IDEA
Ideas for Development in the Americas

Inter-American Development Bank
Research Department

Volume 18
January–April, 2009

Dealing with an International Credit Crunch

Dealing with an international credit crunch is no easy task, as any policymaker in the world would tell you today! Credit flows are the blood of the world's economic system. When a human artery becomes clogged and the blood flow is interrupted, the consequences can be dire unless the flow is restored promptly. Similarly, a sudden stop in capital flows that blocks the normal supply of international credit to countries can inflict serious damage on the affected economies unless decisive action is taken. But if you're not a government like the United States, a safe haven for global savings that can pump billions of dollars into a stimulus package, what's a country to do?

This newsletter looks at this question from the Latin American point of view. Drawing from research that explored the region's experience with the sudden stops in capital flows of the 1990s, it reviews lessons learned that may be of use today. To begin with, countries must realize that it's not necessarily their fault. A defining characteristic of systemic sudden stops is that they originate in shortcomings in international capital markets—i.e. international capital supply shocks—rather than in domestic policy failings. However, while the cause may come from abroad, the solutions must often be home grown and if sudden stops are not handled adequately, then output collapse can be severe and recovery more painful.

In designing a strategy to confront sudden stops and avoid output collapse, several questions come to mind: Can emerging countries afford expansive monetary and fiscal policies in times of crisis? Should they instead restore credibility by tightening monetary and fiscal policy, or will these policies only make matters worse? To what extent are weak initial macroeconomic conditions an important constraint leading to disaster? Do they put a country on an irreversible path? Are they destiny, or can their impact be mitigated during a crisis? Should financial shocks be viewed as temporary or persistent, and what policy options are available? And further down the road, what implications does the latent risk of sudden stops have for economic policies during periods of bonanza?

> There is no substitute for taking advantage of periods of external bonanza to improve macroeconomic fundamentals at home.

This newsletter draws from a new IDB book, "Dealing with an International Credit Crunch: Policy Responses to Sudden Stops in Latin America," which addresses these questions from different angles, bringing in both lessons from country studies as well as cross-country analysis. The book documents policy responses to sudden stop episodes of the late 1990s for eight Latin American countries. But it also takes a more systematic approach by analyzing the impact of policies on output behavior for a wider range of emerging markets. Using both sets of information, and distinguishing between successful and unsuccessful cases, it extracts policy recommendations

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IN THIS ISSUE

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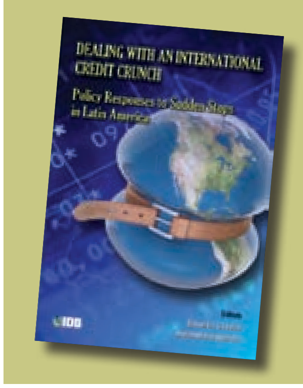

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for countries that might face a sudden stop in the future. As the world teeters on the brink of a major global financial crisis with potentially severe consequences for emerging economies, the issues addressed in this volume come back to the forefront of the policy debate.

The book presents the following main conclusions:

- Expansionary fiscal and monetary policy that does not affect credibility or solvency can reduce output collapse in the aftermath of a sudden stop. Countries that were able to adopt more flexible fiscal and monetary policies in the aftermath of a financial crisis had a loss in output of less than *5%*, while nations with much less flexibility had output contractions above 10%. However—and this is really crucial—countries need to be able to *afford* these policies.
- Initial conditions matter: the same shock can have different consequences in countries with different levels of preparedness and may seriously limit policy options. There are no good substitutes for reducing vulnerabilities during good times to confront the possibility of bad times in the future. For example, successful anti-cyclical policies during financial crises work when governments are prepared to boost spending in a sustainable way—for which they need to have saved before. And to conduct looser monetary policy that does not fuel inflation or lead to balance-sheet problems in either the public or private sectors, a country must have avoided the dollarization specter during the boom years. (Figure 1 illustrates how countries that enjoyed strong initial conditions limited the contraction in their economic output during a sudden stop.)
- Initial conditions are not destiny: even if they haven't done all their homework, countries still have means at their disposal to weather the storm. A targeted use of international reserves during an international credit crunch—for example, sup-

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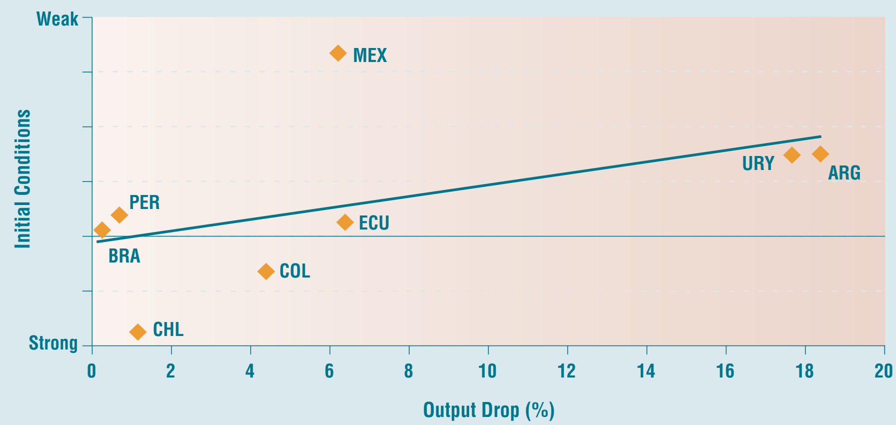
Figure 1. Initial Conditions and Output Declines



Source: Calvo, Izquierdo and Mejia (2008). Systemic Sudden Stops: The Relevance of Balance-Sheet Effects and Financial Integration

This issue of *IDEA* was prepared by Eduardo Cavallo and Rita Funaro. It is based on the research of Paul Castillo, Daniel Barco Rondón, Márcio Garcia, Alberto Ortiz, Pablo Ottonello, Federico Sturzenegger, Ernesto Talvi and Rodrigo Valdés as presented in the book **Dealing with an International Credit Crunch: Policy Responses to Sudden Stopos in Latin America**, edited by Eduardo Cavallo and Alejandro Izquierdo.

