I D E A
Ideas for Development in the Americas

Reform Fatigue

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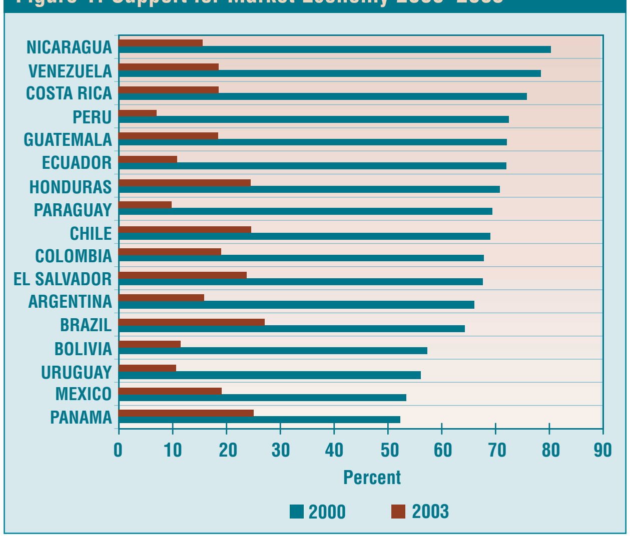
The era of ambitious economic reforms is over. True, most blatantly inefficient economic policies have been corrected in many Latin American countries. But that's not the only reason that reform fever has cooled off. More importantly, there are signs of reform fatigue: the lack of public support, a loss of confidence in the benefits of pro-market reforms, and/or a less proactive stance towards reform. Public opinion has largely turned against further pro-market reforms, and fatigue is also affecting views of policymakers, international organizations and international economic advisers. The sustainability of reform will hinge on the beliefs and attitudes of the following main players: voters, policymakers, opinion leaders and the international community.

Public Opinion Turns Against Reform

Latin Americans have become increasingly critical of pro-market reforms. According to the *Latinobarómetro* annual surveys, which have covered 17 Latin American countries since 1996, in 1998 more than 50 percent of Latin Americans thought that privatization was beneficial for their country. This percentage dropped to 31 percent in 2001 and to 25 percent in 2003. Likewise, in 1998, 77 percent of Latin Americans thought that a market economy was good for the country. In 2003, support for a market economy plunged to 18 percent. Therefore, support for pro-market policies has been declining steadily since 1998.

Figure 1 illustrates the results of Latinobarómetro surveys. In 2000 people were asked, "Do you think that a market economy is good for the country?" In 2003, the question was, "Are you satisfied with the functioning of the market economy?" The figure highlights large cross-country differences in the support for reform. Support for a market economy ranges between about 30 percent in Brazil and about 8 percent in Peru. Nicaragua, Venezuela, Peru and Ecuador are among the countries where support for market economies has dropped by the largest amount.

Figure 1. Support for Market Economy 2000–2003



Source: Latinobarómetro

Policymakers: Rhetoric or Reality

In recent years Latin America's political leaders have increasingly blamed free market policies for low economic growth and high unemployment. During recent political campaigns in Argentina, Bolivia, and Ecuador, candidates critical of "neoliberal" economic policies performed well. In Argentina, Nestor Kirchner won the presidency campaigning against the "neoliberal" model and "lamentable and disastrous" IMF-imposed policies. In Bolivia, Evo Morales, who came within a percentage point of

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winning the election, described his electoral campaign as representing "the victims of neoliberalism." In Ecuador, Lucio Gutiérrez, who was compared to Venezuela's Hugo Chávez because of his military background and populist message, also spoke of how neoliberal policies had brought "disaster" to the country.

Of course anti "neoliberal" campaign rhetoric can fade once a candidate takes office. Gutiérrez won the presidency in Ecuador with the support of left-wing and indigenous groups, yet upon taking office appointed an orthodox finance minister and signed an agreement with the IMF that promised large budget surpluses and opened the state-controlled energy sector. Likewise, while Argentina's President Kirchner may have rejected the neoliberal policies of the Menem era, his differences with the model appear to be one of degrees.

In other words, while the volume of the rhetoric is up, it hasn't yet translated into a region-wide trend of policy rollback.

Opinion Leaders: Whose Side Are They On?

The importance of opinion leaders, who include influential figures in government, the private sector, the media, civil society, academia and trade unions, can hardly be overestimated. The views of opinion leaders may influence not only the probability that a reform is introduced but also the way its effects are perceived by the public, and therefore may make the difference between sustainability and rejection of the reform.

According to the Global Poll conducted by Princeton Survey Research Associates for the World Bank in 2002 and 2003, on average opinion leaders in Latin America have similar views to those of other developing regions with respect to trade liberalization and foreign direct investment, although large differences can be found between countries within the region. Unlike public opinion at large, opinion leaders generally support privatization, but many expect its effect to be only "somewhat positive." Opinion leaders are clearly divided about the impact of the so-called neoliberal model on poverty. Since they do not oppose the core elements of that model, which they consider beneficial for their countries, their views seem to imply that the reform agenda should not be reversed, but expanded, as has also been the trend among international organizations.

International Organizations and Advisers: A Broader View

During the 1990s, international organizations such as the International Monetary Fund, the World Bank and the Inter-American Development Bank were clearly aligned with the "neoliberal model" of liberal trade policies, privatization, fiscal discipline, tax reform, property rights reform and deregulation, which reflected the so-called "Washington Consensus." However, as economic growth stalled and social indicators failed to improve, international organizations expanded with four new reform items: crisis proofing, completing first-generation reforms, advancing second-generation reforms, and improving equity. Crisis proofing aims to reduce vulnerability to crises through such measures as accumulating budget surpluses and reserves, adopting a flexible currency, strengthening supervision and regulation, and increasing domestic savings. Completing first-generation reforms includes making labor markets more flexible and deepening privatization and free trade. Second-generation reforms include judicial, social security, regulatory, tax, education, and political reforms geared toward establishing an institutional foundation that can sustain economic growth. Finally, equity-improving policies comprise improved education, titling programs to secure property rights, land reform, and micro-credit.

Furthermore, a growing number of leading international scholars has moved away from the notion that pro-market reform is the essential precondition to achieve economic development. Paul Krugman has recommended the adoption of controls to international capital flows and other heterodox financial policies, and Nobel laureate Joseph Stiglitz has criticized core components of the pro-market reform agenda such as financial liberalization and privatization. In a similar vein, Dani Rodrik has stated that the key ingredients for economic growth are macroeconomic stability, strong property rights, the rule of law, and producer incentives aligned with social costs and benefits, which do not necessarily translate into the standard set of pro-market policies and institutions recommended by Washington. Jeffrey Sachs has emphasized the need for social protection and human capital accumulation over the standard stabilization-cum-liberalization approach.

