IDEA
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China Ascendant: A Snapshot of Economic Performance

Southeast Asia has been an important pole of economic growth since the mid 1960s when Japan, whose post-war transformation had made it an economic powerhouse, was joined by the "Asian Tigers." The original Tigers of South Korea, Hong Kong, Singapore and Taiwan were followed by a second wave as Malaysia, Indonesia and Thailand posted impressive economic and export growth rates. On the horizon was China, undergoing changes that began to elicit interest in the 1990s. Since 2000, China has been the focus of much of the world's attention.

The attention has included concern in many countries, not least in Latin America. For the region, there are at least three important dimensions to China's emergence on the global economic stage. There is China the successful growth story and possible source of policy lessons; China the market of 1.3 billion consumers; and China the competitor in Latin America's main markets. Devising an effective response to the China phenomenon poses a substantial challenge to Latin American policymakers.

The Chinese economy has expanded dramatically in the past two decades. Latin America as a whole still surpasses China in terms of absolute economic size, but the gap has been closing relentlessly since the 1970s. China is now the world's sixth biggest economy at market exchange rates, and is likely to become the world's leading exporter in this decade.

> For Latin America, China is at once a possible growth model, a potential market and a competitor.

China's growth only slightly exceeded that of Latin America in the 1970s, and both were outpaced by East Asia and the Pacific. Since the onset of a reform process in the late 1970s, however, Chinese growth rates have substantially outstripped those of the other regions. In Latin America's "lost decade" of the 1980s, when annual output growth for the region as a whole averaged 1.3 percent, China grew by almost 10 percent. Its growth was higher still in the 1990s and, since 2000, GDP has risen by an annual average of 8 percent (while Latin America's has stalled at an average of less than 0.3 percent). As Figure 1 shows, China's per capita GDP growth has soared since the 1970s and the growth gap with Latin America has widened significantly.

A conspicuous feature of China's mounting global significance is the increase in its share of international trade. In the 1980s, on average, Chinese exports grew by 5.7 percent a year, just slightly above world export growth. In the 1990s, however, the country's overseas sales grew at twice the rate of world exports. In 2000, Chinese exports grew at almost triple the world rate, and by 2003 there was a more than seven-fold gap between the Chinese and world export growth rates. A broadly similar pattern prevailed for the country's imports. By contrast, Latin America's exports and imports have stagnated, relative to world trade, since the 1980s.

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IN THIS ISSUE

Chief Economist Guillermo Calvo was this year's Frank D. Graham Memorial Lecturer at Princeton University. He joins a list of eminent international economists, including several Nobel Prize winners, invited by the University to deliver an annual lecture in honor of former Princeton professor, Frank D. Graham. Dr. Calvo's presentation on March 26 was titled *Crises in Emerging Market Economies: A Global Perspective*. It can be accessed on the RES website at www.iadb.org/res.

China Ascendant: A Snapshot of Economic Performance

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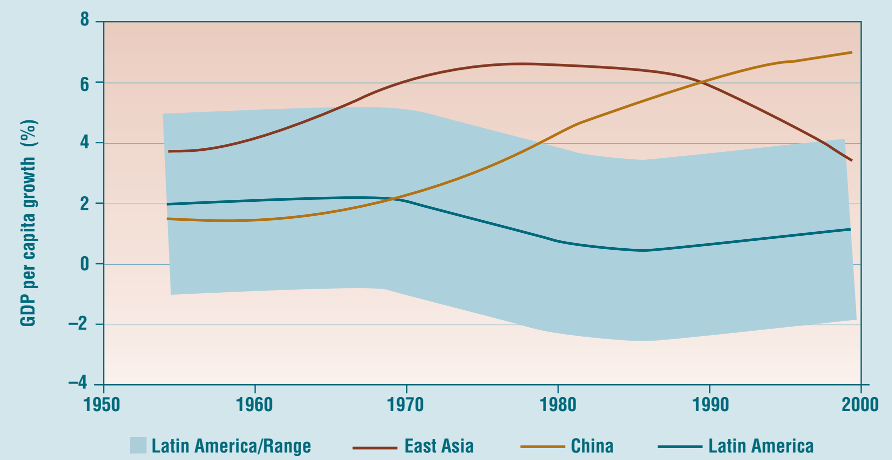
Trade openness has increased in both China and Latin America, but this region remains relatively less open to trade and the gap with China has widened since the 1990s. By this measure China is more integrated into the world economy than some large countries in the developed world (such as the United States) and the developing world (such as India).

China's performance is striking by other measures. Its gross domestic savings rate is among the highest in the world, estimated at about 43 percent of GDP in 2002. This is more than double the Latin American rate and the trend in China has been upward since the 1970s, while that in Latin America has generally been downward.

China's annual inflation has averaged just 1 percent since the mid-1990s, a period punctuated by episodes of slight deflation despite soaring output. In this area the contrast with Latin America is marked, largely because of very high inflation rates in a number of countries during the 1980s, levels that remained significant in some countries in the 1990s. Since 2000, inflation in the region as a whole has fluctuated between a high of 12.2 percent in 2000 and a low of 6.1 percent in 2001. In China, the range has been deflation of –0.8 percent in 2002 and a high of just 1.2 percent in 2003, and 2.4 percent in 2004.

China's external debt is very modest, equivalent to only 46 percent of exports and 13 percent of GDP. Latin America is significantly more burdened by external debt: the corresponding figures are 183 percent and 44 percent. China also has a comfortable international reserve cover, equivalent to 10 months of imports of goods and services. Latin America's cover is about half that.

Figure 1. China, East Asia and Latin America: GDP Per Capita, Annual Growth
(Hodrick-Precott filter, 1996 international dollars)



Source: Penn World Tables
Note: LAC range is a 95% confidence interval for growth rates in LAC.

Both China and Latin America have had very significant access to international capital but, compared to some bigger Latin American countries, a much higher share of China's net capital inflows has consisted of foreign direct investment (FDI), which has climbed spectacularly in the last two decades. Inflows were low in the 1980s in absolute terms and relative to world flows. FDI then soared in the early 1990s and was curbed only temporarily by the 1997 Asian crisis. Latin America as a whole still attracts higher FDI inflows, but the sheer scale of the flows going to China raises questions about the prospect of investment diversion away from Latin America.

Traditionally and with few exceptions, Latin America's economic links with East Asia have been slender. This is changing fast as China's emergence poses challenges for virtually all Latin American economies. The country's size, rapid growth, external openness and trade performance are being felt throughout the region, but perceived in different ways. South American commodity producers mostly see China as a new market that favorably affects export volumes and world prices. Mexico and the countries of the Caribbean Basin, by contrast, perceive head-to-head competition in third markets (particularly the United States) for many of their products. And in all countries there are questions about whether the striking levels of FDI directed at China will divert flows from the region. In these latter areas China the Competitor is claiming the attention of policymakers throughout the region, even in those countries now experiencing the benefits of China the Market.

In response to such concerns the Inter-American Development Bank set up a China Task Force to undertake a preliminary assessment of the implications for Latin America of China's economic performance. This issue of IDEA is based on the Task Force's report: *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean*.

