I D E A Ideas for Development in the Americas

Inter-American Development Bank
Research Department

Ideas Matter

Volume 35
September–December 2014

This year, the Research Department (RES) of the Inter-American Development Bank (IDB) celebrated its 20th anniversary. Fittingly, the department invited past and present staff and collaborators to ponder the development issues of the day and the role of research in confronting the region's challenges—past, present and future. One of RES's early promoters and long-time friend Nancy Birdsall joined Guillermo Calvo, Santiago Levy and José Juan Ruiz as they presented the Chief Economists' view of regional concerns over the years and RES' contribution to resolving them. While the perspectives varied, the bottom line was clear: ideas matter. They matter for analyzing issues, searching for solutions, improving Bank operations, feeding public policy—in short, they matter for development in the region.

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What are the greatest challenges facing the region? It depends upon whom you ask. Birdsall suggested that the region has faced three historic burdens. The first is inequality. Latin America and the Caribbean's resource-based economies have fostered dependence on the external economic environment. The region's institutions have not taken advantage of commodity booms to further development by investing in services that would help reduce inequality. The second burden is inappropriate macro management. In particular, policymakers have attempted to impose a European social welfare model on conditions for which it was not designed. Third, the region has pursued populist economics policies and economic reform rooted in ideas; this contrasts with East Asia's pragmatic approach. In addition to these economic problems, the region faces political challenges as well. On the plus side, it has a larger middle class than Africa or South Asia, income security is growing, and despite persistent inequality, income disparities are declining, in some places for structural reasons rather than because of the commodity boom. Meanwhile, democracy is trickling down to the local level.

Calvo agreed that inequality is a significant problem. However, he brought up a number of issues that relate to the region's image from abroad. Chronic low savings and populism diminish the credibility of countries in the region as partners and places to invest. In terms of the region's economic model and management, many analysts have raised eyebrows at concentrated executive power and unilateral economic policies. In addition, macroprudential measures are not sufficient to ensure financial system stability given current levels of institutionalization. He also argued that the current wave of interest in

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best practices should be viewed with skepticism. Adopting those practices should not be a given. Countries are repeating once-successful strategies for too long. Ironically, relative peace around the region may have its downside. Crises attract attention, and often capital. The region may find it more difficult to secure U.S. assistance than other regions because it is peaceful.

Levy focused on the challenge of trying to build welfare on a base of stagnant productivity. Countries have attempted to build on a Bismarckian foundation, which did not work to begin with, by including additional programs with uncertain aims (e.g., whether a program is intended to target recipients or to transfer income). Policies have resulted in inconsistent impacts in areas such as labor formality and schooling. They have also led to fragile fiscal stability and introduced new distortions. Growth in the region has slowed in the last four years, and the growth of the middle class has been built on external markets, leaving it vulnerable to shocks. In this environment, countries face a problem of high expectations by citizens. While extreme poverty has now largely disappeared, policy must now evolve toward emphasizing social inclusion and providing incentives for higher productivity. Social inclusion must be based on the quality of education and not education coverage. Labor markets and productivity must overcome an ideological heritage of labor regulation and the lack of skills building that results from informality. The region must return to fundamentals. It is hard to produce high-quality jobs for workers with low-quality education, as the labor force must be able to adapt to technological change.

Ruiz also highlighted the problem of slow/low growth under 3 percent and echoed concern that social welfare progress has outpaced economic growth, resulting in unsustainable trends vis-a-vis public expectations. Under these circumstances countries will be hard pressed to maintain the stability of fiscal policy. Countries should engage in more restrictive fiscal policy, control the quality of spending and raise productivity. The region additionally faces the challenge of many forthcoming national elections at a time when fragmentation has increased in legislatures and executive power has become concentrated. Countries must seek greater inclusion and productivity, and institutions must work to maintain or increase their legitimacy.

RES has been debating these kinds of issues since its inception in 1995 under current Harvard professor Ricardo Hausmann. Looking back at the body of research that has emerged from the department, he highlighted the notable evolution of ideas. Initially, research focused on volatility, which he and other economists identified as the Latin American curse holding back the region's development. But as the threat of macroeconomic volatility dissipated, discussion of other economic and political risks floated to the top of the agenda. The list of topics that were born or came of age in RES runs the gamut: Original sin, which precludes countries from borrowing abroad or even locally long-term with domestic currency; Sudden Stops, when private capital inflows to emerging markets

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This issue of *IDEA* was prepared by Rita Funaro and and John Dunn Smith.

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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.

To receive the newsletter electronically, please send your e-mail address to: research@iadb.org. Past issues of this newsletter are available on the Internet at: http://www.iadb.org/idea.

