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INFRASTRUCTURE

Public-Private Partnerships: From Plain Vanilla to Local Flavors

*Juan Benavides and Antonio Vives**

The Cycles of Infrastructure Financing

The approach to financing infrastructure, in a pendular fashion, is swinging back from mostly private toward increased public participation. Opinion polls suggest that the return of the pendulum is surrounded by decreasing enthusiasm about the private alternative. The cycle of postures and proposals started in the beginning of the twentieth century, when most Latin American governments considered that infrastructure's unique charac-

▶ p.2

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FINANCIAL MARKETS

Financial Crises in Latin America

*Guillermo Collich and Juan Giral**

Background: The Environment of the Crises

During the last quarter of a century many countries in the region followed a set of policies based on the use of the exchange rate as an anchor for the price system, which, in theory, should lead to price stability and faster growth. However, these policies did not have the results that one would expect given the theories. Not only did actual results contradict expected outcomes, they also were a triggering factor for many of the economic and financial collapses experienced by the region since 1980. Although there were temporary improvements in price stability, most Latin American countries, particularly the largest ones, paid a stiff price in terms of lower GDP growth, widespread

▶ p.5

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◀ p.1 *Public-Private Partnerships*

teristics required government ownership and management. As a result, infrastructure was thought to be, variously, a natural monopoly, a public good, a prerequisite for development, or an entitlement. Private participation or ownership of infrastructure projects was exceptional and not considered a serious choice. Public utilities are a case in point. With few exceptions, Latin American public utilities were poorly managed and unable to recover the costs of service. Moreover, the provision of other infrastructure services (mainly transportation) was biased toward building new assets (at the expense of maintenance). Thus, bailouts of government-owned utilities, cost overruns of civil works and the extra costs associated with rebuilding assets that were improperly maintained led to mounting fiscal pressures. By the end of the eighties, the statist model of public infrastructure provision had collapsed in most of the countries of the region.

The theory of economic incentives reached its pinnacle at the same time as this crisis in infrastructure investment came to a head. The well-established conceptual advantages of competition and regulation over public command and control dominated the discourse in multilateral institutions. Private participation in infrastructure looked appealing and somehow inevitable. On the positive side, the region pioneered the attraction of private participation in infrastructure, which accounted for about half of the US$786 billion invested in developing countries between 1990 and 2003.[1] Technical studies show that, on balance, privatization and other forms of private participation have made a positive contribution to welfare, in spite of implementation problems.[2]

With the benefit of hindsight, we can say that overoptimism and conceptual simplification pushed the private alternative as the across-the-board solution, even in circumstances where there was little chance that competition or independent regulation could deliver what was expected of them. Private participation in infrastructure declined steadily after 1998 (from US$70.8 billion in 1998 to US$15.7 billion in 2003), failing to make up for the generalized public cutbacks in infrastructure that affected the region.[3] Consequently, total investment in infrastructure declined as well. However, the region's infrastructure requirements appear intimidating: annual infrastructure outlays of about US$117 billion (about 6 percent of GDP) would be needed for Latin America to reach, in 20 years, Korea's current level of infrastructure per worker.[4]

The encouraging aspect of the swing back toward public participation in infrastructure is the acknowledgement that the alternatives for financing infrastructure cannot be reduced to the "private vs. public" dilemma, as the discussion was often framed during the nineties. The irony of this admission is that conceptual simplification prevails, as shown by the fact that the PPP (public-private partnerships) has become the new silver bullet expected to solve the region's infrastructure problems. A mix of confusion and high hopes about the role of public-private partnerships is

■ ***The encouraging aspect of the swing back toward public participation in infrastructure is the acknowledgement that the alternatives for financing infrastructure cannot be reduced to the "private vs. public" dilemma, as the discussion was often framed during the nineties. The irony of this admission is that conceptual simplification prevails, as shown by the fact that the PPP has become the new silver bullet expected to solve the region's infrastructure problems.*** ■

(1) Greenfield projects represented 29 percent and concessions represented 17 percent, respectively, of the US$374 billion total value of infrastructure projects in the region between 1990 and 2003 that involved private participation. The remaining 54 percent was generated by divestitures.

(2) See Chong, A. and F. López de Silanes. 2005. *Privatization in Latin America: Myths and Reality*. Washington, D.C.: The World Bank.

(3) There has been a contraction in total public investment in infrastructure, sometimes larger than the improvements in the fiscal balance (3.08 percent and 2.80 percent of GDP, respectively, in the case of Brazil; see Calderón, C., W. Easterly and L. Servén. 2003. How did Latin America's Infrastructure Fare in the Era of Macroeconomic Crises?' *The Limits of Stabilization: Infrastructure, Public Debts, and Growth in Latin America*. Washington, D.C.: The World Bank, and Palo Alto: Stanford University.

(4) Authors' calculations using Fay, M. and M. Morrison. 2005. *Infrastructure in Latin America: Recent Developments and Key Challenges*. Washington, D.C.: The World Bank and the Inter-American Development Bank. Working Paper; and International Monetary Fund. *World Economic Outlook* April 2005. Washington, D.C.

