CHAPTER 1

Opportunity and Risk in a Globalized Latin America and the Caribbean

Latin America and the Caribbean's Performance Improved in the 1990s

IN THE 1990S LATIN AMERICA AND THE CARIBBEAN (LAC) BEGAN TO RESURFACE FROM THE "LOST decade" of the 1980s. Real per capita income, as measured by gross domestic product (GDP) per person, grew at about 1.5 percent per year,[1] after having declined in the 1980s. Granted, the pace of economic expansion in the 1990s was, like in earlier decades, still slower than that of the seven "East Asian miracle" countries. It also fell short of the growth rates achieved in the 1960s and 1970s in Latin America, during which real per capita GDP grew at over 2 percent per year. But this growth decline relative to the pre-1982 performance affected all world regions, industrial and developing—with the exception of only South Asia (see Figure 1.1).

The incipient growth recovery was punctuated by episodes of regionwide financial turmoil—such as Mexico's Tequila crisis of 1994–95 and the worldwide fallout from the East Asia and Russia crises in 1997 and 1998—and was uneven across the region. As Table 1.1 shows, the majority of Latin America's larger economies—those with populations above 1 million in 1995—shared in the resumption of growth relative to the 1980s.[2] Chile, the earliest reformer in the region, achieved rapid growth, well above historical levels. Other reforming countries such as Argentina, Bolivia, El Salvador, and Peru also grew faster in the 1990s than in previous decades. At the other extreme, several countries that have lagged behind in structural reforms (Ecuador, Haiti, Jamaica, Paraguay, and Venezuela) witnessed a decline in per capita GDP relative to the 1980s. Finally, Brazil's growth rate declined compared to the 1980s, reflecting the adverse effects of macroeconomic imbalances and financial market turbulence during much of the 1990s.

Rising incomes were duly reflected in improving living standards in the majority of LAC economies, as measured by per capita private consumption growth, which rebounded from the negative rates of the 1980s. As with GDP, however, the performance of consumption fell short of the pace witnessed prior to the debt crisis of 1982, and remained considerably behind the pace of the East Asian miracle economies (see Figure 1.2). Nevertheless, the upturn in consumption reached most countries in the region, with Chile and El Salvador the star performers, and Jamaica and Venezuela the only countries—among those for which the information is available—to experience a decline in private consumption per person relative to the 1980s (see Table 1.2).

Opportunities and Risks

The improvement in LAC's economic fortunes followed a sustained reform effort by many countries in the region aimed at enhancing the role of market forces and increasing the region's real and financial integration into the global economy. The incipient economic upturn of the 1990s suggests that this strategy has started to generate new opportunities for LAC in the global scene, especially for earlier and deeper reforming economies. In spite of better opportunities, however, perceptions of economic insecurity run high in the region. Indeed, there is a widely held

FIGURE 1.1

Per Capita GDP Growth

(Regional Medians)

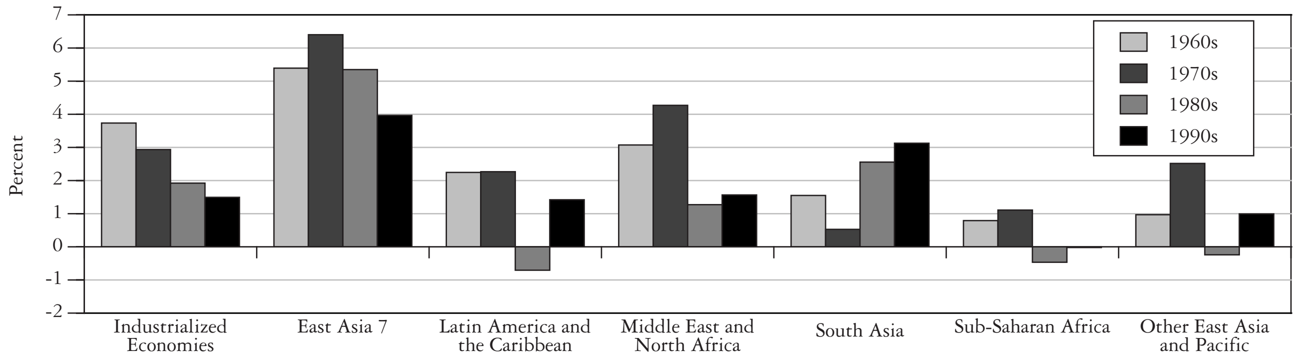

TABLE 1.1

Per Capita GDP Growth in Latin America

(Percent)

