

Inter-American Development Bank

An Enduring Partnership for Development

**Central America
and the IDB Since 1990**



**William R. Large
Editor**

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Central America and the IDB Since 1990

William R. Large, Editor

Inter-American Development Bank

Washington, DC

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THE COUNTRIES OF THE CENTRAL AMERICAN ISTHMUS



In this publication, “**Central America**” refers to the seven countries located on the Central American Isthmus, that is: Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama.

The following table presents statistical data on four principal indicators of each of the countries: Geographical Area; Population; Gross National Product; and GNP per capita.

	(Figures refer to 2003)			
	Geographical Area (1,000 km ²)	Population (millions)	GNP (US\$ billions)	Per capita GNP (US\$)
Belize	23.0	0.3	\$0.8	\$3,190
Costa Rica	51.1	4.0	17.2	4,280
El Salvador	21.0	6.5	14.4	2,200
Guatemala	108.9	12.3	23.5	1,910
Honduras	112.1	7.0	6.8	970
Nicaragua	130.0	5.5	4.0	730
Panama	75.5	3.0	\$12.7	\$4,250

Source: *World Bank Atlas*, 36th edition, September 2004.

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PREFACE

The dawning of the decade of the 1990s represented a major turning point in the modern history of the Central American Isthmus, as the countries emerged from the so-called “Lost Decade” of the 1980s which was characterized by severe external shocks, debt crises, civil wars, political strife, and impoverishment of major sectors of the population.

It was to be a time for the newly democratically elected governments to take on the daunting tasks of consolidating the peace process, reconstructing their war-torn economies, undertaking sweeping macro-economic reforms, adopting innovative social policies and programs in an effort to reduce alarming levels of poverty, as well as for dealing with the crippling effects of several major natural catastrophes, all the while attempting to restart the engines of economic growth and development.

The Inter-American Development Bank was to play a prominent role in these processes and it is the purpose of this publication to document the principal contributions of the IDB during the decade of the 1990s as well as the initial years of the current decade—including selected information pertaining to 2004—working in partnership with the countries of the Central American region in dealing with these challenges.

This publication was prepared by a team led by William R. Large and covers the following topics which were key to the region’s renewed development: reforms in basic infrastructure, development of financial markets, innovations in the social sectors; significant advances in environmental management, strengthening democracy, regional integration, microenterprise development, natural disasters risk management and donor coordination through leadership of consultative group meetings.

The book is the product of extensive interviews and contacts undertaken with literally hundreds of individuals, both in IDB headquarters and field offices, as well as executing agencies, government offices and specialized institutions involved with the projects and programs in the Central American countries mentioned throughout this volume. Its publication would not have been possible without their active collaboration.

We would like to thank the following individuals for their comments and collaboration in this team effort: María del Carmen Acena, Manuel Agosin, Marcelo Antinori, Sergio Ardilla, Walter Arensberg, William Armstrong, Gonzalo Arroyo, Carola Alvarez, Carlos Barbery, Olver Bernal, Joel Branski, Marcelo Cabrol, Caroline Clarke, Martin Crisney, Rafael Cruz, Juan Carlos de la Hoz, Luis Díaz, Robert Devlin, Philippe Dewez, David Einhorn, Marco Ferroni, Kurt Focke, Henrik Franklins, Cristián Gómez, Paulina González-Pose, Jeremy Gould, Mia Harbitz, Jack Hastings, Eleanor Howard, Edmundo Jarquín, Bob Kaplan, Kari Keipi, Michele LeMay, Ezequiel Machado, Dan Martin, Bertus Meins, Marta Mejía, José Ricardo Melo, Carlos Miranda, Sergio Mora, Wolfgang Munar, Heli Nessim, Lionel Nicol, Isabel Nieves, Trond Norheim, Claudia Pasquetti, Alberto Paz, Svante Persson, Ileana Pinto, Marta Preese, Ricardo Quiroga, Alvaro Ramírez, José Ricardo Rayna, Ferdinando Regalia, Rubén Reyna, Charles Richter, Nestor Roa, Lorena Rodríguez, Jairo Sánchez, María Deni Sánchez, Hans Schulz, Helge Semb,

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TABLE OF CONTENTS

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- a. Central American Electric Interconnection System (SIEPAC)
- b. International Network of Mesoamerican Highways (RICAM)

III. Conclusions

IV. Lessons Learned and Challenges for Regional Integration and Cooperation

- A. Some Operational Lessons Learned from Central American Integration
- B. The IDB and Challenges for Central American Integration and Cooperation

Annex I: Summary of the Principal Treaties and Agreement Relating to Central American Economic Integration

Annex II: RCG-CA Meeting (1997) Project Summary

Annex III: RCG-CA Project Summary (2001)

Annex IV: Puebla-Panama Plan: Mesoamerican Initiatives and Projects

Annex V: List of Projects Highlighted in This Chapter

CHAPTER 4. REFORMS IN BASIC INFRASTRUCTURE

89

ADOLFO RUFATT

Introduction

I. General Sectorial Context

II. Background of the Reforms and of the Bank's Role. A Paradigm Crisis

- A. Macroeconomic Backdrop. A Snapshot of Structural Problems
- B. Microeconomic Background. A Model
- C. Short and Long-Run Benefits and Costs. Political Economy of the Reforms

III. Infrastructure Sectors in the Isthmus: An Overview

- A. Frame of Reference
- B. Infrastructure Services Delivery
- C. Institutional Aspects

IV. Reforms Consummated

- A. Introduction
- B. Telecommunications
 - 1. Background
 - 2. Telecommunications Reform in the Region
 - 3. Results Attained
 - 4. Two Representative Cases
 - a. Guatemala
 - b. Panama
- C. The Electricity Sector
 - 1. Background
 - 2. National Power System Reforms
 - 3. Two Representative Cases
 - a. Guatemala
 - b. Panama
 - 4. SIEPAC: Central American Electrical Interconnection System
- D. Transportation Sector
 - 1. Panama: National Ports System
 - 2. Honduras: National Airports System

V. The Role of the Bank

VI. Observations and Lessons Learned

- A. The Reforms Generally
- B. Some Country-and Sector-Specific Lessons

VII. Concluding Thoughts

Introduction

I. Social Development Profile and Issues in the Central American Region

- A. Introduction
- B. Critical Social Sector Issues
- C. Benchmarks of Social Development
 - 1. Growth and Poverty
 - 2. Public Spending in Social Sectors
 - 3. Education
 - 4. Health and Nutrition Indicators
 - 5. Basic Needs Indicators
 - 6. Vulnerable Groups and Regions
- D. Guidelines and Framework for IDB Action in Central America
 - 1. IDB Goals and Policy Framework
 - 2. Millennium Development Goals (MDGs)
 - 3. Country Programming, Policy Dialogues and Strategy Formulation

II. The Bank's Response to Central America's Critical Social Problems

- A. Introduction
- B. Poverty Reduction
 - 1. Poverty Reduction Strategies
 - 2. Financing Poverty Reduction and Policy Change
- C. New Education Strategies
 - 1. El Salvador: The EDUCO Program
 - 2. Guatemala: Education Reform (ARE I)
 - 3. Nicaragua: Tertiary Education
- D. New Health Sector Reform Strategies
 - 1. Guatemala: Health Reform
 - 2. Other Projects Based on the Guatemala Experience
 - 3. A Regional Approach: HIV/AIDS
- E. Strategies for Social Sector Investment, Local Management of Social Services and Social Investment Funds
 - 1. El Salvador: Local Development Program II
 - 2. Panama: Social Investment Program
 - 3. Guatemala: A Model of Local Development and Participation
 - 4. Honduras: From Social Investment Fund to Human Capital Development
 - 5. El Salvador, Honduras and Guatemala Cases
- F. Targeting Social Services to the Poor Through Innovative Social Safety Net Programs
 - 1. Nicaragua: Social Safety Net Programs
 - 2. Honduras: PRAF
- G. Support for Vulnerable & Socially Excluded Groups
 - 1. Honduras: Miskito Coastal Communities
 - 2. Honduras: Indigenous and Black Communities (PAPIN)
 - 3. Nicaragua: Child Care (PAININ I & II)
 - 4. Honduras: Combating Urban Poverty
 - 5. Nicaragua: Emergency Attention to Children
 - 6. Panama: Training and Employment
- H. Bank Mechanisms to Promote Social Sector Development
 - 1. INDES: Improving Social Management and Design of Social Policies
 - 2. Inter-Agency Coordination: Norway, UK, Sweden
 - 3. Flexible Loan Instruments for Social Development

III. Lessons from More Than a Decade of Social Programs and Action in Central America

- A. Successful Elements of Social Development
- B. The Continuing Task for Social Development

Annex I List of Projects Highlighted in This Chapter

Annex II The Cost of Social Exclusion and the Challenge of Social Inclusion of Ethnic Groups

CHAPTER 6. IDB SUPPORT FOR THE STRENGTHENING OF DEMOCRACY IN CENTRAL AMERICA

185

SANDRA BARTELS

Introduction

I. Strategic Frameworks

II. Reform of Justice Systems

- A. Costa Rica: Program for the Modernization of the Administration of Justice
- B. Honduras: Program to Modernize the Administration of Justice
- C. Guatemala: Program in Support of Judicial Reform
- D. Panama: Program to Improve the Administration of Justice
- E. El Salvador: Program to Support the Reform of the Justice System
- F. Nicaragua: Program to Strengthen the Judiciary
- G. Regional Technical Cooperation: Access to Justice
- H. Programs to Strengthen Alternative Dispute Resolution Mechanisms

III. Citizen Security

Honduras: Peace and Citizen Coexistence Project for the Municipalities of the Sula Valley

IV. Reform and Modernization of the Legislative Branch

Panama: Program to Improve the Administration of Justice

V. Citizen Participation

- A. Guatemala: Community Development for Peace (DECOPAZ)
- B. El Salvador: Local Development Program
- C. Honduras: Support for Strengthening Civil Society Organizations
- D. Panama: Darien Sustainable Development Program. A Model of Community Empowerment
- E. Puebla-Panama Plan (PPP): Information, Consultation and Civil Society Participation Program

VI. Other Initiatives: Fiscal Reform as an Integral Part of Processes to Reform the State

VII. Conclusions

VIII. Lessons Learned

Annex: List of Projects Highlighted in This Chapter

CHAPTER 7. ADVANCES IN ENVIRONMENTAL SUSTAINABILITY

223

GUILLERMO ESPINOZA AND PABLO PISANI

I. Background

II. Key Environmental Pressures and the State of the Environment in the Isthmus

- A. Natural Diversity
- B. Tropical Moist Forest
- C. Soil
- D. Water Resources

- E. Hydrobiological Resources
- F. Natural Disasters
- G. Urban Environment and Environmental Quality
 - 1. Water Pollution
 - 2. Urban Solid Waste
 - 3. Air Pollution

III. Rising to the Environmental Sustainability Challenge: Main Environmental Capabilities and Initiatives

- A. Forging Partnerships: IDB's Contribution to Environmental Protection and Management in Central America
- B. Key Environmental Gains
 - 1. Legal and Institutional Frameworks
 - 2. Natural Resources Management and Conservation
 - 3. Sustainable Use of Natural Forests
 - 4. Integrated Water Resources Management
 - 5. Marine and Coastal Resources Management
 - 6. Urban Environment and Pollution Control
 - 7. Multilateral and Regional Integration Agreements

IV. Lessons, Challenges and Opportunities

- A. Lessons
- B. Challenges and Opportunities

Annex I. List of Projects Highlighted in This Chapter Bibliography

CHAPTER 8. NATURAL DISASTERS RISK MANAGEMENT

265

STEPHEN E. MCGAUGHEY

Introduction

I. Disaster Vulnerability in the Central American Isthmus: A Major Social and Economic Challenge

- A. Introduction
- B. A Profile of Disasters in the Central American Isthmus
- C. Sources of Vulnerability
- D. The Economic Consequences of Disasters
- E. National and Regional Institutions for Disaster Response and Risk Management
- F. The IDB's Evolving Approach to Disaster Risk Management

II. IDB Programs for Disaster Risk Management in Central America

- A. Introduction
- B. Major Challenges for Risk Reduction and Disaster Response
 - 1. Hurricane Mitch
 - 2. Two Earthquakes in El Salvador
- C. Loan and Technical Cooperation Programs for Disaster Response and Management in Central America
 - 1. Overview
 - 2. Financing Emergency Response to Disasters and Reconstruction
 - a. Emergency Response
 - b. Reconstruction
 - 3. Risk Prevention and Mitigation
 - a. Fundamental Issues
 - b. Selected Loan Programs and Components
 - c. Environmental and Natural Resource Management: A Complement to Disaster Prevention
 - d. Local Development for Disaster Protection and Response
 - 4. Institution Building for Risk Management
 - 5. Conclusions

III. Some Lessons Learned in Managing Disaster Risk in Central America
Annex I: Major Natural Disasters by Country, Central America, 1992-2001
Annex II: List of Projects Highlighted in This Chapter

CHAPTER 9. DEVELOPMENT OF FINANCIAL MARKETS

299

MARK FLAMING

Introduction

I. Parameters of Progress

- A. The Economic Environment in 1990
- B. The Political Dimensions of Policy Reform
- C. Sequencing of Reforms

II. Level of Effort

III. The Components of Progress

- A. Liberalization
- B. Central Banks and Monetary Policy
- C. Banking Regulation and Supervision
- D. Deepening of Financial Markets
- E. Capital Markets

IV. Maintaining Momentum for the Agenda Ahead

- A. Macroeconomic Stability
- B. Effective Regulation and Supervision
- C. Capital Markets and Institutional Savings
- D. Market Deepening
- E. Financial Systems Infrastructure
- F. Enabling Environment
- G. Regional Harmonization

V. The Evolving Role of the IDB

Annex: List of Selected IDB Loans for Structural Reforms, Provision of Liquidity and Technical Assistance Support

CHAPTER 10. MICROENTERPRISE DEVELOPMENT

325

MARGUERITE BERGER AND GLENN D. WESTLEY

I. Introduction

II. Importance of Microenterprise and Microfinance in Central America

- A. Microenterprises: Key Source of Employment and Income for the Poor
- B. The Importance of Financial Services for Microenterprises

III. Changes in C. A. Create Opportunities for Microenterprise Development

- A. The Economic Environment
- B. Government Approaches to Micro/Small Business Development
- C. Changes in Civil Society Organizations/ NGOs

IV. Development of the Microfinance Industry in Central America

- A. Policy Changes Directly Affecting Microenterprises
- B. First Generation Financial Sector Reforms Create Space for Microfinance
- C. Institutional Strengthening for Microfinance Institutions (MFIs)
- D. IDB Support for MFIs
 - 1. Social Entrepreneurship Program (SEP) and the Prior Small Projects Program (SPP)
 - 2. Microenterprise Global Credit (MG)
 - 3. The Multilateral Investment Fund (MIF)

- E. Recent Financial Reforms and their Effect on Microfinance
 - 1. Improving Prudential Regulation and Supervision of MFIs
 - 2. Credit Bureaus
 - 3. Improving the Legal Framework for Secured Transactions

V. Business Development Services and the Changing Scope of Government Intervention in Central America

- A. Developing a Market for Business Development Services (BDS)
- B. Strengthening Competitiveness
- C. Changing Government Role from Direct Provider to Facilitator
- D. Reducing Informality

VI. IDB Non-Financial Products Support for Microenterprise Development

- A. Knowledge Management: Dissemination and Building Networks
- B. Publications
- C. Recognizing Best Practices through Awards for Microenterprise Development.

VII. Lessons Learned and Challenges Ahead

- A. Lessons
- B. Future Challenges

**Annex I: List of Projects Highlighted in This Chapter
Bibliography**

ABOUT THE AUTHORS

367

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AN ENDURING PARTNERSHIP FOR DEVELOPMENT: CENTRAL AMERICA AND THE IDB SINCE 1990

CHAPTER 1: GENERAL OVERVIEW

William R. Large

In many ways, the dawning of the decade of the 90s constituted a watershed period for the countries of the Central American Isthmus. It was a time when newly democratically-elected governments could finally turn their attention to the dauntingly complex, multiple requirements of achieving macro-economic stability and to liberalizing their economies, intensifying and deepening their reform agendas.

It was also a time to get on with the imperious task of reconstructing their war-ravaged infrastructure, rebuild their institutional capacity and embark on innovative social programs to combat the alarming levels of poverty, social marginalization and exclusion that had been left in the wake of the major upheavals of the 1980s, the so-called “Lost Decade”, from which Central America was to emerge, a period marked not only by severe external shocks and debt crises which affected all of Latin American and the Caribbean but which, in the case of Central America, was fraught with profound internal conflicts, civil wars, and major political strife.

This turning point in the modern history of Central America was a time of redefining the role of the State and of developing new relationships with the private sector and with civil society, of modifying outdated regulatory frameworks and of taking a newly proactive approach to dealing with the critical environmental problems which constituted a severe threat to the region’s natural resources. In addition, there was a recognition of the need for deepening the process of regional integration on the one hand, and at the same time, a growing awareness of the need for a greater degree of decentralization, community participation and capacity building on the local level.

Thus the 90s were to be an important window of opportunity for the IDB to become the major player in the region, not only in terms of financial flows, which, as seen in the following table, totaled over US\$10.9 billion in loans and grants between 1990 and 2004, but also in helping shape the economic and social policies of the countries of the Isthmus through a robust process of constant policy dialogue with governments and, beginning in 1995, through organizing and presiding the periodic Consultative Group (CG) meetings in which the international donor community participated. Special mention should be made of the December 1998 and May 1999 CG meetings in the aftermath of the devastation of Hurricane Mitch, in which the donor community committed US\$10 billion for the purposes of reconstruction and transformation of the countries affected by this major catastrophic event.

CUMULATIVE IDB FINANCING IN THE CENTRAL AMERICAN REGION (1990-2004)

(Amounts in US\$ millions)

COUNTRY	IDB LOANS	IDB GRANTS	MIF ^a	TRUST FUND GRANTS ^b	TOTAL
BELIZE	\$105	\$3	\$6	\$6	\$120
COSTA RICA	942	15	18	27	1,002
EL SALVADOR	2,114	31	32	9	2,186
GUATEMALA	1,750	27	15	24	1,816
HONDURAS	1,731	26	19	66	1,842
NICARAGUA	1,731	43	26	56	1,856
PANAMA	1,474	4	19	20	1,517
	9,847	149	135	208	10,339
REGIONAL	492	34	49	24	599
TOTAL	\$10,339	\$183	\$184	\$232	\$10,938

Source: IDB Data Base.

a The Multilateral Investment Fund, an autonomous affiliate of the IDB which supports the development of the private sector.

b Refers to IDB-administered grant funds provided by numerous member donor countries.

In view of the significance of these profound changes in Central America and of the preeminent role the IDB was to play in working in partnership with the region during this timeframe, this book was commissioned with the purpose of documenting the principal Bank-supported projects and programs in the seven countries of the Central American Isthmus from 1990 through the year 2004.

For this purpose, nine major thematic areas in which the Bank had a major presence were selected for review, in all of which the countries were to achieve noteworthy progress. These are analyzed in a series of reports which comprise this volume, each of which illustrate the Bank's role in helping foster the development of the region, both in terms of financial flows (loans and technical cooperation) as well as so-called "non-financial products", ranging from consultative group meetings, country and sector policy dialogues, regional and country-specific workshops, seminars, conferences, studies, publications and public/community awareness campaigns on relevant developmental topics.

The subjects covered, which are not necessarily listed in order of priority or importance, are the following:

- Donor Coordination through Leadership of Consultative Groups
- Regional Integration
- Reforms in Basic Infrastructure
- Innovative Social Projects/Poverty Reduction
- Strengthening Democracy
- Environmental Management for Sustainable Development
- Natural Disasters Risk Management

- Development of Financial Markets
- Microfinance and Small Business Development Services

Each report is intended to provide a concise but sufficiently detailed examination of a representative sample of significant activities carried out by the countries in projects undertaken with the assistance of the broad range of IDB instruments and products, be they financial, technical or intellectual. The focus of each is to convey a sense of the relevance of the Bank's presence and role in the development process of the countries of the region since 1990, as opposed to simply relating a series of isolated "success stories". They do not attempt to provide a comprehensive analysis of each sector or thematic area or to provide a rigorous, technical analysis to measure project outcomes and impacts.

Rather, each report is structured around three basic components: an introduction to the thematic area, providing background information on the general situation of the sector being reviewed, pointing out the challenges and major sectorial issues facing the countries of the region at the outset of the decade. This is followed by detailed references to a representative sample of specific programs, projects (or components thereof) and technical cooperation operations that were implemented, within the strategic framework for dealing with these issues that was mutually developed by the countries in partnership with the Bank. An important complement to these IDB financings, both loans and grants, are the ample range of non-financial products, which were brought into play to deal with the issues. Most of these are self-contained in special boxes appearing throughout each chapter. Finally, each report concludes with an enumeration of lessons learned and touches on challenges lying ahead.

Each topic was researched and each report written by a specialized expert or current IDB staff member or recent retiree having extensive experience in the particular field in question. In-depth interviews were carried out with involved staff, both in headquarters and the country offices, and background policy and project-related documents were examined (loan and technical assistance proposals, loan administration and project implementation reviews, project completion reports, ex-post and other evaluations by independent experts, etc.). The detailed information provided on each of these projects was later validated for accuracy of content.

In summary, this publication is intended to serve as a narrative of relevant Bank interventions, both financial and non-financial, carried out in partnership with the seven countries of the Central American Isthmus during the decade of the 90s and thereafter, a period of profound change and institutional growth in the region. It aspires to demonstrate a coherent pattern of sustained support and actions taken in dealing with complex socio-economic developmental issues of a region which faced daunting challenges at the turn of the decade of the 90s. Hopefully the many lessons learned in the process will prove useful to guide future Bank action to help grapple with the problematical challenges which constitute serious impediments to growth and the reduction of poverty in the region.

This retrospective view reveals the emergence of several trends which have increasingly come to characterize the Bank's financing activities in the Central American Isthmus since 1990, including, among others, the following:

- From the outset of the 90s, the countries have sought to incorporate sectorial policy reforms as a key element of their economic development strategies. To assist in this process, the Bank increasingly employed policy-based loans (PBL), tying disbursements to compliance with contractual conditions linked to progress in achieving policy reforms. PBL loans were complemented by technical cooperation and resources from the Multilateral Investment Fund (MIF) for studies, hiring expert consultants, and for assistance in drafting legislation and modifications of regulatory frameworks.
- In addition to PBL operations, IDB financing has tended to shift more and more from lending for specific investment projects in isolation, to taking a more sector-wide approach to project design, intensifying the focus on resolving broader issues, many of which have sectorial policy implications.
- As a result, the design of projects has more and more tended to acquire a multi-sectorial focus rather than being concentrated in a single, traditional sector. Thus, for example, many of the social sector projects take on a more integrated approach to human development and poverty reduction, through the incorporation of numerous subsectors under the same umbrella (e.g., education, training, health care, nutrition, community development, citizen safety/security, etc.), an approach which builds on the synergies between the various components and tends to assure a more integral approach to dealing with complex social problems.
- The question of donor coordination has become increasingly important, not only in the context of IDB-led consultative group meetings for Central America which began in 1995, but also in more informal, everyday channels in which both multi-lateral and bilateral institutions and agencies have intensified their ongoing dialogue between themselves and with recipient countries.
- As a corollary, there has been a major increase in the number of bilateral agreements between the Bank and donor countries establishing technical assistance grant funds, many of which prioritize diverse sectors. By way of illustration, in the social sectors there are effective working arrangements with Norway, Sweden and Great Britain for financing complementary activities based on the respective comparative advantages of the Bank and NFISP, Sida, and CABILICA¹.
- Similarly, contacts and consultations with organizations of civil society and the private sector have come to acquire fundamental importance in recent years, as their input and support are being becoming ever more essential to the successful achievement of project objectives and outcomes.
- The process of institutional strengthening, both on the national and sub-regional level, has acquired greater importance as a key element to assure the formulation of more comprehensive and well-articulated economic and social development strategies, plans and

¹ Norwegian Fund for Innovation in Social Programs; Swedish International Development Cooperation Agency, and the United Kingdom Fund for Capacity Building for Local Institutions in Central America.

policies, as well as more effective project execution. In this latter aspect, civil society organizations and the private sector have been assuming an increasingly larger role in project execution, complementing and enhancing the traditional role of public sector agencies.

- An emerging theme of the 90s has been the importance now being given to decentralization and local development, as a means of assuring the incorporation of greater numbers of beneficiaries in Bank-supported programs and projects, especially among marginal and vulnerable sectors of society, in which poverty and extreme poverty are most likely to prevail.
- As an essential element to the success of projects, ever-increasing importance is being given to taking measures to assure the participation of local communities, not only in the design phase, but also in the physical execution of projects and their subsequent management and maintenance, this being particularly true in the case of social and environmental projects. More and more, IDB project teams and the consultants assisting them in the conceptualization and design of projects rely on local community surveys and consultations, thus assuring that projects become more demand-driven.
- Increasing attention is being given to targeting special groups to assure that they receive project benefits, be they women, indigenous groups and Afro-descendants, low-income sectors, youth, the aged, people with disabilities, etc. This is especially the case in health, education, training, housing, nutrition, environment, microenterprise and other social sectors.
- A very positive trend has been main-streaming across various sectors of several activities which have the effect of enhancing the success and impacts of projects, among which are environmental and natural disaster vulnerability assessments; risk management techniques; participation of local communities and civil society organizations; enhancements in targeting benefits to special sectors, especially rural, marginal and the most vulnerable groups; the broadened use of the wide array of Bank non-financial products; and the harmonization of regional economic, financial and social policies, to name but a few.

There follows a summary of the salient points covered in each of the chapters of the book.

Donor Coordination/Consultative Groups

This report, authored by Philip Birnbaum and Jorge Sapoznikow, concerns the role of the Bank with regard to donor coordination for Nicaragua, Honduras, Guatemala and El Salvador (as well as for the entire region after the devastation wrought by Hurricane Mitch in 1998) via periodic Consultative Group (CG) meetings.

Several decades ago, the World Bank instituted and coordinated CG meetings of the donor community, which are a forum in which a recipient country's government outlines its development plans and policies to donor countries and international organizations and pledges of aid and financial assistance are coordinated on that basis.

As mentioned, the decade of the 1990s was a momentous period in Central American history. The Region was experiencing a fundamental transformation from protracted civil wars to peace and national reconciliation, from dictatorship to freely-elected governments and from state-managed to more market-oriented economies, resulting in higher growth rates.

In the decade of the 90s, as the IDB became the major player in the Central American arena in terms of annual developmental financing flows and through exerting a major impact on shaping the transformation and reform agenda of the region, the recipient countries recommended that the IDB assume the leadership role, which first occurred at the June 1995 CG meeting on Nicaragua. The centerpiece of the format introduced at that meeting was a dialogue between donors and the recipient country on prepared documents containing key development issues, moving away from the prepared speeches of the past. That initial meeting ushered in a new era which has continued to the present, during which the IDB has presided over some 20 country-specific CG meetings, the latest of which dealt with Honduras in June of 2004, as well as three meetings relating to the Central American region as a whole.

Among the most significant of the meetings were the following:

- The 1995-6 meetings on Nicaragua focused on the progress achieved during that country's transition from a centrally planned to a market economy and to restoring financial stability and economic growth, with the attendant improvements in macroeconomic as well as social indicators. Though the country continues to grapple with some serious problems, the changes clearly have been positive and there is general agreement that this favorable transformation would not have been possible without the support of the international community. Little doubt exists over the decisive role played by the Consultative Group Meetings in assisting the successive governments to enable them to focus their development plans and policies on accelerating economic growth and poverty reduction, as well as institutional reforms to continue to secure crucial international assistance.
- Guatemala and the 1996 Peace Accords. The report outlines the serious internal problems which threatened to derail the peace negotiations and the firm posture assumed by the Bank and the international community to rekindle the process of dialogue to sign the final accords as a pre-condition to holding the first of a number of CG meetings on Guatemala starting in January 1997, at which the country presented its implementation plan, opening

the door for the participation of civil society, leading to important commitments of external assistance. While the record of compliance has been mixed, especially in the fiscal and citizen security areas, the international community continues to rely on the CG mechanism to emphasize a process of dialogue conducive to successfully carrying out these commitments on the part of the Guatemalan authorities.

- Honduras and El Salvador: Reconstruction and Transformation after Hurricane Mitch in 1998 and the Earthquakes in El Salvador of 2001. These catastrophic events placed in evidence as never before the extreme vulnerability of the region to natural disasters on a major scale. The Consultative Groups played a critically important role in not only obtaining financing commitments for reconstruction for the countries, but also in helping to reorient their priorities not only to reconstruct but to transform their societies based on principles of reducing social and environmental vulnerability and committing themselves to the principles of transparency and good governance, consolidation of democracy, reinforcing decentralization and the participation of civil society and the respect for human rights, gender equality, the rights of children, ethnic groups and other minorities.

Some of the more important impacts of the Consultative Groups have been:

- Improvement in the policy dialogue and high level cooperation between government, the private sector, civil society and even the political opposition of the recipient countries, with as many as 50 entities representing the various and diverse agencies and institutions of the international donor community. Active civil society participation is now a regular feature of Consultative Group meetings.
- As a result of the CGs, there has been a marked improvement in donor coordination, insofar as periodic local meetings of follow-up groups are held in which donors meet regularly with government and civil society to monitor the progress of the commitments assumed during the formal CG meetings, which then feed into the countries' respective national development plans and strategies for poverty reduction.
- Poverty Reduction has become a central theme of the CG meetings, as donors have pressured governments to increase domestic savings to dedicate more resources to poverty reduction programs, as a result of which there have already been substantial increases in public expenditures on primary education, basic health services, potable water, sanitation systems and rural development.
- At the same time, a change has taken place in the level of support of the donor community, with a de-emphasis on traditional large infrastructure projects, in favor of increased support for basic social services and special programs for women, children and indigenous people and Afro-descendants, for land titling and cadastral censuses to facilitate access of the poor rural dwellers to farmlands and for other programs of rural development.
- More and more importance is being given to insistence upon the imperative of transparency and accountability in government in the use of public funds to eliminate corrupt practices, which is a fundamental requisite to maintain the confidence of the public in government,

attract foreign investment and maintain the support of the international financial community. Topics such as improving public administration, modernization of the public sector apparatus and civil service reform have more and more taken central stage. Another key concern in CG discussions is the need to continue entrenching the rule of law and to administer justice evenhandedly to all citizens, the absence of which constitutes an obstacle for quality-of-life improvements as well as foreign investment and tourism.

- A central theme of the meetings has been the support for economic liberalization and the importance of increasing the role of the private sector for expanding economic growth and reducing the role of the public sector in the economy, including privatization of state enterprises, in an effort to increase competitiveness and exports, as well as to expand regional trade and to deepen regional integration, to enable the Central American countries to be effective partners in globalization.

In summary, the chapter concludes that Consultative Groups have played a catalytic role in stimulating the preparation of well formulated and better integrated economic and social development and reconstruction plans as well as inducing improvements in the dialogue between governments and civil society and with the donor community in general, to the benefit of the development of the countries of the region and the well-being of the peoples of Central America.

Regional Integration

This report, which was co-authored by Ennio Rodriguez and Stephen E. McGaughey, is a review of the IDB's support for regional integration in Central America from the 1990s to the present. While the Bank has, since its inception, been a constant advocate and supporter of integration, it was in the early 90s that the IDB formally placed regional integration in the forefront of its core agenda with the approval of its 8th Capital Replenishment.

From the outset of the 90s and up to the present, the Bank has dedicated significant resources to add impetus to a number of regional cooperative efforts, working through both regional and national institutions, cutting across several key sectors, including transport, electric power, the environment, banking and finance, tourism, and even the social sectors. Equally as important has been the support the Bank has given to national and regional structural reforms, both economic and institutional, contributing to the convergence of macroeconomic policies and focusing on critical developmental issues. A major vehicle to enhance this process has been the intensification by the Bank of its regional and national programming exercises and through leadership of Consultative Group meetings between the donor community and the Central American countries, to coordinate external assistance for the region. Most recently, this has led to the Bank's assuming active leadership of the Puebla-Panama Plan (PPP), which has become a practical instrument for accelerating a multitude of important regional programs for the economic and social development in Mesoamerica.

Similarly, and in parallel with intra-regional cooperative efforts, Central America has been actively engaged in pursuing bilateral and multilateral trade agreements with major trading partners, of which the most significant was the recently negotiated Central American Free Trade

Agreement (CAFTA) with the United States. The complexity of these negotiations has placed demands on the national authorities, the private sector and its organizations, civil society, labor and regional organizations and the Bank has been an active partner in supporting the Central American countries in these processes.

The Bank's recently approved Regional Integration Strategy (2003), established with the aim of taking advantage of the globalization process in order to promote sustainable economic growth and poverty reduction, establishes four overall categories of program support, including:

- Consolidation of regional markets through further liberalization of trade, the implementation, analysis and improvement of trade regulatory mechanisms, support for countries' participation in the North-South trade negotiations and in the multilateral forum of the Doha Round of the World Trade Organization (WTO).
- Promoting regional infrastructure through cooperative mechanisms such as the Puebla-Panama Plan, mobilization of private investment and facilitating a regulatory environment in transport, ports, energy and communications.
- Promotion of regional cooperation in key areas such as environment, health, education, natural resource management in watersheds and biological corridors, science and technology, financial sector regulation and border development.
- Institutional strengthening at the country and regional levels.

The Bank has a number of effective financial and non-financial instruments for implementing this Regional Integration Strategy, including the recently approved Trade Sector Facility loans to increase national capacity to export, enhance competitiveness of the economy and the private sector, finance trade promotion programs, undertake trade negotiations and supply technical assistance to key trade agencies.

The report identifies and elaborates, through a number of case studies and project briefs, on several key programs in Central America which received significant support in the period 1990 to the present, including:

- Regional and country programming and the crucial role played by the numerous Consultative Group meetings.
- Institutional strengthening programs to agencies, including SICA (the Central America Integration System); the CABEI (the Central American Bank for Economic Integration); the Central American Monetary Council; CEPREDENAC (the Center for Coordination for Natural Disaster Prevention in Central America); ALIDES (the Alliance for Sustainable Development in Central America); and SIECA (the Secretariat for the Economic Integration of Central America), to name but a few.
- Trade and investment promotion and support for trade negotiations.
- National competitiveness support programs.
- The Puebla-Panama Plan.

- SIEPAC (the Central American Electric Power Grid Interconnection System).
- RICAM (the International Network of Mesoamerican Highways).

Some of the more relevant lessons learned from the financing of programs related to regional integration and trade in Central America have been:

- As the integration process has matured and progressed, regional cooperation and harmonization of national policies and programs becomes key for continuing success.
- Institutional development in the area of integration is an area of major concern. Despite continuous support and some important advances in improving institutional capacity in specific cases, important difficulties remain to be solved in the case of SICA and SIECA, in terms of rationalizing institutional structures, eliminating overlapping, strengthening decision-making capacity and, even more importantly, addressing the issue of financial non-sustainability.
- It is imperative to continue to strengthen regional institutions, to build up their technical capacity to undertake the necessary studies and to organize cooperative programs on high priority themes.
- External assistance should concentrate on enhancing national capacity for membership in free trade areas, especially in the areas of trade promotion, competitiveness and negotiating and administering trade agreements. In this regard, the promotion of national and business competitiveness is a powerful motivating umbrella program to promote increased cooperation among the private sector, labor, civil society and NGOs to help develop consensus and a national “vision”.
- The management of important trade-related side issues—especially labor market and environmental impact and regulation—need to be given priority attention by the regional and international community. Indeed, the modernization of labor market regulation and labor training are critical for the future in hemispheric and regional trade agreements.
- Poverty reduction and social reforms remain an ever-more urgent and decisive agenda item to ensure the fair distribution and the benefits from trade and development. Agricultural sector restructuring is a key issue stemming from the integration and trade agreements because of its impact on poverty reduction and equitable rural development of the Central American region.

Reforms in Basic Infrastructure

This paper, authored by Adolfo Rufatt, traces a series of reforms undertaken by the countries of the region in four areas of basic infrastructure: electric power, telecommunications, ports, and airports, and focuses on what the author refers to as the "subsidiary leadership" role the IDB played in the design, planning and carrying out of these reforms. The support of IDB in these sectors came fundamentally from funding via technical cooperation agreements and the Multilateral Investment Fund (MIF) for the provision of expert technical support in regulation

and privatization, which at the time were relatively new fields of specialty in terms of prior knowledge and experience, not only in Latin America but also in the world at large.

At the outset the report sets forth the basic reasons behind the need for change, within an overall context of the macroeconomic crisis which affected the region at the beginning of the decade of the 90s, in which the demand projections for the repair, reconstruction and expansion of service in these sectors required levels of investments far in excess of the capacity of the existing institutions to access sufficient resources via the internal generation of funds, as well as the limited financial capacity of the governments and the external indebtedness constraints of the countries. Compounding the problem was the generalized situation of poor quality, low coverage and unreliability of existing levels of service; the deterioration of installed capacity; excess personnel and low levels of productivity; distortions in utility rates and user fees and in the incentive structure for consumption and for raising funds for the sorely needed expansion of service; the loss of revenue due to lack of metering; and delays in billing and collections, to mention the principal negative factors affecting these sectors.

These defects mandated the need to move toward a series of reforms designed to increase coverage, improve quality of service, reduce the costs of production through increases in efficiency and supply, and to implement rate structures designed to recover the costs of production and begin to ensure the sustainable growth of these sectors. This was to be achieved within the broader context of redefining the role of the public sector in general, through the separation of the functions of policy formulation and regulation of the provision of service, opening markets through the promotion of private sector participation in financing the expansion and direct supply of service and the elimination of distortions in rates and fees. Therefore, the implementation of the reforms was based on the separation of production, which had until that time been carried out directly by the state-owned and operated enterprises, from regulatory and policy-making functions. Consequently, the reforms covered a broad area which was to directly affect the enterprises, the structure of the market and the institutional and regulatory frameworks of the countries.

Several case analyses in the four basic sectors are presented in the report, detailing the institutional changes which took place, including comparative data on the increased levels of investment which was subsequently forthcoming as a result of these policy shifts, and the impressive increases in output and coverage, quality and reliability of service (especially in the poorer countries of the region), and in the generation of operating income, contrasted with significant reductions in the costs of production, in service losses and customer waiting lists.

To illustrate two of the indicators:

- In the telephone industry, in a period of just ten years (1992-2001), the number of fixed lines more than doubled in Nicaragua and Costa Rica and more than tripled in Honduras, El Salvador and Guatemala, while mobile telephones, which were virtually non-existent at the start of the period, burgeoned through the region. Total operating income in the group of countries increased dramatically, from US\$817 million to US\$2.3 billion over the same period.

- In Panama's port system, in a period of five years, as a result of these changes, the total volume of cargo movement tripled and the number of containers doubled. These results are especially significant, not only for the direct impact on economic activity and employment in the ports, but also the indirect impact on economic activity at the national level, since the handling and trans-shipment of cargo continues to be one of the principal sources of foreign exchange earnings for Panama.

Regarding the role of the IDB in these processes, the paper concludes that the implementation of these reforms might well not have been possible without the support of IDB and MIF technical assistance in providing specialized expertise in regulation and privatization, as well as in the training of a cadre of national technical expertise in these matters. By the middle of the decade of the 1990s, the Bank had become the principal external source of lending for investment and technical support in the area of infrastructure reforms in the countries of the Isthmus. The sum total of loans to Central America and Panama in support of implementing reforms referred to in the report amounted to US\$560 million, with an additional US\$23 million in IDB technical cooperation and US\$18 million in MIF funding.

Lessons learned suggest that success was closer at hand in those cases where:

- Political costs were clearly identified and adequately addressed by policy makers.
- The IDB's technical support did not preempt national ownership and responsibility for the reforms.
- Social equity considerations were properly addressed and attention was paid to both labor force and private investor concerns.

As for the future, there still remains important unfinished business for the countries to attend to, above all the imperative need to continue to strengthen regulatory governance and to deal with the social discontent that has often accompanied the process of privatization throughout Latin America and the Caribbean.

Innovative Social Projects/Poverty Reduction

The report dealing with IDB support for innovation in the social sectors is the most comprehensive and detailed of all the thematic areas which were examined, in view of the importance accorded to social development in the 90s, as reflected in the Board of Governors' mandated targets of channeling half of the number of new loans approved each year, and 40% to those sectors in terms of the amount of the overall annual Bank funding.

The report, authored by Stephen E. McGaughey, points to the growing demands on the governments of the Isthmus to intensify and deepen reform and development of the social sectors in the early 90s as the region emerged from the prolonged period of military and political conflicts which characterized the 1980s. The Bank became the region's chief external partner in assisting to introduce a broad spectrum of economic and social policies, programs and projects,

in an effort to restore social indicators after the "Lost Decade" of the 80s, and data is provided demonstrating the progress that was achieved in education, health care, local, rural and urban development, nutrition and social assistance programs.

The Bank is depicted in its role as the main source of public external funding in the region through its close partnership with the countries during more than a decade, galvanizing essential support for social development programs and reforms. These consist of a wide gamut of innovative operations and a continuing process of learning and adjustment to assist the countries in increasing the effectiveness and sustainability of social policies, programs and projects, through the introduction by the Bank of several new financing instruments, as well as non-financial products which helped to facilitate this process. The report portrays the progress achieved, includes an extensive representative sample of specific cases which illustrate this support in various sectors, points to lessons learned and offers a view of the social development challenges which lie ahead for the region.

The types of operations examined include:

- Poverty reduction strategies
- Education reform
- Health care reform
- Social investment funds and promotion of local management of social services
- Targeting of social services to the poor through innovative social safety net programs
- Programs for vulnerable, socially-excluded groups and regions
- Strengthening of labor markets
- Other Bank mechanisms to promote social sector development in the region, including training courses in the design and formulation of social policies and in effective social sector management carried out by INDES² and inter-agency coordination: IDB partnerships with the Norwegian Fund, Sida (Sweden) and CABILICA (UK).

The paper points to five noteworthy elements of the social development strategy that evolved in the region in the 1990s and into the new century:

- A common task of the social development strategy has been to assist the countries in a measured shift from traditional, reactive social development strategies and policies, to highly targeted and reform-oriented programs which strongly prioritize vulnerable groups and regions.
- Social sector operations have promoted increasing the capacity of public sector national and local institutions to formulate national social development policies and plans and to implement programs and projects in key sectors and regions.

² Inter-American Institute for Social Development, of the Integration and Regional Programs Department of the IDB.

- An important element in the transition from traditional to new generation social reforms has been to increase the participation of decentralized governments, community organizations, the wider civil society, the private sector and potential project beneficiaries in all stages of project conceptualization, design and execution.
- There has been a modification in the content of social sector investments through shifting national policies and programs toward augmenting the QUALITY of public social services, especially in education and public health, and expanding the ACCESS of these services to the many excluded rural inhabitants and especially vulnerable groups.
- The IDB has emphasized the implementation of effective, innovative pilot programs to be scaled up in the future to national programs or multiple local areas that then have wider impacts on reducing poverty and fostering broader social development. The introduction of new loan instruments such as multi-phase lending and the gradual experimentation and modification of social investment programs have favored a process of learning-by-doing and expanding successful social project models to national programs and to other countries with similar experiences.

The chapter concludes with an indication of the many lessons learned which serve as constructs for future social sector reforms, modernization, poverty reduction and targeting, among the most important of which are:

- Sound economic policy and the reduction of macroeconomic constraints are still essential conditions for social development; they lead to increased revenues and facilitate spending on social development.
- Institutional development is a slow, sometimes painful process, but is feasible. Constancy in institutional reform is an essential element for furthering social development in the region.
- Targeted social safety net programs are meeting the social needs of the poor; coordinating supply and demand interventions is crucial for success. Vulnerable groups need special attention and specialized high impact programs.
- Policy dialogues are useful with full participation of all affected groups (stakeholders).
- Private participation in the provision of social services has become a demonstrated and increasingly accepted tool for strengthening social development.
- Decentralization based on mobilizing community commitment and participation is an increasingly effective instrument for social development.
- In education, the question of QUALITY is the central need for the future of the system, although there are still important groups who do not have access.
- Starting to work with children when they are preschoolers and working with the whole family is one of the keys to success in education projects.
- International cooperation in the context of poverty reduction strategies is an effective catalyst to new style social development funding.

- For health care reform, the process is extremely complex to implement, but countries are at the stage of trying to increase access of the poor to primary health care and restructuring national health systems.
- Reducing regional backwardness and local deprivation are fundamental to achieving more effective overall social development of the countries.

As for the future, success will depend on sound social and economic policies, national and regional political commitment and the continuing active partnership with the IDB, which has shown to be a constant and committed party to the process of social change in Central America.

In view of the recent prominence accorded to the issue of the cost to the countries of social exclusion and the challenge of social inclusion of ethnic groups, a brief special report, prepared by Mia Harbitz, has been included as an annex to this chapter, including information on the areas of Bank support in dealing with this topic.

IDB Support for Strengthening Democracy

Events during the decade of the 90s in Central America were heavily influenced by the historic peace accords signed in Nicaragua (1988), El Salvador (1992) and Guatemala (1996). These agreements not only implied the cessation of hostilities but also signified the return to elections and the institutionalization of political parties which in turn ushered in a period of a long-overdue process of democratization of the countries of the Isthmus. In turn, the profound economic reforms which were later introduced challenged the traditional role of the public sector and at the same time strengthened and encouraged the wider civil society to assume ever broader participation in the economic and social arena.

This report, which was authored by Sandra Bartels, argues that the Bank played a catalytic role in this process of transition and strengthening of democracy in Central America through support for the identification of areas in need of reform and modernization, assistance in prioritizing them and subsequently financing programs and projects to carry out several of these activities. An early example is the 1993 seminar carried out in Costa Rica on *Justice in Latin America and the Caribbean in the Decade of the 90s—Challenges and Opportunities*, which gave rise to requests throughout the region for a series of projects reforming and modernizing the judicial systems. The Bank responded by approving loans and technical assistance, of which there have been two stages in Costa Rica and Honduras and a first stage in El Salvador, Panama, Guatemala and Nicaragua, all of which are analyzed in case studies, highlighting some of the significant results and impacts of these programs.

Related also to the judicial sector was a regional technical assistance which financed a groundbreaking study on the topic of strengthening access to justice, analyzed successful experiences of traditionally excluded sectors, which helped orient the formulation of judicial reforms to remove obstacles and enhance access to justice, the results of which were published in a book titled *Access to Justice and Equity in Seven Countries in Latin America*.

In addition, six projects are highlighted (in Costa Rica, Honduras, Guatemala, El Salvador, Nicaragua and Panama) financed by MIF on alternative methods of solving conflict through mediation and commercial arbitration, which played a role in helping to create effective and reliable mechanisms for resolution of commercial disputes, which, given the deficiencies of the judicial systems, have traditionally constituted an obstacle to investment and fuller development of the private sector in the region.

Other sections of the report relate to:

- A pioneering program on reform and modernization of the legislature in Panama, which introduced important improvements in the technical and analytical capacity of the legislative assembly, as well as in its administrative and financial management. A code of parliamentary ethics and honor was elaborated, data bases of existing legislation were developed and budgetary control mechanisms were implemented.
- A program of citizen safety/security in Honduras, which seeks to reduce the indices of insecurity and violence in youths between the ages of 12 and 25 through implementation of preventive activities, strengthening of municipal entities in charge of security, and through promotion of human development activities benefiting at-risk youth groups. This program is linked to the Justice Reform programs as well as to two municipal development programs being carried out in San Pedro Sula.
- A project of “mapping” civil society organizations in Honduras, which play an important role on two levels: in the design and monitoring of Poverty Reduction Strategies; as well as a direct participant in different projects, programs and initiatives, in which they act as beneficiaries, executing agencies or through active participation in “consultative councils”, actively engaging in working with local governments, the central government and with the international donor community.
- Three local/community development programs: in El Salvador, in the previously war-torn areas of Guatemala, and in the Darien Gap of Panama, all of which are model programs which have contributed to strengthening participatory democracy at the local level, empowering previously marginalized segments of society, through a participatory process of consultation, giving them a role in the identification, selection, planning and actual implementation of projects which the communities themselves consider to be of high priority.
- The Program of Information, Consultation and Participation of Civil Society, which is an integral part of the Puebla-Panama Plan, and is designed to stimulate civil society organizations and communities to assume an active role in consultations, with a view toward attaining consensus and a shared vision of this program’s multiple objectives.

Fiscal Reforms: The ongoing process of political-institutional changes in Central America has generated a series of economic, political and social demands on the part of the public which far exceed the capacity of the public sector, the private sector and organizations of the civil society to meet. In order to truly consolidate democracy and meet the unsatisfied demands of the populace, social expenditures and investments need to be increased and for that to be made possible, it is imperative to undertake fiscal reforms to guarantee a sustainable flow of resources

not only to alleviate poverty but also to offer new opportunities for expanding employment. In spite of the efforts already carried out, much remains to be done, as tax revenues in the region as a percentage of GDP are among the lowest in the world. Equally disturbing are the high indices of fiscal deficits and public sector debt as a percentage of GDP, which place a major strain on the capacity of the countries to meet the challenges of attending to the needs of the populace.

In response to this critical issue, in 2003 the Bank financed studies of the taxation systems of Nicaragua, Honduras, Guatemala, El Salvador, Costa Rica and Belize and discussion forums were held, examining the taxation systems of the countries in the light of best international practices, concluding with a menu of options for reforming these systems, to modernize them, improve equity considerations and increase revenue flows to enable the financing of substantial increases in expenditures to overcome poverty. Subsequently, the Bank approved loans to finance three fiscal reform projects, in Nicaragua, Honduras and Panama, which are in the initial stages of implementation and is preparing another for Costa Rica.

A final section of the report includes information obtained from public opinion surveys in Central America regarding the attitudes held toward democracy, government and the principal institutions in these countries, the results of which indicate a disturbing trend of a generalized decrease in the public's confidence in them.

The report concludes with views on what were the more successful elements in the these Bank-supported projects and suggests ways in which future programs can further strengthen democratic institutions in the region.

Advances in Environmental Management

This chapter traces the substantial progress achieved in the area of environmental management and sustainability in the Central American Isthmus during the decade of the 90s to the present. At the outset of the 90s, as in the rest of Latin America and the Caribbean, the countries of the Isthmus had weak institutional and regulatory capacity to deal decisively with environmental issues and while the region still faces daunting problems in environmental sustainability and protection of its natural resources, complicated by poverty, unemployment, deficiencies in the provision of social services, unabated and chaotic urban growth and inappropriate agricultural methods, significant advances were made over this period, as the countries brought to the forefront of their developmental agendas environmental issues which had been largely neglected in prior years.

The report, which was authored by Guillermo Espinoza and Pablo Pisani, analyzes in detail the important efforts carried out by the countries to introduce concerns for the environment in their economic and social development plans by means of:

- The approval of laws constituting a framework to lay the basis for sustainable development, impose a series of conditions and requirements and create a set of instruments for environmental management.

- The creation of new institutions, both regional and domestic, whose mandate is the concern for the environment.
- The formulation of both regional and national strategies and actions plans designed to protect the environment, including the adherence to international and regional agreements on biodiversity, protected areas, and the rainforest, among others.
- The development of specific action plans and activities to conserve natural resources in environmentally fragile zones and generate opportunities for sustainable development in areas of extreme poverty.

The challenges faced by the countries in terms of institutional and regulatory weaknesses are clearly laid out at the outset of the report, followed by an analysis of the major sources of negative impacts in the Isthmus on biodiversity, rainforests, soil, water resources, marine life and coastal resources, contamination of water, air quality and solid wastes in urban centers and finally, the extreme vulnerability to the harsh natural disasters to which the countries and the peoples of the Isthmus have been and continue to be exposed.

This is followed by a section dealing with the responses to the aforementioned problems as the Bank has taken tangible steps to mainstream into its lending activities, specific actions dealing with environmental protection and management on the part of both the public and private sectors. These have been accomplished through the implementation of a broad spectrum of initiatives, according special attention to establishing and supporting appropriate institutional arrangements, placing special emphasis on enhancing the quality of life of the population, promoting citizen participation, incorporating women in the development process, in efforts aimed at poverty reduction (poverty often being one of the root causes of environmental degradation), reducing vulnerability to natural disasters and protecting the cultural values of the communities.

In the ten-year period 1992-2001 alone, the Bank approved loans totaling US\$875 million as well as 130 technical assistance grants totaling US\$42 million for projects directly related to environmental management in the countries of the Central American Isthmus.

The report contains a detailed description of a diverse array of Bank-approved operations, both in terms of financial and non-financial products, during the period in question and comments on the impacts these have had on improving environmental management for sustainable development. In all, some 15 technical cooperations--from the Bank's own resources, trust funds and the Multilateral Investment Fund (MIF)--are analyzed, as well as 14 investment projects financed by IDB loans which financed projects of a national, bi-national and even tri-national nature.

Among the positive impacts and outcomes of these interventions highlighted in the report are:

- An increased awareness in the public eye of the sources of degradation of the environment which hasten the deterioration of the quality of life.

- The importance accorded the environment in the constitutions and in laws and regulations since the early 1990s which have significantly facilitated the management and enhanced the institutional capacity of the region for environmental management.
- Advances in the formulation and putting into place of policies and global and sectorial strategies incorporating environmental aspects which reflect the ever-increasing level of priority now accorded to concern for the environment.
- The incorporation of measures designed to confront global environmental problems into national, sub-regional and regional policies as a result of the opening of markets and in response to the obligations assumed by the countries through adherence to a series of international agreements and conventions.
- The introduction of new instruments for preventive environmental management and recuperation of degraded areas, as well as institutional strengthening arrangements necessary for effective management of these processes.
- The emergence and strengthening of a significant number of organizations at the community level, in the greater civil society and in the private business sector which are becoming more and more seriously involved in directly participating in pro-environmental activities.
- The importance of the constant support of the Bank, in addition to loans and technical assistance, in the form of studies, evaluations, preparation of strategies and action plans, as well as workshops, seminars and publications on environmental issues.

Foremost among the major challenges ahead have to do with continuing the process of further strengthening the countries' capacity for effective environmental management; integrating environmental concerns into the developmental policies of all economic and social sectors; taking more effective measures for conservation of natural resources and consolidation of protected areas, of forestry and marine resources; harmonization of the countries' environmental norms and regulations, in the light of negotiating free-trade agreements, especially CAFTA; and, with respect to the urban context, greater attention to more effective management of solid waste disposal, atmospheric contamination and the imperative need to design strategies and regulatory frameworks to provide incentives for improving the capacity to provide potable water to a rapidly increasing population.

Natural Disasters Risk Management

The countries of the Central American Isthmus are extremely vulnerable to natural disasters. Since 1990 the region has been struck by a series of catastrophic occurrences, including hurricanes, earthquakes, floods, landslides, droughts, forest fires, volcanic eruptions and tidal waves. This report, authored by Stephen E. McGaughey, takes account of the destruction and devastation of these events and the enormous economic, financial and social impacts which resulted from them, which have significantly reduced growth and increased poverty in the region.

Vulnerability has worsened in recent years for a variety of reasons, including a rapidly growing population, deterioration of the environment through deforestation and degradation of watersheds, the expansion of the agricultural frontier and a major increase in the pace of uncontrolled urbanization, resulting in an increase in the number of poor, many of whom inhabit areas of high risk.

In recent years, disasters have struck a growing and significant share of the population, as the number of inhabitants directly affected in the past two decades has doubled, from 3 to 6 million and the number of deaths reported increased sixfold, numbers which testify to the growing economic and social impact of disasters and underscoring the recognition that disaster risk management should be a new and important national policy goal for the countries of the region.

The report refers to the evolving approaches, both of the countries and the Bank, since 1990, to respond to these tragic events, the worst of which were Hurricane Mitch in 1998 and two earthquakes in El Salvador in 2001. During the period 1995-2000 alone, the IDB approved 25 loans totaling US\$956 million to the countries of the region, for both pre- and post-disaster support. In addition, approximately US\$230 million in undisbursed balances of existing loans were reformulated and directly applied to the task of post-disaster reconstruction.

Through the period under study, the Bank has developed a wide gamut of financing mechanisms and options available to the countries to cope with the effects of the disasters and a most significant development has been the emergence of a recognition and commitment in the international community to assist countries in preparing for future disasters through financing mechanisms that help them evaluate their vulnerability, institutional capabilities and financial alternatives, as well as a broad range of public policies that can mitigate future threats. This has led to a growing acceptance on the part of the countries themselves that preparation for disasters through enhancing post-disaster response is not sufficient; rather, it is imperative to introduce policies and programs that reduce the vulnerability of the country to the social, financial and physical impacts of future natural hazards.

Countries have begun to recognize the key role of local community organizations in preparing for and reducing vulnerability to future natural hazards, whether large or small. Local development programs are critical conduits for incorporating local disaster risk prevention and mitigation investments and many risk reduction programs are now organizationally distinct from emergency response functions. Some countries have separated these activities by placing them in different institutions, as both the Bank and the countries have learned the value of having specialized mechanisms not only to deal with disasters but also to finance and promote the introduction of modern risk management capacity as well.

The report outlines the substantial institutional changes which the countries undertook through the course of the 1990s in response to these challenges. Detailed information on the effects of Mitch and the earthquakes in El Salvador is included and reference is made to the key role played by the Bank in coalescing major financial support from the international donor community through Consultative Group meetings in response to these tragic events.

Some 30 individual loan and technical cooperations approved by the Bank since 1990 are described in detail to illustrate the different functional categories of support of the IDB both in ex-ante and ex-post disaster response as well as risk management programs, including:

- Emergency Response and Reconstruction;
- Risk Prevention and Mitigation, including Environmental and Natural Resource Management Services;
- Local Development for Disaster Protection and Management; and
- Institution Building and Technical Capacity for Risk Management

The report concludes with an enumeration of important lessons which have emerged in designing and managing natural disaster programs, including the following:

- A culture of prevention is the key to integrated disaster risk management programs, by maintaining the public's support for preparing for and reducing vulnerability to future disasters. A commitment to a philosophy of preparedness and programs of prevention is critical.
- Since the catastrophic effects of natural disasters fall disproportionately upon the poor households, continued assistance is needed to help local communities and municipal governments better organize themselves to deal with disasters. The recent trend of decentralization in the health and education sectors is also bolstering the capacity of local communities and the public sector to prepare for and respond to disasters.
- Disaster prevention and mitigation should be incorporated into national and regional investment programs as a standard component of public and private responsibilities, rather than as a stand-alone activity in isolation from the functions of the national and local institutions.
- The seriousness of both large and small disasters must be recognized and dealt with. The existence of a range of both small and large disasters justifies incorporating risk management as a standard component of a variety of programs, including watershed development, municipal development, small scale-social investments, agriculture, urban and rural development, rural infrastructure, roads and irrigation works. This will improve the response to localized, smaller-scale disasters, as well as preparing for major catastrophes.
- Anticipating the financial costs of disasters and determining options for responding to these costs is a key task for central government economic and financial authorities. Governments typically have not dedicated sufficient resources to the analysis of different financial scenarios that result from disasters: how to finance loss reduction programs and emergency response and reconstruction, and to compensate for widespread social impacts on the populace.
- Efforts at sustainable development and natural resource management complement measures to reduce vulnerability to natural hazards. Experience in environmental programs

and policies built up in the Central American Isthmus during more than a decade is directly transferable to natural disaster mitigation programs, including such areas as flood control, soil conservation, agroforestry, forest management and watershed management. Environmental agencies have much to offer with risk reduction and should work together with other agencies given these common objectives.

- The new IDB operational policies that facilitate efficient and rapid use of emergency funds have been extremely helpful. The introduction of the Immediate Response Facility has shown that there is considerable value-added from streamlined procurement, disbursement and management policies to accompany emergency response.

Development of Financial Markets

This report, authored by Mark Flaming, chronicles the efforts of the countries of Central America to modernize their financial systems during a period of profound macroeconomic reform. For most of the countries, this period constituted a first generation of institutional reforms as governments transformed the role of the state in financial markets from direct intervention to that of regulator of competitive systems of private sector financial institutions. Significantly complicating matters was the fact that the process required political support from the highest levels of government precisely during a period when policy makers had to face the imperative task of defining and implementing new economic models--a market-based strategy--in what was a delicate post-conflict political environment. Despite these difficulties, the paper suggests that the countries of the region were indeed successful in making significant progress in building a sustainable structure for financial market development, especially when measured on a timeline that takes into account the magnitude of the task.

An indicative measure of this progress is the fact that, collectively, aggregate bank deposits in the countries of the region grew from an average of 42% to 69% of GDP between 1990 and 2001. Credit to the private sector grew from 25% to 52% during the same period, a dramatic increase in the amount of financial resources intermediated through the banking system.

The report describes how the Central American countries began the process of market liberalization, gradually eliminating interest rate and foreign exchange restrictions and privatizing first-tier banking. Central banks became more independent and were modernized operationally, as both policy and institutional reforms established a framework for stable and more efficient financial intermediation.

The modernization of regulatory frameworks and strengthening of supervisory agencies was equally important, achieved through technical assistance and ongoing policy dialogue with the Bank and other multilateral financial institutions. Financial markets grew deeper over the period, as banks developed a commercial focus, with industry leaders forming regional groups, thereby developing economies of scale that created opportunities for reducing overhead costs, diversifying risks and offering a wider range of financial products. In addition, regulated institutions began reaching the microenterprise market through product innovation and specialization.

Finally, reference is made to the steps taken to develop capital markets, as most countries established a legal and regulatory framework and created supervisory bodies for capital markets with IDB and MIF assistance, giving impetus to the development of public sector debt markets. Taken together, the foregoing measures gave significant impetus to the process of transformation of the region's financial markets.

Throughout the report, it is argued that while several other external development institutions supported the modernization effort during this period, the IDB played a leading role in the sector, covering a broad range of development initiatives, including seven loans totaling US\$862 million in support of ambitious structural reforms of financial markets, as well as 12 loans totaling US\$350 million to provide liquidity to the banking sectors and technical assistance support to Central Banks and regulatory agencies in conjunction with robust banking sector reform initiatives. The latter category consisted of 79 non-reimbursable technical support programs, ranging in amounts from US\$150,000 to US\$2 million for strengthening regulators, developing legal frameworks, capital markets infrastructure and supporting financial innovation and micro enterprise lending. Several case profiles of IDB-financed initiatives are included in the report to illustrate the evolution of the reform process in the region.

Several lessons are drawn from the reform efforts of the period:

- Financial systems are an integral part of the broader economy and cannot develop beyond the parameters determined by the economic environment in which they function.
- Political opportunity dictated the pace and sequence of reform, and most countries liberalized their markets prior to establishing adequate regulatory reforms, with the result that several endured bank failures because of inadequate regulatory and risk management systems. For this reason, legal and regulatory frameworks must continue to develop with their markets and the initial achievements in regulatory reform must evolve with more effective supervision.
- Public sector debt markets, insurance and pension systems are still underdeveloped in the region. These markets are needed to generate long-term savings, provide investment vehicles to complement the banking sector and encourage the development of private debt and securities markets.
- One of the major challenges for the region's market is to expand the reach of financial services to marginalized economic sectors, particularly the micro/small business sectors and the rural sector. Given their social and economic importance in the region, these sectors in particular deserve special attention by policy makers when formulating strategies for broader market development.
- Important improvements to the enabling environment are essential, as transactions in financial markets are dependent upon the broader business environment, commercial code and judicial systems, which are in need of reform and streamlining.
- The financial institutions of Central America must be able to operate on a regional level to provide services to increasing integrated economies and to achieve efficient economies of

scale. In the case of capital markets, regionalization will likely be necessary for viability. Market regulators will need to harmonize prudential frameworks and develop the capacity to share information to facilitate this process.

The chapter concludes that each country of the region entered the new millennium with a financial sector more dynamic and better regulated than was the case at the outset of the 90s. The tangible achievements—the legislation, institutional reform and growth in the sector—were significant considering the condition of the markets at the beginning of the decade. In retrospect, the markets made noteworthy progress. Looking ahead, the agenda is still formidable.

Microfinance and Small Business Development

With the consolidation of peace in the period of the early to mid-90s, together with the abatement of the debt crisis and the “Lost Decade” of the 80s came new possibilities for economic growth and development of the countries of the Central American Isthmus, and an important aspect of that period relates to the smallest businesses and the economic activities of the poor—microenterprises. The phenomenal growth of the microfinance industry and its impact on the growth and development of the region is one of the most significant success stories of the past 14 years, as is the emergence of non-financial services, referred to as business development services (BDS), such as training, technical assistance, marketing, information, and technology, which have become an integral part of the microenterprise story as well.

This report, which was co-authored by Marguerite Berger and Glenn Westley, examines the significant role of the IDB in supporting and fostering policy reform, channeling credits and building critically important institutional capacity, the combination of which were key to the development of the regions’ microenterprises and economies as a whole.

The importance of microenterprise as a major source of employment and income for the poor cannot be overestimated, as these entities account for 56% of total employment in the region. Recent household surveys reveal that 71% of all poor earners are connected with microenterprises, either as employees or owners. Furthermore, with microenterprises producing approximately 20% of the GDP while absorbing less than 2% of the total banking system and credit union lending of the region, these firms are still vastly underserved and have great potential for expanding productivity and output as more credit and business development services are made available to them. Equally important to the development of the microenterprise sector are the policy and regulatory reforms which have proven to exert a profound effect on the sector.

The period since 1990 has brought changes in government policies and programmatic approaches to micro and small business development, evolving from what were essentially punitive policies that viewed microenterprises as illegal or transitional economic activities combined with the notion that the government was the only actor capable of assisting in the development of small and medium enterprises and of taking the lead in providing services and subsidized credit. Gradually, over the period, this approach changed to one that recognized the

importance of microenterprises but which now focused government action and resources on an assisting role creating an enabling environment for their development.

Several financial sector reforms were undertaken in the first half of the 90s which succeeded in creating space for microfinance, including:

- Deregulation of interest rates, both for deposits and loans;
- Liberalization of entry requirements for banks and other financial institutions;
- Reduction of reserve requirements to or toward prudential levels;
- Dismantling of targeted credit programs;
- Diminishing the role of publicly-owned banks; and
- Improved prudential regulation and supervision.

More recent reforms, referred to as “second-generation” reforms, were subsequently carried out, the aim of which was to further deepen financial markets, allowing for the extension of financial services to a broader base of clients, including:

- Improving prudential regulations and supervision of microfinance institutions, especially non-bank financial intermediaries, including credit unions;
- Establishing or strengthening credit bureaus, including increasing their coverage down to the very smallest loans; and
- Improving the legal framework for secured transactions and modernizing supporting institutions.

The report traces the evolving approach of the Bank in dealing with the sector, which initially consisted of concessional loans and of technical assistance via the Small Projects Program channeled through individual microfinance institutions at the early stage of their development; later, to offering these products at the national level to several institutions through second-tier financing mechanisms provided by Global Microenterprise Credit Programs. With the changes in the economic environment brought about in large part by improved macroeconomic policy and financial sector reforms; new governmental approaches to micro and small enterprise development and a shifting political environment and corresponding changes in civil society organizations (specifically those focused on economic development), the Bank played an increasingly prominent role in supporting these changes as well as offering concrete initiatives to promote microenterprise development in the newly favorable environment.

The report enumerates the increasingly varied range of IDB instruments which came on the scene during the period, one of the most important being the MIF, which placed at the disposal of the Bank powerful tools in support of microenterprise development, and were utilized for several activities, some of the most prominent being:

- “Upgrading” microfinance NGOs into regulated financial institutions to create a network of efficient and self-sustaining institutions capable of expanding microenterprise access to credit and other financial services.
- Strengthening newly formalized and regulated microfinance institutions, with the objective of expanding the region’s overall microfinance portfolio and providing new products tailored to the needs and demands of microenterprises.
- “Downscaling” of banks and regulated finance companies desirous of reaching down to new, smaller-scale business clients, by helping them to develop microfinance technologies.
- Reforming regulatory frameworks and financial supervision practices to permit growth of microfinance and to control risks inherent in this type of lending.
- Strengthening the credit union sector in order to expand its reach toward microenterprises.
- Providing support for marketing of microenterprise products by private businesses and non-profit organizations.
- Promoting competitiveness through the development of “clusters”, or productive chains of small enterprises, particularly in the industrial sector, reaching microenterprises at the high end and those that are subcontracted by larger firms.

A broad array of specific case studies are included in the report, illustrating the Bank’s support for operations in the above-mentioned categories, ranging from microfinance to technical assistance for developing the legal, regulatory and supervisory conditions necessary for microfinance to grow soundly and reach more clients.

By way of illustration, since its inception in 1993, the MIF has made available US\$17 million through a total of 25 projects for institutional strengthening of microfinance entities in the region; support for improving services to facilitate the transfer of remittances from overseas; equity investments and other types of technical assistance. With regard to business development services, in the past 7 years alone, the Bank and the MIF have financed 26 such programs plus 3 science and technology projects with significant BDS components in the countries of the region, totaling US\$60 million.

In addition, the report outlines the significant support the Bank has offered through nonfinancial products that disseminate information and facilitate contacts among microfinance institutions, most notably through its publications and recognizing best practices through awards at the Bank-sponsored annual Inter-American Forum on Microenterprise.

In addition to concluding with lessons learned, the chapter contains a section on major challenges in microfinance and business development services in the Central American region which help provide a road map for continuing IDB support in the future.

CHAPTER 2: THE IDB AND CONSULTATIVE GROUPS FOR THE CENTRAL AMERICAN COUNTRIES

Philip Birnbaum and Jorge Sapoznikow

Donor-Recipient Country Dialogue

The mechanism of Consultative Group meetings was introduced by the World Bank several decades ago as a way to improve the coordination of international aid delivery to the world's poorest countries. Meetings usually took place at the World Bank's Paris office. The typical Consultative Group is set up as a forum in which a recipient-country government outlines its development plans and policies to donor governments and international organizations and pledges of aid and the terms and conditions thereof are coordinated on that basis.

In the early 1990s the Inter-American Development Bank gradually became the first regional multilateral bank to see its lending programs surpass the World Bank's in Central America. By mid-decade annual IDB funding approvals for virtually every Central American country were between double and triple the World Bank's lending in that period.

In light of this evolution and at the Central American countries' request it was recommended that the IDB head up Consultative Groups for the region. For the Consultative Group meetings slated for late June 1995 in Paris, the IDB and World Bank management teams agreed to try out a new arrangement: the IDB would chair the Nicaragua meeting, the World Bank would head up the meeting on Guatemala,¹ and the two organizations would co-chair the meeting for El Salvador.

The centerpiece of the format introduced for the first IDB-chaired meeting (for Nicaragua) was a dialogue between donors and recipient countries, moving away somewhat from prepared speeches. This gathering was a resounding success on two main fronts. First, during spirited discussions the donors learned of the Nicaraguan Government's plans and the difficulties it was facing in the transition from central planning to a market economy, the first move of its kind in Latin America's history. To compound matters, Nicaragua's economy had been buffeted by natural disasters and the nation was emerging from a decade of dictatorship. A second mark of that Consultative Group meeting's success was the more than one billion dollars in aid pledged to the government of President Violeta Chamorro.

This positive experience set the stage for close to a decade of efforts that have seen the Consultative Groups become the premier donor-recipient country forum for Central America. The dialogue-centered format introduced at the meeting on Nicaragua was a preeminent factor in the success of Consultative Group meetings, as was the preparatory work that went into these gatherings to define *key discussion issues* well in advance. These issues were developed in preparatory papers offering in-depth analyses for Consultative Group members to review in advance of the meeting and prepare their positions. Meanwhile, Bank and recipient-country officials visited donors to sound out their views on the *discussion issues* and their anticipated aid

¹ Since discussions were under way at the time on the Guatemala peace accords, this event was treated as an informal meeting.

pledges. Consequently, participants in the Consultative Group meeting that was the culmination of this exercise were likely to be very well informed on the issues, and a spirit of constructive dialogue prevailed. At the pledging session that traditionally wrapped up the meeting, donors announced their aid promises to the country in question.

The following three sections of this chapter recount the processes that unfolded in Nicaragua with its sweeping transformation in the 1990s; in Guatemala with the peace process; in Honduras with its post-Hurricane Mitch reconstruction and transformation; and in El Salvador following the 2001 earthquakes. Section IV below discusses the principal impacts of Consultative Group meetings on Central America.

I. Nicaragua and the Transition from Central Planning to a Market Economy

Highlighted at the aforementioned June 1995 CG meeting on Nicaragua were the objectives and measures adopted by the Government of President Chamorro. It was pointed out that the decade of the 1980s was marked by internal conflict, leaving the country with a polarized society, severe internal imbalances, hyper-inflation, and an external debt more than six times GDP. Per capita GDP had declined to less than one half its level of the late 1970s. Market institutions had been dismantled and a significant share of productive activities was under state control and the country's economic and social infrastructure was devastated.

The Government authorities described the progress achieved in 1994-95 in the implementation of the structural adjustment program, restoring financial stability and promoting growth. After many years of negative economic growth and hyper-inflation, GDP was expected to grow by 5% in 1995. Inflation in 1995 was projected to drop to 9% and exports, which had expanded by 37% between 1994 and 1995, were expected to grow to a level which was double that for 1992. The Government announced it would continue its reorientation toward a market economy and a strong private sector including privatization of certain state enterprises and further implementation of its public sector reform programs involving restructuring and modernizing key ministries and the civil service.

On the social front, considerable progress had been achieved, as primary and secondary school enrollment was up 35% over 1989 levels. The Nicaraguan officials outlined the proposed National Plan for Sustainable Development for the period 1996-2000 which focused on reducing poverty by improving basic social infrastructure for education, health, water and sanitation services, as well as supporting infrastructure including roads and electrification to help expand production and market opportunities. The Plan also outlined employment and social safety net programs directed to help the poorest sectors of the economy.

In the period following this CG meeting, Nicaragua weathered a crisis touched off by reforms to the constitution processed by the Legislative Assembly that were not accepted by the Executive Branch. Given the sharply polarized political climate created by events in the 1980s and the 1990s reforms, the international community elected to put off the next Consultative Group meeting until the constitutional dispute had been settled. It is a testament to the importance of international support that this decision helped spur a renewal of negotiations in Nicaragua;

ultimately, agreement was reached on the constitutional reforms and the Consultative Group meeting was able to proceed. The possibility that it might not materialize clearly was one spark for the rekindling of constitutional talks.

That agreement having been achieved, there was another major shift in the staging arrangements for Consultative Groups, which had traditionally met in Paris. Under an agreement worked out by the IDB with the Swiss Government, which had indicated a strong desire to assist Nicaragua, the next meeting was scheduled to take place in Geneva. This marked an end to a fixed venue for Consultative Group meetings: henceforward the Groups would convene at the location most appropriate to a given country's circumstances at a given juncture. Following the first Geneva meeting, Consultative Groups met in Brussels, Stockholm, Madrid, Washington, and the Central American capitals, each site having been selected according to the prevailing circumstances.

There is no question that Nicaragua has gained substantially from just over a decade of deep-seated changes. Nicaragua in the twenty-first century is very different from what it was in the 1980s with their 30% decline in GDP and 60%-70% plunges in per capita income, an economy heavily dependent on external aid, skyrocketing external debt and drastically debilitated institutions. Though the country continues to grapple with some serious problems the changes clearly have been positive, and could not have happened without the support of the international community. There can be little doubt of the decisive role played by the Consultative Groups in assisting the Nicaraguan Government to better focus its development plans and policies and to secure crucial international assistance.

II. Guatemala and the Peace Accords

As discussed earlier, the June 1995 gathering of the Consultative Group for Guatemala, chaired by the World Bank, was treated as an informal meeting since peace talks were in progress at the time to seek an end to 36 years of bitter strife. At the request of the United Nations negotiator the IDB participated in the talks held throughout 1995 and 1996 to explain to the two sides the financial implications of the agreements being explored. In mid-1996 the Guatemalan Government asked the Bank to organize a new Consultative Group meeting with the primary purpose of eliciting financial support to defray the costs of implementing the peace accords that were on the negotiating table at the time. Given the country's special circumstances at that point it was the Bank's view that active European Community involvement would be desirable. In subsequent talks with the European Commission it was agreed that the IDB and the Commission would co-host the Consultative Group meetings for Guatemala in Brussels.

Serious problems arising in the latter half of 1996 threatened to derail the peace talks. During those months the Bank held to its position, backed by the international community, that there would be no Consultative Group meeting until a final peace accord had been worked out. This was a key factor in the rekindling of dialogue that led ultimately to the December 1996 signature of the peace agreements. That goal having been attained, the Bank proceeded with arrangements for the first formal meeting in Brussels in January 1997, which proved to be very productive. The Guatemalan Government presented its peace accord implementation program; civil society organizations had a voice at the meeting, and delegates from political parties (including the opposition), the private sector, and the academic community took the floor. Representatives of

the Executive Branch, the Supreme Court, and the Legislative Assembly spoke as well. All in all, the meeting afforded a real lesson in the democratic process.

Guatemala came away with sizable pledges of external aid, the bulk of which has materialized. While the record of compliance with the peace accords has been mixed, notably in the fiscal and citizen security spheres, the international community is continuing to use the Consultative Group mechanism to place emphasis on dialogue to see these agreements honored.

III. Honduras and El Salvador – Reconstruction and Transformation in the Wake of Hurricane Mitch in 1998 and the 2001 Earthquakes

In the early 1990s peace was restored in El Salvador and elections in Nicaragua helped bring an end to civil strife. This eased the pressure that these conflicts in neighboring nations had created in Honduran territory. By mid-decade peace agreements had been signed in Guatemala. Thus, over the course of the 1990s democratic systems took firm root in Central America and its nations set out resolutely to reform and modernize their economies. Though they did post some impressive gains, little was done to improve environmental management, regulate land use, or develop disaster preparedness systems or make countries more disaster-resilient, even though the region's history showed clearly how prone it is to such extreme weather events. Hurricane Mitch in 1998 and earthquakes in El Salvador in 2001 once again pointed up the region's extreme vulnerability, with a human toll in the thousands and billions of dollars in material losses. The region was compelled to seek international aid to rebuild and to assist segments of the population which had been devastated by these catastrophes.

In situations like these the most disaster-vulnerable countries are also the countries most in need of external aid and international financing to support their development efforts. This frequently means competing needs for the shrinking flow of external aid funds. Among these requirements are finance for critical development infrastructure, initiatives to reduce poverty and improve social indicators, and activities to help create gainful employment in sectors exposed to global competition. Yet another competing need is disaster preparedness, along with periodic reconstruction efforts when disasters do occur. The cost of post-disaster reconstruction work is often very steep in countries with scant environmental management or disaster preparedness and inadequate infrastructure.

In late 1998, at the request of donor organizations and affected countries, the IDB established the Consultative Group for the Reconstruction and Transformation of Central America, to coordinate international community support for the emergency created by Hurricane Mitch. The Group's first meeting took place at IDB headquarters in Washington in December, barely two months after the hurricane, with the Presidents of Honduras, Nicaragua, El Salvador and Costa Rica and the Vice President of Guatemala participating. Delegations to the meeting, including donor governments and international organizations, were given a preliminary tally of the losses and came up with tentative pledges totaling roughly US\$6 billion. However, at that juncture the countries still had no firm loss estimates and, more important, had no reconstruction plan.

Accordingly, a decision was made to convene the Consultative Group again in May 1999 to review more detailed documentation. The Group accepted the Swedish Government's gracious

offer to hold this second meeting in Stockholm. In the preparatory work for that gathering consideration was given to problems that had been documented in earlier post-disaster reconstruction efforts, such as the misuse of funds donated by the international community and insufficient regard to reducing vulnerability. Likewise, there had been instances of economies that had rebounded quickly after a natural calamity, thanks to the inflow of reconstruction funds, only to find subsequently that too little attention had been paid to the loss of production capacity, which had tipped the country into recession.

With these considerations in mind it was decided to focus preparations for Stockholm not just on the region's reconstruction needs but on its transformation. Hence, the documents the countries were to present at the May 1999 meeting were termed Reconstruction and Transformation Plans. The Consultative Meeting, which took place as scheduled, proved to be an historic event: participating were the Prime Minister of Sweden, the Presidents of Honduras and Nicaragua and Vice Presidents of Costa Rica, El Salvador and Guatemala, the Secretary-General of the United Nations, the President of the IDB, who chaired the meeting, the Secretary General of the Organization of American States, and the Vice President of the European Union. The international community, having received a firmer tally of the losses, pledged US\$10 billion² in funding—surpassing by far the December meeting offers—to help implement the Plans. What set this meeting apart was the move to embody that commitment in a short document, the “Stockholm Declaration”, which set out guidelines for the use of international community aid money as well as funds put up by the countries themselves to rebuild their economies and make their nations more disaster-resilient.

The merit of the Stockholm Declaration is that it strikes a balance between competing needs for international aid, putting forth proposals that also are satisfactory to the aid providers. In the Declaration the international community pledged to work together with the aid recipients to rebuild and transform countries ravaged by Hurricane Mitch, forging a long-term partnership that is to be guided by the Central American countries' priorities and built around six goals and principles: (i) reduction of social and environmental vulnerability; (ii) reconstruction and transformation solidly underpinned by transparency and good governance; (iii) strengthening of the democratic system and of good governance, furthering decentralization and civil society participation; (iv) respect for human rights, gender equality, the rights of children and of ethnic groups and other minorities; (v) coordination of donor efforts, guided by recipient-country priorities; and (vi) scaling up of efforts to reduce the external debt of the nations in the region.

More than two years after Hurricane Mitch the Consultative Group convened for yet another milestone event, this time in Madrid by kind invitation of the Spanish Government. The original January 2001 meeting date had to be changed when earthquakes rocked El Salvador that month—a reminder, yet again, of the region's extreme vulnerability. Assembled at the rescheduled meeting the following March were the Head of the Spanish Government and the Presidents of Costa Rica, El Salvador, Honduras, and Nicaragua, the Vice Presidents of

² Total amount based on unofficial funding estimates submitted by the donor community, of which 21 bilateral donors pledged US\$4.1 billion (subject to parliamentary approval) and 9 multilateral organizations pledged US\$6.0 million (including IDB US\$3.4 billion and World Bank US\$2.1 billion). The funds were to be utilized over a 4-5 year time frame for emergency and humanitarian relief assistance, long-term reconstruction and transformation, balance of payments support and debt relief.

Guatemala and Panama, the Prime Minister of Belize, the President of the IDB, and the OAS Secretary General.

The central focus of the Consultative Group's careful analysis of reconstruction and transformation processes was Central American integration, the region's participation in the global economy, and the role of international aid on those fronts. Though the image that came through of the region was a more optimistic one, hopeful of solutions to the problems that had plagued the countries in the 1980s, it also was evident that there would be no quick or easy remedies for the region's disaster vulnerability.

The worth of the Stockholm Declaration was reaffirmed following the earthquakes in El Salvador in 2001 when the Consultative Group for the Reconstruction and Transformation of El Salvador took shape. This Group assembled in Madrid in March 2001 in the days preceding the scheduled Regional Consultative Group meeting in that city. The meeting's conclusions conveyed the international community's desire to help El Salvador rebuild in the wake of this natural disaster, adhering to principles similar to the Stockholm Declaration guidelines. Donors pledged close to US\$1.3 billion in reconstruction aid.

An important common thread in all the lead-up work for the Consultative Group meetings discussed above was the involvement of civil society organizations, which were consulted as countries mapped out their reconstruction plans before presenting them at a Group meeting so that civil society proposals could be written in. Delegations from nongovernmental organizations also participated in the meetings themselves. This is one facet of the region's "transformation" in which huge strides have been made in recent years.

IV. The Consultative Groups' Impact in Central America

Since 1995, the Bank has presided over some 20 country-specific Consultative Group meetings and three regional Central American consultative meetings.

Over the course of this period, Consultative Group meetings became the sole conduit for high-level policy dialogue and cooperation on key economic and social development objectives in Guatemala, Nicaragua, Honduras, and El Salvador. Participating in the Consultative Groups were ministry officials, representatives of a broad spectrum of civil society, private enterprise, and opposition parties, and as many as 50 representatives of international donor community agencies and institutions. Active civil society participation now is a regular feature of Consultative Group meetings.

Overall, the quality of the documentation that an aid-receiving country produces for Consultative Group meetings has improved considerably, and such documents are being developed in consultation with members of civil society in the respective country.

The Consultative Groups also have greatly enhanced donor coordination, notably at the local level with donor monitoring groups in the country, or "dialogue groups", which meet regularly with government officials and civil society representatives to track implementation of the aid-receiving country's National Development Plan and Poverty Reduction Strategy.

Out of the Consultative Group process there has emerged a strong consensus among recipient countries and the donor community around priority political, economic, and social challenges and goals. This has had a marked impact on government policy and program development in Central America and on donors' aid priorities and the extent of their support.

A. Support for Poverty Reduction and Human Capital Development ³

Poverty reduction has figured prominently on Consultative Group meeting agendas. Nicaragua, Honduras, Guatemala, and El Salvador already have Poverty Reduction Strategies in place; the continuing challenge for these countries is to effectively implement their strategies while pursuing sustainable economic growth along with targeted initiatives to develop human capital and raise the productivity and income of the poor, who are concentrated in rural and indigenous communities.

At the Consultative Group meetings donors have urged the governments to boost domestic savings by broadening the tax base and improving tax revenue collection so they can devote more money to poverty reduction programs. The Central American countries have sharply increased public spending on primary education, basic health services, water supply and sanitation systems, as well as rural development.

Donors have been adjusting their aid levels as well, moving away from the huge infrastructure projects of the past to support basic social services and special programs for women, children, and indigenous communities and moves to regularize land tenure by way of cadastral censuses to facilitate poor rural dwellers' access to farmland, along with donors' other rural development programs.

B. Good Governance and Improvements in Transparency and Accountability ⁴

The imperative of transparency and accountability in the use of public funds has been a central discussion topic at Consultative Group meetings. This is crucial to eliminate corruption, as a sine qua non for maintaining the public's trust in their governments, attracting foreign investment, and sustaining international donor community support. Transparency concerns have moved to the forefront particularly since Hurricane Mitch, when the donor community pledged close to ten billion dollars for the reconstruction and transformation of Central America.

Countries have done a great deal to improve public administration generally and transparency and accountability specifically. Nicaragua, Honduras, El Salvador, and Guatemala all have programs to modernize key ministries and overhaul the civil service, but more needs to be done to create a professional civil service, one based not on political affiliation, to assure continuity between democratically elected governments. Reforms have been launched in Nicaragua and Guatemala to give the offices of the Comptroller General and the Auditor General more autonomy and strengthen their mandates. The IDB and various bilateral donors have developed a program in Honduras and Nicaragua to improve efficiency and transparency in government procurement and contracting, including the creation of an Inspector General's Office.

³ For further information on Bank-supported activities in the social sectors and poverty reduction, refer to chapter 5.

⁴ For more information on this topic, refer to chapter 6 on strengthening democracy .

C. Reducing Social and Environmental Vulnerability ⁵

When Hurricane Mitch battered Central America in October 1998—the worst natural disaster in the region’s history—the vulnerability of this part of the world to such extreme weather events was underscored once again.

The December 1998 Regional Consultative Group meetings in Washington and the May 1999 Stockholm meeting focused on the reconstruction and transformation of Central America and, more particularly, on ways of lessening the impact of natural disasters by reducing countries’ social and environmental vulnerability and breaking the vicious circle of poverty and environmental degradation. The damage wrought by natural disasters often is magnified by extreme poverty and population explosions, which trigger unchecked urban growth, mass deforestation, and soil degradation that in turn set off deadly floods and landslides.

In recent years the Central American countries, with strong donor backing, have instituted early warning systems and bolstered their disaster preparedness. They also have developed better resource management programs, including regional watershed management. But much more needs to be done in programs to help reduce the vulnerability of poor communities in marginal, high-risk areas.

D. The Resolute Move Toward Market Economies ⁶

Another item high on Consultative Group agendas has been support for economic liberalization and the importance of heightening the private sector’s role in propelling economic growth and paring the State’s role in the economy, including privatization of State enterprises. Increases in competitiveness and in exports are critical, as is expanding regional trade and deepening integration so the Central American countries can be partners in globalization.

The IDB, the World Bank, and other donors are delivering support to Central America’s small and mid-sized business sectors. They also are working with these countries to strengthen financial and banking systems and the associated regulatory apparatus and are helping to further regional integration through the Puebla-Panama Plan.

E. Strengthening the Rule of Law and Human Rights ⁷

One key concern addressed in Consultative Group discussions is the need to continue entrenching the rule of law and to administer justice evenhandedly to all citizens—this being essential for lasting peace and national reconciliation. The public insecurity bred by crime, violence, and impunity for human rights violations undermines public trust and is a roadblock for quality-of-life improvements, new foreign investment, and tourism development.

Programs with international donor community support are operating today in Nicaragua, Honduras, Guatemala, and El Salvador as part of those countries’ moves to modernize the State

⁵ For a further discussion of Bank-supported activities in the areas of environment and sustainable development, see chapter 7, as well as chapter 8 on natural disasters risk management.

⁶ For further information on these topics, see chapters 3, 4, 9 and 10.

⁷ For more information on this topic, refer to chapter 6 on strengthening democracy.

and bolster democratic institutions, in order to extend the reach of their judicial systems and make them more effective. Among these initiatives are legal training programs, modernization of criminal and penal codes, and the creation of modern civilian police systems.

V. Conclusion

Dialogue has been the keynote of the Consultative Groups coordinated and chaired by the IDB. Contributing to that focus have been the drafting of preparatory papers for meetings to offer an in-depth analysis of key discussion issues; pre-meeting visits to donors to explore those issues thoroughly and discuss aid pledges; and participation by the three branches of government (executive, judicial, and legislative) and of civil society organizations and the private sector in Group meetings. Significantly, at the most recent CG meeting, on Honduras in June 2004, the representatives of the Government of Honduras, of Honduran Civil Society, and of the international donor community subscribed the Declaration of Tegucigalpa, which clearly set forth the commitments and efforts to be carried out by each party to advance with the transformation of the country, the consolidation of democracy, sustainable development and the reduction of poverty.

In sum: the Consultative Groups have been very influential in encouraging countries to develop national development and/or reconstruction plans and in nurturing dialogue between governments and civil society and between governments and donor organizations. Central America today is vastly different from 10 or 15 years ago, particularly relative to its situation in the 1980s. Though multiple factors have gone into this transformation, the Consultative Groups clearly have been catalysts, helping to marshal some of the drivers of change.

CONSULTATIVE GROUP MEETINGS FOR CENTRAL AMERICA 1995–2004

1995	1996	1997
NICARAGUA – Consultative Group meeting 19-20 June 1995 Paris, France Chaired by the IDB	NICARAGUA – Consultative Group meeting 17-18 June 1996 IDB headquarters, Washington, D.C. Chaired by the IDB	GUATEMALA – Consultative Group meeting 21-22 January 1997 Brussels, Belgium Co-hosted by the European Commission and the IDB Chaired by the IDB
GUATEMALA – Informal meeting of donors 21 June 1995 Paris, France Chaired by the World Bank		GUATEMALA – Consultative Group follow-up meeting 9-10 September 1997 Antigua, Guatemala Chaired by the IDB
EL SALVADOR – Consultative Group meeting 22 June 1995 Paris, France Co-Chaired by the IDB and the World Bank		
1998	1999	2000
NICARAGUA – Consultative Group meeting 1-2 April 1998 Geneva, Switzerland Co-hosted by the Government of Switzerland and the IDB Chaired by the IDB	REGIONAL MEETING OF THE CONSULTATIVE GROUP FOR THE RECONSTRUCTION AND TRANSFORMATION OF CENTRAL AMERICA 21-22 May 1999 Stockholm, Sweden Co-hosted by the Government of Sweden and the IDB Chaired by the IDB	HONDURAS – Consultative Group meeting 7-8 February 2000 Tegucigalpa, Honduras Chaired by the IDB
GUATEMALA – Consultative Group meeting 22-23 October 1998 Brussels, Belgium Co-hosted by the European Commission and the IDB Chaired by the IDB	EL SALVADOR, GUATEMALA, HONDURAS AND NICARAGUA – Consultative Group Meeting 23-25 May 1999 Stockholm, Sweden Co-hosted by Swedish government and the IDB Chaired by the IDB	EL SALVADOR – Informal Consultative Group meeting 9 February 2000 Tegucigalpa, Honduras Chaired by the IDB

REGIONAL MEETING OF THE CONSULTATIVE GROUP FOR THE RECONSTRUCTION AND TRANSFORMATION OF CENTRAL AMERICA 9-10 December 1998 IDB headquarters, Washington, D.C. Chaired by the IDB		NICARAGUA – Consultative Group Meeting 23-24 May 2000 Washington, D.C. Chaired by the IDB
2001	2002	2003
EL SALVADOR – Consultative Group meeting 7 March 2001 Madrid, Spain Co-hosted by the Government of Spain and the IDB Chaired by the IDB	GUATEMALA – Consultative Group meeting 11-12 February 2002 IDB headquarters, Washington, D.C. Chaired by the IDB	GUATEMALA – Consultative Group meeting 13-14 May 2003 Guatemala City, Guatemala Chaired by the IDB
REGIONAL MEETING OF THE CONSULTATIVE GROUP FOR CENTRAL AMERICA 8-9 March 2001 Madrid, Spain Co-hosted by the Government of Spain and the IDB		NICARAGUA – Consultative Group meeting 27-28 October 2003 Managua, Nicaragua Chaired by the IDB
HONDURAS – Consultative Group follow-up Meeting 28-29 March 2001 Tegucigalpa, Honduras Chaired by the IDB		
2004		
HONDURAS – Consultative Group Meeting 10-11 June 2004 Tegucigalpa, Honduras Chaired by the IDB		

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CHAPTER 3: REGIONAL INTEGRATION

Ennio Rodríguez and Stephen E. McGaughey

I. The IDB and Regional Integration Issues in the Central American Isthmus

A. Introduction

The Central American region has experienced more than four decades of regional integration, with periods of rapid growth in trade, especially in the 1960s and into the 1970s, and then again later restarting trade and growth in the 1990s—the recent period accompanied by solid national and international political commitments. There have been periods of inaction and regression in regional integration, especially in the late 1970s and the “Lost Decade” of the 1980s due to internal and external economic and political factors.

The Inter-American Development Bank supported regional integration from the beginning of the founding of the Central American Common Market (CACM); and it has been an influential partner during periods of emergent integration, national crises, and regional disasters. The Bank itself adopted the thesis of integration from its inception as a regional bank, and in the last decade, the IDB formally placed regional integration up front as one of its core agenda items in Latin America, fully incorporated into its 8th Capital Replenishment and its new Institutional Strategy (1999).

This report reviews the extent and the type of support of the IDB for regional integration in the Central American Isthmus from the 1990s to the present. The Bank has worked with numerous financial and nonfinancial mechanisms through regional and national institutions, using its technical cooperation and loans to add impetus to a number of regional cooperative efforts, cutting across several key sectors, including transport, electric power, health, education, tourism, and the environment, among others. Furthermore, the Bank has worked to support national and regional structural economic and institutional reforms, contributing to the convergence of macroeconomic structures and policies in the region and focusing on the most critical development issues.

Since the countries decided in the early 1990s to initiate a new generation of integration, the Bank intensified its regional and national programming process, leading national and regional consultative group meetings to help coordinate external assistance for the region. This led to the Bank assuming leadership of the Puebla-Panama Plan (PPP), which became a practical instrument for accelerating important regional programs for economic and social development in Mesoamerica.

Similarly, and in parallel with the intraregional cooperative efforts, Central American countries and groups of countries have been establishing bilateral and multilateral trade

agreements with major trading partners and adjacent regions such as Mexico, Chile, Canada, Colombia, Venezuela, and the European Union. Also, the countries have been participating in the latest round of multilateral trade negotiations under the umbrella of the Doha Round of the World Trade Organization (WTO). Simultaneously, the Free Trade Area of the Americas (FTAA) is in an active stage of conceptualization and negotiation, moving toward the goal of a 2005 launching date. In early 2004 the Central American countries completed negotiations with the U.S. for the Central American Free Trade Agreement (CAFTA).

The complexity of these negotiations places demands on the national authorities, the private sector and its organizations, civil society, organized labor, and regional organizations of the Central American Integration System (SICA), the Secretariat for Central American Economic Integration (SIECA), and the Central American Bank for Economic Integration (CABEI). In addition to the formal economic and trade agreements, the countries are coming together in cooperating in a number of tasks highly complementary to trade liberalization. The IDB has been an active partner and participant in accompanying the region in this process.

B. Commitment to Integration in the Central America Isthmus

1. Some Key Elements in Central American Integration

With a shared colonial history and the close proximity of its capitals, development in Central America has been characterized by a series of positive and negative interrelationships among the five countries which were formerly provinces belonging to a same Captaincy General under Spain. Among these interrelationships are: population movements that continue to the present day; shared natural resources and vulnerability to natural disasters; significant economic interaction, which led to the decision in 1960 to forge ahead with trade integration and create the Central American Common Market (CACM), which today transcends purely trade-related issues to include investment flows and other types of regional cooperation; the build-up of intraregional debt balances; multiple relationships among civil society organizations; and a recent legacy of political and military conflicts that threatened to spread throughout the region, but which later gave way to a collective effort to build peace and democracy.

This set of interrelationships makes it possible to speak of a true region and highlights the need to develop common policies and make collaborative efforts in order to address both positive and negative cross-border impacts.

