

# **FINANCIAL CRISES AND LATIN AMERICA DEVELOPMENT**

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Quinto congreso FIAPA—Asofondos

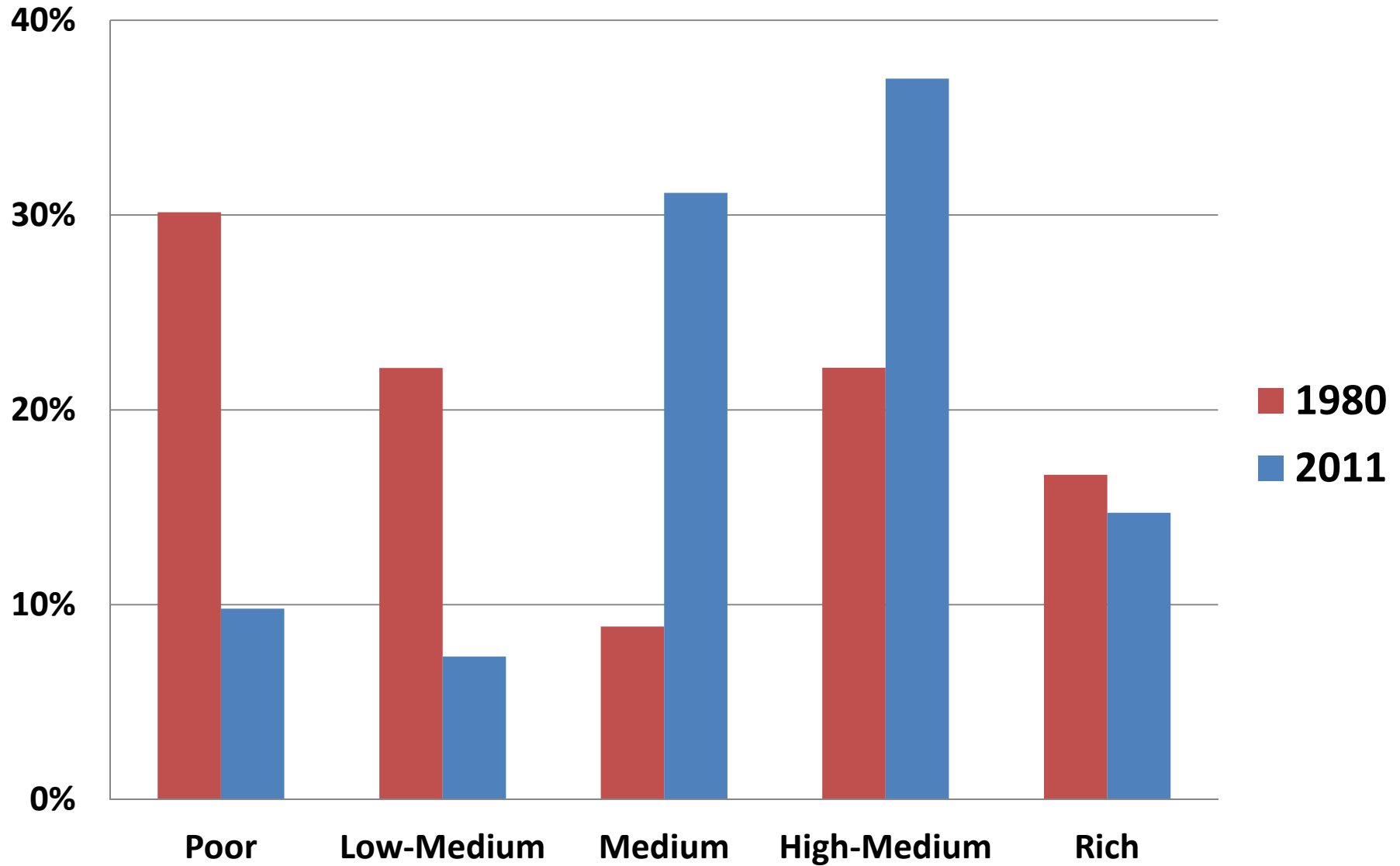
## POINTS TO BE MADE

- Most of world economies doing well
  - Exceptions: U.S. and Southern Europe
- Asia is catching up rapidly
- South American Pacific countries have been doing well and have narrowed the gap with the leaders
- Even Africa has begun to catch up

