F&D
FINANCE and DEVELOPMENT
September 2015

U.S. labor force woes

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Sabina Alkire vs. poverty

Latin America

Finding Its Footing

INTERNATIONAL MONETARY FUND

Finance & Development
is published quarterly in English, Arabic, Chinese, French, Russian, and Spanish.
English edition ISSN 0015-1947

Subscriber services, Changes of address, and **Advertising inquiries**
IMF Publication Services
Finance & Development
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Postmaster: send changes of address to *Finance & Development*, International Monetary Fund, PO Box 92780, Washington, DC, 20090, USA. Periodicals postage is paid at Washington, DC, and at additional mailing offices.
The English edition is printed at Dartmouth Printing Company, Hanover, NH.

FINANCE & DEVELOPMENT A QUARTERLY PUBLICATION OF THE INTERNATIONAL MONETARY FUND
September 2015 • Volume 52 • Number 3

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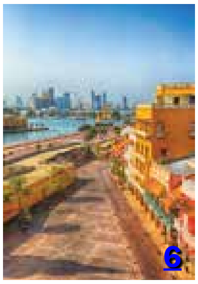
LATIN AMERICA: FINDING ITS FOOTING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FROM THE **EDITOR**

Under Pressure

WHEN we last featured Latin America on our cover in March 2011, the region was in the midst of a period of exceptional economic growth.

Between 2004 and 2013, Latin America recorded impressive growth and strong progress on a range of social issues. High commodity prices combined with strengthened economic management and progressive social policies to propel the region forward.

This strength was all the more striking against the backdrop of the 2008–09 global financial crisis, which mired many advanced economies in recession but saw emerging markets, including many in Latin America, power ahead. This led some observers to dub the period the "Latin American decade."

Now, as the world's economic leaders prepare to gather in Lima, Peru, in October for the Annual Meetings of the International Monetary Fund and the World Bank, the picture looks quite different.

Growth per capita ground to a halt in 2014 and budgets in many countries are under pressure. A decline in the price of commodities—the backbone of the region's exports—and an overall moderation of global trade weigh on the region's economies.

This issue of *F&D* examines challenges facing the region and explores ways to boost growth in the face of slumping commodity prices. Avoiding a prolonged slowdown is critical to realizing the region's key goals: raising incomes of the poor, strengthening education and health care, and ensuring widely shared economic gains.

Columbia University professor and former Colombian Finance Minister José Antonio Ocampo leads off our cover feature on Latin America. He chronicles the region's strong performance over the past decade and argues that to regain its footing, Latin America must upgrade its production structure and diversify its economies, lessening the dependence on commodities.

Alejandro Werner, head of the IMF's Western Hemisphere Department, sees a loss of confidence as the greatest threat and suggests that clarifying the direction of economic policies can boost both business and consumer confidence—a key force for long-term sustainable growth. Articles by Nora Lustig on the urgency of addressing inequality and by Daniel Kaufmann on fostering a culture of good governance point to other areas of reform that can unlock economic potential.

Other articles look at recent developments in the region concerning capital flows, central bank mandates, and trade. A story on Cuba's potential as a major player in Caribbean tourism rounds out our special feature.

Elsewhere in the issue, we look at the effect of unconventional monetary policy on emerging markets, trends in U.S. labor force participation, Islamic finance, and financial stress testing.

Finally, journalist and author Alan Wheatley profiles Sabina Alkire, whose passion for measuring and eradicating poverty has earned her a place among today's top thinkers on global development.

Jeffrey Hayden
Editor-in-Chief

True Calling

Sabina Alkire is passionate about measuring and eradicating poverty

Alan Wheatley

THERE are many development economists, but Sabina Alkire is one of the few who is also an ordained priest. Alkire, the director of the Oxford Poverty and Human Development Initiative (OPHI), wears her religious beliefs lightly. In her small, functional office in Oxford University's plant sciences building—no dreaming spires here—the only spiritual signifier is a mandala of the endless knot, one of the most auspicious symbols in Tibetan Buddhism.

"People who are deep friends think I'm daft to be a person of faith," she says with an infectious, almost girlish, laugh. "I don't see any distinction between myself and an atheist or humanist friends. We're all coming out of a passion."

Yet as she discusses the multidimensional poverty index with which her name is associated, it is clear that she is driven by more than a purely academic passion to observe and better measure poverty as a precondition for eradicating it. "We who work in development service, there's some deep commitment to humanity and to justice—even if the faith is different and even if the doctrine is different," she says.

A detailed picture

The aim of OPHI's index is to supplement the traditional benchmark of income poverty, $1.25 a day, by painting a more nuanced picture of exactly how people are poor in different parts of their lives. "You need both of them to get a good read on poverty," Alkire, a U.S. and U.K. dual citizen, says.

The global Multidimensional Poverty Index (MPI), based on household surveys, consists of 10 weighted indicators in three areas: *health*, measured by nutrition and child mortality; *education*, with years of schooling and school attendance as proxies; and *living standards,* assessed by access to electricity, sanitation, water, type of floor, cooking fuel, and ownership of basic assets. Anyone deprived in one-third or more of the indicators is deemed "multidimensionally poor." The June 2015 global index covered 101 countries with a population of 5.2 billion people, about three-quarters of the world total, and found about 30 percent of them on average to be MPI poor. Alkire's team—and she is at pains to stress that this is a team effort—has broken down the findings into 884 subnational regions, providing information that national averages would miss.

Alkire wants the index to be part of a data revolution to guide the fight against poverty.

One of the attractions of OPHI's MPI is that governments can tailor the methodology of the index to their own circumstances, for example by adjusting the weights and cutoff thresholds. Indeed, Alkire says her team spends most of its time now not on the global index but on national MPIs. Because the MPI can be broken down by indicator, policymakers can not only see the headcount poverty ratio but also zoom in on how different categories of the population, say by region or ethnicity, are deprived. In other words, the index captures both the *incidence* and the *intensity* of poverty at the household level in different dimensions, thereby helping governments to target policy.

"These two components allow people, especially policy analysts, to get better insight into the poverty of a country by making comparisons over time, better insight into the dynamics, and so on," says Milorad Kovacevic, chief statistician at the Human Development Report Office of the United Nations Development Programme (UNDP) in New York. For its annual flagship *Human Development Report* in 2010, the UNDP replaced its human poverty index with an MPI constructed at OPHI by Alkire and Maria Emma Santos, now an assistant economics professor at the Universidad Nacional del Sur in Bahía Blanca, Argentina.

In 2014 the UNDP started calculating the index independently of OPHI because of some methodological differences. But they have since made up and have agreed to produce a single MPI again in 2016. "They are great colleagues and it will be nice to be working together again," Alkire says.

Bhutan, Chile, Colombia, Mexico, and the Philippines have already adopted official national MPIs to help allocate resources and measure whether policies are being implemented appropriately. Several other countries, including Tunisia, are getting ready to follow their lead.

Colombia is using its MPI to guide the country's 2014–18 national development plan, according to President Juan Manuel Santos. "The fight against multidimensional poverty is harder but much more effective," Santos told the third annual meeting of the Multidimensional Poverty Peer Network, held in Cartagena, Colombia, in June. The group, a South-South initiative, counts officials from 40 countries.

Alkire says the index must not "sit and gather dust." She wants it to be part of a data revolution to guide the fight against poverty. "What I really love is that we work with passionate and committed people who take the measurements and use them for policy. We're in a very dynamic and creative phase right now," she says.

If the multidimensional poverty index sounds as though it owes a lot to the work of Amartya Sen, that's because it does. Poverty, Sen wrote in his 2000 book *Development as Freedom*, must be seen as "a deprivation of capabilities, rather than merely as low income." Alkire says she regards the Indian economist very much as her mentor. Indeed, he had agreed to be her doctoral examiner but had to withdraw because of time pressure after winning the Nobel Memorial Prize in Economic Sciences in 1998.

Her bookshelves bulge with his works. A flier for a lecture he gave in Oxford in 2013 sits atop her filing cabinet, and a banner outside her office bearing a quotation from Sen's "Possibility of Social Choice" lecture sums up OPHI's mission: "How can it be possible to arrive at cogent aggregative judgments about poverty given the diversity of preferences, concerns and predicaments of the different individuals within the society?"

Sen is an adviser to OPHI and Alkire is in touch with him quite often. "But he's not hands-on, in the sense that the MPI is our work," she says. "He might be critical of it. He might take a different idea. So he gives a lot of freedom to people who try to develop his work. He's not at all trying to direct it."

A roundabout route

Alkire took a somewhat roundabout route before arriving at poverty measurement. She was born in 1969 in the German university town of Göttingen but left as a baby when her father took a job teaching chemical engineering at the University of Illinois at Urbana-Champaign. Alkire graduated in 1989 from the same university in sociology and premed studies and was accepted into medical school at Johns Hopkins. During her "gap year," however, she decided not to take up the place, to avoid getting into debt.

That year included three months as a volunteer with a nongovernmental organization that conducted systematic immunization among Afghan refugees outside Peshawar in Pakistan. "I was living with a family. Their son was studying at my university and the sisters were my age, so I got completely into the culture and the language and loved Islam," she recalls. In India she spent several weeks at Mother Teresa's home for the dying in Kolkata, visited Tibetan settlements in Himachal Pradesh, and worked in Sri Lankan refugee camps in the south of the country. "It was the normal student gap year experience of simply trying to absorb as much as possible." And then Alkire decided to branch out into theology. "I didn't know what it was, so it was quite an odd choice," she says, disarmingly. "I had a deep faith and still have—it's a big part of my life. I wanted to learn about God and I realized that's not what theology is. It seems to be about the study of texts that have to do with God."

Alkire completed a Diploma in Theology at Magdalen (pronounced *maudlin*) College, Oxford, in 1992, but says it was a close thing: "To be honest, I nearly failed doctrine—I never grasped very clearly the difference between evil and suffering." But she did earn a distinction mark for her Islam paper. "It may have been because I loved the course and also had been learning Koranic Arabic so could put bits in in Arabic." Alkire went on to do an MPhil in Christian political ethics, seeking to explore ways to be useful in development while respecting other people's cultural and spiritual values. It was not, she puts it diplomatically, "a match made in heaven" for Oxford's theology department. Her 1994 master's thesis, "The Concept of Poverty Alleviation in the World Bank since 1990: A Theological Analysis," was too modern for the department's liking and she was turned down for a PhD program. So she switched again, this time to economics, at the urging of Rosemary Thorp, then reader in the economics of Latin America, whom Alkire describes as a "wonderful woman." Alkire says the progression was natural because she had been auditing classes from econometrics to development theory, finding them "very interesting and easy," and was already delving into Sen's work. By 1995, she had a master's under her belt and by 1999 a doctorate followed, both on Sen's capabilities approach to development.

After joining the World Bank, where she worked from 1999 to 2001, Alkire undertook ordination training, which is how she met Edmund Newell, then chaplain to the bishop of Oxford. Whereas Alkire had migrated from theology to economics, Newell studied economics and economic history at Oxford before becoming a priest in the Church of England. They went on to coauthor a book, *What Can One Person Do? Faith to Heal a Broken World*, which examined the United Nations Millennium Development Goals through a theological and practical lens.

"She treats her economics as vocationally as she treats her Christianity. She is totally devoted to it—to the people behind it. That was one of the things that came across really strongly working with her," says Newell, who now heads an education charity and study center outside London.

"This was not about abstract economic theory. It was about practical ways of helping the world's poor. That shines through in the way we worked and shines through in everything she does," he adds.

Alkire had wanted for some time to apply Sen's capabilities approach to gauging multidimensional poverty, and a breakthrough finally came in 2006, when she started to collaborate with James Foster, now a professor at The George Washington University in Washington, D.C., and a leading figure in measurement methods. While a graduate student at

Portrait of Alkire by the late Carl Lazzari, 2006; detail from "The Raising of Lazarus."

Cornell University, Foster in 1984 developed with Joel Greer and Erik Thorbecke (also at Cornell) the eponymous FGT set of poverty indices, which are still extensively used to measure single variables such as income, consumption, and calorie intake. Foster was at first "quite dubious about everything multidimensional," according to Alkire, who was setting up OPHI at the time. "But we had a week of just head-on talking it through," she recalls. "Then, I guess, the penny dropped and we saw what was possible in terms of the methodologies that built on his work," she recalls.

The Alkire-Foster methodology underpinning the MPI stemmed from that marathon brainstorming. Alkire says she has learned a huge amount from Foster. "He has had more of an orientation towards theoretical work. When it comes to proofs, he can do those. It's sort of a language I understand but can't speak," she says. Cue more laughter. "I try, and I'm trying to learn more, but he's head and shoulders above me in that."

A stern critic

Alkire says that learning to meditate soothed away what she describes as the "temper tantrums" of her childhood. Still, her equanimity must have been tested in 2010 when word reached her in Bhutan—during a meditation retreat, no less—that Martin Ravallion, then a leading World Bank researcher, had torn into the new enthusiasm for multidimensional poverty indices. "They had to call me to walk three miles to the hotel and find the Internet to respond," Alkire remembers.

Taking aim at the UNDP's new MPI, Ravallion argued that it was simply not credible to suppose that a single index could capture all the dimensions of poverty. "We can all agree that reducing child mortality is a hugely important development goal, but how can one contend . . . that avoiding the death of a child is equivalent to alleviating the combined deprivations of having a dirt floor, cooking with wood, and not having a radio, TV, telephone, bike, or car?" he wrote.

Five years later, Ravallion, now an economics professor at Georgetown University in Washington, D.C., is still a stern critic. For him, distilling various measures of poverty into a single index is akin to combining all the dials and gauges in a car into just one instrument. "The human development dimensions of welfare are just so important for assessing social progress, but I don't want to add them up in some composite with material goods," he says. "I want to look at them separately. I want to see where a country is doing well or not." Aggregating different indicators into an MPI could be positively harmful if policymakers do not understand the trade-offs that are built in to the index, in Ravallion's view. "I would give a strong warning to handle with care," he says. "Governments look at these indices. They don't know what went into the stew that made them. I don't think that makes good policymaking."

It's an understatement to say that policy analysts like multidimensional indices such as OPHI's MPI more than the economics community does. In addition to the subjectivity entailed in choosing the components and their weights, the index is open to criticism that it relies on international surveys and indicators that may not be applicable in every country. Is it appropriate, say, to measure poverty in Africa the same way as in countries of the former Soviet Union? Statisticians are also sniffy about the headline MPI, which uses ordinal not cardinal data. "The purpose of all these composite indices is communication. No one is pretending that they are very precise," the UNDP's Kovacevic says. "But if people are curious and need to know why things went in one direction and another country's went in another, they can pull down the index and look at the components."

Charles Kenny of the Center for Global Development, a Washington think tank, agrees with Alkire that it is misleading to view the battle against poverty exclusively through the lens of income. Countries such as Haiti and the Democratic Republic of the Congo have recorded modest improvements in child mortality and education even though incomes have stagnated, says Kenny, author of *Getting Better: Why Global Development Is Succeeding—and How We Can Improve the World Even More*. But he too has misgivings that the MPI might be substituting one politically convenient catchall figure—$1.25 in income a day—for another. "One thing I wonder about is that, after arguing that poverty is multidimensional, the MPI ends up as a single number."

Another issue is that any index is only as good as its underlying data, and in emerging market economies that quality is often inadequate. "The knowledge problem in development is twofold: we know less about poorer countries and less about the poorer people in poor countries," says Morten Jerven, author of *Africa: Why Economists Get It Wrong*. For example, on-the-ground surveys to check whether households really do have effective access to electricity—one of the MPI indicators—are simply not frequent enough. "The MPI does some disaggregating and does it a little better than some other measures," Jerven, an associate professor at Simon Fraser University in Burnaby, British Columbia, says. "But if the numbers that go into this are not updated often or based on real observations, these trends may be meaningless."

The quest for better poverty metrics coincides with growing doubts about the ability of conventional statistics, especially GDP, to gauge economic growth in the digital economy, let alone well-being, welfare, and environmental sustainability.

"In order to accurately measure our progress towards sustainable lifestyles, we feel we need to get beyond GDP measures," Gudrun Kopp, Germany's parliamentary state secretary for economic cooperation and development, said in explaining why Berlin had begun to support OPHI's work on multidimensional poverty.

Diane Coyle, author of *GDP: A Brief but Affectionate History*, advocates tracking a dashboard of indicators that contribute to social welfare, such as the Organisation for Economic Co-operation and Development's Better Life Index. "There is a counterargument that you need a single number because that's what voters and politicians pay attention to," Coyle says. "But that, though attractive, just submerges some of the trade-offs that policy has to be about." Alkire acknowledges the usefulness of a dashboard approach but suggests it should include the MPI. "What we don't agree with is that you should only look at deprivations one by one and never see who is deprived in many at once," she says.

OPHI's website commendably provides links to papers and blogs critical of the MPI. "We're not out of the water because there's still a lot of resistance to our work," Alkire says. The OPHI team itself "fights vigorously and happily" over how to make the index better. "Nothing is beyond criticism, and certainly I have plenty of criticisms of my own of the index and the methodology," she adds. Not all data are comparable or up to date, and there are holes in subnational regional surveys. But the index is pretty good and getting better fast as the quality of the survey improves. "There's a whole set of criticisms I understand and respect. On the practical side, though, I disagree with them," she says firmly.

To-do list

So what next for Alkire? She is determined to keep improving the MPI and to broaden its coverage to measure employment, empowerment ("my passion"), and violence. She would love to produce an index that sheds more light on the way women live and are treated, but such an initiative would need broad political backing. "You can't get too far ahead of where countries are," Alkire says. "This is a decision the international community has to take. If they want a gendered index, we know how to do it, but we don't have the data."

It was a misconception that measuring multidimensional poverty requires a lot more data gathering than tracking income or consumption poverty. For instance, the MPI draws on only 39 of 625 questions in the U.S. Agency for International Development's Demographic and Health Surveys, one of OPHI's main sources (UNICEF's Multiple Indicator Cluster Surveys is the other). Little tweaks to the questions would suffice. "Just a few seconds and you have much better information," she says.

In September 2016 Alkire will begin directing her program from the United States, where she has accepted a full-time professorship at The George Washington University—alongside James Foster. "GW has been kind to offer a gentle and wise transition," she says. However, research into measuring poverty will continue at Oxford in one form or another. "How that will actually unfold we have no idea," Alkire says. "I simply want to be able to continue working on this agenda."

In the meantime, she has enough on her plate. The church is keeping her away from her hobbies of cooking, exercise, and meditation. In addition to her duties as honorary chaplain at Magdalen College, she has been heavily committed to her parish of Cowley St John in East Oxford, which has been without a vicar for far too long. "It's been a year, but it's certainly changed my life. I have to be home most Sundays. It's weird," she laughs. God's work, it seems, is never done. ■

Alan Wheatley is an economics writer and editor, formerly with Reuters, and editor and coauthor of The Power of Currencies.

Uncertain Times

After a decade of social and economic progress, Latin America is facing challenging issues

José Antonio Ocampo

NOT long ago, Latin America was a success story of economic growth. While advanced economies suffered a severe recession during the 2008–09 financial crisis in the United States and western Europe, followed by a weak recovery, emerging market economies were seen as the promise for renewed world economic growth. Latin America was viewed as part of that promise.

The 2004–13 decade was, in many ways, exceptional in terms of economic growth and even more so in social progress in Latin America. Some analysts came to refer to the period as the "Latin American decade," a term coined to contrast with the "lost decade" of the 1980s, when a massive debt crisis sent the region into severe recession.

But this positive picture has changed dramatically. Growth per capita ground to a halt in 2014 and much of the region is again viewed with a sense of forgone promise. The sudden deterioration in the region's prospects also reflects significant changes in the international factors that affect the region's economic performance—including a substantial decline in commodity prices, which remain the backbone of the region's (and particularly of South America's) exports—and an overall moderation of global trade. If Latin America is to regain its footing, it must undertake reforms to diversify economies and to upgrade technologically its production structure to make it less dependent on the behavior of commodities.

Morning in Cartagena, Colombia.

Good performance

Although 2004 marked the start of the so-called Latin American decade, some economic improvements had begun years before. Low fiscal deficits have been the rule in most countries since the 1990s. A strengthening of the tax bases facilitated a well-financed expansion of social spending, which had severely contracted during the 1980s. Inflation, which for the region was nearly 1,200 percent in 1990, had fallen to single digits by 2001. These are all significant achievements. But the most remarkable one, given the precedent of the debt crisis, has been the sharp reduction in the ratio of external debt to GDP that took place during 2004–08. At the same time, countries in the region accumulated large foreign exchange reserves. External debt net of foreign exchange reserves fell from an average of 28.6 percent of GDP during 1998–2002 to 5.7 percent in 2008 (see Chart 1). Although the downward trend was interrupted in 2008, when the region ceased to run the current account surpluses it had been enjoying since 2003, it was still low by historical standards in 2014—only 8 percent.

Because low debt ratios make it more likely that a nation can pay its borrowings on time, they have permitted most Latin American countries extraordinary access to external financing. In the mid-2000s, real (after-inflation) interest rates on Latin American external borrowing returned to low levels the region had not seen since the second half of the 1970s, before the devastating debt crisis that led to the lost decade. Because of the prudent debt ratios, monetary authorities in several countries were able to undertake expansionary policies to counter the adverse effects of the strong recession in advanced economies. In particular, all major central banks reduced their interest rates, and several governments increased public sector spending to expand domestic demand. This ability to conduct economic policies that counteracted the business cycle rather than reinforced it was unprecedented in the region's history.

Economic growth averaged 5.2 percent from 2004 through the middle of 2008, the best the region had experienced since 1968–74 (see Chart 2). Moreover, it was accompanied by an investment boom in many countries. Investment as a percentage of GDP increased to levels that were only slightly below the peak reached prior to the 1980s debt crisis—and higher if Brazil and Venezuela are excluded.

And after a brief and sharp slowdown in economic growth in 2009—which was a full-blown recession in some countries, notably Mexico—growth recovered to average 4.1 percent a year in 2010–13. For most countries, the truly exceptional growth occurred from 2004 to mid-2008, although a few countries—Panama, Peru, and Uruguay—did experience a full decade in which their economies grew at average annual rates of over 6 percent from 2004 to 2013.

Since the 1990s, the region has also experienced long-term improvements in human development thanks to an increase in social spending as a proportion of GDP in all countries. The increased social spending facilitated the expansion of education, health, and other social services. These improvements can be characterized as a "democratic dividend," because they followed the broad-based return to democracy in Latin America in the 1980s.

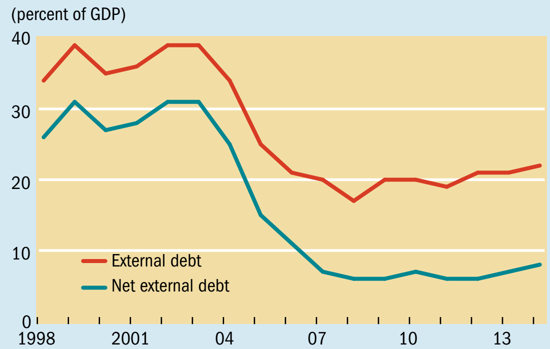
Most notable among the beneficial social changes during the past decade was a large reduction in poverty and related improvements in labor markets and income distribution. According to data from the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) and the International Labour Organization, regional unemployment fell from 11.3 percent in 2003 to 6.2 percent in 2013. Employment in the informal sector—in which workers labor in low-productivity activities, either independently or in very small firms—fell from 48.3 percent of total employment in 2002 to 44.0 percent 2014, and the portion of the population aged 15 to 64 with jobs increased by 4.6 percentage points.

There was also a remarkable improvement in income distribution in most Latin American countries—not only a contrast with the region's history, but also a divergence from the

Chart 1

Borrowing eases

By any measure, foreign debt as a percent of Latin American GDP fell sharply over the past decade.



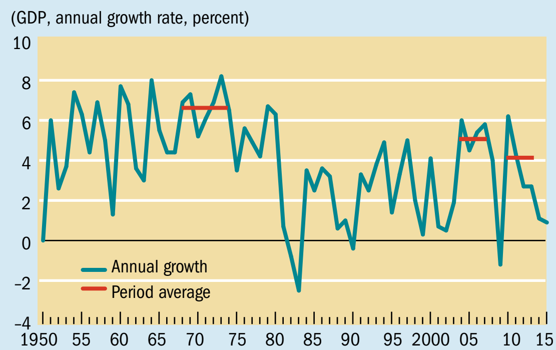
Source: Author estimates based on data from the United Nations Economic Commission for Latin America and the Caribbean.

Note: Net external debt adjusts total foreign borrowing to account for a country's foreign exchange reserves.

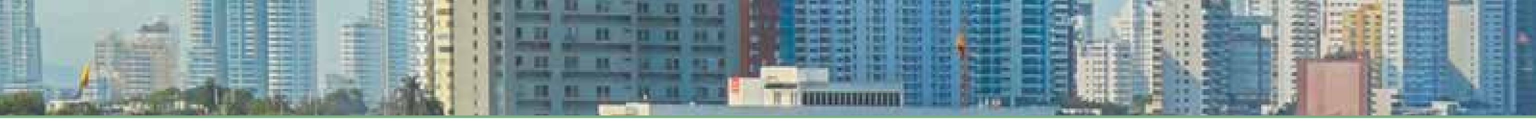
Chart 2

Best in decades

Latin American GDP grew at its fastest rate since the 1970s between 2004 and 2008.