Is the public tired of waiting for reform's long-promised benefits? Are policymakers scared of bearing the political costs? Are international experts less sure of their programs and prescriptions? The articles in this issue of *IDEA* examine the causes and symptoms of reform fatigue and discuss the prospects for the reform process in the region.

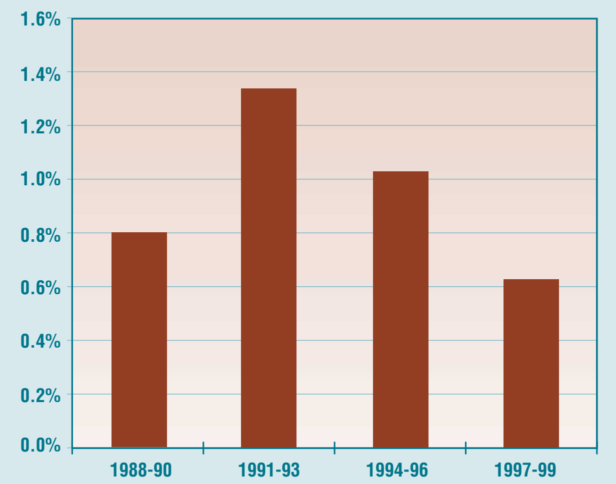
Shattered Economic Expectations

Economic growth has been disappointing. Structural reforms were supposed to put Latin America on the path to sustained economic growth, but that simply has not happened. True, growth rates in the region improved throughout the 1990s but they were well below hoped-for levels. Indeed, whereas during the so-called "lost decade" of the 1980s annual growth in the region was only 1.2 percent and per capita income fell at a rate of 0.7 percent, in the 1990s those rates rose to 3.8 and 2.1 percent, respectively. However, in the 1960s and 1970s, average annual growth was more than 5 percent and per capita income increased by around 3 percent. Undoubtedly, this lackluster economic performance has dulled public enthusiasm for reforms.

But structural reforms were not the only factor influencing productivity and growth in recent decades. Growth trends in developed countries and in the world economy as a whole, which had been encouraging in the 1950s and 1960s, fell in the following decades. In the 1990s, per capita income growth in the developed countries was the same as that of Latin American countries (1.5 percent per year for Latin America, 1.7 percent for the entire world); in the 1970s it had been 4.3 percent in the region and 4.1 percent for all countries. Other international factors limiting growth in Latin America have included unstable international prices of the region's typical exports and major changes in the amounts and costs of capital resources for the region. Growth was also affected by the quality of macroeconomic policies and other circumstances specific to each country.

While results have varied among studies of the reform period, the conclusion that can be drawn is that the reforms have had a positive but modest effect on growth (see Figure 2). Even considering the more optimistic calculations, which place the effect at close to 2 points of additional growth, the reforms by themselves could not have raised growth from –0.07 percent in the 1980s to rates around 3 percent, like those seen in the 1960s and 1970s. One of the reasons for the modest impact of the reforms may have been that they were incomplete, did not have enough internal institutional support, and took place in an unstable international environment, especially in the realm of financing, which in turn may have compromised national macroeconomic policies. This debate suggests that the reforms changed the operation of the economy less than is generally assumed and hence their impact on productivity was muted.

Figure 2. Effect of Reforms on Growth (Latin American average)



Source: Lora and Panizza (2002).

The fact that reforms had only a modest impact on productivity and growth may be at the core of the reform fatigue, even if their effects were positive. Many people probably formed their expectations of the benefits of reforms based on the promises and announcements of the reformers and the prevailing views at the beginning of the process, which were certainly over-optimistic. As people have later corrected those expectations in line with actual results, they may believe there are better policy packages to deal with the problem of low growth. Therefore, even if they do not demand a reform reversal, they become less committed to the original reform process. If this view is correct, policymakers who oversold the potential benefits of the reforms could now be blamed for reform fatigue.

Another explanation, however, is that opinion on the effectiveness of reforms is not based on complete information on its expected and actual results, but rather on a rough association between reform and macroeconomic outcomes. Using *Latinobarómetro* data, IDB researchers have found that several macroeconomic variables affect attitudes toward privatization and the market economy. Support for privatization went from 52 percent in 1998 to 25 percent in 2003, and one third of that decline seems to be associated with the economic cycle. The case of

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Reforms for the Rich?

According to popular belief, reforms help the rich but do little if anything for the poor. Even some economists, who agree that structural reforms tend to increase average income, claim they generate a pattern of economic growth that only benefits the richest segments of the population. If true, this would be a logical reason for reform fatigue. But are the claims of these critics based on fact?

One school of thought argues that reforms tend to be beneficial for the majority of the population. Their basic point is that reforms (especially trade openness and globalization) increase economic growth without producing major income distribution shifts. They conclude that the increase in average income brought about by economic liberalization is fully translated into an increase in the income of the poor.

Despite strong evidence in support of the fact that growth is distribution neutral, Ravaillon (2001) shows that going beyond averages uncovers large differences among countries in how much growth benefits the poor. In particular, he points out that the drop in the poverty rate brought about by a 1 percent increase in the growth of average household income can range between 0.6 and 3.5 percent. At the same time, Foster and Székely (2001) show that the income of the poor does not grow one-for-one with average income, but considerably less. In other words, while reforms do help reduce overall poverty, they may worsen income distribution. And clearly among the poor are some of the groups hurt directly by reforms. There is, therefore, a role for policies that take into account the distributional impact of growth.

The IDB found that structural reforms did not lead to a deterioration of income distribution and trade liberalization probably helped reduce income inequality. However, one study of wage differentials in Latin America found that from 1980 through 1998 economic reform had a short-run disequalizing effect. While domestic financial market reforms, capital account liberalization, and tax reforms widened wage inequality, privatization narrowed wage inequality. At the same time, trade openness did not have a significant effect on wage inequality. Other research, however, found that, on average, trade openness increases inequality and that the effect is stronger in countries where physical capital is relatively scarce.

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The fact that economic reforms (especially trade openness) may increase inequality in developing countries seems to fly in the face of standard economic theory, which suggests that trade openness should increase the income accruing to the relatively abundant factor of production. Given that most developing countries are abundant in unskilled labor, which is also the factor of production controlled by the poor, one would expect trade openness to improve income distribution and hence improve the relative (and not only the absolute) well-being of the poor. However, the distributional effect of reforms is extremely complex. In some countries external tariffs are focused on labor intensive products, as in the case of Mexico; in other countries the most abundant factor of production is land or natural resources.

Much has been said about the short run impact of trade liberalization and other structural reforms on employment and unemployment. Undoubtedly, the widely held perception that reforms hurt workers is behind the opposition of the public to the so-called neoliberal agenda. One of the best efforts to gather opinions on the labor and social impact of the reforms was recently undertaken by the Structural Adjustment Participatory Review International Network (SAPRIN), which used participatory methods to examine the experiences of nine countries, three of them in Latin America. According to this study, the effects of the structural reforms on labor have been predominantly negative.