This picture of a region with a potential vision for the future becomes even clearer when bearing in mind that the competitive advantages of these countries lie in their strategic location.¹ As the Caribbean Basin Initiative has made evident, the Central American

¹ See F. Ballesteros and E. Rodríguez, "Central America: Towards a Harmonized Economic Area." *Integration and Trade*. January-April, No. 1, 1997. This strategic concept has also been proposed by INCAE and Harvard, *Central America in the 21st Century: An Agenda for Competitiveness and Sustainable Development*, Alajuela, 1999.

Isthmus is blessed with a privileged location vis-à-vis the large North American markets. But this location is similarly advantageous with respect to South America, Europe, and Asia given that the Isthmus lies between these regions. Such strategic potential could enable domestic and foreign companies to expand development of manufacturing and services both for export and for the internal Central American market, although this will be an option only if hurdles at border crossings and shortcomings in infrastructure can be overcome.

Central American economic integration has been a source of political and economic stability in a region that in recent decades was plagued by civil wars, severe border conflicts, and strong ideological divisions. In the mid-1980s, during the worst of the period of conflict, regional trade, albeit limited, continued and was what underpinned the common interest in the region's future. In fact, during that time, electrical power continued to flow across borders; the power lines interconnecting the countries never suffered as a result of the armed conflicts. It is this base of shared economic interests that helped keep open channels of communication and helped maintain a certain levelheadedness, which in turn helped rein in the conflict and served as the foundation for building peace. This is a political contribution of integration that warrants strong emphasis.

From a more strictly economic perspective, regional trade is also a source of stability. Reciprocal exports among the Central American Common Market member countries (Costa Rica, Guatemala, El Salvador, Honduras, and Nicaragua) have played a counter-cyclical role. While extraregional exports have traditionally been dominated by commodities subject to swings in their terms of trade, intraregional exports are predominantly manufactured goods whose prices are more stable. Crises in the markets for traditional products (mainly coffee, bananas, meat, and sugar) have less of a contracting effect on these economies thanks to regional trade in industrial goods.

Finally, reciprocal trade has been a significant source of growth in Central America. For these very open economies, exports largely determine their growth capacity. Despite strong diversification in extraregional exports with the development of the textiles and apparel industry, the electronics and service industries, and nontraditional agricultural products, exports within Central America are continuing to represent a growing share of total exports, reaching 28 percent in 2002 (without counting the maquiladora industry).

Furthermore, indicators of export diversification have increased continuously in the region in the late 1980s, and no individual country has failed to benefit by this achievement. This adds to the capacity of the countries to protect their markets somewhat against cyclical declines in international prices or shifts in product markets, prices, and preferences in international markets. Increased diversification adds to the macroeconomic stability of the region.

While export product diversification has increased, the region continues to be appreciably tied to the U.S. markets and, with the exception of El Salvador (which has significant intraregional exports shares), no country exports less than 40 percent of the value of its

exports to the U.S. Therefore, the close historical economic relationship to the U.S. explains the desire of both parties to create the CAFTA free trade area.

Further positive contributions from regional integration have been the improvement in the investment climate and a corresponding increase in foreign direct investment in the area during the 1990s, including intraregional direct investments.

Despite these interrelationships amongst the countries of the region, and despite progress made, reciprocal trade levels have continued to fall short of their potential. Institutional issues such as inefficient customs procedures and nontariff barriers, along with poor transport infrastructure for integration, have largely been to blame for this situation.

2. Trade Integration

The Central American Isthmus participates in numerous trade negotiations and agreements at the regional, bilateral, and multilateral levels (see Annex I). The region, following the depths of the political and economic crises of the 1980s, has moved ahead into a “new regionalism” inspired by deepening structural market reforms, by the return to peace and democratic principles and processes, and by the need to seek opportunities to increase growth and reduce extreme poverty. The increase in intra- and extraregional exports, the encouragement of foreign direct investment, and the modernization of national institutions all add to the effect of ensuring the reforms and giving them needed long-term stability that is sought by investors. The creation of the North American Free Trade Agreement (NAFTA) among Canada, Mexico, and the United States gave urgency in the region to move forward with trade agreements to ensure long-term access to hemispheric markets.

The political dynamics of change in the Isthmus have involved an effort to develop regional institutions with the creation and consolidation of SICA, the Central American Integration System. Similarly, the personal commitment of the Presidents of the Central American countries, and the addition of Panama and Belize to the agreements, has meant that the region was able to begin to take very important regional integration decisions with a special impetus in 1991, 1992, and 1993, leading to numerous advances in the agreements.

Central American Presidents’ Summits have been the effective political mechanism for leading the approval and implementation of the numerous agreements. At the Antigua Summit held in June 1990, the Presidents agreed to formally launch the integration process based on a new approach aiming to seek compatibility between domestic trade liberalization processes and subregional integration.

Box 1

PAECA

The ambitious Central American Economic Plan of Action (PAECA) was launched at the Antigua Summit and included actions such the following: creating a new legal and operational framework for integration; moving forward on subregional tariff issues; creating a trade infrastructure and integration program; regionally coordinating foreign trade promotion and the entry into GATT of those countries that had not yet joined; encouraging different social sectors to participate in making decisions about development; promoting an industrial restructuring policy; privatizing State enterprises; coordinating subregional agriculture policies as well as science and technology policies; coordinating economic adjustment and social adjustment compensation programs; establishing a forum for consultation and coordination among Central American countries to find appropriate solutions to their foreign debt, whether bilateral or multilateral; and holding negotiations in order to streamline international financial cooperation for economic reconstruction, the consolidation of democracy, and productive transformation, with emphasis on joint regional action programs.

In 1992 and 1993, customs harmonization moved forward with the signing of the Protocol to the General Central American Tariffs and Customs Agreement (January 1992, in force as of February 1993), the Protocol Amending the Uniform Central American Customs Code (CAUCA II) (January 1993, in force as of July 1996), and with the accession of Honduras to the General Central American Tariffs and Customs Agreement, to Annex B, and to the January 1992 Protocol (in force as of February 1993).

Trade grew at an average annual rate of 14 percent from 1993 to 1998, with intraregional exports doubling during that period. Between 1999 and 2002, when total exports for Central America (not including the value of maquiladora trade) decreased by 9.8 percent, intraregional exports increased by 17.7 percent (source: Information Technology Office, SIECA). It should be noted that Central American reciprocal trade once again played a counter-cyclical role.

The list of products from Central America that are exempted from free trade (May 2003), with the same restriction for all five countries, is only two items long (unroasted coffee and cane sugar), with four additional products (roasted coffee, ethyl alcohol, petroleum derivatives, and distilled alcoholic beverages) having at least one bilateral restriction. This list has been shortened over time and is an indicator of the deepening of regional free trade. The average external tariff is 7.5 percent, which is lower than the Latin American average, with the common external tariff covering approximately 70 percent of products.

As regards *customs administration*, Central America adopted common standards in the form of the Uniform Central American Customs Code (CAUCA), which is consistent with international standards. CAUCA was approved in June 2002 and is only awaiting ratification by Honduras and Costa Rica. It is accompanied by the corresponding set of regulations (RECAUCA), which enters into force simultaneously with CAUCA. For their part, the countries are implementing programs to modernize customs and harmonize customs regulations and procedures with the support of IDB programs.

In 1966, El Salvador and Guatemala decided to form a *customs union* in accordance with the Guatemala Protocol, which allows subgroups of CACM member states to join the customs union. In 2000, Honduras and Nicaragua joined, as did Costa Rica in June 2002.

Box 2

Trade Regulations in Central America

In recent years, there has been a growing effort to develop the region's *trade regulations* in a manner consistent with its multilateral commitments. The following regulations currently exist:

- Central American Regulation on Rules of Origin for Goods
- Central American Regulation on Safeguard Measures
- Central American Regulation on Unfair Trade Practices
- Regulation on the International Customs Transit System, Declaration and Instruction Form
- Central American Regulation on Standardization, Metrology, and Authorization Procedure Measures
- Central American Regulation on Sanitary and Phytosanitary Measures and Procedures
- A Dispute Settlement Mechanism
- Treaty on Investment and Trade in Services (awaiting legislative ratification)

One of the serious difficulties to be resolved involves the collecting of duties at the point of entry into the customs union and the subsequent distribution of this revenue.

For its part, the common external tariff is limited because of bilateral trade agreements entered into by individual countries or subgroups of countries with, for example, Mexico, Canada, the United States, Chile, Panama, the Dominican Republic, and the Caribbean Community (CARICOM).

Box 3

Customs Union

A customs union is understood to be the creation of a common customs territory with a free flow of goods regardless of their origin, which would eliminate customs. Its characteristics would include:

- The free movement of goods, without exception, regardless of their origin once they are admitted into any member country
- The free trade of services, especially those associated with the trade of goods
- A common external tariff
- Common customs administration
- A mechanism for the collection, administration, and distribution of tariff revenues
- A common foreign trade policy
- Uniform trade regulations

C. IDB Regional Integration Strategy and Instruments

The IDB approved its *Regional Integration Strategy Document* in 2003. This document presents the Bank's diagnosis of regional integration and sets out the IDB's main goal "...to guide Bank support for the creation of regional public goods, specifically *regional integration* and *regional cooperation*, aiming at taking advantage of the globalization process in order to promote sustainable economic growth and poverty reduction." The strategy gives guidelines and defines an action plan for Bank programs in the future and identifies the main financial and nonfinancial vehicles for providing Bank support to the several levels of integration, be they national components, regional agreements, or bilateral and multilateral arrangements.

The IDB's *Regional Integration Strategy* establishes four overall categories of program support, including:

- *Consolidation of regional markets* through the further liberalization of trade, the implementation, analysis, and improvement of the trade regulatory mechanisms, support for countries' participation in North-South trade negotiations and in the multilateral forum of the Doha Round of the World Trade Organization (WTO);
- Promoting *regional infrastructure* through cooperative mechanisms such as the Puebla-Panama Plan (PPP), mobilization of private investment, and facilitating a regulatory environment, in transport, ports, energy, and communications;
- *Institutional strengthening* at the country and regional level; and
- The promotion of *regional cooperation* in key areas such as the environment, health, education, natural resource management in watersheds and biological corridors, science and technology, financial sector regulation, and border development, among others.

The Bank's operational instruments for identifying and guiding the implementation of the programs are Regional Programming Papers (RPs) and Country Programming Papers (CPs) that evaluate issues of national adjustment to the requirements of regional integration. Since 1995, the Bank has organized three Regional Consultative Group meetings for Central America (RCG-CA) in Paris, Brussels, and Madrid and current policy is to update the Regional Programming Paper annually for review by the Bank's Board of Executive Directors.

Box 4

IDB Financial Instruments for Regional Integration

- Regional technical cooperation
- Country lending and technical cooperation
- Special lending in support of trade and integration, including the Trade Sector Facility
- Regional infrastructure lending, and
- Multilateral Investment Fund (MIF)

The IDB has a number of effective *financial* and *nonfinancial* instruments for furthering its Regional Integration Strategy. Recently it has approved Trade Sector Facility loans in several Central American countries to increase the national capacity to export, enhance competitiveness of the economy and the private sector, finance trade promotion programs, undertake trade negotiations, and supply technical assistance to key trade agencies. Also, the Bank is currently evaluating the preparation of a new special fast-disbursing Trade, Integration, and Competitiveness Loan, a package of existing loan modalities, combining trade promotion, institutional development, policy reform, and competitiveness.

Box 5
Trade Facility Loan Components

- Institutional Diagnostic Studies (evaluation of institutional, human resources, and financial capacity; review of informatics; assessment of organizations, procedures, functioning, budgets)
- Implementation of Trade Agreements and Integration Efforts Support (preparation of legal and regulatory frameworks; design and execution of coordination efforts; development of coordination mechanisms)
- Training of Technical Staff and Negotiators
- Installation of Computerized Systems
- Programs to Develop and Diversify Trade
- Maximum loans of US\$5 million

The IDB has utilized a large number of nonfinancial mechanisms such as regional and national consultative meetings in which country and regional policies, programs and financing are discussed with multiple donors and international and regional agencies, as well as seminars, training programs, and direct technical advice to contribute to regional integration.

Box 6

Some IDB Nonfinancial Instruments for Regional Integration

Regional Consultative Group Meetings

- Madrid 2001 and Regional Programming Paper
- Stockholm 1999, Meeting for Reconstruction and Transformation of Central America
- Washington, D.C., 1998, Meeting for Reconstruction and Transformation of Central America following hurricane Mitch
- Brussels 1997 and Regional Programming Paper
- Paris 1995 and Regional Programming Paper

Recent National Consultative Meetings

El Salvador

- CG, March 2001, Madrid
- CG (informal), February 2000, Tegucigalpa
- CG, May 1999, Stockholm
- CG, June 1995, Paris, co-chaired with World Bank

Honduras

- CG, June 2004, Tegucigalpa
- CG (follow-up), March 2001, Tegucigalpa
- CG, February 2000, Tegucigalpa
- CG, May 1999, Stockholm

Guatemala

- CG, October 2003, Managua
- CG, May 2003, Guatemala City
- CG, February 2002, Washington, D.C.
- CG, May 1999, Stockholm
- CG, October 1998, Brussels
- CG (follow-up) September 1997, Antigua
- CG, January 1997, Brussels

Nicaragua

- CG, October 2003, Managua
- CG, May 2000, Washington, D.C.
- CG, May 1999, Stockholm
- CG, April 1998, Geneva
- CG, June 1996, Washington, D.C.
- CG, June 1995, Paris

Press Briefings

- Central America: Challenges and Opportunities on the Road to Free Trade with the United States, November 2003, Washington, D.C., for Media of Central America

Conferences

- First Annual Conference of the Euro-Latin Study Network on Integration and Trade, November 2003, Barcelona
- Second CEPPI-IDB Conference. Economic Implications of the Doha Development Agenda for Latin America and the Caribbean, October 2003, Washington, D.C.

Continued →

Workshops and Meetings

- Financial Services Workshop for Central America, September 2003, Tegucigalpa
- FTAA: Impacts and Perspectives, May 2003, Buenos Aires
- Global and Local: Confronting the Challenges of Regional Development in Latin America and the Caribbean, March 2003, Milan
- Third Cluster Workshop: Agriculture and Agribusiness, January 2003, Washington, D.C.

Regional Policy Dialogue

- Fifth Meeting of the Integration and Trade Regional Policy Dialogue, August 2003, Washington, D.C.

The Central American Isthmus progressed with regional integration in the last decade. There has been a rising national political commitment to the process, and the international environment has been a further stimulus for change. The IDB has mobilized its resources at the behest of its member countries to accompany the many changes and challenges facing the region. Through regional technical-cooperation grants, regional and country loans, regional programming exercises (as well as on a country specific basis) to define priorities, the regional programming process has over the years led to a rich portfolio of activities. That portfolio will be characterized in the next chapter.

II. Key IDB Programs for Regional Integration and Cooperation in the Central American Isthmus

A. Regional Strategy Development in Central America

1. Regional Programming and Consultative Groups

The IDB's active involvement in the new stage of Central American integration comes in response to a request from the Presidents' Summit held at the end of 1990. The Central American Presidents, with Panama participating as an observer, requested that the IDB create and chair a Regional Consultative Group for Central America (RCG-CA) as a programming mechanism for defining the region's priorities in order to address the technical and financial needs that would result from a new economic integration process. Under the IDB's direction, donor countries, cooperation agencies, and international organizations would participate.

In March 1992, in response to the request from the region's countries, the IDB approved the creation of the Program of Support for Central American Development and Integration (PRADIC), which included support for RCG-CA activities.²

Box 7

Key IDB Programs for Central American Integration in the 1990s

Regional. Program of Support for Central American Development and Integration (PRADIC), Technical Cooperation, US\$2.7 million grant ATN/SF-3938-RG (1992).

The IDB provided significant support for the renewal of economic integration and policy coordination in Central America through PRADIC. At the request of the Presidents of the five Central American countries the Bank approved this program to assist in three significant fields: economic policies, trade, and competitiveness through the coordination of economic policies, the organization of international and interregional trade, and competitiveness of the production sectors; support for the Regional Consultative Group (RCG-CA) and meetings with the private sector; and the organization of the Multilateral Steering Committee.

This regional program had several special features. It brought together the public sector, the international community and private sector to promote collaboration, communication, and support for the reinitiated regional integration process. In the economic sphere, focus was on the convergence and harmonization of economic policies among the countries. The program also incorporated a concern for the adaptation of the regional institutions to a new style of economic integration referred to as the "New Regionalism." Additionally, the program introduced the concept of competitiveness of the private sector and mobilized more than 100 regional private-sector organizations to discuss the potential and the conditions for an approved industrial policy and selection of high-opportunity lines of investment for the future of regional and international trade.

² In a survey conducted in Central America, consultant Daniel Masis found that respondents generally agreed that PRADIC represented a watershed in the Bank's involvement with Central American integration. The Bank's participation has been greater and more effective since that project began.

Prior to the creation of the RCG-CA, the Bank had already provided the region with more than US\$21 million in nonreimbursable technical-cooperation financing to: strengthen subregional economic integration institutions, expand operations in the electric power sector, harmonize environmental measures and capital markets, strengthen the social and agricultural sectors, and develop training programs. The effectiveness of some of these projects had been hindered by a lack of centralized institutions and the limited regional impact some of them had. The support of the RCG-CA made it possible to enhance the decision-making process in the region with regard to new areas being considered.

The first RCG-CA meeting chaired by the Bank was held in Brussels in March 1993. Previous activities had been overseen by a Multilateral Steering Committee (MSC) composed of Central American economy ministers and officials from the IDB, the International Monetary Fund (IMF), the World Bank, and the United Nations Development Programme (UNDP). Since 1992, the MSC had been holding meetings and consultations with a view to approving a regional agenda of priorities for the decade, which included regional infrastructure (particularly energy, transport, and telecommunications), social programs, and projects for modernizing the region's productive sector.

The three areas selected for submitting project proposals to the donor community were electric power, the environment, and human resources. Science and technology constituted a fourth area to be included in a regional program, but was to be supported by national programs (with a minimum of three participating countries).

The electric power sector was the area with the most significant technical development. It received the most support from donors and paved the way for what would become the Central American Electric Interconnection System (SIEPAC).

By virtue of this action strategy, the RCG-CA was the catalyst behind obtaining grants totaling US\$4.2 million from development agencies in Canada, Chile, Colombia, Germany, Mexico, Spain, and the European Union, as well as from the Central American Bank for Economic Integration (CABEI).

As a donor to the RCG-CA, the Bank helped to channel the technical support needed to build a pipeline of projects that the RCG-CA continued to consider. In 1994, Canadian funds (ATN/CP-4624-RG) were used to finance a US\$90,000 technical cooperation project to promote more efficient use of the fast-maturing plants currently used in the power sector. In 1995, two operations (ATN/NE-5016-RG and ATN/SF-5016-RG) in the amount of US\$370,000 on biodiversity and strengthening environmental laws were developed from the RCG-CA's project pipeline.³

For the RCG-CA's 1997 meeting, the Bank had its first Regional Programming Paper, approved by its Board of Executive Directors, for supporting the region. Central America

³ Inter-American Development Bank, Integration, Trade, and Hemispheric Issues Division. *Central America: Regional Programming Paper RP-CA*. Washington, DC, IDB, September 1995 (Annex 1: "The Regional Consultative Group for Central America," p. 3).

drew on the Programming Paper for its appeals to the donor community,⁴ specifically on the strategic concept of a harmonized economic area. It also based its approach on its own strategy, namely the Alliance for Sustainable Development (ALIDES), approved by the Presidents. The 1997 RCG-CA document emphasized the optimistic institutional reform program approved by the Central American Presidents in Panama in July of that year.

The main project areas identified include: (i) economic integration; (ii) institutional reform; (iii) infrastructure (electric power, transport, and hydrocarbons); and (iv) functional cooperation (this time aimed at the health sector). A detailed summary of the project areas, the cost of which totals US\$21.4 million, can be found in Annex II.

Of these projects, the Bank focused on those related to infrastructure, while the German cooperation agency, the GTZ, financed the hydrocarbons project. The European Commission indicated its willingness to finance institutional reform projects, although this did not occur, as the Panama Summit commitments were met only in part (this issue is taken up again in the next section).

The Consultative Group for the Reconstruction and Transformation of Central America met in Stockholm in 1999 against the inevitable backdrop of the devastation caused to the region the previous year by Hurricane Mitch. The problem of regional disparities had become more acute owing to the fact that two of the countries hardest hit, Honduras and Nicaragua, already lagged behind the others. Nevertheless, the Stockholm Meeting served to renew the countries' commitment to regional integration.

Central America arrived at the March 2001 RCG-CA meeting in Madrid armed with a series of projects developed consensually by the seven Central American countries. The meeting's objective was to have all of the Heads of State collectively back the integration process and define priorities for external cooperation before the international community. It marked the first time that Central America had approached the international cooperation community with a unanimous position with regard to priority regional projects based on a medium-term integration strategy. The document presented in Madrid was entitled "Regional Proposal for the Transformation and Modernization of Central America in the 21st Century." In addition to public officials, business people and nongovernmental organizations from both the region and the donor countries actively participated in the meeting. The objective of this RCG-CA meeting was not to secure funds *per se*, but rather to provide an opportunity to discuss at length the integration strategy presented by the Central Americans. The set of projects and initiatives is described in Annex III.

The Bank supported the governments' and SICA's preparations for the Madrid meeting via five regional technical-cooperation projects: (i) ATN/SF-5059-RG, which supported the Regional Consultative Group in its second stage of operation; (ii) ATN/SF-6920-RG, aimed at strengthening SICA's Secretariat in order to prepare a regional strategy and a set

⁴ Inter-American Development Bank, *Second Meeting of the Regional Consultative Group for Technical Cooperation for Central America (RCG-CA)*. Washington, DC, IDB, September 1997.

of priority projects, in addition to supporting the presentation of this strategy to the region's main donors; (iii) ATN/SF-7050-RG, executed jointly with the CABEL in order to support consultations with civil society on strategy and projects prior to the RCG-CA meeting; (iv) ATN/SF-6862-RG, which supported a study on regional asymmetries and the preparation of proposals to address them; and (v) support so that representatives of the private sector and other organized civil society groups could prepare what is known as the "Agenda for Central America" through ATN/SF-7003-RG. The second Regional Programming Paper was prepared in 2000 concurrently with the RCG-CA meeting, for which reason it both supported the meeting and included its conclusions. The modernization and transformation strategy and the Programming Paper are consistent with one another. The Paper was the result of an intersectoral, interdepartmental effort at the Bank that made possible more effective support for the new reality of ever broader integration.

The launching of the PPP in June 2001 represents continuity with the commitments of the Central American Isthmus countries in the Madrid meeting, and reflects a clear step toward implementing the investment program. Also, this same period has corresponded to the intensification of the negotiations for the Free Trade Area of the Americas (FTAA).

Box 8

IDB Support for Negotiations of the Free Trade Area of the Americas (FTAA)

- Member of Tripartite Commission with ECLAC and the OAS
- Support for Implementation of Eight Customs-Related Business Facilitation Measures

Summary of Nonreimbursable Financing for FTAA Negotiations:

- Support Working Groups–FTAA Denver 1995 US\$150,000
- Denver Groups – Free Trade – Phase II 1996 US\$750,000
- Free Trade Area of the Americas (FTAA) 1996 US\$150,000
- Governmental Purchases Task Force 1997 US\$149,000
- Free Trade Area of the Americas (FTAA) 1997 US\$500,000
- Support for Publishing Reports in Portuguese 1997 US\$148,000
- Support Pro-Tempore Secretariat FTAA 1997 US\$98,000
- Support Tripartite Committee in FTAA 1998 US\$650,000
- Support to the FTAA Secretariat – Miami 1999 US\$3,000,000
- FTAA Negotiations 2000 US\$650,000
- Support to the FTAA Secretariat – Panama 2000 US\$3,000,000
- FTAA Negotiations Support 2001 US\$750,000
- Technical Support to the FTAA Negotiations 2002 US\$500,000
- Support to the FTAA Secretariat – Mexico 2002 US\$3,000,000

2. Country Programming and Consultative Group Meetings

The Bank has led an active program in the Central American Isthmus of country programming, national policy and program consultative meetings (“encerronas”), since it was given leadership in the organization of the consultative group meetings in the region in 1995. The national consultative group meetings held since that date for El Salvador, Guatemala, Honduras, and Nicaragua as well as the regional consultative group meetings are listed in Box 6. The national consultative meetings and IDB country programming have resulted in the preparation of numerous national loans and technical cooperation projects that responded to national goals including regional integration. By way of example, as will be seen in the following section of this report, the Bank has recently approved several country-specific loans for trade promotion and for competitiveness programs in Central America that contribute to the investment environment and prepare the private sector for the coming free trade agreements.

In sum, the Bank’s effectiveness in supporting Central American integration has increased with each successive regional programming exercise, and the growing interrelationship between regional programming and domestic integration and trade programs has reinforced the Bank’s capacity to take a hand in this multidimensional agenda.

B. IDB Financing for Regional Integration and Cooperation

1. Strengthening Integration Institutions in the Central American Isthmus: Unfinished Business

During the Eleventh Summit of Central American Presidents in 1991, an ambitious restructuring of the integration system was approved, this time including Panama as a full member and keeping open the possibility of incorporating Belize.

However, the regional institutional framework, redesigned in 1991 (with the Tegucigalpa Protocol, which created the SICA) and in 1993 (with the Guatemala Protocol, which reformed the regional economic integration system), was in crisis. During the Sixteenth Summit of Central American Presidents, held in San Salvador, the leaders, in their Program of Immediate Actions derived from the Declaration of San Salvador II for Investment in Human Capital (30 March 1995), requested that the Economic Commission for Latin America and the Caribbean (ECLAC) and the IDB conduct an evaluation of the operations management of Central American integration agencies and institutions in order to modernize them in an attempt to make their procedures and outcomes more effective and efficient.

In response to that petition, the program in support of strengthening and streamlining the Central American institutional framework (IDB-ECLAC) was prepared and carried out between July 1996 and July 1997.⁵ The main outcome of the program was the proposal

⁵ The documents were subsequently published in book form: The Economic Commission for Latin America and the Caribbean and the Inter-American Development Bank, *La integración centroamericana y*

for strengthening and streamlining the Central American regional framework, drafted by a group of high-level representatives appointed by the Presidents of Guatemala, Honduras, El Salvador, Nicaragua, Costa Rica, and Panama, based on research, consultations, and suggestions by the ECLAC-IDB team. The proposal was submitted to the presidents for their consideration during their Nineteenth Summit held in Panama City on 12 July 1997. The Presidents adopted their decisions with respect to the proposal in the Declaration of Panama II and in the Guidelines for strengthening and streamlining the regional institutional framework.⁶

The high-level representatives' proposal contained three key objectives: (i) to bring regional agencies, forums, and mechanisms closer together and enhance their efficiency and effectiveness; (ii) to ensure that each country's authorities and society exercise adequate oversight of regional agencies' activities; and (iii) to reduce the costs that those agencies represent for governments' budgets in each country and to appropriately distribute resources among them.

The proposal sought a “focal point for integration” that would perform the “community function,” balancing it with “intergovernmental negotiation on behalf of national interests.”⁷

In both of the Summit documents, the Presidents accepted many of the studies' findings and recommendations.

Nevertheless, little progress has been made in reforming the regional institutional framework since the 1997 Panama Summit, partly because the primary changes require treaties to be amended, which is a slow process in and of itself, partly because resource issues persist, and partly simply because the needed changes take time and require the building of political consensus. Specifically, a single, unified General Secretariat was never established (SIECA did not become a part of the SICA General Secretariat, nor was it moved to San Salvador).

One of the main challenges of Central American integration continues to be institutional development. Despite the fact that it apparently enjoyed political support at the highest level, the implementation of the 1997 reform met opposition from stakeholders who did not want change. The viability of centrally locating the secretariats is being diminished by the difficulties in reaching consensus, which are compounded by the lack of agreement between foreign ministers and economy ministers with respect to who should lead regional integration.

The Bank gleaned several lessons from the 1997 reform for its support of Central American integration. First, serious reflection must still take place on how integration was handled and on the relationship between the ministers' forums and their respective secretariats. Second, institutional weaknesses still persist when it comes to making decisions about the implementation of regional integration projects, because no focal

la institucionalidad regional [Central American Integration and the Regional Institutional Framework]. Mexico City, Mexico, Comunicación Gráfica y Representaciones P.J., S.A. de C.V., 1998.

⁶ These documents can be found in the ECLAC/IDB book cited.

⁷ Ibid., pp. 121-122.

point for integration has been created to reconcile the community function with intergovernmental negotiations on behalf of national interests. And third, institutions have still not put their financial house in order or succeeded in strengthening their institutional capacity.

For its part, the Puebla-Panama Plan acknowledged this reality and opted for an institutional solution that partially responded to the need to adopt an intergovernmental policy decision-making mechanism for implementing regional projects at the same time as it sought to strengthen regional entities.

Faring better than attempts to streamline the institutional structure of integration have been institutional strengthening programs involving technical cooperation, which have succeeded in fostering significant changes in specific institutions. Some of these programs are mentioned in the following boxes:

Box 9

Selected Programs with the Main Central American Integration Institutions

SICA: Support for the SICA General Secretariat, Technical cooperation ATN/SF-6920-RG, US\$150,000 grant (2000).

This technical cooperation project is directly tied to the strengthening of the capacity of the SICA General Secretariat to prepare a bank of regional projects that were presented to international donors at the Regional Consultative Meeting in Madrid, 2001. This was in response to the infrastructure, economic, and social demands placed on the countries after Hurricane Mitch and to expand the regional agenda for reconstruction and economic and social transformation.

CABEI: Institutional Support for the Central American Bank for Economic Integration and Multisectoral Credit Program, US\$100 million loan 1011/OC-RG-2 (1997).

This program was designed to assist the Central American Bank for Economic Integration to obtain an improved Standard and Poor's classification and provide credit for financing private-sector operations in the region. The strengthening of the financial structure of CABEI was tied to the debt renegotiations with Nicaragua, the implementation of the institutional strengthening component, and the achievement of internal financial goals.

Central American Monetary Council: Program for Harmonization of Public Debt Markets in Central America and Panama ATN/MT-7357-RG, MIF US\$600,000 grant (2001).

The executing agency, the Central American Monetary Council, coordinates the Central Banks in Central America and received assistance from the Multilateral Investment Fund (MIF) to deepen regional capital markets. The program has assisted in expanding and integrating the regional capital market through the identification and definition of major problems that limit the development of a secondary market. Problems in organizing the secondary market that were identified in the program included the lack of standardization of debt instruments, administrative weakness of the intermediaries, and weakness in the settlement system.

Box 10

Supporting Regional Cooperation

Regional. Program for Disaster Mitigation in Central America. Technical Cooperation ATN/JF-6552-RG US\$1.1 million grant from the Japan Fund and US\$300,000 grant from the World Bank (1999).

CEPREDENAC (Coordination Center for Natural Disaster Prevention in Central America) is the regional agency responsible for promoting, coordinating, and orienting regional and national policies for the reduction of risks associated with natural hazards. The region had been impacted by Hurricane Mitch and the operation took on special relevance in increasing cooperation and awareness of the needs of the region to mitigate the impact of disasters in the future by active policies and programs to reduce the main risks. The program complements the new sense of urgency for developing a culture of risk management and protection against natural hazards (drought, windstorms, flooding, and earthquakes) in the Central American Isthmus.

Regional. Strengthening Central America's System of Environmental Laws. Technical Cooperation ATN/SF-5016-RG, US\$240,000 grant and ATN/NE-5016-RG, US\$175,300 grant from Environmental Technical Cooperation Trust Fund (1995).

This program represented an early recognition by the IDB and the Isthmus countries that environmental regulation and management were fundamental long-term issues in the region. The environment became a negotiating issue for FTAA and CAFTA, as well as a major agenda item for Mesoamerican development envisaged in the Puebla-Panama Plan program. This program was concurrent with the creation of ALIDES, the Alliance for Sustainable Development in Central America, in 1994 and provided assistance to CCAD, the Central American Commission for Environment and Development, to evaluate environmental laws and recommend a set of common legal proposals for revising environmental laws, especially those approved in many countries in the mid-1990s.

Regional. New Agenda for Central America. Technical Cooperation, US\$149,000 grant ATN/SF-7003-RG (2000).

Further to the Madrid Regional Consultative Meeting, the IDB provided assistance to the Commission to Formulate a New Agenda for Central America, or the "Comision Nueva Centroamerica," representing civil society and the private sector. The purpose of the Commission was to identify key priority regional projects from their perspective and to participate in the Madrid RCG meeting. Initially the NGOs gave priority to regional infrastructure, especially electric power distribution through SIEPAC and the development of the Central American Logistical Corridor. These proposals became key elements of the agenda of the Puebla-Panama Plan and evidenced strong private-sector support for the investments.

2. Creating Conditions for Increased Trade

As part of its strategy for opening up its markets, Central America is participating in the multiple bilateral trade negotiations as mentioned earlier, in addition to the FTAA and negotiations in the framework of the World Trade Organization (WTO). These concurrent negotiations have brought about a need for institutional strengthening in trade capacity, in terms of handling the negotiations as well as implementing trade agreements and preparing for freer trade.

The Bank has supported this process through a training program undertaken together with the WTO, the CABEI, and Institute for Latin American Integration (INTAL). Also worth noting in this context, for its innovativeness, is the Trade Negotiations Information System project. Not only has the system developed under this project proved highly useful to the region, because it is an interactive information system that is helpful to

governments as well as the private sector and academia, but the system design has also served as a model for the Hemispheric Database established in the framework of the FTAA.

Box 11

SIECA: Program to Support the Establishment of a Central American Information Network and Technical Support for Trade and the Liberalization of Trade in Services. Technical Cooperation, US\$750,000 grant ATN/SF-5462-RG (1996).

The program has helped develop an information system on trade in Central America, tying together the databases of the ministries of economy and trade, a common regional information network, and giving public access to trade data and studies.

A set of projects with a major impact on regional trade was incorporated into the Puebla-Panama Plan as part of the Trade Facilitation Initiative. This Initiative has aimed to address institutional and nontariff barriers that hinder reciprocal trade between the Mesoamerican economies. These projects have gone hand in hand with the Transportation Integration Initiative, through which road integration projects such as the Pacific Corridor, as well as the Atlantic and complementary corridors, have been financed.

Box 12

Programs for Reducing Obstacles to International and Intra-regional Trade

Regional. SIECA: Modernization of Customs and Border Crossings. Technical Cooperation ATN/MT-8206-RG US\$2,015,000 MIF grant (2002).

This program is helping the seven Isthmus member countries of the Puebla-Panama Plan to prepare and institute simplified, standardized, and flexible customs control procedures and information systems for trade in goods among countries. The program especially benefits small- and medium-sized enterprises that find the cost of trade transactions and transit to be a disincentive to trade in the region. SIECA is responsible for the implementation of the Customs Union among the Isthmus countries and for organizing the program.

Regional. CIAT: Customs Measures for Facilitating International Business in Latin America and the Caribbean. Technical Cooperation. MIF grant ATN/MT-7080 US\$3 million (2000).

CIAT, the Inter-American Center for Tax Administration, provides assistance to countries through this program to implement eight measures to improve customs procedures agreed among the countries in the context of the negotiation for the FTAA. These measures are as follows: the temporary importation of trade merchandise by business travelers; the urgent clearance of goods by couriers; simplified procedures for low-value goods; the equipping of customs houses with modern computer systems; utilization of the same versions of coding and commodity descriptions; supply of information on customs procedures; application of uniform codes of conduct for customs officials; and introduction of risk management methods to establish priorities for customs monitoring and verification. This Latin American-wide program is of considerable utility to Central America because of the experience obtained and its applicability to the customs requirements of the region.

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Regional: RIOPPAH, Regional International Organization for Plant Protection and Animal Health: Agricultural Trade through Harmonized Application of Sanitary and Phytosanitary Measures in the Region. Technical Cooperation ATN-MT-7957-RG US\$1.5 million MIF grant (2002).

One of the key elements in facilitating regional trade and the participation in free trade areas is to have coordinated and consistently applied sanitary and phytosanitary procedures and regulations. While such regulations and procedures have been used as barriers to trade, the consistent application of sanitary and phytosanitary measures is now an essential element for the Central American Isthmus to engage in exports and to meet international standards for food safety within the region in the context of CAFTA, the WTO, and the regional customs union. This program benefits small and medium enterprises, agricultural producers and exporters, and public agencies responsible for the administration of this regulatory environment. The regional harmonization component will assist with a standardized, regional legislation, procedures, documents, and certification, and a regional information system and regional manuals.

Negotiations for a free trade agreement between Central America and the United States commenced in March 2003. It is the first agreement to be negotiated between countries with such contrasting levels of development and relative size. The impact on the small countries will hence be great, especially given the potential invigoration of their economies.

In acknowledgment of the asymmetry between the participating economies, a cooperation program was incorporated as an integral part of the negotiations. This is a three-part program that includes: assistance in preparing for negotiations, support for implementation of the agreement, and support for the transition to free trade.

The governments have been working continuously on this comprehensive program with the support of the Tripartite Committee, which is formed by ECLAC, the Organization of American States (OAS), and the IDB. The governments have formulated national action plans that constitute real strategies for meeting the challenges of CAFTA. These action plans are public documents.⁸

During the formulation of these plans, innovative methodologies were developed to include themes and issues common to all the countries, which each country could then adopt depending on its institution-strengthening needs. These methodologies are already beginning to have an impact outside the region; their use is being considered for defining the characteristics of the Hemispheric Cooperation Program accompanying the FTAA negotiations.

The objective of the cooperation program under CAFTA is to help countries reduce the costs of adjusting to trade liberalization and take advantage of its benefits by: (i) boosting their capacity to prepare their market access offers based on an awareness of the vulnerable sectors that will require longer transition periods and what sectors in the target market are of interest owing to their own producers' current or potential competitiveness, providing organizational and logistical support for the negotiations themselves, and strengthening the mechanisms for consultation with civil society; (ii) providing assistance for institutional development leading to the effective implementation of regulations

⁸ See <http://www.iadb.org/INT>.

arising from the agreement; and (iii) providing support for the transition by improving the business climate; developing science and technology programs applied to exports; restructuring vulnerable sectors with an emphasis on small and medium-sized enterprises; rural development; and strengthening their capacity for export promotion and for attracting investment, among other capacities.

At the request of the Trade Ministers, under the aegis of the Tripartite Committee, the Bank has been coordinating the efforts of multilateral donors so that countries' requests can be addressed quickly and in a coordinated fashion. Coordination group meetings were held parallel to the CAFTA negotiating rounds; once the negotiations concluded, a permanent cooperation group was established.

Based on requests from the governments, the Bank has provided support in various areas, e.g. providing technical tools to help them prepare their negotiating positions in the areas of market access and rules of origin; supporting the countries in preparing their requests for international cooperation; and providing training seminars and courses for negotiators, among other activities.

The cooperation and lending instruments available to Central America (and to all of Latin America and the Caribbean as well) include: (i) preinvestment funds to support the preparations and logistics for the negotiations, as well as the processes and mechanisms for consultation with the private sector and civil society; (ii) loans from the special trade facility, with fast-track approval, specifically created by the Bank to support trade negotiation processes; (iii) both regional and national nonreimbursable technical cooperation for the relatively lesser developed countries, which, owing to the scarcity of resources, are used to fund truly relevant activities that cannot be financed with other instruments; (iv) the Multilateral Investment Fund, which provides grants in support of private-sector activities and has made trade facilitation one of its top priorities; and (v) hybrid loans, to which major innovations are being introduced to make them effective instruments for ensuring that the countries have the support they need in implementing the agreement, and for easing the adjustment and transition to free trade.

The following box contains several illustrative examples of these types of instruments:

Box 13
**IDB Country Sector Loan Programs for Facilitating International
and Regional Trade**

Guatemala. Program to Support Foreign Trade. Loan 1318/OC-GU, US\$5 million (2001).

This is the first program that the IDB approved under its Trade Sector Facility, a rapid approval operation keyed to improving the capacity of the Ministry of Economy, Vice Ministry of Integration and Foreign Trade (VMCE), to lead in trade negotiations and administration of trade agreements. The program has three main components: strengthening of the technical capacity of the VMCE; strengthening intergovernmental coordination mechanisms and consultation mechanisms with the private sector; and increasing the negotiating capacity in the area of foreign trade. The four-year program is assisting Guatemala to participate in trade agreement negotiations of the FTAA and CAFTA, administer existing and new agreements, and strengthen trade promotion activities.

Belize. Capacity Building for Trade and Investment Promotion. MIF grant ATN/MT-8047-BL, US\$490,000 (2002).

Beltrade, the Belize Trade and Investment Development Service established in 2000, is being assisted to implement an export promotion plan and to execute an investment attraction program. Medium- and small-sized enterprises are benefited by helping them identify international markets and investment partners. The Belizean economy depends on exports of banana, citrus, and sugar and needs to prepare for changes in its export markets and the end of preferential access to the U.S. and EU markets through promoting diversification. The export promotion program will help identify specific products and markets that represent new opportunities and special attractive niches for Belizean products. The investment attraction plan will assist national and international partners by creating an improved investment image and highlight the opportunities for investing in Belize, and special product lines for future investment and export.

Nicaragua. Strengthening Foreign Trade Management. Loan 1117/SF-NI, US\$5 million (2002).

This loan represented a further step in the continuity and development of IDB trade promotion operations by incorporating trade negotiation and agreement administration, trade promotion, and a significant national information and consultation mechanism, all within a single operation. The Ministry of Development, Industry, and Commerce (MIFIC) receives assistance in its role of negotiating trade agreements, especially CAFTA and the FTAA, and administering existing agreements in Central America and with other bilateral partners. The export promotion component of the loan helps in preparing and implementing a National Plan for Export Promotion to identify product opportunities and market information for the most likely product candidates for export. CETREX administers the one-stop-shop “Ventanilla Unica de Exportaciones” (VUE), a single service point to process export documents. A package of extensive training and public information accompanies the program.

Honduras. Program to Promote Business Competitiveness and Strengthen Foreign Trade Management. Loan 1125/SF-HO, US\$10 million (2003).

In this program, assistance for foreign trade management and competitiveness is unified in a single loan operation. The foreign trade program follows similar lines of support that were requested by Guatemala and Nicaragua, including increasing the government’s capacity to negotiate and administer trade agreements and to promote exports by helping the private sector identify new product opportunities and supply assistance to national and international companies and partners seeking to expand trade in competitive product lines. The competitiveness subprogram (US\$5.4 million) helps to define a National Competitiveness Strategy.

3. Competitiveness

Support for competitiveness is a key issue for Central American countries if they are to take advantage of the benefits and manage the challenges posed by their trade liberalization strategy. The Bank has very actively supported national competitiveness programs, as shown below:

Box 14 **National Competitiveness Support**

Competitiveness Loans. The long-term success or failure of the trade and cooperative agreements and the benefits obtained by each country from their access to free trade areas depends to an important degree on the competitiveness of the national economy and the international business enterprises. The IDB has taken a strong interest in providing substantial assistance to the countries to increase competitiveness and to create an environment for increased competitiveness of the private sector in the Isthmus.

The IDB approved a **Competitiveness Support Loan** for El Salvador (1492/OC-ES, 2003), with total financing of US\$100 million, for rapid disbursement tied to reforms in the maritime and air transportation sectors, improving vocational education and training and technological development and innovation. This program will improve the regulatory and monitoring environment, enhance the investment climate, and modernize the labor training programs supported by government-supervised and administered systems.

In the case of Honduras a US\$5.4 million component of the **Program to Promote Business Competitiveness and Strengthen Foreign Trade Management** (loan 1125/SF-HO, 2003) will help Honduras execute a National Competitiveness Plan, support an active dialogue among government, business, labor and civil society to promote competitiveness awareness, and set up a Competitiveness Fund that will finance promotion and preinvestment and technology transfer activities in key sectors, especially agroindustry and the forest sector.

For Panama, the Bank approved the **Program to Foster Competitiveness** (loan 1410/OC-PN, 2002) for US\$7 million, for a program that will incorporate assisting with a national consensus on competitiveness policies and the creation of an institutional capacity to further a competitiveness culture. A National Competitiveness Strategy will be prepared and a Competitiveness Fund created to use matching grants to assist the private sector to identify and promote new investment and trade opportunities.

A central component of the new integration strategy adopted in the early 1990s was to open up trade with outside markets, both by unilaterally reducing external tariffs and by participating in WTO negotiations and a series of bilateral trade negotiations. This has posed a challenge in terms of competitiveness, one that the countries have addressed with Bank support through national competitiveness programs and investment in infrastructure. For instance, the SIEPAC project [see section 4 (a) below] has been innovative in that it has created an integrated electric power market that will allow for more efficient production and investment decisions, thereby demonstrating integration's potential for boosting the competitiveness of the entire region by lowering the cost of a strategic input.

Box 15

Increasing Private Sector Competitiveness

Regional. Business Advisory Services for Small Rural Producers. MIF grant ATN/ME-7724-RG, US\$495,850 (2001).

This program draws on the experience of EARTH (Agricultural School for the Humid Tropical Region) to provide small business training to rural producers in Central America, especially those following environmentally sound practices. EARTH has set up the Center for Business Training (CFE) that is expanding its scope of coverage to other organizations in Central America having common interests, and that can utilize existing experiences. The CFE specializes in providing training, counseling, and market information services. These services are geared towards small and medium entrepreneurs seeking to improve their competitiveness. The program has two major areas of support. The first is the development of information services and the second is to improve the skills of small producers. It is expected that more than 1,000 small rural producers will benefit from this program in several Central American countries.

Training. System for Demand and Supply of Training Services for Mesoamerica (SIDCAM). MIF grant ATN/MH-7952-RG, US\$1.4 million (2002).

This Central America labor market program will establish an internet-based information system to bring together the demands of the private sector for labor training programs and the private- and public-sector suppliers of labor training services. The program recognizes the fragmented and undeveloped scope of labor training in Central America, where suppliers are not well informed of the demands of the private sector or their services are not always well attuned to the market. The program will promote investment in demand-oriented modern labor training programs. The program is executed by SIECA and incorporates a consultative mechanism between the private sector and SIECA to design a strategy for the program. The information system is developed with input from the buyers of services and the suppliers.

Training. Learning Through Business Alliances. MIF grant, US\$5 million; ATN/ME-8291-RG, US\$5 million INCAE co-financing, and US\$3.4 million contribution from NGOs (2003).

Small and medium-sized businesses make up the greatest share of enterprises in the Central American Isthmus, hence overall competitiveness is not likely to increase in the region without first providing support and incentives to this important business segment. This regional program is to be executed by INCAE, the highly respected regional business education, training, and research center, an institution that has taken the lead in the analysis and promotion of competitiveness in the region through its Latin American Center for Competitiveness and Development (CLACDS). The program will incorporate a fund for financing associations of small and medium-sized enterprises having at least 10 members in each grouping, and it is expected that approximately 800 firms will be benefited by the program in all seven countries through the financing of at least 32 projects over a three-year period. An Investment Stimulus Fund of US\$8 million will be established with MIF and INCAE financing in key sectors such as tourism, textiles, and agroindustry. An extension structure of coordinating institutions will be set up to manage the activities, collect and evaluate proposals, and undertake training.

Accreditation. Reducing Technical Barriers to Trade by Strengthening Accreditation Systems. MIF grant ATN/MT-8225-RG, US\$495,000 (2003).

A key element is added to trade opportunities in the Puebla-Panama Plan area with the participation of Costa Rica and the Mexican Accreditation Agency (EMA) as the executing agency. Conformity assessment entities such as laboratories and certification bodies will test, inspect, verify, certify, and approve products and processes. It is essential that these assessment entities are internationally recognized and accepted by the trading community and through a process of reliable certification of the entities. Therefore, this program extends the capacity to national institutions to act as internationally

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accepted accreditors of assessment agencies. By working with the IAAC, the Inter-American Accreditation Cooperation, it is expected that four national accreditation bodies will be given international recognition.

Coffee. Support for the Competitive Position of Central American Coffees. MIF grant ATN/ME-8292-RG, US\$3 million (2003).

This competitiveness operation is designed to assist the Central American coffee producers to increase the quality differentiation of their product, improve quality and quality control starting at the farm level, and create greater access of the product to higher prices in a quality coffee market. This program responds to a deep crisis in coffee prices since 2001. The program has strong common cooperative elements for the countries because of the interest of the coffee industry processors to establish a stable supply of high-quality coffee in the future, given the importance of coffee production for rural income and employment.

Mundo Maya. (Mundo Maya Organization in Belize, El Salvador, Guatemala, Honduras, and Mexico). **Mundo Maya Sustainable Development Program.** Technical cooperation grants ATN/SF-6782-RG, US\$500,000 and ATN/JF-6782-RG from the Japan Fund, US\$791,600, as well cofinancing from Norway and Sweden, US\$192,500 (1999).

This program is designed to contribute to local and regional development through the encouragement of ecotourism. The countries participating in Mundo Maya created the Mundo Maya Organization in 1992. Subsequently, it was decided to create a Permanent Technical Secretariat to be located in INGUAT, the Guatemalan Tourism Institute, for the purpose of preparing an investment program. This technical cooperation program has financed the establishment of the Secretariat and the preparation of the Investment Plan and is one of the current initiatives of the PPP. The Investment Plan totals US\$150 million in the five countries for a total of 10 locations for the restoration of archeological sites, the implementation of associated infrastructure, environmental protection, and participation of local communities.

4. The Puebla-Panama Plan (PPP): A New Spirit of Cooperation

The Puebla-Panama Plan was established as a flexible, new, agile mechanism to promote regional integration in the Mesoamerican region of southern Mexico and the Central American Isthmus. It was the byproduct of the strengthening of relations between Mexico and the Isthmus and the active cooperation of countries, regional institutions, and the international community. The PPP is an umbrella mechanism that incorporates programs that directly support regional economic integration and cooperation and has become an effective operational mechanism for regional cooperation and investment.

The regional economic integration process had been deepening in Central America in many ways during the 1990s, and the region is responding to multi-tier trade negotiations in the Hemisphere by seeking diverse, alternative trade arrangements with its main trading partners and potential new markets in the region, including Mexico.

The Puebla-Panama Plan has its origins in the Meeting of the Heads of State of Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Mexico held in the Mexican city of Tuxtla Gutierrez in January 1991 ("Tuxtla I"). There the Tuxtla Mechanism was created as a forum for political exchange and ongoing cooperation among the seven countries of Central America (including Panama and Belize). The following year, in July 1992, the Government of Mexico acceded to the Charter of the Central American Bank

for Economic Integration and its Protocol of Reforms (in effect since October of that year).

At the Fourth Summit, held in August 2000 in Guatemala City, the Heads of State and Government of the member countries of the Tuxtla Mechanism for Dialogue and Cooperation issued a new joint declaration and adopted the Mexico-Central America Regional Cooperation Program, or Mesoamerican Cooperation Program 2001-2002, including six priority areas, among others: (i) education and culture, (ii) environment, (iii) health, (iv) tourism, (v) agriculture and livestock, and (vi) disaster prevention and response. The bulk of this cooperation takes place within the framework of the San José Accord, by means of which Mexico makes available to the countries of Central America, under concessionary conditions, a portion of the resources it receives from the sale of oil to Central America.

On 30 November 2000, President-elect Vicente Fox proposed the Puebla-Panama Plan within the framework of the Tuxtla Mechanism. The Plan advanced the broader concept of a Mesoamerican region, and proposed that three dimensions of Mesoamerican interests be addressed concurrently and as a whole: (i) economic growth and the distribution of its benefits, (ii) sustainable management of natural resources, and (iii) social and human development.

On 15 June 2001, the leaders of Mexico and the seven Central American countries met in San Salvador in a special session of the Tuxtla Mechanism, with the aim of putting the Puebla-Panama Plan into action as an instrument to drive regional development and integration and to deepen and strengthen political understanding and international cooperation.⁹

The overall aim of the Puebla-Panama Plan is “to enhance the human and ecological wealth of the Mesoamerican region within a framework of sustainable development that respects cultural diversity.”¹⁰ Geographically, it encompasses the seven Central American countries plus the states in south-southeast Mexico: Campeche, Chiapas, Guerrero, Oaxaca, Puebla, Quintana Roo, Tabasco, Veracruz, and Yucatan. The conceptual basis for proposing that these seven countries and the nine Mexican states join efforts lies partly in their sharing similar economic and social indicators.

Preparation of the Puebla-Panama Plan began with identifying commonalities between the Regional Proposal for the Transformation and Modernization of Central America in the 21st Century and the Mexican chapter of the Plan, under the coordination of the newly created Interinstitutional Technical Group (ITG), consisting of the IDB, CABEL, and ECLAC. With support from INCAE, the ITG reviewed the projects selected for the plan, consulted with the governments and with SICA, UN, and the World Bank, and formulated an initial proposal, which was submitted to the PPP Commissioners

⁹ Special Summit of the Member Countries of the Tuxtla Mechanism for Dialogue and Cooperation. San Salvador, 15 June 2001. Joint Declaration.

¹⁰ Interinstitutional Technical Group for the Puebla-Panama Plan (CABEL-IDB-ECLAC, with support from INCAE), *Puebla-Panama Plan: Mesoamerican Initiatives and Projects*. San Salvador, 15 June 2001.

(appointed by the respective presidents and heads of government). The end result was the development of eight initiatives, each one with its respective projects. That this was modeled on the Program for the Modernization and Transformation of Central America was evident.¹¹

Box 16 **The PPP's Mesoamerican Initiatives**

- **Mesoamerican Initiative for Sustainable Development**
Objective: Promote the conservation and sustainable management of natural resources and participative mechanisms, particularly in local communities, in the area of environmental management.
- **Mesoamerican Initiative for Human Development**
Objective: Reduce poverty, facilitate access by vulnerable population groups to basic social services, and contribute to the fullest possible development of Mesoamerican peoples.
- **Mesoamerican Initiative for the Prevention and Mitigation of Natural Disasters**
Objective: Promote the prevention and mitigation of natural disasters and include a consideration of risk management in projects implemented in all sectors.
- **Mesoamerican Tourism Initiative**
Objective: Promote the development of ecological, cultural and historical tourism by means of regional actions focusing on complementarity, economies of scale and the productive linkages of tourism.
- **Mesoamerican Initiative for the Facilitation of Trade**
Objective: Promote trade in the region through a reduction of transaction costs in trade between countries, and promote the participation of small and medium-sized enterprises in regional exports.
- **Mesoamerican Transportation Initiative**
Objective: Promote the physical integration of the region with a view toward facilitating the passage of people and goods and, in so doing, reduce transportation costs.
- **Mesoamerican Initiative for Energy Interconnection**
Objective: Unify and interconnect electricity markets with a view toward promoting an increase in investments in the sector and a reduction in electricity costs.
- **Mesoamerican Initiative for Integrating Telecommunications Services**
Objective: Develop the infrastructure for informatics interconnectivity in the region.

The eight principal initiatives and the objectives of each category are indicated in Box 16 and the detailed tentative list of some 32 projects under each initiative which have been identified to date are included in Annex IV. The program represents an active agenda and a challenge to the countries and the international community to finance a full range of long-term investments for the regional economic and social integration of the area. Clearly, the program is not solely an investment program, but is made up of investments coupled with a dynamic process of consultation with civil society, the private sector, and

¹¹ Agreement on the first set of projects, on 8 June 2001, was preceded by two presentations and a wide-ranging discussion with the Presidential Commissioners on 30 and 31 May of that same year. See Ennio Rodríguez (Adjunct Coordinator of the PPP Support Team), *The Puebla-Panama Plan: A Political Mechanism for Coordinating Joint Actions*. Washington, DC, Inter-American Development Bank, 25 September 2002. Preliminary version. Page 5.

indigenous communities in Mesoamerica to ensure wide acceptance, consistency, and political leadership in the region.

The PPP has become a guiding mechanism for cooperation among the countries and for coordinating the search for international assistance for priority regional integration investments. It is also adding to the climate for private investment in sectors such as energy that until the 1990s were under the sole purview of the public sector in Central America.

The PPP is organized along the lines of a structure that builds on the successful regional decision-making process of the Isthmus during the 1990s, placing the Heads of State at the immediate front of the process, installing leadership in key committees reporting to the Heads of State, with an Executive Committee of Presidential Commissioners, each leading one of the individual initiatives. Current information on the status of the program can be found on the IDB's website (www.iadb.org/ppp).

The ITG mentioned earlier, which was also formed at the San Salvador Summit, works with Central American integration agencies by providing technical support to both the Executive Committee and the Technical Committees. Currently participating in the ITG are CABEL, the IDB, the Andean Development Corporation (CAF), ECLAC, the Food and Agriculture Organization (FAO), the Inter-American Institute for Cooperation on Agriculture (IICA), SIECA, INCAE, and the UNDP. CABEL, the IDB, and ECLAC are responsible for coordinating the ITG.

The San Salvador Summit also led to the creation of the PPP Commission on Financing and Promotion, chaired by the President of the IDB, which has had remarkable success in securing financing for the projects approved by the Executive Committee. This Committee is composed of the Presidential Commissioners and the Finance Ministers. Multilateral and bilateral donors active in the Mesoamerican region also attend its meetings.

While the Puebla-Panama Plan is showing visible progress in strategic projects, perhaps its greatest success is of a political nature: the consolidation of a decision-making framework within the Tuxtla Mechanism, including the creation of the Executive Committee, the PPP Commission on Financing and Promotion, and the Interinstitutional Technical Group. This has enabled the Mesoamerican countries to promote regional projects that in the past seemed impossible to convert into reality.

The PPP covers the full range of regional integration support for Mesoamerica under the eight Initiatives identified and the current active list of programs and projects. The following are two of the principal examples of the Initiatives, covering the areas of regional electric power and the integration road network.

a. Central American Electric Interconnection System (SIEPAC)

This important regional program began to evolve during the 1990s in the Isthmus as the demand for electricity grew and the cost of additional self-sufficient production capacity

in small country markets become more costly. Clear benefits became evident to the countries from creating an integrated electric power production and distribution system through a regional market to take advantage of surplus generation in countries and to lower costs through economies of scale on the production side. Also, countries were reorganizing the electric sector, diversifying ownership, changing the mix of production systems and sources and introducing private investment and a new competitive environment with modern regulatory structures.

The Presidents of Central America agreed on the initiation of a process of creating SIEPAC in December 1995. A treaty, the Central American Electricity Market Framework Treaty, was signed in December 1996, and by 1999 had been fully ratified by all six participating countries.

The treaty led to the creation of the regional Electric Interconnection Commission (CRIE), as regulator of the electricity market and the Regional Operator (EOR) that is responsible for the technical operation and administration of the commercial aspects of the regional market. The CRIE is the highest authority in the regional electrical market. Both entities were created in 2001. The EPL, or line proprietor, created in 1999 and owned by the countries (and which is in the process of incorporating ENDESA, the Spanish electric power company), will build and operate the first regional transmission system called the SIEPAC Line. Studies have shown the viability of a system of 230 kV with a length of 1,830 km at an estimated cost of US\$320 million. The exchange capacity between two countries would be 300 MW. The EOR will operate the system of the Regional Electricity Market (REM) under detailed rules set out by CRIE.

In 1996 the Bank approved three technical cooperation grants¹² totaling US\$1.5 million for the preparation of the basic studies leading to the formulation of a loan proposal for the development of the regional electric power market.

In 1997, the Bank approved a US\$170 million loan for construction of the SIEPAC line (subsequently reformulated into six individual, country-specific loans¹³ for the same amount as well as a US\$5 million grant (ATN/SF-5502-RG) for the newly created regional power entity Central American Electrification Council (CEAC), and US\$9.9 million in technical cooperation funding¹⁴ for the design of regulatory frameworks, support for the creation of CEAC and EPL, computer facilities for coordinating and managing the integrated system, communications equipment, training, environmental studies and support for the executing agency. Subsequently, in 2002, six loans to the six countries' power companies totaling US\$70 million¹⁵ from the Spanish V Centenario Fund were approved for construction of the SIEPAC line.

¹² ATN/DC-5171-RG (Danish Fund); ATN/SF-5171-SF and ATN/UE-5171-RG (USTDA Evergreen Trust Fund).

¹³ 1370/OC-GU; 1095/SF-HO; 1369/OC-ES; 1096/SF-NI; 1368/OC-CR; and 1371/OC-PN.

¹⁴ 1372/OC-GU; 936/SF-HO; 838/OC-ES; 1017/SF-NI; 796/OC-CR and 1002/OC-RG.

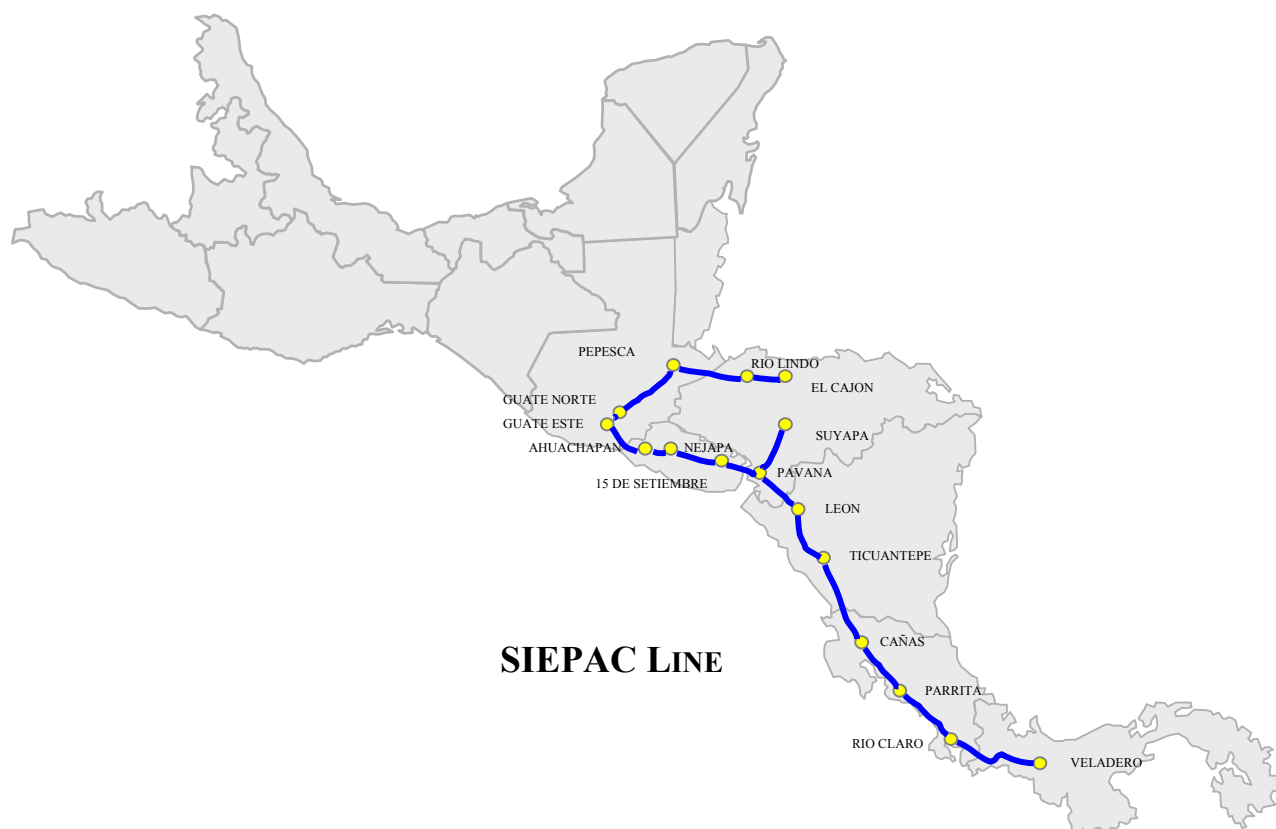
¹⁵ 005/SQ-GU; 007/SQ-HO; 004/SQ-ES; 008/SQ-NI; 003/SQ-CR; and 006/SQ-PN.

Thus the program consists of the creation of a Central American Regional Electricity Market (REM) and the development of a regional transmission system called the SIEPAC Line; with the following benefits:

- Increased competition in a larger market with the addition of more suppliers
- Increased judicial security for investors, risk reduction, and increased sources of funding
- Improved technology with larger scales of operation at a lower cost through development of larger generating plants
- Increased quality of electricity service, with a more robust transmission system with the application of quality criteria
- Taking advantage of the different demand structures of the countries
- Permitting countries to receive assistance during periods of energy rationing
- Creating the potential to integrate the regional system with Mexico (via a connection between Guatemala and Mexico), and
- Increased reliability and confidence in meeting demand requirements

A schematic drawing of the trajectory of the SIEPAC lines is presented on the following page.

The two regional institutions, CRIE and EOR, already have permanent headquarters and start-up staff, and significant progress has been made in creating the regulatory framework. As for construction of the line, environmental and social impact assessments have been carried out for most sections. Some of the next steps to be taken include: (i) completing and approving the regulatory framework; (ii) consolidating CRIE and EOR; (iii) acquiring the rights of way; and (iv) tendering, awarding, and commencing with construction of the works. The SIEPAC line is expected to be operational by the second half of 2007.



SIEPAC LINE

b. International Network of Mesoamerican Highways (RICAM)

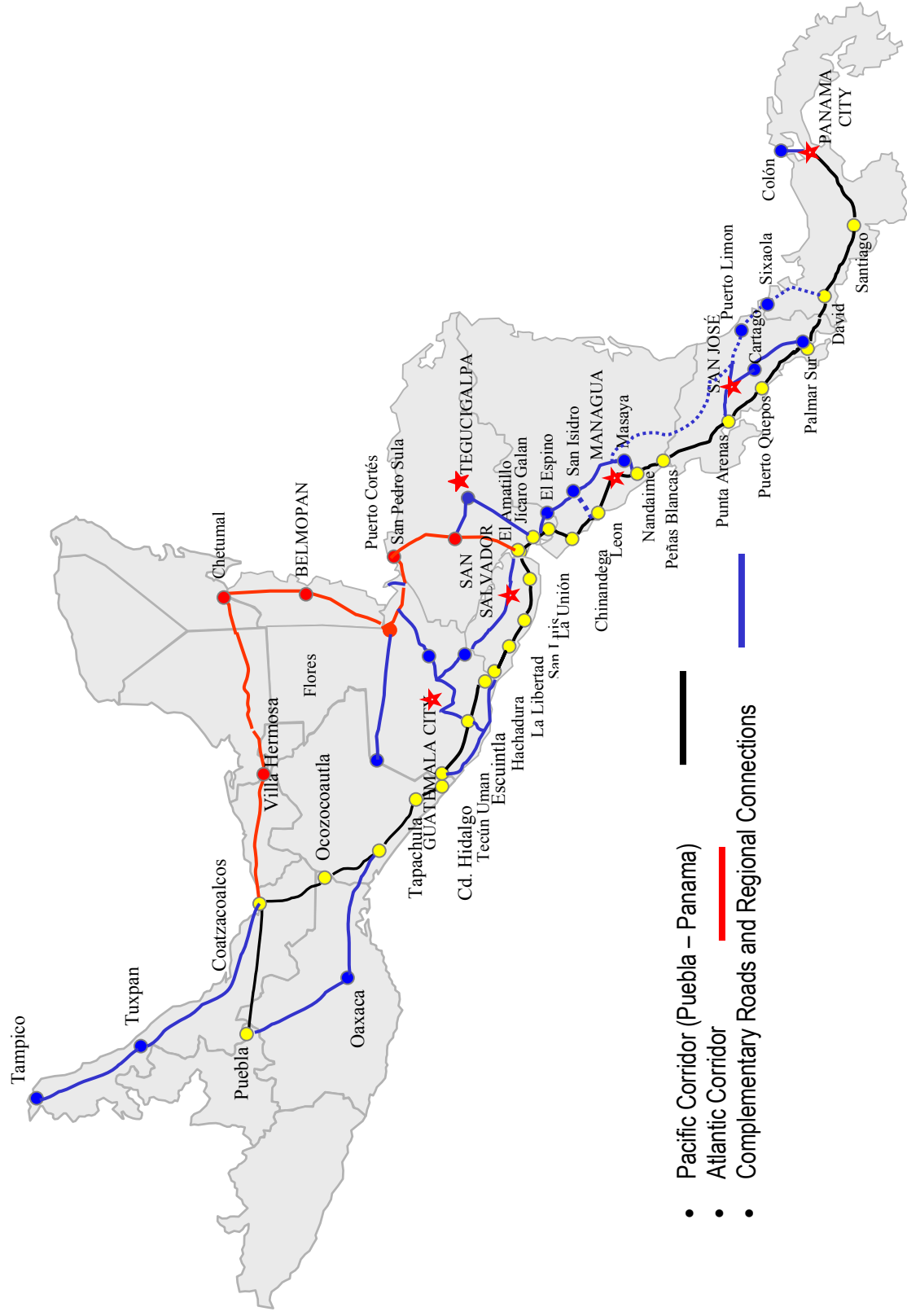
The governments have agreed upon the Mesoamerican Transportation Initiative that has as its objective improvement of the region's internal and external economic linkages by upgrading integration road corridors and harmonizing transport legislation and regulations, thereby reducing transport costs and enhancing the region's competitiveness. These efforts will help overcome existing infrastructure limitations and improve market access. The initiative will be undertaken in a manner consistent with the principles of sustainable development for the Puebla-Panama Plan. The Memorandum of Understanding on the RICAM, signed in June 2002, establishes the legal, institutional, regulatory, and operational framework for execution of the road integration initiative. That document includes the proposal for Mesoamerican highway corridors approved recently by the Ministers of Transport and Public Works of the region and the Presidential Commissioners for the PPP.

The projects included in this Initiative are the following (refer to map on next page):

- The Pacific Corridor (Puebla-Panama)
- The Atlantic Corridor
- Complementary Roads and Regional Connections
- Modernization of Customs and Border Crossings (Trade Facilitation Initiative), and
- Harmonization of Technical Regulations and Standards

Of the total 9,034 kilometers, approximately 3,520 kilometers currently offer satisfactory travel conditions. Improving the remaining 5,514 kilometers will require financing of about US\$3.6 billion. Governments and multilateral and bilateral institutions have financed US\$1.7 billion (47 percent) of works that are now in execution. Financing for the remaining US\$1.9 billion will require a coordinated effort by governments, multilateral entities and bilateral financing agencies, as well as the private sector. The Complementary Roads and Regional Connections Project represents the largest investment, and will require a major effort to attract funding for the projects included in this category.

Given the fiscal constraints and indebtedness of the public sector, it is foreseen that significant private-sector financial participation will be required for approximately US\$1.1 billion. To achieve such participation, countries will have to make an effort to define legal frameworks and regulatory schemes for road concessions. The IDB has contracted an international expert to assess the current status and potential development of road concessions in the region.



To ensure continuity for this work, a Subcommittee on Road Concessions has been created, for the purpose of exchanging views on prior experiences and seeking solutions to common problems facing highway development in the region. In addition, governments will need to make fiscal allocations or seek financing from multilateral financial institutions such as the IDB, CABEL, the World Bank, the Japan Bank for International Cooperation (JBIC), OPEC, CAF, and bilateral financial institutions such as the United States Agency for International Development (USAID), the United Kingdom Development Fund for Latin America (KDF), or the Danish International Development Agency (DANIDA), for approximately US\$800 million.

Harmonization of Technical Regulations and Standards. The objective of this project will be to provide the region with an integrated transport sector that is efficient and competitive, by harmonizing national legislation and regulations governing land transport for passengers and goods, and standardizing technical regulations and specifications for the construction and operation of regional highways. To consolidate the process of harmonizing Central American standards with those of Belize, Mexico, and Panama, technical assistance amounting to some US\$5 million will be required, and some bilateral donors have already shown interest in supporting this project.

III. Conclusions

1. Central America is a region defined by a set of both positive and negative cross-border relationships. At the heart of this region are the five countries belonging to the Central American Common Market (CACM). However, Panama and Belize are participating more and more in the integration process, and are now part of the Central American Integration System (SICA). For its part, Mexico has had a major presence in the region, especially since the San Jose Accord to supply oil to the Central American countries, and then within the framework of the Tuxtla Agreement and the free trade agreements signed with the CACM countries. It is in this context that the Puebla-Panama Plan and its call for Mesoamerican integration were agreed upon.
2. Despite the interrelationships amongst the region's countries, reciprocal trade levels have continued to fall short of their potential. Institutional issues such as inefficient customs procedures and nontariff barriers, along with poor transport infrastructure for integration, have largely been to blame for this situation.
3. A set of projects with a major impact on regional trade was incorporated into the Puebla-Panama Plan as part of the Trade Facilitation Initiative. This Initiative has aimed to address institutional and nontariff barriers that hinder reciprocal trade between the Mesoamerican economies. These projects have gone hand in hand with the Transportation Integration Initiative, through which road integration projects such as the Pacific Corridor, as well as the Atlantic and complementary corridors, have been and will be financed.
4. Generally speaking, integration makes great strides only when the political will exists to deepen the process. In Central America, history has shown that such initiatives have come from the Heads of State, although the private sector and civil society organizations have increasingly become advocates of integration. New possibilities are opening up for the Bank to support integration with its toolkit. The availability of grant resources is therefore essential to promoting decision-making and progress on integration projects.
5. The Bank's effectiveness in supporting Central American integration has grown thanks to the regional programming exercises, particularly the most recent one, which involved an interdepartmental team. At the same time, the growing interrelationship between regional programming and national integration and trade programs is reinforcing the Bank's ability to take a hand in this multidimensional agenda. The growing effectiveness of interventions in support of integration can be seen in the clear relationship between regional programming exercises, the meetings of the Regional Consultative Group, and progress with the Puebla-Panama Plan.

6. The institutional development required for integration is an issue that still poses significant challenges. The Bank has participated actively in strengthening specific institutions, particularly CABEL, and has achieved major successes. Nevertheless, streamlining and strengthening the region's institutional framework is unfinished business for Central American integration. Among the factors explaining this are: the struggle between the foreign ministries and economy ministries for control over the subregional integration process, and by extension, the relationship between SICA and SIECA. As a result, institutional decision-making weaknesses persist with regard to the implementation of regional integration projects, as no integration institution has been created as a focal point to reconcile the community function and intergovernmental negotiations on behalf of national interests. At the same time, these particular institutions have still not put their financial house in order, nor have they managed to strengthen their institutional capacity.
7. The Puebla-Panama Plan recognized these institutional realities and was devised as a flexible, new, agile mechanism to promote regional integration in the Mesoamerican region of southern Mexico and the Central American Isthmus. Its focus is on decision-making mechanisms to implement regional projects. The PPP is an umbrella mechanism that incorporates programs that directly support regional economic integration and cooperation and thus has become an effective operational mechanism for regional cooperation and investment. To the extent possible, the PPP has also served to strengthen integration agencies such as SIECA, in terms of its functions as a secretariat for transport and customs, and RIOPPAH, with regard to systems for protecting plant and animal health; it has even promoted the development of new agencies, for example in the electric power sector.
8. Given the institutional weakness of integration agencies and the reality that governments concentrate primarily on their domestic political agendas, multilateral cooperation has been a catalyst in the integration process and in arranging external cooperation. The Bank's role in organizing the consultative groups and in supporting the PPP reflects this capacity. In a sense, the Bank also supports the integration agencies by providing institutional memory.
9. The Bank's strategy and interventions in support of Central American and Mesoamerican integration have been flexible and have demonstrated its ability to adapt to the goals and priorities of the region's governments. It bears mentioning that the trade, integration, and competitiveness loans to help countries make the most of trade agreements have largely been the result of reflection with the Central American countries. The institutional area is an example where the Bank has accompanied the countries as far forward as they could go, and then sought solutions to enable regional projects to continue despite the absence of the ideal institutional solutions.

10. A central component of the new integration strategy adopted in the early 1990s was to open up trade with outside markets, both by unilaterally reducing external tariffs and by participating in WTO negotiations and a series of bilateral trade negotiations. This has posed a challenge in terms of competitiveness, one that the countries have addressed with Bank support through national competitiveness programs and investment in infrastructure. For instance, the SIEPAC project has been innovative in that it has created an integrated electric power market that will allow for more efficient production and investment decisions, thereby demonstrating integration's potential for boosting the competitiveness of the entire region by lowering the cost of a strategic input.

IV. Lessons Learned and Challenges for Regional Integration and Cooperation

A. Some Operational Lessons Learned from Central American Integration

Several lessons can be drawn from the broad and continuous experience in the Central American Isthmus, in which the IDB has worked in partnership with the countries during periods of rapid change, structural adjustment, and reforms, to finance a wide variety of regional cooperative programs and regional integration programs, as well as closely tied and relevant national reforms.

The experience of the import substitution-based industrialization model of the Old Regionalism is that it failed to produce the hoped-for economic benefits in the “Lost Decade” of the 1980s. Under the New Regionalism of the 1990s and into the new century, structural market reforms, including trade liberalization, financial market reforms, exchange rate and price policies reforms, the privatization of key public services, most of which were initiated in the late 1980s and through the 1990s to the present day, were accompanied by the extension of regional cooperation and integration and the active negotiation of multi-tiered arrangements.

The Central American Isthmus countries have shown a political will to restructure their regional institutions, to redirect the past regional integration into a modern framework, liberalize trade among themselves and lower their common external tariff, include the agriculture sector, attain agreements on the creation of a customs union, and collaborate to obtain the most favorable outcome possible from the FTAA and the CAFTA.

The following highlights some of the relevant operational lessons and opportunities for financing programs related to regional integration and trade in the Central American Isthmus:

1. As regional integration has matured and progressed, regional cooperation and harmonization of policies and programs becomes a key for continuing success.

There was a lot achieved by the countries of the region from unilateral economic reforms and structural adjustments that incorporated trade liberalization. The initial progress in Central America helped increase growth, but also created demands for modernization and development from many social sectors and led to a process of the countries cooperating in a number of sectors that were affecting their ability to participate in trade agreements in the future. Common concerns and agendas arose among the countries for social issues in relation with poverty alleviation, social compensation during times of economic adjustment, local and decentralized institutional reforms, and education and health sector

reforms. Similarly, asymmetries among national economic policies often led to differences in fiscal, monetary, and exchange-rate policies complicating the integration process and trade among the countries. This led the countries to recognize the need to introduce formal mechanisms for coordinating their economic policies among the ministries of economy and the Central Banks. Therefore, it has been learned that coordination of policies and cooperation in sensitive sectors brings benefits to the countries by transmitting knowledge and experience and through focusing policies on high payoff programs.

2. Within the context of the New Regionalism, external assistance should concentrate on enhancing national capacity for membership in free trade areas, especially trade promotion, competitiveness, and negotiation and administering agreements.

The New Regionalism of free trade agreements and economic reforms is placing inordinate demands on the countries' institutions and the private sector to prepare for entrance into new markets, to expand exports in more competitive market environments, to promote trade efficiently and individualize products and services that will have the biggest economic payoff, to participate nationally in negotiations of the FTAA and the CAFTA agreements, and to regulate and administer the agreements locally and regionally. Access to technical assistance, the preparation of relevant studies, the training of a cadre of negotiators and administrators is still a job only just commenced. The IDB has evolved a Trade Sector Facility and is examining a new Trade, Integration and Competitive loan operation that combines all of the institutional, promotional, and training financing in a single package for a country. Programs with these characteristics are imperative for the Central American countries.

3. It will be necessary to continue to strengthen Central America's regional institutions, to build up their technical capacity to undertake necessary studies for negotiating and administering trade agreements, and organizing cooperative programs in high priority themes.

The Central American countries have made progress in streamlining their regional institutional structures during recent years. ECLAC and the IDB financed a proposal for institutional reform that was adopted partially by the countries in the mid-1990s. It is expected that further modernization and strengthening will be required as the FTAA and the CAFTA take effect and during the period of transition for important economic sectors in the coming years. As was amply demonstrated in this report, the IDB has provided substantial regional technical cooperation financing in nearly all critical sectors, but the availability of these funds is limited and other means of financing institutional reforms will have to be evaluated. There will be significant challenges in areas such as agriculture, environmental regulation, customs administration, competitiveness, education and health reform, labor training, policies and regulations, and science and technology, among others. There is some limited regional institutional capacity and there

are cooperative arrangements functioning in some of these areas and sectors, but further institutional support is needed.

4. Poverty reduction and social reforms remain an ever more urgent and decisive agenda item to ensure the fair distribution of the benefits from trade and development.

As the President of the IDB has repeatedly asserted, the FTAA must necessarily be development-oriented rather than just being a vehicle for promoting narrow commercial interests. Unless the benefits of free trade are viewed in the countries as being distributed fairly among the poorest people and less developed countries, unless the workers benefit from the process by greater productivity and income opportunities, and unless the general public is convinced of the economic benefits, then the political sustainability of the agreements may be questionable.

5. Coordinated regional and country programming with the international donor communities will assist the region to take advantage of international assistance and continue with key sector reforms and modernization.

The IDB has been using both regional and country programming to define its loan and technical cooperation programs in Central America and these two are converging in the use of loans and technical assistance to support regional trade issues both at the regional and at the national level. The organization of regional and national consultative meetings has helped orient the international donor community to the needs generated by the regional and international trade agreements and natural disasters in the Isthmus, and has helped the countries and the region to take maximum advantage of these programming exercises.

6. The management of important trade-related side issues—especially labor market and environmental impact and regulation—should be given priority attention by the regional and the international community in their assistance to the region.

The international donor community has traditionally given support to environmental laws, policies, and regulations and institutions in the past decade. The countries all have well-elaborated environmental legislation, but will require continuing assistance in the application of trade-related regulations, for example, for environmental impact analysis and certification of private investment projects, the administration of food safety regulations, the monitoring of the use of agrochemicals that may enter the food chain, and the use and disposal of industrial wastes, among others. Thus the countries will be assigning more resources in the future to the environmental regulation of the business sector, and there will be demands for greater uniformity in the application of the regulation and monitoring of the environment across sectors and countries.

7. The promotion of national and business competitiveness is a powerful instrument for coordinating a number of elements needed by the countries to respond to free trade agreements.

New competitiveness programs are serving as a national catalyst to enhance the factors of production, of labor and business, in preparation for trade liberalization and access to new markets. Some Central American countries have already developed competitiveness plans within the last five to eight years. Other countries have just begun to prepare their plans. Competitiveness programs serve as a powerful motivating umbrella program to promote increased cooperation among the private sector, labor, the civil society and NGOs to develop a national view of the future, to define work programs, to emphasize policies to increase productivity and to install an incentive program for private-sector investment in promising new products and services.

8. The modernization of labor market regulation and labor training are critical for the future of Central America in hemispheric and regional trade agreements.

Free trade agreements such as NAFTA have a labor side agreement and a commission that monitors the application of labor codes. Similarly, Central America will need continuing assistance to reform labor market regulations and institute region-wide improved labor training. A key element of the labor issue is to ensure that labor protection mechanisms are applied uniformly, labor organizations are permitted and protected under the law, that a functioning complaint mechanism exists and that wage regulations are followed by companies. There will be increased international monitoring of labor markets as free trade agreements such as CAFTA and the FTAA are launched. Hence the entire spectrum of labor market regulation.

9. The conduct of agricultural sector restructuring is a key issue stemming from the integration and trade agreements, and its impact on poverty reduction and equitable rural development of the Central American region.

Agricultural sector policies and protectionism are a major negotiating point in all of the regional and international trade agreements to date because of the extensive agricultural preferences and subsidies of industrialized countries of the North; given that the sector is a leading potential exporter and employer for the South. In addition, agriculture is still an important employer of the rural population, albeit with low wages and productivity for the most part. Hence agricultural protection and the impact of trade on Central American agriculture suggests the need for continuing technical assistance, the formulation of agricultural development programs, and key rural infrastructure investments.

10. The mobilization of the civil society, indigenous peoples, and local communities is a step toward ensuring the success of integration and free trade agreements.

In recent years growing attention has focused on the role of local communities, indigenous people, and civil society in development. The PPP has included a consultation mechanism with the indigenous people in the Mesoamerican Region. These communities should be beneficiaries of regional integration and trade agreements, and their exclusion from the benefits of these arrangements would be unacceptable in the present development agenda. Therefore, the various regional programs, such as the PPP, will continue to build on the experience of local development, decentralization programs, social safety net programs and health and education sector reforms to ensure that there are not important communities excluded from the regional programs. International donors should continue to play an active role to support the environment of consultation and collaboration between the local communities and the regional programs.

11. Countries have learned that disaster prevention and mitigation is insurance for national and regional development and that natural disasters can set back regional and local development.

Recent major disasters in Central America—Hurricane Mitch, the El Niño effect, and two earthquakes in El Salvador—have shown that the future development of the Isthmus can be quickly set back by disasters. It has been learned that it is possible to undertake planning and programs to help mitigate the effects of natural disasters so as to reduce the vulnerability of the region in the event of the almost certain devastation produced by windstorms, earthquakes, volcanic eruptions, droughts and flooding. Therefore, a part of the mix of programs in national budgets, investments and organizations, and support from international donors and the regional organization CEPREDENAC should be to continue to strongly promote programs to reduce the vulnerability of the region to disasters. There is an important role for international assistance in this aspect.

12. The PPP has rapidly evolved into a dynamic model for organizing and promoting regional infrastructure investments and coordinating regional cooperation in key sectors.

In 2001 the PPP was launched as a regional initiative with the Government of Mexico and with the assistance of the international community, in particular the IDB. The program has moved quite rapidly to formalize a program of initiatives and projects that are essential components of regional integration and cooperation. It is very important that this initiative succeed, as it has to date, to facilitate a regional dialogue and to finance key investments and activities. This is a highly successful model that will require strong support to ensure its success and continuity.

B. The IDB and Challenges for Central American Integration and Cooperation

It has been seen that the IDB is a strong and permanent partner with the Central American Isthmus countries to promote continuing, viable regional integration and cooperation. In addition, new financial packages are being deployed by the IDB to assist in the current urgent tasks of negotiation of trade agreements, trade promotion, and enhancing competitiveness. Significant side issues will need constant attention in the near term, especially the regulation of labor markets and environmental protection. The IDB has helped to ensure that the Puebla-Panama Plan succeeds in sustaining a regional dialogue and priority investment program that contributes to regional integration. Therefore, it is amply clear that the Bank has been and will continue to be strongly committed to further reforms, modernization programs and institutional support for regional integration and cooperation.

SUMMARY OF THE PRINCIPAL TREATIES AND AGREEMENTS RELATING TO CENTRAL AMERICAN ECONOMIC INTEGRATION

Regional

- General Treaty on Economic Integration. 1960.
- Charter creating the Central American Bank for Economic Integration (CABEI). 1960.
- Charter of the Organization of Central American States (OCAS). 1962.
- Central American Monetary Agreement approved by the Central American Monetary Council. 1974.
- Tegucigalpa Protocol. 1991.
- The Presidents of the region agree to create the Central American Integration System (SICA). 1992.
- At their Fourteenth Summit Meeting, the Central American Presidents sign the Guatemala Protocol of the General Treaty on Central American Economic Integration. 10 October 1993.
- El Salvador and Guatemala initiate process to form a Customs Union. 22 May 1996. Later joined by Honduras, Nicaragua, and Costa Rica.
- General Agreement on Tariffs and Trade (GATT). Nicaragua, 1990; Costa Rica 1990; El Salvador and Guatemala 1991; Honduras, 1994.
- Puebla-Panama Plan, launched 15 June 2001 in El Salvador, within the Framework of the Presidential Summit Agreements between Mexico and Central America, Declaration of Tuxtla Gutierrez, 1991.

Multilateral and Bilateral

- Free Trade Area of the Americas (FTAA). First Summit of the Americas, 1994.
- United States. U.S. Generalized System of Preferences, 1974; Caribbean Basin Initiative, 1983; extended from 2000 to 2008. NAFTA (Free Trade Agreement between the US, Canada, and Mexico), 1994; Negotiations for a Free Trade Agreement with Central America (CAFTA) begun in 2003.
- Mexico:
 - Costa Rica-Mexico. Begun January 1995.
 - Nicaragua-Mexico. Entered into force July 1998.
 - El Salvador, Guatemala, and Honduras-Mexico. As of 1 June 2001.
- Dominican Republic. General Framework for Negotiating an Agreement for the Free Trade of Goods, Services, and Investment in Central America and the Dominican Republic, approved 1997, and the Free Trade Agreement between Central America and the Dominican Republic, approved in 1998, and entering into force on different dates depending on ratification.
- Chile. Free Trade Agreement with El Salvador and Costa Rica entered into force in 2002.
- Canada. Memorandum of Understanding for Trade and Investment between Canada and the countries of Central America, 1998. Free Trade Agreement between Canada and Costa Rica, 2002.
- CARICOM. Framework Program for Central America-CARICOM Cooperation, 1999. Free Trade Agreement between Trinidad and Tobago and Costa Rica, 2002 (pending ratification).
- MERCOSUR. Framework Trade and Investment Agreement between the MERCOSUR Presidents and the Central American Presidents, 1998.
- European Union. Political and Cooperation Agreement EU-CA, 2003, and agreement that at the Mexico Summit in 2004 the parties will agree to launch negotiations for a Partnership Agreement.

Source: INTAL, Timeline of Integration Agreements in the Americas: www.iadb.org/intal/tratados/cronologia.htm.

"Estado de Situación de la Integración Económica Centroamericana hasta octubre de 2003 [Status of Central American Economic Integration as of October 2003]," SIECA, p. 19.

Annex II

RCG-CA MEETING (1997) PROJECT SUMMARY

Project Areas	Amount (in US\$ millions)	Project Description	Amount (in US\$ millions)
Economic Integration	\$4.1	1. Regional Unit for Technical Assistance (RUTA III) 2. Integration of Customs Systems 3. Strengthening the Evaluation Capacity of Governments in Central America	\$0.9 2.4 0.8
Institutional Reform	4.8	4. Institutional Consolidation of SICA's General Secretariat 5. Automatic Financing Mechanism and Administrative Audit Mechanism 6. Strengthening National Capacities to Pursue Cooperation and Integration 7. Transforming and Strengthening the ICAP 8. Transforming and Strengthening the ICAITI 9. Establishing a Central American Tourism Organization	1.5 0.3 1.0 0.6 0.7 0.7
Infrastructure	9.7	Electric power 10. Strengthening Planning Activities 11. Strengthening the Regulatory Framework for the Electric Power Industry Transportation 12. Modernization of the Legal Regulatory Framework 13. Modification of the Legal Framework for Private Sector Participation 14. Institutional Reform in Each Country 15. Modernization and Harmonization of Legal Standards 16. Updating the Regional Master Plan 17. Support for Regional Executing Unit Hydrocarbons 18. Market Integration 19. Institutional Strengthening 20. Rational Use of Oil 21. Environmental Strengthening	3.0 2.0 1.0 5.0 0.5 1.0 0.5 0.5 2.0 0.5 1.7 0.9 0.3 0.3 0.2
Functional Cooperation Health – Stage I	2.8	22. Epidemiological Surveillance and Disease Control; Strengthening Human Resources.	2.8
TOTAL:	\$21.4	TOTAL:	\$21.4

Source: Inter-American Development Bank, Second Meeting of the Regional Consultative Group for Technical Cooperation for Central America (RCG-CA). Washington, D.C., IDB, September 1997.

RCG-CA PROJECT SUMMARY (2001)

Projects to Strengthen Regional Integration	Central American Logistical Corridor 1. Customs Modernization and Regional Highway Network 2. Telecommunications and Logistics 3. Maritime and Coastal Transport 4. Reducing Vulnerabilities in the Transport Sector Integrated Energy Development 5. Regional Interconnection of Electric Power Grids 6. Fuel Storage 7. Subregional Gas Pipelines 8. Regional Power Generator Plants Modernization of Migration Management 9. Statistical Information and Migration Management System
Projects to Reduce Development Asymmetries and Inequities	10. Intersectoral Program for Reducing Social Vulnerability 11. Human Resource Development 12. Municipal Development in Border Areas
Projects for Reducing Vulnerability to and the Impact of Disasters	13. Education and Reduction of Vulnerabilities 14. Agriculture Protection and Food Security 15. Training for Local Communities
Projects for the Rational Management of Natural Resources	16. Comprehensive Resource Management in Shared Watersheds 17. Management of Agricultural Burning and Control of Fires 18. Sale of Environmental Services 19. Improving Environmental Management 20. Gender Equity in Environmental Management
Projects for Productive Modernization	21. Industrial Modernization Program 22. Agricultural Censuses 23. Organic Production 24. Technology to Mitigate Climate Effects
Projects by Regionally Organized Civil Society	25. Use, Management, and Conservation of Natural Resources by Campesino, Indigenous, and Afro-Caribbean Organizations 26. Marketing as an Agent of Change for Development within the Central American Biological Corridor

Source: General Secretariat, Central American Integration System, "Propuestas de Proyectos Regionales para Apoyar la Ejecución de la Estrategia de Transformación y Modernización de Centroamérica en el Siglo XXI" [Proposals for Regional Projects to Support Execution of the Strategy for Central American Transformation and Modernization in the 21st Century], Project fact sheets. San Salvador, El Salvador, SICA, 12 October 2000

PUEBLA-PANAMA PLAN: MESOAMERICAN INITIATIVES AND PROJECTS

Mesoamerican Initiative for Energy Interconnection	Mesoamerican Transportation Initiative
1. SIEPAC (Central American Electrical Interconnection System) 2. Mexico-Guatemala Connection 3. Guatemala-Belize Connection	International Network of Mesoamerican Highways (RICAM): 4. Pacific Corridor (Puebla-Panama) 5. Atlantic Corridor 6. Complementary Roads and Regional Connections 7. Harmonization of Technical Regulations and Standards 8. Port and Maritime Modernization Program 9. Program for Airport Modernization and Air Transportation Overhaul 10. Transportation Logistical Support
Mesoamerican Initiative for Telecommunications	Mesoamerican Initiative for Trade Facilitation and Enhancing Competitiveness
11. Mesoamerican Information Highway (AMI) 12. Regional Regulatory Framework	13. Modernization of Customs and Border Crossings 14. Harmonization of Phyto- and Zoosanitary Standards, Rules of Origin, and Technical Standards 15. Promotion of PYMEX 16. Financial Integration
Mesoamerican Initiative for Human Development	Mesoamerican Initiative for Sustainable Development
17. Regional Health and Human Development Project 18. Fund for Basic Education for Adults 19. System of Demand and Training Services for Mesoamerica 20. Comprehensive Ecosystem Management by Indigenous Communities 21. Statistical Information System on Migration	22. Mesoamerican Program for Environmental Management Systems (PROSIGA) 23. Mesoamerican Program for Sustainable Development of Natural Resources in Multinational Areas 24. Indigenous Consultation and Project Design, Mesoamerican Biological Corridor

Mesoamerican Initiative for Natural Disaster Prevention and Mitigation	Mesoamerican Initiative for Tourism
25. Public Awareness-building for Disaster Prevention 26. Hydrometeorological Information for Competitiveness 27. Development of the Catastrophic Risk Insurance Market	28. Strengthening Airport Security 29. Development of Comprehensive Tours in the Mesoamerican Region 30. Ethnic Tourism 31. Implementation of Tourism Satellite Accounts 32. Certification of Sustainable Tourism

Annex V

LIST OF PROJECTS HIGHLIGHTED IN THIS CHAPTER

COUNTRY	PROJECT TITLE	LOAN OR TC NUMBER	AMOUNT IN US\$ (THOUSANDS)	YEAR OF APPROVAL
Belize	Capacity Building for Trade and Investment Promotion	ATN/MT-8047-BL	\$490	2002
Costa Rica	SIEPAC C.A. Electric Interconnection	796/OC-CR	1,650	1994
Costa Rica	SIEPAC C.A. Electric Interconnection	1368/OC-CR	30,000	2002
El Salvador	Sector Program for Competitiveness Reforms	1492/OC-ES	100,000	2003
El Salvador	SIEPAC C.A. Electric Interconnection	838/OC-ES	1,650	1995
El Salvador	SIEPAC C.A. Electric Interconnection	1369/OC-ES	30,000	2003
Guatemala	Foreign Trade Support Program	1318/OC-GU	5,000	2001
Guatemala	SIEPAC C.A. Electric Interconnection	1372/OC-GU	1,650	2002
Guatemala	SIEPAC C.A. Electric Interconnection	1370/OC-GU	30,000	2002
Honduras	Program to Foster Business Competitiveness	1125/SF-HO	10,000	2003
Honduras	SIEPAC C.A. Electric Interconnection	ATN/SF-4737-HO	300	1995
Honduras	SIEPAC C.A. Electric Interconnection	936/SF-HO	1,300	1995
Honduras	SIEPAC C.A. Electric Interconnection	1095/SF-HO	25,000	2002
Nicaragua	Capacity Strengthening Foreign Trade Negotiations	1117/SF-NI	5,000	2002
Nicaragua	SIEPAC C.A. Electric Interconnection	1017/SF-NI	1,650	1998
Nicaragua	SIEPAC C.A. Electric Interconnection	1096/SF-NI	25,000	2002
Panama	Program to Foster Competitiveness	1410/OC-PN	7,000	2002
Panama	SIEPAC C.A. Electric Interconnection	1371/OC-PN	30,000	2002
Regional	Business Advisory Services for Small Rural Producers	ATN/ME-7724-RG	496	2001
Regional	Business Facilitation through Custom Procedures	ATN/MT-7080-RG	3,000	2000
Regional	C.A. Electrical Interconnection System Studies	ATN/DC-5171-RG	800	1996
Regional	C.A. Electrical Interconnection System Studies	ATN/SF-5171-RG	385	1996
Regional	C.A. Electrical Interconnection System Studies	ATN/UE-5171-RG	340	1996
Regional	CABEI Multisector Credit Loan	1011/OC-RG-2	100,000	1997
Regional	Harmonization of Public Debt Markets in C.A.	ATN/MT-7357-RG	600	2001
Regional	Consultations with Civil Society in Central America	ATN/SF-7050-RG	90	2000
Regional	Learning from Business Alliances	ATN/ME-8291-RG	5,000	2003
Regional	Mitigation of Disasters in Central America	ATN/JF-6552-RG	1,110	1999
Regional	Modernization of Customs and Border Crossings	ATN/MT-8026-RG	2,015	2002
Regional	Mundo Maya Sustainable Development Program	ATN/SF-6782-RG	500	1999
Regional	Mundo Maya Sustainable Development Program	ATN/JF-6782-RG	792	1999
Regional	New Agenda for Central America	ATN/SF-7003-RG	149	2000

Annex V

COUNTRY	PROJECT TITLE	LOAN OR TC NUMBER	AMOUNT IN US\$ (THOUSANDS)	YEAR OF APPROVAL
Regional	Reducing Technical Barriers to Trade Through Accreditation	ATN/MT-8225-RG	\$495	2003
Regional	Support for Trade Liberalization of Services	ATN/SF-5462-RG	750	1996
Regional	SIEPAC C.A. Electric Interconnection	1002/OC-RG	1,650	2002
Regional	SIEPAC C.A. Electric Interconnection - Spanish Fund	003/SQ-CR	10,000	2002
Regional	SIEPAC C.A. Electric Interconnection - Spanish Fund	004/SQ-ES	10,000	2003
Regional	SIEPAC C.A. Electric Interconnection - Spanish Fund	005/SQ-GU	10,000	2002
Regional	SIEPAC C.A. Electric Interconnection - Spanish Fund	006/SQ-PN	10,000	2002
Regional	SIEPAC C.A. Electric Interconnection - Spanish Fund	007/SQ-HO	15,000	2002
Regional	SIEPAC C.A. Electric Interconnection - Spanish Fund	008/SQ-NI	15,000	2002
Regional	Strengthening Environmental Judicial System in C.A.	ATN/NE-5016-RG	240	1995
Regional	Strengthening Environmental Judicial System in C.A.	ATN/SF-5016-RG	130	1995
Regional	Study: Central American Asymmetries	ATN/SF-6862-RG	60	2000
Regional	Support for Agricultural Trade - Food Safety Measures (RIOPPAH)	ATN/MT-7957-RG	1,510	2002
Regional	Support for Central America Integration (PRADIC)	ATN/SF-3938-RG(II)	1,037	1992
Regional	Support for Central America Integration (PRADIC)	ATN/SF-3938-RG(I1)	597	1992
Regional	Support for Central America Integration (PRADIC)	ATN/SF-3938-RG(I2)	424	1992
Regional	Support for Central America Integration (PRADIC)	ATN/SF-3938-RG(I3)	678	1992
Regional	Support for Central American Consultative Groups	ATN/SF-5059-RG	1,120	1995
Regional	Support for SICA Secretariat	ATN/SF-6920-RG	150	2000
Regional	Support to SIEPAC Project	ATN/SF-5502-RG	5,000	1997
Regional	Supporting the Competitive Position of C.A. Coffee	ATN/ME-8292-RG	3,000	2003
Regional	System for Demand and Supply of Training Services	ATN/MH-7952-RG	1,400	2002
Regional	Short-Term Thermal Generation Technology	ATN/CP-4624-RG	\$90	1994

CHAPTER 4: REFORMS IN BASIC INFRASTRUCTURE

Adolfo Rufatt

Introduction

This study is part of a broader analysis undertaken by the Inter-American Development Bank to document the transformation and modernization of the economies and institutions of Central America and Panama since the early 1990s. Following a discussion of highlights of that transition and selected country-specific experiences, this report offers some thoughts and very preliminary conclusions that might provide a useful starting point for a more in-depth, detailed future exploration.