COUNTRY	1960s	1970s	1980s	1990s
Argentina*	2.4	1.2	-2.4	3.0
Bolivia	0.7	1.7	-2.5	1.8
Brazil	2.9	5.7	0.8	0.4
Chile	2.0	0.6	2.5	4.7
Colombia	2.0	3.3	1.2	0.6
Costa Rica	2.3	3.4	-0.8	2.0
Dominican Republic	1.2	5.2	1.5	2.2
Ecuador	1.0	5.8	-0.3	-0.3
El Salvador	2.4	1.2	-3.2	2.8
Guatemala	2.5	3.0	-1.6	1.4
Honduras	1.6	2.4	-0.7	0.3
Haiti	-1.4	1.8	-1.5	-3.1
Jamaica	2.6	-0.4	0.1	-0.2
Mexico	3.4	3.3	0.0	1.5
Nicaragua	3.9	-3.2	-3.7	-0.5
Panama	4.8	1.9	-1.4	3.3
Paraguay	1.7	4.9	0.8	-0.2
Peru	2.2	1.1	-2.4	1.9
Trinidad and Tobago	4.2	4.7	-1.0	1.3
Uruguay	0.2	2.3	-0.2	3.0
Venezuela	1.2	0.4	-2.8	-0.2
Mean	*2.1*	*2.4*	*-0.8*	*1.2*
Median	*2.2*	*2.3*	*-0.8*	*1.4*
Small Countries				
Bahamas	5.3	-0.7	1.5	-2.1
Belize	2.2	4.2	2.6	1.7
Barbados*	5.7	2.9	1.7	0.2
Guyana	1.1	0.8	-3.5	4.0
Mean	*3.6*	*1.8*	*0.6*	*1.0*
Median	*3.7*	*1.9*	*1.6*	*1.0*
Unweighted average	*2.3*	*2.3*	*-0.6*	*1.2*
Overall median	*2.2*	*2.3*	*-0.7*	*1.4*
*Weighted average**	*2.5*	*3.5*	*-0.1*	*1.1*

*Weighted averages use 1995 population.

Note: Decades are defined as 1961–69, 1970–79, 1980–89, 1990–99. Sample period is defined as 1961–98. Exceptions: Bahamas (1961–95), Barbados (1961–95), Guyana (1961–95), Peru (1966–99). For Argentina, Brazil, Chile, Colombia, Ecuador, Peru, and Venezuela, figures are updated to 1999.

view that economic insecurity[3] has become so pervasive that it could undermine social and political support for the ongoing reform process, and even bring it to a halt.[4]

That insecurity is a major concern for large segments of LAC's population is vividly illustrated by recent opinion surveys in the region. In a large cross-country survey undertaken in 1999, for example, nearly two-thirds of respondents said that their parents had lived better than them, while less than half thought that their children would have lives better than their own (see Table 1.3). This pessimistic view about the future affected not only countries experiencing major economic and social difficulties, such as Ecuador or Venezuela, but also others that had seen a marked improvement in their economic performance in the 1990s, such as Argentina, Mexico, and Peru. Indeed, even in these countries, a relatively small percentage of respondents—43 percent in Argentina, 30 percent in Mexico, and 37 percent in Peru—anticipated a better future for their children.[5]

Along with this heightened concern about economic insecurity, there are also strong signs of unsatisfied demand for social insurance. The same survey mentioned above found that three-quarters of the respondents favored increased spending on unemployment insurance. An even higher number supported increased spending on social security (see Table 1.4). Moreover, the extent of support for these programs varied little with the respondents' income and education level, or even with the economic performance of the different countries. In high-performing Chile, for example, 85 percent of the respondents favored increased unemployment insurance, and over 90 percent supported greater pension expenditures.

FIGURE 1.2

Per Capita Private Consumption Growth

(Regional Medians)

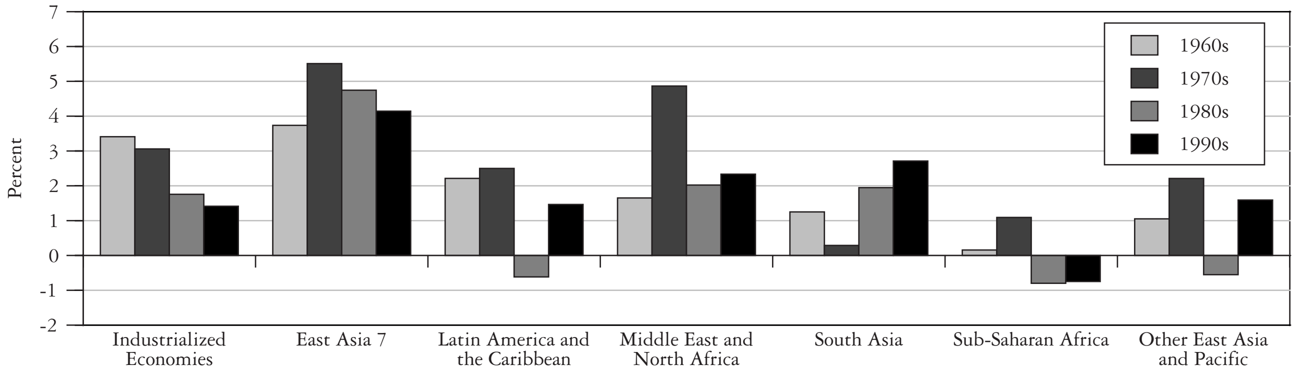

TABLE 1.2

Per Capita Private Consumption Growth in Latin America

(Percent)

