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The Balance on Banking in Latin America

Banks play a pivotal role in economic development. They are a key player in the allocation of capital and, hence, in stimulating growth. In fact, bank credit and gross domestic product (GDP) per capita go hand in hand. Countries with small banking sectors have lower levels of development. Given this link between financial and economic development, the problems with Latin America's banking sector are of great concern.

Why care about bank credit? First of all, when it comes to financing for firms, in Latin America bank credit is virtually the only game in town. Developed countries have capital markets that can complement and in some cases even substitute for bank credit. But strong capital markets have not developed in Latin American countries, meaning the main source of external financing for firms is bank credit.

Given few alternative sources of financing, the development and stability of the banking sector is crucial for achieving stable economic growth. When capital markets are shallow, banks bear most of the burden of searching for safe and profitable investment projects in need of capital, and of supplying them that capital. Without an efficient means of capital allocation, profitable projects would go by the wayside, and economic growth could be hindered.

Besides providing capital efficiently to finance investment projects, banks perform several other tasks that support economic activity. Banks provide liquidity and access to a payments system. Because of the size of transactions or the physical distance between parties in a transaction, cash is often not a practical payment option. The use of non-physical forms of money—such as checks, debit cards, and credit cards—is crucial for the adequate performance of goods and services markets. Banks provide a clearing system and network to facilitate most economic transactions by guaranteeing that the payer at one end of a transaction will in fact deliver the agreed funds to the payee at the other end in a quasi-automatic way. The ability to efficiently transfer funds between agents is essential for a market-based economy.

> Bank credit in Latin America is scarce, costly and extremely volatile.

Providing a safe set of institutions to protect savings, allocate resources efficiently, and support the efficient handling of financial transactions is crucial for development. However, due to problems related to asymmetric information and full contractibility between borrowers and lenders, the management of risks is not straightforward. Creating and maintaining a safe and sound banking system is a difficult task.

Sadly, the banking system in Latin America and the Caribbean does not fare well in performing this task. To begin with, bank credit is scarce in the region. During the 1990s, the average level of credit to the private sector was only 28 percent of GDP, a rate significantly lower than that of other developing countries, such as East Asia and the

▶ *Continued on page 2*

IN THIS ISSUE

Banking and Macroeconomic Instability: A Chicken-and-the-Egg Story 3
Avoiding Crises: A Financial Safety Net 5
A New Look for Banking Systems 7
New Publications 9
Look Who's Talking 12
Network News 16

The Balance on Banking in Latin America

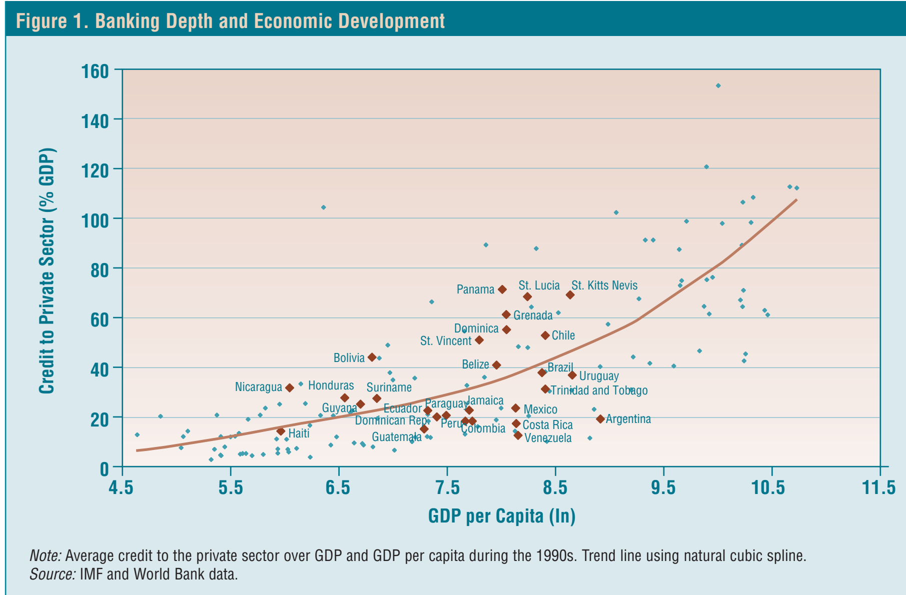
▶ from page 1

Pacific (72 percent), and the Middle East and North Africa (43 percent). The size of the region's credit markets is shockingly small when compared with developed countries (84 percent).

A larger view of the financial sector, including bank credit as well as capital markets, is equally disappointing. Although the current level of credit to the private sector in Latin America compares favorably with the level observed in the past, the banking industries in other developing countries have developed much faster. For example, credit to the private sector in East Asia averaged 15 percent of GDP in the 1960s and now exceeds 70 percent of GDP; in Latin America and the Caribbean credit has gone from 15 percent to 28 percent.

Not only are credit markets small, but in many countries the size of the financial sector is even smaller than what would be expected at their level of economic development. Figure 1 shows that except for Bolivia, Chile, and Panama, most of the continental Latin American countries have small banking sectors for their level of development. Countries such as Argentina, Mexico, and Venezuela have very underdeveloped banking sectors. In Argentina, the level of credit to the private sector during the 1990s (20 percent) was 30 percentage points lower than predicted for its level of development (50 percent). On the other end of the spectrum, most Caribbean countries present larger banking sectors than expected, given their development level.

Figure 1. Banking Depth and Economic Development



Note: Average credit to the private sector over GDP and GDP per capita during the 1990s. Trend line using natural cubic spline.
Source: IMF and World Bank data.

An underdeveloped financial sector in general and a small banking sector in particular means businesses in Latin America face major problems accessing financial markets. For almost all Latin American countries covered by the World Bank's World Business Environment Survey, access to credit was the most serious concern.

Underdeveloped banking sectors mean not only less credit for businesses, but also more expensive credit due to high interest rate spreads—the difference between the interest rate charged to borrowers and the rate paid to depositors. Countries with small banking sectors have high interest margins. Venezuela has the third-highest margin in the world (18.3 percent). Panama, which has a well-developed financial sector, has a low interest spread (3.8 percent), which is close to the mean spread observed in developed countries (3.5 percent). In the Latin American and Caribbean region, Panama and Chile have the lowest spreads. As a whole, Latin America has one of the highest margins in the world (8.5 percent), just below that of Eastern Europe and Central Asia (8.8 percent).

Beyond financial depth and low interest margins, financial stability is also crucial for growth. Here, too, Latin America fares poorly. Compared with other regions, Latin America displays the highest average number of banking crises per country. Moreover, when ranking regions by the share of countries that have experienced two or more crises, Latin America comes out first; 35 percent of its countries have suffered recurrent crises. This share is almost three times higher than in any other region.

In sum, bank credit is the main source of funding for firms and households in Latin America and the Caribbean. Unfortunately, bank credit remains scarce, costly, and extremely volatile. Given the importance of banking to growth and prosperity, the Inter-American Development Bank has made this sector the focus of its *2005 Report on Economic and Social Progress in Latin America*. The Report analyzes the causes of each of these three main characteristics of bank credit and makes policy recommendations. This edition of IDEA is based on that report, summarizing some of the major issues from *Unlocking Credit*: *The Quest for Deep and Stable Bank Lending*.

