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Inter-American Development Bank
Research Department

Housing Finance in Latin America: Time to Build a Better Market

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The average value of a residential dwelling owned by a typical Latin American family is worth close to six years of that family's total income. However, less than one-fourth of all housing in Latin America is financed through formal mechanisms, and housing mortgage credit accounts for a small fraction of total credit.

Why hasn't the housing mortgage industry developed properly in Latin America? To begin with, the risk that lenders will be unable to recover their money from delinquent borrowers tends to be very high. Also, most potential homebuyers don't have the income levels to meet high mortgage payments or even qualify for loans. Economic uncertainty in most Latin American countries also plays a role and manifests itself as high front-end payments to compensate for macro shocks down the road. Finally, the large gap between the typical maturities of savings deposits and credits means the financial base for increased mortgage lending is simply not there.

While all these factors play a part, the one that has received the least attention is collateral use and recovery. In developed countries mortgage loans typically are guaranteed with the property that is purchased with the loan. If the borrower becomes delinquent, the lender can recover its loan by evicting the borrower and disposing of the property.

Throughout Latin America, however, two main hurdles make collateral use and recovery costly and ineffective. One, as stressed by Hernando de Soto, is the lack of property titles, which mainly affects the owners of informal settlings. The other, much less emphasized but no less important, is that existing legislation makes it difficult for mortgage lenders to evict delinquent borrowers. For example, in Uruguay the average duration of legal eviction proceedings is 20 months, but they can take up to six years. In Argentina, the costs and time involved in legally evicting delinquent borrowers from homes varies from one jurisdiction to another because of different rules and regulations. In Peru, the initial process of obtaining an eviction order is relatively short and inexpensive, but delinquent borrowers can delay the execution of such orders for long periods with successive appeals.

> Less than one-fourth of all housing in Latin America is financed through formal mechanisms, and housing mortgage credit accounts for a small fraction of total credit.

The process of evicting delinquent borrowers and recovering properties is also very costly for creditors, with legal fees and

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related costs in some countries representing between one-third and one-half of the total value of mortgages worth $50,000 or less. As a result, mortgage lenders generally don't issue credit to lower-income families because the related legal and economic risks make these potential borrowers ineligible from the lender's perspective.

A second important reason why the region's housing mortgage industry is under-developed is that most potential homebuyers don't earn enough income to qualify for loans. About half of Latin America's population lives with per capita earnings of less than two dollars a day, while 10 percent of the population earns 50 percent of the region's total annual income. In effect, those most in need of housing have no chance of accessing formal credit mechanisms. While this hasn't stopped potential homeowners excluded from formal lending mechanisms from seeking alternative ways of acquiring homes, access to formal finance would allow them to build better houses in a shorter time and have longer periods to pay the loans back.

Another reason for the lack of mortgage credit is interest rate instability. In Latin America, interest rates on deposits typically vary 5.3 percent annually compared to 1.6 percent in developed countries. In Brazil and Argentina, the variation over the past decade has been almost 18 percentage points, and only in Panama have rates fluctuated along the lines of developed countries. Since the cost of attracting deposits is so volatile, the financial system would like to pass on this instability to the debtor but fears that homebuyers would be unable to manage this risk. After all, the price of homes is many times the annual income of most homebuyers. If the homebuyer finances 80 percent of the price, an increase of 5 percentage points in the interest rate would mean that the debtor would have to pay 24 percent more of his income to service his mortgage. Few family budgets could withstand this additional financial burden.

Inflation and general economic uncertainty have a direct impact on savings deposits. Savings instruments in the region typically have short-term maturities, while housing mortgages have long-term maturities. This means that Latin American economies lack the strong domestic savings base to capitalize long-term mortgage credit.

These are not new problems in the region. Governments have been seeking solutions for years with varying degrees of success. This issue of *IDEA* takes a closer look at these problems, reviews the efforts that have been made in the past, and offers some policy suggestions for the future. BACK TO INDEX.

This issue of *IDEA* is based on a series of studies on housing finance sponsored by the Research Department. Eduardo Lora and Arturo Galindo coordinated the project.

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The Record on Home Financing: Room for Improvement

Financing for housing is a basic economic and political necessity—and Latin American governments know it. For this reason, most governments in the region have intervened very actively in the housing finance market since the early decades of the 20th century, mainly through state mortgage banks, compulsory savings funds and subsidized loan programs for the poor. Unfortunately, most of these programs have had a checkered past at best.

The basic system, still used today in some countries, was built around state mortgage banks, and compulsory savings funds financed with deductions from the wages of public sector workers and other workers with stable jobs. The financial assets of savings funds were used to grant mortgage loans at fixed low nominal interest rates to the workers whose earnings capitalized the savings funds. State mortgage banks covered the middle class mortgage market with fixed low-interest loans that were financed by issuing long-term bonds that mostly were purchased by other public sector entities.

In several countries, public sector mortgage banks also were financed through forced investments imposed by the government on the rest of the financial system. Some governments even capitalized their mortgage banks through external borrowings, and occasionally by transferring fiscal resources from other government entities.

These housing mortgage systems were designed to mitigate lender risks associated with non-payment of the mortgage, inflationary pressures, and the capitalization gap between the short-term nature of savings deposits and long-term structure of housing mortgage loans. Capitalizing the system with worker wage deductions and careful selection of borrowers reduced loan delinquency risks. Inflationary risks were minimized through the combination of fixed low-interest mortgage loans, forced contributions to the system, and long-term deposits under privileged conditions denied to other financial institutions.

The system worked for a long time—in fact, it worked for many decades. Over time, however, it began to fall apart as a result of growing political interference, macroeconomic instability and increased competition with other financial institutions for long-term savings deposits. The recent history of these traditional housing mortgage systems in several countries illustrates the nature and severity of the problems.

In Peru, the two central pillars of the system—the housing mutuals and Central Mortgage Bank—were officially liquidated in 1993 after a decade of slow collapse in which their share of the total financial system fell from 50 percent in 1980 to only six percent in 1990. Fixed interest rates and high inflation, which reached a peak of 7,649 percent in 1990, wiped out the value of the system's assets. At the same time, fiscal pressures compelled the Peruvian government to divert resources to other spending needs. The government also severely cut back contributions to the mortgage system. The Peruvian housing mortgage system disappeared until 1995, when private financial institutions started to develop the market again.