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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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Chile: Banking on Policy Credibility

Being prepared pays off. That is one of the big lessons of the Chilean experience with the sudden stop in capital flows in 1998. Hit by the retrenchment of capital flows following the Asian crisis and a decline in its terms of trade due to a drop in copper prices, Chile's net capital inflows plummeted from the equivalent of 7% of GDP in 1998 to less than 1% of GDP in 1999 while capital outflows reached $1.5 billion. But instead of an economic collapse, Chile suffered a small recession thanks to a strong financial system, healthy public finances and a flexible policy apparatus.

Throughout the 1990s, Chile laid the groundwork for strong monetary and fiscal policies. With the objective of maintaining price stability, the Central Bank of Chile used annual inflation targets as the predominant nominal anchor of the economy. Annual announcements aimed at ever lower inflation. An exchange rate band system sought to maintain the current account deficit within sustainable levels and the Central Bank intervened in the foreign exchange market not only at the edges of the band, but also actively within it. From a rather rough management of interest rates on instruments of different tenors in 1990, the Central Bank advanced to managing liquidity in order to achieve a particular overnight interest rate in the interbank market (the target being the monetary policy interest rate). Throughout the decade, fiscal policy too was well-managed, allowing the central government's net public debt to decline from 37.6% of GDP in 1989 to 5% in 1997. Strong growth certainly facilitated this result but institutional factors also weighed heavily. Chile had (and continues to have) strong fiscal institutions ranging from a centralized state and a strong Ministry of Finance to arrangements such as a copper price stabilization fund that allows the authority to set aside abnormally high copper revenues in a transparent way.

The macroeconomic framework and conditions that Chile had built over a decade served it well in the face of the sudden stop.

In addition to strong monetary and fiscal policies, the Chilean economy also enjoyed strong financial institutions. Following the collapse of the banking system in the fallout to the debt crisis of the 1980s, Chile worked hard to improve financial regulation and supervision. These changes allowed for the development of a healthy and resilient financial system.

When the crisis hit, Chilean authorities were in the midst of trying to tame an overheated economy. As the external shocks hit, the current account deficit widened, the exchange rate came under pressure and fiscal revenues declined; the need to control galloping domestic demand and regulate the depreciation of the exchange rate became of paramount importance. Contractionary monetary and fiscal policies were the government's initial policy response.

In a way, the policies were almost too successful. The combined effect of the external shocks and policies was an unexpectedly large and quick adjustment. Imports of goods and services transited from growing 16% year-over-year in second quarter 1998 to sliding 14% in the final quarter of the year. Behind this adjustment was a sudden decline in domestic demand of almost 8%.

This overcorrection highlights another important lesson. When in the eye of the storm, it is often difficult to assess the true nature and duration of a crisis. Chilean authorities initially misjudged the type of shock at hand. However, policymakers were able to bank on previously earned credibility to shift gears and accommodate the shock with expansionary policies before it was too late. By changing course, they were able to keep the economy from slipping into a deeper recession.

The macroeconomic framework and conditions that Chile had built over a decade served it well in the face of the sudden stop. Having capitalized, well regulated and supervised banks made it possible to follow a very contractionary monetary policy during the first phase of the crisis without overly jeopardizing the health of the financial system. And avoiding liquidity risks in government financing let authorities boost interest rates substantially and pump prime the economy later to prevent a collapse.

Peru: Where Reserves Saved the Day

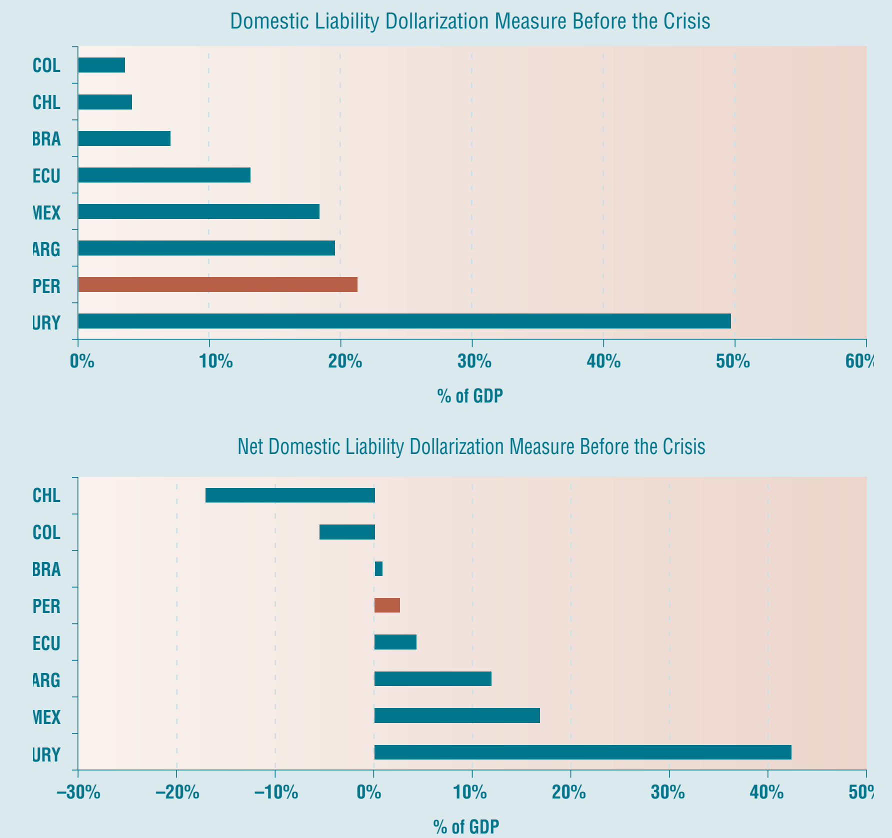
Nobody's perfect. Peru did a lot of things right during the 1990s but it had at least one critical flaw that made it highly vulnerable in the context of the 1998 sudden stop in capital flows: a high degree of financial dollarization. Still, the Peruvian experience teaches that bad initial conditions do not necessarily determine a country's destiny. In spite of its dollarization, Peru emerged relatively unscathed from the sharp decline in its terms of trade and the repercussions of the Asian crisis thanks in large part to savvy management of its extensive foreign reserves.

