BY GLENN YAGO AND THOMAS HALL

Opacity is a bloodless term. So, too, are "corporate governance," "systemic risk" and "financial disclosure." All of these terms are really about economic conditions that can lead to sustained growth, which occurs only when markets are transparent and all of the productive forces in the economy – investors, entrepreneurs, workers and consumers – share the information necessary to invest their financial, human and social capital effectively.

Economies that operate above the heads and behind the backs of their own citizens are unlikely to sustain growth, and are most likely to fall victim to periodic banking crises, financial meltdowns and capital flight. With inadequate domestic savings rates to fund future investments, emerging market countries face skeptical foreign investors unwilling to return to the killing fields of plundered capital. During the closing years of the last century, in some former Soviet republics, Latin American countries and still-crouching Asian tigers, the forced savings of citizens disappeared overnight, assets were airlifted abroad, and the pendulum of boom and bust swung ever more brutally. It's no wonder that governments destabilized and the social fabric of traditional solidarity in developing nations wore exceedingly thin.

Together with Professor Shang Jin-Wei of Harvard University, Milken Institute economists drilled deeply into a new international survey conducted by PricewaterhouseCoopers. The O-Factor Index (or Opacity Index) measures, for the first time, the hidden costs of institutional failure to provide the information necessary to assess and price country, market and corporate risk for projects and businesses worldwide. Opacity is the lack of clear, accurate, formal and widely accepted practices in the capital markets and national economies. Opacity poses an obstacle to economic progress, and where it exists, there are lost opportunities. We have found that opacity deters international capital flows, diverts investment, levies a hidden tax on domestic and foreign investors, raises the risk premium on sovereign government bonds, and exacerbates income inequality. The real lessons of the Asian and Russian financial crises are not captured by IMF finger-wagging against financial mischief, but rather by the real costs imposed upon all the developing world in financing the future. The Opacity Index quantifies these costs.

The Index defines opacity more broadly than related studies from other distinguished organizations that research various aspects of

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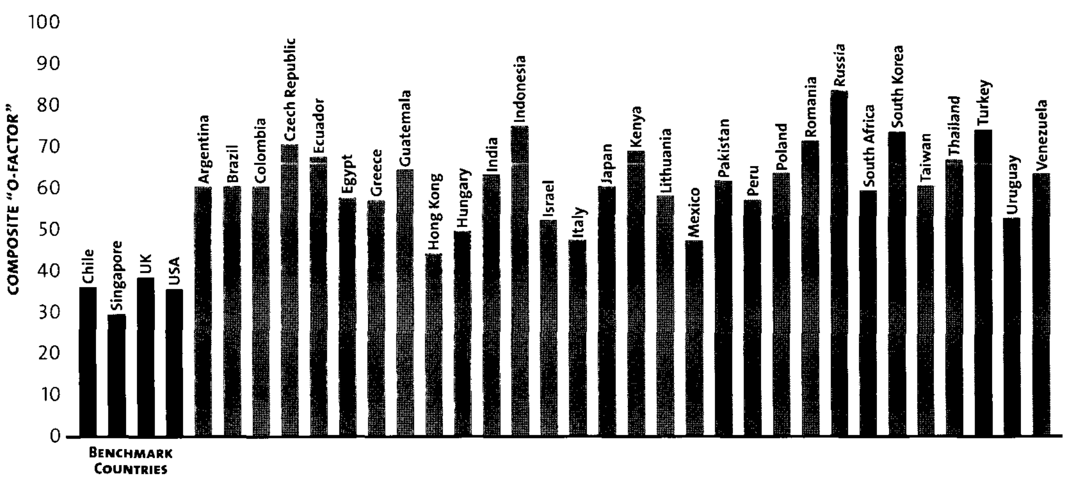
opacity. The Index defines opacity as a lack of transparency in five distinct areas: Corruption, Legal, Economic policies, Accounting and Regulatory – creating the acronym CLEAR.

In a compelling narrative detailing his experiences in development economics, Hernando de Soto's important new book, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Basic Books, 2000) echoes these themes of the costs of opacity. He estimates that the poor in the third world hold more than $9.3 trillion worth of property that avails them little or nothing because of the absence of institutional protections of property rights and the ability to construct secondary markets. Ownership, the most basic information about property, is not established in much of the developing world. Property can only provide security if it can become a means of obtaining credit in order to generate further investment.

