



ANNUAL MEETING OF THE BOARDS OF GOVERNORS

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STATEMENT BY
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CHAIRMAN OF THE BOARD OF EXECUTIVE DIRECTORS OF THE
INTER-AMERICAN INVESTMENT CORPORATION,
AT THE INAUGURAL SESSION OF THE
ANNUAL MEETING OF THE BOARDS OF GOVERNORS

Let me begin by conveying my sincere gratitude to the Government of Peru for its kind invitation to stage this Forty-fifth Annual Meeting of the Board of Governors of the Inter-American Development Bank and Nineteenth Annual Meeting of the Board of Governors of the Inter-American Investment Corporation in Lima.

We return to Lima thirty-three years since we last held an Annual Meeting in Peru, a country with which the Bank has been closely associated since its very beginning. Its first loan was to Peru, in 1961, for a water and sanitation project in Arequipa, the country's second largest city. That first operation in a way defined the institution's vocation for social development and its commitment to expanding the frontiers of development banking. It seems fitting today to invoke the memory of Felipe Herrera, that bold visionary who, as the Bank's first president, set our institution on its course to help combat poverty and enhance social equity across the region.

As one of the founding members of the Bank, Peru has been an active participant in the life of our institution for decades and an inspiration to all of us as it has risen to challenges, essayed solutions, and shared its ideals. As the eminent Peruvian historian Jorge Basadre once reminded us, "just as the fundamental law of economics is not accumulation but rather the use of material goods to satisfy the needs of humankind, the fundamental law of culture is not to amass knowledge but rather to adapt knowledge to human beings so they can fully realize their destiny."

The Bank's core mission is to work with and alongside its borrowing member countries to help all the region's people fulfill their destiny. Sadly, large segments of our population have become disillusioned at the slow pace of progress in improving social and economic conditions in our countries and are even questioning whether we have chosen the right path towards greater social justice. Let me offer some thoughts on where we are and how we may move forward.

I. Rekindling economic growth

After five years of sluggish economies and worsening social conditions in most Latin American and Caribbean countries, the region stands poised to enter a new and, hopefully, sustainable chapter in its growth, with prospects for improved quality of life for its people.

Since we gathered a year ago in Milan, the clouds of political and economic uncertainty have lifted and the region's growth prospects are distinctly more promising, by virtue of a combination of external and domestic factors.

On the external front, the expansion of the advanced economies along with robust growth of China's economy have helped boost trade flows and raised the prices of commodities that contribute the most to the region's trade balance. Meanwhile, U.S. interest

rates are at a forty-five-year low, a significant benefit to a heavily indebted region. Funding flows and foreign direct investment which had plummeted in recent years are picking up.

The steep devaluation of the dollar, in which the region transacts so much of its business, has made Latin America and the Caribbean far more competitive in world non-dollar markets. All of these developments are pushing up growth rates across the region, albeit with some differences depending on countries' individual circumstances.

Just as important have been country decisions to hold fast to fiscal discipline during the downswing of the cycle, at no small sacrifice, and to opt for prudent management of monetary policy. The steep devaluations that followed in some countries are also making the region's economies more competitive in the global marketplace.

In light of these gains, forecasters are predicting roughly 4 percent economic growth for the region in 2004, a vast improvement over the previous five-year average that barely reached 1.3 percent.

Welcome as this turnaround may be, we cannot be complacent. Externally driven improvements in an economy are rarely long-lived, as the region's history, and world history generally, can attest. Sooner or later we can expect to see adjustments in the industrialized economies, particularly the United States, which could affect the global business cycle, interest rates, and commodity prices and trigger currency realignments. The ensuing impact on the region's economies will be determined by the nature and timing of the adjustments and, above all, on the degree of policy coordination among the advanced economies.

How, then, should we handle the current upswing in the region's business cycle?

Very carefully, when projecting into the long term, and building on the favorable situation in the years immediately ahead in order to solidify economic reforms that have worked well, revisit and reconfigure any that have fallen short, and gear up for reforms still needed in order to enhance economic efficiency and thereby deliver greater social benefits to the collective.

