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Editors' Summary

Our outgoing and founding editor, Andrés Velasco, opened his summary of the Fall 2005 issue of this journal by noting that it was surprising that Latin America was "not growing more in this environment of the fastest world growth in thirty years" (p.vii). A similar disappointment with the region's growth performance motivates Mariano Tommasi's LACEA Presidential Address, which was delivered to the association's annual meeting in Paris and is published as the first article in this issue. Tommasi relates the generalized frustration with the region's restrained growth performance to the dashed expectations that many economists had with the market-oriented reforms adopted in most of the region over the last two to three decades.

This tenuous link between policy prescription and policy effectiveness spurs Tommasi to explore "what determines the ability of different polities to undertake the task of producing effective public policies." The approach summarized in the paper involves the construction of an index of "policy quality" based on six desirable characteristics of any policy—namely, stability; adaptability; coherence and coordination; the quality of implementation and enforcement; public regard (defined as "the degree to which policies pursue the public interest"); and efficiency. After placing a number of Latin American countries in the worldwide distribution of the policy quality index (conditional on data availability), Tommasi shows that despite its inevitable degree of arbitrariness, the index is correlated with a number of positive development indicators, such as economic growth, poverty reduction, and changes in the human development index.

Finally, Tommasi investigates the institutional determinants of policy quality. The results are presented largely as simple or partial correlations, owing to data limitations and the almost insurmountable endogeneity problems that plague the relations of interest. Nevertheless, he finds intriguing associations between policy quality and institutional characteristics of national congresses, of political party systems, of judiciaries, and of cabinet stability; the quality of

the civil service; and the relationship between the executive branch and the rest of the state. Tommasi's final stricture will also be useful to many readers of *Economía:* "Advocates and advisors have to think twice before forcing a favorite policy onto a polity at the expense of violating principles such as a reasonable degree of societal consensus, congressional debate, or judicial independence."

One measure of the credibility of domestic institutions—and of a government's ability to pursue stable, coherent policies—is whether private agents in the economy are prepared to hold the domestic currency. Over the last few decades, fear of high, unpredictable inflation in a context of incomplete domestic financial markets has led a growing number of Latin Americans to both hold their savings and borrow in U.S. dollars. Governments find it cheaper to borrow in dollars because lenders have little confidence in their commitment to the long-term value of their currency: this is the so-called original sin. Domestic firms have also increasingly sought cheaper credit by borrowing in foreign currency, and savers in many countries are diversifying their portfolios and using domestic dollar deposits to hedge against inflation. Although such financial dollarization may make sense from the individual agent's perspective, it generates risk-raising externalities that may make the overall result suboptimal, and it may justify policy action to dedollarize.

In the second paper in this issue, Eduardo Fernández-Arias provides a unified treatment of the literature on dollarization and proposes a specific mechanism for market-friendly dedollarization. He identifies three main problems associated with the widespread denomination of onshore domestic assets and liabilities in a foreign currency: increased financial fragility arising from the currency mismatch between firms' liabilities and their revenue; adverse consequences for fiscal and macroeconomic policy (largely resulting from the effects of fiscal considerations on exchange rate policy choices); and the empirical association between dollarization and output volatility.

Some amount of dollarization may be beneficial in allowing for asset diversification and financial depth in the absence of perfect domestic asset substitutes. Moreover, once an economy is dollarized, any attempt to force private agents to return to the domestic currency may cause substantial disintermediation and capital flight. Bearing both sides of this equation in mind, Fernández-Arias suggests that while some level of dollarization may be warranted in any Latin American economy, the observed levels are generally excessive. To avoid the costs of the massive disintermediation that might result from a forced conversion of assets and liabilities from dollars to pesos, the author suggests a gradual approach that relies on the development of domestic-

currency-denominated assets that are attractive substitutes to dollar assets. Since the key risk that drives people to the dollar is the risk that inflation will corrode the real value of their assets, a central component of an effective local substitute is inflation indexation. The proposal also includes a role for enhanced prudential banking regulation, as well as for multilateral banks (which can help by issuing investment-grade instruments in local currency).

Before its costs became better understood, dollarization was used as an anchor for the domestic price level in a number of Latin American countries. Governments have sought alternative arrangements, however, as the systemic risks of dollarization became evident. One of the most important developments in central banking in the past decade and a half has been the increasingly widespread adoption of the monetary policy framework known as inflation targeting. Following the lead of the central banks of Australia, Canada, England, Sweden, and New Zealand, many countries in Latin America adopted this approach, starting with Brazil, Chile, and Columbia.

The essential feature of inflation targeting is the announcement of a quantitative target for inflation, with the goal of anchoring inflation expectations. For this anchoring to materialize, inflation forecasts must be as accurate as possible, since a good measure of the success of the inflation-targeting framework is the gap between inflation forecasts and the inflation target. The third paper in this issue, by Fabia A. de Carvalho and Maurício S. Bugarin, evaluates the quality of inflation forecasts in Brazil, Chile, and Mexico. They find that forecasts have been unbiased, but not fully efficient in using the available information. They also assess the importance of inflation targets in anchoring inflation expectations in these countries. They conclude that in most cases there is room for improvement in credibility.

Inflation targeting is not the only policy innovation to come to Latin America by way of Australia, Canada, New Zealand, and Europe. Another is the widespread use of contingent protection—specifically, antidumping actions under the World Trade Organization. Pablo Sanguinetti and Eduardo Bianchi offer the most extensive analysis to date of antidumping activity initiated by Latin American countries since the late 1980s. They document an impressive increase in the number of antidumping actions by Latin America over the period, with the region's share in world antidumping initiations doubling from 11 percent in 1987–89 to 22 percent in 1995–2003. They find that Argentina, Brazil, and Mexico account for 81 percent of antidumping investigations initiated in the region between 1987 and 2003. Targeted exporting countries were also generally concentrated: Brazil and China were the main targets of Argentine investigations, while the United States and China were the main subject countries

for both Brazil and Mexico. In all three countries, the two sectors with the largest number of actions were chemicals and chemical products and basic metals.