Banking and Macroeconomic Instability: A Chicken-and-the-Egg Story

The size and volatility of credit markets in Latin America and the Caribbean is very much linked to macroeconomic shocks. But much like the proverbial chicken and the egg, it's not entirely clear which comes first. On the one hand, banks have often been an important source of instability in the region. On the other, banks have also been on the receiving end of the relationship; the volatility of bank assets and liabilities reflects a long history of macroeconomic imbalances and a lack of instruments to cope with these imbalances.

The way countries respond to macroeconomic shocks has important implications for the shape of the banking sector. The size of the banking sector and many other characteristics can be linked to the evolution of the macroeconomic environment. For example, the high levels of inflation and macroeconomic uncertainty of the 1980s produced small and/or highly dollarized banking systems in some countries. Fearing their portfolios are vulnerable to macroeconomic fluctuations, depositors have chosen to stay liquid, typically selecting short deposit maturities so they can be "ready to run" in case some factor, typically external, triggered a crisis.

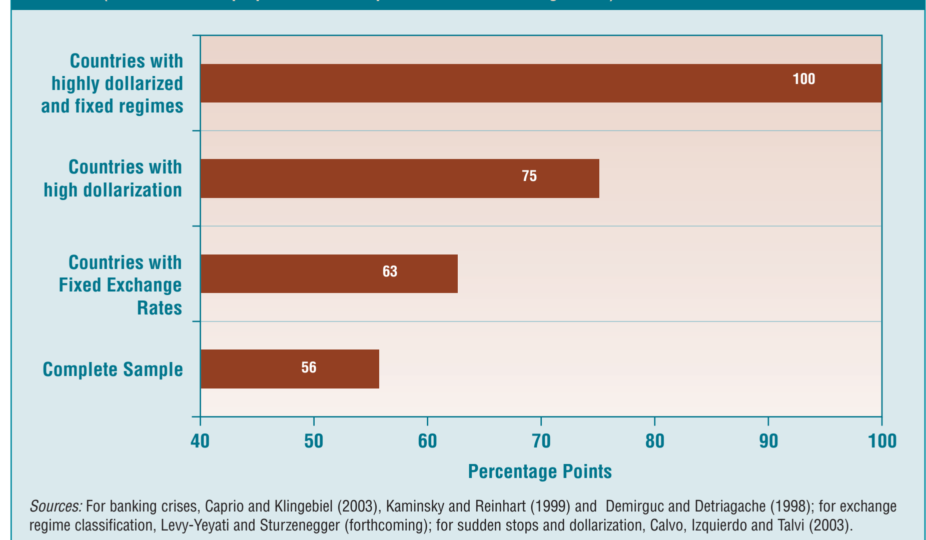
Many of the most recent banking crises can be linked to external factors, which have led to liquidity constraints and contagion across capital markets. Sudden stops in capital flows, namely unexpected cuts in the financing of the current account deficit, have had a profound impact on Latin America and the Caribbean. The bunching of banking crises and sudden stops during the 1990s suggests that a common external element may be partly responsible for bank volatility, particularly because countries facing quite different macroeconomic fundamentals were hit at about the same time. The Russian crisis of 1998 is a case in point, representing a major volatility factor in Latin America and in emerging markets in general.

While it may be tempting to blame banking crises on external factors and there is no doubt that sudden stops have been a deadly trigger, new evidence points an accusing finger at domestic issues as well. Financial dollarization, coupled with large potential changes in relative prices following a sudden stop when economies are relatively closed, may substantially increase the likelihood of a standstill in capital flows, which, in turn, may wreak havoc on the banking system (Calvo, Izquierdo, and Mejía 2003). Particular banking sector characteristics such as high dollarization may in and of themselves be responsible for macroeconomic volatility. Indeed, sudden stops have typically been accompanied by banking crises, particularly in cases of high liability dollarization. Figure 2 shows that in highly dollarized countries, about 75 percent of sudden stops have materialized together with banking crises. These characteristics are mainly the result of poor domestic policies, including high inflation and its effects on liability dollarization, restrictive trade policies that discourage the production of tradable goods and potentially lead to significant changes in relative prices following a sudden stop, and excessive risk-taking by banks leading to excess dollarization.

Why do banks engage in risky behavior? Again, at least part of the problem may lie in high macroeconomic volatility, as it weakens the ability of creditors and regulators to properly assess risks. But moral hazard issues,

▶ Continued on page 4

Figure 2. Banking Crises and Sudden Stops Worldwide, 1974–2003
(% of sudden stop episodes contemporaneous with banking crises)



Sources: For banking crises, Caprio and Klingebiel (2003), Kaminsky and Reinhart (1999) and Demirguc and Detriagache (1998); for exchange regime classification, Levy-Yeyati and Sturzenegger (forthcoming); for sudden stops and dollarization, Calvo, Izquierdo and Talvi (2003).

Banking and Macroeconomic Instability: A Chicken-and-the-Egg Story

▶ from page 3

resulting from a poor regulatory and supervisory framework and the perception that the government will bail out unsuccessful investments, also play a role in encouraging excessive risk-taking and in spawning banking crises. In turn, these moral hazard issues have often been an unintended byproduct of the financial liberalization process in some countries. The upside to financial liberalization is that by promoting savings and improving its allocation, it can improve financial depth and boost economic growth. The downside is that the resulting credit boom may be too much for the system to handle—witness the banking crises of the 1980s and 1990s. Given weak financial regulation and supervision and either implicit or explicit government safety nets, depositors, borrowers and banks were often tempted into risky, and even fraudulent, behavior. Excessive risk-taking opened the door for financing bad credit risks and eventually led to a substantial amount of nonperforming loans. Given that in many cases financial liberalization coincided with the removal of capital account restrictions, much of the lending boom was financed through foreign capital inflows, sometimes directly mobilized by the banking system through increases in bank liabilities with foreigners. This strategy, in turn, made countries more vulnerable to external liquidity shocks. Thus, in many respects, banking crises were accidents waiting to happen in the context of bank fragility due to excessive risk-taking during lending booms spurred by liberalization. Still, it is important to stress that moral hazard issues are not the whole story. The crises of the late 1990s highlight that even when moral hazard plays a minor role, external liquidity factors and sudden stops can bring banking systems to their knees.

Whether they are the cause or the effect, something about banking crises is sure: they exact a high toll on growth and carry daunting fiscal costs. The disruption of the payments system not only hits short-term economic growth, but also affects growth in the long run. Crises typically weaken the balance sheets of banks and borrowers alike. Since banks are a major source of financing, contractions in credit due to plummeting net worth may cut into investment and consumption spending. As depositors lose confidence in the banking system, they may take their money elsewhere, causing savings to decline or capital outflows to surge. As banks are intervened or closed, valuable information on borrowers is lost.

All these factors contribute to the inability of the banking system to function efficiently, and, as a result, to a flight from the formal financial sector. In addition, bank bailouts typically entail high fiscal costs, which, by raising the public debt and debt service cost, may have an impact on consumption and investment. Individually, these considerations are bad enough; but when taken together in times of crisis, they can have a devastating effect on economic growth.

