IDEA
Ideas for Development in the Americas

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The Politics of Policies

The history of economic and social development in Latin America is dominated by the search for new paradigms: simplified ways of understanding how the economy and society function that offer governments a variety of policy alternatives. Latin America has ridden the wave of successive paradigms from the State-run, inward-looking development of the postwar era to the liberalization of the Washington Consensus in the 1990s. As with other paradigms, the region's enthusiasm for the Washington Consensus has waned and it is now in search of a new paradigm that offers better economic results, more stability and greater equity.

But maybe the problem isn't the paradigm, or even the policies! The Fountain of Youth and El Dorado were fantasies, and so are magic formulas for accelerating growth and eradicating poverty. Certain simple ideas can help mobilize society, but they are rarely sufficient for understanding the processes of fundamental change. Sadly, there are no shortcuts to the Promised Land of sustainable development and prosperity for all.

Whatever the policy area, there is no single formula applicable to all circumstances; policies' effectiveness depends on the manner in which they are discussed, approved and implemented. Perhaps it's time to look beyond the specific content of policies to the critical processes that shape these policies, carry them forward from idea to implementation and sustain them over time.

A strictly technocratic approach to policymaking shortchanges the critical steps of discussion, negotiation, approval and implementation, which have at their core the messy world of politics. The political process and the policymaking process are inseparable. To ignore this link may—in fact, has led to failed reforms and disappointments.

The Research Department and the Sustainable Development Department oversaw a number of studies that took a detailed look at the institutional arrangements and political systems at work in Latin America and how they shape the roles and incentives of a variety of actors (some of them professional politicians, others members of civil society) that participate in the policymaking process.

It's time to look beyond the specific content of policies to the critical processes that shape these policies.

One of the goals was to explore the way in which this process contributes to shaping policy outcomes and the political economy of specific countries and sectors.

This year's Economic and Social Progress Report (IPES) entitled *The Politics of Policies* is based on this research. It looks at Latin America over the last 15 years and sees numerous countries that have experimented with similar policies and reforms but often experienced very different results.

- While some countries maintain the basic thrust of their policies for long periods of time, thus creating a predictable and stable environment, other countries change policies frequently, often with every change in administration.
- While some countries adapt their policies rapidly to changes in external circumstances or innovate when policies are failing, other countries react slowly or with great difficulty, hanging on too long to inappropriate policies.

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A Fresh Look at Development

It's a new way of looking at development. And this new perspective demands a new lens. If the focus is the process, rather than the policy, then the criteria to measure, study and evaluate must change. The specific content of policies (eg, whether taxes are high or low, which sectors receive more or less protection) becomes a secondary concern; what's important are some key features that affect their quality. These features are what determine whether a policy "works" or "doesn't work."

An initial, but not exhaustive, list of key features of public policies includes:

- *Stability*—the extent to which policies are stable over time. Stability should not, however, be confused with rigidity. Having stable policies does not mean that policies cannot change at all, but rather that adjustments respond to changing economic conditions or to policy failures rather than to political whims.
- *Adaptability*—the extent to which policies can be adjusted when they fail or when circumstances change. This is the other side of the stability coin. Policies must be flexible enough to respond to shocks or change with the times but not to be politically manipulated.
- *Coherence and coordination*—the degree to which policies are consistent with related policies, and result from well-coordinated actions among the actors who participate in their design and implementation. Given the number of moving parts in the policymaking process and the various interests and incentives involved, lack of coordination may be either intentional or unintentional.
- *The quality of implementation and enforcement.* Many a well-designed policy has fallen by the wayside due to poor implementation or enforcement. Capable, independent bureaucracies and strong judiciaries have much to do with whether a policy is well implemented and enforced.
- *Public regardedness*—the degree to which policies pursue the public interest. Do policies promote the

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Table 1. Key Features of Public Policies since the 1980s

Country	Stability	Adaptability	Enforcement and implementation	Coordination and coherence	Public-regardedness	Efficiency	Policy index
Argentina	Low	Medium	Low	Low	Medium	Low	Low
Bolivia	Medium	High	Medium	Medium	Medium	Medium	Medium
Brazil	High	High	High	High	Medium	Medium	High
Chile	High	High	High	High	High	High	Very High
Colombia	High	High	High	Medium	Medium	Medium	High
Costa Rica	High	Medium	High	Medium	High	High	High
Dominican Republic	Medium	Medium	Medium	Medium	Low	Medium	Medium
Ecuador	Low	Medium	Low	Low	Low	Low	Low
El Salvador	High	High	High	Medium	Medium	High	High
Guatemala	Medium	Medium	Low	Medium	Low	Medium	Low
Honduras	High	Medium	Medium	Medium	Low	Medium	Medium
Mexico	High	Medium	High	Medium	Medium	High	High
Nicaragua	Medium	Medium	Medium	Low	Low	Medium	Low
Panama	Medium	Low	Medium	Low	Low	Low	Low
Paraguay	Medium	Low	Low	Low	Low	Low	Low
Peru	Medium	Medium	Medium	Medium	Medium	Medium	Medium
Uruguay	High	High	High	Medium	Medium	Medium	High
Venezuela	Low	Low	Medium	Low	Medium	Low	Low

Note: The key features of public policies are classified as "high", "medium", or "low" using cluster analysis. For the case of the policy index, because Chile outperforms all the other countries it has been classified as "very high".

These measures are intended to capture features of a country´s public policies over the last couple of decades, or since the return to democracy and do not necessarily reflect the characteristics of policies in the current administration.

Source: Stein and Tommasi (2005).

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general welfare or funnel private benefits to select individuals, factions or regions? This dimension is closely tied to inequality since members of the elite have the economic and political clout to skew policy decisions in their favor and away from the general public.
- *Efficiency*—the extent to which they reflect an allocation of scarce resources that ensures high returns. This feature goes hand in hand with public regardedness since the favoring of specific sectors to the detriment of the public interest is an inefficient allocation of resources.

From the standpoint of development, these features are at least as important as the content of policies as ingredients for economic and social progress. Moreover, they are oftentimes far more enduring, as illustrated by the case in which two parties with very different preferences alternate in power, in a political system that produces majorities for the president in congress and few incentives for cooperation among parties. In such a scenario, the content of policies may shift back and forth (from low protection to high protection, from open capital accounts to capital controls, from capture of regulatory agencies to expropriation of privatized assets). In contrast, one important characteristic of public policies will tend, ironically, to persist: policy instability.

If these features are so important, then measuring them becomes the next challenge. But how can one measure policy coherence or stability? These qualities do not lend themselves to traditional dollars-and-cents or numbers-of-beneficiaries accounting. An approximation in this regard relies on two different sources of data: the Executive Opinion Survey of the World Economic Forum Global Competitiveness Report (GCR), which covers more than 100 countries and has been published annually since 1996, and; a State Capabilities survey, which questioned more than 150 experts in 18 Latin American countries, including public policy analysts, economists, political scientists, and former policymakers regarding the capabilities of the State in a number of dimensions identified as crucial by Kent Weaver and Bert Rockman. Despite their shortcomings, together these data sources provide a good sense of the quality of public policies in different countries. Table 1 summarizes how each country ranked in terms of the six key features and on an overall quality of public policy index ranging from high to medium to low. Chile was the sole country to receive an overall very high policy index rating while Ecuador, Paraguay and Venezuela were among the countries with the lowest public policy quality rating.

The Link with Development

Do these features really have a bearing on a country's development? Matching them up with a series of economic development indicators provides some solid clues. Four measures of economic development were considered:

- Per capita GDP growth between 1980 and 2002. (World Bank's World Development Indicators, WDI)
- The change in the value of the UNDP's Human Development Index (HDI) between 1980 and 2002. (The HDI combines various measures of literacy and life expectance with GDP per capita.)
- The reduction in poverty rates between 1980–90 and 1995–2000. (WDI)
- Two different measures of welfare developed by the World Bank that combine measures of income with different measures of inequality.

The correlations between the six policy features and the overall policy index with each of these measures of welfare are clearly evident. The policy index is positively associated with each of the measures of development. In other words, the better a country performed on the policy index, the better its development performance.

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- While some countries effectively implement and enforce the policies enacted by congress or the executive, others take a great deal of time to do so or are ineffective.
- While some countries adopt policies that focus on the public interest, others enact policies filled with special treatment, loopholes and exemptions.

Why this variation? What determines the ability to design, approve and implement effective public policies? This issue of *IDEA* looks at these and other questions. It draws from *The Politics of Policies* to examine the actors involved in the policymaking process, the stages on which they perform and how the policymaking process plays out in countries throughout Latin America.

