workplace in Mexico between 1994 and 2004 to explore the role of individual and family characteristics in determining gender segregation and wage gaps. The results suggest that completely eliminating hierarchical segregation would reduce the observed gender wage gaps by 5 percentage points, while eliminating occupational segregation would increase gender wage gaps by 6 percentage points. Also, the role of occupational segregation in wage gaps has been increasing in magnitude during the period, while the role of hierarchical segregation has been declining.

Systemic Sudden Stops: The Relevance of Balance-Sheet Effects and Financial Integration (WP-637)

Guillermo A. Calvo, Luis Fernando Mejía, Alejandro Izquierdo

This paper analyzes the characteristics of systemic sudden stops (3S) in capital flows and the relevance of balance-sheet effects in their materialization. A small supply of tradable goods relative to their domestic absorption—a proxy for potential changes in the real exchange rate—and large foreign-exchange denominated debts towards the domestic banking system are found to be key determinants of the probability of 3S. While financial

integration is up to a point associated with a higher likelihood of 3S, beyond that point financial integration is associated with a lower likelihood of 3S.

Stated Social Behavior and Revealed Actions: Evidence from Six Latin American Countries Using Representative Samples (WP-634)

Juan Camilo Cardenas, Alberto Chong, Hugo Nopo

This paper explores the link between what people say they prefer to do and what they actually do. The paper links the results of experiments on trust and pro-sociality in six Latin American capitals with the responses obtained from representative surveys to the same participating individuals. Individuals with higher agreement with a set of pro-social statements are more willing to contribute to the social welfare of the community, and what people say is linked to what people do. This supports the idea that the inclusion of subjective controls on the lefthand-side in an empirical specification does carry useful information.

Soap Operas and Fertility: Evidence from Brazil (WP-633)

Alberto Chong, Suzanne Duryea and Eliana La Ferrara

This paper focuses on fertility choices in Brazil, a country where soap operas (novelas) portray families that are much smaller than in reality, to study the effects of television on individual behavior. Using census data for 1970–1991, the paper finds that women living in areas covered by the Globo signal have significantly lower fertility. The effect is strongest for women of

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New Publications

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lower socioeconomic status and for women in the central and late phases of their fertility cycle. Finally, the paper provides evidence that novelas, rather than television in general, affected individual choices.

On the Micro-Foundations of Contract versus Conflict with Implications for International Peace-Making (WP-644)

José Cuesta, Syed Mansoor
Murshed

This paper expands the micro-foundations of the traditional greed and grievance non-cooperative model of civil conflict between a government and a rebel group. The extensions provide a better understanding of conflict persistence, the consequences of competing international aid and why sub-optimal sanctions provision (“cheap talk”) by the international community are frequent.

Gender and Ethnic Wage Gaps in Guatemala from a Matching Comparisons Perspective (WP-641)

Alberto Gonzales and
Hugo Ñopo

This paper analyzes gender and ethnic wage gaps in Guatemala for 2000–2006. It finds pronounced wage gaps along both gender and particularly ethnic dimensions. Wage gaps in Guatemala are partially explained by differences in human capital characteristics, especially education, between indigenous and non-indigenous and males and females, which calls for equalization of educational opportunities. However, wage gaps are greater than differences in education would predict, which suggests the need for information campaigns to raise consciousness of the need for equal opportunities in labor markets.

Breaking Credibility in Monetary Policy: The Role of Politics in the Stability of the Central Banker (WP-639)

Miguel Rueda

This paper studies the relationship between the hazard rate of the exit of a president of a central bank and a measure of credibility in monetary policy. The expected hazard rate of exit is estimated as a function of legal and political variables. The measure of credibility is the expected probability of a disinflation beginning when inflation is rising. For a sample of 22 Latin American and G7 countries, the paper finds a negative relationship between the hazard rate of exit and the measure of credibility. The results show that legal independence after controlling for the hazard rate of the president's exit is not associated with credibility gains.

Political Participation and Quality of Life (WP-638)

Rebecca Weitz-Shapiro and
Matthew S. Winters

Theoretical literature on procedural utility and the psychological benefits of political participation suggests that people who participate in political activities are more satisfied with their lives because of the resulting feelings of autonomy, competence and relatedness. Individual-level data from Latin America show a positive and statistically significant relationship between voting and life satisfaction. Variation in desire to vote as measured in Costa Rica, however, suggests that the causal arrow may run from happiness to voting. There is a cross-country negative relationship between enforced compulsory voting and happiness.