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evident everywhere. This paper reminds readers of the existence of a continuum of options to accommodate public and private contributions, and emphasize the need to match project characteristics, local context and financial arrangements. This is crucial to clarify the scope of PPP, calibrate expectations and resist the pressures of returning to the mistakes of the statist scheme as a response to the social discontent resulting from the real or perceived failures of privatization.

PPPs and the Limitations of Local Context

Arrangements between public and private actors to deliver a wide variety of services have been used for a very long time. The Roman Empire and medieval kingdoms frequently appealed to external funds and expertise to build and maintain their waterworks.[5] Since the 17th century, France has used concessions to privately fund infrastructure (canals were the first works financed this way). In the early years of the Republic, the United States relied on private turnpike companies to construct highways operated as toll roads. The list of historical examples is full of variety and adaptation to specifics. In contrast, the current wave of enthusiasm over PPPs suffers from the "one-size-fits-all" viewpoint. In the most widely publicized version of PPPs, which originated in the United Kingdom with the Private Finance Initiative (PFI), the government contracts with a competitively selected private sector firm to deliver services on its behalf, which often involves building new infrastructure. The firm has to build, operate, maintain and finance the asset, and provide the service for the long term in exchange for recurrent payments from the public sector. At the end of the contractual period the operation of the asset reverts to the government.

But this first-best, plain vanilla variety of public-private partnership will only deliver under very stringent conditions. First, there must exist sufficient public funds for the government to comply with its payments schedule. Second, the judiciary system, regulatory institutions and the dispute resolution mechanisms must be solid enough to minimize the chances of *ex post* opportunistic behavior.

These circumstances do not generally exist in Latin America and the Caribbean, where contracts have been frequently breached, arbitrarily changed during the life of the contract, or renegotiated.[6] Additionally, the vagaries of the budget process often translate into reductions in the financing available for new investments and for maintaining public assets. The plain vanilla variety of PPPs overlooks expropriation risk and public payments credibility, and it is of little help to develop high impact projects in difficult situations.

■ ***The plain vanilla variety of PPP will only deliver under the following very stringent conditions: i) availability of sufficient public funds for the government to comply with its payments schedule; and ii) the judiciary system, regulatory institutions and the dispute resolution mechanisms must be solid enough to minimize the chances of ex post opportunistic behavior. These circumstances do not generally exist in Latin America and the Caribbean.*** ■

The Incentives to (Mis)behave and the Predisposition to Paralysis

A way to make apparent the continuum of solutions available consists of examining the conflicts that the private and the public sectors face under various configurations of three basic conditions: *availability of public funds*,[7] *project profitability* and *rule of law*. These conditions, while simplifying, concentrate important information about the financial feasibility of a project and institutional problems that cannot be overcome, at least in the short run. Our approach is akin to the work developed by Beato and Vives (1996),[8] but differs in span. While the 1996 paper examines the efficiency-fiscal tradeoff (that is, lower cost of public financing vs. higher private efficiency gains), here we take a more general view, prescribing solutions when the transaction costs incurred to protect property rights are soaring and when liquid public resources cannot be mobilized. Following is a discussion of some of these conflicts.

The availability of public funds to cover contractual payments is a necessary but insufficient condition to use the plain vanilla version of PPP. Current fiscal allocations may appear sufficient to support recurrent payments but fiscal discipline may be lacking. Also, the political process may facilitate the proliferation of "white elephants," that is, projects that do not provide positive social surplus but maximize the political power of their promoters. These two problems compromise the timeliness of public disbursements.

Strong incentives to induce the best effort will materialize only where contracts can be reasonably enforced. In a land fertile for contract breaching,

▶ p.4

(5) See for example: Magnusson, R. J. 2001. *Water Technology in the Middle Ages: Cities, Monasteries, and Waterworks after the Roman Empire.* Baltimore and London: The Johns Hopkins University Press.

(6) See Guasch, J. L. 2004. *Granting and Renegotiating Infrastructure Concessions: Doing it Right.* Washington, D. C.: The World Bank. Of course, the adaptation of contracts to extraordinary changes is a natural part of business life. In this paper we are referring to the observed high frequency of contracts whose conditions have been changed due to the lack of competence of the judiciaries.

(7) Though the two concepts are not identical, we use *fiscal space* for *availability of public funds*.

(8) Beato, P and A. Vives. 1996. Private Sector Participation in Infrastructure: Risk, Fiscal and Efficiency Issues in Public-Private Arrangements for the Provision of Services. Infrastructure 1: 3-14. Reprinted in D. Grimsey and M. K. Lewis (Eds.). 2005. *The Economics of Public Private Partnerships.* Cheltenham, UK: Edward Elgar.

