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Editor's Summary

Some issues of *Economía* focus on one or two hotly debated questions. Others cover a smattering of topics, reflecting current research priorities and policy concerns in Latin America. This issue belongs to the second category. We have papers on subjects ranging from the economics of the arts to the benefits of foreign direct investment, and from the pros and cons of privatization to the consequences of central bank interventions in the market for foreign exchange. All of them help illuminate important policy debates in the region.

Many economists have long claimed that their discipline is an art. More novel is the emergence of an economics of the arts, which attempts to apply economics methods to the study of painting or literature. Outgoing LACEA chief Sebastian Edwards has taken an important step in this direction, devoting his presidential lecture to the nature of the creative process among Latin American painters and the performance of Latin American art as an investment. Edwards uses a large data set on international auctions of Latin American works of art, covering 115 artists from seventeen countries over a twenty-five-year period. His first task is to ascertain at what age artists did their most important (that is, their most expensive) work, in an attempt to shed light on patterns of creativity among artists in the region. Strikingly different patterns emerge. Chilean Roberto Matta painted his most valuable works very early in his career, with price declining continuously with age. The opposite is true for Colombian Fernando Botero, with the most expensive paintings arising in the late stage of his career. Following categories proposed by D. W. Galenson, Edwards labels Matta a conceptual artist—one whose work is based on a concept often arrived at early in life (like Picasso and cubism)—and Botero an experimental artist—one for whom each work is an experiment in a long trial-and-error process. Among the other top Latin American artists, several seem to have done their best work fairly early:

Diego Rivera at thirty-one, Frida Kahlo at thirty-eight, Wifredo Lam at thirty-nine, and Rufino Tamayo at forty-four.

Patterns of creativity also seem to have shifted over time. For the group of artists born before 1900 (Rivera and Tamayo are among them), prices of works of art tend do decline with the age of the artist at the time they were painted. The same is true for painters born between 1900 and 1920 (for instance, Kahlo, Lam, and Matta). The relationship is reversed, however, for those born after 1920 (such as Botero, Bravo, Cuevas, and Toledo). This suggests that leading Latin American artists have mostly gone from conceptual to experimental, with quality and price peaks occurring later in life.

Regardless of differences, an investor who held work by these artists would have done very well. Edwards estimates that for 1981–2000, the annual real return of a portfolio of top Latin painters was a hefty 9 percent, with a standard deviation of 12.6 percent. In the same period, the best performing Latin stock market—that of Chile—offered a return of only 7.3 percent, with a standard deviation of 41 percent. Moreover, the returns on the art portfolio have a very low correlation (a low beta) with an international equity portfolio. Adding Latin American art would therefore lower the overall risk of that portfolio. Readers of this journal can be forgiven if at this point they put down the issue and rush to the nearest auction house.

Art in Latin America seems like a happy story. Much less happy are the results of widespread privatization in the region—or at least that is the charge of a growing chorus of skeptics and antiglobalization activists. Critics claim that privatized firms shed too many workers, charge higher prices or exercise monopoly power, and provide insufficient benefits to the poor.

This is not the case, claim Alberto Chong and Florencio López-de-Silanes in an exhaustive survey of privatization in Latin America. In their own words, "Countries that privatize benefit, and the gains are not only kept by firm owners—they are also distributed to society."

Privatized firms are supposed to be more efficient and therefore more profitable. But sophisticated skeptics look at the academic evidence on the measured high profitability of privatized firms and claim that it is due to selection bias: only the healthiest firms elicit outside interest and are privatized. Alternatively, studies rely on firms sold through the stock market. This could also be a source of bias, since publicly traded firms tend

to be the largest—and hence also the most efficient. Chong and López-de-Silanes survey a large set of recent studies on this point, based on much larger data sets covering firms of many sizes and in many sectors and countries. These studies also consider detailed pre- and postprivatization data for the firms. Chong and López-de-Silanes argue that the evidence is overwhelming: firms do tend to become a lot more profitable after privatization. In Mexico, for instance, the median privatized firm enjoyed a 24 percentage point increase in operating profits.