Source: United Nations Economic Commission for Latin America and the Caribbean.



relatively generalized global increase in inequality in recent years (see "Most Unequal on Earth," in this issue of *F&D*). This narrowing of inequality combined with economic growth resulted in a spectacular reduction in poverty levels and a rise of the middle class. In 2002, the percentage of the Latin American population living in poverty was higher than in 1980, according to ECLAC (2014) data. But the poverty headcount declined by 16 percentage points over the ensuing decade; about half of it represented a reduction in extreme poverty. The only comparable reduction in poverty levels took place in the 1970s, thanks to rapid economic growth at the time. As poverty fell, the middle class (people living on incomes between $10 and $50 a day, according to the World Bank definition) grew from about 23 percent to 34 percent of the population.

Still, these social improvements must be viewed with caution. Labor market informality still predominates in many countries. Improvements in income distribution were for the most part a reversal of the growing inequality during the 1980s and 1990s. And even with the improvements in inequality, Latin America continues to have among the worst income distribution in the world. Furthermore, the increase in availability of education and health care has not been matched by improvements in quality of the services. For example, Latin American students rank low in the Organisation for Economic Co-operation and Development's *Programme for International Student Assessment*. High-quality education is essential to develop the technologically sophisticated areas that produce the high-value goods and services essential to a return to dynamic growth in Latin America.

Good times end

In contrast to the halcyon decade that ended in 2013, the recent economic performance of Latin America has been poor. Growth fell sharply in 2014 to just 1.1 percent—barely above the region's current low population growth of 1.0 percent—and will continue at a similar or even lower rate in 2015, according to both the IMF and ECLAC (see Chart 2). Investment also declined in 2014, and will continue to do so in 2015. Poverty ratios have stagnated at 2012 levels (see Chart 3) and, although no hard data are yet available, this seems also true of income distribution. Unemployment has remained low, but the proportion of the working-age population with jobs fell in 2014.

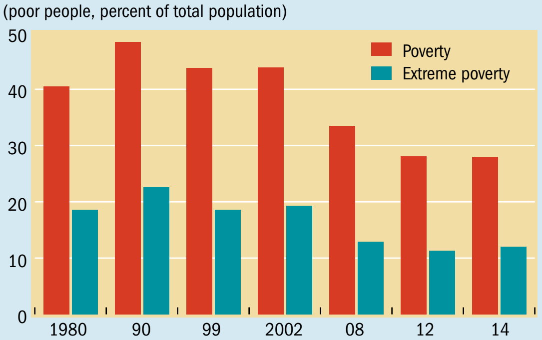
There are, however, significant regional differences in recent developments in Latin America. The sharp slowdown is essentially a phenomenon in South America, which grew 0.6 percent in 2014 compared with 2.5 percent in Mexico and Central America. Furthermore, Venezuela started a severe recession in 2014, which will deepen in 2015, and the two largest South American economies, Argentina and Brazil, will also experience moderate recessions in 2015, according to the IMF (2015). Most other South American countries have continued to grow but experienced a slowdown in 2014 (Chile, Ecuador, Peru, Uruguay) or are experiencing one in 2015 (Colombia). The exceptions are Bolivia and Paraguay, which will continue to grow at 4.0 percent or more in 2015. In the northern part of the region, Mexico will grow, although at a somewhat lackluster rate—2.1 percent in 2014 and a projected 3.0 percent in 2015. That continues the mediocre pattern for the northernmost Latin American economy, which grew at an average rate of 2.6 percent between 2004 and 2013, the second lowest rate in Latin America. Thus, in northern Latin America, it is Central America (with the exception of El Salvador and Honduras) and the Dominican Republic that outperform.

The region is less able than it was in 2008 and 2009 to counteract adverse external shocks.

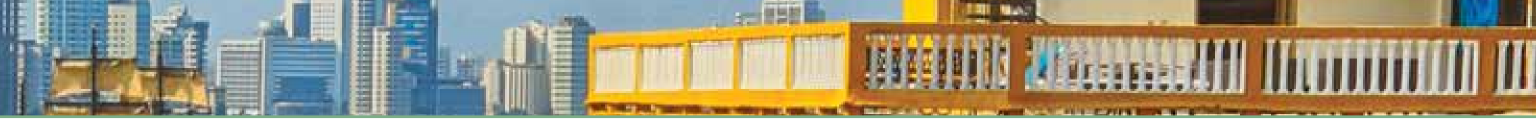
Although some strengths remain, the region is less able than it was in 2008 and 2009 to counteract adverse external shocks, such as the decline in commodity prices or changes in U.S. monetary policy.

A major strength for the region continues to be low external debt ratios. Although they have started to increase, the debt ratios, net of foreign exchange reserves, remain low. With some exceptions, this favorable net debt position gives countries access to private capital markets and, at a minimum, permits most monetary authorities to avoid contractionary policies when managing the current shocks. But, because of rising external imbalances (especially a deficit in the current account) and in some cases rising inflation, the room for monetary authorities to maneuver is more limited than what they enjoyed during the 2008–09 financial crisis. Indeed, some—notably Brazil—have been forced to increase interest rates to counteract rising inflation. On top of this, higher government spending in recent years has constrained Latin America's ability to use fiscal policy to support growth in economies hit by declining international demand. On

Chart 3
Fewer poor
After falling steadily for a decade, poverty levels in Latin America have stagnated over the past two years.
(poor people, percent of total population)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).
Note: Poverty is defined by ECLAC in terms of the country-by-country cost of a basket of goods and services considered essential.



Construction of the Museo Soumaya, Mexico City, Mexico.

average, the region has ceased to run the primary fiscal surpluses (income minus spending before interest payments) that it enjoyed before the crisis.

The greatest risk comes, however, from the current account of the balance of payments. Despite the very favorable terms of trade (export prices relative to import prices), the region has been running deficits on its current account (which largely measures the difference between exports and imports of goods and services, or equivalently how much aggregate spending exceeds the value of national income). One way to understand this is to subtract from the current account the gains in export values generated by improvements in the terms of trade relative to a pre–commodity boom year (2003). Estimated in this way, better terms of trade benefited Latin America at the equivalent of about 7 percent of GDP in 2011–13. But the region not only spent all those gains, it ran a current account deficit. This means that the region in fact *overspent* the commodity boom (see Chart 4). Other estimates (IMF, 2013) suggest even greater overspending. Recent depreciations of many of the region's currencies will eventually help reduce current account deficits (by making exports more profitable and imports more expensive). But in the short term, improvements in the current account will come primarily from lower imports, the result of the economic slowdown.

Outside influence

The change in Latin America's fortunes results in large part from a reversal of the benevolent external conditions that fostered the boom. The excellent performance from 2004 until the middle of 2008 reflected the extraordinary coincidence of four positive external factors: rapid growth of international trade, booming commodity prices, ample access to external financing, and migration opportunities and the burgeoning remittances that migrants sent home.

Two of these positive factors—migration opportunities and rapid world trade expansion—have disappeared, probably permanently, as a result of the financial crisis in advanced economies.

Migration opportunities to the United States are more limited than before the crisis, and high unemployment in Spain has prompted many South American migrants to return home. Remittances, which help prop up demand in recipient countries, have recovered but are still below the 2008 peak.

Likewise, world trade experienced the worst peacetime contraction in history after the September 2008 collapse of the Wall Street investment firm Lehman Brothers. Although trade swiftly recovered, since 2011 it has settled in at a slow rate of growth. Overall, according to IMF data, export volumes have increased only 3.0 percent a year since 2007, the worst performance since World War II and a fraction of the 7.3 percent annual growth rate registered between 1986 and 2007.

The commodity price boom took off in 2004 and, although the rise was interrupted by the sharp contraction in international trade, recovery was also very fast. The benefits of the positive terms of trade were particularly strong for energy- and mineral-exporting economies (Venezuela, Chile, Bolivia, Peru, Colombia, and Ecuador, in that order), followed by the major agricultural exporters (Argentina and Brazil). In contrast, oil-importing countries were hurt, notably those in Central America and the Caribbean.

But when non-oil commodity prices started to fall in 2012 and oil prices collapsed in the second half of 2014, fortunes were reversed. The recent losers have been the energy and mineral-exporting economies that benefited from the boom, while Central American countries are now winners. The economic slowdown in China is a major reason for the commodity implosion, as Chinese demand has been the major determinant of commodity prices. Unanswered is whether this is a short- or long-term phenomenon. My research with Bilge Erten (Erten and Ocampo, 2013) indicates that real commodity prices have followed long-term cycles since the late 19th century. If this continues to be the pattern, the world is at the beginning of a long period of weakening commodity prices.

Latin America cannot rely solely on favorable external conditions.

Therefore, of the four conditions that fed the 2004 to mid-2008 boom, only one remains in place: good access to external financing. The reverberations from the Lehman collapse essentially shut down financing from private capital markets, but only for about a year. Latin American access to international capital markets rebounded sharply after that. Annual bond issues by Latin America have almost tripled—to $9.6 billion a month in 2010–14 compared with $3.5 billion in 2004–07—and the costs of financing have remained low for countries that issued bonds in international private capital markets. The favorable financing climate is the result of low debt ratios and the large amount of liquidity (cash) floating around global financial markets as a result of the expansionary monetary policies of major developed economies seeking to boost their still weak economies (see "Watching the Tide" and "Spill Over" in this issue of *F&D*). The euro crisis of 2011–12, the U.S. Federal Reserve's gradual tapering of its bond purchases, and even the commodity shocks of 2014 have had only small effects on Latin America's access to global financial markets. Moreover, the few countries that lack access to global private capital markets—Argentina, Ecuador, and Venezuela—have had ample financing from China. Global financial conditions may, of course, change given new uncertainties surrounding the euro area in the face of the Greek crisis or if a reversal of U.S. monetary policy draws away investment funds from the region. But at the time of writing, Latin America's access to global capital markets remained favorable.

Going forward

Latin America cannot rely solely on favorable external conditions to propel economic growth in the near future, but must build up favorable conditions on its own. Hence the need for reforms.

Workers leveling soybeans on outbound ship, Porto de Tubarão, Vitória, Espírito Santo, Brazil.

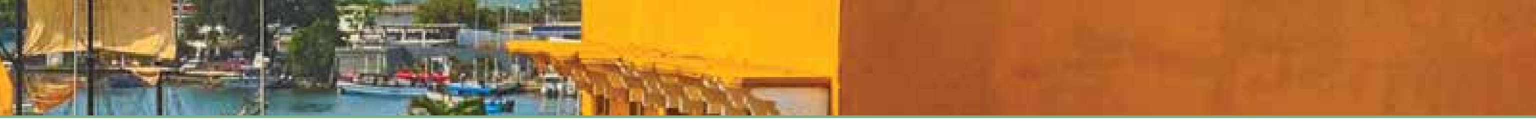
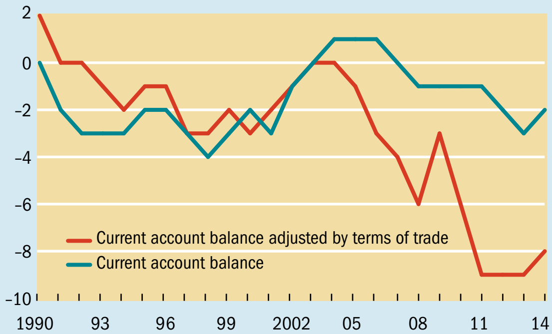


Chart 4

Overspending the boom

Latin America benefited immensely from a big increase in the prices of exports relative to imports after 2003. But, except for a few years, and even with the large increase in so-called terms of trade, the region ran current account deficits.

(percent of GDP)



Source: Author's estimates based on data from the Economic Commission for Latin America and the Caribbean.

Note: The adjustment is an estimate of gains and losses of export values associated with improvements or deterioration in the terms of trade relative to 2003. The blue line represents the actual current account balance. The red line shows how large the deficit would have been in recent years had there not been such a big improvement in the terms of trade. Terms of trade gauges the prices of exports relative to imports. The current account balance measures exports minus imports of goods and services and net transfers.

But the reforms must go beyond traditional *market* approaches that were in fashion in the 1980s and 1990s. The stubborn fact is that market reforms have not delivered strong economic growth. Indeed, GDP growth during 1991–2014, after market reforms, was 3.2 percent a year, compared with 5.5 percent during the era of more active state intervention, from 1946 to 1980. Poor productivity has hampered economic performance, and the growth that has occurred has been unstable.

A basic explanation for this mediocre long-term economic performance is a lack of adequate attention to upgrading technology in the production sector, strong deindustrialization, and the fact that the region has specialized in goods (notably commodities) that offer limited opportunities for diversification and improvements in product quality. This has been reinforced by growing trade with China, which almost entirely imports natural-resource-based goods from Latin America. The net result of relying on traditional export opportunities is a wider technology gap, not only in relation to the dynamic Asian economies, but also with developed natural-resource-intensive economies such as Australia, Canada, and Finland.

It is essential, then, that the region invest in diversifying its production structure and place technological change at the center of long-term development strategies. This should include not only reindustrialization but, equally important, the upgrading of natural-resource-production technology and the development of modern services. Diversifying trade with China away from commodities is another essential element of this policy. The need to focus on new technology to increase competitiveness is critical given the prospects of weak growth in world trade.

But increased exports are not the only avenue the region should travel. Reduced poverty and a larger middle class provide opportunities for domestic markets as well. The best way to exploit richer domestic markets is through regional integration. But this requires, in turn, overcoming the significant political divisions that have blocked the advance of regional integration over the past decade. In particular, after strong growth in intraregional trade in the 1990s within the two major South American integration processes—*MERCOSUR*, which initially included Argentina, Brazil, Paraguay, and Uruguay, and the *Andean Community* of Bolivia, Colombia, Ecuador, and Peru—performance has been rather lackluster (see "Doing It Right" in this issue of *F&D*).

In macroeconomic terms, the most important condition for more dynamic production diversification is more competitive and less volatile real exchange rates. This should be part of a stronger shift toward macroeconomic policies to lean against booms and growth slowdowns and reduce the growth volatility that characterized the past quarter century.

The region also needs to make major advances in two other areas: the quality of education and infrastructure investment. Without better education, bottlenecks in the supply of well-trained workers will hold back the technological advancement the region needs. In turn, the weak infrastructure requires significantly higher investment in highways, ports, and airports—at least doubling current investment levels, according to the Development Bank of Latin America (2014). Such investments should make use of public-private partnerships but also—and even more—call for a larger injection of public sector funds.

This reform agenda must be put in place. It is not a question of market reforms—the meaning that "reforms" usually has in the policy debate—but of a better mix between states and markets. And, of course, that mix must also consolidate and advance social progress, the region's most important achievement over the past decade. ■

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A Clear Direction

Confidence in the economy's future is the key to Latin America's success

Alejandro M. Werner is the head of the IMF's Western Hemisphere Department.

ACADEMIC economists debate whether confidence is an independent force driving economic outcomes or it reflects fundamental information about the current and future state of the economy. But practitioners know that whatever its nature, confidence problems are real, and when times are hard, confidence in policies and policymakers is tested.

And hard times are here. After five years of declining growth, Latin America faces its slowest economic growth in a decade and a half. Business and consumer confidence is close to where it was in the aftermath of the U.S. investment firm Lehman Brothers bankruptcy as the prospect of protracted lower growth haunts many countries in the region. Indeed, confidence indices remain about 30 percent below their 2010 peaks.

There are a number of causes: lack of policy direction now that the commodity boom is over, uncertainty about potential new sources of growth, and political crises associated with unsustainable gains for a growing middle class, along with episodes of corruption. And recent presidential approval ratings mirror the decline in confidence.

A renewed push

To restore confidence, support sustainable long-term growth, and ensure shared prosperity, governments in the region must clarify the direction of their economic policies and deepen Latin America's democracies and market institutions. Stronger policy frameworks and structural reforms are necessary to support the recovery, but political leaders may have to take additional steps to strengthen governance, transparency, and the rule of law.

Trends in the global economy will continue to weigh heavily on growth and confidence in the region, despite an environment much improved over 2008–09. Most notably, the likely continued slowdown in China suggests that commodity prices will remain low for the next three to five years and that South American countries may need to find new sources of robust growth. In addition, the expected liftoff in the U.S. federal funds rate means a return to normal after a prolonged period of easy liquidity in global financial markets. While most observers expect a smooth process, financial markets could get turbulent. In some countries, the effects of these global conditions will be compounded by domestic worries, such as heightened concern about corruption or uncertainty generated by structural reforms that should ultimately boost growth but only after some initial disruption.

Restored confidence is essential to reversing declining growth. So it is imperative to maintain—and in some cases reestablish—fiscal and monetary anchors. On the fiscal front, countries may have to signal clearly that fiscal policy will get back on track following the countercyclical shift after the 2008 Lehman Brothers collapse.

Before 2008, high growth and rising commodity prices allowed governments to spend significantly more while reducing their debt-to-GDP ratios. In 2009, Latin American countries implemented bold fiscal responses to smooth the effects of the global financial crisis. Their countercyclical response successfully reduced the impact of the external shock, but IMF research shows that most of the fiscal expansion came through an increase in wages and expanded social programs, which will be hard to reverse. Moreover, the crisis also required some bending and relaxation of fiscal rules and increases in debt to GDP. The big challenge for the next couple of years will be to get debt-to-GDP ratios back on a downward path, adjust fiscal frameworks to guarantee reasonably quick reversal of countercyclical fiscal expansion, and significantly improve the efficiency of public spending.

On the monetary policy side, the main objective will be to stick as close as possible to what is warranted by the business cycle and inflation pressure, given differences in monetary policy normalization in the major advanced economies. A return to normal monetary conditions in the United States, the possibility of capital outflows, fluctuations in commodity prices, and the associated exchange rate changes—coupled with uncertainty about potential output and gaps—pose challenges for inflation targeting and monetary policy frameworks. In countries with solid inflation-targeting regimes, these challenges are manageable, and exchange rate movements will play a useful role in the adjustment. Countries in the region that lack access to international capital markets and/or have rigid exchange rate systems will face more difficult policy choices. And finally, some countries still have high inflation, which is likely to rise as a result of the external environment—perhaps triggering regime changes.

The reversal of previously benign external conditions warrants close monitoring of vulnerability in the private corporate sector to preserve financial stability. After a long period of high growth, low interest rates, lax financial conditions, strong terms of trade, and strong currencies, businesses in the region increased their leverage ratios. With the reversal of this unprecedented combination of positive conditions, some firms will find themselves with too much debt, which is likely to undermine their financial condition and cause potentially disruptive deleveraging.

Laying the groundwork

But the most important challenge facing the region is to lay the groundwork for the resumption of high and sustainable growth. During the boom years, attractive commodity prices and low interest rates allowed many of these countries to increase investment and maintain a healthy external balance. Now we are back to the historical trap of low saving, low investment, and low productivity growth that hurt the region for so long. To stimulate saving and investment and unleash productivity, structural reforms are critical. This is a continuous and decidedly country-specific process. Some countries may want to focus on reforms that reduce private sector investment bottlenecks, in particular by investing judiciously in infrastructure and facilitating the reallocation of labor and diversification of production. For countries in the region that have slipped in the World Economic Forum competitiveness rankings since 2012, strengthening institutions that foster competitiveness must also be a priority. Last but not least, enhancing labor force skills through education and training is critical to medium-term growth.

Such reforms usually take time to bear fruit, but one of the advantages of investment in infrastructure is the accompanying stimulation of short-term aggregate demand and output. As in other emerging markets, Latin America's widening infrastructure gap requires an estimated additional investment of 3 to 4 percent of GDP a year over the medium term. With few incentives for private sector investment in infrastructure projects, the public sector often has to step in, through public-private partnerships or undertaking investment on its own. Some of the largest countries in the region have already begun or announced important infrastructure programs to address these gaps. And the IMF is expanding its work in this area by helping policymakers evaluate the macroeconomic and financial implications of alternative approaches to infrastructure spending and assess and improve institutional capacity to manage public investment.

Trends in the global economy will continue to weigh heavily on growth and confidence in the region.

But there's more to restoring confidence than strengthening policies and institutions. Political leaders must take charge, explaining priorities clearly and seeking support for hard choices through social dialogue. Studies of structural reforms show that design and social consensus are critical to the success and durability of reforms.

Consider Australia: after a period of subpar growth, it embarked on structural reforms beginning in the mid-1980s, which continued through several phases. In addition to restoring macroeconomic stability, the country undertook a series of fiscal, labor, and product market reforms that substantially improved macroeconomic performance. But a key ingredient of the success was the proactive building of political consensus across government and civil society. An environment that welcomed careful and open discussion of policy options—through think tanks, trade unions, universities, and other institutions—spawned a critical degree of support and social cohesion. Some countries in Latin America have begun to build such an environment, where expert commissions deliberate about the best reforms and propose and discuss them openly. This is an area of the policymaking process that needs and deserves more attention. Forcefully tackling corruption, as some countries in the region have started to do, can also do much to restore confidence and build the institutions needed for sustainable and inclusive growth.

Many countries in the region remain committed to their strong policy frameworks. But given the rapid change in economic performance and the surprising weakness in business and consumer confidence, it cannot hurt to reaffirm this commitment on an ongoing basis, especially with regard to macroeconomic policies. A clearly articulated agenda for structural reforms would also support confidence—in a climate of stronger governance and rule of law—while political leaders clarify policy priorities and foster support for hard choices through social dialogue. ■

Parque Real favela and upscale Morumbi neighborhood, São Paulo, Brazil.

Most Unequal on EARTH

Nora Lustig

Latin America is a region of stark income contrasts but has been making progress

LATIN America is a region with tremendous contrasts. Home to the second richest man in the world and about 5 percent of the world's billionaires, the poor are strikingly poor.

Infant mortality and malnutrition in rural areas and shantytowns, and among disadvantaged groups in Latin American middle-income countries, are much the same as in notably poorer nations. Poverty among afro-descendants and indigenous groups is two, three, and sometimes even more times higher than among the white population.

Latin America is not the region with the largest share or number of poor people in the world (south Asia has that distinction). But it is the one with the most unequal income distribution, which means that the poor there receive a smaller share of total national income than poor people in other regions. As a result, poverty rates in Latin America are systematically higher than would be expected compared with other countries with similar average incomes.

The Gini coefficient is an index of inequality widely used in the social sciences. If all income were to go to one person, the Gini coefficient would be 1. If everybody had the same income, the Gini would be zero. The higher the Gini, the more unequal the country or region. Countries in Latin America, by this measure, are 30 percent more unequal than the world average (see Chart 1).

Fall in inequality

Nevertheless, as inequality was rising in nearly every part of the world, it has been declining in almost every Latin American country since 2000 (see Chart 2). It fell in countries with high growth, such as Chile and Colombia, but also in countries with more modest growth, such as Brazil and Mexico. It fell in countries governed by left-leaning regimes (such as Argentina, Bolivia, Brazil, Chile, Ecuador, El Salvador, Nicaragua, Paraguay, Uruguay, and Venezuela) and in countries with center or center-right regimes (such as Mexico and Peru). It fell in commodity-exporting countries and in commodity importers, in countries with minimum wages on the rise, and in countries with stagnant minimum wages.

An important consequence of the decline in inequality is faster poverty reduction. If the income distribution does not change, any decline in poverty depends on per capita income growth. A reduction in inequality enhances the impact of such growth on poverty. In the 2000s, the proportion of extremely poor people in Latin America declined from 25 percent to about 12 percent—a decrease of more than 50 percent (see Chart 3). Sixty percent of this fall in poverty can be attributed to economic growth, while lower inequality accounts for 40 percent. The two main factors that contributed to the decline in inequality in Latin America are more equal distribution of earnings and government transfers.

Inequality has been declining in almost every Latin American country since 2000.

More equal distribution of labor earnings among wage earners and the self-employed is the most important factor, accounting for 60 percent of the region's decline in inequality. This is because wages of workers with very little education rose faster than those of more educated workers, especially those with tertiary—college or other postsecondary—education. In fact, in Brazil and Mexico, wages for workers with tertiary education have stagnated and, at times, even declined. The common force throughout the region contributing to the narrowing wage gap between skilled and low-skilled workers has been a larger share of workers entering the labor force with secondary and tertiary education (see Chart 4).

The expansion of access to education, especially during the 1990s, produced the expected result: a decline in the wage gap between skilled and low-skilled workers. The number of workers with secondary and postsecondary education grew faster than the number of jobs requiring their higher skills. At the same time there was a rise in demand for low-skilled workers in countries experiencing an agricultural commodity boom, and low-skill wages also rose in response to minimum wage increases—for example, in Argentina and Brazil.

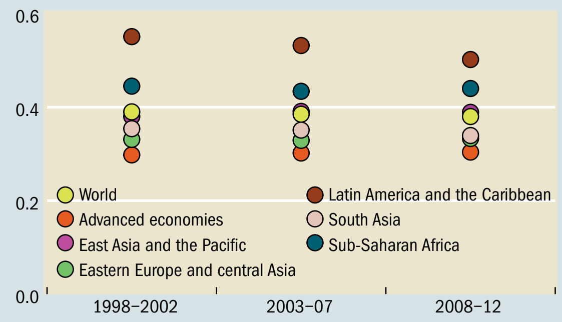
The second most important factor in reducing inequality has been ***government transfers***, which on average explain about 20 percent of the decline. Government transfers have increased in size and are better targeted to the poor. Almost every country in the region runs a flagship cash transfer program that requires families to keep their children in school and receive regular health checkups as a condition for benefits.