In spite of these opinions, no study has been able to provide support for the belief that opening the doors to imports increases unemployment or reduces (aggregate) employment. Interestingly, trade liberalization seems to have produced very little employment reallocation, either between the tradable and non-tradable sectors or within them. The impact of privatization on unemployment has also been overstated. Even in countries where layoffs in privatized countries were massive, the effect on overall unemployment was

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Spotlight on Reform

The status and prospects of the reform process in the region took center stage at the conference "Rethinking Structural Reform in Latin America," co-sponsored by the Federal Reserve Bank of Atlanta and the Inter-American Development Bank. Held on October 23-24, 2003 in Atlanta, Georgia, the conference was attended by approximately 80 participants from throughout the Americas, including policymakers, academics, international financial officials, private sector executives and journalists.

The conference included four panel discussions focusing on governance and institutional reform, "second-generation" reforms such as tax and labor reforms, financial sector reform, and the relationship between reform and macroeconomic stability. The papers and subsequent discussions surveyed a highly varied landscape. Extensive reforms have taken place in trade and finance, with implications that are still unfolding. Significant but less sweeping policy changes have occurred in tax policy and the privatization of state-owned enterprises, though concerns about the fairness of the privatization process have led to an erosion of public support. Relatively little reform has taken place in labor policy. The continued existence of rigid labor markets appears to have prevented workers from gaining the full benefit of reforms, as effective job creation and efficient movement of workers across firms and sectors has yet to take place in much of the region.

Two speakers brought additional perspectives to the conference. In the keynote address, former Costa Rican President Miguel Ángel Rodríguez Echeverría noted that structural reforms in his country have proven difficult to implement and have met with considerable resistance. With or without extensive reforms, countries throughout the region have experienced unsatisfactory levels of growth and insufficient reductions in poverty. To continue reform processes that address these unmet needs, Rodríguez offered the following suggestions:

- Policymakers should draw on the support that already exists for goals such as controlling inflation and achieving macro stability;
- Since reform effectiveness often depends on country-specific conditions, "one-size-fits-all" solutions should be avoided;
- Existing reforms must be complemented by second-generation reforms that include strengthening institutions, improving the enforcement of contracts, coordinating policies within governments, and undertaking "soft" industrial policy to improve the business and investment climate;
- Reforms must be undertaken in ways that bolster democratic processes, the rule of law, transparency, and citizen participation.

Throughout this process, Rodríguez stated, policymakers and the public must learn that progress should be expected to occur only gradually and through a process of trial and error.

In the second day's luncheon address, noted economist Arnold C. Harberger of the University of California, Los Angeles, provided a historical perspective on reforms and other economic policy initiatives in Latin America. He stated that clear progress has been made in several areas as policymakers have increasingly acted on the basis of sound economic principles. Perhaps most notably, countries in the region have moved away from unsustainable measures such as multiple exchange rates and high tariff barriers with widely varying rates. In addition, countries have understood that value-added taxes produce less distortion than other taxes and now national revenues are increasingly drawn from this type of taxation. Countries can continue to progress, he observed, by continuing to follow basic economic principles rather than constantly adopting new policies based on buzzwords and intellectual fashion.

Shattered Economic Expectations

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Argentina is a striking example of the importance of macroeconomic factors. In this country, they explain a drop in support for privatization equivalent to 25 percentage points, which is about 80 percent of the observed drop in the support for privatization in that country (it went from 45 to 13 percent).

In sum, economic reasons are clearly behind reform fatigue. Although the reforms seem to have increased incomes and growth, they did so in a modest way, probably below the expectations created by the reformers. As growth has recently faltered for short-term reasons, support for reform has waned as many people are unable to isolate the influence of the economic cycle from the permanent effect of the reforms.

Looking for Answers

Neither the economic nor the social consequences of structural reforms can totally explain the attitude of the public towards them. Nor is there any evidence that Latin Americans are moving ideologically towards the left, a shift that would imply a reduced appetite for the market vis-à-vis the State. What does explain the public's distaste for reforms? Several tentative hypotheses based on behavioral economics may help to resolve this question.

Some analysts have turned to cognitive psychology to explain why structural reform becomes bogged down. Early research in this area found that individuals are more willing to take risks in order to recover a loss than when they are seeking to protect their gains. It has also been argued that this pattern explains why presidents tend to back away from structural reform programs even after having administered a successful "shock" program of structural reform. If the initial reform overcomes an acute economic crisis and restores stability, presidents are less motivated in a stable environment to push for additional reforms than they were during the initial crisis. According to this hypothesis, once the recovery has taken place, leaders become less willing to take risks. This may have taken place in the early 1990s in both Argentina and Peru—after both economies recovered following bold reforms, Presidents Menem and Fujimori became more risk-averse and the process of structural adjustment slowed.

More recently, Finance Minister Fernando Henrique Cardoso introduced the Real plan when Brazil was suffering from high inflation in 1994; but once he became president the following year, the reform process slowed considerably during his two terms in office. In Ecuador, President Mahuad initiated a process of dollarization during a severe crisis that helped stabilize the economy; however, the structural reforms that would enhance the viability of dollarization have not yet been achieved.

Of course, a crisis is no guarantee that significant structural reforms

> Politicians generally find greater public acceptance of reform in an atmosphere of crisis, although that support can erode once stability returns.

will occur, as shown by Argentina since 2001. Nonetheless, politicians generally find greater public acceptance of reform in an atmosphere of crisis, although that support can erode once stability returns. During the past half decade there has been weak economic growth, but full-blown crises have occurred only in a handful of countries. Consequently, this combination of relative stability and growing dissatisfaction with reforms already in place did not create a receptive climate for reform. On the contrary, the recent economic downturn in the region has created a favorable environment for political actors who oppose the process of structural reform.

Another psychological reason may help explain the rejection of pro-market reforms when countries do not face the pressure of an economic crisis. Most people tend to prefer outcomes that are known with certainty to be positive over the uncertain possibility of a much larger benefit, even when the expected value of the latter is much greater. As the popular saying goes, "better the devil you know." This implies a psychological bias in favor of the status quo, which can help explain popular resistance to any type of reform. However, in the case of pro-market reform, this bias can also help explain the rejection of the reforms once implemented, because a larger role for the markets vis-à-vis the State implies that people are faced with greater risks. Even if reforms improve aggregate welfare, many people may prefer the previous situation where uncertainty was lower. Furthermore, exposing people to risks without offering them means of protection is considered by many to be unethical or at least unfair.

Psychology may offer another fundamental reason why, after a trial period, most people tend to reject even relatively successful reforms: cognitive bias. Two types of cognitive bias are universal aspects of human behavior. One is "confirmatory bias," the tendency to interpret ambiguous evidence as confirming pre-existing hypotheses or beliefs. Experiments performed by psychologists show that if people have different initial beliefs, when they receive

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Is Reform Fatigue a Terminal Illness?