With all this in mind, I would like to draw your attention to three issues that are relevant across the board, even with due regard to the particularities of individual countries.

First, managing the economic recovery so as to make economies more resilient to shifts in the business cycle.

Second, increasing the social dividends of economic growth to reverse the social deterioration of recent years, and heightening the social returns to economic policies.

Third, bolstering countries' negotiating capacity both individually and collectively in preparation for major international negotiations on the horizon.

A. Managing the economic recovery

I would like to outline four policy areas that are of particular importance at this juncture.

1. Strengthening public finances

Public finances have come under considerable stress over the last five years. Public revenues as a share of GDP have held more or less steady in a range of 24 to 26 percent but governments have had great difficulty trimming current expenditure, on account of interest on the debt plus other inflexible public expenditures. Current account fiscal deficits rose from less than 2 percent of GDP in 1997 to close to 5 percent by 2002 in the region's seven largest economies. The brunt of the adjustment was borne by public investment expenditure, which in 2002 was lower than interest payments.

Given the already deficient state of economic and social infrastructure in the region, this situation is not sustainable. The breathing space that may be provided by a period of moderate growth must be used to improve tax administration, modernize the structure of taxes and make public expenditure more efficient. There is no doubt that credible public finances are important for stability in the short run and essential to underpin growth in the medium term and beyond.

Governments throughout our region are looking for ways of reversing the decline in public investment, given the adverse implications of this trend for long-term growth prospects and the countries' ability to achieve their development objectives. In a bid to augment investment some countries are laying the groundwork for public-private partnerships as a means of tapping private-sector financial and other resources to improve the scale, quality, and sustainability of infrastructure investment for the provision of public services. The IDB is contributing to this encouraging development through a number of initiatives, among them a study with the International Monetary Fund and the World Bank on a new methodology for treating investment expenditure in formulating macroeconomic program goals.

2. Reducing public debt and enhancing the debt profile

Latin America and the Caribbean today are struggling under a very heavy debt load. Much of this burden reflects the weight of external borrowings and the effect of exchange-rate fluctuations. Devaluations of the real exchange rate in recent years contributed to a rapid rise in the average debt-to-GDP ratio for the region from 37 percent in 1997 to 51 percent in 2002.

Debt service has become such a heavy charge on government revenues that many countries are now giving priority to public debt management to shield themselves against the

risks that the speed and dynamism of global financial markets can create. Latin American and Caribbean countries are especially vulnerable to volatility in interest rates, exchange rates, and commodity prices, and their financial authorities are continually seeking ways of spreading the risks to which public budgets and the economy overall are exposed.

Despite the U.S. Federal Reserve System's declared patience, interest rates are likely to climb as that country's economy picks up. Experience shows that a 200 basis points rise in U.S. interest rates translates into a 500 basis points increase in the cost of external financing for Latin America and the Caribbean. In today's circumstances, governments could face significant fiscal adjustment to meet the increased cost of debt servicing, a move that could choke economic growth. A clear priority is to seize the opportunities created by the current low interest-rate environment to try to extend debt maturity profiles and bring the debt-to-GDP ratio to a sustainable level. Prudent external debt management that capitalizes on these opportunities is the countries' best and straightest course.

3. Bolstering financial systems

Financial intermediation appears to be stalled in many countries. Since 1998, banking system credit to the private sector has fallen by 20 percent in real terms in the region's seven largest economies, even though banks are liquid and interest rates stable. The problem is not one of constraints on the supply side; we seem to be caught in the grip of weak demand from the real economy and risk aversion on the part of lenders.

Demand should pick up as businesses see new opportunities in a growing economy and find it necessary to begin investing again. Regulators have to be on their guard, therefore, to prevent the recurrence of the kind of euphoria that in past upswings resulted in the accumulation of bad debt and currency mismatches. In the past that unwelcome mixture has sparked banking crises that carried a high fiscal cost, and was one factor behind the buildup of debt.

The region has done a great deal to strengthen and enforce prudential regulations for financial activity but, in many countries, regulatory systems are still too weak and there is insufficient legal protection for creditors. Countries need to finish creating a strong regulatory and oversight framework for vibrant financial institutions in order to reduce the risks to fiscal and overall economic health in the years ahead.