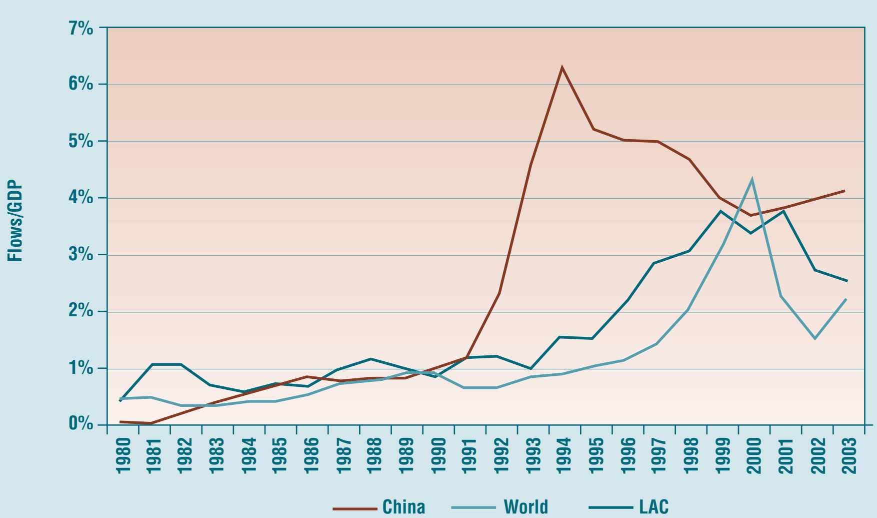
Surging FDI to China: Should Latin America Be Concerned?

FDI flows to China have soared in the past 15 years. The country's share of global flows rose from just 2 percent in 1990 to 6.3 percent in 2003. By the end of the 1990s China was attracting higher flows than Canada and Spain, and very substantially more than Brazil and Mexico, the leading Latin American destinations.

The figures demand caution, since some flows are domestic investment going through Hong Kong to benefit from investment incentives to foreigners in China. This is called "round tripping" and overstates the real level of FDI, but the growth of investment is nonetheless substantial. Liberalization and WTO accession have opened the economy, giving investors access to abundant cheap labor and a huge market. Investment is expected to grow further in light of China's continuing market reform process, expectations that it will preserve its low-cost labor advantage, and the prospect of a significant expansion of the domestic market.

As Figure 2 shows, FDI flows as a percentage of GDP were significantly higher in China than Latin America throughout the 1990s, although the gap contracted by the end of the decade. In output terms, however, the figures for flows were similar by the late 1990s.Given the large number of public firms in China, moreover, FDI would rise faster if the country were to embark on comprehensive privatization. Should Latin America be concerned about the rise in FDI to China? And to what extent is China competing with Latin American countries as an investment destination?

Figure 2. FDI Flows, 1980–2003
(percentage of GDP)



Source: World Economic Outlook. IMF Database.

FDI strategies in Latin America

The factors driving FDI in Latin America vary by country and subregion. One strategy centers on *natural resource-seeking* investment in the Andean Community, Argentina and Chile. Resource-seeking companies invest mainly in the petroleum, gas and mining sectors. Other companies' strategies are based on *market-seeking*. They look for large domestic economies to supply their products or services. These investments are concentrated in the financial, telecommunications and energy sectors in Argentina, Brazil and Mexico, as well as in Mercosur's automobile industry. A third strategy is pursued by *efficiency-seeking* companies that fragment production in order to capture low-wage labor inputs. They invest for export in Mexico (automobiles, electronics and apparel) and the Caribbean Basin (mostly apparel).

Natural resource-seeking FDI in South America has held constant because commodity prices have remained high and companies' enclave investment is mostly independent of countries' macroeconomic conditions. But market-seeking firms in South America have cut their investments, largely because of recent recessions in the region.

Efficiency-seeking FDI features two systems of integrated production. One is the model for the apparel industry in the Caribbean Basin, based on the United States' Caribbean Basin Initiative (CBI). The other is the model for the electronics and automobile industries in Mexico under NAFTA.

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In the apparel industry model, El Salvador, Nicaragua, Guatemala and the Dominican Republic have seen a significant decline in FDI over the last two years. The model is based on geographic proximity, low wages, tax incentives for export-processing zones and special access to the United States. It is being challenged by new competitors such as China, where the availability of low-cost labor often offsets the Caribbean countries' other advantages.

As to FDI in the automobile industry, flows to Mexico rose significantly in the 1990s as firms with US-based plants began to relocate them to Mexico. But the Mexican automobile industry's future is uncertain because Mexico's supplier base has insufficient incentives to invest in the technology needed to transform the industry into an integrated production cluster. Mexico now faces competition from Asian countries, especially China, for efficiency-seeking FDI.

Do Some Countries Face Stronger FDI Competition than Others?

Global savings are scarce. All other things being equal, therefore, a higher return on investment in one country will lead to increased investment in that country, and a corresponding decline in investment in others. This process is effected through the increase in worldwide interest rates. To some extent, this must be happening in China, since its share of global investment has increased sharply: to reiterate, China's share of global FDI increased from 2 percent to 6 percent in the 1990s. Barring a strong positive effect on savings, the outcome would be lower FDI flows to Latin America. A rough calculation suggests that such an increase in China's share of global FDI reduces Latin America's FDI inflows by 4 percent, a small amount.

Of course, the effect of surging FDI to China will not be proportionally the same in all countries. FDI competition can be expected to be more severe among countries exhibiting strong similarities in the sources and sectoral composition of FDI inflows. For example, competition for investment should be sharp between two countries that receive most of their FDI from Japan, or in both of which the electronics manufacturing sector is a target of the flows. Similarities in the sources and sectoral composition of investment were measured using an "FDI source coincidence index" and a "sector coincidence index." What do these indices reveal?

Sources and Sectors: How Similar?

In the 1980s and early 1990s, the leading sources of FDI to the Chinese mainland were Hong Kong, Macao and Taiwan. Their share declined in the 1990s but they are still the prime sources, which suggests that FDI competition between China and Latin America is weaker than the aggregate data indicate.

Four of China's five main sources are in Asia (Hong Kong, Japan, Chinese Taipei and Singapore). By contrast, Japan is the only Asian country among Latin America's five leading sources. Latin American countries, then, evince a low FDI source coincidence index with China.

The two countries that are significant FDI sources for *both* China and Latin America are the United States and Japan. FDI from the United States to both destinations rose until 1997. US flows to Latin America fell dramatically thereafter, from $17 billion in 1997 to $4 billion in 2001, while flows to China stagnated at about $4 billion. It is therefore hard to argue that China negatively affected FDI to Latin America. Other factors loomed larger: the boom in FDI to the region is partly explained by privatization programs that could not continue indefinitely; and the 1997 crisis in Asia and the 1998 crisis in Latin America adversely affected investment in both regions.

As to FDI from Japan, again it cannot rightly be claimed that China has caused a decline in flows to Latin America. In fact, there seems to be a weak and volatile positive trend in investment in the region, while Japanese flows to China move in a boom-bust cycle.

Worth noting is the extent to which the growth of flows to China has been in those sectors in which Latin America receives FDI. Analysis is limited to outflows from the United States because of sector-level data constraints, but the United States is Latin America's leading FDI source and the second source for China, so the analysis is pertinent.

The "sector coincidence index" reveals that there is relatively little similarity in the composition of US outflows to the two destinations. The coincidence is much greater between China and South Korea or India. This is mainly because US flows to Asia are dominated by investment in manufacturing, while other sectors predominate in Latin America.