Whatever the causes of reform fatigue, the loss of popular support for pro-market reforms and the lack of appetite in the political arena for the "neoliberal model" may yield a poor prognosis for the future of reforms. Even if the reform process is not reversed, the economic and social benefits of what has been done so far largely depend on further reforms in order to give institutional support to previous liberalization measures (the so-called, second generation reforms) and to advance social policy reform. Political support is needed not only to maintain the reforms already implemented, but also to pursue these additional reforms. Are Latin Americans and their leaders too tired and disappointed to go on with the reform process? Some analysts fear that this fatigue could be the beginning of the end of more than a decade of restructuring, while others believe the region will recover its desire and commitment to reform.

Political Costs

What are the electoral consequences of reforms? If parties that pursue pro-market reforms are rewarded by the electorate, political selection will tend to deepen the reform process. But if the electorate punishes the reformers, those who want the process to be halted or derailed will stand a better chance of achieving that.

Research supports the widely held view that aggressive liberalization policies are more easily pursued from a political point of view when combined with an anti-inflationary package. This reflects virtually all governments' efforts to protect price stability at all costs during the last decade. On the other hand, pro-market reforms are bound to hit a political wall, since the parties that backed them in the past may be in retrenchment and the whole party system may now be more fragmented in many countries than a decade ago, partly as a result of those policies.

Does all this imply that the reforms are doomed to be stalled or, even worse, that a reform reversal should be expected? Not necessarily. First of all, it is not clear whether different types of reforms carry similar political costs. Second, current knowledge of the political costs of reform is based almost entirely on the experience of reform adoptions and advances. It would be a big leap to assume that reform reversals produce correspondingly large political benefits.

Private Sector Responses

Members of the private sector are not always in favor of pro-market, neutral economic policies. On the contrary, a real concern for the future of reforms is that the appetite of private firms for (and ability to get) interventionist policies seems to have increased in recent years. Surveys of firms conducted by the World Economic Forum in 1999 and 2002 indicate that, in eight of the 11 Latin American countries surveyed in both years, respondents perceived a significant decline in the neutrality of policies.

The responses of international financial investors have also proven interesting, as international markets appear to have become more tolerant of unorthodox economic policy announcements than in past years. In Argentina, Brazil and Ecuador, bond spreads surged before and shortly after the election of presidents who campaigned on a platform of halting or reversing structural reforms. Spreads fell, however, after those presidents took office, and as they left previous reform measures largely intact. This may mean that international investors have become tolerant of threats of reform backlashes, which may increase their likelihood. Another possibility is that investors may have learned to distinguish between political "noise" and real threats to the sustainability of structural reform.

If the sustainability of reform hinges upon the beliefs and attitudes of the main players, there are serious reasons for concern in Latin America, as symptoms of reform fatigue are plenty. Public support for pro-market policies has been waning since 1998 and currently only a minority of the public declares themselves in favor of privatization or free markets. As policymakers have also become less enthusiastic, the reform process is now stalling in many countries and two countries have experienced major setbacks.

Since a large part of the increased rejection of reform is associated with the recent growth slowdown in many countries of the region, an eventual recovery might help jumpstart the process. This is far from guaranteed, however. The political system is very fragmented and the political parties are in disarray in many countries, partly a consequence of the reform process. Another factor working against renewed interest in reform is the nature of public opinion. If, as cognitive psychology maintains, people form their opinions in order to support their previous beliefs and serve their own interests, economic recovery will not necessarily restore confi-

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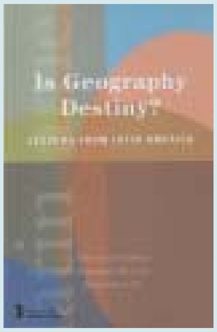
New Publications

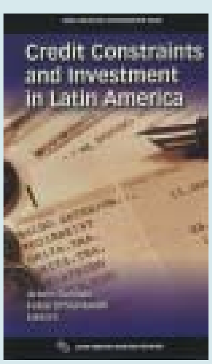
BOOKS



Is Geography Destiny? Lessons from Latin America

By *John Luke Gallup, Alejandro Gaviria* and *Eduardo Lora (Available in both English and Spanish)*

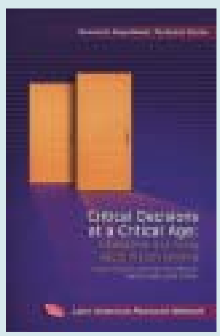
The relationship between geography and development is finally receiving the attention it deserves. For decades the prevailing sentiment was that since geography is unchangeable, there is no reason to take it into account in public policies. This book challenges this premise. It argues that based on a better understanding of geography, public policy can help control or channel its influence toward the goals of economic and social development. Using both an international and a case study approach, the book explores geographical factors—land productivity, health conditions, natural disaster frequency and intensity, and market access—to help explain differences in development between and within countries. It concludes by proposing policies for overcoming the limitations of geography.



Credit Constraints and Investment in Latin America

Edited by Arturo Galindo and *Fabio Schiantarelli*

Researchers have devoted much attention to the macroeconomic effects of financial crises and financial policies, yet there has been little research on the microeconomic implications of such events. This book attempts to fill this gap. It presents new evidence on the nature, extent, evolution, and consequences of financing constraints. It analyzes firms' investment behavior under conditions of severe market failure. The ability of the banking sector to pool resources and channel them efficiently to firms is an important determinant of development and growth. This book uses micro data to study credit supply restrictions at the firm level in Argentina, Colombia, Costa Rica, Ecuador, Mexico and Uruguay.



Critical Decisions at a Critical Age: Adolescents and Young Adults in Latin America

Edited by Suzanne Duryea, Alejandra Cox Edwards and *Manuelita Ureta*

In Latin America, approximately 20 percent of the population is between the ages of 10 and 19. Comprising such a considerable share of the population, this current generation of adolescents is vital to the region's future. The choices they make will determine the course of their lives and impact their personal well-being as well as that of society as a whole. This book uses micro-level data for 18 Latin American countries to examine the choices adolescents make in three areas of behavior: their time allocation toward school and work, their sexual behavior and fertility, and their adoption of adult roles as they marry or cohabitate. The analysis pays particular attention to the accumulation of human capital, a key determinant of living standards at the individual level and social progress at the aggregate level.

RESEARCH DEPARTMENT WORKING PAPERS

Bundling of Services and Household Welfare in Developing Countries Using Panel Data: The Case of Peru (WP-489)

By *Alberto Chong, Jesko Hentschel* and *Jaime Saavedra-Chanduvi*

Using panel data for Peru for the period 1994-2000, this paper finds that when households receive two or more services jointly, the welfare increases of the household, as measured by changes in consumption, are larger than when services are provided separately. Such an increase appears to be more than proportional, as F-tests on the coefficients of the corresponding regressors confirm. The conclusion is that bundling of services may help realize welfare effects.