Throughout the boom years of the early 1990s, Peruvian authorities prepared to meet unexpected foreign currency outflows by building up a protective shield of international reserves. How did it amass one of the largest levels of international reserves in Latin America? To begin with, it established a high marginal reserve requirement ratio that allowed the banking system to accumulate some $3.7 billion in reserve deposits by 1997. Secondly, by reducing inflation from over 7,000% to just 6.5%, the government restored credibility in the domestic currency and progressively absorbed the reduced demand for foreign currency. Finally, the Central Bank added substantially to its international reserves with public sector deposits, mainly from the proceeds of an extensive privatization program. The result was that by the end of 1997, Peru's international reserves represented 78% of the total banking sector's liquidity and almost 18% of GDP.

As important as the quantity of international reserves stashed away in government coffers was the Peruvian government's willingness to use them to provide dollar liquidity during the credit crunch. In spite of its high degree of financial dollarization, Peru avoided a financial crisis with a combination of lender-of-last-resort policy in foreign currency and exchange rate policy that limited volatility in the exchange rate. By pumping foreign currency reserves into the banking system, the monetary authorities staved off the failure of those banks that were more indebted and in this way prevented domestic banking credit from drying up entirely.

Figure 2 plots the level of gross domestic liability dollarization (DLD) —basically dollar loans in the domestic financial system—as a share of GDP for eight countries in Latin America on the eve of the Asian crisis. The upper panel, showing the gross DLD position of each country, indicates that Peru fared worse than Argentina in this dimension. The lower panel shows instead the net DLD position—DLD minus foreign exchange reserves as a share of GDP. Clearly, Peru's large stock of international reserves accumulated during the preceding period of economic expansion was an important element in diminishing the country's vulnerability to the dollarization specter.

Figure 2. Domestic Liability Dollarization: Selected Latin American Countries



Sources: Calvo, Izquierdo, and Mejia (2008).

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However, effectiveness in the use of international reserves may depend on the particular instrument chosen. The Peruvian experience shows that direct and permanent injections of foreign liquidity—in this case, through a continuous reduction of the average and marginal reserve requirement ratios—were more effective to offset the negative effects of the sudden stop on the banking system than the direct sale of foreign currency on the exchange market. This is so because direct injections of foreign liquidity allow banks to boost liquidity in foreign currency without reducing their liquidity in domestic currency.

Although the role of its international reserves was crucial to its success, there are other aspects of Peru's preparedness that contributed to the resilience of the economy to the crisis. The fiscal reforms of the early1990s successfully pared down the large fiscal deficits that had plagued the country during the 1980s. In turn, the improvement in Peru's fiscal position had far-reaching effects on its macroeconomic stability. Initially, it contributed to the accumulation of the Central Bank's international reserves and government liquidity in the financial system. Later, those funds were fundamental to finance a countercyclical fiscal policy that prevented negative GDP growth rates and helped avoid a larger depreciation of the real exchange rate. Being able to spend during the sudden stop episode kept the Peruvian economy moving while the economies of many of its neighbors came to a screeching halt.

The 1990s was also a period of massive investment in Peru, particularly in the tradable sector. One of the main objectives of the structural reforms of the 1990s was to provide a macroeconomic environment that promoted investment. Policies favoring private investment were complemented by

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porting export credit lines—might be a more effective use of available resources than exchange rate market interventions.

- The persistence of the shock is important in determining whether liquidity issues become solvency problems. A short-lived crisis, such as the capital shortage experienced by Latin America in the aftermath of the 1995 Mexican crisis was much less dangerous than the long capital drought that followed the Russian crisis of 1998. Early recognition of the nature of the crisis being faced proved to be very important.
- External financial packages are essential when initial conditions don't help. This explains, for example, why Mexico recovered fairly quickly in the aftermath of the Tequila Crisis in 1994, while Argentina's economy collapsed when the IMF withdrew support in November 2001. Argentina's vulnerability made it clear that a protracted sudden stop requiring substantial real exchange rate depreciation almost inevitably called for debt restructuring given Argentina's substantial liability dollarization. However, there is reason to believe that with international support, the restructuring process could have been much more orderly.