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dry up; policymaking process, which shifts the focus of discussion from the content of policies to the process of creating and implementing policy; educational technology, particularly the one laptop per child program; productive development policies, which offer a new approach to industrial policy; and a number of other issues related to Latin America's low-productivity, low-growth conundrum.

Ideas are the raison d'etre of the Research Department but they are not its only resource. The scores of economists, political scientists and other researchers that have collaborated with the department constitute a talented network of development thinkers and practitioners. As RES closes the book on its first twenty years, it moves into a new phase of its history. In this new era, the goal is not only to continue to generate new ideas for development but to more ably and efficiently debate and disseminate these ideas. In this next phase, it looks to reach out to its vast network of collaborators across the region and the world with its traditional publications and events, and a new emphasis on social media.

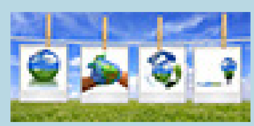
This edition of *IDEA* reviews a few of the highlights of the Research Department's 20th anniversary meeting. More importantly, it invites readers to participate in its ongoing journey to discover new avenues for development in Latin America and the Caribbean by following its twitter account, @IDB_thinks, and its recently launched blog, *Ideas que cuentan*. After recounting the activities and achievements of RES's first 20 years, it is clear that ideas do matter. In the future, using technology and outreach to activate and expand RES' rich network of colleagues can help generate more ideas, and make these ideas matter even more.

MORE THAN MACRO

To a large extent, the Research Department's new blog, *Ideas que cuentan,* was a natural outgrowth of the department's evaluation of its first 20 years. RES has created much knowledge for development of the region in the past two decades. However, it has not always been able to share that knowledge with all of its potential audiences, particularly in Latin America. Social media provides powerful vehicles for reaching out to new readers, and the RES blog will be a cornerstone of a more diversified dissemination strategy.

The blog name, *Ideas que cuentan*, was also inspired by the 20-year anniversary. In reviewing the body of work produced by RES it is clear that the department's principal function and contribution is in generating new ideas. RES counts numbers, recounts stories, and above all comes up with ideas that count for the development of Latin America and the Caribbean and the advancement of its citizens. Moreover, these ideas are not limited to one discipline or even one country. Regional and cross-country analyses typify the RES approach and complement the country or sectorial focus of research common in other IDB departments. Finally, RES is not just a macro monitor. It houses expertise in a myriad of fields. For this reason the blog can be sorted into four broad categories:


macroeconomics and finance


climate change


policy and institutions


social issues

Thus, under one umbrella, readers can find Andrew Powell's piece on what the Great Suppression means for Latin America and the Caribbean's near-term future, Sebastian Miller's article on the political repercussions of climate change, Carlos Scartascini's public policy report card for the region, and Gustavo Crespi's advocacy of the importance of investing in innovation for growth.

The Research Department thanks all of its collaborators and readers for their support and feedback in the past and welcomes any and all comments on its newest venture, *Ideas que cuentan*.

Trends in Inequality

How are the world's poor and middle classes doing, and what is their share of the population? And how well are the global rich doing? In other words, what is happening with inequality, and what implications does it hold?

According to City University of New York scholar Branko Milanovic, the short answer is *It depends*. Delivering the first IDB Development Lecture in conjunction with the Research Department's twentieth anniversary celebration, trends in inequality differ within and across countries, as yet other tendencies play out worldwide.

Sometimes these trends conflict. Between 1988 and 2008, income inequality within countries has increased. Unfortunately—and not surprisingly for those who study the region—2011 data show that inequality in many Latin American countries remains disturbingly high. Inequality between countries, though, tells another story. From 1988 to 2000 rich countries grew richer as the per capita GDP of developed countries grew faster than that of developing countries. Since 2000 developing countries have started to narrow the gap with the rise of a global middle class with daily incomes of US$3–16, and when the size of countries is considered, developed and developing country incomes have been converging throughout the globalization era. In short, China, India and other Asian nations have grown much richer in a very short time, and their middle classes have expanded dramatically. Milanovic noted that, in light of their vast populations and increasing wealth, China and India can even be considered "sumo wrestlers" pushing against the forces of global inequality.

Inequality is pushing back, though, and not even the world's two most populous countries can stop the upward distribution of income. More than half of global gains in income from 1988 to 2008 went to the richest 5 percent of the population. In developed countries, the relative position of the middle and lower middle classes has actually worsened, as they have seen almost no real income growth in recent decades. The middle of the income distribution, a foundation of social and political stability in those countries, is in effect being hollowed out as its members miss out on the benefits of globalization. The rise of what has come to be called the global 1 percent—and its widening gap with the rest of the population—presents additional challenges.