Among Latin American countries the greatest sectoral coincidence is with Mexico, largely because of the high share of manufacturing in total US flows to its NAFTA partner. Argentina,

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Competing with China in Global Trade

Direct competition between China and Latin America is intensifying because their export baskets are increasingly similar, especially in some branches of manufacturing. China's exports have boomed in the past two decades, from $24.9 billion in 1984 to $325.6 billion in 2002, and the country's share of world exports rose from 1.5 percent to 5.6 percent over the same period. China's performance in the US import market is even more striking: its share of US imports rose from 0.46 percent in 1980 to 11 percent in 2002. The export surge is largely associated with manufactured goods.

China's export markets have diversified over the past 20 years and are now more evenly distributed among East Asia, North America and Europe, a reflection of the country's increasing global competitiveness. The exports are highly dynamic. In 1987, about a quarter of Chinese exports were in categories with dynamic world demand. By 2001, more than 60 percent were in those categories, a slightly higher share than the corresponding figures for the United States. Latin America has also become more specialized in goods with dynamic demand, but this is very largely because of Mexico's striking export performance in the US market.

Indeed, China and Mexico tend to have fast-growing exports in precisely those sectors with the greatest world export dynamism. The Chinese and Mexican patterns contrast with the performance of Latin America as a whole if Mexico is excluded, since the region's exports are more concentrated in sectors with stagnant world demand. China's sales are also significantly more diversified in terms of product categories than those from Latin America's more natural resource-based economies.

China's exports, moreover, have advanced from unsophisticated manufactures to more complex goods. In the mid-1980s, almost 90 percent of the country's exports consisted of primary products, resource-based manufactures and low-technology manufactures. This fell to 50 percent by 2002, while the share of high-tech products increased from less than 5 percent to 30 percent. Consequently, China will pose a growing competitive challenge in world export markets, especially in medium-technology goods such as cars, machinery and simple electronics.

Because of its enormous scale and high growth, China is increasingly threatening to countries that rely on labor-intensive manufactures and low wages for their export advantage. Additionally, because of its rapid structural transformation towards more advanced goods, China poses a challenge to many countries' (including Latin American countries') potential to compete in third markets in more sophisticated capital and consumer products. Some sectors will be affected more than others. For example, China's quality, design and marketing scale in textiles and apparel will probably have a strong influence on the global market in this sector, especially given the expiry of the Multifiber Agreement at the start of 2005.

China's emergence, of course, presents both challenges and opportunities: the real promise for other countries is the prospect of their supplying new demand segments of the Chinese production apparatus and of buying increasingly sophisticated (and probably more affordable) finished goods from China. Both sides of the coin are important, but the rest of this short summary focuses on the challenges posed by China to Latin America's exporters.

Comparing the similarity of the Latin American and Chinese export baskets offers clues as to the extent to which they compete in world markets.

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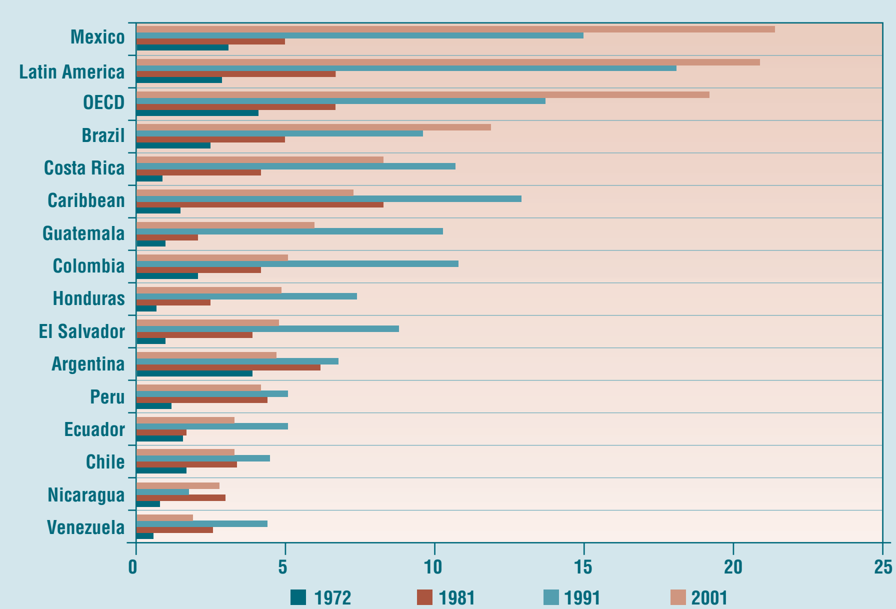
Figure 3. Export Similarity Index with China in the US Market for Selected Regions and Countries, 1972–2001



Source: IDB-INT calculations based on US/Comtrade data.

Competing with China in Global Trade

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Figure 3 shows that the average similarity for Latin America as a whole is relatively pronounced. It has grown over the past decade and is well above the corresponding figure for the OECD countries. And it is miscellaneous manufacturing, especially clothing, that mostly drives China's export similarity with Latin America. China competes most directly with Mexico in Latin America and with the Dominican Republic in the Caribbean. Chile's export structure barely coincides with that of China, while more than a fifth of Mexico's export basket was close to China's in 2001. In that year, in fact, China was more similar to Mexico than any other non-Asian developing country. The similarity with Brazil and Costa Rica has also risen in the past two decades, albeit to a lesser extent.

Within manufactures, moreover, China's export prices (in unit values) are generally lower than those received by Latin American countries. One explanation, consistent with differences in comparative advantage, is that their products are of higher quality or have more attributes than the Chinese goods, thereby raising their value.

Another explanation is that the price difference reflects the greater Chinese product efficiency attendant on very low labor costs. This is consistent with China's explosive export growth, and it raises questions about the share of the manufacturing market that Latin American countries can retain as China's capacity and access to foreign markets grows.

China has significant comparative advantages in product categories that are important to Mexico and the Central American countries (textiles, apparel and electronics). This is a real challenge, largely because these countries specialize in the labor-intensive parts of the production chain in which China has a significant edge. The relatively high overlap in miscellaneous manufacturing can be expected to widen with the expiry of the Multifiber Arrangement.

As the Chinese and Latin American export baskets become ever more similar, direct competition between the two has intensified in world markets, especially in various manufacturing industries. Because of the expansion of China's international production and export base, however, increasingly the challenge to Latin American manufacturers may be across the board. China's growing production and export of manufactured goods with higher value-added means that Latin American countries aiming to export the same goods will face a higher competitive threshold of entry into the global marketplace.

Surging FDI to China:

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by contrast, reveals a very low level of similarity in the sectoral composition of FDI with China, since most US flows to Argentina are concentrated in "other industries" and virtually none goes to manufacturing.

Overall, then, direct FDI effects are small. The main effect arises from FDI's link to trade. In this area Mexico and the CBI countries face tough competition from China. The story is very different for South America, where exports of primary goods are increasing. Thus expansion of the Chinese market could attract FDI to these countries, including investment from China itself.

This issue of *IDEA* is based on *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean*, a report prepared jointly by the Integration and Research Departments of the IDB under the coordination of Robert Devlin, Antoni Estevadeordal and Andrés Rodríguez.