Perhaps the clearest lesson from the research is that countries that were able to conduct countercyclical policies were able to withstand crisis better. In turn, the lucky ones that earned the chance to conduct countercyclical policies were those that had previously resisted the temptation of taking comfort in favorable tailwinds and had prepared for a rainy day. While some basked in the sun of high global growth rates and soaring commodity prices, others remained wary of cycles in the international economy, commodity prices and world financial conditions. Those that did not use the boom years to lay the groundwork for countercyclical policies had much less scope for independent policy actions during the credit crunch. Any attempt to boost spending dramatically, for example, could erode confidence in the country's ability to repay its debts in the future. Thus, the biggest lesson is that there is no substitute for taking advantage of periods of external bonanza to improve macroeconomic fundamentals at home.

This edition of *IDEA* looks more closely at some of these policy responses to the crises of the 1990s as detailed in **Dealing with an International Credit Crunch** in the hopes that it may provide clues for grappling with today's financial morass.

Brazil: A Two-Pronged Strategy for Solvency

The 2002 Brazilian sudden stop was a clear crisis of confidence that mixed political aspects with low liquidity in international financial markets. The leading presidential candidate—now President Lula—was perceived to be non-market friendly and the prospect of his election sent shivers through the investment community. Capital flows fell by some US$24 billion, around 6% of GDP, and there was a large turnaround in the current account. However, political stroking plus targeted economic intervention from a government that had done its financial homework allowed it to maintain solvency and avoid a meltdown. In fact, the Brazilian economy grew more than 4% over the 2001–2002 period, making it a clear case of a successful response to a sudden stop.

Not surprisingly, at least part of the response to this largely political crisis was political in nature. The fear that Lula would stray from Brazil's sensible macroeconomic policies and perhaps even default on its debt had to be assuaged. Brazilian Central Bank Governor, Arminio Fraga, negotiated a deal between all the presidential candidates, foreign investors and the IMF. In a program designed to provide good incentives to the candidates, the presidential wannabes agreed to sensible policies in return for large disbursements from the IMF. Although the entire loan was US$30 billion, only US$6 billion would be disbursed in 2002. The remainder would be disbursed when the next president was in office, provided he fulfilled the IMF program conditions. After Lula won the election and it became clear that he would uphold the three basic tenets of Brazilian macroeconomic policy—the large primary fiscal surplus, inflation targeting, and a floating exchange rate—and that he would not default on the debt, the markets regained confidence and the crisis was averted.

Despite this agreement, creditors tightened their purse strings in the 2001–2002 period. During this sudden stop, the resilience of the banking sector was achieved thanks to several factors. After the end of hyperinflation in 1994, several banks became insolvent. During the second half of the 1990s, two programs were put in place to deal with the private and local government-owned problematic banks. Consequently, in 2001–2002, there were no large banks with weak balance sheets that could pose systemic risk.

The second factor that explained the resilience of the banking sector is that there were no large currency mismatches in their balance sheets. Since the turbulent flotation of the real in 1999, banks were aware of the risks involved in large depreciations and were required, by prudential regulation, to control the exchange rate risk, among other risks. Even so, the sudden stop could have caused disruptions. However, the public sector played an important role during the crisis by providing insurance to banks against exchange rate depreciation through the issuance of dollar-indexed debts or via derivatives. Importantly, the Brazilian public sector had maintained a low level of dollarization prior to the crisis enabling it to assume the exchange rate risk in its own balance sheet, without compromising its own sustainability.

A second strategy that helped tide Brazil through the credit crunch was aimed at exporters and was made possible thanks to the country's accumulated international reserves. Although the exchange rate suffered enormous depreciation during the sudden stop, exporters could not fully profit from this because trade credit lines had dried up. Therefore, the Central Bank intervened to provide trade finance to exporters. Legally, the Central Bank could not sell its foreign reserves directly to exporters. However, an ingenious program was put in place to guarantee that at least some of the reserves sold by the Central Bank were channeled to exporters. Banks were only allowed to purchase reserves if they showed that those reserves were going to be used for export financing. Supporting the export sector helped bring dollars into the country and mitigated the shortage of currency stemming from the reduction in foreign capital inflows.

Throughout this period, monetary policy was conducted through Inflation Targeting (IT). Another important lesson of the Brazilian case is that while IT may be a useful tool for the conduct of monetary policy during normal times, during sudden stops the target becomes elusive as the monetary authority loses control of market interest rates and the exchange rate. Twice during this period the Brazilian Central Bank missed its annual inflation targets, forcing authorities to implement corrections along the way. Thus, IT frameworks should build in contingent mechanisms in order to successfully accommodate external shocks without undermining the credibility of the framework.

Together, the Brazilian Central Bank's interventions to shore up the banking sector and to provide credit to exporters helped the country weather the political and financial storms.

Applying the Past to the Present

Latin America learned many lessons during the 1990s that will most likely apply in the prevailing financial crisis. To begin with, the availability of counter-cyclical policy options, as well as final outcomes, will to a large extent be determined by initial conditions. However, policy reactions will remain key especially in countries where initial conditions have not predetermined their destiny and there is some margin for maneuver. The multilateral system can help these governments by boosting their foreign currency reserves and providing financing for governments with a sustainable fiscal position. In other countries, seeking external financial assistance sooner rather than later might prove to be the least costly option.