Major economic changes have a way of carrying over into politics, and these developments are no exception. China faces rising expectations among its relatively new middle class and those who hope to join it, but those expectations may go unmet as the high growth rates of recent decades appear unlikely to continue. How the Chinese people and government address the gap between aspiration and reality will prove crucial. In developed countries, the lower middle class is expressing its discontent with globalization through opposition to liberal immigration and trade policies, sometimes challenging existing political arrangements as they do so. All countries must figure out how to address the emergence of the global 1 percent, and many will have to determine whether the interests of the rich are compatible with democracy.

How countries deal with worldwide inequality, and whether they do so, involves questions of justice and politics. People may vary greatly in abilities and work ethic, but around the world some two-thirds of worldwide variation in income is explained by where people live and how their opportunities differ. Those who live in developed countries benefit from what Milanovic calls "citizenship rent."

If countries decide to tackle global inequality, they have several tools at their disposal. The first, with arguably

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How countries deal with worldwide inequality, and whether they do so, involves questions of justice and politics.

Research through Policymakers' Eyes

Some investments have large if well-defined upfront costs, readily measured benefits and a fairly predictable lifespan. Think of a truck, a building, a machine or even a financial bond.

Other investments, though, have a very different profile. Their costs are small and vary over time, their benefits defy easy measurement, and they endure indefinitely.

These include investments in knowledge, such as the work of the IDB Research Department. As economist Miguel Székely noted at a panel during the department's twentieth anniversary celebration, RES accounts for only a small portion of the IDB's budget, and its annual expenditures represent only five cents for each person in the region. A former RES staff member who is currently Director of Mexico's Centro de Estudios Educativos y Sociales, Székely noted that those five cents a year have gone a long way. During the department's first 20 years, for instance, the region's poverty rate has fallen by 30 percent. In all of its efforts, he said, RES places a greater emphasis on regional relevancy compared to other international financial institutions, and the department's regional perspective further allows its analysis to go beyond narrowly country-specific questions.

Like Székely, other RES alumni on the panel discussed how its work goes well beyond particular research projects. Alejandro Micco, presently a Subsecretary of Chile's Finance Ministry, noted the department's role in training researchers from throughout the region, who now form a sizeable intellectual community. Moreover, the IDB's annual flagship publication, the RES-produced Development in the Americas series, has shaped regional policy debates and served as a valuable reference. Mario Blejer, a former governor of Argentina's Central Bank and now an independent consultant, observed that policymakers in the region previously had to use or adapt models designed for advanced economies. RES, however, has since aided policymakers by providing models explicitly intended for use in developing countries.

Verónica Zavala, who remains within the IDB as General Manager and Chief of the Office of Strategic Planning and Development Effectiveness, discussed several of the region's needs. Even as urban middle classes have growing demands in areas such as education and infrastructure, Latin America and the Caribbean's integration and infrastructure have not yet reached the level needed at its current level of development. As countries move along their development paths, the IDB is valued for its expertise and its close relationship with the region, which contributes to a sense of long-term stability in working relationships. She noted that the Bank is also seen as an honest broker in disputes and a credible data source.

On the basis of their experience both in and beyond RES, panelists suggested how researchers and policymakers can improve their performance, both separately and together. Székely observed that RES could undertake further efforts in areas such as designing policy interventions, more precisely determining who needs assistance from the public

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Columbia University and IDB: Executive Course on International Financial Issues in Emerging Markets

Following five very successful, fully subscribed courses, Columbia University School of International and Public Affairs (SIPA) and the Research and Learning Departments of the Inter-American Development Bank (IDB) are offering the sixth edition of the Executive Course on International Financial Issues in Emerging Markets, comprising both analytical and quantitative tools for policymakers from emerging market governments and international financial institutions as well as market analysts, based on state-of-the-art emerging-market knowledge.

The program will take place at Columbia University, New York, on March 30th – April 3rd, 2015 and will be led by a world renowned faculty. Candidates worldwide are welcome to apply. IDB will offer tuition waivers to up to 15 policymakers from Latin America and the Caribbean.

Click here for brochure of the course. Program details regarding application and deadlines are available at: https://sipa.columbia.edu/international-financial-issues-in-emerging-markets.

The goal of this training program is to help world practitioners analyze, design and implement macroeconomic and financial policies in a cohesive and comprehensive framework where international financial considerations are at the forefront of the policy discussion.

Please feel free to pass along this information to those who might be interested in attending. **The deadline for applications is Wednesday February 18th, 2015**

New Publications

Available in English only unless otherwise stated.