Regional Integration and the Location of FDI (WP-492)

By *Christian Daude, Eduardo Levy Yeyati* and *Ernesto Stein*

This paper studies the impact of regional integration agreements (RIAs) on the location of FDI, using data on bilateral outward FDI stocks from the OECD *International Direct Investment Statistics*. The dataset covers FDI from 20 source OECD countries to 60 host countries from 1982 through 1999. Findings include that common membership in an RIA with a source country increases FDI from that source by around 27 percent. Countries that are

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more open, and whose factor proportions differ more from those in the source country are likely to benefit more. Also, the increase in the size of the market associated with regional integration initiatives helps to attract more FDI to the RIA as a whole. However, only the countries in the RIA that offer a more attractive overall environment for FDI are likely to be winners in this game. Finally, there is evidence of a small FDI diversion effect. The results suggest that regional integration, on average, contributes to attracting FDI, but the benefits are unlikely to be distributed evenly.

Who Benefits from Labor Market Regulations? Chile 1960-1998 (WP-494)

By *Claudio Montenegro* and *Carmen Pagés-Serra*

Economists have examined the impact of labor market regulations on the level of employment. However, there are many reasons to suspect that the impact of regulations differs across types of workers. This paper takes advantage of the unusually large variance in labor policy in Chile to examine how different labor market regulations affect the distribution of employment and employment rates across age, gender and skill levels. Using a sample of repeated cross-section household surveys spanning the period 1960-1998 and measures of the evolution of job security provisions and minimum wages across time, the results suggest large distribution effects. Employment security provisions and minimum wages reduce the share of youth and unskilled employment as well as their employment rates. There are also large effects on the distribution of employment between women and men.

Inflation and Labor Market Flexibility: The Squeaky Wheel Gets the Grease (WP-495)

By *Ugo Panizza* and *Ana María Loboguerrero*

Inflation can "grease" the wheels of the labor market by relaxing downward wage rigidity but it can also increase uncertainty and have a negative "sand" effect. This paper studies the grease effect of inflation by looking at whether the interaction between inflation and labor market regulations affects how employment responds to changes in output. The results show that in industrial countries with highly regulated labor markets, the grease effect of inflation dominates the sand effect. In developing countries, inflation rarely has a significant effect on labor market regulations, which could be due to the presence of a large informal sector and limited enforcement of *de jure* labor market regulations.

El mercado de crédito hipotecario de Perú (WP-497)

By *Hugo Eyzaguirre del Sante* and *Carlos Calderón Seminario*
(Available in Spanish only)

The objective of this study is to document the evolution of the mortgage market in Peru over the last two decades and, using this base of information, to analyze and understand the economic, financial and institutional factors that have limited or promoted its growth. The document is divided into five sections. The first section describes the evolution of mortgage loans over the past two decades under the economic and housing policies applied by various governments during the period. The second section describes the programs currently being executed by the State to finance social interest housing. The third section presents an analysis of the current state of the mortgage loan market. The fourth section presents an analysis of the current system of constituting and executing guarantees and their impact on the development of the mortgage loan market. The paper concludes with recommendations of policies to expand and stabilize this market.

Concentration and Foreign Penetration in Latin American Banking Sectors: Impact on Competition and Risk (WP-499)

By *Alejandro Micco* and *Eduardo Levy Yeyati*

In recent years, Latin American banking sectors have experienced an accelerated process of concentration and foreign penetration. Exploiting a bank-level balance sheet database for eight Latin American countries, this paper examines the evolution of concentration and foreign penetration indicators and their impact on competition and risk. While concentration did not reduce competition in the industry, foreign penetration may have led to less competitive banking sectors. Moreover, banking sector fragility appears to be positively related to competition and negatively related to foreign participation, despite the fact that foreign banks in the region are associated with higher insolvency risk due to higher leverage ratios and more volatile returns.

La crisis de financiamiento hipotecario en Colombia: Causas y consecuencias (WP-500)

By *Alejandro Badel* and *Mauricio Cardenas*
(Available in Spanish only)

The recent crisis in the mortgage sector in Colombia resulted from an increase in the ratio between loan balances and the value of collateral. The increase was caused by a combination

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of higher borrowing by households, rules for indexing loan balances and the depreciation of housing. As disbursements of new loans contracted, a strong recessive cycle ensued. This translated into greater unemployment, which deteriorated even further the quality of mortgage loans. The crisis deepened and was prolonged by non-economic factors associated with the extreme legal instability. The conclusions emphasize the importance of avoiding the bubbles associated with surges of capital inflows and the need to adjust property appraisals in accordance with economic cycles.

Situación actual del financiamiento a la vivienda en Bolivia (WP-501)

By *Rolando Morales*

(Available in Spanish only)

This paper examines the conditions of the mortgage loan market in Bolivia. Within a complex macroeconomic framework, the expansion of mortgage loans was hindered by a poorly developed financial system and only moderate demand given the low level of family incomes. The study emphasizes some problems that have arisen as a result of the dollarization of monetary assets and liabilities. It concludes with policy recommendations focused specifically on the need to adapt the credit system to the process of progressive construction, provide a subsidy to boost demand from low-income sectors and develop a sector that demonstrates the public and private advantages of home improvement.

La competitividad de Perú después de la década de reforma: Diagnóstico y propuestas (C-105)

By *Alberto Melo*

(Available in Spanish only)

This paper evaluates the current competitiveness of Peru and proposes strategies for further boosting the competitiveness of the country. The determinants of competitiveness that were considered include i) productive resources, ii) market efficiency, iii) infrastructure, iv) technological innovation, v) institutional strength and vii) investors' perceptions.

For Peru to increase its competitiveness over the next five years, the paper proposes that public policy concentrate on the following strategic areas: i) provide clear rules of the game for private economic activity; ii) raise the quality of education and increase worker training; iii) improve transportation infrastructure; iv) eliminate corruption in public administration; v) deepen judicial reform to provide legal security for private economic activity; and vi) reform the financial system to expand access to credit and reform capital markets to facilitate financing for investment in fixed assets.

LATIN AMERICAN RESEARCH NETWORK WORKING PAPERS

The Truth About Privatization in Latin America (R-486)

By *Alberto Chong* and *Florencio Lopez-de-Silanes*

Privatization is under attack. Criticisms run from corrupt deals to abuse of market power and social welfare losses. This paper evaluates the empirical record on privatization and finds four main results. First, greater profitability of privatized firms is not explained by sample selection biases. Second, greater profitability is not derived from market power abuses, worker exploitation and lack of fiscal benefits. Third, the manner in which privatization is carried out matters. Transparent procedures, speed, and limited pre-privatization restructuring lead to better outcomes and less room for corruption. Finally, privatization's success is enhanced by re-regulation or deregulation of industries previously shielded from competitive forces, and effective corporate governance to facilitate privatized firms' access to capital at lower costs. Overall, privatization leads to increased profitability and productivity, firm restructuring, fiscal benefits, output growth and even quality improvements. Most cases of privatization failure can be linked to poor contract design, opaque processes with heavy state involvement, lack of re-regulation and a poor corporate governance framework.