Latin America and the Caribbean are in better economic shape than they were when the Russian crisis struck, giving them some leeway, particularly regarding monetary policy, to implement measures to fight the crisis. Countries have built up US$ 400 billion in international reserves, and they have substantially reduced the level of dollar-denominated debts, particularly within the banking system. Lower levels of debt dollarization allowed Brazil, for example, to loosen monetary policy amid the credit crunch in ways that other countries were not able to do during the aftermath of the Russian crisis. This time around, several Latin American countries swiftly depreciated their currencies without causing major financial turmoil.

Loose monetary policy typically leads to currency depreciation and an increase in exports that helps ease the economic slowdown. However, currency depreciation, which boosted exports as a way out of the crisis for several emerging markets in the past, may be less successful this time around given the ongoing global recession, particularly in rich nations.

On the fiscal front, the picture is less clear. Most of the region's nations built up very little savings during the five-year commodity boom that ended last year, according to a 2008 IDB study titled "All that Glitters May Not Be Gold: Assessing Latin America's Recent Macroeconomic Performance." A simple average of the region's seven biggest economies—Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela—shows that they spent 77% of the extra revenue from the commodity bonanza since 2002. Chile, in comparison, which set aside a considerable part of the increased tax collection into a special fund, spent only 34%, according to the 2008 study. Some nations in Lain America that did not squirrel away enough savings will be forced to cut spending in the face of the current crisis. For others, the most feasible policy will be to maintain the current level of government spending but only a lucky few such as Chile are in a position to increase spending.

For multilaterals, the current crisis offers an opportunity for a different approach when compared with the policy course taken during the Russian crisis. The prevailing view in 1998 was that emerging nations needed to reassure creditors about the solvency of their economies. As a result, emerging countries around the globe were asked to tighten their belts by cutting spending and raising interest rates, which deepened the recession. The IDB study of successful policy responses during past crises suggests multilaterals should follow a selective approach that takes into account each country's initial conditions in order to design tailor-made policies. Countries with their macroeconomic house in order need not enact strong adjustment policies to signal credibility. However, countries need to be particularly cautious regarding the duration of the current crisis; large and/or sustained downturns in global economic trends could make fiscal caution a necessary element of any policy-response package.

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Peru: Where Reserves Saved the Day

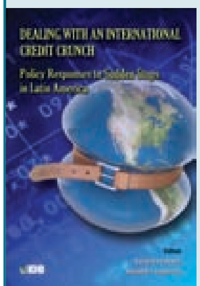
reforms guaranteeing judicial stability and equal treatment for foreign investment. The privatization process took off in 1991 and investment poured in, mainly in the tradable sector. Investment and projects in the mining sector, for instance, propelled average growth rates to 10.1% annually from 1993 to 1997. And they enabled the sector to continue growing at a similar pace (9.9% per year) during the sudden stop of 1998–99. Overall, previous investments in the tradable sector acted as a buffer for the slide in other economic activity in 1997–99.

Peru did not have all its macroeconomic pieces in place when the Asian crisis hit but it managed to survive the shock well. Certainly, the credibility built earlier in the decade by a series of monetary and fiscal reforms paid off. However, the life jacket that really kept the Peruvian economy afloat was its cushion of international reserves.

New Publications

Available in English only unless otherwise stated.

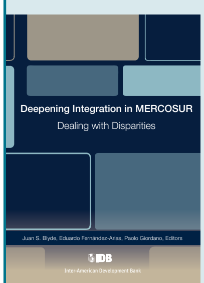
BOOKS



Dealing with an International Credit Crunch.

Edited by Eduardo Cavallo and Alejandro Izquierdo. Inter-American Development Bank. 2009.

As the world confronts an oppressive credit crunch, it is useful to review the policy responses of countries to the systemic sudden stops of the 1990s. Countries have experimented widely, providing a rich array of cases that offer useful policy lessons. This book documents success stories in Chile, Peru and Brazil, and outlines lessons learned from unsuccessful cases as well. It also takes a more systematic approach in analyzing the impact of policies for a wider range of emerging markets.



Deepening Integration in MERCOSUR: Dealing with Disparities.

Edited by Juan Blyde, Eduardo Fernández-Arias and Paolo Giordano.Inter-AmericanDevelopment Bank. 2008.

This book analyzes the most important issues of economic integration and policy coordination that countries face when they advance towards deeper integration and need to address development disparities among partner countries. The volume builds upon the experience of MERCOSUR to explore the various facets of an integrated approach, both to uncover the challenges that disparities pose for integration agreements and to propose actions for dealing with them.

RESEARCH DEPARTMENT WORKING PAPERS

Information, Externalities and Socio-economics of Malaria in Honduras: A Preliminary Analysis (WP-670)

María Victoria Aviles and José Cuesta

This paper explores how different levels of knowledge correlate with desirable preventive and curative practices against malaria in Honduras. The paper additionally analyzes "information externalities" associated with non-specific malaria health services, communicational campaigns and organized community networks. Using the 2004 ENSEMAH survey, the analysis finds that the adoption of desirable prevention and treatment behaviors correlates with proficient levels of knowledge. While information externalities exist, they nonetheless do not deliver adequate levels of knowledge proficiency to induce desirable anti-malaria behavior.