WORKING PAPERS

Balsa, Ana I., Juanita Bloomfield, and Marcelo Caffera

The Effect of Acute and Intensive Exposure to Particulate Matter on Birth Outcomes in Montevideo (IDB-WP-534)

This study explores the impact of air pollution on birth outcomes. It focuses on the effect that breathing particulate matter with a diameter of 10 micrometers or less (PM10) has on premature births and low birth weights. It points out that when the Puyehue volcano in Chile erupted in 2011, the resulting debris substantially increased exposure to PM10 in Montevideo, Uruguay. Prenatal and birth data for 2010–12 from the Perinatal Information System revealed that increases in quarterly averages of PM10 concentrations beyond 50 µg/m3 decreased birth weights, raising the likelihood of more cases of low birth weights and premature births. These data also suggested that PM10 mainly affects birth weight through more frequent premature births—not intrauterine growth retardation. The effects of PM10 increase with each trimester of pregnancy, and are most dangerous during the third trimester.

Caruso, Germán Daniel, and Sebastián Miller

Quake'n and Shake'n…Forever! Long-Run Effects of Natural Disasters: A Case Study on the 1970 Ancash Earthquake (IDB-WP-535)

Using the Peruvian censuses of 1993 and 2007, this paper estimates the impact of the 1970 Ancash earthquake on human capital accumulation of both the generation directly affected and the succeeding generation (37 years later). The main finding is that males who were in utero when the earthquake hit completed on average 0.5 years less schooling, whereas females who were in utero when it hit completed 0.8 years less schooling. Surprisingly, the children of those females ended up receiving 0.4 years less schooling, whereas the children of the affected males experienced no shortage in education. Evaluation of other outcomes suggests that the level of welfare of the individuals affected was negatively impacted in the long run. This paper supports previous literature on early childhood shocks, providing evidence that an intergenerational transmission of shocks exists.

Cesa-Bianchi, Ambrogio, M. Hashem Pesaran, and Alessandro Rebucci

Uncertainty and Economic Activity: A Global Perspective (IDB-WP-510)

The 2007–08 global financial crisis and subsequent anemic recovery have rekindled academic interest in quantifying the impact of uncertainty on macroeconomic dynamics. This paper studies the interrelation between financial market volatility and economic activity, assuming that both variables are driven by the same set of unobserved common factors, and that these factors affect volatility and economic activity with a time lag of at least a quarter. Under these assumptions, the paper analytically shows that volatility is forward looking and that the output equation of a typical VAR estimated in the literature is mis-specified. The paper empirically documents a statistically significant and economically sizable impact of future output growth on current volatility, and no effect of volatility shocks on business cycles, over and above those driven by common factors. The evidence is interpreted as suggesting that volatility is a symptom, rather than a cause, of economic instability.

Chisari, Omar O., and Sebastián Miller

Does Firm Heterogeneity Impact the Effectiveness of Carbon Taxes? Experiments in Argentina and Mexico (IDB-WP-524)

This paper examines the effectiveness of carbon taxes on macroeconomic performance when manufacturing firms have the opportunity to change their scale of operation and degree of formality. The hypothesis is that when tax evasion or elusion is possible, it cannot be ruled out that emissions increase rather than decrease due to the reallocation of resources from the rest of manufacturing towards informal small-scale firms. When informality is high, industry could adapt to carbon taxes by reducing the scale of operation of big firms and increasing the number of small firms. However, when taxes are enforceable in all types of firms, there is a cost in terms of GDP and employment, since small-scale firms are more labor intensive. For numerical experiments, two CGE models calibrated for Argentina and Mexico are used. The "domestic leakage" is found to be more relevant for Argentina than for Mexico.

Dewan, Sabina, and Lucas Ronconi

U.S. Free Trade Agreements and Enforcement of Labor Law in Latin America (IDB-WP-543)

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This paper analyzes whether free trade agreements (FTAs) signed between the United States and Latin American countries during the last decade produced greater enforcement of labor regulations. The paper computes before-after estimates of the effect of FTAs on labor inspections, and makes use of variation across countries, using non-signers as a comparison group. The empirical strategy benefits from the fact that about half of Latin American countries have signed a trade agreement with the United States. Difference-in-differences estimates suggest that signing an FTA produced a 20% increase in the number of labor inspectors and a 60% increase in the number of inspections. The North American Free Trade Agreement (NAFTA), however, does not appear to have the same positive impacts on Mexico.