The Big Three: Presidents, Political Parties and Legislatures

On the policymaking stage, the cast of characters is long and varied but three leading actors share the limelight. Political parties, legislatures and presidents form the inner core of actors, with important roles in democratic representation, in framing the policy agenda, and in formulating, adopting and implementing policies. The nature of the political party system, the structure and functioning of executive-legislative relations, and the constraints and incentives facing presidents can combine and interact to create an environment favorable to effective policymaking or one that is very short-term and special-interest oriented.

Any discussion of policymaking in Latin America naturally begins with presidents, who tend to take the lead in setting the policy agenda and formulating policy proposals. How does the president's central role affect policy outcomes? What is the actual experience of presidents in terms of their ability to pass their agenda and maintain their influence and prestige, and in terms of their orientation to serve the public interest? Answers to these questions must focus on the factors that constrain, enable and motivate the president's choices and actions.

Among the factors constraining the president's strategic options and policy choices are his constitutional and partisan powers. Constitutional legislative powers, such as decree and budgetary powers, give presidents bargaining leverage, influence over the legislative agenda and a means to potentially bypass a recalcitrant legislature. Nonlegislative powers, such as the power to appoint cabinet officials, are important for shaping the policy effectiveness of the administration as well as for building support across parties and strengthening party discipline. Partisan powers relate to the share of seats controlled by the president's party in congress and the cohesiveness of the governing party.

In general, presidents with greater partisan and constitutional powers are freer to develop and implement their policy agenda. Presidents with weak partisan powers may be able to compensate for this limitation by using their constitutional powers to broaden their political support and/or to increase their negotiating leverage in relation to congress. In some countries, such as Chile and Argentina, presidents are fairly powerful in constitutional terms, and their parties (in the case of Chile, their coalitions) typically control a significant share of seats in congress. In others, such as Bolivia, presidents are relatively weak in terms of both their legislative and partisan powers. Brazil, Colombia, and Ecuador stand out as cases in which presidents are powerful in constitutional terms but their party's weight in the congress is small. The reverse has typically been the case in Honduras and Paraguay.

But such traditional measures of presidential powers tell only part of the story. How else to explain the contrast between Brazil and Ecuador? In both countries, presidents are strong in constitutional terms and weak in partisan terms, but in Brazil, presidents since 1994 have tended to preserve their popular standing and legislative support throughout their terms of office while in Ecuador the last three elected presidents struggled to pass legislation and were forced out of office.

The explanation for these differences in outcomes lies in a number of factors, which may include having the appropriate tools at their disposal to build coalitions and achieve their objectives as well as presidential incentives. Since presidents are elected by a much larger constituency than legislators, they tend to be more national in outlook and more disposed to serving the public interest. However, like most politicians, presidents are also driven by personal and political goals. On the one hand, most presidents are concerned with increasing or maintaining their public esteem, political influence and power, in part to boost their effectiveness as leaders but also to improve the chances that their visions and programs will triumph over those of others. On the other hand, presidents are also driven by narrower personal and political ambitions, such as retaining their leadership over a political party, seeking reelection as president (if allowed), rewarding friends, or bolstering the popular following and power of their party. Depending on the institutional environment, these personal and political ambitions may, or may not, interfere with the goal of serving the public good. For instance, in clientelistic party systems, the president may redirect public resources away from programs with broad benefits in order to support the party's clientelist network. An electorally dominant governing party, strong presidential powers, weakly institutionalized parties, a weak congress, and/or a politically captured supreme court can also encourage presidents to make their own power or material ambitions their priority over serving the public good.

Despite the many constraints facing presidents, the office of the president enjoys what has been called

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institutional charisma, a type of influence derived from others' perception of the office which often gives the president a much greater range of action, especially in times of crisis.

Political parties are another key player in the policymaking process. In some countries, parties—even when they are out of office—are important actors in defining and articulating broad policy programs and can engage effectively in public policy debates. More commonly, parties have a more indirect influence through their impact on the workability of executive-legislative relations, the possibilities for coordination in congress, and the incentives of elected officials to cater to narrower or broader sets of social interests.

A party system's degree of institutionalization may have a major impact on policymaking. Party systems can be considered institutionalized when party competition is relatively stable, citizens identify with particular parties, and party organizations are well developed and influential in shaping the policy directions and leadership of the party. In institutionalized party systems, when parties are programmatic in the sense that they compete and derive support based on differences in their policy orientations and achievements, they are more likely to promote greater policy consistency over time and a greater potential for inter-temporal agreements. What does this mean for policy? With institutionalized, programmatic parties, citizens can better select parties and candidates that match their policy preferences. Incentives should be stronger to invest in public goods such as education and public utilities and for policy reforms aimed at advancing broader public interests. This contrasts with the policy outcomes likely in clientelistic systems where narrowly targeted government spending on public works is likely to be favored over investments in broader public goods.

Other party system characteristics that influence the interaction between the executive and legislative branches are the level of legislative fragmentation, the size of the presidential legislative contingent and the extent of party discipline. These characteristics can make or break the executive's efforts to pass its agenda. If the president's party's representation in congress is relatively small and the party system is fragmented, it will be necessary to form some form of inter-party coalition, which sometimes requires trading cabinet or other government positions, favored treatment in allocating public resources, or policy concessions for legislative support. On the other hand, consistent governmental majorities and disciplined parties can promote policy adaptability. This can sometimes be a good thing, unless executive authority is left unchecked, in which case personal and political prerogatives could win out over public regardedness in determining policy outcomes.

Party system nationalization is also likely to have public policy consequences. A nationalized party system implies that parties are generally more national in scope and that they tend to speak and act with a common national orientation, rather than being divided and focused on regional or subnational issues. In highly nationalized party systems, national issues are likely to be central to legislators' careers. Executives might have a greater ability to forge legislative coalitions centered on national issues and thus public policy is likely to be more oriented toward working for the national public good. Under

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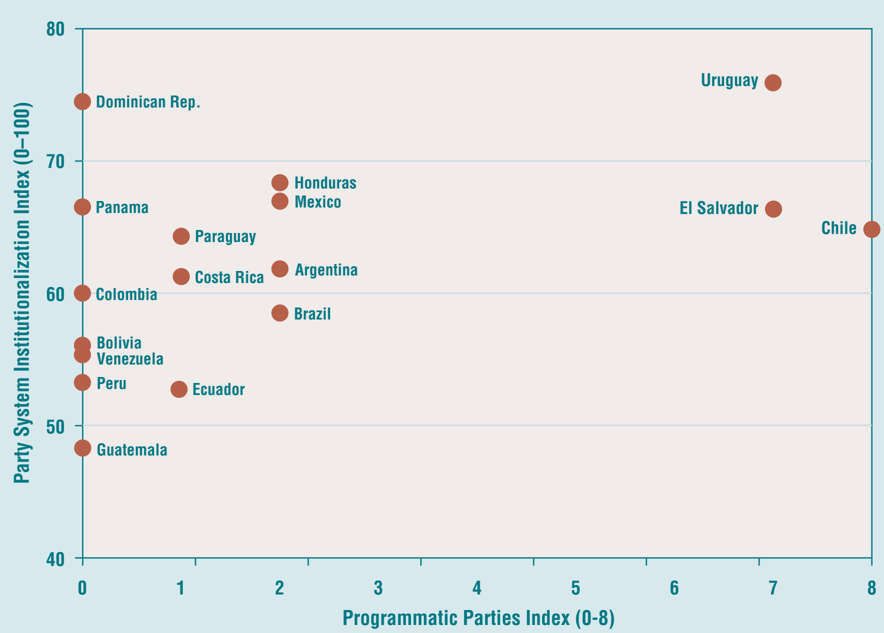
Figure 1. Comparing Party Systems in Latin America: Degree of Institutionalization and Programmatic Character



Source: Jones (2005).

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conditions of weak party nationalization, where the support of the parties varies widely across geographic units, politicians are more likely to focus on delivering benefits to their jurisdictions.

Legislatures round out this trio of influential players in the policymaking game. But the extent and nature of their role varies greatly from country to country. At the more proactive and constructive end of the spectrum, legislatures can develop their own legislative proposals and help direct the policy agenda alongside the president. Given their policy capabilities, such legislatures are also likely to be active and effective in overseeing policy implementation. At the other extreme, legislatures may serve largely as a rubber stamp on the executive's legislative proposals and be unwilling and/or unable to be a watchdog over the conduct of government. In the large middle ground, legislatures can simply block executive proposals or participate in reformulating and amending executive initiatives.