This issue of *IDEA* is based on the research conducted under the direction of Arturo Galindo, Alejandro Izquierdo and Alejandro Micco for the 2005 report on Economic and Social Progress in Latin America entitled: *Unlocking Credit: The Quest for Deep and Stable Bank Lending*.

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IDEA (Ideas for Development in the Americas) is an economic and social policy newsletter published three times a year by the Research Department, Inter-American Development Bank. Comments are welcome and should be directed to *IDEA's* managing editor, Rita Funaro at Ritaf@iadb.org.

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Avoiding Crises: A Financial Safety Net

Banking crises, or near-crises, have been a recurrent and costly problem throughout Latin America and the Caribbean. In all countries, restructuring financial systems is an expensive proposition, both in terms of the direct fiscal cost it entails and the brake it applies on economic activity. In order to avoid such costs, many countries have tried hard to strengthen the financial sector and reduce its volatility.

The main policy front in the battle with financial volatility and eventual systemic banking crises has been to develop and strengthen financial safety networks. A financial safety network is a set of rules and institutions designed to reduce financial instability in order to protect financial intermediation and the payments system. It comprises the definition of prudential rules and their strict enforcement, adequate supervision of banks, establishment of institutions such as deposit insurance and a lender of last resort, and enabling private agents to monitor and discipline banks. Clearly, the recent fragility in Latin American banking markets reveals that there are still many holes in the financial safety net.

A key component of a financial safety net is prudential regulation and supervision of banks. There are at least two classic arguments for banking regulation. The first is to protect small and unsophisticated depositors. Capital regulation and the requirement to inject new capital when necessary or otherwise face closure are ways to align a bank's risk-taking position with the interest of depositors. The second classic rationale for banking regulation stems from the unavoidable need to protect the payments system and the financial system more generally. Often enough, otherwise solvent banks have been subject to pure liquidity runs. Moreover, if some depositors run against a weak bank, other depositors may run against other healthier banks in the system, setting off a chain reaction known as contagion.

How can runs be prevented? One way is for a central bank to promise liquidity to solvent banks—that is, for the central bank to provide lender of last resort services. However, the promise that they will be rescued may weaken banks' incentives to reduce risks. Defining the operation of the lender of last resort implies finding a balance between these trade-offs.

> Market and supervisory discipline may look like an either/or choice but, in fact, they complement each other.

A second way to prevent liquidity runs is by providing deposit insurance. However, if depositors are insured, then the link between the required rate of return and the underlying risk of the bank is broken and the incentives of bank owners and managers may change. These shifts in incentives are normally referred to as moral hazard. Designing a deposit insurance mechanism that boosts credibility in the financial system to mitigate bank panics without generating excessive moral hazard is a difficult task, and failure to strike the appropriate balance can have disastrous consequences indeed. International evidence has shown that a well-defined deposit insurance scheme can contribute to financial stability, but a deficient one can actually increase the likelihood of a crisis.

Capital regulations may then be seen as an attempt to counteract the moral hazard created by the safety net. From this perspective, intervening through prudential regulation and supervision is justified in order to reduce banking sector risks and avoid the potentially damaging impact of crises on the rest of the economy. In this area, Latin American countries still have a long way to go. Despite many reforms throughout the region, especially since the early 1990s, severe weaknesses that regulation has not addressed properly still plague the system. The principal weaknesses relate to the operational independence and resources of the regulatory agency, the existence of a suitable legal framework and legal protection for supervisors, remedial measures in case of bank fragility, weak links between capital adequacy requirements and risk, and lack of consolidated supervision. Weaknesses in regulation increase the likelihood and costs of crises. In the Dominican Republic, lack of regulation and enforcement on credit concentration and related lending, among other issues, led to a large-scale banking collapse in 2003. In Argentina and other highly dollarized countries, weaknesses in addressing the risks associated with financial dollarization also increased the likelihood and costs of the banking crises in 2001 and

▶ Continued on page 6

Avoiding Crises: A Financial Safety Net

▶ from page 5

onward. Another concern in many countries is how to address the risk of holding a high concentration of government debt in banks' balance sheets. All in all, it is clear that prudential regulation and supervision are not tight enough, and further reforms are needed to improve banking oversight.

Assuming that supervisors have appropriate powers and that regulations are properly designed, supervisors may still lack the required information to effectively monitor those regulations. These regulatory and supervisory failures imply that it will in general be useful to harness the market to discipline banks. Market discipline has typically been viewed as the reaction of bank creditors (depositors and other liability holders) to increases in bank risk and the subsequent reaction of banks to the actions of creditors. Discipline is considered effective when banks act promptly to curb any actual or potential negative actions on the part of creditors.

At first sight, market and supervisory discipline may look like an either/or choice, but, in fact, they complement each other. Appropriate regulations can enhance the disciplining power of markets, and markets can reinforce the disciplining power of supervisors. Together they may imply greater discipline than the simple sum of the two components. Depositors discipline banks in Latin America by pulling out their money when banks become more vulnerable or asking for higher interest rates when bank fundamentals look weak. Banks, in turn, increase their capital-asset ratio to compensate for the behavior of depositors. Still, there is enough room to increase the scope of market discipline in Latin America in order to step up private sector oversight of the banking system.

POLICY AGENDA

What can be done to address the deficiencies of the banking system in Latin America and the Caribbean? The following is the outline of a policy agenda that addresses the problems of cost, scarcity and volatility.

- **Plan ahead to avoid crisis**
  - Reduce the likelihood of twin crises by dealing with domestic liability (currency mismatches) via regulation in the banking system and/or creating hedging markets.
  - Reduce liability dollarization by
    - Increasing central bank independence lowers inflation volatility and curtails fiscal pressure.
    - Introducing sound alternatives to dollar assets, such as CPI-indexed instruments.
  - Face sudden stops with a pre-announced monetary policy that reduces uncertainty.

- **Pay for your sins**
  - Crisis resolution processes must ensure that the parties who took the highest risks bear the brunt of the costs.

- **Play safe**
  - Financial regulation must appropriately measure credit risks (including the treatment of dollar loans and government debt) to determine safe levels of capital-adequacy ratios and provisions.
  - Basel I remains a challenge for the region, and the adoption of Basel II demands caution.

- **Define the government's business**
  - The role of government in commercial banking needs to be redefined by specifying its social mandate and ensuring cost effectiveness.

- **Design the right environment**
  - Increasing credit protection requires a serious reform of secured transaction laws. The first step is to create specialized courts for dealing with collateral claims.
  - Establish a regulatory framework for proper information sharing to increase credit access and enhance supervision.

A New Look for Banking Systems

The banking industry has changed dramatically around the world, and Latin America is no exception. During the 1990s, financial crises and regulatory tightening triggered a process of bank consolidation throughout the region. In Argentina, Brazil, Colombia, Costa Rica, El Salvador, and Peru, more than a quarter of all banks either closed or merged between 1996 and 2002. In this consolidation process, banking acquired a distinctly foreign accent; foreign-owned banks moved in while many state-owned banks closed shop.

In many countries, foreign-owned banks have become the main players in the domestic financial system. In Latin America and the Caribbean, local currency lending by branches or subsidiaries of foreign banks represents more than 65 percent of total bank lending. In Argentina, Chile, Mexico, and Peru, foreign banks controlled more than 50 percent of assets in 2002 compared to less than 30 percent in any of these countries in 1995.