Eduardo Lora
General Coordinator

Rita Funaro
Managing Editor

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.

Inter-American Development Bank
1300 New York Ave., NW
Washington, DC 20577

To the Future: Preparing to Cope with Chinese Competition

China's strong advantage in unskilled, labor-intensive manufactures is influencing international prices, factor returns and specialization patterns worldwide. Countries specializing in light manufactures, such as Mexico and those in Central America and the Caribbean, face declining terms of trade and shrinking participation rates in export markets. In countries with a comparative advantage in natural resource-based sectors, such as Argentina, Brazil and Chile, the terms of trade have improved, exports have expanded and the recovery has strengthened. But even in these countries there is concern that increasing specialization in natural resource-based sectors will hamper long-term growth.

All countries in the region, then, will have to consider how to deal with China. Standing still is not an option. If no action is taken, China's impact could erode the value of Latin America's existing assets, for a number of reasons.

First, China's emergence in global markets is likely to increase returns to skills. Because China has much unskilled labor, its international integration should lead to a rise in the worldwide skill premium—the wage of skilled workers against that of the unskilled. And that, in the absence of strong education policies, could worsen inequality in Latin America, a region that already has the world's most marked inequality levels.

Second, higher Chinese demand for raw materials is boosting exports from and growth in some Latin American countries, but this might come at the cost of a reallocation of resources towards natural resource-based industries. Some controversy surrounds this issue, but there is reasonable disquiet that these industries do not generate the dynamic economies associated with manufacturing. Another concern is that high prices for a particular commodity might induce countries to specialize excessively, spurring volatility and lowering growth. The problems attendant on high commodity prices are known as Dutch disease, and countries need policies to deal with them.

> If Latin American countries take no action, China's impact could erode the value of their existing assets.

Third, China's strong state and pragmatic approach to economic policy, coupled to its long-term strategic vision for development, could outstrip Latin American policy frameworks, which are often preoccupied with short-term fluctuations and prone to wide swings in overall strategy. How, then, should the region rethink the policy framework in order to compete?

A Public-Private Alliance

One issue to be tackled is Latin American governments' weak capacity to design and implement forward-looking policies geared to competition, a deficiency that can contribute to underperformance on the part of the private sector. Governments must be strengthened in this area, and policy must be made in a constructive partnership between public and private actors.

There is renewed interest in this issue—partly because Washington Consensus reforms have not yielded the expected benefits and partly in reaction to the success of East Asian economies, most recently China, whose governments have gone beyond market-oriented reforms and engaged vigorously with the private sector. In Latin America, a public-private alliance that rethinks the state's role in complementing market reforms should focus on the market failures that act as binding constraints on development.

Dealing with Dutch Disease

One set of market failures is related to Dutch disease. When the problem is cyclical (such as a temporary oil price hike) an effective policy would be to create a stabilization fund, but this would be fruitless if the matter is not cyclical. One option is to deal directly with the market failures that prevent the economy from devoting more resources to the discovery of new export activities and to raising productivity in existing sectors. A good example is the Chilean government's recent initiative to create an

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"Innovation Fund for Competitiveness" from a new tax on copper exports. This fund can be used to support innovation and R&D in non-traditional, agriculture-based exports and industries in which Chile has a comparative advantage. The goal is to increase productivity, develop new products and markets, and foster export-related services.

Education

The conventional wisdom has held that raising enrollment in primary education is the proper education policy for developing countries. That wisdom is being revised, since it is becoming clearer that increasing primary enrollment without paying due attention to quality might be a monumental waste of resources. China's emphasis on higher education, moreover, suggests the need for a more balanced approach. The emergence of more technologically sophisticated sectors in Latin America, such as fruit and salmon exports in Chile or the medical devices sector in Costa Rica, has been associated with adequate higher education systems that have been critical in supplying high-quality professionals.

Improving higher education requires policies to upgrade curricula (particularly in mathematics and sciences) and motivate public universities to expand high-demand courses. Two- and three-year technical colleges can make an intermediate contribution to nurturing technological capacities. Greater collaboration between business organizations and universities is essential, and governments can promote it by providing universities with R&D grants that are conditional on the research being approved or requested by the private sector.

Export Development and Investment Promotion

Export diversification being crucial to development, Latin America needs policies that encourage entrepreneurs to innovate and invest. Such policies could include offering grants for new exports, or for exporting to new markets, or for new firms. More generally, Latin American countries should take three measures to ensure export growth and diversification.

First, they should avoid episodes of real exchange-rate appreciation, since a competitive real exchange rate facilitates the discovery of new exports and can attract FDI into the export sector. China managed to keep its rate competitive for a long time and thereby encouraged long-term investments in tradable goods.

Second, they should address the prevailing problem of "insecurity" in business conditions (institutions, taxes, crime). The main task is to strengthen institutions, streamline regulations, improve the effectiveness of the state and consolidate the rule of law, so that investors have confidence in the rules of the game.

Third, private-public sector collaboration will be crucial in promoting Latin American exports to China and in attracting investment. The cost of exploring the Chinese market is relatively high and, in the absence of public support, would fall on the shoulders of a few entrepreneurs. One possibility is to offer grants to those who propose new projects to exploit the Chinese market or bring investment home.

The Role of Regional Integration

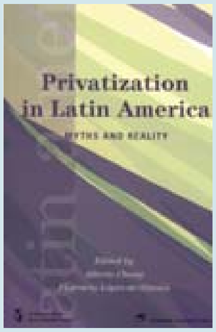
Regional integration is a prime asset that can help Latin America meet the challenges of global competition and the emergence of newly dynamic economies like China and India. Integration offers a way for Latin American firms to attenuate disadvantages in scale and agglomeration as they exploit access to bigger regional markets.

Regional partners can also cooperate in areas that enhance competitiveness, such as higher education facilities, R&D, the development of production linkages and clusters, regional infrastructure development, export- and investment-promotion, and macroeconomic policy cooperation.

Free trade areas (FTAs) can provide a commercial platform that supports scale through market access and a reduction in trade and investment costs. The broader the participation in the FTA and the more extensive the range of endowments among the countries, the less the risk of inefficient trade and investment diversion that would move countries away from their production frontier unless offset by medium- and long-term dynamic effects. North-South FTAs, in particular, display this benign characteristic. In this sense the completion of the Free Trade Areas of the Americas (FTAA) is an opportunity for Latin America to prepare for global competition and the emergence of big markets like China.

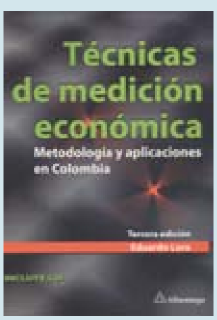
New Publications

BOOKS



Privatization in Latin America: Myths and Reality.
Chong, Alberto and F. Lopez-de-Silanes eds., Stanford University Press and World Bank. 2005

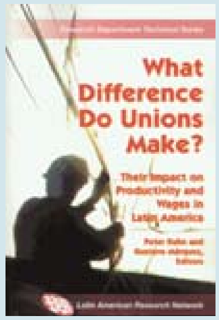
Since the 1980s, thousands of failing state-owned enterprises worldwide have been turned over to the private sector, but now privatization is under attack. What is the real record of privatization and are the criticisms justified? This book evaluates the empirical evidence on privatization in seven countries: Argentina, Bolivia, Brazil, Chile, Colombia, Mexico and Peru. The quality of the data enables the researchers to comprehensively analyze the record of and accusations against privatization, with important recommendations for the future.