Output Collapses and Productivity Destruction (WP-666)

Juan Blyde, Christian Daude and Eduardo Fernández-Arias

This paper analyzes the long-run relationship between output collapses—defined as GDP falling substantially below trend—and total factor productivity (TFP), using a panel of 71 countries during the period 1960-2003 to identify episodes of output collapse and estimate post-collapse TFP trends. Collapses are concentrated in developing countries, especially African and Latin American, and were particularly widespread in the 1980s in Latin America. Overall, output collapses are systematically associated with long-lasting declines in TFP. The paper explores the conditions under which collapses are least or most damaging, as well as the type of shocks that make collapses more likely or severe, and additionally quantifies the welfare cost associated with output collapses.

Do Welfare Programs Damage Interpersonal Trust? Experimental Evidence from Representative Samples for Four Latin American Cities (WP-668)

Alberto Chong, Hugo Ñopo and Vanessa Ríos

This paper argues that welfare programs are linked with the destruction of social capital, as measured by interpersonal trust in laboratory games. The paper employs experimental data for representative samples of individuals in four Latin American capital cities (Bogota, Lima, Montevideo, and San Jose), finding that participation in welfare programs damages trust. The findings also support the notion that low take-up rates may be due to stigma linked with trust and social capital, rather than transaction costs.

Rising Mortality and Life Expectancy Differentials by Lifetime Earnings in the United States (WP-665)

Julian Cristia

Are mortality and life expectancy differences by socioeconomic groups increasing in the United States? Using a unique data set matching high-quality administrative records with survey data, this study explores trends in these differentials by lifetime earnings for the 1983 to 2003 period. The results indicate a consistent increase in mortality differentials across sex and age groups. The study also finds a substantial increase in life expectancy differentials: the top-to-bottom

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New Publications

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quintile premium increased around 30% for men and almost doubled for women. These results complement recent research pointing to almost five decades of increasing differential mortality in the United States.

Report of Results of the LAPOP 2008 Surveys (Reporte de resultados de las encuestas LAPOP 2008) (WP-669)

Lucas Higuera

This document analyzes the relationship between political institutions and subjects such as quality of life and victimization in light of the LAPOP (Latin American Public Opinion Project) surveys. The results show that Latin Americans' perceptions of their life and their country vary from reality and that they still see democracy as the most desirable political system for governing their countries.

Part Time Work, Gender and Job Satisfaction: Evidence from a Developing Country (WP-664)

Florencia Lopez Boo, Lucia Madrigal and Carmen Pagés-Serra

This paper investigates the relationship between part-time work and job satisfaction using a recent household survey from Honduras. In contrast to previous work for developed countries, this paper does not find a preference for part-time work among women. Instead, both women and men tend to prefer fulltime work, although the preference for working longer hours is stronger for men. Consistent with an interpretation of working part-time as luxury consumption, the paper finds that partnered women with children, poor women or women working in the informal sector are more likely to prefer full-time work than single women, partnered women without children, non-poor women or women working in the formal sector. These results have important implications for the design of family and child-care policies.

A Moving Target: Universal Access to Healthcare Services in Latin America and the Caribbean (WP-667)

William D. Savedoff

Healthcare services are more widespread in Latin America and the Caribbean today than 50 years ago, yet this availability is not necessarily reflected in popular perceptions. This study documents the expansion of healthcare services in the Region in terms of medically-trained professionals, service utilization, and insurance eligibility. It finds that people in countries with more doctors have a more positive view of access to healthcare and greater confidence in the healthcare system. However, other factors intervene in this relationship between perceptions and objective indicators, such as the strength of local social networks and wealth. As a consequence of rising expectations, differential access and continuing discontent, public policy can be driven by factors that are least likely to improve the population's health.

RESEARCH NETWORK WORKING PAPERS

The Emergence of New Successful Export Activities in Latin America: The Case of Chile (R-552)

Manuel Agosin and Claudio Bravo-Ortega

This paper surveys overall export growth in Chile and focuses on three case studies of the emergence of successful export activities: wine, pork and blueberries. Each case study discusses how companies, associations, and governments at various levels have addressed market failures and facilitated the provision of public goods necessary for each activity. The case studies additionally profile first movers in each activity and describe the positive externalities they provide to imitators, particularly diffusion of export knowledge. Also included are counterfactual cases of a less successful firm or activity (an unsuccessful wine exporter, other types of berries, and commodity pork production rather than custom cuts, respectively) and a discussion of policy implications.

The Emergence of New Successful Export Activities in Mexico: Three Case Studies (R-555)

Edgar Aragon, Marcia Campos and Anne Fouquet

This paper consists of three case studies of the emergence of three successful export activities in Mexico: avocado production, the manufacture of catheters, and call center outsourcing. Included is a counterfactual case of a less successful activity (mangos, stem cell banking, and other types of business process outsourcing, respectively) and a section on policy implications.

The Emergence of New Successful Export Activities in Uruguay: Four Case Studies (R-556)

Carlos Casacuberta, Rosario Domingo, Hector Pastori, Lucia Pittaluga and Michele Snoeck

This paper studies the emergence of four successful export activities in Uruguay: computer software, forest products, caviar and sturgeon meat, and animal vaccines. Included in each case study is a counterfactual case of a less successful activity (electronics, wine, frog meat, and biotechnology, respectively) and a section on policy implications.

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OUTSIDE PUBLICATIONS

Would a Free Trade Agreement Between Bolivia and the United States Prove Beneficial to Bolivian Households?

Richard Bennett, Carlos Ludena, Bhavani Shankar and Roberto Telleria. Journal of International Agricultural Trade and Development, Volume 5 Issue 1 (2009).