The National Mortgage Bank in Argentina also hit hard times in the 1980s. The bank's basic problem was its dependence on chronically insufficient short-term funding mainly from other state entities to cover mortgage credits of up to 25 years at low fixed interest rates. This situation forced the National Mortgage Bank to obtain rediscounts from the Central Bank of the Argentine Republic at inflation-adjustable high interest rates. The bank also carried a high number of delinquent loans, equivalent to 67.6 percent of its total loan portfolio in 1987, due to administrative deficiencies and political interference.

In the 1990s, the government turned the bank into a wholesale credit institution to curb external political interference in its administration. As a result, the bank was able to help reestablish the housing mortgage system that had been destroyed by years of hyperinflation. At the end of the decade it was partially privatized and was authorized to start making direct mortgage loans again. By 2001 the National Mortgage Bank was again the largest housing mortgage lender, the largest administrator of mortgage loans, and the largest provider of mortgage insurance.

In Uruguay, the housing mortgage market always has been dominated by the state-owned Uruguay Mortgage Bank (BHU), which even until very recently accounted for 80 percent of all housing mortgage credits. BHU

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has enjoyed three great advantages. It has protected its assets from inflation by employing indexed units to adjust the value of its credits. It has had a special regime that allows it to evict delinquent debtors and re-sell properties seized without having to first resort to the courts. Finally, it has selected borrowers based on demonstrated savings capacity.

Despite these apparent advantages, however, BHU has a large capitalization gap between loans and deposits because the bulk of its deposits are short-term and in dollars, not indexed units. BHU also has very high loan delinquency rates that are several times greater than the private financial system's average loan delinquency rates. BHU is currently being restructured under an agreement with the International Monetary Fund (IMF).

In addition to state-owned mortgage banks, many governments in Latin America also have used subsidy programs in an effort to make housing credit more accessible to lower income borrowers. In the past, however, many subsidy programs were administrated inefficiently or generated severe distortions in the housing market. Some of the more common practices included direct government construction of housing for sale at below-market prices, direct and indirect subsidies for builders of "social interest" housing, and price controls on construction materials.

In general, these subsidy programs failed because fiscal resources were diverted to middle and upper income groups, and they became sources of corruption. Such programs also hindered the development of the construction service and supply industries, and shrank the supply of housing for lower income families.

Nowadays it is widely recognized throughout the region that subsidy programs should be transparent and focused on the poor, and that people should receive subsidies instead of housing. However, until the 1990s the most common subsidy systems for facilitating access to housing credit consisted of loans issued by state entities at below-market interest rates to finance new housing built under contract with the government.

What About the Private Sector?

Private housing mortgage systems were eclipsed until the 1990s by the region's state-owned mortgage institutions. Opportunities for private development of housing mortgage markets were created when governments started to liberalize their economies and financial systems. However, with the exception of Chile, Panama, and to a lesser extent Colombia, development of a private sector housing mortgage industry has been hindered since the 1990s by persistent problems involving loan recovery and macroeconomic instability.

The private housing mortgage industry's development also has been undermined by the fact that credit markets in Latin America remain very small due to persistent institutional, legal and macroeconomic difficulties in most countries.

Generally, however, little or nothing has been done to make it easier for lenders to recover their loans or execute evictions against delinquent homebuyers. The fact that lenders have such little legal protection means that available credits to potential homebuyers are scarce and costly.

Until recently, little progress had been made in finding solutions for the inability of low-income homebuyers to qualify for loans due to insufficient income levels. Private mortgage financing generally is directed at middle and upper-income buyers.

For more than a decade now, Latin American housing markets also have become increasingly dollarized in countries like Argentina, Bolivia and Peru. In contrast, housing markets in countries like Brazil, Chile, Colombia and Mexico have developed instruments indexed either to inflation or worker salaries. Real estate markets have become more dollarized across the region as a way of offsetting reductions in the value of money and real estate associated with inflation and currency depreciation. Moreover, as Latin Americans have shifted their savings increasingly into dollars, banks in some countries have diversified lending into dollars as well as local currency. Even so, mortgage credit nowadays is more dollarized than other forms of credit—although it is also riskier relative to other types of debt since most mortgage holders generate their incomes in local currencies instead of dollars.

Clearly, it hasn't been for lack of trying that the Latin American housing finance market is so underdeveloped. However, despite the good intentions, the results have been disappointing.

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Less Risk, More Credit

Housing is a durable good that cannot be hidden, enjoys a strong secondary market and is valuable to other people besides the homebuyer. In other words, housing is potentially a very good guarantee for credit transactions. However, mortgage credit across Latin America accounts for both a very small fraction of the value of the total stock of housing, and a small proportion of total loans in practically every financial system in the region.

One of the key reasons that mortgage financing for homebuyers is very scarce and costly is that lenders confront high risks in terms of recovering the guarantees borrowers put up as collateral for their loans. Typically, in the housing mortgage industry the homebuyer guarantees the loan with the home he or she is buying. In theory this means that delinquent debtors that fail to make their mortgage payments on time are vulnerable to eviction by the creditor as part of the process of recovering the credit by taking control of the loan guarantee—meaning the home on which the mortgage loan was originally issued.

In practice, however, the combination in most countries of slow courts and extensive legal protection for homebuyers that become delinquent on their mortgage payments means that it generally takes years for creditors to recover the homes and dispose of them through auction or resale to a new buyer. The costs involved in legal efforts to recover homes that serve as guarantees against mortgage credits can cost the lender between one third and one-fourth of the total value of the mortgage. As a result, the weak legal protection afforded to mortgage creditors translates into significantly less mortgage credit to potential buyers.

However, there are alternatives for solving this problem and making mortgage credit more widely available to homebuyers. One option involves the creation of extra-judicial mechanisms to speed the process of recovering mortgage credit guarantees. Legislation in some countries allows lenders to include expedited recovery procedures in the mortgage loan contract: if the borrower becomes delinquent chronically, the creditor can recover its loan by taking control of the home and evicting the delinquent buyer. For this mechanism to work efficiently, however, it must be widely available to all mortgage lenders and not just state-owned entities like Uruguay's BHU.