Chart 1

Converging fortunes

Latin America is the region with the highest inequality in the world, but one of only two—along with south Asia—where inequality is falling.

(average Gini coefficient by region and income level, five-year averages)



Sources: Author's calculations based on OECD Income Distribution Database: Gini, Poverty, Income, Methods and Concepts; World Bank, PovcalNet: An Online Poverty Analysis Tool; and CEDLAS and World Bank, Socioeconomic Database for Latin America and the Caribbean.

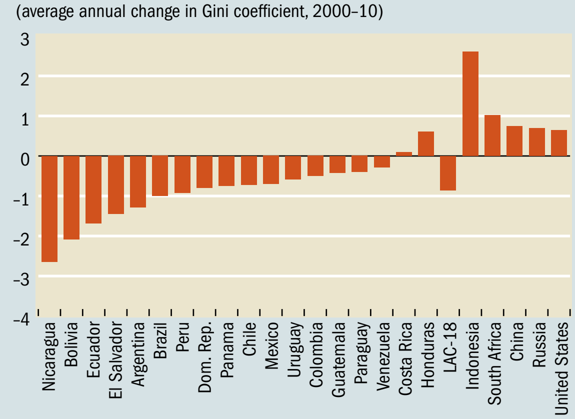
Note: Regional averages were calculated as the averages of within-country inequality for the countries for which data were available; thus, country coverage varies markedly by region.

Chart 2

Strong showing

Almost all countries in Latin America have enjoyed a decline in inequality, in contrast to many countries in the rest of the world.

(average annual change in Gini coefficient, 2000–10)



Source: Lustig, Lopez-Calva, and Ortiz-Juarez (forthcoming).

Note: LAC-18 includes the Latin American countries listed on the *x*-axis.

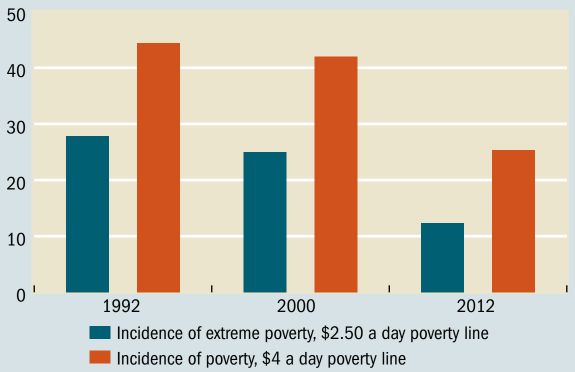
Faced with diminished access to resources in the aftermath of the 1980s debt crisis, many governments in Latin America replaced costly general price subsidies with programs targeted to the poor. Since they were first implemented in Brazil and Mexico in the second half of the 1990s, conditional cash transfers have constituted one of the most important innovations in social policy to benefit the poor. Today, about 27 million households in the region—most of them poor—are beneficiaries of so-called conditional cash transfers. In addition to improving the living standards of the poor, cash transfers have helped improve the health,

Chart 3

Speeding up the fight

A noteworthy consequence of Latin America's decline in inequality has been accelerated poverty reduction.

(number of people with incomes below the poverty line as a share of total population)

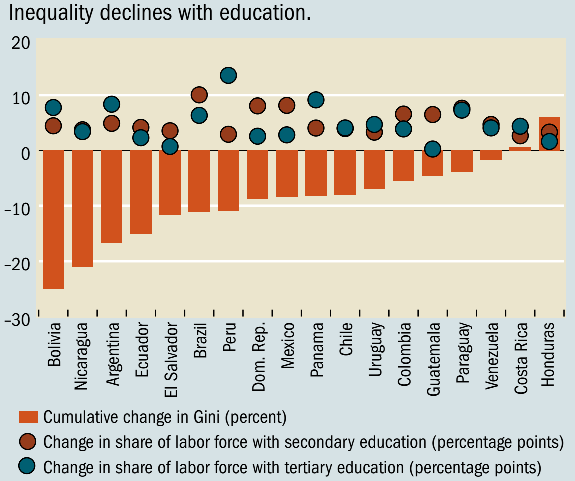


Source: Lustig, Lopez-Calva, and Ortiz-Juarez (forthcoming).

Chart 4

Learning to be equal

Inequality declines with education.



Source: Lustig, Lopez-Calva, and Ortiz-Juarez (forthcoming).
Note: The average change in the Gini coefficient for each country is calculated as the percent change between the end and initial years. The change in educational attainment is calculated as the absolute change between the shares in the end and initial years. Secondary education is defined as 9–13 years of schooling and tertiary education as more than 13 years of schooling. Data cover 2000–12 or closest available for each country.

education, and nutrition of children living in poverty and therefore carry the promise of better employment opportunities in the future.

More recently, some cash transfer programs have incorporated components such as technical assistance, credit, and modest asset transfers to small agricultural producers and microentrepreneurs geared toward increasing productivity and output, especially in rural areas. Many Latin American countries have also instituted noncontributory pensions to provide an income floor to elderly people who are not protected by the formal social security system.

Future prospects

Predicting the evolution of income inequality is tricky. With the Latin American economies facing lower growth prospects and tighter budgets, two things could bring the era of declining inequality to an end. Lower growth—especially in agri-

The prospects for inequality depend on how long the slowdown in growth prevails.

cultural commodity exports—will translate into less demand for low-skilled workers. Hence, their wages are likely to stop rising and may even decline.

Lower growth also means lower tax revenues. As governments try to keep their fiscal accounts under control, they will need to raise taxes, cut expenditures, or both. In such circumstances, minimum wages will not continue their ascending trend and transfers will not continue to grow—indeed, in some countries they may have to be cut back (and in some, cuts have already begun; for example, in Guatemala). In countries with high inflation, transfers may simply be eroded by rising prices.

All else equal, less demand for low-skilled workers and flat or falling minimum wages and government transfers will make inequality go up. However, if lower growth reduces the demand for skilled workers faster than the demand for low-skilled workers, causing the wage gap between the two groups to continue to narrow, the decline in inequality could persist. With the U.S. economy in recovery mode, another potentially equalizing force is increased remittances from Latin Americans living and working in the United States.

In the end, the prospects for inequality depend on how long the slowdown in growth prevails and which forces—equalizing or unequalizing—dominate.

In spite of the decline in household income inequality, the distribution of income in Latin America remains strikingly unequal. By some accounts, the number of billionaires in Latin America in 2014 increased faster than anywhere else. Policymakers must find ways to continue the momentum of declining inequality even in the face of austerity. Improving the lot of the poor should remain a priority even in times of fiscal duress. It is the right thing to do. ■

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Watching the Tide

Copacabana Beach, Rio de Janeiro, Brazil.

Latin America appears better prepared to handle capital outflows than in the past, but its resilience might soon be tested

Andre Meier

SINCE 2009, foreign investors have sent a massive $1.7 trillion to the six Latin American economies that are financially integrated with the rest of the world—Brazil, Chile, Colombia, Mexico, Peru, and Uruguay. Foreign purchases of bonds, equities, and other securities—or portfolio investment—alone accounted for about $640 billion.

These capital inflows were significantly higher than the average over the previous decade, even in relation to GDP. And portfolio investment of similar magnitude has not been seen since the early 1990s (see Chart 1).

The recent strong flows to Latin America reflect a global pattern of capital going from advanced to emerging market economies. Many advanced economies have been stuck at low growth and near-zero interest rates since the global financial crisis, prompting investors to look elsewhere for opportunities. As a result, there has been sustained diversification into assets of emerging markets, where growth and interest rates were higher and overall economic conditions appeared more robust.

A mixed bag

This influx of foreign investment has its benefits. Foreign credit may provide recipient countries with critically needed funding for investment or permit a smoother path for consumption than would otherwise be possible. The recent large inflows have also allowed Latin American governments and firms to lower their interest bill by issuing bonds with lower rates and longer maturities. And to the extent that foreign investors take a stake in the domestic economy—and domestic investors simultaneously invest abroad—they effectively start sharing risk, which can help countries that depend heavily on the fortunes of a particular sector, such as commodities in many South American economies.

However, the strong inflows also have potential downsides. Many observers believe that the recent capital inflows could be followed by large-scale, disruptive outflows. Historically, flows into Latin American bond and equity markets have been especially volatile, creating exuberant conditions during good times, but suddenly stopping or even reversing when investor sentiment changes. Past capital outflows have been triggered by such developments as increases in interest rates in advanced economies, rising risk aversion in global financial markets, and bad economic news from within emerging market economies.

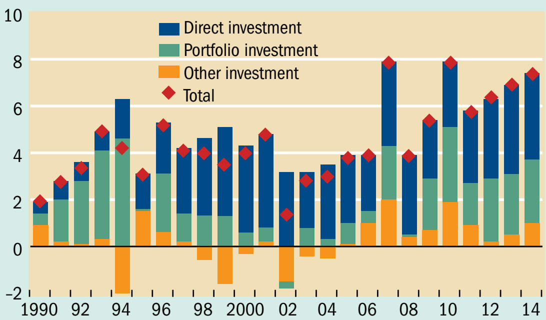
It is easy to see why there are concerns about possible outflow pressures in Latin America today. U.S. interest rates are expected to rise; geopolitical risks remain significant;

Chart 1

Flowing in

Gross capital flows to Brazil, Chile, Colombia, Mexico, Peru, and Uruguay have been exceptionally strong in recent years.

(percent of GDP)



Source: IMF, *Balance of Payments Statistics Yearbook*.
Note: Other investments include derivatives.

and the prospects for the region remain relatively dim following the recent plunge in commodity prices and sharp slowdown in economic growth.

In addition, history continues to cast its shadow. During the 1980s, 1990s, and early 2000s, Latin America suffered a series of economic and financial crises triggered by sudden stops in capital inflows. A prominent example is Mexico's "tequila crisis" of 1994–95, when the peso depreciated sharply and growth collapsed after a period of strong capital inflows suddenly gave way to capital flight. Only a few years later, Brazil (in 1998–99) and Argentina (in 2001) suffered similar currency crises. Memories of these and other crises remain alive in Latin America, reinforcing unease over large swings in capital flows.

Increased resilience

And yet the region has come a long way since the 1990s. All of the financially integrated economies today have floating exchange rates, marking a clear break with a history of currency pegs that tended to collapse during bouts of capital outflows. Today, when foreign capital leaves these economies, currencies are allowed to depreciate. Like a plant that bends, rather than breaks, in a storm, this provides resilience. Indeed, weaker exchange rates can help stabilize demand for domestic assets. Compare that with the historical experience of central banks trying to defend pegged (and overvalued) exchange rates by selling foreign exchange reserves. Such defenses can go on for some time, but central banks eventually risk depleting their reserves, leaving them no choice but to accept a disruptive steep devaluation.

Remarkably, although flexible exchange rates have reduced the need for foreign exchange market intervention, central banks' reserve buffers have grown substantially over the past 10 to 15 years. In almost all of the financially integrated economies, reserves now are large enough to cover more than a full year of external debt service. Buffers of that size—reserve holdings in Brazil and Mexico alone add up to $550 billion—provide reassurance that central banks can intervene to smooth exchange rate movements when necessary, without running out of reserves quickly.

But Latin American countries have gone even further to build resilience. One of the most striking developments is the dedollarization of government debt. As recently as 2000, governments in the region issued most of their debt in U.S. dollars. Doing so was often the only option available, as investors would not have bought debt denominated in domestic currencies that were marred by bouts of high inflation. However, the foreign currency liabilities of governments could wreak havoc on public finances whenever the U.S. dollar appreciated sharply, because the cost of repaying that debt surged. As a result, Latin American central banks have worked hard to establish more credible monetary policy regimes and anchor inflation at low rates. And as investors' trust has grown, governments have been able to issue increasing amounts of bonds in domestic currency. With these bonds, the currency risk is effectively borne by (foreign) investors, rather than Latin American governments.

Potential pressure points

Still, balance sheet vulnerabilities have not disappeared; instead, the corporate sector may have become the principal source of risks. In recent years, Latin American firms have taken advantage of favorable market conditions to issue large amounts of foreign currency bonds. Although some of these bonds have replaced bank loans, overall corporate indebtedness in the region has gone up (Rodrigues and others, 2015). Some firms with particularly high debt may feel the pinch now that weaker economic growth weighs on their earnings. To make matters worse, a sudden rise of the U.S. dollar could cause corporate debt burdens to soar. Thus far, there is little evidence of significant financial pressure on Latin American firms, despite the dollar's recent strength. Country authorities also point out that firms typically protect against exchange rate movements—by owning dollar-denominated assets, making financial hedges, or earning foreign revenue. Nonetheless, corporate currency exposures must be monitored, and managed carefully.

Moreover, capital outflows could still make life more complicated for Latin American governments, even though they have much less dollar-denominated debt. The reason is the very success governments have had in attracting foreign bond buyers. In Mexico, nearly 40 percent of domestic currency government bonds are held by nonresidents, up from 20 percent at the end of 2010 (see Chart 2). Foreigners have also purchased large amounts of Colombia's domestic bonds since their weight in several global benchmark indices was increased last year. Given the size of foreign holdings in some Latin American bond markets today, trading conditions could become very volatile, and interest rates could rise sharply, if many international investors attempted to pull out at once. This underscores the benefits of establishing deep markets with a diversified investor base (IMF, 2014a).

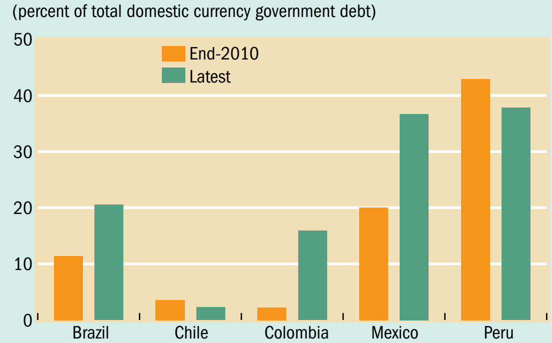
To further gauge the region's vulnerability to capital outflows, it is instructive to examine how the large inflows of recent years have been used. As Chart 3 shows, from 2009

Chart 2

Foreign creditors

In several Latin American countries foreign investors own a large share of government bonds issued in local currency.

(percent of total domestic currency government debt)



Sources: National authorities; and IMF staff calculations.

until 2012, the first four years of the latest inflow episode, there was a more favorable pattern than during the inflow boom of the early 1990s, which ended with Mexico's tequila crisis. In particular, the inflows from 2009 to 2012

- Were more heavily geared toward foreign direct investment, which gives investors a management stake. Such direct investment has proved to be less prone to reversals than portfolio inflows.
- Were not used primarily to finance current account deficits, which shows that some of the foreign capital was saved, rather than spent.
- Coincided with a rise in official reserve buffers and sizable purchases of foreign assets by domestic investors. Both represent a buildup of external wealth that in principle can be drawn down to smooth future capital outflows. For official reserves, this buffer function is obvious. But studies have shown that privately held foreign assets can have a similar effect (Adler, Djigbenou, and Sosa, 2014; IMF, 2014c). For example, during the global financial crisis, as foreign investors withdrew money from Latin America, some domestic investors sold their foreign assets (at favorable exchange rates) and repatriated the proceeds. In the process, they helped stabilize their countries' financial accounts.

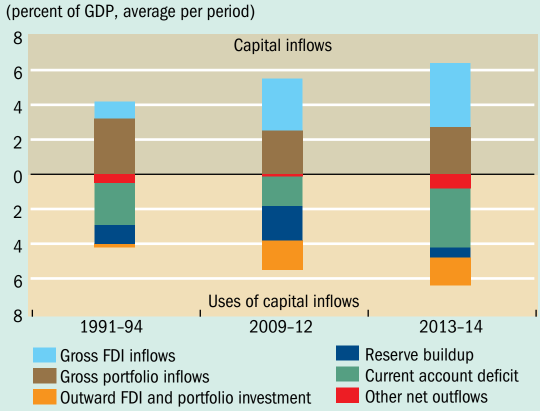
Latin American central banks have worked hard to establish more credible monetary policy regimes.

Chart 3

Using the cash

Recent capital flows to Latin America included a larger share of more stable foreign direct investment. And until 2013 countries used less of the inflows to cover current account deficits.

(percent of GDP, average per period)



Sources: IMF, *Balance of Payments Statistics Yearbook*; and IMF staff calculations.
Note: The countries are Brazil, Chile, Colombia, Mexico, Peru, and Uruguay. The current account balance measures a country's net trade (exports minus imports, both goods and services), net earnings, and net transfer payments. Other net outflows include the balance on other investments, derivatives, the capital account balance, IMF financing, and errors and omissions. FDI = foreign direct investment.

These facts may be comforting, but the concern is that trends worsened during 2013 and 2014. Portfolio investment has edged up and current account deficits have increased, while the buildup of reserves has slowed. Consequently, vulnerability to outflows may have grown.

Fundamentals matter

What can policymakers do to mitigate the risks? It is important to recognize that in countries with open capital markets (in which investors may move funds in and out of a country with minimal restrictions) there is no absolute insurance against episodic large outflows. As seen at the height of the global financial crisis, there are times when foreign investors retrench almost indiscriminately. Most of the time, however, economic fundamentals do matter. Specifically, countries with solid fiscal and external balances, low inflation, sound banking systems, and more credible policy institutions tend to fare better when markets discriminate—as they ultimately did again, for instance, during the "taper tantrum" of mid-2013, when the U.S. Federal Reserve indicated it was considering phasing out its program of large-scale bond purchases (IMF, 2014b). Investors fretted that an end to the program would raise U.S. interest rates and make emerging market investments less attractive.

Dealing with episodic outflow pressures, in turn, is easier when flexible exchange rates help with the adjustment. This requires domestic balance sheets to be robust enough to withstand a depreciation of the currency. Accordingly, policymakers should stay focused on preventing excessive buildup of open currency positions in private companies. Even then, adequate official reserves will be important to allow the authorities to intervene occasionally to stabilize their currency when trading conditions turn disorderly.

In the words of noted U.S. investor Warren Buffett, "Only when the tide goes out, do you discover who's been swimming naked." With sound macroeconomic policies and a vigilant eye on balance sheet risks, Latin American policymakers should be able to avoid overly awkward moments. ■

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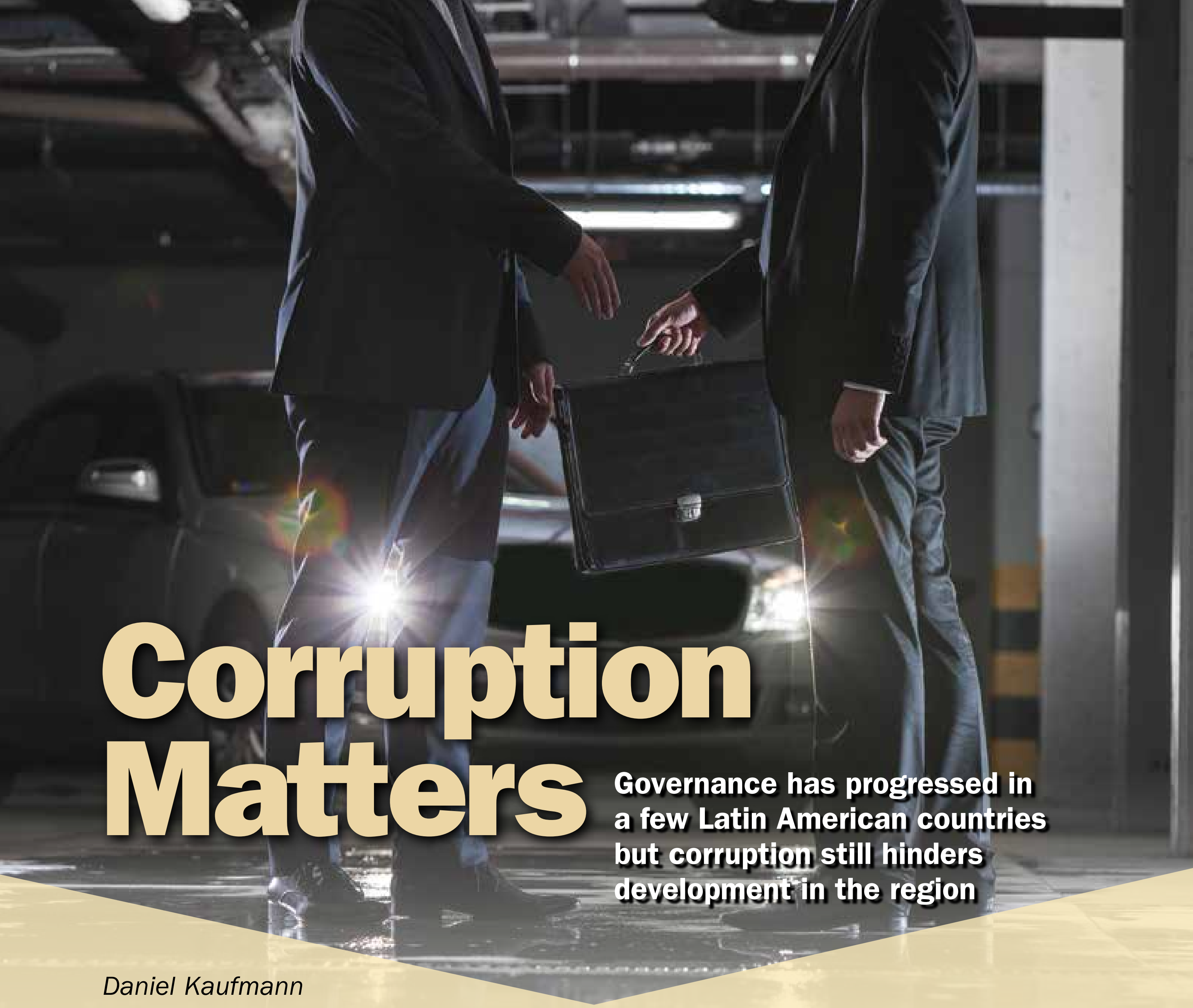


Corruption Matters

Governance has progressed in a few Latin American countries but corruption still hinders development in the region

Daniel Kaufmann

HUNDREDS of millions of soccer fans around the world are following the corruption scandal in the Fédération Internationale de Football Association (FIFA, the sport's world governing body). The U.S., Swiss, Brazilian, Colombian, and Costa Rican governments, among others, are investigating, and executives and officials from regional and national organizations and companies throughout the Americas and beyond have been implicated. Charges include allegations of bribery and collusion in lucrative contract awards and selection of World Cup hosts.

Every scandal and organization is different. Yet this case has characteristics, such as corruption among opaque networks of colluding officials and executives of transnational and national organizations, that are found worldwide. And the FIFA scandal suggests that, even if it takes a long time, there can be eventual accountability, as some judicial actions show.

The ongoing "car wash" case involving Brazil's national oil company, Petrobras, is also relevant: inflated contracts with Petrobras in exchange for kickbacks to former executives and illegal party contributions by powerful construction companies have led to indictments and sentencing by Brazil's judiciary. Allegations of bribery to secure contracts from companies in Italy, Korea, and Sweden have also surfaced. Other countries in the region are experiencing their own high-level scandals, including Argentina, Chile, Guatemala, and Mexico. Some are reacting.

Beyond particular scandals, and the varying responses, the challenge of corruption is vast. Estimates of bribery around the world hover around $1 trillion, and cumulative illicit financial flows from Latin American countries over the past decade are estimated to be about the same.

Defining and measuring

As part of a research project I initiated in the late 1990s with Aart Kraay at the World Bank, we defined governance as the traditions and institutions that determine how authority is exercised (see "Governance Matters: From Measurement to Action" in the June 2000 *F&D*). These include (1) how governments are selected, held accountable, monitored, and replaced; (2) governments' ability to manage resources efficiently and formulate, implement, and enforce sound policies and regulations; and (3) respect for the institutions that govern economic and social interactions.

For each of these three areas we constructed two empirical measures, for a total of six Worldwide Governance Indicators (WGIs), using data from dozens of organizations. Every year, we assess more than 200 countries on voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Corruption is *one* among several measures of broader governance because it stems from weaknesses in other governance dimensions.

Traditionally corruption is defined in terms of individual public officials who abuse public office for private gain. But corruption has a wider reach. It is a costly symptom of institutional failure, often involving a network of politicians, organizations, companies, and private individuals colluding to benefit from access to power, public resources, and policymaking at the expense of the public good.

Systemic political corruption, particularly associated with campaign finance and related "elite (or state) capture"—undue influence on laws, regulations, and policies by powerful corporate interests—plagues many industrialized and middle-income (and democratic) countries around the world, including in North, Central, and South America. In this context of state capture and "legal corruption" it is pertinent to consider an alternative view of corruption—the "privatization of public policy."

Mixed performance

Latin America's performance on governance over the past 15 years has been mixed. On the positive side, it has escaped much of the major strife and terrorism afflicting many countries in other regions. Democracy continues to develop, despite a few setbacks such as in Honduras and Venezuela. And in a number of countries, including Chile, Colombia, Mexico, and Peru, there has been progress on key aspects of economic governance, particularly in terms of improved macroeconomic management, taming the inflation ghosts of the past, paving the way toward fiscal consolidation, and exhibiting more transparency in budgets and procurement—abetted by effective ministries of finance and central banks.

But in many countries this progress in macroeconomic policies has not been complemented by longer-term governance, particularly political and institutional, reforms. WGI evidence suggests that *on average*, government effectiveness, control of corruption, and voice and accountability stagnated in the region, and overall regulatory quality and rule of law deteriorated.