4. Fostering a friendly business climate

Sustained economic growth at a healthy rate will require a much higher level of investment than we have managed in Latin America and the Caribbean in recent years. Investment is at its lowest level in a decade, some 20 percent below the 1997 peak. Macroeconomic stability will provide the needed framework for sustained growth, but that will not be enough. A host of institutional and related reforms are necessary to regain the

confidence of investors. Too often in recent years has one country or another changed the ground rules unilaterally, triggering uncertainty among investors about what might happen elsewhere in the region.

What is needed today, in contrast to the sweeping reforms of the early 1990s, is a more selective effort to gain credibility and thus build firmly on everything the countries have accomplished to date. In order to train the spotlight on this goal, late last year the Bank invited officials, private investors and academics from most of our member countries to participate in a Public-Private Summit to exchange ideas on the business climate and the way forward. The Bank used that very visible opportunity to launch its 'business climate initiative' that is an open invitation to each country to work with the Bank to remove specific impediments to higher investment in its economy.

B. Improving the social dividends of growth

When our economies grow slowly or not at all, there is a high social cost borne disproportionately by the poor. The political cost in lost momentum for reform is also high. Since 1998 a majority of Latin American and Caribbean society has been losing confidence in the possibility of improvements in quality of life in an open, market-friendly economy. This is not surprising in face of the growing inequality of the distribution of income, deteriorating social infrastructure, rising unemployment, and the reversal of a decade-long trend of reductions in the share of the population living in poverty. In 2003 there were 20 million more poor people in our region than in 1997.

Accordingly, at this threshold to a period of renewed growth our countries have to pay as much attention to the distribution of the social dividend as to building macroeconomic stability and a propitious investment climate, by adopting public policies that help create jobs and opportunities for the poor.

Let me mention here some policy priorities to that end.

1. The labor market

Affording remunerative employment to the largest number of people of working age is the principal means of sharing the fruits of economic progress. Our economies have been underperforming and, in fact, the stubbornly high level of unemployment is one of the major sources of discontent with economic reforms in Latin America and the Caribbean. Last year, unemployment in the region averaged a record 10.7 percent; in several countries the unemployment rate topped 15 percent.

Although labor legislation typically seeks to protect workers from the insecurity caused by swings in the economy, it generally has the perverse effect of discouraging permanent employment in the formal economy, and is especially a barrier to young people and women.

One imperative is to remove these disincentives and build effective information, training and surveillance systems to encourage flexibility in labor markets.

2. Social expenditure

It may surprise many of you to hear that in Latin America and the Caribbean during the last decade governments increased social expenditure, in real terms, by about 58 percent per capita. However, the results have been disappointing. Throughout much of the 1990s a sizable share of this increase was funneled to restructuring social security systems. Had those structural reforms been postponed the burden on the public finances could only have been more onerous. We must recognize, however, that social security benefits formal-sector workers, to the exclusion of the majority of the poor who toil in the informal economy.

One encouraging development in recent years is the concerted effort made in many countries to protect public spending for education and health, even in times of tight budgets. However, it is imperative to get better value for money as we move forward. Let me underscore three dimensions to improving the quality of social spending outcomes:

- Higher efficiency of expenditure;
- Focus on greater social inclusion; and
- Encouraging greater participation by citizens.

Efficiency of expenditure

All of our countries subscribed to the Millennium Development Goals (MDGs) at the United Nations Millennium Summit in September 2000 and reiterated their commitment at the Summit of the Americas in Quebec City the following year. These goals set many measurable targets, for example for reducing poverty, lowering infant and maternal mortality and containing HIV/AIDS. These targets are at once a stiff challenge and a yardstick against which to measure progress toward greater efficiency in social expenditure.