> ...issuing ownership titles to families living in informal settlements is a good way of invigorating local credit markets.

Another alternative mechanism consists of delaying the issue of the definitive owner's title to the home until all mortgage-related liabilities are paid in full. In other words, the actual title to the mortgage property would remain under the creditor's legal control until the mortgage is paid in full, and only then would title be transferred to the buyer who purchased the home and may have lived in it for 20 years or longer before the loan is repaid in full.

The downside to this alternative is that, if not structured properly, it could result in some loss of legal protections afforded to the debtor who bought the home with a mortgage credit. However, any imbalances between creditor and debtor could be addressed effectively by overhauling existing laws and judicial procedures to ensure that both the debtor and the creditor are afforded equal protection under the law.

These legal reforms should also include the creation of special courts with professional personnel capable of overseeing any litigation between mortgage lenders and debtors, and they should encourage competition between private companies specialized in the auction under appropriate court supervision of repossessed homes. Moreover, such legal reforms could be undertaken without excluding the creation of extra-judicial mechanisms to expedite the ability of creditors to recover their mortgage loan guarantees from delinquent debtors.

Another major impediment to using homes as a guarantee or collateral for credit, particularly among lower income buyers, is that close to half of the homes that exist today in Latin America's largest cities were built illegally. This means the families living in those homes likely built the home themselves, without any building permits from national or local authorities. Furthermore, since most of the families living in these homes do not have titles to the land on which they live or the homes in which they

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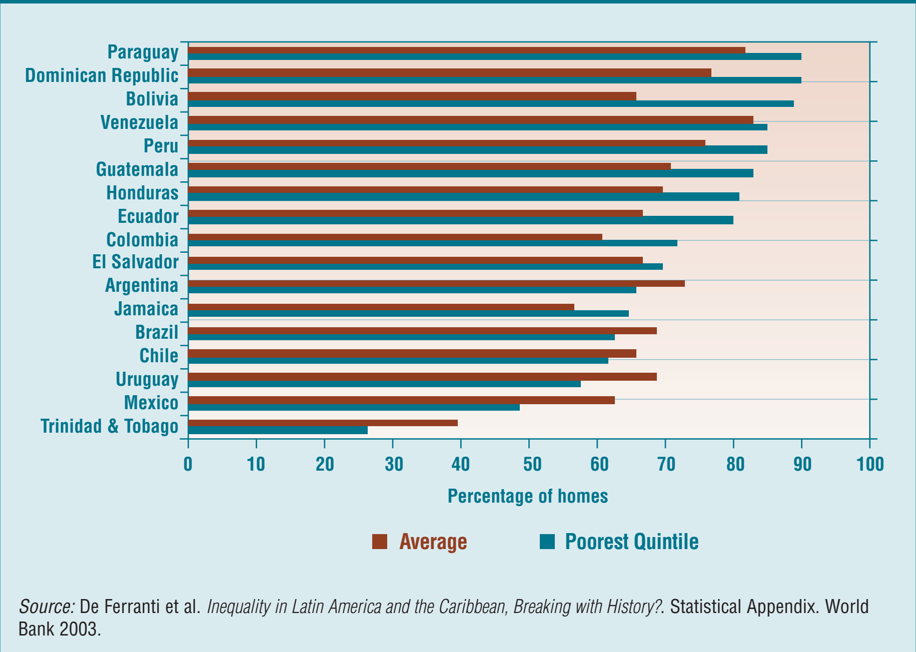
Opening the Door to Low-Income Home Buyers

If you can't pay, you can't borrow; it's as simple as that. But it doesn't necessarily mean you can't have your own home. Access to mortgage credit in Latin America is limited due to low average income levels and the strong concentration of income in a relatively small proportion of the population. Interestingly, however, many low-income families in the region manage to secure decent housing over the years without ever having access to mortgage credit.

How can the poor have their own homes? They build them themselves. Latin America's major cities are littered with self-made houses, and the percentage has been rising for years. For instance, in Mexico City an estimated 60 percent of the population lived in self-constructed homes in 1990 compared to 14 percent in 1952. A similar tendency is underway in Caracas and Lima. While many of these houses are substandard in terms of basic services and construction quality, the fact remains that the percentage of people in the lowest quintile who live in their own home is not much lower than that of the population on average (see Figure 1). Thus, low incomes are not the impediment to home ownership they were once thought to be, but they do restrict access to credit.

Figure 1. Home Ownership by Income Quintile



Source: De Ferranti et al. *Inequality in Latin America and the Caribbean, Breaking with History?*. Statistical Appendix. World Bank 2003.

The problem of access to mortgage credit depends very much on the relationship between the effective value of housing and the family's regular income. A direct subsidy for demand (i.e., to the prospective homeowner) improves this relationship.

Subsidizing the price of housing, construction materials or interest rates also will improve the relationship between the value of housing and the income levels of families wishing to purchase their own homes. However, in the past, such subsidies have proven to be ineffective mechanisms for several reasons. For one, the benefits of such subsidies tend to shift towards families with higher incomes, causing distortions in the market by limiting the supply of housing for low-income families. Subsidies of this nature also fail to guarantee the financial and administrative stability of entities that issue mortgage credit.

The most effective current practices consist of granting a one-time direct subsidy to lower income families that demonstrate the capacity and discipline to comply with payment schedules. Families that lack such capacity can still benefit from housing subsidies, but they should not have access to mortgage credit.

It's also important that direct subsidy programs not be tied to a preselected supply of housing or limited only to projects contracted by the government. However, when the supply of housing is not ample and diversified, subsidies should only be granted when the potential beneficiary already has a commitment to a specific dwelling that doesn't necessarily have to be a new or finished home.

Additionally, the entity issuing the subsidized mortgage credit should not be a state institution. Ideally, attractive lines of credit should be created for banks with a relative advantage serving low-income borrowers efficiently.

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Hammering Out the Macro Distortions

Macroeconomic conditions have long thrown a wrench into the construction of a vibrant housing finance industry and restricted access to credit for low-income families in Latin America. Inflation is one culprit as it burdens borrowers with high front-end payments and reduces the real cost of the total loan for creditors. The other macro structural problem is the mismatch between short-term funding sources and the long-term nature of mortgage loans.