With bigger foreign fish dominating a smaller local pond, fears were that large international banks could exploit their market power by paying lower deposit rates and charging higher interest rates on loans. However, this has not been the case. The increase in concentration in Latin American banking was due to technological innovation and financial liberalization that reduced entry barriers and did not lead to greater market power. Higher concentration neither increased credit costs nor lowered credit levels in Latin America.

Most economists agree that the presence of foreign-owned banks can play a useful role in developing and modernizing the financial system. Rather than lowering credit levels, evidence shows that foreign bank entry has actually expanded credit, although most of this credit is directed toward large firms. Foreign banks also tend to be more efficient than domestic banks and have lower net intermediation margins, reflected in lower overhead costs. For Latin America, Table 1 shows that relative to domestic private banks, foreign institutions have lower overhead costs and interest margins (the loan rate minus the deposit rate).

An area in which the presence of foreign banks represents a mixed blessing is credit stability. Foreign banks have better exit strategies than domestic banks, and hence in times of crisis they can destabilize credit. For example, if an economy is hit by a shock that affects the productivity of overall projects and increases credit risk, most banks might decide to cut back on credit. But if a bank has the option to redirect its funds toward another economy that was not hit by the shock, its credit may be more volatile than others. Usually foreign banks have this choice and can cut credit more than domestic banks.

However, at times foreign banks can help stabilize credit. Foreign banks do not suffer as much as domestic banks when there is an overall decline in deposits since they can usually make up the difference with deposits from abroad or capital transfers from their parent bank. Foreign banks may also be more stable when there is a run on deposits since depositors may perceive foreign banks, backed by a parent in a developed country, as being stronger than domestic banks. Whether foreign banks stabilize or destabilize credit depends on the nature of the shocks that hit the economy. Foreign banks play a useful stabilizing role when shocks come from the deposit availability side. Their potential benefits are also likely to depend on the

▶ Continued on page 8

Table 1

Ownership and Bank Characteristics in Latin America, 1993–2003 (percent)

Bank ownership	Loan Rate[1]	Deposit Rate[1]	Overhead Costs[2]	Loans to Private Sector[3]	Nonperforming Loans[4]	Returns on Assets[5]
Domestic	4.20	2.68	1.10	12	6	28
Public	3.86	1.84	1.40	19	6	12
Foreign	4.01	2.74	1.00	13	5	28

Source: Bank Superintendencies.

Note: For domestic banks we use the sample median. For public and foreign banks it is the private domestic value plus the computed deviation using a regression analysis.

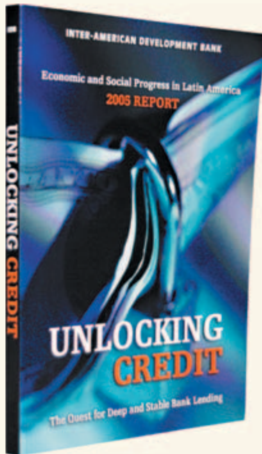
1 Rates are in real terms. 2 Overhead costs over total assets in percentage points

3 Loans to the public sector as a share of total assets.

4 Nonperforming loans over total loans.

5 Return on assets in percentage points.

Unlocking Credit: The Quest for Deep and Stable Bank Lending



Credit supplied by the banking sector is the most important funding source for firms and households in Latin America and the Caribbean. Unfortunately, credit is scarce, costly and volatile. Without deep and stable credit markets, the region will be hard pressed to achieve high and sustainable growth rates and combat poverty.

Given the importance of banking to growth and prosperity, the Inter-American Development Bank has made this sector the focus of its *2005 Report on Economic and Social Progress in Latin America*. The Report analyzes the three main characteristics of bank credit—scarcity, expense and volatility—and makes policy recommendations.

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A New Look for Banking Systems

▶ from page 7

degree of sophistication of the financial system; the less sophisticated the system, the greater the positive impact of foreign banks.

Traditionally, the public sector has been a large player in Latin American banking systems. Views on this issue are extremely polarized. Some economists argue that the need for public intervention is particularly strong in economies where scarce capital, high public distrust, and endemic debtor fraud inhibit the development of a financial sector capable of supporting economic growth. Other economists claim there is little economic justification for government ownership of banks and that it is only dictated by political goals.

The evidence finds that state-owned banks do little to expand credit availability or direct credit toward small firms or sectors that require it the most. Public banks reduce borrowing costs for their customers but this does not necessarily translate into financing for disadvantaged sectors. The presence of public banks does not open the doors to credit for small and medium-sized enterprises, potential homeowners or firms in economic sectors having difficulty tapping credit markets. In fact, the credit access gap between large and small firms in countries with high public participation in commercial banks is actually larger than in countries with low levels of public banking. However, much of the existing evidence on the negative development role of state-owned banks is not as strong as previously thought, although they could be a source of fiscal problems due to their relatively larger share of nonperforming loans.

Whether most banks are privately or publicly owned may also affect the volatility of the banking system. Private bank lending could overreact to recessions and amplify the business cycle. In Latin America, credit extended by public banks is less procyclical than that of private banks. Similarly, deposits are less procyclical at public banks than at private domestic banks. The smoothing effect of public banks is particularly strong when domestic deposits are growing slowly or when credit grows less than total demand deposits. Of course, this

> During the consolidation process of the 1990s, foreign-owned banks moved in while many state-owned banks closed shop.

analysis focuses on bank-level variables and not on aggregate credit. If public banks were to crowd out private credit, their presence could still lead to greater credit volatility.

Over the past ten years, the trend in bank ownership has been clear: foreign-owned banks are up and public sector banks are down. What is not as clear is what this change in ownership means.

New Publications

RESEARCH DEPARTMENT WORKING PAPERS

Employment Protection and Gross Job Flows: A Differences-in-Differences Approach (WP-508)

By Alejandro Micco and Carmen Pagés

This paper examines the effect of employment protection regulation on gross job flows in a sample of developed and developing countries. Unlike most of the existing literature, this analysis indicates that more stringent job security regulations slow down gross job flows, and this tendency is more pronounced in sectors that require higher labor flexibility. These effects occur within the sample of developed and developing countries, and the effects are very large in magnitude. Moreover, these effects are robust to changes in regulatory measures, measurement of sector flexibility requirements, control variables and samples.

Infrastructure, Competition Regimes and Air Transport Costs: Cross Country Evidence (WP-510)

By Alejandro Micco and Tomás Serebrisky

Focusing on air transport, this paper quantifies the effects of infrastructure, regulatory quality and liberalization of air cargo markets on transport costs. During the 1990s, the US implemented a series of Open Skies agreements with numerous countries, which have provided a unique opportunity to assess the effect on prices of a change in the competition regime. The results show that infrastructure, quality of regulation and competition matter. An improvement in airport infrastructure from the 25th to 75th percentiles reduces air transport costs by 15 percent. A similar improvement in the quality of regulation reduces air transport costs by 14 percent. In addition, Open Skies agreements reduce air transport costs by 8 percent.

