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Editor's Summary

This fourth issue of *Economía* contains papers presented at the panel meeting held on 19 October 2001 in Montevideo, Uruguay.

In our initial issue, which came out in the fall of 2000, I ventured that Latin American economists could perhaps afford to turn their attention away from macroeconomic crises and toward longer-term issues. True, Brazil and Ecuador had just gone through financial turmoil, and concerns about Argentina were mounting. But those troubles seemed small in comparison to the much lower inflation, slimmer budget deficits, and stronger banks that practically all Latin American countries had achieved over the previous decade.

Well, it wasn't safe to go back in the water quite yet. The Argentine meltdown has returned macroeconomic stability to the top of the agenda. And as Guillermo Calvo argues in his Presidential Address to LACEA, Argentina is only the most serious example of a broader problem. Globalization has brought many benefits to Latin America, but large and very volatile capital flows are not one of them. Calvo documents a phenomenon he labels sudden stops, in which a capital inflow boom (such as the one that occurred in Latin America in the first half of the 1990s) can turn into a race for the exits overnight, leaving countries no option but to turn the current account around by cutting imports, consumption, and growth.

What causes sudden stops? The currently fashionable theory in Washington is moral hazard: policymakers in developing countries overspend and overborrow on the supposition that they may be bailed out if things go wrong, until eventually their debts become unsustainable and lenders stop lending. Calvo argues that this view has "slim empirical support" and that it requires emerging market policymakers to suffer from "a fantastic lack of judgment, bordering on the insane." More plausible is an alternative view he terms globalization hazard. Specifically, poor information

and investors' susceptibility to rumors, coupled with certain vulnerabilities in borrowing countries (including the dollarization of liabilities and weak fiscal institutions), open the door for self-fulfilling contagion: if a country is perceived as risky, then investors dump its securities, triggering a painful adjustment that will make the investors' worst fears about the country come true. This is a systemic problem, Calvo argues, that cannot be solved by better policies in individual borrowing nations. He proposes an emerging country fund that could intervene in special circumstances, buying the bonds of these countries to prevent contagion and a generalized meltdown.

But not all macroeconomic news in Latin America is bad. A handful of countries—most prominently Brazil, Chile, and Mexico—seem to have found a way to combine anti-inflationary credibility with the exchange rate flexibility necessary to face external shocks. The magic potion is called inflation targeting, and according to Klaus Schmidt-Hebbel and Alejandro Werner, it is working wonders. They report that those three countries have been quite successful in meeting inflation targets and attaining relatively low sacrifice ratios and output volatility levels after adopting inflation targeting. The explicit targets are becoming increasingly credible, as shown by the fact that inflation deviation forecast errors have declined significantly since the adoption of the regime, while the influence of volatile inflation shocks on core inflation has been either small or negative.

Still, inflation targeting remains controversial in some quarters. One issue is whether the need to hit short-run targets may compel policymakers to avoid depreciations at all costs (the so-called fear of floating hypothesis), thereby making inflation targeting indistinguishable from (and just as vulnerable as) exchange rate targeting. Here Schmidt-Hebbel and Werner also report good news: pass-through coefficients from the exchange rate to domestic prices seem to be falling as inflation targeting systems mature. If that is so, central banks may be more relaxed about letting the currency move without fears of re-igniting inflation. Other concerns over inflation targeting are thornier: for instance, can it work in highly dollarized economies? It is not a coincidence that Brazil and Chile (and, to a lesser extent, Mexico) are among the least dollarized nations in the hemisphere. The situation is very different in Argentina, where inflation targeting may be given a high-risk trial in the near future.

Restoring growth requires investment. Getting investors to put up money, however, requires legal protection, which is woefully weak in

many areas of the world, among them Latin America. That is one conclusion of a fascinating line of research that Florencio López-de-Silanes has been pursuing recently in conjunction with several coauthors. In his paper for this issue, he surveys that body of work and attempts to extract policy lessons for the region. Investor protection matters; all legal frameworks are equal in this regard, but some are more equal than others. A controversial conclusion of López-de-Silanes's research is that nations with systems influenced by English common law offer entrepreneurs better terms of external finance and have higher valued and broader capital markets. This might tempt some developing countries into indiscriminately importing Anglo-American regulations—bankruptcy and corporate law, for instance. That would be a mistake, López-de-Silanes argues: "There is no one-size-fits-all set of good laws and regulatory mechanisms. More important, rules that work in developed countries might not succeed in developing countries that are struggling with poor judicial systems and lack of rule of law."