The study is by no means exhaustive: it focuses on reforms that were consummated and on the problems and challenges the countries faced as they crafted and implemented their programs. Accordingly, a number of equally important reform moves that are unfinished or have a long way to go before they yield concrete results have not been included. Since all these processes are still fairly recent, any account of them will necessarily be tentative and preliminary.

Over the past several years the countries of the Central American Isthmus have lived through dizzying changes, not least in their infrastructure sectors. Despite its impressive strides the region still has a long agenda ahead, notably to deepen reform of the State and, more particularly, bolster the policy-making and regulatory capacity of the State and its private-enterprise oversight capabilities. The near-term imperative if the reforms are to be sustainable is to correct serious structural market weaknesses, especially in the electric power sector, and to give national and regional regulatory bodies real authority.

Two main ideas can be distilled from this study. First, to boost basic infrastructure investment and expand the reach of infrastructure services, and make such improvements sustainable, countries will need to manage the tension between cost-recovery needs and the meager ability to pay of the poorest households. The evidence suggests that this tension, which is at heart a social issue, has been the chief cause of discontent and political opposition to reforms pursued over the past decade or so.

Second, moves to bring private enterprise into infrastructure sectors through privatization and concession arrangements and the success or failure of such initiatives are not a private-sector responsibility. Since the outcome of such processes depends on the State's policy and regulatory strength, they are the social and political responsibility of the public sector alone.

I. General Sectorial Context

In the early 1990s Central America and Panama launched sweeping reforms to revive their stalled economies. Preeminent among these were overhauls of financial systems, foreign trade regimes, public finances, and basic infrastructure sectors, including updating of laws and revamping of the institutional and regulatory apparatus. Over that same interval, as international financial institutions rethought their role and the form of their assistance, the Bank reconfigured its country support strategy, particularly in the electric power sector, and moved to replace direct infrastructure finance with technical and financial support vehicles to help implement sector reforms, enhance efficiency, and attract private capital.

Though it is too early for any conclusive assessment of the reforms' accomplishments, with the benefit of hindsight this study offers an overview of the various reform processes and discusses selected cases that may be especially illuminating. A practical starting point is a look at the reform programs' objectives, content, and main conditions and at the support the Bank delivered to further country efforts at a particular political or economic juncture and how its products helped the reforms succeed.

The Challenge of the Reforms: Short- and Long-Term

The quality of IDB teams' contributions depended precisely on their ability to help a government articulate a more thorough rationale to balance the tension between short- and long-range goals.

The Bank's role in these reforms was predominantly one of subsidiary leadership. In other words, its function was to provide guidance and support for country teams and make sure that this leadership did not supplant the national governments' political and intellectual ownership of the reforms, which was crucial. Since these were multi-objective reforms and there were many macro- and microeconomic decisions to be made, that was no easy task. Governments were confronting situations in which political pressures pushed very short-term objectives to the fore and the focus rested on the immediate symptoms of the crisis (pressure to narrow deficits, create jobs, etc.) rather than on medium- and long-range goals that had more to do with a system's expansion and sustainability.

II Background of the Reforms and of the Bank's Role. A Paradigm Crisis

It is clear that in the course of these infrastructure reform programs a *paradigm crisis* was at work in regard to the respective sectors' objectives, structure, and operations. Its proximate cause was a combination of macro- and microeconomic factors. Macroeconomic elements were behind the *window of opportunity* that opened for the reforms—the timing of their launching—whereas their *rationale and content* were driven largely by microeconomic considerations. The macroeconomic elements had to do mostly with the countries' stalled economies and imbalances and their political situation at that point in time. The microeconomic roots lay in the efficiency crisis and secular stagnation of infrastructure sectors.

The IDB also figured prominently in this paradigm shift. In the 1990s, while remaining true to its mission to deliver external finance to complement member countries' internal savings to augment installed capacity, the Bank brought to the fore concerns for sustainable, rational resource allocation.

The New IDB in the 1990s
Structural adjustment and sector lending joined traditional project appraisal as the Bank's chief instruments in support of infrastructure projects, featuring rapid-disbursing policy reform loans to help countries implement macroeconomic and microeconomic rationalization programs.

As with other multinational organizations (IMF, World Bank) and the international financial community at large, the Bank completely reconfigured its support toolkit not only to help countries tackle sector-specific investment needs but also to address in the process their financing and economic growth requirements.

A. Macroeconomic Backdrop. A Snapshot of Structural Problems

Chief among the macroeconomic drivers of the reforms were the repayment crisis associated with external borrowings and debt service, the fiscal crisis stemming from structural problems in government finances, instability and secular balance-of-payments deficits, and pressures to remedy social problems. In these structural circumstances governments had to search for other ways of attracting external capital and financing operation and expansion of basic infrastructure.

A Window of Opportunity for Infrastructure Reforms	
Problems	IDB Instruments
• External Debt • Balance of Payments • Fiscal Deficits • Structural Problems	• External Finance for the Adjustment Period • Structural Adjustment Programs

From a macroeconomic, fiscal, and financial standpoint the countries' aims in pursuing sector reforms and divesting assets, including concessioning out or privatizing infrastructure services, were to relieve State enterprises' strain on the treasury, secure access to other sources of finance, and make their economies more efficient to equip them for global competition.

A Financial Imperative: Maximize Short-Term Benefits

When the short term was the focus, the reform program priority was to maximize sale prices or concession revenues, to the detriment of efficiency goals, correction of tariff distortions, and sustainable capacity increases.

Each of these aims influenced the reforms' design and implementation plans and each of them became an immediate incentive for the launch of reform programs. While macroeconomic concerns may have served as a trigger they also contributed in more than one instance to a weakening of a proposed strategy's internal coherence and conceptual integrity.

B. Microeconomic Background. A Model

At the heart of the reform paradigm was the promotion of the marketplace as the linchpin of efficient resource allocation and, consequently, the strengthening of the subsidiary role of regulation.

The microeconomic roots of the reforms lie in the countries' massive sectoral investment needs, the poor quality of service delivery as evidenced in low coverage levels and unreliability of utility services, deteriorating installed capacity, overstaffing and low productivity, distortions in rates and in the structure of incentives for consumption and for influxes of fresh capital, and commercial losses associated with unmetered consumption and delays in billing and collection. Microeconomic issues thus were the core around which the reform programs' structure and internal logic were articulated.

Microeconomic Rationale for the Reforms	
Problems	Incentives
• Capital Investment Needs • Poor Service Quality • Lack of Maintenance Funds • Overstaffing • Distortions in Service Rates • Technical Losses • Commercial Losses	• Attract External Capital to Increase Installed Capacity • Attract Technical and Managerial Expertise • Heighten Financial and Management Autonomy • Attract Qualified, Well-Paid Personnel

C. Short- and Long-run Benefits and Costs. Political Economy of the Reforms

The outcomes of the reform programs are reflective not just of the technical strengths or weak points of their designs but also, in large measure, of the political will to see the reforms accomplished and the political ability to effect the changes on the ground. There was some tension between macroeconomic and microeconomic goals as countries drew up reform blueprints and selected objectives and instruments. The differences between what countries had proposed and what they ended up achieving reflect the different paths they followed to resolve these tensions internally.

The most salient examples were moves to trim swollen payrolls and depoliticize service providers and strengthen their management and financial autonomy.

The main reason for occasional implementation delays and holdups in reforms was the disparity between costs (primarily short-run) and benefits that would be attained primarily in the long term.

III. Infrastructure Sectors in the Isthmus: An Overview

A. Frame of Reference

Except perhaps in Costa Rica, decisions to embark on infrastructure sector reforms came at times of deep financial, social, economic, political, and civic-military crises. In Panama the reforms unfolded as democracy was reinstated; in El Salvador and Guatemala they took shape as peace programs were launched. Nicaragua's reforms coincided with moves to forge a democratic system and improve the workings of public sector institutions following the demise of the dictatorship. In Honduras the reforms coincided with efforts to restore internal order after a protracted chapter of foreign intervention prompted by political-military conflicts in the region.

The Nineties: Frame of Reference	
El Salvador	• An end to years of civil strife • Peace agreements open the door to sweeping internal changes with support from the international community • Reform directly aimed at market liberalization and fostering of private sector participation
Guatemala	• A country with one of the poorest sets of social indicators • Low tax burden • A two-pronged challenge: rekindle growth and pursue the 1996 Peace Accord development priorities
Honduras	• One of the poorest countries in the hemisphere • Highly controlled, managed economy • Low tax burden and high, downward inflexible fiscal spending; heavy external debt • Major macrofiscal aggregates are the priority reform target • Absence of political leadership for infrastructure reform
Nicaragua	• Economic, political, and social crises • Change and transition. In search of an identity and political model • Triple challenge: equip the country with modern, functional institutions; create credible judicial-system institutions; give the market a viable role • Find the requisite political space for infrastructure sector modernization
Panama	• Severe crisis in level of economic activity • A predominantly financial services economy which inherited a relatively advanced infrastructure base that had steadily deteriorated over time • Once stability and macroeconomic balance had been restored, the country launched an ambitious infrastructure reform program

B. Infrastructure Services Delivery

The economic, political, and institutional crises weathered by the countries in the Isthmus left their mark on all their infrastructure sectors. With the possible exception of Costa Rica with its relatively more advanced economy, poor service quality was the regional norm.

The bulk of the service capacity was in the major cities. Electricity, in particular, was in short supply: in most countries less than half the population had electrical service. Only a quarter of Honduran households had electricity; average per capita consumption was a mere 204 kWh. Poor service with frequent blackouts and supply fluctuations had become a fact of life, with the concomitant cost to industry.

Coverage levels for telecommunication services were just as low. In Nicaragua there were only 1.3 lines per 100 population; the ratios were marginally higher in Honduras, Guatemala, and El Salvador. Telephone service, too, was unreliable and of poor quality, with extremely low call-completion ratios and frequent service interruptions. Telecommunications carriers typically were overstaffed, with anywhere from three to nine times more employees than more efficient companies would have on their payrolls. The central government appropriated telecom companies' monopoly revenues to fund general operations of the rest of the public sector.

Infrastructure Indicators						
	GDP	Electricity			Telecommunications (1990)	
	US\$ per Capita, 1992	Coverage (% of Population, 1984)	Consumption (kWh per Capita, 1990)	System Losses (% of Production, 1990)	Phones Lines per 1,000 Population	# of Requests on Waiting List
Costa Rica	\$1,960	97	1,127	8	155	77,900
El Salvador	1,170	34	425	15	24	160,400
Guatemala	980	37	240	13	31	100,000
Honduras	580	25	204	24	17	209,000
Nicaragua	340	41	266	20	13	n/a
Panama	2,420	66	1,160	24	89	17,900
Chile	\$2,730	85	1,949	10	156	72,500

Figures are not strictly comparable.

Source: World Bank, *World Development Report 1994: Infrastructure and Development*.

The sustained annual investments that would have been required to meet the forecast demand for electricity and telecommunications in a fast-growth economy far outstripped the utility companies' internal cash generating capacity, the State's financial capacity, and countries' external borrowing capacity.

C. Institutional Aspects

On the institutional side, the service delivery model vested all functional responsibilities in the service provider and the sector ministry. With a handful of exceptions, mostly involving formal distinctions, power generation, transmission, distribution, and sale were in the hands of a single provider. In El Salvador five companies—four of them owned by the State utility CEL—distributed power.

The utility companies also were in charge of sector planning, policy-making and regulation. Few if any of them had operational, management, or financial autonomy. Sector policies were driven by political considerations rather than concerns for efficient, sustainable resource allocation. The countries of the Isthmus had no infrastructure platform from which to compete in an increasingly integrated economy and competitive global marketplace—when they had access to world markets at all.

Seldom did these companies have enough money of their own for day-to-day operations and capital projects. Reliant as they were for funding on national revenue and finance ministries, their operations were guided by considerations divorced from sector priorities. Subsidy policies, too, were driven by political exigencies that were usually at odds with efficient resource allocation criteria and sometimes with the redistributive goals the countries were pursuing. An equally important factor in the service providers' poor performance was the role they were forced to play as employers of last resort. The downsizings that ended up being one of the reforms' steepest political costs were ascribed to concession and privatization deals rather than to structural flaws of a given national economy.

IV. Reforms Consummated

A. Introduction

Creating and heightening competition in the market has been the cornerstone of infrastructure reforms in the region. The main goal was to separate productive activities hitherto performed by government-owned providers. Consequently, the scope of the reforms was broad, taking in not just those State enterprises but also market structure and institutional and regulatory frameworks.

Fundamentals of Infrastructure Reforms	
Objectives	Policy Elements
• Increase Penetration Rates • Improve Service Quality • Lower Delivery Costs by Way of Efficiency Improvements • Recover Economic Costs of Production • Assure Sustainable Sectoral Growth	• Create and Open up the Market • Redefine the State's Role in Infrastructure Sectors and Split Policy, Regulatory, and Service Delivery Functions • Create Autonomous, Independent Regulators. • Foster Private-sector Participation in Service Financing, Expansion and Delivery • Remove Distortions in Rates • Regulate Rates for Activities in Which the Market does not Permit Competition

The object of power-industry reforms was to unbundle electricity generation, transmission, distribution and sales. In the telecommunications sector the aims included the separation of local telephony, domestic long-distance service, international long-distance, cellular telephone services, and value-added services.¹ The purpose of the institutional reforms was to segregate the service delivery function from policy-making and regulation.

Except in Costa Rica, which was quite a bit more advanced than the rest of the region by virtue of its State enterprise delivery model, countries in the Isthmus targeted their infrastructure reforms to telecommunications and electricity.

Infrastructure Reforms				
Country	Electricity	Telecom	Ports	Airports
Costa Rica	No	No	No	In progress
El Salvador	Yes	Yes	In progress	No
Guatemala	Yes	Yes	No	Attempted
Honduras	Yes/partial	Underway	No	Yes
Nicaragua	Yes	Yes	No	No
Panama	Yes	Yes	Yes	Attempted

¹ A number of countries have allowed the integration of some of these activities, acknowledging the economies this can yield and/or high institutional or technical unbundling costs.

B. Telecommunications

1. Background

Plummeting costs and the opening up of markets in the wake of telecommunications deregulation in the United States² were a jolt for the traditional operating strategies of State-run companies in the region which possessed monopolies on long-distance service and subsidies for local telephone service.

The State-owned and run telecommunications monopoly model essentially was the counterpart to government-owned electricity, transportation, and water and sewer service providers,³ but the perception that telecom companies were “profitable” greatly influenced the sequencing and nature of reforms in that industry. Because of this profitability—the result of a service monopoly and not a telecom carrier’s efficiency—there was resistance to the reforms in some quarters who underscored the State carrier’s contribution to the national treasury. Unrealistic selling prices and concession-rent proposals also made it more difficult to attract private capital.

However, the substantive considerations behind the pressure for telecommunications reform were impossible to ignore: (i) the companies’ manifest inability to satisfy demand, and (ii) the availability of new technology that was starting to erode the monopoly rents of long-distance carriers and the advent of cellular and mobile telephone services.

All the countries along the Isthmus enacted new laws and regulations and created new regulators. Exclusive service rights were phased out. All the countries but Costa Rica brought private investors into fixed and mobile carriers. All except Costa Rica and Honduras transferred a stake in the former State-owned dominant carrier to a private operator. Costa Rica’s ICE is still State-owned and has legal exclusivity for basic and mobile phone service. Honduras approved the partial privatization of HONDUTEL but the reform program has yet to be completed. A new law has been submitted to the congress to strengthen the regulatory framework and increase competition. New operators have entered the fixed telephone market while the mobile phone subsector continues to grow.

Telecommunications: Facets of the Reform
• Institutional and Regulatory Frameworks • Privatization and Competition • Universal Access

A final aim of the reforms was to assure universal service or access, that is, the population had to have access at least to basic telecommunication services regardless of where they lived or what income bracket they fell into. Only El Salvador and Guatemala

² The 1982 breakup of the ATT monopoly, which separated long-distance and local telephone services (the so-called “baby Bells”).

³ With the notable exception of the United States, where a private company had a monopoly.

included monies for subsidies in their legislation. The results thus far have been modest in Guatemala; El Salvador has been unable to carry through its plan. Other countries have announced their intention to write such provisions into future legislation.

2. Telecommunications Reform in the Region

All the countries enacted new laws and regulations governing the telecom industry and created new regulatory bodies. Some adopted a single law establishing a regulator and prescribing new sector regulations and privatization conditions; others dealt with these matters in separate legal texts.

Though the reform paradigm was conceptually clear there are considerable differences in the legal and regulatory frameworks that took shape in each country over the course of the 1990s as far as the nature of markets and regulatory bodies is concerned. The approaches taken to privatization and concessions of State-owned telecom carriers differ widely as well. Several reasons can be posited for this range of responses: different perceptions of the issues, differences in the caliber of leadership and the strength of political and intellectual backing for the reforms, the frenzied pace of change in telecommunications technology and marketplace conditions, and timing of the reforms.

The key differentiator as far as market restructuring was concerned was an economy's openness to competition. Panama was the first country of the Isthmus to start and finish the process; it left one company—the privatized carrier INTEL SA—with legal exclusivity for telecommunications services, the aim having been to boost the value of the transaction for the State and set the stage for a more gradual phaseout of distortions in rate structures.

El Salvador and Guatemala, on the other hand, which were firmly committed to open markets, launched their reforms two years after Panama's and finished them nearly two years later. Those countries opted to open their markets to competition immediately.

New Telecommunications Regulations		
Country	Regulator	Main Laws and Regulations
Costa Rica	Public Utilities Regulatory Authority (ARESEP)	Public Utilities Regulatory Authority Law (Law 7593) of 9/5/95
El Salvador	General Superintendency of Electricity and Telecommunications (SIGET)	- SIGET Law, Exec. Order 808 of 9/19/96 - Telecommunications Law, Decree 142 of 11/6/97, as amended
Guatemala	Superintendency of Telecommunications (SIT)	Telecommunications Law, Decree 94-96 of 1996, as amended
Honduras	National Telecommunications Commission (CONATEL)	Telecommunications Industry Law, Decree 185-95 of 12/5/95, as amended
Nicaragua	Nicaraguan Telecommunications and Postal Administration (TELCOR)	- Telecommunications and Postal Services Law (Law 200) of 1995, as amended - Law governing Private-Sector Participation in the Operation and Expansion of Telecommunications Services (Law 210) of 1995, as amended
Panama	Public Utilities Regulatory Agency (ERSP)	- ERSP Law (Law 26) of 1/29/96 - Telecommunications Law (Law 31) of 2/8/96

Source: National regulatory agencies.

The differences in privatization yields of sales of State carriers are illustrative of the strong friction between economic, political, and financial goals. Panama's substantially higher privatization earnings are especially significant considering that its market is only a fraction of El Salvador's and Guatemala's. But the latter two countries expanded and diversified their services much more quickly and their rates, especially long-distance charges, came down more swiftly as well. Compounding the efficiency losses and missed development opportunities were regulatory costs, which are proportionately higher in markets that are less open to competition.

All the countries except Costa Rica and Honduras have two or more competing cellular telephone carriers. In El Salvador and Guatemala there is keen competition in basic services; in Panama such competition is only now beginning, the exclusivity clause not having expired until early 2003.

Privatization of Dominant Carriers				
Country	Year	Amount (US\$ million)	Ownership Stake	Buyer
El Salvador	1998	\$275.0	51%	France Telecom
Guatemala	1998	700.0	95%	Grupo Luca
Nicaragua	2001	n/d	n/d	Telia and others
Panama	1997	\$652.0	49%	C&W

Source: ITU, *Americas Telecommunication Indicators 2000*, and carriers.

3. Results Attained

Telephone Service Growth in Central America										
Country	Fixed-line Teledensity (Lines/100 pop.)		Waiting List (Thousands)		Mobile Density (Mobile Tel./ 100 Population)		Digitalization (%)		Operating Revenues (US\$ Million)	
	1992	2001	1992	2001	1992	2001	1992	2001	1992	2001
Costa Rica	10.9	23.0	79.3	19.6	0.10	7.6	36.0	88.0	\$163.9	\$348.2
El Salvador	3.2	10.2	160.4	38.2	0.03 ^a	13.4	69.0	100.0	133.6	586.6
Guatemala	2.3	6.5	100.0	n.d.	0.02	9.7	60.0	100.0	166.3	448.5
Honduras	1.9	4.7	209.3	n.d.	0.04 ^b	3.6	51.5	96.2	103.1	345.2
Nicaragua	1.4	2.9	6.2 ^c	108.4 ^d	0.01 ^a	3.0	43.8	98.6 ^b	50.2	89.7 ^e
Panama	9.8	13.0	18.0	1.7	0.26 ^b	16.4	50.0	100.0	\$200.0	\$437.0 ^f

Note: Figures for the following years correspond to dates other than the general table dates: ^a 1993; ^b 1996; ^c 1994; ^d 1999; ^e 1998; ^f 2000.

Source: ITU, *Yearbook of Statistics*, March 2003.

On the whole, Central America's telecommunications industries have embraced the reform paradigm and the results are mostly promising. Countries have opened the door to private operators and investors; all of them now have separate telecommunications regulators. The result has been dramatic increases (with some intraregional differences) in the quantity, quality, and variety of telecom service offerings. The growth in mobile telephone services and, lately, in Internet service is especially striking.

4. Two Representative Cases

a. Guatemala

Guatemala's telecommunication reform is an illuminating case study of a government which, under pressure from internal political opposition, had to negotiate core aspects of the program to make it work. There still are a number of issues to tackle and resolve in the near future, notably the regulatory agency's lack of autonomy.

Despite that institutional weak point and assorted other problems encountered in privatizing the country's telecommunications carrier (TELGUA SA), it is clear from the results that the reforms have been beneficial.

Guatemala Selected Indicators (1995-2001)				
	1995	1997	1999	2001
Fixed Lines Installed	286,352	429,712	564,329	753,734
Mobile Lines	30,000	64,194	338,490	1,146,441
Lines/100 Population	3.2	4.8	8.1	16.3
Pay-phones	2,595	2,881	3,131	37,487

Source: CIEN. *Avances en el sector telecomunicaciones (1996-2003)*.

The surge in fixed-line subscribers is all the more remarkable considering that the State monopoly GUATEL managed to install only 340,000 lines in 25 years. Furthermore, though the new company TELGUA SA is the dominant fixed-line carrier accounting for

95% of lines, Guatemala now has 14 other companies offering fixed-line service. Though there still are far too few pay-phones in the country, the impressive growth in numbers of public telephones has been concentrated in rural and low-income areas.

Cellphone growth figures are equally impressive. In 1995 COMCEL was the sole carrier; by 2001, even with a near-sevenfold increase in number of lines it had a drastically reduced (if still sizable) 35% market share.

Mobile Telephone Subscribers (1997-2001)			
	1997	1999	2001
Comunicaciones Celulares, SA (COMCEL)	64,194	195,472	400,667
Telefónica Centroamérica SA	---	63,018	162,978
SERCOM (PCS Digital)	---	---	500,171
Bell South SA	---	---	82,625
Total	64,194	338,490	1,146,441

One recent setback amidst this growth trend is a 2001 legislative amendment mandating the transfer to the general public sector budget of monies the Telecommunications Superintendency had accumulated to increase rural telephone service. Resources in that fund created by a 1996 law had come from auctions of spectrum usufruct titles and of numbering ranges and from revenues from fines.

b. Panama

Panama's telecom reform, one of the first privatization programs in which the Bank participated, is a noteworthy case of Bank assistance to a government to chart reform objectives, with due heed to the strength of the political will to see the reforms actually take place. Panama's telecommunications program stands out also because it is the only country in the region to create an autonomous industry regulator. The government gave the privatized carrier exclusive rights to deliver telecommunications services nationwide.

Though that exclusive arrangement meant the deferral of efficiency and growth goals it brought the treasury more money and earned the government some political space by moderating the increase in local telephone rates. These were two very important considerations in Panama—the first to help tackle the nation's external debt problem, the second to forestall political opposition to the reforms.

Despite that decision the telecom sector responded nimbly to the market's growth. Telecommunications figures speak for themselves, mirroring the explosive worldwide growth in the industry in recent years.

Panama: Selected Indicators (1995-2001)					
	1995	1998	1999	2000	2001
Annual line faults (%)	97.0	70.0	52.0	48.0	30.8
Waiting list in major centers	28,790	14,424	6,162	6,440	1,698
Annual investment (US\$ million)	\$44.0	\$64.9	\$162.0	\$58.3	\$43.4
Fixed lines installed (thousands)	303.9	418.8	462.5	428.2	342.9
Households with fixed lines (%)	34.4	54.3	54.8	49.8	44.6
Pay-phones	3,127	7,026	8,607	9,955	11,372

Sources: ERSP and ITU *Yearbook of Statistics* 2002.

Telecommunications quality and reliability indicators have improved significantly. The line-fault average fell by more than two thirds in the period reviewed in the table; the waiting list came down 95%, and 1998-2001 investment was nearly triple the 1992-1995 total (there are no data available for 1996-1997). The number of public telephones is up sharply as well. Panama's network is 100% digitalized and its 16.4% mobile density is the region's highest. This increase in subscribers to the newer technology may well explain the drop in fixed teledensity after the 1999 peak of 54.8% of households with fixed-line service.

C. The Electricity Sector⁴

1. Background

At the center of the strategy for electricity sector reforms in the Central American region are two parallel, mutually reinforcing processes: reform of national power systems and integration of those national systems into a regional grid (**SIEPAC**). Costa Rica's electrical utility is part of the **SIEPAC** initiative even though that country has not revamped its national power system.

Scope of Electricity Reforms in Central America
• Reform of national systems • Integration in a regional power grid (SIEPAC)

Pioneering electric-industry reforms and privatizations in England and in Chile in the 1980s were the trigger for discussions on modernizing the sector in the region⁵ by creating a wholesale power market and introducing competition.

⁴ More accurately, the electricity subsector.

⁵ Jaime Millán, "The Second Generation of Power Exchanges: Lessons for Latin America," in F. Basañes and Robert Willig (eds.), *Second Generation Reforms in Infrastructure Services*. IDB and Johns Hopkins University Press, Washington, D.C., 2002.

Underpinning the power sector reform paradigm⁶ in countries of the Isthmus was a fresh look at the analysis that justified the existence of integrated monopolies. The review found that economies of scale are achieved only in transmission and distribution and that the transaction costs associated with unbundling the various stages in the process into separate companies are lower than the costs of efficiency losses and welfare losses created by electric monopolies.

Policy Fundamentals for Electric Sector Reform
• Transmission and distribution lines freely accessible to large consumers, generators, and distributors • Deregulation of wholesale prices and prices for large consumers • Lack of competition in markets means regulating transmission rates as well as those for small and medium consumers

The electric sector's technological complexity was another reason why countries broadened regulators' mandates to give them a proactive role in protecting and developing the market and, on the policy front, to assure the requisite institutional space for system expansion planning.

2. National Power System Reforms

All the countries but Costa Rica have passed laws or drafted legislation to bring in new regulatory frameworks for their power industry. Some are further along than others: Guatemala, El Salvador, Nicaragua and Panama already have laws on the books; a bill has been crafted in Honduras. There are policy and regulatory bodies in some of the countries—some predating the reforms, others created as part of the reform process.⁷ Thus, all the countries have power industry regulators and policy-makers.

The reforms call for the separation of policy, regulatory, and business functions hitherto concentrated in the State electrical utility, a new explicit regulatory framework, vertical and horizontal restructuring of the industry, and changes in ownership rules.

State-owned power utilities operating in Guatemala, El Salvador, Nicaragua and Panama prior to the reforms have been vertically and horizontally unbundled. Honduras's draft legislation calls for vertical unbundling. The Framework Treaty for the Central American Electricity Market signed on 30 December 1996 by the presidents of the six countries of the Isthmus mandates separate activity accounting when utilities are vertically integrated. El Salvador and Guatemala allow vertical reintegration, requiring only separate accounting or the creation of separate companies, respectively.

⁶ Paulina Beato and Carmen Fuente, "Retail Competition in Electricity," in F. Basañes and Robert Willig, op. cit.

⁷ Policy-making refers to the setting of framework objectives for the industry in line with national government policy. The regulatory framework is the overall environment in which activities are regulated, including the structure of the industry and nature of the regulator.

Electricity operations have been horizontally unbundled in all countries with the entry of new players; in Costa Rica, however, the public power utility is still horizontally integrated. El Salvador, Guatemala, Nicaragua and Panama have completely privatized energy distribution. All the countries now allow private investment in generation—the industry segment with the heaviest investment requirements—though they have opted for different approaches. Electricity generation has been privatized fully in Panama and partially in El Salvador and Guatemala; Nicaragua is about to follow suit. Neither Guatemala nor El Salvador have restrictions on horizontal reintegration.

Central American Power Industry Reforms at a Glance ¹						
	GU	ES	HO	NI	CR	PN
1. Vertical Unbundling	Yes	Yes	Yes	Yes	No	Yes
2. Horizontal Unbundling	Yes	Yes	Yes	Yes	No	Yes
3. Private Sector Participation	G, T, D	G, T, D	G, T, D	G, D	G, T, D	G, D
4. Asset Divestment	G, D	G, D	D	G, D	No	G, D
5. Vertical Integration Allowed	Yes	Yes	No	No	ICE	No
6. Horizontal Integration Allowed	Yes	Yes	Yes	No ²	ICE	No ³
7. Sector Authority	MEM	DGE	GE	CNE	MINAE	CPE
8. Electric Sector Planning	MEM	UT (T)	ENEE	CNE	ICE	ETESA
9. Regulator	CNEE/ MEM	SIGET	CNE/ SERNA	INE	ARESEP	ERSP
10. Independent Regulator	No	Yes	No	Yes	Yes	Yes
11. Minimum Demand, Unregulated Customers (kW)	100	0	250	2,000	NA	500

1. According to laws passed in Guatemala, El Salvador, Nicaragua and Panama and Honduran draft legislation.

2. Concentration dominant position $\geq 25\%$. However, 100% of distribution was sold to a single company.

3. Distribution $\leq 50\%$. Generation $\leq 25\%$.

The Guatemalan and Honduran regulatory bodies that have responsibility solely for the electricity subsector are attached to ministries. The other countries' regulators are less restricted because they are not part of a ministry. The Costa Rican, Salvadoran and Panamanian regulatory agencies are multisectoral; in Nicaragua they are in charge of the energy sector as a whole.

3. Two Representative Cases

a. Guatemala

From 1959 onward, Instituto Nacional de Electrificación (**INDE**) and Empresa Eléctrica de Guatemala (**EEGSA**) were the twin pillars of growth of the electric industry. By 1990 the power utilities were in financial trouble, less than half of Guatemalan households had electricity, and blackouts and energy rationing had become a familiar experience.

In 1992 the government authorized private investment in electricity generation, with exclusive contracts with EEGSA and INDE. A few years later it abolished laws that had protected INDE's legal monopoly and authorized the sale of the State's 95% stake in EEGSA.

Guatemala. Power Sector Reform			
Legal Framework	Institutional Framework	Asset Divestment	Market Structure
Electric Power Law (1996-97) and Regulations governing the Wholesale Power Market Administrator (1998)	- Ministry of Energy and Mines (MEM) - National Electric Energy Commission (CNEE) - Wholesale market (MM)	Sale of EEGSA and of INDE distribution operations	All stages open to competition
- Open access to generation, transmission, and distribution. - Functions split among separate agencies. CNEE is the industry regulator. MEM is responsible for policy and indicative planning, with a subsidiary role in rural electrification. - Wholesale market created; in charge of all short-term and long-term block power purchases and sales between market agents. - Electricity generation, transmission, and distribution operations are to be in the hands of separate companies or juridical persons.¹ - End-consumer rates are regulated by CNEE, which can set transmission fees. No controls on generation prices.² - Power distributors must comply with quality standards.			

¹ The law did not, however, place strict limits on cross-ownership.

² The outcome sought by this law has been greatly muted because of the many take-or-pay contracts with **INDE** that are still in force.

At this writing there are 18 generating companies in Guatemala but their respective market shares reflect the heavy pre-reform concentration. **INDE**'s Empresa de Generación de Energía Eléctrica (**EGEE**), the leading generator, accounted for 42% of output in 2002; the four largest companies together contribute 77% of total generation. Distribution now is in the hands of four large privately owned regional companies and about 10 municipal utilities.

Guatemala's electric sector reform process is particularly interesting not just because of what it has achieved but also because of its two serious challenges: the weakness of the regulatory agency (attached to the Executive Branch) and the fact that the model allows cross-ownership. A further important consideration is the large number of pre-reform purchase agreements, which is delaying and diluting the reforms' impact.

Guatemala's chosen reform model is a very open one and thus envisages light regulation, but it does allow cross-ownership and makes for a market with few competing generators and nonregulated buyers. This would make it easier for one player to become dominant and ultimately capture the Wholesale Market Administrator (**AMM**) and **CNEE**.

b. Panama

In 1974 Instituto de Recursos Hidráulicos y Electrificación (IRHE) was given responsibility for electricity services in Panama.⁸ By the early 1990s IRHE was showing all the signs of a highly politicized enterprise, with rapidly deteriorating service quality. Electricity rates were high but not high enough to make up for the agency's technical and commercial inefficiencies, maintain its plant or add capacity. The situation had worsened dramatically toward the end of the 1980s when the government intervened and IRHE revenues were used to fund the central government budget.

Panama: Power Sector Reform			
Legal Framework	Institutional Framework	Asset Divestment	Market Structure
Law establishing the Regulatory and Institutional Framework for Electricity Service (1997) and Law establishing the Energy Policy Commission (CPE) (1997).	Energy Policy Commission (CPE); Public Utilities Regulatory Authority (ERSP); generating companies, distribution utilities, one transmission company.	51% of distribution company shares; 51% of thermal generating company shares; 49% of hydroelectric generating company shares.	Competition in all stages except transmission.

The first step in Panama's power-sector overhaul was the restructuring of IRHE pursuant to Resolution 266 of 27 November 1997. As mandated in Law 6 of 3 February 1997 eight corporations were created for electricity service delivery—four for generation, three for distribution, and one for transmission. The private sector bought a stake in seven of them. The transmission company **ETESA** was set up as a wholly State-owned corporation operating under commercial law.

The generating and distribution companies were privatized. Private investors acquired 49% of the shares of the Fortuna, Chiriquí and Bayano hydroelectric utilities and 51% of the stock of the Bahía Las Minas plant.

The terms of the stock sale were governed by Law 6 which had established the institutional and regulatory framework for the electric industry. The transparency of the legal framework and of the process overall was reflected in the shares' sale price. The per-client proceeds of the distribution company stock sales were the highest in Central America.

⁸ In the 1960s Panama had private electricity providers: (1) Compañía Panameña de Fuerza y Luz in the metropolitan area; (2) Empresa Hidroeléctrica de la Chorrera; (3) Santiago Eléctrica; and (4) Empresas Eléctricas de Chiriquí. IRHE started out as the provider for the predominantly rural Central provinces. The nationalization of power companies began with Compañía de Fuerza y Luz in 1972 in metropolitan Panama City and Colón. Power utilities elsewhere in the country were nationalized in 1974.

Some recent episodes of friction between the Executive Branch and ERSP notwithstanding, the government's leadership and political resolve were fundamental to the success of electricity sector reforms in Panama. ERSP also played a vital role in earning credibility for the reform process generally and making sure the rules did not change.

4. SIEPAC: Central American Electrical Interconnection System

The object of the SIEPAC project is to develop Central America's first regional power transmission system and create and launch a regional electricity market. Undergirding this initiative are the reforms on which each country in the Isthmus has embarked. Eventually any qualified agent, regardless of its location, will be able to sell or buy electricity.

At a total cost of roughly US\$320 million the SIEPAC line will boost cross-border firm transfer capacity from the current 50 MW to 300 MW. The SIEPAC grid is an indivisible trunk transmission network connecting 16 substations from Veladero in Panama to El Cajón in Honduras, traversing Costa Rica, Honduras, Nicaragua, El Salvador and Guatemala and with a branch line between Pavana and Suyapa substations in Honduras.

SIEPAC: The Regional Power Market (MER) Three Imperatives
Regulatory framework: Uniform market rules for regional transactions
Institutional framework: Two regional institutions: Regional Electric Interconnection Commission (CRIE) and Regional System Operator (EOR)
The line: The 1,830-kilometer, 230-kilovolt "SIEPAC line" will run from Guatemala to Panama

SIEPAC Underpinned by and Complementing Country Reforms
- One aim of the reforms is to bring more private capital into the power industry, notably to boost generation capacity, where the most money will be needed. - Despite the individual countries' efforts at reform, risk profiles and marketplace conditions are impeding the development of competitive markets in each of them. - The SIEPAC initiative will facilitate the entry of larger power generation projects and innovative technology. This should push down costs and spur competition once more operators are competing for generating business.

Under the terms of the Framework Agreement, **CRIE** and **EOR** are juridical persons established under international public law. They have legal capacity to act in judicial and out-of-court proceedings and are authorized to perform such acts, contracts, and operations as may be necessary or expedient to discharge their mandate within Central America and Panama and beyond.

Framework Agreement for a Central American Electricity Market	
Approved and ratified by the governments of the six countries; Entered into force in 1999. Provides the requisite legal undergirding.	
Regional Electric Interconnection Commission (CRIE)	The regulatory body; the regional power market's highest authority. It is to work closely with country regulators—its national counterparts.
Regional System Operator (EOR)	Grid operator and administrator of the regional transactions market.
Under the Framework Agreement each country is to grant a concession to a company with public or mixed capital, Empresa Propietaria de la Línea (EPL), to build and operate the first regional transmission grid.	

EPL was legally incorporated in February 1999. The founding members were the six public power utilities designated by the respective governments, holding equal shares. The Spanish private corporation ENDESA joined in early 2002. Like any other EPL shareholder, current or future, ENDESA has rights and obligations pro rata to its share of the contributed capital.

Features of the Regional Electricity Market (MER)
• Open access for market agents to the regional and national transmission grids. • EOR is a not-for-profit agency with authority for continuing operation of the Regional Transmission System (RTR) as an integrated grid to assure open network access. • EOR Board of Directors is made up of representatives of the different groups of market agents. • RTR transactions must adhere to MER technical and commercial rules. • EPL is to have the SIEPAC line built and operating (opening and closing switches) as prescribed in the regional regulations.

The plan is to review the approved regulations after the regional electricity market has been operating for a time, to refine and firm up their content. In the interim the regional agencies will institute temporary electric interconnection regulations for existing power lines and the new Honduras–El Salvador connection which has been operating since August 2002.

The SIEPAC line is expected to be completed and in full operation in late 2007.

D. Transportation Sector

Transportation industry reforms have proved to be more complex than others and to take longer to complete. Regarding air and sea transport, a number of the countries in the Isthmus have attempted to overhaul and concession out their national airport systems and some seaports in which labor concerns have been the most important bottleneck to deal with. The risk profile in the roads sector is particularly complicated for a number of reasons, among them the lengthy investment payback periods, uncertainty and other problems in estimating demand, and political risks (constitutional impediments), all of which have made it harder to secure international finance for road and highway projects. The focus of road system reforms has been the reconfiguration of institutions to privatize

road infrastructure construction and maintenance and make for more sustainable maintenance funding.

Costa Rica, El Salvador, Guatemala, Honduras and Panama all launched airport concession programs. More recently Panama, Honduras, and El Salvador went through similar exercises for maritime ports. Two of these initiatives—for ports in Panama and airports in Honduras—were successfully concluded. These cases are noteworthy because of the growing importance of transportation sector reforms, including regional integration ventures.

1. Panama: National Ports System

This reform program is the first successful one of its kind in the region. It is significant because Panama's port sector is one of the biggest drivers of its economy and the concession experience has shown how much can be gained in efficiency and competitiveness, and how quickly an industry can grow, if the right kind of institutions are in place. It also is a textbook example of the importance of giving all stakeholders input into a program's design from day one. In this particular case it was the competition created in the market with the entry of a privately operated port that spurred dockworkers—initially opposed to the plan—to push for State port reform.

This overhaul of a port system that was the legacy of civil and military investments on and around the Panama Canal was essential for sustained growth of an open economy in which port operations contributed a hefty share of gross domestic product.

In the late 1980s the ports of Cristóbal and Balboa dominated the cargo handling business. The State-owned Autoridad Portuaria Nacional (National Ports Authority-APN) created in 1974, built port facilities and operated and oversaw port operations. It also was the licensing authority for new port development. Users of those two ports had been complaining for years about excessive charges and inefficiency, the shortage of cargo handling equipment, and poor facilities maintenance. Container transshipment costs were nearly 70% higher than rates charged in Kingston, Jamaica, and 50%-150% above costs in Spain, the United States and Costa Rica. Freight transportation costs were high as well, between 50% and 100% above the equivalent charges from and to the United States.

Panama was perhaps one of the few countries in Latin America with no privately owned terminals.

The idea of a mega port center developed around existing terminals at either end of the Canal and linked by rail had been floated and shelved several times. In 1991 the Panamanian government resuscitated the scheme. With support from international organizations it set out to devise an efficiency program for the APN and promote private investment in the country's port industry. The program accomplished little in the way of APN reforms and stalled in its efforts to attract private investors or operators via concessions or privatization deals. The political will for the reforms was lacking and port

workers unions resisted them, claiming that they failed to address their employment, financial, or social concerns.

The only (albeit important) fruit of that effort was the 1995 opening of the Atlantic port of Manzanillo. Promising shorter queuing times and lower costs thanks to more competitive tariffs and greater efficiency, the new facility quickly attracted and diverted traffic from the port of Colón, which meant lost business and lost income for the APN and for dockworkers. It soon became evident that ports needed to be more efficient and more competitive, and port workers became advocates and stakeholders with the Executive Branch in wanting the port system concession plan to proceed.

The port of Manzanillo had been privately owned and run from the start. Concessions were awarded for the Balboa, Cristóbal and Coco Solo Norte facilities by way of a call for tenders open to qualified investors and operators. Hutchinson came away with the concession for Balboa at the Pacific entrance to the Canal and Cristóbal on the Atlantic side; Evergreen was the successful bidder for the Atlantic port of Coco Solo Norte.

Reform of the National Ports System		
Owner	Predecessor	Location
Hutchinson Panama Ports Company (PPC)	APN (*) Cristóbal	Atlantic
	APN Balboa	Pacific
Evergreen Colón Container Terminal (CCT) Colón Port Terminal (CPT)	APN Coco Solo Norte	Atlantic
Manzanillo Manzanillo International Terminal (MIT)	MIT Private	Atlantic

* The National Ports Authority (APN): operator, regulator, and compliance agency until 1997

National Ports System: Freight Activity* (Thousands of Metric Tons)				
	1996-97^a	1999	2000	2001
Evergreen	91	1,455	1,138	1,253
MIT	3,100	6,153	6,955	6,417
Hutchinson	1,701	5,993	6,762	6,877
Total	4,893	13,601	14,855	14,547

* Includes loading and unloading

^a Figures refer to the average of the years 1996 and 1997

Source: Compiled by the author from Maritime Ports Authority (AMP) data

National Ports System: Container Activity* (Thousands of Container Units)				
	1996-97 ^a	1999	2000	2001
Evergreen	14	131	122	130
MIT	290	536	606	570
Hutchinson	110	74	81	232
Total	414	741	809	932

* Includes loading and unloading

^a Figures refer to the average of the years 1996 and 1997

Source: Compiled by the author from Maritime Ports Authority (AMP) data.
The 1999 falloff in Hutchinson activity reflects the diversion of traffic to MIT

Impact of the Entry of Private Operators (Number of Vessels)				
	1996-97 ^a	1999	2000	2001
Evergreen	1,090	1,413	1,426	1,525
MIT	1,010	1,516	1,596	1,602
Hutchinson	2,224	3,099	2,444	2,871
Total	4,334	6,028	5,466	5,988

^a Figures refer to the average of the years 1996 and 1997

These changes have had an appreciable effect, with direct impacts on port activity and employment and spillover effects on the nation's economy. The cargo handling and transshipment business is still one of Panama's top external revenue generators. **In the space of five years the National Ports System has seen the metric tonnage of cargo triple and the number of containers double** (though vessel traffic was up only 40%) thanks to investments in the sector and the ensuing efficiency gains.

Competition in the Market and Regard for Labor Rights Were the Keys to Successful Port Concessions
The competition that the Manzanillo port sparked with the Colón facility prompted the government to concession the rest of the national ports system. Giving dockworker unions input into the program's design was the key to crafting proposals that duly addressed their concerns. The concession exercise was successful; compensation for downsized workers came out of concession payments.

2. Honduras: National Airports System

The concessioning of Honduras's National Airports System (SNA) is the first such deal consummated in the region. Costa Rica, Guatemala, El Salvador, and Panama all had attempted without success to put their airport infrastructure out to concession: there were legal setbacks in Costa Rica, Guatemala and El Salvador came up against political problems, and Panama was unable to put together a plan that could reconcile the different development objectives for its airport infrastructure.

The Honduran program is interesting also because of the debate it touched off in the country's technical and political teams to decide on the best strategy to adopt. The SNA takes in four major airports—Toncontin, San Pedro Sula, La Ceiba, and Islas de la Bahía (Roatán). At the heart of the strategy debate was the choice to be made between a master concession and separate concession contracts for each airport. The separate-concession option had the merit of heightening competition (one important objective) whereas a master concession would get around the difficulty of attracting prospective operators and investors to such modest deals and offered the prospect of capturing economies of scale in Honduras's small domestic and international aviation market.

The concession process culminated in 2000. A master concession covering the four main airports was awarded to InterAirports S.A., a consortium of local and foreign investors, with Aeropuertos de San Francisco as the system operator.

The elements of reform in the airport systems in Honduras were to be similar to that in other infrastructure sectors—rewriting legislation and the revamping of institutions and regulatory framework. Up until 1999 civil aviation services (with the single exception of air navigation services) had been provided by the Civil Aviation Directorate (DGAC), which also was the regulatory body. As a government agency attached to the then-Ministry of Public Works and Transportation (SECOPT) its mandate included policy-making for the sector.

Unfortunately, the legal, institutional, and regulatory reforms did not materialize. The most important task still on the agenda is to create an autonomous body for economic regulation of the industry.

Perhaps the most visible accomplishments of the airport concession exercise are the incorporation of a qualified operator for the National Airports System, the relief the program is bringing to public finances, the transfer of infrastructure finance to the private sector and—an important consideration for the expansion and sustainability of airport facilities—the overhaul of the pricing system and airport service fee levels.

However, the reforms have not been problem-free. First of all, demand contracted probably beyond the worst scenarios foreseen, reducing the concessionaire's resource base to meet its contractual obligations. Although this is no doubt a business risk which a concessionaire must accept as part of the rules of the game, much of the discontent with the reforms is certainly due to the increase in airport fees. However, for the first time, the fees are probably close to the economic costs of providing the services. Also, the increase reflects the costs of the concession fee agreed with the concessionaire.

Master Concession Contract	
Terms of Reference	Operate, maintain, develop and expand airport capacity, aviation activities at airports and ancillary activities as provided in the contract
Duration of Contract	20 years, renewable for 10 years
Grantor	The Honduran State, via the Ministry of Public Works, Transportation and Housing (SOPTRAVI)
Regulator	Civil Aviation Directorate (DGAC) on behalf of SOPTRAVI
Contract Supervisor	Superintendency of Concessions and Licensing (SCL), deconcentrated agency of the Office of the Comptroller General of Honduras (which reports to the National Congress)
Legal Framework	Concessions Law of November 1998. Open Skies Law (agreement between the U.S.A. and countries in the Isthmus). (Pending) Law to create a National Civil Aviation Administration (ANACI)
Concession Rent	34.5% of gross revenues
Capital Investment Plan	Urgent improvements costing US\$26 million by 2003 and a further US\$34 million over the life of the concession

It is still too soon to calculate what concrete benefits the airports concession will mean for Honduras. What is clear is that, at least in the short term, results have definitely been affected by the global economic crisis and the even deeper crisis in the aviation industry.

A new private consortium recently assumed airport operations. The contract was renegotiated and subsequently ratified by the congress and the executive branch. The concession fee was brought from 39.5% to 34.5% and investment commitments were scaled down to reduce short term pressures on airport tariffs.

The concession fee issue highlights one of the dilemmas involved in concessioning and privatization projects, and should be addressed by reform program designers. The problem is choosing between either the short-term benefits of fiscal income or the long-term economic benefits.

V. The Role of the Bank

The Bank assisted the countries in the design, development, and implementation of all the infrastructure reforms essayed over the period reviewed here. According to its Seventh Capital Replenishment mandates, in the early 1990s the Bank's activities were to have supported World Bank programs. However, Bank technical teams quickly found project design and development spaces of their own and by mid-decade the Bank had become the leading provider of infrastructure finance and technical support for infrastructure ventures in the region.

To help countries put through their reform programs the Bank approved fast-disbursing policy-based loans (PBL) to supplement domestic saving and provide balance-of-payments support. Perhaps its most important contribution was technical-cooperation funding associated with these infrastructure sector initiatives. The newly created Multilateral Investment Fund (MIF) proved to be a crucial adjunct to the Bank's own lending resources to see the reforms accomplished.

The reforms most likely would not have happened without the support of IDB and MIF technical cooperation funding.

The Bank's financial products were fundamental in securing the requisite technical support and specialists in regulation and privatization, areas of expertise that at the time were at the frontiers of knowledge and experience not just in the region but around the world. It would be no exaggeration to say that without Bank and MIF technical-cooperation funding the reforms could not have been consummated. This is all the more significant when one considers that these technical cooperation resources accounted for just a fraction of total Bank funding flows to the region over this interval.

The leverage effect of technical-cooperation resources has been equally important in the **SIEPAC** project, in which some US\$15 million in technical-cooperation funding is assisting directly in a US\$320 million investment project. That money is expected to leverage over US\$2 billion in electric sector investments in the Isthmus over the next ten years.

The Bank's technical teams have obviously been guided in their work by Bank rules and operating policies and by a common program development paradigm. However, when one distills the learning process that unfolded over those years two trends in particular stand out. One is the lesson learned of the evolution, at the design stage, toward more sharply targeted programs and simpler conditionality regarding substantive elements of reforms. The other is the folding of infrastructure reforms into broader reform programs aimed at modernizing the public sector in general. The first of those trends was clearly a positive one; the benefits of the second are more debatable.

Human resources training in infrastructure sectors is arguably one of the most valuable intangibles that Bank funding has brought the region.

This look back at reform programs generally and at the Bank's role specifically would not be complete without a mention of the invaluable training and development opportunities captured by local professionals who were assigned to work with Bank project teams and external consultants on the programs' design, development and implementation. They were directly involved in crafting legislation, regulations, and institutional frameworks and gained experience serving as able interlocutors with the political teams responsible for decision-making in each country.

The reforms in Panama, Guatemala, and Nicaragua are stellar examples of the human resources training benefits of these programs. In Panama, in particular, most of the professionals who have been part of program executing units since the early 1990s now hold very senior positions in regulatory and oversight agencies.

IDB Financial Support^a (US\$ millions)			
Country	Fast-disbursing PBL^b	Technical Cooperation	MIF
El Salvador	\$70	\$0.75	\$1.97
Guatemala	100	7.65	1.15
Honduras	155	5.00	1.13
Nicaragua	114	6.00	11.60
Panama	120	3.34	1.81
	Project Financing	Technical Cooperation^c	Other^d
SIEPAC	\$170	\$14.9	\$115.8

^a These figures are exclusively for loans approved to help implement the reform projects discussed in this report

^b Policy-based loans

^c Includes loans (US\$9.6 million) and grants (US\$5.3 million)

^d Spanish Quincentennial Fund and ENDESA-Spain

A vital adjunct to this financial support was the discussions and exchanges of views and experiences that were a feature of project teams' work across the region. Workshops, seminars, and other discussion forums with technical, political, and civil society groups were funded out of the Bank's operational budget. Such gatherings yielded the greatest benefits when they were organized early on in a program. They were especially productive in electricity sector programs and, to a lesser degree in more recent transportation sector reforms.

VI. Observations and Lessons Learned

A. The Reforms Generally

Countries in the Central American Isthmus have unquestionably benefited from infrastructure reforms. Perhaps the most challenging task now before them is to consolidate the gains achieved thus far and tackle the many unfinished issues on the agenda. One of the most pressing needs is to dissociate the reforms' goals and instruments from their political costs, particularly the social toll exacted by the typical State-enterprise privatization exercise.

As countries pursued these reforms and rationalized basic infrastructure service delivery all the political costs associated with resolving such major systemic problems as an economy's inability to (i) create jobs, (ii) reduce poverty, or (iii) improve income distribution, ended up being ascribed to the privatized enterprise. The State-owned companies had been transformed into vehicles unable to alleviate these problems. The social tolls of human resources rationalization programs and of restructuring of rates and fees thus are the chief political costs imputed to concessions and privatizations.

The political costs of what were systemic problems in the region's economies—unemployment and poverty—were laid at the door of the privatized enterprise, the keystone of the reform.

Priority focuses for the countries now if they are to cement the gains achieved thus far are employment creation, poverty reduction, and improvements in income distribution. It is somewhat ironic that political costs should be blamed on the reforms, given the evidence that the poorest households typically have borne the brunt of the economic and social costs of State providers' inferior service.

A second observation emerging from this retrospective view is that while there was a fairly broad consensus as to the conceptual model for the reforms, i.e., a more or less homogeneous package of economic policy objectives and desirable features, there were considerable differences in practice in the countries' choices of approaches and instruments and in the attendant political processes. Each country had to orchestrate its own reform in its own setting.

With that theoretical model as a guide each country mapped out reform plans and negotiated and adjusted the scope of the reforms and specifics as to measures and vehicles. Telecommunications reform is a good example of distinct policy options: for Guatemala and El Salvador the prime goal was development; Panama, in very different macroeconomic and political circumstances, was more concerned with fiscal objectives and political support, though development goals were not neglected.

A third observation from a look back at this array of country experiences is that while a list can be assembled of features and instruments that are indispensable for a successful reform program—the “necessary conditions,”⁹ coming up with a list of “sufficient conditions,” i.e., instruments whose presence would assure a program’s success, would be much more elusive.

Country Ownership of Reform Programs: Necessary Conditions	
• • •	Solid local teamwork
	Thorough understanding of the programs’ rationale
	Political resolve, clarity as to the attendant political costs

This was manifest in the relative difficulty or ease with which countries carried through their reforms. Programs unfolded most smoothly in countries that had a solid work team, the requisite political resolve underpinned by a thorough understanding of the **programs’ rationale**, and a coherent policy agenda. As far as the Bank’s contribution was concerned (above and beyond its financial assistance) its support was most effective where technical teams helped in efforts to make sure those elements were in place.

A fourth lesson emerging from the accumulated experience with infrastructure programs is that one of the key outcome drivers was the depth of understanding of the **why of the reforms**, i.e., a clear awareness of what we might call the generic objectives of the reforms but of their political costs as well.

Lastly, countries have had a much easier time with reforms when they had recourse to a solid technical support program and the financial resources to pay for it. MIF assistance was especially vital on this front, having funded a great deal of the groundwork for discussions and government decision-making. Technical cooperation resources furnished by the Bank in parallel with fast-disbursing policy-based loans were important also to defray the costs of program executing units, which sometimes served as training grounds for local technical teams.

B. Some Country- and Sector-Specific Lessons

To judge from industry performance markers, telecommunications reform in Guatemala has been a success. However, those reforms illustrate how important it is for democratic nations to shape a political consensus around a core set of policies and goals in their blueprints for change to avoid rewrites or adjustments later on as draft legislation makes its way through the system. In the end such changes undermine the internal consistency and integrity of reform initiatives. Political opposition to TELGUA SA’s privatization complicated the process enormously, hurt the reforms’ image abroad, and had much to do with the tepid response from qualified operators and the ultimate share sale price.

⁹ Antonio Vives, “*Ten Commandments for Sustainable Private Participation in Infrastructure*,” Inter-American Development Bank, Washington, D.C.

Two weaknesses in Guatemala's electric sector reforms were echoed elsewhere in the Isthmus. The first was the power regulator's lack of autonomy, which was typical of the region's electricity reforms other than in the case of Panama. The second was the lack of restrictions on cross-ownership of companies operating in different stages in the process. It is too early to gauge the import of these regulatory weak points and what they will mean for the systems' future performance. While the new or revamped regulations and institutions admittedly are not perfect, a different set of circumstances clearly is at work today and it is fair to ask how important it was for these programs to be implemented exactly as designed as opposed to compromising to achieve a less than ideal outcome but still help shape a new environment in which to pursue future reforms.

This experience speaks to the importance of identifying a program's critical policy facets, i.e., the minimum policy package needed to lay the foundations for reform and make for a "superior" transition. This is no trivial consideration: the mere acknowledgment that there is a "second best" avenue—though it may open a window of opportunity for forward movement—can provide an easy out, allowing hard decisions to be sidestepped and standing in the way of essential substantive changes. This is a fundamental distinction for the Bank when it comes to its ability to separate out the transitory interests of one administration from the more permanent interests of the State.

Panama's experience with infrastructure reform points up another important feature of these programs: the dialogue between local technical teams and Bank teams working on the reforms and the learning that comes out of these contacts. At the outset the Bank's assistance to the government took the form of a timid program to enhance efficiency in public enterprises. After witnessing that initiative's meager results the two sides together worked out a program to thoroughly revamp the institutional and regulatory framework, ownership structure and financing of State enterprises. Ongoing dialogue, continual exploration of ideas, and above all the **subsidiary role of Bank teams in reform program leadership and ownership are crucial to the programs' success.**

The experience in Panama also appears to confirm the importance of clearly segregated functions and an autonomous regulatory body independent of the Executive Branch. Panama is a small country with much more limited telecommunications and electricity markets than its neighbors along the Isthmus. To judge from investor response (and the ultimate sale prices) the stability and transparency of the country's laws, regulatory environment, and institutions may well have been one of the chief draws for foreign private investors. The autonomy and independence of the national public utilities regulator (ERSP) was put to the test during the administration change in early 2000, which had no appreciable effect in that regard.

Competition in the market and regard for labor rights were the keys to successful port concessions.

There are valuable lessons to be drawn from Panama's port industry reforms. Competition from the privately run Atlantic port of Manzanillo with the State-owned Colón complex on the same coast was the spur for the government to concession out the rest of the national ports system. The need for reforms had become patent as State-owned and-operated ports lost business and saw their activity decline. Initially the port workers unions resisted the reforms, but once they were given a say in the program's design it became possible to put together proposals that duly addressed their concerns. The concession process came to a successful conclusion; compensation for downsized workers came out of concession payments.

Lastly, the airport concession in Honduras highlights the need for an exhaustive discussion, careful selection, and clear formulation of the objectives to be achieved. In the short term the 39.5% concession fee offered by the winning bidder had a favorable impact on fiscal revenues, but had an adverse effect on sector activity levels and its potential rate of growth.

VII. Concluding Thoughts

Over the past several years the Central American nations and Panama have lived through dizzying changes, not least in their infrastructure sectors. Though the countries still have a long infrastructure agenda ahead of them most now have rewritten policies and rules in place and a modern, transparent institutional apparatus.

New telecommunications technologies have erased market-segmenting barriers. By and large this has meant an end to the erection of legal barriers that can allow monopoly rents at the expense of efficiency. Though there still are some substantive issues to resolve in the electricity sector the integrated regional power market offers tremendous opportunities for the future. The most pressing concerns for the region, especially if it is to attract efficient investment, are the existence of cross-ownership of companies engaged in associated activities and the need to create national and regional regulators and give them real authority.

Removed now from the region's work agenda is a lengthy list of issues that were front and center in the early 1990s, such as heavy commercial losses, overstaffing, inefficient rates and fees structures, and political intrusions into utility company operations and priority-setting. The reforms charted in the early part of the decade and still to be completed were designed to tackle issues and objectives of that era. In an acknowledgment of the essentially dialectical nature of the process of perceiving and understanding problems and proposing solutions¹⁰ the region's agenda today is addressing not just those pieces of unfinished business but also the paradigm challenges created by new market structures and reconfigured institutions.

¹⁰ Thomas S. Kuhn, *The Structure of Scientific Revolutions*. University of Chicago Press, 1962.

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CHAPTER 5: INNOVATION IN THE SOCIAL SECTORS

Stephen E. McGaughey

Introduction

The Central American Isthmus is an area of seven countries (Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama), 37 million inhabitants and a critical number of poor people and backward areas. In the 1990s the region stepped up its population transition from rural to urban areas and its political democratic transition following the armed and political conflicts of the 1980s. These changes have been tied to rapid internal economic adjustments and reforms. Simultaneously, there was a rising social and political participation leading to growing expectations and demands on governments to foster more rapid social reform and development.

The Inter-American Development Bank was the countries' chief external partner in the region in introducing a broad spectrum of economic and social policies, programs and projects, trying to restore social indicators after the "lost decade" of the 1980s. Progress on social fronts has been made by the countries since the early 1990s in education, health care, local rural and urban development, nutrition and social assistance programs.

This report depicts the Bank in its role as the main source of public external funding in the region, and its very far-reaching partnership with the countries during more than a decade, galvanizing essential support for social development programs and reforms. The IDB's programs with the countries contain a wide gamut of innovative operations and a continuous process of learning and adjustment to assist the countries in increasing the effectiveness and sustainability of social policies, programs and project operations, including the introduction of new financing instruments to facilitate the process. This report portrays the progress in the countries, the partnership with the Bank, lessons learned and a view of the social development agenda ahead.

The operations examined herein include:

- Social development and poverty reduction strategy formulation
- Education reform
- Health care reform
- Social investment programs and local management of social services;
- Targeting social services to the poor through innovative social safety net programs
- Programs for vulnerable, socially-excluded groups and regions; strengthening labor markets

The social programs of the 1990s and beyond contain common threads that go to the heart of creating a new framework and capacity for social development in Central America. Common design elements in the IDB's programs and projects have shaped the program format, institutional capacity of the countries and communities, beneficiary

groups, national policies and programs of social assistance in this critical period of social change.

There are at least five noteworthy elements of the social development strategy that evolved in the region in the 1990s and the early 2000s:

(i) A common task of the social development strategy has been to help the countries in a measured *shift from traditional, reactive social development strategies and policies, to highly targeted and reform-oriented programs* that focus on building national poverty reduction for high priority, vulnerable groups and regions. The new policy orientations are seen throughout the operations described here, include support for and financing of national poverty reduction strategies, new style national social safety net programs, deep reforms of the health and education sectors, and setting up new, targeted programs for excluded, vulnerable groups, such as handicapped persons, indigenous communities and regions.

(ii) All of the social sector operations have promoted *increased public sector national and local institutional capacity to formulate national social development policies and plans, and to execute programs and projects* in key sectors and regions. The operations have encompassed education and health reform, local development and decentralization, poverty reduction strategies, urban as well as rural development and a common ingredient of all the IDB's programs has been to support the primary capacity of governments to manage social development and poverty reduction activities. The design of new institutional means has been one of the main challenges and elements that has defined the success, or lack thereof, in each operation.

(iii) An important element in the transition from traditional to new generation social reforms in the region has been to *increase the participation of decentralized governments, community organizations, the wider civil society, the private sector and potential program beneficiaries* in all stages of project conceptualization, design and execution. It has been seen that greater participation leads to social investments that are closely akin to the communities' needs and that the public and private resources are more efficiently and transparently applied to these needs. The cases outlined in this report support the view that local participation can be introduced in education, health care, local development, social safety net programs and in formulating national poverty reduction strategies.

(iv) There has been a modification in the content of social sector investments by shifting national policies and programs toward *augmenting the quality of public social services*, especially in education and public health, and expanding the access to these services of the many excluded rural inhabitants and vulnerable groups. This emphasis on quality and access by excluded groups has become the theme of the 1990s and beyond for primary and secondary education programs, primary health care, nutrition assistance, social infrastructure investments, local development, and employment training.

(v) The IDB has emphasized the implementation of effective, innovative *pilot programs to be scaled up in the future to national programs or multiple local areas* that then have wider impacts on reducing poverty and fostering social development. The introduction of new loan instruments, such as multi-phase lending, and the gradual and experimental modification of social investment programs have favored a process of learning-by-doing and expanding successful social project models to national programs and to other countries with similar experiences.

This report looks at individual program and project experiences, emphasizing **innovative** ideas, activities and programs. The experience of the IDB in Central America suggests that governments and communities, with selective international support can make quite significant improvements in the general social well-being now and in the future.

I. Social Development Profile and Issues in the Central American Region

A. Introduction

The present report reviews the role of the Inter-American Development Bank in the Central American Isthmus (Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama) during the 1990s and into the early 2000s, in promoting policies and financing programs to further the countries' social development. The report identifies the most innovative social sector financing operations and non-financial activities of the Bank that were fostered in the countries in response to the inadequacies of past social sector development. Social development here is broadly viewed to include all programs and policies primarily directed by the public sector intended to increase human capital, reduce poverty, lessen income inequality, mitigate extremes in regional development, assist the most vulnerable social groups, and respond to national crises and economic difficulties that impact disproportionately on the poor.

In this period, and as a result of the economic crisis of the 1980s, the IDB played an increasingly decisive and active role in increasing external financing and technical assistance to help deal with the social ills in the Isthmus. The economic crisis, combined with the political crises and armed conflicts that affected several countries in the area, left the region's social and economic indicators well below levels at the start of the "lost decade" of the 1980s. During the same period, and in response to the basic social and economic issues of Latin America, the Bank's member countries agreed to redirect its policies and strategies through the 7th and 8th Permanent Increase in Capital to accommodate and support the countries as they went through significant political, economic, social and institutional transformations in response to the grave social repercussions of the economic crises of the 1980s.

Whereas many Latin American countries initiated significant first generation economic reforms in the late 1980s, several Central American countries lagged somewhat in the implementation of the reforms until the first-half of the 1990s. Countries such as El Salvador, Nicaragua and Guatemala, having had years of internal armed conflict, were faced with daunting transformations and reforms to initiate a process of catching up with the lost social development--the "lost decade"--of the 1980s.

The IDB responded flexibly in the Central American region to the social needs, institutional demands and economic requirements of the 1990s and beyond, financing highly innovative, nontraditional social projects, programs, and technical assistance. It is the purpose of this paper to portray some of the most appealing and effective models of social reform and the key social development programs that were supported by the Bank that helped the countries initiate new and successful strategies for social development. It will be seen that the Bank worked simultaneously across several social fronts using a variety of financing mechanisms and program instruments, permitting the targeting of

Bank financing and non-financial instruments, and coordinating with other interested external funding sources for the benefit of the countries of the region.

B. Critical Social Sector Issues in Central America

That the decade of the 1980s is called Latin America's "lost decade" is widely acknowledged, and the period represented an especially deep economic, political and social crisis for the region. The 1980s involved an extended period of economic stagnation, with severe impacts of the international recession in the period 1982-1985, fiscal deficits and international balance of payments deficits throughout the region, permanent debt problems, international debt default by major countries, international debt renegotiations throughout Latin America, declining regional terms-of-trade and the initiation of structural adjustment programs. The market-oriented structural adjustment programs of the IMF and the World Bank incorporated a new pattern of economic reforms, including reduced government intervention in the economy, constrained government spending and intervention, increased taxes to cover expenditures and reduced fiscal deficits, freeing exchange rates, deregulating interest rates and eliminating price controls, and improving national governance. The emergence of what was to be called the "Washington Consensus" influenced national economic and social policies and led eventually to a rethinking of the approaches to poverty and inequality.

The 1980s constituted a problematic political period for the Central American region. On the political front the military conflicts in El Salvador and Nicaragua, and the continuing military and political crises in Guatemala, led to severe social deterioration and emigration. The economic and political integration process in the region was set back. But during the latter part of the decade the governments started a process of political recovery, democratization, negotiation of the armed conflicts and the modification of the role of the State in social reform and development. This changed the willingness of the governments to increase social and political participation and accommodate the social demands stemming from the worsening social indicators of the earlier period.

Hence at the start of the 1990s, the social profile of the region was of great concern to national governments and the international community. Public social expenditure, as a percent of GDP spending, was segmented in the region with Costa Rica and Panama spending in the lower range of 15 percent to 20 percent of GDP, Nicaragua and Honduras spending from 7 to 10 percent of GDP, and El Salvador and Guatemala committing less than 5 percent of GDP to social sector spending annually. This undoubtedly reflected the late start of El Salvador and Guatemala in embracing social development until after they negotiated the peace accords that were signed in 1992 and 1996, respectively. In any case, the rate of overall social sector spending for the region at the start of the 1990s was quite low by Latin American and international comparative standards.

Social Equity in Central America

Social equity is a pending goal in Central America at the turn of the century. The end of military conflicts, democratization of the political regimes, and modernization of economies has not managed to alleviate the historical social inequalities within the region. These inequalities, or equity gaps, are multiple: between urban and rural zones, between the rich and the poor, between the indigenous and the non-indigenous, between men and women. The region is still the scene of social inequality that negatively affects the human development of the majority of the population. Millions of Central Americans have limited or no access to opportunities for good employment, a quality education, or the services to meet their health necessities.

Source: ALIDES: Central American Alliance for Sustainable Development, signed in 1996 by the Presidents of Central America, Belize, and Panama

The challenges at the end of the 1980s and the early 1990s, in comparison to the latter part of the 90s to the present, were quite different. Emerging from the decade of the 1980s, the main challenge in the region was to modernize economic structures and to recover economic growth that had fallen on a per capita basis rather dramatically during the 80s. By the 90s it was evident that it was insufficient to count on economic reforms and growth alone to make significant social progress through redistributing the gains from economic growth, by automatically reducing the impacts of the economic crisis on the most vulnerable groups and by gradually changing social spending—rather, it was and continues to be necessary to deal with the social problems head on through reforms and targeted public spending.

C. Benchmarks of Social Development in Central America

1. Growth and Poverty

The performance of the Central American economies in the 1990s is contrasted with the “lost decade” in which there were across the board reductions in growth throughout the area and significant declines in per capita income and increases in poverty.

A return to growth took place in the 90s, especially in the first half of the decade. However, growth slowed again in the latter part of the 90s in El Salvador, Honduras and Guatemala. Nicaragua increased its growth rates in the latter half of the 90s; this represented a postponement in the return to growth compared to other countries that had reinitiated positive growth in the early 90s. ECLAC (CEPAL) was to refer to the latter half of the 1990s as the “lost half-decade” in Latin America, a confirmation of the return of slow growth. In the 90s there was mixed evidence of the reduction in poverty rates (with the poor measured as a percentage of the population earning less than US\$2 daily). Costa Rica and Panama reduced their rates manifestly, but El Salvador, Guatemala, Nicaragua, and Honduras, coming out of the armed conflicts and political instability with the associated dislocations and economic impacts, were slow to reduce poverty levels (this based on relatively solid information from household surveys).

Central American Region. GDP Growth and Poverty in the 1990s						
	% Growth Real GDP		% Growth Per Capita Real GDP		Poverty Rate % of the Population	
	1981-1990	1991-2000	1981-1990	1991-2000	Early 90s	Late 90s
Belize	5.1	4.5	2.4	1.4	n.a.	n.a.
Costa Rica	2.5	5.3	-0.3	3.2	35.9	30.5
El Salvador	-0.3	4.6	-1.4	2.4	n.a.	64.0
Guatemala	0.9	4.0	-1.6	1.4	n.a.	n.a.
Honduras	2.5	3.2	-0.7	0.3	77.2	75.3
Nicaragua	-1.2	3.3	-4.1	0.5	70.7	72.7
Panama	1.6	4.4	-0.5	2.7	47.8	36.6

Sources: Growth and GDP: *Las economías de los países centroamericanos: Evolución y desafíos de largo plazo*. Manuel R. Agosin, Roberto Machado and Paulina Nazal. IDB, November, 2002;

Poverty rate threshold of US\$2 per day: *Background Report on Social Indicators in Latin America at the Turn of the Century*. Sarah Gammage and John Schmitt for Social Development Division of the IDB, February 27, 2002.

An interesting aspect of the change that took place is that the region was late coming to the rural-urban demographic transition. In 1999-2000, Guatemala, El Salvador and Costa Rica were more rural than urban, and Honduras was evenly divided between rural and urban. These predominantly rural populations have limited access to basic social services, and it is correspondingly more difficult for the public sector with its restricted budgets and weak organization to supply these services to dispersed rural inhabitants.

Also, the under-15 year age group still makes up a startling high (although now declining) percentage share of the population. Add to this that the indigenous groups that make up from 5 to 15 percent of the population in the countries, except for Guatemala where these groups are more than 60 percent of the population, present a special social challenge.

2. Public Spending in Social Sectors

Social public spending constitutes a substantial share of public spending (recognizing here the numerous issues in defining consistently and measuring social spending). This share has increased in Costa Rica, El Salvador, Guatemala and Nicaragua during the 1990s, has fallen slightly in Honduras, and has remained steady in Panama. This is a rough indicator of the overall capacity of governments to promote social development. Also, social spending as a share of GDP has risen in all countries, except for Honduras.

A Lost Half-Decade

In Latin America, the lessons learned over the past decade of intensive reforms should be the basis for a reorientation of development strategies. The achievements of the reform period, particularly price stability and dynamic export growth, should be maintained. However, it should also be recognized that the expectation that economic liberalization would generate rapid growth in the region has not materialized. Indeed, growth rates since 1990 have been half of what Latin America achieved during the period of State-led industrialization from the mid-1940s through the 1970s. Growth volatility has also been high and income distribution has worsened in several countries.

*International reform should thus be accompanied by the launching of renewed national development strategies based on three primary elements: counter-cyclical macroeconomic policies aimed at reducing the intensity of the business cycle and, particularly, the vulnerability of the region's economies to external financial cycles; active productive development strategies suited to today's open economies, which would strive to improve their international competitiveness and offer more opportunities to small firms and micro-enterprises; and **more ambitious social development policies that would help to ensure that the benefits of growth reach the entire population**. An ambitious political leadership committed to a deep regional integration process should also be part of the solution.*

Source: *A Lost Half-decade in Latin America*, by Jose Antonio Ocampo, Executive Secretary, ECLAC (United Nations Economic Commission for Latin America and the Caribbean, www.eclac.org).

Costa Rica and Panama, countries with higher development indicators, show the largest share of GDP in social spending; Nicaragua displays an increasing commitment to social development, albeit from a quite low starting point. El Salvador, Guatemala and Honduras have a substantial challenge to increase social spending from their relatively low shares of GDP.

Public Social Spending				
	% of budget		% of GDP	
	1990-91	1998-99	1990-91	1998-99
Belize	n/a	n/a	n/a	n/a
Costa Rica	38.9	43.1	15.7	16.8
El Salvador	21.3	27.0	3.3	4.3
Guatemala	29.9	46.2	3.4	6.2
Honduras	36.5	43.3	7.9	7.4
Nicaragua	35.4	37.0	10.8	12.7
Panama	38.6	38.4	18.6	19.4

Source: CEPAL. "Social Expenditure in Latin America: Overview of a Decade", Chapter IV, *Social Panorama of Latin America, 2000-2001*, pp. 113-144

3. Education

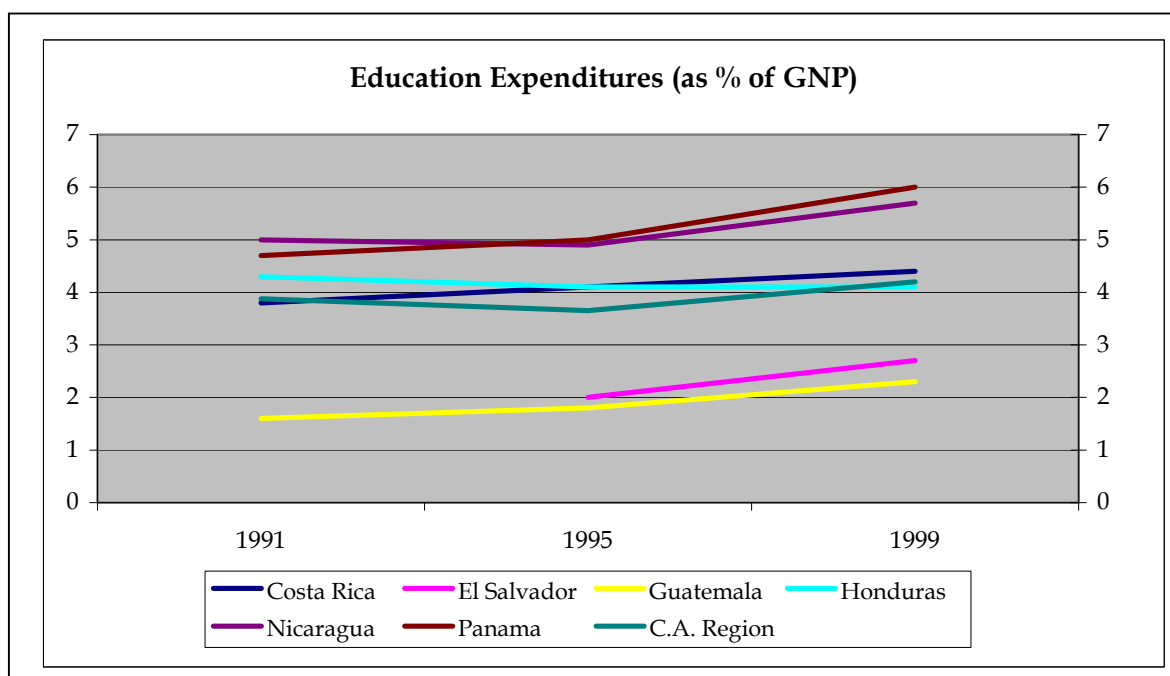
There has been positive progress in education in the Central America region as measured by the overall enrollment and coverage of primary education. There persists a low enrollment in primary schools of rural children and especially children from the poorest families; many of the recent education reforms and programs have been directed to benefiting the balance of these excluded children. Also, the main issue of education reform has been reshaped to one of **improving the quality** of education at all education levels. The attainment of high enrollment rates in the primary levels is also leading to increased pressure on the physical and technical capacity of the secondary education system to absorb the increased numbers of students. The quality of education of primary and secondary education is being furthered by training teachers, creating new curricula, producing new texts, involving the community and families in the management of the local schools, and increasing the management capacity of the ministries of education.

School Enrollment (as % of target population)								
	Pre-School		Primary		Secondary		Post-Secondary	
	1990	1997	1990	1997	1990	1997	1990	1997
Belize	24	27	112	121	41	49	n/a	n/a
Costa Rica	61	74	101	104	42	48	27	30
El Salvador	21	40	81	97	26	37	16	18
Guatemala	26	35	78	88	N/a	26	8	9
Honduras	13	14	108	111	N/a	32	9	10
Nicaragua	12	23	94	102	41	55	8	12
Panama	53	76	106	106	63	69	22	32
Average	30	41	97	104	43	45	15	18

Source: World Bank: *World Development Indicators*, 2001.

Indicators of education progress throughout the decade of the 90s show impressive increases at all levels and in all countries as indicated in the accompanying table. Literacy rates among adults declined only slightly in the period while many of the illiterate adults are women in rural areas.

Evidence of rising national government commitment to education is reflected in increased spending on education. This increase has received substantial international technical assistance and financing and the IDB has been a main contributor in this process. As a percentage of GDP, public spending on education has increased during the



Source: World Bank, *World Development Indicators*, 2002; Aggregates calculated for the Human Development Report Office

1990s. Some countries have already reached important education milestones. Costa Rica and Panama have continued to expand public spending as an above average share of their respective GDPs. Other countries are still spending a relatively low percentage of GDP on education, especially Guatemala, Honduras and El Salvador, and this indicates the need to continue to intensify the support for the sector in the future, focusing on the quality of education, ensuring an adequate physical infrastructure, increasing the access of the poor to the system and expanding the successful model of community management and participation in schools, a model that was particularly successful in El Salvador, as will be seen in Section II C.1 below.

4. Health and Nutrition Indicators

There is a mixed pattern of health indicators and child nutrition in the region. Life expectancy increased by 4.4 percent overall in the region in the past decade and this is comparable with the more well-off countries in Latin America. Infant mortality rates have declined dramatically (28.8 percent overall) and this is a measure of greater access to health care of mothers and children. However, there is some evidence of uneven improvement and even declines in nutrition measures of children less than five years old. The percentage rates of infant mortality are still much too high in the region, especially in the poorest countries where the national infant mortality rates are much higher than the rates in Costa Rica and Panama.

	Life Expectancy at Birth (years)		Trend +/-	Under-five Mortality Rate ^a		Trend +/-
	1990	1999		1990	1999	
Belize	71	72	+	34	28	-
Costa Rica	75	77	+	15	12	-
El Salvador	61	65	+	46	30	-
Guatemala	67	70	+	56	40	-
Honduras	64	69	+	50	34	-
Nicaragua	66	70	+	51	34	-
Panama	72	74	+	26	20	-
Average	68	71	+	39.7	28.3	-

Source: World Bank: *World Development Indicators*, 2001.

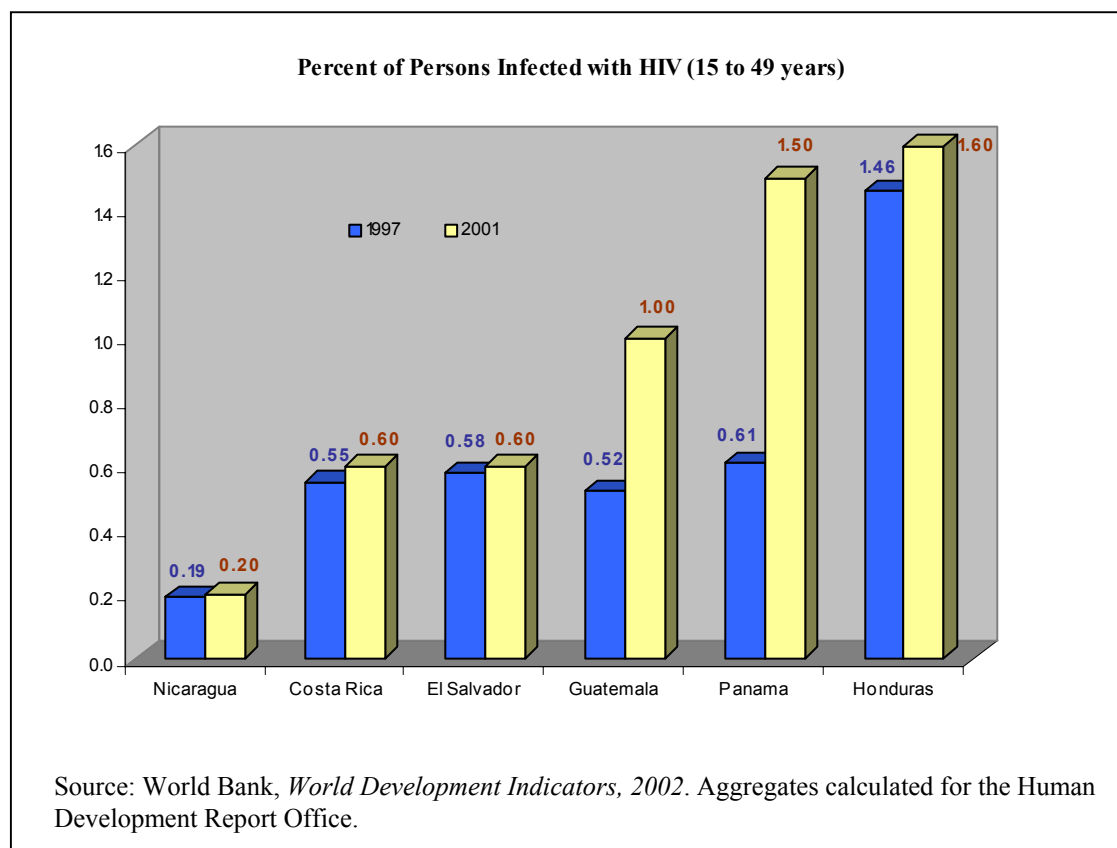
a/ Per 1,000 live births.

Evidence of the low nutrition levels in the region suggests a considerable policy and program task ahead. Mostly, there were improvements in nutrition indicators in the 1990s, but the economic slowdown in the latter part of the 1990s slowed the improvements that were taking place earlier. The social safety net programs in Nicaragua and Honduras presented later in this report are responses to this clear need for public sector action to target health, nutrition and education benefits to the poorest groups, especially in rural regions.

Indicators of Child Malnutrition					
	Below Average Height		Trend +/-	Below Average Weight	
	% 1990-94	% 1995-99		% 1990-94	% 1995-99
Belize	n/a	n/a		6	n/a
Costa Rica	n/a	6		2	5
El Salvador	17	11	-	10	6
Guatemala	40	46	+	27	24
Honduras	40	39	-	18	25
Nicaragua	23	25	+	11	12
Panama	10	n/a		6	n/a
Average	26	25	-	12	15

Source: World Bank: *World Development Indicators*, 2001.

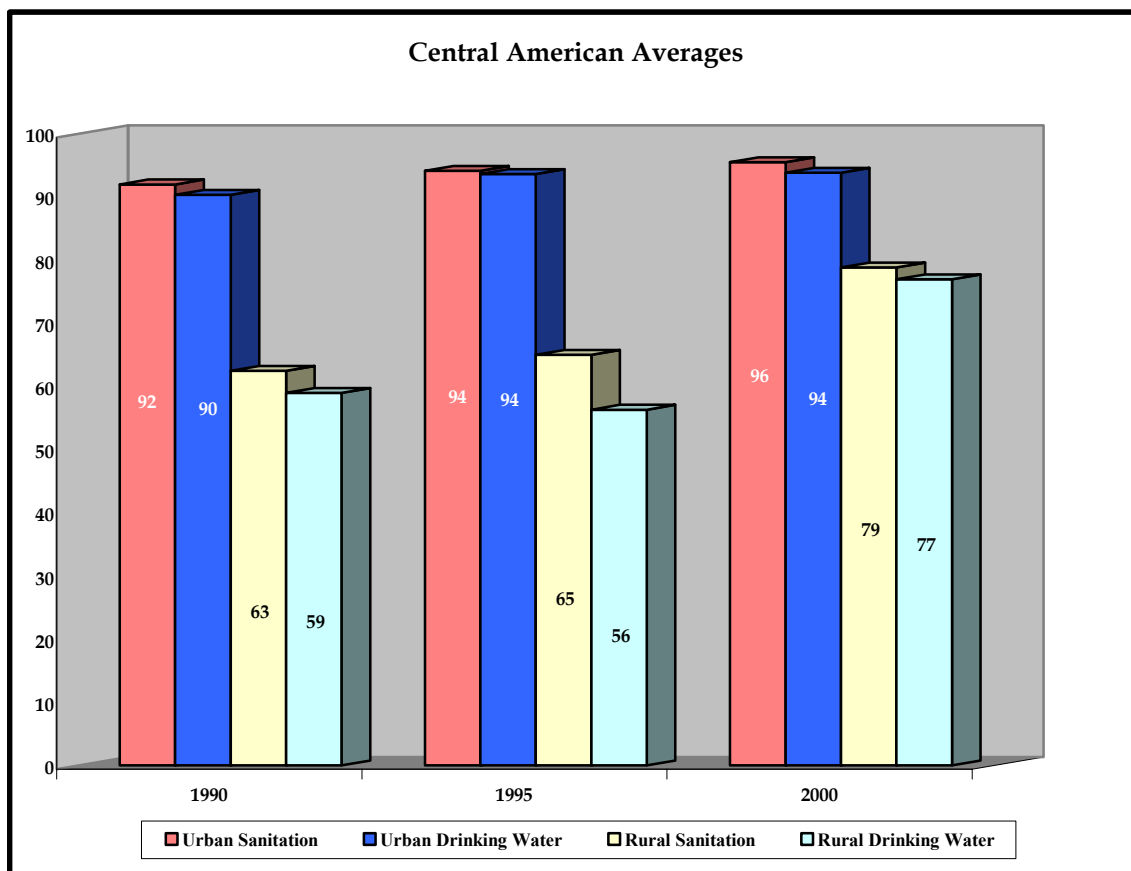
The number of mothers that are attended at birth is poles apart in the region, ranging from 97 percent in Costa Rica, 90 percent in El Salvador, to 35 percent in Guatemala, 55 percent in Honduras, and 77 percent in Belize. Maternal mortality rates are at variance with important dichotomies ranging from Costa Rica (55 per 100,000), to Guatemala and El Salvador with 200 deaths and 300 per 100,000, respectively. This is one measure of the access of the population to basic health care.



In the last decade there is evidence of the growth in the region of HIV infection, as the percentage of the population between the ages of 15 to 49 infected by HIV shows increased rates, which are now above 1 percent in Guatemala, Panama and Honduras. This identifies another important area of cooperation among the countries in the region, in which the IDB is assisting the countries to develop operational action plans.

5. Basic Needs Indicators

Access to water and sanitation is a measure of the access of the population to basic services.



Source: World Bank, *World Development Indicators*, 2002; Aggregates calculated for the Human Development Report Office

Central American urban centers are well served by these services. During the 1990s the access of the rural population to these services has increased by at least 15 percentage points. This is a gauge of considerable improvement, even though there is still a significant gap between rural and urban areas. A major task is to increase the access of the rural population to water and sanitation services to improve rural health indicators.

6. Vulnerable Groups and Regions

A lesson learned by the countries and external funding sources is that for poverty reduction and other social programs to have a significantly measurable impact, the programs must foster activities to target the most vulnerable groups and areas. A number of programs have evolved to target the most vulnerable groups including in their coverage poor children and women, malnourished children, the disabled, people affected by the presence of insecurity and violence, and the significant indigenous population numbers.

Poverty rates in the most vulnerable groups are considerable throughout the region. Malnourished children represent an important share of the population; the share of children that are malnourished range from up to 33 percent of the children in Guatemala, in the 15 to 20 percent range in El Salvador and Honduras, and above 10 percent in Nicaragua and Panama.

Another indicator of malnourishment is the measure of percent of the children less than five years old that are below the expected height for that age. Large differences among countries are evident with Guatemala, Honduras and Nicaragua showing above average rates in the region.

Similarly, the poverty rates among the children are the highest rates among any particular demographic group, and are as high as 72 percent in Nicaragua, with the lowest rates in Costa Rica and Panama. Poverty is also concentrated in women in rural areas and more than 60 to 70 percent of rural women are classified as poor; these rates are two to three times the poverty rates for women in urban areas. Given that many poor women are also heads of households, there is a need to deal with this group of poor to build up human capital and focus benefits on their children to break the cycle of poverty. Also, there are high rates of violence victimization in Central America and the violence affects more of the poor than not.

Some Indicators of Vulnerable Groups and Regions							
	% Indig. Pop.	% Children Malnourished	% with Disabilities	% Violence Victim. Rate	% Child Poverty Rate	% Poverty Rates Women Adults	
						Rural	Urban
Belize	19	N/a	n/a	n/a	n/a	n/a	n/a
Costa Rica	1	N/a	9	30	20	18	7
El Salvador	7	18	2	37	63	77	31
Guatemala	66	33	n/a	43	46	50	12
Honduras	15	17	n/a	42	56	60	25
Nicaragua	5	11	12	40	72	78	49
Panama	6	12	n/a	38	36	41	10

Source: *Background Report on Social Indicators in Latin America at the Turn of the Century*. Sarah Gammage and John Schmitt for the Social Development Division of the Inter-American Development Bank, February 27, 2002.

D. Guidelines and Framework for IDB Action in Central America

1. IDB Goals and Policy Framework

The Bank's overall policy framework is established by its member countries through the dialogue and guidance contained in its capital replenishment exercises of which the Bank has completed eight general increases. The 7th Capital Replenishment covered the period 1990-1993, and the 8th Capital Replenishment, approved in 1994, has been in effect to the present day, subject to institutional reviews and programs carried out by the governing bodies of the Bank in recent periods. Both of the recent capital replenishments brought social development to the forefront as one of the key goals of the IDB. In the 7th Capital Replenishment the IDB established that at least 50 percent of its lending would go to benefit the lowest income groups. The 8th Capital Replenishment mandated allocation of 40 percent of the total loan volume and 50 percent of the total number of Bank operations to social needs, equity and poverty reduction. This compares with the share of IDB's accumulated total lending of 25 percent for social sector projects, at the time of the negotiation of the 8th Capital Replenishment.

The 8th Capital Replenishment identifies three general areas for IDB involvement--poverty reduction and social equity; modernization and integration; and the environment. This is in line and maintains continuity with the emphasis in the 7th Capital Replenishment on low-income beneficiaries, women in development, environmental management and support for micro-entrepreneurs. Poverty reduction in the 8th Capital Replenishment is guided by an emphasis on improving the capacity of governments to implement social development, with a priority on education, health care and vocational training; the promotion of the decentralization of social programs, an emphasis on improved effectiveness and monitoring of social development programs, and poverty reduction to activities in rural and urban development. The IDB member countries agreed in the 8th Capital Replenishment to strengthen the programming process in the countries to identify the strategic areas of work with each country on a regular and systematic basis.

Following the 8th Capital Replenishment exercise, the IDB has continued to refine its goals and program in concert with its member countries. In 1999 the Bank's governing authorities developed an institutional strategy that identified four areas of priority action, as follows: social sector reform; modernization of the state; competitiveness; and economic integration. These priorities are in furtherance of the fundamental goals of the IDB to promote sustainable economic growth, poverty reduction and social equity. Hence the IDB has placed at the center of its goals and activities the promotion of social development and social equity, and this is fully reflected in the IDB's support for social development in the Central American region during the 1990s to the present. It is within this context that the Bank's programs have been furthered in Central America during the last decade.

2. Millennium Development Goals (MDGs)

The Bank and its member countries have accepted the MDGs (approved by governments at the Millennium Summit in September 2000) as a fundamental source of guidance for its support for social development in the region. The MDGs are essentially social development goals encompassing objectives of reducing poverty, fostering the development of human capital, achieving social equity and access to health and material well-being, and the need for cooperation among international development institutions to achieve these goals.

