Issue 1, 2004

Research Abstracts

Center for Latin American Economics

Federal Reserve Bank of Dallas
Research Department

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Contents

Preface

The Center for Latin American Economics is pleased to present this issue of *Research Abstracts*. We wish to note, however, that this will be the last issue we publish. We have enjoyed assembling these *Research Abstracts*, and we will continue to serve readers of Center for Latin American Economics publications in the future.

As always, the main body of *Research Abstracts* contains the titles, authors, and abstracts of the papers, and if possible, the web sites where you can find the papers. An index at the back lists all authors and how to contact them to request copies of the papers.

This edition's contributions include Latin America-related work on debt management, regulation versus privatization of public utilities, dollarization, the distributional impacts of trade liberalization, and the transmission channels of monetary policy, including inflation targeting and money supply management, plus many more. There are 74 papers by 108 authors or coauthors. Here at the Center for Latin American Economics, we find the analysis in these papers invaluable not only for our own scholarly and technical research but also as bases for the briefings we make. We hope that you will gain as much from these papers as we do.

Research Abstracts appears on the Federal Reserve Bank of Dallas web site, www.dallasfed.org, in the Center for Latin American Economics section.

Even though we are ceasing publication of *Research Abstracts*, we will continue to issue information on conferences, meetings, and on Latin American economics to members of the Center for Latin American Economics. We will continue to issue working papers and other Latin America-related publications. If you are not yet a member of the Center for Latin American Economics, we invite you to join by filling out the application form at the back of this publication. Membership is free. Please send communications to the following address:

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Abstracts

The Political Economy of Economic Integration in the Americas:
Latin American Interests

by Marcelo de Paiva Abreu

This paper addresses reasons for the marked heterogeneity of interest concerning an FTAA in different Latin American economies. Different groups of economies are considered with an emphasis on their size, present trade structure, and trade orientation. Section 3 analyzes the political economy of protection in different Latin American economies, underlines the important contrasts between past experiences in different Latin American economies in the transition from high protection to more liberal trade regimes, and considers possible economic reasons for such contrasts. Section 4 addresses the political economy of protection in the United States. Several aspects of the process of formation of the FTAA are considered in Section 5. These relate to liberalization schedules, comprehensiveness of offers, and reciprocal gains. Estimates of the FTAA's effects are reported and considered. Finally, the interaction in terms of substance and timing between the FTAA negotiating process and other negotiations, especially in the World Trade Organization, is considered. (PUC Discussion Paper no. 468, available at www.econ.puc-rio.br/pdf/td468.pdf)

Evaluating the Chilean Government's Debt Denomination

by Elías Albagli

This paper proposes a framework to assess the convenience of the current public debt denomination of the Chilean government, through its implications on fiscal budget risk management. A "Value at Risk" methodology is proposed to compare alternative denominations regarding currency and interest rate. If the correlations found between the main factors affecting the fiscal result are valued at their point estimates, the exercise suggests that swapping the current debt denomination in fixed interest payments to variable payments indexed to Libor or government bond rates would significantly reduce fiscal results' volatility. The results also point to reduced current currency denomination in U.S. dollars toward a stronger position in euros or British pounds. A more statistically rigorous analysis that considers the volatility of estimated correlations, however, recommends taking previous conclusions with caution. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/259.htm)

Labor Market Rigidity and Structural Shocks:
An Open-Economy Approach for International Comparisons

by Elías Albagli, Pablo García and Jorge Restrepo

We construct performance-based measures of labor market rigidity in an open economy framework. We derive and estimate an indicator that depends exclusively on the theoretical measure of unions' bargaining power, with which we rank a sample of 18 heterogeneous countries. The indicator is obtained from unemployment persistence to structural shocks identified using a SVAR with long-run restrictions. We find that Korea, Hong Kong, Chile, and the United States are relatively flexible, while Germany, Sweden, Spain, and Colombia are among the most rigid labor markets. Our index shows high correlation with labor market performance and institutional regulation variables, mainly associated to union representation. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/263.htm)

Incentives Versus Synergies in Markets for Talent

by Bharat N. Anand, Alexander Galetovic and Alvaro Stein

We study what type of organization will host projects where talented individuals are pivotal. A cash-constrained and talented individual must invest in acquiring a skill essential to execute a project. Skill acquisition may be financed by either a corporation, which inserts the project into its pre-existing organization; or a specialist that finances single-project firms. The specialist can make talent the residual claimant. The corporation can exploit cross-project synergies by centralizing operations, which weakens incentives. Property rights may be weak: talent may leave and develop the project elsewhere after acquiring the skill. We find that weak property rights help corporations: for a given level of centralization, both effort and profits increase as property rights weaken. When the corporation can freely choose the strength of property rights and centralization, we find that, first, weak property rights are preferred; and, second, the corporation always chooses some centralization, eschewing first-best effort incentives. Moreover, whenever the corporation finances, it is socially efficient. We apply the model to examine several apparently puzzling phenomena in markets for talent. These include dominance by large firms despite severe conflicts of interest and high effort exertion by talent within large firms. (Paper available at www.webmanager.cl/prontus_cea/cea_2004/site/pags/20040316113817.html)

Determinants of Parents' and Teachers' Expectations of Child Ability in Belo Horizonte, Brazil

by Maria Ligia de Oliveira Barbosa and Laura Randall

Expectations are a significant determinant of student achievement. We study the determinants of mothers' and teachers' expectations about their child's school achievement in the fourth grade in public elementary school in Belo Horizonte, Brazil. We examine the contribution of color, family income, gender, the parents' highest level of education, and a measure of the child's academic ability to mother's expectations and to teacher's opinions of the student's achievement. This is explored for students in general, for white and nonwhite students, and for those in the lowest socioeconomic category.

Testing Real Business Cycle Models in an Emerging Economy

by Raphael Bergoeing and Raimundo Soto

RBC models have been successful when applied to developed economies: their abilities in replicating the data of emerging countries remain largely unexplored. The rapid but unstable growth process in developing countries and their relatively less developed market structure pose a formidable challenge to neoclassical general equilibrium models. Using data of the Chilean economy, we explore the effects of market rigidities and macroeconomic policies on the dynamics of consumption, investment, inflation and factor markets. We find that business cycle models replicate much of the observed fluctuations of real and monetary variables in the Chilean economy, despite its idiosyncratic economic structure. Using a calibrated model, we find that technology shocks, fiscal policies, and labor market rigidities are the main sources of economic cycles, while monetary policies and wage indexation play a minor role. Econometric tests support the use of our calibrated model as an adequate representation of the Chilean data. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 126)

Idiosyncratic Productivity Shocks and Plant-Level Heterogeneity

by Raphael Bergoeing, Andrés Hernándo and Andrea Repetto

Using plant-level data on Chilean manufacturing firms for the 1980–99 period, we estimate and characterize disaggregate total factor productivity. We show that idiosyncratic productivity shocks are a quantitatively relevant source of the observed heterogeneity in the behavior of plants. Both exit and input demand decisions are correlated with our estimates of plant level productivity. We then use these estimates to study the microeconomic sources of aggregate growth. We decompose productivity dynamics into production reallocation and within plant efficiency changes. We find that both sources of productivity growth have significantly contributed to efficiency gains in Chile during the last two decades. Although reallocation effects are always positive, the magnitude of their contribution is larger during periods of negative or low growth. Within-plant productivity growth contributes positively only during the 1990s, consistently with the existence of a lag between the implementation of major market-oriented structural reforms—mostly undertaken during the late 1970s and early 1980s—and their complete effect on the economy. Once reforms were consolidated, unbounded within-plant efficiency gains driven by technology adoption and innovation occurred. (Banco de Chile Working Paper no. 173, available at www.webmanager.cl/prontus_cea/cea_2003/site/pags/20031125155448.html

