WORLD BANK LATIN AMERICAN AND CARIBBEAN STUDIES

Viewpoints

SECURING OUR FUTURE IN A GLOBAL ECONOMY

by
David de Ferranti
Guillermo E. Perry
Indermit S. Gill
Luis Servén

with
Francisco H.G. Ferreira
Nadeem Ilahi
William F. Maloney
Martin Rama

THE WORLD BANK WASHINGTON, D.C.

Copyright © 2000 The International Bank for Reconstruction and Development/THE WORLD BANK 1818 H Street, N.W. Washington, D.C. 20433, U.S.A.

All rights reserved Manufactured in the United States of America First printing June 2000

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequence of their use. The boundaries, colors, denominations, and other information shown on any map in this volume do not imply on the part of the World Bank Group any judgment on the legal status of any territory or the endorsement or acceptance of such boundaries.

The material in this publication is copyrighted. Requests for permission to reproduce portions of it should be sent to the Office of the Publisher at the address shown in the copyright notice above. The World Bank encourages dissemination of its work and will normally give permission promptly and, when the reproduction is for noncommercial purposes, without asking a fee. Permission to copy portions for class-room use is granted through the Copyright Clearance Center, Inc., Suite 910, 222 Rosewood Drive, Danvers, Massachusetts 01923, U.S.A.

David de Ferranti is vice president and Guillermo E. Perry is chief economist in the World Bank's Latin America and the Caribbean Regional Office. Indermit S. Gill is lead economist and Luis Servén is lead specialist in the World Bank's Latin America and the Caribbean Regional Office. Francisco Ferreira is professor of economics at the Pontifical Catholic University-Rio de Janeiro, Brazil. Nadeem Ilahi is an economist with the International Monetary Fund. William F. Maloney is senior economist in the World Bank's Latin America and the Caribbean Regional Office, and Martin Rama is senior economist in the World Bank's Development Research Group.

Cover design by Janelle Welch/The Magazine Group

Cover photography—Globe: NASA Goddard Space Flight Center; Inset photos, clockwise from top: Catherine de Torquat/Sygma; Bill Pogue/Stone; Robert Frerck/Stone; Margo Pinkerton/Liaison Agency.

de Ferranti, David.

Securing our future in a global economy

Guillermo E. Perry.

p. cm. — (World Bank Latin American and Caribbean Studies.

Includes bibliographical references.

ISBN 0-8213-4730-6

Library of Congress pending

Contents

Acknowledgments	ix
Acronyms and Abbreviations	xi
Chapter 1: Opportunity and Risk in a Globalized Latin America and the Caribbean	1
Latin America and the Caribbean's Performance Improved in the 1990s	
Opportunities and Risks	
Why Economic Insecurity?	
This Report	
LAC's Volatility is High—But has not Risen in the 1990s	
Dealing with Economic Insecurity Requires a Comprehensive Insurance Approach	
LAC's Volatility Arises from Multiple Sources—Domestic and Foreign	
External Risks Can Be Reduced by Diversification and Liquidity Management	
Anticyclical Macroeconomic Policies Ease Adjustment to Shocks	
Deeper and Stronger Financial Systems Are a Key Part of Social Protection Policies.	
Deep Crises are Particularly Damaging for the Poor	
The Poor Try to Protect Their Long-Term Welfare in Crises—As Long as Their Assets Permit	
New Income Support Programs for the Unemployed Need to be Established.	
Administrative Capacity and Labor Policies are Key in the Choice of Instruments	
Self-Insurance for Slow-Reforming Economies	
Unemployment Insurance for Advanced Reforming Economies	
Public Works Programs Provide Insurance Support for Informal Sector Workers	
Targeted Programs for the Poor Need to be Better Protected in Downturns	10
Save in Good Times to Finance Social Spending in Bad Times	
Supranational Action and the Role of the International Financial Institutions	
Myths and Realities About Economic Volatility	
Securing Our Future	
Notes	11
Chapter 2: Economic Insecurity in Latin America and the Caribbean: The Stylized Facts	12
Methodological Considerations	
Aggregate Volatility in Latin America	
Volatility in Aggregate Output.	
Volatility in Aggregate Consumption	
Differences in Volatility Across Countries Within the Region	16
Regional Trends in Economic Volatility	
Transmission of Aggregate Volatility to the Labor Market.	
Are Latin American Workers Facing More Risk?	
Changes in Earnings Volatility	
Trends in Unemployment Rates	
Changes in Turnover Rates	
Rise in Informality	
·	