The late 1980s and early 1990s were also characterized by substantial declines in tariff rates in these three countries (with Mexico starting both its tariff reductions and its antidumping actions a little earlier). This raises the question of whether these actions are merely reintroducing protection through the back door. In their econometric analysis, the authors do find a significant negative association between (lagged) tariff rates and antidumping initiations, but such protection does not appear to be applied in a blanket manner, as with a tariff. Instead, the paper's main finding is that antidumping action appears to be strongly influenced by macroeconomic conditions. In particular, sluggish (or negative) GDP growth and appreciated exchange rates are robustly associated with increases in contingent protection.

When the authors disaggregate activity by sector, they find no empirical support for the notion that actions are more common in heavily concentrated industries (controlling for industry fixed effects). Sanguinetti and Bianchi interpret this as a rejection of the political economy view that industries with powerful lobbies are most likely to be protected in this way, although, as Marco Bonomo notes in his comments, the results may be consistent with a relatively broad view of the political economy hypothesis.

The fifth paper in this issue shifts the focus to education. A number of countries in Latin America and the Caribbean have effectively reached universal primary enrollment. As these countries debate where to direct their next efforts, Norbert Schady examines the arguments for expanding early childhood interventions. He reviews the main theoretical arguments for public investment in early childhood development and provides a selective discussion of the evidence from the United States, before turning to a comprehensive survey of the evidence on early childhood outcomes in Latin America and the Caribbean.

The main conceptual argument for investment in early childhood is that the formation of certain skills occurs during sensitive and critical periods in a child's life. Once those periods pass, it is either impossible or much harder to acquire those cognitive and psychosocial skills (such as self-control or patience), which in turn are important inputs in other productive skills accumulated later in life. The rationale for public, as opposed to private, intervention arises largely from credit constraints or information failures. Moreover, the evidence from the United States suggests that returns to center-based interventions (in both small-scale initiatives, such as the Perry Preschool Project, and large-scale programs, such as Head Start) can be very high.

Turning to Latin America, Schady first establishes that Latin America and the Caribbean demonstrate no great aggregate (GDP-adjusted) shortcoming in gross preschool enrollment rates relative to the rest of the world. He goes on to show, however, that the available studies present evidence of substantial deficits between Latin American children, on average, and the global populations used to norm a variety of mental development and cognitive achievement tests. Those shortcomings tend to display a socioeconomic gradient (meaning that they are worse for children from poorer families than for children from affluent families) and to become more pronounced with age.

Schady's review of the impacts of various programs to improve skill formation among young children provides a sense of possible solutions, ranging from the specific (like the *Proyecto Integral de Desarrollo Infantil* in Bolivia or preschool construction projects in Argentina) to the more general (such as the impacts of the *Oportunidades* conditional cash transfer on child indicators). On the whole, the specific preschool-based interventions are found to have positive impacts on various childhood development indicators. More general programs had, at best, a limited impact. Schady argues that such general-purpose programs, while useful in terms of their own original objectives, may need to be combined with more specific interventions to enhance their early-childhood effects. Although this evidence is quite suggestive—and generally in line with findings in the more plentiful U.S. literature—the paper argues that the empirical knowledge base on early childhood development in Latin America is still thin, and much more work is needed, particularly with regard to long-term effects.

Early in the paper that opens this issue, Mariano Tommasi cites an example of a policy reform that has often failed in Latin America for reasons related to credibility and institutional strength: namely, the privatization of the pension system. In the last paper of the issue, Solange Berstein, Guillermo Larraín, and Francisco Pino return to this topic in considerably greater detail. In 1981 Chile introduced a pension system based on privately managed individual accounts. In the twenty-five years that followed, developing countries across Latin America, central and eastern Europe, Africa, and Asia, as well as some developed countries such as Sweden, reformed their pension systems following some variant of the Chilean model.

The Chilean reform clearly addressed the fiscal problems that had plagued the previous pay-as-you-go system. It also took care of the political economy problems of the old system, which redistributed resources toward groups with political clout, instead of benefiting vulnerable sectors of society. In this paper, Berstein, Larraín, and Pino consider two aspects that have received less

attention. First, they show that pension payments as a fraction of the worker's wage (the so-called replacement rate) are similar to the average value across OECD countries. However, Chilean women will be worse off relative to men than their counterparts in OECD countries. This is due to the fact that under individual capitalization, in contrast with a pay-as-you-go system, annuity payments are decreasing in the worker's life expectancy and increasing in the worker's labor market participation. Since women live longer and work fewer years, their pensions are lower.

The second finding is that a large share of workers contribute to their accounts for only a small portion of their working years—that is, many workers have a low contribution density. This finding, combined with the stringent requirements for access to the state-funded minimum pension, implies that a significant share of workers will be unable to finance a pension above the minimum pension level, yet they will not be eligible for the minimum pension. The authors conclude by exploring various policy approaches to improving coverage and raising the level of benefits in the Chilean pension system.

Two of the papers included in this issue were presented at the panel meeting in Santiago, Chile, in May 2005. The other four were discussed at the panel meeting held in Paris, France, in October 2005. As usual, associate editors of *Economía,* members of the 2005 panel, and outside discussants and referees have done a superb job. Thanks are due to them all.