Fiscal Sustainability in Emerging Market Countries with an Application to Ecuador (WP-511)

By Carlos Díaz Alvarado, Alejandro Izquierdo and Ugo Panizza

This paper surveys the recent literature on fiscal sustainability, with particular emphasis on emerging market countries. It discusses the main elements that differentiate emerging market countries from industrial countries and then discusses how probabilistic models can help to evaluate fiscal sustainability in an uncertain environment. Based on this discussion, the paper uses Ecuador to illustrate an application of the probabilistic model, and of the framework to evaluate the impact of shocks to current account financing on sustainability.

Privatization in Mexico (WP-513)

By Alberto Chong and Florencio López-de-Silanes

In Mexico, privatization led to a significant improvement in firm performance, primarily through productivity gains, and has provided greater access to services. Moreover, the often-overlooked fiscal impact of privatization, based on reduced subsidy outlays and higher tax revenues, can help pay off debt or finance social spending.

Mexico's experience provides several lessons for future privatizations. First, the privatization process must be carefully designed and transparently administered. Second, restructuring firms prior to privatization, which fails to raise net sale prices and lengthens the privatization process, should be avoided. Finally, it is essential to carefully deregulate and re-regulate privatized firms to ensure that they behave appropriately as well as to provide a sound corporate governance framework.

Argentina's Distributional Failure: The Role of Integration and Public Policies (WP-515)

By Leonardo Gasparini

This paper documents the income distribution changes in Argentina during the last three decades. Within that time frame, inequality increased substantially, and despite economic growth during some periods, poverty also rose significantly. Two types of events have shaped Argentina's income distribution: deep macroeconomic crises and periods of openness and integration. The sizeable increase in inequality in the 1990s appears to be associated with reallocations away from unskilled-labor intensive sectors, and especially toward skill-biased technological change within most sectors. Both factors have been stimulated by the process of economic integration. The depth and speed of the reforms and the absence of public policies to ease the transition contributed to the particular severity of Argentina's changes in income distribution.

LATIN AMERICAN RESEARCH NETWORK WORKING PAPERS

The Elasticity of Substitution in Demand for Non-Tradable Goods in Latin America: The Case of Argentina (R-485)

By Martín González Rozada, Pablo Andrés Neumeyer, Alejandra Clemente, Diego Luciano Sasson and Nicholas Trachter

The objective of this paper is to estimate the elasticity of substitution in the

▶ Continued on page 10

New Publications

from page 9

demand for non-tradable goods relative to tradable goods in Argentina. This parameter plays a crucial role in the analysis of the macroeconomic equilibrium of a small open economy (Mendoza, Galindo and Izquierdo, 2003). Using two data sets, estimates of approximately 0.40 and 0.48, respectively, are found for this elasticity.

An Empirical Examination of Union Density in Six Countries: Canada, Ecuador, Mexico, Nicaragua, the United States and Venezuela (R-487)

By Susan Johnson

Union density is an indication of the strength and potential influence of the labor movement in an economy. This paper examines and compares union density in six countries: Canada, Ecuador, Mexico, Nicaragua, the U.S. and Venezuela. Two determinants of union density are examined: (1) the structure of the paid labor force, and (2) the probability that a worker with given labor force characteristics is a union member. The union density gap between Canada, the country with the highest union density, and each country is decomposed in order to explore the contribution of each determinant to the gap.

The Elasticity of Substitution in Demand for Non-Tradable Goods in Costa Rica (R-489)

By Gilberto E. Arce and Edgar Robles C.

This paper estimates the elasticity of substitution in the demand for non-tradable goods in Costa Rica. Using quarterly information for the period 1980-2002, estimates between 1.46 and 1.66 are found. The main caveat of this exercise is that total trade-output ratios are computed with GDP instead of gross output and that price data need to be approximated using CPI data. Using an alternative dataset of annual information that allows us to deal with these limitations by gathering consistent sectoral price and consumption data from national accounts, lower estimates between 0.22 and 0.26 are reached.

OTHER PUBLICATIONS

On the Empirics of Sudden Stops: The Relevance of Balance Sheet Effects. Calvo, Guillermo A., Alejandro Izquierdo and Luis-Fernando Mejía. NBER Working Paper 10520.

Using a sample of 32 developed and developing countries, this paper analyzes the empirical characteristics of Sudden Stops in capital flows and the relevance of balance-sheet effects in the likelihood of their occurrence. The paper finds 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.

Effective Labor Regulation and Microeconomic Flexibility. Caballero, Ricardo J., Kevin Cowan, Eduardo M. Engel and Alejandro Micco. NBER Working Paper 10744.

Microeconomic flexibility, which facilitates the process of creative destruction, is at the core of economic growth in modern market economies. This process is not instantaneous, however, largely because of adjustment costs, some technological and others institutional. Chief among the latter is labor market regulation. While few economists would object to such a view, its previous empirical support is rather weak. This paper revisits this hypothesis and finds strong evidence for it. Using a new sectoral panel for 60 countries and a methodology suitable for such a panel, the paper finds that job security regulation clearly hampers the creative destruction process, especially in countries where regulations are likely to be enforced. Moving from the 20th to the 80th percentile in job security, in countries with strong rule of law, cuts the annual speed of adjustment to shocks by a third while shaving off about one percent from annual productivity growth. The same movement has negligible effects in countries with weak rule of law.

Fear of Sudden Stops: Lessons from Australia and Chile. Caballero, Ricardo J., Kevin Cowan, and Jonathan Kearns, NBER Working Paper 10519.

Latin American economies are exposed to substantial external vulnerability.

Continued on page 11

New Publications

▶ from page 10

Domestic imbalances and terms of trade shocks are often exacerbated by sudden stops of capital inflow. This paper explores ways of overcoming external vulnerability by drawing lessons from a detailed comparison of the response of Chile and Australia to recent external shocks, as well as from Australia's historical experience. In order to understand sudden stops and the mechanisms to smooth them, it is useful to identify and then distinguish between two inter-related dimensions of investors' confidence: country-trust and currency-trust. Lack of country-trust is a more fundamental and serious problem behind sudden stops. But lack of currency-trust may lead to country-trust problems and weaken a country's ability to deal with sudden stops. The paper additionally discusses steps to improve investor confidence along these two dimensions in the medium run, and policies to reduce the impact of country-trust and currency-trust weaknesses in the short run.

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

This paper examines the reasons behind the sudden increase and the slow recovery of unemployment in Chile after the economic slowdown that took place in 1998 as a result of the Asian Crisis. The paper analyzes the response of employment and wages to this economic shock and shows that Chile exhibits substantial wage rigidity. The paper argues that a large increase in minimum wages, pre-determined before the slowdown, and a widespread practice of negotiating inflation-indexed long-term wage contracts prevented wages from adjusting to the changing economic conditions and thus slowed employment growth.

Sudden Stops and Exchange Rate Strategies in Latin America. Galindo, Arturo and Alejandro Izquierdo. In: Pierre van der Haegen and José Viñals, editors. *Regional Integration in Europe and Latin America.* Aldershot, United Kingdom: Ashgate.

Recent crises in Latin America have motivated a lively debate on the choice of an exchange rate regime. This paper explores the hypothesis that the choice of an exchange rate strategy following a sudden stop in capital flows (and the success of this strategy) may be influenced by the fiscal costs, such as the materialization of contingent liabilities, that countries face when the real exchange rate depreciates to its new equilibrium. When fiscal sustainability is at stake, it may be very difficult to commit to a credible monetary policy, given that lack of access to capital markets at the time of a crisis may lead to the expectation that a series of liabilities will have to be monetized. In cases of extreme fiscal insolvency, it may even be necessary to surrender monetary policy (i.e., via dollarization) at the same time that a fiscal adjustment or other solvency resolution mechanisms are implemented.