Franco Chuaire, María, Carlos Scartascini, and Mariano Tommasi

State Capacity and the Quality of Policies: Revisiting the Relationship between Openness and the Size of Government (IDB-WP-532)

The literature has identified that countries with higher levels of openness tend to have a larger public sector as a way to reduce risks to the economy posed by openness. This paper argues that a number of policies can mitigate trade-induced risks, and many of them do not necessarily imply increased public spending. Yet, these policies often require governmental capabilities not available to any country. For that reason, the relationship between openness and the size of government might be mediated by the quality of its public sector. While countries with weak governmental capabilities will tend to rely on increased spending to deal with trade-induced volatility, countries with stronger governmental capabilities might address such challenges by more efficient, less costly means. The empirical analysis in this paper shows that the effect of openness on government consumption is mediated by the quality of government institutions.

Mariscal, Rodrigo, Andrew Powell, and Pilar Tavella

On the Credibility of Inflation Targeting Regimes in Latin America (IDB-WP-504)

Inflation targeting has been adopted in a set of emerging economies, including eight countries in Latin America. The success of this regime may depend critically on the credibility of the target and the expectation that the authorities will take appropriate actions if the target is breached. This paper makes use of a database of inflation expectations, and attempts to measure whether expectations are well anchored for inflation targeters in Latin America. A tighter anchoring of expectations is interpreted as a gain in credibility. Also considered are the effects on the regime's credibility if the inflation target is breached. The results indicate that while inflation expectations have not been fully anchored over the entire sample period, credibility has risen, but at the same time the cost of breaching the target has grown.

Molina, Ezequiel

Can Bottom-Up Institutional Reform Improve Service Delivery? IDB-WP-513

This paper makes three contributions to the literature. First, it provides new evidence of the impact of community monitoring interventions using a unique dataset from the Citizen Visible Audit (CVA) program, in Colombia. In particular, it studies the effect of social audits on citizens' assessment of service delivery performance. Second, the paper introduces a theoretical framework to understand the pathway of change, the building blocks necessary for social audits to be effective. Third, using that framework, the paper answers the following questions: i) under what conditions do citizens decide to monitor government activity?; and ii) under what conditions do governments facilitate citizen engagement and become more accountable?

Saiegh, Sebastián M.

Partisanship, Ideology, and Representation in Latin America (IDB-WP-533)

This paper uses joint scaling methods and similar items from three large-scale surveys to place voters, parties, and politicians from different Latin American countries in a common ideological space. Contrary to conventional wisdom, the findings reveal that the "median" voter in Latin America is located at the left of the ideological spectrum, and that voters' ideological locations are highly correlated with their partisan attachments. The location of parties and leaders suggests that three distinctive clusters exist: one located at the left of the political spectrum, another at the center, and a third at the right. The results also indicate that legislators in Brazil, Chile, Mexico, and Peru tend to be more "leftist" than their voters. The ideological drift, however, is not large enough to substantiate the claim that

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a representation gap exists in those countries.

POLICY BRIEFS

Castro, Lucio, and Carlos Scartascini

The Devil is in the Details: Policy Design Lessons from Field Experiments in the Pampas (IDB-PB-232) (Available in English and Spanish)

There is growing evidence that individual responses to public policies are, to a large extent, mediated by the way the policies are framed, by people's cognitive and computational capabilities, and by people's subjective beliefs. For example, people may react to price changes but not to complicated schemes that rely on people's computational abilities. Similarly, people may react better to simple information (e.g., a picture) than to a very detailed analysis of benefits and costs. Therefore, even very well-intentioned policies may not have the desired impact if they do not take into account people's capabilities and beliefs. This policy paper draws on lessons that should help policymakers design more effective public policies by reviewing the evidence from recent field experiments and quasi-experiments sponsored by the Inter-American Development Bank.

TECHNICAL NOTES

Gingerich, Daniel W.

When to Protect? Using the Crosswise Model to Integrate Protected and Direct Responses in Surveys of Sensitive Behavior (IDB-TN-702)

The applied social sciences have witnessed a growing use of sensitive survey techniques (SSTs) to study the relationship between facets of an individual's background and his or her propensity to engage in sensitive behavior. The rationale undergirding the use of these techniques is the assumption that the rate of misrepresentation and/or non-response under direct questioning among individuals bearing the sensitive trait would be so high as to make the use of direct questioning infeasible. But is this actually the case? Presently available methodological tools do not provide an answer. The current paper presents a survey questioning strategy and corresponding statistical framework that simultaneously addresses the question of whether or not the use of a SST is required to study a given sensitive behavior, provides an estimate of the prevalence of the sensitive behavior in the population of interest, and, in its extended form, describes how individual characteristics relate to the likelihood of engaging in that behavior.