The Millennium Development Goals (MDG)

1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality and empower women
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, malaria and other diseases
7. Ensure environmental sustainability
8. Develop a global partnership for development

In addition, the recent poverty reduction strategies prepared in the context of the HIPC debt reduction program are similarly tied to the MDGs.

3. Country Programming, Policy Dialogues and Strategy Formulation.

The 8th Capital Replenishment of the IDB gives high priority to country programming, whereby the Bank and each country engage in an in-depth review and analysis of the national development issues for medium-term periods of three to four years, establishing agreement on the issues and then constructing tentative lending and technical cooperation programs for the period. The Country Paper, a product of careful technical and policy consultative exercises in each country with the government authorities and the civil society, is approved by the Bank's Board of Directors, and an annual progress report is updated for the Board each year as a part of a year-to-year lending program agreement. This process creates the roadmap for IDB action with each country. The programming process and the Country Papers in the Central American region clearly reflect the signal importance of social sector reform and poverty alleviation in the work program of the Bank and its borrower member countries.

In addition, the IDB conducts policy dialogues for sectors at the country level tied to the multi-annual and annual programming process. Workshops have been held in several countries in Central America during which Bank authorities and national leaders meet to analyze frankly and directly indicators of economic and social progress, appropriate economic, social and other sector policies, institutional issues and guidelines for future work. These "retreats" (*encerronas*) have been conducted in several Central American countries in conjunction with the peace accords, and usually at the time of a government change following elections. Similarly, regional consultations have been organized among the countries and international financing and technical assistance sources for the purpose of agreeing on a framework for financing. Just such a regional consultative group

meeting was organized for Central American in response to Hurricane Mitch.¹ The consultative meetings placed social development at the center of the national and regional work program, and have led to commitments to finance new innovative social investments in Nicaragua, Honduras, Guatemala and El Salvador, many of which are identified in this report.

¹ For more information on this subject, see Chapter 2 on the IDB and Consultative Groups for Central America.

II. The Bank's Response to Central America's Critical Social Problems

A. Introduction

This section examines the various subsectors, functional areas and programs in which the IDB has directed its lending and technical assistance for social development in Central America since 1990. There are a number of common themes and issues that tie together the programs during the period in question.

The innovative programs highlighted have been directed by the IDB and the national governments of the region to erect poverty reduction strategies and to finance programs and reforms for education, health care, local development and social safety nets, social investment programs, and to assist socially-excluded and vulnerable groups in specific regions. In addition, the Bank has introduced in recent years important new loan instruments to further the goals of its 8th Capital Replenishment.

These programs may be viewed together with common threads and goals that are seen as follows:

- Helping with a measured shift in the countries from reactive social development policies to highly targeted and reform-oriented programs focused on high priority, vulnerable groups and regions;
- Promoting increased public sector institutional capacity in formulating national social development policies and plans, and executing reforms and programs in key sectors and regions;
- Increasing the participation of decentralized governmental units, community organizations, the wider civil society, the private sector and potential program beneficiaries in all stages of project conceptualization, design and execution;
- Facilitating a shift in national policies and programs toward augmenting the quality of public social services, especially in education and public health, and expanding the access to these services of many excluded rural inhabitants and vulnerable groups; and
- Implementing effective, innovative pilot programs that lead to results that can be scaled up in regional or national programs having wider favorable impacts on reducing poverty and social development.

B. Poverty Reduction: Linking with the Region, Working with Governments, Communities, Civil Society and Local Citizens

It is a long and respected tradition in the IDB that the borrowing nations play a key role in the Bank's policy formulation through their membership and participation in its governing bodies. This has led the Bank in its various capital replenishment exercises and interim reviews of institutional goals to set policies and overall institutional goals in accordance with a consensus among country borrowers and the main capital contributors. This culture of participation and consultation also extends to the preparation of annual

and multi-year formulation of lending and technical assistance targets and programs. In particular, this involvement of borrowers in policy formulation and programming of operations explains why the Bank has been responsive to the countries needs and has given central priority to social development, poverty alleviation and the reduction of inequality as central guiding precepts for its financing over more than a decade and a half in the Central American region.

1. Poverty Reduction Strategies

Since 2000, national Poverty Reduction Strategies (PRSs) have gained prominence as frameworks to help poor countries develop and implement effective policies and programs to reduce poverty. The PRSs have been prepared by governments in Central America to identify priorities for public expenditures, policy reforms and key measures aimed at meeting specific long-term goals pertaining to poverty reduction. Basic characteristics of the PRSs include: (i) a country-driven and country-led approach; (ii) a broad-based consultation process with stakeholders; (iii) a results-based approach with measurable goals and indicators, as well as monitoring and evaluation systems; (iv) a long-term vision with intermediate indicators aimed at measuring progress toward the long-term goals; (v) a framework for ample support by international agencies; and (vi) a comprehensive approach that considers the necessary macroeconomic and institutional conditions required to meet the PRS goals.

Building on past work and experiences oriented toward the reduction of poverty in the late 1990s, the International Monetary Fund and the World Bank encouraged poor countries to prepare PRSs. Both institutions linked debt reduction under the enhanced Highly-Indebted Poor Country (HIPC) initiative to the preparation and a track record of successful implementation of a PRS. The IDB joined the IMF, World Bank, and other multilateral and bilateral agencies in supporting countries in the process of preparing PRSs. In Central America, beneficiaries of the initiative include Honduras and Nicaragua as a part of the HIPC initiative and Guatemala as a national stand alone exercise.

The IDB has provided support for the country preparation of PRSs through its lending and non-lending activities. This support includes: (i) a poverty reduction focus in the IDB's country policy dialogues; (ii) support to countries in strengthening their information systems; (iii) technical support to the entities responsible for drafting the PRSs; (iv) reviews and the preparation of comments on draft PRSs; (v) help in identifying strategic options for sector approaches; (vi) identification of indicators and monitoring and evaluation systems; (vii) support to the consultation processes; and (viii) loans aimed at setting up the institutional and financial frameworks for PRS implementation as well as to reach the goals established in the PRSs. This support generally has been through several sector loans in Honduras and Nicaragua.

To date, two countries in the region that are participating in the HIPC debt reduction initiative have completed PRSs: Honduras and Nicaragua. In addition, two non-HIPC countries, Guatemala and Belize, have completed or are in the process of updating their PRSs, with significant IDB support.

Several lessons and conclusions can be drawn from the Bank's participation in the process. The PRSs provide a common framework for establishing the priorities of the IDB as well as for other international agencies within the development context and priorities established by the countries. For example, the Honduras and Nicaragua PRSs served as the centerpiece for the preparation of the World Bank's and the IDBs own country strategies. Both Banks have harmonized their actions and sought to ensure complementarity of their programs within the context set by the PRSs.

While these efforts represent an initial first step by the countries, the strategies serve as underpinnings for further improvements in national poverty reduction programming and financing. The PRSs also serve as a basis for promoting and monitoring the Millennium Development Goals.

2. Financing Poverty Reduction and Policy Change

- **Nicaragua: Social Policy Reform Program to Support the Poverty Reduction Strategy.** Loan 1114/SF-NI. US\$30 million. (2002)
- **Honduras: Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction Strategy.** Loan 1087/SF-HO. US\$30 million. (2001)

The Bank has developed some quite innovative approaches to support transformation of poverty reduction strategies into effective policy change and into focusing greater resources on programs that favor vulnerable groups, backward regions, reduce urban and rural poverty and lessen income inequality. Specific cases of new financing schemes include funding for the poverty reduction strategies in Nicaragua and Honduras. Both of these countries have completed poverty reduction strategies with the assistance of the international community, and this has allowed for their participation in the HIPC debt reduction program.

Nicaragua: Poverty Reduction Strategy. In the case of Nicaragua, the Bank approved in 2002 a US\$30 million loan for *Social Policy Reform Program to Support the Poverty Reduction Strategy*. The loan operation is a sector loan disbursed in two steps (tranches) and is designed to assist the government in the implementation of the Enhanced Economic Growth and Poverty Reduction Strategy (ERCERP). The loan disbursements are linked to the fulfillment of a number of key policy and program goals set out in the ERCERP to facilitate the monitoring of the program, and to provide funds to ensure that social sector spending is sustained and targeted to fundamental social programs in education, health and social welfare. As the country fulfills the conditions it will then be able to benefit from the HIPC debt reduction initiative. Underlying the programs is a commitment of national authorities to reach the Millennium Development Goal of reducing poverty levels by 50 percent by 2015.

The conditions mutually agreed upon with national authorities favor a number of critical elements of the poverty reduction strategy. These include the definition of intermediate targets to monitor the progress of poverty reduction, starting from agreed upon baseline

values of the targets and the assignment of clear responsibilities among public authorities to monitor the program's progress. In social sector spending for education, health and social welfare, the baseline levels of spending must be sustained over the loan period; and there must be sufficient resources to meet specific physical and budgetary targets. The overall ERCERP targets for 2015 are: in education, 90 percent access to primary education and illiteracy reduced to 10 percent; in health, reduce maternal mortality by 75 percent relative to 1994 levels; and in social welfare, reduce extreme poverty by 50 percent compared to 1995 levels. The loan program will facilitate the achievement of intermediate targets as a pathway to the 2015 goals.

There are some important common elements in this program with similar ones in the Central American region that represent the application of lessons learned over the years by the countries and the IDB in the operation of social programs. These components foster the decentralization of public social services in education, health and social welfare. Earlier education decentralization reforms and efforts are being refined and intensified with far greater participation of the local community in the administration of schools. For the health sector, primary health care systems will be expanded to increase the cost-effectiveness and targeting of the services to the neediest groups. Similarly, for social welfare programs, the goal of streamlining services employs the results of highly successful social safety net programs and child health programs to improve the impact of social spending over the short-term.

Honduras: Poverty Reduction Strategy. In Honduras the IDB has provided steady support for the poverty reduction strategies of the nation. The program *Reforming the Institutional Framework and Creating Instruments for Implementing the Poverty Reduction Strategy* (loan 1087/SF-HO), played a key role in establishing the institutional mechanisms and capacity to prepare and implement the poverty reduction strategy, with a benefit of US\$934.4 million from the HIPC debt reduction initiative. In particular this loan of US\$30 million, available in two tranches, facilitates institutional development in three areas: (i) creating an institutional framework and capacity including technical support for the Social Cabinet; (ii) support for the creation of a special financing mechanism, the Poverty Reduction Fund, and the organization of the budgetary and spending processes for better focusing public spending on poverty reduction; and (iii) institutionalizing citizen participation in the poverty reduction strategy through the creation of an Advisory Council of the Civil Society.

C. New Education Strategies, Basic, Secondary and Higher Education Reforms and Increasing Access to Education by Priority Groups

- **El Salvador: Modernization of the Education Sector, EDUCO.** Loan 879/OC-ES. US\$37.3 million. (1995)
- **Guatemala: Project to Support Educational Reforms, ARE I.** Loan 1054 OC/GU. US\$15.4 million. (1997)
- **Nicaragua: Tertiary Education Program.** Loan 1072/SF-NI. US\$3.84 million. (2000)

There is little debate among observers, policy makers, government, and the regional populace that the improvement in education and the greater access of the poor to quality education is a main element in the equation to expand employment opportunities, ameliorate poverty, reduce income inequality and increase national economic and technical competitiveness. This has been demonstrated especially in Costa Rica where the country has made a long-term significant national commitment to education. The IDB has placed education reform as a key and central element in its strategy of providing national social development assistance.

There are two core goals in the education reforms. The first is to increase the **quality** of education. Much progress was achieved in the 1990s in providing increased **access** to primary education for a large proportion of the school age population in Central America, especially in urban centers. But greater access to primary education was not enough, and a fundamental job in the last decade has been to boost the quality of education through a number of mechanisms such as institutional reform, especially decentralization and greater community participation, by increasing the average numbers of years completed of schooling and preparing the education system by dealing with the transition of more students to secondary education, and refocusing attention on both higher education and preschool education. Similarly, there is a far greater awareness of the urgency to focus programs on the access of education of the rural poor. Thus a more integrated view of the role of the IDB and the Central American governments in education has emerged that has changed the traditional agenda of education development from one of massive access of youth to one of reduced drop-outs and repetition rates and increased quality of education.

Some quite innovative and ground-breaking projects can be highlighted as paradigms of the new education reform model. Examples of these unique new approaches can be found in El Salvador and Guatemala.

1. El Salvador: The EDUCO Program

The program was co-financed by the IDB and the World Bank for the purpose of (i) improving access to education; (ii) improving education quality in both academic achievement (output) and learning environment (education inputs); and (iii) strengthening the managerial, financial and administrative capacity of the Ministry of Education (MINED) to set policies and guidelines for the sector and deliver public education services efficiently. The program includes the functioning of the schools under the new EDUCO regime (where the parents contract the teachers) as well as the autonomous schools that function under the local educational development councils. Among the lessons learned that should be highlighted are that the political support for reform must be accompanied by well-defined indicators of progress and that the decentralization of public resources should be accompanied by greater independence in the management in the areas that most affect the quality of education.

An evaluation of the EDUCO operation indicates that the program met its objectives satisfactorily as indicated by the following factors: (i) an increase in the gross rate of rural school enrollment and an increase in the number of students that complete the sixth

grade; (ii) improvement in the performance of the students of the third and the sixth grade in mathematics and the Spanish language; (iii) a reduction in the drop-out rates and of repeating students; (iv) the development and application of a new legal framework for education reform, decentralization, and school autonomy; (v) an increase in the financial resources to the school system; and (vi) an increase in parent participation and the reduction in the period required to provide educational services.

The program design included emphasis on improving the quality of education and about 60 percent of the financing went for this central purpose, including curriculum development, production and distribution of teaching materials, libraries, training of school directors and teachers, the development of a system of educational evaluation and the development of a health and student nutrition program. The balance of the funds was destined to the expansion of access to kindergarten and primary education and the modernization of the institutional structure of the MINED, including a new legal structure, new mechanisms for the administration, planning, information, communication, evaluation and monitoring of the modernization program. Attention was given to the review of teachers' incentives, improvement in the supervisory system, the design and implementation of a communication plan and a pilot program for a basic education fund.

The numerous EDUCO results befit a considerable effort of the IDB and other international finance institutions, especially the World Bank, to assist the government of El Salvador to implement a fundamentally sound and highly targeted reform benefiting the poor, and shifting the nature and character of education management and participation of the community in the education system. This was particularly relevant as one of the important reforms following the Peace Accords. Evidence of the impact of EDUCO is seen in the following areas: increased access of the community to education; an increase in the enrollment of students, reduction in dropouts and repeating students; an increase in the number of EDUCO schools, hence an across-the-board positive impact on all relevant education indicators. Enrollment increased from 85 percent to 96 percent in basic education. There was a large increase in the number of students finishing the sixth grade, rising from 1,280 to 7,584 in EDUCO schools, reaching 100,000 students in public schools, having achieved an average of 28 to 32 students per classroom, EDUCO students missed about 25 percent days of schooling fewer than the public system overall, indicators in mathematics and Spanish learning rose significantly, and the number of parents associations increased from less than 1,000 in number to approximately 3,000.

2. Guatemala: Education Reform (ARE I)

The Bank's strategy for education in Guatemala has rested on four pillars during the latter half of the 1990s: (i) education reform and strengthening of management capacity to allow for higher investments in the sector under medium- and long- term planning; (ii) specific programs to improve the quality of education services; (iii) approval of new loans subject to increased investment capacity; and (iv) close coordination with other international financial institutions.

The Guatemala Education Reform is an operation that was built upon the prior experience in the region, especially of the EDUCO operation in El Salvador, to focus

financing on the improving the quality of basic education, improving the administrative and institutional organization of basic education services and increasing the participation of beneficiary communities and parents in the management of education in the local schools.

In Guatemala the education reform, an outcome of the Peace Accords, sought to increase the integration of the indigenous regions and communities through education by spreading bilingual and intercultural values in the education system. The main components of the program were (i) to improve education quality by improving the quality of teaching, educating girls, introducing intercultural values, producing bilingual and Spanish textbooks, creating classroom libraries and improving curricula, (ii) expanding primary education for the purpose of reducing high repetition rates and (iii) promoting community participation in education at the local level. The program strongly supported education for vulnerable and excluded groups of indigenous people, girls and rural poor, and implemented institutional improvements as a key vehicle to achieve these goals and effectively manage the program.

Recent evaluations of the program have verified the merits of the initiation of reform. Active coordination existed among the interested international financial institutions in the implementation of education reforms mandated by the Peace Accords, especially between the IDB and the World Bank. Important quantitative targets were achieved in the program, including the provision of 1.3 million bilingual textbooks including in four main Mayan languages and 12 secondary languages, 2,200 mini-libraries of more than 240 texts were established, and more than 8,000 local school committees were created with parents' participation. New curricula were established, concentrating on citizenship, multicultural identity, equity and development, languages, science and social sciences, among others. Teacher training and quality groups were implemented to ensure the application of the new curricula with the preparation of training modules and with a total distribution of close to 300,000 individual modules to teachers. Some of the funds were reoriented after Hurricane Mitch to the benefit of some 250 affected schools. More than 132,450 children participated in the preschool program in 13,245 National Centers for Preschool Education.

ARE I is viewed by national authorities and international observers as a highly successful, pioneering education reform program. While the subsequently approved ARE II program has not progressed as anticipated because of issues of political and institutional transition, ARE I, on its own merits, has set the stage for future education improvements in the country.

3. Nicaragua: Modernization and Accreditation of Tertiary Education

This operation was approved by the IDB in 2000 and it was the first Sector Facility operation of the Bank, which is a new flexible loan modality. This program introduced to Nicaragua a new overall approach to higher education, introducing the notion of accreditation and tying the higher education system to the secondary formal and technical education level by providing incentives for the universities to assist the secondary level development and quality.

The loan for US\$3.8 million is modernizing higher education in Nicaragua through (i) a process of systematic self evaluation of the universities, (ii) reaching agreement on a national accreditation system that would be efficient and transparent, (iii) improving the linkages between higher education and secondary education and the private sector, and (iv) improving the management of the private and public university system.

The program has been quite successful and within a short period has exceeded expectations and the goals originally set forth. Nontraditional program execution structures were established, emphasizing the relationship between the education sector and the Ministry of Finance and giving technical independence to the technical directors of the program. By establishing a high degree of technical development and ensuring the political neutrality of the executing unit, the program has been well accepted and has encouraged transparency in the utilization of public funds.

D. New Health Sector Reform Strategies, its Provision and Access of the Poor to Basic Health Services

- **Guatemala: Program to Upgrade Health Care Services.** Loans 890/OC-GU and 891/OC-GU. US\$25.0 million and US\$13.5 million respectively. (1995)
- **Panama: Institutional Transformation of the Health Care Sector, Phase I.** Loan 1350/OC-PN. US\$35 million. (2001)
- **Nicaragua: Hospital Network Modernization.** Loan 1027/SF-NI. US\$48.6 million. (1999)
- **Honduras: Local Capacity Building for Managing HIV/AIDS Infection in the Garifuna Population.** Technical Cooperation ATN/KB-7592-HO. US\$150,000. (2001)
- **Regional Approaches to HIV/AIDS,** including Guatemala, Honduras and Puebla-Panama Plan

In as much as the IDB has provided very innovative assistance to stimulate and accompany the reform process in education, similarly, the health sector has been given intense and consistent support in Central America during the 1990s and the early 2000s. This support has included a very important experience in Guatemala in the mid-1990s that initiated a high impact change in health policies and institutions, this at a time when the country was completing a complex process of negotiations leading to the Peace Accords.

1. Guatemala: Health Reform

The program to upgrade health service in Guatemala included a policy reform loan for US\$25 million and a parallel loan of US\$13.5 million to finance technical advisory services, to reinforce and enhance the limited institutional capacity of the public sector to implement the reforms and upgrading of the system. The main objectives of the program included extending the coverage of basic health services with emphasis on the poorest groups in society; the participation of private health providers; increased public spending by expanding the sources of funding for the health sector; and redirection and focussing assignment of resources to meet the essential health needs of the population.

The program has facilitated the execution of reforms in several areas, including: (i) reforms in the structure of the health sector, including the restructuring of the Ministry of Public Health and Social Welfare (MSPAS), the initiation of a process of budgetary decentralization from the Ministry of Public Finance, and the establishment of coordination mechanisms for the sector; (ii) reforms in financing, allocation and use of public resources, including increasing and improving the allocation of budgetary resources to the sector; reassigning public expenditure, limiting outlays on hospitals and reorienting the resources, extending coverage and improving basic health services; and modifying the regulatory framework and budget in relationship to the new goals; and (iii) reforms in the system of individual health care, including necessary changes in the primary health care model, expanding the basic services to the poorest groups through the participation of private health providers for local and basic services and with the participation of the community.

This has been one of the most successful health reform programs supported by the Bank. In particular, through its execution the following results were obtained: (i) a new health law was prepared, approved and entered into effect, (ii) outlays on health were increased and were redirected to basic health services, (iii) improvements were made in the administration of the public health budget, (iv) a primary health care package was defined, (v) the new health services package was provided via a system of private providers (nongovernmental organizations--NGOs); (vi) budgetary procedures were simplified; and (vii) the central units and structure of the MSPAS were reorganized.

In February 1998, the Health Law established the institutional basis for the reform of the health sector, recognizing the participation of the State and Civil Society in the design and implementation of policies, and promoting the decentralization of health services. In great measure, because of the political support that the program enjoyed, it was possible to introduce changes of broad impact and with a high degree of public awareness, especially in the expansion and reorientation of the Service Delivery System, an innovative model for the expansion of primary coverage based on the composition of a basket of basic services with the participation of the private sector provider. This constitutes a best practice replicated in other countries of the area such as Nicaragua and Panama.

The impact of these policy changes has been sufficiently successful so that with its own funding (in the middle of a process of fiscal austerity that has characterized the period 2002-2003) the Guatemalan government has maintained the contracts of the NGOs for supplying basic health services in the country. In January 2003, the government had active agreements with 116 NGOs in 19 of 22 Departments of the country for a value of US\$18 million. The contracts extended coverage to more than 3 million rural inhabitants.

2. Other Projects Based on the Guatemala Experience

Starting with the experience of the health reform program in Guatemala in the expansion of coverage, operations aspiring to achieve similar results were prepared and carried out with Bank support in Panama and Nicaragua.

In the case of **Panama**, the improvement in the provision of services is done through NGOs and private sector groups. In terms of innovations they include (i) the design of several alternative types of health services packages in order to benefit the population; (ii) designing contracts that provide financial incentives to stimulate sound performance of the health providers, measured for pre-established goals, using ten different indicators; (iii) the active preparation of beneficiaries to undertake social audits of the contracts and, as authorized contributors, to measure the performance of the contracts; and (iv) the promotion of the same packages of services within the public sector using the same contract monitoring methods. In its first year of execution, the project has initiated contracts to provide care for 300,000 people, this representing 65 percent of the target population, fully one year earlier than originally planned in the program.

In **Nicaragua**, with the lack of private health services, the design of the program required putting together packages of services and performance contracts with public health centers. The definition of the goals and the financing, and the quantification of the performance of the providers have resulted in clear increases in the services to mothers and infants (80,000 pregnancies and 55,000 children) and at the same time have promoted the development of management tools in the health centers as a step forward in the decentralization process. The availability of resources has encouraged new forms of planning and decision making at the local level.

Both experiences, in Panama and Nicaragua, have demonstrated that it is possible to promote health reform appropriate to the policy and institutional realities in each country, cementing strong public and private sector relationships, payment for performance and auditing of the results, all to the benefit of targeted low income groups.

3. A Regional Approach: HIV/AIDS

The Bank's approach in the region to the challenge posed by HIV/AIDS consists in providing support in the following areas: local capacity building for managing HIV/AIDS, particularly for vulnerable population groups; development and implementation of the National Strategic Plan to fight HIV/AIDS through existing and future Bank operations and inserting HIV/AIDS activities into non-health operations. In addition, the control of transmittable diseases such as HIV/AIDS, malaria and tuberculosis has been identified as the kind of intervention for which a regional approach would produce more benefits than a national one, and the production of key regional public goods in health is therefore supported.

Honduras. Local Capacity Building for Managing HIV/AIDS Infection in the Garífuna Population (ATN/KB-7592-HO). In Honduras, a 2001 UK trust-fund (CABILICA) financed project seeks to foster locally designed interventions in the Afro-descendant communities, as opposed to external delivery programs, to build on the high levels of existing social capital, ensure a better community response, and lay the basis for future interventions and cooperation with the public health sector and donor agencies. This project has used an innovative methodology in the area of HIV/AIDS, mapping the assets and resources available in the community that could become pivotal for local

HIV/AIDS management. The project has already significantly increased the managerial capacities of local NGOs and the methodologies used are generating important results, such as a generic tool-kit for NGOs.

In **Guatemala**, HIV/AIDS activities are being financed within the Health Care Services Improvement Program to contribute to the reduction of the spread of HIV, and in particular the effects of the epidemic on vulnerable individuals, through institutional modernization and investments in prevention activities. Guatemala was the first country in the region to request a modification to an existing operation to meet the new health priorities, and the design of the original program was sufficiently flexible to allow for such adjustments.

In **Honduras**, HIV/AIDS activities are financed through a two-step approach. On one side, the Institutional Health Sector Reform Program is financing comprehensive care activities for HIV-positive people as well as those living with AIDS. Bank resources are supplementing grants from the Global Fund on AIDS, Malaria and Tuberculosis, helping to maximize social benefits. On the other side, HIV/AIDS activities have also been mainstreamed into an environmental management program the **Bay Island Environmental Management Program** (938/SF-HO). Among the priorities in this program is to build local capacity for planning and managing the effects of growth on natural resources and environmental quality. Through the HIV/AIDS activities, the program seeks to mitigate the potential adverse social impacts of the continuous flow of tourism and migration.

Finally, and as a pivotal operation in the context of the **Puebla-Panama Plan**, the Bank is financing a regional program (**HIV/AIDS in Mobile Populations in Meso-America**) aimed at testing and evaluating a program aimed to reduce vulnerability and risk contexts in 11 transit stations through the Puebla to Panama axis. This project is a pilot activity both because the lessons learned will provide inputs into potential interventions at a larger scale in the region, and in that it is being carried out in cooperation (financial and technical) with other donors.

E. Strategies for Social Sector Investment, Local Management of Social Services, and Social Investment Funds

- **El Salvador: Local Development Program II.** Loan 1352/OC-ES. US\$70 million. (2001)
- **Panama: Social Investment Program.** Loans 854 and 855/OC-PN. US\$30.0 million. (1994)
- **Guatemala: (DECOPAZ), Community Participation for Peace Consolidation.** Loans 968/OC & 984/SF-GU. US\$50 million. (1996)
- **Honduras: Social Investment Fund (FHIS I AND II).** Loan 889/SF-HO. US\$31.5 million. (1992); Loan 948/SF-HO. US\$40 million. (1995)
Family Assistance Program (PRAF I). Loan 949/SF-HO. US\$20.0 million. (1995);
Family Assistance Program II (PRAF II). Loan 1026/SF-HO. US\$45.2 million. (1998);
Social Investment Program (FHIS III). Loan 1028/SF-HO. US\$50.0 million. (1998)
- **El Salvador, Honduras and Guatemala: The Tri-National Program for Sustainable Development in the Upper Lempa River Basin.** Loans 1330/OC-ES - US\$14 million; 1331/OC-GU - US\$4.5 million; and 1082/SF-HO - US\$3.3million. (2001)

The Bank has developed several different instruments to promote local participation in social investment. This section examines the success of an instrument--the social investment fund--and how this model gradually evolved from compensatory social spending to more highly focused programs. Another instrument is also examined, the local development program that is regionally targeted and locally managed, and which demonstrates the value of local participation in directing social investments to the highest priority and local needs.

One of the leading and imaginative areas of contribution of the IDB to social development in the region has been in support of social investment funds as specialized, agile, effective, targeted public programs to benefit the underprivileged in the poorest regions and for those affected by macroeconomic adjustment programs. The notion of the social investment fund arose primarily as a stand alone specialized fund, generally independent of the line ministries of governments, to channel investment in local social infrastructure such as water systems, schools, clinics and latrines, and in the process, to generate short-term employment in compensation for the effects of macroeconomic adjustments that took place throughout Latin America during the late 1980s and through the early 1990s. The social investment funds became very important and effective means to transfer substantial resources for investment in local infrastructure. The funds and other related local development programs have functioned throughout the Central American region and there are outstanding examples of successful programs in Nicaragua, El Salvador, Panama, Guatemala and Honduras that are highlighted below.

Evolution of Social Investment Funds and Local Social Development Approaches in Central America

Early Models and Formats

Goals	Employment and Local Social Infrastructure, Compensating for Macroeconomic Adjustment
Institutional Structure	Centralized
Financing	Dependent on External Sources
Beneficiaries	Individuals and Communities, not Highly Targeted
Participation	Through NGO Representation in Boards; Unsystematic Community Involvement via Project Requests
Management & Adm.	Temporary Agency outside of Line Ministries
Procurement	Competitive; Centralized; Projects Originated with Contractors
Monitoring & Supervision	Highly Organized, Strong Financial Orientation

Second Generation Funds

Goals	Direct Compensation (Subsidies) for Economic Adjustment; Response to Natural Disasters
Institutional Structure	Central Coordinating Agency with Local Involvement through NGOs, Municipal Governments; Active Coordination with Line Ministries especially Health and Education
Financing	Dependent on External Finance
Beneficiaries	Individuals and Families, Targeted to Poor
Participation	Balance between Central and Local Participation, NGOs, Community Organizations
Management & Administration	More Local Planning and Organizational Structures
Procurement	Community Involvement in Project Selection, Transparency Key
Monitoring & Supervision	Highly Organized, Stronger Interest in Poverty Impacts and Financial Aspects.

Part of the process of appropriating the social investment funds for poverty reduction has been in the transformation of funds from a simple highly-targeted usually centrally-organized and administered format, to new institutional formats that encompass mechanisms for the decentralized participation of communities in the selection of projects and in the allocation of investment funds among regions and purposes. The early experiences with organizations were very successful in allocating resources for the delivery of local social investments in water and sewage, school buildings and health clinics. It is generally thought that the programs were somewhat less successful in the creation of employment. Also, there was concern that their separate identity from the line ministries made them less sustainable, and there was a chance that the funds eventually might be shut down for lack of resources given their strong dependence on external funding.

As the commitment to poverty reduction rose in the region and in the agenda of the IDB it was quite natural that the social investment funds and local development programs would be viewed as attractive institutional options for targeting poverty reduction among the neediest groups in the countries. The IDB acted decisively in assisting in strengthening the institutional capacity at the national and local level to make these programs more sustainable through greater commitment and involvement of local

municipal governments and community organizations. Thus there was a progressive improvement in the role of the social investment funds because of their capacity to focus on local poverty issues and to work with nongovernmental organizations and local governments.

The success of the programs was further enhanced by the good data bases that were developed in the institutions, effective procurement systems and in-depth monitoring and supervisory systems that worked parallel to and transparently from the management structure of the organization. The inheritance of these monitoring and information systems fed quite well into the expanded role of the funds as a second generation of reforms. The presence on their boards of directors and management of representatives from the private sector, municipalities, NGOs, and religious organizations also helped the social funds to be more attentive to local needs, and this became a key element in their new structure and functions.

Nicaragua: A Prototype of Comprehensive Support for Social Development

Since the early 1990s the IDB has been a constant partner with Nicaragua in undertaking a wide range of programs to assist the poor, to strengthen institutions for the preparation of poverty reduction strategies and to implement directed social sector reforms. This has permitted the development of approaches and most recently for the provision of social safety nets for the poor and attention for the most vulnerable groups and regions of the nation. The following is a list of the most important and innovative operations to reduce poverty.

SOCIAL SECTOR REFORM PROGRAMS

- Preparation of the Education Reform Program (#1034/SF-NI) US\$9.4 million (1999).
- Support for MINSA Hospital Modernization (#1027/SF-NI) US\$48.6 million (1998).

SOCIAL INVESTMENT FUND PROGRAMS

- Program to Fight Poverty and Strengthen Local Capacity (#1067/SF-NI) US\$50 million (2000).
- Social Infrastructure Investment Program Phase III (#1003/SF-NI) US\$54 million (1997).
- Public Services Reform Program (#933/SF-NI) US\$114 million (1994).

INNOVATIVE PROGRAMS TO GAIN SPECIFIC EXPERIENCES IN SOCIAL DEVELOPMENT AND POVERTY REDUCTION

- Low Income Housing Program (#1111/SF-NI) US\$22.5 million (2002).
- Social Safety Net (#1055/SF-NI) US\$9 million (2000).
- Social Safety Net, Phase II (#1109/SF-NI) US\$20 million (2002).

INSTITUTIONAL SUPPORT PROGRAMS RELATED TO THE POVERTY REDUCTION STRATEGY

- Support to Poverty Reduction Strategy Implementation (#1071/SF-NI) US\$10 million (2000).
- Social Policy Reform to Support the Poverty Reduction Strategy (#1114/SF-NI) US\$30 million (2002).
- Municipal Strengthening and Development (#1086/SF-NI) US\$12 million (2001).
- Strengthening of the Ministry of Family Affairs (#1061/SF-NI) US\$1 million (2000).
- Social Development Policy Support (#1032/SF-NI) US\$2.1 million (1999).

PROGRAMS TO ASSIST THE MOST VULNERABLE GROUPS AND REGIONS

- Comprehensive Child Care Program II (#1081/SF-NI) US\$25 million (2001).
- Atlantic Region Development Program (#1051/SF-NI) US\$8 million (1999).
- Program Childhood Care (#973/SF-NI) US\$3.5 million (1996).

Thus there was a progressive improvement in the capacity of the social investment funds to undertake their original functions of supplying key small-scale social investments, and extending this capacity to finance greater local government and community involvement in the selection and execution of social investments. Some outstanding examples of social investment funds and local development operations financed by the IDB are highlighted below:

1. El Salvador: Local Development Program II

The experience in El Salvador in the development and transformation of an initially highly successful social investment fund to assist in the post-war reconstruction and then, at a second stage, to assist in local development and reconstruction following Hurricane Mitch, demonstrates the validity and value of the social investment funds as their institutional structures and functions were accommodated to changing social and economic situations.

In 2001, the IDB approved a US\$70 million loan to El Salvador, **Local Development Program II**, to be executed by the Fund for Social Investment for Local Development (FISDL). The design of this program may be viewed as the culmination of years of experience gained from the earliest social investment funds, which have been transformed into more complex decentralized programs. The program includes the strengthening of a mechanism that had been established in an earlier loan for Phase I, approved in 1997. The 2001 loan targets the funding of operations that provide assistance to the poorest communities in El Salvador. This is coupled with direct technical support to municipal governments and the strengthening of the capacity of the FISDL to monitor local development in the country. Social investments for a total of US\$56.4 million were financed, of which 80 percent went for reconstruction in 152 municipalities following the earthquakes in January and February 2001. The balance has gone to 86 poor municipalities who participated in a competitive process for the allocation of the remainder.

Accompanying the substantial funds for earthquake reconstruction and poverty alleviation, are management systems and mechanisms to facilitate municipal development, including the funding of municipal development plans, institutionalization of integrated financial management, and a program to increase local government revenues to finance the projects. A total of US\$7 million was assigned to local institutional capacity building. The FISDL has available US\$1.5 million for policy formulation and technical and administrative capacity building, as well as internal administrative and human resource management.

This program represents a leap forward in developing a local development institutional model that is being applied in several countries of the region, especially in Guatemala, Honduras and Nicaragua.

2. Panama: Social Investment Program

This program is rather characteristic of the first generation of social investment funds. The program incorporated funding for the provision of basic social services in education, health care, sanitation, and road infrastructure, supplying materials and equipment for the delivery of services, and training personnel and community participation in the formulation, management and maintenance of the projects. The funding provided for institutional strengthening of the social investment fund (FES) and the development of a monitoring system. Extensive training was provided for parents' associations in the education programs, health committees and personnel, the operation and maintenance of basic sanitation projects, and environmental consulting services. The program matches the profile of similar operations that have been approved throughout the region during the 1990s, executed under an independent social fund, largely financed through external funding and targeted to local social infrastructure.

3. Guatemala: a Model of Local Development and Participation

DECOPAZ, the **Program of Community Development for Peace**, was developed as a highly innovative program, providing social investment for many poor communities that had been affected by the years of armed conflict, to start a process of rebuilding communities, provide assistance to the poor and develop social capital, typified by the development of community organizations and operating links between the national government, local governments and the local communities. The program incorporated local executing organizations and local entities representing a number of micro regions in which the process of local community planning and selection of the social investments was made. The program started in 1997 in two Departments, Huehuetenango and Quiché, and eventually completed coverage of some 390,000 inhabitants in 500 communities and implemented more than 3,000 infrastructure and community development projects and 275 local production projects. This was a complex program that represented a first step toward integrating community decision making into social investments after the Peace Accords were signed in 1996. Literally thousands of meetings and consultations with communities resulted from the program, leading to the selection of high priority investments.

It can be concluded that the program was largely successful and was an important first step in training and motivating the communities to become involved in the selection of investments in their areas. Very useful experience was obtained in the program from the health, education, housing, and other related subprograms. While the program took longer and the administrative and management difficulties were underestimated at the start (certainly not unusual for new operations), the benefits of the program were considerable. The lessons learned will be quite relevant for future local development options in Guatemala and other countries; and this was a very important step in the progressive improvement of the institutional arrangements for local development in the Central American region. A majority of the local organizations set up in the program reached a level of operational maturity that will allow them to sustain new programs and activities in the future.

4. Honduras: From Social Investment Fund to Human Capital Development

Honduras presents a very significant model of IDB support for social investment that started with the financing of a traditional social investment fund to compensate the poor for economic adjustment programs; this was followed by a social investment program coupled to a family direct subsidy program and a stand alone family subsidy program; and, finally, to a fully developed and highly targeted human development program. This progression of institutional and program adjustments with the IDB accompanying the Government of Honduras in these very fundamental institutional reforms and policies for poverty reduction, champions a long-term view of the commitment of the Bank to innovation and demonstrates its ability to adjust its programs to the changing requirements of the countries.

The Honduran **Social Investment Fund** program was approved by the IDB in 1992 as a traditional compensatory program for the poor during a period of economic adjustment. This characteristically contained subprograms for the rehabilitation of schools, the purchase of school furniture, the rehabilitation of health centers and the construction of latrines, and a complementary program of hygiene training for the target population. The program contained institutional strengthening for the FHIS that functioned to upgrade critical social infrastructure and to finance job creation. The FHIS had been in operation since 1990 with funding from Germany, USAID and the UNDP. The IDB accompanied the adjustment process by financing sector adjustment programs and social investment funding to provide direct compensation for the economic adjustments that were taking place.

In 1995 the IDB financed the Honduran **Social Compensation Program**, which included two sub-programs for social development, one for the FHIS (stage II) for direct local social investments in the traditional areas of education, health and water, and another for the **Family Assistance Program (PRAF)**, and technical assistance to give institutional support to both operations. The PRAF consisted of cash equivalent coupons assigned to family participants in health and education centers. The large subprogram to monitor and evaluate the impact of the operation provided the ingredients for improving the program of family allowances at a later date.

In 1998 a new operation **Family Assistance Program (PRAF II)** was approved, providing the start of a new programmatic approach in targeting the welfare of the poorest groups, to stimulate the use of health, nutrition and education services and to simultaneously increase the supply of these services. The program focused quite clearly on the very poorest families and their children. It was directed to increase the demand for education services, encourage educators to aid in children's learning, educate mothers on basic hygiene practices, focus health services on pregnant women and nursing mothers, and provide health care to the target group. The program involves a shift in institutional goals of the PRAF to encourage more use of the social services by the poor, and an increase in supply of appropriate health and education to the target group. This is seen as a change from compensating for lost income during economic adjustment periods, during natural disasters, to one of helping the poorest families to accumulate human capital for the long-term.

It should be noted that simultaneously with the funding of the Phase II PRAF program, the IDB funded a third stage of the FHIS which, while originally a local development program was quickly transformed into financing to assist in reconstruction after Hurricane Mitch in late 1998. Investments included critical reconstruction for relief, health and sanitation for the affected populations, municipal social investment plans and basic needs for the groups most gravely affected by the catastrophe.

5. El Salvador, Honduras and Guatemala: Blending Local Sustainable Development and Poverty Reduction

While not strictly classified as a social development operation, this regional development program, **The Tri-national Program for Sustainable Development in the Upper Lempa River Basin**, is a quasi-social development operation that is directly and indirectly focused on poverty reduction by improving natural resource management and economic productivity. The regional context is an area of the Upper Lempa River, uniting the Governments of El Salvador, Honduras and Guatemala in common local sustainable development issues.

In addition to the IDB loans, the Tri-national Program involves additional funding by the Nordic Development Fund of US\$3.0 million, and the GTZ of Germany for US\$1.25 million. The program is designed to promote the sustainable management of the region's natural resources, reduce the vulnerability to natural hazards, promote local productive activities, and strengthen local governments and local community organizations. A Tri-national Commission was set up to manage the program. Direct social investments include water and sanitation and local roads, the preparation against national disasters that directly assists the vulnerable population in the region, and the promotion of micro enterprise development that will assist the most vulnerable groups of low income families and women, and support local community entities, especially organized women's groups.

F. Targeting Social Services to the Poor through Innovative Social Safety Net Programs: Combining Demand and Supply Side Programs

- **Nicaragua: Social Safety Net I.** Loan 1055/SF-NI. US\$9.0 million. (2000) and **Social Safety Net, Phase II.** Loan 1109/SF-NI. US\$20.0 million. (2002)
- **Honduras: Family Assistance Program II.** Loan 1026/SF-HO. US\$45.2 million. (1998)

Very closely akin to the poverty reduction strategies and representing continuity with more focused and targeted programs for poverty reduction, is the support and experience the IDB has provided in recent years to design and finance social safety net programs that aim to help the most vulnerable social groups in Central America. These programs were started in countries that participated in the HIPC initiative and prepared poverty reduction strategies--Honduras and Nicaragua. The highly targeted social safety net programs contain some of the most innovative and highly effective impacts of the IDB's new generation of poverty reduction assistance to the countries. Some of these programs have evolved from, were associated with or have taken advantage of the institutional structures and lessons learned from the social investment funds. The lessons learned from different

types of social investment fund programs have been integrated into the social safety nets in which the beneficiaries are clearly categorized and identified from the start and the impact of the program is measured by sophisticated monitoring programs.

It became clear from the social investment programs, from the practice of establishing ad hoc programs, that there was a need to better ensure that the benefits reached the priority poor families—which is in great measure the origin of the social safety net programs. Even the least successful social development experiences have provided important institutional lessons that are now being adopted by the countries in Central America. Social safety net programs are vehicles for integrating education and health reform into the poverty reduction strategies on the supply side (availability of the services) and the demand side (capacity and incentive of the people to use the services) of the services-poverty equation.

1. Nicaragua. Social Safety Net Programs

The **Social Safety Net (RPS)** in Nicaragua was approved by the IDB in 2000, the first stage of a multi-phase program, the second of which was approved in 2002. This program represented a further stage in a series of social sector funding programs for Nicaragua that included (i) traditional social sector operations; (ii) social sector reforms; (iii) social investment funds; (iv) innovative programs to gain specific experiences in social development and poverty reduction; (v) institutional support related to the poverty reduction strategy; (vi) and support for the most vulnerable groups and regions. (See the box in preceding Section E summarizing IDB's support of social programs in Nicaragua.)

The purpose of the RPS has been to establish an institutional framework for direct support to the poorest families, increase the services and attention to preschool children and children through the fourth grade of primary school to reduce their dropout rates, and to establish a system of targeting and evaluation of the effectiveness of the program to ensure the achievement of its principal goals. The support model included three subprograms or categories of direct subsidies as follows: the food subsidy; the education subsidy composed of the school pack and an education subsidy; and the school and health supply-side subsidy. The purpose of these various subsidy programs is to establish the joint responsibility of the families, especially the mothers, the communities and their organizations, the local government, the school and health unit managers, and the central government authorities, to stimulate school attendance of the children, and to get the mothers to follow good health practices using the local health services and receive training in reproductive health issues.

Contrasting Features of Second Generation Social Investment Funds And Social Safety Net Programs

Second Generation Social Investment Funds	Social Safety Net Programs
• Individual or Area Oriented, Individual Subsidy Payments • National or Regional Geographical Coverage • Response to Macroeconomic Adjustment, Natural Disasters • Primarily Infrastructure-Centered • Targeted to Supply of Education, Health and other Public Social Services • Independent Specialized Agency • Ranging from Limited to More Involvement of Local Authorities and Community Organizations • Development of Information Systems on Project Execution, Inputs and Costs, Less on Beneficiaries • Supply Oriented • Detailed System of Financial, Procurement and Construction Control, Less Focused on Beneficiaries	• Family, Mother and Children Oriented • Local Municipal and Highly Targeted Poor Areas • Integrated with Poverty Reduction Programs • Poor Family Human Capital-Centered • Primary School Age and Preschool Age Children Access to Social Services • Integrated into Ministries and Line Agencies of the Government • Heavy Involvement of Local Governments, Private Providers of Social Services and Community-based Organizations • Highly Evolved System of Monitoring of the Impact of Services • Supply and Demand Orientation • System of monitoring the impacts on the well-being of children and families, as well as financial and procurement aspects

The institutional responsibility was changed and better focused from the first to the second phase of the loans, and the program and the executing unit were moved out of the FISE, the social investment fund, to the new Ministry of the Family. In the first phase the institutional structure had three levels of responsibility—the national or central authority, the municipal level agencies and the community level. A national advisory council was established along with a municipal level advisory council to integrate the views of the community and beneficiaries locally, and at the national level, to integrate the views of the line ministries and nongovernmental organizations.

A systematic evaluation of the impact of the operation was included in the Social Safety Net program from the beginning. The results of the first phase have been very encouraging and have fully justified the second phase financing, including the incorporation of relevant adjustments from the lessons learned in the first stage.

Some results include (i) effective targeting in which in the first phase fully 80 percent of the beneficiaries were in the target group of the poorest families in the priority areas, the participation of 10,000 households in the first phase and 12,500 households in the second phase; (ii) in health, nearly a 50 percent increase in the vaccination rate for children between 1 and 2 years old. There was a much greater positive impact in terms of the measurements of the growth and size of the children, and family expenditures leading to food and nutrition improvements; (iii) for education, a 21.7 percent increase in the enrollment of children between 7 and 13 years old, a 30 percentage point increase for the

7 to 8 year olds, and a 19 percent increase for those in the 12-13 year age group. The school dropout rate was reduced, keeping 9 percent more children in school. Thirty-two percent of those who attended school did so regularly. The positive impact of the program demonstrates its value as a channel for assistance for other reasons such as natural disasters and economic recessions.

Consequently, the program has demonstrated the value of integrating education, health, family services and direct subsidies as a means and incentive for human capital formation; it demonstrates the value of providing targeted training to mothers, and giving them primary responsibility for distributing the funds in the family for its benefit; and the selection of families following exacting and open criteria.

2. Honduras. PRAF

Along with the prior example of Nicaragua, Honduras has received substantial cooperation from the IDB in developing social safety net programs. This operation called PRAF, is based on an initial program of direct payments to compensate for economic adjustment. PRAF II is being closely monitored to identify the impacts of the program. This operation is reviewed in a prior section.

G. Support for Vulnerable and Socially-Excluded* Groups and Regions, and Strengthening Labor Markets

- **Honduras: Program to Support Local Development Among Miskito Coastal Communities.** Technical Cooperation ATN/JO-7939-HO, Japan Fund grant. US\$350,000. (2002)
- **Honduras: The Program to Support Indigenous and Black Communities (PAPIN).** Innovation loan 1090/SF-HO. US\$1.6 million and Austrian Trust Fund grant US\$1.0 million. ATN/AE-7638-HO. (2001)
- **Nicaragua: Comprehensive Child Care Programs (PAININ), Stage 1.** Loan 973/SF-NI. US\$3.5 million, co financing from the Government of Norway US\$2.8 million. (1996). *Stage 2*, Loan 1081/SF-NI. US\$25 million. (2001)
- **Honduras: Comprehensive Pilot Program to Fight Urban Poverty.** Innovation loan 1066/SF-HO. US\$8.1 million. (2000)
- **Nicaragua: Emergency Support to Boys and Girls and Adolescents Affected by Hurricane Mitch.** Technical Cooperation ATN/JF-6677-NI. Japan Fund grant of US\$550,000. (1999)
- **Panama: Training and Employment System.** Loan 1403/OC-PN. US\$8.4 million. (2002)

As an ingredient of the IDB's strategy to support the countries of Central America, targeting the development problems of highly vulnerable groups has become a major concern that has emerged from the experiences of financing of social investment funds, local development, sector reforms, and poverty reduction strategies, and as a response mechanism for significant natural disasters in the late-1990s and early-2000s. Programs to benefit vulnerable groups have taken a variety of forms in reaction to the needs of each group. Groups benefited have included indigenous communities in Honduras and Nicaragua in the Atlantic areas, peoples of Afro-Caribbean descent, poor urban street children throughout the region, the rural poor, women heads of households, the disabled

* Refer to Annex II for more information on the issue of social exclusion in Central America.

in both urban and rural areas, and indigenous communities throughout the highlands of Guatemala, among others. The programs are also closely tied to civil society and community organizations that have been working with the vulnerable groups for a long time, but with serious financial limitations and without social recognition. Also, there are good examples of the IDB working closely with other multilateral and bilateral agencies to foster cost efficient methods of incorporating vulnerable groups into poverty reduction strategies.

1. Honduras: Miskito Coastal Communities

The Technical Cooperation **Program to Support Local Development Among Miskito Coastal Communities**, while a small program in funding terms, helped bring to the forefront the dilemma of the interracially mixed Miskito communities of indigenous, Afro-Caribbean and pirate groups dating back to the 17th century, people who rely substantially on lobster harvesting to make a living. Even though these are highly profitable activities, the divers from the communities receive low wages and are threatened by disabilities and deaths caused by the dangerous nature of the work and the decompression injuries that are not uncommon. Of some 5,000 divers, it has been estimated that about one-half are disabled from the decompression syndrome. The program has prepared a local development action plan and identified immediate needs of the communities, alternative sources of income, poverty indicators and general living conditions. The studies have developed a community social and economic mapping to understand better the structure and dynamics of the community and the cultural values of the region. The program originates from the IDB's *Action Plan to Combat Social Exclusion due to Ethnic or Racial Motives* (June 2001). Local organizations with the cultural values of the area and representing the disabled are cooperating in the design of the action plan. Relevant immediate needs are being developed to license divers, establishing rehabilitation systems, and training in safe diving, among others. The Association for Indigenous Socio-Economic Development (BAYAN) is executing the program.

2. Honduras: Indigenous and Black Communities (PAPIN)

The **Program to Support Indigenous and Black Communities (PAPIN)** seeks to generate better and more culturally-attuned models for the infrastructure programs of the indigenous and black communities. The program applies an “ethno-engineering” concept that involves adjusting the infrastructure works to the specific cultural, social and environmental characteristics of the beneficiary ethnic communities. Simultaneously, the program promotes gender and social equity in ethnic groups, local organizations and governments. The program is being applied in two pilot areas and serves as the basis for possible expanded future lending by the Bank. A key element in the program is the training of the ethnic community leaders to better understand the national, regional and local regulatory, legal and institutional environment and to represent the interests of their communities.

3. Nicaragua: Child Care (PAININ I and II)

The **Comprehensive Child Care Programs (PAININ), Stages 1 and 2**, represent a significant advance in the scale and impact of programs targeted to the poorest, vulnerable groups of society—preschool children of the poorest rural families.

The program promotes the integrated attention to vulnerable children of preschool ages less than six years old. It was created in 1996 through a first phase which was designed to test the approach to comprehensive attention of the vulnerable age group--the coverage in the first stage was 33,000 children. The evaluation of the first stage indicated (i) the effectiveness of the care model in achieving a positive impact on the target population, (ii) the extensive participation and support of the community for the projects and (iii) the effectiveness of the institutional arrangements.

A second loan of US\$25 million was approved in 2001, the objectives of which are (i) to extend the coverage of the program by applying specific selection criteria of vulnerability, (ii) to improve the quality of the care, and (iii) to strengthen the institutional management, financing, and supervision of the child care program. The program relies on contracting civil society organizations to execute the comprehensive care. There are two methods of care: (i) through the community child care centers; and (ii) from a mobile team using community home bases. Through the second system it is expected that 80,000 children will benefit by the third year of execution representing a very significant share of the targeted children.

There were important lessons obtained in the first stage leading to adjustments in the procedures of the program to improve the targeting of the funds to the poorest families and children. The first stage demonstrated the effectiveness of the child care model, the efficacy of the program in getting broad participation and support, and the competency of the institutional model for delivering the services. The net enrollment in the elementary schools in the PAININ areas was increased thanks to the program. The Community Child Care Centers (CICOs) were successes in the first stage in terms of creating a favorable child care environment in the locale and encouraging the participation of parents in the construction of the centers, and, finally, the success was clearly shown by the CICOs attracting new sources of funding that reduced the program's per beneficiary costs. The operating system establishes the functions of the central government authorities as regulators and monitors of the program, and leaves the local community organizations, NGOs, to implement it.

The main lessons learned in Stage 1 permitted PAININ II to incorporate better targeting criteria, a new system of rewards and incentives for the executing units, and a new management scheme for the food supplements. Funds were set aside for the Atlantic Coast so that about 14 percent of the children to benefit from the program would be from that area.

4. Honduras: Combating Urban Poverty

In 2000 the IDB approved an Innovation Loan to finance a **Comprehensive Pilot Program to Fight Urban Poverty**, which has a multidimensional relationship to several important issues for Honduras and its capital city, Tegucigalpa. The city was heavily affected by flooding during Hurricane Mitch in October 1998. With the need to develop the Historical City Center of Tegucigalpa, this could not take place without dealing with the fundamental social issues of the population living and working in the area. This highly innovative program incorporates the participation of government organizations, local residents and the transient population, many poor families and children of all ages working and living in the city center. The program seeks to establish community understanding and agreement on the future uses of the urban spaces, and works to find ways of incorporating the vulnerable poor, especially the transient population, into the process, increasing their welfare.

The subprogram to assist the most vulnerable groups makes up a substantial share of the operation, and is targeted to three age groups: children up to six years participating in preschool child care programs by providing support for mothers; for the 7 to 14 age group a program for the child to learn and participate in art and cultural programs in music, the graphic arts, and theater, as a means of expressing themselves and achieving stable community involvement and relationships; and the 14 to 18 year olds who will benefit from vocational training to participate more effectively in the formal labor market. About 300 children are benefiting from the program.

The program brings together three important organizations, the Honduran Child and Family Institute (IHNFA), the Ministry of Culture, Art and Sports (SCAD) and the municipal government of the Central District of Tegucigalpa, under the coordination of the Ministry of Finance (SEFIN).

An especially original aspect of this operation is the employment of cultural assets and values to draw the young children that have been marginalized by their past transient relationship with the areas into community participation.

5. Nicaragua: Emergency Attention to Children

The Technical Cooperation **Emergency Attention to Boys and Girls and Adolescents Affected by Hurricane Mitch** (1999), assisted street children affected by Hurricane Mitch. It is estimated that there are several thousand street children in the country, and many were seriously affected by this natural disaster. This program assisted Casa Alianza, which also received a contribution from Covenant House of New York and provided assistance to hundreds of street children, through several interventions, including a program to contact the children on the street, the provision of psychological assistance, working with them in a center for education and training for transition from the street to a more stable environment, health services and monitoring, special assistance to young mothers, and a crisis center and shelter for girls. The demand for these services is well beyond the current capacities, but this program strengthened an on-going practical and effective program for dealing with street children. This program, while justified

because of the impact of Hurricane Mitch, provided useful insights for the design of the social safety network programs in Nicaragua.

6. Panama: Training and Employment

In 2002 the IDB approved innovative operations directed at improving the labor market, creating opportunities for training and employment for targeted groups, especially the young, and the creation and/or strengthening of public labor institutions. The overall objective of this program is to create employment opportunities for youth, increasing their labor skills, and modernizing labor market policies. The program is targeted to jobless youth and disadvantaged groups to provide workforce entry assistance, assistance in transitions from school to work, and innovative job training for disadvantaged groups. Disadvantaged and vulnerable groups include female heads of households, indigenous people, Afro-Panamanians, the elderly, and the disabled. The funding of in-service training benefiting 420 enterprises and 5,400 workers should increase the competitiveness of the companies and the workers.

H. Bank Mechanisms to Promote Social Sector Development in Central America

- **Inter-American Institute for Social Development (INDES)**
- **Special bilateral trust funds (Norwegian Fund, CABILICA, Sida - Sweden)**
- **New, flexible lending instruments (innovation loans, multiphase loans, sector loans)**

1. INDES: Improving Social Management and Design of Social Policies

The Inter-American Institute for Social Development was created by the IDB in Washington, D.C., in 1994, to train public sector and civil society professionals in the design and formulation of social policies, and in effective social sector management to promote the economic and social development of Latin America and the Caribbean (LAC). The Institute has worked at creating a curriculum and methodologies to accompany the countries of LAC in the process of social development and change. The students of INDES are agents of social change in the region. Central America has benefited from the creation of the earliest national programs of INDES, in which, rather than sending a limited numbers of candidates to Washington for training, a national program replicates the Washington curriculum and training at the local level and is able to train hundreds of professionals over a two year period.

The specific objectives of the INDES programs are (i) the training of professionals of executing agencies and local organizations in the design and implementation of social programs and policies, including the incorporation of modern concepts, techniques and methodologies for social management, (ii) to contribute to the creation and maintenance of a network of national professionals committed to the development of trained professionals in fields related to the design and management of social policies and programs, and (iii) to support the creation of a network of trainers and social managers committed to social project development at the local level.

It is estimated that in the three countries, Honduras, Nicaragua and Guatemala, more than 1,800 people will have been trained in techniques of social management, of which about 40 percent will be central government staff, and the balance, local government and civil society organization professionals and local leaders. This training takes place in more than 70 courses, workshops and seminars, and they are directly related to the main social development policies in each country.

Honduras. With a contribution from the Department for International Development (DFID) of the United Kingdom, the government created a National Program for Training in Social Management and the Design of Social Policies, in which 500 social managers receive training, including from the public sector (central, regional and local governments), civil society leaders and professors from several universities. The two-year program includes ten courses of four weeks each to train 100 central government staff, 150 regional and local functionaries, 50 civil society leaders and 50 professors. A network of trainers who are committed to give continuity to the program will be established.

Nicaragua. Thanks to a donation from the Norwegian Agency for Development Cooperation (NORAD), in 2000 a two-year program was established in Nicaragua, *The National Program for Training in Social Management and Design of Social Policies*, in coordination with the *Secretaría de Acción Social*. The program has trained a total of more than 500 social managers in all aspects of social policy formulation and program execution. The program implemented ten courses of four weeks for 180 government central government social sector staff, 120 municipal level staff, 30 leaders of the civil society and twenty university professors. The program created a national network of social managers. Local universities have been given support to carry on the training in the future after the internationally-financed part of the program is completed.

Guatemala. Based on an invitation from the Ministry of Education and with funding from the Government of Norway and its Norwegian Fund for Innovation in Social Programs, INDES organized a pilot program for training in social management for a group of 35 public sector professionals of the central government. This program complements the peace process and the social reform programs that are being implemented. In 2003 a full-scale national training program was approved with a donation from NORAD, and the goal is to train 630 professionals both at the central and municipal levels, including NGO land and community leaders, as well as 90 trainers from local universities during a two-year execution period.

2. Inter-Agency Coordination: Bilateral Trust Funds and Social Development: (Norwegian Fund; CABILICA; and Sida)

The Regional Operations Department (RE2) of the Bank has developed agreements with several bilateral development agencies for the purpose of coordinating efforts between the IDB, the bilateral agencies and social development programs to assist in the development of innovative social programs in Central America, Mexico, Haiti and the Dominican Republic. Three trust funds were created and are administered by the Regional Department. The funds have become a successful model of financing

nonreimbursable technical assistance and are key tools for the identification, preparation and execution of innovative social operations, and an effective mechanism for the exchange of experiences and knowledge about social programs. The three trust funds are directed by a Technical Committee with the active intervention of the Social Programs Division of the Department, to guarantee the technical quality of the operations, the correct execution and dissemination of information on the lessons learned. The trust funds have assisted in building up a solid program of social financing in Central America.

Norwegian Fund for Innovation in Social Programs (NFISP). The Norwegian Fund for Innovation in Social Programs (NFISP) was established in 1996 with a US\$1.5 million grant from the Government of Norway. A 1998 evaluation concluded that funded activities were both innovative and of high impact and that the NFISP had fully met its first-year goals and in some respects surpassed them.² Subsequently, the Fund was replenished with an additional US\$5.6 million, US\$100,000 of which were delegated for administration by the IDB Country Office in Honduras. To date, the NFISP has supported a total of 70 technical cooperations.

The NFISP was designed as a flexible funding instrument to finance technical co-operations in four strategic areas of work of the Social Programs Division of Region 2, namely: (i) preparation of high-impact reform-oriented projects; (ii) participatory approaches to social development; (iii) the design of innovative projects; and (iv) support of initiatives in new areas. The activities financed have had a clear relationship with the Bank's project pipeline with key support for the development of country-level social sector strategies and the preparation of the Bank's policy agenda in the social sectors.

Importantly, the technical cooperations have permitted the development of innovative responses to chronic problems of marginal groups. The NFISP has been particularly important in the work with Afro-Latin populations in the region, for example, to support the identification of best practices for the inclusion of Afro-descendent women and the development of a computerized archive of indigenous and Afro-Latin professionals in Honduras.

The NFISP has also supported a significant effort in promoting exchange visits by health care managers and professionals both between countries within Central America as well as between Central America, the Caribbean and the rest of Latin America. This has enabled, for example, the transfer to Central America of lessons learned on Colombian health decentralization. Moreover, the NFISP has allowed the Bank to develop new methodologies, for example, that take into account the political and institutional context of social reform as well as to design a policy toolkit to facilitate political and institutional assessment during project preparation and follow-up.

United Kingdom Fund for Capacity Building for Local Institutions in Central America--CABILICA. The CABILICA Fund was established in 1999 by the United Kingdom's Department for International Development (DFID), with a contribution of

² IDB and Government of Norway, *At the Cutting Edge: An Evaluation of the Norwegian Fund for Innovation in Social Programs (NFISP)*, March 1997-August 1998.

US\$3 million. The Fund's objective is to create and strengthen the management capacity of local institutions in Central America, thus enhancing their participation in the design, execution, monitoring and evaluation of Bank loans. The direct beneficiaries are local government institutions, such as municipal councils, and civil society organizations, including associations, and capacity building service providers.

The CABILICA Fund has been supporting capacity building efforts at three levels: human resource development, institutional organizational capacity and institutional framework strengthening. Eligible activities for funding under CABILICA include: (i) project design, (ii) participatory planning, (iii) institutional and stakeholder analysis, (iv) associate capacity, and (v) monitoring, evaluation, and social auditing; through a variety of capacity building methods such as training of trainers, and on-site training.

CABILICA's innovative approach is based on principles of local ownership, partnership and recipient responsibility and has proved to be highly responsive to the Bank's regional strategies and to the 8th Capital Replenishment's focus on poverty reduction and social equity. More specifically, CABILICA funds have supported programs that aim at the strengthening of local and municipal governments, and the strengthening of civil society, two core strategic developmental objectives for Central America.

Since the Fund's creation, 18 technical cooperation projects have been approved, providing added value to Bank operations in areas such as education, health, social inclusion, and municipal development, among others. In addition, there has been a high level of acceptance from beneficiary organizations and direct beneficiaries, enhancing the projects' effectiveness and sustainability. Examples of technical cooperation projects include a pilot to strengthen local capacity building for HIV/AIDS management in the Garifuna population of Honduras, a project to strengthen community participation for school management in Panama, a pilot project for effective transmission of municipal development plans to the new municipal authorities in Nicaragua, and a series of training courses on procurement targeted to municipal actors from El Salvador. In terms of distribution by sectors, most of the funds have been allocated in the social sector. However, projects have also been supporting sustainable environmental management, risk prevention, and modernization of the State, among other sectors, in an effort to mainstream capacity building issues beyond the social sector. Priority has been given to the Central American initiatives. Honduras is the largest individual recipient country, with three approved technical cooperation projects, totaling US\$363,400.

In 2001 the Fund's mid-term review was conducted, to measure the degree to which the Fund has progressed and generated relevant outcomes. It was highlighted that the Fund has been pivotal in developing Bank's knowledge in institutional strengthening and local capacity building. As a result of CABILICA funded activities, Bank specialists have increased their understanding and expertise on capacity building tools, enhancing program design and implementation. Moreover, at the local level, the fund has provided valuable technical assistance to local and national organizations in their effort to maximize the effects and impact of multilateral assistance programs.

One of the key practices promoted by the CABILICA Fund is the close follow up and monitoring of its projects and the dissemination of lessons learned of executed projects. The Fund is expected to continue this important function, thereby contributing to the debate around best practices and methodologies that may be expected to improve the Bank's understanding and work with local actors.

Sida³-IDB Partnership. The overall objective of the Sida-IDB Partnership Program in Central America, established in 1999 with an initial trust fund grant of US\$1.7 million, is to improve the effectiveness and impact of Bank and Sida poverty reduction operations in the region. The Partnership was designed to enhance collaboration between the IDB and Sida at the project, program and policy levels, based on the premise that significant benefits can accrue from the combination of the complementary comparative advantages enjoyed by each institution. Its rationale is a shared commitment to introduce innovative solutions to the compelling social and economic problems facing the disaster prone Central America region at a time of rapid change.

The Partnership is managed by a Sida financed coordinator – a Sida specialist working in the Social Programs Division of Region 2 --and a technical review committee working under the supervision of the Division Chief. Financial resources are available to support technical cooperations designed and executed by joint project teams comprising IDB and Sida staff.

This requirement has promoted dialogue between the IDB and Sida both at the level of headquarters as well as country representations. Initially, this exchange focused on four key social development areas – local development, particularly social investment funds; housing and physical environment in poor urban neighborhoods; capacity building of local governments and strengthening civil society capacity to participate in Bank and Sida financed operations. Subsequently, the areas of mutual interest have expanded to cover gender, health reform, citizen security and regional environmental issues as well as basic infrastructure.

Priority countries for the Partnership are Nicaragua, Guatemala, El Salvador and Honduras. However, most of the technical cooperations (33 percent) have had a regional focus that has contributed to the transfer of experience and lessons learned between countries. One important innovation is the creation of local technical committees, comprising IDB and Sida representatives from the respective country offices, in Honduras (2001) and Nicaragua (2003), which has placed Partnership resources closer to country-based demands.

A 2002 mid-term review concluded that the Partnership has significantly enhanced collaboration between the two institutions, with benefits for both institutions as well as beneficiary countries. The indicators were the number of technical cooperations financed by the Partnership (17 in 2002) and an increased level of non-financial collaboration in a range of joint project, program and policy activities. An additional indicator of the impact

³ Swedish International Development Cooperation Agency.

of the Partnership model was joint and complementary funding of 6 IDB operations in Honduras for a total investment of US\$11.8 million.

Sweden subsequently extended the duration of the Partnership for an additional 2 years until June 2005 with a second contribution of US\$1.2 million.

Most recently, the Partnership has initiated collaborative work with **upstream activities** related to the preparation of country strategies and policy dialogue papers. This work will assist the preparation of IDB country strategies for Guatemala and El Salvador and provide inputs for the development of Sida regional and country strategies. This development builds on a tax reform policy project, partly financed by the Partnership that has stimulated debate on this critical issue throughout the region.

To date, the Partnership has financed 28 technical cooperations in eight priority areas for a total funding of US\$1,8 million.

3. Flexible Loan Instruments for Social Development

In 2000 the Bank approved important additions to its lending instruments that would enhance its ability to provide innovative support for social development in Central America. While these new lending instruments are not strictly limited for application to social development, their existence has allowed for some new approaches to this area. Recent examples of the countries' use of these four new lending products are as follows:

- Innovation Loans (ILs) support the testing and piloting of new approaches and emphasize capacity-building and learning up to the equivalent of US\$10.0 million per loan, by a short approval procedure.
- Multi-Phase Program Loans (MPLs) build upon existing multi-phase operations and expand the Bank's ability to provide continuous support for programs that require more time to achieve fruition.
- Sector Facilities (SFs) help support rapid and tangible action in specific sectors without the delays associated with a long preparation period for a total amount of up to the equivalent of US\$150.0 million. The creation of the first three of such Facilities: the Education Facility, the Health Facility and the Trade Facility was approved and the authority to approve individual operations of these three Facilities, of up to the equivalent of US\$5.0 million per loan was delegated to Bank management.
- Finally, the Project Preparation and Execution Facility (PROPEF) amends the current Project Preparation Facility (PPF), to facilitate a more seamless transition from preparation to execution by financing additional project start-up activities.

These flexible instruments are an essential part of the Bank's institutional strategy aimed at improving responsiveness, rationalization of efforts, and increased delegation of authority. The expected outcomes of using these instruments are greater flexibility and receptiveness on the part of the Bank, the cementing of partnerships with borrowers, and

the encouragement of a results-oriented culture, based on learning, feedback and the application of experiences. This will enhance the likelihood of successful outcomes in these and other programs in the future. The instrument will increase the IDB's ability to stay engaged in crucial sectors and thematic areas, and to continue to provide pivotal assistance in social sectors.

III. Lessons from More than a Decade of Social Programs and Action in Central America

A. Successful Elements of Social Development in Central America

This section will summarize some of the most important lessons that have been learned in Central America in the last decade in the design and implementation of social sector loans and technical assistance programs. The IDB has provided sustained support to the countries of the region and has participated in a large number of cross cutting programs for social development. Nicaragua has been profiled (see Box in Section II. E) as an example of a country that has received virtually the full range and depth of support from the Bank over the 1990s up to the present day. Similar support has been provided to El Salvador, Honduras and Guatemala and to an important extent in the remaining countries. It was shown earlier that the countries and the IDB have developed new, targeted forms of support for reducing poverty, increasing access to basic social services and assisting the poorest families and vulnerable groups in society. These new instruments are the product of years of evolving forms of assistance, augmenting new operations with the lessons learned in previous stages of experience.

Some of the main lessons are outlined below and serve as constructs for future social sector reforms, modernization and poverty reduction and targeting.

- **Sound economic policy and the reduction of macroeconomic constraints are still essential conditions for social development; they lead to increased revenues and facilitate spending on social development.**

Social sector spending, while having expanded in the countries of the region in the past decade, will need to rise much further in the future. Sound economic policy is critical for increasing public resources assigned to the task; hence social sector reform is fully dependent on sustaining sound macroeconomic policies in the future.

- **Institutional development is a slow, sometimes, painful process, but is feasible. Constancy in institutional reform is an essential element for furthering social development in the area.**

The modernization of public institutions for social development has been occurring in Central America in recent years, demonstrating that reform is feasible. However, it is a slow process of improvement as lessons learned are applied in subsequent stages of improvement. Examples of this process have included the education sector in El Salvador, where national commitment for a decade has begun to show significant institutional changes, and in Honduras and Nicaragua where the progression has been from effective social investment funds to targeted social safety net programs.

- **Targeted social safety net programs are meeting the social needs of the poor; coordinating supply and demand interventions is crucial for success. Vulnerable groups need special attention and specialized, high impact programs.**

The social safety net programs are the first social programs that have combined mechanism for the direct access of the poor to the needed social services, jointly with measures to increase the supply of appropriate cost-effective health, education and nutrition programs. This combination requiring increased institutional commitment and coordination among central government, local governments and community organizations, has shown to have favorable impacts on the beneficiary groups and to have reached groups that have in the past not easily been reached.

- **Starting to work with children when they are preschoolers and working with the whole family is a key to the new approaches.**

It has been shown with the experience from the education reforms and safety net programs in Central America that the most effective programs target the families and the children of the poor, giving the mothers incentives to send their children to school, to take advantage of feeding programs, to utilize basic health services locally with well known, community-based private provider agencies. Monitoring of these programs has shown good improvement in social indicators across the board, and should encourage the expansion of these programs in the future.

- **Policy dialogues are useful with full participation of all affected groups.**

As the region moved into a democratic transition in the early 1990s, and with the success of the negotiations for peace agreements, the implementation of policy and program dialogues at several levels and types of participation have been tried and tested to ascertain their value in promoting national commitment to social reform and change. The implementation of consultative meetings for individual governments or on a region-wide basis, have helped to identify priorities and the availability of funding for social development. Country-level social sector reviews have helped countries to move to more successful reform models. The preparation of poverty reduction strategies has facilitated the participation of society in development strategy formulation and implementation.

- **Private participation in the provision of social services is a demonstrated and increasingly accepted tool for strengthening social development.**

Models of incorporating private providers in the form of local community organizations and other NGOs should encourage countries to continue to mobilize private interest and commitment to education, health care, nutrition programs, training activities, treatment of the disabled and vocational education, among others. The goal is to balance public interest through regulation and monitoring and to construct financial incentives to mobilize the capacity of local organizations to work within communities, and to target beneficiaries cost-effectively.

- **Reducing regional backwardness and local deprivation is an important element in the future of the region.**

As poverty reduction measures have been refined in Central America they are increasingly tied to specific improvements in the region where there are a number of the most vulnerable, excluded groups and the poor.

- **Decentralization based on mobilizing community commitment and participation is an increasingly effective instrument for social development.**

There has been a strong trend in the decentralization of social programs in the Central American region. Cases have included local development programs in El Salvador and Guatemala, social safety net activities in Nicaragua, health reform in Guatemala, and education reform in El Salvador and Honduras. It is demonstrated that these operations reach vulnerable groups, have concrete and measurable impacts, mobilize the civil society and local government contributions, and lead to sustainability.

- **In education the quality of education is the central need for the future of the system, even though there are still important groups who do not have access.**

As has been shown, access to education in Central America has increased significantly over the review period. While there is still a need to increase the formal education access of the rural poor, attention has shifted to increasing the quality of education, requiring relatively less investment in infrastructure and more attention to management, community and parent participation in running the local schools, and increasing the training of teachers.

- **For health care reform, the process is extremely complex to implement, but countries are at the stage of trying to increase access of the poor to primary health care and restructuring national health systems.**

It has been found that health sector reform is one of the most difficult and complex unfinished social development tasks in the region, because of the difficulty of integrating various models of attention, whether they be public direct, social security systems or private providers, operating under new competitive rules affecting payments system for health care workers. Initial steps have shown the benefit of increasing the access of the poor to primary health care, but there are a variety of unfinished tasks in the region to modernize the system, to make it cost effective and to increase access.

- **International cooperation in the context of poverty reduction strategies is an effective catalyst to new style social development funding.**

There has been shown a strong willingness of external funding sources to cooperate in the social sectors. This cooperation has ranged from closely knit cofinancing

agreements for reforms in countries and sectors, most frequently in education and the health sectors, to trust funds to assist in project identification and development.

- **Natural disasters have a significant impact on social variables and may be expected to continue to be very significant in Central America.**

The Central American Isthmus has been prone to natural disasters, including hurricanes, earthquakes, droughts and flooding. These events have had significant impacts on the poor, the public social infrastructure (schools, hospitals and water systems), and private capital (houses, factories, etc.), and have slowed progress in social funding and set back social indicators. Consequently, public management of disaster hazard risks is critical for sustaining future social development in the region.

B. The Continuing Task for Social Development in Central America

The IDB has been an active and permanent partner for social development. After the decade of the 1980s it expanded its funding for social development, social reform, poverty alleviation, local social investment, and attention to vulnerable groups in the Central American region. The IDB has employed and has at hand a broad menu of financial and nonlending instruments to foster social improvements in the region, and the regional social indicators show important improvements and shifts in the social situation in the areas of health and education and social investment. The Bank has adjusted its program of support to the requirements of each country, recognizing that some countries, such as Costa Rica and Panama have achieved some significantly higher measures of social development than Belize, El Salvador, Honduras, Guatemala and Nicaragua.

The national experiences of the period of time under consideration give optimism for further progress in the fundamental tasks of reducing poverty, inequality, helping vulnerable groups and regions and in reforming social services. Very powerful results have been obtained from social sector reforms, social safety net programs and local development decentralization efforts. The opportunity to continue the paths of reform, and deepening and broadening the reforms now and in the future has been assured by the experience and commitment of the past. Future success will depend on sound social and economic policies, national and regional political commitment and the continuing active partnership of the IDB, which has proven to be a loyal and committed party to the process of social change in Central America.

Annex I

LIST OF PROJECTS HIGHLIGHTED IN THIS CHAPTER

COUNTRY	PROJECT TITLE	LOAN OR TC NUMBER	YEAR OF APPROVAL
El Salvador	Modernization of Primary Education (EDUCO)	879/OC-ES	1995
El Salvador	Local Development Program II	1352/OC-ES	2001
El Salvador	Tri-National Prog. – Devel. Upper Lempa River Basin	1330/OC-ES	2001
Guatemala	Health Sector Program	890/OC-GU	1995
Guatemala	Program to Upgrade Health Care Services	891/OC-GU	1995
Guatemala	Community Devel. for Peace Consolidation (DECOPAZ)	968/OC-GU	1996
Guatemala	Community Devel. for Peace Consolidation (DECOPAZ)	984/SF-GU	1996
Guatemala	Project to Support Educational Reforms (ARE I)	1054/OC-GU	1997
Guatemala	Tri-National Prog. - Dev. Upper Lempa River Basin	1331/OC-GU	2001
Honduras	Honduras Social Investment Fund	889/SF-HO	1992
Honduras	Bay Islands Environmental Management	938/SF-HO	1994
Honduras	Honduras Social Investment Fund II	948/SF-HO	1995
Honduras	Family Assistance Program (PRAF I)	949/SF-HO	1995
Honduras	Family Assistance Program II (PRAF II)	1026/SF-HO	1998
Honduras	Social Investment Program (FHIS III)	1028/SF-HO	1998
Honduras	Comprehensive Pilot Prog. Urban Poverty Alleviation	1066/SF-HO	2000
Honduras	Implementing the Poverty Reduction Strategy	1087/SF-HO	2001
Honduras	Managing HIV/AIDS Infection in Garífunas	ATN/KB-7592-HO	2001
Honduras	Tri-National Prog. - Dev. Upper Lempa River Basin	1082/SF-HO	2001
Honduras	Indigenous and Black Communities Support (PAPIN)	1090/SF-HO	2001
Honduras	Indigenous and Black Communities Support (PAPIN)	ATN/AE-7638-HO	2001
Honduras	Support Local Devel. - Miskito Coastal Communities	ATN/JO-7939-HO	2002
Nicaragua	Public Services Reform Program	933/SF-NI	1994
Nicaragua	Comprehensive Childhood Care Program (PAININ I)	973/SF-NI	1996
Nicaragua	Social Infrastructure Investment Program Phase III	1003/SF-NI	1997
Nicaragua	Hospital Network Modernization	1027/SF-NI	1998
Nicaragua	Preparation of the Education Reform Program	1034/SF-NI	1999
Nicaragua	Social Development Local Policy Support	1032/SF-NI	1999
Nicaragua	Atlantic Region Local Development Program	1051/SF-NI	1999
Nicaragua	Emergency Support Children & Adolescents (Mitch)	ATN/JF-6677-NI	1999
Nicaragua	Modernization and Accreditation of Tertiary Education	1072/SF-NI	2000
Nicaragua	Poverty Alleviation and Strengthening Local Capacity	1067/SF-NI	2000
Nicaragua	Social Safety Net I	1055/SF-NI	2000
Nicaragua	Support to Poverty Reduction Strategy Implementation	1071/SF-NI	2000
Nicaragua	Strengthening of the Ministry of Family Affairs	1061/SF-NI	2000
Nicaragua	Municipal Strengthening & Development Program	1086/SF-NI	2001
Nicaragua	Comprehensive Child Care Program (PAININ II)	1081/SF-NI	2001

Annex I

COUNTRY	PROJECT TITLE	LOAN OR TC NUMBER	YEAR OF APPROVAL
Nicaragua	Social Policy Reform to Support Poverty Red. Strategy	1114/SF-NI	2002
Nicaragua	Low Income Housing Program	1111/SF-NI	2002
Nicaragua	Social Safety Net Stage II	1109/SF-NI	2002
Panama	Social Investment Program	854/OC-PN	1994
Panama	Social Investment Program	855/OC-PN	1994
Panama	Institutional Transformation of Healthcare Sector I	1350/OC-PN	2001
Panama	Training and Employment System Development	1403/OC-PN	2002

THE COST OF SOCIAL EXCLUSION AND THE CHALLENGE OF SOCIAL INCLUSION OF ETHNIC GROUPS

This topic has been gaining prominence not only in Latin America and the Caribbean (LAC) but also in the IDB in recent years, and especially so following the United Nations Conference Against Racism, Racial Discrimination, Xenophobia and Related Intolerance which was held in Durban, South Africa in September of 2001. A prior, preparatory conference on the same theme was held in Santiago, Chile the previous December and is considered significant in that it brought to the fore a recognition of the chronic state of social, economic and cultural exclusion, on the basis of race and ethnicity, which afflicts millions of inhabitants of LAC and an urgent need for the countries to take measures to ameliorate the situation.

The term “Social Exclusion” describes the situation of marginalization and poverty experienced by certain social groups, the principal consequences of which are a lack of access to basic social services, including safe drinking water, sanitation facilities, minimal health care, adequate shelter, education and information, most often resulting in a state of poverty. Social exclusion also implies a lack of participation in decision-making and in the civil, social and cultural life of the community.

The impact of social exclusion in LAC is significant, in that while precise and reliable data are not available, it is estimated that the population of indigenous peoples and Afro descendants in LAC constitute about 40 percent of the total number of inhabitants of the region, of which approximately 80 percent of the total group are living in poverty or a state of extreme poverty.

The Latin American region is the most unequal in the world and, according to the 2003 UNDP Human Development Report, the majority of the countries in the Central American Isthmus rank among the lowest in the world in terms of poverty and inequality, as shown in the following table:

	HDI* Ranking	Human Poverty Index Value (%)
Costa Rica	42	4.2
Panama	59	7.8
Belize	67	8.8
El Salvador	105	17.2
Honduras	115	19.9
Guatemala	119	22.9
Nicaragua	121	24.3

* Human Development Index

In 2001, the Bank adopted an Action Plan to Combat Social Exclusion due to Race or Ethnicity, which emphasizes three fields of action:

- Production of inputs for decision-makers, through data collection and socially-excluded groups and research and diagnostic studies about the causes and consequences of social exclusion in the region
- Capacity building on two levels—internally, through awareness raising and training of Bank staff on the issue of social exclusion and externally, through training of excluded communities on leadership and development of projects and through coordination with other multilateral institutions, and
- Project identification, development/preparation and execution, through researching and seeking best practices, implementation and supervision of projects that promote social inclusion, including consultation with social excluded communities themselves.

Several conferences and workshops have been held, in broad coordination with other multilateral agencies and with governments and with civil society of LAC countries, as well as training through collaboration with the Bank's Inter-American Institute for Social Development (INDES).

Research has shown that poverty targeting is not sufficient to reach traditionally excluded groups, as most of these tend to continue to remain excluded and poor for various reasons, such as cultural or geographical isolation. Given their different levels of organization and cultural backgrounds, alternative methodologies and approach need to be employed in working with indigenous and Afro-descendants. In recognition of this reality, there has been, over the past decade, a steady increase in the number of Bank-funded projects with components specifically targeting traditionally excluded groups, starting with a few scattered interventions in the past to a more substantial increase over the past 4 years as demand has increased and the region's understanding of the issues pertaining to social exclusion based on ethnicity and race has broadened.

In the case of the seven countries of the region, by the end of 2003, there were 26 ongoing projects that specifically target indigenous or Afro-descendant populations. Of these, three target training, ten are investment programs, three are studies and ten are a mix of studies and pilot experiences which are expected to be expanded as experience is gained and lessons are learned. These projects often differ from the Bank's regular lending operations insofar as they require non-traditional approaches, greater flexibility and extra resources, for instance in carrying out culturally appropriate consultations with project beneficiaries during the development and design phase of the projects.

A brief description of these projects is presented in the tables which follow. It should be pointed out that most are in the early stages of implementation, which limits the amount of available information at this time in terms of project impacts and outcomes.

Although modest in terms of overall IDB lending to the region, these initiatives represent an important set of first steps upon which the expectation is that the issue of the cost of social exclusion and the benefits of social inclusion will be mainstreamed into the social and economic policies, plans and programs of the region and of the Bank.

Prepared by Mia Harbitz

Mia Harbitz works as an IDB social development specialist with particular interest and expertise in the field of social inclusion. During her 10-year career with the Bank she has worked in headquarters with the Central American region and spent five years in the Bank's country office in Costa Rica, prior to which she was Resident Representative for Norwegian People's Aid in Nicaragua. Before that she was a development consultant in various countries of East Africa and the Middle East, thus gaining a wide experience in developmental issues in multi-ethnic environments and diverse cultures

PROJECTS IN EXECUTION AND IN THE PIPELINE (AS OF XII/31/03)

Loan or TC Number	Objective
BELIZE	
ATN/DC-8053-BL Garifuna Culture Support (2002) US\$150,000	To provide technical support to the members of the National Garífuna Council to develop business plans for culturally and environmentally sound income generating activities, as well as a strategy for fundraising for small projects.
ATN/SU-7608-BL Support for Toledo Eco-Tourism Projects (2001) US\$150,000	To support the Mayan population and the Mayan Eco Tourism Association in the development and marketing of small hotels and other initiatives.
GUATEMALA	
1398/OC-GU Natural Resource Management in Upper Watersheds (202)	To improve the management of the natural resources in the high altitude watersheds in Guatemala, by developing a strategy for supporting small scale rural producers in improving the management of natural resources in a financially and environmentally sustainable way, thereby improving the living conditions of the beneficiary population, of which the majority (71 percent) are indigenous people.
1450/OC-GU National Census (2003)	To institutionally strengthen the national statistics systems and support the implementation of the XI Population Census, the VI Housing Census and the IV Agricultural Census, which in turn will provide updated census data as inputs to the design and development of social and economic development strategies and programs. There will an improved disaggregation of data on gender, ethnic and minority groups. which will improve decision making processes. To prepare the loan program, a prior technical cooperation, ATN/SF-7849-GU for US\$ 150,000 was granted, the objective of which was to promote citizen participation in the census.
ATN/NO-7774-GU Rural Women's Role in the Consolidation of Democracy II (2002) US\$750,000	To increase the individual and collective participation of women, both indigenous and non-indigenous, in rural areas, to prepare and promote them to decision making positions within their communities and municipalities.
ATN/CF-8364-GU National Training Program for the Design and Management of Social Policies and Programs (2003) US\$1.8 million	To develop and strengthen institutional capacity mainly in the social sectors, through training of key social managers who will be able to face the challenges posed by an equitable, inclusive and efficient development of the country. The training will be adapted to reflect the needs and realities of Guatemala, with emphasis on intercultural aspects. A major part of the training will take place outside Guatemala City in an effort to reach the traditionally excluded groups. A prior pilot course was carried out in order to tailor the training to Guatemala's specific needs, the cost of which was US\$76,000, financed by ATN/NS-7566-GU (2001).
ATN/SF-8143-GU Poverty Alleviation of Disabled Populations (2002) US\$250,000	To generate information to analyze the situation of disabled populations, including that of youth, to identify interventions that would spur local development and alleviate their condition of poverty and social exclusion. The following activities are contemplated: socioeconomic and demographic diagnostic studies, awareness building of local capacity through training, and operational planning of local development interventions.

Loan or TC Number	Objective
HONDURAS	
ATN/SC-8013-HO Socio Economic Study of Ethnic Minorities (2002) US\$138,000	To provide the necessary input to the design of a possible future loan (see HO-0197 below) by providing in depth studies of (i) institutional and organizational reality and potential; (ii) limiting factors as well as potential for productive activities for ethnic groups; (iii) human development reality and potential; and (iv) a comprehensive system for monitoring and evaluation of HO-0197 (see below).
ATN/AE-7729-HO Basic Production Recovery in Garifuna Communities Post-Mitch (2001) US\$150,000	To provide technical assistance to the 10 Garifuna communities that were the most affected by Hurricane Mitch to recover basic production, and at the same time identify their productive potential, and determine the need for human development in the area.
HO-0197 (pipeline) Poverty Reduction Among Indigenous and Black Peoples	To reduce poverty in indigenous and black communities by strengthening their organizational, institutional and culturally appropriate income generating capacity.
1090/SF-HO Support to Indigenous and Afro descendant Communities (PAPIN) (2001)	To improve the conditions for investments in infrastructure in indigenous and Afro descendant communities, through constructing basic infrastructure using culturally appropriate technology and methods, and by promoting social and gender equality. This project is also supported by ATN/AE 7638-HO (US\$1,000,000), as well as ATN/CP-7563-HO (US\$ 225,000), which aim to reinforce the organizational and institutional capacity of indigenous women in their communities.
1113/SF-HO Bay Islands Environmental Management Program II (2002)	Specific objectives are to (i) consolidate and strengthen the regional environmental management scheme for coastal and marine resources throughout the archipelago; (ii) expand the coverage and quality of potable water, wastewater and solid waste management services; and (iii) strengthen local capacity to plan and manage tourism development and growth with emphasis on land use planning and administration at the municipal level, in a multicultural and pluri-ethnic society. Two technical cooperations were executed in preparation for this loan project: ATN/PD-7841-HO Management of Ecological Systems in the Bay Islands; and ATN/KB-7787-HO (US\$125,000) Strengthening of Local Capacity and Institutional Arrangements for the Environmental Management of the Bay Islands.
1112/SF-HO Modernization of the Statistics System (2002)	To improve the governmental decision making process through the sustained development and consolidation of the national statistics system, ensuring the timely and accurate production of critical data, allowing Honduras to have the required data for the design and implementation of equitable social and economical development policies and programs.
ATN/JO-7939-HO Support to Active and Disabled Divers in the Honduran Mosquitia (2002) US\$350,000	Undertake diagnostic studies of the situation of Honduran coastal communities in their different and interrelated dimensions. Findings and recommendations for specific interventions will provide inputs to the formulation of a local development plan for Miskito coastal communities dependent on lobster diving.

Loan or TC Number	Objective
ATN/SF-7571-HO National Program for Training in the Design and Management of Social Policies and Programs (2001) US\$1,650,000	To develop and strengthen the institutional capacity of Honduras, mainly in the social sectors, through training of a critical mass of social managers who will be able to face the challenges posed by an equitable, inclusive and efficient development of the country. A substantial part of the training will take place outside of Tegucigalpa. To prepare the national program a pilot course was implemented to adapt the curriculum to respond to local needs, financed by ATN/SF-6876-HO (US\$55,400).
ATN/NC-7644-HO Anthropological Study of Garifuna Communities (2001) US\$140,000	To provide the necessary information on the HIV/AIDS situation in Garifuna communities as an input to other projects (e.g. HO-0197, and health sector programs).
ATN/NO-8212-HO Technical Support for Initiatives on Social Inclusion and Gender Equity. (2003) US\$407,819	To support both the Government and the Bank's Honduras Country Office in their efforts to promote social inclusion, with emphasis on gender and ethnic groups.
NICARAGUA	
ATN/SF-8144-NI Poverty Alleviation and Inclusion of Disabled Populations (2002) US\$300,000	To provide an analysis of the problems faced by the disabled populations in Nicaragua to identify interventions to promote local development and alleviate their condition of poverty and social exclusion. The following activities will be carried out: (i) Socioeconomic, demographic, institutional, policy and legal diagnostic, as well as a mapping of the Government's efforts to promote social inclusion; (ii) Awareness and local capacity building; (iii) departmental investment plans.
1110/SF-NI Rural Productive Reactivation Program (2002)	To increase, in a sustainable fashion, the income of rural families, including indigenous and Afro descendant families. The specific objective is to increase productivity of agricultural activities through an integral approach.
NI-0180 (pipeline) 2005 Census	To strengthen the national Institute of Census and Statistics, and support the carrying out of the 2005 National and Housing Censuses. The program includes a component to enhance the participation of ethnic groups throughout the census process.
1084/SF-NI Socio-Environmental and Forestry Development Program II (2001)	To improve the socio economic conditions and the quality of life of the population in the most important watersheds, and minimize the impact of natural disasters on these through the sustainable use of renewable natural resources, with special consideration for socio cultural conditions for pilot projects. Contains a component that specifically targets indigenous and Afro-Caribbean communities on the Atlantic Coast where the major concentration of poverty is found.
ATN/SF-8181-NI Agricultural Diversification in Indigenous Communities (2002) US\$160,000	To contribute to income generation and the nutritional level of approximately 200 families in 20 indigenous communities in the Northern Autonomous Region, through the breeding and commercialization of sheep.

Loan or TC Number	Objective
PANAMA	
1427/OC-PN National Land Management Program (2002)	The Program attends micro agriculture producers in rural areas of Panama, including indigenous people with potential for improving production, but who lack basic support and resources to attain that potential.
ATN/SF-7042-PN Strengthening of National Policies for Disabled Persons Organizations. (2000) US\$4,860	To stimulate the dialogue between the Government and Civil Society as an input to the formulation of national policies to promote the social and economic inclusion of persons with disabilities.
REGIONAL	
ATN/NS-8241-RS Best Practices for Social and Political Inclusion of Afro Descendant Women (2003) US\$90,000	To attempt to shape a regional consensus regarding appropriate methodologies for combating the social and political exclusion of Afro descendant women, and document the need for explicit attention to this group to achieve equitable growth.
ATN/SF-7778-RS Design of INDES Course for Afro-descendants (2002)	This four week course was carried out in July of 2002 with Afro-descendant participants from all of Latin America. Lessons learned have been introduced in subsequent INDES courses.

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CHAPTER 6: IDB SUPPORT FOR THE STRENGTHENING OF DEMOCRACY IN CENTRAL AMERICA

Sandra Bartels

Introduction

The political and institutional context of the 1990s in Central America is marked by the signature of peace accords and subsequent elections in Nicaragua (1988), El Salvador (1992) and Guatemala (1996). In addition to bringing about the cessation of hostilities, determining which matters would be subject to agreement and building consensus among the parties, the accords addressed the issue of the basic demands that needed to be met to demobilize the armed groups and establish public policies for their incorporation into the productive, social, political and cultural system and open up social spaces for their effective insertion into national life. The peace accords were accompanied by elections and the institutionalization of political parties and forums for political debate, which launched democratization processes in the countries of the Isthmus.

By the early 1990s, all the countries of the Central American region had elected civilian governments and by the middle of the decade had held elections without institutional ruptures and with peaceful transitions from one civilian government to another.

On the economic front, the reforms carried out during the 1990s contributed to the recovery of economic growth after the severe crisis of the 1980s (see Table 1). Economic reforms posed a great challenge with respect to institutional organization and policy management. Public institutions were modernized and civil society organizations, which sought broader opportunities for citizen participation, were strengthened.

Table 1			
Central America: Average Economic Growth (%)			
	1981-90	1991-95	1996-2000
Belize	5.1	4.3	4.8
Costa Rica	2.5	5.6	5.0
El Salvador	-0.3	6.2	3.0
Guatemala	0.9	4.3	3.8
Honduras	2.5	3.6	2.9
Nicaragua	-1.2	1.5	5.1
Panama	1.6	5.5	3.4

Source: IDB-estimates based on official sources and the *World Bank's World Development Indicators 2001*.

The Bank has acted as a catalyst in this process of transition and strengthening of democracy in the countries of the Isthmus through the support it has lent to the process of identifying and prioritizing needs for reform and modernization, through financing for programs and projects, including the establishment of strategic goals and the promotion of short-term tactical activities, such as building consensus among the promoters of change.

One example is the seminar on *Justice in Latin America and the Caribbean in the 1990s, Challenges and Opportunities* held in 1993 in San José, Costa Rica. That meeting was decisive in drawing the attention of governments to the importance of institutional issues, in this case the need for judicial reform intended to establish an independent, streamlined, reliable and more broadly accessible system of justice. This nonfinancial activity gave rise to a demand for a series of projects to reform and modernize the justice system that the Bank has supported with loans and technical assistance.

Similarly, a regional meeting on civil society and participation held in November 1995 in San José, helped to visualize the importance of citizen participation in the identification, design and implementation of development projects. Since then, the Bank has supported many participative experiences technically and financially. Another important example is the regional seminar on citizen coexistence and security held in San Salvador in June 1998, which helped to place this topic on the development agenda.

This paper is an initial effort to summarize some of the activities backed by the Inter-American Development Bank that merit special mention on account of their particular support for strengthening democracy in the Central American countries.

The paper is divided into eight sections. The first analyzes the strategic frameworks; the second explores good practices in projects for the reform and/or modernization of the justice system; the third examines a citizen security program; the fourth analyzes a pioneering program in modernization of the legislative branch; the fifth refers to different projects and programs in which citizen participation has played a fundamental role; the sixth analyzes some initiatives in the area of fiscal reform; and the seventh and eighth contain conclusions and, in addition to taking stock of the previous sections, presents lessons learned, stressing what was well done and can be replicated and what can be improved.

I. Strategic Frameworks

Since the beginning of the decade of the 90s, the Bank made significant progress in the formulation of conceptual frameworks to guide its work to support the reinforcement of democracy in the countries of the region.

The Eighth Capital Replenishment called on the Bank to make a greater commitment to strengthening democratic forms of government, through support for reform of the State and the strengthening of institutions, in an overarching framework of economic and social reform.