The Deterioration in Prospects of Older Workers	
Changes in Income Distribution	
Conclusion	
Notes	35
Chapter 3: Designing Social Policy When People Face Risk: A Conceptual Framework	27
The Need for Sound Analysis	37
Approach and Implications	
Advantages of a Disciplined Approach	
Clearer Rationale for Government Action	
Useful Insights	
A Powerful Tool for Organization	
Conclusion	
Notes.	
INOICS	
Chapter 4: Macroeconomic Volatility in Latin America and the Caribbean: Causes and Remedies	45
Sources of Aggregate Volatility in LAC	45
External Shocks	45
Macroeconomic Policy Volatility	49
Absorption and Amplification of Shocks: The Importance of Financial Markets	50
Weak Links with World Financial Markets	52
Shallow Domestic Financial Markets	53
The Combination Increases the Likelihood of Economic Crises	54
Other Amplification Mechanisms	57
Summary	61
Policies to Deal with Aggregate Volatility in LAC	61
Terms of Trade Risk	65
Capital Flows	66
The Financial System	
Fiscal Policy	67
Monetary and Exchange Rate Policy	67
Supranational Action	68
Annex 1	68
Notes	70
Chapter 5: The Response of LAC Households to Economic Shocks	72
The Risk of Unemployment: Who is Most Affected?	
1 /	
Are the Poor Most Likely to Become Unemployed?	
Are Older, Less-Educated Men More Likely to Become Unemployed?	
Who Becomes Unemployed and for How Long?	
Household Responses to Income Shocks: Findings of Panel Studies	
Do Aggregate Shocks Hurt the Poor More than the Rich?	
Does Ownership of Assets Reduce Vulnerability to Aggregate Shocks?	
Do the Poor Engage in Self-Destructive or Myopic Coping?	
Are All Downturns the Same in their Effects?	
Conclusion	
Notes	
INOICS	
Chapter 6: Helping Workers Deal with the Risk of Unemployment	89
A Typology of Programs	90
Main Findings	92
Who Is Covered by these Programs?	95
How Much Do the Programs Cost?	
What Are the Efficiency Effects and Insurance Benefits?	
What Are the Main Weaknesses of these Programs?	98
Policy Implications	
Self-Protection: The State of Labor Markets	99
Self-Insurance: Individual Savings Accounts	00

Severano	rpe" Insurance: Risk-Pooling Programs The Pay Provisions as Insurance for Unemployment. Works Programs as Insurance for Unemployment.	102
	ntional" Unemployment Insurance	
Notes		108
Chanter 7: He	elping Poor Households Deal Better with Economic Crises	111
	ding Over Economic Cycles	
	o Governments Vary Spending Over the Economic Cycle?	
	portance of Political Factors	
	ality of Social Services Over the Cycle	
	pending During Booms and Busts	
	Economic Policy Under Political Constraints	
	rg-Term Goal of Social Policy Must be to Improve the Distribution of Assets	
	d Programs Should be Permanent and Better Protected During Crises	
	Reprograms Should be Fermanent and Better Protected Burning Crises	
	ional Financial Institutions Can Help Overcome Political Constraints to Insurance	
	<u>*</u>	
		_
notes		125
Bibliography		127
Davas		
Boxes Box 2.1	Defining and Measuring Insecurity	14
Box 2.1	Trends in Aggregate Volatility in Latin America and the Caribbean	
Box 2.3	Why Might Workers Prefer to be Precarious or Unprotected?	
Box 2.5 Box 2.4	Income Mobility and Risk in Two Countries	
Box 2.4 Box 3.1	Market Insurance, Self-Insurance, and Self-Protection: Distinguishing Features and Examples	
Box 3.2	A Theory of Comprehensive Insurance.	
Box 3.3	The Framework in "Real Life" Situations	
Box 4.1	Excess Sensitivity to Disturbances: The Case of Chile	
Box 4.2	Weak Financial Markets and Volatility: A Framework	
Box 4.3	The Welfare Cost of Volatility and the Gains from International Risk-Sharing	
Box 5.1	Informal Self-Employment: Precarious Workers or Voluntary Entrepreneurs?	
Box 5.2	Data Sets and Methodologies Used	
Box 5.3	Where Does Time Go During a Crisis?	
Box 5.4	Do Families Mortgage Their Children's Future? Other Evidence.	
Box 6.1	Income Support Programs for the Unemployed: Main Features	
Box 6.2	Data Sources and Methodology	
Box 6.3	Labor Markets: Latin America's "Forgotten Reform".	
Box 6.4	Combining Mandated Self-Insurance and Market-Type Unemployment Insurance	102
Box 6.5	Who Really Pays for Unemployment Insurance?	
Box 6.6	Some Guidelines for Countries that Have Unemployment Systems	
Box 7.1	How Do Pro-Poor Governments Vary Spending Over the Economic Cycle?	114
Box 7.2	Data Sources and Classification into Targeted and Social Spending	115
Box 7.3	Social Spending Over Economic and Political Cycles in Latin America	116
Box 7.4	Colombia's Healthcare Reform	118
Box 7.5	Mexico's Progresa Program: Works Well, But Would it Do as Well in Crises?	120
Box 7.6	Social Programs, Entitlements, and Countercyclicality in the U.S.	124
Tables		
Table 1.1	Per Capita GDP Growth in Latin America (Percent)	2
Table 1.1		
	Per Capita Private Consumption Growth in Latin America (Percent)	
Table 1.3	Survey Responses in Latin American Countries on Expected Changes in Living Standards	<i>/</i> 4
T.L. 1 /	(Percentages Unless Otherwise Noted)	4
Table 1.4	Survey Responses to Social Insurance-Related Questions in 14 Latin American Countries,	
T.1.1. 1 5	by Socioeconomic Category (Percentages Unless Otherwise Noted)	4
Table 1.5	Economic Insecurity: Twelve Myths	17