At the end of 2013, Latin America's governance quality trailed that of other predominantly middle-income regions, such as central and eastern Europe, which progressed during the transition from central planning to market based and accession to the European Union. Similarly, except in voice and accountability (a relative strength of Latin America), east Asia, with its focus on a long-term strategy and independent merit-based bureaucracies, surpassed Latin America on many governance dimensions, including government effectiveness, rule of law, and corruption control (see Chart 1). Latin America's average score is below the world median in all governance indicators except voice and accountability, which barely tops the median. It rates particularly poorly on (implementation of) rule of law. And on personal security and common crime, the region is at the very bottom.

Regional averages hide much variation across countries. Chile, Costa Rica, and Uruguay, for example, score relatively high in governance, unlike most other countries, which are below the world median, and some, such as Venezuela, that rate very poorly. Trends also vary: some countries—such as Uruguay, with an increasingly open political system, law-abiding population, and low tolerance for corruption, and Paraguay, which started from a very low base—have improved on corruption control over time, while Venezuela experienced a marked deterioration.

In an effort to reduce petty corruption associated with excessive bureaucracy, a number of countries, such as Colombia, Mexico, and Costa Rica, have cut red tape, but many others are lagging. More broadly, in terms of global competitiveness, as measured by the World Economic Forum, only 7 of 18 Latin American countries rank in the top half of their index covering 144 countries. Only Chile—ranked 33rd and dropping—and Panama (48th) make it to the top 50. The main factor lowering the region's competitiveness is its subpar institutional quality.

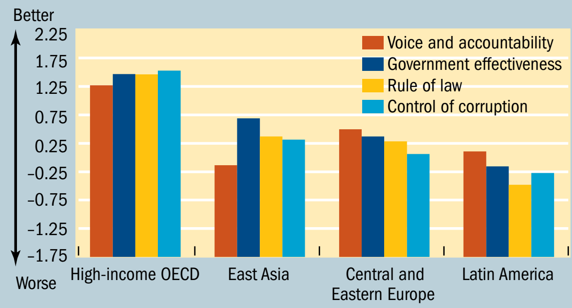
Several countries in the region have depended highly on their primary commodities, notably natural resources such as oil and minerals. With some exceptions, such as Chile and to an extent Colombia and Brazil, on average countries rich in extractives have worse governance and corruption control than the rest of the region. Evidence from all regions, including Latin America, suggests that resource-rich countries generally did not seize the opportunity for governance reform during the commodity supercycle of the past decade. The data suggest that in many countries, including in Latin

Chart 1

Mixed performance

Latin America's governance indicators are below those of other regions in all but voice and accountability.

(worldwide governance indicator score, end-2013)



Sources: Worldwide Governance Indicators data from www.www.govindicators.org; and author's calculations.

Note: Theoretical range of indicators is from –2.5 (worst) to 2.5 (best); standard deviation units. OECD scores exclude countries from central and eastern Europe.

America, voice and accountability deteriorated (where constraints on civil society worsened during the period, particularly in some oil-rich countries), as did corruption control and, except for example in Colombia and Brazil, rule of law (see Chart 2).

Governance matters

Research based on the WGI data shows how much governance matters for development. On average, we found a 300 percent *long-run* development dividend from good governance: an improvement in governance, for example, from the low corruption control (or rule of law) of Venezuela to the level in Argentina, Mexico, or Peru or from the level of any of these three countries to the higher levels of Costa Rica was *causally* linked in the long term to a threefold rise in per capita income, one-third less infant mortality, and significantly higher literacy rates. And there is no evidence that resource-rich countries' additional income and potential flexibility from commodity windfalls can compensate for shortfalls in governance. The data suggest that the development dividend of good governance is at least as high for resource-rich economies as for other countries. In fact, there is recent research evidence that poor governance hinders investment in oil exploration.

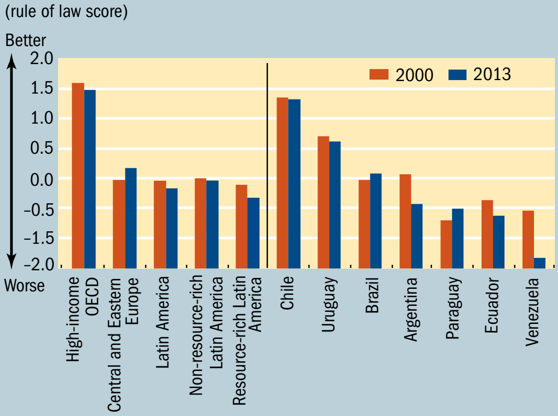
Beyond the effect on incomes, according to many other researchers (including the IMF's Gupta and others, Mauro, and Tanzi) corruption undermines outcomes in education, health, public investment, and income equality. It thwarts development, including by entrenching powerful groups and weakening the tax base, undermining public finances (as in Greece), and misallocating talent (away from productive activities toward profiteering from corruption) and public investment (toward expensive capital-intensive projects and away from education and health). And corruption is a significant tax on investors.

Chart 2

Rule of law

Some countries in Latin America exhibit satisfactory rule of law scores but many, including resource-rich ones, rate poorly and have not improved.

(rule of law score)



Sources: Worldwide Governance Indicators data from www.www.govindicators.org; and author's calculations.
Note: Score can range from –2.5 (worst) to 2.5 (best); standard deviation units.

This is more than academic. Despite progress in some countries, Latin America's growth has historically been below potential (and far below that of east Asia) and is slowing markedly, as is foreign investment. More than a third of people still live on less than $5 a day in a region rich in natural resources. Income inequality is among the highest anywhere (see "Most Unequal on Earth" in this issue of *F&D*), and education and innovation trail peers in the rest of the world.

Addressing corruption

Attempts to fight corruption have never succeeded when they are narrowly focused on traditional initiatives such as yet another unenforced anticorruption law or one more anticorruption campaign or agency. It requires an integrated governance approach that alters incentives and addresses corruption systematically, tackling capture and corrupt networks. Such an approach must prominently feature a stronger judiciary, along with political funding reform, meritocratic systems, and transparency and accountability. It must involve all branches of government as well as civil society, the media, and the private sector.

Political reforms are obviously a priority, including the democratization and modernization of political parties and an open and meritocratic system of party leader selection. Many countries in the region have adopted regulations on political financing, but these suffer from loopholes and tend to be ill enforced (reflecting an all-too-common gap between law and practice) because of weak monitoring and enforcement as well as a lack of transparency. These need to be addressed; further, political reform must include an enforced ban on corporate contributions, caps on individual funding and campaign expenditures, full disclosure of campaign contributions and spending, and stronger election monitoring (as Mexico has done).

Given how difficult it is for politicians to reform their own political system (potently visible in the United States as well), the focus on rule of law reforms is even more central to address corruption, particularly in a region where impunity prevails in many countries. The police and the judiciary are weak in most countries and are often subject to political and corporate influence, patronage, and corruption, even infiltration by organized crime in some. Brazil and Chile have shown that strengthening the judiciary is possible, yet a meritocratic—and thus rejuvenated and depoliticized—cadre of well-paid judges remains a challenge in many other countries, as does reforming the police force. Whistle-blowers must be protected and given monetary incentives to come forward.

The high-productivity and competitive segment of the private sector is painfully aware of how much it is undermined by companies that engage in corruption or exercise undue influence. Surveys of firms point to the extent of bribery in procurement and the judiciary in the region and to weaknesses in anticorruption efforts. Private sector leaders can be an important ally in promoting good governance and fighting corruption and elite capture, and they can support tougher antibribery enforcement and implement policies concerning conflict of interest and ”revolving-door” behavior between the public and private sector.

Multinational corporations from high-income countries and China also have a major responsibility. For instance, complemented by enforcement from their host country regulatory agencies, U.S. and European oil companies should fully embrace—rather than continue to resist—implementation of the section of the U.S. Dodd-Frank legislation that mandates companies in the extractives industries to disclose detailed payments to foreign governments. Further support from the governments of many high-income countries is also needed: they must fully expose and do away with safe havens and mandate disclosure of companies' beneficial owners as well as tightening enforcement of the Organisation for Economic Co-operation and Development's foreign bribery legislation.

Increased *transparency* is broadening the scope for more open governments (including, at the global level, via the Open Government Partnership, OGP). In Latin America, there has been progress on economic and financial transparency, but political transparency has a long way to go to address state capture and conflict of interest. National and subnational public officials, politicians, and judges should be required to fully disclose in timely and accessible fashion their business interests, assets, campaign funding sources, deliberation on draft laws, and voting records. Full transparency is also needed to tackle corruption in procurement, encompassing all sectors, state enterprises, and municipalities, and subject to civil society oversight. Governments should publicly list bidders that collude or bribe, barring them from government contracts—as Chile, Colombia, and Brazil, for example, now do.

Such transparency reforms, if combined with innovations brought about by the open data movement and with powerful new diagnostic tools on governance, can help rigorously analyze governance vulnerabilities and expose corruption and collusion. To help translate this invaluable information into accountability and reform, civil society (including academia and think tanks) should be further engaged and empowered. Crucially, the media should play a more central role in investigating and exposing capture and corruption, but in many countries that will mean prying open the media's highly concentrated ownership structure.

Rich in reform opportunity

The basic governance reform pillars mentioned above are at least as relevant in resource-rich countries, but complementary measures are often also needed in extractive industries. Natural resource governance benefited from some notable initiatives during the commodity booms of the past decade. Key international financial institutions and multilateral development banks, as well as nongovernmental organizations got involved, and the Extractive Industries Transparency Initiative (EITI)—which now includes 48 countries—was launched. New approaches and tools helped with country assessment and strategy development; for example, the Natural Resource Charter, with its emphasis on policy formulation throughout the decision chain. But effective implementation is needed. And technocratic economic policy and disclosure initiatives must be complemented by enhanced accountability and rule of law.

Transparency reform is essential: countries should join the EITI, adopt its global standards, and tackle subnational, social, and environmental issues, as Colombia is starting to do. As oil prices fall, there is an opportunity for specific fiscal reforms, including reducing energy subsidies (as in Ecuador and Mexico), strengthening tax compliance by the powerful and broadening the overall tax base (moving away from excessive reliance on extractives), adopting well-governed sovereign wealth funds (as in Chile), and enhancing the effectiveness of revenue sharing and public expenditures at the subnational level, where waste and corruption often prevail.

Latin Americans' previous high tolerance for corruption and impunity is declining.

Further, as is beginning in Mexico and Brazil, resource-rich countries should revamp their national oil companies, submit them to market rigor, reduce political interference and institute systems for merit-based appointments, and enforce effective oversight, disclosure, and corporate integrity. Stronger and meritocractic agencies in extractives and related sectors are also essential, as is attention to social and environmental challenges (such as those faced by Colombia and Peru). And greater transparency in the legislatures of many countries—including Bolivia, Chile, Ecuador, Peru, and Venezuela—is also needed.

Overall, Latin America exhibits a major governance deficit. Unless it improves, sustained and shared growth is in jeopardy, the large middle class is under threat, and gross inequalities are unlikely to be addressed. Yet there is hope and opportunity. Latin Americans' previous high tolerance for corruption and impunity is declining. Civil society is demanding change, and some countries have embarked on reform, as in Brazil and Chile. After all, the governance strength of a country can be inferred not from the unrealistic absence of any corruption but from the resolve and quality of its institutional response. The change in public sentiment, coupled with lower commodity prices and the socioeconomic and fiscal strains brought about by slower growth throughout the region and in China, suggests that the time for governance reform is now. ■

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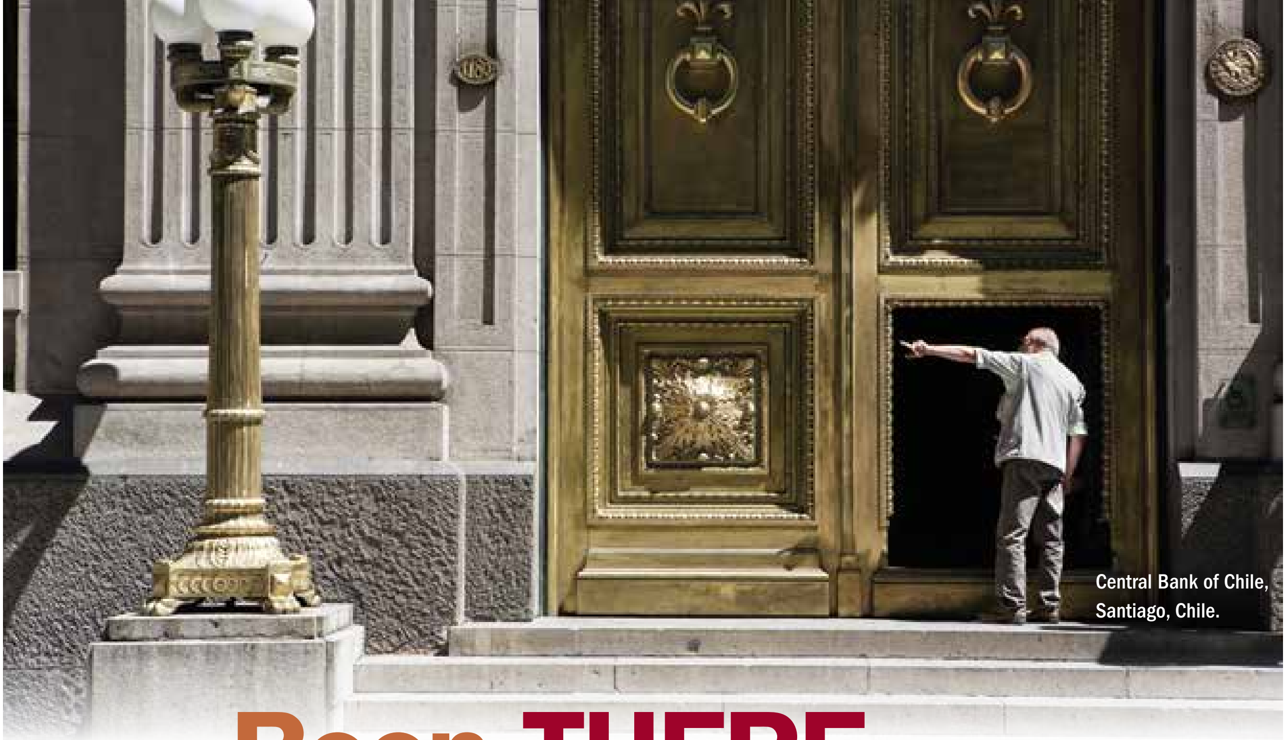


Central Bank of Chile, Santiago, Chile.

Been THERE, Done THAT

Luis I. Jácome

Tasking central banks with mandates beyond inflation control recalls bad past experiences in Latin America. Will things be different?

THE severity of the global financial crisis upset a number of economic verities, including the nearly universal consensus that the primary responsibility of central banks is controlling inflation.

Several critics have blamed central banks for failing to act to prevent the recent global financial crisis, in part because their narrow mandate gave them limited duties for preserving financial stability. In turn, central bank actions to prevent a protracted recession following the financial crisis have raised questions about whether central banks should be more concerned about growth and employment—not only during crises but under normal circumstances too.

The current environment of low growth with little threat of inflation increases the likelihood that central banks will be charged with additional tasks to enhance economic growth and employment. And potential bubbles give impetus to the notion that central banks have a role to play in preventing another financial crisis. In fact, some central banks have already undertaken so-called macroprudential policies to foster the overall stability of the financial system, not just that of individual financial institutions.

While this discussion is going on in advanced economies, it inevitably will spread to Latin America. Policy debates nowadays are global. Assigning central banks the responsibility for preventing banking crises is likely to gain traction in a region with a history of chronic financial instability, while asking central banks to contribute to economic growth and employment may also be appealing because growth is expected to remain low—as in the rest of the world.

However, assigning Latin American central banks multiple responsibilities is akin to going back to the future. Many central banks in Latin America once had several mandates, including preserving the stability of banks and fostering economic activity and employment—often with unhappy results. History, then, can provide a useful perspective on how to shape future central bank policies in Latin America. After all, as the well-known U.S. novelist William Faulkner once said, “The past is never dead. It’s not even past.”

A varied past

The history of Latin American central banks can be divided into three main periods: the early years that began in the 1920s, the developmental phase that started after World War II, and the golden years since the 1990s (Jácome, 2015). In each of these periods, central banks had alternative mandates and policy frameworks that rendered different inflation trends. The Great Depression in the 1930s and the collapse of the Bretton Woods system in the early 1970s each marked the beginning of a new era of central banking in the region. The global financial crisis and the Great Recession seem to be playing a similar role today.

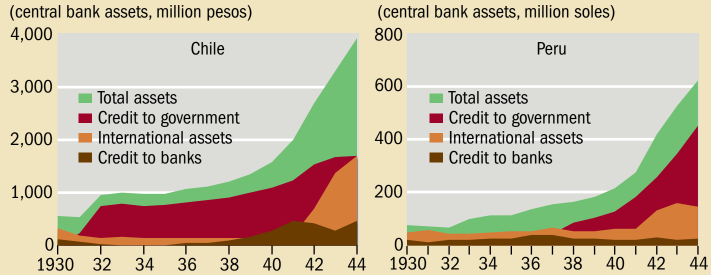
The first central banks were established in Latin America when the gold standard ruled the international monetary system. They included the Reserve Bank of Peru (1922) and the Bank of the Republic of Colombia (1923). Chile and Mexico established central banks in 1925, followed by Guatemala, Ecuador, and Bolivia in 1926, 1927, and 1929, respectively. Central banks were given three key objectives: maintaining monetary stability, financing the government on a limited basis, and helping preserve bank stability.

Under the gold standard, central banks were committed to preserving the convertibility of currencies at a fixed exchange rate while allowing capital to flow freely in and out of their economies (an open capital account). Central banks could issue banknotes only if they were backed with international reserves—mainly gold and foreign currency convertible into gold.

By the late 1920s, the effects of the Great Depression were being felt in Latin America. As the advanced economies fell into recession, the demand for commodities declined. So did export prices for the largely commodity-producing Latin American economies, which in turn fell into depression. The situation was compounded because capital fled the region to take advantage of higher real interest rates in the United States.

Chart 1
Credit climb

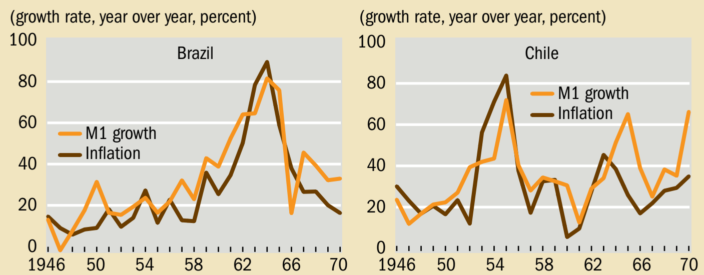
During and after the Great Depression central banks in such countries as Chile and Peru substantially expanded their financing of government expenditures.



Sources: Central Bank of Chile and Reserve Central Bank of Peru, annual reports.

Chart 2
Up, up, and away

After World War II loose monetary policies aimed at fostering development led to a sharp increase in inflation in such countries as Brazil and Chile.



Source: Jácome (2015).
Note: M1 = cash in circulation and checking accounts.

Preserving the gold standard during the Great Depression became impossible and Latin America abandoned it. Central banks no longer had to ensure the convertibility of domestic currencies, but maintained fixed exchange rates with the support of capital controls to limit capital outflows. A transition period of central banking started as monetary policy became expansionary to provide large-scale credit to governments to help restore economic activity. Central bank balance sheets expanded rapidly in such countries as Chile and particularly Peru, where credit to the government increased more than threefold between 1933 and 1938, and rose another 300 percent in 1944 (see Chart 1). In Mexico credit to the government represented close to 45 percent of the Bank of Mexico's total assets in 1940.

Addicted to central bank financing

While it was initially necessary to expand central bank balance sheets to bring the Latin American economies back from the brink of collapse during the Great Depression, governments became addicted to central bank financing of their spending. Eventually, the monetary expansion entailed in financing government outlays sowed the seeds of high inflation in Latin America.

Latin America endorsed the Bretton Woods system, established in 1945, in which countries committed to maintain a fixed—although adjustable—exchange rate with the support of an enhanced array of capital controls. At the same time, the central banks' areas of responsibility were drastically changed as governments started to play a decisive role in the formulation of monetary policy. Central bank mandates multiplied. The overarching policy mandates became regulating money and fostering employment in Argentina and promoting the orderly development of the economy in Chile, Colombia, and Peru. The Bank of Mexico was required to formulate monetary, credit, and exchange rate policies with three objectives: promoting the stability of the purchasing power of money, financial system development, and sound economic growth. In practice, central banks turned into development banks—and financed agriculture, industry, and housing, as well as the government deficit. The ultimate result was increasing inflation.

Central bank financing of economic development proved inconsistent with maintaining a fixed exchange rate. Lax monetary policies boosted aggregate demand, but also resulted in current account deficits that eroded international reserves, which led to currency crises and ultimately to a rise in inflation, as illustrated by Brazil and Chile (see Chart 2).

After the Bretton Woods system broke down in the early 1970s and exchange rates became increasingly flexible worldwide, macroeconomic instability worsened in Latin America along with political turbulence. A new transition period for central banking had started as monetary policy simply adjusted to soaring inflation, accommodating rising prices rather than resisting them by restricting the amount of money available. But not long after the Bretton Woods breakdown, a steep rise in oil prices changed things dramatically.

The amount of cash sloshing around in the international financial system rose sharply as oil-exporting countries invested their newfound wealth. Many of these so-called petrodollars found their way to Latin America. These capital inflows provided a large amount of external financing to the region—financing that was largely in the form of dollar-denominated bank loans. But this source of financing did not last long. By the early 1980s, capital inflows turned to outflows because monetary policy tightened (and interest rates rose) in the advanced economies—at a time when most Latin American countries had accumulated sizable budget deficits, current account imbalances, and foreign debt. This situation triggered large devaluations, which made the dollar-denominated liabilities of firms, banks, and the government difficult to repay and pushed inflation through the roof. During this decade monetary policy accommodated the soaring inflation.

A policy turn

The 1990s in Latin America marked a turning point for monetary policy. After more than 50 years of burdening central banks with multiple objectives, governments granted them political and operational independence to permit the institutions to focus primarily—and sometimes exclusively—on containing inflation. One by one, countries accepted that the main contribution of monetary policy to economic growth was to achieve and preserve low and stable inflation because it reduced uncertainty in decision making by consumers and investors.

Chile started the trend in 1989, and in the following decade most Latin American countries approved new laws in which central bank independence was the backbone of reforms to avoid the inflationary bias from political influences on monetary policy. Breaking with the past, government financing—the main historical source of inflation—was restricted and even banned. Countries also introduced, in most cases, exchange rate flexibility to allow the exchange rate to play the role of external shock absorber. In addition, starting in the last half of the 1980s, many countries began reforms to the structures of their economies to make them more market oriented. Those structural changes—such as trade reform, which opened the economies to external competition—also helped reduce inflation.

As inflation declined to single digits in the late 1990s and early 2000s, Brazil, Chile, Colombia, Mexico, and Peru made inflation targeting their policy framework—conducting monetary policy usually by adjusting their short-term interest rates to signal the stance of monetary policy and drive inflation expectations to the preannounced target for inflation. The credibility of the inflation-targeting regimes increased over time as central banks fulfilled their promises. Building credibility reinforced the effectiveness of monetary policy, as market participants kept inflation expectations aligned with central banks' targets.

An expanded mandate for central banks might be well received in Latin America.

Institutional reforms of central banks were instrumental in making the past 15 years the longest period of price stability in Latin America since 1950. This achievement was built on four main pillars: the political and operational independence of central banks, central bank accountability, flexible exchange rates and open capital accounts, and disciplined fiscal policy.

Global financial crisis

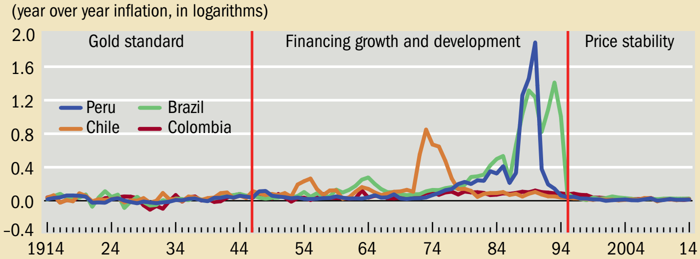
Will the Great Recession feed a Latin American debate about a new era of central banking as it has in advanced economies? An expanded mandate for central banks might be well received in Latin America. Being responsible for financial stability may be well regarded as a natural complement to the existing central bank role of lender of last resort to prevent systemic financial crises like those in the past. The additional mandate on financial stability would likely require that Latin American central banks become responsible for macroprudential policy. This is a plausible institutional reform because it would allow countries to benefit from central banks' expertise in assessing macroeconomic and finan-

Chart 3

Rocky road

Latin America grappled with sky-high inflation for years until it began to subside in 1994 and came under control in 2000.

(year over year inflation, in logarithms)



Source: Jácome (2015).