Physical assets (not to mention the intellectual or organizational assets also untapped in the developing world) can only be converted into capital to produce and compound economic growth when it exists, is measured and can be traded in a market protected by laws and regulations. Countries that adopt corporate disclosure laws and reduce opacity – both in the private sector and in the policy/regulatory arenas – will likely increase the quantity of investment and reduce its cost. Plentiful capital at reasonable cost spurs a deep and healthy financial sector, and creates more income and wealth. Transactional trust in commerce and investment enables requisite uncertainty to be priced as risk. Bond rating agencies, real estate appraisers, insurance companies and credit analysts can all quantify, measure, monitor and manage risks that are disclosed. But hiding information creates hidden costs that overwhelm developing economies far beyond normal business costs and risks.

FINANCIAL MARKET OPACITY



THE CASE OF LATIN AMERICA

All of the CLEAR dimensions coincide in

financial markets. The chart opposite shows three measures of financial sector size in Latin American economies – size being a standard proxy for a more elusive "depth" of financial markets. The least opaque country in the region, Chile, dominates in terms of equity market capitalization and total banking assets, each expressed as a percentage of GDP. Argentina and Brazil lag behind.

Statistical analysis confirms a negative correlation between financial depth and both of what de Soto calls the "bell jar" – the closed circle of players who dominate the country's wealth.

But as financial depth increases (because of increased transparency), more resources are allocated to projects offering the best returns. Better-managed companies with profitable prospects will attract more capital. If this dynamic prevails, inequality should decline, at least initially, because such enterprises stimulate the development of a middle class. If such a class becomes a major buyer of

The more corruption and accounting opacity, the shallower the financial markets. Opacity deters the development of financial sectors, which in turn, decelerates growth.

accounting opacity and corruption: the more corruption and accounting opacity, the shallower the financial markets. Opacity deters the development of financial sectors, which in turn, decelerates growth.

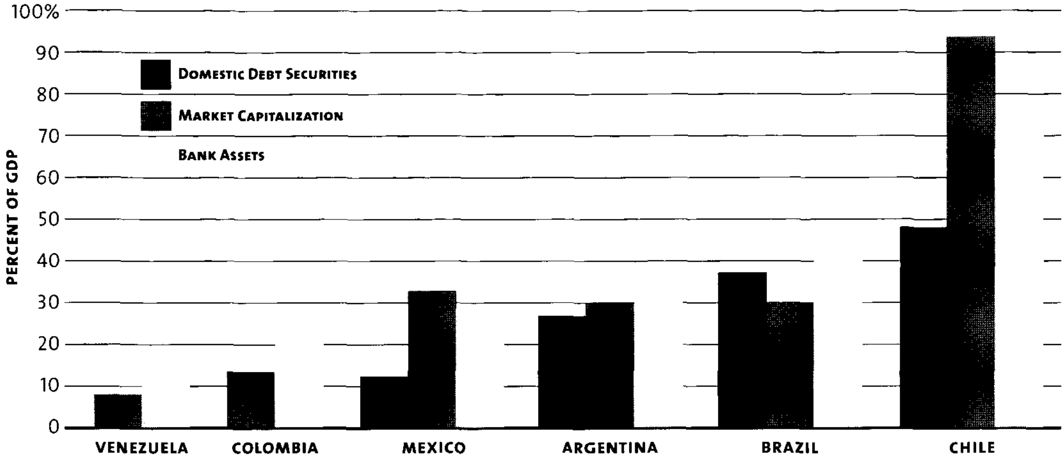
Skeptics argue that economic growth in and of itself is not enough to generate equitable long-term development in Latin America. Indeed, they would contend strong growth rates would only exacerbate inequality. A closer look, though, suggests they are almost certainly wrong.

Imagine a country with a high level of inequality and a small financial sector. In such a country, the financial sector is likely to function through "crony capitalism," with scarce credit allocated on the basis of personal relationships rather than the objectively analyzed risks and rewards of proposed investments. What's more, the resources left after the inner circle is satisfied are likely to be allocated in ways that ignore the needs of people outside securities (either as individual investors or through mutual and pension funds, as in Chile today), then policies promoting transparency may become popular as well. The result can be a virtuous circle of transparency, development and international openness.