Table 2.1	Long-Term Volatility in Latin America (Standard Deviations of Growth Rates, Percent)	16
Table 2.2	Volatility in Latin America Over Time (Standard Deviations of Growth Rates by Decade, Percent)	21
Table 2.3	Real Wage Grown Volatility in Latin America and the Caribbean, Percent	
Table 2.4	Average Unemployment Rates in Latin America and the Caribbean, Percent	
Table 2.5	Labor Turnover, LAC and OECD Countries	
Table 2.6	Income Inequality Measures by Country, 1986–96	
Table 3.1	Government Policies and Their Effect on Individual Comprehensive Insurance	
Table 4.1	Volatility in Terms of Trade Shocks for Selected Latin American Countries	
Table 4.2	Estimated Welfare Gains from Diversification (Latin America and the Caribbean,	,
14510 1.2	Percent of Private Annual Consumption).	63
Table 4.3	International Portfolio Diversification (Ratios to Total Wealth).	
Table 4.4	An Overview of Policies to Deal with Aggregate Volatility	
Table 4.A.1	Empirical Determinants of GDP Growth Volatility (Dependent Variable: Standard	0)
14010 1.71.1	Deviation of GDP Growth, 1975–99)	60
Table 5.1	Unemployment Rates by Household Income and Consumption Quintile	
Table 5.2	Unemployment Rates by Age, Education, and Gender	
Table 5.3	Annual Probability of Becoming Unemployed from Formal and Informal Work (Percent)	75
Table 5.4	Income Variance of Formal Salaried vs. Self-Employed Workers (Theil Index)	
Table 5.5	Unemployment Duration, in Years	
Table 5.6	Metropolitan Brazil: Percentage Income Changes by Head's Wage Bracket	
Table 5.7	Mexico: Proportional Income Change by Income Quintile, 1995–96.	
Table 5.8	Rural El Salvador: A Dynamic Decomposition of Poverty Changes, 1995–97	
Table 6.1	How Various Income Support Programs for the Unemployed Work	
Table 6.2	Contrasting the Brazilian and U.S. Unemployment Insurance Systems	
Table 6.3	Income Support Programs for the Unemployed: Beneficiaries Across Population Groups	
Table 6.4	Income Support Programs for the Unemployed: Costs per Beneficiary	
Table 6.5	Income Support Programs for the Unemployed: Effects on Employment, Earnings, and Consumption	
Table 6.6	Costs of Unemployment Insurance: Burden-Sharing Among Workers, Employers, and Government	
Table 6.7	Income Support Programs for the Unemployed: Summary of Findings and Policy Implications	
Table 7.1	Targeted Public Spending per Poor Person in Argentina and Mexico, 1994–96	
Table 7.2	Elasticities of Spending to Growth, by Type of Spending	
Table 7.3	Changes in Latin American Social Protection Spending, 1970–95 (Broad Spending Categories)	
Table 7.4	Main Characteristics of Targeted Conditional Transfers	. 119
Figures		
Figure 1.1	Per Capita GDP Growth (Regional Medians).	7
Figure 1.2	Per Capita Private Consumption Growth (Regional Medians).	
Figure 2.1	Long-Term Volatility of Real GDP Growth	
Figure 2.1	Long-Term Volatility of Real Private Consumption Growth	
Figure 2.2 Figure 2.3	GDP Growth Volatility and Country Size	
Figure 2.5	GDP Growth Volatility and Per Capita Income.	
Figure 2.4 Figure 2.5	GDP Growth Volatility and Private Consumption Growth Volatility	
_	Volatility of Real GDP Growth by Decade (Regional Medians)	
Figure 2.6 Figure 2.7	Volatility of Real Private Consumption Growth by Decade (Regional Medians)	
0	Volatility of Growth of GDP and Private Consumption in Latin America	19
Figure 2.8		20
E:	(Ten-Year Window, Regional Medians)	
Figure 2.9	,	
Figure 2.10	Long-Run Own Wage Elasticities, 1980–95, Chile	
Figure 2.11	Wage and Unemployment Okun Coefficients	
Figure 2.12	White- and Blue-Collar Wage Volatility, Mexico	
Figure 2.13	White- and Blue-Collar Wage Volatility, Argentina	
Figure 2.14	Unemployment Rate and Expected Duration, Montevideo	
Figure 2.15	Unemployment Rate and Expected Duration, Interior Uruguay	
	Unemployment Rate and Expected Duration, Greater Santiago	
	Labor Turnover, LAC and OECD Countries	
	Evolution of Turnover in Chile, 1980–95	
	Evolution of Turnover in Colombia, 1980–91	
Figure 2.19	Expected Tenure in Current Job, Montevideo (Months)	29