Note: Latin American monetary history can be divided into three phases over the past century. Prior to World War II, most of which was dominated by the gold standard, inflation was low but volatile. In the 50 years following World War II, when many central banks were tapped to finance government spending and development projects, inflation eventually soared. After 1995, when controlling inflation became the goal of most central banks, price increases subsided. Using a logarithmic scale compresses the data range while portraying the scope of the data. To account for any negative inflation years, the year-to-year growth is calculated as 1 + inflation rate in each year. The peak annual rate in the chart is 7,462 percent.

cial risks and put difficult macroprudential decisions in the hands of a politically independent institution. However, there are also potential costs. In particular, central banks could be considered excessively powerful institutions governed by unelected authorities, which could heighten the so-called democratic deficit argument used in the past against central bank independence. Moreover, the independence of central banks might also come under scrutiny if another financial crisis erupted despite the new mandate. Central bank accountability may also be weakened because the objective of financial stability is difficult to quantify. The challenge for Latin American countries is to design institutions and policy frameworks for preserving financial stability that do not undermine monetary policy credibility (see Jácome and Mancini-Griffoli, 2014).

The case for making central banks in Latin America responsible for economic growth and employment is less clear cut. Central banks cannot consistently influence economic growth and employment, given that their economic activity depends highly on external factors (such as demand for commodities) in the short run and hinges on structural changes to enhance productivity and foster employment in the long run. Therefore, adding growth and employment to central banks' area of responsibility may put monetary policy effectiveness at risk and would make accountability a cumbersome process, especially if inflation and growth become conflicting objectives.

As an alternative, some Latin American central banks have already assigned more weight to output when they make their policy calculations, without any explicit broadening of their mandate. They aim at smoothing short-term cyclical fluctuations to help employment and protect financial stability.

It took about 80 years for Latin American central banks to achieve low and stable inflation, which improved their countries' welfare. This was a long and rocky journey in which central banks tried different mandates and policies while many countries experienced long periods of high inflation (see Chart 3). Future developments will not necessarily entail a return to elevated inflation or even hyperinflation, but there is a risk that giving central banks responsibilities they cannot meet effectively may undermine their hard-won political independence and credibility. The result would be to achieve price stability—at the cost of higher interest rates and lower economic growth. ■

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Doing It RIGHT

Augusto de la Torre, Daniel Lederman, and Samuel Pienknagura

If Latin America is to rely on trade to enhance economic growth, it must find the correct approach

AS the recent period of relatively high growth fades into memory, Latin America and the Caribbean is haunted again by the region's long history of failure to approach the living standards of high-income countries.

Indeed, income per capita in the region (hereafter called Latin America for sake of simplicity) has hovered at about 30 percent of that of the United States for more than a century. It is not surprising, therefore, that the challenge of boosting growth—with social equity—has moved to center stage in the region's policy discussions. It has led policymakers to pay increasing attention to international trade as a potentially powerful source of growth and, in particular, to the role that regional trade integration can play. For example, an objective of the Pacific Alliance—the 2012 integration agreement between Chile, Colombia, Mexico, and Peru—was "driving further growth, development and competitiveness of the economies of its members."

In many ways, that push toward regional integration has been influenced by the success story of the east Asia and Pacific region (hereafter east Asia), where there is a close and positive association between rising intraregional trade, growing exports to the rest of the world, and convergence toward the living standards of high-income countries.

But we have found that regional integration by itself is not the crucial ingredient in the east Asian growth potion. Instead it is the way these countries go about it. The link between intraregional trade and growth observed in east Asia reflects two important trade patterns: a high incidence of intra-industry trade, that is, trade flows within narrowly defined sectors or industries, such as electronics and heavy machinery; and a high participation in global value chains, in which trade is associated with multicountry production operations. For example, an auto company may manufacture transmissions in one country, chassis in another, and export these to another country where they are assembled into a vehicle.

We found that once endemic structural factors—such as geography, economic size, and natural resource abundance—are taken

Employee working on mobile phone assembly line in Manaus free-trade zone, Amazonas, Brazil.

into account, Latin America fares relatively well compared with east Asia merely in terms of intraregional trade volume and connectivity among regional trade partners. Where Latin America differs markedly from east Asia is in those key features of trade—intra-industry trade and participation in global value chains. This suggests that policies aimed at simply boosting intraregional trade connections and volumes in Latin America are unlikely to do much to boost growth. Latin American authorities should design policies that favor a more vigorous participation in intra-industry trade and in global value chains.

East Asia's integration

Latin America's attention to the regional integration experience of east Asia is not surprising. Since the 1970s, the share of intraregional exports within the latter region has increased from about 35 to 55 percent, and total exports have skyrocketed. Alongside these achievements, east Asian living standards moved closer to those in the United States, suggesting that intraregional trade among Asian countries played an important role in their convergence (see Chart 1).

In contrast, intraregional exports in Latin America have stagnated at 20 percent since the 1970s, and the region has experienced relatively low growth in total exports, while economic convergence has remained elusive.

Yet, when trade flow data are broken down, Latin American countries are not as unconnected to their regional partners as the overall numbers seem to indicate.

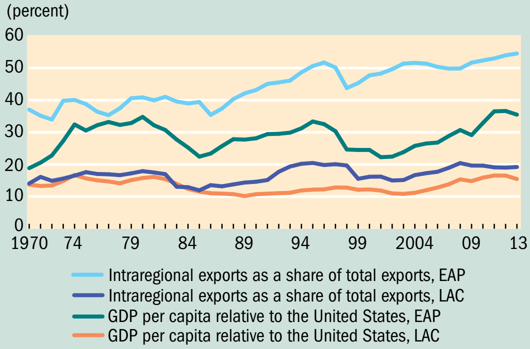
- In 2013, the average Latin American country had an active export relationship with close to 88 percent of possible regional partners, compared with 83 percent in east Asia.
- Latin American countries are no strangers to formal trade agreements. Between the early 1960s and recently, Latin American countries have experimented with trade agreements of varying nature, depth, and size. Notable examples include MERCOSUR, comprising countries in the southern cone of South America; the Andean Community; CAFTA, which includes Central American and Caribbean countries; and, recently, the Pacific Alliance.
- Regional partners in Latin America have more similar export baskets than do regional partners elsewhere. This means that Latin American countries are naturally biased to trade more with partners outside the region.
- The relatively low intraregional trade within Latin America is partly a result of the region's geography and economic size. The distance between the median country pair exceeds that of any other region, and the economic size of the median country pair is lower than anywhere else but Africa. When geographic and size impediments to trade are factored in, the region's measured performance in intraregional trade relative to east Asia's improves substantially.

Another way to highlight the importance of geography and size on measures of intraregional trade for Latin America is to include exports to the United States, which is relatively close to many countries in Latin America. The share of the region's exports to the United States was about 40 percent in 2013, which implies that the share of intraregional trade is 60 percent.

Chart 1

Trade and income

Overall, east Asian nations trade with each other far more than do Latin American nations, and east Asian national incomes are closer to that of the United States.



Sources: United Nations, COMTRADE; and World Bank, World Development Indicators.

Note: LAC = Latin America and the Caribbean, which includes Argentina, The Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay, and Venezuela. EAP = east Asia and the Pacific, which includes Australia, Brunei Darussalam, Cambodia, China, Fiji, Hong Kong SAR, Indonesia, Japan, Korea, Lao P.D.R., Malaysia, Mongolia, Myanmar, New Zealand, Papua New Guinea, Philippines, Samoa, Singapore, Solomon Islands, Thailand, Tonga, Vanuatu, and Vietnam.

The same holds true for the Asia and Pacific region. If both Japan and China are included, the share of intraregional exports in total exports is about 55 percent. But if Japan is excluded, the share is about 40 percent. And if only China is excluded the share drops to about 25 percent.

Deterring growth

As we said, any trade-related factors behind Latin America's low growth do not seem to be related merely to connectivity and trade volumes with regional partners. Rather, the type of trade the countries conduct (or fail to conduct) with one another and with global partners may better explain the region's predicament. Moreover, the same factors that underpin the region's relatively low trade volumes may also shape how its international commerce is structured. That is, it is plausible that differences in distance and size among Latin American trading partners compared with those in east Asia explain differences in their trade structure.

Economists have shown that intra-industry trade and participation in global value chains can enhance the progrowth effects of trade by exerting competitive pressures on domestic producers and facilitating learning and the access to foreign technologies and know-how that foster innovation and productivity gains.

Trade openness can by itself deliver productivity gains, regardless of how a country's trade is structured. International trade shifts resources to sectors in which the local economy has a comparative advantage and also raises competitive pressures, pushing out unproductive local firms and encouraging the reallocation of capital and labor from those firms to more productive ones.

What makes intra-industry trade and insertion into global value chains different from broad trade openness, however, is their potential to generate greater learning and technological spillovers that enhance productivity. In the case of intra-industry trade, foreign competition pushes local producers, especially exporters, to upgrade the quality of their products or to produce different varieties of the product. But these improvements are not independent of technology—it is likely that upgrades by local exporters build on the foreign technologies to which they are exposed through trade.

Trade openness can by itself deliver productivity gains.

Exposure to foreign technologies and know-how is the main channel through which a country's growth and productivity are enhanced by participating in global value chains. Value chains are characterized not only by tight links between firms at different stages of the production process; their success also hinges on the quality of the products delivered by firms involved in the process and the efficiency with which these products are delivered across different stages of production. These traits facilitate quality enhancements and knowledge diffusion across firms inside the chain and can benefit other local firms that interact with firms in the value chain.

However, participation in value chains does not guarantee knowledge flows and exposure to foreign technologies. The learning potential and knowledge flows appear to be greatest in countries that join at intermediate stages of production, where interaction with suppliers and buyers is highest.

It is in intra-industry trade and participation in global value chains that economies in Latin America lag. Despite the region's good connections to regional and more distant trading partners, its degree of intra-industry trade, captured by an index ranging from zero to 1, was only about 0.25 in 2011 (de la Torre and others, 2015). This contrasts with 0.35 among east Asian and Pacific countries. Furthermore, although for the past two and a half decades Latin American countries have increased their participation in global value chains much faster than countries from other regions, they still are well behind east Asian countries. In east Asia nearly 50 percent of exports were part of value chains in 2011; in Latin America it was close to 40 percent.

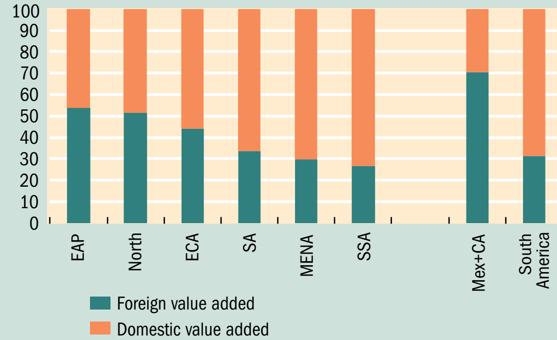
There are also important differences between Latin American countries and Asian countries in the way they participate in these production chains. Firms in Latin America normally are either in the early stages of production through the supply of raw materials (mainly South America) or in the final stages of production as assembly lines (Central America and Mexico). East Asian firms tend to participate in the intermediate stages of production—receiving inputs from abroad, transforming them, and shipping them to more advanced stages of production. They then maximize the potential for learning and knowledge transfers (see Chart 2).

Chart 2

In play

In multi-nation production processes, the value that countries in east Asia and the Pacific add to foreign products is about the same as the value they receive. Latin American countries mainly add value—at the beginning or end of the process.

(percent of total global value chain participation)



Source: de la Torre and others (2015).

Note: Participation in global value chains is proxied by the value a country adds to exports that are part of a multistage trade process. The green part of the bar represents the value the region adds to products, and the orange part measures the value added by other regions. Technological flows and learning are maximized when a country is in the middle of a value chain—when it adds about as much value to a product as do other countries in the process. EAP = east Asia and Pacific; ECA = Europe and central Asia; MENA = Middle East and North Africa; MEX+CA = Mexico and central America; North = member of the Group of 7 and other western European countries; SA = south Asia; SSA = sub-Saharan Africa.

Changing emphasis

When Latin American policymakers focus on regional integration, they must emphasize development of intra-industry trade and integration into global production networks.

Governments could try to induce such changes in trade patterns directly by, say, providing incentives to specific sectors. But, as a recent report by the Inter-American Development Bank (2014) argues, these types of interventions are only effective if policymakers know more than private sector firms. Instead, broad-based policies—such as those that improve the contractual environment for firms, encourage labor market flexibility, and enhance the quality of education and infrastructure—will attract new investment, raise skills, and lower trade costs. This can foster more dynamic and competitive firms that could in turn actively participate in global production networks. ■

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Yanquis in HAVANA

Tourists with traditional flower ladies in Old Havana, Cuba.

Nicole Laframboise

The thaw in relations between the United States and Cuba could lead to a big shake-up in Caribbean tourism

IT'S not clear how many Americans have dreamed of strolling through Havana as Ernest Hemingway once did, sipping Cuba libres or daiquiris and driving a vintage car to *Finca La Vigia*, Hemingway's home outside of town. But the world may be about to find out.

The rapprochement between the United States and Cuba could lead to the full removal of travel restrictions between the two countries, and—given the colorful, tumultuous history between them—liberalization could open a floodgate of visits from U.S. baby boomers, thirsty for a glimpse of the Havana so cherished by the Nobel Prize–winning U.S. author.

The impact of removing all barriers to U.S.–Cuba travel is uncertain, but it is the focus of much interest in the region. Tourism is the main driver of growth and employment in many of the island countries in the Caribbean, where Cuba is a giant, not only in land size but as a tourist destination too. After Cancún in Mexico and the Dominican Republic, Cuba is the third largest destination for tourists in the Caribbean. Cuba had more than 3 million visitors in 2014, according to the Caribbean Hotel and Tourism Association, a 5.3 percent increase over 2013. Most of them came from Canada, Europe, and South America.

El Floridita bar, a favorite of Ernest Hemingway's, Havana, Cuba.

Close to home

A major question is what will happen when the market with the greatest number of tourists in the region is opened to a large potential supplier of tourist attractions—and compared with most destinations, one that is a stone's throw from the United States.

The United States already does business with Cuba, in particular exporting foodstuffs and medical products for cash (since 2000). And after the United States eased the travel ban on its citizens traveling to Cuba (for specific purposes) in 2012, the number of U.S. tourists headed there rose by 33 percent almost immediately, to about 98,000. But that number probably pales in comparison with the number if travel restrictions were ended.

Can Cuba absorb a sudden surge in tourists? The country has a complex system of parallel currencies—the peso for Cubans, a convertible peso for tourists, and multiple other exchange rates. This alone renders international comparisons about things like market size or production capacity difficult. However, the Association for the Study of the Cuban Economy, based in the United States, estimates that capital formation has fallen sharply over the past two decades and economic growth has slowed in recent years. It seems likely that, in the short run at least, Cuba will not have the capacity to host many more tourists than it does now because it will take time to grow the number of hotel beds and supporting infrastructure.

There has been little empirical research on this topic, and most of what has been done focuses on the near term, which has tourism infrastructure constraints. During this period, lifting travel bans for U.S. citizens will give U.S. consumers a relatively cheaper beach travel option, creating a higher demand for tourism in Cuba that could raise prices there, all else equal. How this will play out depends on many factors, including what happens with the millions of tourists who now vacation in Cuba.

Economist Rafael Romeu, who has assessed the possible impact on the Caribbean of liberalization of U.S. travel to Cuba, says that current U.S. travel restrictions have effectively acted as trade protection for the rest of the Caribbean—particularly Puerto Rico and the U.S. Virgin Islands—because of their open borders with the mainland. Romeu, a former IMF economist, uses an economic model that captures the U.S.–Cuba restrictions and also controls for natural disasters and other factors. The so-called gravity model Romeu uses estimates the specific costs to U.S. tourists caused by the bilateral restriction in terms of nautical miles and finds that the total cost for Americans visiting Cuba is the equivalent of going to the South Pacific, or even Antarctica, for a holiday (see box). This suggests that distant tourist destinations may have received more U.S. visitors than they would have without U.S. restrictions on Cuban travel.

The costs of travel restrictions

Gravity trade theory accounts for the amount of trade or tourism between countries on the basis of the size of the country and its trade costs. Commonly the model uses the geographic distance between countries as a proxy for the costs of trade. Rafael Romeu models a counterfactual situation that isolates the effect of the bilateral tourism restrictions between the United States and Cuba, then controls for their removal. The model's estimations control for distance, language, income, trade agreements, and other things—like market concentration. Romeu estimates that the restrictions raise the cost of travel for a U.S. tourist beyond what someone from Asia would pay to go to Cuba. Removing the barrier would be equivalent to a sharp drop in the cost of travel between the United States and Cuba.

Not zero sum

Lifting restrictions would raise the purchasing power of U.S. consumers in the short term. In this sense, Romeu's original model found that opening Cuba to U.S. travelers would increase the total number of tourists visiting the Caribbean by between 4 and 10 percent (Romeu, 2008). So policymakers in other Caribbean islands need not despair. Growth in U.S. tourism to Cuba will not necessarily mean an equivalent reduction in visitors to other points in the Caribbean. In other words, it need not be a zero sum game. Moreover, there are a large number of potential new Caribbean tourists from places like Canada.

That does not mean that change would come without dislocation. It probably would involve redistribution—the so-called substitution effect. An influx of U.S. tourists with relatively higher purchasing power would quickly fill Cuba's hotels, outbidding and displacing traditional tourists. At least some of the sunseekers displaced from Cuba would likely go to other islands in the Caribbean, including those abandoned by the U.S. tourists. Which of those islands wins or loses is harder to parse.

Romeu predicts that destinations that are culturally different from the United States would fare better. In other words destinations where a share of visitors now come from non-U.S. markets—such as the Dominican Republic, Guadeloupe, and Barbados—would be better positioned to pick up tourists displaced by Americans going to Cuba. Places that today are heavily dependent on the United States—such as the U.S. Virgin Islands, Aruba, The Bahamas, and Cancún—could

Tourists photographing classic cars, Havana, Cuba.

lose U.S. tourists to Cuba. The net effect would depend also on how many U.S. visitors who were not previously Caribbean vacationers Cuba would attract.

IMF researchers (Laframboise and others, 2014) confirmed findings in the literature that tourism arrivals and expenditures are sensitive to price and income effects, and are particularly sensitive to unemployment in the markets that supply the tourists. They also found that arrivals in higher-end destinations were not sensitive to price factors (including the impact of the exchange rate). These sensitivities—elasticities in economist-speak—could also play a role in determining where in the Caribbean displaced Cuban travelers end up.

The charm of a midcentury Cuba won't last long.

Timing is important

Romeu recommends that Caribbean destinations move to expand their customer base before any opening between Cuba and the United States. Timing is important because capturing tourists dislocated by the influx of Americans into Cuba could offset some losses and secure a share of the growing tourism pie. Romeu also recommends other steps, such as specializing in and delivering customized services to clients, based on noneconomic features like culture and language; increasing airline competition; and guarding against increasing costs, particularly tourist visa requirements aimed at U.S. visitors.

Indeed, consideration of the importance of price to most travelers points to an ongoing need to contain costs, and for less-cost-sensitive high-end destinations to ensure that product and service quality remain consistent with their premium brand.

Because Cuba still appears amazingly as it was in the 1950s, more Americans could soon see it just as the iconic, hard-drinking Hemingway did. This time-capsule effect could be a key drawing card for nostalgic retirees who want to hang out at the *El Floridita* bar, the birthplace of the daiquiri and Hemingway's favorite watering hole (where his alleged record of drinking 15 extra-cold sugarless daiquiris in one sitting took place). The opening of Cuba to U.S. travelers could bring a major upheaval in Caribbean tourism, but if countries prepare and invest, the gains from trade need not necessarily come at their neighbors' expense. However, time may be of the essence. The charm of a midcentury Cuba won't last long once this unique market expands and modernizes to accommodate the arrival of American tourists. ■

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What Is Direct Investment?

Investors often seek profits from a long-term stake in a foreign operation

Tadeusz Galeza and James Chan

FOREIGN investors can have myriad motivations for seeking to earn profits in another country. But they have fundamentally two core choices when deciding how to deploy their capital.

They can make a portfolio investment, buying stocks or bonds, say, often with the idea of making a short-term speculative financial gain without becoming actively engaged in the day-to-day running of the enterprise in which they invest.

Or they can choose the long-haul, hands-on approach—investing in an enterprise in another economy with the objective of gaining control or exerting significant influence over management of the firm (which usually involves a stake of at least 10 percent of a company's stock). In the most extreme case, investors may build new facilities from scratch, maintaining full control over operations.

It is the intent of lasting interest that is the crucial component of direct investment. A portfolio investor can sell a stock or bond quickly—whether to cement a gain or avoid a loss. Most corporations entering a foreign market through direct investment expect to substantially influence or control the management of the enterprise over the long haul.

Faces of investment

A number of factors influence a company's decision to engage in direct investment, including analysis of the trade costs with a foreign country. If these costs—including tariffs (taxes on imports), trade barriers such as quotas, and transportation—are higher than the cost, including the costs of production abroad, of establishing presence in the foreign country, the business will maximize its profits through direct investment.

Companies may invest with the idea of producing components that become part of a bigger product. An automaker may invest in a plant to build transmissions that are shipped to a final assembly plant in another country. This so-called *vertical direct investment* accounts for most of the investment by advanced economies in developing ones. The cost advantages associated with investing in a foreign country—and in many cases performing only a portion of the production process in that country—drive such investment. Abundant or unique natural resources or low labor costs influence the decision to move production overseas and import intermediate or final products from subsidiaries in host economies to the parent company's country (intrafirm trade).

A company may also invest in a foreign country by duplicating there its home country manufacturing processes. This may be done to supply goods or services to a foreign market. That's called *horizontal direct investment*. In countries with tariffs or other barriers to imports, a foreign firm may find that setting up local operations allows it to circumvent the barriers. Even though trade taxes have been falling over the years, such tariff jumping is still a common way to enter markets where the greatest benefit of direct investment is access to the local market. Another factor driving horizontal direct investment, specifically between advanced economies, is access to a pool of skilled employees and technology. In contrast to vertical direct investment, horizontal direct investment is likely to compete directly with local firms for local market share.

Of course investment need not be purely horizontal or vertical. A foreign subsidiary may provide goods to the parent company and receive services from the headquarters—a clear example of vertical direct investment. But the same subsidiary may also supply the local market, as part of the parent company's horizontal direct investment strategy.

Direct investment takes different shapes and forms. A company may enter a foreign market through so-called *greenfield direct investment*, in which the direct investor provides funds to build a new factory, distribution facility, or store, for example, to establish its presence in the host country.

But a company might also choose *brownfield direct investment.* Instead of establishing a new presence the company invests in or takes over an existing local company. Brownfield investment means acquiring existing facilities, suppliers, and operations—and often the brand itself.

Local effects

Countries may encourage inward direct investment to improve their finances. Firms that set up operations in host countries are subject to local tax laws and often significantly boost the host country's tax revenues. Direct investment can also help a country's balance of payments. Because portfolio investments can be volatile, a country's financial circumstances could worsen if investors suddenly withdrew their funds. Direct investment, on the other hand, is a more stable contributor to a country's financial structure. Direct investors do not wish to take actions to undermine the value or sustainability of their investments.

Other positive effects associated with inward direct investment include increased employment, improved productivity, technology and knowledge transfer, and overall economic growth. Increased competition from foreign firms, whether new or acquired, often forces competitors to increase their productivity so that they don't go out of business. Suppliers and service providers to the direct investment enterprise may also increase their productivity, often because the investor requires higher-volume or higher-quality orders. The increase in volume and variability of products and services in the economy leads to overall improvement in the market's quality and size.

Host countries also benefit from a transfer of knowledge and technology, which often stems from workforce turnover. Incoming firms frequently offer more training opportunities than local employers. This knowledge is later transferred to local companies when trained employees leave the foreign enterprise for local businesses. In addition, there may be some incidental spillover of knowledge through informal networks, when employees exchange ideas and opinions about their workplace practices.

But direct investment may not always be viewed positively from a host country perspective. Because productive companies engage in direct investment, the increased competition they provide may force the least productive local companies out of business. Opponents of direct investment argue that foreign, especially brownfield, investment is a simple ownership transfer that does not generate new jobs. Some critics, moreover, point to the risk of a sudden reversal of the direct investment and a fire sale of assets, drastically reducing their value and, in extreme cases, forcing facilities to close and companies to lay off workers. Direct investment is often restricted in certain companies and industries, such as those involving sensitive high-technology products and in defense-related companies.

Because direct investment depends on the host country's decision to attract and accommodate investments, foreign companies often maintain close relations with the local authorities. This entanglement of business and politics may have an adverse effect on the host country. Perhaps the most common argument against direct investment is the potential power and political influence of foreign investors. The leverage investors have over policymakers becomes troublesome when a foreign company gains significant control over a sector of the economy or becomes a critical, or even the largest, employer in the market.

Attracting direct investment

Despite the potential problems of unregulated direct investment, governments of both advanced and developing economies tend to actively seek foreign investors and the capital they bring.

Advanced economies attract direct investment because of their stable policies, pool of skilled workers, and sizable markets. Developing economies are more interested in greenfield investment, which creates new facilities and jobs. Governments often set up special economic zones, provide the property for construction of facilities, and offer generous tax incentives or subsidies to attract capital. These special economic zones, if properly designed, allow industries to concentrate in one geographic area, often placing suppliers close to buyers and providing the necessary infrastructure to meet investors' requirements.

Countries with a comparative advantage, such as favorable policies or a significant pool of skilled workers, frequently develop investment-promotion programs, which can include marketing campaigns, information offices, and even bilateral negotiations between governments and foreign firms. Unlike the tax and other fiscal incentives offered to foreign investors, information campaigns do not erode tax revenues from direct investment.