Técnicas de Medición Económica. Metodología y Aplicaciones en Colombia.
Lora, Eduardo. Tercera edición. Bogotá: Alfaomega. 2005

(*In Spanish only*)

The measurement of phenomena such as economic growth, inflation or unemployment rates is based not only on strictly economic concepts but on techniques in the fields of accounting and statistics. The purpose of this book is to study the conceptual foundation and the statistical methodology that economists and other social scientists use to describe economic phenomena in Colombia.



What Difference Do Unions Make? Their Impact on Productivity and Wages in Latin America.
Kuhn, Peter and *Gustavo Márquez,* editors. 2005

This book represents one of the first attempts to obtain evidence on union effects in Latin America. Following an examination of union density across countries, the studies in this volume evaluate the impact of unions on private-sector firm performance, agricultural productivity, and educational outcomes in public school systems. Union effects are considered for Argentina, Brazil, Peru, Uruguay and Guatemala.

RESEARCH DEPARTMENT WORKING PAPERS

Labor Market Regulations and Income Inequality: Evidence for a Panel of Countries (WP-514)
By César Calderón, Alberto Chong and Rodrigo Valdés

This paper presents evidence on the impact of labor regulations on income inequality in a sample of 121 countries over the 1970–2000 period. It is found that: (i) *de jure* regulations do not improve income distribution; (ii) relative compliance with existing regulations improves income distribution; and (iii) *de facto* regulations are weakly associated with improving income inequality.

Inequality, Institutions, and Informality (WP-516)
By Mark Gradstein and Alberto Chong

This paper presents theory and evidence on the determinants of the size of the informal sector, proposing a simple theoretical model in which the informal sector's size is negatively related to institutional quality and positively related to income inequality. These predictions are then empirically validated using different proxies, and the results are shown to be robust with respect to a variety of econometric specifications.

Should the Government be in the Banking Business? The Role of State-Owned and Development Banks (WP-517)
By Ugo Panizza, Eduardo Levy Yeyati and Alejandro Micco

This paper surveys the theoretical and empirical literature on the role of state-owned banks and presents some new results. The paper shows that state-owned banks in developing countries have fiscal costs because they have lower returns than comparable privately-owned banks. However, this low profitability might stem from state-owned banks' activity on projects characterized by low private sector investment and high social return. While no evidence is found that state-owned banks promote economic growth or financial development, the evidence that state-owned banks lead to lower growth and financial development is not as strong as previously thought.

Bank Ownership and Performance (WP-518)
By Alejandro Micco, Mónica Yañez and Ugo Panizza

This paper uses a new dataset on bank ownership and bank performance for 119 countries over the 1995-2002 period to reassess the relationship between bank ownership and bank performance in developing and industrial countries. Ownership is strongly correlated with performance in developing countries, but not in industrial countries. In particular, state-owned banks in developing countries

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New Publications

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tend to have lower profitability and higher costs than their private counterparts, while the opposite is true for foreign-owned banks.

Search Methods and Outcomes in Developing Countries: The Case of Venezuela (WP-519)
By Cristóbal Ruiz-Tagle and Gustavo Márquez

This paper uses a newly developed panel dataset for Venezuela in the period between 1994 and 2002. It is found that previous job status is a primary determinant of success in moving to employment, and that the use of employment agencies increases the likelihood of that move within each labor status.

Bank Ownership and Lending Behavior (WP-520)
By Ugo Panizza and Alejandro Micco

This paper examines whether bank ownership (public versus private, domestic versus foreign) is correlated with bank lending behavior over the business cycle. The paper finds that state-owned banks may play a useful credit-smoothing role because their lending is less responsive to macroeconomic shocks than the lending of private banks. Evidently, this differential behavior is due to an explicit objective of stabilizing credit rather than to the presence of "lazy" public bank managers.

Currency Mismatches, Balance-Sheet Effects and Hedging in Chilean Non-Financial Corporations (WP-521)
By Kevin Cowan, Erwin Hansen and Luis Oscar Herrera

This paper assembles a new firm-level database that builds a more comprehensive measure of currency exposure, considers differences in exposure across firm-level variables that may correlate with firm-level risk aversion, and identifies changes in the level and distribution of dollar debt across two distinct policy regimes. It is found that mismatches have significant balance-sheet effects. Also, firms most exposed to currency risk are best prepared to take this risk.

The Housing Market in Colombia: Socioeconomic and Financial Determinants (WP-522)
By Michel Janna, Santiago Moz and Sergio Clavijo

This document provides an overview of the housing system in Colombia, exploring its socioeconomic and financial determinants and offering recommendations to improve the collection of basic data on the construction sector, household socioeconomic conditions, and mortgage markets. The paper also estimates a simultaneous econometric model for the housing market using quarterly data over the period 1991–2004.

Microeconomic Interventions after the Washington Consensus (WP-524)
By Andrés Rodríguez-Clare

This paper examines the microeconomic interventions used to complement Washington Consensus reforms in Latin America. As the kind of interventions currently in vogue lack a sound theoretical and empirical foundation, or are applied ineffectively, countries should select interventions aimed at discovering new profitable activities (horizontal policies) and at creating innovation clusters (vertical policies). The appropriate mix depends on a country's stage of development.

RESEARCH NETWORK WORKING PAPERS

An Econometric Cost-Benefit Analysis of Argentina's Youth Training Program (R-482)
By Víctor Elías, Fernanda Ruiz Núñez, Ricardo Cossa and David Bravo

The Youth Training Program (YTP) was an important component of Argentina's labor policy of the 1990s. It offered three-month courses and targeted young people, most of whom were not employed and had a low level of education. The program was offered by different institutions chosen through a bidding process and included courses in agriculture, manufacture, construction and services. An econometric cost-benefit analysis of the fifth round of the YTP finds a 10% return on expenditures.

The Impact of Training Policies in Latin America and the Caribbean: The Case of Programa Joven (R-483)
By Cristián Aedo and Sergio Núñez

This paper evaluates Programa Joven, a training program conducted by Argentina's Labor Ministry, by applying a non-experimental evaluation methodology to program participants and a control group. The paper finds that the program increased earnings only for young males and adult females. Furthermore, the program significantly increased employment only for adult females. Finally, while the benefits for young males and adult females outweighed program costs after nine years, the benefits for all participants outweighed costs after 12 years.

OTHER PUBLICATIONS

Microeconomic Flexibility in Latin America. Caballero, Ricardo, Eduardo Engel and Alejandro Micco. *Economía Chilena*. Volume 7 (2): 5-26. 2004. Also: NBER Working Paper No 10398.

The authors characterize the degree of microeconomic inflexibility in several Latin American economies and find that Brazil, Chile and Colombia are more flexible than Mexico and Venezuela. The difference in flexibility is mainly explained by the behavior of large establishments, which adjust more promptly in the more flexible

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economies, especially when accumulated shocks are substantial. In Chile flexibility declined in the aftermath of the Asian crisis, accounting for a substantial fraction of the large decline in TFP-growth since 1997. If it were to persist, it could permanently shave off almost half of a percent from Chile's structural rate of growth.