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the higher the profitability of a project, the easier for a government to either cap project revenues (if they echo anti-market and reform discontent sentiments) or grab a chunk of the profits (if public funds are extremely scarce). The credibility of an incentives-based contracting program will plummet after the first renegotiation, or even worse, the program may become trapped in a purely redistributive setting, as discussed elsewhere.[9]

On the other side of the profitability spectrum, the most difficult situation for investment is faced by socially desirable projects that are financially unprofitable in a context of fiscal stress. Those projects are customarily overlooked, in part because the existence of liquid funds (either public or private) tends to be considered indispensable. The predisposition to investment paralysis can be overcome when other resources can be put together in a sensible way.

Choice of Financial Structures

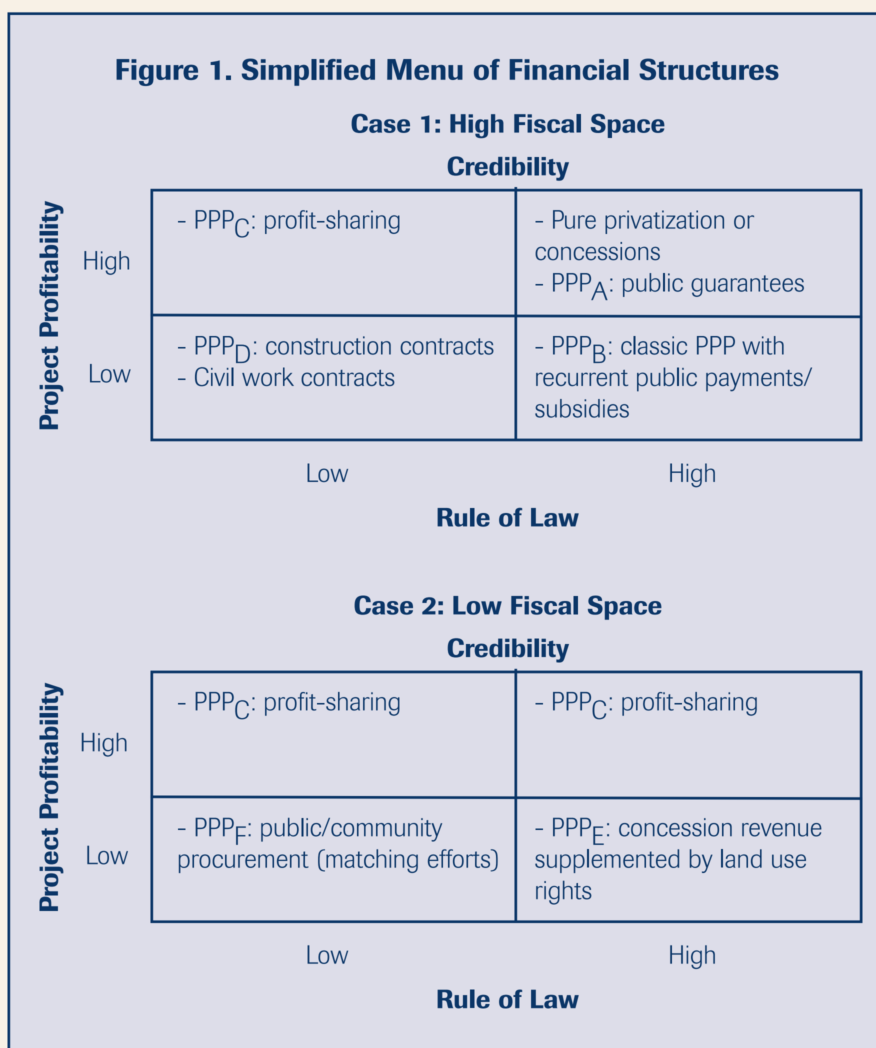
As previously discussed and for simplicity of explanation, we assume that *fiscal space*, *project profitability* and *rule of law* are the conditions dictating the fundamental risks of a project. Furthermore, we restrict these conditions to taking only two values, "high" or "low."

These simplifications will not apply to every situation: other conditions and intermediate states must be evaluated in due time. But they illustrate some critical cases and the need to scrutinize the context. The solutions that we propose to match the conflicts and difficulties analyzed so far comprise (see figure 1): (i) profit-sharing arrangements between governments and private investors when a third party cannot enforce neither property rights nor incentive schemes (e.g., toll road concessions); (ii) use of plain vanilla PPPs when the "value for money"-fiscal trade-offs can materialize; (iii) mobilization of non-cash resources for economically sound projects that cannot be repaid by conventional sources.

The simplified menu includes the purely public and private options and six flavors of PPP. We discuss each of them in turn.

- There are two varieties of the plain vanilla flavor that apply when both fiscal space and rule of law are *high*: PPP_A for projects needing credit enhancement (e.g., public minimum revenue guarantees) and PPP_B for projects needing recurrent payments (e.g., shadow tolls, performance-based contracts).
- The private option requires a *high* rating in each of the three conditions, as much as the PPP_A variety. Lack of public funds and/or weak rule of law make privatization vulnerable.
- Profit-sharing (which we call PPP_C) can align the interests of governments and investors to deter expropriation when the project is highly profitable and public funds are abundant but the rule of law is *low*; profit-sharing also works if governments decide to override the rule of law through creeping expropriation of

Figure 1. Simplified Menu of Financial Structures



(9) Strong, J., J. L. Guasch and J. Benavides. 2004. Managing Infrastructure Investment Risks in Latin America: Lessons, Issues and Recommendations. In J. Benavides (ed.), *Recouping Infrastructure Investment in Latin America and the Caribbean – Selected Papers from the 2004 IDB Infrastructure Conference Series*. Washington: IDB.

private profits, a likely scenario when public funds are in acute shortage.