COUNTRY	1960s	1970s	1980s	1990s
Argentina*	2.2	1.1	-1.7	4.0
Bolivia	..	..	-1.3	1.0
Brazil	2.4	6.4	-0.6	1.9
Chile	4.7	0.2	0.5	5.8
Colombia	2.6	3.2	0.7	1.4
Costa Rica	1.4	2.7	-1.7	1.2
Dominican Republic	3.1	4.6	1.0	0.9
Ecuador	1.8	3.9	-0.1	0.2
El Salvador	1.7	0.9	-3.4	5.2
Guatemala	1.9	2.6	-1.2	1.5
Honduras	1.1	1.6	-0.1	0.2
Haiti	-2.6	1.1	-0.7	..
Jamaica	1.0	-0.3	2.4	-2.8
Mexico	2.8	2.5	0.0	1.1
Nicaragua	3.6	-3.5	-4.6	0.0
Panama	..	..	3.6	3.0
Paraguay	3.3	3.0	1.0	3.2
Peru	4.0	0.9	-2.1	1.5
Trinidad and Tobago	4.6	4.9	-2.1	1.5
Uruguay	-0.4	0.8	0.2	4.1
Venezuela	..	6.1	-1.6	-0.6
Mean	*2.2*	*2.3*	*-0.6*	*1.7*
Median	*2.3*	*2.5*	*-0.6*	*1.4*
Small Countries				
Bahamas	..	22.7	2.3	..
Belize	..	..	-2.3	2.1
Barbados*	..	..	..	0.9
Guyana	1.3	-0.3	-3.6	5.8
Mean	*1.3*	*11.2*	*-1.2*	*2.9*
Median	*1.3*	*11.2*	*-2.3*	*2.1*
Unweighted average	*2.1*	*3.3*	*-0.5*	*1.7*
Overall median	*2.2*	*2.5*	*-0.6*	*1.5*
*Weighted average***	*2.3*	*3.7*	*-0.5*	*1.7*

*Consumption figures for Argentina and Barbados correspond to total, and not private, consumption. Argentina: 1961–98, Barbados: 1967–94.
**Weighted averages use 1995 population.
Note: Decades are defined as 1961–69, 1970–79, 1980–89, 1990–99. Sample period is defined as 1961–98. Exceptions: Bahamas (1978–87), Barbados (1967–94), Belize (1981–98), Bolivia (1961–79, 1981–98), Guyana (1961–88), Haiti (1966–90), Honduras (1961–97), Nicaragua (1961–96), Panama (1981–98), Peru (1966–98), and Venezuela (1975–98).

Why Economic Insecurity?

What lies behind these perceptions of insecurity and social insurance demands? There are several factors. On the one hand, the unprecedented severity and duration of the crisis unleashed in 1982—reflected in a sharp and long-lived decline in per capita incomes from which LAC has taken many years to recover—left a profound imprint across the region's social fabric concerning the dangers of economic instability.

On the other hand, the incipient recovery from the "lost decade" of the1980s came along with a radical change in economic strategy in many LAC economies—a shift away from the protected government-led development model of previous decades, and toward a new paradigm of strengthened domestic and foreign market forces in the context of a global economy. Barriers sheltering domestic economies from global trade and financial trends were lowered, obstacles to competition in domestic markets were removed or substantially weakened across LAC, and governments reduced considerably their direct involvement in economic activity.

These reforms deserve much of the credit for LAC's expanding economic opportunities in the 1990s. However, while the reforms assigned a greater role to the action of domestic and global market forces, they also led to the weakening of major components of the rudimentary and inequitable traditional social protection system. The weakening of extensive barriers to domestic and foreign competition made it harder to sustain a generous provision of public sector jobs and stringent firing restrictions that had resulted in virtual lifetime employment for formal sector workers.

The removal of these old mechanisms incompatible with the new market-oriented economic model has not been matched by the development of a new social protec-

TABLE 1.3

Survey Responses in Latin American Countries on Expected Changes in Living Standards

(Percentages Unless Otherwise Noted)

	WHOLE SAMPLE		COUNTRY				
	N	%	ARGENTINA	BOLIVIA	BRAZIL	CHILE	COLOMBIA
	14,839	100	1,200	794	1,000	1,200	1,200
Taking everything into consideration, would you say that your parents lived better, the same, or worse than how you live today?							
Better	9,081	61.2	63	51	64	45	78
Same	3,261	22	22	31	9	32	14
Worse	2,139	14.4	12	16	25	22	8
No answer	358	2.4	3	3	2	1	1
And regarding your children, do you believe that they will live better, the same, or worse than how you live today?							
Better	6,843	46.1	43	56	58	61	36
Same	3,071	20.7	22	20	12	22	21
Worse	3,261	22	20	13	21	11	38
No answer	1,664	11.2	16	11	9	7	6

Source: Mirror on the Americas poll, 1999, *Wall Street Journal.*

TABLE 1.4

Survey Responses to Social Insurance-Related Questions in 14 Latin American Countries, by Socioeconomic Category

(Percentages Unless Otherwise Noted)

	WHOLE SAMPLE		AGE			EMPLOYMENT		
	N	%	18–29	30–49	50+	SELF-EMPLOYED	GOVERNMENT	PRIVATE SECTOR
Unemployment Insurance								
No answer	551	3.7	3	4	4	4	5	3
Spend more	10,088	73.4	74	73	73	74	69	74
Spend less	2543	17.1	18	18	16	17	19	17
Don't know	857	5.8	5	5	7	5	7	6
Pensions								
No answer	172	1.2	1	1	1	1	2	1
Spend more	12,426	83.7	83	83	86	83	84	84
Spend less	1861	12.5	13	13	10	13	12	13
Don't know	380	2.6	3	3	3	3	2	2
Defense and the Armed forces								
No answer	623	4.2	4	5	5	4	6	3
Spend more	4810	32.4	33	31	34	34	28	29
Spend less	8359	56.3	58	57	53	56	59	60
Don't know	1047	7.1	5	7	9	6	7	7

Source: Mirrow on the Americas poll, 1999, *Wall Street Journal.*

tion and insurance system more suited to the changed economic environment. Thus, while households and workers in LAC's reforming economies have gained access to new economic opportunities, they may have been left more exposed to new risks as well. Growth resumption in the new economic environment entails faster job creation in expanding industries, and thus new opportunities, but also job destruction in declining sectors, and hence new risks.