Another key—and controversial—issue is who gains from privatization. Are these increases in efficiency passed on to consumers? The question is hard to answer for two reasons (among many). In the case of utilities, preprivatization service prices often involved subsidies, so one would expect postprivatization price increases even in the absence of poor regulation and monopoly power. Moreover, the quality of services and access to them often improve after privatization, and this has to be considered in assessing the impact of privatization on the welfare of consumers. Chong and López-de-Silanes argue that monopoly power cannot explain higher prices or profits. Their comparison of the behavior of firms in competitive and noncompetitive (regulated) sectors indicates that price increases are not larger, and output and employment growth not smaller, for firms in the noncompetitive sector.

This evidence is suggestive, but the issue remains controversial. Discussant Eduardo Bitrán, for instance, argues that too little restructuring before privatization and regulatory capture after privatization resulted in too little competition in some cases. Discussant Luis Felipe López-Calva adds that even if competition prevails, the gains from the greater efficiency have not been equally distributed, with displaced employees and some poor consumers standing as net losers from the process. This could help explain political opposition to further privatization in Latin America.

Chong and López-de-Silanes do not deny that there have been cases of failed privatization, but they argue that these have been the exception rather than the rule. Failures can be explained, in their view, by the way certain firms were privatized: opaque sales, poor contract design, insufficient deregulation ex ante, and regulatory capture ex post. In other words, the failures occurred for political reasons, which need to be understood and addressed before the next round of privatization—if there is one.

Privatization is one way to enhance productivity. Foreign direct investment is another, and it is one on which Latin American policymakers have

placed a great deal of hope. The idea is that the foreign firms bring new ideas, technology, and know-how, which can be expected to spill over to competitors in the same sector (horizontal externalities) and to upstream suppliers (vertical externalities).

That is the hope. The reality has been somewhat different, since horizontal externalities have proved hard to find and in some cases have even turned out to be negative. The paper by Laura Alfaro and Andrés Rodríguez-Clare focuses on vertical externalities (also known as backward linkages) and delivers some good news: according to their results, multinational corporations seem to have a positive linkage effect.

Most papers so far look at the share of inputs bought domestically. Since this share tends to be smaller for multinational corporations than for domestic firms, these papers tend to be skeptical about the potential of multinationals to generate backward linkages. This can be misleading, argue Alfaro and Rodríguez-Clare, because multinationals are likely to purchase more inputs than local firms, regardless of the source. They focus on a different measure, developed in earlier theoretical work by Rodríguez-Clare: the ratio of the value of inputs bought domestically to the total workers hired by the firm. This coefficient suggests that foreign firms have a higher linkage potential than local firms in Brazil, Chile, and Venezuela, while the evidence for Mexico is ambiguous.

Does this amount to a case for subsidizing or providing other special incentives for foreign firms engaging in direct investment? Not necessarily. One problem is that some of the inputs demanded domestically by multinationals may well be traded, in which case the additional demand is unlikely to matter either from the point of view of scale or technology transfer. A safer bet, argue Alfaro and Rodríguez-Clare, is directly to improve local firms' access to inputs, technology, and financing. That is a sound recommendation, though it is easier said than done.

If financing for firms in Latin America is expensive and unstable, one culprit is the volatility of international capital flows. It is by now uncontroversial that these flows are subject to periodic sudden stops, to use the phrase coined by the late Rudiger Dornbusch. A growing literature on the causes of sudden stops tries to ascertain whether idiosyncratic country characteristics (that is, bad policies) or changes in the international environment (such as an increase in U.S. interest rates) cause those sudden and drastic cutoffs in international lending.

Much less studied are the consequences of sudden stops—that is, the systematic investigation of why such a shock can be devastating in some cases (Argentina?) and much less traumatic in others (Chile?). That is the task that Pablo E. Guidotti, Federico Sturzenegger, and Agustín Villar undertake in the fourth paper of this issue. They start by defining a sudden stop as an episode showing a contraction in aggregate capital flows larger than one historical standard deviation in those flows and larger also than 5 percent of GDP. They then apply this definition to all countries in the world since 1974, and they find that sudden stops seem to be a fairly common phenomenon: there are 313 episodes, 265 of which required an accompanying adjustment in the current account. These episodes affect both rich and poor, with the highest incidence among middle-income countries, including some well-behaved ones such as Singapore and Chile.