This paper seeks to provide insight into whether the Bolivian economy and its households would win or lose from entering into a trade liberalization agreement with the US. The article indicates that reaching a trade agreement with the US would pay off. However, an absolute trade liberalization scheme would not be the best option for the Bolivian poor. Sector specific measures in the form of protection for sensitive commodities would ensure that expected benefits are more evenly distributed across most Bolivian households. Negative impacts from the elimination of US trade preferences to Bolivia and failure to sign a trade agreement with the US suggest that a strong protectionist trade policy and limited trade relations must be avoided if economic growth and household wellbeing are to improve.

Can Foreign Aid Reduce Income Inequality and Poverty?

Cecilia Calderon, Alberto Chong and Mark Gradstein. Public Choice, February 2009.

This paper's goal is to examine the effect of foreign aid on income inequality and poverty reduction for the period 1971–2002. The paper finds some weak evidence that foreign aid improves the distribution of income when the quality of institutions is taken into account; however, this result is not robust. This finding is consistent with recent empirical research on the ineffectiveness of aid in achieving economic growth or promoting democratic institutions.

Openness to Trade and Output Volatility: a Reassessment

Eduardo Cavallo. Economía. Volume 9, Number 1, Pages 105–152. Fall 2008.

This paper presents new empirical evidence that suggests that the net effect of trade openness on output volatility is stabilizing. The results confirm that exposure to trade raises output volatility through the terms-of-trade channel as previously documented in the literature, but also show that this is counteracted by a quantitatively larger stabilizing effect. Additional evidence is presented showing that the latter effect comes (at least in part) through the financial channel.

Does Openness to Trade Make Countries More Vulnerable to External Crises, or Less? Using Gravity to Establish Causality.

Eduardo Cavallo and Jeffrey Frankel. Journal of International Money and Finance, Volume 27, Issue 8, Pages 1430–1452. December 2008.

Openness to trade is one factor that has been identified as determining whether a country is prone to sudden stops in capital inflows. Several authors have offered empirical evidence that having a large tradable sector reduces the contraction needed to adjust to a cut-off in funding. Such studies may, however, be subject to the problem that trade is endogenous. Using the gravity instrument for trade openness, which is constructed from geographical determinants of bilateral trade, this paper finds that openness indeed makes countries less vulnerable to crises, and that the relationship is even stronger when correcting for the endogeneity of trade.

Foreign Participation and Hiring Patterns after Privatization

Alberto Chong and Virgilio Galdo. Labour: Volume 23 Issue 1, Pages 195–207. March, 2009.

Critics of globalization claim that foreign ownership of privatized firms is linked to negative post-privatization labor outcomes, such as more firing and less hiring. This paper uses new firm-level data for a cross-section of countries to test this idea and provides evidence that foreign purchasers of state-owned enterprises tend to acquire firms that were already better restructured before privatization. Additionally, this paper does not find evidence that foreign participation in privatized firms is linked to negative labor outcomes.

Volatility and Firm Growth

Alberto Chong and Mark Gradstein. Journal of Economic Growth, March, pp 1–25, Volume 14, Number 1. March, 2009.

A growing body of macroeconomic evidence suggests that volatility is detrimental for economic growth. The channel through which this materializes, however, is less clear. Moreover, substantive evidence based on disaggregate data is scarce. This paper provides empirical support for this relationship using a detailed cross-country firm-level dataset. It also provides additional evidence that institutional obstacles magnify the adverse effect of perceived volatility on firm growth.

Television and Divorce: Evidence from Brazilian Novelas

Alberto Chong and Eliana La Ferrara. Journal of the European Economic Association, Papers and Proceedings. April, 2009. (Also published as WP-651)

This paper studies the link between television and divorce in Brazil by

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Look Who's Talking

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

Klaus Schmidt-Hebbel presented the OECD's flagship publication, *Going for Growth 2009,* in a policy seminar at IDB headquarters on March 5, 2009.

The fifth edition of *Going for Growth*, the flagship publication of the Organisation for Economic Co-operation and Development (OECD), is like its predecessors based on a benchmarking and analytical process that identifies five policy priorities for each member country in order to enhance long-run economic growth. The report's methodology consists of decomposing GDP per capita, the best available proxy for welfare, into labor utilization (hours worked) and labor productivity factors. Although both areas are affected by policy, productivity is considerably more important and is therefore the focus of most of the 50 policy indicators used in the analysis. On the basis of these indicators, the benchmarking methodology proceeds in three steps: i) identifying performance weaknesses, defined as deviations from the OECD average, in subcomponents of GDP per capita; ii) identifying related policy weaknesses on the basis of policy indicators and analysis; and iii) selecting the most important policy weaknesses as priorities for reform. The third step results in five recommendations for each OECD member country, three based on benchmarking alone and the remaining two based on the country-specific expertise of OECD researchers.

In contrast to previous editions of Going for Growth, however, the 2009 report discusses which long-term growth policies are likely to aid recovery from the current financial crisis. While the crisis represents a failure of regulatory and supervisory policies, it does not invalidate the need for reforms to improve labor and product market performance; moreover, the likelihood of structural reforms increases in periods of crisis. In the short term, policies should stimulate short-run demand and strengthen long-term growth. OECD analysis suggests policy mixes drawn from the following options: i) enhanced infrastructure investment; ii) tax cuts for lower income groups; iii) increasing human capital through labor training; and iv) reforming product market regulation, particularly through removing obstacles to starting up businesses. Any fiscal stimulus that is implemented must nonetheless be timely, temporary and targeted, and its size must be determined by overall economic conditions, initial fiscal balance and debt levels, and the size of the automatic stabilizers in effect. The targeting of such a package must additionally strive for short-term stabilization, long-term growth, and job creation, as well as include a "green" component to make future economic activity more environmentally sustainable.