- Current economic problems in N. America and Western Europe are not due to financial crises.
- Financial crises are symptom – not cause – of current depression state of U.S. and E.U. economies
- I am optimistic that the S. American catch-up will continue.
- Reason
  - Most countries are becoming more integrated with each other and with the rest of the world
  - Saving for retirement systems have been getting better

**ALL ARE GETTING RICHER AND CATCH UP IS  
OCCURRING**

## Percent of World Population by Income Group: 1980 and 2011



## ALL GETTING RICHER

	1964	1984	2004
10 <sup>th</sup> Percentile	648	1,060	2,092
50 <sup>th</sup> Percentile	1,000	1,396	4,785
90 <sup>th</sup> Percentile	9,568	14,833	21,769

GDP Per Capita in 1990 U.S. Dollars (PPP)

Source: The GGDC Total Economy Database

**NEXT SLIDE DOCUMENTS THE CATCH-UP OCCURRING IN  
THIS CENTURY**

## **DECADE PER CAPITA GROWTH**

### **North America:**

USA	8%
Canada	12%
Mexico	11%

### **South America:**

Brazil	28%
Chile	35%
Colombia	33%
Ecuador	30%
Peru	64%
Venezuela	15%

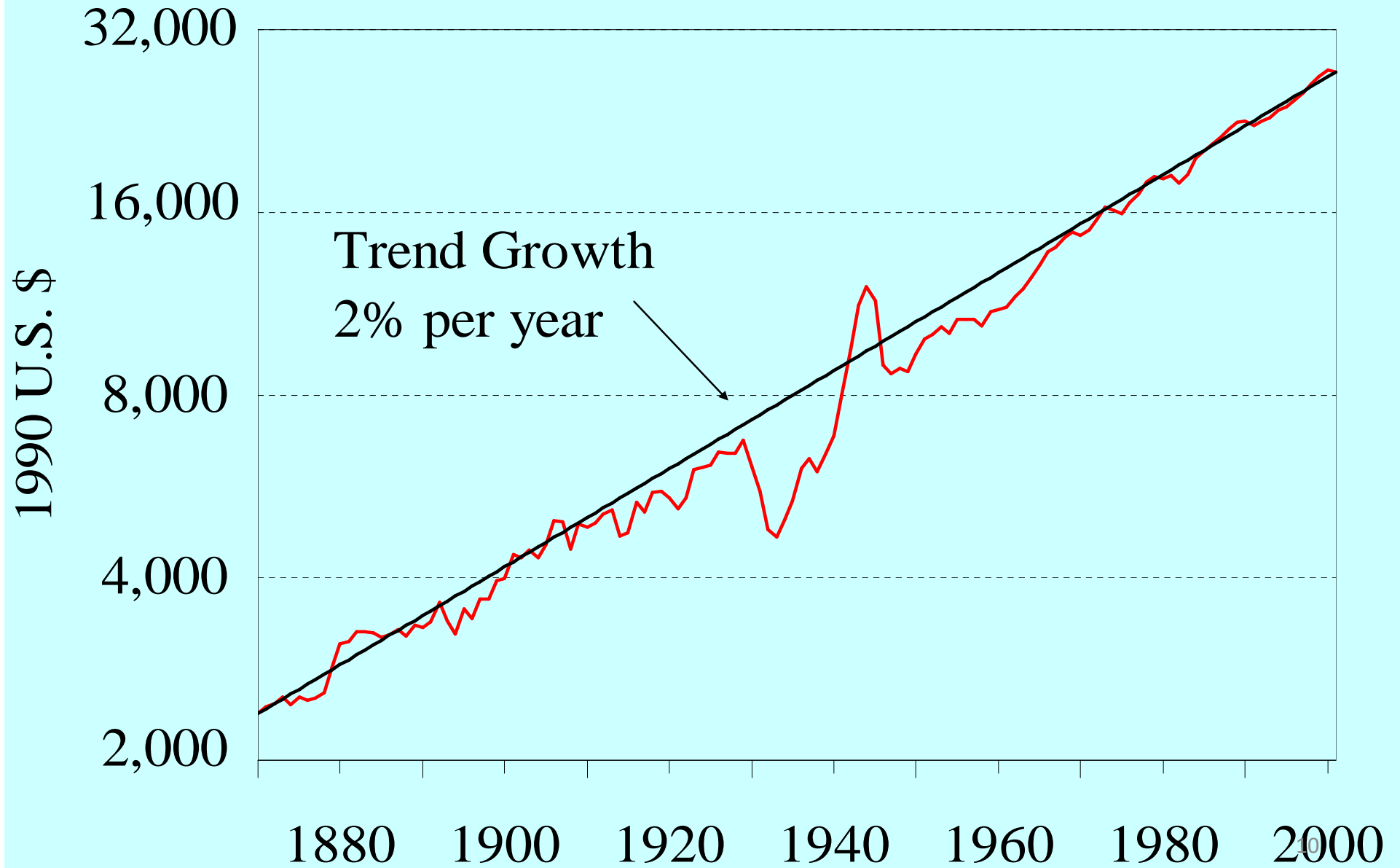
Source: GGDC Total Economy  
Database

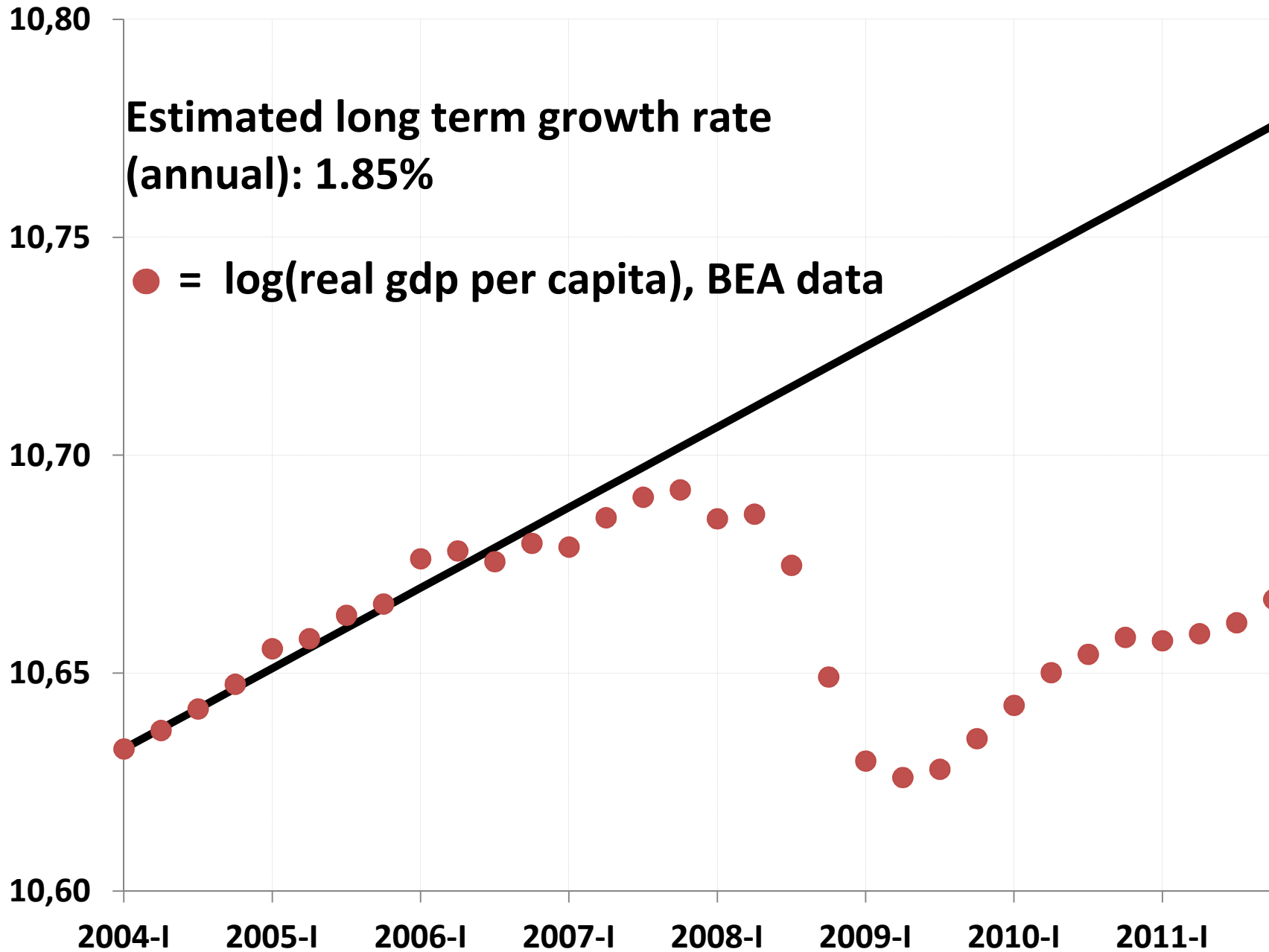


# U.S. ECONOMIC CONDITIONS

1. First, long term picture
2. Second, recent picture

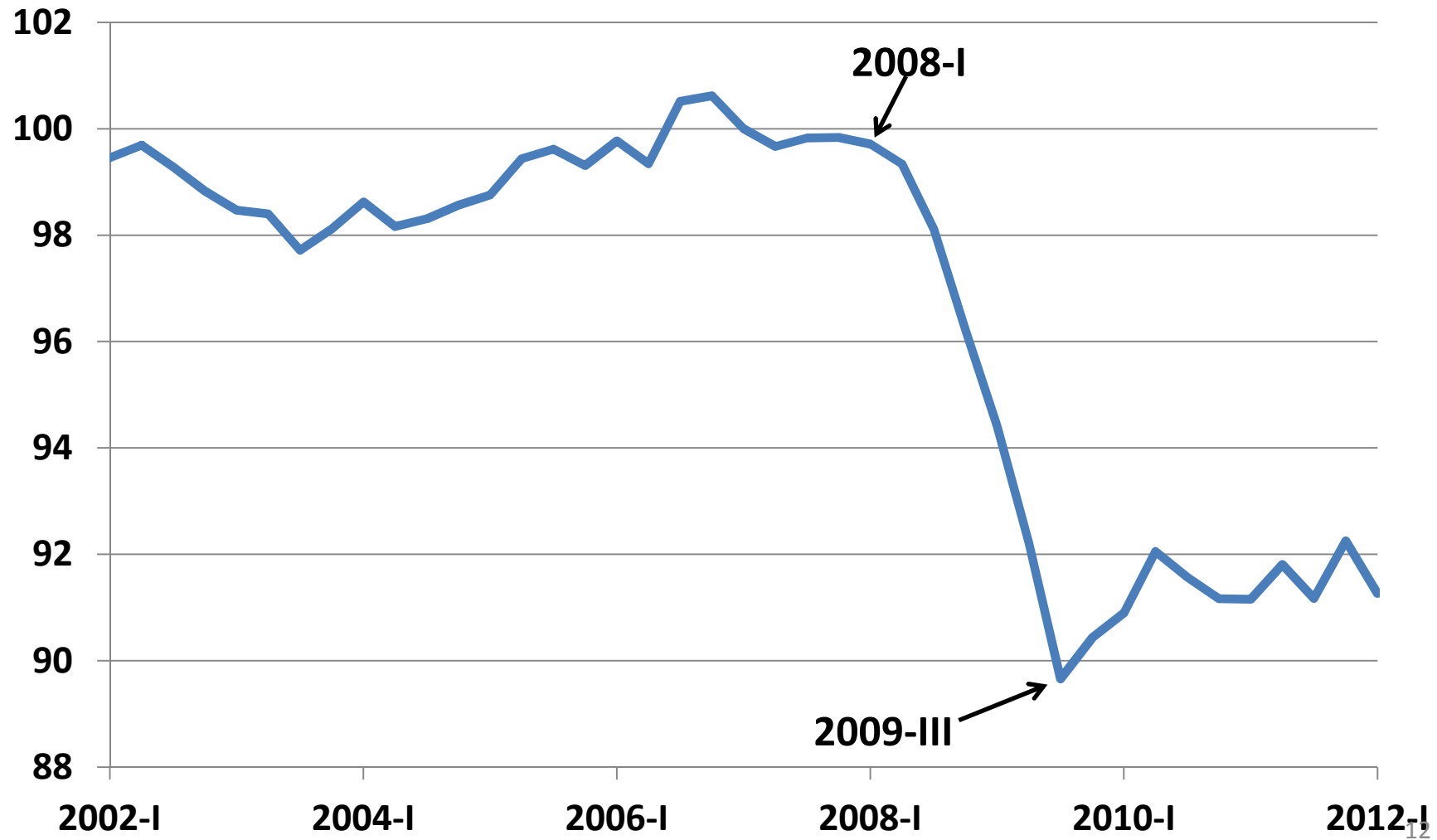
# U.S. GDP per Capita





# U.S. HOURS PER WORKING-AGE-PERSON DEPRESSED

(2007-I = 100)



## Private Balance Sheet Averages for 1999-2008 Relative to GNP

Total Assets	6.79
Tangible assets	<b>3.78</b>
Government debt	0.50
Private debt	2.51
Total Liabilities	2.51
Net Worth	4.28
Source: Flow of Funds Tables D3 and B100.e	

## QUESTION

Why is private sector's net worth less government debt only 3.8 GNPs while the stock of private capital including intangible capital is 5.1 GNPS?

This discrepancy is about 1.3 GNPs

Answer:

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Answer:

**The market value of private capital is less than the stock because of taxes and regulations**

# MARKET VALUE OF BUSINESSES

Private business sectors market values:

$$V = (1 - \tau^{div}) K'_T + (1 - \tau^{div})(1 - \tau^{profit}) K'_I$$

- Assumes all investment financed by retained earnings, which is nearly the case

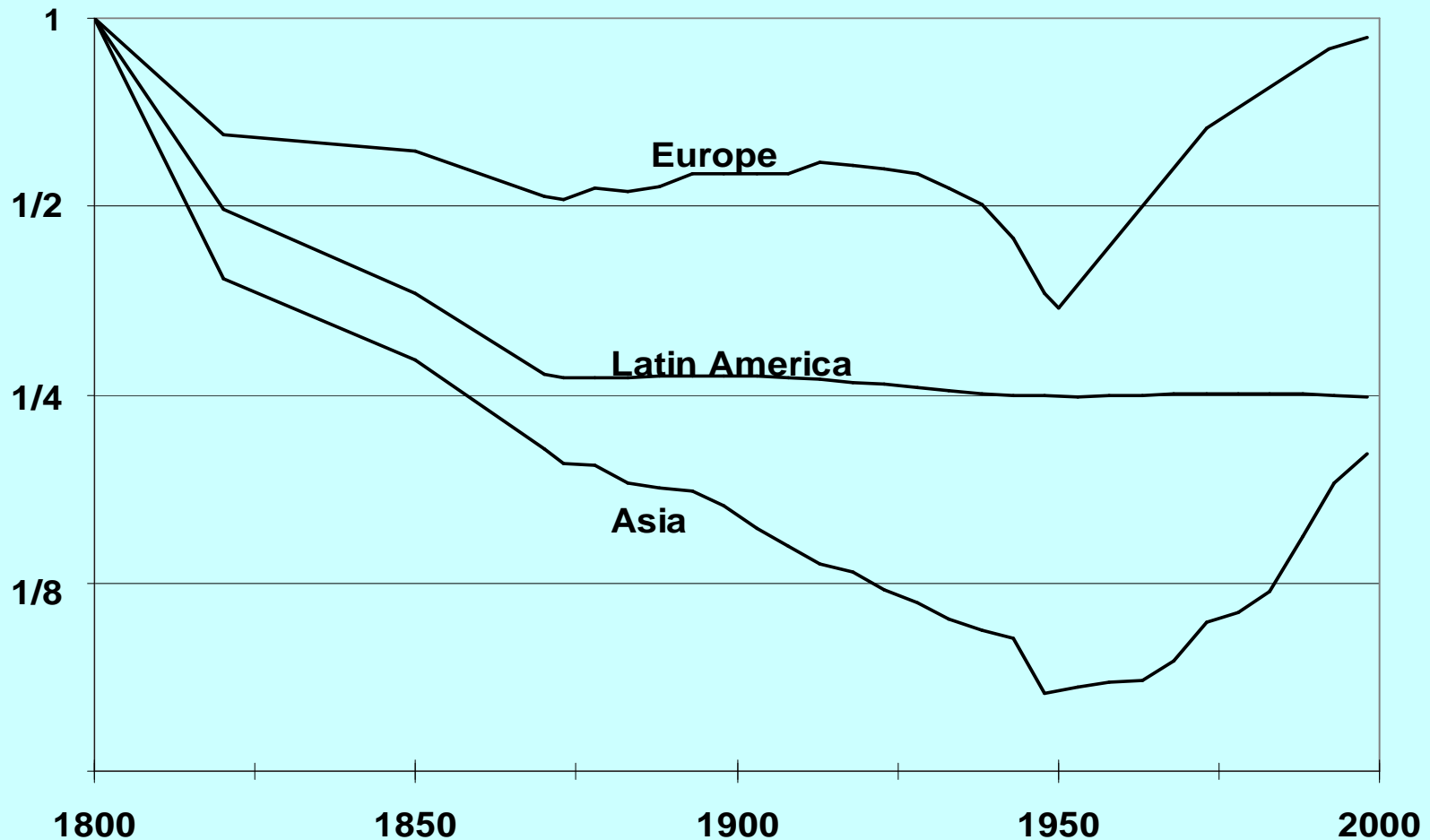
See McGrattan and Prescott (2005, *RES*)



# REGIONAL 20<sup>TH</sup> CENTURY GDP PER CAPITA

# REGIONAL LEVELS RELATIVE TO LEADER

Income: Fraction of the Leader, 1800-1998



# **WHY I PREDICT SOUTH AMERICAN WILL CATCH UP IN THE 21<sup>ST</sup> CENTURY**

# IMPORTANCE OF PENSION SYSTEM FOR DEVELOPMENT

- Chile set up individual savings accounts in early 1980s
- Chile used these savings to acquire American retailers in Chile, who acquired and enhanced know-how capital
- Chilean retailers used their know-how to set up subsidiaries in other S. American countries
- These investments turned out to be good ones on average
  - Which is good for Chilean savers
  - Which is great for people in the countries where they invested

# ADVICE

- Invest in neighboring countries
- Don't write off N. America, Western and Central Europe, and Asia as places to make direct foreign investments
- Brazil has a made major foreign direct investments in the U.S. and China