Privatization in Bolivia: The Impact on Firm Performance (R-461)

By *Mauricio Garrón B.*, *Katherina Capra,* and *Carlos Gustavo Machicado*

This report studies the change in performance of Bolivian State Owned Enterprises (SOEs) that have been transferred to the private sector. The paper focuses on how ownership affects management by measuring the characteristics of management and relating them to both ownership structure and performance. It argues that the characteristics of private management that follow privatization are a key factor in determining the effects of privatization on performance.

Peruvian Privatization: Impacts on Firm Performane (R-481)

By *Máximo Torero*

In the nearly ten years since Peru privatized major State Owned Enterprises (SOEs), the overall impact of the

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New Publications

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process is not yet clear. This paper analyzes the impact of privatization through a detailed statistical and econometric analysis of first difference (the difference between pre- and post-privatization performance), and second difference (change in performance of privatized firms relative to the change in performance of SOEs) on profitability, operating efficiency, employment, leverage and convergence. The results showed that privately-owned firms are more efficient and more profitable than comparable state-owned firms and were consistent with previous literature. In the most competitive sector, the financial system, the newly privatized banks converged towards the leading private banks over time. While the impact of privatization on employment is negative in the short-run, there are more positive impacts in the long term, especially since SOEs traditionally hire employees for political rather than technical reasons. This paper demonstrates that, as the result of privatization, there is a significant increase in indirect employment through services and significant growth of total employment—both direct and indirect.

OTHER PUBLICATIONS

On the Determinants of Original Sin: An Empirical Investigation. Hausmann, Ricardo and Ugo Panizza. *Journal of International Money and Finance*. 22: 957–990.

Most countries do not borrow abroad in their own currency, a fact that has been referred to as “original sin.” This paper describes the incidence of the problem and tries to uncover its cause. The paper finds weak support for the idea that the level of development, institutional quality, monetary credibility or fiscal solvency is correlated with original sin. Only the absolute size of the economy is robustly correlated. The paper also explores the determinants of a country’s capacity to borrow at home at long duration and in local currency. It finds that monetary credibility and the presence of capital controls are positively correlated with this capacity.

Debt Composition and Balance Sheet Effects of Currency Depreciation: A Summary of the Micro Evidence. Galindo, Arturo, Ugo Panizza and Fabio Schiantarelli. *Emerging Markets Review*. *December.*

This paper surveys recent empirical evidence on the determinants of the currency composition of debt, and on the impact of exchange rate fluctuations on economic activity and investment when currency mismatches are present. Microeconomic evidence suggests that Latin American firms tend to match the composition of their debt with the currency composition of their income stream and that liability dollarization can reduce or possibly reverse the typical Mundell-Fleming result of expansionary devaluations.

Currency Mismatches, Debt Intolerance and Original Sin: Why They are Not the Same and Why it Matters. Eichengreen, Barry, Ricardo Hausmann and Ugo Panizza. NBER Working paper 10036, NBER Cambridge MA.

This paper discusses three concepts widely used in the literature on balance sheet factors in emerging market financial crises. Two of them —”original sin” and "debt intolerance”—seek to explain the same phenomenon: the volatility of emerging-market economies and their difficulty in servicing and repaying their debts. The debt-intolerance school traces the problem to institutional weaknesses that lead to weak and unreliable policies, while the original-sin school fingers the structure of global portfolios and international financial markets. The literature on currency mismatches, in contrast, examines the consequences of these problems and how they are managed by macroeconomic and financial authorities. Thus, the hypotheses and problems to which these three terms refer are analytically distinct. The tendency to use them synonymously has been an unnecessary source of confusion.

Who Benefits from Labor Market Regulations? Chile 1960–1998. Montenegro, Claudio and Carmen Pages. NBER Working Paper No. 9850.

Economists have examined the impact of labor market regulations on the level of employment. However, there are many reasons to suspect that the impact of regulations differs across types of workers. This paper takes advantage of the unusually large variance in labor policy in Chile to examine how different labor market regulations affect the distribution and rate of employment across age, gender and skill levels. To this effect, the authors use a sample of repeated cross-section household surveys spanning the period 1960–1998 and measures of the evolution of job security provisions and minimum wages across time. The results suggest large distribution effects. Employment security provisions and minimum wages reduce the share of youth and unskilled employment as well as their employment rates and have large effects on the distribution of employment between women and men.

Look Who's Talking

This section of the newsletter spotlights presentations or events sponsored by RES in the past quarter.

Rising from the Ashes: Lessons from Post-Collapse Recoveries in Uruguay

Ernesto Talvi (CERES, Uruguay) presented a policy seminar to the Bank on September 12, 2003.

From the 1980s debt crisis to Argentina's recent collapse, Latin America has a long history of coping with economic disasters. The accepted wisdom of international economics prescribes access to fresh lines of credit, which in turn will spark investment and reactivate economic growth. But what do we know about the immediate aftermath of these collapses? What conditions must be in place for an economic resurgence? Once the bottom has been reached, what rejuvenates economic activity?

In this Latin Macro Watch seminar, Ernesto Talvi of the Uruguayan think tank CERES argued that a nation's economy has an enormous capacity for self-rehabilitation. In a detailed analysis of three economic collapses—Uruguay in the 1980s and today, and the current malaise in Argentina— Talvi found that a significant portion of the economic recovery in these crises occurred in the months immediately after the "trough," or lowest point of the crisis, and did not rely entirely on new investment and fresh credit lines. His argument for an economy's ability to rejuvenate itself provides a new lens through which to view an economic collapse and has important implications for the analysis of a country's post-collapse debt sustainability.

Talvi demonstrated that financing through bank credits and private capital flows declined dramatically during Uruguay's economic crisis of the 1980s, then struggled to revive in the period following the "trough." Investment, meanwhile, also dried up and failed to recover its former flow. Nevertheless, Gross Domestic Product (GDP) growth wildly outpaced the resumption of financing and investment. Uruguay's GDP recovered almost 80% of its losses in the eight months after the "trough" of the 1980s crisis, and according to Talvi, the same trends are evident in Uruguay and Argentina today.

Talvi's assertions that a post-collapse economy will pick up independently of access to traditional sources of finance did not go unchallenged. Some attendees argued that the role of new credit and new investment should not be so easily discounted. They pointed out that while a post-collapse economy may quickly recover much of its lost ground, there are long-term effects to consider as well. Without new sources of financing, a country will not be able to sustain long-term economic growth.