An essential factor in the success or failure of any housing finance system is the ability of homebuyers to adapt to short-term interest rate fluctuations and avoid becoming delinquent on their monthly mortgage payments. One solution to this potential problem is to issue long-term credit at fixed interest rates. However, this type of mortgage credit is very scarce in a region plagued by a history of macroeconomic instability. Only recently have lenders in Chile, Mexico and Peru started to develop non-indexed debt markets in local currency at maturities greater than five years.

Long-term credit at fixed interest rates is the ideal system for mortgage lenders and homebuyers, but it requires substantial macroeconomic stability and credible institutions committed to keeping inflation down. Mortgage credit in the United States is mostly at fixed interest rates, but Latin America still has a long road to travel before it achieves similar levels of macroeconomic stability and policy credibility.

However, fixed-interest credit is not the only alternative.

In England, for example, most long-term credit is issued at variable interest rates. However, credit markets where most loans are at variable interest rates also require strong macroeconomic stability so that any interest rate fluctuations will be moderate over time. The British market is also backed by an efficient and broad credit insurance system that is not generally available in Latin America.

In recent years, lenders in Argentina, Bolivia and Peru have developed medium-term debt instruments at fixed interest rates and denominated in dollars. However, while dollarization was crucial to the recovery of financial intermediation in the region after long periods of macroeconomic instability, a dollar-based mortgage credit system is not the most appropriate system for Latin America since most households earn their income in local currency.

An essential factor in the success or failure of any housing finance system is the ability of homebuyers to adapt to short-term interest rate fluctuations and avoid becoming delinquent on their monthly mortgage payments.

The biggest risk in a dollar-based housing mortgage system is the gap between local currency and dollars that can develop quickly at both the corporate and family levels. Banking regulation aims to keep dangerous gaps in local and foreign currencies from growing and destabilizing banking systems. However, existing financial system regulatory frameworks in the region do little or nothing to prevent banks from issuing loans in dollars to sectors, including families, that do not generate any dollar income.

As a result, payments problems inevitably occur whenever the national currency depreciates. Since wages and salaries are not indexed to the dollar, any devaluation of the national currency increases the average family's debt burden but not its level of real income. Under these conditions borrowers quickly become insolvent and loan delinquencies increase, hurting the overall stability of the financial system. In highly dollarized countries, fluctuations in the real exchange rate also cause economic contraction and increased unemployment.

One alternative explored in Latin America has been to index mortgage obligations to inflation or salary growth. This mechanism clearly protects credit contracts from inflationary fluctuations, and its use has been successful in countries with moderate inflation like Chile and Colombia.

Chile's success was based on two elements: the creation of a credible indexation unit, and confidence in the government's macroeconomic policies. The credibility of the unit of indexation is essential. In Chile, the formula for calculating this index has not been changed since it was first established in the mid-20th century. Thus, the housing mortgage system developed in a climate of strengthening macroeconomic stability,

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Hammering Out the Macro Distortions

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particularly after the 1980s. This encouraged the emergence of long-term institutional investors, which together with the country's institutional stability enabled the rapid development of credit markets in indexed units.

Developing such markets isn't easy, however. Other Latin American countries that have experimented with inflation-indexed credit systems have not been successful. Argentina, Brazil, Colombia and Uruguay ventured into this area in the 1980s and early 1990s, but ultimately failed to develop robust credit markets because of the absence of long-term institutional investors.

They also had difficulty defining how to measure and calculate indexation in a way that would appeal to the interests of both issuers and investors. This problem was compounded by the lack of clear legal rules, since indexation mechanisms were generally established by government decree instead of congressionally approved legislation. Among potential investors, this created uncertainty about the long-term value of such instruments.

The biggest risk that indexed financial systems confront is that indexation will become generalized throughout the rest of the economy. In Chile, for example, one of the byproducts of financial system indexation has been the indexation of salaries to inflation, which has had unfavorable repercussions for employment growth.

Financial systems based on indexed instruments make sense in economies with medium and relatively stable rates of inflation. In recent years, Latin America has achieved significant progress in substantially reducing inflation. Still, today's lower inflation rates are not a guarantee of future stability, particularly given the fiscal vagaries in several countries. The prudent course would be to allow indexed financial markets to develop simultaneously with long-term markets denominated in local currencies, and allow investors to make their own choices based on their individual valuation of macroeconomic policy credibility.

Efficient housing mortgage markets require long-term investors and instruments. The potential investors already exist or are being developed in most Latin American countries. These potential investors include private pension funds and insurance companies. Still needed in most countries, however, is the development of long-term instruments.

Globally, the prevailing tendency is to make mortgage credits tradable in capital markets. This can be done in two ways. One is for mortgage lenders to issue bonds backed by their mortgage portfolio and their assets. The second way is for non-lending institutions to issue mortgage backed securities (MBS). European countries generally prefer the first alternative, while the United States employs MBS. The U.S. model has been used in countries such as Colombia and Mexico.

Banks in Europe grant long-term credit and issue bonds backed by their own mortgage loans. In practice the most important aspect is that the banks are guaranteeing their paper with their own capital. Under this model, the bank keeps the credit on its balance statement and assumes the credit risk. However, this system also requires sufficiently high levels of capitalization to manage credit risks efficiently, plus an appropriate regulatory framework and a strong modern banking oversight system.

Under the MBS system widely used in the United States, banks do not keep mortgage credits on their balance sheets. Instead, the financial entity that issues the mortgage credit sells that credit to a title agent shortly after the mortgage is issued, mainly to Ginny Mae, Freddie Mac and Fannie Mae. These three entities are private institutions but are widely perceived to have a public guarantee. Under the MBS model the investors assume the risk.

The MBS system became popular in the United States during the 1980s; before then, most mortgage credit was financed with short-term deposits. The MBS system developed after interest rates increased sharply at the start of the 1980s, hurting the payment capabilities of debtors and the financial system's stability. Europe very recently has started to experiment with MBS systems, but existing regulatory frameworks made the system's expansion difficult.