In addition, the improving economic environment in LAC relative to the 1980s may itself be partly responsible for the heightened social insurance demand. Perhaps paradoxically, economic analysis—this report shows—suggests that in better times, when individuals have more to lose and can afford more of the costs of protecting against risk, they may also demand more effective protection and insurance mechanisms. All these factors make economic insecu-

COUNTRY								
COSTA RICA	ECUADOR	GUATEMALA	MEXICO	PANAMA	PARAGUAY	PERU	URUGUAY	VENEZUELA
1,000	1,200	1,000	1,200	1,000	600	1,045	1,200	1,200
56	67	57	43	52	75	80	59	70
26	20	31	35	24	14	12	18	19
14	10	11	20	21	6	6	20	10
5	2	1	3	3	5	2	3	2
52	34	51	30	48	48	37	46	53
25	21	23	23	20	26	19	22	17
11	29	17	41	21	13	26	19	19
12	16	8	6	12	13	19	13	12

EMPLOYMENT				EDUCATION			INCOME		
UNEMPLOYED	RETIRED	HOUSEWIFE	STUDENT	PRIMARY	HIGH	UNIVERSITY	HIGH	MIDDLE	LOW
3	4	4	3	4	3	4	4	4	3
80	74	73	74	74	75	71	72	73	74
13	16	17	19	16	16	19	19	17	17
3	6	7	5	7	5	6	4	6	6
1	1	1	1	1	1	1	2	1	1
88	88	84	82	83	85	83	83	85	83
9	9	12	15	13	12	14	14	11	13
1	2	3	2	3	2	2	2	2	3
3	5	4	3	4	4	5	5	5	3
36	33	35	32	37	33	27	32	31	34
56	54	52	60	50	57	62	58	56	57
5	8	9	5	8	7	7	6	8	7

rity one of the major unresolved items in LAC's policy agenda.

Inequality stands as the region's other big pending issue. Indeed, as noted earlier, inequality and insecurity are related. Increased economic opportunities tend to enhance income mobility—the chances of moving up or down the distribution ladder. Thus, these added opportunities for economic improvement may come along with greater risks of moving down or being left behind—hence the concern with insecurity and inequality.

The social costs of insecurity should not be downplayed. Uncertainty about future employment and income has a direct adverse impact on welfare, because most households and workers care not only about the level of their standard of living, but also about its certainty—as the survey evidence above clearly illustrates.

Further, economic uncertainty itself can hamper real income growth, a fact confirmed by extensive empirical research focusing on LAC and other regions.[6] In essence, high degrees of uncertainty tend to discourage growth-enhancing long-term commitments, such as investment in physical and human capital, as individuals attempt to retain extra flexibility in order to deal with a volatile environment.[7] As a result, the choice of investment projects and production technologies is biased by inefficient "short-termism" that leads to a diminished growth potential for income and living standards.

Finally, there are reasons why economic insecurity is particularly damaging for the poorer segments of the population. On the one hand, the poor often lack the means to protect themselves from adverse income and employment shocks—means such as accumulated financial assets or access to credit. For the very poor, this implies that unfavorable temporary shocks may result in drastic declines in consumption, bringing it down below subsistence levels and permanently damaging their well-being. On the other hand, growth in income of the poor is primarily determined by overall economic growth (Dollar and Kraay 2000).[8] As economic volatility hampers aggregate growth, it also hurts the growth of income of the poor and their chances to rise out of poverty. In fact, a 1999 World Bank study shows that economic insecurity ranks high among the concerns expressed by the poor in LAC and across the world (Narayan and others 1999).

This Report

The purpose of this report is to assess the extent, causes, and effects of economic insecurity in LAC and identify policies and institutions that can help reduce the degree of insecurity faced by workers and households in the region, while allowing them to take advantage of the enhanced economic opportunities brought about by the reforms of recent years.

Insecurity is a broad topic, however, and this report cannot cover all of its many aspects. Thus, the report leaves aside issues related to crime and violence and insecurity caused by natural disasters, to focus on the specific issue of insecurity caused by economic fluctuations. Within this narrower area, social security and pensions, which have more to do with life-cycle considerations than economic fluctuations, are also excluded from the discussion.

This still leaves a wide range of issues to be addressed in the chapters that follow. The analysis of how workers and households react to economic insecurity, the policy challenges these responses present, and the policies that are best suited for countries in the region are based on recent empirical and theoretical research conducted at the World Bank and elsewhere, on economic volatility and social risk management, drawing on the experiences of countries in Latin America and other parts of the world.[9]

This report begins by stating the facts concerning economic insecurity in LAC (Chapter 2). It then sets out a general analytical framework to help organize the various options available to individuals and governments for dealing with economic insecurity (Chapter 3). Using this framework, the remaining chapters focus on measures to deal with risks. First, the causes of macroeconomic or aggregate volatility are examined and some remedies suggested (Chapter 4). This report then examines how these risks affect individuals and households, and their responses to economic shocks (Chapter 5). The risk of becoming unemployed is of concern in the region and elsewhere, and public responses to help workers deal with this risk take up a full chapter (Chapter 6). Finally, the subject of appropriate social insurance and social protection against the risk of poverty is considered in some detail (Chapter 7). We summarize the findings of these chapters here.