Privatization and Firm Performance in Bolivia. Capra, Katherine, Alberto Chong, Mauricio Garrón, Florencio Lopez-de-Silanes and Carlos Machicado. In *Privatization in Latin America: Myths and Reality*. Alberto Chong and Lopez-de-Silanes, eds. Stanford University Press and World Bank Press. 2005.

This chapter studies the change in performance of Bolivian state-owned enterprises that have been transferred to the private sector. The paper focuses on how pwnership afftects management by measuring the characteristics of managements and relating them to both ownership structure and performance. It argues that the characteristics of private management that follow privatization are a key factor in determining the effects of privatization on performance.

Privatization in Mexico. Chong, Alberto and Florencio Lopez-de-Silanes. In *Privatization in Latin America: Myths and Reality*. Alberto Chong and Lopez-de-Silanes, eds. Stanford University Press and World Bank Press. 2005.

In Mexico, privatization led to a significant improvement in firm performance and service access. Moreover, the often-overlooked fiscal impact of privatization can help pay off debt or finance social spending. Mexico's experience provides several lessons for future privatizations. First, the privatization process must be carefully designed and transparently administered. Second, restructuring firms prior to privatization should be avoided. Finally, privatized firms must be carefully deregulated and re-regulated to ensure they behave appropriately and provide a sound corporate governance structure.

Ethnicity, Race and Gender in Latin American Labor Markets. Duryea, Suzanne and Maria Eugenia Genoni. In *Social Inclusion and Economic Development in Latin America*. Johns Hopkins University Press. 2004

This paper analyzes labor market outcomes by gender, race, and ethnicity in four Latin American countries. The share of workers earning "low wages" is highest among the indigenous and Afro-Brazilian women and lowest among the non-indigenous and White Brazilian males. The indigenous in Bolivia, Guatemala, and Peru, along with Afro-Brazilians, have less capacity to generate income because of their lower levels of human capital, lower remuneration in the labor market, and lower access to high quality jobs. Thanks to the education they are receiving today, very young generations in Brazil and Peru have a relatively bright outlook while indigenous populations—particularly female—in Bolivia and Guatemala will face persistent labor market problems.

Women in the LAC Labor Market: The Remarkable 1990's. Duryea, Suzanne, Alejandra Cox Edwards and Manuelita Ureta. In *Women at Work: Challenges for Latin America*. Inter-American Development Bank. 2004

This paper examines levels and trends of labor market outcomes for women in the 1990's using household survey data for 18 Latin American countries. The outcomes analyzed include labor force participation rates, the distribution of employment of women across sectors of the economy (formal versus informal), and earnings. Overall, women have made substantial progress in many areas. Perhaps the salient development of the 1990's was the brisk-paced, secular rise in female labor force participation rates; 30% of this increase is attributable to increases in female schooling.

Do State-Owned Banks Promote Growth? Cross-Country Evidence for Manufacturing Industries. Galindo, Arturo and Alejandro Micco. *Economic Letters* 84: 371–376.

This paper tests the efficiency of different structures of bank ownership in terms of its ability to target manufacturing sectors in need of credit. The paper finds that state-owned banks do not play a significant role in the development of industries that rely more on external finance and/or that have less tangible assets to pledge as collateral.

Creditor Protection and Financial Markets: Empirical Evidence and Implications for Latin America. Galindo, Arturo and Alejandro Micco. *Economic Review*-Atlanta Fed. Volume 89 (2). 2004

This paper looks at the impact of creditor protection on the size of financial markets, and documents the state of Latin American creditor protection. It then discusses the effect of enhanced creditor rights on small and medium-sized firms and how the dynamics of financial markets are affected by the regulation of creditor rights. To examine the effects of adverse economic shocks on creditors, the authors study the credit cycle in various countries.

Perspectivas del desarrollo económico colombiano: los retos del gobierno de Alvaro Uribe Vélez. Lora, Eduardo. In *Conflicto y paz en Colombia: Consecuencias y perspectivas para el futuro*. Libros de Cambio. 2004. (In Spanish only)

Why did Colombia lose its ability to sta-

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bilize the economy and why have its economic growth possibilities weakened? This article addresses these two questions and discusses whether the Uribe administration has adequately attacked the causes of instability and low growth. It also evaluates the chances that the government's strategy will be successful given the opportunity offered by two additional factors: demography and international integration.

Effects of Tariffs and Real Exchange Rates on Job Reallocation: Evidence from Latin America. Haltiwanger, John, Adriana Kugler, Maurice Kugler, Alejandro Micco and Carmen Pagés. *Journal of Policy Reform*. Volume 7 (4): 191–208.

This paper uses new, harmonized measures of job creation and destruction for a number of countries in Latin America to investigate the impact of the removal of protectionism on net employment and gross job reallocation in Latin America. A robust pattern shows that reductions in tariffs and exchange rate appreciations increase the pace of job reallocation within sectors. There is also some evidence of declining net employment growth as trade exposure increases.

Port Efficiency, Maritime Transport Costs and Bilateral Trade. X. Clark, D. Dollar and Alejandro Micco. *Journal of Development Economics*. 75 417–450. 2004.

This paper investigates the determinants of shipping costs to the U.S. with a large database of more than 300,000 observations per year from different ports around the world. Distance, volumes and product characteristics matter. In addition, port efficiency is an important determinant of shipping costs. Variations in port efficiency are found to be linked to excessive regulation, the prevalence of organized crime, and the general condition of the country's infrastructure.

Reform Fatigue: Symptoms, Reasons and Implications. Lora, Eduardo, Ugo Panizza and Myriam Quispe. Economic Review. 2004

After more than a decade of pro-market reform in Latin America, symptoms of fatigue are evident among all the major players—policymakers, public opinion and even members of the international community. This paper describes the symptoms and causes of reform fatigue, and explores the implications for the future of reform. Clearly, economic reasons are behind the reform fatigue. Political reasons play a much lesser role.

The Pain of Original Sin. Eichengreen, Barry, Ricardo Hausmann and Ugo Panizza. In Other People's Money: Debt Denomination and Financial Instability in Emerging-Market Economies. B. Eichengreen and R. Hausmann, eds. University of Chicago Press. 2005.

The currency denomination of the foreign debt has not, until recently, figured prominently in theories of economic growth and cyclical fluctuations. This paper shows that neglect of this problem constitutes an important oversight. In particular, the composition of external debt - and specifically the extent to which that debt is denominated in foreign currency—is a key determinant of output stability, capital flows volatility, exchange rate management, and country credit ratings.

The Mystery of Original Sin. Eichengreen, Barry, Ricardo Hausmann and Ugo Panizza. In *Other People's Money: Debt Denomination and Financial Instability in Emerging-Market Economies*. B. Eichengreen and R. Hausmann, eds. University of Chicago Press. 2005.

Most countries do not borrow abroad in their own currency and do not borrow in local currency at long maturities and fixed rates even at home, a fact that has been referred to as "Original Sin." This paper describes the incidence of the problem and tries to uncover its cause. The paper finds weak support for the idea that the level of development, institutional quality or monetary credibility and fiscal solvency are correlated with international Original Sin. Only the absolute size of the economy seems robustly related to Original Sin.

Why are Latin Americans so Unhappy about Reforms? Panizza, Ugo and Monica Yañez. Journal of Applied Economics. May 2005.