Policy-Driven Productivity in Chile and Mexico in the 1990s

by Raphael Bergoeing, Patrick J. Kehoe, Timothy J. Kehoe and Raimundo Soto

Both Chile and Mexico experienced severe economic crises in the early 1980s, but Chile recovered much faster than did Mexico. Using growth accounting and a calibrated dynamic general equilibrium model, we conclude that the crucial determinant of this difference between the two countries was the faster productivity growth in Chile, rather than higher investment or employment. Our hypothesis is that this difference in productivity was driven by earlier policy reforms in Chile, the most crucial of which were in banking and bankruptcy procedures. We propose a theoretical framework in which government policy affects both the allocation of resources and the composition of firms. (Paper available at www.econ.umn.edu/~tkehoe/papers/chile-mexico.pdf)

Why Is Manufacturing Trade Rising Even as Manufacturing Output Is Falling?

by Raphael Bergoeing, Vanessa Strauss-Kahn and Kei-Mu Yi

For the OECD as whole, as well as for the United States, manufacturing exports have been rising, while manufacturing output (both expressed as a share of total GDP) has been falling. We examine the prevalence of this puzzling fact across individual OECD countries, as well as for particular sub-industries of manufacturing. We then address whether the standard international trade paradigms are capable of quantitatively resolving the puzzle. We extend the basic monopolistic competition-cum-Heckscher-Ohlin model to allow for non-homothetic preferences, non-unitary demand elasticities and for changing trade barriers and country-size distributions over time. In a calibrated version of the model, we find that while the extended model can replicate the puzzle qualitatively, it cannot do so quantitatively. We suggest that the unexplained part of the puzzle may be due to vertical specialization—the phenomenon by which countries specialize in particular stages of a good's production sequence—leading to "back-and-forth" trade, and creating a distinction between "gross" trade and value-added trade. The standard trade paradigms only include value-added trade. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 178)

Regulation of Privatized Utilities:
The Chilean Experience

by Eduardo Bitran and Pablo Serra

The privatization of Chile's public utilities has led to substantial new investment and improvements in internal efficiency. However, the limited information available to regulators and their insufficient technical capacity have combined to prevent efficiency increases being fully passed on to consumers in price reductions. In fact, drastic price cuts have occurred only where competition has emerged, so achieving competition wherever possible should be the main policy goal. Competition can be enhanced by either modifying existing regulations, as happened in long-distance telecommunications, or by a more active antitrust policy. To achieve this, the regulatory institutions clearly need strengthening.

Foreign Direct Investment and Foreign Restriction in Mercosur:
Preliminary Conclusions and Research Agenda

by Gustavo Bittencourt

This paper identifies some issues to build a research agenda on the effects of transnationalization and economic development among Mercosur countries. The first section discusses an analytical framework that aims to understand the relations between Foreign Direct Investment (FDI) and the balance of payments constraint to growth in developing countries, and states that different "types of FDI" may affect this constraint in opposite directions, as they are explained by alternative theories. Section II contains an historical perspective of the transnationalization process in these countries, using a long-run FDI series analysis and resuming some characteristics of the last period. Finally, in the third section, some preliminary conclusions are outlined, attempting to meet the analytical framework and the empirical stylized facts, which allows identification of some issues or topics for this research agenda.

May the Pro-Poor Impacts of Trade Liberalization Vanish Because of Imperfect Information?

by Jean Marc Boussard, F. Gérard, M. G. Piketty, A. K. Christensen and T. Voituriez

In this paper, we try to evaluate the change in welfare gains and their distribution due to trade liberalization when imperfect information is considered. The results of two versions of a computable general equilibrium (CGE) model, using GTAP database and representing goods as well as capital flows, are compared. In the first one, a standard world CGE approach is followed. In the second version, we include risk aversion, imperfect information, and production lag in the agricultural sector. After a brief description of the two versions, changes in welfare, represented by the income of two types of household (middle low and middle high) in three regions (Europe, United States, Rest of the World) after agricultural trade liberalization, are presented. Theoretical and political consequences of the results are discussed. (Paper available at www.iaae-agecon.org/conf/durban_papers/index.asp?session_id=22&paper_id=38)

Monopoly Regulation, Chilean Style:
The Efficient-Firm Standard in Theory and Practice

by Álvaro Bustos and Alexander Galetovic

This paper analyzes the foundations of "efficient-firm" regulation (implemented in Chile for almost two decades) and the formulas that are used to set the prices of water/sanitation companies, electric power distributors, and the dominant phone companies. We show that efficient-firm regulation implies setting prices equal to long-run average cost, which is optimal when the firm is required to be self-financing. In contrast, this is not true of the best-known alternatives, namely regulation based on rate-of-return or a price cap. We also show that in both efficient-firm and price-cap regulation, the fixed and exogenous period that is maintained between price-setting processes stimulates productive efficiency. We argue that the price-setting formulas and procedures used assume that the regulator has sufficiently precise information to determine the costs of a hypothetical efficient firm, without the need for information from the real firm. Nonetheless, modern regulatory theory and practice both show that prices cannot be set without drawing upon information that only the real firm possesses. The model developed in this paper is used to discuss the potential gains from replacing efficient-firm regulation by a price cap. We conclude that price-cap regulation also requires considerable amounts of information from the real firm; so, for the time being, Chile should focus on improving regulatory procedures, rather than changing the underlying mechanism. (Paper available at www.webmanager.cl/prontus_cea/cea_2004/site/pags/20040316122141.html)

Vertical Integration and Sabotage in Regulated Industries

by Álvaro Bustos and Alexander Galetovic

An essential facility produces "access," an essential input used by a competitive downstream industry. The access charge is regulated. The essential facility can vertically integrate into the downstream segment and sabotage rivals increasing their costs. We systematically study the vertical integration decision and the optimal level of sabotage. Contrary to most of the literature, we allow for free entry into the downstream segment, so that prices equal long-run average costs. We find the following: First, sabotage does not pay when diseconomies of scope are large or the subsidiary's market share is small. Second, when sabotage pays, and the subsidiary coexists with rivals in equilibrium, optimal sabotage increases with the subsidiary's market share and scope economies. On the other hand, when the essential facility optimally sabotages to exclude rivals, the intensity of sabotage falls with economies of scope. Third, unless the subsidiary is implausibly more efficient than independent firms, vertical integration never benefits consumers. (Paper available at www.webmanager.cl/prontus_cea/cea_2003/site/pags/20030805172005.html)

Trade and Wages in Uruguay in the 1990s

by Carlos Casacuberta and Marcel Vaillant

The main facts of the Uruguayan labor market in the nineties may be summarized in three main phenomena: increase in wage inequality with an increase of the skill wage premium and changes in the interindustrial wage structure; destruction of unskilled jobs, associated to trade openness and changes in the productive specialization that implied technical change biased to the employment of workers with higher skill; decrease of the role of unions in wage negotiation. This paper attempts an empirical strategy to evaluate the impact of increased trade openness in the industry wage premiums and in the skill wage premiums, combining micro and macro data. We find a link between trade openness and both industry and wage premiums in the 1990s in Uruguay: in a given industry, reduced protection implied an increase in the skill premium and a lower industry relative wage.

Empirical Investigation of the Effects of the Fundamentals on the Exchange Rate

by Juan R. Castro and Atsuyuki Naka

This paper examines, by using several econometric techniques, the effects of foreign reserves and other fundamental variables on the exchange rate using the target zone theory. This paper uses monthly data from Chile for January 1979 to November 1997. The data used consist of foreign reserves, credit from the Central Bank, domestic reserves, imports, exports, claims on government, GDP, foreign liabilities, domestic and foreign interest rate. We find that the interest differential does not have any effect on depreciation, rejecting the target zone implication that the domestic interest rate can be used to manage the exchange rate. We find that foreign reserves support the exchange rate by reducing exchange rate depreciation, and the exchange rate and foreign reserves follow a negative relationship, which supports the assumption that increasing the foreign reserves appreciates the exchange rate. The levels of foreign reserves have not increased due to favorable terms of trade but rather due to foreign inflows through debt and direct investment.