In this era of fiscal restraint it is incumbent on each country to make sure that every outlay has a clear purpose and to check its progress systematically. Of course, each country should challenge itself to do even better than the MDGs—for example, most of us should be aiming to achieve higher coverage and quality in secondary and tertiary education since we long ago achieved universal primary education. One milestone on this path was last November's Declaration of Brasilia, in which a number of heads of state, ministers, and civil society representatives pledged to push for attainment of the MDGs. This is a significant step forward on the way toward 2015 which is the target year for achieving the Millennium Goals.

Enhanced efficiency of social expenditure must go hand in hand with efforts to achieve greater progressivity, targeting society's most disadvantaged. Today, as we again look to a

period of growth, we have to seize the opportunity to build robust social protection systems that will work in good times and, more importantly, when times are bad.

There are flagship social protection programs in some of our countries that hopefully will inspire others to develop similar operations tailored to their own circumstances. The common purpose is to protect benefits for society's poorest and lay the groundwork for breaking the links that are bequeathing poverty from one generation of a family to the next.

Social inclusion

Inequality in income distribution in Latin America and the Caribbean is part and parcel of social exclusion, particularly exclusion on the basis of ethnicity and race. Indigenous and Afro-Latin populations are, as a group, the least educated, the most afflicted by disease and malnutrition, the poorest of the poor. Targeting spending is a proven way of addressing social exclusion, but much more important is the political leadership to spark changes in attitudes, enact legislation and put it into practice, and develop intelligent positive-discrimination schemes to give voice to these and other historically excluded segments of the population such as persons with disabilities. These are the building blocks of social change which is, in turn, the foundation for lasting improvements in quality of life as sought with the Millennium Development Goals.

Citizen participation

The social dividend accruing from higher economic growth will also be greatly enhanced to the extent that citizens partner with government to help decide on and chart the course ahead. The ethos of the benevolent State should steadily give way to more active participation of the citizenry in decision-making. We must use the resources of society at large to make inroads against poverty and social exclusion. Corporate citizens could play an especially important role here, not merely out of a sense of charity or philanthropy but because it is good business.

C. International trade negotiations

Let me turn to a topical issue of transcendental importance for opportunities for economic growth, job creation, social progress, and improved political relationships in the years immediately ahead: the regional, hemispheric, and global trade negotiations that are currently engaging the attention of all our countries.

Trade liberalization is one of the cornerstones of the structural changes at work in Latin American and Caribbean economies. At first, in the late 1980s and early 1990s, many countries unilaterally lowered tariff and other barriers to trade. Today the effort is dominated by negotiations in regional, hemispheric, and global forums, including landmark arrangements between countries at distinctly different levels of development. These

simultaneous negotiations severely test the capacity of many countries, especially the smaller nations, to protect and advance their interests.

The global Doha Development Round and the Free Trade Area of the Americas (FTAA) initiative have been at center stage over the last year. Both processes have lost some momentum over differences of opinion on such issues as trade in agricultural goods and other topics. Since most developing countries—a number of them in our region—have a comparative advantage in agricultural production, rationalizing agricultural trade is a unique opportunity for them to reap the economic benefits of trade liberalization. This issue may well finally have to be resolved at the global level in World Trade Organization negotiation forums.

What I would like to stress here is that even with the impasse in agricultural trade talks there is room for progress and gains in the FTAA process. The key is to have a clear, common agenda and work step by step toward the ultimate objective, with due regard always to the particular interests of the different parties to the arrangement. Negotiations are continuing between subregional groups and the United States, including the Central American Free Trade Agreement (CAFTA).

Bilateral arrangements between the United States and subregional groupings in Latin America and the Caribbean are not, however, a substitute for a full FTAA. The FTAA is a process rather than an event. As such, it is a regional public good that opens opportunities for cooperation in areas beyond immediate trade liberalization. For example, the atmosphere of cooperation created by trade negotiations has unleashed a major physical-integration effort for investment in regional infrastructure in South America (the IIRSA) and from Mexico to Panama (the Puebla-Panama Plan). As countries engage one another, deeper forms of cooperation and benefits will emerge that will anchor the region's structural reform and enhance the quality of its institutions.