Using a sample of countries in Latin America and data for the period 1965-99, we have found that financial development reduces income inequality. Controlling for the level of per capita income, these societies have achieved broader income distributions as national financial markets have deepened. Greater transparency across the five CLEAR dimensions accelerates this welcome trend.

Too often, bidding wars break out between developing countries competing for foreign investment on the basis of generous tax incentives. Even if countered by increasing tariffs on imported consumer goods, this strategy can cause a decline in government revenues, and it will certainly distort the allo-

STRUCTURE OF FINANCIAL MARKETS LATIN AMERICA
(AS A PERCENT OF 1999 GDP)



cation of resources. Sometimes, this rush to tax competition transfers wealth abroad. Our research suggests that transparency and tax breaks are substitutes – that financial reform can make these tax concessions unnecessary.

Recent reform in Latin America and elsewhere in emerging markets has often been enacted according to the Brazilian expression, *para o Inglês ver*, "for the Anglos to see." This old saying must be updated; better still, it should be retired. Latin America and other emerging markets have the potential to become hosts for far greater amounts of foreign capital. More important yet, emerging markets can raise domestic investment, achieve greater financial sector depth, and create institutions and markets that will unlock the gates to economic development.

ANSWERS TO THE PUZZLER, PAGE 87

"The American scholar faces taunts...for not meeting a payroll, for not coming down from the ivory tower, for not getting wet behind the ears of his smarty egg head. Come to think of it...if he's so gosh darn smart, why hasn't he gotten rich?" — D.N. McCloskey, *If You're so Smart.*

A. daffodils
B. natch
C. miffed
D. Chesterton
E. Christ
F. lighter than air
G. oompah
H. so tonight
I. kosher hot fry
J. entrench
K. yeti
L. ignorant sow
M. famed women
N. yams
O. Otho
P. urban
Q. rhinoceros
R. effect
S. stove
T. ohm
U. swagger
V. magnetron
W. athlete
X. rotations
Y. Twiggy

Back by popular demand!

Back by popular demand! Well, to be honest, my wife and kid missed the feature, and my creative juices were flowing this morning. And besides, we had all this extra space... Herewith, a heads-up on economic policy research you may not know about.

A TRILLION HERE, A TRILLION THERE

Federal budget forecasts are always wrong, and usually they are wrong by laughably large amounts. For example, between April and July of last year, the Congressional Budget Office "adjusted" its estimate of the 2001 surplus by $95 billion. And that was hardly a record. In 1982 and again in 1991, the CBO missed the actual deficit number by nearly 3 percent of GDP – almost twice the size of the 2001 error when measured in percentage terms.

No, explains Rudy Penner of the Urban Institute, the forecasters at CBO aren't dumb. Nor are they cynically manipulating their estimates to serve their benefactors in Congress. The job is simply harder than is generally understood. Penner should know; he served as CBO director from 1983 to 1987.

Penner assays the CBO forecasting process, explaining among other things, how past errors in forecasting affect future errors. Equally important, he ruminates on the question of how policymakers should use forecasts they know will be wrong – and how the Congressional Budget Office should package its results to minimize the consequences of error.

The big lesson, he argues, is that the longer the forecast, the less credence should be placed on the numbers. Thus, the second five years of a 10-year forecast should be labeled with appropriate warnings. And the CBO should resist the temptation to publicize cumulative values for the surplus/deficit – if the forecast is a little bit wrong in the first few years, the cumulate estimate for the remaining years is likely to be a lot wrong. [*"Errors in Budget Forecasting," Urban Institute Research Report. For copies, e-mail paffairs@ui.urban.org.*]

HOW DO YOU SAY "YAHOO" IN UZBEK?

You've heard about the digital divide in American education – the reality that middle-class kids are more likely to use and learn about information technology than their low-income peers. But are you ready for the digital divide on a global scale?

Actually, this is not a joking matter. Information technology can ease the problem of playing economic catch-up in poor countries – it is simpler, after all, to distribute computers with Internet connections than it is to build schools and factories. But making the transition to an economy driven by information technology requires the