The nature of the legislature's role is in part shaped by their capabilities, including the experience and qualifications of legislators, the strength and specialization of committees, and the availability of professional support staff and research units. Their role is also affected by the balance of constitutional and partisan powers between the executive and legislative branches and electoral and party-based incentives. For instance, in Latin America the rate of reelection is relatively low, which means that legislators have an incentive to orient their activities toward advancing a political career outside the legislature and tend to lack experience. Their career objectives are in many countries furthered more by satisfying party leaders than by catering to constituents' interests and demands.

Different types of legislatures result from these different characteristics. Legislatures that have more experienced legislators, well-developed committee systems and ample support staff tend to be more constructive or proactive. Legislatures with weaker capabilities play a limited policymaking role or are active in a fairly obstructionist, rather than constructive, way.

How do the characteristics of legislatures affect the qualities of public policies? Relatively marginal legislatures typically do not interfere with policy adaptability. But they are likely to generate greater policy volatility, unless they have been long controlled by a single party or are not very ideologically polarized. Moreover, since they are less representative of citizen concerns and provide little oversight of the executive, policy outcomes may be more private regarding. Obstructionist legislatures, which are largely veto players, are likely to hinder policy adaptability, especially if a fragmented congress impedes inter-temporal bargaining. Constructive legislatures should contribute to more public-minded policy, given their greater capacities with respect to representation and oversight. They also may limit volatility by providing a check on ill-conceived policy changes.

While these are not the only actors in the policymaking process, presidents, parties and legislatures occupy center stage in most countries in the region. Identifying the underlying characteristics of each, how these define their role, and examining how they interact is key to understanding policy outcomes in Latin America.

The Wild Card: Social Protest

In the past decade, social mobilization has become a force to be reckoned with in Latin America. Democracy has breathed new life into the exercise of citizen's rights and freedoms of expression, assembly, and demonstration. Drawing on these rights and freedoms, social protest has turned into a powerful political instrument, which has even been able to topple presidents. In Latin America's complex political game, social protest—and the streets where it is played out—have become the wild card.

Political players run the gamut from actors with constitutionally ascribed roles and functions to actors whose participation is less defined and more fluid but nonetheless very influential. At one end of the spectrum is the president, congress, political parties, judiciary, cabinet and subnational governments. At the other end is what is collectively known as civil society: business, labor unions, the church, the media, think-tanks and this rising star, social movements.

Traditionally, social movements were viewed as deviations from the norm, essentially resulting from social atomization, alienation, and frustration. However, a fresh look sees individuals who are rational, socially active, and well-integrated into the community, but anxious to assert their interests through channels other than those offered by established institutions. Given the generally peaceful and self-managed nature of these movements and the support of the media, which helps publicize, legitimate, and amplify them, social movements have become a complex and influential political actor. Social demonstrations may even become an instrument for effective action by political actors who are well established within the traditional political system.

Explaining the Rise of Street Power

What factors explain the rise of street power and its powerful impact on the political processes of the region? One explanation places the blame on the "weakness of the State," or its inability to fulfill the expectations for improvement generated by democracy. On the one hand, the State has lost its traditional bases of support (organized labor, agricultural landowners, and the urban middle class) as fiscal austerity measures eliminate privileges and whittle away at the old corporate and patronage State. On the other hand, it has failed to win over an expectant disadvantaged class still deprived of adequate services. In Argentina the resignation of President Fernando De la Rúa is related to this type of crisis. A series of corruption scandals, a protracted economic recession followed by economic collapse, and deep disenchantment with politicians were behind the rallying cry of protesters, "*Que se vayan todos*" ("Let's get rid of them all!").

Social movements organized around specific demands can be agenda-setters if they are constructive, or veto players, if they are not, while unstructured and spontaneous mass movements tend to destabilize the policymaking process.

The weakness of representative democracy has also fueled social protest. Democracy has neither halted authoritarian practices, patronage, populism and corruption nor delivered efficient services and development. According to popular perception, public policies do not respond to the needs and demands of all citizens, excluding vast sectors of the population from the benefits of growth. Political parties have become a principal casualty in this loss of confidence in democratic processes, further deepening the crisis of representative institutions. The protests that erupted in relation to the electoral fraud and corruption of the government of President Alberto Fujimori in Peru can be associated with this crisis of democracy as can the demonstrations that culminated in the deposing of Presidents Fernando Collor de Melo in Brazil, Raúl Cubas in Paraguay, and Jorge Antonio Serrano in Guatemala. The fall of President Carlos Andrés Pérez and the subsequent collapse of the traditional party system in Venezuela can be attributed to street reaction to both the prolonged failure of the State to boost living standards and the perception of widespread corruption in the political class.

A third explanation is the absence of a shared sense of nationhood. To generate a feeling of national identity, the State must produce a vision for a shared future from which a community of citizens with obligations and rights can be created. When benefits appear to be concentrated in a minor-

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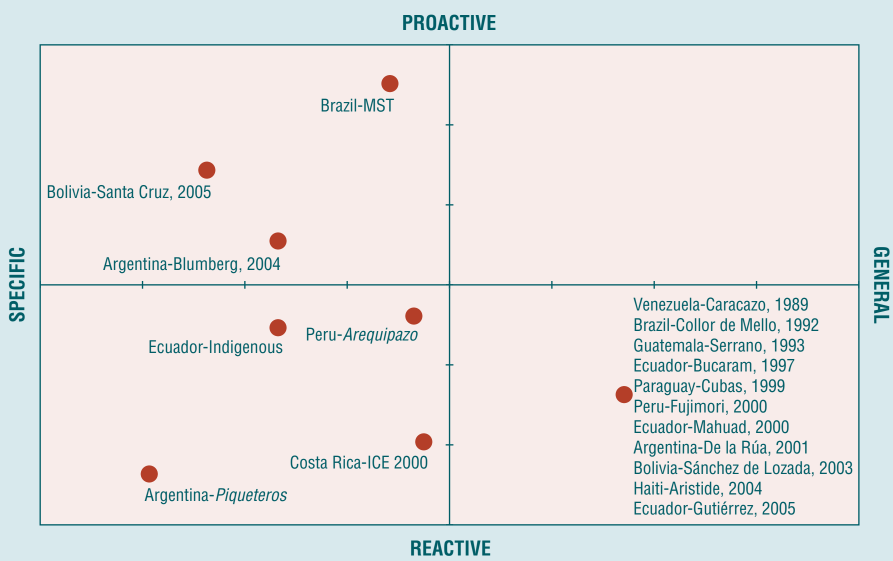
ity while sacrifices are always being asked of the same (excluded) groups it is very difficult to foster a sense of belonging to the same political community. In this context, movements typically create parallel national identities. This type of crisis is the hardest to resolve and has long afflicted both Bolivia and Ecuador. Ongoing deficiencies in governmental performance are compounded by conflicts over nationhood, igniting the clamor of indigenous communities for greater voice in the system and demands for greater autonomy from different regions of the country. In both countries, the crises have forced the resignation of several presidents, and the political landscape remains unstable.

Social mobilizations are rooted in *structural* and *circumstantial* factors. Circumstantial factors, such as an increase in fuel prices or a proposal to privatize a State enterprise, can launch a wave of social protest. But usually structural factors—such as long-term economic stagnation, widespread poverty, unemployment, or political corruption—lurk behind these circumstantial triggers. These events become catalysts with which social leaders can mobilize the population to take to the streets.

Figure 2. Classification of Social Movements



Source: Authors' compilation.

Social Mobilization and Policymaking

Social movements organized around specific demands tend to play a role as agenda-setters, if they are constructive, or merely as veto players, if they are not. The Blumberg case in Argentina illustrates the agenda-setting role. A father named Blumberg, whose child had been kidnapped and later murdered, started a movement to protest rising insecurity and crime, mainly in the Province of Buenos Aires. In April 2004, the widespread protests induced the government of Néstor Kirchner to incorporate the fight against crime into the political agenda and led to the adoption in record time of several reforms to the criminal code.

By contrast, unstructured and spontaneous mass movements tend to destabilize the policymaking process, often with unforeseeable consequences. Most of the time, they spark policy instability, as new governments want to distance themselves from the policies that brought down the previous governments. In countries in which such movements occur repeatedly, they contribute to imparting a short-term focus to other political actors, and may discourage investments in policy capabilities.

The growing prominence and impact of social mobilizations raises an important question: are they good or bad for democratic governance? The answer is not straightforward. On the positive side, a participatory and organized civil society (of which organized social movements are an example) can be an important component of an efficiently operating representative government. These movements have incorporated new actors into the political system, who previously played only a marginal role, thus enhancing the inclusiveness of the democratic system.

