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Editor's Summary

Nearly two decades after a wave of policy changes swept through Latin America, economic reforms continue to be the focus of much discussion. Critics claim that the promarket reforms have failed to deliver economic growth, and that the time has come to try something else. Advocates claim that the reforms were never given a fair chance—too little was done, often too late. Complete the reform process, they claim, and growth will come.

Both sides do agree on one point: Latin America seems to be suffering from reform fatigue, and another wave of reforms is unlikely to happen any time soon. Certainly not in countries led by left-leaning populists, such as Argentina's Néstor Kirchner or Venezuela's Hugo Chávez. The reform momentum has even stalled in countries led by promarket conservatives—Mexico under Vicente Fox and Colombia under Alvaro Uribe are two examples. If such reforms are now unpopular in many quarters, did the politicians who initially adopted them bear a political cost? Was the Washington Consensus electorally bad for friends of Washington? That is the question studied by Eduardo Lora and Mauricio Olivera in the lead article of this, the tenth issue of *Economía*.

Lora and Olivera analyze the outcome of sixty-six presidential elections and eighty-one parliamentary elections in seventeen Latin American countries from 1985 to 2002. Their general conclusion is striking: reforming parties and politicians were rewarded electorally only when reforms involved macroeconomic stabilization and a sharp reduction in inflation; otherwise, their reforming zeal cost them dearly at the polls. Economic outcomes do matter for electoral outcomes. Lora and Olivera find that the incumbent's party is rewarded in presidential elections for reductions in the inflation rate and in legislative elections for increases in the growth rate. Changes in unemployment and income distribution, however, do not appear to influence voters' behavior.

What is even more surprising is that, at the polls, policies matter irrespective of their results—that is, their effects on growth or inflation. Electorates seem not to like reform policies of the kind applied in Latin America in the 1990s. In a regression with electoral outcomes on the right hand side, reform indexes have a negative and significant effect, even when the authors control for changes in inflation and growth. The point estimate of the effect of policies on electoral results implies that the incumbent's party typically lost 15 percent of its vote in presidential elections on account of the average amount of promarket reforms introduced during its term. More aggressive reformers (say, those reforming one standard deviation above the mean) sacrificed 27 percent of their vote on account of promarket reforms. Statistically, this seems to be a very robust result for presidential elections.[1]

Moreover, lying about one's true intentions does not seem to be a good electoral strategy. Several Latin American politicians—including Fujimori in Peru, Menem in Argentina, and more recently Gutiérrez in Ecuador—first ran as opponents of the Washington Consensus, then followed orthodox policies. The paper shows that a candidate that said one thing on tax policy and then did another was, on average, punished more severely at the polls. Campaign promises do not seem to matter for the effect of other policies on voting behavior.

These results raise two kinds of questions. For academics, the issue is why inputs (policies) matter and not just outputs. Is it ideology, pure and simple? Or is it that because outcomes represent an extremely noisy signal of politicians' competence, the choice of policies conveys some information that voters find useful? For policymakers, the question is political: what has to change in Latin America before ambitious reforms become feasible again? Are all large-scale reforms out of the question, or only those that carry the Washington Consensus label? Both sets of questions remain very much open.

The unpopularity of the reforms does not mean, however, that policy is frozen everywhere. Trade is one area in which reform has not stopped dead

1. The total effect of reforms on electoral outcomes is the sum of two effects: a direct effect that runs from policies to votes and an indirect effect that runs from policies to economic outcomes to votes. The first is typically large and negative, while the second is positive insofar as the reforms lowered inflation and stimulated growth. The figures given correspond to the total effect—that is, after the positive indirect effects have been taken into account. The direct negative effects are much larger. See the paper for details.

on its tracks. Liberalization agreements, of both the bilateral and regional kind, continue to be signed, though at a less frenzied pace than a decade ago. Nearly fifty deals have been forged in the Americas since 1990s. But this veritable "spaghetti bowl" of overlapping and sometimes contradictory agreements has costs as well as benefits. One cost, studied by Antoni Estevadeordal and Kati Suominen in the second paper of this issue, results from the rules of origin applied.

At heart, the matter is simple: if Brazil gives Paraguay preferential access to its market, Brazilian policymakers want to make sure that the new imports entering Brazil are, in fact, made in Paraguay and not in a third country attempting to benefit from Paraguay's preferential status. But what sounds simple in theory becomes devilishly complicated in practice. What, precisely, is a Paraguayan good? Goods often have imported inputs, and in few or no items is 100 percent of value added likely to originate in Paraguay. Where, then, should a country draw the line?