Socio-Economic Conditions, Police, and Criminal Production

by Daniel Cerqueira and Waldir Lobao

This article develops a theoretical model of criminal production that explicitly incorporates such variables as income inequality and police power. In the traditional literature since Becker, such variables do not appear explicitly from a theoretical model even though they are almost always present in empirical specifications. The model, which considers heterogeneous individuals, permits comparisons in socioeconomic conditions (such as income and occupation), in social conditions (population density and level of crime) and in the allocation of resources to public security with respect to their impacts on criminality. We develop a VAR/VEC model for two decades of homicides in Rio de Janeiro and São Paulo that confirms the signs theoretically expected and suggests the fundamental role played by socioeconomic conditions in fueling the dynamics of crime in Brazil.

Forecasting Chilean Industrial Production and Sales with Automated Procedures

by Rómulo Chumacero

This paper presents a rigorous framework for evaluating alternative forecasting methods for Chilean industrial production and sales. While nonlinear features appear to be important for forecasting the very short term, simple univariate linear models perform about as well for almost every forecasting horizon. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/260.htm)

Three-Structured Smooth Transition Regression Models Based on CART Algorithm

by Joel Corrêa Da Rosa, Álvaro Veiga and Marcelo C. Medeiros

In the present work, a tree-based model that combines aspects of CART (Classification and Regression Trees) and STR (Smooth Transition Regression) is proposed. The main idea relies on specifying a parametric nonlinear model through a tree-growing procedure. The resulting model can be analyzed either as a fuzzy regression or as a smooth transition regression with multiple regimes. Decisions about splits are entirely based on statistical tests of hypotheses, and confidence intervals are constructed for the parameters within the terminal nodes as well as the final predictions. A Monte Carlo Experiment shows the estimators' properties and the ability of the proposed algorithm to identify correctly several tree architectures. An application to the famous Boston Housing dataset shows that the proposed model provides better explanation with the same number of leaves as the one obtained with the CART algorithm. (PUC Rio Working Paper no. 469)

Bank Competition, Agency Costs and the Performance of Monetary Policy

by Leonardo Soriano De Alencar and Márcio I. Nakane

This paper extends the general equilibrium literature on bank competition in order to evaluate its role on the performance of monetary policy. A new formulation of a financial contract taking into consideration both market power by banks as well as costly state verification is proposed here. Numerical simulations with the model economy parameterized to the Brazilian case are performed. Two cases are examined: one in which the banking sector is perfectly competitive and the other one when banks have market power. The main conclusions of the paper are the following: (1) greater competition in the loan market enhances the response of the real economy to an interest rate shock; (2) increased competition and/or a more efficient verification technology reduce the reaction of both the default rate and of the bank interest spread to an interest rate shock; and (3) the influence of the verification technology in the economy's dynamic response is greater when banks operate under perfect competition.

Macroeconomic Management in Emerging Economies and the International Financial Architecture

by José De Gregorio

In the past few years, and most recently with the crisis in Argentina, views about emerging markets and the international financial institutions have changed significantly. This paper reviews macroeconomic management in emerging economies and the role of the international financial institutions in helping to secure their stability. It discusses the role of macroeconomic policies, in particular exchange rate policies, arguing that a very strong case can be made for exchange rate flexibility. However, as recent evidence confirms, this choice requires an institutional framework that credibly commits the economy to low inflation, preventing price instability even in the presence of strong fluctuations in the exchange rate. Also discussed is the role of the international financial institutions in a world of recurrent currency crises and contagion. Despite the need for increased transparency, accountability, and greater independence for the International Monetary Fund, to avoid its being seen as an institution that primarily serves the political goals of its main shareholders, and despite the need for improved procedures to handle crises, the best recipe for stability is at the domestic level. Good macroeconomic policies are those that bring about low inflation, fiscal prudence, and a strong financial system: these are necessary and almost sufficient conditions to avoid the type of crisis experienced repeatedly in the last decade. However, strong institutions must support this set of policies. The ultimate goal of macroeconomic policy is to serve as the basis for prosperity and for improving the well-being of the entire population, and here there is no substitute for macroeconomic stability. (Paper available at www.webmanager.cl/prontus_cea/cea_2002/site/pgs/20030327141422.html)

Rapid Growth of Monetary Aggregates and Inflation:

The International Evidence

by José De Gregorio

This paper presents empirical evidence for low-inflation countries in which M1 has grown persistently for at least one year at rates much higher than the inflation rate. In none of these episodes has there been a similar increase in inflation, as a straightforward application of the simplest version of the quantity theory of money would suggest. This evidence confirms the idea that even in a world of long-run neutrality of money, the use of monetary aggregates to conduct monetary policy could be highly misleading. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/256.htm)

Structural Change in the Brazilian Demand for Imports:

A Regime-Switching Approach

by Igor Alexandre C. De Morais and Marcelo Savino Portugal

The aim of this paper is to apply a Markov switching model to check the characteristics of the Brazilian demand for imports equation based on annual data from 1947 to 2002 and on quarterly data from 1978:1Q to 2002:2Q. The results show that this model satisfactorily describes the structural and conjunctural characteristics of Brazilian foreign trade in the past decades. The long-term analysis, based on annual data, allowed for the identification of cyclic periods of trade closure and openness that coincide with the historical events of the Brazilian economy. The conjunctural analysis, based on quarterly data, indicates different elasticities for a regime with rise and fall in imports. (Paper available at www.ufrgs.br/ppge/pcientifica/textos2003/texto13_2003.pdf)

Regional Economic Growth in Chile:

Convergence?

by Rodrigo Díaz and Patricio Meller

The Chilean economy has shown rapid economic growth during more than 12 years, but with large differences across regions. This work examines why these differences exist and whether they will continue. This paper presents an empirical examination of the convergence hypothesis—that power regions grow more rapidly than the rich, such that their outputs per capita become more alike. This effort also permits us to derive an estimate of the factors that explain regional growth. The econometric results do not reject the convergence hypothesis. However, the speeds of convergence are very slow. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 180)

A Currency of One's Own?

An Empirical Investigation on Dollarization and Independent Currency Unions

by Sebastián Edwards and Igal Magendzo

In this paper we analyze whether "common currency" countries—that is, dollarized and independent currency union countries—have outperformed countries that have a currency of their own. The paper is empirical and estimates jointly the probability of being a common currency country and "outcome" equations for growth, volatility, and inflation. We find that both types of common currency countries have lower inflation than countries with a domestic currency. Dollarized countries have lower growth and higher volatility than countries with a domestic currency. Currency unions, on the other hand, have higher growth and higher volatility than countries with a currency of their own. (National Bureau of Economic Research Working Paper no. 9514)

Currency Mismatches, Debt Intolerance and Original Sin:

Why They Are Not the Same and Why It Matters

by Barry Eichengreen, Ricardo Hausmann and Ugo Panizza

Recent years have seen the development of a large literature on balance sheet factors in emerging-market financial crises. In this paper we discuss three concepts widely used in this literature. Two of them—"original sin" and "debt intolerance"—seek to explain the same phenomenon, namely, the volatility of emerging-market economies and the difficulty these countries have in servicing and repaying their debts. The debt-intolerance school traces the problem to institutional weaknesses of emerging-market economies that lead to weak and unreliable policies, while the original-sin school traces the problem instead to the structure of global portfolios and international financial markets. The literature on currency mismatches, in contrast, is concerned with the consequences of these problems and with how they are managed by the macroeconomic and financial authorities. Thus, the hypotheses and problems to which these three terms refer are analytically distinct. The tendency to use them synonymously has been an unnecessary source of confusion. (NBER Working Paper no. 10036, available at www.nber.org/papers/w10036)

Privatizing Highways in Latin America:

Is it Possible to Fix What Went Wrong?