The Bank has been closely involved, along with the Organization of American States and the United Nations Economic Commission for Latin America and the Caribbean, in the secretariat function of the FTAA negotiations. Equally important, the Bank has been assisting countries in building capacity to undertake hemispheric and global negotiations and offering technical support to help with the difficult task of implementing the corresponding changes in domestic legislation and institutions.

More important yet is the critical support the Bank has been providing to some countries to enhance their ability to compete for business, including planning for an expanded, high-quality integration infrastructure.

What needs to be stressed here is that the true challenge of this process is to translate development promise into real investment, exports, economic growth, jobs, and poverty reduction—in short, into quality-of-life improvements. The negotiation phase, difficult as it

may seem, is only the beginning. As you know, the Bank has developed a set of initiatives such as the competitiveness program, funding for integration infrastructure, and loans to support fiscal and customs system reforms, to help countries through the painful transition and equip them to compete in a global economy without the benefit of preferential arrangements.

The Bank's Charter mandates our institution to work for the development of the borrowing member countries collectively. At the present juncture this calls for scaled-up efforts to deploy regional public goods to further the cause of integration. Our vocation to promoting integration is perhaps the most vivid proof that we are "more than a bank." It therefore is very gratifying to report that the Board of Executive Directors recently approved special arrangements for funding a work program of regional public goods.

II. Strengthening the Bank and the Corporation

Over the past year we took action to further strengthen our institution and increase its capacity to work closely with the borrowing member countries in their quest for greater social justice. Let me enumerate a few highlights:

- A new Capital Adequacy Policy and associated procedure for fixing a standard lending rate are now in place. This enables the Bank to align its risk management methods and procedures more closely with current international banking practice. You, the shareholders, have every reason to be proud that, thanks to your unswerving commitment to the Bank's financial soundness, our institution can now offer its borrowers stable loan charges that are lower than those of its comparator multilateral development banks.
- Following receipt of the final report of the External Review Group that had been appointed by the Board of the IIC, with the goal of spurring private-sector economic activity, the IDB's and IIC's Management and Boards of Executive Directors directed much attention to articulating a vision for the institutions' work in that sphere. While there still are many questions about the benefits of a merger between the IIC and the Bank's private sector window, the Corporation adopted a short-term action plan and is already seeing improvements in process efficiency and financial performance. In the Declaration of Nuevo León adopted earlier this year, heads of state called on the Bank to triple its lending to small and medium-sized businesses and microenterprises. We readily accept this challenge and expect the Corporation to play a pivotal role, along with the MIF, in ensuring that we succeed in the very important work of raising productivity and competitiveness in this sector that is central in the fight against poverty.
- As a follow-on to my commitment in Milan last year regarding the imperative of aligning internal corporate governance of the Bank with the tighter legislation that

several of our member countries had recently enacted, including the Sarbanes-Oxley Act in the United States, Management recently forwarded to the Board of Executive Directors a set of broad recommendations covering such areas as corporate governance structure—principally the creation of a separate Audit Committee; relationship with external auditors and their responsibilities; and enhanced disclosure in financial reporting. In the course of the past year we adopted a staff rule to protect whistleblowers, established a fully independent Office of Institutional Integrity, adopted a Code of Ethics for members of the IDB and IIC Boards of Executive Directors and the MIF Donors Committee, and made substantial progress in amending the Code that applies to staff.

- The procurement of goods and services is a central activity in our line of business and also a potential space for corrupt behavior. Last year we hired consultants to assess our procurement rules and practices, both for our projects and for Bank procurement. We recently received the final report on Bank procurement and expect to receive shortly the report on procurement in Bank-funded operations. Both reports will make recommendations aimed at ensuring that we work by ‘best practices.’ This subject is on the work agenda of Management and the Board for the months ahead.
- Another of our commitments in Milan was to launch a process of civil society consultation to frame a new Information Disclosure Policy. I am pleased to inform the Governors that the policy was approved last November. Progress is also being made on a proposal to renew the Independent Investigation Mechanism to align it to best practices in our comparators.

III. The regional political scene: the leadership challenge

It is vital that we continue strengthening and renewing the Bank so it can continue to be an active, reliable partner of its borrowing member countries as they strive to consolidate growth and distribute its social dividends.