RESEARCH NETWORK WORKING PAPERS

New Export Activities in Brazil: Comparative Advantage, Policy or Self-Discovery? (R-551)

Armando Castelar Pinheiro,
Regis Bonelli

This paper examines Brazil's export discoveries in aircraft, cell phones and swine meat. All cases confirm the importance of efficiency gains and sunk costs in expanding exports and lead to the following conclusions: both economic policy and comparative advantage played important roles in new export activities; economies of scale were crucial to competitiveness; and a well-known brand helped overcome information asymmetries and facilitate entry into export markets. Regarding public policy, while governments can foster discoveries, policy alone cannot produce a successful exporter.

An Experimental Study of Labor Market Discrimination: Gender, Social Class and Neighborhood in Chile (R-541)

Claudia Sanhueza, David Bravo,
Sergio Urzua

This paper studied the presence or absence of gender discrimination. The study consisted of sending fictitious Curriculum Vitae for real job vacancies published weekly in the Santiago newspaper El Mercurio. A range of strictly equivalent CVs in terms of qualifications and employment experience of applicants are sent out, varying only in gender, name and surname, and place of residence. The results show no significant differences in callback rates across groups, in contrast with what is found in other international studies.

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New Publications

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Ability, Schooling Choices and Gender Labor Market Discrimination: Evidence for Chile (R-558)

Claudia Sanhueza, David Bravo, Sergio Urzua

This paper analyzes the impact of schooling levels on gender gaps in the Chilean labor market. The paper uses a rich data set on labor market outcomes, schooling attainment and schooling performance, as well as variables characterizing individuals' family background. Although the results show statistically significant gender differences in several dimensions of the Chilean labor market, these gaps depend largely on individuals' level of schooling. These findings should not be taken as decisive evidence of discrimination in the Chilean labor market.

Is There Labor Market Discrimination among Professionals in Chile? Lawyers, Doctors and Businesspeople (R-545)

Claudia Sanhueza, David Bravo, Sergio Urzua

This paper analyzes gender differences in three Chilean professional labor markets: business, law and medicine. The results show that differences in wages attributed to gender are only present in the legal profession. In business/economics, a vector of current family condition eliminates the gender effect and in medicine, taking into account hours worked, size of firm and region also eliminates gender differences. The paper further shows that individuals' perceived locus of control (internal or external) is relevant in explaining the distribution of earnings.

OUTSIDE PUBLICATIONS

Labor Institutions and Income Inequality: An Empirical Exploration

Cesar Calderon and Alberto Chong, *Public Choice*, June 2008.

This paper presents evidence on the impact of labor regulations on income inequality. It finds that both *de jure* and *de facto* regulations improve the distribution of income although the former appear to be non-robustly associated with improving income inequality. This result partly reflects the fact that regulations are endogenous and, more interestingly, that different regulations yield distinct effects.

Does Compulsory Voting Help Equalize Incomes?

Alberto Chong and Mauricio Olivera, *Economics and Politics*, June, 2008

This paper explores the link between compulsory voting and income distribution using a cross-section of countries around the world. The empirical cross-country analysis for 91 countries from 1960 to 2000 shows that when compulsory voting can be strongly enforced the distribution of income improves. Since poorer countries have relatively more unequal distribution of income it might make sense to promote such voting schemes in developing regions, such as Latin America. This assumes that bureaucratic costs related with design and implementation are not excessive.

Foreign Aid, The Donor's Perspective.

Alberto Chong and Mark Gradstein, *Journal of Development Economics*.

This paper examines the factors affecting support for foreign aid among voters in donor countries. The theoretic-

cal model suggests that government efficiency is an important factor, and ties individual income to aid support through the elasticity of substitution. An empirical analysis of individual attitudes, based on the World Values Surveys, reveals that two factors are positively related to support for foreign aid: satisfaction with one's own government performance and individual relative income. Furthermore, aid is negatively tied to inequality, corruption and taxes.

(Lessons from the Financial Crisis of 2002. Eduardo Fernández-Arias, In Uruguay: What Did We Learn from the Financial Crisis of 2002)

Algunas enseñanzas de la crisis financiera de 2002. Eduardo Fernández-Arias, En Uruguay: Qué aprendimos de la crisis financiera de 2002. Available in Spanish only. World Bank and Economics and Finance Ministry of Uruguay.