by Eduardo Engel, Ronald Fischer and Alexander Galetovic

This paper reviews the Latin American experience with highway privatization during the past decade. Based on evidence from Argentina, Colombia, and Chile, we find that private financing of new highways freed up fewer public resources than expected because public funds were often diverted to bail out franchise holders. Furthermore, many of the standard benefits of privatization did not materialize because of pervasive contract renegotiations. We argue that the disappointing performance of highway privatization in Latin America was due to two fundamental design flaws. First, countries followed a "privatize now, regulate later" approach. Second, most concessions were awarded as a fixed-term franchise, thereby creating a demand for guarantees and contract renegotiations. This paper also extends our previous work on formal models of highway privatization. We relax the self-financing constraint, which ruled out the public provision of highways by assumption, and show that whenever the privatization of a highway is optimal, government transfers are undesirable. Alternatively, if government transfers are optimal, it is always the case that the full public provision of the highway should be preferred over privatization. We also model the role of flexibility and opportunistic behavior in highway concession contracts, and show that, by contrast with its fixed-term counterpart, a flexible-term franchise provides flexibility without inducing opportunistic behavior. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 163)

Soft Budgets and Highway Franchising

by Eduardo Engel, Ronald Fischer and Alexander Galetovic

Latin American governments progressively substituted build-operate-and-transfer (BOT) contracts for government-provided highways during the 1990s. Because under BOT a private-franchise holder finances and operates the road in exchange for tolls, it is often claimed that BOT represents a privatization of highways. We argue that, as currently applied, the BOT model is an imperfect and incomplete privatization, because the franchise holders' budget constraint has been soft, with losses being shifted to tax payers via minimum-income guarantees and contract renegotiations. Soft budget constraints are inconsistent with the standard arguments in favor of BOT contracts and call into question their avowed advantages. Moreover, both renegotiations and minimum income guarantees allow governments to finance current expenditures with future tax receipts, sidestepping the normal budgetary process. We propose various changes to the current model aimed at correcting its defects. First, franchises should be awarded through present-value-of-revenue auctions rather than fixed-term franchises. Second, the agency in charge of monitoring contract compliance and regulating franchises should differ from the agency that plans and auctions projects. Third, franchises should be subject to hard budget constraints, so that both profits and losses are privatized. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 176)

Targeting Inflation When Debt and Risk Premia Are High:

Lessons from Brazil

by Carl Favero and Francesco Giavazzi

The paper examines the effectiveness of monetary policy under different fiscal regimes by complementing the inflation-targeting framework typically proposed in central bank models with an equation for a fiscal policy rule. The authors show how the likelihood of falling into a "good" equilibrium depends on the parameters of the fiscal rule. The authors argue that the recent Brazilian experience exemplifies the critical behavior of fiscal policy. Brazil, during 2002, had probably fallen into a bad equilibrium, where default expectations and high risk premia were hindering the effectiveness of monetary policy. But the economy was just over the edge: a small change in the fiscal rule, such as that announced by the new administration, could have been enough to bring the economy back to normal conditions and rapidly stabilize the spread, the exchange rate, and through these two variables, inflation expectations, inflation, and the dynamics of the public debt. (Paper available at www.dse.unibo.it/seminari/giavazzi.pdf)

The Credit Channel in an Emerging Economy

by Viviana Fernández

To date, there is no consensus about how frictions in the credit market affect the transmission of monetary policy to the real economy. The traditional money channel states that when the central bank reduces its reserves, commercial banks are forced to reduce their demand for deposits. If prices are sticky, in the short-run a decrease in real monetary holdings should lead to higher real interest rates and should translate into a contraction of interest-sensitive components of aggregate spending. The most recent literature has focused on the role of the credit channel. This states that the direct effect of monetary policy on interest rates is amplified by changing the terms and availability of bank loans. Given that firms and consumers lack perfect substitutes for bank loans, they will be unable to offset the reduced supply of loans. This article tests the existence of a credit channel in Chile. Our sample comprises 19 banks that operated in Chile over January 1999–December 2002. Over that period, banks primarily offered loans to firms in the manufacturing and the financial services sectors (13 and 26 percent of total loans, respectively) and to individuals through consumption and mortgage loans (9 and 10 percent of total loans, respectively). Our estimation results show that the supply of demand deposits are affected by bank characteristics—such as liquidity, past-due loans share, and capitalization—economic activity, the level of interest rates, real exchange depreciation, and by Santiago Stock Exchange trading. Our results support the existence of a credit channel in the Chilean economy. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 175)

Extremal Dependence in Exchange Rate Markets

by Viviana Fernández

Exchange rate markets exhibit correlation in the short run, but the issue is whether such correlation lingers over long periods of time, and under extreme events (that is, either large appreciations or depreciations). In this paper, we analyze dependence between nominal exchange rates under extreme events for a sample of 10 countries with dirty/free float regimes over the period 1998–2002. In addition, we investigate whether currencies have exhibited extreme dependence on the euro since its adoption in 1999. Our findings are the following. First, in general, there is no evidence of extremal dependence between returns pairs. Second, the degree of dependence is stronger under large appreciations than under large depreciations. These conclusions are robust to filtering out the data for serial correlation and heteroscedasticity. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 165)

Extreme Value Theory:

Value at Risk and Returns Dependence Around the World

by Viviana Fernández

This paper presents two applications of extreme value theory (EVT) to financial markets: computation of value at risk and assets returns dependence under extreme events (that is, tail dependence). We use a sample comprising the United States, Europe, Asia, and Latin America. Our main findings are the following. First, on average, EVT gives the most accurate estimates of value at risk. Second, tail dependence decreases when filtering out heteroscedasticity and serial correlation by multivariate GARCH models. Both findings are in agreement with previous research in this area for other financial markets. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 161)

Can the Distributional Impacts of Macroeconomic Shocks Be Predicted?:

A Comparison of the Performance of Macro–Micro Models with Historical Data for Brazil

by Francisco H. G. Ferreira, Phillippe G. Leite, Luiz A. Pereira da Silva and Paulo Picchetti

How well can economists predict the distributional impacts on individual households of macroeconomic shocks and policies resulting from the financial crises of the late 1990s? Such an ability would have obvious implications for both social and macroeconomic policymaking. In this paper, we present a macro-micro model composed of an applied general equilibrium model linked to a microeconomic model of household income determination. The general equilibrium model uses parameters econometrically estimated on time series and is disaggregated by representative groups of households. The household income model econometrically estimates individuals' occupational choices and income based on a household survey cross section. To simulate shocks and policies, the top macro model feeds vectors of changes in prices, wages, and employment levels per household groups into the bottom micro model for individuals. We use this framework to measure—departing from 1998 data—the poverty and distributional consequences of the 1999 Brazilian financial crisis and its IMF-led stabilization package. We then compare the predictive performance of this macro-micro model with observed data for 1999. It is relatively good for occupations as it captures the rise in unemployment, the growth of the informal sector and the decline in unskilled urban employment that indeed characterized the 1999 crisis. It is less satisfactory for earnings as the model predicts declines in wages larger than observed. However, overall, the macro-micro model does a relatively good job predicting poverty and inequality levels, when compared with those actually observed in 1999. What seems to matter is the accuracy of the macro (time series) rather than that of the micro (cross sectional) part of the framework. While this approach has obviously not delivered the ability to predict the distributional outcomes of macroeconomic shocks or policy packages with perfect accuracy, it provides an experimental tool capable of simulating the micro distributional effect of a macro policy counter factual. Hence, with more experiments and improvements, the discussion can begin about how stabilization policy frameworks could be amended at the margin to allow the "credibility" of such packages to be built on both its macro stabilization and micro social objectives. (Paper available at econ.worldbank.org/files/35587_wps3303.pdf)

The Privatization of Social Services in Chile:

An Evaluation

by Ronald Fischer, Pablo González and Pablo Serra

We examine the privatization of Chilean social services that began in 1981. We conclude that the reform has had a positive impact by providing competition to public providers (health and education) and insulation from political capture (pension funds). The major lesson, however, is that the full benefits from privatization-cum-competition are slow to arrive and require able regulators to achieve them. Some of the benefits of competition are lost through rent dissipation, especially in the providers' search for the more attractive customers. These rents are due in part to the limitations of consumers when deciding on highly complex issues under asymmetric information. Another source of inefficiency is regulations introduced to avoid moral hazard problems, but which also have the effect of limiting competition. The performance of social service markets is improving, and this can be attributed to changes in regulation (fewer restrictions and more transparency), the consolidation of the industries, and hypothetically, better decisions on the part of consumers. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 167)

A Macroeconomic Simulation Model for the Banco de Previsión

by Alvaro Forteza

The aim of this paper is to present the macroeconomic model used to simulate the part of the Uruguayan pension system covered by the Banco de Previsión Social. The model in this paper is a variant of the overlapping generation models that have been extensively used to study fiscal policy in general and social security policy in particular (Auerbach and Kotlikoff, 1987; Falkinghan and Johnson, 1993; Obstfeld and Rogoff, 1996, among others). The contribution of this paper is to adapt the general model to the particular conditions of Uruguay.