In my address to the inaugural session of the 1999 Annual Meeting in Paris, I underlined the importance of bolstering our democracies in order to harmonize economic achievements with social dividends. Although I touched on this theme in subsequent Annual Meetings, I feel compelled to return to it once again because it is so critical if we are to be successful in advancing our economies and societies.

Political developments in the region are creating a mixture of hope and concern. That democracy is becoming firmly rooted in the region’s major countries is a promising sign, as is the democratic renewal of governments in countries that barely a decade ago were caught up in wrenching political-military strife. Yet another positive sign is that some countries in the region, which are trying to manage severe socioeconomic tensions and heed increasingly

insistent calls for change, have been able to absorb and democratically process these tensions and demands, amidst a widespread perception that the public has little tolerance for nondemocratic solutions. These are encouraging signs indeed.

On the other hand, political difficulties in some countries in the region today or in the recent past are cause for concern. The media and the citizenry in those parts of the region would appear to have an image of political instability etched in their minds.

Though all the empirical evidence suggests that the people of Latin America and the Caribbean back the liberal democratic system as an invaluable asset, it also shows many of them to be thoroughly disenchanted with how democracy is working and with governments' inability to improve the day-to-day lives of citizens and give them hope for a better tomorrow.

In some cases discontent reached the extreme of cutting short a presidential term, and there has been more than one episode of civic upheaval. But every case shows that the previous complementarity between political and economic liberalization agendas is suffering the effects of the malaise of over five years of economic recession. Whereas the fruits of more stable economies and reined-in inflation were shared across a broad spectrum of the population, reform and liberalization policies did not always achieve their objective of distributing equitably their costs and benefits. When public policies are captured by private interests, small groups or coalitions typically carry off the lion's share of the benefits, leaving the masses to shoulder the costs.

Disillusioned though some in Latin America and the Caribbean may be with how the democratic system is performing, the majority still backs that system. What, then, are the roots of this worrisome political instability that plagues some countries in our region? One factor, certainly, is how gaping social disparities or unethical behavior in the high echelons of government and the corporate world is eroding the credibility of institutions and the political leadership, but this cannot be the whole explanation.

Expert analysts of the region's political scene are warning us of the need for the political leadership to pay attention to the political system and its workings. In some countries the instability is fueled by the fragmentation of political parties, which are facing the challenge of changing or disappearing. The expert consensus is that democracy needs solid, institutionalized political parties driven by a long-range vision, ideas, and agendas. The agenda to renew the party system, now being pursued, and to reconfigure the electoral system, calls for serious reflection on the part of political leaders.

Overall, it would appear that the electoral and political system is not, in all cases, appropriately aligned with the requirement of modern, participatory democracies to build consensus and forge agreements on policy priorities and on institutional, political, and

economic reforms that have such a significant impact on the workings of society in the long run.

As the issues of institutions and politics have moved onto the development agenda, the Bank has been working with the Organization of American States, the United Nations Development Programme, and other agencies on research and outlining suggestions to improve the working of our democratic political system. The fruits of this work have been shared with the member countries in the form of publications, seminars, and conferences.

In light of the many ways in which public policies can be captured by private interests it is essential for the Bank to assess *ex ante* who stands to benefit from the reforms that it is supporting and build in mechanisms to ensure a broader distribution of the anticipated benefits. This means identifying and mitigating those risks that could keep public policies from addressing general societal interests and ensuring that the fruits of progress are equitably shared.

I believe that this is a fitting note on which to conclude my remarks to you today. If our countries are to seize the opportunities now opening up, it is vital that they move quickly to surmount the most serious instability problems and dispel political uncertainty. Though growth will come from hard work and sustained savings, investments, and technical change in the broadest sense, it also will depend on the international climate and the depth of our region's integration, by way of trade and investment, into an increasingly interdependent, competitive world. In the long run, the region's advancement will depend on the ability of its leaders to build sturdy, rule-of-law institutions which endow the economy with resilience to shocks and fairly distribute the benefits and costs of growth. That is the best and only course for enduring peace, stability, and progress in our region.