The *Frame of Reference for Bank Action in Programs for Modernization of the State and Strengthening of Civil Society*, approved in March 1996, sets forth basic guidelines to direct Bank actions in four areas: the executive branch, the judicial system, the legislative branch and civil society.

The *Subnational Development Strategy*, approved in April 2002, provides the Bank with a general framework for supporting the borrowing member countries in their attempts to promote socioeconomic development through the decentralization of functions and the allocation of funds to local levels of government. The strategy defines the institutional objectives that the Bank is interested in promoting in its borrowing member countries that are committed to subnational development. It also contains recommendations on effective means of achieving them and indicates the concrete instruments and resources that the Bank can mobilize for that purpose.

In 2002, the *Strategy for Promoting Citizen Participation in Bank Activities* was formulated and the *Strategy for Modernization of the State* was approved in 2003.

The *Strategy for Promoting Citizen Participation in Bank Activities* is intended to establish criteria and general guidelines and spheres of action to expand, strengthen and systematize citizen participation in Bank activities. Unlike the sector strategies that establish priorities for the Bank's action in a given sector or thematic field, this is a corporate strategy, since it refers to institutional procedures for including citizen participation in operational activities.¹

The *Strategy for Modernization of the State* establishes the basic criteria to guide the Bank's activities in this field, defines priority spheres of action and indicates the financial and nonfinancial instruments available to support the countries of the region in building up the institutional capacity of the State and society as a whole. Through its priority fields of action, the strategy profiles the basic institutional requirements for democratic governance, within the framework of the general goals of sustainable growth and poverty reduction.

¹ See document GN-2232, October 2002.

II. Reform of Justice Systems

“While the just and the equitable are both good, the equitable is superior.”

Aristotle

The subject of judicial reform falls within the framework of the overall processes of reform and modernization of the State that have been carried out in the Latin American and Caribbean countries in the last 20 years. Modernization of justice systems is an imperative for fortifying democracies and is a core element for the economic and social development of these countries.

The role played by the judicial branch in strengthening and consolidating democratic systems is unquestionable. The rule of law, or to put it another way, a State subject to law and the existence of a minimum degree of legal security, are substantive requirements for the consolidation of democratic governance.

From the economic standpoint, for a market to function properly, a series of rules must exist that it can operate under – a series of rules that are enforced. This function of enforcing the rules is the fundamental responsibility of the justice system. Accordingly, in the final analysis, it is the justice system that assigns and protects the economic and social rights of stakeholders.

In this context, an improvement in justice systems will have a direct positive impact on the economies of countries. For example, lower crime rates or less complicated formalities for enforcing rights should lead to higher investments and improve long-term growth prospects.²

Weaknesses in the justice system and their negative impact on the economy are exemplified by the high transaction costs that undermine the efficiency of the production factors. Those costs stem from ignorance of the legal rules, of jurisprudence and of due process, the time required to enforce a guarantee or obtain recognition of a right, and the unpredictability of court rulings. Entrepreneurs transfer the transaction costs to their prices on domestic and international markets which, of course, affects the competitiveness of their products.³

It was in this context that the Bank began to support the modernization of justice systems. Since then, eight projects have been approved in the justice sector in Central America, in addition to a number of national and regional technical cooperation projects.

² For a more extensive analysis of the subject see Mauricio Rubio: “Normas, Justicia y Economía en Colombia”, in *La Economía Política de la Reforma Judicial*, edited by Edmundo Jarquín, Fernando Carrillo, IDB 1997.

³ For more information see Néstor Humberto Martínez: “Estado de Derecho y Eficiencia Económica”, in *Economía Política de la Reforma Judicial*, edited by E. Jarquín y F. Carrillo, IDB 1997.

The important mission that the law can fulfill when used as an instrument of social change should also be stressed. The extent of poverty in Latin America points clearly to the need for a new approach, perhaps based on one of the oldest teachings of Aristotle, who said that while the just and the equitable are both good, the equitable is superior.

Justice has been universally accepted as a basic social right. It should be kept in mind that the legal system is the last frontier where citizens can see whether their rights and redress for violation of those rights are effectively protected. Accordingly, it is necessary to facilitate and promote real and not just theoretical access to justice. The promotion of reforms in justice systems is a factor that boosts the confidence of citizens in the legal system and improves the quality of life in a country.

Like all complex processes, the reform of justice is a long-term undertaking and positive results are difficult to see in the immediate demands of the short term. Despite problems that stem from the difficulty in measuring the results, there are some very clear examples of positive new trends in the justice sector that have been brought about by the reforms. However, the process is far from being completed or concluded. On the contrary, it is a fledgling process in which only the first steps have been taken and the first lessons are being learned.

The Bank's involvement in the reform of the justice system has focused on changes on the constitutional/legal and institutional planes. They include primarily computerization of the legal process, reform of criminal procedures, decentralization, reforms in the governing structure of the judicial branch and the distinction between jurisdiction and administration. Some processes to modernize the justice system have included alternative dispute settlement mechanisms and some have been accompanied by the recognition of justice for indigenous peoples.

Table 2 presents a list of eight judicial reform projects in which the Bank has participated and details about them are given below.

Table 2: Loans Approved

Country	Project Title	Year of Approval	Amount (US\$000)
Costa Rica	Program for the Modernization of the Administration of Justice 859/OC-CR	1995	\$11.2
Costa Rica	Program for the Administration of Justice, II 1377/OC-CR	2001	22.4
Honduras	Program to Modernize the Administration of Justice 974/SF-HO	1996	7.2
Honduras	Program to Support Modernization of the Administration of Justice, II 1115/SF-HO	2002	30.0
Guatemala	Program in Support of Judicial Reform 1120/OC-GU	1998	25.0
Panama	Program to Improve the Administration of Justice 1099/OC-PN	1998	18.9
El Salvador	Program to Support Reform of the Justice System 919/OC-ES and 920/OC-ES	1996	22.2
Nicaragua	Program to Strengthen the Judiciary 1074/SF-NI	2001	\$12.0

A. Costa Rica: Program for the Modernization of the Administration of Justice

In February 1993, the Bank held a seminar in San José, Costa Rica, called *Justice in Latin America and the Caribbean in the 1990s, Challenges and Opportunities*. Pursuant to the event, Costa Rica was the first country to ask the Bank for support in designing an operation in the justice sector. Preparation of this first loan in a sector that was new for the Bank, led the country's Supreme Court to establish a technical committee to prepare a modernization plan.

Once the first version of the plan had been prepared, the court convoked a national debate on the subject between February and August 1993 in the course of which more than 5,000 people took part in workshops and regional forums to define objectives and goals for a comprehensive program to modernize and reform the administration of justice in the country. This participative exercise culminated in September 1993 with the First National Congress on the Administration of Justice, whose conclusions were used in preparing the final version of the plan and as a guide for the design of the operation with the Bank. The consultations extended to all parts of the country, in an exercise to define priorities. Justice system stakeholders and operators, users and the general public participated.

The Program for the Modernization of the Administration of Justice in Costa Rica was approved in 1995 and it was the IDB's first investment operation in the sector in Latin America.

Costa Rica: Modernization of the Administration of Justice
Loan 859A/OC-CR: US\$11.2 million (1995)

The objectives of the program were:⁴

- Consolidation of a modern system of administration within the Judiciary
- Improvement of management in courts and throughout the Ministry of Justice
- Facilitation of access to and utilization of information, and
- Training programs for various officials engaged in the administration of justice

Executing the program introduced the challenge of rethinking the organization of justice as it relates to the traditional forms of managing judicial processes and examining common activities carried out by courts that could be susceptible to consolidation and specialization to make better use of available resources.

As part of the program, a strategic planning exercise was carried out that served as the basis for revitalizing the mission entrusted to the judiciary and to establish the vision that propelled the process of change in different areas, one of which was judicial management. This exercise helped to understand the context, the strengths and weakness of the system and the short- medium- and long-term objectives and to prepare the strategy and the human and financial resources to achieve the goals. This planning was also fundamental for obtaining political commitment on the highest level and for the sustainability of the program of reforms.

The Most Important Achievements of this Project were:

- A new management system⁵ implemented as a pilot project in the Second Judicial Circuit of San José, with the objective of speeding up the processing and resolution of conflicts. The new system included specialization in different areas by the courts and today there are courts that deal with family matters, alimony and domestic violence, to give an example. It also involved consolidating the courts

⁴ The evaluation of justice reform operations prepared by the Bank's Office of Evaluation and Oversight (OVE), October 2002, says in this regard: "... To achieve these objectives, the operation forayed into an area that the Bank had not entered until then – reorganization of the justice system. The novelty of this approach and its similarities to other reform processes being undertaken by the OECD, quickly turned the operation into a pilot project that was very closely monitored by the Bank and civil society in general."

⁵ The evaluation of stage one pointed to concrete results in terms of improved efficiency in case processing in all matters falling within the program's area of influence. As an example, the Collections Court was able to increase monthly notifications by 55% between 1998 and 2000 and the number of rulings handed down by the magistrate of that court was 63% higher than in 1998; the traffic court was able to wind up 80% more cases in 1999 than in 1998, and maintained that percentage in 2000; the alimony court increased its productivity in 2000 measured by the ratio of sentences per judge and per total staff of 44% and 63%, respectively, compared to 1998; and the organizational change has lessened the time it takes to issue a collection order from four days in 1998 to 40 minutes in 2000. The productivity of the Family and Domestic Violence Court, expressed in the number of cases concluded and rulings per judge, increased in 2000 by 10% and 58% compared to 1998; the rulings of the Administrative Court grew by more than 50% in 2000 compared to 1998; the Civil Court improved its effectiveness in rulings in 2000 by 56% compared to 1998; and the Criminal Court also experienced improvement in cases concluded by magistrate and staff, but not as dramatically, since demand has increased as have staffing levels for magistrates and officials. The ratio between "out" and "in" cases in the Criminal Court of Appeals has risen from 29% in 1998 to 70% in 1998 and 88% in 2000.

which resulted in both large and small courts, where the largest – the Juzgado Civil de Hacienda de Asuntos Sumarios [Summary Collections Court] – is currently dealing with about 30,000 cases. It also included the outsourcing of certain administrative areas, such as the agreement with the banks for the collection of child support payments. This new management system was a major turning point in the operation and administration of the courts.

- Introduction of the Costa Rican judicial information system (SCIJ), for the integrated management of judicial processes, with access to laws, executive decrees, regulations and other general rules, included in the national current legislation system of the Office of the Attorney General, linked to the case law of the courts. This information system is an important tool for legal operators, since they can consult all the legislation in effect in the country, the case law of the courts and judicial doctrine.
- Introduction of the penitentiary administration information system (SIAP) which covered the three largest centers (50% of the prison population). SIAP is an information system for the Ministry of Justice and the judicial branch, kept in high-security servers, which allows for consultations on: (i) the register of prisoners; (ii) the register of sentences; (iii) the register of decisions; and (iv) the register of consultations by sentence execution magistrates.
- The traditional organization of courts was transformed by using a strategy that permitted the incorporation of a circuit administrator and courtroom administrators; the abolition of the clerk;⁶ the appearance of the figure and functions of the case management judge and the deciding judge,⁷ which completely relieves judges of administrative decisions. The separation of administrative aspects from judicial aspects in court organization was quite complicated since it meant that administrators were to perform administrative functions, relieving the judges of them, so that judges could concentrate on strictly jurisdictional matters. Before the project was implemented, judges spent more than 60% of their time working on purely administrative matters. In addition to improving case management, the reform has also improved the quality of rulings, since although the number of cases resolved has increased, there has been no increase in the number of appeals for review of lower court rulings.

⁶ Another profound change was the replacement of the court clerk by the case management judge. The idea was to place the management of court procedures in the hands of a professional judge who would act on the basis of legal criteria, avoid the delegation of functions, and administer the court as the person in charge of organizing the proceedings and arguments of the parties.

⁷ Each court has a group of magistrates who are deciding judges and case-management judges. The first are responsible for handing down decisions and hearing evidence. The deciding judges have their offices in the upper floors of the building for greater privacy and convenience in their work. In some courts, the judges rotate in decision and case-management functions, which has produced good results. The entire corps of judges – deciding and case management – is coordinated by a judge elected by his or her colleagues to perform that function.

A second stage of program for the administration of justice (loan 1377/OC-CR) was approved in 2001. The first program had emphasized investments in technology and the development of information systems. Although the second stage does not abandon this line of investment until all the judicial circuits are covered, it is much more ambitious in design. This second project is much more comprehensive and includes the following components: (A) institutional strengthening for the prevention of crime, which includes: (i) developing national policies and strategies for crime prevention; (ii) promoting the use of out-of-court conflict resolution mechanisms; and (iii) improving community-police relations; (B) strengthening the Public Defenders' Office, which includes: (i) making administrative and functional improvements; and (ii) improving case management; (C) strengthening the Public Prosecutors' Office, which includes: (i) strengthening management and strategic planning; (ii) improving the management of prosecution teams; (iii) providing services for victims; and (iv) strengthening human resources; (D) judicial efficiency in conflict resolution, which includes: (i) office management; (ii) procedural reform; (iii) resolving more cases out of court; (iv) improving legal training and the practice of law; and (E) better managerial capacity of the judicial branch, which includes: (i) reforming the decision-making structure; (ii) reorganizing the managerial system; and (iii) institutionalizing gender policies.

The design of this second stage stresses the importance of access to justice, in a cross-cutting approach incorporated into all its components, based on nondiscrimination on the basis of nationality, ethnic group, gender, social class, etc., which confers a fundamentally social nature on the program.

B. Honduras: Program to Modernize the Administration of Justice

In 1996, the Bank approved a program to modernize the administrative of justice (loan 974/SF-HO) which supported the Supreme Court in preparing legal reforms, expanded the geographic coverage of the justice system, and defined and implemented basic training and administrative measures. Some of the most radical reforms supported by the program were intended to restore the public's faith in the integrity and capabilities of magistrates and other judicial authorities.

The main achievement of the program was that it created favorable conditions for the approval of Legislative Decree No. 262-2000⁸ which amends the composition of the Supreme Court and the procedure for appointing the justices, creates the Judicature Council and expands the powers of the Constitutional Bench, and guarantees the financial independence of the judicial branch, aspects which are all closely linked to the independence of the judiciary. Another important feature of the program was that it brought services to the majority of the population, since it established justice centers in different localities that previously had no formal authority where they could file their complaints.

⁸ For more information see *Informe Final de Evaluación Externa del Programa de Modernización de la Administración de Justicia* (Loan 974/SF-HO), Inter-American Development Bank, Tegucigalpa, Honduras, 20 November 2000, pages 7 to 11.

Honduras: Selection of Justices. A Transparent and Participatory Exercise.

One of the factors with the greatest impact on the independence of the judiciary is the procedure for naming its senior officials and the guarantees they are given that they can continue in their posts and not be removed simply on political grounds.

The bill on constitutional reform enhanced transparency in the selection of Supreme Court justices. The report on the preliminary version of the bill justifies the need to pass the reform, mentioning “sectarian depolitization, the appointment of the best men and women to the judiciary, the exclusive concern of the justices with judging and executing sentences, citizen participation in the process of proposing candidates and economic viability, with the derogation of constitutional provisions which, 19 years after the constitution was promulgated, still allow the 3% of the budget that corresponds to the judiciary to be allocated gradually.”⁹

Approval of Decree 262-2000 introduced the following changes:

- The justices continue to be elected by Congress, but the vote of two thirds of the members is required, which reaffirms the need for a broad consensus among the legislators and not a simple party majority;
- The justices are no longer freely selected by Congress. Congress is required to chose them from a list of candidates proposed by a nominating committee;
- The term of appointment was raised from four to seven years so as not to coincide with the presidential or legislative terms of office;
- The number of Supreme Court justices was raised to 15;
- A Constitutional Bench was established with broader powers; and
- The Judicature Council was created.¹⁰

Management of change also needs to be carried out strategically, through leadership, motivation, information and commitment.

The recent constitutional reform ended the political dependency of the judicial branch as well as its financial dependence on the executive branch, since it empowered the Supreme Court to prepare a budget for the judiciary and send it directly to Congress. This involved an amendment to the constitutional requirement to reserve 3% of tax revenues for the judiciary’s budget. Apart from insulating the courts from potential financial

⁹ Idem

¹⁰ Hernando Paris (consultant): *Diagnostic Report on the Justice Sector*, November 2001

problems, this measure gave the judicial branch greater financial stability. It has been able to increase salaries, invest in training and new installations, cover the cost of its administrative modernization and pay for other reforms.¹¹

Another merit of this project was to take justice to places where it was not present before. Eighty magistrate's courts were created in different municipalities in 16 departments of the country.

In 2002, the Bank approved the second phase of the program to support modernization of the administration of justice (loan 1115/SF-HO). The main objective of this program is to institutionalize and deepen the process of modernizing the justice sector that began in stage one and to extend the reform to other entities in the sector such as the Public Prosecutor's Office and the Investigations Police of the Ministry of Security, whose roles have changed since the new Code of Criminal Procedure came into effect. The improvements in efficiency, rapidity and legal security that mark this second stage are indispensable for ensuring governance and are a sine qua non for the country's economic development. One of the most important achievements in preparing stage two was the consensus that was built for reform of the justice sector among the different operators of the system. The authorities have demonstrated their will and commitment to reforming and modernizing their judicial structures to improve how justice is administered and to define the type of organization that is best suited and responsive to the needs of citizens.

C. Guatemala: Program in Support of Judicial Reform

One of the greatest structural weakness of the Guatemalan State lies in the justice administration system, as the Peace Accords point out when stressing the obsolescence of legal procedures, slowness of proceedings, the absence of modern systems and the lack of control over judicial officials and employees, which leads to corruption and inefficiency.

Some of the commitments made in the Peace Accords include: promoting the legal reforms necessary to give priority to the criminal prosecution of crimes that cause the greatest social harm; establishing a public criminal defense service to assist persons who are unable to hire a private attorney; introducing multilingualism into the justice system, and applying an effective plan for the protection of witnesses, prosecutors, and justice collaborators.

Through the loan in support of judicial reform (1120/OC-GU), the Bank has backed improvements in justice administration by coordinating the institutions in the sector, supporting the improvement of services in rural areas and strengthening the managerial and administrative capacity of the institutions.¹²

¹¹ Idem

¹² "The project presents an integrated vision of the justice system and acts through different components with the basic intent of increasing access to justice, particularly for indigenous communities and the communities that suffered most from the war. The loan proposal points to the significant benefits of the experience gained by the Bank in formulating projects of this kind and incorporates lessons learned from previous projects." *Evaluation of Operations of Judicial Reform*, prepared by the Office of Evaluation and Oversight (OVE), October 2002.

This Bank-sponsored program recognizes the multiethnicity and multiculturalism of indigenous peoples and guarantees their access to justice by extending the coverage of judicial services to most of the indigenous population in their own languages.

**Guatemala: Program in Support of Judicial Reform
Loan 1120/OC-GU: US\$25 million (1998)**

The objective of this program was to strengthen the rule of law by providing support for the different institutions in the justice system and for coordination among them, to improve access to justice and the quality of judicial services. The program was divided into two subprograms:

- **Subprogram A:** Access to justice, whose objective was to increase coverage in the communities most heavily affected by the armed conflict and/or geographically remote communities.
- **Subprogram B:** Institutional strengthening, whose objective was to build up the managerial and planning capacity of sector institutions, establishing mechanisms for interagency coordination to improve the administration of justice.

While the program is still being carried out it has already produced some interesting results, including:

- Four justice administration centers (CAJ) were constructed in areas affected by the armed conflict and/or geographically remote communities, each staffed with a lower court judge, a prosecutor, a victim assistance office, a criminal public defender, a legal aid office, a mediation center and an interagency coordination service. This has facilitated coverage in areas where it did not previously exist and has provided access to justice for 1.5 million people who were previously forced to travel long distances at high economic cost to protect their rights in the justice system.
- Sensitivity campaigns were held for the indigenous population regarding the State's way of administering justice and the differences with their world vision and legal practices.
- Justice operators at these CAJs were trained in multiculturalism and multilingualism, which are highly important for serving indigenous groups. This has translated into the acceptance of cultural experts and use of their testimony for the decriminalization of cases linked to indigenous religious practices.
- The program to expand the coverage of the Criminal Public Defense Administration was completed and continues to be implemented under the full responsibility of the institution, which assists 12,500 cases a year, far more than the 2,200 cases/year initially estimated. The average cost is less than US\$100 and the benefits go to groups unable to accede to a professional criminal defense. The administration's presence has grown and expanded with implementation of a

police station project, where counsel is provided for low-income accused, doing away with the old practice of arbitrarily depriving them of their liberty.

- An information system to support the justice sector (SIASEJU) was established and has developed information management and processing systems in the four sector institutions and is preparing to interconnect them, which will permit the institutions to exchange information, work with a single file and reduce processing times in criminal cases.
- Thirty-six magistrate's courts were built and are in operation.
- Ten district prosecution offices were built.
- The accreditation system for public defenders currently covers 2,200 cases a year.

D. Panama: Program to Improve the Administration of Justice

Since the return of democracy in 1990, the different governments have made efforts to reestablish the independence of judicial institutions, strengthen them and modernize the law. In the early years, judicial investigation was made independent and the complement of judges was renewed, with these factors serving as the foundation for continuing with the reform of the justice system. With the approval of this program in 1998, Panama has embarked on intensive work to modernize and transform its justice system.

Panama: Program to Improve the Administration of Justice Loan 1099/OC-PN: US\$ 18.9 million (1998)

The program seeks to improve the quality of the country's legal and judicial services, with the objective of strengthening the rule of law. This is a long-term objective and this operation constitutes the first stage. It is divided into two subprograms: (i) **Subprogram A**, which is intended to support the country in improving its justice system, in order to shorten response time, guarantee due legal process, and lower barriers to citizen access; and (ii) **Subprogram B**, which is intended to support the country in enhancing the quality, efficiency, and transparency of the legal actions and proceedings of the public administration in order to improve relations between the State and civil society.

One of the merits of this program is to have achieved the convergence of the three main institutions in the justice system: the judiciary, the Office of the National Public Prosecutor (in charge of prosecuting criminals and investigating crimes) and the Office of the Government Solicitor (government attorneys). The last two make up the Office of the Attorney General.

Subprogram A involves organizational reengineering of the judicial agencies (courts, prosecutors' offices, public defenders' offices, etc.), breaking with the old approach in which the judges were managers, professionalizing management and removing all administrative activities from the duties of court officials, thereby optimizing the use of resources by achieving economies of scale. This program is being carried out in the

country's two largest circuits – San Miguelito in Panama City and the province of Chiriqui. Subprogram A has supported the creation of mechanisms for planning and control of strategic and budget management for the explicit establishment of institutional goals that ensure continued improvement in the results of judicial institutions as they relate to impact, effectiveness, quality and productivity. It has helped to improve the judicial investigation of crimes and reduce the high levels of impunity.

The great merit of subprogram B has been to strengthen the presence of the Office of the Government Solicitor as a public institution, through a series of reforms intended to improve the technical and legal capacity of public institutions, in order to forestall arbitrary actions by the public administration and prevent pockets of administrative corruption.

E. El Salvador: Program to Support the Reform of the Justice System

The peace accords signed by the government and the Farabundo Martí National Liberation Front in 1992 laid the groundwork for reform of the justice system. In 1993, an independent body created under the accords, the Truth Commission, issued a report that pointed out the need to reform the administration of justice to enable it to effectively and efficiently resolve the cases that arose during years of conflict. In 1996, the Bank approved a first loan to support the Salvadorian government in reforming its justice system.

El Salvador: Program to Support the Reform of the Justice System Loans 919/OC-ES and 920/OC-ES: US\$22.2 million (1996)

This program has three components: (i) Support for implementing a series of legal reforms concerning commercial and criminal legislation and administrative procedures and alternatives for conflict resolution; (ii) Activities to improve the treatment of juvenile delinquents and at-risk youths by working jointly with the five institutions in the justice sector (the National Judicature Council, the Ministry of Justice, the Office of the Prosecutor General, the Office of the Deputy Secretary of Justice, and the National Magistrates' Council, as well as the Salvadorian Child Protection Agency (ISPM); and (iii) Strengthening strategic planning and the administrative capacity of the six institutions taking part in the project and promoting integrated planning and coordination across the sector.

To help in implementing the new legislation, the loan supports a wide variety of training programs on the content and application of the laws and on specific skills such as mediation techniques. Training is provided for magistrates, the College of Attorneys, court-appointed counsel, prosecutors, law students and people working with juvenile delinquents and at-risk youth. The activities under the second component include the renovation and construction of juvenile detention centers so that juveniles will not be held in adult prisons, development of vocational training and social education programs for at-risk youths, remodeling the vocational training centers for juvenile prisoners, establishment of clinics to treat prisoners with drug or alcohol addictions, and establishment of a training program for administrators of the juvenile justice system.

The third component includes technical assistance for developing statistical systems and performance indicators, improving financial planning and human resource management systems for executive and technical personnel, and the development of information systems. The program seeks to improve coordination in the justice sector as a whole by supporting a planning committee for the entire sector and a pilot integrated justice center that brings magistrates, prosecutors and attorneys together under one roof to provide a variety of services.

The most significant results of the program are:

- Implementation of an ISO 9000:2000 quality management system for the services of the Office of the Prosecutor General which, in 2000, became the first Latin America justice institution to possess ISO 9000 certification.
- Improvement in the system of juvenile justice, since the program financed the rehabilitation of infrastructure at juvenile centers, based on the standards for such centers established by the United Nations. Under the crime prevention and social reintegration subprogram, more than 3,000 scholarships were given to at-risk children and juveniles about to be released, which helped to prevent and reduce juvenile delinquency, with the corresponding improvement in citizen security.
- Support for the legal reforms initiated by the government through information and training events for system operators in the new criminal law and criminal procedures. Some initiatives in new areas were also promoted, such as the presentation of a draft code of civil and mercantile procedure and the groundwork was laid for a judicial career path in the judicial branch.

F. Nicaragua: Program to Strengthen the Judiciary

This project was approved in 2001 and has recently started up. Its design stresses independence of the judiciary as a key element for developing a systematic strategy for justice reform in Nicaragua.

Nicaragua: Program to Strengthen the Judiciary Loan 1074/SF-NI: US\$12 million (2001)

The specific objectives are: (i) to expand access to justice in order to meet the needs of vulnerable groups in Managua and the country's interior; (ii) to improve the organization and operation of the courts, strengthening and rationalizing the administrative functions of the judiciary; and (iii) to increase confidence in and improve the quality of service by creating and consolidating career paths in the judiciary and the civil service, and creating mechanisms for communications with users.

The main merits of the program's design are: (i) introduction of a judicial career path, conferring transparency on the process of selection and promotion of judges and consolidating their internal independence, making their positions depend exclusively on their professional performance and the incentive structure established in the rules governing the career path; and (ii) the comprehensiveness of the program, since all its activities form part of processes that are permanently and simultaneously interrelated and are present in three dimensions: access to justice, management, and human resources.

Some Conclusions Regarding Judicial Reform Projects

The visible changes and partial improvements in the operations of the justice sector financed by the Bank in Central America over the last decade suggest that the comprehensive approach to reform has been a success. There have been fewer violations of human rights; the countries have individually reduced the backlog in the courts and the time required to obtain a ruling, at least in some types of cases; a larger number of clients is being served; the magistrates are better trained; and access to justice has expanded.

Apart from the partial successes in implementing the reforms, more than a decade of experience with reforms supported by the Bank in Central America has generated a great deal of knowledge about institutional weaknesses in justice systems and the different alternatives for building up the system's organizations. Although it is impossible to always know what would work best in each country, it is at least possible to identify the potential benefits of introducing training programs, judicial career paths, new laws or administrative mechanisms, and to mitigate the problems that can arise.

G. Regional Technical Cooperation: Access to Justice

The Bank has contributed significantly to the learning process about reform and modernization of the judicial branch and has financed studies to support the design of sector operations. One example is a nonreimbursable regional technical cooperation program for US\$200,000 approved in 1998 (ATN/SF-6029-RG) which financed a study on access to justice in Latin America. The results were published in a book called *Access to Justice and Equity: Study in Seven Latin American Countries*.¹³

The objective of this study was to analyze success stories in public and private services for access to justice for social sectors that have been traditionally excluded, in order to guide the formulation of reform programs whose objectives are to improve access to justice.

The following activities were carried out under this project:

- An analysis of obstacles to access to justice through a study of how the justice administration system functions as a guarantee of the rule of law;
- Identification and analysis of best practices in public and private services that have expanded and improved access to justice (for example, social services by attorneys, public defenders, legal aid, etc.);
- Preparation of lines of action based on the above-mentioned studies, intended to improve the opportunities for equitable access to justice; and
- Holding a regional forum to analyze and validate the studies conducted and promote the implementation of successful practices.

¹³ *Evaluation of Judicial Reform Operations*, prepared by the Office of Evaluation and Oversight (OVE), October 2002.

In designing this project, the need of the countries to evaluate mechanisms that effectively promote access to justice was kept in mind, as was identification of procedures and components to improve the Bank's work in this area.

The project also attached special importance to the capacity of society to resolve its internal conflicts. The study prioritized access to justice as a factor in more comprehensive and sustainable development in balance with social peace.

The study contributes elements that are useful for planning general and specific actions to promote access to justice for bypassed sectors and detects trends in judicial reform that are of interest and impact in that regard.

H. Programs to Strengthen Alternative Dispute Resolution Mechanisms

Starting in 1996, through the Multilateral Investment Fund (MIF), the Bank financed six commercial mediation and arbitration programs in Costa Rica, Honduras, Guatemala, El Salvador, Nicaragua and Panama. The projects for alternative dispute resolution were a reaction to the problems of the justice systems in the region. The absence of reliable and effective mechanisms for resolving commercial disputes was an obstacle to private sector development and investment.

The main objective of alternative dispute resolution (ADR) was to create an incentive to boost investment and commercial transactions. It also sought to ease congestion in the courts, reduce the costs and time required for dispute settlement, increase community participation in conflict resolution, facilitate access to justice and provide society with a more effective means of settling conflicts. These programs have strengthened alternative dispute resolution methods and have created a regional movement for their support, consolidation and use. In general, the focus has been on four main activities: legal framework, creation and/or strengthening of mediation and arbitration centers, training for arbitrators and mediators/conciliators, and dissemination and orientation.

The creation of mediation and arbitration centers was intended to provide a private space where parties can settle their disputes more quickly and effectively. The quality of the services provided by the centers has built up confidence among entrepreneurs and is a good example of cooperation between the public and private sectors.

An OVE evaluation of MIF projects in the field of alternative dispute settlement which analyzed the results obtained from these projects concludes that: (i) use of alternative commercial dispute resolution methods has been very successfully introduced in almost all the countries of the region; (ii) legislation on arbitration and mediation was modernized and harmonized in almost all the countries; (iii) specialized human resources were trained in this field; and (iv) an inter-American network of commercial arbitration was established.¹⁴

¹⁴ For more information see OVE's *Evaluación de los Proyectos del FOMIN: Métodos Alternos de Resolución de Disputas Comerciales*, MIF/GN-78-2.

The use of ADR has had a strong impact on the legal culture of the Central American countries and these projects have been key in promoting the use of ADR in the region. In most of the countries, there was no experience with ADR for commercial disputes. Accordingly, in addition to contributing financing, the MIF contributed a defined methodology and its know-how for project execution.¹⁵

III. Citizen Security

“The main cause of urban violence is not poverty but social inequality.” (Gilberto Gil on taking office as Minister of Culture of Brazil)

“In the Americas, estimates place the number of violent deaths at close to 517,465 a year; approximately 140,000 of those deaths are homicides. If the opportunity cost of the region’s homicides is calculated, Latin America is destroying capital of about US\$27.7 million a year. For many countries, violence is the leading cause of death among the general public and in almost all countries it is the leading cause of years of healthy life lost. An estimated 14% of the region’s GDP is lost on account of violence. This, combined with insecurity, is the main concern of citizens in almost all countries.”¹⁶

During the 1990s, public demand has arisen for greater security for persons and property, as a result of the increase in violence. This demand has led the Central American governments to propose responses to address the problem, through public crime prevention policies.

In this context, the Bank’s involvement in programs for citizen security and coexistence fundamentally provide technical support for defining strategies and policies for citizen security. The final goal of projects on social peace and citizen security is to create permanent every-day mechanisms to bring about a change in attitude by individuals and institutions in order to help reweave the social fabric.

The lines of financing for these programs are directed to components linked to strategic planning of public policies on security, reform, and institution-building and development. One irreplaceable element in the Bank’s strategy in citizen security programs is participation by civil society in the prevention of violence and crime.

With support from the Norwegian government, the Bank organized the first forum on peaceful coexistence and citizen security, held in San Salvador in June 1998. The forum was the launching pad for the Bank’s work in this area. As a result of the event, a book was published entitled *Peaceful Coexistence and Security: A Challenge for Governance*,

¹⁵ Idem

¹⁶ Rodrigo Guerrero: “La Violencia Vista desde la Salud Pública: Tratar los Factores de Riesgo” in *Convivencia y Seguridad Ciudadana: Un Reto a la Gobernabilidad*. IDB, University of Alcalá, Alcalá de Henares, Spain, 2000.

which is a collection of the documents presented during the forum. This publication offers an initial overview of the program on citizen security in the region.

The experience gained from the projects – limited to the design phase – only allows for a preliminary evaluation of the Bank's experience in the process of formulating the citizen security project in Honduras.

Honduras: Peace and Citizen Coexistence Project for the Municipalities of the Sula Valley

In March 2003, the Bank approved the peace and citizen coexistence project for the municipalities of the Sula Valley, whose main objective is to support local authorities in managing security and coexistence. The most relevant characteristic of this project is its participative and comprehensive nature.

**Honduras: Peace and Citizen Coexistence Project for the
Municipalities of the Sula Valley
Loan 1123/SF-HO: US\$20 million
Technical Cooperation ATN/SF-7713-HO: US\$150,000 (2003)**

The main objective is to improve the levels of peace, coexistence and citizen security in the 17 municipalities in the Sula Valley Region, contributing to a reduction in insecurity and violence among young people from 12 to 25 years of age, through comprehensive activities for crime prevention and institution-building for municipalities and security institutions, protection for youths and promotion of human development.

The project takes a comprehensive and preventive approach. It includes actions to fortify the agencies with responsibilities for citizen coexistence and security and preventive actions, and links public and civil society actions to improve coexistence in the most vulnerable groups through programs in schools, public spaces and community and institutional activities. It will also carry out communications and awareness campaigns on this issue so that everyone can be involved in solving the problem.

The project also supports the introduction of an integrated information system that compiles and consolidates information from primary sources (police, forensic services and the public prosecutor) to support the planning of security in the Sula Valley Region and, in particular, to support the municipalities in monitoring and preventing violence. Statistical and georeferenced information will be generated to allow for closer follow-up on the status of violence and delinquency in the region and facilitate decision-making, through the establishment of a violence observatory in the San Pedro Sula municipal government.

In Honduras, the Bank is helping to reinforce the rule of law through coordinated actions in different programs and projects. The peace and citizen coexistence project for the municipalities of the Sula Valley complements other initiatives for reform of the State that are under way, such as the programs mentioned earlier to modernize the administration of justice, phases I and II, the Tegucigalpa and San Pedro Sula Municipal Development Program (1024/SF-HO) and the San Pedro Sula Municipal Development Program, phase II (1104/SF-HO). Through the justice projects, support is being provided for legal reforms, including, in connection with the project under consideration here, the preparation and passage of a law on domestic violence, a child and adolescent code and a new code of criminal procedure, revision of the code of civil procedure, creation of magistrates' courts in the Sula Valley region, and programs to train judicial staff in the

application of the new laws. Also, with the justice program (phase two) an information system is being established, which is being coordinated with the system to be introduced in the Sula Valley region under the peace and coexistence project.

The efforts made during project preparation to coordinate with other donors carrying out actions to promote citizen security and reduce violence in Honduras is a further example of the comprehensive approach being taken to human security.

The Honduran government has made security and implementation of the pending reforms priorities on its new agenda. Congress, the Supreme Court, the Ministry of Security and the Office of the Attorney General are working actively to implement the new policy proposals. Owing to the interrelationship between the perception of whether the justice system operates appropriately under the rule of law, security and the investment climate, every action to improve the legal framework, the processing of court cases and security levels will help to create a better climate for economic growth.

This project was designed from a local standpoint, with broad participation by local governments and the citizenry, in order to create social responses to insecurity, open up real channels for citizen participation in the prevention of violence, facilitate the creation of material social and psychological conditions in a climate of security, and establish an environment for collective learning, where community action is the basic principle for achieving social peace.

IV. Reform and Modernization of the Legislative Branch

Given the central role that the legislative branch plays in representative democracy, it is imperative for the countries of the region to have strong legislatures. The legislative assembly is the institution that analyzes and drafts the laws that guide and govern society and oversees the executive branch. For the legislature to be in a position to carry out the variety of functions for which it is responsible, it needs to have institutional and organizational capacity, credibility and legitimacy. The Bank is taking the first steps in this area through a technical cooperation loan for the modernization of Panama's legislative assembly. This was the first project that the Bank approved in this area, which has had very significant results and lessons learned that can be applied to similar projects.

Panama: Project to Modernize the Legislature Loan 923A/OC-PN: US\$2.8 million (1996)

The objective of the program was to bolster the technical and analytical capabilities of the Legislative Assembly, to help it conduct its legislative business and oversight functions more effectively and strengthen its management and political consensus-seeking capacity.

The most important achievements of this project were:

- The system for providing assistance to the legislature was reworked, grouping the 21 standing committees with the creation of eight technical secretariats divided by areas of work, including the establishment of a multidisciplinary technical team. Acceptance by the legislators of the role of technical advisors has been gradual, since it implied a substantive change in the way in the legislative assembly operated in drafting laws. Just as the presence of advisory services has made it possible to include technical elements in the political debate that were not always present before, it has also implied a change in the dynamics of political negotiation, since general access to technical reports is allowed, which can be used by those who support a legislative initiative and those who oppose it. This has helped to raise the technical and analytical quality of the legislators and of the political debate.
- A parliamentary code of ethics and honor was drawn up.
- The budget committee's capacity for oversight and follow-up was fortified by connecting the legislative assembly to the information system on budget performance operated by the national government (integrated financial management system – SIAFPA). This has helped legislators in their functions of overseeing government spending.
- A database on current legislation (LEGISPAN) was developed to ensure legal security and facilitate the analysis of legislation. The assembly was also connected to the Global Legal International Network (GLIN). A digitizing center was established and provided with equipment to keep the database up to date. The potential of the digitizing center goes beyond maintaining LEGISPAN, since it can be used for other tasks such as transcribing sessions of parliament and the daily publication of the official gazette of laws on the Internet, digitization of administrative and personnel documents, etc. Also, the digitizing center is being considered as one of the alternatives for housing the regional headquarters of the GLIN program, which is being supported by the Bank and the US Library of Congress. Apart from the support that the center provides for the technical secretariats and other bodies of the legislative assembly, a cooperation agreement has been reached to exchange digitized information with other public and private institutions, such as the Foundation to Support the National Library and the Office of the Government Solicitor, among others.
- A system to track legislation and documentation has been established, with emphasis on the first debate.
- An electronic voting system was designed and implemented, which permits information on the votes cast by each legislator to be recorded and made public.

- A draft law on a legislative career path was prepared and passed, accompanied by feasible financial alternatives for implementation. The legislative career path was implemented under current staffing budgets and 320 officials entered the path.

This project has improved the technical and analytical capacity of the legislative assembly and its financial management capabilities. There has also been a substantial improvement in its oversight capacity. All these factors, in turn, have strengthened the process of consolidating democracy.

V. Citizen Participation

Participation empowers people and allows them to act as players and overseers of their own development; it is one of the objectives of development and one of the means. It can help to create and maintain stable democracies and good government and promote economic growth.¹⁷

In the context of globalization, multiple economic crises, growing poverty and the pressing need to create better standards of living for broad sectors of the population, participation by all sectors of society is imperative. For this reason, the Bank is promoting participation by civil society organizations in development projects and different nonfinancial activities, such as consultative groups. Consultative groups are a very important mechanism for dialogue and discussion, as a means of seeking consensus on priority areas of action among governments, civil society organizations and donors' groups.¹⁸ To date, the Bank has organized and moderated 23 consultative groups for the Central American countries.

This section examines experiences that demonstrate how citizen participation is an integral part of the projects financed by the Bank. The DECOPAZ program as part of the peace process in Guatemala is a very successful project that has been a catalyst for the social reincorporation of communities affected during years of conflict. The local development program in El Salvador shows how organized participation that is suitably focused can be a means and an end for community development. The mapping of civil society organizations that was done in Honduras was intended to improve an understanding of the role played by those organizations in the country and their capacity and involvement in development programs. The sustainable development program in Darién, Panama, is a valuable example of empowerment of interested parties through consultation and participation in the different stages of project design and execution. Lastly, consultations with civil society on the Puebla-Panama Plan point to the importance that the Bank and the countries attach to active participation by civil society organizations and communities in different activities financed by the Bank.

¹⁷ *The World Bank Participation Sourcebook. 1996.*

¹⁸ For more information refer to chapter 2 on Consultative Groups for Central America.

A. Guatemala: Community Development for Peace (DECOPAZ)

"It was just as important for us to come together for the benefit of the entire community as it was to have water in our taps."

Resident of Tuisoch DECOPAZ

After prolonged political and military conflicts throughout the 1980s, the peace accords signified the start of a pacification process and the beginning of a political transition which involved new forms of political and social coexistence. The Bank has acted as a catalyst, not only supporting the processes themselves, but also and in particular, supporting their consolidation through different activities targeted basically to the sectors hardest hit by the conflicts.

The armed conflict in Guatemala, the longest in Central America, was brought to an end with the signature of the final peace agreement by President Álvaro Arzú's government and the Guatemalan National Revolutionary Union on 30 December 1996.

In Guatemala, the crystallization of peace is the product of almost a decade of negotiations during which a series of agreements were signed on full respect for and observance of human rights; the establishment of an historical clarification commission to examine human rights and the violent events that occurred during the internal armed conflict; respect for the rights and identity of indigenous peoples; land tenure; and strengthening of civilian power and the subordination of the army in a democratic society. One very important aspect of this process was the creation of a civil society assembly that permitted the different social groups to design a mechanism for dialogue and consensus building regarding the content and scope of the points on the negotiating agenda. This made it possible to separate people from the problems, identify national interests and establish objective criteria for making commitments that facilitated the conclusion of the process of negotiating the peace accords.¹⁹

Poverty, exclusion and injustice are the problems that have required and continue to require the most attention, if the communities that were hardest hit by the armed conflict are to be reintegrated. The community development for peace program (DECOPAZ) financed by the Bank was able to establish institutions that allowed a start to be made on the reintegration of Guatemalans who had suffered directly during the 35 years of civil war. The main objective of the DECOPAZ program was physical, human and social recapitalization in the areas that suffered most from the armed conflict.

¹⁹ Richard Aitkenhead Castillo: "La Visión del Proceso de Paz" in *Convivencia y Seguridad: Un Reto a la Gobernabilidad*, edited by Jorge Sapoznikow, Juana Salazar and Fernando Carrillo. Inter-American Development Bank – University of Alcalá, Alcalá de Henares, Spain, 2000.

**Guatemala: Community Development for Peace (DECOPAZ)
Loans 968/OC-GU and 984/OC-GU: US\$50 million (1996)**

The DECOPAZ program:

- Is an integral part of the government's plan for the consolidation and strengthening of democratic society.
- Is connected to actions with immediate impact carried out locally to promote the peace process.
- Conforms to the principles and guidelines established in the Peace Agreements.
- Makes it possible to carry out the investments envisaged in the Peace Accords (education, health, housing, etc.) more efficiently.

The identification and design of the program were the result of a broad process of consultation between the national government, the departmental governments and committees of displaced persons/refugees/repatriated persons.

Basis of the program

- The program delegates preidentification, selection, planning and execution of projects considered to be local priorities to the community.
- For effective delegation, the program is based on a participative and transparent institutional arrangement for allocating government resources to the communities, and the communities are provided with technical support to identify their priorities by consensus, define and then carry out the investments. It uses a methodology that allows for systematic participative work that favors the development of local capacity.

The following program results are worth mentioning:

- The beneficiary population has been effectively organized and 93 microregional associations in eight municipalities have been legally established. The beneficiaries have developed skills in the selection, implementation and management of investment projects and to date, investments have been made in more than 3,150 projects which have improved access to basic education, primary health care and basic sanitation by the beneficiary population. In addition, program resources were utilized to grant productive credits totaling US\$4 million.
- Processes have begun for a closer tie-in between the associations' microregional investment plans and municipal development plans, which will allow for more solid integration of the associations with society and government institutions. This participative process has allowed the population hardest hit by the armed conflict to exercise their citizenship rights and rejoin the country's economic life.
- This social recapitalization has also meant better and higher levels of community organization and greater confidence by the communities in government institutions.

B. El Salvador: Local Development Program

In recent years, municipal governments have been playing an important role in the economic and social development of Central America. The fiscal crisis in Latin America

has stimulated the 'rediscovery' of lower levels of government, reactivated decentralization processes, and led to the rise of organized citizenry. Local politics provide a vital framework for democratic competencies, citizen participation and achievement of higher levels of equity. It is within this context that the IDB is backing a series of initiatives to enable municipal governments to become the leaders in civic participation in local development.

Community participation allows for optimization of the use of resources and is a very important tool for social communications among the participating groups.

**El Salvador: Local Development Program
Loan 1067/OC-ES: US\$34.1 million (1997)**

The program's goal is to improve the living conditions and development opportunities of the poorest sectors of the Salvadorian population by:

- Implementing a participatory planning and budgeting mechanism that delegates project responsibilities to local actors; and
- Developing and implementing investments in social and economic infrastructure projects.

The most significant achievements to date include:

- Participative democracy has been strengthened by building confidence and empathy between the public sector and the citizenry.
- The program has had a redistributive impact on the country's most disadvantaged sectors.
- It has financed 880 projects in 168 municipalities, thereby creating jobs for their inhabitants, which has benefited more than 1.2 million people or about 33% of the country's total population.
- It has benefited participation by women. About 52% of the projects had women participating in decision making during the project cycle. In 2002, the total population of El Salvador was 6.5 million, with women accounting for 3.3 million. The economic and social impact on the family group of women's participation in the projects has been considerable. For example, in the municipality of Tecoluca, women have worked as unskilled labor on all the road projects (street paving and urban improvement). As a result of their participation, these women have formed a team that is contracted by the municipal government for other projects to improve communications or infrastructure. In the municipalities of San Pedro, Masahuat and Juayúa, participation by women in vocational workshops has permitted them to find alternative sources of work in commercial enterprises, shops, corn dough mills, or microentrepreneurial sewing operations. Although participation by women has increased significantly, there is

still much to be done to achieve greater involvement by them in decision making, since in general their participation is limited to traditional areas, such as unskilled labor.

- This program is bringing about decentralization in decision making about investments in infrastructure to the local governments for the first time in Central America.

The success of the local development program in El Salvador highlights the importance of participation as a means and an end of development. In the case of this program, participation strengthened local institutions in their administrative and self-management capacity, confidence, transparency, accountability and access to financial resources. This, in turn, is indispensable for the sustainability of the program in the medium and long terms.

C. Honduras: Support for Strengthening Civil Society Organizations, Stages I and II

In light of the importance and the growing role played by civil society organizations, in 2001, the Sida²⁰/IDB Partnership provided technical cooperation financing of US\$42,800 (ATN/FW-7489-HO) to map civil society organizations (CSOs). The intention is to provide a tool that will allow counterpart, institutional players and the CSOs themselves to identify and understand the sector and facilitate interaction between CSOs and the other social players and among the CSOs themselves.

Honduran CSOs play a very important role on two levels of public interest: a general level in the design and monitoring of the Poverty Reduction Strategy (PRS) and a specific level linked to their participation in different projects, programs and initiatives as beneficiaries, as executing agencies, or as members of consultative councils for follow-up (in many cooperation alternatives with local governments, the central government or international donors). CSOs are also very active under the master plan for national reconstruction and renewal.

A map of CSOs is not simply a directory containing relevant data about them. The mapping of civil society carried out under this project is more than just a detailed inventory of organizations. It is also a physical map, with details on their location, their areas of work, their different relations, etc.

This mapping has also included a major descriptive effort and the establishment of a conceptual framework to understand the way in which all the players in civil society operate, their role in development, their capacity to interact, their scope and limitations.²¹

²⁰ Swedish International Development Cooperation Agency.

²¹ For more information see *La Sociedad Civil en Honduras: Caracterización y Directorio*. Sida-IDB Honduras, January 2003.

The efforts that go into constructing a map of civil society should allow for the identification of valid counterparts, the construction of collective forums that are suitably representative, and the installation of appropriate mechanisms for liaison with the different social entities, in order to obtain effective coparticipation in national development policies, programs and projects.

D. Panama: Darién Sustainable Development Program. A Model of Community Empowerment

The Bank approved loan 1160/OC-PN in 1998 for US\$70.4 million to finance the Darién sustainable development program,²² which is intended to contribute to the sustainable social and economic development of the province of Darién and to the management and protection of the region's natural resources. The Bank and the Panamanian government agreed to adopt a participative strategy for program design and execution. To achieve effective participation, community consultations were held prior to designing the program and an institutional system for participation in execution was established to ensure that the different communities and organizations would be duly involved and represented.

The methodology used in the consultation included a means of identifying community stakeholders based on cultural criteria, classifying them by ethnic groups, endogamic groups and kinship groups that made it possible to identify their traditional authorities and include them in the consultations so that commitments were backed by their own daily mores, to ensure seriousness and compliance.

As part of the methodology, maps were prepared of cultural land use which made it possible to determine whether operations were sustainable and to design adjustments to land use, tailoring it to each culture to ensure that the solutions included in the program's land management plans would be internalized and effective.

The consultation took the form of 45 workshops with the communities residing in the zone. The methodology used for the workshops included the reflection/validation technique, where a dynamic of reflection on specific issues is established and the audience is prompted to identify alternative solutions. The alternatives were compared by facilitators using sustainability scenarios to transform them into viable proposals that could be presented as program initiatives, contributing to its design.

The consultation process was crucial for achieving consensus and support from the affected communities and for the government to internalize residents' views, their needs, ethno-cultural characteristics and the benefits arising from their active participation, which led the parties to support a program based on the empowerment of local communities.

²² For more information see Chapter 7 on environmental management.

E. Puebla-Panama Plan (PPP): Information, Consultation and Civil Society Participation Program²³

The Puebla-Panama Plan has determined that it is indispensable to include effective processes of information, consultation and participation (ICP) if it is to achieve its objective of sustainable development. These processes promote dialogue between the government and civil society and consolidate a shared view of development on all levels in the region.

The main objective of the ICP process that the Bank has launched is to continuously involve civil society organizations and local communities so they will play an active role in all stages of the Puebla-Panama Plan, contributing to the sustainability of the projects. A series of consultations has already been held with representatives of CSOs and indigenous peoples on the regional level in each of the Central American countries.

Meetings organized under the ICP process have been good for the image of the PPP, with 63% of the participants stating that their opinion of the plan changed as a result of the initial consultation meetings. Everyone who said that their opinion had changed, moved from opposing the plan to supporting it.

In general, it can be said that:

- Information activities have contributed to a better understanding and more effective involvement in the activities of the PPP by the groups affected.
- Consultations are an effective instrument for identifying and considering the preferences of the groups involved in the Plan's activities and for creating ties of cooperation and confidence between representatives of governments and civil society.
- Participation helps to ensure during project preparation, implementation and evaluation that the benefits actually reach the population involved and builds up the capacity of communities, reduces costs, heightens the sense of ownership and establishes a better platform for evaluation and feedback for future activities.

VI. Other Initiatives: Fiscal Reform as an Integral Part of Processes to Reform the State

The processes of political and institutional change in the countries of Central America created a series of economic, political and social demands that outstrip the response capacity of government institutions, the productive sector and social organizations.

To consolidate democracies and satisfy unmet demands of Central American society, social spending and investments must be increased. To achieve this, fiscal reform is imperative to ensure there will be a sustainable source of funds to alleviate poverty in

²³ For more information see Chapter 3 on regional integration.

certain sectors of society and to try to provide equal opportunities for those groups compared to the community in general.

In general, the fiscal reforms supported by the Bank seek to eliminate distortions and facilitate legislative and administrative processes, increase revenues, eliminate exonerations and simplify tax systems (in order to be able to collect and to reduce evasion), trying to improve the efficiency and effectiveness of tax collection and administration. On the spending side, the goal is to bring about significant improvements in the efficiency of public spending to be able to support social areas, eliminate excessive and superfluous spending, improve the process of budget approval and execution, bring about a decided improvement in transparency in the management of public resources and institutionalize accountability on all levels.

Despite the efforts made in the Central American countries, much remains to be done to achieve a sustainable fiscal balance. The average tax burden is very light in most of the countries, at between 10% and 14% of GDP, which is extremely low when compared to the tax burden in the developed countries or in other developing countries. Direct taxes and social security contributions in particular are significantly lower.

For example, in Honduras, revenues as a percentage of GDP in 2003 were less than 16% measured against the official GDP²⁴; in Nicaragua they were 14.3% of GDP. In Guatemala they were the lowest in Central America, at about 10.6% in recent years. In Costa Rica revenues accounted for 12.8% of GDP and in El Salvador they were 11.2% in 2002. Belize is the exception, where revenues amounted to 19.3% of GDP in 2003. With that exception, revenues are insufficient to finance the public spending necessary to surmount poverty and spur development.

Insufficient per capita public social spending²⁵ and the modest social indicators of the countries of the region, except for Costa Rica and Panama, compounded by serious problems with the shortage of resources – sharper in recent years because of the slowdown in growth – make it impossible to meet the most urgent demands and simply highlight the urgency of comprehensive fiscal reform in the countries. Despite the efforts to spend more on the social sectors, El Salvador, Guatemala, Honduras and Nicaragua have not achieved significant per capita levels of social spending: in the period 2000-2001, it was in the order of US\$100 or lower, which is less than one fifth of the Latin American average.

Another aspect that demands sweeping tax reform in the Central American countries is the fiscal situation and public debt. Data for recent years indicate that fiscal deficits have become chronic and unsustainable. A budget crippled by a very high level of debt has less room to maneuver to promote priority sectors and spending. This is of particular importance for the region owing to its debt problems and budget inflexibility.

²⁴ GDP is probably quite under-estimated, distorting the estimates. Based on using official GDP, which assumes under-estimating GDP, tax collections would be less than 11%.

²⁵ For more information on levels of public social spending see Chapter 5.

For example, data for 2003 on the deficit and the debt in the Central American countries show the following: the fiscal deficit of Belize in 2003 was 6% of GDP, its foreign debt was 84.6% and internal debt was 4.9% of GDP; Costa Rica's foreign debt was 20.1% of GDP, its domestic debt was 35.9% and the fiscal deficit was 2.8% of GDP. For El Salvador, the foreign debt as a percentage of GDP was 30.8%, the internal debt was 13.6% and the deficit was 2.1% of GDP. Guatemala had a deficit of 1.6 % of GDP and the data for its external and internal debt in 2003 are 19.9% and 6.7%, respectively. Honduras had a deficit of 5.4% of GDP, an external debt of 72.5% and an internal debt of 3.1%, while Nicaragua had a deficit of 2.3%, foreign debt of 156% and domestic debt of 38.4% of GDP. The size of the imbalances is significantly larger in Honduras and Nicaragua. Those two countries are part of the Heavily Indebted Poor Countries Initiative (HIPC), which involves significant condoning of foreign debt if the countries comply with certain conditions.

Guatemala was the first Latin American country to arrive at a comprehensive fiscal pact, through a consensus-building process. In the peace accords signed in 1996 it was recognized that sustained economic and social development was needed for lasting peace and that the government should lead the process. As a result, the *Agreement on Socioeconomic Aspects and the Agrarian Situation* established commitments to reform public management and fiscal policy.

As part of the activities financed by the Bank to support the countries of the region in bringing about comprehensive fiscal reform, the Bank approved a technical cooperation project for US\$100,000 (ATN/SF-8571-RG) in 2003, **Harmonization of Tax Policy Systems in Central America**. The operation financed tax studies in six countries (Nicaragua, Honduras, Guatemala, El Salvador, Costa Rica and Belize) and discussion forums were held to examine the tax systems in the countries in light of best international practices, concluding with a menu of options to reform the tax systems with a view to modernizing them, enhancing equity considerations and boosting revenues to finance substantial increases in spending to alleviate poverty.

Although the findings of the studies varied from country to country, certain generalizations can be made:

- The tax systems, which are quite similar throughout the region,²⁶ are behind with respect to best international practices. As a result, they are poor collectors.
- Considerably more taxes could be collected (2%-3% of GDP) without increasing tax rates; exemptions that have no economic justification need to be eliminated, and in general the tax base should be expanded.
- The zero VAT rate practice (which allows beneficiaries to get tax credits for the VAT paid on their inputs) is particularly bad for collections and causes huge distortions.

²⁶ The exception is Belize, which has a rather unique system, but with good collections.

- The countries abuse corporate income tax exemptions, ostensibly for promotional purposes but which actually benefit certain interests.
- Separate tax schedules on different types of income must be replaced by a single personal income tax that adds up all sources of income and tax is paid on the total.
- In cases in which the tax administration allows it, consideration should also be given to replacing geography-based individual income tax to a worldwide system.
- Property taxes should be strengthened so that they can become an important source of municipal revenue. To this end, property registries should be established or improved.
- Tax administration should be modernized urgently. Without better administration, tax policy reforms will remain on paper.

The studies were followed by closed-door meetings with economic policymakers and then by seminars for civil society in general. Policymaker meetings were held in Nicaragua, Honduras, Belize, and Costa Rica. Open meetings were held in Costa Rica (on two occasions), Honduras, Nicaragua, and Guatemala. It should also be noted that new technical cooperation projects are being processed to finance research on possible tax reforms in the Central American countries.

This project also led to specific tax reforms in the region. Some of the recommendations made in the study conducted for the project were implemented under the May 2003 reform in Nicaragua. The IDB study provided support for the reform currently being discussed in the Costa Rican Legislative Assembly. In addition, the Governments of Honduras and Belize have expressed interest in implementing the recommendations made in the respective country studies.

The Bank has approved three fiscal reform projects that are in the initial stages of implementation: in Panama, the **Program to Strengthen Economic and Fiscal Management, Phase II** (loan 1430/OC-PN), in Nicaragua, the **Program for Modernization of the State and Fiscal Reform** (loan 1497/SF-NI) and recently in Honduras, and is preparing a fourth project in Costa Rica (strengthening of digital management in the fiscal area).

Panama: Program to Strengthen Economic and Fiscal Management, Phase II Loan 1430/OC-PN: US\$10 million (2002)

The main objective of this program is to expand management capacity and strengthen fiscal administration in the public sector. Specifically, the objectives are to: (i) enhance the Ministry of Economic Affairs and Finance's planning capacity; (ii) strengthen financial management; (iii) make tax collection more efficient and effective; (iv) improve the quality of public investment; (v) expand the management and oversight capacity of the customs administration; and (vi) institutionally strengthen the land-registration system.

Nicaragua: Modernization of the State and Fiscal Reform
Loan 1497/SF-NI: US\$25 million (2003)

The main objective of the program is to improve the country's fiscal situation:

- On the revenue side, it is anticipated that domestic tax and customs collections will increase through the establishment of a stronger legal framework, improved regulations, a tax code, and more efficient, fairer, and less arbitrary collection institutions; exports will be promoted; and the cost of collection will be lowered.
- On the spending side, government resources will be managed more efficiently and transparently, through the establishment of guidelines to prepare properly defined budgets.

In Nicaragua, the IDB and the World Bank have prepared a *Country Financial Accountability Assessment (CFAA)* that was presented and discussed with the Nicaraguan government in August 2003. The CFAA notes that public financial administration has improved as a result of the greater efficiency obtained by integrating the budget, accounting, treasury, public debt and procurement, which are very important activities for achieving thoroughgoing financial reform. The groundwork has been laid for participation by the public in overseeing public spending, although the obstacles posed by the lack of public consultation, the difficulty in obtaining information on public finance and the lack of public access to information will have to be surmounted before it can be implemented. The capacity to manage and provide detailed information on public foreign debt has been built up, but modernization of domestic debt management and the compilation of data on accruals and better coordination among the different agencies involved with the public debt are still pending priorities.

The Bank is supporting the countries of the region in the search for consensus on fiscal reform, since the success of reforms of fiscal institutions largely hinges on political will and recognition on the part of the authorities of the need for reform and public support for bringing it about. Through projects and technical cooperation activities, the countries are receiving support in boosting tax revenues by improving their tax administrations, implementing more efficient and progressive tax systems, and rationalizing public spending.

VII. Conclusions

Although it is true that there has been a clear advance in democracy in the countries of Central America through free, open and competitive elections, the process of strengthening and modernizing the branches of government has been slow. There is still an urgent need to support and strengthen the legislative and judicial branches and other State institutions, in order to achieve legal security and political stability and predictability. Modernization of the State implies a complementary process of strengthening civil society. In a democratic country, citizens have responsibilities that are not limited to production and services, but which extend to oversight and participation in public management. Participation is a way of exercising the rights and discharging the duties of citizens, while also promoting democracy.

In the recent 1990s, a learning process for society has taken place in the countries of the region that has resulted in a democratic transition that is qualitatively different from earlier experiences, since although the democratic system is stronger and less exposed to institutional breakdown, it is quite exposed to more critical and conflictive relations between citizens and those who wield political power. Opinion polls which indicate that governments and institutions are carefully scrutinized by citizens are clear examples of this process. Day by day, citizens are demanding more political goods from their democracies.

Data on public opinion from 17 countries over the last eight years published in *Latinobarómetro*²⁷ point to a region whose values change very slowly but which reacts quickly to political and economic events. The data from the 2003 report indicate that for 64% of the people surveyed in the 17 countries, democracy is the only system under which a country can become developed. This demonstrates that democracy is growing stronger in the region and that the possibilities of an institutional breakdown are increasingly less likely. Despite poor economic performance, support for democracy continues, since the public is not willing to trade the freedom that democracy has brought in the last decade.

²⁷ **LATINOBARÓMETRO** is a public poll conducted each year of opinions, attitudes, behavior and values in the 17 Latin American countries where it is taken. The poll began to be applied regularly in eight countries of the region in 1995 and was extended to 17 in 1996. The third and fourth polls in 1997 and 1998 were supported by the IDB. **LATINOBARÓMETRO** is the first ongoing study in the region of public opinion on the economy, politics, democracy, international agreements, trade and current issues. It is intended to be a long-term tool at the disposal of social and political stakeholders in the region. Its general objective is to obtain quantitative information on the opinions, attitudes and behavior of Latin Americans as an aid in decision making for public and private social and political players.

Support for Democracy	
Costa Rica	77%
Honduras	55%
Nicaragua	51%
Panama	51%
El Salvador	45%
Guatemala	33%

However, a decade of democracy has also produced a widespread drop in confidence in institutions:

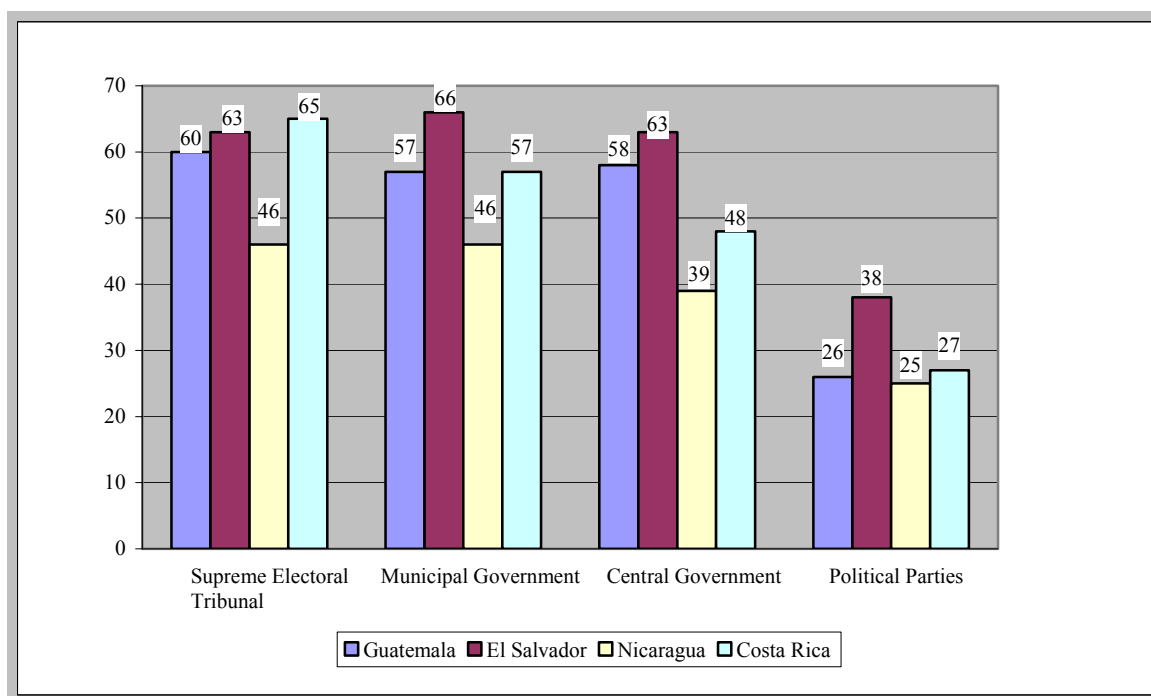
	1996	2003
Church	76%	62%
Television	50%	36%
The Military	41%	30%
The President	39%	31%
Corporations	36%	30%

According to the 2003 report, this general loss of confidence can be explained by unfulfilled expectations of social inclusion. Eighty-four percent of the people surveyed say that people with little or no education should be listened to by people with high levels of education. The report also indicates that there is a negative correlation between corruption and confidence, and that the greater the headway in the fight against corruption, the greater the confidence in institutions.

Another study of public opinion conducted by FLACSO²⁸ in 1999 on the political culture in Central America that covered four countries (Guatemala, El Salvador, Nicaragua and Costa Rica) points out that the electoral tribunals and local governments are rated positively but that the public lacks confidence in legislatures and political parties (see Table 3). A reading of the results of this study demonstrates that confidence in electoral tribunals is indicative of citizen satisfaction with elections in the countries of the Central American region in the last decade, since in the 1990s, elections ceased to be a traditional channel for selective political exclusion and became a means for electing representatives of the citizenry. Also implied is express acceptance of elections as a suitable and legitimate means of gaining access to power. Approval of the work of local governments is mainly due to their capacity to respond directly to the basic needs of the public, thereby improving the quality of life and transparency in management. On the other hand, the lack of confidence in legislatures and political parties reflects their inability to carry out all the functions expected of these public institutions and their lack of flexibility to adapt to change. These weaknesses do not favor the stability of democracies.

²⁸ Latin American Social Sciences University, in English.

Table 3
Central America 1999: Confidence in Institutions



Source: Ricardo Córdova and Gunther Maihold: *Democracia y Ciudadanía en América Central. Perspectiva*.

This study demonstrates the importance of continuing to support modernization and strengthening of the legislative branch and reform and modernization of political parties, which are key institutions in the political process. The lack of credibility of legislatures erodes the foundations of stability in the political system. The capacity to build consensus in parliaments is often obstructed by weakness in technical, informative, and analytical support for debate and scant parliamentary information. Political parties need to democratize themselves internally to promote citizen participation and strengthen their structure, so they can demonstrate transparency and accountability in their financing.

One of the most important lessons learned in this process of support for the countries in strengthening and modernizing the branches of government is that the greatest difficulties in project implementation and success do not lie, in general, in the technical aspects of reform. Instead, the thorniest problems lie in how to generate and maintain suitable leadership during the entire process and achieve and maintain the consensus of the different stakeholders.

The subject of access to justice is a natural sphere for Bank action, given its closeness to social reform and the Bank's commitment to the weakest links in civil society, i.e. the poor and the excluded. The Bank's projects should gravitate increasingly in this direction in order to bring citizens closer to local and community justice and promote their participation in project design and execution.

Local governments are a forum that facilitates the consolidation of democracy, given their proximity to the people, but their weak institutional and economic capacity stands in the way of their independence from the central government and it is difficult to separate their dynamics from national politics. The Bank's action has been and continues to be essential in building up the capacity of local governments and in facilitating the processes of citizen participation.

It is imperative for the Bank to continue supporting the modernization of State institutions, not just to rationalize their structure and management processes, but also to democratize them.

VIII. Lessons Learned

The Bank has played and continues to play a central role in supporting the countries of the region in political openness, the development of institutional capacity and empowerment of the citizenry as a means of promoting their economic, political and social development.

The projects to modernize the justice sector have been broadly participative, since programs should not simply reflect the needs and outlooks of magistrates or persons with an institutional role in the justice system; they should reflect social and economic realities in each country if authority is to be exercised effectively.

The Bank has strongly promoted programs or projects that respond to the needs and experiences of the groups involved, thereby strengthening the processes of community organization.

In the projects for citizen security, the Bank has promoted closer cooperation between multilateral agencies, governments, private foundations, academic institutions and nongovernmental organizations to mobilize resources and avoid unnecessary duplication of efforts in the field of crime prevention and security.

The Bank is playing a central role in discussions of the need for sweeping fiscal reforms in the region, through its support for the countries in the quest for consensus through dialogue with the different sectors of society on viable alternatives for fiscal reform, so that the public's demands regarding the quantity and quality of public services can be met.

The Bank should support projects that include alternative dispute resolution mechanisms as a means of counteracting the litigious culture of the countries, making dispute settlement more accessible and less costly and alleviating court backlog. It should provide support for countries that have already made a start, through a second stage, to consolidate the gains and bring the region closer to world trends in alternative dispute resolution.

It is also important to extend the use of dispute resolution mechanisms to regional integration agreements, such as the Central American Common Market and/or regional

programs such as the Puebla-Panama Plan (in areas such as energy, telecommunications, etc.).

Quality parameters should be defined for the justice system so that the results of interventions can be measured.

A regional vision of reform of the judicial branch should be promoted that encompasses problems and strategies for solutions, in order to improve the possibilities of success in legal and judicial reforms, which would also lead to success in combating corruption.

It is crucial to provide more technical assistance for the countries to build consensus and mitigate differences in the policy sphere between State institutions, civil society and the private sector, promoting national dialogues.

Governments, society at large and the donor community are increasingly concerned with development effectiveness. This has led to a movement to seek new approaches to steer cooperation toward results that will be visible in the long term. Accordingly, the Bank needs to help the countries to develop their capacity for monitoring and evaluation on the local and national levels.

As a corollary, it can be concluded that the democratic challenge since the start of the 1990s demands political and institutional changes in this new century to build up the legitimacy and capacity of governments so they can tackle the challenges of integration.

Annex

LIST OF PROJECTS HIGHLIGHTED IN THIS CHAPTER

COUNTRY	PROJECT TITLE	LOAN OR TC NUMBER	YEAR OF APPROVAL
Costa Rica	Modernization of the Administration of Justice	859/OC-CR	1995
Costa Rica	Mediation and Arbitration Project	ATN/MT-5397-CR	1996
Costa Rica	Program for the Administration of Justice, Phase II	1377/OC-CR	2001
El Salvador	Program to Support the Reform of Justice	919/OC-ES	1996
El Salvador	Program to Support the Reform of Justice	920/OC-ES	1996
El Salvador	Modernizing Commercial Legislation and Developing Alternative Methods of Commercial Dispute	ATN/MT-5391-ES	1996
El Salvador	Local Development Program	1067/OC-ES	1997
Guatemala	Community Development for Peace Program (DECOPAZ)	968/OC-GU	1996
Guatemala	Community Development for Peace Program (DECOPAZ)	984/SF-GU	1996
Guatemala	Program in Support of Judicial Reform	1120/OC-GU	1998
Guatemala	Program to Strengthen Alternative Methods for Commercial Dispute Resolution	ATN/MT-6210-GU	1998
Honduras	Program to Modernize the Administration of Justice	974/SF-HO	1996
Honduras	Promoting Alternative Methods of Commercial Dispute Settlement	ATN/MT-5453-HO	1996
Honduras	Tegucigalpa and San Pedro Sula Municipal Development Program	1024/SF-HO	1998
Honduras	Mapping of Civil Society Organizations	ATN/FW-7489-HO	2001
Honduras	Peace and Citizen Coexistence Project for the Municipalities of the Sula Valley	ATN/SF-7713-HO	2001
Honduras	Modernization of the Administration of Justice, Phase II	1115/SF-HO	2002
Honduras	San Pedro Sula Municipal Development, Phase II	1104/SF-HO	2002
Honduras	Peace and Citizen Coexistence Project for the Municipalities of the Sula Valley	1123/SF-HO	2003
Nicaragua	Alternative Mechanisms for Settling Property Disputes	ATN/MT-6669-NI	1999
Nicaragua	Strengthening the Judiciary and Improving Access to Justice	1074/SF-NI	2001
Nicaragua	Modernization of the State and Fiscal Reform	1497/SF-NI	2003
Panama	Project to Modernize the Legislature	923/OC-PN	1996
Panama	Promoting Alternative Methods of Settling Commercial Disputes	ATN/MT-5452-PN	1996
Panama	Program to Improve the Administration of Justice	1099/OC-PN	1998
Panama	Darien Sustainable Development Program	1160/OC-PN	1998
Panama	Program to Strengthen Economic and Fiscal Management, Phase II	1430/OC-PN	2002
Regional	Strengthening Access to Justice Systems	ATN/SF-6029-RG	1998
Regional	Harmonization of Tax Policy Systems in Central America	ATN/SF-8571-RG	2003

CHAPTER 7: ADVANCES IN ENVIRONMENTAL SUSTAINABILITY

Guillermo Espinoza and Pablo Pisani

I. Background

Foreword

This report chronicles the IDB's support for environmental management in the 1990s in Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama. It offers an account of initiatives over that interval to make Central American economic and social development environmentally sustainable and describes the general state of the environment and the region's impressive gains since 1990. At the dawn of the 90s environmental management and stewardship were still low on the list of concerns, their development relevance not yet explicitly recognized. Each of the countries was grappling with its own environmental problems within its own borders, with varying degrees of success; but these were isolated, tenuous efforts with no regional articulation. As time has passed these considerations have moved much further to the fore.

The IDB's work in this region during the "environmental decade" and lessons extracted from its operations are discussed, as are some issues and areas in need of further support. Activities targeted for Bank assistance and Central America's advances in environmental management and protection are highlighted. The document looks at the challenges awaiting these countries to entrench environmental protection as one underpinning of sustainable development. The proactive involvement of stakeholders across the social, economic and political spectrum will be fundamental for such efforts, to leave a valued legacy to future generations. The ultimate aim is to fortify environmental management and effectively protect the natural resources that represent the national wealth of these seven countries and which are quality-of-life and economic growth drivers.

This study draws on IDB technical data taken primarily from country reports, summaries of finished and ongoing programs, and issue-specific strategies and action plans. It looks at completed operations, active projects, and initiatives still at the preparatory stage. Additional information was obtained from documents produced by regional and national environmental organizations and other international cooperation providers. The authors consulted also with environmental experts in the region and environment sector specialists in the Bank's Country Offices and at its Washington, D.C., headquarters.

The review highlights IDB activities, past and present, which have sought to bolster environmental management and sustainability in the Central American Isthmus, as one of a multitude of initiatives and partnerships pursued in the region by the countries themselves and by international and national organizations.

As the 1990s drew to a close Central America's prospects looked bright for the first time in three decades. The prevailing climate of social peace and ongoing democratic reforms had a great deal to do with the region's much more promising economic outlook as the economic, social, and political situation in the nations along the Isthmus marked a distinct improvement over 1990.

Over the course of the last decade the seven countries achieved impressive gains toward environmentally sustainable socioeconomic development, with the advent of environmental management and a growing awareness across the social spectrum of the importance of environmental stewardship. Since the 1992 Earth Summit, in which the region figured prominently, and the 1994 formation of the Central American Alliance for Sustainable Development (ALIDES) there have been a remarkable number of initiatives in these countries to

foster respect for and sustainable use of natural resources and promote intergenerational responsibility.

Like the rest of Latin America, the Central American nations at the start of the 1990s lacked a sturdy institutional and regulatory base to resolutely address environmental stewardship and sustainable development imperatives. Some setbacks along the way notwithstanding, what the region accomplished during the last 10-14 years was no small feat considering the huge array of political, economic, and social variables that come into play when countries move to incorporate the environmental dimension into the day-to-day workings of society.

Environmental pressures in Central America are a multifaceted issue: they affect a vast share of rural and urban populations alike; they take in numerous productive sectors; they are associated with natural events that are difficult to control; they call for strong political decisions; they demand resources and realistic, gradualist solutions; they require augmented public and private sector capacity, and they must be tackled creatively if countries are to rise to the challenges of sustainable development.

Countries in the Isthmus are still contending with very serious problems stemming from social, political, economic and cultural conditions that have direct implications for environmental sustainability and natural resources protection. In 1999, 60% of the region's population—22 million people—were poor; 15 million of them were living in extreme poverty.¹ One tenth of the economically active population was unemployed; nearly one third of Central Americans aged 15 and over could not read and write; one quarter of the region's children were suffering from chronic malnutrition. Close to nine million people had no safe drinking water source and 31% of the population was without access to health services.

Leading the list of ongoing country priorities have been social issues that affect quality of life, poverty reduction, entrenching democratic systems, and strengthening governance. Environmental protection and environmental quality are coming in for special attention as a mounting priority on citizens' lists of demands, especially because these issues are so directly connected to other development-relevant variables. This is posing further challenges for the region as it seeks a sustainable development path that will offer viable solutions to the stresses it is facing, not the least of which is to safeguard the Isthmus's remarkable cultural and ethnic diversity and heritage.

In the 1990s these countries came to recognize the need for regional integration initiatives to lay the foundations for environmental sustainability since natural attributes so often transcend national geopolitical borders. This is a prime consideration in this part of the world given its mega-biodiversity and rich cultural and ethnic mosaic. As economic and population growth rates have risen over the last decade it has become clear that any one country's sound or unsound use of resources in its production apparatus eventually can have a regional impact on water quality and quantity in transboundary watersheds, marine and terrestrial biodiversity in natural geographic corridors, soil productivity, maritime fisheries, climate, and other spheres.

¹ Central American Commission for Environment and Development (CCAD) and Central American Council for Forests and Protected Areas. *Central American Forestry Strategy—Fourth Consultation Draft*. May 2002.

Consequently, in the 1990s countries in the Isthmus set out to incorporate the environmental dimension into the workings of their economies and societies by: (i) enacting framework laws to lay the foundations for sustainable development and mandate environmental management requirements and instruments; (ii) creating and building capacity in regional, national, and sectoral environmental institutions; (iii) crafting regional and national strategies and action plans to protect significant environmental features, including compliance with international and regional conventions on biodiversity, protected areas, forests, etc.; and (iv) pursuing specific initiatives to conserve natural resources in fragile environments and create conditions that can generate sustainable development opportunities in areas of extreme poverty.

The Inter-American Development Bank has played an integral part in the movement to improve environmental management in the public and private sectors and in initiatives to further sustainable development in the Isthmus. Particular focuses of Bank support have been quality-of-life improvements, promotion of citizen participation, mainstreaming women in development, poverty reduction, safeguarding of community cultural values and, most recently, the creation of regional sustainable development spaces.

II. Key Environmental Pressures and the State of the Environment in the Isthmus

Environmental Pressures and State of the Environment

Two central considerations in any review of the state of the environment in Central America are the tie-ins between environment, socioeconomic progress, and politics and the importance of a healthy environment for quality of life at the community, national, and regional level. Though Central America's economies are doing well and democratic systems of government are taking firm root, these countries still are grappling with poverty, rapid urbanization, low academic attainment of large segments of their populations, and unfinished social agendas. Nevertheless, they have made real strides in natural resources conservation and environmental stewardship, notably in efforts to make society understand that nature and landscape resources can make economies more competitive by adding value to such sectors as tourism, forestry, and fisheries, and that the environmental goods and services generated by these natural assets can propel economic growth.

It is no easy task to explain the present state of the environment in a region in which environmental concerns historically took a back seat and very complex social forces have been at work. Thanks to myriad efforts the region now has an institutional base for environmental protection and management, but the process it required to create such an understructure is anything but linear and unfolds over many more years than the discrete period examined here.

The countries also will need to tackle a set of underlying issues that are constraining their environmental management capacity and performance. Among the concerns and needs to be addressed are: (i) bolstering of national, provincial, and local environmental institutions; (ii) effective laws and regulations to give form to environmental management and regulate a host of environmental variables and economic activities; (iii) subsidies that are threatening environmental quality; (iv) the low political priority of environmental management concerns, and (v) day-to-day pressures on the environment as the population mushrooms.

A. Natural Diversity

As a bridge between oceans and a funnel for the movement of species between North and South America, the Central American Isthmus is teeming with biodiversity and has an astonishing concentration of life forms and high endemism (**Table 1**). Regions like Guatemala's Altos Cuchumatanes mountains and Sierra de las Minas, Belize's Mayan Mountains, the Talamanca mountain range that cuts through Costa Rica and Panama, and the Darién Range in Panama are stellar examples of these natural treasures.

Central America is rich in biodiversity, home to important reducts of tropical moist forests and with a phenomenal concentration of fauna and flora and high levels of endemism. These treasures are key to its nations' development, especially for rural communities.

Though the region occupies barely 1% of the earth's surface it is home to an estimated 7% of global biodiversity (**Table 2**).²

According to a 1997 assessment, 11 of the 24 Mesoamerican eco-regions identified by Dinerstein (1995) were in a critical state and another 11 were in danger of disappearing because of the

² Idem Note 1.

acreage of forested land that has been converted to other uses, deforestation, unsustainable use of forests for wood production, forest ecosystem degradation and fragmentation, and forest fires.³

Table 1 Central America. Known Plant and Vertebrate Diversity (excluding ocean fish)								
	Central America	Belize	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Plants	20,000	3,409	10,000	3,360	8,000	7,524	7,000	9,915
Amphibians	n/d	42	178	33	112	111	62	170
Birds	1,174	571	864	524	669	715	676	929
Mammals	273	163	236	129	250	228	251	232
Reptiles	n/d	121	228	100	231	210	172	228
Freshwater Fish	n/d	116	135	40	220	88	157	146

Source: ANAM, 1999; CCAD, 1998; CONABIO, 2000; CONAP, 1999; MARENA, 1999; MARN, 2000; Miller, Chang and Johnson, 2001; Ministry of Natural Resources and the Environment of Belize, 1998; Obando, 2002; UNEP, 2001, and SERNA, 2001.

Another statistic to illustrate the importance of Central America's natural resources is that the region has 8% of the planet's mangrove swamps. Along its 14,696 kilometers of coastline are 1,600 kilometers of reefs, including the world's second largest barrier reef which stretches from the tip of the Yucatán peninsula southward into the Gulf of Honduras.⁴ Close to 22% of the region's population lives along these shores, which generate at least US\$750 million annually in fishing revenues, give direct employment to over 200,000 people, and support at least 250,000 indigenous people who depend directly on these coastal resources for their livelihood.

Table 2 Examples of Species Diversity in Central America Relative to Selected Countries Considered to be Mega Diverse, for Selected Groups (number of species/1,000 km²)						
	Area (km ²)	Plants	Amphib.	Birds	Mammals	Reptiles
Central America	511,217	39.12	n/d	2.97	0.53	n/d
Australia	7,686,849	3.25	0.03	0.11	0.03	0.08
Brazil	8,511,965	6.46	0.06	0.20	0.05	0.05
Colombia	1,141,748	39.41	0.51	1.54	0.40	0.42
Indonesia	1,919,270	10.40	0.14	0.80	0.27	0.28
Mexico	1,953,162	13.20	0.14	0.50	0.22	0.36

Source: CONABIO, 2000; Obando, 2002, and UNEP, 2001.

³ G. Hernández (ed.). 2002. *Biodiversidad en Mesoamérica. Informe 2002. Informe Regional sobre el Cumplimiento del Convenio sobre la Diversidad Biológica*. Darwin Foundation (U.K.), IUCN, and CCAD.

⁴ J. J. Rodríguez and N. Windevoxhel. October 1998. *Análisis Regional de la Situación de la Zona Marina Costera Centroamericana*. Inter-American Development Bank.

Natural diversity is the region's lifeblood, since its different ecosystems are home to a sizable share of its population and have tremendous local economic development potential. The conservation and rational use of these assets are crucial for these nations now and as a potential competitiveness advantage down the road.

B. Tropical Moist Forests

Central America's spectacular natural resource endowment is its leading output and income generator. The region's tropical moist forests are critical to its economies and its residents as a source of raw material for the timber industry both for domestic consumption and as foreign-exchange-generating export commodities. These forests also yield traditional goods such as food, energy, nonwood forest products, medicines, and environmental goods and services for urban populations and regional business corridors.

Central America's dwindling natural forests and the damage being done to fragile ecosystems by human activity topped the region's environmental agendas in the 1990s.

The region's vast forests spread over some 18.1 million hectares, or 35% of its total land surface.⁵ However, by the mid-1990s an estimated 388,000 hectares of forest were vanishing every year.

The rate of agricultural encroachment into forest areas in the 1990s varied considerably from one country to another. El Salvador and Honduras are cases in point: over that interval El Salvador lost 7,000 hectares annually, or 4.6% of its total forest cover; Honduras lost 59,000 hectares a year, or 1% annually (**Table 3**).

Table 3			
Central America. Changes in Forest Cover, 1990-2000			
Country	Total Forest 2000 (000 ha)	Average Annual Change in Forest Cover, 1990-2000	
		000 ha	Percentage
Belize	1,348	-36	-2.3
Costa Rica	1,968	-16	-0.8
El Salvador	121	-7	-4.6
Guatemala	2,850	-54	-1.7
Honduras	5,383	-59	-1.0
Nicaragua	3,278	-117	-3.0
Panama	2,876	-52	-1.6

Source: WRI, 2001

given way to crop farms and grazing lands and irrigated acreage has increased. Guatemala, Honduras, Nicaragua, and Panama were still pushing back their agricultural frontiers in the 1990s. El Salvador and Costa Rica, on the other hand, had run out of agricultural land decades earlier and thus had converted vast tracts of forest to rangeland, notably in the 1960s and 1970s.

Between 1990 and 1995 more than two million hectares of the region's forests disappeared.

The following are some of the contributing factors:

- **Conversion of forest land to other uses: farming, ranching, urban expansion.** Overall, the agricultural land area has grown as forests have

⁵ CCAD and Central American Council for Forests and Protected Areas. *Central American Forestry Strategy. Fourth Consultation Draft*. May 2002.

The loss of natural forests has been an inherent feature of the growth of rural settlements on Central American mountainsides. These hillside lands are a cornerstone of the region's subsistence economies, accounting for over 80% of the total acreage planted to basic grains. They also make up an estimated three quarters of the annual crop acreage regionwide and two thirds of the total perennial crop acreage.⁶

Deforestation and unsustainable forest use are threatening the region's biodiversity.

- **Unsustainable use of forests for fuelwood.** A leading contributor to deforestation in the region is the use of woodlands to meet energy demands, especially for cooking. Though a considerable amount of fuelwood is extracted from agricultural land and secondary forests, huge numbers of trees are being felled to supply energy needs. In 1996, for instance, fully 92% of total wood output was used for fuel and the other 8% for industry.
- **Forest ecosystem degradation and fragmentation and forest fires.** In 1997 and 1998 forest fires destroyed over 1.5 million hectares of forests along the Isthmus. One million hectares—5% of the region's land surface—was agricultural land. The estimated loss to the regional economy in 1998 was US\$14 million.⁷
- **Forest pest infestations.** The increase in pest infestations in recent years, mostly a result of management problems, has heightened the risk of forest fires and is causing serious concern.

C. Soil

Soil deterioration is a longstanding problem in this part of the world, and the 1990s were no exception. It is triggered chiefly by slope-eroding practices which create watershed conservation problems. Land-use intensification and the sharp increase in irrigated acreage have exacerbated soil degradation processes at many points across the region. The past thirty years have seen a significant increase in the region's total arable, permanently cropped land, with the ensuing soil conservation problems.

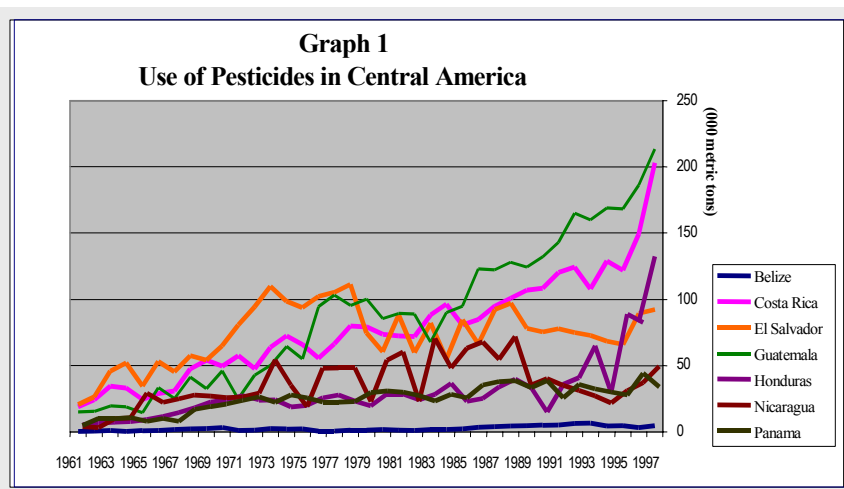
Per capita pesticide use in Central America is the highest in the world, with the resulting damage to soil quality. Pesticide use is on the rise in the region owing to the intensification of farming systems and the lack of technical training.

Chemical pollution of soil has become more and more of a concern in Central America over these three decades as agriculture has intensified and pesticide use has mounted (**Graph 1**). Per capita pesticide use in the Isthmus—at close to 2 kilograms per capita annually, the highest in the world—is on the rise.⁸ The impact of agrochemical pollution on soil and water and hence on human health is causing growing alarm in the region, particularly in Costa Rica and Guatemala.

⁶ Idem Note 3.

⁷ L. Pratt and P. O. Girot. *Executive Profile for the Regional Dialogue on the Environment: Mesoamerican Subregion*. Inter-American Development Bank. 2002.

⁸ J. R. Cabezas. *Midterm report: Project Identification for the Puebla-Panama Plan. Mesoamerican Sustainable Development Initiative*. Central American Commission for Environment and Development and Inter-American Development Bank. May 2002.



In Mesoamerica (including Mexico) 74% of cultivated land, 11% of permanent rangeland and 38% of forested land⁹—some 52 million hectares in all—are marked by soil erosion. As the soil has become progressively impoverished, communities across the region have seen their income and development prospects diminish.

D. Water Resources

Though at first glance the region may appear to have abundant freshwater supplies there are sharp disparities in the geographic distribution of this resource and hence in the volumes of water available to different populations. Water deficits are widening in some areas. The abundant per capita freshwater supply in countries like Belize (66,470 m³), Panama (51,616 m³), and Nicaragua (37,484 m³) stands in stark contrast to figures elsewhere in the Isthmus, such as El Salvador's 2,820 m³ per person.^{10 11} This has direct implications for water quality and water access and, in some countries, for water and sanitation infrastructure costs, which has left these countries with serious shortfalls in this regard.

One reason for Central America's deteriorating water quality is that the bulk of the population lives on the Pacific side but the bulk of water resources are on the Caribbean side.

By virtue of its warm subtropical climate Central America is much richer in water resources than many developing countries. Average annual precipitation is relatively high, as much as 7,500 millimeters annually in some parts of the Isthmus. In theory there would appear to be no reason for any pressure on the water supply for the current population, but human settlements have put strain on groundwater supplies and unsustainable farming practices have left water resources unfit for other human uses, as will be discussed in the sections below on urban environment and environmental quality.

Failed policies, obsolete and mutually contradictory laws, and distorting subsidies have perpetuated inefficient water use and consumption patterns. Their legacy is overpumped aquifers, polluted and unusable water bodies, and damaged aquatic ecosystems with the ensuing effects on human health. With a handful of exceptions there are no integrated water resources

⁹ United Nations. *GEO: Latin America and the Caribbean Environment Outlook*. 2002.

¹⁰ Countries with less than 5,000 m³ of water resources available per capita are considered to be in "stress" for water supply for human use.

¹¹ Idem Note 7.

management policies in place in the region. One consequence of that policy void is the region's fragmented, antiquated institutional apparatus for water resources management.

E. Hydrobiological Resources

The region's extraction rates for marine species point up the need for sustainable management of its fishery resources. Between 1984 and 1998 Nicaragua's annual marine catch soared from 4,235 tons to 23,259 tons, Belize's maritime catch tripled and Honduras increased its annual catch by 250%.¹² The situation was similar for lobsters, conches, and sea urchins and, more recently, for sea cucumber exports.

Overfishing that is threatening marine fishery productivity coupled with the continuing (and accelerating) destruction of coral reefs and mangrove systems across the region are jeopardizing the sustainability of marine and coastal resources generally.

Wetlands and marine-coastal environments have been put at risk by the expansion of agricultural acreage, urban and industrial development, and mass tourism. A compounding factor is the growth of the fishing industry centering on a select group of products, which is making it more difficult to achieve sustainability levels in the use of marine-coastal resources and consequently in marine biodiversity. The response of countries such as Honduras, Guatemala and Costa Rica since the last decade has been to substantially boost exports of shrimp and tilapia, virtually all of them from aquaculture operations. The setting up of shrimp farms also has triggered significant land-use changes in Pacific mangrove areas.

Though these new economic activities make the region more competitive, countries will need to do more to strike a balance between aquaculture activities and sustainable use of marine and coastal resources, given the natural wealth that these ecosystems represent and what they mean for local communities' lifestyles.

F. Natural Disasters

The Central American Isthmus is vulnerable to an array of weather events such as earthquakes, droughts, volcanic eruptions and hurricanes that are devastating for its people and wipe out or damage infrastructure and facilities. So staggering is the economic, human, and environmental toll taken by these natural calamities that only some broad themes will be touched upon in this section; a separate report (chapter 8) is devoted entirely to natural-disaster issues.

Hurricane Mitch which battered the region in 1998, leaving a trail of environmental destruction, is an illustrative example. The damage to the regional economy has been estimated by ECLAC to be US\$6 billion, Honduras and Nicaragua having been the hardest hit. While Mitch may well have been an unprecedented phenomenon its impact on the region's people, infrastructure, and environment unquestionably was magnified by the countries' environmental vulnerability which had worsened over the years. Consequently, their natural disaster prevention and management capabilities need bolstering. The loss of forest cover, unsound land use practices, and alarming

¹² Idem Note 8.

water pollution levels—all traceable to human activity—clearly amplify the damage caused by natural catastrophes.

Likewise, the countries' lack of land-use management tools, institutionalized integrated watershed management systems, or environmental codes governing water resources management aggravates the harm wrought by extreme weather events. Such instruments are crucial to instill a preventive approach as countries work to strengthen their disaster mitigation capacity.

Hurricane Mitch spurred a rethinking of the question of the region's vulnerability to natural hazards. Out of this process came the move to further integrate the environmental dimension into cross-sectoral concerns and the design and implementation of new funding vehicles to improve natural disaster prevention and management.

G. Urban Environment and Environmental Quality

The most striking transformation in Central America in the last three decades is its rising urban concentration, driven primarily by migration from the countryside to cities (**Table 4**). The urban share of the population is trending upwards: in 1975, the region's cities were home to 42.6% of the total population; in 1990 they accounted for a 43.2% share and by 2000 they represented 55% of the total.

Table 4										
Urban Growth in Central America: Key Data										
	Population						Urban Concentration			
	Urban Population (000)		Urban Population as Share of Total (%)		Urban Population Growth Rate (%)		Cities with Population of 750,000 or More		Population of Cities with 750,000 or More Inhabitants (000)	
	1980	2000	1980	2000	1980-1985	1995-2000	1980	2000	1980	2000
Belize	-	-	-	-	-	-	0	0	0	0
Costa Rica	984	2,029	43.1	49.3	3.7	3.2	0	1	0	1,063
El Salvador	2,023	3,467	44.1	59.9	2.0	3.0	1	1	753	1,415
Guatemala	2,538	4,483	37.2	43.8	2.7	3.0	0	1	0	2,697
Honduras	1,248	3,126	35.0	53.8	4.7	4.4	0	1	0	1,241
Nicaragua	1,464	2,807	50.1	61.7	3.6	3.2	0	1	0	1,319
Panama	970	1,646	49.7	61.5	2.9	2.3	0	1	0	1,088

Source: L. Lawrence Pratt and P.O. Girot. *Executive Profile for the Regional Dialogue on the Environment. Mesoamerican Subregion*. Inter-American Development Bank. 2002.

Urban dwellers outnumber rural residents in virtually every country in the region; the differences are largest in Panama, Nicaragua and El Salvador. Only in Guatemala are rural dwellers still in the majority—though Guatemala City with its population of 3.2 million is the largest city in the Isthmus as well as the second fastest growing city in all of Latin America, after Toluca, Mexico.

1. Water Pollution

One of the stiffest environmental challenges with which the region has been contending and will continue to face in the coming years is the management of water resources for human consumption and urban water pollution. A sizable share of the population is still without access to safe water or sanitation services.

By the close of the 1990s over half the region's population were living in cities, with the concomitant deterioration in air and water quality and solid waste management problems.