The long-term recommendations in the 2009 edition of *Going for Growth* are in part based on new empirical findings. Although the current financial crisis provides an opportunity to reverse an OECD-wide decline in infrastructure investment, such investment must be undertaken in a sound regulatory environment and with careful cost-benefit analysis of projects. Fiscal stimulus based on infrastructure can begin prior to the implementation of those projects through maintenance expenditure and beginning "off-the-shelf" projects (i.e., those that are, in U.S. parlance, "shovel-ready"). The research underlying this recommendation cites the high short- and long-term multiplier effects of public investment on GDP. Appropriate tax cuts depend largely on each country's existing tax structure, but available evidence offers a rank ordering of the long-term growth effects of various types of taxes. Corporate taxes have the most deleterious growth effects, followed by labor income taxes, taxes on goods and services, and taxes on immovable property.

Of particular long-term importance is the strengthening of education and training, which largely determine productivity and growth. As experience from previous downturns has shown that extensive use of early retirement decreases productivity, policy responses such as mandatory training programs for the unemployed are likely to facilitate transition to new employment, as well as stimulate aggregate demand. In the United States, an extension of unemployment insurance payments is advisable, as is aid conditioned on participation in training programs.

A final important area for reform is product market regulation, especially the reduction of obstacles to trade, foreign direct investment, and firm entry. Strengthening competition in product markets is expected to increase long-term productivity by improving the utilization of resources and spurring entrepreneurship, promote the entry of new firms, and may also help to raise demand in the short term. Studies conducted by the OECD additionally indicate that strengthening product market competition accelerates the convergence of country growth rates with the OECD average.

New Publications

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exploiting variation in the timing of availability of the signal of Rede Globo—the network that had a virtual monopoly on telenovelas in the country—across municipal areas. Using three rounds of Census data (1970, 1980 and 1991), it finds that the share of women who are separated or divorced increases significantly after the Globo signal becomes available. The effect is robust to controlling for potential determinants of Globo's entry strategy and is stronger for relatively smaller areas, where the signal reaches a higher fraction of the population.

Net Foreign Asset Positions and Consumption Dynamics in the International Economy. *Fabio Ghironi, Talan Iscan and Alessandro Rebucci. Journal of International Money and Finance. 27, pages 1337–1359. 2008.*

This paper finds that permanent worldwide productivity shocks lead to net foreign asset and consumption dynamics that are broadly consistent with interpreting the U.S. as the relatively impatient model economy and are not consistent with symmetric models with equal discount factors.

Oil Shocks and External Balances. *Lutz Killan, Alessandro Rebucci and Nikola Spatafora. Journal of International Economics. 77, pages 181–194. 2009.*

This paper shows that the effect of oil demand and supply shocks on the merchandise trade balance and the current account depends critically on the response of the non-oil trade balance. The results provide evidence of an intermediate degree of international financial integration. Also, the paper documents the presence of large and systematic valuation effects in response to these shocks. Valuation effects overall tend to cushion the effect of oil demand and supply shocks on the NFA positions of oil exporters and oil importers. Finally, it quantifies the overall importance of global business cycle demand shocks as well as oil-market specific demand and supply shocks for external balances.

Network News

Latin American and Caribbean Research Network

The following proposals were selected to participate in the research project: ***Information and Communication Technologies (ICTs) and Societal Empowerment in Latin America and the Caribbean***

- ICTs and Student Absenteeism in Argentina. MBC Consultores Mori
- A Study of the Mechanisms that affect Student Absenteeism in Argentina. Results from a Field Experiment. MBC Consultores Mori
- Impacts of ICTs on Productivity and Corruption in the Allocation of National Identity Cards within the Bolivian Police. Grupo de Investigación Almuray
- Investing in learning at secondary schools in Chile. Universidad de Chile
- Benefits of Information in Colombia's agricultural markets. CEDE, Universidad de los Andes
- Empowering Internally Displaced People in Colombia through the use of ICTs. Universidad del Rosario.
- ICTs and Small and Medium Enterprises' (SMEs) Performance in Costa Rica: A Randomized Controlled Experiment. Fundación CAATEC.
- ICTs and Student's Achievement: Evidence from a Randomized Experiment in Ecuador. Stratega BDS.
- Modern ICTs Can Empower Honduran Farmers by Providing Access to Current Market Price Information. Alpresa S.A.
- Evaluating the Effectiveness of Online Sexual Health Education for Risk Reduction among Public School Students in metropolitan Colombia. GRADE, Peru
- Evaluating the Effectiveness of Radio Programs as a means for Financial Education among Low-Income Households in Cuzco. GRADE, Peru
- Can ICTs Prevent Malaria? Evidence from a Randomized Experiment in the Border Between Ecuador and Peru. SASE, Perú
- ICTs, Job-Search, and Informality: A Randomized Social experiment for Disadvantaged Youth in Peru.¨ SASE, Perú
- The impact of ICT in health promotion: a randomized experiment with Diabetes patients. Universidad Ort, Uruguay
- A randomized experiment to evaluate the impact of ICT in health prevention in adolescents. Universidad Ort, Uruguay

The research proposals are available on our web site: www.iadb.org/res/network

www.iadb.org/res/researchnetwork