This paper uses opinion surveys to document the discontent with pro-market reforms implemented by most Latin American countries in the 1990s. It then explores four possible explanations for discontent: (i) an overall movement of the population to the left; (ii) an increase in the political activism of those who oppose reforms; (iii) a decrease in trust for political actors; and (iv) the economic crisis. The main finding is that the macroeconomic situation plays an important role in explaining this discontent.

The FTAA and the Location of FDI. Daude, Christian, Eduardo Levy-Yeyati and Ernesto Stein. In *Integrating The Americas: The FTAA and Beyond*, A. Estevadeordal, D. Rodrik, A. Taylor and A.Velasco eds. Harvard University, 2004.

What effect will the FTAA have on FDI from the US and Canada to Latin America? How will it affect FDI from the rest of the world? What are the implications for a country such as Mexico, whose preferential access to the US may be diluted? This paper addresses these and other questions by assessing the likely impact of the FTAA on countries in the region.

Look Who's Talking

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

Improving Latin American International Insertion.

Fidel Jaramillo presented a policy seminar on Feb. 8, 2005.

Latin America has a long history of efforts to integrate the region's countries into regional and global economic arrangements. Most recently, these efforts have included free trade agreements between Chile and the United States and between Central American countries and the United States, as well as more recent efforts to arrive at a free trade agreement between Andean nations and the United States. Within a larger historical perspective, though, Mr. Jaramillo argues that Latin American countries can only be fully inserted into international trade and finance through a process of transforming national economies and increasing social inclusion.

The transformation process proved particularly intense during the 1990s, when countries in the region either initiated or deepened their trade liberalization, particularly through tariff reductions. This development was accompanied by a boom in foreign direct investment, as well as other capital flows, and an improvement in export performance. Latin America's export performance, however, was poor compared to that of other regions, and those exports consisted largely of primary goods with little diversification or value added. The net effect of these conflicting influences was a resumption of growth after the economic crises of the 1980s, but this growth occurred only at low rates and was subject to high volatility. Under these circumstances the GDP gap with industrialized countries continued to widen, in contrast to the experience of other developing countries. Social conditions did improve moderately during the reform process, but inequality increased in most Latin American countries—with the notable exception of Brazil, where inequality was already high.

No single factor explains the region's disappointing performance, but political instability deserves particular attention. The weak rule of law that accompanies such instability leads to a lack of confidence in institutions and poor control of corruption, both of which can dampen investment and growth.

In light of recent experience, the region is currently revising its approach to resuming and sustaining long-term growth in order to reduce poverty and inequality. In particular, many countries in the region are increasingly basing their development strategies on trade and regional integration. Trade is not a panacea for growth, however, as shown by the mixed findings in the literature on this issue. What countries must do in order to take full advantage of trade liberalization is seek wider market access opportunities, engage in productive transformation and enhance social inclusion, a strategy that in turn depends upon political, fiscal and financial viability.

In order to confront obstacles posed by both industrialized countries and from within the region, especially in regard to manufactured goods, Latin American countries have sought out a combination of bilateral, multilateral and regional agreements, and they have additionally pursued trade with non-traditional markets such as China and other Asian nations. In addition to these measures, however, countries must work to increase their competitiveness through policies that help increase total factor productivity (TFP), which worsened throughout the region in the 1990s, with the exceptions of Chile and Peru.

Meeting these goals calls for trade capacity building. This requires policies that facilitate export promotion, increase countries' insertion into global production chains through increasing flows of foreign direct investment, and improving logistics and infrastructure, particularly ports, airports, and customs procedures. Productive transformation is also necessary in the longer term, as the region's primary-goods producers are likely to be the principal "winners" in current free trade agreements. Although an abundance of natural resources is not in itself an obstacle to development, excessive concentration in natural resource sectors slows growth, and Latin America has so far done little to diversify its productive base. Toward this end, countries should engage in an explicit diversification strategy that develops innovation clusters to advance the sustainable use of existing comparative advantages.

Although some critiques of trade liberalization are based on the belief that increasing openness leads to greater inequality—and income polarization has in fact increased recently—there is no clear correlation between openness and inequality. Nonetheless, as economists have generally found inequality to be bad for growth, countries must reduce inequality as part of a larger growth and development agenda. In more concrete terms, policy should aim to create opportunity through increasing access to credit and ensuring property rights and titling, as well as increasing social capital. In addition, social safety nets must be built and/or maintained in order to mitigate the impact of trade adjustment, and growth

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must be supported by long-term education, health and labor policies. These measures in turn depend on fiscal, financial and political factors, particularly efficient and equitable tax collection, tax policy reforms, debt management, and institutional strengthening.

Adjustment to a trade-based development strategy will face several challenges in the near future. The first involves political leadership and the political climate. Although many current heads of state in the region enjoy high approval ratings, including those in larger countries, several Latin American countries will be having elections in 2005 and 2006, with uncertain policy implications. In addition, while employment issues and poverty still top public concerns, trade liberalization and its impact have increasingly entered public consciousness.

The Chilean Social Security Model: A Refreshing View.

Guillermo Larraín offered this policy seminar on Feb. 9, 2005.

Given the current level of international interest in restructuring social security programs, particularly in the United States, Dr. Larraín surveyed the Chilean social security system by describing its structure, assessing its strengths and weaknesses, and examining its ongoing challenges.

Chile's system, which consists of a combination of measures, is based on three pillars. The first is a government-administered minimum pension system for low-income workers. Following 20 years of contributions, workers are eligible for a minimum pension regardless of the total amount of their contributions; any shortfall between contributions and outlays is "topped off" with public funds. A second pillar consists of mandatory savings for most formal-sector workers; these savings are administered by private-sector pension funds. The third pillar, utilized primarily by high-income households, consists of voluntary savings that are exempt from taxes until they are withdrawn from accounts at the time of retirement.

Of particular national and international interest is Chile's use of privately administered pension funds. Since the conversion from the previous state-administered system, these funds' size as a percentage of gross domestic product has grown steadily and substantially, with a solid real rate of return on assets, while rates of coverage have not decreased. There is some evidence that the pension funds system has displayed a positive macroeconomic impact, with financial development contributing to productivity and eventually growth. Nonetheless, as increasing productivity depends on reforms in other sectors of the economy as well as on financial sector development, the pension funds system should not be seen as a macroeconomic panacea.

In spite of the general success of the pension funds approach, Chile's social security system remains a work in progress. The system is currently burdened with transitional costs, as there is currently a gap between contributions and outlays that is expected to continue until 2015.

The system has additionally failed to address thus far a series of exogenous problems. First, the flexibility of Chilean labor markets over the last three decades has increased job churning and led to the increased use of temporary labor contracts. Under these circumstances, workers who face unemployment spells attempt to avoid illiquid savings either by underdeclaring their earnings or opting out of the formal sector altogether.

A second weakness in the system is its inability thus far to provide adequately for women, who, compared to men, enter the workforce later, withdraw more often from the workforce for family reasons, earn less, retire earlier, and live longer. In addition, Chilean women display particularly low levels of workforce participation by regional standards. Under these circumstances, many Chilean women are unable to provide the 20 years of contributions that would entitle them to a minimum pension, a problem carried over from the previous system.