Recent Trends in Border Economics

by Thomas M. Fullerton Jr.

Greater cross-border economic integration in many regions has caused the field of border economics to expand rapidly. It has also occurred as a consequence of growing recognition of the necessity to examine economic phenomena within the unique contexts imposed by geopolitical market segmentation. Some of the areas in which substantial research efforts are being directed include population, business cycle transmission, exchange rates, industrial development, labor markets, and natural resources.

Short-Term Water Dynamics in Chihuahua City, Mexico

by Thomas M. Fullerton Jr. and Ana Cecilia Nava

Time series analysis of water consumption patterns has not been investigated on a wide scale basis. For many municipalities, such efforts offer a means for developing potentially useful planning tools. Because data requirements are not extensive, model development is feasible in most areas of the world. The work at hand examines the applicability of such a tool in Chihuahua City, an important metropolitan economy in northern Mexico. Sample data are from January 1988 through December 2000. In addition to estimating a linear transfer function equation of water consumption in this city, the model is subjected to a series of simulation benchmark tests.

Social Protection in a Crisis:
Argentina's Plan Jefes y Jefas

by Emanuela Galasso and Martin Ravallion

We assess the impact of Argentina's main social policy response to the severe economic crisis of 2002. The program aimed to provide direct income support for families with dependents for whom the head had become unemployed due to the crisis. Counterfactual comparisons are based on a matched subset of applicants not yet receiving the program. Panel data spanning the crisis are also used. We find that the program reduced aggregate unemployment, though it attracted as many people into the workforce from inactivity as it did people who would have been otherwise unemployed. While there was substantial leakage to formally ineligible families, and incomplete coverage of those eligible, the program did partially compensate many losers from the crisis and reduced extreme poverty. (World Bank Policy Research Working Paper no. 3165)

Vertical Integration in the Electric Sector:
A Guide for the User

by Alexander Galetovic

This work values the pros and cons of vertical integration in the electric sector. The principal conclusions are the following:
(i) Although vertical integration is not bad per se, the majority of its advantages appear when there exist separate monopolies of transmission and distribution and each one exploits its market power individually. When the prices these monopolies can charge are adequately regulated, the majority of arguments in their favor disappear. (ii) When the access charges at the monopolistic stages of transmission and distribution are regulated correctly, it increases the attraction of vertical integration to extend market power to generation and distribution. (iii) A vertically integrated enterprise of a certain size will discriminate against its competitors and will attempt to impede the entrance of new firms. This discrimination will increase costs of nonintegrated generators and the price that their users pay, even if there exist economies of scope. (iv) The incentive to discriminate increases with the market participation of a vertically integrated generator and with the intensity of economies of scope. (v) It is very unlikely that economies of scope are transmitted into lower final prices. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 158)

Electrical Transmission and the 'Short Law':
Why Bidding Is Much Better than Regulation

by Alexander Galetovic and Juan Ricardo Inostroza

There exist at least two procedures to set the rates for users of transmission lines. One consists of regulating them through procedural standards. The other method is competitive bidding. In this work we show that expected rates are unambiguously lower if competitive bidding is used. Bidding dominates regulation for three reasons: First, competition guarantees the lowest expected rates. Second, the bidding increases the negotiating power of the regulator. Third, if, as in Argentina, the beneficiaries of the transmission project are permitted to participate in the bidding, the competition is intensified. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 177)

Vertical Mergers and Competition with a Regulated Bottleneck Monopoly

by Alexander Galetovic and Ricardo Sanhueza

Consider a bottleneck monopoly whose access charge is regulated above marginal cost and provides access to an oligopoly of downstream firms. Should the monopolist be allowed to vertically integrate into the downstream market? For the general run of oligopolistic market structures, we show that a vertical merger (or any set of vertical restraints that eliminates the externalities between the upstream and the downstream firm) will not decrease welfare in most cases. Vertical integration is irrelevant if the downstream market is perfectly competitive. With an oligopoly, the short- and long-run effects are somewhat different. In the short run, consumers and the integrated firm always win, but competitors are hurt because they lost oligopolistic rents. Most of the time welfare increases unless output is redistributed away from efficient competitors toward a very inefficient vertically integrated firm. Finally, if there is free entry, competitors and consumers are indifferent in the long run, and vertical integration always increases welfare. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 181)

Monetarism Beyond M1A

by Pablo García and Rodrigo O. Valdés

This work analyzes, from an empirical standpoint, the information contained in the M1A aggregate in Chile and compares it with other aggregates. The findings reveal that, at least for now, the M1A aggregate does not seem to have particularly valuable information that would make it a better indicator of inflationary pressures within the monetary policy decision horizon. This is consistent with the practice that central banks followed in the past, when they used quantitative targets for money and focused their analyses on broader aggregates. One possible explanation for the excessive importance given in Chile to the monetary aggregate M1A is the history of financial repression in which the country lived until the mid-1970s. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/262.htm)

Inflation Targeting and Sudden Stops

by Javier Gómez

Sudden stops seem to create the perfect environment for disinflation, especially when central banks defend the exchange rate by increasing interest rates. We propose a variation of the output gap model that incorporates the sudden stop shock. The use of the model in policy analysis shows that fear of floating is pro-cyclical and inflation targeting, counter-cyclical. The model is run for Brazil, Colombia, Korea, and Thailand, the inflation targeting countries that have recently had sudden stops. The three policy implications direct attention to the medium and long run. First, the central banks that are targeting inflation should focus on inflation, not during but after the sudden stop. Second, they could complement this medium-term view by monitoring a measure of inflation of nontraded goods. Third, the monetary authorities could eventually introduce an escape clause to the CPI inflation target under a sharp depreciation.

Wage Indexation, Inflation Inertia, and the Cost of Disinflation

by Javier Gómez

Wage increases based on past inflation increase inflation inertia and hence increase the cost of disinflation. Higher central bank credibility and a higher frequency of wage negotiations correspond to lower inflation inertia and a lower cost of disinflation. We have come to these conclusions using two models where the determination of wages captures forward- and backward-looking wage indexation and wage contract length. The policy implications are that the cost of disinflation can be decreased by using target or forecasted inflation in the negotiations of wage increases and by making every effort to increase central bank credibility.