The overwhelming share of direct investment occurs among advanced economies.

According to the IMF (2014), 63 percent of global direct investment occurs between advanced economies and 20 percent is between advanced and emerging market economies (including low-income countries). Six percent is between emerging market economies, and 11 percent of total direct investment flows from emerging market to advanced economies.

That the overwhelming share of direct investment occurs among advanced economies may seem counterintuitive. But given the large size of these economies, it stands to reason that horizontal direct investment in which advanced economies access pools of skilled workers, advanced technology, and large markets in other advanced economies dominates global direct investment.

Data on direct investment can be hard to interpret because of investments in tax havens. The level of investment in these countries is large, but investors tend to have no physical presence there. Given the pass-through nature of these investments, the usual costs and benefits associated with direct investment, other than collection of fees and taxes, do not apply.

Foreign direct investors may, as their critics claim, buy out domestic assets, pushing local firms out of business or imposing their policies on governments. But the overall benefits to both host and investing economies from foreign direct investment significantly outweigh the costs. Capital inflows from foreign direct investors help finance a country's spending—on investment, for example—and increase tax revenue, create jobs, and produce other positive spillovers for the host economy. ■

Tadeusz Galeza and James Chan are in the Statistical Information Management Division of the IMF's Statistics Department.

Reference:

International Monetary Fund (IMF), 2014, Coordinated Direct Investment Survey *(Washington).*

Lost Workers

Job seekers in line to enter a job fair at the Jacob K. Javits Convention Center, New York, United States.

Ravi Balakrishnan, Mai Dao, Juan Solé, and Jeremy Zook

Reversing the decline in U.S. labor force participation is essential to boosting growth in the world's largest economy

IT is not supposed to be this way. As the U.S. economy recovers, hiring increases and people who had stopped looking for jobs when times were bleak should be inspired to look again. Instead, the proportion of the U.S. population 16 years and older with a job, or looking for one—the labor force participation rate—continues to fall. It went from about 66 percent at the start of the global financial crisis to 62.6 in June 2015 (see Chart 1), its lowest point since 1977.

What is more remarkable is that half of the gains in participation rates between 1960 and 2000—those driven by sweeping social changes such as the post–World War II baby boom and the entry of women into the workforce—have been reversed in the past seven years. The equivalent of 7.5 million workers has been lost from the U.S. labor force.

Critical for the U.S. economy

The future dynamics of the U.S. labor market matter for two crucial reasons. First, the size of the labor force will be central to determining the pace of U.S. economic growth over the next 5 to 10 years. And because the U.S. economy is the world's largest, its trajectory is crucial to global growth. Second, the extent to which the recent declines in participation rates are reversible will be a principal factor affecting future wage and price inflation and, as a result, the timing and pace at which the Federal Reserve, the U.S. central bank, raises interest rates. The level and direction of U.S. rates have broad effects on capital flows around the world—especially on movement in and out of emerging market economies.

The aggregate labor force participation rate had been declining since 2000, long before the onset of the Great Recession. The golden era for increasing labor force participation was 1960–90, when rates increased from 60 to 66 percent. This reflected the post–World War II baby boom generation reaching adulthood and women's increasing presence in the workforce. But this boost to the size of the labor force started to fade in the 1990s as baby boomers began to retire and participation rates for women began to decline. Indeed, since the bursting of the dotcom bubble and the 2001 recession (when many Internet-based companies failed), the labor force participation rate has continued to fall.

For men, the trend is longer lasting: male participation rates have been declining since records began in 1948. The downtrend for prime-age males has been of particular concern, and much research has focused on declining labor market opportunities and the associated stagnant wage growth for low-skilled workers in the 1980s, as well as increasing polarization in the 1990s (Aaronson and others, 2014).

This article focuses on the decline in the aggregate participation rate since 2000. And a mix of factors is at work. Structural changes, mostly linked to population aging, have been an important part of the downtrend. Aging matters because men and women reduce their participation markedly in the decade before age 65 (by at least 40 percentage points), and participate at even lower rates afterward. As a result, a shift in the age distribution toward older workers lowers the *aggregate* participation rate even if the participation rate for individual age groups does not change. In fact, the participation rate of older workers actually rose during the crisis, but the overall participation rate still fell.

However, cyclical factors related to the availability of jobs and wage behavior have also been important, particularly following the Great Recession. For policymakers, the distinction between structural and cyclical forces is paramount, because each requires a different policy response. Therefore, a key question for economists is how much of the decline is accounted for by each factor.

We found that aging is responsible for about half of the decline in participation since the Great Recession. This effect is calculated by holding the participation rate of each age group constant at the level of a particular year—2007 in our analysis—and letting the population shares of each group vary according to their historical pattern. It reflects that the share of the population 55 or older has increased significantly since 2007 (for men, for example, the share has increased by about 6 percentage points to nearly 33 percent).

To estimate the importance of cyclical factors, we use state-level data and analyze the variation in participation rates and cyclical factors across states and time. This analysis suggests that cyclical forces account for an additional 30 to 40 percent of the decline.

The remainder of the post-2007 decline reflects other forces, such as a significantly lower youth participation. This decline has not been driven mainly by increasing college enrollment rates, as some observers have conjectured, but by a decline in the number of college students who are also working. Rising applications for disability insurance have also played a role in shrinking the labor force. Some of this increase reflects population aging, with 80 percent of insurance recipients over 45, although applications clearly accelerated following the Great Recession. Even those eventually denied benefits left the labor force while their applications were pending. Although it is open to debate how much of the recent rise in disability insurance recipients is structural or cyclical, most of it is irreversible.

A temporary reversal

Importantly, we found that up to one-third of the post-2007 decline in participation rates is reversible as the U.S. jobs market continues to improve (Balakrishnan and others, 2015). Over the next few years, this should mean that about 2 million workers will return to the labor market. However, by 2017 participation rates should again start to decline as the underlying forces of population aging more than offset the cyclical bounce back.

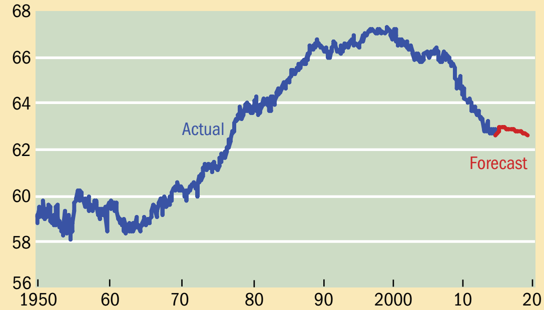
This forecast takes into account nondemographic structural forces such as college enrollment, the share of students working, and retirement patterns. Specifically, the participation rate of younger workers is expected to bounce back somewhat as school enrollment declines a little more (and gets closer to its pre–Great Recession level) and more stu-

Chart 1

Out of action

Since the early part of the century, the portion of the U.S. adult population either working or looking for a job has fallen steadily.

(labor force participation rate, percent)



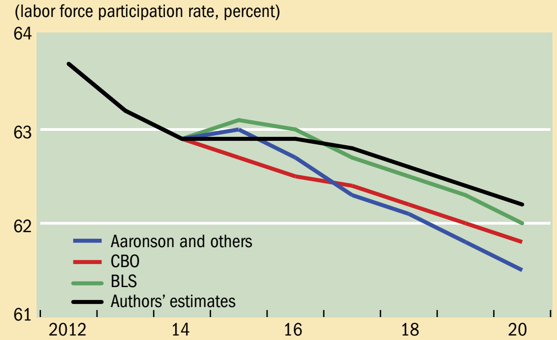
Sources: U.S. Bureau of Labor Statistics; Haver Analytics; and authors' estimates.
Note: The labor force participation rate measures the percentage of persons aged 16 and over who have jobs or are actively seeking them.

Chart 2

Secular decline

A number of economic forecasters agree that the overall labor force participation rate will continue to decline.

(labor force participation rate, percent)



Sources: Aaronson and others (2014); U.S Congressional Budget Office (CBO, 2014); U.S. Bureau of Labor Statistics (BLS); Haver Analytics; and authors' estimates.
Note: The labor force participation rate measures the percentage of persons aged 16 and over who have jobs or are actively seeking them.

dents start working—prodded by improved job opportunities and the need to pay off student loans. Older workers, however, are forecast to have no bounce back—since their participation rates increased during 2007–13 and the recovery of wealth lost during the crisis allows many who postponed retirement to finally do so.

The declining trend in the overall participation rate is something predicted by other forecasters, although there are some important differences (see Chart 2). For example, in the projection by the U.S. Congressional Budget Office, the downward pressure from population aging outweighs the cyclical bounce back more than it does in our estimates over the medium term. Aaronson and others (2014) also have a lower participation rate path, as they assume that labor market polarization into low- and high-income jobs and rising disability rolls will outweigh increasing longevity, educational attainment, and changes in marriage and fertility. The U.S. Bureau of Labor Statistics has a 2020 forecast similar to ours (Toossi, 2013).

A fuller picture of the labor market requires an examination of factors beyond the unemployment rate.

Chart 3

Room to grow

The employment-to-population ratio, which measures how many of those able to work are actually working, suggests potential for further labor market improvement.

(employment-to-population ratio, percent)

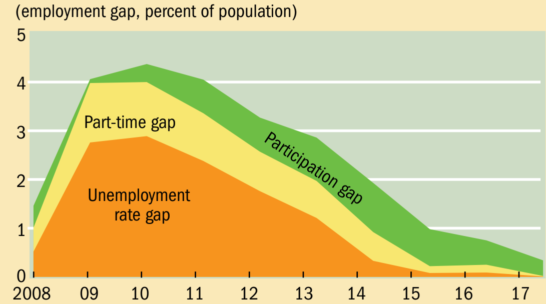
Sources: U.S. Bureau of Labor Statistics; and Haver Analytics.
Note: The employment-to-population ratio measures the share of the civilian noninstitutional population aged 16 and over that is employed.

Chart 4

Narrowing gap

The difference between the trend and the actual employment-to-population ratios, the employment gap, has been shrinking in recent years.

(employment gap, percent of population)



Sources: U.S. Bureau of Labor Statistics; Haver Analytics; and authors' estimates.
Note: The unemployment rate gap and the labor force participation rate gap measure the deviation of the rates from trend (often called natural) levels, and the part-time gap adjusts for the number of workers involuntarily working less than full time.

A new measure of labor market slack

What do these participation trends mean for the level of slack (that is, unused resources that can be employed without triggering inflation) in the U.S. economy?

If we look simply at the unemployment rate—which has steadily declined from double digits to about 5.5 percent in the second quarter of 2015—it may look as if there is not much labor market slack at all. After all, the rate is just above many estimates of the current "natural" level of unemployment—the rate that would prevail once cyclical factors have played themselves out and the economy is growing at trend. Some argue that a negligible difference between the unemployment rate and the natural rate—the so-called unemployment gap—is equivalent to full employment.

However, there is more to labor market slack than the unemployment gap, especially following the dislocations caused by the Great Recession. While a shrinking unemployment gap suggests that the economy is approaching full employment, the employment-to-population ratio paints a different picture (see Chart 3). Indeed, this ratio, which measures how many of those able to work are actually employed, is still more than 4 percentage points below its level on the eve of the Great Recession. What could cause such a disconnect? First, there are workers who want and are available for work but did not search for jobs in the previous four weeks and were not classified as unemployed (so-called marginally attached workers). Moreover, there are still numerous part-time workers who would like to work more hours but cannot as businesses continue to face difficult conditions. While there may be some structural component to the increase in part-time workers (from firms' greater ability to predict peak loads, for example), some of it undoubtedly reflects a legacy of weak cyclical conditions. Adding these components to the unemployment rate suggests that some labor market slack remains.

As Federal Reserve Chair Janet Yellen has emphasized, a fuller picture of the labor market requires an examination of factors beyond the unemployment rate. These include gauges of labor market dynamism such as job openings, hires, and quits, which have nearly recovered to precrisis levels. The growing number of quits is particularly encouraging because it signals that people are more confident in leaving their current job to pursue higher-paying, better-fitting opportunities.

To bring all these elements into a single measure of slack, we compute a broadly defined "employment gap" that includes deviations of unemployment and participation rates from their trend or natural levels and adjusts for the large number of involuntary part-time workers.

As one would expect, our measure shows a substantial employment gap following the Great Recession, largely driven by bulging unemployment and involuntary part-time workers. The participation gap, in turn, started to grow after 2010, as the prolonged recession led many to become discouraged and abandon the workforce (see Chart 4). It is this legacy that the labor market has been working through. Now, with an unemployment rate that has fallen to well within 1 percentage point of most estimates of the natural rate of unemployment, the remaining slack stems mainly from the participation gap, and to a lesser extent from the part-time gap. We expect that overall labor market slack (that is, the employment gap) will disappear in 2018. This gradual decline in labor market slack implies a still important role for accommodative macroeconomic policies, such as supportive monetary policy measures, to help reach full employment.

Boosting the participation rate

Moreover, policies to reverse the decline in the participation rate are vital to the labor supply expansion needed to boost potential growth over the next 5 to 10 years. Enhancing growth is a key preoccupation in the United States, where many forecasts put potential growth around 2 percent—far from the more than 3 percent average rates that prevailed before the Great Recession.

Key measures include enhancing job search and training programs and targeting benefits for low-income families—child care support, for example. Immigration reform should also be part of the solution. To counter the effects of an aging population, the United States should augment its visa program for high-skilled immigrants, which would also enhance the productivity of the workforce. ■

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Stock ticker, Times Square, New York, United States.

SPILL OVER

Jiaqian Chen, Tommaso Mancini-Griffoli, and Ratna Sahay

The Federal Reserve's recent unconventional monetary policies seem to have affected emerging markets more than traditional policies

WHEN the United States sneezes, the saying goes, the rest of the world catches a cold. This adage is not mere folklore. The recent global financial crisis drove home the importance of the United States to the world economy—for both good and bad.

On the positive side, the crisis helped illustrate the power of U.S. monetary policy to prevent a global depression. But those same policies also had important side effects, especially raising asset prices and flooding emerging market economies with capital inflows. Policymakers in these economies expressed concern about the so-called spillover effects of U.S. policy, which increased market volatility and exacerbated related financial stability risks.

We will examine these spillover effects, with a view to gauging what policies best mitigate the risks of destabilizing spillovers.

Unconventional policies needed

The global economy would likely have suffered more had central banks not followed so-called unconventional monetary policies that relied on such innovations as buying nongovernment bonds (widely dubbed "quantitative easing") to pump up the economy when traditional policies, such as cutting interest rates, were no longer feasible. Nominal interest rates were brought to nearly zero early in the global recession—and have been kept at that minimum level since (the so-called zero bound). Unable to lower rates further, central banks resorted to asset purchase programs that massively increased central bank balance sheets.

As the period of accommodative monetary policy continued, policymakers in emerging markets began to voice concerns. They claimed that the monetary expansion in advanced economies had spilled over into their economies, causing a surge in capital inflows, especially into debt instruments such as bonds (see Chart 1). Their currencies appreciated and their asset prices rose rapidly. Emerging markets' policymakers worried about painful adjustments imposed by large shifts in the exchange rate on exporters and on firms that compete with imports. They worried about growing liabilities in temporarily cheaper foreign currencies that risked suddenly becoming a lot more expensive (called balance sheet mismatches). Vulnerabilities to financial systems also stemmed from rapidly rising asset prices, a buildup of credit bubbles, and heavy and rising corporate borrowing. Many policymakers recalled earlier episodes of surging capital inflows, when attempts to dampen bubbles by raising interest rates to increase the cost of borrowing failed because the higher rates attracted more capital inflows and stoked currency appreciation.

An even sharper wave of criticism from emerging market policymakers erupted after the Federal Reserve, the U.S. central bank, dropped hints that it was considering reducing the pace of asset purchases (or "tapering" in the jargon). When former Fed Chairman Ben Bernanke mentioned this possibility in May 2013, there was a spike in market volatility in emerging markets (see Chart 2) as asset prices dropped sharply.

Crucial questions

There are three important questions concerning spillovers themselves and policies aimed at containing and coping with them:

- Do unexpected changes in U.S. monetary policy affect capital flows to and asset prices in emerging markets and by how much?
- Do these effects differ depending on the phase of U.S. monetary policy—whether interest rate policy was used during the conventional phase preceding the global financial crisis or assets were purchased massively during the unconventional phase (called quantitative easing) after the onset of the crisis? Monetary policy was eased a number of times before the global financial crisis without evoking such strong reactions. It is important, therefore, to distinguish between these two phases to understand better the concerns of emerging market economies.
- Do the effects of sudden changes in U.S. monetary policy vary with the domestic economic conditions of emerging market economies? That is, do the characteristics and policy choices of recipient countries determine the impact of changes in U.S. monetary policies on their economies?

Tailored tools

To investigate these questions it is essential to capture the *surprise* (or the unexpected) component of U.S. monetary policy announcements. It is these announcements, after all, that set off the spillovers.

Not all announcements are alike. Some are perfectly anticipated by market participants, others not at all. If an announcement corresponds perfectly to what the market expected, it should have no effect on asset prices or portfolio allocations, because these will have been determined in advance based on

Unable to lower rates further, central banks resorted to asset purchase programs.

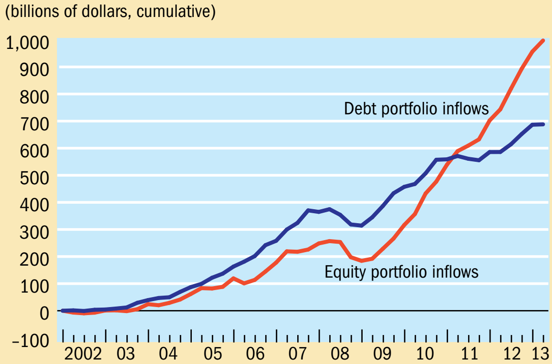
the expected announcement. That does not mean, though, that monetary policy is ineffective, only that there is not sufficient information to judge its effectiveness. Other examples are also possible. If the central bank announced an increase in interest rates (of, say ¼ of 1 percent) that was smaller than what markets anticipated (of perhaps ½ of 1 percent), then asset prices should increase. But it is not necessarily true, based solely on the observed policy move, that tighter policy (in the sense that rates were hiked by ¼ of 1 percent) was good for asset prices. The correct interpretation is that because the policy was less tight than anticipated (looser with respect to expectations) asset prices rose. It is essential, then, to capture (in the economists' lingo, "control for") the surprise component of monetary policy announcements—that is, the extent to which an announcement differed from what markets expected. Only then can the effects of monetary policy announcements be compared equally, on what might be called "per unit of surprise" terms.

Chart 1

Capital surge

Foreign purchases of stocks and bonds in emerging market economies grew sharply after the U.S. Federal Reserve loosened monetary policy following the global financial crisis.

(billions of dollars, cumulative)



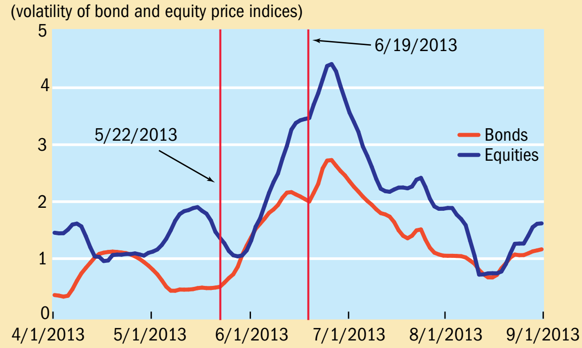
Source: IMF, *International Financial Statistics*.

Chart 2

Roller coaster

Stock and bond prices in emerging market economies gyrated wildly after the U.S Federal Reserve hinted in 2013 that it might wind down its large-scale asset purchases.

(volatility of bond and equity price indices)



Source: Bloomberg.

Note: Equity prices are measured by the MSCI Emerging Markets Index (MSCI) and bond prices by the J.P. Morgan Emerging Markets Bond Index (EMBI). Volatility of indices is measured as 30-day standard deviations.

A second dimension of announcements is also important: their informational content. Announcements can provide information about future policy intentions of the central bank relative to the level of policy rates. This is referred to as the *signal* component of announcements. This component is essential for monetary policy; in fact, it is the primary means through which monetary policy has any bite. A one-time increase or decrease in the policy rate will have little impact on the economy. It is only by signaling future changes in policy rates that the central bank is able to affect the longer-term rates relevant for such economic decisions as investment, hiring, and consumption.

As long as markets remain liquid as they grow, risks of spillovers should be contained.

But monetary policy announcements can contain other information as well, which we call the *market* component of announcements. Through their communication, central banks can relate information about the availability of bonds to private investors (due to the evolving size of the central bank's balance sheet) and risks to (or uncertainties about) growth and inflation, as well as changes in central bank preferences (for example, on how quickly to bring inflation back to target) and objectives.

Both dimensions of announcements—their surprise and informational content—can be observed in bond prices immediately following monetary policy announcements (in this study, for a one-day window). On one hand, surprises related to the signal component of announcements should affect shorter-term bonds. That is because central banks can only commit to following a course of policy over a period of approximately three years, a period for which they can reasonably forecast the economy. Anything beyond that would be discarded by markets as cheap talk. On the other hand, surprises related to the market component of announcements should affect the premium to hold longer-term bonds. A so-called principal component statistical method is used to extract movements in shorter- and longer-term bond yields on announcement days: the first are taken to represent signal surprises and the second market surprises.

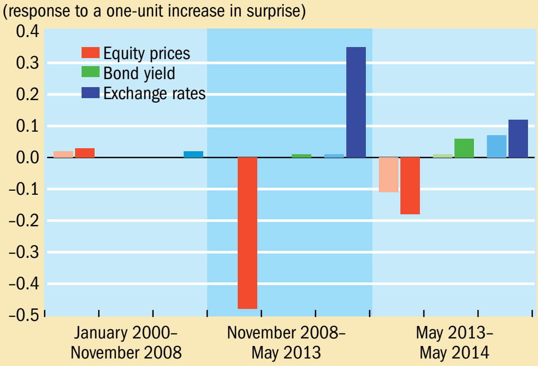
The final step is to measure changes in asset prices and capital flows in emerging markets in response to monetary policy surprises in the United States. This is done following a so-called event study methodology, which examines market reactions in emerging market economies immediately following a monetary policy announcement in the United States. The method is particularly useful in establishing causality, because the dominant shock on announcement days is likely the result of the monetary policy announcement. In addition, the impact on financial markets in emerging markets is assumed to be felt immediately or at least within two days. On average, then, changes in asset prices and capital flows within this time frame can be attributed to U.S. monetary policy shocks.

Chart 3

Surprise

Unexpected announcements from the U.S. Federal Reserve had a far bigger impact during the unconventional phase of monetary policy than before 2008.

(response to a one-unit increase in surprise)



Source: Authors' calculations.

Note: The figure depicts the estimated impact of a hypothetical surprise tightening of monetary policy on equity prices, bond yields, and exchange rates over three phases of U.S. monetary policy: conventional, unconventional, and the period when the U.S. Federal Reserve hinted at reducing its bond purchases. The effects of a market surprise are depicted in light colors. Those of a signal surprise are shown in darker colors. Positive values for exchange rates signify a depreciation of the foreign currency relative to the U.S. dollar.

Spillovers have grown

We examined the reaction of 21 emerging market economies—Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, Russia, Singapore, South Africa, Taiwan Province of China, Thailand, and Turkey—to 125 U.S. monetary policy announcements between January 2000 and March 2014 and found that U.S. monetary policy surprises have an immediate (at least over a two-day window) effect on capital inflows and asset price movements in emerging market economies.

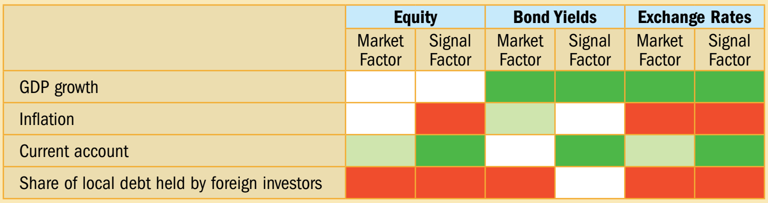
But when we separately examined the periods before the crisis (during the conventional monetary policy phase) and after November 2008 (when large-scale asset purchases started), we found that spillover effects "per unit" of U.S. monetary policy surprise were different and stronger during the unconventional phase. For many assets, spillovers were even larger when the United States began to discuss the tapering of its asset purchases (May 2013 to March 2014). In general, across all phases of monetary policy, spillovers were greatest when announcements surprised markets with information on the future course of policy rates (signal surprises), as opposed to market surprise information that affected longer-term U.S. bond yields (see Chart 3).

We presume that the larger spillover effects during the unconventional phase were likely mostly structural, the result of the bond purchases introduced in the unconventional monetary policy phase and the liquidity that was created. Spillovers per unit of surprise do not seem to

Chart 4

Fundamentals matter

Real GDP growth, current account positions, inflation, and the shares of local debt held by foreigners significantly impact the spillover effects of U.S. monetary policy on equity, bond, and foreign exchange markets.