An adequately functional MBS system must be built on several pillars, including a stable macroeconomic framework that avoids generalized fluctuations in the ability of debtors to make payments, and that reduces the uncertainties confronted by investors. An effective MBS system also requires solid securitization companies with access to capital, high credit risk ratings and acceptable guarantees for investors. Additionally, an MBS system needs an effective legal framework that guarantees the property rights of debtors and creditors, in particular allowing creditors mechanisms to recover their guarantees without incurring excessive costs. Also, mortgage credit instruments must be relatively homogeneous, credit issuers must use modern, tested methods for evaluating risk, property registries and valuation methods must be efficient and economical, and tax systems should be created that do not discourage financial transactions.

These policies and programs can help iron out macroeconomic kinks, but they cannot substitute for good macroeconomic management. A full-blown macro crisis can bring the whole structure tumbling down. BACK TO INDEX.

New Publications

RESEARCH DEPARTMENT WORKING PAPERS

Las instituciones del financiamiento de la vivienda en Argentina (WP-498)

By Marcela Cristini and Ramiro Moya
(Available in Spanish only)

This paper analyzes the deepening of Argentina's mortgage financing in the 1990s and compares it to the market collapse that occurred in the decade prior. It shows that the market's rapid development was fueled by macroeconomic stability that occured within a context of proper market and legal institutions. More recently, the severe macroeconomic crisis led to a series of defaults that weakened the lender's right to collect mortgage payments. Given the experience of the 1980s, the market is expected to be slow to recover. The recovery will likely involve the creation of a unit of account for the denominating contracts, implementing market capital instruments different from banking instruments, and improving available information.

Financiamiento de la vivienda en Chile (WP-502)

By Carlos García and Felipe G. Morandé
(Available in Spanish only)

In the last 20 years, housing financing in Chile has achieved an important level of development. The fundamental reasons for this development are: a) eliminating the effect of inflation on long-term debt value by creating a unit of account; b) provisional reforms in the beginning of the 1980s that were key for the creation and development of a long-term capital market; and c) housing policy. Despite this progress, much remains to be done, especially reducing transaction costs, considering lesser risks not currently covered, and improving access to financing for many more sectors of society.

Los efectos del sector público en el financiamiento a la vivienda: El mercado hipotecario de Uruguay (WP-503)

By Eduardo Gandelman and Néstor Gandelman
(Available in Spanish only)

This paper studies the Uruguayan mortgage loan market. The principal operator in this market is the state-run Banco Hipotecario del Uruguay (BHU). This bank has found itself in financial difficulty of late, owing primarily to political interference in technical decisions, practical (not legal) difficulties in pursuing non-performing loans, and the general crisis in Uruguay's financial system. Analysis of the BHU's bookkeeping reveals severe currency and maturity mismatches and a credit portfolio with a high degree of non-performing loans. The private sector, meanwhile, is shackled by the legal obstacles it faces in recouping non-performing loans.

The Effect of Conditional Transfers on School Performance and Child Labor: Evidence from an Ex-Post Impact Evaluation in Costa Rica (WP-505)

By Andrew Morrison and Suzanne Duryea

Conditional transfer programs are becoming a common approach to influence household decisions. The evidence to date is that these programs are good at promoting certain outcomes such as school attendance, but that other outcomes such as reducing child labor are more difficult to achieve. This study examines the impact of *Superémonos*, a conditional transfer program in Costa Rica, which provides poor families with a subsidy for the purchase of food conditional upon their children's regular school attendance. The paper finds strong evidence that the program achieves its goal of improving school attendance and much weaker evidence regarding school performance. The program does not reduce the likelihood that youth will work. These findings are discussed in the context of the results from impact evaluations of other conditional transfer programs.

Inequality and Institutions (WP-506) Will also appear as a forthcoming CEPR working paper.

By Alberto Chong and Mark Gradstein

This paper presents theory and evidence on the relationship between inequality and institutional quality. We propose a model in which the two dynamically reinforce each other and set out to test this relationship with a broad array of institutional measures. We establish double causality between better institutional quality and a more equal distribution of income, but also demonstrate that the link from the latter dominates the former. These results are shown to be robust to various specifications and different data sources covering various time-spans.

On the Empirics of Sudden Stops: The Relevance of Balance-Sheet Effects (WP-509)

By Guillermo A. Calvo, Alejandro Izquierdo and Luis-Fernando Mejía

Using a sample of 32 developed and developing countries, we analyze the empirical characteristics of Sudden Stops in capital flows and the relevance of balance sheet effects in the likelihood of their occurrence. We find

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that large real exchange rate (RER) fluctuations accompanied by Sudden Stops are basically an emerging market (EM) phenomenon. Sudden Stops seem to come in bunches, grouping together countries that are different in many respects. However, countries are similar in that they remain vulnerable to large RER fluctuations. This may be the case because countries are forced to make large adjustments in the absorption of tradable goods, and/or because the size of dollar liabilities in the banking system (i.e., domestic liability dollarization, or DLD) is large. Openness, understood as a large supply of tradable goods that reduces leverage over the current account deficit, in combination with DLD, is a key determinant of the probability of Sudden Stops. The relationship between Openness and DLD in the determination of the probability of Sudden Stops is highly non-linear, implying that the interaction of high current account leverage and high dollarization may be a dangerous cocktail.

LATIN AMERICAN RESEARCH NETWORK WORKING PAPERS

The Impact of Trade Liberalization on Employment, Capital, and Productivity Dynamics: Evidence from the Uruguayan Manufacturing Sector (R-479)

By Carlos Casacuberta, Gabriela Fachola and Néstor Gandelman

This paper studies the impact of trade liberalization on labor and capital gross flows and productivity in the Uruguayan manufacturing sector. Uruguay opened its economy in the presence of—at least initially—strong unions and structurally different industry concentration levels. Higher international exposure implied slightly higher job creation and an important increase in job and capital destruction. Unions were able to dampen this effect. Although not associated with higher creation rates, unions were effective in reducing job and capital destruction. Industry concentration also was found to mitigate the destruction of jobs but had no effect on job creation or capital dynamics. The changes in the use of labor and capital were accompanied by an increase in total factor productivity, especially in sectors where tariff reductions were larger and unions were not present. The authors found no evidence of varying productivity dynamics across different industry concentration levels.