LAC's Volatility is High—But has not Risen in the 1990s

Like most developing regions, LAC suffers from high economic volatility, well above the levels experienced by industrial economies. Furthermore, living standards—as measured by per capita consumption—are more volatile than real incomes, a feature shared with much of the developing world but not with most OECD countries. This reflects a lack of adequate instruments for consumption-smoothing in developing countries.

Contrary to a widely held view, however, there is no evidence that volatility has increased following the region-wide shift toward a market-oriented economy and the increased integration of LAC into global markets. On the contrary, the volatility of income growth has declined in most of the region's economies, and in a number of them it has fallen below the levels of the 1970s. To a lesser extent, the volatility of private consumption has also declined. In addition, there is no evidence that the income and employment uncertainty faced by the majority of workers and households in the region has changed for the worse—

although economic insecurity must surely have risen for specific groups of workers adversely affected by the reforms in some countries, especially some elder workers in the formal sector, whose skills may have been rendered obsolete by economic restructuring.

Dealing with Economic Insecurity Requires a Comprehensive Insurance Approach

There are three major options available for dealing with risk: market-type insurance, which involves sharing of risks among individuals (or countries); self-insurance, which typically entails precautionary saving or accumulation of assets in good times to shelter consumption in bad times; and self-protection, which involves the adoption of measures to reduce the likelihood of adverse shocks. In general, effective risk-management strategies should employ all three types of instruments. The more instruments are available, the better the chances of sheltering living standards from economic insecurity.

This general perspective illustrates the role of public policies in dealing with risk. Government interventions are warranted by the presence of incomplete or imperfect domestic insurance markets that lead individuals to costly and inefficient self-insurance or self-protection decisions, such as distress sales of assets or reduced investments in human capital (for example, taking children out of school) at times of crisis. Government interventions, in the form of *social insurance* and *social protection,* attempt to remedy these market failures, augment the availability and scope of market insurance and efficient instruments for self-insurance, and buttress the self-protection efforts by individuals that pay off only if sustained for some time. As with other types of insurance, the design and implementation of these policy interventions must deal with the serious challenges posed by adverse selection and moral hazard.

This conceptual framework also shows how increased demand for social insurance may indeed result from an improvement—rather than a deterioration—in the economic environment, a factor that might be partly behind the results of LAC opinion surveys mentioned above.

LAC's Volatility Arises from Multiple Sources—Domestic and Foreign

LAC's macroeconomic volatility reflects both external disturbances—in international goods and financial markets—and volatile domestic fiscal and monetary policies. Although the 1990s have witnessed a decline relative to the 1980s in the volatility arising from each of these sources, the region faces larger terms of trade volatility than most other developing regions. Likewise, the volatility of capital inflows and domestic policies is also higher in LAC than in industrial economies and the more stable developing regions, such as the East Asian miracle economies.

Further, the economic impact of disturbances is magnified by the region's weak links with international financial markets and the insufficient development of domestic financial systems, which lag behind those of other world regions. In theory, domestic and foreign financial markets should play a major role in facilitating risk diversification and easing the adjustment to shocks. In practice their imperfections make them have the opposite effect—they amplify aggregate shocks and are themselves a source of volatility.

Thus, for example, developing countries should be able to diversify terms of trade risks by hedging in international financial markets. In practice, however, these markets are not deep enough, and capital flows behave procyclically with respect to trade shocks, amplifying the international business cycle. More generally, in spite of recent progress with the development of new international financial instruments such as contingent credit lines, world markets still offer few possibilities for risk diversification and insurance against aggregate disturbances. Hence, as discussed below, there is a role for supranational policy actions aimed at the creation of missing markets and the enhancement of instruments for international risk diversification.

Governments Can Do Much to Reduce Volatility—Even in a Globalized Economy

Governments possess a broad range of possible measures to reduce aggregate volatility, that can improve risk-sharing, enhance economywide self-insurance, and reduce the likelihood of adverse aggregate shocks. Given the rudimentary state of international insurance markets, the main options left to governments involve self-insurance and self-protection mechanisms. Many such mechanisms have already been adopted by various countries in the region, and all entail economic costs. Thus, the policy mix best suited to each economy is largely dependent on country-specific factors shaping the cost-effectiveness of the various policy options.

External Risks Can Be Reduced by Diversification and Liquidity Management

Nevertheless, some clear general principles emerge from the analysis. To deal effectively with terms of trade volatility, countries can resort to risk diversification and hedging in international commodity markets, self-insurance through commodity stabilization funds, and self-protection through trade diversification. Facilitating foreign direct investment (FDI) is another way of diversifying risks, and FDI also yields other benefits such as innovation spillovers, enhanced corporate governance, and higher investment. Allowing domestic investors to hold foreign assets also improves their own risk diversification strategy and increases the resilience of the economy as a whole.

In turn, facing up to capital flow volatility in a context of limited international insurance possibilities requires holdings of liquid assets and a prudent debt management strategy, and avoiding excessive short-term liabilities, "bunching" of repayments, and currency mismatches between assets and liabilities. Capital controls may offer another self-protection tool to limit exposure to international financial disturbances, but their effectiveness remains under debate. They may affect the composition of flows—discouraging volatile short-run transactions if properly designed—but they seem powerless to alter their volume beyond the near term.