This last point suggests that reforming the judiciary and ensuring fair and expeditious enforcement may be just as important as reforming the laws themselves. López-de-Silanes devotes the second half of the paper to this pressing issue. He finds that indiscriminately increasing judicial budgets or salaries is unlikely to succeed—unless complemented, that is, by changes that increase accountability and present judicial officials with the right incentives. Choice and specialization can also help: small claims courts, courts devoted to particular subject matters (such as taxes or divorce), and greater reliance on extra-judicial dispute resolution have reduced backlogs in several countries. Courts do not live in a separate world, however, and meddling by the executive or the parliament is commonplace in many countries. Strengthening the constitution to guarantee judicial independence may be the most important legal reform of them all.

If trying to revamp the judiciary is trendy among Latin American policymakers, holding forth on the adoption of new technologies and Internet penetration is even more so. But, as Antonio Estache, Marco Manacorda, and Tommaso Valletti argue in their paper, becoming a new economy nation requires a great deal more than governmental good will. Citizens gain access to the net by purchasing services from existing fixed telephone companies. The high cost of these services, the authors argue, is the main obstacle to faster Internet diffusion in Latin America.

Costs are high because competition is insufficient. The telecommunications sector is frequently characterized as a monopoly, both natural and unnatural. Competition has to be fostered by appropriate regulation. This has not happened in Latin America: "Most governments in the region do not seem to appreciate that negotiating privatization is the easy part; they underestimate the importance of introducing and enforcing a regulatory regime that results in outcomes mimicking the effects of competition."

Competition is a key part of the story, but not the only part. Two of the largest Internet users in the region, Uruguay and Costa Rica, also happen to be the two countries that have not privatized basic telephony. The reason, of course, is money: both countries are affluent (for the region) and have a reasonably egalitarian distribution of income. Statistical work shows that such economic factors outweigh all others in predicting cross-country differences in Internet usage. A pessimist might conclude that, trendy talk aside, surfing the net will remain the privilege of the Latin American rich for some time.

Tackling poverty and inequality requires better schools, as most people would agree. The last two papers in this volume focus on efforts to improve Latin American education. The initial point is discouraging: despite relatively high spending levels (as a share of GDP), performance is not improving. In the 1960s, Latin Americans averaged more years of schooling than the citizens of any developing area; by 1990, East Asians had surpassed them by almost a full year (on average). Children from Latin America perform poorly in international standardized tests. Colombia took second-to-last place in 1995 in the international mathematics and science study (TIMMS), while Chile ranked thirty-fifth out of thirty-eight participating nations in 1998.

What is to be done? Alejandra Mizala and Pilar Romaguera survey possible answers. Latin American nations have experimented with education policies almost as much as they have experimented with macroeconomic schemes: privatization, decentralization, vouchers, smaller class sizes—all have been tried at one time or another. There is a large and growing empirical literature on the effects of such policies, but the results are mostly inconclusive. The problem has to do with statistics, and not with a peculiarity of Latin American schooling. If the question is which inputs (such as textbooks or small classes) are likely to improve educational outputs most cost effectively, the problem is that the extent to which a child enjoys

such inputs is not independent of other characteristics (like parental education or income) that also affects the child's achievement.

Disentangling the effects often proves difficult. There is some evidence showing, for instance, that students in Chilean private schools perform better than those in public schools, even after holding constant measured school inputs and student socioeconomic characteristics. This suggests that a move toward more private schooling may be beneficial. Several caveats apply, however. One is that it remains unclear which characteristics of the private schools account for the better performance. Another is that the empirical results hold for marginal changes only. A massive reallocation of students between the public and private systems would change the average makeup of each, and because of so-called peer effects, averages matter in determining performance.

In the 1990s, Argentina experimented with one particular kind of educational reform: decentralization. Management of secondary schools was transferred from the federal government to the provincial governments. The theoretical literature suggests that both good and bad things might come from this. If local school managers are closer and more accountable to the users, or if decentralization leads to increased competition or experimentation, then school performance could improve. But local jurisdictions may not have the necessary managerial skills, could have trouble securing financing, or could be vulnerable to capture by local interests; in that case, educational quality would suffer.

What about actual practice? Sebastian Galiani and Ernesto Schargrodsky argue that decentralization raised the scores of public school students in Argentina. To avoid econometric complications arising from unobservable factors that might be correlated with test performance, they focus on the difference in public and private school test outcomes. It is this measure that improves slightly with decentralization.

Transferring schools to a badly run province, however, will not have the same effect as transferring them to a well-run province. Galiani and Schargrodsky show that the effect of decentralization on test scores is positive when schools are transferred to provinces that run fiscal surpluses, but negative when provinces with fiscal deficits are involved. If sustained fiscal gaps are a good proxy for a province's administrative capacities, then local political and administrative reform may be a desirable prerequisite for decentralization, in Argentina and elsewhere.

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