Effects of Land Titling on Child Health (R-491)

By Sebastián Galiani and Ernesto Schargrodsky

This paper analyzes the impact of land titling on child health through a case study from Argentina. Twenty years ago, a group of squatters occupied a piece of privately owned land in a suburban area of Buenos Aires. When the provincial Congress passed an expropriation law transferring the land from the former owners to the squatters, some of the former owners surrendered the land (and received compensation), while others decided to sue in the slow Argentine courts. The paper takes advantage of this natural experiment to evaluate the effect of the allocation of urban land property rights on child health. The results show that children in the titled parcels enjoy better nutrition and lower teenage pregnancy rates than those in the untitled parcels.

OTHER PUBLICATIONS

Fear of Sudden Stops: Lessons from Australia and Chile. Caballero, Ricardo, Kevin Cowan and J. Kearns. Prepared for the IDB conference "Financial Dedollarization: Policy Options," December 2003. Forthcoming in conference volume.

Latin American economies are exposed to substantial external vulnerability. Domestic imbalances and terms of trade shocks are often exacerbated by sudden financial distress. This paper explores ways of overcoming external vulnerability, drawing lessons from a detailed comparison of the response of Chile and Australia to recent external shocks and from Australia's historical experience. The paper argues that in order to understand sudden stops and how to smooth them, it is useful to highlight two dimensions of investor confidence: country-trust and currency-trust. While these two dimensions are interrelated, there are important distinctions. Lack of country-trust is a more fundamental and serious problem behind sudden stops. But lack of currency-trust may both be a source of country-trust problems as well as a factor in weakening a country's ability to deal with sudden stops. The paper offers ways to improve these two dimensions of investors' confidence in the medium run, and policies to reduce their impact in the short run.

Volume and Quality of Infrastructure and Income Distribution: An Empirical Investigation. Calderón, César and Alberto Chong. *Review of Income and Wealth* 50(1): 87-106.

This paper provides evidence of the link between infrastructure develop-

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ment and income distribution for the period 1960-97. The authors use roads, railways, telecommunications, and energy measures. They find that both quantity and quality of infrastructure are negatively linked with income inequality. The quantitative link tends to be stronger in developing countries than the qualitative link. These findings hold when using different econometric methods and most infrastructure measures.

Democracy, Persistence, and Inequality: Is There a Political Kuznets Curve? Chong, Alberto. *Economics and Politics* 16(2): 189-212.

This paper aims to provide comprehensive empirical evidence on recent theories that link democracy and income inequality for the period 1960-1997. Simple cross-country regressions demonstrate a non-monotonic link between these two variables when using ordinary least squares, instrumental variables, and Eusufzai tests. The paper also employs dynamic panel data techniques to account for potential simultaneity and heterogeneity problems. Using the preferred econometric methodology provides support for the existence of a political Kuznets curve. Moreover, it appears that income inequality is unconditionally persistent.

Bundling of Public Services and Welfare in Developing Countries: The Case of Peru. Chong, Alberto, Jesko Hentschel, and Jaime Saavedra. World Bank Working Paper Series No. 3310. http://econ.worldbank.org/

Using panel data for Peru for the period 1994-2000, this paper finds that when households receive two or more services jointly, household welfare increases 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.

Privatization in Latin America: What Does the Evidence Say? Chong, Alberto and Florencio Lopez-de-Silanes. Economia: *Journal of the Latin American and Caribbean Economic Association*. Spring.

In response to criticism of privatization, 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.

Inward-Looking Policies, Institutions, Autocrats, and Economic Growth in Latin America: An Empirical Exploration. Chong, Alberto and Luisa Zanforlin. *Public Choice*. April, 1-27.

This paper explores the institutional determinants of economic growth in Latin America by testing for a possible "Northian" explanation that links institutional quality and economic growth. The authors employ a simple framework to better understand policymakers' choices and persistence regarding the inward-looking policies that were pursued between the 1930s and the 1980s. They argue that in Latin America, Olson's (1982) idea of encompassing interest should be expanded to cover not only the economic stakes of power holders, but in particular, their psychic income, which includes their political stakes.

Labor Market Adjustment in Chile. Cowan, Kevin, Alejandro Micco and Carmen Pagés. Forthcoming in *Economia*.

This paper argues that the slowdown in employment growth in Chile after 1997 is the result of a negative aggregate demand shock together with downward rigidity of real wages. Two institutional characteristics of the Chilean labor market contributed to this wage rigidity: a statutory minimum wage that became increasingly binding in the years following the Asian crisis, and the prevalence of long-term-price-indexed wage contracts. Using micro-data from the Chilean employment survey, the paper shows that close to 6% of workers were affected by the rise in the minimum wage that took place between 1997 and 2000. These rigidities at the

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micro level seem to be behind the slow recovery of aggregate employment during the period of mild output growth after 1999. More rigid real wages also explain why Chile experienced a relatively larger fall in employment compared to other economies that faced substantial output reductions in the 1990s.

Political Institutions and Growth Collapses. Gaviria, Alejandro, Jessica Seddon, Ugo Panizza and Ernesto Stein. *Latin American Journal of Economic Development*. April, 2004.

Institutions for conflict management are positively associated with the ability to react to economic shocks. But are these results robust to different ways of defining the quality of such institutions? This paper seeks to answer this question with two different indices to measure the quality of conflict management institutions. The first is an index of political constraints on the executive's ability to arbitrarily change the rules of the game and thus reduce redistributive struggles. The second index measures the degree of political particularism, defined as policymakers' ability to further their careers by catering to narrow interests rather than broader national platforms. The paper finds that high levels of political constraints and intermediate levels of political particularism are associated with a quick recovery from economic shocks.

What Makes Reforms Likely: Political Economy Determinants of Reforms in Latin America. Lora, Eduardo and Mauricio Olivera. *Journal of Applied Economics*, 7 (1). May, 2004.

This paper tests the main hypotheses of the recent theoretical literature on the political economy of reform in Latin American countries between 1985 and 1995. The paper first reviews the literature and extracts the main testable hypotheses. Then, a system of indices measures the extent of reform in five policy areas. These indices are the dependent variables in panel regressions where the main explanatory variables are indicators of crisis, political variables and indicators of channels of contagion. There is very strong support for the well-known hypothesis that crises make reform viable and also for the hypotheses that reforms are more likely at the beginning of government periods. None of the hypotheses on the role of political and distributional variables, the importance of compensation schemes or contagion, finds support in the results. Rather disappointingly, however, most of the reforms seem to have responded to a process of convergence.