OUTSIDE PUBLICATIONS

Caballero, Julian

Do Surges in International Capital Inflows Influence the Likelihood of Banking Crises? *The Economic Journal.* DOI: 10.1111/ecoj.12172

This article asks whether capital inflows bonanzas increase the probability of banking crises and whether this occurs through a lending boom mechanism. Results indicate that bonanzas more than triple the odds of a crisis, raising its probability to 14% (from an unconditional probability of 4%). This effect exists in the absence of a lending boom and is found in both net and gross inflows bonanzas. This effect is driven by portfolio-equity and debt flows. While the effect of debt is channeled through excessive lending, the effect of portfolio-equity flows is present even in the absence of a lending boom.

Caballero, Julian

Banking Crises and Financial Integration: Insights from Networks Science. *Journal of International Financial Markets, Institutions and Money.* doi:10.1016/j.intfin.2014.11.005

This paper explores whether the level of *de facto* financial integration of banks in a country increases the incidence of systemic banking crises. The paper computes a measure of financial integration based on network statistics of banks participating in the global market of inter-bank syndicated loans. The network statistics used are indegree, outdegree, betweenness, clustering coefficients, authority, and hub centrality. The paper finds that for the period 1980–2007 the level of financial integration of the average bank in a country is a robust determinant of the incidence of banking crises. While borrowing (weighted indegree) is positively associated with a higher incidence of crises, betweenness is associated with a lower incidence. That is, the more important is the average bank of a country to the global bank network, as captured by betweenness, the fewer the number of crises the country experiences.

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Cavallo, Eduardo, Andrew Powell, Mathieu Pedemonte and Pilar Tavella.

A New Taxonomy of Sudden Stops: Which Sudden Stops Should Countries Be Most Concerned About?. *Journal of International Money and Finance*, Volume 51 (2015) 47–70

This paper proposes a new taxonomy of Sudden Stops comprised of seven categories with definitions depending on the behavior of gross and net capital flows. The incidence of different types of Sudden Stops is tracked over time and the type of Sudden Stop related to economic performance. Sudden Stops in Net Flows associated with reductions in Gross Inflows are more disruptive than those in which surges in (only) Gross Outflows dominate. The paper further discusses the mechanisms that might result in Sudden Stops in Gross Flows that are not Sudden Stops in Net Flows, such that shifts in financial assets or liabilities do not require a sharp current account adjustment. Still, it is found that Sudden Stops in Gross Inflows that do not provoke a sharp contraction in Net Flows may also be disruptive, including Sudden Stops that are driven by "other flows," which include banking flows. The results suggest new avenues for research and future policy analysis.

Fernández, Andrés and Adam Gulan.

Interest, Leverage, and Business Cycles in Emerging Economies: The Role of Financial Frictions. Forthcoming in *the American Economic Journal: Macroeconomics.* Online at *https://www.aeaweb.org/forthcoming/output/accepted_MAC.php*

Countercyclical country interest rates are an important characteristic of business cycles in emerging markets. This paper provides a microfounded rationale for this pattern by linking interest rate spreads to the dynamics of corporate leverage. For this purpose a financial accelerator is embedded into a business cycle model of a small open economy and a novel panel dataset for emerging economies is estimated that merges macroeconomic and financial data. The model accounts well for the empirically observed countercyclicality of interest rates and leverage, as well as for other stylized facts.

Fernández, Andrés and Felipe Meza.

Informal Employment and Business Cycles in Emerging Economies: The Case of Mexico. Review of Economic Dynamics. *http://dx.doi.org/10.1016/j.red.2014.07.001* This paper will also be published in the IDB working paper series as WP-515.

This paper documents how informal employment in Mexico is countercyclical, lags the cycle and is negatively correlated to formal employment. This helps explain why total employment in Mexico displays low cyclicality and variability over the business cycle when compared to Canada, a developed economy with a much smaller share of informal employment. To account for these empirical findings, the authors build a business cycle model of a small, open economy that incorporates formal and informal labor markets and calibrate it to Mexico. The model sheds light into the channels through which informal economic activity may affect business cycles. Introducing informal employment into a standard model amplifies the effects of productivity shocks. This is linked to productivity shocks being imperfectly propagated from the formal to the informal sector. It also shows how imperfect measurement of informal economic activity in national accounts can translate into stronger variability in aggregate economic activity.

Powell, Andrew and Pilar Tavella.