- The option that we call PPP_D (construction financed and performed by the private sector) can be viewed as a more modest and riskier version of PPP_B when recurrent payments are uncertain due to weak enforcement. Note that this uncertainty does not originate in the absence of public funds. The role of the private sector reduces to the building phase.
- The public option (e.g., civil works) can be applied when both project profitability and rule of law are *low*, but fiscal space is *high*. As with option PPP_D, efficiency gains will not be easily seen because there is little room to draw on incentives.
- We imagine two ways to get out of the inaction caused by the absence of liquid funds to finance investment or maintenance. A possibility is to bring together in-kind state contributions, such as exclusive land rights granted to project sponsors that capture some of the value created by infrastructure services, as proposed by Engel, Galetovic and Fischer.[10] This solution, which we call PPP_E, can be applied where those exclusive rights are credible. A second option is to set up a system of matching efforts to reduce budget pressures, which we call PPP_F. Contributions could be in-kind (when the opportunity cost of labor is low) or come from the use of slack existing assets (e.g., public machinery during idle periods). Solution PPP_F is less demanding in property rights enforcement than PPP_E.

■ ***The use of tailor-made PPP may enhance the business climate by avoiding the costs of inefficient renegotiation and other forms of rent-seeking.*** ■

Concluding Remarks

The use of tailor-made PPP may enhance the business climate by avoiding the costs of inefficient renegotiation and other forms of rent-seeking. Improvements in fiscal space and the quality of the judiciary will increase the application of the plain vanilla approach and the purely private option; but reaching this may need considerable time. The simple examples presented here confirm the need of developing PPP flavors other than plain vanilla to suit the conditions prevailing in a country, along the continuum of possibilities. The application of this conceptual framework to real life problems will surely enrich the initial and small menu in vogue. ■

(10) Engel, E., R. Fischer, Ronald and A. Galetovic. 2005. Highway Franchising and Real Estate Values, *Journal of Urban Economics* 57:432-448.

◀ p.1 ***Financial Crises***

bankruptcies of financial institutions, and extraordinary increases in foreign debt and debt service, which placed severe restrictions on the availability of fiscal resources for investments in education, health and infrastructure.

The purpose of this article is to point out some of the lessons that should be learned to avoid the mistakes of past policies and strategies. The article also discusses several of the complexities that are behind previous financial crises in the region. A thorough understanding of such issues could be useful in the design and implementation of future Bank strategies to address financial issues as well as projects in the financial sector. This analysis is particularly important now that the global markets are entering again a period of increased liquidity as a result of rising oil prices. This article will explore the situation in several countries and the role that some of the factors identified played in past financial crises. The article provides a historic perspective of financial crises; discusses the economic doctrine of the 1980s that transformed the policy approach against inflation and became itself the source of new crises; presents the results of the new approach and the consequences of the failed programs; and, finally, contrasts the results under the pre-1980 development approach with active monetary policies and controls of foreign capital movements, with those of the new policy prescriptions adopted in the 1980s.

A Historical Perspective

Until the mid-1960s, financial crises in Latin America were associated with the vagaries of external demand caused by wars or natural disasters and their impact on commodity prices, which were transmitted to domestic economic activity and the banking sector when exporters and other debtors could not repay their loans.[1] These cyclical events triggered several financial crises in the region.[2] During the 1950s and 1960s, the developing countries made efforts to diversify their economies and modernize

▶ p.6

(1) World Bank. 1989. *World Development Report*. Financial Systems and Development. Chapter 3, pp 47-61.

(2) Earlier and now forgotten examples include the overproduction of basic commodities during World War II, when the region became a supplier as a result of a temporary demand shock.

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their financial sectors, which until then, consisted mainly of private commercial banks, many of them foreign owned and engaged in short-term lending to finance exports and other local commercial and agricultural activities. This approach focused on making credit available to priority areas, in particular for the purpose of industrialization; to provide credit facilities at reasonable interest rates;[3] and to increase agricultural production and productivity.[4] To make credit available in priority areas, new financial institutions were created and portfolio regulations were enacted that, for example, even required banks to open rural branches.[5] Another development was the improved regulation and supervision of financial institutions by central banks. This development strategy worked during the 1960s and many countries in the region grew rapidly.