Owing primarily to Central America's rapidly growing population and urban concentration rates, approximately 80% of sewage is being discharged untreated into rivers and other water sources across the region. In San Salvador only around 2% of sewage and liquid wastes are treated and in Guatemala City, only 3%.¹³ More than 95% of households in San José, Costa Rica, have piped water but only 20% of dwellings are connected to sewer systems; the rest rely on individual septic tanks. Though this has prevented concentrated discharges into rivers, the infiltration of nitrates and bacteria has polluted aquifers.

Increases in surface and groundwater pollution from raw sewage and industrial wastewater discharges pose a public health threat in many Central American urban areas. The impacts of organic and nitrate loads in the most heavily urbanized watersheds are being felt in marine-coastal ecosystems. Red tides triggered by toxic algae blooms have directly impacted nonindustrial fishing in the region, notably along the Pacific coast.

2. Urban Solid Waste

Solid waste is another problem that has worsened as cities have swelled. At a rough estimate the region produces 19,000 tons of garbage a day, 50% of which is collected. Though the countries are making some inroads, solid waste collection and disposal is still a serious concern in the larger cities. Guatemala City's 3.2 million residents, for instance, produce on the order of 1,200 tons of waste a day, 80% of which is collected, but all of it is deposited in open dumps. In San Salvador, the region's second most populous city with 1.3 million inhabitants, only 60% of the 700 tons a day of solid waste output is collected and properly disposed of. Only in San José and Panama City is more than 90% of solid waste picked up and, of those two cities, only San José rates acceptably in terms of final disposal (**Table 5**).

¹³ Idem Note 8.

Table 5 Final Solid Waste Disposal in Major Central American Cities						
City	Population (million)	Waste Volume (Tons/day)	Percent Collected	Final Disposal Type * (percentage)		
				Good	Fair	Poor
Guatemala City	3.2	1,200	80			100
Managua	1.0	600	70			100
Tegucigalpa	1.0	650	75			100
San Salvador	1.3	700	60	100		
San José	1.0	960	90	100**		
Panama City	0.8	770	90		100	

* Good=sanitary landfill; Fair=controlled landfill; Poor=open dumping

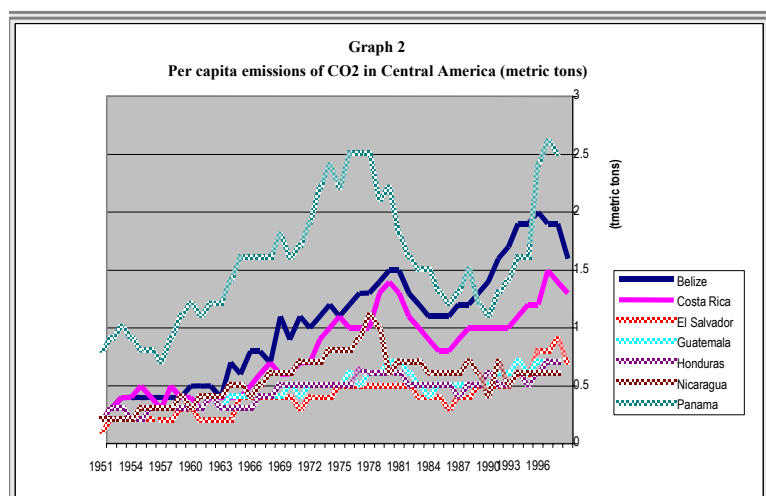
** The final-disposal situation began to improve only in 2002 when the La Carpio sanitary landfill opened. Even then some problems persist because of the potential effect on neighboring communities. The Río Azul sanitary landfill, which had operated until then in the city, presented serious environmental problems, particularly water pollution.

Source: UNEP, GEO-LAC, 2001; WRI, 2000.

3. Air Pollution

Mobile-source air pollution emerged as a problem in the 1990s in the region's major cities mostly because of the rapidly mounting number of motor vehicles. Costa Rica's fleet, for instance, doubled in those 10 years to 677,000 vehicles in 2000 (an average of 130 per 1,000 population).¹⁴

Motor vehicle concentration figures differ across the region and across individual countries as well. Guatemala's national average is 17 vehicles per 1,000 population but the average soars to 109 per 1,000 in Guatemala City. El Salvador's nationwide average is 61 vehicles per 1,000 inhabitants; its capital, San Salvador, has 113 vehicles per 1,000 population.



This surge in vehicle numbers brings with it demands for road infrastructure investments to keep congestion and air pollution from worsening. Pollution levels in the region reflect a gradual shift in greenhouse gas sources from land-use changes and deforestation, which were triggers in the past, to industry and transportation. The region's per capita carbon dioxide emissions illustrate this transition (Graph 2).

¹⁴ Idem Note 8.

III. Rising to the Environmental Sustainability Challenge: Main Environmental Capabilities and Initiatives

Environmental Development in Central America

During the 90s Central America traced its own path toward environmental sustainability. While present-day problems and the task ahead may be formidable, that decade saw myriad efforts in individual countries and on the regional integration stage to conserve natural resources and the environment. Each country bolstered its environmental institutions, approved laws to further sustainable social and economic progress and took initiatives to safeguard its environmental heritage, improve environmental quality, and make for sustainable natural resources use.

Over the course of the last decade these countries have strived to develop institutions sturdy enough to take on the environmental challenges facing the region. With new laws and instruments in place they are better equipped to manage environmental stresses.

These moves to tailor environmental development approaches to local, country, and regional circumstances have received backing from a host of international organizations and donor countries. The IDB, for one, has provided technical assistance, loans, and other support for a variety of initiatives, a selection of which are described in this chapter.

A. Forging Partnerships: IDB'S Contribution to Environmental Protection and Management in Central America

The region went to the 1992 Earth Summit in Rio de Janeiro with a collective proposal to address a list of issues—deforestation, significant biodiversity loss, deficiencies in sanitation, and soil, water, and air pollution—which ranked high on its sustainable development agenda. There was already deep concern in that era over the effects of global climate change on the region and the environmental problems that go hand in hand with underdevelopment and extreme poverty.

To help Central America achieve environmentally sustainable socio-economic progress the IDB has significantly enlarged its project portfolio, made attention to environmental protection a permanent feature of its operations, and helped fashion common natural resources conservation strategies and improve environmental legislation and regulation.

In their proposal the countries in the Isthmus called upon specialized environmental agencies, international organizations, and industrialized nations to help them individually, and the region at large, along the necessary path toward sustainable development in the 1990s, since given their circumstances at the time they were not in a position to tackle this challenge on their own. Heeding the call, the IDB reconfigured its institutional agenda to include technical and financial support for this purpose and make environmental protection a cross-cutting theme in all the initiatives it targeted for assistance.

As the leading multilateral development agency for Latin America and the Caribbean the IDB augmented its lending portfolio in the 1990s to advance sustainable development in Central America. Environmental screening became a permanent feature of the Bank's operations;

measures were adopted to effectively address any adverse socioeconomic consequences of programs and projects which it funds. The Bank also developed strategies and action plans to guide its support for borrowing member countries to tackle critical environmental-protection issues and sought the further support of other international organizations and its nonregional member countries for additional funding.

A pivotal development in the move to incorporate the environmental dimension into IDB activities was the agreement on the institution's Eighth General Increase in Resources, which mandated the following priorities for the Bank and for its support: strengthen each country's legal framework and institutional apparatus for environmental protection and management; improve environmental quality of Bank operations; promote energy efficiency and conservation and efficient energy use in Bank operations; improve urban environmental quality; institute sound natural resources management systems and practices and protect biodiversity; effectively address community resettlement problems; develop environmental information, and support environmental education and training.

The IDB has been a full partner in Central American efforts to date to take environmental consequences into account in the region's socioeconomic development. IDB projects and other activities have been instrumental in getting environmental issues onto public agendas across the region; in spurring the creation of regional, national, local, and sectoral institutions to pursue environmental sustainability in their respective spheres of action; in fostering clean production in key economic sectors in each country with a special emphasis on small and mid-sized manufacturers; in developing laws and standards to promote the environmentalization of human

Table 6 CESI* Project Approvals for Central America, 1992-2001**		
Object of Support	Loans (US\$ million)	Technical Cooperation (US\$ million)
Urban Environment	\$349.5	\$5.5
Water Resources Management	60.4	4.1
Natural Resources Conservation	195.3	6.0
Institution-Strengthening	30.0	5.3
Energy	16.5	1.4
Natural Disaster Mitigation	150.5	2.9
Environmental Management	23.8	11.3
Pollution Control	29.9	0.9
Coastal Resources Management	-	0.2
Sustainable Tourism	11.0	0.9
Other	8.3	3.4
Total	\$875.3	\$41.9

* The IDB's Committee on Environment and Social Impact.

** Projects relating directly to the environment. Does not include regional operations or environmentally relevant sector projects.

Source: List of loans and country technical cooperations cleared by CESI. Project categories are those used by CESI. Some projects relating to coastal resources are included under Sustainable Tourism.

activity; and in furthering country and regional efforts to balance the economic betterment of low-income communities with environmental stewardship and sustainable use of natural resources, especially in very fragile environments.

In sum, the IDB has resolutely supported the environmental efforts of its member countries in the Isthmus. One of its most important contributions has been to give coherence and technical content to environmental stewardship initiatives, with due heed to country priorities. In monetary terms alone the Bank supplied US\$875.3 million in loans to the region and US\$41.9 million in technical cooperation between

1992 and 2001 (Table 6). Though the technical cooperation figure is lower, there were over 130

such operations in Central America during the same period, thanks in large measure to the Bank's strategy focuses: spur processes tailored to local realities; marshal national and outside funding support; and give environmental issues the requisite political importance and technical coherence.

The Bank targeted the bulk of its support to improving the human environment, with a special focus on basic urban sanitation, natural resources conservation, and natural disaster mitigation. As the following sections will illustrate, the Bank also helped each country set up and bolster environmental institutions, pursue sustainable natural resources use and development, and conserve protected areas and fragile ecosystems.

B. Key Environmental Gains

1. Legal and Institutional Frameworks

The region made tremendous strides in the 1990s in constructing an institutional base for environmental management that had been virtually nonexistent 10 years before (**Table 7**). Today, general or framework laws in place in each of the countries prescribe the fundamentals of environmental management, including a lead national policy agency, and key environmental management tools such as environmental impact assessment, pollution abatement plans, voluntary agreements, environmental audits, economic valuation of natural resources, emission and environmental quality standards, and reporting and information systems. Depending on the support furnished for the purpose these laws and management tools are at different stages of development, as will be discussed below.

*Building Capacity for
Environmental Sustainability*

Table 7			
Framework Environmental Legislation in Central America			
Country	Enactment Year	Law	Environmental Authority
Belize	1992	Environmental Protection Act	Ministry of Natural Resources
Costa Rica	1996	Environment Law	Ministry of Environment and Energy (MINAE)
El Salvador	1998	Environment Law	Ministry of Environment and Natural Resources (MARN)
Guatemala	1986	Environmental Protection and Remediation Law	Ministry of Environment and Natural Resources
Honduras	1995	Environment Law	Ministry of Natural Resources (SERNA)
Nicaragua	1996	Environment and Natural Resources Law	Ministry of Natural Resources (MARENA)
Panama	1998	Environment Law	National Environmental Authority (ANAM)

The main achievements of IDB support for country efforts to structure environmental institutions and build environmental management capacity can be summed up as follows: (i) citizens' environmental rights and obligations now are formally enshrined; (ii) the environmental functions of the State and of the responsible public agencies have been defined; (iii) Central American countries now have environmental institutions and authorities; (iv) most countries have created a specialized national executive agency for environmental management; (v) a whole set of tools and instruments has been designed and made functional to facilitate environmental management in these countries; and (vi) national, local, and sector-specific environmental

policies have been or are being developed and implemented. This marks a huge advance over the 1980s when in many countries the environmental authority was compartmentalized and ranked lower in the government's political hierarchy and there were no laws mandating the use of different environmental management tools.

Some examples of Bank-funded operations are El Salvador's Environmental Protection Program (PAES), notably the technical support furnished to build capacity in that country's Ministry of Environment and Natural Resources (**Box 1**), the National Environmental Management System in Nicaragua and institution-strengthening of the Ministry of Natural Resources (**Box 1**), and Panama's National Environmental Program and support for the National Environmental Authority (ANAM) (**Box 2**). Costa Rica's National Conservation Areas System was another important target of support. Practically speaking, the IDB has been a part of every environmental institution-building process in every country in the Isthmus.

Box 1
Institution-Building

**El Salvador: Environmental Protection Program and Ministry of
Environment and Natural Resources**
Nicaragua: National Environmental Management System

El Salvador

Since the 1992 signature of the Peace Agreements in El Salvador there have been calls from across the political and social spectrum for a coherent environmental policy to systematically address the root causes of the nation's deteriorating environmental conditions, with an eye to sustainable development.

The Economic and Social Development Program devised by the Government of El Salvador as part of its new planning approach built the environmental dimension into a new strategy, which sought, among other aims, to alleviate serious environmental problems at the time and protect the environment in the future.

Executive Order 73 of 1991 created the National Environment Council (CONAMA) and its Executive Secretariat (SEMA) in the Ministry of Agriculture. The following year CONAMA approved an Environmental Agenda and associated Action Plan intended primarily to set priorities, coordinate work, and target efforts to halt the deterioration of natural resources and environmental degradation. In 1994, pursuant to that agenda and action blueprint, SEMA approved a National Environmental Strategy and the El Salvador Environmental Protection Program (PAES) was developed with Bank support.* Taking a long-range view, that program was designed to strengthen and leverage environmental management in the country by way of technical cooperation support and loans for the Ministry of Environment and Natural Resources, natural resources management in the Lempa River basin, environmental quality improvements in critical areas, and water resources management. Launched in 1996, the project was completed in 2002.

With two further technical cooperation operations** the IDB continued to help El Salvador reconfigure its environmental management institutions and craft core environmental legislation, including measures to strengthen SEMA (which subsequently became a ministry) and the environment units of sector agencies with lead responsibility for sewage treatment and solid waste management. The Bank also furnished support for implementation of the country's Environmental Information System, Environmental Impact Assessment System, and human resources training. One highlight was the support delivered to lay the legal groundwork for the Environment Law and enabling regulations.

Continued →

Nicaragua

Since 1995 the IDB has provided assistance to Nicaragua to improve environmental management in 12 government agencies, via the National Environmental Management System. IDB sector loans have helped the country create environmental management units and devise and implement environmental standards and procedures.

On the list of sector loan recipients are the Ministry of Transportation, Nicaraguan Water and Sanitation Authority, Nicaraguan Power Administration, Nicaraguan Power Transmission Agency, Rural Development Agency, Social Investment Fund, Ministry of Agriculture and Forestry, Small and Medium-sized Business Administration, and Ministry of Health. These agencies have made varying degrees of progress on building an environmental dimension into their work.

* ATN/SE-4336-ES and 1209/OC-ES

**ATN/SE-4406-ES and ATN/SE-5025-ES

Box 2

Panama: Institution-Strengthening: National Environmental Program and National Environmental Authority

Panama's Environmental Protection Law (Law 41) enacted in July 1998 created the National Environmental Authority (ANAM) as the nation's lead environmental protection agency. To implement the National Environmental Strategy, the National Environmental Program (PAN) was approved pursuant to Law 41 as a funding vehicle to help ANAM develop and strengthen the Inter-Agency Environmental Protection System (SIA). Efforts in that regard have been under way since 1999 with US\$15.8 million in IDB loan funding.*

The PAN's strategy thrust and examples of its focuses are as follows:

- **Strengthening of ANAM, the SIA and Decentralized Environmental Management:** Develop capacity in ANAM regional offices, the SIA, a network of Sectoral Environment Units, and five local governments. The main outputs sought are an environmental management information system and an indicative environmental management plan for the nation.
- **Development of Environmental Management Laws, Standards, and Instruments:** Strengthen environmental management in Panama by devising and implementing national and sector-specific requirements for such instruments as project environmental assessments, environmental audits, environmental compliance control, environmental quality standards for critical areas, and clean production standards.
- **Environmental Management Initiatives:** Promote the allocation of preinvestment resources to spur access to existing funding sources for locally demand-driven investments in environmental areas and fields not covered by existing resources.

*1222/OC-PN

The Bank also has deployed its toolkit to make for more coherent institution-building processes in Central America and, more recently, to identify gains and ascertain what items remain on the future agenda. It has supported major regional studies like the Review of Environmental Institutional Development Projects (REFINA) (**Box 3**) and the Integrated Methodology for Reviewing Environmental Impact Assessment (IMREIA) (**Box 4**).

Box 3

Review of Environmental Institutional Development Projects (REFINA)

The object of this study was to review the contribution made by institution-strengthening projects in selected countries to gauge the progress achieved in this sphere and offer a comprehensive overview of the experience gained in different IDB-supported operations. The study's costs were defrayed with US\$140,000 in technical cooperation funding* in 2001-02. It selected a number of typical capacity-building operations—in El Salvador, Peru, Argentina, and Colombia—from which to extract lessons and refine strategy approaches for this kind of operation in the future.

One distinctive feature of these capacity-building projects is the diversity and mix of their components and their different reach—national, regional, or local. This makes for a wide array of scenarios depending on the different countries' priorities for developing and bolstering their institutional apparatus. This ties in also with the 1990s approach to environmental institution design and development, a task undertaken by most countries in the region over that interval when operational concerns took precedence over strategy visions when constructing environmental management systems.

Generally speaking, the more closely an institution-strengthening program meshes with processes already in motion or the more solid the existing learning base the greater the program's strategic impact. A complicating factor is that countries typically embark on capacity-building as they reconfigure their environmental institutions. This makes it difficult to map out an action plan or choose specific targets since it may not be clear which institutions and processes are to be strengthened. Hence the need for a strategic vision of such operations that transcends separate or discrete components.

One noteworthy lesson emerging from the El Salvador project is the importance of sustained support over time if a country is to institutionalize environmental protection processes, building capacity in the public and private sectors alike. This sets the stage for strategy frameworks that will make for more coherent environmental management and move this issue up the hierarchy.

* ATN/NP-7578-RS

Box 4

Integrated Methodology for Reviewing Environmental Impact Assessment (IMREIA)

The object of the Integrated Methodology for Reviewing Environmental Impact Assessment (IMREIA) was to ascertain the implementation status of environmental impact assessment (EIA) practices and systems in the IDB's 26 borrowing members, including all the Central American countries. The study* was conducted in 2000 and 2001 at a cost of US\$400,000.

The following were some of the findings of the review of structural and procedural facets and perceptions of EIA systems:

- The preventive approach has been institutionalized and incorporated into the decision-making process.
- Countries have created an institutional and legislative base for EIA so they are equipped to identify actions likely to have the greatest environmental consequences and apply environmental protection criteria, and they have core administrative procedures in place.
- Thanks to country capacity building, most parts of the region now have experience in environmental impact guidelines and reporting and mitigation and compensation measures.
- EIA application is stronger on the procedural side, however with relatively scant visible evidence of substantive improvements in preventing adverse environmental impacts.
- Among the major weaknesses cited are the needs to validate strategic environmental assessments as an integral part of the hierarchical decision-making sequence and to institute effective project EIA monitoring.

Selected Indicators of Situation of EIAS in Central America

Indicator	Belize	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Year in which EIAS was instituted	1995	1996	1998	1986	1994	1994	1995
Review period	1995-2000	1998-2000	1998-1999	1999-2000	1994-2000	2000	1995-1999
Studies presented	270	401	223	353	110	20	959
Studies approved	67	395	28	271	107	15	575
Studies rejected	3	6	-	14	3	2	384
Projects that monitor environmental management plans once the studies have been approved	-	395	20	-	-	15	30
Projects that include citizen participation at some stage	7	-	2	-	3	-	192
Studies with prescribed review deadlines met	-	40	221	-	-	-	-

* ATN/JF-6618-RG

2. Natural Resources Management and Conservation

Central America made definite progress beginning in the 90s on natural heritage conservation. The size of protected areas increased between 1989 and 1997, particularly in Belize, Costa Rica and Panama. Belize's protected areas now occupy 40% of its national territory; Costa Rica's and Panama's cover over 20% of their total land surface (**Table 8**).

Systematic moves toward integrated environmental heritage management

Table 8 Protected Areas: Size, Percentage of Total Country Area, 1989-1997 Growth								
	Total Area (km ²)	Protected Areas (km ²)		Protected Areas as % of Total Land Area		% Growth in Size of Protected Areas (1997 over 1989)	Protected Marine and Coastal Areas	
		1989	1997	1989	1997		Number of Areas	Size (km ²)
Belize	22,818	n/d	9,130	n/d	40.0	n/d	2	340
Costa Rica	51,100	6,103	12,044	11.9	23.6	97.4	14	3.17
El Salvador	20,737	222	52	1.1	0.3	-76.6	1	2.5
Guatemala	108,517	992	21,666	0.9	20.0	2,084.1	3	-
Honduras	111,980	5,808	11,309	5.2	10.1	94.7	5	10
Nicaragua	121,497	433	16,375	0.4	13.5	3,681.8	15	10,103
Panama	75,517	13,142	19,000 (*)	17.6	25.16 (*)	44.6 (*)	7	12,164

Source: L. Lawrence Pratt and P.O. Girot. *Executive Profile for the Regional Dialogue on the Environment. Mesoamerican Subregion*. Inter-American Development Bank (revised).

J. J. Rodríguez and N. Windevoxhel. *Análisis Regional de la Situación de la Zona Marina Costera Centroamericana*. Inter-American Development Bank. October 1998.

(*) Figures taken from the *National Environmental Strategy*, ANAM, 1998.

All the countries have crafted and approved a national biodiversity strategy and, to further integration on this front, have mapped out and recently approved a Regional Strategy for Conservation and Sustainable Use of Biodiversity.

Much has been achieved in the region in ecosystem protection and management, with gains in natural resources management particularly. The Central American Policy on Conservation and Rational Use of Wetlands adopted in July 2002 will help the countries protect and manage the region's wetlands. All the countries signed on to the Ramsar Convention and have designated one or more of their wetlands as Ramsar sites (Wetlands of International Importance). By the end of 2001 there were 31 such sites across the region, creating a total protected area stretching over 1,512,498 hectares. Underpinning this process, as discussed earlier, were IDB-supported studies to systematize experiences, environmental status reports, and issue-specific strategies and action plans.

Three other large-scale initiatives for ecosystem and biodiversity conservation, management, and recovery in the region warrant mention here. One is the Mesoamerican Biological Corridor (MBC) ratified in 1997 and launched in 2000 (**Box 5**). A project approved in 2002, financed out of the IDB-administered Japan Special Fund, consulted indigenous communities living along the MBC. The aim was to instill a new culturally and environmentally sustainable approach in initiatives in this sphere.

The second Bank-funded operation of note is the Project for Conservation and Sustainable Use of the Mesoamerican Barrier Reef System (SAM), which the IDB sees as an opportunity for future support and continuity of work done to date. The third initiative is the Mundo Maya program which proposes to make an area with a predominantly indigenous population encompassing Mexico, Guatemala, Belize, Honduras and El Salvador environmentally sustainable. This program's primary focus is sustainable development of forest farming and forestry activities and tourism sector growth, via an approach that meshes environmental and social considerations and calls for a heavy measure of local community participation.

Box 5

Mesoamerican Biological Corridor (MBC)

The Mesoamerican Biological Corridor (MBC) is a strategic land-use management framework aimed at preserving the ecological continuity between North and South America. It takes in the seven Central American countries and the five southeastern Mexican states (Campeche, Chiapas, Quintana Roo, Tabasco and Yucatán)—a total land area of approximately 768,990 square kilometers, which is just 0.51% of the earth's surface but is home to an estimated 8% of global biodiversity.

The MBC initiative emerged as one in a series of moves to implement and honor regional and international conventions on biodiversity use and conservation. One of the guiding principles of the Central American Alliance for Sustainable Development (ALIDES) is respect for and sustainable use of the earth's living resources and diversity. Among the avenues it envisages to pursue that strategy aim is the linking of national protected area systems into a Central American Protected Areas System (SICAP). The idea of a Mesoamerican Biological Corridor was an effort to cement that interconnection.

The genesis of the Corridor goes back to 1994 and the Paseo Pantera project. The vision has evolved over time: at the outset the chief concern was to conserve Mesoamerica's natural assets by creating more protected areas and purchasing heritage land for conservation; more recently the Corridor has come to be seen as a strategic initiative embracing the concepts of sustainable use, productive landscape remediation, interconnection, and community-based management. Today the MBC is conceived as a platform for sustainable development encompassing natural resources conservation, economic competitiveness, and poverty alleviation efforts.

One of the MBC's aims is to connect protected areas in order to conserve the region's current resource endowment, enabling the free movement and dispersal of flora and fauna and hence preserve the continuity of life processes. Another is the gradual remediation of degraded environments around protected areas through productive landscape restoration, which in the process will enhance quality of life in communities in the connecting areas.

By dint of the MBC biodiversity and forest ecosystem conservation plans the region will increase its contribution to mitigate climate change problems, with the consequent sale of their carbon quotas to countries having an excess level of carbon discharge, and prevent the destruction wrought by fires and floods. Another important MBC benefit will be to help reduce vulnerability at three levels: in local communities by preventing landslides and washouts, at the country level by preserving the water balance, and worldwide by contributing to global climate stability.

The Bank has helped its member countries in the Isthmus to strengthen national protected areas systems and adopt management systems that promise effective long-range protection and make biodiversity concerns an integral facet of associated regional, national, and sectoral strategies (**Box 6**).

Box 6

Costa Rica: Institutional Strengthening of the National Conservation Areas System

Costa Rica's National Conservation Areas System (SINAC) is a decentralized, participatory institutional management system with responsibility for forests, wildlife and protected areas. Its mandate is to plan and implement programs and measures to pursue sustainable management of the nation's natural resources base.

The IDB has assisted the Ministry of Environment and Energy with natural and cultural resources protection and management in protected areas by preparing studies to come up with alternative natural resources management approaches, providing equipment and developing training activities, helping to make protected areas financially self-sustaining, and identifying employment sources for local communities. The Bank furnished US\$1.9 million in technical cooperation funding* for these activities between 1992 and 1995.

The program's chief outputs were a SINAC Development Plan and associated draft legislation and implementation plan, specific management plans for the Manuel Antonio and Cahuita National Parks and the Arenal Conservation Area, and feasibility or prefeasibility studies for the aforesaid areas and for Tortuguero and Bajo Tempisque.

Another noteworthy contribution of the program was the creation of decentralized mechanisms for coordination and decision-making on management plan content and on ways of involving local communities in natural resources conservation and development in conservation areas. In that way the program was a vital catalyst for the subsequent administrative overhaul of the nation's protected areas.

*ATN/JF-3917-CR

By way of new technical-assistance delivery and investment finance avenues the Bank has supported conservation and rational use of biodiversity; living-resources management approaches that are appropriate to indigenous cultural traditions; ecotourism development tied in to protected areas management; biodiversity assessment in project design and execution, and interagency partnerships to achieve the goals of international agreements that seek to safeguard the region's natural and cultural heritage (**Box 7**). Bank support has been instrumental as well for sustainable use of natural forests, through environmental management tools designed and interventions targeted to marginal areas where sustainable development of human activities has been a priority (**Box 8**).

Box 7

El Salvador: Ministry of Agriculture—Environmental Protection Project (MAG-PAES)

The MAG-PAES project has helped partner more than 19,000 poor basic-grains farmers in a participatory scheme to conserve natural resources in El Salvador's Tenancingo and Guazapa regions. Two of its specific goals were to introduce new environmentally benign farming practices and build capacity for local social project management, the ultimate aim being to raise farmers' income and reduce extreme poverty in the targeted areas. The Bank provided a loan of US\$35.9 million* for this operation, which has been under way since 1995.

The project enlisted 19 municipalities and 173 communities in the departments of San Salvador, Cuscatlán and Cabañas. Over 70,000 people have taken direct part in its promotional component alone. It provided support for 8,500 farm plans built on sustainable agriculture principles, 22.5% of them implemented by women. Soil, water and forest conservation practices and a heavy emphasis on crop diversification and agribusiness are two features of this sustainable-agriculture initiative.

* 886/OC-ES

Box 8

Panama: Darién Sustainable Development Program

The province of Darién is one of the most biodiverse regions in Panama, home to important forest and estuary ecosystems, mountain ranges teeming with biodiversity, significant fishery resources and fragile coastal and marine ecosystems. With a surface area of 16,671 square kilometers and a population of 60,000 (2000) Darién is the poorest and least developed province in the country. Its population is made up of indigenous groups (Embera, Wounaan and Kuna), Afro-Darienite communities, and campesinos who have migrated from other provinces.

Close to 41% of the province has been designated a protected area. Darién National Park, a Biosphere Reserve spreading over more than 5,790 square kilometers, is the largest in Panama and in all of Central America. Another quarter of the park (26%) is demarcated for indigenous communities; the other 33% is occupied by forest reserves and concessions and agricultural operations. The backbone of the provincial economy is low-commercial-value crops and very extensive ranching, which have degraded fragile environments. Small-scale fishing generates little added value; commercial fishing is being done in estuarine breeding grounds. Because of the dearth of development opportunities in Darién and unreliable communications with the rest of the country neither the government nor the private sector has any significant institutional presence in the region and local governments are facing serious budget constraints.

IDB support in the form of a US\$70.4 million loan* toward a US\$88 million program launched in 1998 has helped further sustainable production and social progress in the province and improve natural resources protection and management. The program's aims are to: (i) institute land-use planning to improve natural resources management and protection; (ii) support investments to give communities access to economically sustainable activities and core social services, particularly transportation infrastructure; (iii) build administrative capacity in regions, municipalities, indigenous communities, and civil society, and (iv) coordinate the activities of other funding providers and donors, especially with the Colombian government.

The program is conceived as an integrated, participatory initiative to address an array of problems in Darién, centering on land-use planning, promotion of sustainable development in productive areas, and conservation of fragile environments. Its first-stage focus was to regionalize and bolster Panama's institutional apparatus for environmental protection, create consultation spaces to ascertain the most pressing needs of Darién communities, and preserve significant sociocultural traditions and customs.

The following are some of the project's notable first-phase accomplishments:

- Creation of Local Consultative Committees for Darién's 29 districts.
- Study on tenure of land occupied by settlers in the community of Madungandí as an input for planned concertation forums for indigenous people and settlers.
- Cadastre recording and titling of 25,000 hectares of land in Bayano.
- Launching of a concertation forum to deal with land disputes between the Kuna de Madungandí community and settlers.
- Inventory of 50,000 hectares of forest in Alto Darién as a resource for ANAM's scientific management of natural production forests.
- Validation of local land-use planning methodology to be used in the Darién region.
- Execution of an action plan to strengthen ANAM in Darién.
- Execution of a capacity-building project for the four Darién municipal districts and the Emberá-Wounaan General Congress.
- Diagnostic assessment of technology transfer actions in the Darién region.
- Construction of the first two sections of the Pan American Highway between Puente Bayano and Agua Fria 1.
- Implementation of the Canglón-Yaviza highway maintenance project which will make the community of Yaviza and surroundings accessible year-round.
- Implementation of the Darién Health Services Improvement Plan.
- Rehabilitation of El Real Hospital.
- Construction of power distribution line between the communities of Metetí and Puerto Quimba.
- Construction of Sambú, Boca de Cupe, Barriales and Capetuirá water supply systems.

* 1160/OC-PN

IDB support has been vital in shaping an integrated vision of natural resources management with an accent on environmental and social sustainability in watersheds (**Box 9**).

Box 9

Natural Resources Management in Watersheds

Guatemala—Chixoy Project: This five-year venture funded by a US\$17.9 million IDB loan* was launched in 2002. It will further renewable natural resources management and rural development in the upper Chixoy River basin, whose 14 sub-basins extend over 5,945 square kilometers (5% of the country's total land area). Administratively the upper Chixoy basin is divided into three regions, six departments and 32 municipalities. Among the project's early achievements are integrated systems for sustainable natural resources use and productivity, notably for forests and water resources, and a slowing of erosion, deforestation, and sedimentation which were constraining natural resources use.

Honduras—El Cajón project: The IDB supported this 1993-1998 operation in the El Cajón reservoir basin with loans of US\$24.5 million**. The 448.7 hectares targeted occupy 52% of the basin. The project's aim was to encourage communities to adopt conservation practices in order to reduce soil erosion and soil loss and raise farmers' standard of living and, in so doing, lessen adverse impacts on the reservoir. To that end it focused on the introduction of sustainable forestry practices, environmental management of protected and fragile areas, promotion of environmental education, and adoption of systems to optimize farm forestry operations.

* 1398/OC-GU

** 787/OC-HO and 918/SF-HO

3. Sustainable Use of Natural Forests

Though the region's forest management agenda is by no means finished, marked progress has been made on various fronts since 1990. One milestone was the Central American Forest Action Plan (PAFT-CA) which gave the region a consensus-based common forestry agenda and paved the way for two important agreements—the Convention for the Conservation of Biological Diversity and Protection of Priority Wilderness Areas in Central America and the Regional Convention for the Management and Conservation of Natural Forest Ecosystems and the Development of Forest Plantations.

Creating Development Opportunities

The Bank has played a prominent part in the regional learning process about economically viable approaches to sustainable forest resource use. It has produced important studies on forestry policy effectiveness in Central America, on investment finance for natural resources conservation, and on integrated forest

Box 10

Panama: Shaping a Forestry Policy

This 2001 technical cooperation program* was designed to lay the foundations for sustainable development of forestry activities in Panama. Its centerpiece was the design of a forestry management plan and sustainable forest management regulations underpinned by environmental, social, legal, and technical criteria.

A second key component was the development of a forestry policy and strategy that laid out core forestry development principles for the country along with objectives, strategies, and management tools concordant with the National Environmental Strategy. The program also supported measures to assure sound supervision of forestry operations and devise incentives for sustainable forest management.

*ATN/NC-7015-PN

resources management. It has supported sustainable forest resources management and planning projects in Honduras, Panama (**Box 10**), El Salvador, and Nicaragua (**Box 11**), and projects involving property rights and natural resources conservation in Belize (**Box 12**).

Box 11

Nicaragua: Socioenvironmental and Forestry Development Program (POSAF). An Example of Environmental Sustainability of Natural Forests

A pilot program that ran from 1995 to 1997 to validate a variety of agroforestry and silvo-pastoral systems provided the design groundwork for the **Socioenvironmental and Forestry Development Program (POSAF)**. The POSAF initiative was to lay the foundations for a national program by producing feasibility studies, organizing public consultations, and launching an agroforestry and forest recovery demonstration project. The aim was to come up with viable implementation and investment approaches for sustainable natural resources development and, ultimately, to raise the income of the targeted rural households and improve natural resources management in priority watersheds. The IDB provided a US\$15.4 million loan* for the program.

As further groundwork for a national program the POSAF operation bolstered Nicaragua's environmental institutions, notably its forestry agencies, to eliminate overlapping mandates and some inconsistencies in environmental legislation; in addition, to train government specialists.

The agroforestry and forest recovery demonstration pilots prepared the terrain for management plans for five protected areas covering a total of 19,000 hectares and forest management plans taking in 30,800 hectares, investments in silvo-pastoral systems, agroforestry and reforestation initiatives benefiting 4,700 small and mid-sized farms (total surface area 57,600 hectares), and small-scale community forest development projects in Waspan that targeted 15 indigenous communities, involving a total of 15,000 hectares.

The POSAF program is now finished and a second phase has been approved funded by a US\$32.7 million loan.** While echoing the first-phase aims, this second stage puts the accent on watershed planning and management.

* 970/SF-NI ** 1084/SF-NI

Box 12

Belize: Environmental and Social Technical Assistance

This program's primary purpose was to assure sustainable development of southern Belize by way of land-use planning concordant with that region's social and environmental priorities, new national land management mechanisms, and identification of environmental and social projects that could minimize the potential indirect impacts of improving the Southern Highway, particularly for Mayan, Garifuna and other communities. The program was funded with a US\$2.6 million IDB loan* from 1997 to 2002.

The program's achievements, in brief, were to create a blueprint, appropriate to local realities, of the desired development model (the Southern Region Development Plan—PDR), with heavy local input and careful attention to communities' cultural and ancestral integrity. The PDR laid the foundation for rational resources use and environmentally and socially sustainable allotment of State lands. A set of environmental and social requirements were incorporated into the highway's design and construction in keeping with the thrust of the Plan while institutional capacity was built for environmental impact assessment, monitoring, and oversight of human activities. Thanks to the PDR Belize was able to create a system of protected areas and other fragile environments in that part of the country.

Other accomplishments were the strengthening of communities' organizational capacity and dialogue with government institutions to give local residents a real say in decisions on the PDR and its design and subsequent implementation. The creation of a Southern Belize Development Corporation, also aided by the program, will make the participatory process funded by the loan sustainable.

* 1017/OC-BL and ATN/DC-5610-BL

4. Integrated Water Resources Management

For a variety of reasons, inefficient water use and consumption patterns have predominated in Central America, resulting in overpumped aquifers and waterbody pollution. Various collaborative initiatives

*Incorporating Externalities and
Developing Social Capital in Under-
resourced Communities*

have been launched in the region to improve water resources management. One noteworthy regionwide venture is the Action Plan for Integrated Water Resources Management and Conservation in the Central American Isthmus (PACADIRH). Countries also have taken action on their own, particularly when their water resources are under stress. El Salvador's Action Plan for Integrated Water Resources Management and Costa Rica's Comprehensive Water Resources Management Policy and Strategy, currently in the early stages (**Box 13**), are two examples of such country efforts.

Box 13

Costa Rica: Comprehensive National Water Resources Management Policy and Strategy

In 2003 the IDB approved a US\$260,000 technical-cooperation operation to develop a rational, sustainable, responsible, shared approach to water resources management in Costa Rica, with a Comprehensive National Water Resources Management Policy and Strategy as its centerpiece.

The aim of the technical cooperation, with the Ministry of Environment and Energy as responsible agency, is to systematize existing data on water resources management, water balances and case studies; develop a Water Resources Policy; assist in the process of securing legislative passage of the Water Law; devise an institutional framework for water resources management to better coordinate and demarcate the functions of the various national and local agencies (watershed commissions and projects) and shape a water resources management strategy.

* ATN/WP-8467-CR

A triple focus of Bank assistance for integrated water resources management has been water resources planning, policy development, and administration, backed by a strategy that pays due heed to the problems inherent in managing multiple water sources and uses. In time the region's water supply systems and water use patterns can be expected to become more efficient, with improvements or, at the least, no deterioration in water quality. The Bank has supported important moves to harmonize and achieve coherence in regional and national interventions in this sphere (**Box 14**). More recently it has been exploring support for a new generation of transboundary integrated water resources management programs that take in communities in two or more countries.

IDB loans and technical cooperation for urban and rural water supply and sanitation systems also have helped countries in the Isthmus rewrite laws and build sturdy institutions.

Box 14

The IDB's Integrated Water Resources Management Strategy and a New Generation of Integrated Resource Management Programs

Adopted in 1998, the IDB's Integrated Water Resources Management Strategy seeks to instill efficient water use and conservation principles in its operations by integrating economic and noneconomic incentives and featuring participation avenues and shared environmental responsibility. The strategy marks a vision shift from concerns about increasing the water supply to integrated management of demand for the water resource in which the social, environmental, and economic values that society ascribes to water all come into play.

The strategy is being successfully incorporated into new Bank operations in this sphere. Some highlights are the Tárcoles River Basin Management Program in Costa Rica, the El Cajón Reservoir Renewable Natural Resources Management Program in Honduras, Guatemala's Upper Chixoy Basin Renewable Natural Resources Management and Conservation Project, and similar ventures in Panama and Belize.

The Bank has provided support for integrated water resources management programs, including the challenging task of making watersheds shared by two or more countries environmentally sustainable. Some examples:

- **Sixola River Binational Watershed Program (Costa Rica–Panama):** This project, prepared by technical cooperation*, seeks to assure environmental sustainability of a priority development area for the two countries through integrated management of water resources specifically and natural resources generally, to create economic opportunities for local communities that will help conserve and manage shared coastal areas and watersheds. An ad hoc binational environmental institutional apparatus will be strengthened as well through a GEF/IDB project.
- **Tri-National Sustainable Development Program for the Upper Lempa Basin (El Salvador—Guatemala—Honduras):** The goal of this recently launched five-year program is to enhance Upper Lempa basin residents' quality of life through activities to foster sustainable development of this watershed and break the poverty-natural resources degradation cycle. This is to be accomplished by way of integrated natural resources management, measures to make the region more resilient to natural disasters, fostering of productive activities and diversification of the economy, strengthening of local governments, and organizational capacity building in local communities. The program cost is US\$31.3 million**. One Guatemala component envisages payments for environmental services generated by natural forests, with an emphasis on water. The program also is expected to generate subregional policies and institutional and regulatory frameworks to improve integrated water resources development.

* ATN/SI-8060-RS

** 1330/OC-ES; 1331/OC-GU; 1082/SF-HO

5. Marine and Coastal Resources Management

Recognizing that Central America's coastal zones and marine resources are strategic assets for its nations, the Bank has promoted integrated coastal management programs tailored to each country's social and economic aspirations. Objects of Bank support have been coastal management activities and

investments to further national economic policies and regional integration and create income generators for services such as coastal erosion prevention and maintenance of protected marine environments, incentives to conserve fishery resources, and tighter interface between coastal area management and other facets of natural resources management (**Box 15**). To that end the Bank now is supporting programs that fit within a strategic institutional approach to achieve sustainable development of coastal and marine ecosystems, as for example, in Panama, where technical cooperation ATN/FG-8276-PN is financing preparation of a future investment project.

*Balancing Development and
Conservation of Fragile
Environments*

In addition, Bank support for regional harmonization of environmental norms for ports and maritime transportation is being provided, an example of which is the Integrated Program of Control of Sea Pollution in the Gulf of Honduras, currently at the design stage, with financing from technical cooperation ATN/PD-7402-RS, to be submitted to the GEF.

Box 15

Key Elements of the IDB's Marine and Coastal Resources Management Strategy. Honduras: Bay Islands Environmental Management Project

Central aims of the IDB's Marine and Coastal Resources Management Strategy approved in June 1998 are to:

- Foster integrated coastal resources management as a frame of reference for future Bank operations, with a view to sustainability of coastal activities.
- Reduce the indirect and cumulative effects of human coastal activities.
- Instill procedures to prevent and reduce conflicts in coastal areas.
- Build institutional capacity in coastal authorities and marine resources administrators.

The **Bay Islands Environmental Management Project** in Honduras (islands of Roatán, Utila and Guanaja) is an example of this strategy in action. The project's first phase (1994-2002) was funded by a US\$23.9 million loan* to preserve and improve environmental quality in the Bay Islands by creating a comprehensive marine and coastal ecosystems management system, strengthening local natural resources planning and management capacity, improving the supply of safe drinking water and basic sanitation, and instituting a cost recovery mechanism to foster sustainable development of the islands.

The project's second phase has been in full development since 2002. Funded by a US\$16.5 million loan,** its purpose is to protect and restore natural resources and coastal and marine ecosystems in Honduras's Bay Islands, its goal being to improve local residents' standard of living and quality of life. Global Environment Facility (GEF) cofinancing will be sought for this phase to promote key stakeholders' participation in marine and coastal ecosystem protection and remediation, biodiversity monitoring and research, creation of a regional protected areas system, and private investment in biodiversity conservation.

Some of the project's accomplishments to date are the implementation of a management plan for the reef, including rules for management of artisanal fishing, sustainable tourism and management of water quality. Other outputs are a geographic information system for decision support, a water-supply watershed protection program, reforestation of critical areas, a formal and nonformal environmental education program, a training program for municipal employees, a water and sanitation master plan for the islands of Roatán and Cayo de Guanaja, new water and sewer systems in the communities of Coxen Hole, French Harbour and Oak Ridge, a solid waste collection, management and disposal plan for the islands of Roatán and Guanaja, and construction of sanitary landfills in Roatán. Active local community involvement, the use of private capital where called for, and explicit attention to the social dimension are essential facets of this program.

* 938/SF-HO

** 1113/SF-HO

6. Urban Environment and Pollution Control

The IDB has furnished considerable support to Central America for programs to curb urban pollution, spur private sector participation in sanitation programs and environmental services delivery, create environmental planning and compliance agencies with real authority in metropolitan areas, design more effective land-use planning and urban growth containment policies, and remedy critical environmental situations in the region's largest cities.

Improving Quality of Life in Cities

The focus of Bank support in this sphere has been an effective and efficient multisectoral management strategy to combat urban pollution. One important requirement that the Bank has understood and addressed in its activities is to involve the whole spectrum of societal stakeholders in the design and implementation of urban pollution abatement solutions. However, the bulk of IDB support has gone into devising definitive solutions

to critical environmental situations in the region's largest cities, such as the National Pollution Control Program in Critical Areas in El Salvador (**Box 16**) and the Lake Managua and City of Managua Environmental Sanitation Program in Nicaragua (**Box 17**). Other operations selected for assistance were an urban solid waste management program in Belize, a local environmental management program in Honduras (**Box 18**), a solid and liquid waste management project in Guatemala City, and MIF-funded clean manufacturing programs in Panama, Guatemala, El Salvador and Costa Rica targeted to small and medium-sized businesses, featuring private sector participation (**Box 19**).

Box 16

El Salvador. Pollution Control Program in Critical Areas. Integrated Solid Waste Management

The IDB provided technical-cooperation support* for the **Pollution Control in Critical Areas Program** in El Salvador to develop a legal and regulatory base for integrated solid waste management. Among the program's outputs and accomplishments are a set of technical standards for composting and sanitary landfill management projects; identification of appropriate final disposal sites; regulations governing integrated solid waste disposal nationwide, and informational activities and training in these topics. One component of the operation established the institutional, legal, regulatory, and monitoring groundwork for air and water pollution control.

* ATN/SC-6147-ES (1998) and ATN/SF-6762-ES (1999)

Box 17

Nicaragua. Lake Managua and City of Managua Environmental Sanitation Program

The **Lake Managua and City of Managua Environmental Sanitation Program** funded with loans of over US\$60 million* from the IDB, the Nordic Fund, and Germany's KfW is helping to rehabilitate and modernize the city of Managua's sanitary sewer system by constructing collecting and intercepting sewers and treatment facilities (67 hectares of facultative lagoons for biological treatment of effluent and ancillary works). The program also is improving environmental sanitation along the shores of Lake Managua by destroying anopheles mosquito breeding grounds, leveling low-lying areas, building stormwater outfalls, launching biological control of mosquito larvae, and creating a community education and participation program. It has developed a biological, physical, and chemical monitoring system for the lake and helped conduct annual epidemiological and entomological surveys.

In the wake of Hurricane Mitch the treatment plant and sewer system designs had to be reworked and the program had to be expanded to continue rehabilitating and modernizing Managua's sanitary sewer system. With US\$15 million in loan funding** that work is now under way.

* 978/SF-NI

**1060/SF-NI

Box 18

Honduras. ISO 14001 Certification for the Municipalities of Tegucigalpa and San Pedro Sula

As part of multisector programs to modernize municipal management and enhance residents' quality of life, Honduras's largest cities, Tegucigalpa and San Pedro Sula, have embarked on an ambitious plan with IDB assistance* to incorporate the environmental dimension into the local development model. Work is under way to create the requisite legal framework, build local institutional capacity for environmental management, and improve municipal solid waste services, basic sanitation and sewer services and green spaces, among others. The ultimate goal is an action plan to attain ISO 14001 certification for these municipalities to afford assurances of sound environmental performance and continuous improvements in environmental management.

* 1024/SF-HO

Box 19

Programs to Promote Business Sector Participation in Clean Production in Guatemala, El Salvador, Costa Rica, and Panama

With MIF support the IDB has helped small and mid-sized businesses in Guatemala, El Salvador, Costa Rica, and Panama adopt clean production technologies and practices.

Technical cooperation projects for US\$1.2 million* currently in progress in Panama, for example, are endeavoring to improve competitiveness of small and medium-sized manufacturing enterprises by developing and implementing environmental management tools. The environmental quality standards developed and new clean production agreements have helped shape an environmental regulatory framework for industry. Demonstration projects have showcased clean industry, initiatives and accomplishments have been disseminated, and specialized training has been delivered. One benefit of this program is an environmental reward system for cleaner production to spotlight the most impressive achievements in clean production, technology innovation, and employee initiatives, among others.

* ATN/MT-7257-PN and ATN/MH-7258-PN

7. Multilateral and Regional Integration Agreements

Following the Earth Summit the Central American nations signed on to a series of international and subregional pacts as a signal of their collective resolve to tackle key environmental issues that concern them all (**Box 20**).

*Fulfilling International Agreements
and Cementing a Regional Vision of
Sustainability*

Meanwhile the countries have continued to pursue regional agreements and make international commitments on an array of environmental issues. In some cases the Central American nations were the first in the world to come up with regional strategies and policies on such matters as biodiversity, forest management and, more recently, conservation and rational use of wetlands. These agreements and their monitoring have been instrumental in environmental policy development in the Isthmus, advancing regional environmental integration in the process.

Box 20	
Main Environmental Agreements Signed by Central American Countries	
International Agreements	Regional Agreements
• Convention on Biological Diversity. Rio de Janeiro, 1992. Ratified by the seven Central American countries. • Convention on Wetlands of International Importance Especially as Waterfowl Habitat. Ramsar, Iran, 1971. Ratified by the seven countries. • United Nations Framework Convention on Climate Change. New York, 1992. Ratified by the seven countries. • Kyoto Protocol to the United Nations Framework Convention on Climate Change. Kyoto, 1997. Signed by the seven countries. • Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal. Basel, 1989. Ratified by three countries, endorsed by another three. • Convention on International Trade in Endangered Species of Wild Fauna and Flora. Washington, D.C., 1973. Amended at Bonn, 1979. Ratified by three countries, endorsed by the other four. • United Nations Convention to Combat Desertification in Countries Experiencing Serious Drought and/or Desertification, Particularly in Africa. Paris, 1994. Ratified by five countries; approval being secured in the other two. • Vienna Convention for the Protection of the Ozone Layer, Vienna, 1985. Endorsed by the seven countries. • Cartagena Protocol on Bio-Safety to the Convention on Biological Diversity. Montreal, 2000. Signed by five of the seven countries. • Convention Concerning the Protection of the World Cultural and Natural Heritage, Paris, 1972. Ratified by five of the seven countries.	• Agreement Establishing the Central American Commission for Environment and Development (CCAD), San José, 12 December 1989. Ratified by the seven countries. • Protocol to the Agreement Establishing the Central American Commission for Environment and Development, San Salvador, 1991. Ratified by five countries; ratification proceedings underway in one country. • Agreement for Conservation of Biodiversity and Protection of Priority Wilderness Areas of Central America. Managua, 1992. Ratified by six of the seven countries. • Regional Convention on Climate Change. Guatemala City, 1993. Ratified by six countries, endorsed by one country. • Regional Agreement on Transboundary Movements of Hazardous Wastes, Panama, 1992. Ratified by six of the seven countries. • Convention for the Management and Conservation of Natural Forest Ecosystems and Development of Forest Plantations. Guatemala, 1993. Ratified by four of the seven countries. • Convention for Cooperation in the Protection and Sustainable Development of the Marine and Coastal Environment of the Northeast Pacific and associated Action Plan. Guatemala, 2002. Signed by six of the seven countries. • Regional Protocol on Access to Genetic and Biochemical Resources and on their Associated Traditional Knowledge. 2002. Endorsed by the seven countries.
Source: CCAD. <i>Central America at the World Summit on Sustainable Development: Our Environmental Commitment</i>. Johannesburg, 2002.	

A further accomplishment in the 1990s was a fresh round of institutional integration moves across the region. That decade also saw the startup of new environmental bodies such as the Central American Commission for Environment and Development (CCAD) founded in the late 1980s (**Box 21**).

Box 21

The Road to Environmental Integration: The Central American Commission for Environment and Development (CCAD)

Central America took the first steps toward environmental integration in 1989 following the Esquipulas II Peace Accords, when Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua signed the Agreement Establishing the Central American Commission for Environment and Development (CCAD). A subsequent addendum to the pact admitted Belize and Panama to the Commission. At this writing the Dominican Republic and Mexico are observers in this environmental integration movement.

The mission of the CCAD, a body of the Central American Integration System (SICA), is to deepen environmental integration in the region in order to further its development, guided by principles of economic, social, and environmental sustainability. Accordingly, the CCAD works to harmonize environmental management policies and systems within its regional action sphere. The IDB-supported PROSIGA program is one of a number of ongoing initiatives to advance regional integration (**Box 23**). Another is the Puebla-Panama Plan (**Box 22**).

The CCAD's strategy roadmap is laid out in the Central American Regional Environmental Plan (PARCA), a medium- and long-range strategy blueprint to directly tackle environmental challenges in the region. Its three strategy focuses are biodiversity and forests, water, and environmental production and management. Underpinning that three-pronged strategy goal is a set of policy aims: change attitudes about natural resources use; promote women's participation; reduce countries' social and environmental vulnerability; decentralize environmental management, and promote public participation and social equity.

The Central American Alliance for Sustainable Development (ALIDES)¹⁵ launched in 1994 consolidated policies, laws, and technical arrangements for the monitoring of regional and international agreements. Within the ALIDES framework the CCAD shepherded regional pacts, including provisions for technical monitoring bodies such as the Central American Forest Council and the Central American Council for Protected Areas. The region's forestry and protected-areas directors, respectively, make up those two councils, which share a secretariat (CCAD/AP).

By way of loans and technical cooperation the Bank has directly furthered the countries' combined quest to protect environmental features that are important to them all. Its studies to systematize environmental experiences, environmental status reports on the region, and issue-specific strategies and action plans have prepared the terrain for agreements and other initiatives to address the Isthmus's most pressing concerns. The Bank's contributions to integrated management of marine and coastal environments, conservation and integrated management of water resources, biodiversity conservation investments, indigenous communities' use rights to

¹⁵ ALIDES gave birth to the Isthmus's first-ever official document associating economic development with the pursuit of quality of life improvements in harmony with nature.

natural resources in tropical forests, and environmental management in small and mid-sized cities are just a few of the avenues whereby it has brought its knowledge and experience to the regional integration process.

Box 22

The Puebla-Panama Plan and Regional Environmental Integration

The Puebla-Panama Plan (PPP) set in motion in 2001 has ushered in an integrated regional development opportunity for Mesoamerica. It affords a regional programmatic framework to spur economic growth, reduce poverty, and augment the region's human capital and natural assets while honoring its cultural and ethnic diversity. The comprehensive regional strategy roadmap envisages an array of Mesoamerican projects and initiatives with Central American integration as its prime focus. Including Mexico's southernmost states within the Mesoamerica concept bolsters this Central American integration dream. The Plan marks a fresh vision of integration, stretching its geographic reach to take in a region that shares similar characteristics and faces similar challenges for sustainable socioeconomic progress.

The PPP's Mesoamerican Sustainable Development Initiative (MSDI) is a cross-cutting programmatic framework. Its overall objectives are to: (i) fashion a regional agreement on a programmatic framework for environmental management and sustainable development, complete with targets, national and regional action plans, and a portfolio of investment and technical-cooperation projects; (ii) help create and set in place a modern institutional apparatus, building management capacity in national and regional authorities to assure environmental quality and sustainability of regional environmental public goods; (iii) ensure the quality of investments (roads, energy, telecommunications and other infrastructure) in all PPP initiatives by harmonizing environmental standards and procedures and making countries more resilient to natural hazards; and (iv) promote sustainable development of multinational natural land and marine-coastal areas of Mesoamerica. The MSDI is guided by the principles of the Mesoamerican Biological Corridor and regional environmental priorities marked out in the Central American Regional Environmental Plan (PARCA) advanced by the Central American Commission for Environment and Development (CCAD). The IDB is supporting this initiative with a US\$200,000 technical-cooperation operation* currently in progress.

* ATN/SF-8261-RG

Region-wide efforts to improve environmental institutions and bolster environmental management have come in for Bank support as well, a prime example being the recently launched Puebla-Panama Plan¹⁶ (**Box 22**). The region now is moving into a second stage in environmental integration, the aim being to harmonize national regulatory frameworks developed in the 1990s so as to achieve regional coherence. The Bank is very actively involved in this process as well (**Box 23**).

If the keynote of the 1990s was institutional capacity building to equip countries to manage the pressures of deteriorating environmental conditions and further sustainable development, the three-part challenge in the present decade is to solidify instruments, laws, and institutions, come up with better responses to investment demands, and strengthen integration ties to advance regional environmental management.

¹⁶ Further treatment of this topic is presented in chapter 3 on regional integration.

Box 23

Support for Harmonization of Central American Environmental Regulations

Through support it is furnishing for the Central American Program for Modernization of Environmental Management Systems (PROSIGA), and more specifically the Project to Support Harmonization of Environmental Regulatory Frameworks,* the IDB is helping to set in motion the first concrete environmental management venture featuring three components with central regional leadership and coordination: environmental impact assessment, regional policies on hazardous substances and wastes, and economic instruments for environmental management. Each of the components has demonstrated the possibilities and limitations of the three different harmonization paths. In the environmental impact assessment sphere work is needed to further develop the instruments the various countries have already adopted and regulated, to move on now to regional issues. There are plans for a regional pact on toxic substances. Moves to harmonize economic instruments will unfold as the countries construct their respective vehicles.

*ATN/SF-7154-RG

VI. Lessons, Challenges and Opportunities

A. Lessons

Though deteriorating environmental quality is still a concern at different points along the Isthmus the countries have made impressive strides in environmental protection since the beginning of the 90s with substantive support from the IDB. New national, regional, and sector policies, laws containing express environmental management mandates, management tools, institutions, participatory processes, measures targeting specific issues, and new strategies in which environmental management is a cross-cutting theme in considerations of competitiveness, social development, and economic integration are just some of the concrete manifestations of these efforts. A host of opportunities has opened up for the region to equip itself for environmental protection challenges.

The following are some of the prime focuses of the Bank's considerable support to further environmental sustainability in the region:

- **Raising public awareness of environmental degradation problems that are diminishing quality of life.** The public awareness and formal or nonformal environmental education components that have been a feature of most IDB-funded institution-strengthening projects in the region have prompted greater concern about the environment and inspired communities to advocate for environmental stewardship. Participatory, consensus-based environmental strategies have been fundamental in this public awareness-raising and in forging civil society-State partnerships.
- **Giving environmental issues a more prominent place in national constitutions and in laws and regulations intended to advance environmental management and build institutional capacity.** Today national environmental authorities are higher up in the political hierarchy (ministries, national environment commissions, etc.) and thus have a higher profile. The IDB has helped elevate environmental concerns in legislation and institutions by way of country and sector-specific capacity-building programs. Virtually every national environmental institution and framework environmental law in the region has received Bank support. Thanks, in turn, to these new environmental management tools and sector laws and regulations, environmental concerns have moved up on political agendas and there are clear rules in place governing the different sectors and activities. The Bank has played an important role in helping each country pursue the environmental management goals mapped out in the early 1990s.
- **Developing and implementing general and sector-specific policies and strategies containing an environmental dimension, which seek to mesh and prioritize environmental issues with other pressing concerns.** In many instances Bank loans and technical cooperation have given countries the resources and technical know-how to craft national environmental strategies. Such is the case of El Salvador's Environmental Protection Program (PAES), Panama's National Environmental Program (PAN), and the National Environmental Management Strategy being developed in Costa Rica. The Bank will be continuing its support for development of watershed, land-use, and natural resources

conservation plans, strategies for the management of fragile environments, etc. Noteworthy initiatives in this sphere have targeted the Bay Islands (Honduras), Darién (Panama), the Upper Lempa River Basin (El Salvador, Guatemala and Honduras) and forestry development (Nicaragua).

- **National, subregional, and regional policy measures to tackle global environmental challenges as the region opens up to new markets and countries move to comply with international conventions and agreements.** With Bank assistance, countries in the Isthmus have helped shape and implement global environmental policies and strategies, some of them intended to reverse global environmental threats such as climate change and ozone layer destruction, with programs and initiatives aimed at highlighting Central America's low share of global responsibility for the causes of those threats. The Bank also has helped a number of countries explore prospects for applying the Clean Development Mechanism.
- **Adoption of environmental management tools, notably economic instruments, and updating of command and control tools that provide a battery of mechanisms to assist in comprehensive environmental management.** With IDB support the Central American countries have developed legislation mandating preventive environmental management and environmental remediation instruments and have fortified the institutional base needed to make those instruments work. A recent object of Bank support has been the systematization of gains achieved in the past decade and elucidation of the challenges the countries are facing today to perfect these tools and the work that awaits them down the road, using for instance the Integrated Methodology for Reviewing Environmental Impact Assessment (IMREIA). The Bank also is helping to integrate environmental legislation across the region as a step toward countries' effective incorporation of the environmental dimension, for example via the Program to Support Harmonization of Environmental Regulatory Frameworks in Central America and CCAD regional integration programs.
- **Creation or strengthening of civil society and business organizations with environmental protection missions and greater participation of such organizations generally in decisions affecting environmental quality.** Local communities and other stakeholders have been directly involved in the design and execution of IDB-supported natural resources management programs targeting natural forests or coastal areas. The programs also have opened avenues of support for civic organizations to help them spur environmental improvements and rational natural resources use. This has bolstered civic groups' organizing and leadership capacity for environmental amelioration action. With MIF support the Bank has helped the business community adopt cleaner technologies to improve production processes, secure environmental seals of approval or certification for their products, and create spaces for dialogue and compacts with country environmental authorities. The Bank thus has helped in the greening of production in a number of countries. Overall this has made for a clearer understanding of the environment-development connection, particularly where the vision of sustainable development is concerned.

- **A multitude of positive experiences with environmental conservation and sound environmental use on the part of the public and private sectors and civil society at the local, subnational, national, subregional, and regional levels.** This is the clearest measure of a decade of efforts, affording good examples of what environmental management can accomplish. The Bank's considerable support on this front has taken the form of loans and technical cooperation as well as environmental case studies and issue-specific strategies and action plans, workshops, seminars and other discussion forums, and publications.

B. Challenges and Opportunities

On the whole, countries in the region have made great strides in environmental protection and management but they still have a way to go to fulfill their environmental policy and legislation mandates. Most of them are still short on institutional capacity and resources to shape, implement, enforce, and evaluate environmental policies effectively and efficiently. To develop substantive capacity to strengthen environmental management the region thus needs: (i) clear, integrated mandates; (ii) skilled human resources; (iii) optimized financial capacity; (iv) administrative procedures that expedite decision-making; and (v) instruments launched and fully operational.

Despite the gains posted over the last decade in environmental management and environmentally sustainable socioeconomic development some stiff challenges still await the region to meet sustainable development imperatives. The following are the major tasks for the present decade:

- **Building environmental management capacity.** Institution-strengthening is still a challenge for countries in this region. The most pressing need now is to build on the gains achieved thus far rather than looking to fine-tune or adopt new policies. Entrenching the environmental dimension is a huge job for these countries, which will need to seize the opportunities opened up in earlier processes. Moves now under way to harmonize environmental legislation should improve the situation and, once solid legal undergirdings are in place, will refine requirements for management tools already in use, such as environmental impact assessment (EIA), standards development for integrated management of hazardous substances, and economic instruments. It will be up to the authorities to decide which priorities require support, match actions to actual resource availabilities, accentuate urban environmental quality management, make subnational agencies partners in environmental management, proactively apply the policies and strategies devised, monitor the workings of environmental management tools, and make countries' environmental management activities more financially sustainable. Some viable mechanisms to that end are the economic valuation of natural resources use and pricing of environmental goods and services. Existing tools such as EIA systems need to be strengthened by improving EIA monitoring, since these instruments are doing more for administrative procedures than for substantive decision support. The task of updating the systems and shifting their focus to the substance of impact assessment is still on country agendas.
- **Incorporating the environmental dimension into policies of other sectors and territorial divisions.** This will mean improving environmental management and putting it at the service of sustainable land use at the national, regional, municipal, local, and watershed level. Some fundamental actions that countries will need to pursue and articulate to that end are to

introduce an environmental dimension into government economic programs and policies; implement an integrated national policy that addresses the environmental consequences of social and economic development, with deeper internal and external integration and valuation of local communities and resources; spur the adoption of decentralized management models, particularly at the municipal level, and implement integrated management models and initiatives for such specific priority spheres as urban and coastal and marine environments, water resources, biodiversity protection, and solid waste management.

- **Design of strategies and regulatory frameworks to improve the water supply, to be able to deliver acceptable volumes and quality of water to growing urban populations.** The lack of controls on coastal aquifer extraction and sewage discharges are compromising the medium-term viability of water sources that currently supply the bulk of the region's population. Much remains to be done to achieve integrated water resources management; the design and implementation of strategies and regulatory frameworks that duly address urban and rural water and sanitation issues are the necessary starting points.
- **Residential solid waste management in major cities.** In light of population increases in the region in the past decade and anticipated growth figures for the coming years the countries will need to establish the policy and regulatory groundwork and create incentives to improve residential solid waste collection and disposal and promote reduction, recycling, and reuse.
- **Air pollution in large cities.** Vehicle congestion and the resulting air pollution are a further cause of concern in the region. Measures are needed to control the number of motor vehicles, promote public transit, regulate stationary pollution sources, and encourage the use of alternative and renewable energy sources.
- **Natural resources conservation and consolidation of protected areas and extremely fragile environments.** A number of protected areas have been created or enlarged in the region and some have received special designations, but in situ conservation and monitoring still need to be bolstered. This will require closer adherence to regional and national strategies and action plans involving biodiversity, wetlands and natural forests, by way of legal reforms that strike a balance between resource conservation and resource use. Countries also need to intensify participatory management and administration schemes for protected areas and extremely sensitive environments.
- **Building capacity in environmental managers.** Civil society and private organizations are gradually taking on a more prominent role in environmental management, traditionally a public-sector domain. More needs to be done to advance this process. The task list would include improving professional development programs, with particular emphasis on environmental administration and ecology-based research; expanding environmental education and information programs to make the public more aware of environmental issues and gradually make a place for these concerns on communities' priority political agendas; creating real avenues for public involvement in environmental management, eliciting input across the social spectrum, and providing environmental education; and encouraging citizens to make their voices heard in such participatory processes, develop a sense of ownership of environmental concerns and steadily step up their demands for environmental progress.

- **Trade agreements require harmonized environmental standards.** In light of the negotiations of the Free Trade Agreement between the United States and Central America (CAFTA) it is urgent that countries take the necessary steps to adjust their standards to improve production processes if they are to seize the opportunities that will be opening up as they gain broader access to U.S. markets. This also will help accelerate the various Puebla-Panama Plan initiatives, particularly for purposes of integrating environmental standards and procedures.
- **Tighter interagency coordination is needed in international cooperation.** International cooperation providers have traditionally addressed countries' environmental needs separately, following an internal logic and with minimal if any interagency coordination. Given the cross-cutting nature of concerns on today's agendas, the movement toward regional integration, and the need to promote an integrated environmental vision, the support delivered by international organizations and donor countries would need to be mutually complementary and synergistic in order to achieve impacts that will truly further sustainable development.
- **Recent moves to tackle regional environmental issues and the associated regional environmental integration process need to be scaled up.** The region is in need of support to quickly address itself to the challenges of current integration ventures (the Puebla-Panama Plan and Mesoamerican Initiative) and free trade negotiations. Capacity-building and information development are essential to improve decision-making on regional environmental concerns.

Annex I

LIST OF PROJECTS HIGHLIGHTED IN THIS CHAPTER

COUNTRY	PROJECT TITLE	LOAN/TC NUMBER	YEAR OF APPROVAL
Belize	Land Administration	1017/OC-BL	1997
Belize	TC for Land Administration	ATN/DC-5610-BL	1997
Costa Rica	System of Conservation Areas	ATN/JF-3917-CR	1992
Costa Rica	Water Resources National Strategy	ATN/WP-8467-CR	2003
El Salvador	Support of Environmental Management	ATN/SF-4336-ES	1993
El Salvador	Decontamination of Critical Areas (PAES)	1209/OC-ES	1999
El Salvador	Environmental Management Program	ATN/SF-4406-ES	1993
El Salvador	Support for Environmental Management (MAG-PAES)	ATN/SE-5025-ES	1995
El Salvador	National Environment Protection Program	886/OC-ES	1995
El Salvador	Design Decontamination Critical Areas	ATN/SC-6147-ES	1998
El Salvador	Support to Municipal Solid Waste Management	ATN/SF-6762-ES	1999
El Salvador	Sustainable Management of the Lempa River Basin	1330/OC-ES	2001
Guatemala	Priority Basin Natural Resources Management	1398/OC-GU	2002
Guatemala	Sustainable Management of the Lempa River Basin	1331/OC-GU	2001
Honduras	Environmental Management “El Cajón” Watershed	787/OC-HO	1993
Honduras	Environmental Management “El Cajón” Watershed	918/SF-HO	1993
Honduras	Bay Islands Environmental Management	938/SF-HO	1994
Honduras	Bay Islands Environmental Management II	1113/SF-HO	2002
Honduras	San Pedro Sula & Tegucigalpa Municipal Development	1024/SF-HO	1998
Honduras	Sustainable Management of the Lempa River Basin	1082/SF-HO	2001
Nicaragua	Forestry Resources Management/ Conservation Program (POSAF I)	970/SF-NI	1996
Nicaragua	Social Environment for Forestry Development (POSAF II)	1084/SF-NI	2001
Nicaragua	Environmental Improvement Managua Lake	978/SF-NI	1996
Nicaragua	Implementation Sanitation Measures Managua Lake and City	1060/SF-NI	2000
Panama	National Environmental Program (PAN)	1222/OC-PN	1999
Panama	Darien Sustainable Development	1160/OC-PN	1998
Panama	Support for Marine Coastline National Program	ATN/FG-8276-PN	2003
Panama	Forest Sector & Strategy Policy	ATN/NC-7015-PN	2000
Panama	Promotion of Clean Production Techniques for Business	ATN/MT-7257-PN ATN/MH-7258-PN	2000
Regional	Evaluation of Institutional Strengthening Projects	ATN/NP-7578-RS	2001
Regional	Maritime Transport Pollution Control	ATN/PD-7402-RS	2001
Regional	Sustainable Development Basin Area Río Sixaola	ATN/SI-8060-RS	2002
Regional	Environmental Assessment Review in Latin America & C.A.	ATN/JF-6618-RG	1999
Regional	Support for MesoAmerican Environmental Program (PPP)	ATN/SF-8261-RG	2003
Regional	Support for Harmonization of Environmental Regulations in C.A.	ATN/SF-7154-RG	2000

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CHAPTER 8: NATURAL DISASTERS RISK MANAGEMENT

Stephen E. McGaughey¹

Introduction

Since the 1990s, the six Central American countries, plus Panama, that make up the Central American Isthmus have been struck by a series of natural disasters –brought on by floods, hurricanes, landslides, forest fires, earthquakes, volcanic eruptions, and tidal waves— and have become more vulnerable to such hazards. Vulnerability has worsened for a variety of reasons, including a rapidly growing population, an increase in the number of poor, deterioration in the environment through deforestation and degradation of watersheds, the expansion of agriculture into previously unfarmed areas, and a major increase in the pace of urbanization. Simply put, there are now more people in harm's way in Central America and Panama.

The recent disasters of Hurricane Mitch, the El Niño phenomenon, and twin earthquakes in El Salvador were catastrophic for El Salvador, Honduras, and Nicaragua, and severely impacted Guatemala. In addition, Belize, Costa Rica, and Panama have been affected directly by these and other disasters, or indirectly by the disasters befalling their neighbors. The number of deaths, the magnitude of the population displaced, the housing damaged, and the roads, bridges, schools and health facilities destroyed or damaged all increased notably from the 1980s to the end of the 1990s. The economic, financial, and social impacts of the disasters have been very substantial, and have reduced growth and increased poverty in the region.

The countries of the Central American Isthmus, regional institutions, and the international community responded promptly to these crises. Working together, they have put in place plans to modernize the region's emergency/disaster management agencies and strengthen organizations to deal with disasters before they strike, in the form of risk management programs and policies. The introduction of disaster risk management programs in national institutions, as well as sector and regional policies and strategies, has been facilitated by international aid and assistance. The Inter-American Development Bank has been a major contributor to this process of institutional modernization and reform for disaster risk management.

In 1999, the region took a major step forward with the agreement by the heads of states of Central America and Panama to a Strategic Framework for the Reduction of Vulnerabilities and Natural Disasters in Central America. The main regional disaster prevention organization, CEPREDENAC (the Center for Coordination for Natural Disaster Prevention in Central American), provided technical leadership. The framework committed the countries to shift their disaster program priorities from post-disaster

¹ The author wishes to give special recognition to Caroline L. Clarke, Senior Disaster Prevention & Risk Management Specialist, in the Natural Resources and Management Division, for her valuable insights and contribution to this Chapter.

emergency response to pre-disaster risk prevention, and mitigation of disasters (see Box 1). The major disasters of the late 1990s pushed this process of change forward, complementing the countries' efforts, begun in the mid-1990s, to strengthen their emergency agencies. New legislation has been approved in several countries to coordinate systems of prevention and mitigation at the national, regional, and local levels.

Box 1 **The Disaster Risk Management Approach**

Disaster risk management refers to the planning and application of policies, strategies, and measures that reduce and/or control the possible adverse effects of the natural phenomenon on populations, economic and social infrastructure, and goods and services. Disaster risk management covers a wide range of activities before, during, and after disasters strike, including risk identification, prevention, and mitigation, emergency/disaster preparedness, financing risk transfer, and emergency response and reconstruction.

Ex-ante Measures:

- **Risk Reduction:** Measures and actions taken *before* the threat (natural hazard) appears. The broadest term, it includes risk prevention (prospective management of risk), risk mitigation (corrective actions to reduce existing risk), and emergency/disaster preparedness.
- **Risk Prevention:** Measures and actions that attempt to predict *new* risks and prevent their occurrence, associated with new development projects and investments. In practice, complete risk avoidance is rarely feasible but, like mitigation, is considered to be a standard of what is acceptable or feasible risk reduction. Tools such as land use planning and building standards are used here.
- **Risk Mitigation:** Intervention measures aimed at reducing *existing* risk. Mitigation assumes that in many circumstances, it is neither possible nor feasible to avoid or control risk completely, but it can be reduced to levels that are acceptable or feasible, through such measures as, for example, retrofitting infrastructure to be more resistant to earthquakes, wind, or floods, land terracing against landslides, redundancy in service provisions, education, and reinforcement of adobe homes to withstand earthquakes.
- **Emergency/Disaster Preparedness:** These measures put the country in a state of readiness to respond effectively and rapidly to a disaster or emergency when it occurs. These include planning measures to organize and facilitate operations for the effective and opportune provision of early warnings, search and rescue activities, and rehabilitation of the population and the economy in case of a disaster. These are primarily civil protection systems, but also include emergency and contingency planning of line ministries, social investment funds, and businesses to deal with humanitarian needs and to stabilize the situation.

Ex-post Measures:

- **Emergency/Disaster Response.** Institutional response and coordination of operational activities to save lives, protect assets, and achieve an adequate state of normalcy as quickly as possible following the disaster. This is what is often thought of as humanitarian assistance to stabilize life safety and restore basic services.
- **Recovery** is another broad term, expressing a process to restore adequate and sustainable living conditions in the affected area or communities and productive activities. The recovery process includes the measures of rehabilitation, repair, reconstruction, or replacement of destroyed, interrupted, or deteriorated infrastructure and goods and services, as well as the reactivation of economic and social activities in affected communities.

The IDB also responded to the disasters by refining its own programs and policies to support the countries in their shift from emergency/disaster management to risk management. In 1999, the Board of Executive Directors approved a new Policy on Natural and Unexpected Disasters that stressed prevention and improved the efficiency of the Bank's post-disaster response time and services. Together with the Policy in 1999, the Bank established a mechanism for quick financing of the countries' emergency needs, the Immediate Response Facility. Subsequently, at its annual meeting in 2000, the Bank considered an action plan for disasters, which has served as the framework for coordinating a range of programs and policies which focus on a wider set of pre-disaster risk management programs and policies. The Disaster Prevention Sector Facility, a dedicated loan instrument with streamlined preparation, is available to the countries since 2001 to promote new disaster risk management institutional policies. The Bank now regularly incorporates risk management subprograms into technical cooperation and loan programs in other sectors.

The IDB has provided considerable support for natural disaster response and disaster risk management activities. In the period 1995-2000 alone, the Bank approved 25 disaster-related loans totaling US\$956 million to the countries of the region for pre- and post-disaster support. Projects included emergency response and reconstruction, as well as resources for pre-disaster prevention and mitigation, closely related to programs on environmental and natural resource management, housing, local development, and institutional building and technical capacity for risk management.

The experience of recent years has yielded solid lessons for application in future disaster risk management programs. The main one is vigilance. A culture of prevention and awareness needs to be constantly promoted in the countries to sustain the preparedness and risk management programs through periods when disasters are less frequent. Otherwise, institutional capacity will wane and the countries' vulnerability will continue to increase.

Countries have also begun to recognize the key role of local community organizations in preparing for and reducing vulnerability to future natural hazards, whether large or small. Local development programs are critical conduits for incorporating local disaster risk prevention and mitigation investments and organization. The improvement of emergency response institutions throughout the region has led to the conclusion that risk reduction programs are organizationally distinct from emergency response functions. Some countries have separated the activities by placing them in different institutions or have separated the functions in individual agencies.

The IDB has learned the value of having specialized mechanisms to deal with disasters and to finance and promote the introduction of modern risk management capacity in Latin America. The acceptance of these risk management practices as an integral part of social and economic development is just beginning in Central America, and the IDB stands ready to continue supporting this process in the coming years.

I. Disaster Vulnerability in the Central American Isthmus: A Major Social and Economic Challenge

A. Introduction

Over the last 3 decades, the incidence of catastrophic disasters in the Central American region has risen. In the late 1990s, a series of windstorms, floods, landslides, droughts, forest fires, and earthquakes struck the region. The major natural disasters (Hurricanes Mitch, Iris, and Keith, El Niño; earthquakes) have been accompanied by many thousands of lesser, local disasters. The destruction and devastation following these disasters has been the unfortunate byproduct of environmental mismanagement and rapid and poorly controlled urbanization that have increased the vulnerability of local populations to natural hazards. All of these disasters, both large and small, have disproportionately affected the poor population and regions. Moreover, they have set back countries' efforts to increase their growth rates. The economic and financial costs of responding to each disaster have been very high. The disasters have made it necessary for the international community to mobilize financial resources and technical assistance, often diverting them from more basic assistance strategies; and they have detracted from the main business of social and economic programs of the region.

The Guatemala Declaration and a New Regional Strategic Framework. In 1999, in the aftermath of Hurricane Mitch and the very serious economic and social damage that resulted, the leaders of the Central American countries came together in Guatemala to pledge to strengthen the regional and national institutions responsible for the prevention, mitigation, and emergency response to disasters. Governments, with the support of international and regional institutions, undertook an evaluation of their disaster policies and activities, and approved a structure for natural disaster policies and programs in the Declaration of Guatemala. The *Strategic Framework for the Reduction of Vulnerabilities and Natural Disasters in Central America* is a regional commitment to the prevention and mitigation of disasters. It challenges the regional and national agencies to integrate the new concept of risk management, prevention, and mitigation into their programs and seeks international assistance to support these objectives. Fundamentally, it integrates the natural disaster framework with regional sustainable development policies. This strategy represents a significant step forward by the region to delimit effective responses to disaster risk. In December 2003, the countries evaluated their progress in meeting the goals of the Framework, published in a series of national reports, "*Mitch+5*".

Also in the late 1990s and early 2000s, the IDB reacted to the crisis by introducing new policies, programs, and lending mechanisms to help the countries reduce their exposure to natural hazards and the inevitable future disasters with risk prevention, mitigation, and preparedness programs.

The IDB took the lead in coalescing international donor support for the region after Hurricane Mitch through Consultative Group Meetings. The Bank also committed significant financial and technical resources to assist the countries most affected by the disasters. It focused its technical support on increasing both national and regional capacity to respond to emergencies and to decrease vulnerability in countries through their reconstruction programs. However, even before the catastrophe of Hurricane Mitch in 1998, the Bank had begun to incorporate environment and natural resource management activities and programs into its loans and technical assistance programs that sought explicitly to reduce the countries' vulnerability in some areas.

This report summarizes the IDB's financing and other complementary activities to deal with disaster emergencies, reconstruction, and prevention and mitigation. It depicts the Bank's shift in emphasis from post-disaster response programs to a new style pre-disaster risk management—especially the reduction of potential losses through prevention and mitigation of risk. For the IDB, disaster-related services now include not only emergency measures and reconstruction, but the implementation of national and regional policies and programs that reduce vulnerabilities to natural hazards over the long term.

B. A Profile of Disasters in the Central American Isthmus

In recent years, disasters have struck a growing and significant share of the population in the region. The number of inhabitants directly affected by disasters doubled, from about 3.1 to 6.1 million, and the number of reported deaths increased sixfold, from 3,565 to 20,626, in the last two decades (1981-90 and 1991-2000). During the 1980s, a large number of people throughout the entire region saw their livelihoods severely damaged by disasters, while in the 1990s, Honduras, Nicaragua, Belize, El Salvador and Guatemala suffered earthquakes, hurricanes and drought. These stark numbers testify to the growing economic and social impact of disasters and underscore the recognition that disaster risk management is a new and important national policy goal for the development of the Central American region.

The most devastating recent event was Hurricane Mitch, which struck extensive areas in 1998, especially Honduras and Nicaragua, as well as parts of Guatemala and El Salvador. Millions of people were affected. Just before Hurricane Mitch struck, the El Niño phenomenon had caused droughts throughout the region. This increased the countries' vulnerability to the high winds and heavy rains of the hurricane. The extensive destruction of social, productive, and basic infrastructure set back economic development in the region and shifted the attention of government authorities and civil society to reconstruction, and away from core development needs.

The diversity and intensity of natural hazards that have befallen Central America can be seen in the list of major disasters from 1992 to 2001 in Annex I. This list omits the many thousands of small disasters that happen frequently throughout the region. Several disasters jolted the whole region, including Hurricane Mitch in 1998 and the El Niño drought of 1997-98. Others were more localized, including numerous tropical storms such as Michelle that affected Honduras and Nicaragua in 2001; Hurricane Iris in Belize

and Guatemala in 2001; droughts in Costa Rica, Nicaragua, Guatemala and Honduras in 1997 and 2001; Hurricane Cesar in Costa Rica and Nicaragua in 1996; volcanic eruptions in Nicaragua in 1995 and 1992, and in Costa Rica and El Salvador in 1990; Tropical Storm Bret in Nicaragua and Honduras in 1993; and a tsunami (tidal wave) in Nicaragua in 1992.

C. Sources of Vulnerability

Several trends in Central America contribute to its growing vulnerability to natural hazards. Population pressures, the expansion of the agricultural frontier, massive deforestation, the degradation of watersheds, and poorly planned, rapid urbanization all combine to increase the destruction caused by the region's natural hazards.

Widespread environmental deterioration, on the one hand, and rapid and unregulated urban growth, on the other, are the two most significant elements shaping the disaster risk profile of the region. One source of environmental deterioration has led to others. Deforestation has continued at a rapid pace. This has increased water runoff, landslides, soil erosion into reservoirs, lakes and river, forest fires in the degraded areas, downstream flooding, and in turn worsened the vulnerability of communities, watersheds, and the region with the direct loss of property and life.

Population expansion and agriculture expansion have increased pressure on natural forests and resulted in the loss of forest cover. The economic and demographic transition under way in Central America has transformed the region from a predominately rural society to one with rapidly growing urban centers. Many rural poor families have relocated to cities to seek employment, and end up living in vulnerable areas, including riverbeds and steep slopes. Many dwellings are poorly constructed. Public services are fragile and subject to interruption by disasters.

Despite enormous private and public investments in physical assets, measures have not kept pace to protect assets and to ensure the safety of urban dwellers. Vital goods and services such as food distribution networks, water supply, and fuel distribution systems are particularly vulnerable to damage caused by natural hazards. The breakdowns in these systems have led to significant problems for the threatened populations. The interruption of water networks in an earthquake, for example, not only reduces the capacity to fight fires, but also accelerates the deterioration of health conditions and with it, the increase in the number of victims.

Today the Central American region is more at risk of suffering truly catastrophic disasters than it was 50 years ago. Certainly the region has seen the consequences of this cumulative vulnerability in recent years, as the economic costs, social disruption, and human toll from disasters have all risen.

D. The Economic Consequences of Disasters

To ascertain the impacts and vulnerability issues in Latin America, the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) undertook a

review of the region, in conjunction with the IDB.² The major long-term economic impacts of natural disasters fall into several categories: the destruction of economic and social infrastructure, environmental damage, external imbalances, extraordinary fiscal imbalances, inflationary processes, and negative income distribution.

The significance of the economic loss from natural disasters is a function of the both the geographic scope and magnitude of the event relative to that of the affected national, regional, and local economy. In the case of Hurricane Mitch, ECLAC estimated that the ratio of the loss to Gross Domestic Product (GDP) was 13.2 % for Central America. This was the highest relative impact measured of major events in Latin America, greater than any experienced in Mexico or the Andean Region.³

Table 1. Costs of Damage, Selected Natural Disasters		
Country	Event/Date	Total Damage (millions US\$ 1998)
Central America	Hurricane Mitch/Oct 1998	\$6,000
Costa Rica	El Niño/1997-98	93
Nicaragua	Hurricane Cesar/1996	53
Costa Rica	Hurricane Cesar/1996	157
Nicaragua	Tsunami/1992	30
Nicaragua	Eruption Cerro Negro/1992	22
Nicaragua	Hurricane Joan/1988	1,200
El Salvador	Earthquake/1986	\$1,400

Sources: ECLAC and IDB, *A Matter of Development: How to Reduce Vulnerability in the Face of Natural Disasters*, 2000.

Hurricane Mitch had a clear and devastating economic and social impact on Central America. The total economic loss was on the order of US\$6 billion, according to ECLAC. This represented a significant loss of GDP for the three countries most affected: Honduras, Guatemala, and Nicaragua. The GDP of Honduras fell by 7.5 percent following the disaster.

While the catastrophic events of the late 1990s and early 2000s and the size of the impacts attracted the concern of the national authorities and the international community, the frequency and economic significance of the events do not differ greatly from previous natural disasters in the area. Damage from Hurricane Joan in Nicaragua in 1988 and from the earthquake in El Salvador in 1986 each exceeded US\$1 billion, according to

² *A Matter of Development: How to Reduce Vulnerability in the Face of Natural Disasters*, March 2000, prepared for a seminar at the annual meeting of the Inter-American Development Bank, New Orleans, March 25-26, 2000.

³ Ibid.

ECLAC estimates. These were very substantial economic and social costs relative to the size of the economies of those countries in the late 1980s.

E. National and Regional Institutions for Disaster Response and Risk Management⁴

In the 1990s, the emergency institutions in the Central America Isthmus underwent a gradual technical improvement and organizational transformation. Most of these institutions were called national emergency committees or civil protection/defense committees. They were either attached to civil authorities (typically ministries of public works, interior, or defense) and administered by them, or to military authorities. At the beginning of the 1990s, they were largely dedicated to emergency preparedness and post-disaster response. They were organized in such a way as to provide very little risk prevention and mitigation –let alone to identify and promote disaster risk management programs and policies in development planning. The organizations were centrally managed, although they had operational capabilities at the local level. Compounding the problem, local organizations and governments were relatively weak, as a result of the social, political, and military conflicts of the 1980s.

Over time, these emergency organizations gradually began to recognize and incorporate the concepts of disaster preparedness into their work programs, although not on a systematic basis. At that time, the organizations had limited experience in coping with large-scale disaster response. Frequently, ad hoc organizations were established by the countries after the large disasters, thereby sidestepping the official entities. These institutional dynamics often confused lines of authority and responsibility in managing the crises and generated logistical problems.

The crises of the late 1990s stemming from Hurricane Mitch and El Niño accelerated national and regional demands for the transformation of national and regional emergency response institutions and line agencies—environmental ministries, housing institutions, road sector agencies, municipal governments, planning agencies, and finance ministries. Major natural disasters also increased the international and regional commitment to strengthening local authorities and community organizations by highlighting the importance of effective action at the local level.

In 1995, just seven years after its beginnings as a regional NGO, CEPREDENAC had sharpened its focus, governance structure, and mission and it was formally incorporated into SICA (the Central American Integration System) as the specialized regional disaster prevention agency, with participation of all the Central American Isthmus countries. From the start, international multilateral and bilateral sources, especially the Nordic

⁴ Much of this section is derived from the following source materials: (1) Alan Lavell. “Prevención y Mitigación de Desastres en Centroamérica y Panamá: Una Tarea Pendiente” in *Desastre y Sociedad*, No. 1, Año 1. Julio-Diciembre 1993. pp. 2-22. LA RED (Red de Estudios Sociales en Prevención de Desastres en América Latina. (2) Luis Rolando Durán Vargas. *Análisis del Estado de Situación de Sistemas Nacionales y Avances de Implementación del Marco Estratégico para la Reducción de las Vulnerabilidades y el Impacto de los Desastres*. San José de Costa Rica, 21 de octubre de 2002. Centro de Coordinación para la Prevención de los Desastres Naturales en América Central (CEPREDENAC) y BID. (borrador), p. 37.

countries, provided substantial assistance to the organization. Following Hurricane Mitch, the IDB, the World Bank, the UN Development Programme (UNDP), and many traditional bilateral sources provided major funding. CEPREDENAC worked with other SICA regional organizations and national emergency management and scientific institutions to further the application of prevention and mitigation strategies and disaster risk management. CEPREDENAC's leadership was pivotal in leading to the Guatemala Accord of 1999, which led to the incorporation of disaster risk management in regional development policies and strategies.

The non-governmental sector was also consolidating its efforts in risk management both regionally and nationally in the late 1980s and the early 1990s. In the early 1990s, an active regional network of universities and national NGOs from Central and South America was launched, including LA RED (The Network of Social Studies for Prevention of Disasters in Central America). Again, support from international institutions such as the OAS and bilateral donors, has been critical.

As mentioned, in the aftermath of Mitch, significant political and financial support was mobilized for CEPREDENAC and for the conversion, reorganization and strengthening of disaster institutions throughout the region and the crises stimulated national support for several countries to reform their institutions. They set up new organizational structures and agendas, invested in human resource development, decentralized participation in prevention and mitigation programs, and introduced disaster risk management, and legislative reforms.

- **Belize** established the National Emergency Management Organization (NEMO) in 1998 and from 1999 to the present, the country invested heavily in a variety of measures, including studies, training, the creation of a national emergency operations center, the preparation of a disaster management plan, and the evaluation of natural hazards and risks.
- **Costa Rica** approved the National Emergency Law in 1999. The law has a strong disaster prevention, mitigation, and response component establishing links within the prevention system among COEM (the Center for Emergency Operations), the technical advisory committees and the regional, local and community emergency committees. The law improves construction codes and procedures and regulates the demolition of buildings in high-risk areas, on an emergency basis.
- **El Salvador** created, in 2002, the SNET (National Service for Territorial Studies), attached to the Ministry of Environment and Natural Resources, for the promotion of disaster risk management policies and programs. The long-standing National Emergency Committee (COEN) has the responsibility for emergency preparedness and response. This institutional separation of core functions from post-emergency response is helping El Salvador promote risk reduction more broadly and is a desirable organizational reaction to the past experiences in the region. At the local level the FISDL (Social Fund for Local Development) and COMURES (the National

Congress of Municipalities) have also joined SNET and COEN, by introducing local disaster risk management programs.

- **Guatemala** established a Natural Program for Mitigation and Response to Disasters in 2001 that formalizes SINAMRED (the National System for Multisectorial Management of Risk Reduction). SINAMRED is a coordinating mechanism for CONRED (National Coordinator for Disaster Reduction), the lead institution responsible for prevention and mitigation programs and the decentralization of these activities, and SEGEPLAN, the coordinating institution for the Sectoral Development Planning System. This step is promoting the integration of risk management functions across sectors and across regions in the country.
- **Honduras** passed the National Emergency Law in 1990, establishing the basis for the functioning of the main government disaster agency, COPECO (Permanent Emergency Commission). COPECO works in a network with other specialized government and private agencies, especially the Secretariat of Environment and Natural Resources, firefighter brigades, the Red Cross, the Secretariats of Health and Education, and national and community organizations. In 2003, Honduras approved a new Land Use Law, which is helping to facilitate the national and local application of disaster risk management practices.
- **Nicaragua** approved an innovative integrated approach to organizing future risk management activities in 2000. SINAPRED (National System for Disaster Prevention, Mitigation and Response) established a lead institution and secretariat for a multisectoral and regional system of institutions with the responsibility for prevention and mitigation functions, including local municipal authorities and community NGOs.
- **Panama** established the SINAPROC (National System for Civil Protection) in 1982 as a network of national institutions responsible for coordinating key emergency institutions. Today, SINAPROC works as a system of institutions, each responsible in its own functional areas or sectors, including the main line ministries, such as the environmental agency, as well as civil society institutions. The COE (Center of Emergency Operations) was set up and equipped to administer the operational aspects and coordination during emergencies. Panama benefited from having the Secretariat of the CEPREDENAC located in that country through the 1990s, although CEPREDENAC was rotated to Guatemala in January 2004.

Several trends characterize the modernization of national disaster risk management systems in the region. Reinforced by regional policies and programs, countries are incorporating disaster risk management as a main item in the agenda of emergency agencies originally designed exclusively for emergency response and are bringing in line agencies to diminish risk. At the same time, the national agencies have incorporated municipal authorities and local organizations into their network of activities. They have mounted educational programs for local communities on emergency preparedness, as well as prevention and mitigation. This growing culture of local prevention and

mitigation through community involvement will improve response to future disasters—both large and small.

F. The IDB's Evolving Approach to Disaster Risk Management

Since the mid-1990s the IDB has worked in close partnership with the countries in responding to natural disasters.

An important step was to speed up disbursements to react immediately to disasters. Starting in 1993, the Bank delegated to its Country Offices approval authority of modest amounts of technical cooperation funds, usually up to US\$50,000, to provide emergency agencies with funds—usually within 48 hours. This step also signaled a public commitment of the Bank to the country in times of crisis. Once the original emergency had been addressed, the Bank proceeded rapidly to mobilize important additional resources by reformulating existing loans with undisbursed balances, approving new loans and technical cooperation operations, and launching the new emergency operation facility in the late 1990s.

Typically, in a few weeks, the Bank is able to approve the reassignment of as-yet undisbursed balances of loan and technical cooperation projects to respond to the financial demands of reconstruction. El Salvador and Honduras benefited from loan reformulations after Hurricane Mitch and the two earthquakes. Often the reassigned funds are related to the initial objective of the loan being reformulated. For example, funds for a health loan operation might be used to reconstruct or reequip health posts or hospitals; education loan funds might be reassigned to reconstruct affected schools. Reformulation of existing loans is not always an efficient approach, however, as it may disrupt the overall country programming strategy with the Bank, and it may displace the use of funds from other sectors.

Through a variety of mechanisms, IDB has steadily supported reconstruction and rehabilitation efforts in its regional member countries after disaster strikes. The early generation of Bank disaster-related projects typically financed big-ticket items, such as the rebuilding of water and sewerage systems, electricity, and roads and bridges. Through the 90s, these have been complemented by large infrastructure investments with projects to reestablish social services, such as health, education, and housing. The Bank also has worked with countries to incorporate good engineering into construction to ensure that new infrastructure will be less vulnerable to future natural hazards.

The new generation of Bank disaster-related projects aims to help countries move from recovery efforts back to the path of development as efficiently as possible. Bank financing is aimed to directly benefit the poor. It includes small projects to repair and rebuild water and sanitation infrastructure, stabilize slopes in danger of sliding, and flood control works in low-income communities. Other steps benefiting the most vulnerable are programs to protect recurrent public expenditures that improve living conditions and economic opportunities for the poor. This newer generation of projects has also helped countries ameliorate adverse macroeconomic impacts of the disasters, including financing

to cover the shortfall in recurrent public expenditures for vital social programs, assisting to cover balance of payments shortfalls and restructuring debt exacerbated by the need to pay for the recovery.

In summary, two fundamental shifts have occurred in the Bank's policies, practices, and programs for natural disasters. First, the Bank has broadened its objectives of disaster risk management by ensuring greater attention to prevention and mitigation, as opposed to the more traditional preparedness and preparation and emergency response. Second, the IDB, in close consultation with its member countries, decided to establish new mechanisms to assist in natural disasters. The Bank set out the full range of Bank options in the Policy on Natural and Unexpected Disasters, approved in 1999 (see Box 2). An Action Plan, prepared in 2000, lays out a framework for support to reduce disaster risks through a variety of instruments (Box 3). The range of Bank activities is presented in the next section of this chapter, which provides examples of IDB-financed programs carried out in the Central American countries from 1990 to the present.

Box 2
IDB Instruments for Natural Disaster Programs

Post-disaster:

- Policy on Natural and Unexpected Disasters (March 1999)
- Technical Cooperation for Natural Disaster Emergencies
- Reformulation of existing loans and reassignment of loan funds to emergency activities and reconstruction
- Immediate Response Facility (formerly called Emergency Reconstruction Facility)

Pre-disaster:

- Disaster Prevention Sector Facility
- Investment loans and technical assistance operations

Box 3
**Components of the IDB Action Plan
for Disaster Risk Management**

- Assist in creating and strengthening national systems for disaster prevention and response
- Encourage a culture of prevention
- Reduce vulnerability of the poor
- Involve the private sector
- Expand risk information for decision-making
- Foster leadership and cooperation in the region

II. IDB-Supported Programs for Disaster Risk Management in Central America

A. Introduction

During the period 1995-2000, the Bank approved 25 loans totaling US\$956 million for the countries of the Central American Isthmus for pre- and post-disaster support. Projects ranged from emergency response, reconstruction, prevention and mitigation measures, closely related environmental and natural resource management, local development for disaster protection and response and institution building and enhancing technical capacity for risk management. The main beneficiaries of IDB lending were El Salvador, Honduras and Nicaragua, as a consequence of Hurricane Mitch and the two earthquakes in El Salvador in 2001. Guatemala also received significant assistance after Hurricane Mitch and the El Niño phenomenon. In addition, approximately US\$230 million in undisbursed balances of existing loans were reformulated for Belize, El Salvador and Honduras for post-disaster reconstruction support.