Figure 2.20	Expected Tenure in Current Job, Interior Uruguay (Months)	30
Figure 2.21	Expected Tenure on Job, Greater Santiago	30
Figure 2.22	Self-Employment versus Industrial Productivity, OECD and LAC	31
Figure 2.23	Growth and Income Mobility in Argentina	34
Figure 2.24	Growth and Income Mobility in Mexico	35
Figure 4.1	Volatility in Terms of Trade Growth (Regional Medians)	
Figure 4.2	Share in Total Exports of Four Most Important Commodities (Selected LAC Countries)	46
Figure 4.3	Volatility of Terms of Trade Shocks by Decade (Regional Medians)	47
Figure 4.4	Median Private Gross Capital Flows to Latin America (Percent of GDP)	48
Figure 4.5	Spread of Foreign-Currency-Denominated Sovereign Debt Instruments (bps)	
	(Selected Major Latin American Countries)	48
Figure 4.6	Coefficient of Variation of Gross Private Capital Flows (Percent of GDP, Regional Medians)	49
Figure 4.7	Volatility of Reserve Money Growth (Regional Medians)	50
Figure 4.8	Volatility of Public Consumption Growth (Regional Medians)	50
Figure 4.9	Monetary Volatility and Fiscal Volatility	
Figure 4.10	Fiscal Volatility and Terms of Trade Volatility	
Figure 4.11	Chile's Excess Sensitivity to Shocks	
Figure 4.12	Copper Prices and Chile's Current Account	
Figure 4.13	Average Private Domestic Credit (Percent of GPD, Regional Medians)	
Figure 4.14	Stock Market Capitalization and Turnover Ratios (Regional Medians in Percent, 1990–98)	
Figure 4.15	Stock Market Capitalization and Turnover Ratios for Selected LAC Countries, 1995–98, Averages	
Figure 4.16	Stock Market Illiquidity (Regression Coefficient of Absolute Price Changes on Trade Volume)	
Figure 4.17	GDP Volatility and Credit Depth	
Figure 4.18	Credit Crunches in Argentina	
Figure 4.19	Credit Crunches in Brazil	57
Figure 4.20	Credit Crunches in Mexico	58
Figure 4.21	Fire Sales	
Figure 4.22	Excess Vulnerability	60
Figure 4.23	Why is Latin America More Volatile than Industrial and East Asian Countries?	61
Figure 5.1	Income Gains and Losses in Seven Episodes of Volatility in Brazil	
Figure 5.2	El Salvador: Cumulative Distributions of Real Income Per Capita, 1995 and 1997	
Figure 5.3	Brazil: Moves Into and Out of Poverty, by Level of Education	
C	a. Into Poverty During Growth	82
	b. Into Poverty During Recession	
	c. Out of Poverty During Growth	
	d. Out of Poverty During Recession	82
Figure 5.4	Change in Housework Time Due to Labor Force Entry	83
Figure 5.5	Brazil: Probability of School Dropout	
Figure 5.6	Brazil: Probability of Repeating a Grade at School	
Figure 5.7	Brazil: Probability of Child Aged 10–15 Starting Work	
Figure 6.1	Workers Pay for UI even Though the Contributions are Levied on Firms	
Figure 6.2	Workers and Firms Share UI Costs even Though Contributions are Levied on Firms	
Figure 7.1	Targeted Social Spending Over the Economic Cycle	112