The Economic Doctrines in Vogue in the 1980s

With the oil shock of the early 1970s, many non-oil producing countries in the region were confronted with a new terms of trade phenomenon: the price of an essential commodity (oil) had multiplied several times while the prices of their export commodities had not. This was not the usual deterioration in the terms of trade between manufacturing goods and raw materials, but rather, a new balance of payments situation that non-oil producers had to face. To do so, governments became convinced of the need to follow an alternative economic strategy "to cope with the long-standing problems of acute external payments constraints, wildly fluctuating exchange rates, and difficulties in sustaining a rapid path of economic growth and controlling inflation that undermined the stability of the balance of payments leading to multiple exchange rates practices."[6] This search included a reassessment of the interventionist and protectionists policies followed until then.[7]

The new development focus led to the introduction of important policy experiments in several Latin American countries during the 1980s, most of which were based on Mundell's monetary approach to the balance of payments. This model prescribed using the exchange rate rather than monetary policy to control inflationary pressures because, under the fundamental premises of this approach, monetary policy was believed to be ineffective for this purpose. The model also sponsored lifting central bank and other regulatory controls[8] over inflows of foreign financing to attract foreign capital as a means to achieve a convergence of domestic and international interest rates.[9] This was expected to result in an acceleration in GDP growth as the foreign inflows lifted financial constraints.[10] However, as will be explained below, the volatility of these inflows created the conditions for worse financial crises.

Results of the New Approach and Consequences of the Failed Programs[11]

The countries implementing the Mundell model experienced transitory success. As the model predicted, the rate of inflation fell and inflows of short-term foreign capital increased markedly. However, these results also reflected the fact that there was an implicit guarantee of convertibility provided by the exchange rate anchor (pre-announced exchange rate devaluation schedules as in Argentina's and Uruguay's *tablitas* or fixed exchange rates as in Chile). Banks were flooded with these funds and used them, among other things, to grant financing denominated in dollars for luxury imported goods and investments in non-tradables.

Later on, interest rate differentials were reversed in favor of the developed financial centers as U.S. interest rates rose in the late 1970s and early 1980s to control domestic inflation. As a result, capital flows turned against the developing countries. Since local banks used the short-term foreign inflows to provide domestic credit, they were unable to repay their liabilities to foreign banks. This resulted in a foreign exchange crisis with unprecedented repercussions for the region's economy: local banks with poor portfolios and/or in distress had to be rescued or taken over by the government, which assumed the foreign liabilities. In the 1990s, the region again experienced several bouts of financial liberalization that attracted foreign capi-

(3) Organization of American States, Charter of Punta del Este, Objective No. 19.
(4) Organization of American States, Charter of Punta del Este, Objective No. 29.
(5) New institutions were created to finance industrial activities, such as CONADI in Honduras, CODESA in Costa Rica, BNDES in Brazil and CORFO in Chile.
(6) Bernstein, E. M.. 1976. "La Política de Tasas de Cambio en América Latina" in Carlos Díaz-Alejandro, Simon Teitel and Victor Tokman (eds.) *Política económica en centro y periferia; ensayos en homenaje a Felipe Pazos*. México, Fondo de Cultura Económica.
(7) World Bank Symposium. 1983. *Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay. Applications of the Monetary Approach to the Balance of Payments*. Washington, D.C.
(8) Many central banks in Latin America had restrictions over foreign capital inflows and outflows to avoid sudden foreign exchange crises. Some of those restrictions were very severe.
(9) The lack of central banks regulations and controls over capital movements created an opportunity for domestic capital flight and money laundering.
(10) Frenkel, R. 2005. *Presentation to the Buenos Aires Consensus*. Buenos Aires.
(11) A referee has provided the following warnings and qualifications to our contentions. From the macroeconomic point of view, fiscal deficits and fiscal regimes may not be sufficiently linked to the development of financial crises. Also, it is widely recognized that any exchange rate regime (fix or float) is unsustainable with a permanent and increasing fiscal deficit; and the role of connected lending must be appraised, as it is difficult to find a banking crisis in the region with no important role for connected lending.

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tal inflows and facilitated credit growth in a favorable private market environment. External developments once again affected the region's financial system, including the Tequila crisis (1994-96), the East Asia crisis, (1997) and the Russia crisis (1998).

The end results of these experiments were severe economic crises in the region (in Argentina, Chile, and Uruguay in 1981-1982; in Brazil in the late 1990s; again in Argentina and Uruguay in 2001-2002; in Mexico in 1982 and again in 1995; and in Colombia in 1982 and again 1999). Latin America "ranked highest in terms of the average number of crises per country as well as for the recurrence of banking crisis in 1974-2003."[12] Government reliance on external funds to finance the fiscal deficit, as well as the bailouts of financial institutions and an overindebted private sector led to successive crises that made it necessary for many countries to enter (several times) into multiple year restructuring agreements (MYRA) for their external debt and repayments terms during the 1980s, 1990s and early 2000s.

The domestic impact of the financial crises and subsequent external debt renegotiations led to the 1980s being called a *lost decade* for Latin America in terms of missed growth opportunities (GDP grew at an average annual rate of 1.7 percent, while gross domestic investment declined by 1.5 percent a year). External debt grew from an average US$20 billions in 1970 to US$476 billions in 1990 and US$728 billions in 2002; external debt service payments hindered future GDP growth by absorbing a disproportionate share of revenues from exports of goods and non-factor services. Debt service went up from an average 13 percent in 1965-80 to 36.3 percent in 1985, declining to 20.5 percent in 1990 and to 19.4 percent in 2001.[13] An important conclusion reached from these experiences is that the depth of a country's financial system is not a factor in limiting the impact of the crisis. This is illustrated, particularly, by the experiences of Argentina, Brazil, and Mexico, large countries with well developed financial system, which went through some of the worst crises in the region and, in some cases, as a consequence, have seen foreign banks takeover many distressed local banks.