The countries have at present a wide gamut of financing mechanisms and options available from the Bank to cope with the effects of disasters depending on the size, intensity and seriousness of the impacts on the country. And there has emerged a recognition and commitment in the international community to assist countries in preparing for future disasters through financing mechanisms that help the countries evaluate their vulnerability, institutional capabilities and financial alternatives, and introduce a broad range of public policies that mitigate future threats. There is a wide acceptance now that the preparation for disasters is not just in the organization of the post-disaster response, but rather through the introduction of policies and programs that reduce the vulnerability of the country to social, financial and physical impacts of future natural hazards.

This section will present the loan and technical cooperation programs of the IDB for major categories of disaster lending in the Central American region. The IDB's method of support for Central America before and after natural disasters will be presented from a variety of angles –as a coordinated response to major disasters, assisting individual country and regions through loans and technical assistance projects and sector approaches to disaster prevention and mitigation.

B. Major Challenges for Risk Reduction and Disaster Response

This subsection will present the two serious challenges the countries and the IDB have had to face in Central America in recent years –Hurricane Mitch in 1998 and two earthquakes in El Salvador in early 2001. In each case the Bank mobilized its leadership, technical staff and financial resources in an immediate response to the human suffering and economic loss. After Hurricane Mitch a series of national and international consultative meeting were organized to mobilize the support of the international financial donor community for reconstruction. These two major disasters are models for future

response and they raise the expectation of more thoughtful pre-disaster preparation for natural hazards throughout the region in the future, leading to a recognition and political commitment to anticipate and reduce the vulnerability of the countries to natural hazards.

1. Hurricane Mitch

Mitch, an intense, slow moving hurricane, struck the region in late October and early November 1998, and left major impacts in Honduras and Nicaragua, in Guatemala and El Salvador to a lesser degree, and while it did not strike Costa Rica, new migration from the affected areas in Nicaragua and Honduras was induced. This was the worst natural disaster in the history of Central America, affecting a larger area, and more people and assets than ever before.

Official statistics, even though in some cases only partial, can only begin to tell the story of the devastation wrought by Hurricane Mitch throughout the region. The toll on human lives was substantial, as there were more than 10,000 recorded deaths, 9,000 people reported missing and over three-quarters of a million evacuees.

Destruction and serious damage to infrastructure were particularly widespread, as thousands of kilometers of roads were seriously damaged, 365 bridges collapsed, water and electricity services were especially affected, 33,000 homes were destroyed and hundreds of thousands seriously damaged, 4,000 schools were destroyed and a large number of health centers damaged.

In Honduras, seventy percent of agricultural production was lost, especially coffee, banana, melon, watermelon and basic grains and in Nicaragua, 80 percent of the coffee harvest was lost.

Immediately following the hurricane the IDB dispatched urgent missions to the region to ascertain the damage and accelerate financing and assistance measures. From the Bank's portfolio of loans, resources were redirected to urgent emergency needs. Within two months the Bank had approved US\$370 million in new loans for reconstruction in Honduras, Nicaragua, Guatemala and El Salvador. In addition, US\$310 million were redirected from existing loans already approved by the Bank before the disaster and US\$100 million was contributed to the Central American Reconstruction Fund. The Multilateral Investment Fund (MIF) approved a US\$12 million fund for micro-credit institutions. Emergency grants of US\$400,000 to the countries hit by Mitch were approved by the IDB as well as a US\$1 million technical cooperation grant to assist Honduras prepare a national reconstruction plan.

Following Hurricane Mitch a series of meeting were organized with the participation of the heads of state of Central America. The first meeting, the *Consultative Group for the Reconstruction and Transformation of Central America*, was held at the IDB Headquarters in Washington in December 1998, hosted by the President of the IDB, with the participation of the Presidents of Honduras, Nicaragua, El Salvador, Costa Rica, the Vice President of Guatemala, the President of the World Bank, the Managing Director of the International Monetary Fund and 50 donors from the international community.

Pledges of US\$6.2 billion were made in that meeting and it was agreed that a series of international and national follow-up meetings would be held to follow through on these pledges. It was agreed that the consultative group would meet again in May 1999 in Stockholm under the joint auspices of the IDB and the Government of Sweden. A significant outcome was that it was agreed in the initial meeting in Washington that consideration would be given to accelerating debt reduction for Honduras and Nicaragua in response to the financial demands of the disaster.

The following meeting, *The Consultative Group Meeting for the Reconstruction and Transformation of Central America*, was held in Stockholm in May 1999, with the participation of the national, regional and international leaders including the Prime Minister of Sweden, the President of the IDB, who chaired the meeting, the Presidents of Nicaragua and Honduras, Vice Presidents of Guatemala, El Salvador, Costa Rica, the Secretary General of the United Nations, the Secretary General of the OAS and the Vice President of European Union, among more than 500 participants.

The President of the IDB emphasized four central issues in his opening remarks at the Consultative Meeting: (i) the urgency of affecting a rapid recovery in light of the devastation and loss of life in the Isthmus; (ii) the need not to overlook the opportunity to promote the transformation of the region, the theme of the consultative meeting being “*Reconstruction Must Not be at the Expense of Transformation*”; (iii) the continued need to effectively implement the national reconstruction and transformation plans; and (iv) to further strengthen regional integration. The international community and the national governments committed themselves to transparency and accountability, decentralization and local participation, environmental protection, poverty reduction and the sustenance of democratic institutions and procedures.

2. Two Earthquakes in El Salvador

The reaction of the international community to the devastating tragedies of two earthquakes one month apart in El Salvador demonstrated that the countries of the region and the international community had learned lessons from the natural disasters of the 1990s. The countries and international and regional partner organizations responded rapidly and the countries employed IDB's new financial mechanisms for quickly directing resources to the emergency and to accelerate economic, financial and social recovery. The deepening commitment of the government, civil society and citizens to establish new disaster organizations and to prepare for future events was recognized as a byproduct of this experience.

Box 4

Earthquakes in El Salvador

On January 13 and February 13, 2001, El Salvador was hit by earthquakes that took 1,160 lives and damaged an estimated US\$2.9 billion in infrastructure, especially private housing, public infrastructure in education, health and transportation. The first earthquake was the second most powerful earthquake (7.6 on the Richter scale) in a century in El Salvador. The second earthquake (6.5 on the Richter scale) was more narrowly concentrated than the first. The two events hit housing hard, destroying over 150,000 dwellings and extensively damaging another 185,000 units. The two events affected a wide population in well over 100 municipalities, and led to a jump in poverty rates.

The Government of El Salvador presented its National Reconstruction Plan to the international community at a regional consultative meeting in Madrid in March 2001, just one month after the second earthquake. Similarly, the Bank approved two Emergency Reconstruction Facility loans of US\$20 million each (the first was approved on February 9, 2001 only a few days before the second earthquake and less than a month after the first), and reprogrammed US\$180 million of its ongoing portfolio to help finance the country's reconstruction and recovery.

In the years following the earthquakes, El Salvador's efforts were focused on meeting the demands of the recovery. The IDB worked with the Government to incorporate prevention and mitigation measures into national programs. A US\$70 million housing program, approved by the Bank at the end of 2001, includes mapping of areas at risk to natural hazards (earthquakes, flooding, landslides), and tied housing benefits to locating outside of high risk areas. It also financed the promotion of information on low cost building techniques for hazard resistant construction and community mitigation measures and preparedness. A sustainable development program for the upper watershed of the Rio Lempa included an early warning system for communities at risk for floods. A US\$70 million local development program included a component to assist community and local authorities to identify disaster risk potential in their area and financed community mitigation measures prioritized by municipal development plans.

The Bank is also helping El Salvador build capacity to meet the challenges posed by future threats. Bank TC resources facilitated an evaluation of the viability of reorganizing the government's risk identification and management capabilities into a single agency. This resulted in the creation of the previously mentioned SNET agency in 2002. This program, **Financial Management and Risk Reduction of Natural Disasters**, ATN/SF-8315-ES for US\$250,000, evaluated the potential economic implications of future disasters and developed a financial strategy for risk management, as well as an action plan to strengthen risk management capacity of the country. These programmatic approaches – building the policy expertise and leadership and incorporating risk reduction measures in development investments – are helping El Salvador modernize its capacity to reduce the ever-increasing losses from disasters.

C. Loan and Technical Cooperation Programs for Disaster Response and Management in Central America

1. Overview

The following sections examine the principal loan and technical cooperation operations of the IDB in the region in the mid-1990s and early 2000s. IDB-financed disaster programs and activities are categorized generally as *Emergency Response and Reconstruction* and *Prevention and Mitigation* programs. In practice the distinction among the various component programs of disaster prevention, mitigation, emergency response and reconstruction and recovery is a formal one because many of the elements may overlap in any given loan program.

Each of the main functional categories of support of the IDB in disaster response and risk management programs is examined below and include:

- Financing Emergency Response and Reconstruction
- Risk Prevention and Mitigation, including Environmental and Natural Resource Management Services
- Local Development for Disaster Protection and Management
- Institution Building and Technical Capacity for Risk Management

2. Financing Emergency Response to Disasters and Reconstruction

Emergency response and reconstruction involves financing to clean up debris after a disaster, clear roads, temporarily replace or repair infrastructure, supply emergency temporary housing for families and assist people who have been evacuated. Prior to the introduction of new IDB disaster policies and mechanisms in 2000, there were few ways to respond immediately to emergencies and, therefore, the Bank was not heavily involved in the early emergency response financing for disasters. More often, bilateral organizations such as USAID, and from European countries or the United Nations organized the rapid disbursement of funds to attend emergency disaster requirements. The IDB would reformulate existing loans having undisbursed balances as an immediate method for recognizing certain government emergency outlays, but generally the Bank entered the financing equation at the point of reconstruction with specific new loans or through reformulation of its loan portfolio.

a. Emergency Response

New style emergency operations were established by the IDB in the late 1990s and have been approved in several countries as a result of earthquakes, hurricanes and tropical storms. They allow for quick approval by the Bank authorities of up to US\$20 million for the rapid disbursement of funds in time to assist in the emergency. **Belize** (loan **1275/OC-BL**, 2000) was one of the first countries to benefit from this program when the IDB approved US\$20 million after Hurricane Keith. The program covered a wide gamut of emergency activities including the removal of debris, repairs of damaged roads, bridges, drainage structures and city streets. The program also incorporated

environmental rehabilitation activities, repairs to water supply and sanitation systems, the restoration of schools and health facilities, the stabilization of damaged housing and the provision of temporary housing. The Project Execution Unit was financed by the loan as were the costs of the necessary studies to guide the physical and economic recovery of the areas affected by the hurricane. This operation incorporated innovative provisions for simultaneous auditing of loan fund disbursements.

The IDB demonstrated the utility of the new emergency loan mechanism for the twin earthquakes in **El Salvador** (loans **1310/OC-ES** and **1315/OC-ES**, 2001). As previously indicated, within a period of a few weeks two emergency reconstruction loans of US\$20 million each were approved for the earthquakes that occurred one month apart. The first emergency operation focused on families that had lost their houses, to relocate them to temporary housing, and stabilize hillsides. The program was executed by the Social Investment Fund for Local Development (FISDL) a capable institution the IDB has worked with on several projects for over a decade.

The second loan program was also managed jointly by the FISDL and the Ministry of Public Works with the assistance of consultants for the independent auditing of disbursements and procurement. More than one-half of the funds were for expenditures of the government made prior to the approval of the loan. The second program's funds were used as follows: (i) approximately US\$14 million to remove debris and rent private unimproved lots, with an option to buy and provide temporary housing for 37,000 units for people affected directly by the earthquake; and (ii) US\$5 million to repair and protect sections of the road system affected by the February 13 earthquake. Basic services in the areas of electricity, water and sanitation, education, health, housing, municipal government buildings and services were financed.

b. Reconstruction

The reconstruction of infrastructure damaged or destroyed by hurricanes, floods and earthquakes is a traditional but significant part of the financing required by the countries in Central America after disasters. Because of the locale and typology of the region, disasters often destroy roads and bridges, water systems and agricultural infrastructure, housing and important public infrastructure of schools, hospitals and clinics. The rehabilitation and reconstruction of these systems is a critical element in restoring economic activity and reducing the impacts on the poor. The reconstruction components involve replacing bridges, reconstructing roads, rebuilding schools and hospitals, restoring water systems and financing housing construction and selecting sites and using construction codes that reduce future vulnerability to natural disaster of the public and private sectors. It has been learned from disasters that communities are not only affected by the catastrophic events of Hurricane Mitch, multiple earthquakes or volcanic eruptions, but also by the accumulated impacts of many smaller events such as floods, landslides, forest fires or drought that reduce people's income, destroy private property, damage local water systems and lead to the displacement of families, microenterprises, crops and livestock.

As early as 1991, the IDB was assisting in reconstruction after a disaster in Central America. In **Costa Rica** (loans **636/OC-CR** and **637/OC-CR**, 1991) the Bank assisted with sewerage and water supply reconstruction in medium sized cities after a major earthquake in Limón. The project aimed to restore or replace the sanitary infrastructure damaged by the earthquake, through investments to rebuild the water supply and sewage systems in the city of Limón and the water supply systems of 16 rural communities.

In **El Salvador** (loan **1314/OC-ES**, 2001) the IDB financed US\$58 million for roads in rural areas affected by earthquakes. The program contains four components: (i) the rehabilitation and improvement of about 300 km of tertiary gravel roads in rural areas in the first phase; (ii) the reconstruction and rehabilitation of approximately 100 km of sustainable rural roads damaged by the January 13, 2001 earthquake; (iii) the creation and the consolidation of new road maintenance systems; and (iv) the continuation of the modernization of the Ministry of Public Works (MOP). With at least 300 km contracted for maintenance during Phase I, the creation of contracting modalities and maintenance funds are elements in protecting and sustaining rural roads. The strengthening of the environmental component also adds to the sustainability of the program.

Hurricane Mitch destroyed roads and potable water systems in both Honduras and Nicaragua. In **Honduras** (loans **1029/SF-HO**, 1999 and **1053/SF-HO**, 2000) the IDB provided funding of US\$25.8 million and US\$28.6 million for roads, bridges and water systems. More than 300 km of roads were repaired, and several critical bridges in Tegucigalpa and in other areas were reconstructed or rebuilt on an urgent basis. Water distribution pipes were laid, principally in Tegucigalpa. Supplementary financing was approved to cover rebuilding and restoring 89 km of paved primary roads, the rebuilding and paving of 17 km of secondary roads, building and repairing 600 meters of bridges and repairing the damage in Taulabé at km 140 on the Tegucigalpa-San Pedro Sula highway.

The main road system in **Nicaragua** was severely impacted by Hurricane Mitch, for which the Bank provided a loan of US\$50 million (loan **1036/SF-NI**, 1999), with US\$18 million in cofinancing. Hurricane Mitch justified this large-scale rehabilitation program of major segments of the Pan-American Highway in Nicaragua as the best short-term, economic option in light of the massive destruction of the alternative road network system in the so-called Natural Corridor between Managua-León-Chinandega-Guasaule. Since the reconstruction of the Natural Corridor would have taken five years, it was agreed that the Pan-American Highway could be rehabilitated sooner, thereby generating benefits of improving the overall transportation system of the country in a shorter timeframe.

Following sound risk management criteria, road design and construction criteria were incorporated to reduce the vulnerability of the reconstructed works to natural hazards, and new financing mechanisms were created to increase the regular maintenance of the road and water systems to further add to the mitigation of the impacts of future disasters.

Housing, especially of the urban poor, is often heavily involved in the high cost of damage to infrastructure caused by disasters in Central America. In **El Salvador** (loan

1379/OC-ES, 2001) the US\$70 million loan included a US\$20 million component to assist the lowest income groups to construct earthquake resistant housing and the preparation of risk maps to avoid the location of housing in high-risk areas. In this program, 8,000 families were benefited. Hence, disaster prevention, mitigation and reconstruction were simultaneously achieved in promoting safer housing construction, the preparation of risk maps, locating housing in less vulnerable areas, and through housing construction and reconstruction and upgrading of community services.

Similarly, in **Nicaragua** (loan **1111/SF-NI**, 2002), a subprogram was included in the US\$22.5 million loan to incorporate the preparation of environmental maps to define the degree of risk in areas where housing is located, and establishes rules that limit the financing of housing in high risk zones and promotes the introduction of mitigation measures in medium risk areas.

The IDB and the countries have taken advantage of post-hurricane and post-earthquake operations in several countries to insert relevant reconstruction and prevention components. In **El Salvador** (loan **1327/OC-ES**, 2001) some irrigation areas were affected by the earthquakes of early 2001, and this operation incorporates a component for the rehabilitation, reconstruction and transfer of irrigation systems to private producers at an estimated cost of US\$12.9 million, or about 40 percent of the cost of the program. The irrigation systems affected by the earthquakes were given priority during the first twelve months of the investment program. The activities involve the rehabilitation and reconstruction of up to 3,900 hectares in public and private irrigation systems. The program incorporates modern systems of irrigation maintenance and management to reduce the vulnerability of the systems to future natural hazards.

3. Risk Prevention and Management

a. Fundamental Issues

Prevention and mitigation of disaster risks is a key element in dealing with natural hazards. These programs are aimed at helping countries prepare for unforeseen disasters, to identify measures and risks, undertake mitigating measures that reduce risks, and develop stable national and local organizations and institutions to deal with future disasters.

Even before systematic risk management policies and programs assumed prominence in the IDB's agenda, the Bank worked with its member countries to promote the use of modern engineering techniques and codes in construction programs. Dams were designed and constructed taking into account potential hazards such as flooding and earthquakes. Road construction and rehabilitation were undertaken with a view to minimizing a variety of natural and environmental hazards. Housing and buildings such as schools and clinics were designed and located in such a way as to minimize the potential effects of disasters. These policies and practices clearly reduced the vulnerability to disasters without having being part of a formal disaster risk management policy. Rather they were the byproduct of good engineering, sound construction practices, experience from prior disasters and sound environmental procedures.

b. Selected Loan Programs and Components

Two good examples of financing prevention and mitigation activities were included by **Guatemala** (loan **1147/OC-GU**, 1998) following the El Niño phenomenon of 1997 and 1998, and in **Belize** after the country recognized the impacts that could have occurred with Hurricane Mitch.

During 1997 and 1998, Guatemala had been hit by several disasters (landslides, flooding, mudflows) associated with El Niño. As a result of the ongoing government concern, which increased following the declaration of emergency in August 1998, the project sought to reduce disaster-related loss of life and property damage.

The program had two components: *prevention works*, including drainage of farm and forest lands, watershed management, dredging, riverbank protection, protection of approaches to bridges and flood control works; and *mitigation and reconstruction works*, including repair and reconstruction of drainage works, riverbank protection, and stabilization of river channels. Also included were drainage works in farming and urban areas, cleanup, canalization and riverbank protection to prevent flooding, cleaning and rehabilitation of drainage ditches and sewerage systems, road improvements, repair and rebuilding of bridges, protection and repair of schools, historic monuments and archeological sites, repairing of access roads, and watershed management. With the assistance of CONRED, the national emergency agency, local communities and organizations were mobilized and the various executing agencies coordinated efforts.

The **Belize** program (loan **1211/OC-BL**, 1999), financed by a US\$21.3 million IDB loan as well as an US\$8.3 million loan from the Caribbean Development Bank, had three main elements: the mitigation of potential hazards to the country from future natural disasters; the creation of an institutional response capacity; and the maintenance of infrastructure financed by the program. In October 1998, Hurricane Mitch missed Belize but the evacuation of the country's coastal areas revealed to the government the vulnerabilities of its basic emergency shelters, potential critical drainage problems in low lying areas, and the relative incipient emergency response capacity of public and private institutions. This led government authorities to request the assistance of the IDB and the Caribbean Development Bank to remedy the indicated deficiencies.

Vulnerability to future natural hazards was reduced through the first component, which incorporated subprograms to finance the improvement of existing regional shelters and a series of new regional shelters designed to resist storm surges and damaging hurricanes. Drainage systems for Belize City were upgraded, rehabilitated and extended to new urban areas. In the institutional component, the National Emergency Management Organization (NEMO) benefited from the financing of studies, training, the creation of a national emergency operations center, the preparation of a disaster management plan and the evaluation of natural hazards and risks. The maintenance of the shelters is essential to ensure that they are ready to be used to respond to the natural disasters of the future.

There are other operations that have that incorporated similar criteria and subprograms that could qualify as prevention and mitigation activities. Examples of programs financed in the early 1990s with disaster prevention and mitigation components include an electric power and dam construction program in Costa Rica and road rehabilitation programs in Honduras and Panama. In **Costa Rica** (loan **796/OC-CR**, 1993) the Electric Development Program III includes the study of earthquake risks (active faults) and use of anti-seismic techniques for the design of construction, as well as geological surveys to identify unstable slopes and the use of this information to determine the optimal location of construction sites and installation of electric transmission lines. In **Honduras** (loans **668/OC-HO** and **875/SF-HO**, 1991) a road rehabilitation program financed several mitigation works including: upgrading and expansion of drainage works; the construction of protection works and stabilization of banks in unstable slopes; the repair and upgrading of flood control works; and planting of trees to stabilize slopes. In **Panama** (loan **769/OC-PN**, 1993) a road rehabilitation and administration program financed the rehabilitation and replacement of bridges whose original design and construction incorporated reasonable specifications, in accordance with international standards for highways and bridges, plus a safety margin of 10% for the mitigation and reduction of potential future damages. This project was approved two years after the 1991 earthquake affected Chiriqui and Boca de Toro.

The IDB also financed in **Guatemala** (loan **1398/OC/GU**, 2002) a US\$40 million operation for a natural resource management watershed program. The more intensive management of natural resources in the upper segment of the watersheds in Guatemala will reduce vulnerability to natural disasters. The operation contains a US\$4.5 million component for risk management, reduction of vulnerability and environmental services.

An urban development program in **Guatemala** (loan **1409/OC-GU**, 2002) focuses on marginal poor urban settlements and provides assistance to organize social services for the most vulnerable groups in more than 30 communities. It supplies basic infrastructure (water and sanitation, roads, drainage, street lighting), and it introduces elements of risk management and mitigation of natural disasters through prevention of landslides, the use of risk criteria for the location of the infrastructure, and promotion of land titling. This demonstrates the most desirable approach of including prevention and mitigation components in IDB operations as standard program components.

c. Environmental and Natural Resource Management: A Complement to Disaster Prevention

The IDB has been a leader in financing *watershed management programs* and environmental programs in Central America. The operations incorporated components of forest area protection and management and agroforestry techniques to increase land protection and management, thereby reducing the vulnerability of the lower watersheds and agricultural infrastructure.

The IDB financed one of the most important multi-country natural resource programs in **El Salvador** (loan **1330/OC-ES**, 2001), **Guatemala** (loan **1331/OC-GU**, 2001) and **Honduras** (loan **1082/SF-HO**, 2001) for the sustainable management of the Upper

Lempa River Basin. The Lempa River crosses the three countries and is an area of significant rural poverty and low agricultural productivity. US\$3.9 million were assigned to a subprogram of disaster prevention and mitigation. These investments are designed to reduce the vulnerability of the Upper Lempa watershed to natural hazards by making the local communities aware of the potential for disasters, mobilizing local communities to create monitoring and warning mechanisms for the inhabitants, and evaluating risk factors through the preparation of risk maps. Investments are made in local structures to reduce erosion, stabilize slopes, and reduce riverbank degradation.

Other watershed operations have been financed in **Guatemala** (loan **871/OC-GU**, 1991) for the Chixoy River Basin and in **Honduras** (loans **787/OC-HO** and **918/SF-HO**, 1993) for the Environmental Management of the Cajón Watershed, both of which are key sources of water resources for hydroelectric generation in Central America. The Chixoy program was aimed at improving the management of the upper Chixoy River valley and included financing for a number of measures that contribute to the mitigation of landslides, flooding and fire hazards, including: soil conservation and sustainable farming practices; forest protection (forest surveillance and fire fighting, removal of flammable materials, education programs) and a gully erosion component. The El Cajón loan financed significant soil conservation measures and forest fire management programs.

After Hurricane Mitch, in **Honduras** (loan **1077/SF-HO**, 2001), a new

watershed management program was financed with a US\$25 million loan. The operation includes a first phase for 14 sub-basins covering 17,600 km² with a population that exceeds one million inhabitants. By improving resource management in the watersheds and supporting the local institutions and mechanism for local community participation, vulnerability to natural threats are reduced.

Box 5

Typical Mitigation Measures in Environmental Protection and Watershed Management Programs:

- Hydrological, topographic, sedimentation, erosion, and engineering studies
- Flood control and water management interventions
- Engineering works for riverbanks and stream control
- Reforestation of watersheds and drainage basins
- Landslide control, terracing and development of retaining walls and drains
- Land use studies and planning

Box 6
Natural Resource Management and Forestry-based
Rural Development in Nicaragua:
Instruments for Prevention and Mitigation of Disasters

The IDB has given considerable support during the last decade to Nicaragua to help it better manage and protect its natural resources, to develop its rural economic and promote agricultural development and competitiveness. This has provided a roadmap for strengthening national and local institutions and to provide assistance for the prevention and mitigation of natural disasters.

Financing has been provided for two forestry development programs, **Socioenvironmental and Forestry Development Programs, POSAF I and II**. The first loan (970/SF-NI) for US\$15.4 million was approved in 1996, and a second loan (1084/SF-NI) for US\$32.7 million in 2001, with parallel funding from the Nordic Development Fund (NDF) of US\$3.0 million. Between the first and the second loan, Hurricane Mitch hit Nicaragua and the affected watersheds benefited from the first operation, which targeted the improvement in the introduction of the management and recovery of soil, forest and water resources, the consolidation of protected areas, and the strengthening of local private and public institutions working on environmental and forest management and protection. Agroforestry projects focused on conservation of soil, combined forestry and agricultural activities, and the conservation and protection of natural forests contributed to multiple environmental benefits. All of these activities served to provide increased protection for resources and the local population during times of flooding, drought or windstorms. Municipal conservation works added another dimension to protection of the local community and added the institutional and organizational skills that would be useful in mitigating disasters.

There were important lessons taught from POSAF I that were then introduced into POSAF II. It was also learned that it is better to concentrate programs in critical areas and watersheds than to distribute the activities over wider, dispersed areas. A community works component for natural disaster prevention and mitigation for US\$4.0 million was added to the second operation, building on the municipal resource conservation program of the first project.

A program for food and agricultural production in **Guatemala** (loan **1153/OC-GU**, 1998) contains a US\$12.5 million component for direct support for forestry through a program of payments to the private sector to provide incentives for the protection and good management of natural forests, yielding benefits in the form of water conservation, management and soil conservation, protection of biodiversity and the overall protection of the watershed. Several pilot programs were designed to benefit 50,000 hectares during the life of the program.

d. Local Development for Disaster Protection and Response

One of the keys to reduce the vulnerability of local communities to disasters is to educate them on prevention and mitigation measures and organizing and creating systems to monitor and alert them to potential disasters. Many local development programs now include these components to educate and organize communities and provide increased prevention capabilities for local governments.

With US\$53,000 financing from the CABILICA Fund of the United Kingdom, a technical cooperation project (ATN/KB-8051-RS, 2002) provided assistance to municipal government associations benefiting local municipal organizations in **Honduras**, **Nicaragua** and **Panama** and FEMICA (the Federation of Municipalities of the Central

American Isthmus). The program financed the development of publications and videos to educate local governments and communities on the benefits of organizing and preparing for natural disasters, reducing community vulnerability through mitigation programs that promote and regulate local investment and productive activities. Publicity was given to prevention and mitigation of disasters through the national press with newspaper coverage in the tens of thousands and programs which reached hundreds of thousands of television viewers in Honduras, Nicaragua and Panama.

A large number of *social investment programs* have been financed by the IDB for local and municipal development throughout Central America. It was demonstrated in El Salvador, Guatemala, Honduras and Nicaragua after earthquakes and Hurricane Mitch, that the presence of organized social investment funds, with sound management and experience in organizing literally thousands of small-scale local social investments, is key to implementing public programs for emergencies, rebuilding communities and dealing with displaced communities.

The reconstruction loan of US\$70 million in **El Salvador** (loan **1352/OC-ES**, 2001) utilized capable existing institutions to assist in the local reconstruction and prevention by mobilizing citizens, community organizations and local governments to better define investment priorities. This program disbursed resources rapidly as good management and monitoring systems had been in place for several years.

Box 7

El Salvador: Lower Lempa Community Participation

The Lempa River's lower valley, a fertile flood plain on El Salvador's Pacific coast is a valley prone to severe flooding, such as the deluge triggered by Hurricane Mitch in 1998. It is also exposed to tidal surges, landslides and earthquakes. The population has grown rapidly to more than 35,000 since the civil war ended a decade ago. Every time the Lempa over-runs its banks, residents risk losing their crops, their possessions and their lives.

Furthermore, many of its settlers are ex-combatants who fought on opposing sides in the war. Communities on one of the river banks were founded by former army soldiers; those on the other were former guerrillas and dissidents. Over time, groups splintered and pursued divergent development strategies. And while external aid flowed in generously, traditionally there was little coordination among the myriad projects underway.

Using a US\$100,000 grant (ATN/KB-6476-RG) from the Fund for Capacity Building for Local Institutions in Central America (CABILICA), established in 1999 by the United Kingdom's Department for International Development (DFID), the IDB helped finance training courses and technical assistance to hone the skills of members of community-based groups, productive organizations and municipalities of the Lower Lempa in the long-term management of risks associated with floods and other natural threats. Part of the grant was used to bolster community networks for emergency response and improve the Lower Lempa's early warning systems. Another portion was used to strengthen a local committee formed by delegates from the various groups to act as a representative body for the valley's dealings with national agencies on risk management, disaster prevention and emergency response issues. In addition, a series of public meetings were held where residents were invited to discuss a range of risk-management measures.

Excerpt, IDB press article, Nov. 4, 2003

Honduras (loan **1028/SF-HO**, 1998) mobilized the FHIS (Honduran Social Investment Fund) for the execution of emergency financing after Hurricane Mitch. Besides the usual emergency activities the program also provides for medium-term investments for local development in conjunction with local governments. After the main emergency response was substantially achieved, the operation reactivated a program of consultation with local communities to determine their needs and priorities. Since social development organizations are involved in local development they have ready-made contacts and capacities to mobilize community organizations and governments.

Hence, the merit of local organizations in promoting and implementing prevention and mitigation activities has been amply demonstrated throughout Central America. In the future international assistance programs should continue to provide priority assistance to these community and local area organizations and governments who are in daily contact with the community and can help implement effective risk management in rural and urban areas and reduce community vulnerability.

4. Institution Building for Risk Management

The IDB has been supplying specialized technical assistance for the execution of reconstruction programs, the conceptualization of new risk management policies and the evaluation of alternatives for financing disaster reconstruction and prevention and mitigation programs. Also, institutional support for disaster risk management activities has been included in most of the latest IDB loans whether for emergency response, reconstruction or disaster prevention and mitigation.

In **Honduras** (Technical cooperation ATN/SF-6441-HO, 1999) and **El Salvador** (Technical Cooperation ATN/JF-7685-ES, 2001) the IDB financed nonreimbursable programs of US\$1.0 million and US\$750,000, respectively, to assist in designing and implementing reconstruction programs. After Hurricane Mitch the administrative and operational demands on Honduran public institutions went well beyond their normal institutional operating capacity. These programs reinforced the agencies with staff and funds to fulfill the many administrative, technical and managerial requirements of the reconstruction programs.

Box 8

TC Support for Reconstruction Operations by Financing the Preparation of Important Studies

As reconstruction operations take a more measured stride toward permanently reconstructing the affected social and public infrastructure, it is vitally important that their design help to safeguard the asset in question so that it will provide benefits in the future. Applying risk management criteria at this stage avoids reconstruction in high risk areas or mitigates possible future impacts in the same area by the use of updated engineering codes, some relocation of infrastructure, construction of improved housing, retrofitting damaged infrastructure or adding environmentally sound water and land management infrastructure, and improved maintenance systems for the new infrastructure.

IDB technical cooperation programs have financed many of these studies, necessary for safe reconstruction including:

- Preparation of complementary engineering design, technical specifications, aerial studies and topographical surveys for the rehabilitation of urban infrastructure

- Evaluation of alternative sites

- Impact and reconstruction needs assessments

- Definition of strategic guidelines for reconstruction programs

- Preparation of technical documents for consultative groups dealing with reconstruction

Hurricane Mitch and the earthquakes in early 2001 placed a severe strain on the Salvadorian public agencies responsible for monitoring of the reconstruction process. Following the March 2001 Madrid Regional Consultative Meeting, technical assistance was approved to help increase the capacity of the government to monitor the financial and the physical progress of the earthquake reconstruction. The program also increased the ability of the government to report progress in reconstruction to the donor community and the Salvadorian civil society.

The IDB is providing nonreimbursable technical cooperation to the governments of **El Salvador** (US\$250,000, ATN/SF-8315-ES, 2003) and **Honduras** (US\$150,000, ATN/SF-8025-HO, 2002) to evaluate their policy options for managing future financial risks associated with disasters. The program assists the national economic authorities to delineate the range of financial risks and the options for reducing financial impacts of disasters. Mechanisms for financial risk reduction in the public sector include the reprogramming of public budgets, the creation of reserve funds, the selective use of insurance, lines of credit, credit programs from bilateral and multilateral sources, and donations. The organization of the response to disaster necessarily must include the creation of technical and institutional capacities to manage the financial dimensions of natural disasters. The role of the government in facilitating the development of the insurance sector is being examined as well.

5. Conclusions

IDB loans for disaster emergency response, reconstruction, prevention and mitigation have incorporated substantial institutional improvement programs for furthering risk

management programs and policies in Central America. Previously mentioned technical cooperation programs clearly have been designed for this purpose.

Road reconstruction and rehabilitation programs in El Salvador, Honduras and Nicaragua after Hurricane Mitch included activities to design the reconstruction investment program to reduce future disaster vulnerability and to expand the options for financing road maintenance programs that are so critical for adding to the useful life of the investments. Watershed programs include significant prevention and mitigation components and have placed priority on the development of local community institutions and organizations to manage and protect natural resources. This adds to the capacity of the community to prepare itself and reduce its vulnerability to the many local and regional natural hazards.

In El Salvador after the earthquakes in 2001, a number of risk management components were introduced to train and prepare national institutions to prepare risk maps and manage investments in housing to minimize risks. This was an important program experience for the agencies involved. Also, the irrigation rehabilitation program in El Salvador added institutional components for maintenance activities, favored the transfer of ownership to farmers' groups, and added investments for the reduction of impacts of future natural hazards, such as floods and earthquakes.

In Guatemala, the IDB financed institutional programs to assist CONRED and the many local community and government organizations to mobilize communities for the prevention and mitigation of disasters. In this program the focus again was on building local capacity to implement the programs. Emergency response programs in El Salvador and Belize added to the capacity of national emergency agencies and line ministries to incorporate risk management investment and organizational practices in their programs on a regular basis.

In summary, the IDB has provided and continues to provide very significant institutional support in its disaster loan and technical assistance programs for the Central American emergency agencies in order to introduce and sustain local and regional disaster risk management programs.

III. Some Lessons Learned in Managing Disaster Risk in Central America

The series of major disasters that have struck the Central American region since 1990 have led to numerous national and regional initiatives. These range from creating new institutional and strategic frameworks for coordinating disaster-related policies, to establishing national institutions for the prevention and mitigation of disasters, to strengthening the information base for evaluating future risks, to mobilizing local communities and governments to reduce vulnerability, to installing monitoring and warning systems. This process is still in its initial phase; it will require further national commitment, as well as international aid and assistance, to consolidate the institutions and policies.

A number of significant lessons in designing and managing future programs have emerged from this experience; these are summarized below.

- **A culture of prevention is the key to integrated disaster risk management programs.**

The key to creating a culture of prevention, in turn, is maintaining the public's support for preparing and reducing the vulnerability of the nation to future disasters. A commitment to a philosophy of preparedness and programs of prevention is critical; this leads to the identification of investments, policies, and regulatory activities to reduce vulnerability to natural hazards. The relevant regional, national and local authorities need to be sufficiently well funded to keep in place the administrative structures and functions to improve the identification and quantification of risk, implement policies, organize communities, orient investments and sustain an acceptable level of spending for risk reduction commensurate with the threats.

- **Since natural disasters fall disproportionately upon the poor households, continued assistance is needed to help local communities, with the support of local municipal governments to better organize themselves for natural disasters.**

There has been good experience in recent years with social investment funds throughout Central America; these funds have been assisting local municipal development and community organizations. The insertion of a philosophy of disaster prevention, mitigation, and preparation into existing successful institutional arrangements has a dual advantage; it can be done at a reasonable cost, and it will reach the poor in the most vulnerable areas of the countries. The recent trend of decentralization in the education and health sectors is also bolstering the capacity of local communities and the public sector to prepare for and respond to disasters.

- **Prevention and mitigation activities cut across all sectors and functional government programs. Thus, disaster prevention and mitigation should be incorporated into national and regional investment programs as a standard component of public and private responsibilities, rather than as a stand-alone activity, isolated from the functions of the national and local institutions.**

Recent experience has shown that risk management can accompany reforms and investment in housing for the poor; urban and rural development investments can strengthen capacity to regulate land-use to reduce risk; municipal development programs can include components to create capacity in the local government to organize monitoring and warning systems for the community; and social safety net activities managed through community organizations can be used to reduce poverty caused by disasters.

- **The seriousness of both large and small disasters must be recognized and dealt with.**

The occurrence of major natural disasters, such as Hurricane Mitch, should not overshadow the need to deal with small-scale disasters such as landslides, floods, and windstorms that occur in localities on a regular basis. The impact of these lesser hazards may add up to important overall economic and social effects on vulnerable people, productive activities, and infrastructure. The existence of a range of both small and large disasters justifies incorporating disaster risk management as a standard component of a variety of programs, including watershed development, municipal development, small-scale social investments, agriculture, urban and rural development, rural infrastructure, roads and irrigation works. This will improve the response to localized, smaller-scale disasters, as well as preparing for the major events that take place less frequently.

- **Anticipating the financial impacts of disasters and determining options for responding to these costs is a key task for central government economic and financial authorities.**

Governments typically have not dedicated enough resources to the analysis of different financial scenarios that result from disasters: how to finance loss reduction programs and the emergency response and reconstruction, and to compensate for widespread social impacts on the populace. Countries cannot depend solely on external funding sources, donations, or debt reduction programs to deal with a major natural catastrophe. Preparing for the future with sound financial risk management analysis and policies will help the country identify alternative sources of funding, and weigh the options and cost-effectiveness of using insurance, creating emergency funds, or having agreements with private and public sources of funding for an action plan before disasters strike.

- **Efforts at sustainable development and natural resource management complement measures to reduce vulnerability to natural hazards.**

Experience in environmental management programs and policies built up in Central America during more than a decade is directly transferable to natural disaster mitigation programs, including such areas as flood control, soil conservation, agroforestry, forest management, and watershed management. Environmental agencies have much to offer with risk reduction and should work together with other agencies given these common objectives.

- **Some core institutional elements of success in emergency response and rehabilitation programs are now recognized.**

The first element is to work with capable institutions that have well-established organizational experience in the community. It is too late at the time of a disaster to create new institutions or administrative experience. Also, it is probably best to postpone significant economic, social or institutional reforms until reconstruction has begun after the emergency, since undertaking complex reforms may slow down the emergency response or create an environment that is unfavorable to the reforms themselves. Transparency in the use of funds is essential to create and sustain national and international commitment to the emergency and reconstruction activities.

- **New IDB operational policies that facilitate efficient and rapid use of emergency funds are helpful and should be continued.**

The introduction of the new IDB Immediate Response Facility has shown that there is considerable value-added from streamlined procurement, disbursement, and management policies to accompany emergency response. The introduction of independent, concurrent auditing of outlays for loan programs raises the public's commitment to the program and ensures that the funds, while quickly disbursed, go directly for the purposes of the program. The financing of management firms and consultants to assist the national authorities to accelerate the execution of the programs has reaped high dividends.

MAJOR NATURAL DISASTERS BY COUNTRY, CENTRAL AMERICA, 1992 - 2001

Country	Year	Event
Belize	October 2001	Hurricane Iris
	June-August 2001	Drought
	October 1998	Hurricane Mitch
Costa Rica	June-August 2001	Drought
	October 1998	Hurricane Mitch
	May 1998	El Niño Drought
	July 1996	Hurricane Cesar
	February 1996	Floods
	October 1995	Tropical Storms Opal and Roxanne
	November 1994	Tropical Storm Gordon
	December 1993	Floods
	August 1993	Tropical Storm Bret
El Salvador	June-August 2001	Drought
	February 2001	Earthquake
	January 2001	Earthquake
	October 1998	Hurricane Mitch
	October 1995	Floods
	June 1993	Landslides
	October 1992	Floods
Guatemala	October 2001	Hurricane Iris
	June-August 2001	Drought
	October 1998	Hurricane Mitch
Honduras	October-November 2001	Tropical Storm Michelle
	June-August 2001	Drought
	October 1998	Hurricane Mitch
	May 1998	El Niño Drought
	November 1997	Tropical Storm Marcos
	October 1994	Floods
	November 1993	Floods
	September 1993	Tropical Storm Gert
Nicaragua	October-November 2001	Tropical Storm Michelle
	June-August 2001	Drought
	October 1998	Hurricane Mitch
	December 1997	Fires
	May 1998	El Niño Drought
	July 1996	Hurricane Cesar
	November 1995	Eruption of Cerro Negro Volcano
	September 1993	Tropical Storm Gert
	August 1993	Tropical Storm Bret
	September 1992	Tsunami
	August 1992	Floods
	April 1992	Eruption of Cerro Negro Volcano
Panama	June-August 2001	Drought
	October 1998	Hurricane Mitch
	July 1992	Tornado

LIST OF PROJECTS HIGHLIGHTED IN THIS CHAPTER

COUNTRY	PROJECT TITLE	LOAN/TC NUMBER	YEAR OF APPROVAL
Belize	Hurricane Rehabilitation and Disaster Preparedness	1211/OC-BL	1999
Belize	Hurricane Keith Emergency	1275/OC-BL	2000
Costa Rica	Sewerage & Water Supply Program Intermediate Cities	636/OC-CR	1991
Costa Rica	Sewerage & Water Supply Program Intermediate Cities	637/OC-CR	1991
Costa Rica	Electric Development Program III	796/OC-CR	1993
El Salvador	Emergency Project (Earthquakes)	1310/OC-ES	2001
El Salvador	Emergency Project II (Earthquakes)	1315/OC-ES	2001
El Salvador	Sustainable Rural Roads Program	1314/OC-ES	2001
El Salvador	Housing Program	1379/OC-ES	2001
El Salvador	Retooling Agro-Enterprise	1327/OC-ES	2001
El Salvador	Sustainable Management of the Lempa River Basin	1330/OC-ES	2001
El Salvador	Local Development Program II	1352/OC-ES	2001
El Salvador	Implemen. & Monitoring. Reconstruction Program	ATN/JF-7685-ES	2001
El Salvador	Finan. Admin. and Risk Reduction Natural Disasters	ATN/SF-8315-ES	2003
Guatemala	Chixoy River Basin Conservation	871/SF-GU	1991
Guatemala	Emergency Support. Natural Disaster Program	1147/OC-GU	1998
Guatemala	Food & Agriculture Sector Program	1153/OC-GU	1998
Guatemala	Sustainable Management of the Lempa River Basin	1331/OC-GU	2001
Guatemala	Priority Basin Natural Resources Program	1398/OC-GU	2002
Guatemala	Program Against Urban Poverty	1409/OC-GU	2002
Honduras	Road Rehabilitation	875/SF-HO	1991
Honduras	Road Rehabilitation	668/OC-HO	1991
Honduras	Environmental Management Cajon Watershed	918/SF-HO	1993
Honduras	Environmental Management Cajon Watershed	787/OC-HO	1993
Honduras	Road and Water Infrastructure Emergency Program	1029/SF-HO	1998
Honduras	Social Investment Program (FHIS III)	1028/SF-HO	1998
Honduras	National Reconstruction Program	ATN/SF-6441-HO	1999
Honduras	Emergency Road Complementary Program	1053/SF-HO	2000
Honduras	Sustainable Management of the Lempa River Basin	1082/SF-HO	2001
Honduras	Natural Resources Management of Priority Basins	1077/SF-HO	2001
Honduras	Financial Preparedness for Catastrophes	ATN/SF-8025-HO	2002
Nicaragua	Forestry Resources Conservation Program (POSAF I)	970/SF-NI	1996
Nicaragua	Panamerican Highway Rehabilitation	1036/SF-NI	1999
Nicaragua	Low-Income Housing Program	1111/SF-NI	2001
Nicaragua	Social Environment for Forestry Development (POSAF II)	1084/SF-NI	2001
Panama	Road Rehabilitation and Administration Program	769/OC-PN	1993
Regional	Lower Lempa Valley Community Participation	ATN/KB-6476-RG	1999
Regional	Organizing Local Communities to Prepare for and Mitigate Natural Disasters	ATN/KB-8051-RS	2002

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CHAPTER 9: DEVELOPMENT OF FINANCIAL MARKETS

Mark Flaming

Introduction

The countries of the Central American Isthmus¹ launched ambitious financial sector reform programs at the beginning of the 1990s. The impetus for this effort came from an urgent need to build sustainable economic models in countries that finished the prior decade in a state of macroeconomic insolvency. Policy makers assigned primary importance to the reform programs, acknowledging that creating efficient financial markets were a fundamental component in the broader process of economic development. To undertake the task, national governments had to forge a unified vision for their financial sectors, redefine the state's role vis-à-vis the private sector, and develop a close working relationship with the IDB and other multilateral finance institutions for financial and technical support.

The countries of the region achieved significant milestones in the development of their financial markets since 1990. The following table provides basic indicators for the countries of the region at the end of 2001.

INDICATOR	BL	GU	HO	NI	ES	CR	PN
Population (millions)	0.23	11.68	6.58	5.21	6.40	3.87	2.86
GDP (US\$ millions)	\$805	\$20,599	\$6,222	\$2,471	\$13,804	\$15,768	\$12,521
Number of Banks	n/a	32	23	6	13	21	77
Banking Sector Assets (US\$ millions)	\$69	\$7,579	\$3,856	\$1,839	\$9,051	\$7,104	\$34,022
Credit to Private Sector (% of GDP)	65%	20%	46%	51%	40%	28%	117%
Loans in Foreign Currency	n/a	21%	25%	82%	100%	51%	100%
Real Lending Rate	14.1%	10.6%	14.6%	14.4%	6.2%	14.3%	11%
Interest rate spread	9.1%	10.2%	9.3%	13.8%	3.8%	12.1%	4.1%

Data compiled from *IMF Financial Statistics Bulletin* and *IDB Banking System Monitor*

As an indicative measure of the progress of the period, consider that collectively, bank deposits in the region grew from an average of 42% of GDP to 69% of GDP from 1990 to 2001. Credit to the private sector grew from 25% to 52% of GDP.² In simple terms, this means that the countries of region made a dramatic increase in the amount of money

¹ The "Isthmus" refers to all of the countries of Central America, plus Belize and Panama. At times, the term "Central America" is used to refer to a subgroup of countries that excludes Panama. In these cases, the distinction is necessary to make generalizations that do not apply to Panama because of the unique nature of its international banking center.

² *IMF Financial Statistics Bulletin*. Period data refers to the years 1990-2001, unless otherwise specified.

intermediated through the banking system, and that these resources were channeled through credit to the private sector.

This essay will chronicle the efforts of governments of the Isthmus to modernize their financial markets during the period. The magnitude of the task in 1990 challenged the countries of the region to an era of reform and modernization that would extend well beyond a single decade. In a longer term perspective, the period will appear as a transition phase for financial markets. Accordingly, the achievements of the period are significant as initial reforms that launched a long term modernization process.

To characterize the first generation of modernization efforts, progress must be measured against the parameters that shaped the development process itself. The first part of the document, Parameters of Progress, sets reference points for measuring progress in the region, identifies the political dimensions of the reform process, and defines realistic timelines for developing safe and sound financial markets in the developing economies of the Isthmus.

The section Level of Effort provides an overview of the resources dedicated to the modernization process, and details the IDB's role in the region.

The section entitled Components of Progress characterizes the reform initiatives in the principle areas of the modernization process. This measures the scope of the effort, and describes how the countries of the region began the process of market liberalization, modernization of central banks and monetary policy, the development of regulatory frameworks and supervisory institutions, the deepening of the banking sectors, and the first phase of capital market formation. These efforts defined the starting point for transformation of the markets, and the decade of experience that policy makers have carried forward into the new millennium.

The final section entitled Maintaining Momentum for the Agenda Ahead summarizes the principal challenges of the next phase of financial sector modernization in the countries of the region.

The IDB's role in the development of financial markets on the Isthmus is an important dimension to the story. The IDB was one of many external development institutions that supported the modernization effort during the decade. However, the IDB played a leading role in this sector, and case profiles of IDB financed initiatives help to illustrate the evolution of the reform process. The countries and the IDB gathered years of experience in employing external resources in national reform efforts. This sub theme of the development story reflects the effectiveness of the IDB's partnership with the region, and the relevance of IDB support instruments in these efforts.

I. Parameters of Progress

Financial sector modernization began in the 1990s as part of a larger process of economic reengineering. Progress is measured with reference to the forces that shaped that process, and to a time frame that extends beyond that decade.

Financial sector modernization on the Isthmus began as a response to the daunting macroeconomic challenges facing the countries of the region at the end of the “Lost Decade” of the 1980s. These origins prescribed the strategic choices for policy makers, the instruments for reform initiatives, and political dimensions for the process. From this perspective, the countries of the Isthmus shared a common starting point for their respective efforts to modernize their financial markets. Likewise, these shared origins gave rise to a common set of factors that set parameters for the process, and ultimately the progress that was achieved.

Three factors – the economic environment in 1990, the political dimension of policy reform, and the sequence of financial sector modernization – set defining parameters for progress in financial market modernization. The pervasiveness of these factors on the Isthmus provides a common framework for characterizing progress in each of the countries. Understanding the effect of these factors on the process also helps to define standards for measuring the achievements of the period.

In this regard, the measure of progress is common to all of the countries of the region. The measure of progress in an individual country is less tangible, however. Financial sector modernization is a multi-faceted endeavor that proceeds according to processes unique to each country. It is instructive to chart the course a country has taken by assessing the sequence and depth of reform initiatives. However, a comparative assessment of sustainable results will require more than just the data available since 1990. Some countries of the Isthmus were clearly more aggressive in their reform agenda than others. Nicaragua and El Salvador, for example stand out as countries which launched major reforms in virtually every area of their respective markets. By comparison, modernization of the Costa Rican market progressed incrementally without fundamental structural change. However, even this intraregional comparison would tell little about market evolution in El Salvador and Costa Rica without characterizing the opportunities and obstacles each country weighed at the beginning of the decade of the 90s. Likewise, extra-regional comparisons provide perspective on long term objectives, and provide an appropriate framework for a forward looking assessment. However, the measure of progress of a country in a specific time period must begin with clarity about the beginning point and the factors that shaped the process.

A. The Economic Environment in 1990

The condition of financial markets at the beginning of the decade of the 90s reflected the macroeconomic environment of the countries of the region. Policy makers had to build public confidence in government in general, and in the state’s commitment to maintaining the integrity of the financial markets.

Any just measure of progress in restoring national and foreign investor confidence in the financial markets of the Isthmus during the 1990s must acknowledge the challenge that policy makers faced at the beginning of the decade. The performance of financial markets in a given country is tied inextricably to the overall level of development of the economy and political environment. Economic actors will only employ monetary resources when all the other production factors promise an efficient and predictable return on investment. An investor not only assessed business opportunities, but also the transaction risks inherent in the legal and judicial system, the exchange risk inherent in the country's fiscal and monetary policy, and the stability of the political climate. On the other side, savers had to believe in their currencies, the banks, and their own government's commitment to currency convertibility, before depositing savings in the system. Both perspectives were bleak at the beginning of the decade of the 90s.

Recall that both Nicaragua and El Salvador only emerged from their civil wars at the beginning of the 90s. The government that assumed power in El Salvador in June 1989 signed the Chapultepec Peace Accords in 1992 after 12 years of civil war. In Nicaragua, the Violeta Chamorro administration assumed power in April 1990 to face the cumulative effect of civil war, economic mismanagement and massive decline in national production capacity. Costa Rica and Honduras were recovering from spillover effects as well, and Guatemala was still grappling with its own internal conflicts.

Financial markets left the "Lost Decade" of the 1980s in correspondingly poor condition. Both El Salvador and Nicaragua had nationalized financial systems. Costa Rican markets were almost completely state controlled. The prevailing doctrine of state intervention in financial markets in the 1980s left a legacy of currency devaluations, regulated interest rates, punitive reserve requirements, and large state-owned financial institutions that distorted markets with politically driven credit programs. Capital markets were undeveloped. The legal and regulatory environment either prohibited or did not accommodate private participation in financial intermediation, and the Central Banks and supervisory authorities were not prepared to play their corresponding roles in a modern financial system. As a measure of the general lack of trust in the financial system, consider that bank deposits in the Central American countries ranged from 4% to 36% of GDP in 1990, compared to 160% in Panama.

In this context, government reform programs were first and foremost a declaration to the public regarding the State's intentions to maintain macroeconomic stability and define a fundamentally new role for the State in support of the development of financial markets. Understandably, public confidence would grow over time in proportion to macroeconomic performance and government consistency in successive programs of support to the financial sector. From this point of departure, perhaps the most significant and enduring achievement of the period is that governments succeeded in restoring public confidence in their payment systems and financial markets. The Central American countries raised the average volume of deposits in their respective banking systems from 25% to 49% of GDP over the period. This is a general reflection of an intangible but

significant achievement – the restoration of public confidence in their government’s commitment to a credible reform agenda.

B. The Political Dimensions of Policy Reform

Policy dialogue regarding financial sector modernization expanded over the decade of the 90s, incorporating all branches of government, the private sector and civil society. The pace of reform was driven by the evolution of consensus. The reform model introduced new institutional values for both the State and private sector.

For the countries of the Isthmus, the 1990s were a decade of first generation reforms in a dawning era of economic liberalization. The policy makers that ushered in the decade managed broad reform programs, and had to build consensus on many fronts in fragile political environments. Thus, progress achieved during the period follows a learning curve, as policy makers learned to manage a new development agenda in an increasingly participatory and complex political environment.

Governments faced daunting fiscal and external account imbalances with few options for external financing. The IDB joined the World Bank, International Monetary Fund (IMF) and other key bilateral development agencies in providing financing for immediate balance of payments support while the countries established a sustainable economic framework. All of the financial sector structural programs were launched in parallel with macroeconomic programs supported by the IMF. The creation of safe, sound and efficient financial systems was one of the first priorities of this stabilization effort. Thus, governments launched their financial sector reform programs in the early 1990s as part of their commitment to correct structural deficiencies in exchange for short term liquidity financing.

The Washington-based multilateral Institutions developed the “policy based loans” specifically for this purpose. This vehicle made the reform agenda a matter of public record in a way that changed the relationship of policy makers to their constituents, and the public’s perception of reform. The initial financial sector reform programs took the form of contracts that were signed and ratified by both executive and legislative branches of government. In practical terms, this meant that policy makers had to define the reform agenda through a process of national dialogue and political negotiation. In the case of programs financed by the multilateral finance institutions, each country also had to present and justify their program to their regional peers. Once formalized, execution of the reform programs was accountable to both national law and the terms and conditions of a sovereign contract with a foreign third party. Thus the vehicle for defining financial sector reform added political dimensions that profoundly shaped the process. At times, the legal obligation to carry out specific reforms in return for liquidity financing provided the incentive to maintain momentum; in other circumstances the contractual nature of the program imposed rigidities that stalled progress. In all cases, perceptions varied widely among the constituents to the process.

Given this political dimension, the pace of reform was driven by the ability of policy makers to mobilize consensus on multiple fronts. The period under study represents about three electoral cycles in most of the countries, with a limited number of political opportunities to carry out reforms of the magnitude required in the financial sectors. In most countries, policy makers had to define their reform programs in fragile political environments, and launch the most important reforms against political opposition from entrenched interests. For example, the creation of an independent and professional monetary authority in the central bank requires that central governments subject their fiscal performance to external scrutiny. Independent banking supervisors remove political considerations from the control of financial institutions. And withdrawal of the State from first-tier financial services eliminates a powerful vehicle for disbursing political favors in the form of State bank loans. These changes entailed a redistribution of significant political power in the small countries of the region. Such reforms required political consensus for execution, and the opportunities emerged in different ways at different times in each of the countries.

Case Profile: El Salvador

El Salvador was able to sustain national policy dialogue and political commitment to the financial sector reform program throughout the period. The process began in the early 1990s with the privatization of the previously nationalized banking sector, and evolved to encompass regulatory reform, creation of public, second-tier lending facilities, and development of the pension and capital markets. By the end of the period, the Salvadorian banking sector was the most efficient in Central America, and its banks were leading the trend towards regionalization.

Policy makers in El Salvador established a framework for policy dialogue that facilitated sustained cooperation between the central bank, the executive and legislative branches of government, and the private sector. The government also made aggressive use of IDB resources to support the national program. By 1995, the government had carried out two Multisectoral Credit Programs that provided liquidity to private sector banks, a policy based loan for structural reform of the investment sector, and a technical assistance program for institutional development of financial sector regulators.

In the case of El Salvador, the uninterrupted sequence of IDB supported finance and technical assistance programs provided continuity to the country's internal policy dialogue regarding financial issues. Authorities were also able to respond quickly at important moments of the process, by adapting the focus of existing programs. The technical programs of support to the financial market regulators were particularly dynamic in this regard. When the failure of two finance companies threatened public confidence in the banking system in 1997, authorities were able to mobilize immediate technical support with the assistance of the IDB, and restore confidence in the system by combining resources with private sector banks. Policy makers went on to establish the Institute of Deposit Insurance, and borrow additional funds from the IDB for a second program of institutional strengthening banking, capital markets, and pension supervisory agencies.

While the policy based loans brought financial sector modernization to the highest levels of policy dialogue, the technical assistance programs financed by the IDB supported the institutional aspect of the reform program. The combination of these instruments provided multiple resources for policy makers to draw from, and helped sustain program momentum over time.

The political nature of financial sector modernization is derived primarily from the transfer of control from the State, or monopolistic institutions, to regulated markets. The countries of the Isthmus succeeded in generating a critical mass of consensus to initiate the process in the 1990s. However, the long term development of market-based financial sectors in the countries will depend on the transformation of values in public debate and in the institutions that regulate and intermediate in the markets. Most countries succeeded in creating the institutional structure capable of cultivating the values necessary for efficient markets, but the depth of institutional maturity will have to be measured in decades to come.

C. Sequencing of Reforms

Market-based models of financial intermediation require strong foundations to sustain growth with stability. The modernization process necessarily followed a sequence that required a first generation of foundational reforms. Success will be measured ultimately in the future stability and depth of the financial markets.

Policy makers approached their financial sector reform programs with two principal objectives: to stimulate the flow of credit to the economy, and to build a safe and sound financial system. Strategically, governments sought to deepen financial markets by creating enabling conditions for private sector competition in a safe and sound prudential framework.

The strategy required a sequence to government initiatives in the sector. In general, financial sector reform should be divided into two main phases. The first order of reforms is dedicated to establishing an adequate legal and institutional framework for prudential regulation and banking supervision, and creating an independent and professional central bank. These measures are necessary to provide adequate controls for the expansion of the financial system that typically results from the second generation of reforms. Liberalization measures such as lifting interest rate and foreign exchange controls, reducing legal reserve requirements, and eliminating State intervention in the banking sector are best implemented when the financial sector is adequately prepared for subsequent expansion and competition.

The market-based strategy also required governments to change their role in the development of financial markets. During the previous decades, the State had directly controlled markets and dispensed credit through high profile lending programs. The new model required policy makers to dismantle the instruments of State intervention, and assume a regulatory role which appeared passive in contrast to the programs of the previous decade. The strategy required patience on the part of policy makers anxious to stimulate economic growth, and good political timing to implement the important structural changes.

All of the Central American countries launched a multi-faceted reform program by 1993 with the assistance of the IDB. The financial markets in Nicaragua and El Salvador required immediate and wholesale reconstruction, and both countries sustained robust programs of liberalization and regulatory reforms throughout the period. On the other

end of the spectrum, Panama and Costa Rica focused reform efforts on the development of their legal and regulatory frameworks without a strong liberalization program. A comparison of these two extremes helps to illustrate the conditions that facilitated the more aggressive programs.

Case Profiles: Nicaragua and Costa Rica

Nicaragua

Nicaragua began economic reconstruction in earnest at the beginning of the 1990s. The condition of the country after the civil war created a sense of urgency and a political climate conducive to aggressive structural reform. The IDB and other international development organizations provided considerable technical and financial support, and the country made significant progress in stabilizing its economy early in the decade. In 1991, parliament passed legislation creating the Superintendency of Banks, and allowing the creation of private banks. The government encouraged the creation of private banks by relaxing initial capital requirements, providing lending liquidity, and closing or selling all of the State banks that dominated the market. The banking sector expanded rapidly in an attempt to capture early market share, and by 1998, twelve private banks were operating in the banking sector.

The pace of financial sector development in Nicaragua is a tribute to the resolve of its policy makers. The need for immediate action created political opportunity, and the authorities implemented an aggressive program of financial sector reengineering. Progress was swift, but it came at a price. Some banks grew rapidly without adequate capital or risk management systems, and were unable to manage the expansion. Regulatory authorities were unable to intervene in time to avert bank failure. By 2000, at least seven banks had to be liquidated due to insolvency.

Costa Rica

The political and economic conditions in Costa Rica created a very different environment for policy makers. The government suffered substantial fiscal losses because of the failure of Banco Anglo in 1994, but was not able to muster the political consensus to restructure the State's domination of the banking and insurance sectors. Historically, private banks have operated under a legal framework that grants quasi-monopolistic privileges to the State banks. As a result, the private banks developed an extensive network of off-shore affiliates, the size of which was unknown until regulatory changes in the late 1990's. Legal changes in 1997 finally granted permission to private banks to accept sight deposits, and since that time the private sector has slowly gained market share in national markets.

In the last half of the 1990s, monetary authorities initiated institutional reforms in preparation for gradual and sustainable growth of the private sector in financial markets. In 1997, the central bank launched a concerted effort to develop a money market that will provide the banking sector with the tools for managing liquidity. In 1999, the banking superintendent began implementation of a regulatory and supervisory regime directed at controlling the extensive off-shore networks of its private banks.

In contrast to Nicaragua, measurable progress in the liberalization of the Costa Rican market was gradual. Policy makers still face the challenge of large reforms to reduce the role of the State in financial markets. Nevertheless, during the decade Costa Rica made progress in creating the tools and institutions to manage risk for future growth in the private financial markets. The benefits of Costa Rican progress in the future will take the form of stable and sustainable growth of the private sector, if policy makers can mobilize the consensus to redefine the role of the State in the markets.

Countries that liberalized their markets and reduced the direct role of the State banks made visible progress than can be measured by changes in the structure of their markets. In addition, the reforms that focused on legal and institutional reforms established an important foundation for future market development. The case of Nicaragua illustrates that rapid progress in liberalization can create costs as well, if banks and regulators cannot manage the risks of rapid expansion. The long term objective of all of the countries of the Isthmus was and is to modernize their financial markets by developing regulatory and risk mitigation mechanisms capable of managing the risks associated with growth. Markets require time to find an optimal balance between growth and stability.

II. Level of Effort

The modernization initiatives of the period under review were driven by collective action. Typically, a core group of high-level policy makers from the executive branch and the central bank spearheaded a dialogue that evolved into a national plan for financial sector modernization. The IDB supported these efforts in the early stages with technical support from staff and external consultants, who assisted authorities in defining the program. Technical staff from the central bank and supervisory agencies joined the effort to define programs for their respective institutions. Early in the conceptualization stage, the dialogue broadened to include the banking community, private sector business, and ultimately the legislative branch. These actors developed a common technical language over the period, and the number of initiatives which came forth provides an indication of the maturity of that process.

The IDB program of loans and technical assistance are indicative of the scope of the campaign. Countries also employed their own resources, as well as support from other development partners, notably the International Monetary Fund (IMF) and the World Bank. Nevertheless, the IDB played a leading support role in most of the countries, and IDB programs covered the full range of development initiatives. On seven occasions, central governments secured financing for ambitious structural reforms of their financial markets. The IDB provided US\$862 million for this purpose.³ Twelve other loans totaling US\$356 million were extended by the IDB to provide liquidity to the banking sectors and technical assistance support to Central Banks and regulatory agencies, in conjunction with robust banking sector reform initiatives. These programs represent the collective efforts of central governments, central banks, regulatory agencies, and parliaments to create a modern legal, regulatory and institutional framework for financial intermediation.

At the institutional level, the IDB financed seventy-nine non-reimbursable technical support programs, ranging in amounts from US\$150,000 to US\$2 million for strengthening regulators, developing legal frameworks, capital markets infrastructure, and supporting financial innovation and microenterprise lending. These programs reflect the effort expended by public and private institutions to modernize their organizations and deepen the financial market through product innovation.

³ See Annex for details.

Collectively, the IDB programs represent over a decade of policy dialogue and technical partnership. The respective roles of the participants evolved over the period, as institutions developed confidence in their changing roles. Each of the visible achievements of the period represents the collective action of political and private institutions that continue to mature in their new roles.

III. The Components of Progress

A. Liberalization

Liberalization of financial markets evolved with progress in eliminating interest rate and foreign exchange restrictions, privatizing first-tier banking, regulatory reform and fiscal discipline. All countries made progress in some areas; the largest benefits accrued to those that could coordinate reforms on multiple fronts.

Liberalization gives name to the strategy that guided financial sector development efforts in Central America from 1990 to the present. In this period, governments began relinquishing their roles as direct participants and controllers of financial markets, and assuming their modern role of rectors of a market-based system of safe and sound intermediation. In practical terms, policy makers had to dismantle the monopolistic privileges of the interventionist model, support the creation of independent regulatory institutions, and create a macroeconomic environment conducive to efficient financial intermediation. For most of the countries of the region, the main achievement of the period was in building an institutional foundation for this long term transition.

The overall effects of market liberalization were linked to progress in the broader agenda of economic reform. Governments had liberated interest rate controls by the early 1990's. However, the task of liberating resources for financial intermediation required deeper structural reform. High legal reserve requirements on deposits were necessary to sterilize resources in the banking system to compensate for the inflationary effects of chronic fiscal deficits, and foreign exchange controls helped hold in check the devaluation effects. These resources could not be liberated in open markets until governments controlled their fiscal deficits, and central banks developed more modern instruments for implementing monetary policy. Legal reserves on bank deposits was still punishingly high, but the general trend was positive, as the average effective rate on legal reserves in Central America declined from 25.6% in 1995 to 16.9% in 2002.⁴

For countries like Nicaragua and El Salvador, the privatization or liquidation of State-owned banks was a fundamental achievement in liberalization of their respective markets. In both countries, governments redefined the role of the State in the markets by phasing out direct retail operations (first-tier banking) and creating second-tier facilities designed to lend resources to private first-tier banks. For all countries of the region the development of regulatory and supervisory regimes was an important component of the

⁴ Executive Secretariat of the Central American Monetary Council: *Informe Económico Regional 2000 and 2002*.

liberalization process. Regulatory reform provided incentives for the development of commercial banking, and required banks and supervisors alike to develop risk management capacity prior to substantial growth. The potential cost of uncontrolled expansion was much greater than the immediate benefits of increasing intermediation levels. In fact, more than one country in the region paid high costs for uncontrolled expansion of their financial markets.

El Salvador: Reaping the Benefits of Modernization

El Salvador stands out in Central America as a country that was able to associate its multi-faceted liberalization program with robust performance of its financial markets. The government privatized the banking system and quickly developed institutional capacity to provide liquidity to the growing markets through the Banco Multisectorial de Inversiones, a second-tier lending facility. The authorities also maintained an ongoing program of technical support to the supervisory agencies.

More than any other country in Central America, the Salvadorian government was able to complement its program of financial sector liberalization with fiscal discipline. The combined effect of these efforts can be seen in the performance of the financial sector. Rates of growth in private sector credit and total deposits as a percentage of GDP are, with Nicaragua, the highest of the countries of the region. More importantly, the Salvadorian banking sector achieved levels of efficiency that outpace by far any of its neighbors. In 1999, interest rate spreads were 4.7%, less than half of the 10.6% average of the other Central American countries. Finally, El Salvador's ability to dollarize its economy in 2000 is also an indication of the depth of its liberalization reform program in the 1990s.

The following sections describe the achievements of the period with respect to specific institutional reforms. Collectively, these efforts represent the maturation of a credible strategy for private sector-led development of financial markets.

B. Central Banks And Monetary Policy

Central banks of the region made progress towards independence and operational modernization. Policy and institutional reforms established a framework for stable and efficient financial intermediation.

The countries of the region initiated a process of transforming their central banks⁵ into independent and professional institutions capable of fulfilling their role as rectors of the currency and payment system in liberalized markets. The transformation had political and operational dimensions. The legal codes of all countries had to be modified to give the central banks the authority to carry out their mandates independent of conflicting political objectives. The central banks themselves had to develop operational capacity to perform their role in a liberalized market. The transformation of the central banks was a foundational component of the modernization process, and their own institutional development mirrored the overall evolution of their respective markets.

The degree of independence of the central bank is one of the primary measures of progress in the modernization of financial markets. Independence is the basis of

⁵ All the countries have central banks, with the exception of Panama.

authority, and the central banks of the region required authority to maintain interest rate and exchange stability in markets, especially when central bank policy exposed the damaging effects of public sector fiscal performance. Likewise, the central banks needed the authority to maintain discipline in the banking sector, protecting their integrity as the lender of last resort. The central banks entered the 1990s, in practical terms, as instruments of government macroeconomic and credit policy. Their transformation has been slow but steady, in the face of conditions that are particularly acute in the small countries of the region.

The legal status of the central banks at the beginning of the decade of the 90s reflected the function of the central banks in the countries' governance tradition. The executive branches exploited their legal authority to exercise direct control on central bank policy through political appointments and representation on the governing board. During the legal reform process, policy makers grappled with challenges of assigning an unprecedented degree of independence to a public institution that would limit the control exercised by the other branches of the central government. These changes were part of larger policy considerations regarding the evolving governance structure of the countries, and consequently legal reform was only incremental.

Nevertheless, most of the central banks made considerable progress in developing de facto independence over the decade, and this was a particularly significant achievement for the small countries of the region. The performance of the central banks built credibility and public consensus regarding their role in the new political and economic model. Policy makers elevated the authority of the central banks early in the decade by assigning them a leading role in macroeconomic programs that were carried out in partnership with the IMF, IDB and World Bank. The economic model itself prescribed more fiscal discipline for central governments and transparent parameters for central bank operations. The economic programs were a matter of public record, national dialogue, and external monitoring by the Washington-based institutions, and this made all policy makers accountable for the performance of the central bank in its independent role.

This achievement is particularly significant in small countries, given that the effectiveness of the central bank is derived as much from the moral authority of its governors and macroeconomic conditions, as from the letter of the law. Historically, the fiscal deficits of central governments and of State-owned enterprises set rigid limits for central bank monetary policy. In addition, most of the central banks of the region struggled with the quasi-fiscal effects of debts they carried on behalf of central governments and failed public institutions. In this regard, the operational autonomy of the central banks was prescribed by the pace of the broader economic programs. However, some countries did initiate an important break with the historical practice of obscuring fiscal deficits in the central banks. The case of the Central Bank of Costa Rica illustrates the significance of such actions.

Costa Rica: Central Bank Financial Autonomy

The 1995 reform of the Banco Central de Costa Rica (BCCR) defined a calendar for government repayment of debts to the BCCR. The BCCR had incurred these debts by assuming the foreign exchange risks of public sector enterprises, and consequently, the resulting costs were disassociated from the entities responsible. The Ministry of Finance commenced paying according to the schedule, and eventually issued bonds to finance accelerated payments on the obligation. In the political area, this kind of action created transparency in public finances that facilitate more informed public policy about the respective roles of the government and the central bank. The cost of the debt was associated with the central government, where it is openly scrutinized during the budgeting process. And the action set an important policy precedent for protecting the integrity of the central bank as a monetary institution.

The central banks themselves devoted significant resources to developing institutional and operational capacity, and the IDB supported these efforts with a program of financial and technical assistance. The modernization of central bank operations in the region provided significant support to financial sector development and strengthened institutional credibility.

For example, the development of open-market monetary instruments in the central banks and the elimination of interest rate and currency controls created more transparent incentives for public sector fiscal discipline. Central banks moved from immobilizing liquidity through direct controls to pricing it through open transactions in the currency markets. This gave the private sector the opportunity to compete for access to capital in the financial system, and associated the price of capital with the effect of public sector deficits. The proliferation of newspaper articles, publications and open seminar agendas demonstrates that the transparency of the modern system facilitated open public debate about the effects of public finances on economic development.

In addition, with their new open-market instruments, central banks abandoned their credit programs and developed their primary role in maintaining systemic liquidity and last-resort support to the financial system. This established clearer incentives for prudential management of banks, and created a money market that gave banks the market instruments for managing their liquidity on a daily basis. In addition, the central banks made operational improvements in their respective payments systems, particularly in the area of clearance and settlements of interbank transactions.

The importance of these efforts deserves special mention. Historically, the region's banks have maintained high cash reserve levels to manage liquidity in the absence of efficient money markets. This practice has contributed to high intermediation margins. The central banks began building a market structure conducive to stability and efficiency. In addition, the markets that developed for trading the instruments issued by the central governments and the central banks laid the foundation for the development of capital markets throughout Central America.

The IDB supported all of the central banks of the region with technical assistance during the period under review. The case of the Central Bank of Nicaragua is particularly impressive with the respect to the scope of the modernization effort.

Nicaragua: Case Profile

Nicaragua faced the most daunting challenge of any of the countries of the region. The modernization of the Banco Central de Nicaragua (BCN) entailed a redefinition of the BCN's former role in a command economy, and a fundamental restructuring of every operational department of the institution.

Beginning in 1991, the IDB provided financial support to a technical assistance program coordinated by the IMF in conjunction with their support to the macroeconomic stabilization program. The BCN contracted international experts to support systems development in the new operational departments, analytical capacity for monetary programming, and information systems for all aspects of central bank management. The BCN also began the long term process of educating the emerging generation of economists in market driven models in foreign universities.

The BCN's traditional role as a liquidity source for cyclical agricultural financing made the institution particularly vulnerable to the weaknesses of the Nicaraguan banking sector in the first half of the 1990s. However, by 1996, the BCN had closed its lending windows and redefined its role as a lender of last resort. By 1997, the program of open-market operations became functional.

In 1998, the IDB financed the second Financial Sector Reform Program. This program contemplated the sale or liquidation of the remaining public banks, and included a second program of technical assistance to the Central Bank to support the institution in its role in the process.

C. Banking Regulation And Supervision

The modernization of regulatory frameworks and supervisory agencies advanced on both policy and institutional levels. The capacity and authority of regulatory agencies was strengthened through technical assistance and ongoing policy dialogue. As authorities grew confident in the reform process, they made increasing use of IDB advisory and technical resources.

The publication of the Basle Committee's Standards for Capital Adequacy in 1988 marked the beginning of an era of modernization of regulatory regimes. At that time, the financial markets of the region had antiquated legal and regulatory frameworks, and banking supervisory agencies lacked the autonomy and technical competence to fulfill their role. Under these conditions, early liberalization of financial markets, and the rapid growth of private banks in the early 1990s created instability in the banking sectors, and governments launched reform programs early in the decade to establish an adequate regulatory environment.

The modernization initiative proceeded on two levels. The first phase of regulatory reform began on the policy level and in almost all countries involved legislation of a new legal framework. The IDB ascribed a high level of importance to these reforms, and conditioned disbursement of policy based loans to the central government on the legal enactment of specific reforms in this area. In addition, the IDB financed technical

assistance programs to support the parallel process of policy and operational development on the institution level.

Two main factors defined the pace of regulatory reform. First, all of the countries had to legislate profound reforms of their banking laws to create an adequate legal framework for the authority of regulators, as well as foundational components of prudential regulations. These reforms were part of the broader policy debates regarding the independence of central banks and regulatory agencies. Legal changes had to be negotiated through a complex political process, and political actors had to acquire competency in complex technical matters. Secondly, the reform initiative had to overcome the entrenched interests of the economic groups that controlled the financial institutions. In the era of financial oppression and State intervention in the financial markets, private banking institutions operated in high-risk macro environments, restrictions on financial intermediation, and limited legal protection in their role as lenders. Consequently, economic groups developed banks to provide financial services to their own members. International prudential standards eventually imposed capital requirements and limits on risk concentration and related party lending, which threatened the primary functions of most banks in the region in the early 1990s. Under these circumstances, policy makers had to introduce the new rules of the game to provide incentives to banks to adopt a more modern role, but allowing adequate time to make the transition.

Most of the IDB's technical assistance programs provided support to the institution building process. Over time, the IDB played many roles in this process, and adapted its role as conditions evolved in each country. In the early stages of the reform process, the contractual obligation to carry out regulatory reforms created policy debate, accountability to external parties, and incentives to carry through with the programs. Policy makers grew more confident and competent as the reforms process advanced. As the reforms gained momentum, policy makers made increasing use of IDB advisory and technical assistance resources.

In the case of Nicaragua, the IDB supported the modernization process from its beginnings, and as a result was able to provide immediate assistance to policy makers in important moments that required decisive action. The government of Nicaragua reinstalled the rights of private banks in 1991, and encouraged growth by establishing low barriers to startup and lax prudential regulations. Economic groups seized the opportunity immediately, and founded institutions with limited capital and a propensity for related party lending and risk concentration. In subsequent years, the Government drastically reduced the role of the State banks, providing further opportunity for the growth of the private sector banks. Prudential reform played a prominent role in all of the IDB financial sector loans during the period. Parallel technical assistance programs provided institutional support for the creation of the Superintendency of Banks. Later in 1998, the Financial Sector Reform II was designed to support completion of reform implementation, and disbursement of the loan was conditioned upon satisfactory compliance with regulatory plans for every bank in the system. The process strengthened the de facto authority of the Superintendency of Banks. In 1999, the regulator played a

decisive role in managing a potential crisis by liquidating a significant number of private banks, while maintaining public confidence in the system.

The IDB played a similar role in El Salvador, and consequently was able to respond to a request for assistance from the government in a time of crisis. El Salvador launched an aggressive reform program at the beginning of the decade. The IDB supported that process by conditioning large loans on changes to the Central Bank law, the Banking Law and the strengthening of the regulatory authorities. In 1997, the regulatory authorities faced a potential crisis that was provoked by the failure and questionable conduct of two finance companies. At that time, the IDB was supporting an extensive program of technical support to the regulatory agencies. The IDB responded to an urgent request for assistance by enlisting the technical support of the Banking Supervision Department of the Federal Reserve Bank of the United States. The timely intervention was instrumental in averting a crisis, and supporting the credibility of the regulatory authorities.

Costa Rica also employed the resources of the IDB to strengthen its regulatory regime. As in El Salvador, the IDB was providing technical support for modernization of the banking superintendency. Beginning in 1998, the superintendency instigated a profound restructuring of the institution. The IDB helped finance the costs of external support to the institution, and the Bank was able to once again enlist the assistance of the U.S. Federal Reserve Bank to provide training courses in banking supervision to a new generation of professionals. In the cases of both El Salvador and Costa Rica, policy makers took decisive action, and enlisted the support of the IDB with technical execution, outside the bounds of the lending program.

In the case of Panama, the IDB maintained a policy dialogue for most of the 1990s before authorities implemented their program. Panama's legal and regulatory framework at the beginning of the decade reflected the country's long tradition as an international banking center and off-shore banking haven for international banks. Banks in the international center represented some of the world's largest and most sophisticated institutions, and the assets of the system were more than the other Central American countries combined.⁶ Panama had to weigh the benefits of reform against the cost of a negative reaction from the international banking center. Nevertheless, in 1997, Panama launched an aggressive regulatory reform program. The National Congress passed one of the most modern banking laws in Latin America, establishing a legal basis for information sharing and cooperative supervision with foreign regulatory agencies. The Superintendency of Banks was created and quickly set to the task of developing operational capacity to supervise sophisticated international banks. Despite the progress in the regulatory area, the Financial Action Task Force listed Panama as materially incompliant with the Basle Committee's guidelines for controlling money laundering in 1999. Although the weaknesses were related to non-banking aspects of the legal and institutional environment, the Superintendency of Banks coordinated efforts to address problem areas, and Panama was removed from the black list the following year.

⁶ Even in 2002, Panama's banking system had US\$34 billion dollars in assets, compared to the combined total of US\$31 billion for the rest of Central America.

The pending regulatory reform agenda is still significant in the Central American countries. The initial achievements at the policy and institutional level gave credibility and momentum to regulatory reform. However, the political culture of the countries will have to lend decisive support to the effort to empower supervisors with the authority they require to enforce the new regulations. Given the nature of political culture in small countries of the region, this support will have to come from the highest levels of all branches of government.

D. Deepening of Financial Markets

Financial markets grew deeper over the period. Banks developed a commercial focus, with industry leaders forming regional groups. Regulated institutions began reaching the microenterprise market through product innovation and specialization.

Financial markets expanded in the region in the 90s in response to a combination of factors that generated incentives for financial intermediation. Deposit rates were still negative in real terms in all of the Central American countries at the end of the 1980s, due in large part to high inflation. However, with the liberation of interest rate controls, banks were able to set positive real prices for savers as macroeconomic conditions stabilized over the decade. Banking regulators adopted modern prudential standards that required banks to limit lending to clients related to the bank and diversify risk across economic sectors. These conditions gradually changed the business of banking, and created incentives for banks to develop financial instruments to expand their markets.

Governments of the region provided support to banks to stimulate the expansion of financial services to the real economy. At the beginning of the 90s, the lack of liquidity, particularly long term resources, posed a constraint to the growth of private sector lending. In response, governments developed second-tier lending facilities to provide banks with liquidity to meet unmet demand for credit. The IDB supported this approach with technical assistance in creating the lending facilities, and with nine Multisectoral loans for lending capital over the period, complementing domestic savings with long term financing that was generally unavailable in the markets. In addition, the IDB supported the Central American Bank for Economic Integration (CABEI) with financing for its program of support to the Central American private sector.

The table below summarizes the general trend of the period. Overall, total deposits increased dramatically as a percentage of GDP, and banks channeled the bulk of those resources to the private sector.

Credit to the Private Sector and Total Deposits (% of GDP)			
	1990	2001	Change
Belize			
Private Credit	37.3%	64.5%	73%
Total Deposits	36.2%	62.1%	72%
Costa Rica			
Private Credit	15.1%	27.7%	84%
Total Deposits	36.5%	38.4%	5%
El Salvador			
Private Credit	20.1%	40.3%	100%
Total Deposits	24.1%	53.1%	116%
Guatemala			
Private Credit	12.5%	20.0%	60%
Total Deposits	16.1%	25.7%	60%
Honduras			
Private Credit	24.4%	45.6%	87%
Total Deposits	23.8%	47.7%	100%
Nicaragua			
Private Credit	3.8%	51.2%	1,247%
Total Deposits	3.9%	64.1%	1,531%
Panama			
Private Credit	46.7%	116.8%	174%
Total Deposits	160.3%	190.7%	30%

Within this generally positive trend, performance varied significantly between countries, and these differences help illustrate the factors that drove this process. El Salvador and Nicaragua saw dramatic increases in savings rates. Both countries made a transition from nationalized financial systems to private sector-led competition models in the 1990s. In contrast, Costa Rica's State banks continued to dominate their market, impeding growth and innovation through competition. Costa Rican private banks grew over the period, but an unknown quantity of their assets was managed in non-bank and off-shore affiliate institutions. As a result, it is not possible to know the precise scale of banking services available to the Costa Rican consumer, and the structure of the banking system presents considerable challenges for regulatory and tax authorities. However, recent legal and regulatory changes have provided the authorities with greater powers to supervise the banking system on a consolidated basis (including the offshores), and the quality of banking statistics is expected to improve as a result.

The emergence of regional financial groups in the region is also an important indication of the maturity of the markets. Given the structure of the markets at the beginning of the decade, the emergence of larger banks with a regional scope was a necessary step towards gaining efficiency in financial intermediation. Markets were generally fragmented in many small banks with high operating costs. For the banks committed to commercial banking, regionalization was a natural step in their growth process. By the end of the 90s, the larger groups were developing economies of scale that created opportunities for reducing overhead costs, diversifying risks, and offering a wider range of financial products.

It is difficult to track the evolution of the bank groups, because none of the countries of the region have legislation that requires consolidated reporting in a detailed format. Nevertheless, the table below shows the market share, measured in assets, of the ten largest groups operating in Central America. Excluding Panama's international banking center, at the end of 2001, the 10 largest groups managed over a third of the assets of the banking sectors of the region.

Assets of Bank Groups as Percentage of Total Assets in Sector								
	CR	ES	GU	HO	NI	CA Subtotal	PN	CA & PN
December 2001 (%)	20.7	62.9	7.8	25.3	83.7	34.9	11.8	19.0

Data from the Executive Secretariat of the Central American Monetary Council

Financial institutions expanded the markets through product innovation and specialization in markets previously unattended by the banking system. Over the period, banks developed instruments for personal loans, credit cards, leasing, factoring, mortgages and business lending. In most of the countries of the region, the microenterprise sector constituted the largest unserved segment of the business community, and some banks made the investment in developing financial instruments to serve that market.

The Evolution of Microenterprise Lending⁷
Bank competition for new market niches in the 1990s created incentives for specialization in the microfinance market. The IDB supported this development with lending capital and technical assistance. Four of the IDB's liquidity loans in the 90s took the form of Micro Global Credit programs that provided funding to regulated financial institutions lending to the microenterprise sector. In parallel technical assistance programs, the IDB supported participating financial institutions in developing systems and specialized lending vehicles to service the sector. In Nicaragua, program resources were spread widely across the banking sector, as several banks launched aggressive programs to capture market share. In El Salvador and Costa Rica, the programs provided important support to institutions seeking to specialize in the sector. In Guatemala, banks partnered with community-based organizations who assisted in managing the direct relationship with the clients. While the Micro Global Credit programs provided support to existing banks, the IDB group also supported the creation of specialized microfinance institutions. For 25 years, the Small Project Program had supported community-based development organizations, many of them with credit programs for microentrepreneurs. In the 1990s, the Multilateral Investment Fund (MIF) began supporting the creation of regulated financial institutions specializing in microfinance. The Financiera Calpiá in El Salvador was one such case. Financiera Calpiá, S.A. assumed the lending operations of a non-profit association, AMPES (Asociación de Pequeños y Medianos Empresarios Salvadoreños). In 1994, the MIF provided US\$800,000 in founding capital, joining AMPES and other investors in the creation of a regulated finance company specializing in microfinance. By the end of 2001, Calpiá had converted into a bank with US\$41.5 million in assets and 35,000 clients.

⁷ For more information on this subsector, refer to Chapter 10 on Microfinance.

The microenterprise sector and the rural sector of the countries of the region still employ the majority of the population, and these sectors do not have adequate access to financial services. This will be the ultimate challenge for the financial sectors of the region, to develop products and distribution channels that expand the reach of the formal markets.

E. Capital Markets

Countries of the region began developing their capital markets in the latter half of the 1990s. Most countries established a legal and regulatory framework and created supervisory bodies for the capital markets with IDB-MIF assistance. Development of public sector debt markets will be the first step in the region towards broader capital market growth.

The region's policy makers directed their attention to capital markets after the first wave of banking sector reforms, and consequently capital markets are still in the initial stages of development. Banking sector development was much more important to the global objective of short term economic development and justifiably dominated initial reform efforts. The table below demonstrates that countries repeated the reform sequence established in banking sector programs, but began the process later.

Capital Market Development Initiatives 1990 – 2001			
	Established Legal Framework	Established Regulator	IDB/MIF- Financed Modernization Program
1991		Costa Rica	
1994	El Salvador		Regional El Salvador
1995	Guatemala		
1996		El Salvador Guatemala	
1997		Costa Rica (Phase II)	Costa Rica Guatemala Panama
1998	Costa Rica		Nicaragua
1999	Panama	Panama	El Salvador
2001			Regional

El Salvador, Guatemala, Costa Rica and Panama succeeded in passing global capital markets legislation, as well as in establishing a supervisory authority for their respective markets. All countries had at least one stock exchange with enlisted brokerage firms by the end of the 1990s.

The exchanges of the region varied widely in terms of transaction volume at the end of the 90s, however they displayed common characteristics. All of the markets were dominated by public sector debt issues. The majority of negotiable paper was issued by the Central Bank or Treasury, and about half of the issues were purchased by public

sector institutions. In comparison, private sector debt issues were still a small part of the markets, and only a handful of firms had issued equity shares. Most volume occurred in the primary markets, where short term public issues were purchased for term. Secondary market trading was mostly repurchase transactions conducted by banks for liquidity management.

Securities Market Indicators 1998 and 2002						
	CR	ES	GU	HO	NI	PN
Market Volume 1998 (US\$ millions)	\$23,818	\$6,650	\$10,127	\$2,789	\$558	\$848
Market Volume 2002 (US\$ millions)	\$24,461	\$7,569	\$8,016	\$1,306	\$527	\$1,414
Primary Market	21%	14%	24%	100%	79%	64%
Secondary Market	79%	86%	76%	0%	21%	36%
Repurchase Operations (of total)	54%	79%	72%	0%	2%	17%
Volume by Sector						
Public Sector	91%	88%	99%	98%	91%	42%
Private Sector	9%	12%	1%	2%	9%	58%
Volume by Currency						
National Currency	38%	0%	96%	78%	68%	0%
Foreign Currency	62%	100%	4%	22%	32%	100%

1998 data from Garcia, Ketterer and Vegara, *Mercados de Liquidez y de Deuda Pública en Centroamérica, 1999*. Data for 2002 compiled by the Central American Monetary Council, except for Guatemala, which was provided by the Guatemala National Stock Exchange.

No data available for Belize.

The IDB/MIF financed capital markets modernization programs in most of the Central American countries in the later half of the 1990s. The first program, the Regional Capital Markets Harmonization Program, engaged policy makers and private sector actors in initial discussions about the long term development of institutional infrastructure for capital markets. Individual programs followed in five countries. For the most part, the countries focused on establishing the legal and regulatory framework for the markets. Market activity languished, however, in the absence of a coherent strategy for organizing supply and demand for securities in an efficient trading environment.

The demand for securities is undeveloped in the region. Only Costa Rica, El Salvador and Panama had initiated collective investment vehicles by the end of the 1990s. El Salvador was the first country to implement a system of private administrators of public pension funds, and Panama followed in 1999. The role of insurance and pension funds as institutional investors is still undeveloped due to the structure of those markets.

The principle impediment to growth in the capital markets of the region has been the lack of organization of the public sector debt markets. The treasuries and central banks supply the region's markets with the bulk of tradable securities. However, these institutions designed their respective debt instruments for their immediate institutional objectives,

and did not issue these securities in a standardized form conducive to secondary market trading.

All of the countries established securities exchanges in the 1990s, and in most countries governments supported their development by issuing debt through the exchanges, in some cases granting them monopolies on secondary market trading. Overall, the initial focus on developing the securities exchanges discouraged the emergence of a robust interbank market, or of secondary market makers. Money markets are the driving force of debt and equity markets, and in Central America, they are generally fragmented and inefficient, divided between the exchanges, the Central Bank's lending facilities, and the informal interbank market.

Clearance and settlement systems were designed and have been adequate for primary market issues, but basic infrastructure is lacking for robust secondary market trading. Finally, administrative idiosyncrasies and lack of operational and reporting standardization impedes regional trading, which will be critical for building economies of scale in the markets.

Case Profile: Public Debt Market Organization in Costa Rica

In 1997, the IDB/MIF financed a program of support to the Government of Costa Rica's plan for developing its public sector debt markets. The program was conceived and organized by a coordinating committee representing the central bank, treasury, and the securities market regulator. The committee developed a unified plan for developing the market.

The central bank and treasury coordinated their respective debt issues through a weekly auction. Both institutions began a process of standardizing their instruments to facilitate secondary market trading and yield curve development. The Treasury launched an internal reform of its operations, reorganizing them along the functions of front, middle and back office, and the regulator gradually phased in regulations requiring standardization of all issues in the market, both public and private.

Finally, the committee launched an ambitious project for the creation of a book-entry clearance and settlement system. During the design of the system, the committee was able to engage all actors in the system in an assessment of all transactional flows in the market. In the process, policy makers worked with the private sector to define a market model to create depth and liquidity in the money and debt markets.

The Costa Rican government was the first in the region to implement a program for organizing its own debt market as a strategy for broader market development.

In 2001, the IDB supported a regional program for the harmonization of the public sector debt markets. The program assisted the central bank governors and Ministers of Finance of the region in (i) drafting and adopting a regional memorandum of understanding for the "Adherence to Minimum Standards for Harmonization of Public Debt Markets," (ii) creating country-specific diagnostic reports and market development plans, and (iii) defining standards and programs of training of key personnel. This initiative marked two important milestones in the development of financial markets in the region. First, policy makers developed a coherent strategy for developing the securities instruments needed for domestic debt financing, bank liquidity management, and the institutional

savings market. Just as importantly, however, the policy makers of the region made a significant commitment to developing their individual sectors within a long-term plan for development of a regional market.

IV. Maintaining Momentum for the Agenda Ahead

Every country in Central America passed into the new millennium with a financial sector more dynamic and better regulated than it was at the beginning of the 1990s. The tangible achievements – the legislation, institutional reform and sector growth - were indeed significant considering the condition of the markets at the beginning of the decade. In retrospect, the markets made significant progress; looking forward the agenda is still formidable.

The need for deeper financial markets, and more effective supervision, still drive the pending agenda in the region. The microenterprise and rural sectors comprise a majority of the economically active population in the region, and they do not have access to adequate financial services. The banking crises at the end of the 1990s were a reminder that governments still need to build effective supervisory regimes to enforce industry regulations.

Further progress in financial market modernization will depend a great deal on factors exogenous to the markets themselves. Fiscal discipline and monetary stability will continue to shape public confidence in national financial markets. The legal code and judicial system must provide an adequate enabling framework for financial institutions to develop creative instruments and lending policies. The regulatory and administrative framework that comes to bear on business must be streamlined. Collectively, these factors determine the competitiveness of businesses in the region's economies, and growth in financial intermediation will evolve accordingly. Importantly, during the 90s, governments built the credibility they will need to address this broader agenda in the decades to come.

The following categories organize the pending agenda in areas of action where policy makers can leverage the achievements of the period into future reform initiatives.

A. Macroeconomic Stability

Governments of the region contained inflation to manageable levels during the 1990s, and investor confidence and price stability improved substantially from the 1980s. This trend must continue, with an aggressive commitment to controlling fiscal deficits. The banking systems of the region still hang in a delicate balance with macroeconomic performance, and price stability is still the primary prerequisite for the confidence that will fuel growth in financial markets. Financial market development will parallel government commitment to fiscal discipline.

B. Effective Regulation and Supervision

Legal and regulatory frameworks must continue to develop with their markets. No country in the region has a framework for consolidated supervision of banks and their affiliates, and this is an urgent priority.

Initial achievements in regulatory reform must evolve into effective supervision. In the small countries of the region, the authority of the market regulators is derived in part by law and at least in equal measure by the support of all branches of government. The legal and regulatory frameworks created in the 1990s need a greater degree of political support to be effective. Policy makers will need to make deliberate attempts to broaden political consensus around the importance of market regulation and supervision, and to engage the highest levels of government in the process.

C. Capital Markets and Institutional Savings

Public sector debt markets, insurance and pension industries are still undeveloped in the region. These are the markets that will generate long term savings, provide investment vehicles to complement the banking sectors, and encourage the development of private debt and securities market.

D. Market Deepening

The microenterprise and rural sectors are still marginalized in the region's economies by factors that also impede the extension of financial services to these sectors. Given their social and economic importance throughout Central America, these sectors in particular deserve special attention by policy makers when formulating strategies for broader market development.

E. Financial Systems Infrastructure

Modernization of payment system infrastructure and clearing and settlements systems will provide a foundation for product innovation, risk management and administrative efficiency. All of the countries of the region would reap immediate benefits from improvements in the money market in the form of more efficient liquidity management and impetus to bond market development.

F. Enabling Environment

Transactions in financial markets are also dependent upon the broader business environment, commercial code and judicial system. The secured transaction framework requires fundamental reform in order to provide financial institutions with vehicles for guaranteeing loans. Judicial procedures related to financial transactions need to be streamlined to enable banks to manage client risks.