On the negative side, these mobilizations are often manipulated by established political actors or emerging leaders, as well as by special interests. Moreover, mass protest clearly becomes a problem if it becomes a structural device rather than a circumstantial mechanism for engaging in politics, and if traditional democratic institutions become incapable of supporting legitimate and effective governance. In this case, the effect is more likely to be chronic political instability than enhanced citizen participation.

Policymaking in Chile: Why Does it Work?

Policymaking in Chile is the best in Latin America. Obviously there are still problems, but in terms of the key features of public policies, Chile ranks at the top. How does it do it? The answer to this question is not clear cut. In fact, with one of the strongest presidencies in the region and a congress with good capabilities for policymaking and oversight, and with multiple veto players but an admirable capacity to adapt, Chile's policymaking success is more of an enigma than a model.

The Chilean president is among the most powerful in Latin America, with ample control over the legislative agenda. While the president is very powerful, the Chilean policymaking system is studded with veto players, strategically written into the constitution by the outgoing military government to serve as land mines to policy changes by subsequent elected governments. These include a bicameral congress, a comptroller general, and an independent locus of judicial power, including regular courts, a constitutional tribunal, and an electoral tribunal. Less traditional (and more contested) checks on policy formation include a relatively autonomous military and until March 2006, unelected senators in the upper chamber of congress.

The Chilean Congress is among the strongest in Latin America in terms of its policymaking capabilities and boasts one of the highest levels of technical specialization in the region through its system of policy committees. Chilean legislators are fairly well educated and have long careers in Congress. Their levels of technical expertise are high by Latin American standards. A seat in the Chamber (and even more so, in the Senate) is a feather in the cap of any Chilean politician, something that cannot be said about congressional seats in much of Latin America.

Despite the strength of the executive and the fact that some important negotiations take place within and among parties that are not necessarily in congress, the Chilean Congress is an important political and policymaking arena. Crucial political and policy exchanges are debated openly and later enforced in the national legislature. The level of debate and transparency of the Chilean Congress is quite high.

Political parties in Chile are moderate, pragmatic yet programmatic, and strongly institutionalized. The tradition of three ideological blocks, left–center–right, has survived, but the lines between them have blurred. For instance, socialist parties still receive their historical share of electoral support, even though their leftist ideology has been watered down considerably. Since 1990 the six parties with congressional representation have been organized into two national coalitions, the *Concertación* (center-left), and the *Alianza* (right), which formed around the 1988 plebiscite called to decide whether Pinochet should remain as president.

The workings of the Chilean party system are influenced by a peculiar type of proportional representation electoral system with just two seats elected in each district ("binomial"). The lists (coalitions/parties) that receive the two highest shares of votes each win one of the two seats available in each district. Only if the first-place list wins by a ratio of more than two to one do both seats for the district go to the list that won the most votes.

This binomial system reduces the number of relevant actors to a few parties organized into two encompassing stable coalitions. It strengthens the party leadership, but at the same time encourages politicians to respond to their constituencies and have long legislative careers. Finally, given how difficult it would be for one coalition to double the vote share of the other in any given district, under the binomial system, congressional representation for each coalition oscillates at around 50% of the members of each chamber.

How is Policy Made?

The Chilean president is constitutionally very powerful. Yet the three presidents who have served since democracy was restored (Patricio Aylwin, Eduardo Frei, and Ricardo Lagos) have exercised that power in a relatively careful and consensual manner. The Chilean president is, undoubtedly, the agenda-setter in the policymaking process, and has enough tools at his disposal to be able, on occasion, to twist arms to get his preferred policies passed. Many important policies are developed primarily within the cabinet (with the assistance of technically capable and politically savvy ministers). The process of negotiation and agreement operates in several, usually sequential, stages. Since Chile has relatively strong parties and party identities, the president initially tries to build a consensus for his policies within his own party, and then with his own coalition, usually by negotiating with the leaders of the other parties in the coalition. Then comes the give and take with the opposition, mostly through open venues such as congress.

Technical input enters the policymaking process at multiple nodes. The Chilean cabinet and bureaucracy are very solid by Latin American standards. Chile also has several well-established and reasonably well-manned think tanks, with institutionalized links to the different political parties and coalitions.

In a system with many veto players and a president with strong agenda-setting powers, policies are difficult to

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Inclusiveness versus Effectiveness: The Case of Colombia

Inclusiveness (representativeness) and effectiveness are both desirable traits in democracies. Unfortunately, as countries advance along the democratic continuum, they sometimes face trade-offs between these two characteristics. The more people, interest groups and/or political parties represented in the system, the more inclusive that system will be. However, it will also be more difficult to reach agreement, more prone to gridlock and, hence, less effective. Colombia is just one of the countries that has faced this dilemma.

A key building block of the policymaking process in Colombia in the past was the *Frente Nacional*, an agreement signed in 1958 between the two traditional parties (*Liberal* and *Conservador*) to share power, with parties alternating in the presidency, and strict parity in key policymaking arenas such as congress, the cabinet, courts, governors and mayors. Thanks to this pact, which remained influential in the 1980s, policymaking in Colombia was quite effective. Growth was strong, averaging 4.7 percent between 1950 and 1990, and fiscal deficits were low. The perception was that Colombia had side-stepped the populist tendencies that plagued the rest of Latin America.

Before the Constitution of 1991, the president was institutionally very powerful, as was the finance ministry, typically headed by a well-respected technocrat. The rules of the political game reined in the role of congress in economic policy and enhanced the decision-making capacity of the government. The *Frente Nacional* coalition, sustained through cabinet and governorship appointments, ensured ample majorities in congress. While the structure of committees provided some incentives for legislators to specialize and gain policy expertise, electoral rules encouraged them to focus more on their constituents and less on national policymaking. Thus, legislators focused on getting their "pork" (in the form of *auxilios parlamentarios*, or discretionary funds assigned to each legislator) and for the most part delegated national policymaking—particularly macroeconomic policy—to the executive. But even in cases in which the president could not count on the support of the legislature, he had ample powers to legislate by decree, which he did to pass some important tax reforms during this period. The Supreme Court exercised some control over the use of decrees, overturning about 25 percent of them, but was not as independent and active as today's Constitutional Court.

All told, the number of key players in the national policymaking game has increased, and cooperation among players has become more difficult to achieve.

This policymaking process was reflected in the quality of Colombia's public policies. Before 1991, Colombian policymaking was marked by its stability, adaptability, coordination and coherence, and efficiency. The one weak spot was its deficit in political participation. The *Frente* was an agreement of a collusive nature, which ensured cooperation among those included, but excluded important sectors of the population, notably the left. Political participation at the subnational level was also lacking. Governors and mayors were appointed rather than elected, and on occasion had weak roots in their jurisdictions. Additionally, clientelistic practices were a common way to gather and maintain political support. Both factors—lack of participation and clientelistic practices—help explain the poor performance of the country in terms of the public-regardedness of some of its public expenditure policies.

Demands for further political participation at both the subnational and national levels helped propel the transition to a new constitution. The process of decentralization, which led to the election of mayors in 1988, coupled with new sources of revenue from oil, made it necessary to redefine the way the political and economic pie was shared. Excluding the left from regular channels of political participation had led to guerrilla activity and escalating violence, involving the drug cartels as well, which culminated with the assassination of three presidential candidates in the 1989 electoral campaign, including the likely winner, Luis Carlos Galán. The idea of constitutional reform gained political support at a time of political unrest when incorporating insurgent groups into

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Inclusiveness versus Effectiveness: The Case of Colombia

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the formal political system was seen as a priority.