Source: Authors' calculations.
Note: Green boxes denote factors that dampen the effects of U.S. unconventional monetary policy shocks; red boxes denote factors that amplify the effects. The darker the color, the more pronounced the effect. The signal factor refers to the information about future monetary policy a shock conveys. The market factor refers to the information about the availability of bonds to private investors, risks to growth and inflation, and changes in central bank preferences and objectives. Current account is the balance of a country's net trade, net earnings, and net transfer payments.

depend on the size of the shocks, whether they were associated with loosening or tightening of policy, or whether they came at a turning point in the policy stance (a first attempt to tighten policy, for instance, after an uninterrupted sequence of cuts).

But we also found that spillovers were affected by a country's economic situation. Countries with stronger fundamentals experienced smaller spillovers. That is, higher real GDP growth and stronger current account positions, as well as lower inflation and smaller shares of local debt held by foreigners, significantly dampened spillover effects, especially during the period of unconventional monetary policy. Some have argued that the effect of fundamentals became stronger over time, as investors began differentiating between countries. But this study finds that fundamentals mattered even in the initial responses to U.S. monetary policy announcements. The green boxes in Chart 4 show the domestic factors that helped dampen the shocks, while the red boxes show those that amplified them.

We also examined whether larger markets and/or more liquid markets (those with many buyers and sellers) exhibited larger spillovers. In theory, the effects of market size alone are ambiguous. This is because there are two opposing forces at play. Larger markets attract more foreign investors, which increases volatility, while at the same time these markets tend to be more liquid, which should dampen volatility. Indeed, in practice, market size alone is not a significant amplifier or dampener of spillovers. However, once we control for market liquidity, there is some evidence that larger markets face bigger spillovers. The effects of market liquidity are clearer—more liquid markets dampen the effect of spillovers, as expected. Thus, as long as markets remain liquid as they grow, risks of spillovers should be contained.

Policy implications

It is not surprising that U.S. monetary policy spills over to the rest of the world, given its dominance in global markets. But we found that especially large spillovers are mostly a recent phenomenon, dating from the global financial crisis.

That spillovers seem larger during the unconventional policy phase underscores a cost of interest rates hitting zero. Hence if large spillovers are to be avoided, proper policies need to be adopted in good times to minimize risks of hitting the zero lower bound in bad times. These policies could include other macroeconomic areas, such as spending and taxation, to stabilize the relationship between debt and GDP and maintain fiscal room to support the economy in downturns. Even structural reforms in, say, labor markets or education to boost growth and employment could come into play. To maintain financial stability, prudential policies should also be used. Such prudential policies could include imposition of capital or liquidity requirements on lenders and loan-to-value or debt-service-to-income limits on borrowers.

There is also a lesson for emerging market economies. Because the adverse effects of spillovers from U.S. monetary policy are related to the economic conditions of the recipient country—that is, better fundamentals and more liquid markets help dampen the effects of U.S. monetary policy shocks—emerging market economies should improve their fundamentals as much as possible. Other policies, such as foreign exchange intervention, or even capital flow management measures, can be used during periods of turmoil or crisis to deal with excess volatility and disorderly market conditions, but should not be viewed as a substitute for good overall economic policies.

Spillovers are more prevalent and larger if they are the result of *signal* surprises. This is good news, because the signaling channel is better understood by central banks, and can be better managed through clear communication about immediate and future policy intentions. The Federal Reserve and other influential central banks should, therefore, be able to contain the source of shocks that lead to global spillovers.

At the same time, even though *market* surprises have smaller spillovers, their effects are less differentiated across countries and more unpredictable. To mitigate the effects of *market* surprises, advanced economy central banks should focus on minimizing shocks to long-term bond yields when the central banks reduce or end their reliance on unconventional monetary policies. They could do this, for instance, by letting the assets they have accumulated mature rather than selling them. If they do choose to sell them, they should do so in a very predictable manner. ■

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Noteworthy WOMEN

There is a notable lack of gender diversity on currencies around the world

Christopher Coakley

WHEN it comes to money, it is a man's world. Or so it seems, judging from the faces of the great and the good who adorn the vast majority of countries' bills and coins. Yet some countries do use their currency to honor the contributions of their female leaders, artists, and other trailblazers—past and present. The United States is a latecomer to the club, announcing in June 2015 that it would feature a woman on a banknote for the first time in over a century. So who are the women getting recognition—and why does it matter?

Martha Washington on 19th century U.S. dollar note; Queen Elizabeth II on Australian $5 note.

Births and marriages

The last American woman on a dollar note was Martha Washington, the first First Lady, in the 19th century. And indeed, even today, women often find a place on a banknote or a coin by virtue of birth or marriage. The likeness of Queen Elizabeth II, head of more than a dozen sovereign states, passes between hands across the globe.

It is perhaps a reflection of obstacles in society that some of the world's most celebrated women emerged from the shadows of their husbands, arguably eclipsing them in the process. Charismatic figures—on their nation's banknotes today—include the politicians Eva Perón in Argentina and Corazon Aquino in the Philippines and artist Frida Kahlo in Mexico.

Eva Perón on Argentine 2 peso note.

> ***"Supporters of better gender balance on banknotes point to the inspiration such idols can give young girls."***

> ***"How important it is for us to recognize and celebrate our heroes and she-roes!"***
> ***—Maya Angelou***

It is striking how many banknotes pay tribute to pioneering women who had to break in to political, artistic, and scientific circles from the outside. Leading suffragettes are currently honored on the dollar bills of Australia, Canada, and New Zealand. Marie Curie, the physicist and chemist who was born in Poland but became a French citizen, has been featured on both francs and zlotys: such is the pride of both France and Poland in the first woman to win a Nobel Prize. Supporters of better gender balance on banknotes point to the inspiration such idols can give young girls.

Marie Curie on Polish 20,000 zloty note.

And yet the focus is not always on the achievements of individual women. In the 1960s, China's 1 yuan note showed a woman on a tractor, reflecting the economic principles that the government wished to promote. Today the 2 yuan note depicts anonymous ethnic minority women, a message of inclusion that eschews individual identification.

Woman driving tractor on Chinese 1 yuan note from the 1960s; ethnic minority women on current 2 yuan note.

Jane Austen on U.K. £10 note.

Value of money

U.K. and U.S. campaigns for women on banknotes have stirred significant debate, including lively exchanges on the merits of various candidates, but ugly episodes as well. In June 2013, British feminist activist and journalist Caroline Criado-Perez was subjected to a coordinated attack of abusive messages on social media after her successful campaign to feature Jane Austen on the £10 banknote.

Successful economies recognize and reward the efforts of everyone, both men and women.

The debate has touched a nerve, perhaps because their conspicuous absence on banknotes raises broader questions about how women are undervalued in the economy. Studies show that gender gaps in labor force participation and pay remain stubbornly wide.

Earlier this year, an IMF report found that 90 percent of countries it studied had at least one legal obstacle to women's economic activity. The IMF study concluded that when women fully participate in the labor market, there can be significant economic gains.

Successful economies recognize and reward the efforts of everyone, both men and women. It is about time our money did the same. ■

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A WIDER Field of Vision

Stress tests must be adapted and broadened to assess the stability of the financial system as a whole

Dimitri G. Demekas

WHEN engineers want to make sure a structure or a system is well designed, they employ a technique called stress testing: they expose the system to shocks and strains that are far greater than what will be experienced in normal use to confirm specifications are met, determine breaking limits, or examine modes of failure.

Managers of financial institutions and, more recently, financial regulators adapted the tool of stress testing to measure the strength of individual financial institutions. They do so by subjecting portfolios to numerical simulations of large hypothetical "shocks," such as a severe recession, housing price decline, or stock market crash, and estimating their effect on profits, capital, or the ability of financial institutions to continue meeting their obligations.

But using stress tests to assess the resilience of the financial system as a whole is not as simple as adding up the results for the individual institutions. New approaches and techniques are needed to make stress tests a useful tool for financial stability analysis.

Simple start

Stress tests were first used for banks in the early 1990s (see box). These early models were relatively simple: they assumed an exogenous shock and traced the impact of associated losses on the capital of the individual bank. They made simplistic assumptions about how the bank would react to the shock—in terms of profit distribution, credit expansion, or debt reduction, for example. They focused on the solvency of the bank (how much capital it had left after the shock). The risk that an institution would run out of cash (liquidity risk) was treated independently from solvency, if at all, and interactions among banks and the feedback effects on the economy as a whole were generally ignored.

These stress tests had what economists call a microprudential, or single-institution, focus: their objective was to assess the likelihood of failure of individual institutions under adverse conditions. This, in turn, it was thought, would ensure the stability of the financial system as a whole.

Too much and too little

But even as bank regulators were adopting stress tests, many understood that ensuring the soundness of each institution was neither necessary nor sufficient to ensure that the financial system as a whole would remain stable and continue to function. As the late Andrew Crockett, then general manager of the Bank for International Settlements, put it, the microprudential approach to financial regulation may "strive for too much and deliver too little."

It may strive for too much because the occasional failure of an individual institution is not a problem if other institutions can step in and serve its clients, borrowers, and depositors. Building a regulatory system designed to avoid any failures risks providing excessive protection.

And it may deliver too little because firm-level regulation takes into account neither the potential for contagion among individual institutions nor how each institution pursues compliance with capital rules. When, for example, a regulator pushes a troubled bank to restore its capital-to-assets ratio, the regulator does not care whether the bank increases its capital or shrinks its assets. But if a substantial proportion of the banking system shrinks assets simultaneously to meet capital requirements, the damage to the economy as a whole may be considerable. Unless the regulators take into account the interconnectedness and collective behavior of institutions in response to a shock and their possible impact on the financial system and the economy, they may fail to minimize the risk of distress for the system as a whole and the associated economic costs—in short, systemic risk (Crockett, 2000).

The recent global financial crisis underscored dramatically the importance of systemic risk and the failure of microprudential regulation to contain it. In 2008, U.S. Federal Reserve Chairman Ben Bernanke called for a widening of the "field of vision" of regulators and supervisors to incorporate systemic risk (Bernanke, 2008). Or, as Crockett had put it, "marrying the microprudential and macroprudential dimensions of financial stability."

A new generation

Moving from traditional microprudential stress tests toward a "new generation" of macroprudential stress tests presents two challenges:

• Introducing systemwide or *general equilibrium dimensions,* so that the outcome of the stress tests depends not only on the size and nature of the initial shock and the buffers of each financial institution but also on the behavioral responses of these institutions to the shock and on their interactions with each other and with other economic agents, including borrowers, depositors, and investors. This is particularly important if the stress tests cover a long time horizon, say three or five years, during which the effect of these interactions can be sizable.

New approaches are needed to make stress tests a useful tool for financial stability analysis.

• Shifting the focus of stress tests from individual institutions to the resilience of the system as a whole—its ability to continue functioning and providing financial intermediation services to the real economy.

How much progress have stress testers made in tackling these challenges? How much has this "wider field of vision" been adopted in practice?

A review of the experience of central banks, supervisory agencies, and the IMF since the crisis finds that stress testing has made significant progress in tackling the first of these two challenges but much less in dealing with the second.

Many models that incorporate some systemwide "general equilibrium" dimensions into stress tests are available and widely used. They fall into two broad categories.

• ***Balance-sheet-based models*** use individual bank balance sheet data to assess the impact of a shock on asset quality, income, and—ultimately—capital (for solvency tests) or various measures of cash flow or liquidity (for liquidity tests) of individual banks. The results are then aggregated to give an idea of the vulnerability of the system as a whole.

In this approach—common across central banks and supervisory agencies around the world—the dimensions the stress tester intends to capture, whether solvency-liquidity interactions, behavioral responses, or macroeconomic feedback effects, are built explicitly into the model. This makes it possible to trace the effect of the shock through various channels and figure out how much each channel contributes to the final outcome.

This benefit comes at a price. First, analytical and computational complexity and data requirements increase rapidly as features are added to the models. This renders them slow, cumbersome, and costly to construct and run. Second, because they rely on bank balance sheet data, they depend crucially on the availability and quality of these data.

But by far the biggest flaw in this approach is the fact that, given the different ways banks are interconnected, the sum of the losses or capital shortfalls of individual banks is not representative of the vulnerability of the system as a whole: correctly aggregating individual shortfalls requires some knowledge of the complex interdependence between individual bank balance sheets.

• ***Market-price-based models*** use (mostly) market data to infer the probability of distress or default of individual institutions. They capture—at least in principle—all sources of

Origins of financial stress testing

One of the early adopters of stress tests was the U.S. financial services firm JPMorgan Chase & Co., which in the early 1990s used what is called value at risk (VaR) methodology to measure the market risk of a given shock—how much the changes in asset prices would affect the value of the bank's portfolio.

Regulators soon caught up. It had long been understood that banks financing themselves with government-insured deposits have an incentive to take excessive risks. So the goal of capital regulation was to force banks to internalize at least some of the unexpected losses should these risks materialize, thus mitigating moral hazard and protecting depositors. Regulators saw that stress testing was a way to estimate potential losses under adverse scenarios, and could be a key input in capital regulation.

Stress tests became a regulatory staple in the early 2000s, when the international rules on capital adequacy known as Basel II required banks to perform stress tests for market risk and, in some cases, credit risk. These tests had to be "plausible, severe, and relevant" to help banks evaluate their capacity to absorb losses and identify steps they could take to reduce risk and conserve capital (BCBS, 2005). Equipped with this tool, regulators could ensure the soundness of each institution by requiring it to hold a minimum amount of capital in proportion to its risky assets.

vulnerability and contagion, including the risk of bank runs triggered by investors' self-fulfilling fears. Such risk might not reflect the real financial condition of a bank, which may have been healthy before the run. Another advantage is their computational simplicity.

An obvious weakness of these models is their reliance on market data, which are "noisy" and may overestimate or underestimate risks. That means that bank risk indicators estimated from these data may be excessively volatile,

The obvious remedy is to use many extreme but plausible scenarios for stress tests.

and may not provide a sound basis for bank management or supervisory action. Another pitfall is that by extracting information from market data and constructing a summary metric of bank soundness, market-price-based models do not allow the stress tester to differentiate between the various factors—initial shock, risk interdependence, common exposures, and cross-institutional contagion—that contribute to the final result: all these factors are lumped into the probability of default or distress generated by the model. This has led some critics to dismiss such models as "black boxes."

In contrast to the progress made toward incorporating general equilibrium dimensions into the traditional microprudential stress-testing framework, relatively few advances have been made in tackling the second challenge: correctly measuring the resilience of the financial system as a whole and its ability to continue providing financial intermediation services under stress.

This measurement must be done in a way that allows individual banks and their supervisors to take action on the results. It is hard to build a model that correctly measures systemic risk and the contribution of individual institutions to that risk and then relates the results to each bank's established regulatory framework, such as capital adequacy ratios or liquidity rules. And it is even harder to make this model robust enough to use in a variety of environments and for a variety of financial institutions, but simple enough to explain to supervisors, bank managers, and market participants.

Moving the dial

How do we move from where we are today toward more effective macroprudential stress tests?

Use a variety of models: Given the limitations of the existing stress-testing frameworks, it is surprising to see several central banks and regulatory agencies relying on single individual models. This makes the outcome of the stress test hostage to the limitations of a single analytical framework.

Instead, a variety of models should be used for macroprudential stress testing. The challenge would then be to interpret and synthesize the results of the different models into a coherent and persuasive narrative. Should the different results be combined or averaged according to a strict rule? Should qualitative judgment be used in weighing different—and potentially contradictory—results? These are complex questions on which there is no consensus among practitioners. But this is a challenge well worth tackling, because it would enhance insight into systemic risk and the quality of the ensuing conversation about financial stability, both within the supervisory agency and with the banks.

Run more—and smarter—stress scenarios: Most stress-testing exercises are limited to one or two macroeconomic stress scenarios (for instance, an "adverse" and a "severe" recession scenario). This approach has a major problem: resilience to a shock of a given probability does not imply resilience to all shocks with the same probability. It also ignores the increasingly important cross-border nature of risk: banks and other financial institutions are increasingly interlinked across borders and may be vulnerable to shocks that originate in—or propagate through—a foreign country or market. The outcome of a test of a single stress scenario focused on a domestic recession may thus be misleading.

The obvious remedy is to use many extreme but plausible scenarios for stress tests. This would provide a better sense of the resilience of the system to a range of shocks than would a single scenario. Using multiple scenarios (as well as a variety of models) would also have another big advantage: it would minimize the scope for individual institutions to "game the test"—gear portfolio choices toward passing a specific stress test—a risk that regulators recognize (Office of Financial Research, 2012; Bank of England, 2013).

In addition to the *number*, a related issue is the type of scenario used in stress tests. In most cases, the main stress scenario is an adverse macroeconomic shock exogenous to the financial sector, such as a severe recession or a housing price bust. But in many actual crises, the shock originates entirely inside the financial system and is then followed by a recession. In a study of 43 banking crises in 30 countries, Alfaro and Drehmann (2009) show that only about half were preceded by adverse macroeconomic conditions.

Effective macroprudential stress tests should therefore involve a higher number and a wider range of "smart" stress scenarios covering a variety of risks, including domestic macroeconomic shocks, asset price moves, and cross-border contagion. Such testing would require an in-depth understanding of the risks affecting the financial system, including cross-border dimensions, and would complicate the task of synthesizing and communicating the results—especially when accompanied by a variety of models. It is these challenges that have held back many supervisors from moving in this direction. But given the significant pitfalls of limiting the number of scenarios to just one or two, it may be time to reconsider the cost-benefit balance of the current approach.

Expand coverage to nonbank financial entities: Microprudential stress tests have been traditionally applied to banks because these were the predominant agents of financial intermediation. But today the line between banks and nonbanks (such as investment banks that provide commercial-bank-like services) is blurred; the nonbank industry has expanded greatly in size and importance; and the global financial crisis demonstrated that banks and nonbanks are deeply entwined and risks move easily between the two. So stress tests should cover both banks and nonbanks, and the choice of which nonbank entities to incorporate into the stress-testing framework should depend on country circumstances. Priority should be given to sectors that are closely connected with banks through ownership or financial linkages—typically insurance companies, for which well-established stress-testing models already exist. Asset management companies, mutual funds, and sometimes pension funds can also be important providers of liquidity to banks and could be affected by—or be a channel for—a systemic shock.

Explore agent-based models: Micro- and macroprudential stress-testing models—like all traditional economic models—share a fundamental trait: they assume that individuals and institutions always behave rationally in ways that can be modeled based on past experience, and that policy decisions influence this behavior in the same way for all market participants. These assumptions miss some critical points about financial crises, notably

- the fact that market participants are heterogeneous and often make less-than-rational decisions, especially under stress;
- the emergence of a new dynamic under stress, when relationships among financial institutions can change suddenly; and
- the fact that the response of regulated institutions to policy signals depends partly on the conditions they are facing. For example, raising the regulatory capital requirements put in place in normal times to ensure banks have sufficient capital buffers may have no positive effect on systemic stability in times of crisis.

Agent-based models can capture many of these aspects. An agent-based model assumes autonomous, heterogeneous agents with limited information and specifies simple rules that dictate how they will act under different circumstances. These rules can vary across different types of agents (for instance banks, depositors, investors) and allow for herd behavior and panics. The model determines how these agents can interact (for example, how they form networks) and can explore various types of shocks. Agent-based models are increasingly used for macrofinancial modeling, and relatively simpler versions have been used to explore the impact of stress scenarios on bank solvency, liquidity, and contagion.

Agent-based models are complex and have their own pitfalls. Implementing them would require a shift in the approaches traditionally taken by (and the skills traditionally required of) stress testers. Nevertheless, the limited experience so far suggests that they can provide unique insights into the aspects that matter most in a stress scenario: the behavior of banks and other economic agents in times of crisis.

Embed stress tests into the financial stability policy framework: The recent explosion of interest in stress testing is creating a risk. Policymakers, regulators, market participants, and the broader public may focus excessive attention on stress tests, take their results out of context, and give them much greater weight than they merit in guiding policy action. This risk is evident in the way stress test results tend to dominate the public debate on the health of banks in the United States following the introduction of the Dodd-Frank Act, the centerpiece of postcrisis regulatory reforms in the United States, as well as in Europe, following a string of highly publicized tests by the European Banking Authority. This unprecedented attention on stress tests seems at times to overshadow, rather than inform, the conversation about financial stability among all relevant stakeholders in society.

This risk has been noted before. In setting out best-practice principles for macroprudential stress testing, the IMF put it this way (IMF, 2012, pp. 44-45):

"Regardless of how extensive the coverage of risk factors, how refined the analytical models, how severe the shocks incorporated in the stress tests, and how careful the communications strategy, there is always the risk that the 'unthinkable' will materialize.

[…] No matter how much a stress tester tries, stress tests always have margins of error. Their results will almost always turn out to be optimistic or pessimistic ex post. In addition, there will always be model risk, imperfect data access, or underestimation of the severity of the shock. One should therefore set stress test results in a broader context."

The call to embed stress tests firmly in the financial stability framework is essentially a call for caution. Macroprudential stress testing is just one of many tools to assess systemic resilience. It should be treated as a complement to other tools, such as early warning indicators, and—crucially—should be combined with the insights gained by the ongoing supervision of individual financial institutions. ■

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This article is based on the author's IMF Working Paper 15/146, "Designing Effective Macroprudential Stress Tests: Progress So Far and the Way Forward."

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Global Aspirations

Queen Alia International Airport, Amman, Jordan.

Ananthakrishnan Prasad

Islamic financing is transcending its traditional geographic boundaries and branching out with sukuk and other financial products

BRITISH Prime Minister David Cameron announced at the 2013 World Islamic Economic Forum that he wanted London to become "one of the greatest centers of Islamic finance anywhere in the world." For people following financial developments, the prime minister's remarks came as no surprise. In recent years, Islamic banks have begun operating in such countries as Denmark, France, Luxembourg, Nigeria, Switzerland, South Africa, and the United Kingdom. In addition, a number of large European and American banks, such as Citibank and HSBC, have opened Islamic banking windows.

The United Kingdom has five banks dedicated to Islamic finance, more than 20 banks offering Islamic products, and 25 law firms with Islamic finance units. There is $38 billion in sukuk—the Islamic equivalent of bonds—listed in London, primarily issued by businesses and banks based in the Middle East. And an issue of £200 million worth of sovereign sukuk in June 2014 was the first such offering outside the Islamic world. Since then, Hong Kong SAR, South Africa, and Luxembourg have issued sovereign sukuk.

Islamic finance is one of the fastest growing segments of the financial industry, and not just in the Middle East. The growth of Islamic banking outpaced conventional banking over the past decade and now accounts for more than 20 percent of banking system assets in 10 countries: the Islamic Republic of Iran and Sudan, which have full-fledged Islamic financial centers, as well as Bangladesh, Brunei Darussalam, Kuwait, Malaysia, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen (see Chart 1).

Globally, Islamic finance assets grew at double-digit rates in the past decade to reach an estimated $1.8 trillion at the end of 2013, with further growth expected (Ernst & Young, 2014; IFSB, 2014; Oliver Wyman, 2009). This growth reflects demand from large and relatively unbanked Muslim populations seeking to deposit money or invest in sharia-compliant banks and financial products—those that are acceptable under Islamic law (see box). It also represents relatively rapid growth in many countries where these populations reside, as well as the large pool of savings in oil-exporting economies looking for sharia-compliant investment opportunities.

Distinct qualities

The absence of fixed interest rates and the asset-backed nature of lending of course mean that Islamic banks operate differently from conventional banks. Islamic banks are typically funded by current accounts, which do not receive interest, and profit-sharing investment accounts, on which investors receive a return determined by the eventual profitability of the bank or the pool of assets financed by these accounts. The bank uses these funds to purchase assets—for example, homes in the case of a mortgage or industrial equipment in the case of a business loan—that the bank then sells or leases to the borrower. The financial gain is related to the underlying profitability or rental value of the asset. The bank also engages in equity-like financing of economic projects, sharing both profits and risks with entrepreneurs.

Sukuk operate in a similar way. The investor provides funds used to purchase assets that are then sold or leased to the borrower, with payments made gradually over time. The principal amount is typically not guaranteed, and the return is linked to the underlying purchase price of the asset and the profits it earns, which are then used to compensate the investors. Investors may also engage in partnerships with the issuer on a profit- and loss-sharing basis.

Banking dominates Islamic finance, accounting for about four-fifths of the sector in 2013. But the sukuk market is growing fast (see Chart 2). Its assets equal about 15 percent of the industry, which includes leasing, equity markets, investment funds, insurance, and microfinance.

The growing reach of Islamic finance promises a number of benefits. The principles of risk sharing and asset-based financing can help promote better risk management by financial institutions and customers.

Moreover, Islamic finance institutions can increase the financial inclusion of underserved populations and improve access to finance for small and medium-sized enterprises. And sukuk are well suited for infrastructure financing, thereby supporting growth and economic development. According to a study by the International Finance Corporation (IFC, 2014) among nine countries—Egypt, Iraq, Jordan, Lebanon, Morocco, Pakistan, Saudi Arabia, Tunisia, and Yemen—there is a potential financing requirement of \$8.6 billion to \$13.2 billion for Islamic financing of small and medium-sized enterprises, with a corresponding deposit potential of \$9.7 billion to \$15.0 billion. Since many such enterprises refrain from borrowing from conventional banks for religious reasons, there is huge untapped potential for Islamic financing in these countries.