What determines how painful a sudden stop turns out to be? Guidotti, Sturzenegger, and Villar find that openness, the exchange rate regime, and the extent of liability dollarization matter. Being more open and having a flexible exchange rate help a quick recovery of output, while having a large share of dollar debt deepens and prolongs the pain. The paper also characterizes different adjustment patterns across regions: East Asia tends to adjust to a sudden stop by expanding exports, while Latin America tends to adjust by contracting imports. Naturally, the latter is associated with a bigger recession than is the former. The differences are striking. In Malaysia, for instance, exports contribute 82 percent of the typical improvement in the current account, while in Brazil the figure is a paltry 4 percent. One reason for the contrasting performance is that Asian economies have historically been more open, and their exchange rates adjust more quickly to external shocks.

This suggests that the policy debate on financial crises could usefully be refocused. Much ink has been spilled recently on how to avoid sudden stops. According to Guidotti, Sturzenegger, and Villar, however, sudden stops are very common and unlikely to go away completely. It would thus be advisable to focus on avoiding traumatic recessions once an unavoidable sudden stop has hit. Countries can do things ex ante that help avoid nasty consequences ex post: limiting the dollarization of debt and making exchange rates more flexible are two examples that are receiving a great deal of attention in Latin America.

The problem with flexible exchange rates is that (almost) all countries like them in principle, but few countries actually use them in practice. After the Asian crisis of 1997–98 and again after the collapse of the Argentine currency board in 2001, many emerging markets vowed to adopt freely floating rates, often coupled with inflation targeting. Reality has been different from rhetoric, however. As capital returned to emerging markets over the last year, most countries in Asia and Latin America have intervened in the exchange markets and accumulated reserves to slow down the appreciation of their currencies.

This raises two questions. Why do countries intervene? Are those interventions effective? The paper by Matías Tapia and Andrea Tokman focuses on the second of these. The long and distinguished empirical literature on the effects of sterilized intervention deals mostly with advanced countries. It is also plagued by simultaneous equation biases, since interventions are supposed to affect the exchange rate, but the decision to intervene is often a function of movements in the exchange rate.

Tapia and Tokman address this problem by focusing on what is plausibly a more exogenous variable: the announcement by a central bank of its willingness to intervene in the future. Such announcements, they argue, "are not conditional on daily events. Rather, they reflect the central bank's main concerns regarding the behavior of the exchange market, ranging from issues such as liquidity or potential misalignments to excessive volatility." The paper focuses on the case of Chile, which employs a flexible exchange rate. In two different periods since the advent of floating in 1999, the central bank announced it was planning to intervene, specified a period and the maximum amount to be spent in that period, and then followed suit with actual sales of dollars on the spot market. Tapia and Tokman find that the announcement of intervention had a large and significant effect, appreciating the exchange rate by 2.7 percent in the first of these episodes.

As with any sterilized intervention, whether announced or actual, the question arises as to why it is effective in a world of high capital mobility. The authors conjecture the effect could be due to either a signaling channel (sterilized intervention today signals a tightening of policy in the future) or an information channel (if the exchange rate is misaligned, the announcement helps drive it back to its fundamental level). In both cases, it is crucial that the words of the central banker be credible: in the first case, for instance, the announcement should be followed by a tightening,

lest next time people pay no heed to the announcement. Some of this may have been at work in Chile: the August 2001 announcement was indeed followed by intervention, but not by a sizeable tightening, and the second announcement, in October 2002, seems to have had much less of an effect on the value of the currency.

This is very interesting and suggestive work, but it leaves open the question of why intervention is so common, even for countries like Chile (and Canada, Sweden, Australia, and others) that claim to be floating quite cleanly. In the last year, as capital returned to emerging markets, interventions in the other direction (to prevent the currency from appreciating) have been large and persistent in Argentina, Brazil, Colombia, and Mexico. It is a popular policy, but is it a sound one? That is an issue I hope future papers in *Economía* will explore.

This journal is a collaborative effort. As usual, thanks are due to many people. Associate editors worked hard to guide papers to publication; members of the panel contributed insights and spirited discussion; and *Economía* staffers helped put it all together. The articles in this issue were presented at a panel meeting held on 11 October 2003 at the Universidad de las Américas in Puebla, Mexico. Gonzalo Castañeda and Nora Lustig were gracious hosts and efficient organizers. We are grateful to all of them.