The Long-Run Volatility Puzzle of the Real Exchange Rate. Hausmann Ricardo, Ugo Panizza and Roberto Rigobón. NBER Working Paper 10751.

This paper documents large cross-country differences in the long run volatility of the real exchange rate. In particular, it shows that the real exchange rate of developing countries is approximately three times more volatile than the real exchange rate in industrial countries. The paper tests whether this difference in volatility can be explained by the fact that developing countries face larger shocks (both real and nominal) and recurrent currency crises or by different elasticities to these shocks; it finds that the magnitude of the shocks and the differences in elasticities can only explain a small part of the difference in RER volatility between developing and industrial countries. Results from ARCH estimations confirm that there is a substantial difference in long-term volatilities between these two sets of countries and indicate that there is also a much higher persistence of deviations of the variance of the RER from its long-run value when the economy suffers shocks of various kinds.

Variaciones sobre un viejo tema: El Acceso de las PYMEs al Crédito. Rodríguez-Clare, Andrés. Forthcoming in *Ensayos en Honor a Eduardo Lizano Fait,* Grettel López and Reinaldo Herrera, editors. San José, Costa Rica: Academia de Centroamerica.

For many years there has been debate on how small enterprises obtain access to credit; a variety of policies have been implemented, and access to credit has even been subsidized. This article explores this topic from a conceptual perspective, then discusses various policy options in light of that perspective.

Look Who's Talking

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

A Decade of Development Thinking: What Have We Learned?

The Research Department (RES) celebrated its tenth anniversary with a conference entitled "A Decade of Development Thinking." The conference was held on September 17, 2004 at IDB headquarters in Washington, DC. Chief Economist Guillermo Calvo presided over the conference, along with the IDB's first Chief Economist, Ricardo Hausmann. The highlight of the event was a closing panel discussion in which experts discussed how economic development thinking has changed over the past ten years. Following is a summary of that panel discussion.

In his introduction, Chief Economist's **Guillermo Calvo** illustrated the problems of low growth and financial instability experienced by Latin American and the Caribbean (LAC) countries over the last 40 years. In response to the "Lost Decade" of the 1980s, policymakers in the 1990s pursued reforms such as privatization, trade opening, fiscal strength, and financial reform. Evidence shows that the reforms, except in the case of Chile, failed to recapture the robust economic growth of the 1960s and 1970s. Income per capita growth has leveled off, and poverty persists at disturbingly high levels. In addition, the region is particularly vulnerable to international capital flows. Data relating capital flows and EMBI spreads revealed a region suffering from extreme volatility.

Guillermo Perry, chief economist of the LAC Region at the World Bank, addressed the high sensitivity of the region's per capita income growth to capital flow reversals. Reducing that sensitivity is vital to the region's development and requires limiting currency and maturity mismatches in both the private and public sectors as well as reducing deficit and pro-cyclicality biases. Reflecting on the extensive reforms LAC undertook in the past decade, he said they have helped, but that exaggerated expectations have fueled the current backlash. Another important factor is that LAC countries do not rank among the leaders in innovation, a major driver of high growth. Innovation stems from active government policies that promote education and research and development. Finally, Perry stated that lost investment opportunities, high crime, and weak institutions are all examples of how inequality can limit economic growth.

Center for Global Development President **Nancy Birdsall** offered two explanations for LAC's slow development: a long history of low public savings and high inequality of assets and income. The first problem has resulted in large public debt, high interest rates, less employment, and an overvalued exchange rate. Consequently, LAC macroeconomic policymakers are forced to be brilliant, not merely adequate, in their work. Secondly, longstanding inequality has led to difficulties in taxing the rich and to strong pressure for extra government spending. Given the problems stemming from inequality, solutions will require more than macroeconomic fixes like privatization and trade liberalization. Policymakers must emphasize fiscal institutions and seek creative mechanisms to create assets for the poor.

Nora Lustig, president of Universidad de las Americas in Puebla, Mexico, introduced the importance of human development, particularly health care, into the discussion. Studies show a positive relationship between health and economic growth. In addition, there are "poverty traps:" people are so poor that the private sector can find no value in lending them money. Although there are economic benefits associated with higher levels of education, they can be very low against the opportunity cost. Public policy, then, has a role in developing human capital and alleviating poverty by minimizing economic volatility and cushioning micro risks with insurance to the poor.

Mariano Tommasi, director of the Economics Department at Argentina's Universidad de San Andrés, spoke of how LAC countries' weak policymaking capabilities hinder development. Argentina, for instance, suffers from high policy volatility and policies characterized by rigidity, incoherence, low quality, and poor enforcement. Crucial to the impact of policies are institutional fundamentals. Good public policies require political transaction environments that allow for the enforcement of agreements over time. Political institutions in Argentina function in a manner that leads to non-cooperative policymaking, and hence to poor quality policies.

Harvard University Professor **Andrés Velasco** reflected on the lessons learned by the Latin American development community in the last ten years. Surprisingly, what had been expected to be easy—economic growth—has turned out to be difficult, and what had been expected to be difficult—successful macroeconomic policies—has turned out easy. Concentrating on Chile, he pointed out that per capita income growth there has been mediocre and cautioned against the tendency to view the country as the exception that proves the Washington Consensus rule. However, Chile does provide a successful model for macroeconomic policy, with its flexible exchange rate, low public debt, small fiscal deficits, and well-regulated banks. Chile's example should lead LAC countries to adopt free-floating exchange rates and build up healthier fiscal institutions.

Ricardo Hausmann, Harvard University professor and former IDB Chief Economist, concentrated on macroeco-

▶ *Continued on page 13*

Look Who's Talking

from page 12

nomic volatility and low economic growth. The former results from imperfections in both internal and external financial markets. Internally, LAC countries have poor institutions, which in turn leads to bad domestic financial markets and causes global investors to sour on the region. Externally, international debt is for the most part issued in developed world currencies. Nevertheless, LAC has failed to develop a second-best solution to deal with the imperfections of the financial market.

Like Velasco, Hausmann urged caution in viewing Chile as a model. Although Chilean growth is not that impressive, LAC countries have adopted Chilean policies but have not achieved even Chilean results. He suggested that a reconsideration of why the Lost Decade occurred must take place. During the rush to develop and implement the Washington Consensus, a group of institutions important for development and growth may have been undervalued and destroyed.

IDB President **Enrique Iglesias** closed the session. He pointed out that Latin America suffers more than other regions from pendulous swings between pro-state and pro-market policies. Also, international factors, while important, have also affected other regions and countries but have not prevented them from achieving impressive levels of development.

He noted that the development community understands some things better now than before, such as proper management of macroeconomic policy and the interaction between economic and social forces. Other, newer ideas, such as the role of institutions or social capital in development, are not as well understood. There are even more ideas that require further study, like the relationship between the macro and micro levels and the relationship between politicians and their advisors.