The 2002 financial crisis in Uruguay provides lessons for both countries with financial vulnerabilities and multilateral organizations. This article focuses on three lessons: a) the minimalist strategy adopted to resolve the banking crisis and the subsequent re-profiling of the public debt as a key to a solid recovery; b) the need to use effective public debt indicators that adequately measure the underlying debt during boom times in order to correctly evaluate the risk of fiscal unsustainability and define a prudent fiscal policy; and c) the importance of financial dollarization as a macroeconomic risk factor and the justification for prudent financial de-dollarization policies. The chapter also provides ideas for future international cooperation among multilateral organizations and financially vulnerable countries such as Uruguay.



Network News

www.iadb.org/res/researchnetwork

The Selection Committees for the following research projects on Productivity have announced the proposals selected for the studies:

- **Understanding Productivity Levels, Dispersion and Growth in Latin American and Caribbean Industries**
A project of the IDB Research Network

- Argentina UTDT – Universidad Torcuato Di Tella
– CIF – Centro de Investigación en Finanzas
- Argentina IERAL – Fundación Mediterránea
- Bolivia INESAD – Instituto Nacional de Estudios Avanzados del Desarrollo
- Brazil Universidade Federal do Rio de Janeiro & IPEA
- Colombia Fedesarrollo – Fundación para la Educación y el Desarrollo
- Uruguay Universidad ORT & Universidad de la Republica – Departamento de Economía

- **Estimating the Causal Effect of Economic Policies on Productivity in Latin America and the Caribbean**
A project of the IDB Country Studies Initiative

- Brazil Eduardo Pontual Ribeiro & João Alberto DeNegri, UFRJ
- Chile Rodrigo Fuentes & Jose Miguel Benavente, PUC-Chile
- Colombia Marcela Eslava, John Haltiwanger, Adriana Kugler, Maurice Kugler & Camilo Morales
- Uruguay Carlos Casacuberta & Dayna Zaclicever, Universidad de la República

- **The Political Economy of Productivity: Actors, Arenas and Policymaking**
A project of the IDB Country Studies Initiative

- Argentina Santiago Urbiztondo, Sebastián Saiegh, Marcela Cristini, Cynthia Moskovits
– FIEL
- Bolivia Luis Carlos Jemio M., Fernando Candia C., José Luis Evia V., INESAD – Instituto Nacional de Estudios Avanzados del Desarrollo
- Brazil Carlos Pereira, Bernardo Mueller, Marcus Melo, Lee Alston, FGV – Fundação Getúlio Vargas
- Chile Nicolás Eyzaguirre, Cristobal Aninat, José Miguel Benavente, Ignacio Briones, Patricio Navia, Jocelyn Olivari, Universidad de Chile

- Colombia Marcela Eslava & Marcela Meléndez,
- Costa Rica Edgar Robles Cordero, Gilberto E. Arce, Ecoanálisis S.A.
- México Angel Calderon & Dwight D. Dyer, Colegio de Mexico
- Venezuela José Manuel Puente, Abelardo Daza, Pavel Gómez, Michael Penfold, IESA
– Instituto de Estudios Superiores de Administración

EVENTS

LACEA (Latin American and Caribbean Economic Association) Annual Meeting November 20–22, 2008 ■ Rio de Janeiro, Brazil

The IDB Research Department will participate with numerous seminars including:

- Quality of Education in Latin American and the Caribbean
- The Science of Happiness
- Quality of Urban Life in Latin America and the Caribbean
- Understanding Quality of Life in Latin America and the Caribbean
- Disaster Risk Management in Latin America and the Caribbean
- The Political Economy of Development
- Social Programs, Poverty and Productivity
- Brazil and the Global Economic Outlook
- All that Glitters may not be Gold: Pending Macroeconomic Challenges for Latin America and the Caribbean
- Resolving Banking Problems

Fifth Workshop of the Latin American Financial Network (LFN)

November 19, 2008 ■ Rio de Janeiro, Brazil
Call for Proposals

The fifth workshop of the LFN, co-organized by the IDB and the World Bank LAC Chief Economist Office will immediately precede the LACEA Annual Meeting. The LFN seeks papers on any topic in finance, although preference will be given to papers with relevance to emerging countries and Latin America in particular. Papers must be sent to lfm@iadb.org no later than September 30, 2008. Decisions will be announced by October 15.