# U.S. ACADEMICS SAVE MOSTLY IN DEFINED-CONTRIBUTION PLANS

- People working in the private business sector do as well
- Federal and private business employees do as well
- Only important exception is state and local government employees, who have underfunded defined benefit plans
- But this is changing
  - Already Michigan, Alaska, and Washington, D.C have shifted to defined-contribution plans

# WHO OWNS STOCKS?

- Pensions funds and individual retirement accounts own 75% of U.S. stock market (Federal Reserve Board, *Flow of Funds*)
- Not a few rich people

# THE EURO CRISIS

- This crisis is the result of demographic changes
  - There is a shortage of needed savings opportunities
- The Germans and French have behaved in a totally irresponsible way by lending to Greeks



# WHAT EUROPE SHOULD DO

- Thomas Sargent in his 2012 Nobel Prize Address points out that the U.S. did not bail out the member states in the 1840s when many became insolvent
  - There was no collapse in output and employment
- So let Greece go bankrupt
- U.S. should not bail out California and Illinois

# A LITTLE FISCAL CONSTRAINT WILL NOT SOLVE THE PROBLEM

- Incentives need to be changed so people work a larger fraction of their lifetimes
  - Some reforms in Europe – Sweden, France, Germany, and even Italy
- Sweden moved to individual savings accounts and indexed full retirement age to life expectancy
- France eliminated 33% social security tax on those that reach full retirement age and continue to work
- Average retirement age has started to increase in Europe

# COLUMBIAN LIFE EXPECTANCY IS INCREASING

- This will mean more savings
- Colombia should follow policies that result in a larger formal market sector
  - For example lowering its high minimum wage and reducing effective marginal tax rates
  - And making it easy to start-up, expand, and contract businesses

## POSSIBLE PROBLEM WITH ANNUITIES

- Mortality rates could fall
- Solution: Have current payout of pension funds be contingent upon life expectancy for an age-cohort
- Share this risk

# A GOOD WAY TO SAVE FOR RETIREMENT

- Save directly and get higher returns
  - I estimate real returns will average 5% in the stock market
  - And higher in unincorporated businesses
- With this savings strategy, there will be accidental bequests unless someone lives to a very old age

# STOCK MARKET IS THE PLACE TO SAVE

- The stock market is the safest place to save even though stock prices are excessively volatile
- There is strong regression to fundamentals
- Expect an average real return of 5% in the stock market

# **AN IMPORTANT FACT**

**EVERYONE CAN NOT INCREASE THEIR SAVINGS BY  
LENDING MORE AND BORROWING LESS**

**PRIVATE SECTOR BORROWING AND LENDING MUST BE  
EQUAL**

# **CREATE A GOOD BUSINESS ENVIRONMENT WHICH FOSTERS THE CREATION OF NEW BUSINESS ENTERPRISES**

- A good system has workers moving quickly from where they are less productive to where they are more productive
- Remember the accounting identity

## **Income = Output**

- Income is by definition claims against output and there is always a residual claimant
- Output increases are the result of increases in hours worked and output per hour only



# U.S. SUBPRIME CRISES

- U.S. de facto nationalized its mortgage market and not surprisingly bad policies were followed.
- These policies resulted in loans being made that should not have been made.
- There is a law that banks must invest locally even if there are not qualified local borrowers.
- Quasi government enterprises, in particular Fannie Mae and Freddie Mac, guaranteed a big share of the home mortgages
  - They had to be bailed out by the tax payers

- Over 40% of U.S. publically traded corporations accounting profit are from their wholly owned foreign subsidiaries
  - Only 12% of their reported investments are in their foreign subsidiaries
  - Clearly there are accounting problems and they are associated with intangible investments, which are expensed, and therefore not part of measured output (GDP)

# To CONCLUDE

Pacific South American Economies should

- Be open and compete across borders
- Develop a broad based private-ownership economy
  - Defined contribution pension plans is doing this in your countries
- Not subsidize inefficient producers – Japan, Mexico, and Italy did and lost a decade of growth

**THANK YOU FOR YOUR ATTENTION**