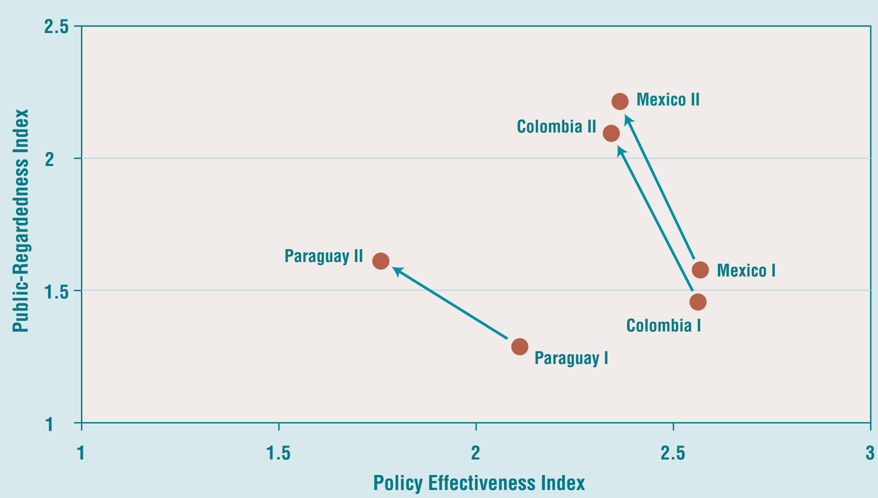
The result was the adoption of the 1991 Constitution, which changed the policymaking process dramatically. While the president is by no means weak by regional standards, the 1991 Constitution limited the power of the executive in a number of ways. It introduced the election of governors, which the president had previously appointed, and endowed them with significant fiscal resources. It reduced the discretion of the president (and congress) on a number of important policy issues: in some cases, such as pensions or intergovernmental transfers, because they were "hard-wired" into the constitution; in others, such as monetary and exchange rate policies, because they were left under the orbit of a newly independent central bank. It also weakened the partisan powers of the president with changes in election rules that reduced and diluted the president's legislative contingent. The new constitution gave congress a freer rein in policymaking by curtailing the executive's ability to legislate by decree, and by making it easier for the legislature to overrule a presidential veto. A newly created Constitutional Court endowed with *ex ante* constitutional review powers and appointment procedures encouraged judicial independence.

What did these constitutional changes mean for policymaking? Congress became increasingly involved in national policy discussions, introducing significant changes into legislation proposed by the executive. Passing legislation became more costly. The executive must make more concessions, and more "pork" needs to be distributed in order to pass legislation, as the number of "sponsors" involved in each bill has substantially increased. Even after legislation passes through congress, it can still be derailed by the Constitutional Court, which not only has made it more difficult for the executive to bypass congress but has become a more active—some observers say overly active—player in the policymaking game. Subnational governments have also become more important players in some aspects of policymaking, including social policies.

All told, the number of key players in the national policymaking game has increased, and cooperation among players has become more difficult to achieve. While these developments are positive in that they generate stronger checks and balances on the discretion of the executive, they can also have a negative impact on policy effectiveness. In fact, a few of the key features of public policies more directly linked with effectiveness (stability, efficiency, coordination, and coherence) declined after 1991. On the other hand, the country improved substantially in terms of public-regardedness (which is still low, however) thanks to the increase in checks and balances, greater participation at both the national and subnational levels, more public awareness of clientelistic practices, and less discretionary power for the executive to distribute subsidies and credit to select sectors.

Colombia has not been the only country moving in the direction of more participation and inclusiveness. Other countries moving in that direction include Mexico and Paraguay (See Figure 3). In all these cases, the improvement in terms of inclusiveness has gone hand-in-hand with some declines in policy effectiveness. The challenge is to try to bring more participants into the fold without losing effectiveness in the process.

Figure 3. Evolution of Key Features of Public Policies (1-4 Scale)



Note: The periods are as follows: Colombia I = before 1991, Colombia II = 1991-present; Mexico I = 1950 - mid 1990s, Mexico II = 1990's - 2003 ; and Paraguay I = 1954-1989, Paraguay II = 1989-2003.

Source: Stein and Tommasi (2005).

Main Messages

The study of policymaking in Latin America has only just begun. *The Politics of Policies* merely whets the appetite of researchers interested in delving into the complex process that lies behind policies. Still, ten main messages can be extracted from this study that can help guide future research.

1. Processes matter!

The process by which policies are discussed, approved, and implemented (the policymaking process) has an important impact on the quality of public policies, including the capacity of countries to provide a stable policy environment, to adapt policies when needed, to implement and enforce policies effectively, and to ensure that policies are adopted in pursuit of the public interest.

2. Beware of universal policy recipes that are supposed to work independently of the time and place in which they are adopted.

Latin America's recent experience with the reforms of the "Washington Consensus" shows that reforms with similar orientation and content can have very diverse results in different countries. One of the pitfalls of advocating universal policy recipes is that policies are not adopted and implemented in a vacuum. Rather, they must proceed within the context of a country's political institutions. These political institutions, as well as the policymaking processes they in turn help shape, can have a profound impact on the success or failure of any policy.

3. Certain key features of public policies may be as important in achieving development goals as their content or orientation.

The impact of public policies depends not only on their specific content or particular orientation, but also on some generic characteristics of the policies. An "ideal" policy that lacks credibility and is poorly implemented and enforced may be more distortionary than a "suboptimal" policy that is stable and well implemented. Six key features—*stability*, *adaptability*, *coherence and coordination*, *the quality of implementation and enforcement*, *public regardedness*, and *efficiency*—have a great deal of bearing on whether policies can actually enhance welfare, be sustained over time, and contribute to overall development.

4. The effects of political institutions on policymaking processes can only be understood in a systemic manner.

The complexity of policymaking reflects the multiplicity of actors with diverse powers, time horizons, and incentives that participate in them; the variety of arenas in which they play the game; and the diversity of rules of engagement that impact the way the game is played. A focus on a few institutional characteristics (such as whether the country is presidential or parliamentary, or whether the electoral rules are of the plurality or proportional representation variety) will only produce a very fragmented and unsatisfactory understanding of these processes. In order to understand them more fully, the institutional set-up needs to be treated in a systemic or "general equilibrium" way.

5. Beware of recipes for political and institutional reform that are supposed to work independently of the institutional environment, the time and the place in which they are adopted.

The merits of potential changes in political and institutional rules must be considered carefully, with an understanding of how these rules fit within the broader institutional framework. Broad generalizations about the merits of different political regimes, electoral systems, or constitutional adjudication of powers among branches are not very useful. Partial equilibrium views that stress the importance of a single institutional dimension may lead to misguided institutional and policy reforms. Understanding the political and policymaking processes in each country with its specific historical trajectory is a crucial prerequisite for developing appropriate policy and institutional reform proposals.

6. Policy or institutional reforms that have important feedback effects on the policymaking process should be treated with special care, and with an understanding of the potential ramifications.

Policy reforms often have feedback effects on the policymaking game. In some sectors, these feedback effects can alter the specific sector policy game by creating new actors or changing the rules of engagement among them. But some reforms (particularly in areas such as decentralization, budget processes or civil service reforms) can have a much broader impact, and alter the dynamics of the country's policymaking. Beware of these feedback effects before embarking on policy or institutional reforms.

7. The ability of political actors to cooperate over time is a key determinant of the quality of public policies.

Multiple actors (such as politicians, administrators and interest groups) operate at different points in time over the course of the policymaking process. Better policies are likely to emerge if

Main Messages

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these participants cooperate with one another to uphold agreements and sustain them over time. In systems that encourage cooperation, consensus over policy orientation and structural reform programs is more likely, and successive administrations are more apt to build upon the achievement of previous ones.

8. Effective political processes and better public policies are facilitated by political parties that are institutionalized and programmatic, legislatures that have sound policy making capabilities, judiciaries that are independent, and bureaucracies that are strong.

- Institutionalized, programmatic parties tend to be consistent long-term policy players. A political system with a relatively small number of institutionalized parties (or coalitions) is more likely to generate inter-temporal cooperation, and to lead to the emergence of consensual sustained policy stances on crucial issues.
- Policies tend to be better when legislatures develop policymaking capacities and constructively engage in national policymaking, rather than when they simply adopt a subservient role, rubber-stamping the wishes of the executive.
- A well-functioning and independent judiciary can be a facilitator, fostering bargains between political actors by providing enforcement that binds them to their commitments, and by ensuring that each of the players does not overstep its boundaries.
- A strong and technically competent civil service can contribute to the quality of public policies by making policies more stable, by enhancing the overall quality of implementation, and by preventing special interests (which often choose to wield their influence during the policy implementation stage) from capturing the benefits of public policies.

9. Most of these "institutional" are not built overnight. Building them, and keeping them in place, depends on the political incentives of key political actors.

The incentives of professional politicians such as presidents, legislators, and party leaders (as well as their interaction with the rest of society) are crucial for the workings of institutions. Improving the capabilities of congress requires that legislators have incentives to develop such capabilities. Independent judiciaries are only built over time, but they can be destroyed over night. Adopting the best civil service law in the world will not work if patronage involving positions in the bureaucracy remains an important currency used by politicians to reward their partisan base.