Rules of origin attempt to settle the issue, but in doing so they face many pitfalls. If the set of rules is too stringent, then the bulk of Paraguayan goods may be left out of the Brazilian market. Indeed, such rules can be used as protectionist devices that effectively undercut trade preferences and contradict the avowed liberalizing intent of free trade agreements. Another problem is that rules of origin are almost inevitably complex (the paper identifies several kinds, each with its own subcategories). Applying them can be very costly, especially for the poorer economies in the region.

Estevadeordal and Suominen offer three main conclusions. First, putting stringent rules of origin into an agreement makes it more politically feasible, since the rules can be used as a tool to pay off protectionist interests. Second, there is evidence that restrictive rules of origin undercut the liberalizing potential of free trade agreements. NAFTA is a particularly egregious example of this, with many Mexican goods subjected to rules that verge on ludicrous. It is unfortunate, therefore—and this is the third conclusion of the paper—that the NAFTA model of rules of origin is increasingly being used in other agreements in the region. This does not bode well for free trade in the Americas.

Not all is lost, however. NAFTA-type rules are at least precise, and they leave less room for arbitrary application than do other types of rules of origin used in earlier agreements. Moreover, the growing homogeneity of rules that follow the NAFTA model simplifies the life of customs officials and lowers transaction costs. Last, and most important, the NAFTA rules of

origin have what trade experts call lenient facilitation devices. In English, this means that the rules themselves include ways to reduce their restrictiveness. A key aspect is diagonal cumulation, which allows countries tied by the same set of origin rules to use products that originate in any part of the common rules-of-origin zone as if they originated in the exporting country. Therefore, argue the authors, the rules of origin in a future Free Trade Area of the Americas—if one ever materializes—should not be all that restrictive. One can only hope they are right.

Financial regulation is another area in which policy is changing, as a result of both internal needs and international changes in standards. The 1988 Basel Accord on bank capital—the so-called Basel I agreement—is now in place throughout the region, and discussion has shifted to whether and how Latin American countries should apply Basel II. It is widely accepted that bank capital ought to be regulated, but how to do so remains open to debate. The simple approach of Basel I divides assets into very broad risk categories and establishes an 8 percent minimum capital requirement for risky assets. The potential for arbitraging one's way around this simple rule has grown, however, as risk management becomes more sophisticated. In response, Basel II goes well beyond simple quantitative requirements, proposing two basic approaches: the standardized approach, which uses external credit rating agencies together with a table that maps those ratings directly into capital requirements; and the internal ratings-based (IRB) approach, in which the banks themselves estimate their customers' default probability (without relying on external rating agencies) and then use a particular formula to determine capital requirements as a function of the estimated default probability.

The third paper in this issue, by Giovanni Majnoni and Andrew Powell, focuses on a key aspect of Basel II application. Many emerging markets do not have many (or any) external rating agencies, so the standardized approach may not be applicable. The internal ratings-based approach, in turn, is complex, and its application and supervision may stretch limited supervisory resources. Majnoni and Powell suggest a simplification of the IRB approach that could be used as a transition arrangement. In their centralized ratings-based (CRB) approach, banks would rate their clients, but the regulator would determine the rating scale and the way in which the banks' ratings map into default probabilities. Using a centralized scale would facilitate comparison across banks and greatly ease the monitoring of banks' ratings. Those requirements would also be easier to monitor,

since the regulator would determine how banks' ratings feed into capital requirements.

The hard part of the approach is deciding what kinds of standards the regulator should apply, since what works in rich countries may not work in emerging economies. Basel II's IRB approach suggests a formula for calculating a bank's capital requirement as a function of three basic variables: default probability, exposure at default, and loss given default. A regulator might then ask a bank to hold provisions and capital to cover a specified percentage of the distribution of losses to ensure the continued solvency of the bank except in highly extraordinary circumstances. The calibration of the Basel II IRB formula uses a value at risk of 99.9 percent with a horizon of one year—that is, a bank is only expected to use up its capital in one year with a probability of 0.1 percent, or once every 1,000 years.

Majnoni and Powell employ a bootstrapping technique to calculate loss distribution functions for Argentina, Brazil, and Mexico, using data on loan performance from public credit registries. They then use these functions to estimate the size of expected and unexpected losses of an average-sized bank with a loan portfolio randomly drawn from the universe of loans within the financial system. Their results show that these three countries have significantly higher default probabilities than Group of Ten (G10) countries. As a result, both current practice under Basel I and the suggested standards under Basel II may be inadequate. To achieve a 99 percent level of protection, capital requirements would need to be close to 15 percent, which is significantly higher than the 8 percent level recommended in Basel I. Even higher levels would be required to achieve 99.9 percent protection, as intended in Basel II. They also find that Basel II's IRB approach would result in levels of 90–95 percent protection rather than the 99.9 percent goal. This is not surprising, since the IRB was calibrated for the safer economies of G10 countries.