Who Works Much and Who Works Little in Brazil?

by Gustavo Gonzaga, Phillippe G. Leite and Danielle Carusi Machado

In the literature on the Brazilian labor market there are few econometric studies on length of workweek. Most research on the workweek is focused on its legal and business aspects. The objective of this article is to study the profile of the employed in terms of workweek through data from the National Survey through the Household Sample (PNAD/IBGE) in the years 1992 and 1999. We attempt to establish the relation between the workweek and individual characteristics of the worker and of his occupation, such as: professional experience, sex, role in the family, race, position within occupation, sector of activity, educational level and dwelling location (metropolitan or nonmetropolitan area or natural regions). We estimate the likelihood that the worker will belong to one of three different regimes of work schedule—short workweek (39 hours per week or less), average (40 to 44), or long (45 or more)—conditioned on their characteristics and on their occupational type, through the use of a multinomial logistic model. The results show that the three principal factors that influence the determination of the number of working hours are individual characteristics associated with level of schooling, family composition and degree of formalization of employment. In particular, it is verified that less educated workers and those with little professional experience are the most likely to work long or average workweeks. (PUC Dept. of Economics Discussion Paper no. 471)

Income Function of Chilean Households: *Life Cycle and Persistence of Shocks*

by Paulina Z. Granados

Statistical information about households, coming from the National Statistics Bureau's supplementary income survey for 1990–1998 (approximately 30,000 homes annually), reveals that the expected component of Chilean households' income function is significantly determined by the effects of age, generational cohort, and time, along with a set of idiosyncratic household characteristics. To determine the dynamics of the random component, the process that supports the average residue by generation is estimated, which seems to be best described by either a moving average process of first and second order or an autoregressive process of first order. However, separating by educational level, only the income functions of low-education heads of households follow these processes, accepting white noise for higher-education households, which accounts for the influence of less-educated households in the results for the full sample. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/257.htm)

A Characterization of the Argentinian Production Sector Prior to the 1998 Crisis

by Pedro J. Gutiérrez and Eduardo Félix Marroquín

This paper formally characterizes the Argentinian production sector in the period before the last crisis. To do so, we jointly estimate the capital stock, its depreciation rate, and the aggregate production function of the Argentinian economy during the 1990s. In this respect, the paper not only completes the Argentinian statistics, but also proposes new estimation methods, goes beyond the usual qualitative and financial studies carrying out a quantitative analysis in real terms of the Argentinian production sector, and provides the government with a powerful instrument to design and evaluate economic policies. The paper concludes that the Argentinian capital stock is obsolete, scarce, and, from the real economy point of view, one of the main determinants of the crisis suffered by the country since 1998.

Mexico's Maquiladora Performance During the 1990s:
An Environmental Economic Assessment

by Pablo Hernandez

Maquiladora exports partly explain Mexico's pattern of trade specialization and foreign sector expansion during the 1990s. Maquiladora plants in Mexico export primarily to the U.S. market under preferential tariffs on their imported intermediate inputs. These plants' reliance on imported intermediate inputs remains significantly high throughout the 1990s. Disturbingly, the emissions and recorded Mexico–U.S. transfers of hazardous waste associated with maquiladora activity have steadily increased during this period, particularly, from maquiladora activity in Mexico's six-state northern border region. This paper connects the Mexican northern border maquiladora export expansion with the rise in maquiladora emissions and Mexico–U.S. transfers of waste during the 1990s. Two mechanisms, sector scale and sector product composition, are derived from a one-industry model, which isolates maquiladora activity from the rest of the Mexican economy. Scale refers to the change in emissions and bilateral transfers of waste given an increase in the economic activity from a particular maquiladora sector. Product composition refers to sector differences in output and emissions due to (a) differences in less-skilled labor wages across maquiladora sectors and (b) maquiladora sector differences in the demand for imported intermediate inputs. An empirical test reveals a weak presence of the scale effect and a strong presence of a product composition effect in terms of an increasing demand for imported intermediate inputs. A variable for maquiladora sector-type has no impact on emission estimates. A positive impact on emission estimates, due to an increase in the demand for imported intermediates, is noticeable following the Mexican peso crisis: 1995–99.

Dedollarization, Indexation and Nominalization:
The Chilean Experience

by Luis Óscar Herrera and Rodrigo O. Valdés

This paper revisits the Chilean experience with dollarization, indexation and nominalization in the 1958–2003 period. The purpose is to understand how Chile generally avoided dollarization and actually dedollarized in the 1980s to draw some lessons for other countries. We find that many policies that Chile pursued are not easy to implement elsewhere. Some key characteristics of the Chilean process are related to initial institutional conditions and developments, whereas others are connected to macroeconomic performance and specific regulations. Indexation plays a key role in explaining how dollarization can be avoided. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/261.htm)

The Center and the Periphery:
The Globalization of Financial Turmoil

by Graciela L. Kaminsky and Carmen Reinhart

This paper studies how financial turbulence in emerging market countries can spread across borders. We construct indices of "financial globalization" and evaluate the repercussions of turmoil in three emerging markets that experienced financial crises in the late 1990s: Brazil, Russia, and Thailand. Our findings indicate that financial turbulence in these countries only spreads globally when they affect asset markets in one or more of the world's financial centers. Otherwise, spillovers are confined to countries in the same region. Also, episodes of worldwide globalization of turmoil are mostly episodes of synchronized crashes, while regional turbulences include both joint crashes and rallies.

The Unholy Trinity of Financial Contagion

by Graciela L. Kaminsky, Carmen Reinhart and Carlos A. Vegh

Over the past 20 years, some financial events, such as devaluations or defaults, have triggered an immediate adverse chain reaction in other countries—which we call fast and furious contagion. Yet, on other occasions, similar events have failed to trigger any immediate international reaction. We argue that fast and furious contagion episodes are characterized by "the unholy trinity": (i) they follow a large surge in capital flows; (ii) they come as a surprise; and (iii) they involve a leveraged common creditor. In contrast, when similar events have elicited little international reaction, they were widely anticipated and took place at a time when capital flow had already subsided.

Emerging Markets Instability:

Do Sovereign Ratings Affect Country Risk and Stock Returns?

by Graciela L. Kaminsky and Sergio Schmukler

Financial market instability has been the focus of attention of both academic and policy circles. Rating agencies have been under particular scrutiny lately as promoters of financial excesses upgrading countries in good times and downgrading them in bad times. Using a panel of emerging economies, this paper examines whether sovereign ratings have an impact on country risk and stock returns. We also find that these changes are transmitted across countries, with neighbor-country effects being more significant. Rating upgrades (downgrades) tend to occur following market rallies (downturns). Countries with more vulnerable economies, as measured by low ratings, are more sensitive to changes in U.S. interest rates.

Semiparametric Estimation and Testing in a Model of Environmental Regulation with Adverse Selection

by Pascual Lavergnc and Alban Thomas

We consider a principal agent model of environmental regulation with adverse selection where firms are regulated through contracts. We show how the model allows us to recover information on structural cost parameters. We use a semiparametric method to estimate consistently such parameters without specifying the distribution of the agent private information. We also show how to check for the specification of the econometric models, as well as auxiliary parametric assumptions, by means of specification tests based on parametric estimation. Results are used to discuss a selection of economic issues related to environmental regulation. (Brazil: Directorate of Macroeconomic Studies, Seminários DIMAC no. 137, Instituto de Pesquisa Econômica Aplicada)

The Regional Influence on the Uruguayan Economy:

An Analysis of the Past Twenty Years

by Cecilia Llambí, Bibiana Lanzilotta and Gabriela Mordecki

The purpose of this paper is to estimate the influence of Argentina and Brazil on the Uruguayan economy between 1980 and 2002. The analysis of the relations between the regional GDPs indicated the existence of a long-term equilibrium between the growth rates of Argentina, Brazil, and Uruguay. Particularly, the growth rate of Uruguay is determined in the long run by the mean of the growth rates of Argentina and Brazil. In addition, demand equations of Uruguayan exports from Argentina and Brazil were estimated to analyze in detail one of the channels by which this relation is verified. The empirical approach consisted in cointegration techniques and autoregressive vectors with error correction mechanism (VECM).

Imperfect Rationality and Inflationary Inertia:

A New Estimation of the Phillips Curve for Brazil

by Angelo Fasolo Marsiglia and Marcelo Savino Portugal

This paper presents some new estimates for the relationship between inflation and unemployment in Brazil based on a new Keynesian hypothesis about the behavior of the economy. Four main hypotheses are tested and sustained throughout the study: (i) agents do not have perfect rationality; (ii) the imperfection in the agents expectations generating process may be an important factor in explaining the high persistence (inertia) of Brazilian inflation; (iii) inflation does have an autonomous inertial component, without linkage to shocks in individual markets; (iv) a nonlinear relationship between inflation and unemployment is able to provide better explanations for the inflation–unemployment relationship in the Brazilian economy in the past 12 years. While the first two hypotheses are tested using a Markov Switching-based model of regime changes, the remaining two are tested in a context of a convex Phillips curve estimated using the Kalman filter. Despite the methodological and estimation improvements provided in the paper, the impulse-response functions for the monetary policy presented the same properties shown in the literature that uses Brazilian data.