A parallel set of ideas, the Washington Consensus, developed during the 1980s. For the financial sector, this consensus emphasized supply-side actions to mobilize domestic savings and facilitate efficient domestic and foreign investment. The prescribed supply-side policies included tax and labor markets reforms; market-opening reforms such as liberalizing foreign trade and reducing tariffs and nontariff barriers; and the reduction of government intervention in the economy.[14] This model favored the introduction of debt-equity swaps into debt renegotiations to privatize public enterprises. The results in terms of economic growth were modest at best. The 1990s were again a decade of economic setbacks, leaving a legacy of modest growth for the next decade (as reflected in the modest economic recovery of 1999-2003). The region's GDP grew by only 3.4 percent in 1990-2000 and 1.4 percent in 1999-2003. Our hypothesis is that these results can be explained by the negative impact of large debt service payments, which reduced the funds available to undertake socially valuable investments in areas such as health, education, and infrastructure.

Although the model commonly used in the region before the 1980s has plenty of drawbacks (and cannot be relied on in the future), the Mundell-Washington Consensus approach yielded a dismally inferior performance. Inflation reached three-digit rates in many countries following implementation of the new approach. Between 1965 and 1980, rates of growth in GDP and investment were relatively high, particularly when compared to the meager growth rates posted in the 1980s and early 2000s period. The reason for this lackluster performance was the debt repayment burden that resulted from the increases in external debt noted earlier.[15] Servicing the external debt required the region to generate large trade surpluses by increasing exports and reducing imports. Thus, exports grew by 3.4 percent a year between 1980 and 1993, while imports increased by only 0.3 percent a year during the same period.[16] On the fiscal side, generating these surplus-

▶ p.8

(12) IDB. 2005. *Unlocking Credit: The Quest for Deep and Stable Bank Lending*. Report on Economic and Social Progress in Latin America. Washington, D.C.
(13) World Bank. 1980, 1989, 1990, 2001. World Development Report; and 2003. World Development Indicators.
(14) A. Rabushka, "From Austerity to Growth: A New Role for the IMF," in R. J. Myers (ed) The Political Morality of the International Monetary Fund (New Brunswick, N.J.: Transaction Books, 1987), p. 151.
(15) Debt renegotiations took place under the U.S. Treasury sponsored Brady and Baker plans.
(16) World Bank , World Development Report. 1995. *Workers in an Integrating World* pp.187.

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es forced regional governments to curtail public expenditures on social services and infrastructure. As a result, while governments followed market-friendly strategies, the policy environment actually resulted in a "neglect of the state's vital functions threatening social welfare and eroding the foundations for market development."[17] The Washington Consensus paid scant attention to the complementarity between markets and governments.

Inflation continued to be a problem in some countries despite being one of the main aims of the new policies. Debt renegotiations introduced a new factor in the financial problems of the region: debt-equity swaps (under which debts were exchanged for equity in public corporations or financial institutions). Debt-equity swaps led to a significant increase in the foreign-owned share of the financial sector in several countries. Moreover, in countries such as Mexico and Argentina, many banks are owned by corporations from a limited number of countries, increasing their bargaining power with respect to national supervisory or regulatory bodies. Later, once the consequences of the crises became apparent, some banks ceased their local activities, sometimes affecting as well their investment and insurance operations and other subsidiaries or branches.

The Presence of Foreign-owned Banks[18]

The increased presence of foreign-owned banks in Latin America has been questioned because their potential benefits are tempered by the risks associated with international banking, which may temporarily increase the inflow of foreign capital, but may also quickly reverse that flow for reasons having nothing to do with local conditions, and trigger new financial crises.[19] Moreover, the repatriation of profits from these institutions restricts the potential for financial deepening of the host country. Furthermore, experience shows that during a financial crisis, foreign banks either limit their responsibility for providing capital to their local branch or abandon the country altogether. The 2002 crisis in Uruguay highlights another factor leading to financial crisis: moral hazard in the presence of contagion. A bank based in Uruguay exchanged US dollar holdings originating in individual deposits with a bank based in Argentina (both banks shared the same owners group and top managers) for their holdings of Argentine government bonds, which later became part of the default package of the bank based in Argentina. Because the Uruguay-based bank was unable to return the US dollar deposits, it had to be rescued by the government at a cost exceeding US$500 million. Its bankruptcy precipitated a run on dollar deposits and the subsequent crisis.