10. Leadership, if functional, can be a vital force for institution building.

Individual leaders can play a vital role as catalysts in the development of institutions. Functional leadership can encourage deliberative processes that allow policies and institutions to adapt to the needs and demands of society. Leadership, however, can also be dysfunctional. Rather than contributing to institution building, dysfunctional leaders can have the opposite effect. Their accumulation of power allows them to get things done, but at the expense of weakening institutions.

Policymaking in Chile

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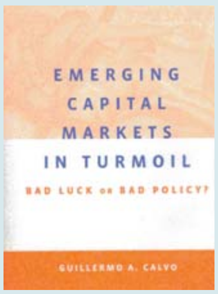
pass, but they are passed through negotiations, policy concessions, and a few occasional particularistic benefits. Once policies are passed, any bargains struck during these negotiations are very stable, and policy is very credible. This very policy stability makes it a very strong currency in political exchanges. Moreover, the institutionalized nature of parties makes them important actors for the inter-temporal enforcement of these negotiations, minimizing transactions costs and associated distortions.

The salient features of the Chilean policymaking process are a party system characterized by two long-lived coalitions, a powerful executive with de facto control over the agenda, a comparatively independent judiciary, a relatively corruption-free bureaucracy, and a series of veto points in the policymaking process that let adversely affected actors block policy change. The small number of actors, which interact repeatedly, as well as the predictability of policy implementation and law enforcement, leads to a policymaking process in which transaction costs are low and inter-temporal political exchanges are credible.

Chile seems to be on a path of institutional and policy consolidation. The initial democratic governments have maintained the core of the economic reforms undertaken under the military dictatorship, while steadily (albeit slowly, according to some views) advancing on the social and democratic front. These steps have taken place thanks to a policymaking style that is much more consensual and institutionalized than that of other Latin American countries.

New Publications

BOOKS



Emerging Capital Markets in Turmoil: Bad Luck or Bad Policy?
Guillermo Calvo. MIT Press. 2005.

Since the mid-1990s, emerging market economies have been hit by dramatic highs and lows; they have been lifted by large capital inflows, then plunged into chaos by constrained credit and out-of-control exchange rates. This book provides a timely reassessment of the importance of external factors in making emerging market economies safer from financial turmoil and offers important policy lessons for dealing with inevitable future episodes of financial crises.

RESEARCH DEPARTMENT WORKING PAPERS

Does Privatization Deliver? Access to Telephone Services and Household Income in Poor Rural Areas Using a Quasi-Natural Experiment in Peru
(WP-535)
By Alberto Chong, Virgilio Galdo and Máximo Torero

This paper takes advantage of a quasi-natural experiment in Peru by which the privatized telecommunications company was required by government to randomly install and operate public pay phones in small rural towns throughout the national territory. Using a specially designed household survey for a representative sample of rural towns it is possible to link access to telephone services with household income. It was found that regardless of the income measurement, most characteristics of public telephone usage are positively linked with income. Remarkably, the benefits occur at both non-farm and farm income levels. Not only do the findings hold when using instrumental variables but they are further confirmed when using propensity scores matching methods.

Social Security Coverage and the Labor Market in Developing Countries
(WP-537)
By Paula Auerbach, Maria Eugenia Genoni and Carmen Pagés-Serra

This paper analyzes the reasons behind the low rates of contribution to social security programs in developing countries. Using a large set of harmonized household surveys from Latin America we compare contribution patterns among wage employees, for whom participation is compulsory, with contribution patterns among self-employed workers, for whom participation is often voluntary. Our results indicate that on average more than 30% of the explained within-country variance in contributions patterns may be accounted for by individuals' low willingness to participate in old-age pension programs. Nonetheless, we also find evidence that some workers are rationed out of social security against their will.

Targeting Inflation in a Dollarized Economy: The Peruvian Experience
(WP-538)
By Adrián Armas and Francisco Grippa

This paper discusses the unique experience of Peru's Central Bank with inflation targeting in an economy characterized by a high degree of financial dollarization. The paper outlines how Peru has taken financial dollarization into consideration in the design of monetary policy, then deals with monetary policy implementation and the Central Bank's strategy for controlling financial dollarization risks. The paper concludes with analysis and lessons drawn from the Peruvian case.

Exchange Rate Policy and Inflation Targeting in Colombia
(WP-539)
By Hernando V. Vargas

This paper examines Colombia's experience with an inflation-targeting monetary policy following the abandonment of exchange rate bands in 1999, and two episodes in 2003 and 2004 that deviated from this general behavior. In these episodes, the Central Bank intervened in the foreign exchange market on a relatively large scale in order to affect the trend of the exchange rate (managed floating). These episodes are examined to draw lessons and highlight the main challenges facing monetary and exchange rate policy.

Flexible Exchange Rate with Inflation Targeting in Chile: Experience and Issues
(WP-540)
By Andrea Tokman, Rodrigo Valdés and José De Gregorio

The first five years of the flexible exchange rate and inflation targeting regime in Chile have shown positive results. Inflation is under control, the exchange rate has moved with external conditions, monetary policy has been countercyclical and the cycle has

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apparently smoothened. Even though exchange rate volatility has increased, this has also happened in other countries with similar characteristics. This increased volatility has lower extreme real exchange rate valuations than in the past. Important progress in derivatives market deepening, as well as in a lower pass-through from the exchange rate to inflation, have helped increase the credibility and feasibility of the current policy framework, while minimizing potential costs.

LATIN AMERICAN RESEARCH NETWORK WORKING PAPERS

Child Malnutrition, Social Development and Health Services in the Andean Region
(R-495)
By Carlos Larrea, Pedro Montalvo and Ana María Ricuarte

This paper analyzes the social, ethnic and regional determinants of child malnutrition, as well as the effects of access to health services in the Andean region, by comparing conditions in Ecuador, Peru and Bolivia. These three countries are marked by a high prevalence of stunting and by wide socioeconomic, regional and ethnic disparities. The analysis used Demographic and Health Survey data from Peru (1992, 1996 and 2000) and Bolivia (1997), and Living Standards Measurement Study data for Ecuador (1998).

Political Institutions, Policymaking Processes, and Policy Outcomes in Mexico
(R-512)
By Fabrice Lehoucq, Francisco Aparicio, Gabriel Negretto, Benito Nacif and Allyson Benton

This paper uses a transaction-costs framework to link the policymaking process (PMP) and the outer features of public policies in Mexico. It shows how a highly secretive PMP, centralized around the presidency, fashioned nationalist policies that were stable, adaptable, coordinated and private-regarding for the urban-based corporatist pillars of the regime. When growth faltered in the late 1970s, however, this PMP was unable to adapt to economic volatility, although it remained dominant in an increasingly turbulent polity. The article also explains why democratization in the 1990s is giving rise to a less centralized and more open PMP that benefits larger shares of the population.

Insider Trading and Corporate Governance in Latin America
(R-513)
By Juan Cruces and Enrique Kawamura

Unlike outside investors, controlling groups have the option to trade on inside information and can exercise it at the expense of outside investors. This paper computes informed trading probabilities (ITPs) for the universe of liquid stocks from seven Latin American countries, trading both at home and as ADRs, and applies ITPs in order to address corporate governance questions. It is concluded that ITP proxies for unobservable corporate governance quality as the heterogeneity of firm behavior seems to be recognized by the market and priced accordingly.

Corporate Governance and Value in Brazil (and in Chile)
(R-514)
By Ricardo Leal and André Carvalhal-da-Silva

This paper constructs a corporate governance practices index (CGI) from a set of 24 questions that can be objectively answered from publicly available information. The goal is to measure the overall quality of corporate governance practices of the largest possible number of firms. CGI levels have improved over time in Brazil, and an examination of CGI components demonstrates that Brazilian firms perform much better in disclosure than in other aspects of corporate governance. The results are placed in context by offering a comparative analysis with Chile.

The Effect of Corporate Governance Practices on Company Market Valuation and Payout Policy in Chile
(R-515)
By Fernando Lefort and Eduardo Walker

This paper asks whether corporate governance practices at the firm level within a single country affect these firms' market valuation. This question is crucial in assessing the potential benefits for firms of changing their own practices, even though they cannot affect their country's rules. In particular, the Chilean case presents at least three interesting features that are especially relevant for other emerging economies. First, the Chilean corporate structure presents highly concentrated ownership, widespread use of pyramid structures to separate cash from control rights and opaque ultimate ownership identification. Second, a recent amendment to the Securities Market Law and the Corporations Law aims to improve corporate governance in Chile. Finally, the Chilean capital market is relatively developed, with more than two decades of substantial

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participation by institutional investors. The paper finds that firms with higher coincidence between cash and control rights tend to be consistently more valued by the market. This result suggests that potential conflicts of interest between controllers and minority shareholders are penalized by the Chilean capital market.