A third problem, which affects the population as a whole, is the combination of increasing life expectancy and an increasing tendency toward early retirement, which threatens to place a financial strain on the system. A corollary problem emerged during the transition to the pension funds-based approach: some individuals opted for early retirement, but with lower pensions that may not be adequate for their needs and/or are diminished by excessive administration charges.

Fourth, the pension funds system has yet to find the optimal balance between competition and concentration—i.e., the right number of pension fund administration firms for the size of the economy. Although excessive concentration presents dangers of systemic vulnerability and rent-seeking behavior at the expense of beneficiaries, a large number of funds may be no better for beneficiaries because of duplicative administrative costs and the failure to take advantage of economies of scale. Finding the right number of providers is further complicated by the non-spontaneous, mandatory nature of demand in the pension-fund market. While the optimal number of providers remains an open question, beneficiaries' interests are to some extent protected by the

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separation of functions between asset managers and account managers.

In addition to these current difficulties, Chile's social security system faces a variety of ongoing challenges. The first challenge entails incorporating into the system a larger percentage of women and of the estimated 20 to 30% of workers who are self-employed. A second challenge involves finding the optimal means of creating and regulating competition in the pension funds industry. Current proposals include aggregating demand through either groups of firms or groups of individuals. A third and final challenge is determining the appropriate investment and risk-diversification model for pension funds, a task that promises to be quite complicated.

Latin American Reforms in a Historical Perspective.

José Antonio Ocampo delivered the Sixth Carlos F. Díaz-Alejandro Lecture, co-sponsored by the Inter-American Development Bank and the Association for the Study of the Cuban Economy, at the Inter-American Development Bank on March 7, 2005.

Assessing Latin America's recent economic liberalization in relation to other periods in the region's development, Mr. Ocampo noted that the region's economic policies in the last quarter-century have been based on two major assumptions: i) that state-directed industrialization has proven inefficient; and ii) that the liberalization of market forces was necessary to make economies competitive and dynamic. These assumptions have nonetheless collided with reality. The last 25 years have witnessed one of Latin America's worst periods of economic performance, with growth rates much lower than during the period of state-directed industrialization. In fact, the development gap between Latin America and industrialized regions has again widened to approximately the same distance as in the late nineteenth century.

These circumstances lead to several questions regarding the respective performance of state-directed and liberal development models. The first of these questions is why the state-directed model of development, particularly as manifested by import substitution, collapsed as of the mid-1970s. Addressing this issue, however, first requires a clarification of terms; well before that time the region had largely moved from a pure import-substitution to a mixed model featuring export promotion, regional integration, gradual tariff reduction and, in inflationary economies, gradual devaluation schemes. Moreover, from the mid-1960s to the mid-1970s Latin America displayed strong economic performance. In addition, critiques of state-directed development are largely based on isolated periods of weak export growth, such as the immediate post-war era, or disruptions stemming from international market conditions and domestic political turbulence. While the region did lose world market share in primary goods, foods and petroleum during the state-directed development period, it is perhaps less well-known that Latin America's global market share of manufacturing exports increased after the late 1950s.

State-directed development may be consequently seen as collapsing in spite of its successes rather than because of them. The model was ultimately undone by countries' macroeconomic vulnerabilities. These included large external deficits, fiscal weaknesses, and distortions generated by abundant external financing after the first oil shock of the 1970s.

A second issue to address is why Latin America was so severely affected by the debt crisis of the 1980s; during the "lost decade" the region recorded lower levels of growth than during the Great Depression of the 1930s. This phenomenon is largely explained by two external shocks: a major reversal in the capital account and a collapse in non-petroleum primary goods prices. While in the 1930s the region benefited from a debt moratorium, which was tolerated by the United States, during the 1980s responses to the debt crisis were incomplete and slow in coming, as well as constrained by highly conditional financing. This combination of circumstances was, as Carlos Díaz-Alejandro stated, a crisis greater than could have been caused by either shocks or misguided economic policies alone.

A third question is why Latin America's recovery after the debt crisis has proved so frustrating. Three responses are frequently provided, though none speaks directly to central concerns. The first of these responses is to emphasize the positive effects of structural reforms undertaken in the region. A second answer is to point out that markets have not enjoyed the appropriate conditions for flourishing. Third, Latin American countries have displayed only slow productivity growth in recent years. These explanations, though, do not address the following issues: i) why Latin America displayed strong growth before the 1980s; ii) that nothing can guarantee full utilization of resources; iii) the economic losses that occurred during the structural reform period; and iv) whether microeconomic and "static" efficiency is in fact preferable to dynamic macroeconomic efficiency. Moreover, slow productivity growth appears to have resulted from underutilization of productive resources, particularly the underutiliza-

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tion of human resources owing to high levels of informality.

These issues must be addressed in part because of the central paradox of the region's political economy: in spite of increasing international insertion in recent years, Latin America has recorded only slow growth. This paradox appears to have resulted from limited productive linkages to national economies, a new set of enclaves in the manufacturing sector, limited employment effects in natural resources industries, and a deterioration of the relation between growth and the balance of trade. This combination of circumstances has led to greater dependency on external finance, which in turn has increased real volatility and decreased investment. While the post-reform model has increased firm-level efficiency, the resulting gains have occurred only at the micro level. This stands in contrast to the previous model, which strove for macro-level and dynamic efficiency in all productive resources by creating new production capabilities and linkages.

A fourth question to consider is whether Latin America's economic performance is associated with its relatively poor social performance. It should first be noted, however, that the region has continued to make progress according to most social indicators, and in that respect the eighties were not a "lost decade." Additionally, the advance of democracy in the region has been reflected by an increase in social spending. Nonetheless, the rate of progress has slowed in recent decades, and human capital continues to be grossly underutilized.

These ongoing problems stem from defects in the linkages between the economic and social systems. In recent years the region has experienced a deterioration in income distribution on top of an already stratified social structure. Although social policies remain oriented toward alleviating poverty, inequality has yet to find a place on the agenda. This concern is particularly pressing because growth in recent years has translated into income gains primarily for the upper classes and/or the highly educated. Given disparities in educational quality and access, however, most individuals' earnings ability is determined at the time they begin schooling.

Addressing underlying social issues and returning Latin America to higher growth rates calls for an extensive policy agenda. Details may differ among countries, but three pillars are essential. The first is the pursuit of greater real stability in national economies. The second is the formulation of strategies for development of production in open economies. Third, countries must improve social linkages with the economic system.

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Network News

Latin American Research Network

Call for Proposals

The Development of Latin-American Bond Markets

The purpose of this study is to further knowledge of the state and development of the main non-bank credit vehicle: the bond market in Latin America. The study covers both public and private debt instruments, because the two are closely intertwined.

- Institutions interested in submitting proposals should inform Raquel Gómez.
- Research proposals must be received by May 2, 2005.
- Proposals may be sent electronically to red@iadb.org
- For more information visit www.iadb.org/res/bond-markets

Market Institutions, Labor Market Dynamics, Growth and Productivity: An Analysis of Latin America and the Caribbean

Five of the papers produced through this project were published in the *Journal of Policy Reform*, December 2004 Issue.

Child Health, Poverty and the Role of Social Policies

Eight of the outcome-papers from this study were published in a special issue on Child Health in Latin America of *Economics and Human Biology* (Volume 2, Issue 3, December 2004.)

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