A Developing Country View on Liberalization of Tariff and Trade Barriers

by Patricio Meller

The key issue of the Doha Development Agenda (DDA) is the following: What type of OMC rules would maximize the rate of development of developing countries? In this short note, we provide a short synthesis of developed countries' disturbing trade barriers, which negatively affect developing countries' export growth. Also, we suggest some guidelines that would represent the ideal outcome of the Doha Trade Round from a developing country perspective. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 171)

International Comparisons of the Supply of Professionals and the Relative Position of Chile

by Patricio Meller and David Rappoport

The objective of this work is to make international comparisons reflective of a surplus or deficit of professional and technical workers in Chile. While the quantitative aspect of the presence of professional and technical workers is relevant, one of the central results of this article from the point of view of Chilean competitiveness in a global context is the relative qualitative level. In this context, the results are troubling. The central conclusion is that Chile has a relatively low supply of professional and technical workers after adjusting for national income per capita. Moreover, Chilean professional and technical workers show poor performance compared with their counterparts in other countries (principally developed countries) with respect to their level of comprehension in operating in an information economy. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 174)

Public Debt Management in Brazil

by Alessandro Missale and Francesco Giavazzi

The paper presents a simple model where debt management helps to stabilize the debt ratio and thus reduces the probability of a debt crisis. The optimal debt composition is derived by looking at the relative impact of the risk and cost of alternative debt instruments on the probability of missing the stabilization target. This allows us to price risk against the expected cost of debt service and thus to find the optimal combination along the trade-off between cost and risk minimization. The empirical evidence suggests that a large share of the Brazilian debt should be indexed to the price level. Price indexation should be preferred to Selic rate indexation while the share of dollar-denominated (and indexed) bonds should be drastically reduced from the current high level. These policy prescriptions appear robust to alternative methods of estimating the optimal debt structure. The share of fixed rate bonds should also be increased. Fixed rate debt avoids large interest payments when the Selic rate rises during a crisis or reacts to negative supply shocks and thus when debt stabilization is endangered by slow output growth. Because of their short maturity, around one year, fixed rate bonds ensure a sufficiently fast reduction of debt servicing costs in the event of a rapid fall in interest rates. If the term premium required on fixed rate bonds is not too high, issuing such bonds in exchange for Selic rate bonds increases the probability of debt stabilization. We provide evidence on the term premium that suggests that such a strategy is indeed optimal. (Directorate of Macroeconomic Studies, Seminários DIMAC no. 131A, Instituto de Pesquisa Econômica Aplicada)

Methodological Challenges of the Systems of Evaluation and Incentives in Education:

The Case of the SNED in Chile

by Alejandra Mizala and Pilar Romaguera

The work analyzes the most important challenges faced by evaluation and incentive systems, that is, which elements to consider in the measurement of student performance and how to compare different schools with students of different socioeconomic levels. This analysis is fundamentally methodological and is applied with respect to the National System of Evaluation of Teacher Performance (SNED) applied in Chile since 1996. The various indicators that can be used to evaluate educational establishments are compared and contrasted as methodologies for the comparison of establishments. The analysis allows determination of which measures allow for more or less equitable measures of performance. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 159)

Returns to Schooling and Rewards for Performance:

The Latin American Experience

by Alejandra Mizala and Pilar Romaguera

The objective of this study is to discuss analytically and methodologically the evaluation of performance and the introduction of educational incentives in Latin America. Incentives permit more adequate remuneration of teachers and accordingly motivate better performance and greater quality of education. Similarly, performance evaluations and incentive payments are associated with an improvement of information availability and the strengthening of accounting clarity in the education system. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 157)

The Regulation of Electricity Prices and the Viability of Investment in Generation in Brazil

by Ajax R. B. Moreira, Pedro AM-S David and Katia Rocha

The generation of electrical energy in Brazil is predominantly hydroelectric and is integrated through an extensive transmission network covering practically all of the country. That characteristic and the fact that hydroelectric flows follow a seasonal pattern of great variability implies the need to construct high-capacity reservoirs. The optimal utilization of hydraulic reservoirs is an intertemporal stochastic problem that is currently solved in a cooperative and centralized form. This model determines the production and price of energy in the spot market. The spot price is the marginal cost of operation. One of the most important concerns about the electrical energy markets—especially after the restructuring of the Brazilian energy sector—is that of self-sustaining productive capacity. This issue is especially critical in a system of rising demand, as Brazil's is. In the dominant model of optimization of generation resources, economic signaling for the expansion of the system is controlled indirectly through the valuation of the "cost of energy deficit." Nevertheless, this signaling has been shown to be inefficient, as was verified in the rationing period (2000–01). In the present article, we propose models of alternative regulation for electric generation that modify the criteria for transmission and the rule of energy price setting in a way that guarantees the viability of investment in generation; and criteria for the regulator to use to evaluate the results of these models that guarantee investment at the minimum cost for the final consumers. (Directorate of Macroeconomic Studies, Seminários DIMAC no. 133, Instituto de Pesquisa Econômica Aplicada)

Efficiency and Profitability Indicators:
The Case of Water Distribution in Córdoba, Argentina

by Ángel Enrique Neder, Carlos F. Ceballos Ferroglio and Rinaldo A. Colomé

The methodology presented here allows, from accounting information, generating some indicators that reflect the evolution of costs, prices, and performance of the water distribution firm in Córdoba, Argentina. These indicators are not only an appropriate instrument for softening the problems that emerge from asymmetric information but also they constitute a preliminary value for the determination of the X factor in the case of tariffs regulation by price cap method. In addition, taking into account the firms, they are also a practical element for making decisions and for the definition of business strategies.

Growth, Demand and Exports in the Uruguayan Economy, 1960–2000

by Jimena Pardo and Nicolás Reig

This paper analyzes the relation between economic growth and external demand in Uruguay during 1960–2000. Following Thirlwall's post-Keynesian theoretical approach, which is based on Harrod's foreign trade vision and Kaldor's "demand oriented" theories, we study the effects on the output growth rate that external demand can generate in the long run, including balance of payments constraint. Empirical evidence about some relevant variables is presented. Different econometric tests are applied to study the existence of a long-run relation between output and exports and to estimate elasticities of demand for imports and exports. The role of balance of payments constraints and the relevance of Harrod's foreign trade multiplier in the adjustment process of external imbalances are considered. We conclude that there is empirical evidence to support Thirlwall's law, which suggests a balance of payments constraint to output growth in the long run, although it is not possible to rule out "supply side" constraints. (Documento no. 11/02, Universidad de la República, Facultad de Ciencias Sociales, Departamento de Economía, Montevideo, Uruguay)

Models of Merger Simulation:
Application to Brazilian Cases

by Heleno Martins Pioner

This article presents new tools in support of antitrust policy. We explain some models of merger simulation, a relatively recent technique used by antitrust organizations that permits forecasts of the new industry price level after the merger. To illustrate the virtues of the method, we apply the model to some well-known acquisitions in Brazil and analyze the results.

Economic and Political Changes in Brazil:
Facts and Perspectives

by Marcelo Savino Portugal

This article presents some considerations about recent Brazilian economic policy. Some hypotheses about the economic perspective for the forthcoming years are also considered. Although the current government politically represents the opposition to the previous administration, not only in rhetoric but also in their attitudes, it seems to have chosen to maintain the economic policy and the agenda of structural reforms.