■ *Government policies should pay particular attention to: i) the consistency of fiscal policy and cautious domestic and foreign borrowing practices on the part of both private and public entities; ii) effective monetary policy that is conducive to price stability, particularly with respect to regulating external financing flows; and iii) appropriate exchange rate parities that avoid overvaluation of the currency* ■

The Bunching of Crises or Lessons Unlearned

In summary, financial crises unfold due to a combination of factors: terms of trade shocks; exchange rate policies favoring a vulnerable pattern of investment and/or consumption; the impact of fiscal difficulties on the domestic banking system and the economy; the liberalization of restrictions on the current and/or capital accounts of the balance of payments without adequate safeguards; political instability; and contagions and spillovers from financial crisis in other countries.[20]

The record of crises in several Latin American countries that result from relying repeatedly on the exchange rate as a sort of anchor for the price system merits further research to ascertain the rationale for this behavior. The current situation of increasing oil prices raises again the specter instability and deteriorating economic performance and balance of payments for the non-oil exporting countries of the region. It would be wise, at this juncture, to remember the events that followed the oil shock of 1973. Today, another price bonanza for oil producers raises again the possibility of large amounts of short-term money looking for investment opportunities and tempting local governments by offering transitory financing for their expanded trade imbalance. If improperly handled, this could lead to a repetition of previous mistakes, particularly renew foreign indebtedness or the adoption of monetary policies, especially in the foreign exchange area, that make matters worse. On the other hand, the impact of an oil shock in the 2000s would not necessarily be drastic in countries that have deepened their local capital markets and receive net remittances from abroad (which could counterbalance the negative effect of high oil prices). This is a topic needing further research.

(17) World Bank, World Development Report. 1997. *The State in a Changing World*. pp.24.
(18) The dynamics of acquisition of local by foreign banks exhibits a different dynamics by country, reflecting the perceived stability, market size, and liquidity, and growth expectations.
(19) World Bank, World Development Report 2002. *Building Institutions for Markets*.
(20) Carsten, A. G., D. C. Hardy and C. Pazarbasioglu. IMF, Finance and Development, Sept. 2004.

Conclusions and Recommendations to Avoid a Financial Crisis

The region's experience shows that financial crises arise from either poor macroeconomic policies or poor banking practices or both together. The relationship between financial crises and macroeconomic problems is complex. Some crises precede macroeconomic problems; while in other occasions, the macroeconomic problems generate the financial crisis (for example, deteriorating terms of trade create macroeconomic problems and, as a result, producers and exporters cannot repay their debts). In addition, there are situations wherein large debt service payments force governments to curtail domestic expenditures for education, health and infrastructure, in turn, slowing down domestic economic activities. Government policies should pay particular attention to: i) the consistency of fiscal policy and cautious domestic and foreign borrowing practices on the part of both private and public entities; ii) effective monetary policy that is conducive to price stability, particularly with respect to regulating external financing flows; and iii) appropriate exchange rate parities that avoid overvaluation of the currency.

The major lesson that this study yields is that monetary policy and effective financial regulations, particularly the regulation of international capital flows, play a major role in averting financial crises and deserve priority attention.[21] In addition, contrary to the mainstream economic thought of the past twenty years that monetary policy is ineffective in controlling inflation and regulating financial markets, the recent experience of the United Kingdom and other developed countries highlights the important role that monetary policy plays in maintaining price stability.[22] Further reinforcing this view are the results of a recent IDB forum that detailed the elements that can result in deeper and more inclusive financial intermediation.[23] ■

First Regional Forum

Challenges and Opportunities for the Development of Insurance Markets in Latin America and the Caribbean

November 7-8, 2005, Washington D.C.
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The Inter-American Development Bank, the Association of Latin American Insurance Supervisors (ASSAL) and the Inter-American Federation of Insurance Companies (FIDES) will host a seminar to discuss the main problems concerning the Latin America and the Caribbean insurance markets. Industry, regulators and experts would present their own technical perspectives and past country experiences on the issues faced by their markets. These discussions would then lead to conclusions that would help show where development is needed.

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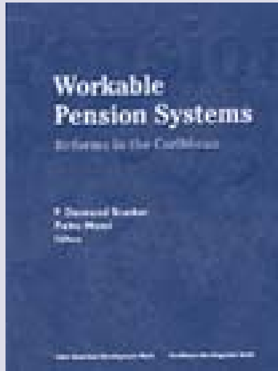
(21) IDB. 2005. Report on Economic and Social Progress in Latin America. Washington, D.C.
(22) Apparently some countries are beginning to foresee the danger. A recent communication (No. A 43l8 1706 2005) from the Central Bank of Argentina (BCRA) establishes minimum capital requirements according to new classification rules and regulates short-term capital inflows. Chile also introduced new regulations of short-term foreign capital movements.
(23) Developing Financial and Capital Markets: The Challenges of the Decade. A Regional Financial Forum. June 13, 2005.