Anticyclical Macroeconomic Policies Ease Adjustment to Shocks

In most LAC economies, fiscal policy has failed to play its intended stabilization role. Governments have generally adopted an expansionary stance in booms and a contractionary stance in recessions. To some extent, this reflects constraints from world and domestic financial markets. It has also resulted, however, both from the failure of governments to provide for bad times by saving in good times, and the lack of a sufficiently diversified fiscal revenue base, which in several countries in the region is excessively biased toward natural resource revenues. Tackling these two issues should be a policy priority, along with the adoption of contingent fiscal rules that can facilitate the response to shocks and make it more transparent, and the implementation of a prudent public debt management strategy along the lines mentioned earlier.

Finally, adequate monetary and exchange rate policies can also make an important contribution to the absorption of shocks. The choice of specific policy rules in this area, like in others, faces a fundamental tradeoff between credibility and flexibility. Rigid exchange rate pegs without the option of an independent monetary policy may enhance credibility, but can also make adjustment to shocks more painful in the presence of inflexible labor markets or inadequate fiscal policy. Floating exchange rate arrangements with active monetary policy may offer enhanced flexibility to deal with shocks, but can erode credibility unless clear and transparent rules for monetary policy—possibly contingent on developments in world goods and financial markets—are publicly announced and strictly followed by the authorities. Intermediate options such as adjustable pegs, crawling pegs, and exchange rate bands probably offer the worst of both worlds without the advantages of either one.

Deeper and Stronger Financial Systems Are a Key Part of Social Protection Policies

Development of deeper capital markets and strong banking systems is a major priority to allow them to play their intended role of shock absorbers and hence mitigate the economic impact of disturbances. Enhanced capital and liquidity requirements for banks—perhaps set in a procyclical manner—under adequate supervision, and prevention of currency mismatches can go a long way toward strengthening the banks, so that they can contribute effectively to self-insurance against shocks. Strong and deep financial systems are of paramount importance to facilitate savings and market insurance against microeconomic risks.

Deep Crises are Particularly Damaging for the Poor

How are households affected by adverse economic conditions, and how do they respond to crises? To answer these two questions, this report systematically used household panel data for Argentina, Brazil, El Salvador, and Mexico in both rural and urban settings. Several findings emerge that should make us reconsider some commonly held beliefs about how households respond and when, how, and how much governments should help them.

First, economic contractions differ significantly in their effects on poverty and human capital investments: in deep recessions the poor suffer greater proportional losses in income than the wealthy. In moderate recessions, the opposite appears to happen—in many cases, the greatest proportional income losses were borne by the rich, and some groups often thought to suffer disproportionately—such as the elderly or single mothers—do not appear to be especially badly affected, although this is not true in every crisis and in every setting. For example, the findings differ between countries or, for the same country, between rural and urban areas. On the whole, however, the conventional wisdom that the poor invariably are affected more severely during recessions needs to be qualified.

Second, the poor seem to have gained more during growth periods than is generally acknowledged. This does not mean that the poor should not be helped; it merely implies that from the perspective of poverty alleviation, growth-oriented policies must be given a high priority, regardless of concerns of high inequality in the region.

The Poor Try to Protect Their Long-Term Welfare in Crises—As Long as Their Assets Permit

Third, the poor—like those with more wealth—are reluctant to permanently compromise their family's future during economic crises perceived to be temporary. This is especially true of parental decisions about their children. The poor do not, for example, frequently pull their children out of school during bad times—although they do when the recession is severe. But the fact that some educational and health outcomes are hurt during especially bad times may be as much the result of the government's inability to maintain the quality of social services as the household's decision to invest less during crises.

Finally and unsurprisingly, access to "reserves"—such as assets and underused family labor—reduces a household's vulnerability to shocks, in the sense of having to adjust through reduced consumption or critical investments such as schooling and health. Assets may be the key factor for explaining differences in the responses of poor versus rich households in large versus moderate economic contractions. In brief or mild contractions, even the limited assets of the poor can help weather the crisis; in more severe or recurring crises, the poor may eventually exhaust their assets and be forced to suffer drastic declines in their well-being, with adverse long-term effects. Hence policies aimed at strengthening the human capital of the poor (education, health) can enhance their self-insurance and self-protection efforts.

New Income Support Programs for the Unemployed Need to be Established

The common form of public unemployment support in much of LAC has been mandatory severance pay provisions in employment contracts. In the old economic environment, these schemes effectively pooled unemployment risks over a greater population because consumers actually subsidized potentially bankrupt firms through higher prices. But with globalization and reduced barriers to trade, this is no longer possible: prices are determined by world markets, so the pooling of unemployment risk becomes restricted to the firm. These provisions have also proved to be contentious, complicated to enforce, and judicially burdensome.

With neither economic efficiency nor administrative ease to recommend mandated severance pay, some countries in the region have moved away from it, and others are contemplating change. This report considers the experience of both reformers and nonreformers in this regard, and also employs theoretical principles to provide guidance to countries in the region. In deciding whether to move toward government-mandated self-insurance—through schemes such as individual savings accounts to be accessed in case of unemployment—or to forms of unemployment insurance that involve the pooling of risk, several factors must be considered.

Administrative Capacity and Labor Policies are Key in the Choice of Instruments

The first critical issue is the administrative capacity of government. While administrative capacity can always be built over time, it does limit the options of government in the immediate future. However, a blend of practicality and analytical rigor can help countries devise strategies that efficiently bridge immediate action and long-term vision.