Corporate Governance and Ownership: Measurement and Impact on Corporate Performance and Dividend Policies in Argentina
(R-516)
By Ricardo N. Bebczuk

This paper assembles, for the first time, quantitative measures of the quality of the corporate governance and ownership structure of 65 non-financial listed companies in Argentina with information for 2003-2004. Overall, Argentine companies seem to be poorly governed vis-à-vis international practices. In turn, ownership appears to be quite concentrated at the level of the largest ultimate shareholder, but separation of control and cash flow rights prevails in less than half of the companies; pyramiding is the main mechanism for creating this division. The paper additionally tests the predictions of recent theories linking those measures with corporate performance and dividend policy. In regard to performance, the results point to a sizable and robust effect of our governance measure on both the return on assets and Tobin's q. Moreover, the separation of control and cash flow rights for the largest shareholder—an indicator of incentives to expropriate minority shareholders—hinders performance directly, and also attenuates the beneficial impact of good governance rules. When it comes to dividends, only the governance measure appears to exert a positive and marked effect on the cash dividend-to-cash flow ratio. However, the estimates prove to be fragile to the inclusion of some additional controls correlated to governance.

Ownership and Control in Colombian Corporations
(R-520)
By Luis H. Gutierrez,
Carlos Pombo and
Rodrigo Taborda

This paper studies the separation of ownership and control for an average of 140 listed non-financial corporations in Colombia during the 1996-2002 period. Breaking down the sample according to corporations' listing status and economic activity shows that voting rights are greater than cash flow rights because of the presence of indirect ownership across firms that belong mainly to pyramidal and cross-share holdings. The study sample also includes an important set of non-affiliated firms. Ownership statistics show high concentration among the four largest voting blocks, which is similar to the levels observed in continental Europe, but the largest stake has voting rights that are on average 20% lower than the average observed in that region. Finally, holding investment and trust funds play a central role as the holdings' ultimate controllers.

OTHER PUBLICATIONS

Macroeconomic Shocks, Inflation and Latin America's Labour Market.
Ana Maria Loboguerrero and Ugo Panizza in *Monetary Policy and Macroeconomic Stabilization in Latin America,* Langhammer, R.J. and L. Vinhas de Souza, Editors. Springer. 2005.

This paper looks at how macroeconomic volatility is transmitted to the labour market. It estimates employment, unemployment, and wage Okun coefficients and uses them to show that, compared with industrial countries, Latin American countries adjust more through wages than through employment. It shows that inflation plays some role in explaining the difference between employment elasticity in Latin America and industrial countries but that there is a difference between the two regions that cannot be explained away by differences in inflation. When focusing on Latin America, the paper finds that within the Region, inflation increases labour market flexibility in countries that have highly regulated labour markets and do enforce the regulations.

The Gender Wage Gap In Peru 1986-2000. Evidence From A Matching Comparisons Approach.
Hugo Ñopo. *Económica*, La Plata, Vol. L, No. 1–2, 2005.

This paper uses the matching methodology in order to understand the distribution of the gender wage gap in Peru. The results suggest a monotonic reduction of gender differences in participation and employment rates; however, they also denote a cyclical evolution of the gender gap in hourly wages. The combined effect of participation, employment and hourly wages measured by the share of monthly labor income generated in the economy by males and females, also shows a monotonic reduction during the 15 years studied.

Look Who's Talking

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

From Recovery to Sustained Growth in Latin America

Seminar in honor of former IDB President, Enrique V. Iglesias

A great deal has changed in Latin America between the time Enrique V. Iglesias assumed the presidency of the IDB in 1988 and his retirement at the end of September 2005. Countries in the region have brought once-rampant inflation under control, and all IDB members have made the transition to democracy. Other challenges have arisen, such as volatile international capital flows, advancing regional integration, and the need to improve national and regional competitiveness in an era of globalization. Underlying these immediate concerns is the larger question of why the region has made inconsistent progress in development, particularly in comparison to other regions, and thus failed to realize its potential.

A panel of distinguished experts addressed these issues at the Research Department seminar "From Recovery to Sustained Growth in Latin America," held in honor of President Iglesias at the Auditorium of the IDB Conference Center on September 15, 2005. Participants explored two principal concerns. First, why has the region failed to achieve a higher level of economic development, in spite of experimenting with a variety of strategies? Second, how can the region's current growth bonanza be converted into the foundation of stable long-term growth rather than the latest episode in a long line of boom-and-bust cycles?

In the course of his introductory remarks, IDB Chief Economist Guillermo Calvo observed that approaches tried and found wanting in recent decades have included both state-led and heterodox approaches such as import substitution industrialization and the more laissez-faire approach embodied in the policies of the Washington Consensus. The shortcomings of the latter have led to popular demands for increasing the role of government in the region's economies and for slowing the pace of state reform. Whether these currents in public opinion will lead to a new development paradigm, or merely the modification of the current paradigm, remains to be seen. Nonetheless, the failings of recent policies should not obscure several genuine achievements. These include an ongoing improvement in macroeconomic management, as shown by increasing respect for fiscal balances and central bank independence, the opening of economies to international trade, and a commitment to attracting private investment as part of an overall development strategy. These changes in policy and governance have combined with external factors such as low international rates and increasing prices for raw materials—largely driven by an increase in demand from China—to produce the region's current high growth rates.

However, as noted by panelist Michael Mussa, a Senior Fellow of the Institute for International Economics, viewing the region as a monolithic whole ignores important differences in countries' history and institutions. Comparing South American countries, he noted that Paraguay has remained largely isolated and had a relatively small number of autocratic leaders, while similarly landlocked Bolivia has experienced a history of political instability with numerous changes in leadership; Chile, the product of a much different institutional environment, has enjoyed a history of largely stable government and low levels of corruption since colonial times. What many countries in the region do share, however, is a vulnerability to shocks as a result of international capital-flow cycles, booms and busts in raw materials demand, and geographical circumstances. Unfortunately, Latin American countries have dealt with shocks less effectively than nations in other regions, particularly East Asia. Recent years, however, have witnessed improvements in governmental institutions and fiscal management in several of the region's larger economies. While the region is benefiting from these changes in governance, as well as from low capital costs, concerns about volatility remain. The experience of past financial crises suggests that countries should improve their domestic financial structures and their safeguards against financial system shocks, as well as prevent overly exuberant domestic growth based on cheap credit.

John Williamson, also a Senior Fellow at the Institute for International Economics, observed that the failures of state-led and Washington Consensus policies resulted less from the strategies themselves than from a failure to consider them as part of an integrated strategy and act accordingly. In recent years, for example, governments have depended too much on freely floating exchange rates than managed floating regimes. Overall issues that countries in the region must consider in order to sustain the present wave of externally driven growth are the following: improved macroeconomic management, particularly through the avoidance of uncompetitive exchange rates, investment in the growth-promoting areas of infrastructure and education, and income redistribution. The latter, which is still not taken seriously enough in the region, should be carried out through investing in the income-earning capacity of the poor.

Countries in the region should additionally undertake a series of measures

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to reduce their vulnerability to Sudden Stops in international capital flows or other financial shocks. First, promoting exchange rate flexibility can dampen the effects of Sudden Stops or prevent them entirely. Second, governments should limit their foreign borrowing in boom times, and excessive foreign borrowing by the private sector should be discouraged by measures such as tax penalties on dollar-denominated borrowing. Third, sovereign debt should be issued in growth-linked bonds. Fourth, multilateral development banks should increase their lending and borrowing in local currencies.

Rather than adopt a new development model, governments should concentrate on sustaining growth through prudent macroeconomic management and restricted borrowing, as public borrowing should not crowd out that of the private sector. Further liberalization, moreover, should take place in areas such as business creation. Public-private partnerships, on the other hand, can lead to creative accounting and divert attention from the question of which activities are most appropriate for the public and private sectors, respectively.

José Antonio Ocampo, Under-Secretary-General of Economic and Social Affairs of the United Nations, suggested that considering only the region's disappointing performance in recent decades does not take into account previous eras of impressive growth, particularly the inter-war period of the twentieth century and the earlier years of state-led growth, misleadingly labeled "import substitution industrialization." Of particular importance was state-led growth in Mexico and Brazil in the period 1950-1980. If other regions have displayed more rapid growth in the postwar decades, they have done so after major economic declines. Moreover, Latin America suffered in the 1980s from an unfortunate convergence of low commodity prices, high interest rates, poor institutions, and dependence on primary sectors of production. Recent successes have stemmed largely from an increase in commodity prices and a decrease in interest rates.