Acknowledging an economy's self-recuperative abilities, with or without new financing, also provides a novel perspective on how multilateral financial institutions should carry out debt sustainability analyses in the wake of a financial crisis. Talvi asserted that debt sustainability analyses should be conducted on the basis of a country's pre-collapse economic activity level. With the depreciated real exchange rate that accompanies an economic collapse already increasing debt levels, it is especially important that a debt sustainability analysis be undertaken accurately.

If public debt in Uruguay is calculated at post-collapse GDP levels, it reaches 101% of total GDP and leads to a required primary surplus of 4.1%. If that same debt is calculated at the pre-collapse economic activity level, which Talvi posits is a more accurate gauge of a country's economy, it totals only 67% of total GDP and requires a primary surplus of 2.7%, a crucial difference for an economy on the mend. Private sector debt also shows a marked difference, from 65% to 45%, when it is calculated at pre-collapse levels rather than post-collapse levels.

Evaluation of Fiscal Adjustment in IMF-Supported Programs

Marcelo Selowsky addressed the Bank on November 17, 2003.

In response to frequent criticism of the fiscal policy recommendations made for its economic programs, the International Monetary Fund (IMF) commissioned the organization's Independent Evaluation Office (IEO) to conduct a study charged with improving those programs' fiscal design. Marcelo Selowsky, assistant director of the IEO presented the results of that study titled "Evaluation of Fiscal Adjustment in IMF-Supported Programs." The report found little evidence to support criticisms that IMF-recommended fiscal policies were too inflexible, rarely achieved their intended fiscal targets, or restrained social spending in countries ravaged by economic crisis. Nevertheless, Selowsky and his colleagues did suggest the

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IMF offer clearer, more transparent explanations of the rationales behind their programs and the attending policy recommendations.

Many critics of IMF fiscal adjustment policies claim the organization applies a "one size fits all" approach, recommending identical policy prescriptions—usually severe fiscal austerity—to a wide range of countries with individual economic concerns. But the report, based on studies of over 100 IMF-country arrangements, found that the Fund established a large variety of fiscal targets corresponding to the borrower country's initial economic conditions and financing prospects. Moreover, fiscal targets proved to be surprisingly flexible, with two-thirds of programs revising those targets at some point. Likewise, little evidence was found to back claims of excessive fiscal austerity. One-third of IMF-country programs called for the borrowing country to increase its primary deficit, the measure of a government's fiscal deficit before calculating interest payments.

Another favorite complaint of IMF bashers is that borrower countries can rarely achieve the fiscal targets set for them by the Fund. However, IMF programs achieved nearly one-half of the targets within a two-year period, and nearly all of that achievement occurred within the first year. Yet the news about fiscal target performance wasn't all good; the study estimated that 60 percent of programs underperformed. Most of that underperformance, though, was the result of no improvement in fiscal balances and shortfalls that resulted from weak economic performance rather than overly ambitious targets.

There is also concern that IMF programs lead a country to reduce unnecessarily their public spending. Instead, Selowsky and his colleagues found no reduction in health and education spending as either a share of Gross Domestic Product (GDP) or total government expenditures. In fact, government public sector expenditures temporarily increased by 0.3–0.4 percentage points of GDP. The case studies did reveal that programs critical to a nation's most vulnerable population frequently come under the most intense pressure during economic shocks or budgetary retrenchments. Consequently, the IMF needs to do a more effective job of assisting countries in preparing systems to protect key programs in times of crisis. Two suggestions were to invite countries to identify critical programs in need of protection and to formulate a work program with the World Bank on budgetary systems to protect the programs in real time.

Though the IMF's fiscal adjustment efforts by and large received the IEO's approval, the effectiveness and clarity of the Fund's explanation of its programs was routinely criticized. This was particularly acute in documentation explaining how the pace and magnitude of a specific program's fiscal adjustment was determined. Furthermore, the rationale for revising fiscal targets was not clearly brought out, and program documents failed to establish links between the fiscal stance and private sector recovery, the basis for private sector recovery assumptions, and the trade-off between aggregate demand and market response or debt sustainability. The report consistently demonstrated the need for explicit explanations of IMF fiscal adjustment recommendations, and of the framework that supports them.

Besides the recommendations to provide greater assistance in helping countries carry out their most crucial programs and to provide clearer explanations of fiscal adjustment programs, the IEO also suggested that the Fund's internal review process focus to a greater extent on early brainstorming, that programs should give greater emphasis to institutional reforms in the fiscal area, and that the surveillance process should be used to provide a longer-term road map for fiscal reforms and program assessments.

Historical Origins of the Knowledge Economy: Implications for Development

Joel Mokyr presented a policy seminar cosponsored by the Research and Sustainable Development Departments (SDS) on December 12, 2003. The presentation was made during the IDB Discussion Series on "The Knowledge Economy in Development: Towards Definition of Outcomes, Outputs and Indicators in Bank-funded Projects," organized by the Information Technology for Development Division of SDS.

Drawing on his research in intellectual and economic history, Northwestern University Professor Joel Mokyr discussed the conditions that have allowed Western nations to engage in sustained economic growth and technological advancement since the mid-eighteenth century. He refrained from offering specific suggestions for Latin America, but he noted that historical experience provided a way to understand the circumstances under which sustained growth can occur.

Mokyr framed his discussion by describing types of knowledge and how they may or may not interact to

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produce economic and technological results. One type consists of *useful knowledge*, which has technological implications. Useful knowledge can be in turn divided into *propositional knowledge*, which involves the regularities and phenomena of the natural world that can be discerned through sciences such as physics, biology, and chemistry, and *prescriptive knowledge*, which encompasses instructions and techniques for a variety of processes and inventions. Each technique depends on a certain epistemic base, or the amount of propositional knowledge needed to support that technique; the development of the steam engine, for instance, was made possible by an understanding of atmospheric pressure. A second type, *social knowledge*, represents the sum of all useful knowledge possessed by the members of a society. Even individuals in that society who do not themselves understand the processes of a technology or the scientific principles behind it may either know how to operate that technology or simply benefit from its widespread application.

Mokyr noted that the interactions among types of knowledge largely determine economic growth and technological progress. Before approximately 1750, periods of economic growth were sporadic, subject to reversal, and dependent on institutional factors such as peace, law and order, and respect for property rights. Prosperity additionally involved only a small technological component, as the techniques used were not thoroughly understood.

As of about 1750, however, the technological component of prosperity was greatly increased by what Mokyr called the "Industrial Enlightenment" in Northwestern Europe, particularly Britain. This facet of the Age of Reason entailed, along with a belief in the possibility and desirability of material progress, the application of free inquiry and widespread dissemination of findings to a variety of scientific and technical problems. The ethos of the time also included growing tolerance for intellectual deviance and rebellion against established procedures, which provided an increasingly conducive atmosphere for invention.