We are pleased to announce the following publication of the Inter-American Development Bank:



Workable Pension Systems Reforms in the Caribbean

Edited by P. Desmond Brunton and Pietro Masci

English, 468 pages
ISBN: 1-931003-77-7
17 x 23 cm
US $24.98

Virtually all nations can expect to have a significant population of retired person who will make a claim on the society's economic resources. This volume is geared to helping devise workable and efficient pension systems for the nations of the Caribbean. The requirements for reform are extremely complex and encompass political, policy, and technical issues. *Workable Pension Systems: Reforms in the Caribbean* offers specific discussions of instruments, programs, and experiences in various countries, and potential solutions that drawn on the collective expertise and talent in the region.

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Book Reviews, Articles & Papers:

The Financial Economics of Privatization, *William L. Megginson,* Oxford University Press, 2005

Over the last 20 years the wave of privatization has been impressive and over 100 governments around the world have raised over $1 trillion through the sale of State Owned Enterprises (SOEs) to private investors. Emerging and developed countries have undertaken privatization programs that have led to greater efficient utilization of resources reducing the role of on the economy.

A number of studies have been undertaken on privatizations and its various aspects. The book of Megginson – continuing the work he had previously undertaken on specific studies – represents one of the most comprehensive analysis of the motivations and impact of privatizations. The book covers various crucial topics – previously analyzed in the literature and also by the same Megginson, e.g., scope and motivation of privatization, forms and techniques of privatizations. He then looks at the impact of privatization from the point of view of groups of countries (e.g., transition and non-transition economies) and sectors (e.g., telecommunication, airlines).

In this respect, the book represents a unique source for information related to the details of asset sales privatization, statistics of privatized companies from more than 50 international stock exchanges, regulatory changes and provides sources for privatization information for investors, government officials, bankers, researchers. The publication could be easily included in a graduate program in privatization courses.

The more innovative chapter is that of the impact of privatization on financial market development. The framework of analysis is very interesting looking at aspects such as rise of capital base finance, impact on stock and bond market, institutional investors and corporate governance. The role of privatizations and capital market development is particularly relevant taking into consideration that overwhelming has demonstrated conclusively a direct link between capital market development and economic growth.

Megginson examines the growth in global capital market valuation, trading volume and security issuance over the past two decades and one of the main findings is that privatizations have extraordinarily increased the capitalization and liquidity of all non-U.S. stock markets as measured by the turnover ratio and particularly the European stock markets. Also the book shows that privatizations have had a significant impact on the share ownership by individuals and institutional investors, i.e., privatizations have dramatically increased the number of shareholders in many countries.

However, the book does not recognize the significant differentiation among group of countries – and in the case of the privatization in Latin American and Caribbean (LAC)- does not fully investigate that those capital markets have not grown despite massive privatizations and also pension reforms. Megginson seems to suggest that governments have adopted share issue privatizations programs as a means to jump-start the growth of capital markets. In LAC- in large part- privatizations have not been carried out with share issues and the growth of capital markets was relying more on market oriented pension reforms. In Europe, the pensions systems remain virtually untouched, and capital markets have been growing in response to government debt management and privatizations. It would worthwhile to investigate these different experiences and see why despite privatizations, LAC financial and capital markets have not taken off. Additional work remain to be undertaken to contrast in a more analytical fashion the privatizations and their capital markets impact in different regions of the world.

P.M.

White Elephants, *James A. Robinson and Ragnar Torvik,* Journal of Public Economics 89: 197-210, 2005.

Though underdevelopment is thought to be about lack of investment, misallocated (over) investment is a deeper problem in developing countries. White elephants are projects with negative social surplus. Robinson and Torvik explain the emergence of white elephants as a particular form of inefficient redistribution. White elephants are part of an exchange relationship between politicians and voters, where the incumbents have important advantages, supported in cases where politicians face commitment problems in offering policy favors in exchange of votes. This is an important characterization of white elephants, as the press often reduces them as a manifestation of sheer venality or as a symptom of megalomania of rulers. In their model, politicians maximize their own utility but they also care about the outcome for agents in their “region”. As well, voters value their own utility but also have an ideological bias. Politicians cannot credibly commit to policies that are not on their best interests: promises of taxes or income transfers different from zero are not credible to any voter group, and the voters realize this.

Projects that are ex-post profit making can never be used to affect the election probabilities (as its benefits have symmetrical effects on political outcomes) and will be launched and operated only if the expected rents for the incumbent politician are very high. There are three reasons for the political evaluation of a project to differ from the

social optimum. First, politicians value their own expected increase in profits rather than the actual increase. Second, they value the increase in income of agents of their group by less than the actual increase in utility. Lastly, they value costs in marginal rather than in average (overall for society) terms. Therefore, an ex-post loss-making project can be used by the incumbent to increase his election probability, whenever the political rents of operating the project are sufficiently high. And the more voters care about the economy relative to other factors, the more the incumbent can tilt the reelection probability by committing to a loss-making investment project. It is the very inefficiency of the project that makes it politically appealing.

These results highlight the need of a comprehensive approach to deal with infrastructure financing, including: (i) more rigorous project screening and cost-benefit analysis, (ii) improvements in redistributive policy as a way to minimize the link between voting and project targeting; (iii) incentives to induce private investors to reveal their rejection of poor projects in the bidding contests.

J.B.

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