Acknowledgments

HIS REPORT IS THE RESULT OF A COLLECTIVE EFFORT BY A WORLD BANK TEAM COORDInated by the Office of the Chief Economist for Latin America and the Caribbean region and led by Guillermo Perry. Main authors by chapter were Guillermo Perry (Chapter 1), Indermit S. Gill (Chapters 1, 3, 5, 6, and 7), Luis Servén (Chapters 1, 2 and 4), William F. Maloney (Chapters 2 and 5), Nadeem Ilahi (Chapters 3 and 7), Francisco H. G. Ferreira (Chapter 5), and Martin Rama (Chapter 6).

At the World Bank, major contributions were made by Wendy Cunningham, Gabriel Gonzalez, Emily Gustafsson-Wright, Norman Hicks, William Jack, Pedro Olinto, Bernadette Ryan, Guilherme Sedlacek, Rashmi Shankar, Mark Thomas, and Quentin Wodon. Outside contributors included Carlos Arango (University of Illinois), Ricardo Caballero (MIT), Jonathan Conning (Williams College), Adriana D. Kugler (Universitat Pompeu Fabra), Donna MacIsaac (consultant), Alejandra Mizala (Universidad de Chile), Marcelo Neri (Fundação Getulio Vargas), Martin Ravallion (Université des Sciences Sociales, Toulouse), Dani Rodrik (Harvard University), Pilar Romaguera (Universidad de Chile), James M. Snyder (MIT), Alvaro Trigueros (Universidad Centroamericana, San Salvador), and Irene Yackovlev (MIT).

Valuable comments were received from Ian Bannon, Suman Bery, François Bourguignon, Ariel Fiszbein, Marcelo Giugale, Gillette Hall, Emmanuel Y. Jimenez, Steen Jorgensen, Homi Kharas, Kathie Krumm, Klaus Schmidt-Hebbel, and Michael Walton.

The report also benefited from the comments and suggestions provided by participants at the Forum on Poverty, Vulnerability, and Inequality held in Lima in August 1999. Special thanks to Katherine Bain for facilitating the report team's participation at the Forum. Valuable comments were also received at the Latin America Economists' Retreat held in Baltimore in November 1999.

The report team was advised by a Steering Committee consisting of Robert Holzmann, Gobind T. Nankani, and Dani Rodrik. Xavier Coll, Ana-Maria Arriagada, Charles Griffin, and Donald R. Winkler also provided guidance and support.

However, any errors or omissions in the report are the sole responsibility of the authors and should not be attributed to any of the above individuals or the institutions they represent.

Finally, Diane Stamm, Christopher Neal, and Lee Morrison made a superb effort to see this publication through the final stages of production.

Acronyms and Abbreviations

ECLAC Economic Commission for Latin America and the Caribbean

EDS Encuesta de Desarrollo Social

ENEU National Urban Employment Survey

ENH Encuesta National de Hogares EPH Permanent Household Survey FDI Foreign direct investment

FGTS Fundo Garantia por Tempo de Servicio

FHIS Social investment fund

FONASA Fondo Nacional de Salud (formerly SERMENA)

GDP Gross domestic product
GNP Gross national product
IA Individual savings accounts
IBGE Brazilian Statistical Institute
IDB Inter-American Development Bank
IFI International financial institution

IFPRI International Food Policy Research Institute

ILO International Labour Organisation
 IMF International Monetary Fund
 ISAPRE Instituciones de Salud Previsional
 LAC Latin America and the Caribbean
 LSMS Living Standards Measurement Survey

NIC Newly industrialized country

OECD Organization for Economic Cooperation and Development

PETI Programa de Erradicação do Trabalho Infantil

PME Monthly Employment Survey

PNAD Pesquisa Nacional de Amostra de Domocilios PRAF II Programa de Asignacion Familiar, Second Phase

PW Public works

SP Mandatory severance pay

SIMCE Sistema de Medicion de la Calidad de la Ensenanza

SUS Sistema Unico de Saude
TG Training for the unemployed
UI Unemployment insurance