This trend both reflected and encouraged several cultural and institutional trends. Particularly prominent among them was the publication of the first encyclopedias, which Mokyr referred to as the "search engines" of their time. In addition to the propositional knowledge that was available at the time, the first encyclopedias included prescriptive knowledge on the basic procedures involved in trades such as making candles, soap and textiles. A corollary development was the publication of technical manuals sold in shops and/or made available at lending libraries. The infrastructure underpinning these developments, moreover, was provided by widespread improvements in roads and the corresponding development of nationwide postal services.

From an economic perspective, these social and institutional changes substantially reduced access costs to information. This reduction in costs in turn helped to clear the historical bottleneck in communication between *savants*, the collectors of knowledge, and *fabricants*, the makers of goods. The second half of the eighteenth century witnessed the establishment in national capitals and smaller cities of numerous scientific societies that brought together many of the leading scientists, engineers and manufacturers of the time. Over time, greater flows of information facilitated greater trade and forced economic actors to emphasize value-creating rather than rent-seeking behavior. This shift in orientation from zero-sum to positive-sum outcomes effectively undermined the power of the guilds that had controlled most trades and manufacturing in Europe during previous centuries.

In contrast to previous periods of growth in Europe and elsewhere, however, the process begun after 1750 has sustained itself virtually continuously since then, in spite of disruptions including major wars and natural disasters. While access to existing knowledge improved steadily, the base of knowledge itself grew, the result of continuous and accelerating feedback between propositional and prescriptive knowledge. Thermodynamics, for instance, developed in part to understand the dynamics of the steam engine, and advances in thermodynamics led to the invention of the more efficient and powerful internal combustion engine. Similarly, technological improvements in devices including telescopes, microscopes and computers have increased human ability to examine and analyze nature, with extensive implications.

Underlying these developments were the institutions that provided incentives for research, dissemination of information, and investment. The emergence of intellectual property rights, which continue to evolve and provoke controversy, gave inventors the means to profit from their works. The embodiment of these rights in the patent system, moreover, provided a simultaneous impetus to the publication as well as the protection of inventions, as the patent system provided a knowledge base for further developments in addition to ensuring inventors' rents for a limited period.

Reforms for the Rich?

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small. The dismissal of close to 150,000 workers in Argentina due to privatization between 1987 and 1997 can only account for 13 percent of the increase in unemployment during the same period. However, between 80 and 90 percent of the personnel cuts were offset by new jobs in the same sectors, leaving a very small net unemployment effect. Similar results obtain for other big privatizers such as Bolivia, Mexico or Peru. Furthermore, though work conditions in the privatized firms often deteriorated, wages seem to have gone up substantially, as has become clear at least in the cases of Argentina, Chile and Mexico. Therefore, the social losses appear to concentrate in those laid off who were not reinstated directly or indirectly in the privatized firms. Many of them moved to the informal sector with earnings substantially below their previous wages.

Thus, the social consequences of reforms can hardly be used as factual support for reform fatigue. Although there is no consensus on some of the distributional effects, the prevalent view among researchers is that these effects were mild. And in spite of all the fuss about the employment implications of trade liberalization and privatization, there is very scant evidence to support it.

However, peoples' views are not necessarily formed on the basis of the indicators and models used by economists. In forming their opinion about the social and distributional consequences of the reforms, people may attach an important weight to some observations that may not be representative of the general outcome. There are two reasons for this. First, people tend to compare their own economic situation with those of their immediate "reference group" (neighbors, peers, relatives, etc.) rather than with the society at large. Due to this "rivalry effect" people resent when others in their reference group do better than themselves, even if all are getting better off or even if income distribution for the society as a whole is improving. The second reason is the high visibility of the consumption patterns of those at the very top. In the "winner-take-all-society" a few at the top in some professions (especially arts, sports and some other businesses) make astoundingly high incomes and consume accordingly, gaining the attraction of the media and the public opinion.

Both the rivalry effect and the winner-take-all effects may have tainted Latin Americans' opinion of reforms. Economic liberalization created new opportunities, opened the way to greater social and economic mobility and facilitated the adoption of conspicuous patterns of consumption by those able to afford them, all in plain sight of the less fortunate.

The social consequences of reforms can hardly be used as factual support for reform fatigue. Although there is no consensus on some of the distributional effects, the prevalent view among researchers is that these effects were mild.

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Network News

Latin American Research Network

- ***Final seminar of the study on Child Health, Poverty and the Role of Social Policies***

  February 23, 2004
  IDB Headquarters
  Washington, DC

- ***Final Seminar of the study on Political Institutions, Policymaking Processes and Policy Outcome***

  Harvard University, Center for Basic Research in the Social Sciences
  May 20-21, 2004

Agendas for these seminars and drafts of the final papers will be posted on our web site after January 30 and April 30, respectively.

Euro-Latin Network

Third Annual Meeting
February 26, 2004
Madrid, Spain.

The seminar, organized jointly with the Banco de España, will present the outlook for the region from the point of view of various analysts as well as the experience of European investors in Latin America.

Latin American Competition Forum

Second Annual Meeting with the Organisation of Economic Co-operation and Development (OECD)
Topics include: Institutional Challenges in Promoting Competition; Peer Review of Peru's Competition Law and Policy; and Advocacy and Communications Tools and Techniques.
IDB Headquarters
Washington, DC
June 14–15, 2004

www.iadb.org/res/events

Is Reform Fatigue a Terminal Illness?

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dence in reforms. Though this does not bode well for the likelihood of further ambitious pro-market reforms, neither does it doom other countries to follow the reform reversals of Argentina and Venezuela. A more likely scenario is that, especially where pro-market reforms are well advanced, the eventual recovery of economic growth will lead to further institutional and social policy reforms that buttress the original reforms.

Looking for Answers

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the *same* additional information, their views do not tend to converge, but to become more polarized, as they process that information selectively in order to confirm their initial beliefs. The second universal behavior is "self-serving bias," people's tendency to believe the hypothesis that best serves their interests. An implication of this bias is the tendency to attribute success to one's own effort but failure to external forces, such as bad luck or ill-intentioned behavior of others.

The implications of these biases can be devastating for the sustainability of reform. It has been argued that, in the case of Argentina, these biases are at the root of resistance to reform. In spite of the initial success of privatization and foreign direct investment deregulation in the early 1990s, even before the Tequila crisis of 1995, people were already focusing on the (alleged) negative outcomes of those reforms, such as unemployment and wealth concentration. A series of well-known events provided further ammunition to those anti-market beliefs, polarizing public opinion and reinforcing a deep-rooted position against both free markets and foreign influences.

Cognitive psychology thus offers some hypotheses that may help explain lack of support for reform. They are related to some principles of behavior toward risk—namely, that when confronted with losses, people are better prepared to assume risks than when they find themselves in a situation that they consider normal—and some universal cognitive biases: confirmation bias and self-serving bias. With only casual evidence, however, the relevance of the psychological approach remains an open question.