If bank regulation needs modernizing in Latin America, public transport does too. The spectacle of streets packed with old buses spewing black smoke is all too common in many cities of the region, from Mexico City to Quito and from São Paulo to Santiago. Poor public transport induces more private cars to enter the streets, worsening congestion and pollution.

If you think that this is a textbook case of the state not doing the job of providing public services, think again. Bus systems are private in many cities in Latin America, and that does not seem to solve the problem. As Juan Carlos Echeverry, Ana María Ibáñez, Andrés Moya, and Luis Carlos

Hillón document in their paper in this volume, the market for urban buses is ripe with market failures: unclear definition of property rights on the curbside and on the road; cartelization that results in fares set above the competitive equilibrium levels; misalignment between the incentives of bus drivers and owners, in a typical principal-agent conflict; and congestion and pollution externalities. In many developing countries, these market failures are exacerbated by weak regulation and enforcement. The result often is too many buses each carrying too few passengers in unsafe conditions, clogging the streets and soiling the air as they move (or fail to move) along.

One city in Latin America to have tackled the problem head-on is Bogotá, Colombia. Its so-called TransMilenio system is now being imitated in Quito and Santiago, among others, as well as several cities in Colombia. Echeverry, Ibáñez, Moya, and Hillón explain the logic behind the new system and analyze is effects. The key elements of the new system are as follows: (i) a hybrid public-private system, with concession contracts for private service providers; (ii) competition "for the road" (rather than "on the road") in a tendering process, with fare-setting based on long-term investment recovery; (iii) remuneration based on kilometers traveled rather than passengers transported, so as to prevent drivers from fighting over passengers on the street; (iv) separation between the transportation service and the fare collection process; and (v) exclusive road and curb-side service in metro-like stations.

Congestion, pollution, traffic accidents, travel times, and waiting times all fell dramatically along the corridors where TransMilenio was first put to work. The system was initially hailed as the solution of Bogotá's serious transport problems. Not all results were unambiguously positive, however, as the paper makes clear. Increased ridership resulted in jammed buses and rising waiting times. Moreover, the full system covering the entire city is not expected to be operating until 2015. This gradual transition did not help: older buses were displaced to secondary streets, where traffic and pollution increased.

A cost-benefit analysis of the system as is, with approximately 25 percent of the routes in operation, reveals welfare gains for users of the new routes, but an overall negative effect stemming primarily from increases in travel time for passengers using the traditional transport system. Since congestion costs are highly nonlinear, the welfare losses from heightened congestion in unserved corridors more than offset the benefits from TransMilenio, even though those benefits are sizeable. The authors conclude by

arguing that the adoption of a new public transport system must be coupled with improved regulation of all other public transport providers, so as to avoid the problem that arose in Bogotá.

What happens to workers' wages and employment prospects once they are displaced from their current jobs—for instance, by trade reform? If they are likely to be re-hired quickly at comparable wages, then no policy response is called for; but if some wage losses are large and lasting, then targeted help for displaced workers may be called for. David Kaplan, Gabriel Martínez, and Raymond Robertson study the issue for the case of Mexico, using an administrative data set that allows them to follow individual workers over a period of thirty-two quarters in four regions that vary significantly in labor market conditions. They focus on the differences in institutions, inequality, and labor market conditions that may explain differences in wage behavior after displacement.

One striking result is the heterogeneity of worker experiences, which range from large wage losses to many instances of gains after displacement. This is consistent with earlier results for other countries, but it cannot be attributed to differences in institutions (rates of unionization) or inequality, which are quite similar across Mexico. Rather, Kaplan, Martínez, and Robertson argue that labor market conditions, which vary quite a bit across time and regions within Mexico, explain the heterogeneity of experiences. In good times and in the most economically active regions, postdisplacement wages are generally higher than they were in the previous jobs. However, workers who are fired during times of high unemployment and in less economically active regions experience lasting effects on wages. If any public assistance is to be disbursed, Kaplan, Martínez, and Robertson argue, it should go to these workers.

All papers but one included in this issue were presented at the panel meeting held in San José, Costa Rica, in October 2004. The local hosts, and particularly Juan Rafael Vargas, provided much help. As usual, associate editors of Economía, members of the 2004 panel, and outside discussants and referees have done an outstanding job. Thanks is due to them all.