An issue of greater importance than growth, though, is the region's persistent inequalities in income, wealth, health and education, and coverage by public services. An index of human development in the region's countries is thus more likely than GDP per capita to provide valuable insights. In addition, Latin America's inequality may be aggravated by the process of globalization.

Countries can nonetheless diminish their vulnerabilities. In addition to reducing volatility in capital flows and exchange rates, governments can increase their investments in infrastructure, with particular goals that include avoiding procyclical expenditures and allowing private investors to assume risks and enjoy rewards in potentially profitable areas such as oil and telecommunications. Governments can also promote productive strategies including diversification, competitiveness on a system-wide as well as a sectoral basis, and addressing the contradictions of economies that include both globally competitive businesses and large informal sectors.

Gerardo della Paolera, President of The American University of Paris, noted that institutions can change as a result of shocks, and the current era of recovery may lead to a better understanding of the causes of sustained growth. While growth depends on investment, rigid political institutions and short-sighted elites may be too occupied with preserving the political status quo and collecting rents to include other segments of the population in the growth process; the participation of the middle class in this process and the expansion of the middle class are essential. The region's elites have largely failed to grasp that, in a global economy countries compete for trade and investment, systemic improvements in areas such as education and the quality of the civil service are essential.

Ricardo Hausmann, former Chief Economist of the IDB and presently Professor at the Kennedy School of Government at Harvard University, stated that Latin America fares well when circumstances are in its favor, but not as well as it might. This raises a variety of issues. In particular, it is clear that the concept of an aggregate production function, on which most growth analyses are based, is not well understood. Much experience suggests that it is necessary to engage in strategic planning for growth rather than consider ingredients of growth in isolation. Countries cannot bypass political economy issues. "Picking winners" is necessary, even though this process entails costs, which make many governments afraid to make hard choices. However achieved, growth is necessary to reduce inequality, and measures such as promoting business development should not be left out of growth strategies.

LAC-7 Macroeconomic Outlook

Guillermo Calvo addressed the IDB Board of Directors on October 19, 2005.

Latin America and the Caribbean are in frank recovery thanks in large part to favorable external factors. Precisely because the region's improved performance is so dependent on the external environment, analysts point to a weighty U.S. foreign debt and soaring oil prices as possible spoilers for the region's economic future. But IDB Chief Economist Guillermo Calvo downplayed these potential threats in a presentation to the IDB Board of Directors on October 19,

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2005. Outlining the elements of the current recovery, analyzing the likely trajectory of global imbalances and taking a historic look at oil prices, Calvo concluded that Latin America's macroeconomic outlook is cautiously optimistic.

He began with a global perspective of private capital flows and highlighted very clear trends. Mid-1997 through 2002 were crisis years for emerging markets. Capital outflows from these countries peaked in 2000 and continued to pour out until mid-2002. During this same period, private capital inflows to the United States remained high. But in the past two years, this situation has changed. The United States is no longer receiving (net) private capital while inflows to emerging markets have picked up, totaling $99 billion in 2004. Emerging market bond spreads are also way down and are actually at below their pre-crisis levels. This is particularly noteworthy because EM spreads are usually associated with long-term Treasury bonds. The good news is that despite rising interest rates in the United States, EM spreads have done just the opposite and actually come down.

The recovery in capital flows to emerging markets in general, and to Latin America in particular, has been accompanied by a coordinated improvement on other fronts. Asset prices have boomed in Latin America as stock prices are up 174% in the past two years. Bank credit to the private sector has also begun to eke up, rising 5.8% in real terms in the region as a whole. Commodity prices have also enjoyed a boost since 2002, led by petroleum (+234%), metals (+100%) and foods (+23%). As a result, the terms of trade for the seven largest economies in the region, LAC-7, are up 15.1% since fourth quarter 2001.

Investment in the LAC-7 has followed a similar pattern, posting an average annual growth rate of 11.9% since fourth quarter 2002. On a country-by-country basis, Argentina and Uruguay with very dramatic investment declines during the crisis years also showed the healthiest increases in the past two years. Colombia and Venezuela also suffered significant declines during the lean years—albeit far less than Argentina and Uruguay—and have enjoyed good, but not as outstanding, investment growth since 2002. Even countries that took much less of a hit during the crisis period, including Chile, Peru and Brazil, can boast important increments in investment in recent years.

All this has translated into a welcomed recuperation in economic activity. After more than five years of near stagnation, average annual growth for the LAC-7 has increased at a 4.9% clip in the past two years and is projected to register similarly positive growth rates in 2005. Uruguay recorded the highest surge in GDP growth at 12.4% annually for 2003 and 2004 followed by Argentina at 10.2%. But even in Colombia and Venezuela, which showed the least expansion, GDP grew 4.5% annually on average.

The same coordinated response is evident in an overall appreciation in real exchange rates by 14.4% since October, 2002. Only the Mexican peso has remained virtually unchanged (+0.7%) while all other exchange rates appreciated, including the Brazilian real by an impressive 50.7%. Official reserves are up as well, a further reflection that things are going well. The region's fiscal performance has improved as well, with the deficit now well under 1% of GDP, proving that adjustments are easier to make in good times. Finally, public debt levels have also begun to contract after ballooning to 47.6% of GDP in 2002.

The prevalence of the same trends throughout the region suggests that indeed external factors are at play. And if external factors fueled the recovery, could they not spell its demise? This is the fear, especially in light of the "hard landing hypothesis" put forth by Paul Krugman and others. According to this viewpoint, once China changes its currency policy and its cheap loans to the United States (by acquiring US Treasuries as it accumulates international reserves) are no longer available, the United States could enter a downward spiral that would have serious repercussions on emerging markets.

Calvo suggested that this doomsday scenario is exaggerated. Although the current account deficit of the United States is now being financed by Asian Central Banks who buy U.S. Treasury bonds, they are in turn issuing their own debt to the private sector. Thus, it is Asian private investors who indirectly are lending to the U.S. government. Should the Asian countries float their currencies and stop buying U.S. public bonds, the private sector will still have enormous savings and will buy these bonds through other channels. Asian exchange rates are not the critical variable. Far more important would be political and other factors that may generate high market volatility and induce the private sector to spend rather than save. Yet U.S. interest rates are still low, despite recent hikes, and the U.S. public debt is still small compared to other industrialized countries (37% of GDP in the United States compared to 160% of GDP in Japan and 101% in Italy, for example). All told, at least in the near term (one to two years) the current imbalances are not a serious threat.

In the same vein, Calvo suggested that worries over the effect of oil prices are also overly alarmist. Looking at oil prices from a historical perspective, he showed that in real terms the current $59 per barrel price is well below the 1980 peak of nearly $100 per barrel. Moreover,

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Look Who's Talking

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oil futures show prices leveling off at around $62 per barrel 12 to 14 months out rather than climbing indefinitely. Most importantly, oil dependence is way below its historic highs in both industrialized and emerging countries. In the United States, for instance, the amount of oil used per unit of GDP has fallen 40 percent since 1975, in developed Europe 30 percent and in emerging Europe 40 percent. This reduced dependence and far lower real prices means the world is in far better shape than it was for the 1970s crisis. On the other hand, oil producers in Latin America—namely Venezuela, Ecuador and Mexico—could find themselves dramatically affected by changes in the price of oil as they impact on fiscal revenues. Their dependence on oil has brought them benefits recently but is also a source of great vulnerability.

Overall, Calvo believes that the prospects for Latin American economies are good and that threats from the U.S. deficit, Asian exchange rate policy or oil prices are far less menacing than they are made out to be. Of course, if conditions change and interest rates rise, for instance, then growth would be very negatively affected. Perhaps of greater concern is that despite all the good news, Latin America and the Caribbean is still growing less than other emerging markets.

Calvo's assessment seems even more likely following the announcement of Ben Bernanke as the next U.S. Fed Chairman. Bernanke's nomination has been very well received both by the market and the pundits as it further dissipates fears of a hard landing of the U.S. economy in the near future.

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Network News

Latin American Research Network

Call for Proposals
Discrimination and Economic Outcomes

The objective of this research network study is to provide empirical evidence on the impact of discrimination on economic outcomes.
Proposals are due Nov. 22, 2005.

Project Seminar
Development of Latin-American Bond Markets

Dec. 5, 2005
Buenos Aires, Argentina.

Project participants from Argentina, Brazil, Chile, Colombia, Mexico and Uruguay will present their draft papers for discussion.

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