What Drives Fiscal Decentralization?. Panizza, Ugo. *DICE Report*. Volume 2(1): 21-25.

This paper summarizes the recent literature on empirical regularities as an explanation for cross-country differences in the level of fiscal centralization and looks at the relationship between centralization and secession.

Less Risk, More Credit

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reside, they can never use the dwelling or land as collateral in credit transactions with mortgage banks and other financial institutions.

However, the experience of some countries like Peru has demonstrated that issuing ownership titles to families living in informal settlements is a good way of invigorating local credit markets. Much of the land illegally occupied around Latin America's largest cities either belongs to the state or to a handful of landowners. This implies that governments theoretically should not find it too difficult to devise acceptable procedures and compensation mechanisms for landowners on whose properties informal homes may have been built.

The upside to issuing clear land titles to poor homeowners was shown in Peru's capital city of Lima, where about 200,000 families were granted legal owner titles to the land on which they lived during 1998 and 1999. Within a relatively short time, nearly one-quarter of these families sought loans to improve or expand their homes, using their new ownership titles as collateral for the credits they applied for.

Although definitive studies have not been done yet, it's also likely that issuing ownership titles to families who built homes on land they did not own originally can lead to direct improvements in the quality of that housing, expand the secondary resale market so that poorer families can become upwardly mobile socioeconomically, and create new jobs.

Look Who's Talking

This section of the newsletter spotlights presentations or events sponsored by RES in recent months.

Minimizing Macroeconomic Volatility and Avoiding Crises: What Have We Learned?

Andrés Velasco presented a policy seminar to the Bank on March 8, 2004.

One of the greatest challenges currently facing the international financial community is preventing and managing the macroeconomic crises that have wracked emerging markets, particularly Latin America and the Caribbean, with disturbing frequency in recent decades. Since 1980 alone, nearly every Latin American nation has suffered the volatility, uncertainty, and instability of a deep economic crisis. Several, like Argentina and Mexico, have lived through them twice. In a presentation for the New Ideas in Policy series, Harvard University and Universidad de Chile Professor Andrés Velasco suggested several steps that Latin America and the global financial community should take to prevent the recurrence of economic crises.

First, the region must develop stronger institutions to increase credibility and gird itself against economic volatility and catastrophe. However, Velasco cautioned that establishing strong institutions does not necessarily mean implementing inflexible economic policies, such as a currency board. Such inflexible economic policies prevent institutions from developing; furthermore, a good institution does not need tough rules to be effective.

Second, monetary and exchange rate policy should be oriented toward a free-floating currency. Despite the nervousness inspired in regional governments by such a policy, primarily due to the real exchange rate volatility that can result, a freely trading domestic currency produces virtuous results over time. In addition, a floating currency improves economic institutions and other political mechanisms. Analyses have shown that free-floating exchange rates build support for central bank independence and give institutions the flexibility to operate most effectively.

Given the notorious role that indebtedness has played in Latin American economic crises, some economists and observers have called on governments to limit their borrowing. In response, Velasco points out that many economic meltdowns have occurred even when the country has no significant debt problems. The answer, then, is not *less* indebtedness, but better indebtedness. A key component of *better* indebtedness is to borrow more in domestic currency and less in dollars. Another key component is to improve the risk-sharing inherent in indebtedness.

Nevertheless, Latin American countries cannot be expected to bear the entire burden themselves. There is also a role for the international financial community to play in providing liquidity, rethinking crisis management, and helping to overcome thin capital markets. International liquidity crises require a net international provider of liquidity, a role perhaps not adequately filled by the International Monetary Fund. In crisis resolution efforts, more attention must be paid to broader concerted actions, such as coordinated debt rollovers. The current efforts in crisis management, which revolve around the development of a sovereign debt restructuring mechanism, are misguided because sovereign bonds are only a small part of the problem. Finally, there is a role for international financial institutions to play in creating new markets to keep capital markets flush. Providing funds to countries in their own currency, or in a basket of emerging market currencies, represent two possibilities of new types of markets that can be explored.

Back to the Future: Is Latin America Entering a New Expansionary Cycle?

Ernesto Talvi addressed the Bank at a LatinMacroWatch seminar on April 14, 2004.

Evidence from recent quarters suggests that current conditions affecting Latin America's major economies closely resemble conditions at the beginning of the region's growth and investment boom from 1991 to 1997. Recently, as was the case during the early 1990s, international financial conditions have appeared particularly favorable. After a long period of high emerging market spreads following the Russian financial crisis of 1998, spreads for most major Latin American economies' debt have declined to approximately the same level as during the early 1990s.

Further benefits have resulted from the combination of rising commodity prices and a weakening US dollar vis-à-vis the Euro. Although petroleum prices have been rising, the relative weakness of the dollar has made petroleum less expensive than it otherwise would be for oil-importing countries. At the same time, prices for non-

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petroleum commodities exported by countries in the region are also rising.

Present circumstances further resemble the early 1990s in that the world's three major economic regions—the United States, Europe, and Japan—are all experiencing simultaneous growth. This trend has resulted in a return of external capital flows to emerging markets.

These conditions, combined with increasingly favorable real exchange rates and rising international reserves for many countries in the region, have led to a steep increase in asset prices as measured by local stock market indices. This trend is accompanied by accelerated growth in financial leverage, particularly on the part of private enterprise, after the extensive deleveraging that occurred during the collapse years. In fact, the releveraging of the private sector appears to be constrained only by the tendency of financial institutions in the region to rely on collateralized loans.

Releveraging is expected to lead to growing current account deficits as private sector imports of intermediate and capital goods increase, as occurred during the early 1990s. This development, however, is occurring as public-sector debt is declining both in dollar amounts and as a percentage of GDP. Public deleveraging, though, has been accompanied by a combination of low inflation and high dollarization of debt during both the collapse years of 1998-2003 and the current incipient recovery. This combination has proven both a curse and a blessing. Under these conditions governments in the region have engaged only in explicit defaults rather than the implicit defaults that occur in inflationary periods, with an accompanying increase in fiscal transparency and accountability. On the other hand, debt dollarization reduces the scope of potential policy interventions and increases vulnerability to Sudden Stops.