Iglesias emphasized the role of political factors, whether that be leadership, parties, or institutions, calling it the greatest issue facing LAC development. Of particular importance is the need to generate consensus, which has been a very difficult task for the Latin American political class. He advised that because development is much more complex than anticipated 40 years ago, there is a need to develop a holistic view of development.

Debt Intolerance

Carmen Reinhart (University of Maryland, School of Public Affairs and Department of Economics) addressed the IDB Board of Directors on June 2, 2004

The syndrome of "debt intolerance," occurs when countries with weak institutional structures and problematic political systems borrow in order to avoid difficult fiscal decisions, but subsequently find themselves unwilling or unable to repay. Debt intolerance is by no means a recent phenomenon: the historical record shows repeated defaults by several European countries before 1900 and, in some instances, well into the twentieth century.

For currently debt-intolerant countries, the threshold for "safe" debt levels is surprisingly low, at about 35 percent of GNP, with attendant risks of default and debt restructuring. For some countries, which have histories of bad credit and high inflation, the threshold is even lower. Another notable characteristic of debt-intolerant countries is that their debt-to-GNP ratio is much higher than that of countries with no history of default (on average, the figure for frequent defaulters is 28 percent, while that of their non-default peers is only 14 percent).

For purposes of cross-national comparison, countries are divided into three "debtors' clubs." The first, and most exclusive, consists of advanced economies with continuous access to capital markets. At the other extreme are highly indebted poor countries with no access to capital markets. Between these two clubs lies a continuum of countries with intermittent access to capital for whom only incremental changes in risk can greatly increase the chance of default. That risk is influenced particularly by debt level, a history of high inflation, and a history of previous defaults.

Whatever countries' debt history may be, they can graduate from debt intolerance through sustained discipline in borrowing. Under almost no circumstances has it been possible for countries to grow out of their debts; the only example is provided by Swaziland in 1985. Foreign debt reversals, defined as a decline of 25 or more percentage points of GNP within a three-year period, are generally achieved by one of the following two means: i) default or restructuring, or ii) significant debt repayment. Once countries have achieved debt reversals, they must refrain from releveraging to previous levels of indebtedness, and they must hold down debt levels for about 25 years in order to escape the cycle of debt intolerance. Experience to date indicates that financial markets cannot be counted on to discipline countries' borrowing behavior, as the pursuit of high yields has repeatedly led to ill-advised investments in emerging markets.

In addition to international debt intolerance, the newer phenomenon of domestic debt intolerance poses additional dangers. Before the 1980s, domestic debt in developing countries did not represent a great cause for international concern, as financial repression through bank financing usually provided access to funds at low interest rates. Following the banking crises in many developing countries during the 1980s, the restructuring and in some cases privatization of financial systems led governments to seek new sources of debt. Movement toward other sources, including debt denominated in foreign currencies, increasingly blurred the line between debt placed on domestic and international markets.

Continued on page 14

from page 13

Governments' use of debt to finance deficits appears to have been intensified by the effects of structural reform policies such as lower tariff revenues and a reduction in the de facto "inflation tax" as macroeconomic discipline figured more prominently in national policies.

The tendency to incur dollarized domestic debt calls for particular attention, as this represents a form of domestic debt intolerance. Resulting from similar factors as external debt intolerance, dollarized debt paradoxically makes countries more vulnerable due to a currency mismatch between revenues and debts. Given debt-intolerant governments' past behavior toward foreign creditors, a wave of restructurings or outright defaults of domestic debt may take place in the early part of the twenty-first century.

Attaining an Effective Social Policy: From Diagnostic to Design

Ricardo Paes de Barros (Instituto de Pesquisa Economica Aplicada) spoke at the IDB on June 29, 2004.

In the struggle against poverty, social policy is a vital weapon. Determining a social policy's objectives and planning a policy to accomplish them, however, are complex and delicate tasks. Paes de Barros stressed there is no "magic bullet" social policy to reduce poverty. Poverty is a global problem that requires local solutions, so an effective social policy depends on the consideration of specific factors, such as the socioeconomic and institutional environment of a country, state, or municipality.

Three steps are needed to construct a social policy: data, diagnostic, and design. Latin American policymakers can use the abundant data on Latin American countries and localities to help create a better, more specific diagnostic that will permit the design of a more specific, more effective social policy. In order to design more revealing, insightful diagnostics, a "decision tree" should be implemented that asks 25 questions in three categories: two macro questions, 12 micro questions, and 11 operational questions.

Using simple empirical analysis, policymakers can make a more informed decision on how to answer the two macro questions: should economic growth or inequality reduction be emphasized, and to what extent should social policy contribute to growth? Examining the first question, Paes de Barros displayed graphically the combinations of growth and inequality reduction necessary to reduce extreme poverty by 50% in Brazil and Honduras. The graphs revealed that 105% growth in Honduras (assuming 3% per year) would reduce extreme poverty by 50% in 24 years, whereas in Brazil only 55% growth in 15 years would reduce poverty by the same amount. Brazil could achieve the same reduction in poverty in half the time with half the growth if it achieved a one time 3% reduction in inequality. However, halving the time and growth in Honduras would require a 20% reduction in inequality. Thus, Honduras should focus on improving its growth, and Brazil on reducing inequality.

Among the 12 micro-oriented questions, policymakers must decide on the relative importance of providing opportunities to acquire job capabilities, i.e. education and training, versus opportunities to use those acquired capabilities. Put simply, which is the greater problem: the lack of a skilled workforce or the lack of jobs for the available labor force? Policymakers benefit tremendously from close examination and comparison of specific characteristics of the localities, as shown by a graph that plotted the relationship between per capita income and mean years of schooling among Brazilian states. Maranhao, for example, placed among the states whose residents have the least education, but, more importantly, it fell below the trend line in terms of per capita income. This indicates that Maranhao lacks quality jobs in relation to the amount of education its residents possess. In the case of Maranhao, then, the first priority for policymakers should be finding jobs of higher quality, rather than education.

One of the most important operational questions is whether social programs should be aimed at a targeted group or universally provided. Paes de Barros presented a case where a targeted program has not been successful: Brazil's unemployment insurance program. Among the beneficiaries of the program, 21% are unemployed and 34% are economically inactive. However, 45% of the beneficiaries have some sort of job. Even more significantly, 53% of those aid recipients are not poor. Thus, a program that policymakers intended for the poor and unemployed has been much more universal in scope.

In conclusion, Paes de Barros pointed out that with the available resources, policies could be designed that would have a much greater impact on poverty. A closer examination of empirical facts, such as the abundant data available in Latin America, could improve the effectiveness of social spending. With more perceptive, detailed diagnoses of the region's problems, officials will be able to design policies that more efficiently engage them.

What Can We Learn From Development Policy Evaluation, and Why Does It Matter? Theory and Evidence from Colombia and Mexico

Orazio P. Attanasio (Centre for the Evaluation of Development Policies, Institute for Fiscal Studies, and University College London) spoke on October 19, 2004 to the IDB Board of Directors.

A major component of the recent criticism leveled at the IDB and other interna-

Continued on page 15

▶ from page 14

tional financial institutions has been their alleged failure to adequately assess the effectiveness of the thousands of projects to which they lend billions of dollars. Evaluations, critics say, are critical tools for measuring the usefulness of a program and provide vital information that leads to more informed decisions about whether it should be expanded, modified, or halted. Furthermore, public accountability requires international financial institutions to provide a greater number of evaluations, and to use more effective methods in doing so.