Capital Inflow Surges in Emerging Economies: How Worried Should LAC Be? Forthcoming in Economia, The Journal of Lacea. Online at *http://www.cid.harvard.edu/Economia/Forthcoming%20papers/Powell%20Tavella%20Capital%20inflow%20surges%20Economia_Revision_Aug_Final.pdf*

This paper analyzes capital inflow surges to emerging economies. Probit models estimated for the period 1980–2005 discriminate well between surges associated with banking crises or recessions, and those that end without such events. The composition of inflows and the extent of financial reform are significant determinants of outcomes. Applying the models to Latin America and the Caribbean we find relatively high estimated probabilities for recessions and lower probabilities for banking crises for post-2005 surges. While there were no financial crises in the seven largest Latin American economies, some surges may have contributed to the slowdown in growth. The results constitute a prima-facie case for macroprudential interventions.

Look Who's Talking

The Economic Development of East Asia and Latin America in Comparative Perspective

Anthony Elson presented at the IDB his new book, **Globalization and Development: Why East Asia Surged Ahead and Latin America Fell Behind**. The following is a summary of his presentation.

Between 1975 and 2000 East Asia and Latin America crossed over in terms of real per capita GDP in relation to that of the United States: East Asia's proportion dramatically increased, while Latin America's declined. In addition, between 1970 and 2007 East Asia more than quadrupled its shares of global trade and financial activity; during this period Latin America's share of global trade increased relatively little and its share of global financial activity declined by more than half.

These trends played out against a backdrop of major changes in global economic development. First, a large divergence in per capita incomes emerged across countries, showing that income convergence was conditional rather than absolute or inevitable. Second, growth was uneven both over time and space, and it proved to be path-dependent according to countries' circumstances and policy decisions. Third, trade came to be dominated by major exporters and increasingly intra-industrial as global value chains and production networks grew and intensified. This change was accompanied by a shift in the importance of value added from manufacturing to concept activity (e.g., research and development, branding and design) and logistics (e.g., distribution, marketing and sales).

The present attempt to explain how East Asia overtook Latin America has three conceptual origins. The first is that the Washington Consensus and other approaches emphasizing macro constraints on growth are not in themselves sufficient to explain countries' respective economic performance. Second, research and thinking in development have shifted away from an emphasis on "proximate" determinants of growth (e.g., capital accumulation and total factor productivity) to "deep" determinants (e.g., geography, trade and institutions). A third source is the emergence of what has been called the "new structuralist" approach to development thinking. While the "old structuralist" approach emphasized top-down industrial policy, the new version is more lateral, as the government works alongside the private sector to address market failures. In particular, governments can assist firms and activities with comparative advantage, foster a "learning society" that facilitates adaptation, and encourage export complexity through the promotion of manufacturing that can be upgraded over time. The new structuralist approach thereby focuses on structural transformation as achieved rather than as the spontaneous result of changing underlying conditions.

Based on these foundations, several complementary theses help to explain the "big reversal" between East Asia and Latin America. The first is the "originalist" thesis involving countries' initial conditions, such as colonialism, culture and ideology. The Latin American experience of colonialism largely involved extractive states, in contrast to the settler states of North America, and it left a legacy of inequality. East Asia's experience of colonialism, on the other hand, was shorter and less profound than Latin America's. From a development point of view, some aspects of East Asia's colonization can be seen as relatively benign. These include capital accumulation, the development of state structures, and improvements in infrastructure.

Four other explanations are useful as well. The "macro fundamentals" thesis holds that, while macro stability is required for development, such stability represents a necessary but not sufficient condition for growth. The "structuralist" thesis maintains that East Asia's industrial policies had more successful impacts than those adopted in Latin America. The "institutionalist" thesis, which allows for a positive role of government, suggests that Latin America has had less effective administrative states than East Asia. Whereas Latin America has suffered from extensive patronage and relatively weak administrative states, East Asia has enjoyed stronger administrative states with clear benchmarks and lower levels of rent-seeking, with consequently lower levels of distortion, possibly as a legacy of Confucianism. Moreover, East Asia has taken a generally cooperative approach to public-private relations, as deliberation councils including businesses, industry representatives and government have worked to promote industrialization through the removal of bottlenecks. Finally, the "political economy" thesis points to the importance of state-society relationships. Governments in East Asia have generally been strong, autonomous and

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Look Who's Talking

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bureaucratic, facing relatively weak competition from other parts of society; in this setting even corrupt states have proven effect. In Latin America, on the other hand, corruption has existed in the absence of an effective administrative state. A corollary to these features is that East Asian societies display greater social trust and cohesion and a greater willingness to respect government than their Latin American counterparts.