Addicted to Dollars

by Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano

Dollarization, in a broad sense, is increasingly a defining characteristic of many emerging market economies. How important is this trend quantitatively and how important is it for the conduct of monetary policy and the choice of exchange rate regimes? Though these questions have become a hot topic in both the theory and policy literature, most efforts are remarkably uninformed by evidence, in no small part because meaningful data has been lacking, except for a very narrow range of assets. This paper attempts to move the discussion forward and shed light on the critical questions by proposing a measure of dollarization that is broad both conceptually and in terms of country coverage. We use this measure to identify trends in the evolution of dollarization in the developing world in the last two decades and to ascertain the consequences that dollarization has had on the effectiveness of monetary and exchange rate policy. We find that, contrary to the general presumption in the literature, a high degree of dollarization does not seem to be an obstacle to monetary control or to disinflation. A high level of dollarization does, however, appear to increase exchange rate pass-through, reinforcing the claim that "fear of floating" is a greater problem for highly dollarized economies. We also review the developing countries' record in combating their addiction to dollars. Concretely, we try to explain why some countries have been able to avoid certain forms of the addiction, and we examine the evidence on successful de-dollarization. (National Bureau of Economic Research Working Paper no. 10015)

Debt Intolerance

by Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano

This paper introduces the concept of "debt intolerance," which manifests itself in the extreme duress many emerging markets experience at debt levels that would seem manageable by advanced country standards. We argue that "safe" external debt-to-GNP thresholds for debt intolerant countries are low, perhaps as low as 15 percent in some cases. These thresholds depend on a country's default and inflation history. Debt intolerance is linked to the phenomenon of serial default that has plagued many countries over the past two centuries. Understanding and measuring debt intolerance is fundamental to assess the problems of debt sustainability, debt restructuring, capital market integration, and the scope for international lending to ameliorate crises. Our goal is to make a first pass at quantifying debt intolerance, including delineating debtors' clubs and regions of vulnerability, on the basis of a history of credit events going back to the 1820s for over 100 countries. (National Bureau of Economic Research Working Paper no. 9908)

Infrastructure, Transport and Production Development in an Agricultural Region:

A Case Study

by Ricardo J. Sánchez

This study addresses the relationships between the development of agricultural and transport infrastructure investments. The case of study is an area in central and northern Argentina that accounts for more than 80 percent by volume of the country's agricultural exports passing through the ports. Exports by the agroindustrial complex account for 58 percent of the total value of Argentine sales. It is known that investments in infrastructure generally help to reduce the costs of enterprises and to enhance productivity. The main idea presented in this study is that investments in transport infrastructure are a necessary condition for the productive development of a region, especially in relation to external trade through ports and navigable waterways. In the case of Argentina, a positive relationship has been observed between the development of port and waterway services (with reduced costs and operating times, improved reliability, and new services) and expansion of the agricultural border, growth of productivity and agricultural production, and its industrialization.

The Economics of Financial Matching

by Eduardo Siandra

In this paper we try to place the phenomenon of financial matching in the broader context of financial economics. We explore the conceptual links with collateral, leverage, role of capital in financial intermediaries and nonfinancial corporations, the risk shifting between the financial and the nonfinancial sectors, and public policy implications. A broader research agenda is outlined. Although this is a far cry from a survey, we summarized two paradigms of financial economics, which can buttress this endeavor. Finally, we prepared a small analytical example to analyze financial matching in a corporate governance setting. (Documento no. 10/02, Universidad de la República, Facultad de Ciencias Sociales, Departamento de Economía, Montevideo, Uruguay)

Unemployment and Consumption in Chile

by Claudio Soto

This article presents an empirical study of the effect of unemployment on aggregate consumption of nondurable goods in Chile (1990–2002). Using an error-correction model, the results show that unemployment lags have a negative and statistically significant short-run impact on consumption growth. Three hypotheses that relate unemployment and consumption are also analyzed. First, it is shown that unemployment is not a good predictor of future disposable income. Therefore, it does not signal changes in permanent income. Moreover, the results do not support the implications of the certainty-equivalence version of the permanent income hypothesis. Second, there is evidence that unemployment affects income volatility. Hence, the relationship between unemployment and consumption could be explained by the precautionary savings motive. However, for this mechanism to be consistent with the fact that unemployment has a negative impact on consumption growth, the effect of uncertainty on consumption must be persistent. Finally, there is also evidence that unemployment could affect consumption through its effect on income distribution. However, the latter result is not robust. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/258.htm)

Effects of Foreign Exchange Intervention Under Public Information:

The Chilean Case

by Matías Tapia and Andrea Tokman

This paper studies the effects of exchange rate interventions using daily and intraday data for Chile, from 1998 to 2003. Its main contribution is the recognition of the role played by transparency and public announcements in the success of the intervention policy, through the existence of an expectations mechanism that directly impacts the exchange rate. Three foreign exchange policy instruments are distinguished—spot, dollar-denominated paper (BCDs), and announcements—and treated as independent interventions. Time series estimations are used to capture the effect of the traditionally studied spot interventions, as well as the effects associated to the announcement channel that we propose as potentially relevant. Results show that the impact of individual interventions (spot and BCD) are extremely small and, in most cases, nonsignificant. Also, the importance of the hypothesized announcement mechanism is confirmed. The impact of central bank actions on the exchange rate's level and trend seem to be channeled through the public announcements made by the monetary authority. The market adjusts its expectations to the information revealed through them, with the exchange rate responding accordingly. These effects occur on longer time spans than the ones suggested by the traditional literature. The negligible effect of individual interventions is also found, for the year 2001, with the use of intraday data. (Paper available at www.bcentral.cl/esp/estpub/estudios/dtbc/htm/255.htm)

Fear of Disruption:

A Model of Markov Switching Regimes for the Brazilian Country Risk Conditional Volatility

by Mauricio Yoshinori Une and Marcelo Savino Portugal

In the literature, little role is attributed to the country risk conditional volatility in the determination of the macroeconomic equilibrium in a developing small open economy (DSOE). This paper posits the prime hypothesis that, in the presence of multiple equilibria and self-fulfilling prophecies, one of the reasons why investors prefer to speculate in a certain country's sovereign bonds, raising its country risk levels, is the switch of the expected macroeconomic fundamentals' conditional variance toward a higher regime. Nonlinear GARCH models are applied to monitor different switching regimes of the Brazilian country risk conditional volatility, with special emphasis on Markov switching regimes. Results indicate that the high volatility regime periods, better identified by the latter, coincide with all the severe liquidity crisis episodes suffered by Brazil from May 1994 through September 2002. Thus, although not free of limitations, the country risk's high conditional volatility regime might determine a bad equilibrium and its monitoring might work as a practical tool to assess the duration of liquidity crises in a DSOE highly dependent on foreign capital inflows such as Brazil.

An Estimation of the Distributive Effect of Price Bands, 1984–2000

by Andres Venturelli

Between 1984 and 2000, bands on the prices of wheat, sugar, and cooking oils have been imposed in Chile, in an effort to stabilize product prices. This paper shows that the bands have served more to maintain than to stabilize prices. By raising prices on average, these policies generate net transfers from consumers to producers and the government. Accordingly, the bands have not only stabilized prices but have served as a form of protectionism. This paper presents empirical models to show that the effect of the bands upon consumers by income group is clearly regressive. Three factors have biased the transfers against consumers: (a) the band scarcely has an upper bound; (b) prices have fallen during the years in which the band was in effect, retarding declines in internal prices; (c) the reference price used by customs officers is systematically lower than actual import costs. (Universidad de Chile, Centro de Economía Aplicada Working Paper no. 162)

Bolsa or NYSE:

Price Discovery for Mexican Shares

by George M. Von Furstenberg and Carlos B. Tabora

Is price discovery and the calibration of news through American depositary receipts or shares, traded in central markets, superseding local discovery in peripheral markets? This question remains very much open as the evidence we present on the durability of price innovations in two major Mexican stocks that are household words provides little support for the inevitable demise of local markets. Rather, it appears that such markets may have some advantage in information efficiency that may compensate for the extra costs.

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