Unique challenges

While the expansion of Islamic finance is expected to support growth, it does pose challenges in terms of the regulation, supervision, and conduct of monetary policy. In addition to the overall supervisory mechanisms conventional finance requires, Islamic finance calls for protection of investment accounts, sharia governance, and certain aspects of capital adequacy requirements in relation to Islamic contracts and treatment of investment accounts. These regulatory and legal issues are particularly important because of the increasing complexity of transactions as they seek to circumvent the prohibition against interest. Risk management is thus equally important for Islamic banks as for conventional banks, although the approach differs in some aspects given the unique nature of underlying Islamic contracts—for instance, to recognize the profit- and loss-sharing characteristic.

Islamic finance has important implications for tax policy. Tax systems typically favor debt- over equity-based financing. Ensuring a level playing field for the tax treatment of Islamic financial transactions is essential or it will be at a competitive disadvantage. There are gaps in central bank instruments in managing the liquidity of Islamic banks. A key issue is to

What is Islamic finance?

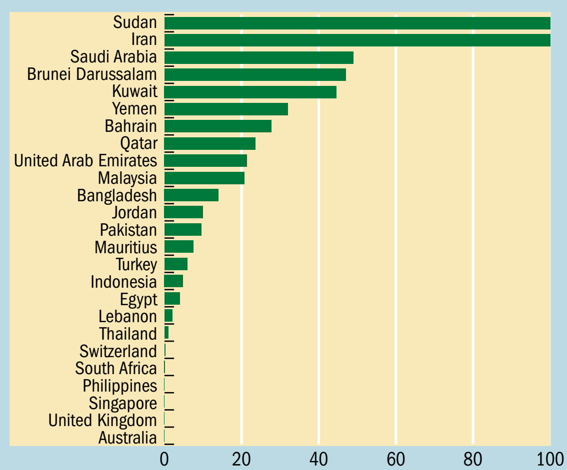
Islamic finance is the provision of financial services in accordance with Islamic ethical principles and law (sharia). Islamic law requires that financial transactions be geared toward supporting productive economic activity and that funding providers share in both the risk and the profit of the investments they finance. Islamic finance therefore encourages parties in a financial transaction to share the risk and the profit. Tansactions are asset backed or asset based—investors have a claim on the underlying assets. Islamic finance bans the payment of interest (because earning profit from the exchange of money for money is considered immoral), prohibits financial products that involve excessive uncertainty (including short sales and gambling), and rules out financing of activities considered harmful to society.

Chart 1

Expanding the reach

Islamic finance accounts for over 20 percent of banking system assets in 10 countries.

(percent of banking system assets, end-2013)

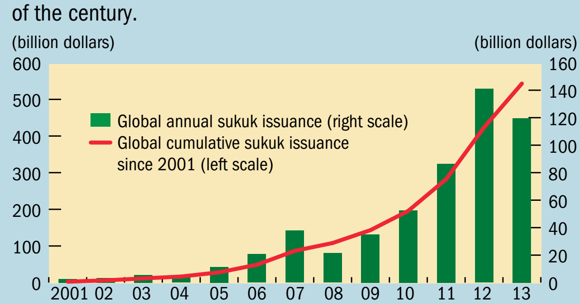


Source: Thomson Reuters Zawya.

Chart 2

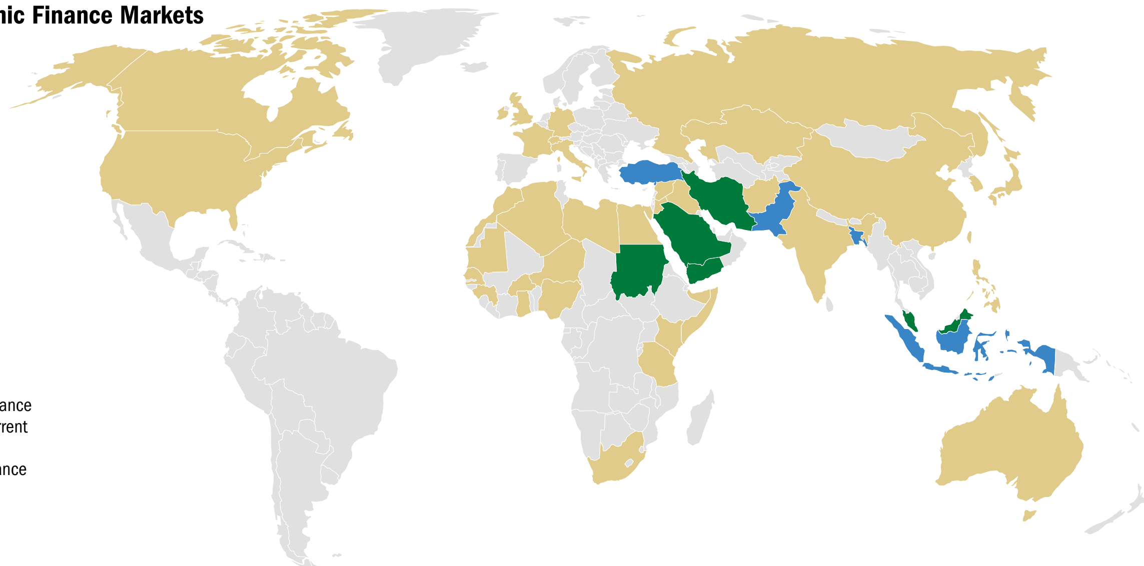
Soaring sukuk

Global sukuk issuance has increased dramatically since the turn of the century.



Source: Islamic Financial Services Board.

Importance of Islamic Finance Markets



Source: IFSB (2014).

broaden the range of sharia-compliant instruments and build liquid markets. Underdeveloped safety nets, notably a lack of sharia-compliant deposit insurance and lender-of-last-resort facilities, plague Islamic financing. Low consumer literacy rates and the relative scarcity of sharia scholars also present challenges for the industry's development.

These factors may weaken the scope for Islamic finance to enhance access to finance in jurisdictions where financial development is particularly important for growth. They may also imperil the safety and soundness of the industry. Continuous efforts are therefore needed to improve the way existing standards for Islamic finance are applied, both nationally and internationally.

The industry is still largely nascent, lacks economies of scale, and operates in an environment that does not take advantage of its special characteristics. To fulfill its potential for solid growth, Islamic finance must progress in a number of areas.

Standards have been defined by Islamic standard-setting bodies (including the Islamic Financial Services Board, based in Kuala Lumpur and established in 2002), but regulatory and supervisory practices in many jurisdictions still do not fully address the specific risk characteristics of Islamic banks. This can encourage institutions to capitalize on loopholes to circumvent unfavorable regulations in jurisdictions where Islamic banks operate side by side with conventional banks or across borders. A critical issue is how capital adequacy is defined. Islamic banking standards give supervisors the discretion to reduce capital requirements if an Islamic bank is funded by profit-sharing accounts that reflect the loss-absorbing nature of the transaction. But such discretion must be applied both transparently and without overestimating banks' ability to impose losses on their account holders.

A critical gap facing Islamic banks and the monetary authorities in their jurisdictions is the relative dearth of sharia-compliant money market instruments and markets. This undermines Islamic banks' scope for effective liquidity management, forcing them to hold greater cash balances than necessary and constraining their ability to deploy their deposits in the best interests of their depositors and their country's macroeconomy. Similarly, without transactions in sharia-compliant money markets central banks have limited instruments available to achieve their monetary policy objectives, especially where Islamic banks represent a significant portion of the system. In such cases, an important priority is to encourage the development of shorter-term securities that can be used for transactions between Islamic banks and as collateral for monetary operations.

Islamic financial instruments also pose particular challenges in the areas of consumer and investor protection. For example, account holders in Islamic banks may not always be aware of their exposure to loss: these risks must be explained transparently. Moreover, governance arrangements for Islamic banks should provide an appropriate role for investment account holders, given the additional risks they bear. These difficulties argue for close attention to Islamic Financial Services Board standards.

Enforcing compliance

A growing concern is that responsibility for ensuring sharia compliance is too often left to sharia boards at individual banks, which can lead to inconsistency. To address this problem, a two-pronged approach is required: a strong sharia governance framework at the national level and a role for regulators in ensuring that bank-level sharia supervisory boards are independent and meet certain standards.

A key challenge in all financial systems is to establish frameworks to ensure that shocks to individual institutions and markets, when they occur, are contained and do not undermine confidence in the stability of the broader financial system. Among other things, this requires an effective deposit insurance system, frameworks for legal and bank-specific resolution in the event of financial crises, and the ability to provide emergency liquidity assistance when appropriate.

In many jurisdictions where Islamic banks operate, such frameworks are not yet in place, and where they are, they have yet to be adapted to Islamic finance. In the case of deposit insurance, for example, it is important to clarify how much coverage extends to profit-sharing investment accounts and to ensure that insurance premiums collected from Islamic banks are not commingled with those collected from conventional banks. And the roles of the resolution authority and the sharia board in bankruptcy need to be clarified.

The recent global financial crisis highlighted the importance of policymakers in responding systemwide to risks to financial stability. Islamic finance is often touted as inherently less risky than traditional banking, because lending is asset based and a large share of the financing is in the form of profit- (and loss-) sharing accounts. However, these potential advantages have not been fully tested and may be at least partly offset by Islamic bank balance sheets' heavy investment in sectors relatively vulnerable to cyclical booms and busts, such as real estate and construction. This argues for improved capacity to monitor the buildup of systemic risk and the development of regulatory and other macroprudential instruments to respond if necessary.

The sukuk market is expected to continue to expand very rapidly.

Different tax treatment of debt and equity and higher taxation from multilayered transactions may put Islamic finance at a disadvantage, which calls for balancing measures in jurisdictions where Islamic finance operates alongside a conventional financial system. For example, most corporate tax systems permit the deduction of interest payments from taxable income; to ensure comparability would require similar treatment of the profit payments associated with sharia-compliant contracts. And there are additional complexities associated with the application of certain indirect taxes—such as stamp duties levied on legal documents and other transaction taxes—given that sharia-compliant financial transactions often involve multiple steps. The growing cross-border reach of Islamic finance has brought such issues to the fore and argues strongly for close adherence to best practices.

A growing market

Global issuance of sukuk has grown significantly since 2006, albeit from a low base, and reached $120 billion in 2013: outstanding sukuk totaled $270 billion at the end of that year. Although this represents only about ¼ percent of global bond markets, and issuance is still concentrated in Malaysia and the Gulf Cooperation Council countries, there is growing interest in Africa, east Asia, and Europe. The demand is driven by a range of entities—sovereigns, multilateral institutions, and multinational and national corporations from developed and emerging market economies—that desire to broaden the range of economic activities and development projects they finance.

Demand for sukuk from Islamic finance institutions, which have few other options for sharia-compliant instruments, is natural. But there is also strong interest from the conventional financial world, thanks to the opportunity these instruments present for diversification. And the development of sovereign sukuk means the ability to establish benchmark yields that will facilitate sharia-compliant funding by private sector entities.

Financing of infrastructure

Sukuk have demonstrated a strong track record in financing infrastructure upgrades. Malaysia has used them for airports, marine ports, and roads. And Queen Alia International Airport in Jordan and the Hajj Terminal, King Abdulaziz International Airport Project in Saudi Arabia are just two examples of Islamic-financed public-private partnerships. The risk-sharing aspect of sukuk gives them an advantage as a funding instrument for infrastructure projects: their design resembles that of public-private partnerships through which investors finance and own the assets, leading to true securitization. Sukuk are designed from the outset to spread risk more broadly because all investors share uniformly, and more flexibly over time because payments are tied to underlying returns rather than to fixed schedules. Moreover, experience shows that sukuk can help countries tap a growing, dedicated, and globally diversified investor base and close countries' infrastructure gaps. The sukuk market is expected to continue to expand very rapidly, and its development will give Islamic banks access to the high-quality liquid assets needed to comply with international liquidity standards. Deepening this market calls for development of the legal and regulatory framework, strengthening the infrastructure, stepped-up sovereign issuance with diversified maturity to manage public debt under a strong public financial management framework, and secondary market development. International standards for accounting and statistical treatment of sukuk are also a key ingredient.

As Prime Minister Cameron suggested, there is enormous potential for Islamic finance to foster inclusive growth, finance infrastructure, and promote stability, if policies are put in place that take its unique characteristics into account. ■

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This article is based on a recently published IMF Staff Discussion Note, "Islamic Finance: Opportunities, Challenges, and Policy Options," by Alfred Kammer, Mohamed Norat, Marco Piñon, Ananthakrishnan Prasad, Christopher Towe, Zeine Zeidane, and an IMF staff team.

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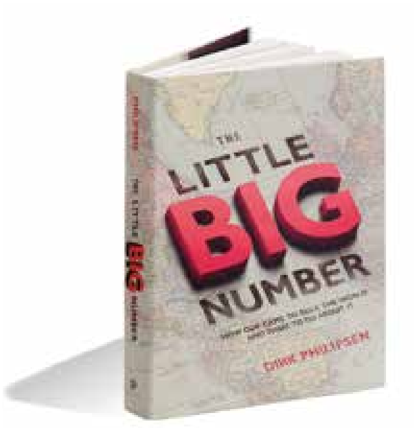
When Big Is not Beautiful



Dirk Philipsen

The Little Big Number

How GDP Came to Rule the World and What to Do about It

Princeton University Press, Princeton, New Jersey, 2015, 416 pp., $29.95 (cloth).

GDP is out of favor in some quarters. Some environmentalists take issue with the idea of prioritizing economic growth, measured by GDP, at all. Others argue that a wider perspective on progress is urgently needed. The global financial crisis, climate change, and the focus on inequality—all have contributed to a renewed interest in alternative ways of measuring how the economy is doing.

Many readers will therefore like the polemical tone of *The Little Big Number.* It looks at the history of GDP, its inadequacies as a measure of social welfare, and the environmental consequences of seeking continuing economic growth. It covers some of the same ground as a number of other books, including—from the same critical perspective—Lorenzo Fioramonti's *Gross Domestic Problem*, and—from a more nuanced perspective—my own *GDP: A Brief but Affectionate History* and Zachary Karabell's *The Leading Indicators*.

Dirk Philipsen's book has some additional historical detail but it is a rather emotional book. There are, for example, assertions like: "It is safe to say our ancestors, for some 200,000 years prior to the agricultural revolution, engaged in labour only to the very extent to which it helped them survive." Really? No cave paintings, ancient jewelry, religion? Or, because of our "fixation with the accumulation of things," trying to capture the reality of late 18th century life "by saying that people were poor would represent a fundamental misread." So were they not less well-nourished than we with more illnesses, and shorter lives, and many children dying in infancy? Did women (and even men) not spend hours in domestic drudgery? I do not hesitate to call people in the 18th century poor on this basis; it was nothing to do with a passion for accumulating cars or handbags. I don't want more than one washing machine but wouldn't be without the one.

The Little Big Number identifies the turn to growth rather than levels of national income as a policy aim in the 1950s. Philipsen attributes this to American optimism as the victor in World War II. Another possibility is that it was driven by the dawning Cold War, and the need to demonstrate over and over that the American system was superior to the Soviet one. Geoff Tily pinpoints a 1961 Organisation for Economic Co-operation and Development document as the first official reference to targeting growth, so quite a while after the end of the Second World War.

The second half of the book looks at the "beyond GDP" debate, oddly asserting that nobody paid much attention to the limitations of our conventional economic measurement between Robert Kennedy's assassination and congressional hearings in 2001. This is U.S.-centric; the global environmental movement kept the candle burning for alternatives all through that period.

Philipsen likes indicators such as the Global Progress Index. These show progress coming to a complete halt in the 1970s. This always seems absurd to me: even if the 1970s were a real turning point in terms of costs to the environment, which gets a heavy weight in such alternative indices, there has been a lot of welfare-enhancing innovation and straightforward growth since the 1970s. It's not just the invention of the cancer-busting drug tamoxifen or of the Internet, but the fact that more westerners live in houses with phones, indoor toilets, and central heating. Of course there is a trade-off with the environment but is that really no progress? Nor is Philipsen interested in the issues about defining either market output or social welfare for the growing category of digital goods that are often free and have strong public good characteristics.

The book advocates ditching GDP completely, and having a national dialogue about economic goals based on the principles of sustainability, equity, democratic accountability, and economic viability. It isn't clear how this prescription fits with the several "dashboard" initiatives under way now, which are described here. Named in a nod to the kind of indicator dashboards many companies use, these include a number of indicators meant to capture a broader sense of social well-being, such as work-life balance, environmental quality, and civic engagement. They were recommended by the influential Stiglitz-Sen-Fitoussi Commission in its 2009 report.

The dashboard approach is attractive, as is public consultation. However, it isn't yet clear which dashboard is best or what should go in it.

So the real need now in order to create a "Beyond GDP" set of social accounts is for the hard grind of the kind that the forerunners and creators of modern national accounts, Simon Kuznets, Richard Stone, and James Meade and their many colleagues, sustained through the 1930s and 1940s in creating GDP in the first place.

Some nominal aggregate measure of activity is necessary for fiscal and monetary policy. The national accounts statistics as a whole also contain a lot of the material that could furnish a meaningful dashboard, so again it would be a waste of an intellectual asset to ditch all of that. However, the answer to the underlying question, are we going to move "beyond GDP"? is a resounding "yes."

Diane Coyle
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Being Human

Richard Thaler

Misbehaving

The Making of Behavioural Economics

W.W. Norton & Company Inc, New York, 2014, 432 pp., $27.95.

Behavioral economics sees the world as full of humans, not "econs," in the language Richard Thaler and Cass Sunstein popularized in *Nudge*, their seminal work in this area. Now Thaler has a new book on the subject, but this time he describes his struggle for acceptance of behavioral approaches by the economics profession. The result is a very human book, starting with a moving tribute to Amos Tversky, whose work with Daniel Kahneman would surely have won him the Nobel Prize had he not died tragically at 59.

In the spirit of full disclosure, I worked with Thaler when the U.K. government was setting up the first major "nudge unit" to test behavioral concepts. I enjoy his company and his ideas: when I took him to the pub in London, we discussed whether the British habit of buying drinks in "rounds," taking turns to pay for everyone, leads to drinking too much.

The book is highly readable but also a serious study of behavioral economics as an example of a paradigm shift, as suggested by Thomas Kuhn in *The Structure of Scientific Revolutions*. Debate inside the University of Chicago and beyond was clearly intense and sometimes personal. Thaler describes his own career as a struggle against the prevailing orthodox model of "rational choice." The book lists "anomalies," findings that appear to contradict the rational model, from fields as far apart as game shows and pension savings. These findings were clearly not received warmly by many economists. Thaler talks of "running the gauntlet" at seminars, where opponents said the evidence was irrelevant because it is still possible to assume people behave "as if" they were following the rational choice model. His stories suggest that many econs display the very human trait of confirmation bias, which is not surprising given the radical way behavioral insights challenge traditional theories.

Thaler's anomalies compellingly demolish old approaches, but what should take their place? Presumably we need to base our models on assumptions consistent with how humans actually behave. The real success of behavioral economics is that it has led governments to change policies and the way they are implemented. Thanks to behavioral insights more people now donate organs in Brazil, pay taxes in Guatemala, hesitate to litter in Denmark, use condoms in Kenya, and save for retirement in India, the United States, and the United Kingdom. The list is long, impressive, and growing. Of course, the book isn't perfect: Thaler is human. Those outside American universities don't get much attention. Thaler is, in many ways, a traditional economist—not surprising for someone who has spent so much time in American economics departments. In fact, while I was Executive Director at the IMF and the World Bank, my gripe about economists there was that despite their apparent diversity, all had been trained at American universities to think in similar ways. In the book, you will look in vain for references to University College, London's Centre for Behaviour Change, or the Centre for Behavioural Economics at the National University of Singapore. I would also have liked to read more about philosophical issues: the balance between libertarian and paternalist aspects highlighted in Thaler's first book. Thaler is very much a utilitarian, but shies away from measures of subjective well-being.

Thaler worked hard to keep the book to a manageable length, which unfortunately meant skipping over some other interesting topics, such as applications to development policy in, for example, Abhijit Banerjee and Esther Duflo's *Poor Economics* and the World Bank's 2015 *World Development Review*. Nor does he get into the nitty-gritty of testing behavioral insights. Theories are not precise enough to tell us what works in various situations and contexts, so testing is crucial. Joseph Henrich, Steven J. Heine, and Ara Norenzayan have pointed out that nearly all research in psychology is conducted on a small subset of people from cultures that are Western, educated, industrialized, rich, and democratic—or WEIRD, to use their arresting acronym.

Global institutions should therefore be wary of applying such findings to other cultures. I tested this out at a lecture in Australia, showing the audience messages the U.K. nudge team had used to persuade people to donate their organs. The message the Australians chose as most persuasive differed from the one obtained through U.K. randomized trials. The Australian audience was fairly WEIRD but clearly different.

Thaler has a message for the IMF: there is plenty of room for behavioral approaches to fiscal areas—improved tax collection, for example—but behavioral economists should move from the world of microeconomics to macro. This leap represents an understanding that politicians, bureaucrats, managers, workers—and even staff in international institutions—turn out to be human. Policy prescriptions that assume otherwise can go badly astray. In my view, failing to read this book should definitely count as misbehaving.

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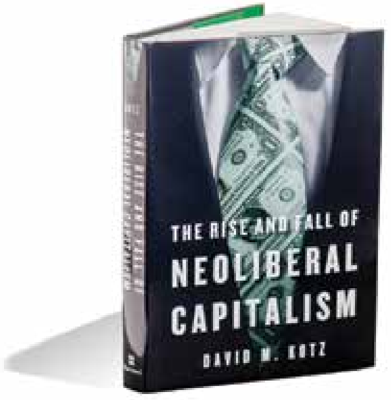
Paradise Lost?



David Kotz

The Rise and Fall of Neoliberal Capitalism

Harvard University Press, Cambridge, Massachusetts, 2015, 270 pp., $39.95 (cloth).

The worst kind of nostalgia is pining away for a time that never was. The Bible kicked it off with its account of Eden. Hollywood kept it going with films about the Wild West. Economist David Kotz contributes to the genre with *The Rise and Fall of Neoliberal Capitalism*. The book is an economic history of the period after World War II, when—according to Kotz—capitalism was gentler, more humane, and much better regulated.

The form of capitalism Kotz thinks held sway between the end of the war and the early 1980s was fraught with contradictions. He asserts that even though taxes were higher then, people did better and the economy grew faster. Even though trade was more restricted, companies thrived. Even though prices for many goods were not allowed to float freely (they could be set under "fair trade" rules), people saved more. Even though Wall Street's commissions were fixed and higher than today's averages, the financial sector accounted for a much smaller share of GDP and of profits than it does now.

Kotz says there was harmony between employees and employers, with unions granted a seat at the table. (However, somewhere under a parking lot or football stadium lies disappeared labor union leader Jimmy Hoffa, who can confirm or deny just how harmoniously labor and business interacted.) The economic geniality and harmony of the 1950s, 60s, and 70s was a hallmark of post–World War II capitalism, Kotz suggests.

In Kotz's history, every group was better off yesterday than today, except the 1 percent. But Kotz doesn't mention how the environment fared or how safe workers were in the workplace before the U.S. Occupational Safety and Health Administration and Environmental Protection Agency. Nor does he talk about health care or today's medical, pharmaceutical, and scientific breakthroughs. Kotz also bypasses innovation. This book is about economics; it is not a business book.

He also passes rapidly over finance. And when he glances at it, Kotz does so mostly in negative terms—for example, in his examination of mortgages, especially the saga of Countrywide, the largest provider of home mortgages before the housing crisis.

A problem with Kotz's book is that no one knows for certain whether his counterintuitive view that when capitalism was more tightly regulated it was more vibrant is right or wrong. There is a lot of noise in the numbers Kotz uses to make his points. For example, he writes that GDP grew at an average rate of 4 percent from 1948 to 1973 and slowed to 3 percent from 1973 to 2008. This fall-off in the growth rate indicates to Kotz that when capitalism was restrained by tougher rules and regulations, it did better. Far from slowing growth, as many economists argue, New Deal and post–WWII regulations accelerated it. The argument is capitalism does best when its hands are tied.

Global growth, according to Kotz, followed much the same trajectory. He argues that the global slowdown was the result of a capitalist system that was more competitive (and more cutthroat), and as market prices replaced managed prices, these more intensely competitive forces were a drag on growth. Really?

I find other arguments about growth during these periods to be much more persuasive. For instance, during the 1950s and 60s, the economy was vigorous because the world was still rebuilding in the aftermath of the war. In addition, housing exploded as the country tried to accommodate the baby boom. Housing sales, as we know, have a powerful effect on the economy since homeowners tend to fill up their new digs with everything from furniture to dishwashers and refrigerators.

The big question is how today's capitalism compares with post-WWII.

Investments in big projects—infrastructure, housing, and so forth—have among the highest and longest-lasting economic multiplier effects, and these effects were especially beneficial for young males without skills trying to decide whether to go to college under the GI Bill or acquire skills some other way. Taken together, big infrastructure projects led not just to jobs but to a shortage of labor. Such shortages drove up wages and increased savings.

The big question this book raises is how today's form of capitalism compares with what it was immediately after World War II. It is an interesting question and could even yield counterintuitive answers, but Kotz's case is not persuasive. He just doesn't make the case that highly regulated economies are healthier, grow faster, and accommodate the needs of people better than more laissez-faire forms of capitalism.

I was disappointed. This book seems to be the kind of project that was begun when the world leaned one way but finished when it was leaning the other way, and Kotz failed to include those changes in the book. In other words, the highly regulated, fast-growing, harmonious period Kotz wrote about (with as much nostalgia as an economist can muster) never really took place.

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