In spite of an encouraging constellation of circumstances, the beginning of a new expansionary cycle faces systemic risks. The most notable of these are the consequences of current and potential measures by the United States Federal Reserve Board. While the Fed's current maintenance of low interest rates holds down spreads on emerging market debt, any increase in the Federal Funds rate could result in an increase in emerging market spreads and a drop in the price of bonds issued by Latin America's larger economies. The financial tightening that may result from these conditions poses a risk to the region's growth.

Within the region's overall scenario of potential growth, Argentina remains a major source of uncertainty. While emerging market spreads have generally been declining since late 2002, Argentine spreads remain high. This problem is aggravated by the composition as well as the stock of debt. In 2004 Argentina is scheduled to make debt payments largely to international financial institutions, particularly the IMF. While the country's debt payments to IFIs will notably decrease in 2005, this decline will be more than offset by a sharp increase in scheduled payments of internal debt.

Argentina's spreads may decline once the country's public debt is restructured, but such restructuring remains problematic. Given that the nominal stock of public debt is equivalent to 76 percent of GDP, high and sustained growth levels are necessary to achieve a debt workout under expectations of a 3 percent primary surplus. International creditors have so far rejected Argentina's offer of a 90 percent writedown of public debt, but smaller reductions depend on growth that permits substantial payments beyond interest on debt already in default. In a 4 percent GDP growth scenario, a 75 percent discount of nominal debt is feasible, while 5 percent growth would be necessary to make a 55 percent writedown realistic. Although realistic projections have produced a range of feasible outcomes between 55 percent and 90 percent, appreciations in the real exchange rate may facilitate a writedown of between 55 and 75 percent.

Foreign Direct Investment in Latin America: What Should We Expect in the Near Future?

Jonathan White, an Associate at consulting firm A.T. Kearney, addressed the Bank in a Research Department Policy Seminar on April 27.

Global foreign direct investment (FDI) flows are undergoing a sea change. After several years of decline, a slight rise in the flow of FDI dollars is expected. Even more importantly, China has emerged as the preferred destination for global investors. Amidst the flux and competition of the international arena, there are reasons for optimism, but Latin America faces several significant challenges in the struggle to capture FDI.

Basing his presentation on the 2003 FDI Confidence Index, an annual survey of global executives conducted by A.T. Kearney's Global Business Policy Council, White began by highlighting global trends. Worldwide FDI has plummeted since peaking at $1.4 trillion in 2000. While FDI bottomed out at $651 billion in 2002, a slight uptick

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to $653 billion was expected once final 2003 figures became available. Furthermore, global investors plan to increase investment in the years to come. While the expected increase is positive news, a more fundamental change in FDI is its destination. Of the top ten most attractive FDI targets, six were emerging markets: China, Mexico, Poland, India, Russia, and Brazil.

For the second year in a row, China topped the list. Since the early part of the decade, China has separated itself from other important emerging market FDI destinations. This is largely related to China's role as a leading exporter to the United States of a wide array of consumer goods, including electronics, footwear and apparel, and household goods. In fact, China's surge has made Asia the second most attractive region for FDI, following only North America, after surpassing Latin America in 2001 and Europe in 2002.

Regardless of China and Asia's strength, however, several factors endogenous to Latin America have contributed to the region's waning attractiveness as an FDI destination. Investors see the region's significant bureaucratic and legal hurdles as stifling entrepreneurship and undermining competitiveness. In Latin America, for example, it takes 74 days to start a business, longer than any other developing region in the world. Additionally, Latin American income distribution, the most unequal on the planet, continues to limit the region's ability to maximize its human capital. Finally, the region's relative macroeconomic instability continues to worry investors. This is particularly true in Brazil, where 69 percent of global investors surveyed indicated that macroeconomic stability would be the most prominent factor in determining the country's FDI flows.

The news is not all bad for Latin America, however. In terms of FDI per capita, the region compares very favorably to emerging market rivals China, India, and Eastern Europe. Mexico, in particular, scores high in this category with nearly $140 of FDI per person. There is furthermore a bright economic opportunity for the region in the growing U.S. Hispanic market. This market, expected to grow from 38 million to 75 million by 2020, could help drive offshore investment opportunities. And China, the alleged rival and ferocious competitor, also offers extraordinary economic opportunity through its burgeoning market. China's voracious appetite for goods like automobiles, petroleum, aluminum, and commodities can be exploited by Latin American economies, and the expected boom in Chinese FDI outflows over the next decade could be an important source of investment for Latin American countries.

More optimism derives from the fact that two of the five countries identified by the survey as "emerging giants" are Latin American countries: Mexico and Brazil. Both countries made strong upward moves as attractive FDI destinations in the last year. Mexico climbed from ninth to third, and Brazil from thirteenth to ninth. Mexico and Brazil were recognized for their attractive infrastructures, transparency, and access to market exports. Both countries scored particularly well with heavy manufacturers, ranking just behind China and the U.S. as attractive destinations for those investors. Mexico and Brazil do, however, suffer in comparison to other emerging markets in the areas of education and production costs.

Opening the Door to Low-Income Home Buyers

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For example, mortgage credits issued by such institutions could be partially refinanced with second-tier entities that obtain their funds under preferential conditions from multilateral entities or else through explicit fiscal transfers from the government. Moreover, banks active in this market should be allowed to set their own margins freely if conditions in the mortgage market are competitive.

Another area where direct subsidies can expand access to mortgage credit for low-income borrowers relates to the high fixed costs of information, registration and the risks associated with non-payment. The recent experiences of Chile and Mexico in this regard suggest it makes good sense to grant direct subsidies to financial intermediaries for costs associated with issuing credit contracts and registering the properties, and also for legal costs associated with repossessing dwellings from delinquent mortgage holders and putting those seized properties up for auction. However, governments that employ these subsidies must ensure they do not reduce the incentives for mortgage credit entities to safeguard the quality of their credit portfolios.

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