Attanasio analyzed the evaluation process and drew lessons from evaluations of prominent Mexican and Colombian social programs. He addressed the difficulty of producing credible evaluations, defined as determining the effect of a policy intervention or welfare program on beneficiaries, potential beneficiaries, non-beneficiaries, and a given market or institution (as opposed to analyzing other aspects such as operation or targeting). This difficulty is compounded by occasionally tricky political economy. Among his recommendations for more effective evaluations, he proposed that they take place earlier in the implementation process, and that a demand for an evaluation be created by including it in the budgetary process.

Development program evaluations contain a fundamental problem. In order to accurately evaluate a program's impact, it must be measured against what would have occurred in the absence of the program. However, there is no way of knowing for certain what would have occurred had the program not been implemented. The most common solution is to compare individuals, households or communities that receive the program to those who do not; however, due to government targeting or differences among individuals, the comparisons can never be absolutely identical.

Consequently, the random allocation of programs to individuals, known as "randomization," has been emphasized in the recent evaluation literature. The primary advantage of such a method is that it allows for a controlled variation of subjects that in turn produces credible results, but it poorly gauges the effect of individual components of a program, limits extrapolation, and can be difficult to defend politically.

In the political arena, evaluations are not always viewed favorably. They are not popular among either politicians or the constituency automatically created by a program's implementation. To overcome the political resistance to evaluations, it is necessary to create demand by including them in the budgetary process and through evaluation promotion by international organizations and civil servants.

Progresa (now called Oportunidades), a Mexican social program focused on improving health, nutrition, and education, illustrates the advantages and disadvantages of randomization. The model evaluation was assigned randomly to a set of communities, and from those communities, a comprehensive data base has been compiled. Oportunidades is a renowned success story and has been exported to several countries throughout the world. Nevertheless, the limits of the randomization method are evident in the evaluation's emphasis on the program's total effect: there is no evidence as to what the effects of a slightly different program would have been. Additionally, political pressures would hamper the implementation of a large-scale randomization.

Attanasio recommended some changes in the evaluation process. Most crucially, the evaluation needs to take place earlier in the process and different versions of the program should be tried and tested. These changes would allow program designers to make modifications that would increase effectiveness. In addition, randomization, despite its limitations, should be used in the design stage. Finally, a demand for evaluation must be created within the budgetary process. With these changes, evaluations would more accurately identify areas of success and pinpoint necessary modifications. Most importantly, this would maximize the effectiveness of the programs evaluated.

Housing in Colombia: Socioeconomic and Financial Determinants

Sergio Clavijo from the Banco de la República, Colombia presented a policy seminar on October 27, 2004.

Around the world, nearly every country has experienced a housing market boom since the mid-1990s. The most notable exception is Japan, but Colombia also experienced a collapse in housing prices and has only recently begun a fragile recovery. Sergio Clavijo co-authored "La vivienda en Colombia: sus determinantes socio-económicos y financieros" with Michel Janna and Santiago Muñoz, a paper that examines the Colombian housing market and its relationship to housing markets in developed countries. In this seminar, Clavijo presented the paper's findings.

In the late 1990s and early 2000s, Colombian housing market prices in real terms collapsed. Their 37% decline stood in sharp contrast to skyrocketing prices in developed countries like the United States, Great Britain, and Spain, where prices rose 27%, 89%, and 58%, respectively. Only Japan, where housing prices dropped 19%, accompanied Colombia in its descent.

Unfortunately, the Colombian housing market differs from international ones in more areas than just prices. Particularly problematic differences can be found in financing for housing, where Colombia differs dramatically from developed countries. An analysis of the mortgage market in Colombia, the United States, the United Kingdom, and Spain between 2000 and 2002 showed that credit in Colombia was extended between 10 and 12 years

▶ Continued on page 16

Look Who's Talking

from page 15

on average, whereas credit in Spain was extended from 18 to 20 years, in the United Kingdom from 22 to 23 years and in the United States from 25 to 30 years. Credit as a percentage of house value ranged from 70% to 100% in the United States, Spain, and United Kingdom; in Colombia, credit could only be extended for up to 70% of house value. Finally, the real interest rate in Colombia ranged between 8% and 13%, as compared to 0% to 6% in the more developed countries. In sum, in Colombia, less credit was offered for a shorter length of time and at a higher interest rate.

The Colombian mortgage market is also much smaller than its European and North American counterparts. While the percentage of Colombians who take out mortgages is only slightly less than in Europe and North America, mortgages represent a dramatically lower portion of GDP. In the United States, mortgage portfolios were 58% of GDP, and in the European Union, the number was 33%; in Colombia, however, mortgage portfolios equaled only 5% of GDP. Another important indicator of the housing market is yield, and here again Colombia trails. Between 1995 and 2002, Spain had 21% real annual yield; the United States registered 7%; and the United Kingdom showed 10%. Colombia produced only 0.5%. Not surprisingly, then, Clavijo recommended that Colombia improve the ways to generate competition that would stimulate early payments and reduce the cost of long-term credit.

Clavijo also presented an econometric analysis of supply and demand in the Colombian housing market. Housing demand was found to be highly elastic to price and household income, sensitive to income stability and moderately elastic to the real housing interest rate. Housing supply, meanwhile, demonstrated that sales prices were elastic to building costs and that these costs were easily passed on to consumers.

Following Clavijo, RES economist Arturo Galindo put Colombia's housing market financing problems in a Latin American context. Credit is scarce throughout the region, and due to various factors, housing credit accounts for only a small amount of the available credit. One factor is that access to credit increases sharply as income rises; this situation is exacerbated by Latin America's income inequality and macroeconomic volatility. Other factors are the difficulties borrowers face in creating collateral and the difficulties creditors face in enforcing their rights to redeem collateral. Colombia has improved its management of fluctuations in interest rates and maturities; however, macroeconomic instability remains a problem, and much work remains to protect the rights of creditors.

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Network News

Latin American Financial Network (LFN)

December 2-3, 2004
Cartagena, Colombia

The second annual workshop of the LFN, organized jointly with the Universidad de los Andes, will look at general financial issues crucial for Latin America. The objective is to gather eight papers from distinguished researchers on both banking and capital markets. Overall, the objective of the network is to focus on the microeconomics of financial markets, potential policies to promote financial development, and their implications on general economic activity. The meeting will close with a presentation of this year's Economic and Social Progress Report on banking credit.
www.iadb.org/res/lfn

Latin American Research Network

- The Board of Directors of the Inter-American Development Bank approved a $1,250,000 Technical Cooperation to finance four studies under the Latin American Research Network. The call for papers for these additional studies will be launched in early 2005.
- Second seminar of the study on Corporate Governance in Latin America and the Caribbean

  Cartagena, Colombia • December 2, 2004
  Participating countries: Argentina, Brazil, Chile, Colombia, Costa Rica and Venezuela.
- Second seminar of the study on the Preparation of Basic Textbooks on Latin American Economies

  Buenos Aires, Argentina • January 13–14, 2005
  Participating countries: Argentina, Brazil, Colombia, Costa Rica, Uruguay and Venezuela.