The second critical issue is the nature of labor markets, which influences the level and nature of risks faced by workers. The logical first step is to do more to reduce the likelihood of adverse employment shocks. Most LAC economies have high levels of informal employment, and many have high rates of formal unemployment as well. While these phenomena have diverse causes (for example, high rates of taxation, overregulated labor markets, poor macroeconomic policies that impede growth), labor policy changes are widely regarded as lagging other economic reforms in the region. For governments that wish to facilitate comprehensive insurance decisions by their workers and households in a rapidly changing global economy, labor policies should receive a high priority on the reform agenda.

Self-Insurance for Slow-Reforming Economies

Countries that have not yet pursued comprehensive economic—especially labor market—reforms may be better advised to rely more on self-insurance-type schemes such as individual capitalization funds. Their "insurance fundamentals" favor such schemes: self-insurance is the preferred option when losses are frequent, it is less demanding in terms of administrative capacity, and the schemes entail low labor market efficiency costs and low fiscal costs. The weakness of these schemes is their low attractiveness to poorer workers, for whom forced saving may have high costs, some of which could be lowered through risk-pooling or government subsidies.

Unemployment Insurance for Advanced Reforming Economies

LAC economies that have reduced the risk of unemployment through comprehensive economic and labor reforms should consider conventional unemployment insurance. While administrative considerations are always important, this capacity can generally be built. Carefully designed unemployment insurance schemes that involve pooling but keep efficiency losses low—for example, by keeping benefits frugal and mimicking the market as much as possible—are likely to increase welfare. Besides helping workers deal with idiosyncratic risk, insurance schemes that involve pooling of risk have—when designed well—also shown their worth as "automatic fiscal stabilizers," which governments in the region have lacked.

Political opposition to labor market flexibilization is almost always related to the perception of higher unemployment risks in downturns. Hence, a sequencing option to overcome political constraints may be to adopt labor market reforms simultaneously with efforts to strengthen unemployment insurance.

Public Works Programs Provide Insurance Support for Informal Sector Workers

Those who cannot be reached through such contributory schemes should be assisted through programs that implicitly pool risks such as public works programs, and share some other characteristics with good unemployment insurance, principally keeping benefits frugal. Such schemes should be thought of as insurance—not emergency—programs, the difference being that insurance programs are permanent while emergency programs are temporary.

Targeted Programs for the Poor Need to be Better Protected in Downturns

The region has improved the poverty impact of social spending through reform over the last decade by, for example, replacing generalized subsidies with programs specifically designed to help the poor. However, during crises, spending on tightly targeted programs for the poor does appear to suffer more than general social expenditures. Governments could do better to protect these programs from cuts. Experience in the region and in the U.S. shows that a successful strategy requires explicitly accounting for political economy factors that make programs resilient to both political and economic changes. Such factors may include deliberately building in some features that have been associated with long-lived government interventions.

Save in Good Times to Finance Social Spending in Bad Times

Governments in the region do appear to have behaved in a pro-poor manner in the most general terms, especially since the return of democracy to the region. While authoritarian and democratic regimes in LAC appear to have responded similarly to economic crises—both cut social spending sharply and about equally—greater increases in social spending take place under democratic regimes. In fact, social spending increases only when there is both democratic rule and a nonshrinking economy. But this is also where governments run the greatest danger of adding policy risk to economic risk. Well-intentioned governments or those under political pressure to sharply increase spending on social programs during growth episodes only to have to reduce spending in the next contraction both raise risk and sow the seeds of social discontent.

There is considerable room for improving the design of targeted programs, especially how they relate to the economic cycle. While meeting many of the goals they were designed to accomplish in both rural and urban settings, targeted conditional transfer programs such as Mexico's *Progresa* and Brazil's *Bolsa Escola* may not be particularly well suited to assist those who become poor during economic downturns. Through their innovative links with human capital accumulation, these programs may be better suited than earlier interventions for addressing structural poverty concerns. However, the broad political support they enjoy make them a resilient policy instrument to offset cyclical swings in the quality of education and health services. Even if more conventional instruments such as public works programs—when designed well—are better safety nets, targeted conditional transfer programs offer a strong option to form the third leg of a comprehensive social safety net—along with social security for the aged and income support for the unemployed.

Supranational Action and the Role of the International Financial Institutions

The global economy also poses risks that cannot be effectively addressed by individual countries on their own. Imperfections in international insurance and financial markets prevent national economies from properly diversifying terms of trade risks, and typically lead to a withdrawal of financial support when it is most needed—that is, at the time of adverse shocks. In this context, just as national governments have a major role to play because of incomplete or imperfect domestic insurance markets, the imperfections of international markets provide a rationale for supranational action. It would aim at improving the self-insurance and self-protection choices available to individual countries that may entail too high a cost in terms of economic efficiency and growth, and provide insurance by making available financing during bad times. IFIs can help developing economies efficiently deal with risk by leading the way in developing new financial markets and instruments, such as contingent credit lines and borrowing guarantees. In addition, by deploying their financial resources anticyclically, that is, reducing their lending in good times and increasing it in bad times, they can partially counteract the procyclical behavior of private capital flows and cushion the adjustment to disturbances.

Myths and Realities About Economic Volatility

In the light of the report's analysis, Table 1.5 shows how some widely held notions about economic volatility and its effects in LAC should be reassessed and qualified. In a nutshell, volatility, though still high, does not seem to have worsened, governments can do much to reduce it even in a global economy, and closer scrutiny reveals that households and governments do not always respond to economic shocks in stereotypical ways.