The contrasting experiences of East Asia and Latin America offer the following lessons, which particularly relate to growth:

1. GDP growth is key to long-term poverty reduction.
2. A sound macro policy framework is a necessary but not sufficient condition for growth.
3. Rapid growth requires structural change through manufacturing.
4. Industrial transformation requires technological capability.
5. "What you export matters." In other words, export diversification is key to growth.
6. Removing trade barriers involves more than tariff reduction. Infrastructure, logistics and trade facilitation services must also be considered to eliminate bottlenecks such as long waiting times at ports.
7. Independent and professional public administration is needed for the effective design and implementation of macro and industrial policy.
8. Governments must deal with the "commitment problem" in order to attract and retain foreign investors. In addition to narrowly defined property rights, governments must also give investors confidence that they will be able to keep production facilities and profits. This can be done even in the absence of a strong legal system.
9. Finance leads growth, and financial liberalization must be carefully sequenced with an effective framework of supervision and regulation.
10. Income inequality is a severe impediment to growth. It affects political processes via patronage and distorts development.

Research through Policymakers' Eyes

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sector, and better understanding institution-building. Blejer stated that policymakers must display a sense of ownership of the measures they adopt, and for this reason names and labels matter. A policy package with a name like the "Washington Consensus," for instance, is currently less likely to be embraced by policymakers and accepted by the public than policies perceived as being from the region's own experts. Researchers, for their part, must avoid the intellectual arrogance that creates resistance, especially since ideas they strongly advocate can have unintended consequences in practice.

Trends in Inequality

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the highest economic benefits and lowest political costs, is increasing poor countries' growth rates and improving their citizens' opportunities. A second approach, lowering barriers to migration, can reduce citizenship rent and lower inequality across countries, but migration can aggravate inequality within countries and strain political systems. The third and weakest tool, according to Milanovic, is reducing inequality within countries. Even if all countries reduced their own levels of inequality, great disparities between countries would remain.

As if the landscape of inequality were not complicated enough already, countries face its challenges in an era of high capital mobility. Developing and developed countries, moreover, are likely to feel very different effects. In poor countries, greater capital mobility is expected to make investment more rewarding as well as stimulate growth. Rich countries, though, may well be sailing into a "perfect storm" of rising inequality as several factors come together. Parts of the population in those countries have both large amounts of capital and highly valued professional skills, and they are increasingly likely to form families with each other instead of people from other socioeconomic classes. The advantages of these groups are thus likely to be reinforced over generations. The role of money in politics is likewise expected to reinforce the advantages of those who can afford to participate, even going so far as buying legislation.

Network News

Latin American and Caribbean Research Network

Project: Structure and Composition of Firms Balance Sheets

This project focuses on the financial challenges derived from the increased exposure of corporations to international debt that the Latin American and Caribbean region may face in coming years. Objectives are to produce in each country studied a firm-level database on currency composition of balance sheets, a survey on hedging activities of international debt issuers, and an analytical paper studying the financial challenges. The project aims to provide a solid empirical basis to underpin the policy dialogue with the IDB's borrowing member countries and to assist in formulating policy recommendations.

The following proposals have been selected:

- "Explaining Liability Dollarization, Exchange Rate Exposure and Risk Management Policies in Latin American Companies." Universidad de San Andrés - UDESA.
- "Structure and Composition of Brazilian Firm's Balance Sheets." Fundação para Pesquisa e Desenvolvimento da Administração, Contabilidade e Economia – FUNDACE.
- "Corporate Currency Risk and Hedging in Chile: Real and Financial Effects." Universidad de Chile
- "Structure and Composition of Firms' Balance Sheets in Colombia." Fundación para la Educación Superior y el Desarrollo – FEDESARROLLO.
- "The Determinants of Offshore Debt Issuance and Corporate Hedging of Non-Financial Firms in Peru." Instituto de Estudios Económicos para el Desarrollo – IESEC.

Policy Seminar

Optimal Fiscal Management of Commodity Price Shocks

Speaker: Pierre Richard Agénor

Moderator: Eduardo Fernández-Arias

Discussants: Osmel Manzano and Gustavo García

Where: IDB Headquarters
Washington D.C., Conf. Room CR200

When: January 13, 2015
12:00–1:30 pm

Call for Proposals

XVIII Workshop in International Economics and Finance

Guatemala will host the XVIII Workshop in International Economics and Finance organized by Universidad Torcuato Di Tella, the World Bank LAC Chief Economist Office, LACEA, the Inter-American Development Bank's Research Department and the Central Bank of Guatemala in 2015.

The Workshop will take place in Antigua, Guatemala on March 12 and 13, 2015.

Event information: Click here

Papers submission: Papers should be sent using the Web Submission Form available from December 15 until January 11, 2015.

Due date: January 11, 2015.

www.iadb.org/res/researchnetwork