Securing Our Future

We hope this report will succeed in calling to the attention of policymakers the problem of economic insecurity in Latin America and the Caribbean. Uncertainty about future living standards is a major concern for workers and households in the region, and the report shows that there are good reasons for this. LAC, like other developing regions, is subject to much larger economic fluctuations than industrial economies, and has fewer instruments available to protect consumption levels from economic shocks.

However, contrary perhaps to popular perception, the trend toward globalization in the 1990s has not made matters worse. Growth has risen and volatility has declined in the majority of economies in the region, and several that pursued strong reform policies have enjoyed both higher growth and lower volatility than in earlier decades, while countries whose reform drive lagged behind have been among the worst performers in the 1990s. The lesson is that with globalization, good policies can reap larger rewards than before, but bad policies may be more severely punished.

This report shows that to face the new situation, adequate macroeconomic policies and structural reforms need to be matched with the development of a social protection and insurance system suited to LAC's changed economic environment.

Notes

1. The figures mentioned in this section refer to the regional median growth rate—that is the rate of per capita GDP or consumption growth in the region's "typical" economy.

2. It is important to note that available GDP growth data reach up to 1999 for the major eight Latin American economies (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela). The discussion in the text and the figures in the tables are based on this updated information. In contrast, private consumption growth information only reaches up to 1998. Preliminary forecasts for 1999 alter somewhat the performance of specific countries, but paint a broadly similar regional picture.

3. These concerns with insecurity may reflect in part concerns with (in)equity, as not all groups of economic actors have shared equally in the upturn, and some specific groups may have lost out with the reforms, at least in the short term.

4. The following discussion draws from Rodrik (1999).

5. The just-released 1999–2000 poll from Latinbarometer shows a slightly less pessimistic picture, with 58 percent of the respondents regionwide expressing the view that their parents lived better, and 52 percent anticipating a better future for their children.

6. The Inter-American Development Bank (1995) presents a comprehensive study of the causes and consequences of volatility in Latin America, as part of which the GDP growth cost of the region's "excessive" volatility (relative to industrial economies) is estimated at over 1 percent per year. Empirical studies with a cross-regional focus include Ramey and Ramey (1995) and Aizenmann and Marion (1993).

TABLE 1.5

Economic Insecurity: Twelve Myths

MYTH	REALITY
1. Aggregate volatility has increased in LAC.	Volatility of output and consumption is still much higher in LAC than in industrial countries, but it appears to have declined in the 1990s in many of the economies in the region.
2. Workers in LAC face higher uncertainty now than ever before.	Microeconomic data show no conclusive pattern—likely a general improvement, but a possible deterioration for some groups of workers in specific countries.
3. A greater demand for social insurance is unequivocal proof of greater economic risks.	As countries become wealthier, demand for overall insurance may go up even if risk does not. Demand for insurance involving risk-pooling may rise even if overall risk declines.
4. Globalization means that countries are powerless to reduce aggregate risk.	Governments can do a lot to reduce volatility through policies such as trade diversification, commodity stabilization funds, precautionary fiscal targets, deepening of the financial sector, and strengthening banking systems.
5. Expanding global financial markets leave no room for supranational action.	IFIs have a major role to play in the development of instruments and markets to facilitate international diversification of risks, and to ease the adjustment to shocks through countercyclical financing and contingent credit lines.
6. The rise of democracy in the region has not helped the poor much.	Both autocratic and democratic governments in LAC reduce spending during economic downturns. However, poverty-related programs have expanded much more under democratic governments.
7. Governments in the regions have not been pro-poor.	Governments have not been successful at protecting social spending in downturns. In part the reason is that poverty-related programs may have grown too quickly in good times, to levels difficult to maintain in bad times.
8. The poor are always hurt more than the rich during economic contractions.	The poor are hurt more than the rich when economic contractions are deep and persistent. Moderate fluctuations usually hurt the rich more than the poor, although even these smaller losses suffered by the poor may be socially troublesome.
9. Poorer families respond to economic crises in ways that are harmful to their longer-term well-being.	The poor adjust to crises by trying to protect their long-term interests to the extent that their assets—including human capital—permit. In particular, they do not pull their children out of school during contractions, except when the downturns are long or deep.
10. OECD-type unemployment insurance is unsuitable for all LAC economies.	Countries that have raised growth and lowered unemployment through comprehensive economic reforms should seriously consider these schemes; countries that are only beginning labor reform should view them as a longer-term goal.
11. The informal sector is a safety net for unemployed formal workers. Informal workers never become unemployed.	The intersectoral flow goes both ways. Informal sector workers often join the pool of the unemployed.
12. Public works programs are just an emergency device for times of crisis.	Public works programs should be viewed as insurance for informal sector workers, and should be maintained in good times—but their nonlabor content should be strongly procyclical.

7. For example, regarding physical investment in developing countries, the adverse impact of uncertainty is documented by Servén and Solimano (1993), Pindyck and Solimano (1993), Aizenmann and Marion (1993), and Servén (1999).

8. It is worth noting that this applies both to upturns and downturns, and to recent years as well as the 1970s and 1980s.

9. Much of this research was carried out in the context of a World Bank regional study on "Social Risk Management in Latin America," conducted at the Office of the Chief Economist of the Latin America and the Caribbean region under the supervision of Indermit Gill. Other major contributions to this report include Rodrik (1999), Caballero (2000), and Snyder and Yackovlev (2000).