G. Regional Harmonization

The financial institutions of the Central American countries must be able to operate on a regional level. Ultimately, regional scope is necessary to develop economies of scale, especially in capital markets, and the institutions need to be able to provide financial services to an increasing integrated regional economy. Banks have demonstrated this trend already. Policy makers have committed to regional cooperation in the development of their public debt markets. This trend should continue, particularly in the area of regulation. Market regulators will need to harmonize prudential frameworks and develop the capacity to share information.

V. The Evolving Role of the IDB

The IDB has supported the Central American countries through a period of policy and institutional reform of their financial markets. The process began with sweeping macroeconomic reform programs packaged with large liquidity loans, and continued through technical assistance projects for the modernization of institutions and market infrastructure. The pending agenda for the development of financial markets will require an ongoing program of reform on both policy and institutional levels. However, the impetus and context for reform has evolved in the region, and in the future, countries will call on the IDB for a different mix of resources.

The macroeconomic urgency that drove the first generation of financial sector reform has abated. Likewise, the policy based loans that gave structure to the reform initiatives in the 1990s have already made their most significant impact. Already by the end of the decade of the 90s, the majority of modernization efforts were defined and supported outside of the IDB's traditional lending program through technical assistance projects. With the further passage of time, the modernization process will be driven increasingly by the collective will of policy makers and the private actors in the financial markets. The IDB's role in the process will depend increasingly on the Bank's relevance as a policy dialogue partner, and source of technical assistance.

Annex

LIST OF SELECTED IDB LOANS TO CENTRAL AMERICA'S FINANCIAL MARKETS AND BANKING SYSTEMS FOR STRUCTURAL REFORMS, PROVISION OF LIQUIDITY AND TECHNICAL ASSISTANCE SUPPORT TO CENTRAL BANKS AND REGULATORY AGENCIES

COUNTRY	LOAN NUMBER	PROJECT TITLE	YEAR OF APPROVAL	US\$ MILLIONS
Costa Rica	590/OC-CR	Agricultural Global Credit Program	1990	\$45.5
Costa Rica	701/OC-CR	Global Credit for Microenterprise	1992	\$10.0
Costa Rica	742/OC-CR 743/OC-CR	Investment Sector Loan/Multisector Credit *	1993	\$170.0
Costa Rica	1030/OC-CR	TC Loan for Structural Reform	1997	\$12.7
El Salvador	850/SF-ES 612/OC-ES	Multisectorial Global Line of Credit I	1990	\$60.0
El Salvador	915/SF-ES 780/OC-ES	Global Credit for Microenterprise	1993	\$24.0
El Salvador	885/OC-ES	Multisectorial Credit II	1995	\$100.0
El Salvador	1173/OC-ES	Institutional Strengthening Financial Sector Regulatory Institutions	1999	\$3.8
El Salvador	1265/OC-ES	Modernization Social Security Institute	2000	\$5.8
Guatemala	886/SF-GU	National Microenterprise Program	1992	\$10.0
Guatemala	917/SF-GU 784/OC-GU	Financial Sector Program *	1993	\$132.0
Guatemala	1400/OC-GU	Financial Sector Program II *	2001	\$200.0
Honduras	718/OC-HO	Multisectoral Global Credit Program	1992	\$60.0
Nicaragua	864A/SF-NI 638/OC-NI	Sector Program of Trade and Finance *	1991	\$132.5
Nicaragua	789/OC-NI	Non-Conventional Credit Program	1993	\$23.6
Nicaragua	979/SF-NI	Public Administration Reform*	1996	\$32.0
Nicaragua	1015/SF-NI	TC Loan for Financial Sector Reform	1998	\$0.8
Nicaragua	1014/SF-NI	Financial Sector Loan *	1998	\$65.0
Panama	1074/OC-PN	Financial Sector *	1997	\$130.1
		Total		\$1,217.8

* Fast-disbursing, Policy Based Loan (PBL).

CHAPTER 10: MICROENTERPRISE DEVELOPMENT

Marguerite Berger and Glenn D. Westley

I. Introduction

Consolidation of peace in Central America in the late eighties to mid nineties, together with the end of the debt crisis and the “lost decade” of the eighties, brought new possibilities for economic growth and development to the region. A noteworthy chapter of the story of Central American development since 1990 relates to the smallest businesses which provide economic opportunity to poor – microenterprises.¹ The phenomenal growth of the microfinance industry in Central America and its impact on the growth and development of the region is one of the success stories since 1990. Markets for business development services (or non-financial services), such as those for training, technical assistance, marketing, information, and technology, have also grown, and although their development is still incipient and their impact more limited, they are part of the microenterprise development story as well.

This report looks behind these trends in the region and examines the significant role of the Inter-American Development Bank in supporting and fostering policy reform and investments in institutional capacity that were key to the development of Central America’s microenterprises and economies as a whole.

Although focused on microenterprises, this report looks at these businesses within the broader context of the economies in which they operate. Microenterprises are part of a continuum of business activity classified by size. The standard definition of microenterprise is based on the number of employees working in the enterprise, and although there is a statistical concentration of businesses in Central America in the zero-to-ten employees, this definition is to a certain extent arbitrary. One cannot easily separate all ten-employee firms from those with eleven or even more employees. The definition is really nothing more than a rule of thumb used to put boundaries around the cluster of businesses at the lowest end of the business continuum. This chapter looks mainly at trends in the region with particular implications for the zero-to-ten employee microenterprises and at IDB programs designed to address the problems of this segment. However, the report would not be true to the reality of microenterprise development if it did not also address issues and programs related to small business development that affect microenterprises or subsegments of the microenterprise sector to some degree.

¹ The IDB defines microenterprises as businesses with fewer than 10 employees. In the literature, this employment-based definition is the most commonly used measure of microenterprise, although the ceiling may be either 5 or 10 employees. Less frequently used definitions are asset size (generally under US\$20,000) or net income of the owner (below the poverty line). Not all microenterprises are owned and operated by poor people, but there is a concentration of poverty in the sector.

II. The Importance of Microenterprise and Microfinance in Central America

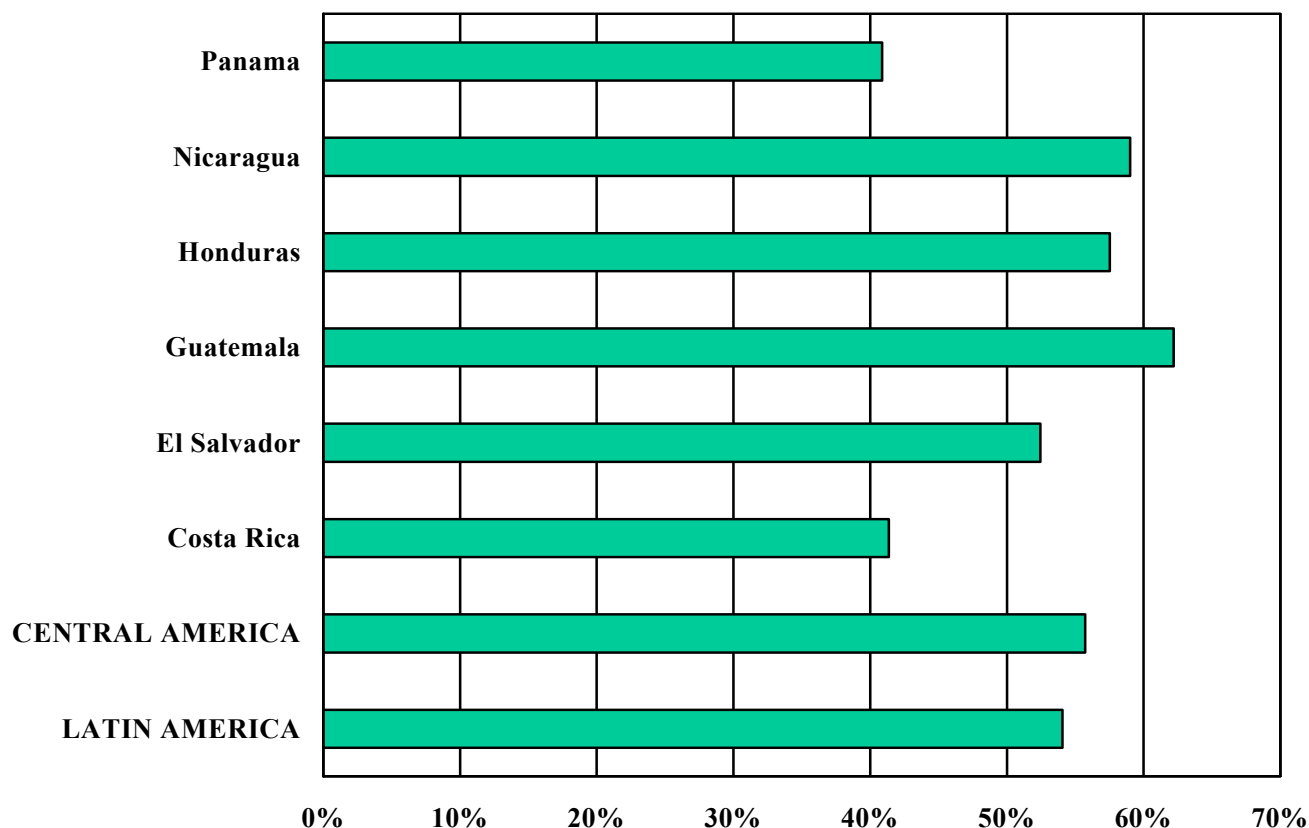
A. Microenterprises: Key Source of Employment and Income for the Poor

Despite their name, there is nothing small about the role of microenterprises in the economy of Central America, or for that matter, in that of Latin America. Figure 1 shows that microenterprises account for a little over half of total employment, both in the Central American region and, more broadly, in Latin America. In Central America, microenterprises account for 56 percent of total employment, of which employees of microenterprises account for 26 percent and firm owners (mostly owners of firms with no employees) account for 30 percent.

While reliable data on the share of GDP produced by microenterprises is much more difficult to find, data from four Latin American countries (Mexico, Brazil, Dominican Republic, and Belize) indicate that microenterprises produce about 20 percent of GDP.

Not only are microenterprises important to overall production and employment, they are also a key to poverty alleviation. Analysis of the 1998-99 household surveys in Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama shows that 71 percent of all poor earners are connected with microenterprises, either as employees or as owners. In fact, the breakdown is as follows: 35 percent of the poor earners in Central America are employees of microenterprises, and 36 percent are owners of microenterprises—in almost all cases the owners of firms with no employees. With 71 percent of the poor earners connected to microenterprises, policy-makers concerned about poverty reduction must consider how to stimulate employment and income growth within these firms. Corroborating these data, a wider analysis of 15 countries in Latin America reveals virtually the same result: 72 percent of all poor earners are connected with microenterprises, split evenly between employees and firm owners.

Figure 1
Microenterprise Share of Employment, 1998-99 (%)



Data not available for Belize

Source: Household Surveys. Note that these surveys define microenterprises as firms with 5 or fewer employees.

B. The Importance of Financial Services for Microenterprises

The substantial role of microenterprises in production and employment, together with a growing body of evidence that increased usage of banking services is associated with greater economic efficiency and growth, implies that better serving these firms could yield growth rate gains that are significant in macroeconomic terms. For example, King and Levine (1993) find that a 10 percentage point rise in the ratio of private banking system credit to GDP is associated with an increase in the annual GDP growth rate of about 1/3 of a percentage point. Ghani (1992) finds an even larger growth effect, approximately 1/2 of a percentage point. With microenterprises producing approximately 20 percent of GDP but absorbing less than 2 percent of the total US\$29 billion in credit union and banking system credit in Central America, these firms are still vastly underserved and have great potential for expanding productivity and output, as more credit is made available to them. The fact that microenterprises account for over half of total employment also suggests that macro economically-significant employment gains

could be derived from easing constraints on microenterprise access to credit and other financial services.

Complementing this macro-level view are the numerous studies that measure, at the individual firm level, the increases in income and employment that have ensued from access to credit. These studies follow both a “case” group of microenterprises that received credit and a “control” group of microenterprises that did not. As the many impact studies surveyed by Sebstad and Chen (1996) make clear, microenterprises, including those below the poverty line, derive substantial income gains from access to credit, with the gains typically increasing over time as additional, larger loans are extended to them.² These studies also report substantial employment creation by micro loan programs.

Another piece of evidence that microenterprises have many high-return projects waiting in the wings, frustrated by lack of finance, is the very high loan rates routinely paid by these firms when credit is made available to them. These rates are often 20-30 percentage points above the country’s inflation rate, far in excess of commercial bank rates. Moreover, when good micro lending programs are started up, they often attract a huge following despite charging such high real loan rates. This means that large numbers of microentrepreneurs have productive uses for credit, with rates of return 20-30 percentage points above inflation or more, clearly very lucrative activities.

Credit is not the only financial product of importance to microentrepreneurs, though it often receives the bulk of the attention in much of what is said and written about the provision of financial services to microenterprises. This imbalance is unfortunate since the provision of savings services is also very important and there is also a latent demand for appropriately tailored deposit services from microenterprises. In the credit unions of Central America the pure savers (those members with savings but no loans) typically outnumber the borrowers, sometimes by margins of 2:1 or more.

Thus, there are many ways in which the development of microfinance in Central America can increase the income and employment of the firms that access these services, and in so doing, measurably impact the overall growth rate and employment levels of the Central American economies. Equally important to the development of the microenterprise sector, but far from having the impact of microfinance during the period since 1990, are policy and regulatory reforms to create a promising business climate for this sector, and the provision of non-financial business development services, such as training and marketing, in a sustainable manner.

² This is not to say that business failures don’t occur among borrowers. For example, Hulme and Mosley (1996) find that while some borrowers *are* left worse off after they have made use of their loans, they are a distinct minority. In the 13 programs whose impact they evaluate, all are found to raise the average income levels of program participants. These findings of a positive overall impact are similar to those found in other impact studies as well.

III. Changes in Central America Create Opportunities for Microenterprise Development

Since 1990, three processes of change have supported microenterprise development in the countries of the Central American region: (i) changes in the economic environment brought about in large part by improved macroeconomic policy and financial sector reforms; (ii) changes in governmental approaches to micro and small enterprise development; and (iii) a changing political environment and corresponding changes in civil society organizations, specifically those focused on economic development. The IDB played an important role in supporting these changes as well as concrete initiatives to promote microenterprise development in the newly favorable environment.

A. The Economic Environment

Major changes in the economic environment opened up new possibilities for microenterprise growth, especially through the development of microfinance services. Most prominent among these changes are: (i) macroeconomic policy reforms, which created greater stability; (ii) financial sector reforms, which created space for the development of a sustainable microfinance industry; and (iii) second generation institutional and microeconomic reforms, which are allowing for better risk management in microfinance, and competition, both of which lower the cost of financing for microenterprises.

Since 1990, IDB's support for microenterprise development became increasingly varied and sophisticated, particularly in its support for microfinance. An expanding range of instruments allowed the Bank to play an even more important role in the development of sustainable microfinance in the region. IDB support evolved from one-off small project loans charging negative interest rates, to small project packages benefiting groups of microfinance institutions (still NGOs) and moving them closer to market rate financing, to global loans supporting a wide range of institutions through a second tier institution and the Social Entrepreneurship Program (SEP) which built on the earlier small projects and supported both financial and non-financial services for microenterprises. With the creation, in 1993, of the Multilateral Investment Fund (MIF) bringing a new approach to the private sector, the Bank group acquired a powerful tool for microfinance development. The discipline of negotiation and management of equity investments from the Bank brought a wider range and greater sophistication of instruments. MIF made a significant contribution at a critical turning point in the development of the microfinance industry in Central America, supporting the first microfinance institutions (MFIs) to "transform" themselves into regulated financial institutions.

B. Government Approaches to Micro/Small Business Development

To a lesser extent, the time period since 1990 has brought changes in government policies and programmatic approaches to micro and small business development. The approach had evolved from the 1970s and 80s, when punitive policies were targeted to microenterprises that were viewed as illegal and transitional economic activities. This

had been coupled with the notion that the government was the only actor capable of assisting in the development of small and medium enterprises, and to the extent that resources allowed, that government should take the lead in providing services, especially cheap credit, technical assistance and training, to small and medium enterprises in order to compensate for the disadvantages they faced due to their size. Gradually, over this period, the approach changed to one that recognized the importance of microenterprises as well as small and medium enterprises, but focused government action and resources in an assisting role, creating the proper environment for the development of these businesses. Some countries, such as Guatemala created Vice Ministries or other offices for the Micro, Small and Medium Enterprises to facilitate these processes.

In 1990 non-financial, business development services (BDS) were either non-existent or run entirely by governments with continually declining levels of funding and quality. Although not as significant as in microfinance, IDB's involvement has nonetheless played an important and ever increasing role in this area.

The IDB contributed to the development of a new approach by: (i) financing pilot programs for private delivery of business training through vouchers; (ii) providing support for marketing of microenterprise products by private businesses and non-profit organizations (with an approach that moved from producing and then selling to selling and then producing); (iii) providing support for restructuring of government programs and functions for micro and small enterprise development; and (iv) promoting competitiveness through the development of clusters of small enterprises, particularly in the industrial sector, reaching microenterprises at the high end and those that are subcontracted by larger firms.

C. Changes in Civil Society Organizations/NGOs

The involvement of NGOs in this area was, in part, a legacy of the years of civil strife. During this period, non-governmental organizations grew in size and importance, often supported by international donors. Beginning in the 1970s some aid donors preferred to find ways of working with low-income communities outside the traditional channels of official development assistance, dealing directly with non-governmental organizations based in these communities. This coincided with the birth of the IDB's Small Projects Program (SPP) in 1978. With support from outside donors the NGO sector grew dramatically in Central America, and by the early 1990s a number of these organizations had reached considerable size.

The NGOs in Central America operated in all sectors of development activity: from health and education to human rights. A subset among them focused on economic development, generally in agriculture or income-generating activities in rural and urban areas. It was with this group that the IDB worked in the late 70s and the 1980s, helping to build the most effective institutions in the region.

With the political changes of the late 80s and the 1990s, the role of nongovernmental organizations in Central America changed dramatically. They began to work more with

governments in the region. Although the NGO sector as a whole maintained its political and advocacy functions, parts of the sector became parallel providers of services, especially social services with financing from international development agencies and local governments. Some of the existing NGOs that had focused on economic development opportunities for the poor began to specialize in financial services and emerged as an alternative to ineffective government credit programs and to informal moneylenders who were often the only option for microentrepreneurs.

For different reasons, these organizations began to seek greater independence from official sources of financing – whether of their own governments or international donors. The different strategies used include membership, private sector contributions, selling services, and for the most solvent NGOs, the receipt of local bank loans.

Some began to see their small income-generation projects that made loans to self-employed people running microenterprises as potentially sustainable operations, and they began to think about their credit programs as something more than a revolving fund dependent on grants to keep running.

In a combination of searching for funding sources other than governments, multilateral and bilateral development agencies on the one hand, and engaging in efforts to provide a wider range of services to their customers on the other, NGOs specializing in microcredit began to look into the possibilities of creating regulated financial institutions.

As part of its new civil society program, the IDB supported the development of the NGO sector with a series of seminars and ongoing dialogue with NGOs and between these actors and the governments, beginning in the mid 1990s. These efforts focused on developing legal frameworks, improving the environment for civil society organizations to operate within, building networks and training. The Bank also continued to support individual NGOs with financing from the Small Projects/Social Entrepreneurship Program, which focused on those NGOs specializing in economic development. This program was, and continues to be, the main source of IDB support for the development of NGOs and their activities.

IV. Development of the Microfinance Industry in Central America

Collectively, the regulated banking institutions (such as the commercial banks and finance companies) and non-regulated financial NGOs that serve the microenterprise sector are known as microfinance institutions, or MFIs. Of the approximately four million microenterprises in Central America, about 375,000, or 9.4 percent, have credit from an MFI (see Table 1). Total credit outstanding is US\$175 million. Central America's 9.4 percent penetration rate is far above the 2.6 percent registered for Latin America as a whole and represents one of Central America's important development stories. Virtually the entire microfinance industry and its current level of outreach have been the fruits of recent labors, with coverage in 1990 having been only a tiny fraction of today's levels.

The keys to this still evolving success story are changes in the economic environment, brought about largely by macroeconomic and financial sector reforms, and institution building efforts to create and strengthen microfinance institutions. IDB played a significant role in both of these efforts, beginning in the 1980s and continuing with greater force and focus since 1990.

Table 1 Share of Microenterprises in Central America and Latin America with MFI Credit					
Country	Number of Single-Person Firms	Number Of Firms With 1-5 Employees	Total Number of Microenterprises	Number of Microenterprises with MFI Credit	Share of Microenterprises with MFI Credit
Bolivia	1,300,313	62,008	1,362,321	379,117	27.83%
Nicaragua	377,148	40,422	417,570	84,285	20.18%
El Salvador	606,569	60,617	667,186	93,808	14.06%
Honduras	832,941	58,239	891,180	107,054	12.01%
Chile	1,069,139	138,045	1,207,184	82,825	6.86%
Guatemala	1,328,476	93,238	1,421,714	71,187	5.01%
Costa Rica	232,328	78,891	311,219	12,794	4.11%
Ecuador	1,396,139	298,524	1,694,663	65,719	3.88%
Dominican Republic	1,315,016	77,172	1,392,188	49,437	3.55%
Colombia	5,726,653	775,152	6,501,805	219,240	3.37%
Paraguay	319,113	668,213	987,326	30,203	3.06%
Perú	4,102,561	2,763,632	6,866,193	185,431	2.70%
Panamá	267,854	21,150	289,004	6,390	2.21%
México	8,503,552	1,770,393	10,273,945	67,249	0.65%
Uruguay	314,891	27,018	341,909	1,600	0.47%
Brazil	16,567,943	2,421,810	18,989,753	62,485	0.33%
Argentina	1,807,615	103,555	1,911,170	4,940	0.26%
Venezuela	2,906,975	340,296	3,247,271	2,364	0.07%
Latin America	48,975,225	9,798,375	58,773,600	1,526,128	2.6%
Central America	3,645,316	352,557	3,997,873	375,518	9.4%

Data not available for Belize.

Sources: IDB, 1998. Household surveys from 1998-99 for the number of microenterprises; Christen (2001) and IDB loan files.

A. Policy Changes Directly Affecting Microenterprises

Consolidation of peace in most of Central America in 1989-90 and in Guatemala in 1996, a world economy that grew much more rapidly in the 1990s than in the 1980s, and the broad adoption of economic stabilization and reform programs by the Central American countries were among the major factors that returned the region to a path of faster economic growth and reduced inflation levels since 1990 as compared to the “lost decade” of the 1980s (Table 2). In fact, at present, all the countries have achieved single-digit inflation levels. The process of stabilization was most dramatic in Nicaragua, where inflation declined from levels of over 10,000 percent in 1988 to 20 percent by 1992 and fell even further after that point. In addition, economic growth in the Central American countries was notably faster in the 1990-97 and 1998-2003 periods than in the 1980s.

Starting in 1997, a number of external shocks assailed the region, including: the Asian and Russian financial crises of 1997-98 that affected flows of capital and technology to Central America and to developing countries in general, a number of natural disasters including Hurricane Mitch and El Niño in 1998-99, the 70 percent fall in wholesale coffee prices over the period 1997-2001, and the world economic recession since 2001. The effect of these events varied by country, but by 2002, real GDP growth had clearly slowed in all countries compared to the earlier 1990-97 and 1998-2001 periods.

Table 2: Inflation (% Change in Consumer Prices)							
	Belize	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
1981-90	4.2	27.2	19.2	15.1	20.9	2,438.9	1.8
1990-97	2.7	18.3	12.9	17.0	21.5	1,288.6	1.1
1998-2002	0.3	10.7	2.3	6.5	10.7	9.1	1.1

Sources: IDB (1998), ECLAC (2003), IDB (2002), and IMF *International Financial Statistics*, July 2003.

The generally more buoyant economic conditions and the increased price stability of the 1990-2003 period as compared to the “lost decade” of the 1980s provided a much more favorable macroeconomic environment for the development of the financial sector in Central America. This is because recessions generally lead to repayment problems for many clients and diminished profits or losses for the financial institutions that lend to them, while times of greater prosperity are generally associated with greater client capacity to repay and larger profits for lenders. Inflation rates that are higher are generally also more volatile. This makes setting a loan rate that covers inflation, all operational costs, and a profit margin more difficult. As a result, financial institution profitability is often harmed either because loan rates are set too low, directly reducing profit margins, or are too high, curtailing demand and compromising the repayment capacity of some clients.

Set against this more favorable macroeconomic background, the Central American countries carried out both first and second generation reforms to their financial systems. Both have been important in stimulating the rapid development of the microfinance industry in the region.

B. First Generation Financial Sector Reforms Create Space for Microfinance ³

The reform of domestic financial systems has been one of the most important means through which the Central American countries have tried to increase the productivity of their economies and raise their economic growth rates. These reforms were strongly embraced in Central America, with many or most countries in the region now having:

- Deregulated interest rates, of both deposits and loans
- Liberalized entry requirements for banks and other financial institutions
- Reduced reserve requirements to or toward prudential levels
- Dismantled targeted credit programs

³ For more information on this topic, see Chapter 9 on development of financial markets.

- Diminished the role of publicly-owned banks, and
- Improved prudential regulation and supervision

Most reforms were carried out in the 1988-96 period, but significant reforms have occurred after 1996 in some countries, notable examples being the improvement of prudential regulation and supervision in Panama starting in 1997 and in Costa Rica starting in 1998. In addition, reserve requirements have continued to be reduced, falling from a region wide average of 26 percent in 1995 to 17 percent in 2002.

As a result of the “first generation” reforms up to the mid-1990s, financial systems grew much larger, taking in far more savings and putting out a greatly increased volume of loans. There were substantial increases in the ratio of broad money (savings deposits, time deposits, checking accounts, and cash) to nominal GDP in the Central American countries. The efficiency of the Central American financial systems increased as well, as competition intensified and inefficient targeted credit programs and state banks were scaled back or closed down.

The removal of interest rate ceilings at this time permitted deposit rates to be increased, which attracted greater deposit volumes. A number of other reforms, such as the reduction in reserve requirements and curtailment of mandatory targeted credit programs with artificially low interest rate ceilings, have further increased deposit rates and consequently increased deposit mobilization. Liberalized entry requirements have permitted new foreign and domestic banks to start up operations--increasing competition, branching, and deposit rates, and improving services. Improved prudential regulation and supervision has increased the public’s confidence in the banking system, a *sine qua non* of deposit taking.

Financial sector reforms were conducive to the delivery of financial services to micro and small enterprises in two major ways. First, because of the removal of interest rate ceilings, it becomes possible for financial institutions to charge the high interest rates such lending requires. Second, by fostering greater competition and efficiency in serving traditional, larger-firm customers, intermediaries are encouraged to look for new, unexploited market segments such as serving smaller enterprises. Although state-owned banks and targeted credit programs did not reach the microenterprise sector with their lending operations, their heavy involvement in small business and rural lending served as a deterrent to the entrance of private lenders. Their diminished activity following the first generation reforms induced financial institutions to target first microenterprises, and then small business and small rural producers.

An unfortunate counter-trend has developed in two countries, however--Honduras and Nicaragua--where usury ceilings have again been imposed on loan rates. Such limits can block the ability of microenterprises to gain access to small loans, given the high average administrative costs of making such loans, and the corresponding need for lenders to charge relatively high loan rates to recoup their costs. Past experience in the region has shown that competition is a more effective and enduring method to bring down microcredit rates. It is fortunate, that while both countries have limited nominal loan rates

to a fairly low level, neither imposes any limit on the commissions that may be charged. In this way, the effective interest rate, consisting of the nominal interest rate plus the effect of the commissions, has been left unregulated. This experience demonstrates the need for IDB support to continually revisit financial policy areas that are fundamental to the existence of sustainable microfinance services, if these services are to remain sustainable.

C. Institutional Strengthening for Microfinance Institutions (MFIs)

In addition to creating space for microfinance to develop through policy and regulatory reform, more can be done to extend financial services to the vast majority of microenterprises that have no access to formal credit by strengthening those financial institutions that serve microenterprises, both institutionally and financially. The IDB and other development agencies, as well as the governments in Central America, have focused a great deal of attention on institutionally and financially strengthening these so-called microfinance institutions, or MFIs.⁴

Large infusions of government and donor money for institutional strengthening, as well as for equity investment and on-lending helped make possible the development and growth of the MFIs in Central America. To have achieved the outreach levels cited earlier, financially solid institutions had to be created. At first, institutional development for microfinance started with relatively weak NGOs engaged in microlending and helped build their institutional and financial capacities. While these organizations generally embraced the social mission of providing credit to low income microentrepreneurs, they did not have the banking skills, or in many cases, the mind-set or desire to create strong financial institutions. The first and foremost challenge faced by those NGOs that did attempt to become sustainable banking institutions was to keep arrears at very low levels (below 10 percent and in most cases, below 5 percent), even while lending to a poor clientele with little collateral. In addition, the MFIs of Central America faced many other challenges in their growth and development since 1990, including the need: to keep lending rates high in order to cover their costs (and help ensure sustainability); to make a profit in order to capitalize the institution (and underwrite future growth); to provision adequately for loans whose recovery was doubtful; and to rapidly expand outreach while maintaining portfolio quality and profitability. While many institutions did not overcome these challenges, some did, and these latter MFIs have grown rapidly and now serve much of the market attended to by the Central American MFIs.

Those MFIs that took the additional step of becoming regulated and going on to take deposits faced a number of additional challenges, which again was done with substantial assistance from donors, including the IDB. These MFIs had to become proficient at looking after the now vastly more complex liabilities side of their operations. They had to

⁴ Although the term *microfinance institution (MFI)* has been traditionally used to refer to financial institutions specializing in the micro and small enterprise market or in very small transactions, the recent and growing entry of mainstream finance companies, banks and credit unions into this niche has blurred the lines between MFIs and other intermediary financial institutions (IFIs). For purposes of this paper, those non-specialized IFIs that have a large portfolio of microenterprise credits and are actively competing in this niche are also referred to as MFIs.

develop capacity in: liquidity management (to prevent liquidity squeezes and resulting panics and runs), asset/liability matching (so that short term deposits weren't used excessively to fund longer term loans or foreign currency borrowings weren't used too much to fund domestic currency loans, leaving the MFI vulnerable to a sudden rise in interest rates or to an exchange rate devaluation), and in the selection and pricing of appropriate deposit instruments. On the plus side, the leverage provided by deposit-taking allowed for a major expansion of the MFI's funding base and therefore its credit outreach, as well as the provision of valuable savings services to its target population. Box 1 provides a sketch of Financiera Calpiá, one of the leading MFIs in Central America and the world. As with many of the successful MFIs in Central America, the IDB had significant involvement in its development.

Box 1
Financiera Calpiá of El Salvador: A Leader in Microfinance
in Central America and the World

The Case of Financiera Calpiá demonstrates how the Bank's support to microfinance institutions evolved over time as the needs and capabilities of these institutions evolved.

Financiera Calpiá is one of Latin America's best-known success stories and has a world-wide reputation for excellence in microfinance. In 1991 Financiera Calpiá, AMPES/Servicio Crediticio back then, received a US\$456,865 Small Project loan plus US\$135,000 in technical assistance from the IDB (SP/SD-9136-ES, ATN/SD-3848-ES). The project enabled the expansion of credit and other financial services to microentrepreneurs in El Salvador. Together with a subsequent US\$800,000 equity investment from the MIF in 1994 (EQU/MS-001-ES), this Small Project strengthened Financiera Calpiá's institutional capacity and supported its transformation from an NGO into a formal sector, regulated financial intermediary. Financiera Calpiá also participated in the IDB's Global Loan Program for Microenterprise in El Salvador during the 1990s, and was the largest user of the program's funds.

The results have been impressive. Financiera Calpiá is now one of the leading MFIs in all of Latin America, with over US\$31 million in outstanding loans to 36,000 clients, compared to US\$10 million in loans and 13,000 clients in 1995, prior to its conversion from NGO to financiera. Calpiá consistently maintains a high-quality loan portfolio. Its current 4.7 percent loan delinquency rate (30 days or more overdue) ranks it ahead of the majority of commercial banks in Latin America, despite lending to a target group with little collateral or income. Calpiá is both profitable and efficient, and is now expanding the spectrum of its financial services to microentrepreneurs by offering high-demand products such as savings deposits and credit cards.

Today Financiera Calpiá is poised to transform itself once again, this time into a full-fledged commercial bank.

Central America is also home to some of the most successful commercial banks that can be classified as MFIs. The development of these institutions followed close on the heels of the creation of the first specialized MFIs by NGOs. Some of the most well known of these banks are: Multicredit Bank in Panama, Banco Agrícola in El Salvador, Banco Hondureño del Café, and Bancafé y BanRural in Guatemala. The IDB, together with other international development agencies, has helped these institutions develop new loan and deposit products to attract microenterprise clients.

Apart from the specialized MFIs and the commercial banks, there is another important class of financial institutions that provides credit to microenterprises in Central America: the credit unions. These are member-owned, cooperative financial institutions that in 2001 had 1.3 million members in these countries, with total outstanding loans of US\$1.2 billion and total outstanding savings of US\$1.2 billion. While not all credit union members are microentrepreneurs and not all loans are business loans, a significant fraction of each total is no doubt related to microenterprises, approximately 30 percent in the case of total outstanding loans. Due in part to major, long-term donor strengthening programs which took place in the late 1980s and in the 1990s—particularly in Guatemala, El Salvador, Honduras, and Nicaragua—credit unions in the region have expanded rapidly. In 1991, credit unions in these countries had only 511,000 members, total outstanding loans of US\$263 million, and total outstanding savings of US\$257 million. Hence, in the last 10 years, membership has more than doubled and savings and credit volumes have more than quadrupled. Not only did outreach indicators such as these show large increases, but the financial solidity of the credit unions has increased markedly as well, as loan delinquency was brought under control, profits began to be earned and put into reserves, and many other long-standing problems were overcome as well. Box 2 sketches some of the salient aspects of the Guatemala credit union strengthening program, which confronted problems typical of those encountered in the other programs. The Guatemalan program is widely considered one of the most successful in the world.

Box 2

Credit Union Strengthening in Guatemala

In 1987, the credit unions of Guatemala suffered from many problems: uncompetitive deposit rates, loan rates so low that little or no profit was earned, low levels of institutional capital (reserves and retained earnings), erratic provisioning for loans that were unlikely to be recovered, poor quality of financial information, weak risk management practices, and uncompetitive salary levels. Working with a group of 20 of the largest and most promising credit unions, the World Council of Credit Unions (WOCCU) helped these credit unions to overhaul key prices, policies, and practices and put into place improved auditing and control, strategic planning, marketing, information, and other systems. The effort was highly successful by nearly any measure.

From program initiation in 1987 until its end in 1993, the delinquency rate of the consolidated, 20 credit union portfolio fell from over 30 percent to 8.1 percent. Provisioning of loans overdue more than one year increased from 36 percent to 100 percent. Institutional capital rose from 4.5 percent of assets to 10.7 percent and total assets in real terms increased at an average compounded rate of 17 percent per year. The total number of credit union members nearly doubled. With the strengthening program having created a base of financially solid, well-managed credit unions, growth then further accelerated.

In the next six years (1994-99), the number of members tripled and real assets nearly quadrupled. At the same time, financial soundness was maintained, with the delinquency rate on the consolidated portfolio falling slightly to 7.4 percent and the consolidated capital/asset ratio increasing to 12.6 percent.

This success story was the subject of research and dissemination efforts by the IDB, featured in an international seminar hosted by the Bank and in the book, *Safe Money: Building Effective Credit Unions in Latin America*, edited by Glenn D. Westley and Brian Branch, published in 2000.

The supply of credit from MFIs (specialized institutions as well as banks, finance companies and credit unions) is supplemented by informal sources of credit for working capital and investment needs—from relatives and friends, moneylenders, informal savings clubs, pawnbrokers, supplier credits, and so forth. However, the amounts available and the terms of the loans from such sources can be very limiting, and so the output and employment microenterprises can create through their use may be severely restricted. Evidence of this is the huge following that good microfinance programs have attracted when they were started up, despite charging very high real (net-of-inflation) loan rates. The growth of the microfinance industry in Central America is evidence that large numbers of microentrepreneurs there either have little access to such informal sources of credit or else greatly prefer the credit products provided by MFIs and credit unions. This rapid growth of the microfinance industry in Central America since 1990 has undoubtedly played an important role in the region's development.

D. IDB Support for MFIs

The IDB Group was the most important international funding source of microfinance development in Central America during the 1990s and early 2000s, in terms of volume of investment, innovation and strategic directions. The Bank and the MIF have financed a wide range of operations in support of microfinance, working with both the public and private sectors. The main areas of intervention, utilizing the broad range of financing instruments at the disposal of both the Bank and the MIF have been:

- i) “Upgrading” of microfinance NGOs into regulated financial institutions to create a network of efficient and self-sustaining institutions capable of expanding microenterprise access to credit and other financial services.
- ii) Strengthening newly formalized and regulated MFIs, with the objective of expanding the region's overall microfinance portfolio and efficiency and providing new financial products tailored to the needs and demand of microenterprises.
- iii) “Down-scaling” of banks and regulated finance companies wishing to reach down to new, smaller-scale business clients, by helping them to develop microfinance technologies.
- iv) Building a regulatory framework and financial supervision practices that will permit growth of microfinance and control the risks inherent in this activity.
- v) Providing emergency credit to help MFIs manage deteriorating portfolios while continuing to serve microenterprise borrowers affected by natural disasters.
- vi) Strengthening the credit union sector in order to expand its reach toward microenterprises.

Box 3

Innovative Project Helps Savings and Loan Cooperatives Extend Services to Poor Populations in Rural Areas

MIF: Deepening the Rural Financial Services of the Cooperative Savings and Loan System in Guatemala, as part of the Innovation Initiative, ATN/ME-7624-RG (US\$554,500) (2001)

Bank support for the region's savings and loan cooperatives has been provided through the MIF Innovation Initiative. One of the projects funded aims to help rural low-income families in Guatemala and other parts of Latin America gain permanent access to quality financial services, through the cooperative savings and loan system. Under this project, the National Federation of Savings and Loan Cooperatives (FENACOAC) has introduced the "rural community banks" methodology in three of its member cooperatives (San Jerónimo, Movimiento Campesino, and Santiago de Coatepeque) in collaboration with Catholic Relief Services/Guatemala. This methodology will group together members from each participating community to form a financial center of considerable independence, backed by the member cooperative.

Access to credit among indigenous and other population groups living outside urban zones in Guatemala is basically restricted to informal financing sources, such as family members, moneylenders, and merchants. Poor rural populations often do not qualify to use the cooperative system let alone commercial banking services, and this project will give them access to formal financial services for the first time.

IDB support for MFIs changed significantly over the 1990s and early 2000s and became increasingly more sophisticated as the microfinance industry grew and evolved over the same period. IDB was able to provide concessional financing and technical cooperation through the Small Projects/Social Entrepreneurship Program to individual microfinance institutions at the early stages of their development, financing and technical assistance at the national level to several institutions through the second-tier financing mechanisms created by the Microenterprise Global Credits, and strategic investments and technical assistance to more advanced microfinance institutions through the Multilateral Investment Fund. Other technical cooperation and loan programs from both the IDB and the MIF served to develop the legal, regulatory and supervisory conditions necessary for microfinance to grow soundly and reach more clients. Finally, the IDB has given major support through non-financial products that disseminate information and facilitate contacts among microfinance institutions, most notably through its publications and the Inter-American Forum on Microenterprise.

1. Social Entrepreneurship Program (SEP) and the Prior Small Projects Program (SPP)

The Social Entrepreneurship Program (SEP) replaced the Small Projects Program (SPP) in 1998, both initiatives having been created to promote social capital and economic development among poor, disadvantaged population groups. Over its 25-year lifetime the program has become a key instrument enabling the Bank to promote community-based economic development. The SEP finances business operations that generate social benefits, and it helps community organizations develop microenterprise in traditional fields such as financial services and agricultural production, alongside innovative areas such as environmental management and low-income housing. Between 1990 and 2003,

the Bank financed 88 SEP/SPP projects in Central America totaling US\$45.7 million, directly serving over 56,000 microentrepreneurs and indirectly benefiting a further 167,000 people.

The SEP, while then known as the Small Projects Program, was the first program to lend directly to microfinance NGOs in Central America, also providing technical cooperation programs for institution-strengthening. The program paved the way for leading players to emerge in the region's microfinance sector, such as Financiera Calpiá in El Salvador, Credifundes in Panama, Financiera Confía in Nicaragua, and FINSOL in Honduras. These institutions are now part of the regulated financial sector, but they all started out as credit NGOs and received their main startup support from the Bank through the SPP/SEP. The program also supported a number of NGOs that continue to play an important role in the region's microfinance sector which have not yet become formally established; these include Fama in Nicaragua, Génesis Empresarial in Guatemala, and Finca in Costa Rica.

Box 4

Social Entrepreneurship Program Supports Small-Scale Farmers in Costa Rica

Agricultural Diversification for Microproducers in León Cortés. SP/SF-00-11-CR (US\$300,000); ATN/SF-7295-CR (US\$160,000) (2000)

Besides playing a key role in the startup of many microfinance programs and institutions, the SEP was also a key instrument in financing rural production; in fact, one third of all SEP projects are concentrated in this area.

The objective of this project is to help small-scale farmers boost their incomes through agricultural diversification, access to credit, and better marketing services. The project works with two categories of producers: (i) small-scale coffee growers – to introduce avocado production as a complementary crop; and (ii) wild blackberry producers – to systemize and professionalize their cultivation and processing techniques. Approximately 300 families are expected to benefit from the project's loan and technical-assistance services.

Two years of project execution have produced the following results: an active portfolio (US\$175,000) of 71 farmers who are receiving credit from the program, with an average loan of US\$2,465 each. The number of hectares newly sown with diversified crops has surpassed the 90-hectare target by 22 percent. A total of 450 farmers have received training and technical assistance – 330 more than planned, which implies an attainment rate of 275 percent.

Major progress has also been made in utilization of organic production technologies, with an estimated 75 percent of beneficiary farmers now using organic fertilizer of some kind.

As these institutions grew, their needs for capital to expand and technical cooperation to improve management have increased and diversified, and also became more sophisticated. The Bank supported this process through a variety of financing and technical cooperation instruments; and, as a result, the region now has a viable, sustainable, and thriving microfinance industry that is reaching increasing numbers of microentrepreneurs and integrating them into the formal economy, with its attendant benefits.

Box 5

Innovative SEP Project Supports Low-Income Housing in Nicaragua

Nicaragua: Pilot Microcredit Project for Low-Income Housing SP/SF-0106-NI (US\$500,000) and ATN/SF-7554-NI (US\$35,000) (2001)

As the SEP evolved over time, the program tended to prioritize funding for innovative projects. In Nicaragua, for the first time, it entered the housing sector, which is a key element in the well-being of excluded population groups and a major source of work for many microentrepreneurs.

In Nicaragua, 58 percent of the population lives in overcrowded conditions; 47 percent of all families live in houses to which they do not hold legal title; 39 percent of homes are built with temporary materials; and 83 percent of homes are not connected to a sewerage system. Low-income families lack long-term financing under terms that would enable them to pay for a home offering adequate living conditions. The Bank is supporting Corporación Nicaragüense Financiera, S.A. (CONFIA, S.A.) through this project; and the Fundación Colmena is developing a lending technology suited to the needs of low-income housing finance. The program expects to benefit over 3,000 people comprising families with incomes of under US\$250 per month.

2. Microenterprise Global Credit (MG)

Beginning in the early 1990s, the Bank targeted microfinance sustainability and integration into the financial system. This process began with the creation of the Global Credit Program for Microfinance (MG) and included the strategic use of the Multilateral Investment Fund (MIF) and the Social Entrepreneurship Program (PES).

The Bank's MG Credit Program is an important chapter in the story of microfinance in Latin America, especially in Central America. The Program provides financing to commercial banks and other formal financial intermediaries to facilitate their entry into the microenterprise market and is the largest wholesale microfinance program in Latin America. Unlike the specialized microfinance institutions that received financing specifically earmarked for them through other IDB funding sources, the intermediary financial institutions (IFIs) participating in the Micro Global Credit Program are not chosen in advance. They "choose themselves" -- as long as their overall financial performance is sound -- by electing to tap the Microenterprise Global Credit funds through a local wholesale, apex, or second-tier institution (a national development bank or fund).

The MG Programs utilize a two-tier structure to accelerate the expansion of microfinance services towards the microenterprise sector. A second-tier institution channels financial resources through retail lenders, first-tier intermediary financial institutions (IFIs), which in turn lend directly to microenterprises. Such a wholesaling mechanism can theoretically channel more resources to the microenterprise sector more efficiently than separate smaller operations can, and is therefore a very attractive model for development agencies interested in having a big impact while streamlining their own operations. The financial resources may also be accompanied by technical assistance in support of the first-tier institutions' efforts to improve their services and financial performance.

Table 3: Overview of Microenterprise Global Credit Program Results in Central America

Country	Total Financing (000 US\$)*	IDB Financing (000 US\$)	Total Technical Cooperation (000 US\$)*	Number Participating IFIs	Number of Credits *	Average loan size US\$ *
Guatemala	\$12,500	\$10,000	\$3,300	4	11,389	\$1,200
Costa Rica	17,600	13,000	3,300	5	6,531	1,114
Nicaragua	29,500	23,600	4,500	7	10,716	766
El Salvador	30,000	24,000	0	15	45,503	660
TOTAL	89,600	70,600	11,100	31	74,139	--
AVERAGE**	\$22,400	\$17,650	\$2,775	8	18, 535	\$861 **

Source: Berger, Marguerite; Alison Beck and Maria Lucia Lloreda. 2003. *The Second Story: Wholesale Microfinance in Latin America*. Washington, DC: Inter-American Development Bank.

Notes: * includes both IDB and counterpart funding

** weighted average

Four countries in the region received support under IDB's global microenterprise program: Costa Rica (1992, Loan 701/OC-CR), El Salvador (1993, Loans 780/OC-ES and 915/SF-ES), Guatemala (1992, 886/SF-GU) and Nicaragua (1993, 789/OC-NI). To date the Bank has lent over US\$70 million for these programs, and nearly US\$90 million has been invested, including counterpart funding. Even though these programs work with the formal banking sector and finance companies, the average loan size for the Central American programs is only US\$861, clear evidence that the loans are reaching microenterprises. In two of the participating Central American countries -- El Salvador and Nicaragua -- the projects had significant immediate and longer-term impacts on microenterprise access to create and enhance the development of a sustainable microfinance industry. In Guatemala and Costa Rica the policy environment limited the impact of the programs on long-term development of the microfinance industry, although the programs were successful in reaching a large number of microenterprises, especially in Guatemala.

Box 6
**IDB Expands its Support for Microfinance with Global Loans for
 Microenterprise in Central America**

In the 1990s the Bank developed a new microfinance support instrument, extending coverage of financial services to microenterprises that were previously largely unserved by the financial sector. The two cases described below reflect the diversity of experiences with this instrument in Central America.

El Salvador: Global Credit Program for Microenterprises, Loans 780/OC-ES (US\$16 million) and 915/SF-ES (US\$8 million) (1993)

The program provides credit support and administrative/operational management assistance to the microenterprise sector in El Salvador. It also helps to provide institution-strengthening to nongovernmental organizations (NGOs) and intermediary financial institutions (IFIs) that work with micro- and small-scale entrepreneurs in the country's urban and rural areas. The program includes: (i) a global line of credit; (ii) training and technical assistance for microentrepreneurs; and (iii) institutional strengthening of NGOs and IFIs.

Although a total of 15 financial institutions participated in this program, most of the funds disbursed were absorbed by just one of them, Financiera Calpiá. The loan served to consolidate Financiera Calpiá's position at a critical stage in its development, enabling it to start providing services not only in urban fringe areas but also in rural zones. The impact of the loan went beyond the immediate support given to Calpiá and a few preliminary steps by commercial banks – it had a demonstration effect that generated growing interest in this sector among banks.

Guatemala: National Microenterprise Program, Loan 886/SF-GU (US\$10 million) and Technical Cooperations ATN/SF-3965-GU (US\$2.4 million) and ATN/SD-3965-GU (US\$900,000) (1992)

This global credit program for micro- and small-scale entrepreneurs in the country's urban and rural areas extended the coverage of microfinance institutions through IFIs, which have been strengthened in the key aspects of microlending. Program outcomes include the following: the private market has become more open to financing microenterprises and small and medium-sized businesses, and loans have been granted to over 8,000 beneficiaries in three years. The portfolio arrears rate is roughly 3 percent. The fact that 80 percent of loans went to customers in rural areas, compared to 20 percent in the capital, reflects a major decentralization process. A sectoral breakdown shows that commerce has received 61 percent of the financing, the manufacturing industry absorbed 23 percent, and the service sector 16 percent.

Only a few commercial banks were lending to the microenterprise sector when the first MG Program was designed. The idea was that with the right incentives, more banks would see the sector as a valuable market, and would begin to invest their own resources. It was believed that banks' reluctance to reach down to smaller business customers was due to the relatively high start-up cost of microfinance technology – training staff and implementing systems to manage a high volume of small loans with minimal collateral and to the riskiness of making such loans without the appropriate microfinance technology. To encourage participating IFIs to invest in microfinance, some MG Programs included a technical cooperation component that defrayed part of the banks' cost of launching or developing their microfinance operations.

The results of these programs were encouraging. The loans did succeed in promoting the development of microfinance in Central America. They reached smaller businesses and more women than other credit operations in their countries. They brought new clients into the formal financial system, and new lenders into microfinance. They also helped further the agenda for reform of regulations and supervisory norms to create an enabling environment for microfinance.

3. The Multilateral Investment Fund (MIF)

The MIF finances innovative microenterprise development projects, most of which aim to create better conditions for such enterprises to harness their potential operating capacity. They also seek to improve access to funding sources, in order to meet the heavy demand that exists for financial services among the region's microenterprises.

Thanks to the MIF's great flexibility and innovation capacity, it has been a key instrument in the development of microfinance institutions (MFIs) in the region, providing financing totaling US\$17.1 million through 25 institution-strengthening projects between 1994 and 2003. . Four types of interventions have been used: equity investments, a "line of activity" for MFI institution-strengthening, operations to support the development of better money remittance services, and other types of support. The breakdown of these operations is shown below:

Table: 4 MIF Operations to Support Microfinance Institutions in Central America <i>(in US\$ thousands, with number of projects)</i>					
Country	MFI Investments	"Line of Activity" (TC to MFIs)	MFI Remittances	Other MFI Support	Total
Costa Rica	-	\$260 (1)	-	-	\$260 (1)
El Salvador	\$800 (1)	1,022 (4)	\$1,500 (1)	\$4,635 (2)	7,957 (8)
Guatemala	-	584 (2)	-	300 (1)	884 (3)
Honduras	-	843 (3)	-	2,015 (2)	2,858 (5)
Nicaragua	750 (1)	1,170 (4)	750 (1)	-	2,670 (6)
Panama	2,250 (1)	242 (1)	-	-	2,492 (2)
TOTAL	\$3,800 (3)	\$4,121 (15)	\$2,250 (2)	\$6,950 (5)	\$17,121 (25)

Note: No operations in Belize in this area.

The technical cooperation program, "Line of Activity for Strengthening of Financial Institutions for Microenterprise," has supported the consolidation and expansion of microfinance services in the region, and this has enabled regulated financial institutions (mainly banks and other lending institutions) to downscale as well as NGOs to upgrade. Between 1994 and 2003, 15 of these projects have been funded totaling US\$4.1 million in the Central American countries.

Box 7

MIF Supports Institutional Transformation: FUNADEH Becomes FINSOL

MIF: Honduras. Institutional Strengthening of Financiera Solidaria (FINSOL, S.A.)
ATN/ME-6342-HO, (US\$300,000) (1999)

The National Foundation for the Development of Honduras (FUNADEH) is a private organization that promotes microenterprise and small business development through training and credit activities. In 1997, it achieved financial sustainability and took the steps needed to become a regulated financial institution, capable of providing financial services and taking deposits from the public. In 1999, the National Banking and Insurance Commission and the Central Bank of Honduras authorized the creation of Financiera Solidaria, S.A. (FINSOL).

The IDB Group has supported this transformation and that of many other institutions that have followed a similar path. IDB and MIF support has provided FINSOL with an information system suitable for complying with oversight regulations and requirements, and for carrying out operations online in its branches. That support has also enabled FINSOL to design and operate deposit-taking products, and train its staff for institutional change. FINSOL has now grown into a financial institution with 12 branches, four of them in rural zones.

At present, it has a total credit portfolio of over US\$7 million, distributed among more than 12,000 loans. Deposit-taking services have begun and in December 2002 the corresponding balance stood at US\$1.5 million – represented by some 1,000 certificates of deposit.

FINSOL is another example of how MFIs have positioned themselves as major providers of financial services to a population group underserved by the regulated financial sector.

There are also other mechanisms that support innovations in financial services and business development aimed at the microenterprise sector, such as the “Innovation Program Initiative”. In Central America, different projects have been supported under this modality (see Boxes 8 and 12, for example).

Box 8

Harnessing the Power of the Internet to Train Professionals in Microfinance Institutions in El Salvador

MIF: ATN/ME-8082-RG (US\$234,000) (2002)

The aim of this project is to raise the efficiency of middle and lower MFI management in Latin America and the Caribbean through distance training. The international firm Exchange LLP, the NGO “CRECER” in Bolivia, and the technical-assistance agency Catholic Relief Services in El Salvador are partnering to design distance learning courses to specifically address MFI training needs. This pilot scheme will be implemented in El Salvador and subsequently disseminated throughout the region.

The project innovates by building on existing technologies in the private sector to solve one of the greatest challenges to MFI growth, namely human resources development. Internet-based learning is new to MFIs in the region, since it was not previously available in Spanish.

The incipient development of microfinance in the region suffered a potentially devastating setback in 1998, as it tried to overcome the effects of Hurricane Mitch. In one of the clearest illustrations of the Bank’s responsiveness to the needs of the region, the Bank acted

boldly and swiftly to support the recovery of the microfinance industry by creating a financing facility with support from the MIF. The program's success led to its institutionalization as a permanent fund (see Box 9 below) for all countries of Latin America and the Caribbean, to support microfinance recovery rapidly when natural disasters hit. Out of this experience, the Bank also produced a guidebook to help MFIs prepare for disasters and their potential effects on their microfinance portfolios.

Box 9

Microfinance Institutions and their Customers Recover from Natural Disasters with Support from the IDB Group

MIF: Central American Microenterprise Recovery Program, ATN/ME-6303-RG (US\$12.9 million) (1998)

The objectives of this program included helping microenterprises recover in areas damaged by Hurricane Mitch in October 1998, which were also the zones that had the greatest microenterprise and small business productive development. In addition, the purpose of the program was to strengthen IFIs working with microenterprises in the region both financially and operationally, by extending credit backed by a program for recovering IFI infrastructure.

Project execution concluded in June 2000, having granted 33 loans to a number of IFIs in Honduras, Nicaragua, El Salvador and Guatemala, enabling them in turn to support over 22,000 affected microentrepreneurs. Except in Honduras, where most customers were urban, the majority of beneficiaries were campesinos and small-scale rural producers. Over 50 percent of credits were granted to women, with an average loan size of US\$379, which shows that the aim of rapidly reaching the poorest customers was in fact achieved.

In Honduras, loans totaling US\$2.4 million were granted to 13 IFIs, supporting some 12,000 microentrepreneurs. In Nicaragua, a total of US\$2.7 million was extended to 13 IFIs, providing support to 7,000 microentrepreneurs. In Guatemala, a total of US\$1.5 million was lent to four IFIs, to support 1,650 microentrepreneurs; and in El Salvador, US\$1.9 million was extended to five IFIs to provide support to 1,730.

In view of the proven efficiency of this program in assisting microentrepreneurs and alleviating their working conditions, by helping to boost the sustainability of the most important microfinance entities in areas of Central America affected by Hurricane Mitch, the remaining funds and amounts obtained from loan repayments were used to create a Program for **Microfinance Recovery in the Aftermath of Natural Disasters** (ATN/ME-7048-RG). That program, approved in July 2000, was funded with MIF resources up to US\$10 million. In 2001, following the earthquakes in El Salvador, loans totaling US\$2.6 million were extended to Salvadorian MFIs (ATN/ME-7546-ES), to provide them with the liquidity needed to develop mitigation mechanisms for their clients and to underpin their own financial and operational sustainability.

The MIF has also contributed to microfinance industry development through technical cooperation programs aimed at strengthening the regulatory framework and supervisory practices of financial institutions in general. Although these operations mostly did not include a specific MFI-strengthening component, they did promote financial sector development as a whole, thereby opening up opportunities for creation or expansion of the microfinance industry. Between 1994 and 2003, the MIF financed ten operations of this type in Central America totaling US\$14.1 million.

E. Recent Financial Reforms and their Effect on Microfinance

By the mid 1990s, the great wave of first generation financial reforms that had swept Central America since the late 1980s began to slow down as the majority of the countries in the region had adopted much of their initial reform agenda. Although at a slower pace, since then there has been significant attention given in Central America to carrying out a second generation of financial reforms. The aim of these reforms is to further deepen financial markets, allowing for the extension of financial services to a broader base of clients, and making financial services more secure by facilitating the assessment and management of risk by individual institutions and the bank superintendencies overseeing the system as a whole. While some success in carrying out these reforms can already be claimed, there is still much to do.

The second generation financial reforms discussed here are:

- Improving prudential regulation and supervision of MFIs, especially non-bank financial intermediaries, including credit unions
- Establishing or strengthening credit bureaus, including increasing their coverage down to the very smallest loans; and
- Improving the legal framework for secured transactions and modernizing supporting institutions

Although the bulk of reform in these areas remains to be done, significant progress has been made in the last few years in improving prudential regulation and supervision and strengthening credit bureaus and registries. Reducing business informality by streamlining the requirements and processes for compliance with pertinent laws and regulations will also help micro and small enterprises gain access to financial services by enabling them to present formal documentation when applying for loans. This will be discussed in Section V (D) below.

1. Improving Prudential Regulation and Supervision of MFIs

At the beginning of the 1990s most countries in Latin America had prudential banking regulations that impeded lending to microenterprises. Often designed with traditional commercial bank lending technologies and large loan sizes in mind, these regulations can create unnecessary difficulties and inefficiencies for credit unions and other MFIs, raising the already high cost of making micro-loans, increasing the risk of insolvency for lenders, and restricting microcredit supply.

Today, the prudential regulations governing MFIs in Central America have greatly improved. For example, Central American prudential regulations generally avoid the following ill-advised practices with regard to microfinance:

- Extremely low limits on unsecured lending, even when arrears are extremely low⁵
- Excessive provisioning for unsecured loans
- Extensive and unnecessary loan documentation and financial reporting requirements for MFIs
- Excessive minimum capital requirements to start up an MFI

In El Salvador and Honduras the Bank, together with other development agencies, provided assistance for the development of new laws and norms regulating non-bank financial intermediaries. In the case of El Salvador, the results were very positive, with improvements made to the regulations and supervision of the financial system in general and strengthened opportunities for commercially viable microfinance.

Box 10

Strengthening of the Legal, Training, and Financial Framework in Honduras

MIF: Honduras. Strengthening the Financial Sector ATN/MT-7240-HO (US\$1.5 million) (2000)

The MIF helped the Government of Honduras broaden its financial sector reform process and introduce international banking and insurance standards. The aforementioned program is divided into two components: (i) strengthening of the financial system regulatory and prudential framework; and (ii) strengthening of the training structure in the Honduran Association of Banking Institutions (AHIBA) and the Honduran Chamber of Insurance Companies (CAHDA), with a view to improving the system's human resources.

The following activities in the first component have been successfully implemented during the execution stage: (i) 100% of the non-bank financial institutions were supervised by the National Banking and Insurance Commission (CNBS); (ii) coverage of the central credit registry was extended to encompass all loan operations; and (iii) the computer interconnection among the CNBS, the Central Bank of Honduras (BCH), and institutions in the financial sector was completed.

These activities have helped to make the Honduran banking system a safer and sounder system. The extension of supervision to all non-bank financial intermediaries and expansion of the Central Credit Registry to include information on all loan operations will allow incipient MFIs to develop and afford greater confidence to their customers.

However, despite these positive efforts, the government had recently adopted some measures that may prove harmful to the microfinance industry as a whole. New regulations permit credit-granting NGOs not supervised by the CNBS to capture savings deposits from their clients. When problems arise in any of the NGOs, it will likely have the effect of decreasing public confidence in microfinance institutions; hence there is still much work to be done with regard to regulations and supervision of financial institutions, so that a broad-based microfinance industry can flourish in Honduras and in other countries of Central America.

A number of other improvements could still be made in Central America in the prudential regulation and supervision of microfinance. For example, only Costa Rica and El Salvador supervise credit unions, which are important MFIs that take deposits in the Central American countries. This leaves hundreds of thousands of small depositors

⁵ This is ill advised because much micro lending is unsecured yet has very high repayment rates. These high repayment rates are achieved not by chance but because of the large amount of information that is gathered on clients in order to analyze client ability and willingness to repay loans.

unprotected and denies the benefit of externally imposed financial rigor to this class of MFIs. In Honduras, supervision of MFIs is being delegated to auditors, although auditors generally have little understanding of how MFIs work and how they should be supervised, both of which are often quite different from banks.

2. Credit Bureaus

Public credit bureaus typically gather together the credit histories of all banking system borrowers, or all banking system borrowers with loans above a certain size. Credit bureaus help to assure the safety and soundness of the banking system by giving bankers and supervisors a tool to detect borrowers that may not be overextended at any single financial institution but are over-indebted from the banking system as a whole or are engaged in other irregularities.

Since microenterprises often possess little collateral with which to secure a loan, one of the few resources they may have to help them obtain credit is their history of repayment of past loans. By making this credit history information widely available, a credit reporting system gives lenders better information on potential good borrowers who might otherwise have been rejected. It may also lower the cost of microcredit since the lender no longer has an information monopoly about the microentrepreneur's willingness and ability to repay loans.⁶ Finally, credit bureaus strengthen incentives for prompt repayment by borrowers who wish to avoid damaging their credit reputation. In light of this disciplining aspect of credit bureaus, financial institutions will be more willing to make loans, particularly to microenterprises, which may possess little of the usable collateral that larger firms do.

Though more remains to be done, the Central American countries have made substantial progress in securing the benefits of credit bureaus for their banking systems and for microfinance, and IDB has aided this process. Costa Rica, El Salvador, Nicaragua, and Panama now have central credit registries that extend all the way down to cover even the smallest of loans. In Honduras, the IDB provided technical assistance to establish a credit bureau,⁷ but required reporting to the bureau does not yet extend to small loans. In Guatemala, there is a private credit bureau financed and administered by the Bank Association, and a new Central Registry is under consideration by the Superintendency. In order to fill the gap with respect to information on microenterprise borrowers, the NGO association, REDIMIF is in the initial stages of creating an alternate registry for microcredits, in collaboration with the credit unions and the banks. As an indication of the usefulness of credit bureaus to MFIs, the two regulated MFIs in Nicaragua, Confia and Findesa, have severely taxed the capacity of the Nicaraguan credit bureau to respond to their 300-400 information requests per day.

⁶ Of course, these two benefits (cost of credit and geographic mobility) apply to firms of all sizes, but they are particularly important for microenterprises since these firms often lack the collateral that would enable them to obtain a loan easily and cheaply from a financial institution that they have not dealt with before.

⁷ ATN/MT-7240-HO: **Strengthening the Financial Sector**. See preceding Box 10.

3. Improving the Legal Framework for Secured Transactions and Modernizing Supporting Institutions

In the Central American countries, as in most of Latin America, poorly formulated laws and inadequate or nonexistent legal registries impede the use of movable goods as collateral to secure loans. While this is a general system failure that affects lending to firms of all sizes, it also affects the many financial institutions that seek to increase the security of their micro and small enterprise lending by taking collateral. In addition, fragmented, poorly organized and manual search registries are too costly to be used in the case of micro and small business loans. It currently takes six months to two years to seize and sell collateral in the region. A lengthy legal process involving the courts is required, and collateral once seized, must be sold under court supervision.

Central America has made progress on some aspects of these problems, especially in the related area of land titling, but governments are only now beginning to address the broader issues of secure transactions. With regard to the latter, the IDB is developing a strategy to assist governments in this process and has provided financing to carry out studies, as has the World Bank, to support the preparation of potential legislation in this matter.

V. Business Development Services and the Changing Scope of Government Intervention in Central America

During the late 1990s, the governments of the Central American countries began to rethink their role as direct providers, not only of financial services, but also of services for business development (especially training, advisory services, technological innovation and marketing of products). This coincided with a renewed interest in non-financial business development services, which are an important adjunct to microfinance. The IDB has been able to provide resources and information to aid this process, through a wide range of instruments and its non-financial activities. The IDB and the MIF projects to support this process can be classified around five main objectives, which have been financed with different instruments, as follows:

- (i) Strengthening and expansion of “clusters” and productive business chains – i.e. firms that produce goods or services in the same branch of activity or constitute a value chain in the production of certain goods and services. The strengthening of such clusters and chains is essential for boosting the competitiveness of small businesses, including the most dynamic microenterprises. To achieve this objective, the MIF has funded several technical cooperation projects, supporting business partnership networks, dialogue between the public and private sectors, and investments in pilot activities or infrastructure. The Bank has also provided financing to governments through innovation loans and through some of its science and technology loans.
- (ii) Development of small-scale producer or trader cooperatives and associations, in order to provide comprehensive services to microenterprises and small

businesses aimed at making such entities sustainable. The Bank has supported this goal by providing funding and technical cooperation through the Small Projects and Social Entrepreneurship Programs.

- (iii) Reform of the legal and regulatory framework and administrative procedures, to create an enabling environment for the formal establishment and growth of microenterprises and small businesses. This objective has mainly been supported through MIF technical cooperation provided to governments.
- (iv) Strengthening of business development services (BDS) with a view to creating a sustainable market for them. To achieve this goal, the MIF has funded technical cooperation for private nonprofit associations or enterprises that provide services to microenterprises and small businesses; and the IDB and MIF have funded voucher systems for training or technical assistance that subsidize microenterprises and small businesses when they purchase such services.
- (v) Public-sector reforms aimed at streamlining and strengthening the State's role in microenterprise development. The MIF has supported two governments in the region in this global process by financing technical cooperation.

In the past seven years alone, the IDB and MIF have financed 26 Business Development Service programs in Central America plus 3 Science and Technology projects with significant BDS elements, for a total of US\$59,576,000. Table 5 below shows the distribution of this financing among three different types of BDS programs during this period:

**Table 5: IDB and MIF Financing for Business Development Services
for Micro and Small Enterprise, 1995-2002
in US\$000 (with number of operations)**

	Belize	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama	Regional	Total
Training	\$700 (1)	-	\$850 (1)	\$2,520 (2)	\$2,992 (2)	\$1,022 (1)	\$2,690 (1)	-	\$10,074 (8)
Technical Assistance	1,455 (1)	-	2,170 (3)	1,500 (1)	705 (1)	1,400 (1)	721 (1)	\$2,679 (3)	9,175 (11)
Innovation/ Technology Programs	-	\$3,573 (3)	-	-	15,000 (1)	672 (1)	18,082 (3)	-	37,327 (8)
Business Start-up	-	-	-	-	-	-	1,200 (1)	1,800 (1)	3,000 (2)
Total	\$2,155 (2)	\$3,573 (3)	\$3,020 (4)	\$4,020 (3)	\$18,697 (4)	\$3,094 (3)	\$22,693 (6)	\$4,479 (4)	\$59,576 (29)

Source: Tabuenca, Antonio García; Justo de Jorge Moreno; Fernando Coral Polanco; and Carolina Perondi. Forthcoming. *Lecciones aprendidas en programas de servicios de desarrollo empresarial (SDE) para la pequeña empresa en América Latina, 1995-2002*. Washington, DC: Inter-American Development Bank, Micro, Small and Medium Enterprise Division.

In the early days of Bank support for microenterprise development (1978-89), the Small Projects Program, the only instrument available to support the sector at the time, provided financing for projects only if the executing agencies/institutions offered both financial and non-financial services to microenterprises. Over time, the IDB and the microenterprise support organizations of the region learned from this experience that it was generally not a good idea to link the two types of services in the same institution. For microfinance, in particular, the provision of training to the borrowers tended to increase the costs of lending (forcing the institution to charge higher interest rates or decapitalize itself) and even led to higher arrears. In addition, the non-financial, or business development, services provided were generally limited to basic training and technical assistance in management or accounting, not the sophisticated range of services available today. The separation of business development services from credit, which occurred in the late 80s and the 90s, coincided with a greater emphasis on business development services as valuable in their own right, not just as an accompaniment to credit.

A. Developing a Market for Business Development Services (BDS)

Business development services (also called non-financial services) consist primarily of training, technical assistance (one-on-one business help), marketing, information, and technology services. In certain key regards, the business development services (BDS) industry in Central America is running some 10-15 years behind the microfinance industry; that is, BDS is where microfinance was in the late 1980s. Moreover, the BDS industry can usefully look to the microfinance industry for some lessons on building a healthy, growing industry of service providers that are financially self-sufficient and provide large numbers of micro, small and medium enterprises with needed business development services.

When many of Central America's leading microfinance institutions began their lending operations in the 1980s or early 1990s—making US\$50, US\$100, or US\$500 loans—many observers did not believe these lenders could develop a mass market if they charged fully cost-covering loan rates. After all, doing so often implied charging 20, 30, or 40 percentage points more than the going bank rates, given the very high unit administrative costs of these tiny loans. Even if lenders could develop a mass market at fully cost covering loan rates—serving tens and even hundreds of thousands of microenterprises—there was the additional question of whether they *should* charge low-income microentrepreneurs such high prices.

Today it is clear that there is massive demand for microcredit even at high interest rates, provided that the credit service is of good quality—timely and with a minimum burden of transactions costs placed on the borrower. In addition, charging loan rates that enable lenders to break even or earn a profit guarantees the sustainability of the service over time and allows microenterprises access to credit when they need it. Sustainable institutions, such as Financiera Calpiá in El Salvador, also have the ability to build equity over time and leverage their capital by borrowing from other financial institutions, thereby furthering their outreach towards the hundreds of thousands of

microentrepreneurs who would gladly pay the price for credit if only it were available at the going rate.

The lesson from microfinance to the region's BDS industry is that donor or government subsidies should be used intelligently. There is simply not enough donor or government money to reach all the microenterprises with all the business development services that they need and demand. Public and donor funds can be used in a strategic way to help build a sustainable BDS industry capable of providing services on an ongoing basis. This can be done by using concessional funds: (i) to overcome the startup costs associated with building the institutions that provide BDS, (ii) to compensate for specific and important market failures, and (iii) to strengthen and rationalize the policy and regulatory environment in which BDS providers and microenterprises operate. Lessons from microfinance also provide a wealth of new formulas and timeframes for cooperation between the private sector, governments and donors, aimed at achieving the desired sustainability within reasonable deadlines. Experience shows that self-sustainability is often attained gradually, starting by covering fixed costs, and eventually achieving sustainability and even profitability. Thanks to activities to document and disseminate best practices supported by the Bank and other organizations today, a process that took 20 to 30 years in the region in the case of microfinance, should be substantially shorter in the case of BDS.

A good example of the use of public or donor money to overcome failures in private markets for business development services is the funding of training voucher programs. Microenterprises considering whether to take a training course from a particular provider face the difficulty that they cannot really know in advance how useful the training will be to them, and therefore whether it will be worth the cost. Because training courses generally have to be paid in advance, microentrepreneurs will be reluctant to take such courses, and so there will be a general underinvestment in training. Many countries — including El Salvador, Guatemala, Nicaragua and Panama — have used training vouchers, with support from the IDB and MIF, to overcome this informational type of market failure. Vouchers worth a certain amount of money toward the cost of a training course are given to microenterprises interested in obtaining training. The voucher programs significantly reduce the cost of the first few training courses taken by the microentrepreneur. In this way, they act much like free product samples given out on street corners; both overcome informational barriers and build a clientele willing to pay full price for the good later on.

Box 11

Vouchers Help Microenterprises to Try Out Private Training Services

MIF: El Salvador. Pilot Training Program for Microenterprise, ATN/ME-6984-ES (US\$870,000) (2000)

In order to stimulate microentrepreneur participation and investment in training and technical-assistance activities, improve supply and adapt it to real demand among microenterprises, and thus help to boost the productivity of the microenterprise sector in eastern El Salvador, the Salvadorian Comprehensive Education Foundation (FEDISAL) used MIF resources to implement an intervention methodology that included investments from private institutions, government bodies, and international technical cooperation.

The program is divided into three components: (i) a training and technical-assistance voucher system; (ii) a supply improvement system; and (iii) improvement of supply and its adaptation to real demand from microenterprises. The voucher system has proven a successful experience for FEDISAL-BONOMYPE, enabling it to begin to stimulate demand for training and technical assistance among microentrepreneurs in eastern El Salvador. In the first year of project execution, when vouchers were first distributed, 3,900 vouchers were used for 245 training courses. In the first two years alone, 18,000 vouchers had been distributed, of which 7,700 were used for some 550 courses.

In the departments of La Paz, San Vicente, La Unión, San Miguel, Usulután and Morazán, there has been participation from over 2,000 microenterprises in the subsistence (60 percent), simple accumulation (33 percent) and capital accumulation (7 percent) categories. The interest that participants have shown in continuing their training demonstrates that microenterprises value the results.

Marketing is another major area of BDS in which there has been support from the IDB for numerous Central American initiatives to improve the commercialization of handicrafts and agricultural goods. The Bank group supports export marketing initiatives on a big scale for small and medium enterprises, and the most advanced microenterprises, but it has also provided considerable support to cooperatives and producers associations that represent microenterprises through the Small Projects and Social Entrepreneurship Programs and the MIF, as the following box illustrates. Marketing may well be the non-financial service most like microfinance in its potential to reach sustainability. This is because the marketing company's job is to solve one of the microenterprise's biggest headaches, selling its product. Marketing/distribution firms help to create a revenue stream for the producer and thus are able to take their fees out of an immediately available income flow, something that is not the case with the provision of training, technical assistance, information, and most other business development services.

Box 12

Microenterprises Reach International Markets with Marketing Support Services

MIF: Facilitating Sustainable Linkages (Honduras, Nicaragua, and Guatemala) ATN/ME-7625-RG (US\$482,500) (2001)

The MIF is using the Innovation Initiative to support financial service and business development innovations for the microenterprise sector.

This project fosters linkages with international markets for rural craftworkers in three Central American countries. Using three export firms – Oyanca (Nicaragua), La Casa (Guatemala) and Atuto (Honduras) – business development services are provided to rural and urban microentrepreneurs (mainly women), through a joint venture with the technical assistance agency Weidemann Associates Inc. The project focuses on the decorative furnishing subsector and aims to strengthen production, export, and marketing systems in the region. The project's buyers include Pier One, Country Originals, Toyo, Montage, and Exploris. Products have been exhibited in a number of international events, such as the New York International Gift Fair and the International Home Furnishing Show in High Point, North Carolina. Ceramic lamps produced in San Juan del Oriente, Nicaragua have proven one of the most successful items and are now being sold in the United States through the prestigious Wildwood Lamps firm, and were included in the catalogue of latest Tommy Bahama Collection.

In the case of microfinance, initiatives in related areas have had a major impact on the microenterprise sector, especially financial sector reforms. In the non-financial services area, a similar phenomenon is emerging, with the Bank's support for simplified business registration, secure transactions, and the development of clusters of producers of specific related products creating space for growing microenterprises to be more successful. Even though these initiatives are primarily oriented to small and medium enterprises, some microenterprises will benefit from them directly and many more will benefit indirectly. Bank actions for the development of business development services in the lower-end, microenterprise market have had greater success when coupled with initiatives such as these.

A major challenge for the future in developing the Central American BDS industry is, whenever possible, to make BDS support more developmental of the BDS *market*, as opposed to working only with a single BDS provider at a time, as has often occurred in the past. If done well, such an approach can multiply the impact of the project by strengthening many providers instead of just one.

The adoption of a market development approach is particularly important in BDS because of the tremendous number of different business development services. Consider training for example, where some firms specialize in training carpenters, others in training clothing makers, others in food preparation training, and so forth. Marketing, technical assistance, and the other areas of BDS are similarly specialized by type of economic activity. With so many different specialties, it is difficult to achieve the economies of scale available to the microfinance industry, where there is much more product homogeneity (short term loans, long term loans, savings deposits, etc.), and so a fairly small number of providers suffice to supply the market. In order to achieve greater outreach and effectively build the very heterogeneous BDS industry, therefore, donors

must generally try to strengthen markets, not just single providers. This approach also lessens the distortionary effects on the market that arise when the project provides assistance to any one provider over the others, and thus gives that one provider an artificial advantage.

B. Strengthening Competitiveness

Recently, the Bank has begun to expand its support for small business and microenterprises with financing from the MIF and the Bank's new innovation loans, focusing on clusters of businesses engaged in related economic activities.

The purpose of these recent operations is to support Central American efforts to become more competitive in world markets, by undertaking needed reforms and partnering with the private sector in proactive programs that increase the quality, efficiency and volume of output in specific sectors and expand their products' access to markets. Although not aimed at microenterprises specifically, these projects should directly benefit those microenterprises that are able to grow quickly, have or can develop the capacity to export or to produce export-quality products for local markets, and those that are part of the production chain for key products, serving as suppliers of inputs to larger businesses.

These actions, much of which take place at the local level where firms of particular industry segments or supply chains are concentrated, involve: improvements in infrastructure, creation of mechanisms and services to improve product quality, design, and standardization to international specifications; increasing productivity through technology transfer and adaptation, work force training, and management strengthening; developing business linkages, partnerships and associations for the purpose of identifying common problems, prioritizing business infrastructure and other needs, and taking action to solve these problems, accessing markets and services and influencing public policy, such as regulatory and tax reform at the local level. The results of this new approach are only now beginning to register, but the approach holds great promise for the future.

Box 13 Helping Businesses Become More Competitive

Panama: Program to Foster Competitiveness, Loan 1410/OC-PN (US\$7.0 million) (2002)

The IDB Group supports consensus-based approaches that assist in identifying, analyzing and carrying out the sequence of actions that are necessary to achieve greater competitiveness. The creation of a National Competitiveness Agenda with public and private sector participation is one instrument to systematically increase competitiveness through the design of a consensus-based strategic framework. The development outcome sought, over multiple phases of interaction, is the improvement of the business climate measured by sustained increases in business investment, which produces positive impacts on employment, productivity and export gains.

Continued →

In this innovation loan to Panama, the IDB is promoting such a dialogue under the guidance of a National Competitiveness Council and local clusters in 4 productive sectors (Tourism Colón, Tourism Bocas del Toro, Agro-industry, Information Technology, Transport and Logistics). In October 2002, the program was launched with a national event that brought together private sector and public leaders. Program implementation has been very promising as each of the five clusters have prepared Competitive Cluster Strategies (CCS), and have collaborated with the Ministry of Economics and Finance to properly develop project initiative plans prior to presenting them to the Competitiveness Council for approval. Similar efforts are being pursued in Honduras, Nicaragua and three other LAC countries that will examine issues both in business climate and business development, in coordination with national competitiveness councils.

It is interesting to note that in one of the clusters in particular, Tourism in Bocas del Toro, there is a strong participation by microenterprises.

C. Changing Government Role from Direct Provider to Facilitator

El Salvador is an excellent example of a government that has decided to adopt the role of facilitator instead of direct provider of BDS at the same time fostering a market development approach in much of its work with the BDS sector. The government of El Salvador has decided that it does not have sufficient funds to directly provide BDS to all the clients who demand these services, and therefore has reorganized itself to facilitate direct provision by the private sector, often using program modalities that are developmental of entire market segments. Much of this work is being carried out by the National Commission for Micro and Small Enterprise (CONAMYPE), with substantial grant assistance from the IDB. Examples of BDS market development programs that CONAMYPE is carrying out include: i) a voucher program, to stimulate the training market for micro and small enterprises; ii) a matching grants program, to stimulate the technical assistance market for micro and small enterprises; and iii) BDS market fairs, both real and virtual. The matching grants program provides subsidies to micro and small enterprises to test out technical assistance services, just as voucher programs do for training services. Technical assistance (TA) differs from training in that TA is a customized service delivered one-on-one to a firm, instead of in a classroom to a group of people from a number of different firms. BDS market fairs bring together BDS suppliers and demanders (the latter being micro and small entrepreneurs) in given sectors and try to match supply and demand. This may be done either at a specific time and place or else virtually (through the Internet). The governments of Honduras, Guatemala, and Nicaragua have also promoted such BDS market fairs.

Box 14

Consolidation and Refocusing of Microenterprise Support Policies and Programs

The IDB Group, acting through the MIF, has supported governments in Central America in their efforts to rationalize programs and enhance microenterprise support policies. Two examples of this type of project financed to date are presented below.

El Salvador: Support for Microenterprise and Small Business Development, ATN/MT-6952-ES (US\$850,000) (2000)

The National Microenterprise and Small Business Commission (CONAMYPE) is a public body whose mission is to promote and develop a range of modern, competitive, and profitable microenterprises and small businesses (MSBs), with capacity for wealth and job creation, coordinated within the country's economic system in the framework of national development strategies. The IDB Group is using this operation to help introduce mechanisms to facilitate and promote MSB development. The program is intended to cover the entire microenterprise and small business sector, developing regulations in favor of MSBs, coordinating the various agents that work on their behalf (government, private sector, and cooperation agencies), and establishing best practices for MSB development, including a system for policy impact monitoring.

Guatemala: Institutional Development and Policies to Support Micro, Small, and Medium-sized Enterprises ATN/MF-6500-GU (US\$900,000) (1999)

The program aims to help organize the micro, small, and medium-sized enterprise sector in Guatemala, through coordination and consensus-building between the public and private sectors, providing mechanisms for discussing and developing specific policies for the sector. This operation has characteristics and objectives that are very similar to those pursued by the project in El Salvador described above.

D. Reducing Informality

Regulated banking institutions often lend only to officially sanctioned businesses, not to unregistered enterprises. This increases the cost of credit for unregistered businesses and diminishes their likelihood of being able to borrow. By registering themselves, these firms, most of which are microenterprises, can also take advantage of numerous other benefits of formalization besides credit access, such as being able to:

- Write enforceable contracts
- Buy insurance
- Use the court systems
- Limit the personal liability of their owners through incorporation
- Participate in public training and procurement programs
- Avail themselves of the benefits of police and judicial system protection from crimes against their property
- Reduce side payments required to get around regulations governing formal businesses
- Freely use advertising, an advantage whose significance is suggested by the fact that two-thirds of all small business customers in the U.S. are brought in by the signs displayed outside of shops and factories

While much remains to be done in Central America to reduce the number of steps required to register a business, and the time and cost involved, progress is being made.

For example, the IDB began a program in the year 2000 to drastically simplify business registration in Costa Rica. The idea is to create “one stop shops” where microenterprises and other businesses can accomplish all the steps required to become registered in a single visit, thus reducing time the entrepreneur needs to spend by over 75 percent and the fees and other direct monetary costs by over 50 percent.

Box 15
Making it Easier to Register a Business

MIF: Costa Rica – One-stop Shop for Microenterprise and Small Business Formalization, ATN/MH-7408-CR (US\$660,000) (2001)

This operation, executed by the Ministry of the Economy, Industry and Commerce, promotes microenterprise and small business participation in Costa Rica’s formal economy. With Bank support, the aim is to design a simple, flexible, and efficient one-stop shop for registering businesses, thereby increasing the rate of formalization in the sector. At the time of this writing, progress has been made with interagency agreements between participating State bodies that reflect their legal and technical commitment to create a one-stop shop. Amendatory legislation has been proposed and technical studies have been carried out in relation to how the one-stop shop would operate.

VI. IDB Non-Financial Products Support for Microenterprise Development in Central America

Not all of the IDB’s contributions to microenterprise development can be easily measured in terms of operations approved, funds disbursed, or even businesses and families directly benefited. The Bank plays a major role in the dialogue with governments and the private sector that identifies problems, gives rise to and refines new ideas, discovers how to actually carry out proposed solutions, and provides much-needed timely feedback during implementation. One of the ways the Bank has contributed to the development of microenterprise in the past twelve years, has been to maintain a constant dialogue with governments and the private sector, through official missions and the day-to-day contact of the IDB’s field offices in the region.

Other ways that the Bank engages a broad audience of microenterprise development practitioners, policy makers and the business community, include the dissemination of information about microenterprise development, through conferences, seminars and publications. The Bank puts particular emphasis on identifying and disseminating best practices. In recent years, a majority of its publications have had this focus and in 1999, the Bank created an award to recognize top institutions and individuals working to promote the development of microenterprise throughout Latin America. This award is presented every year at the Bank-sponsored Inter-American Forum on Microenterprise. Since the creation of the Forum and the Award, three Central American institutions have been recognized, and are leading by example in this field (see box 17 below).

A. Knowledge Management: Dissemination and Building Networks

It is important to create and strengthen communication channels in Central America, especially in order to spread knowledge of best practices. To this end, the Bank has held conferences on various topics of relevance to organizations that work with microenterprises in the region. These events not only offer the chance to gain new knowledge, but they also facilitate the formation of contact and knowledge management networks among individuals and institutions working on behalf of microenterprise.

Box 16

Inter-American Forum on Microenterprise

The Microenterprise Forum has become an event of major importance in the region given the diversity of participants from the public and private sectors who support microenterprise development in Central America. The Forum serves as a meeting point to debate current issues and topics of major significance for the sector, foster information exchange and stimulate network formation, and the forging of new business partnerships. The Forum is evidence of the importance of international cooperation, not only as regards grants and financing, but also in terms of knowledge transfer and exchange of experiences between countries with similar levels of development. In September 2003, the Sixth Inter-American Forum on Microenterprise was held in Guatemala City, attracting over 1,000 attendees. The Forum's theme, **"How to Confront Changes and Manage Risks for Micro and Small Enterprises?"** highlighted strategies to help microenterprises cope with unfavorable political and economic climates.

B. Publications

The IDB's case studies of success stories in Central America have proven to be very useful as guides to other institutions in the region developing similar programs or enterprises. The Bank also publishes an annual magazine and a newsletter on the latest advances in microenterprise development, a series of books and occasional papers on topics such as financing microfinance, microfinance and poverty reduction, rural finance, credit unions, leasing, entrepreneurship, business clusters and local development. Two guides are now in circulation: one, based on the experience of Central America in dealing with natural disasters, is a guide for microfinance institutions on how to handle the recovery from such a crisis; the other has been developed together with the Association of Bank Superintendencies of the Americas (ASBA) and provides guidelines for governments on the regulation and supervision of microfinance.

C. Recognizing Best Practices through the Inter-American Awards for Microenterprise Development

In 1999, the IDB Group established the Inter-American Awards for Microenterprise Development to reward successful and innovative work by organizations that provide high-quality microfinance and business development services, and to recognize individual leaders in the region who have excelled by applying management practices to microenterprise development and for the benefit of disadvantaged populations. This contest is open to regulated financial institutions and nongovernmental organizations

(NGOs) that are active in the field of microcredit, and also to institutions that supply business development services to microentrepreneurs.

Box 17

The Inter-American Awards for Microenterprise Development in Central America

In Central America, Financiera Calpiá of El Salvador (1999), Fundación de Apoyo a la Microempresa (FAMA) of Nicaragua (2002), and Fundación José Nieborowski of Nicaragua (2003) have won the microfinance prize in the regulated and unregulated institution categories. This award recognizes regulated and unregulated financial intermediaries, such as NGOs, that have successfully expanded their supply of microfinance services. The organizations that excel in this field have demonstrated an ability to provide financial services to low-income customers, without prejudicing their financial viability and institutional sustainability.

Despite an unfavorable climate resulting from the damage caused by Hurricane Mitch, these institutions have made a successful recovery and have overcome their problems. FAMA stood out for its strong financial performance with a coverage strategy that embraces approximately 17,526 customers in 13 of Nicaragua's 18 departments, and for the wide range of microenterprise services it supplies, meeting the needs of its customers, of whom 73 percent are women.

In 2003, the Fundación Nieborowski of Nicaragua won the award for serving customers in rural areas where few institutions venture and offering agricultural and housing credit to a customer base of whom over 60 percent are women. The award cited the institution's healthy financial performance, robust growth of its volume of operations, low arrears rate, sound provisioning policies, low incidence of restructured loans, and a steady increase in profitability.

The Foundation for Indigenous Development and Education - FUNDEMI/TALITA KUMI also won the award for excellence in business development services in 2003. This Guatemalan NGO works with indigenous communities in rural zones and is notable for: (i) its community development programs involving campesino families, with a special gender focus, in northern and western Guatemala; (ii) the flexible and comprehensive strategy of its programs and services, serving 13 cooperatives with approximately 1,300 members, and over 600 communities; (iii) its solidity, image, and capacity in leading a labor training voucher program; (iv) its management capacity and efforts to provide sustainable services; and (v) the quality of the technical assistance it provides to its beneficiaries.

VII. Lessons Learned and Challenges Ahead

The years since 1990 have witnessed far-reaching achievements in the development of microenterprise in Central America, especially with regard to expanding microenterprises' access to credit and other financial services. The Inter-American Development Bank played a prominent role in the development of microenterprise in Central America throughout the period, supporting policy reforms and improvements in financial services and business development services for microenterprises. This rich experience has yielded important lessons, both for the Bank, and for the countries of Central America. These lessons provide a basis to build on in the future, as the countries address the myriad problems still confronting their microenterprise sectors.

A. Lessons

In its support for microenterprise development the IDB has found more productive ways to deploy funds than to subsidize the recurrent costs of microfinance NGOs and BDS providers. Its support has truly been in the form of investments, and become increasingly so over time. This approach has proven to be the correct one. But perhaps most significantly, the development of the microenterprise sector since 1990 has shown the importance of adapting IDB support to changing circumstances, the need to be innovative, as well as the need to be present in the sector over a long period of time, to give consistent support and consistent signals. The Bank's actions in other countries are closely watched in Central America and as a regional leader, the Bank sends powerful signals to governments and the private sector, especially regarding policy reform.

While many challenging problems remain to be addressed, clearly there have been significant progress and successes, not only in terms of the actions of governments and the private sector, but also in the many programs supported by the IDB during the period covered by this report. In both microfinance and business development programs the keys to these successes in reaching and having a positive and sustainable impact on microenterprises have proven to be: (i) enlightened local leadership of the executing institutions; (ii) the State creating space and an enabling environment for these initiatives to flourish; and (iii) continuity, perseverance and adaptability of donor support. IDB is directly responsible for only one of these pillars, the last. In Central America, IDB had the benefit of working with excellent institutions in recent years, institutions that had been nurtured in part with Bank support in the 70s and 80s. The success of microfinance at the turn of the century would not have been possible without sustained institutional support for over a decade prior to that. With the policy, legal, regulatory, institutional and programmatic reforms of the late 1980s and early 90s, governments moved from a direct execution role in this sector to more of a facilitating role and created an environment in which it was possible for new private sector initiatives to emerge. IDB accompanied and supported these changes with sector loans in the first half of the 90s, and with technical cooperation, primarily from the MIF, in the latter part of the last decade and up to the present. The MIF, the Social Entrepreneurship Program, and more recently the Bank's Innovation Loans, have supported the strengthening of institutions, new programmatic approaches, and the creation of public private partnerships that provide quality, sustainable business development services.

B. Future Challenges

Major challenges continue to confront microenterprises in Central America and the microfinance and BDS industries that support them. These challenges prompt local actors and the IDB to focus efforts on the following priorities.

- 1) Continuing to strengthen and build MFIs, credit unions, and BDS providers to supply high quality financial and business development services to an ever larger share of the region's microenterprises, including its poor microenterprises, through sustainable and, when possible, profitable microfinance and BDS

activities. With microfinance nearing or having reached saturation levels in a few of the major Central American cities, the next frontier is to move on to the smaller cities, towns, and rural areas, as well as new financial products such as leasing, factoring, credit cards and improved mechanisms for channeling remittances to productive uses. Extending financial services to rural areas, which have their particular characteristics, risks and other factors to consider will be the big challenge for the next several years. BDS is in its early stages and so its development in the region will likely focus on urban areas for the foreseeable future. The development of BDS lags behind microfinance and thus presents a bigger challenge. Approaches such as those focusing on enhancing the competitiveness of industrial clusters offer part of the solution.

- 2) Continuing to strengthen and improve the policy and regulatory business environment for microfinance, BDS and microenterprises themselves. This includes such things as reducing the time, cost, and complexity of registering a new business; implementing simplified business tax regimes for micro and small businesses; simplifying government procurement procedures to encourage participation by microenterprises; changing laws to permit private parties to agree to rapid, non-judicial enforcement of contracts; improving prudential regulation and supervision of credit unions and MFIs so that the regulations and supervisory procedures are appropriate for the sector; improving the legal framework for secured transactions and modernizing registries so that financial institutions can seize and sell collateral in less than the six months to two years it typically takes in Central America; and strengthening credit bureaus so that they cover even the smallest loans, thereby allowing microenterprises to build a documented credit history and promoting additional micro-lending. The region faces many ongoing policy challenges, especially in the financial sector, where it may be difficult to prevent erosion of reforms made. This challenge arises again and again with each new election cycle.
- 3) Finding innovative ways to support the smallest economic activities of the poor within the microenterprise sector. This means developing policies and institutions that aim to balance social impact (in terms of expanding access to services for the poor that will enable them to strengthen their livelihoods) with the sustainability, profitability and overall development of the financial sector and business services market. The financial system is not the appropriate place to address poverty issues head on. However, advances in organization, technology and regulation can help continually expand the frontier of financial services outward to reach ever smaller and ever poorer customers. But non-financial services are often more critical than financial ones to strengthening the livelihoods of poor microentrepreneurs. Therefore, innovation and support must continue in this area as well.
- 4) Rationalizing the role of government and of donors, to avoid creating impediments rather than support for sustainable microfinance and BDS. This calls for the cautious and strategic use of government and donor programs that

subsidize the development of these services, targeting concessional resources to institution building and expanding access, not underwriting ongoing costs or keeping prices artificially low. There is not nearly enough donor and government money to reach any substantial share of the approximately four million microenterprises in Central America with either direct services or substantial subsidies. Therefore, building sustainable, self-financing microfinance and BDS industries is key to meeting microentrepreneurs' urgent demands for financial and business development services. Donor coordination, a challenge in itself, will also play an important role in developing sustainable financial and business development services.

- 5) Although not specific to the microenterprise sector, or even the micro-small-medium enterprise continuum, one of the most difficult challenges facing the region in coming years is improving the competitiveness of its economies as a whole, of specific sectors and of enterprises. Meeting the challenges outlined above will help to improve competitiveness, especially for the backbone of the region's economies – the micro and small enterprise sectors. However, a concerted and coordinated effort will be required, addressing infrastructure, energy, communication, human resource development, governance and policy needs as well as the provision of adequate services, which has been the focus of this review. The countries of the region and the IDB are already working to address this challenge, and the lessons since 1990 should prove useful in the design of reforms, programs, and mechanisms for execution and coordination to meet the challenge.

Annex I

LIST OF PROJECTS HIGHLIGHTED IN THIS CHAPTER

COUNTRY	PROJECT TITLE	LOAN OR TC NUMBER	AMOUNT US\$	YEAR OF APPROVAL
Costa Rica	Agricultural Diversification - León Cortes	SP/SF-00-11-CR and ATN/SF-7295-CR	\$592,000	2000
Costa Rica	One-Stop Shop for Formalizing Micro and Small Business	ATN/MT-7408-CR	660,000	2001
Costa Rica	Global Credit for Microenterprise	701/OC-CR	13,000,000	1992
El Salvador	Credit and Training for Micro Entrepreneurs	SP/SD-9136-ES	465,865	1991
El Salvador	Credit and Training for Micro Entrepreneurs	ATN/SD-3848-ES	135,000	1991
El Salvador	Global Credit for Microenterprise	780/OC-ES	16,000,000	1993
El Salvador	Global Credit for Microenterprise	915/SF-ES	8,000,000	1993
El Salvador	Equity Investment in Financiera Calpiá, S.A.	EQU/MSF-0001-ES	800,000	1994
El Salvador	Pilot Training Program for Microenterprise	ATN/ME-6984-ES	870,000	2000
El Salvador	Support for Microenterprise and Small Business	ATN/MT-6952-ES	850,000	2000
El Salvador	Project for Microenterprise Recovery	ATN/ME-7546-ES	2,635,000	2001
El Salvador	Harnessing the Power of Internet to Train Professionals	ATN/ME-8082-RG	234,000	2002
Guatemala	National Program for Microenterprise	886/SF-GU	10,000,000	1992
Guatemala	Institutional Development for Micro, Small & Medium Enterprises	ATN/MT-6500-GU	900,000	1999
Guatemala	Rural Financial Services	ATN/ME-7624-RG	554,500	2001
Guatemala	Micro and Small Enterprise Development	ATN/SF-3965-GU	2,400,000	1992
Guatemala	Micro and Small Enterprise Development	ATN/SD-3965-GU	900,000	1992
Honduras	Institutional Strengthening of FINSOL	ATN/ME-6342-HO	300,000	1999
Honduras	Strengthening the Financial Sector	ATN/MT-7240-HO	1,500,000	2000
Nicaragua	Non-Conventional Credit Program	789/OC-NI	23,600,000	1993
Nicaragua	Microfinance Low Income Housing	SP/SF-0106-NI	500,000	2001
Nicaragua	Microfinance Low Income Housing	ATN/SF-7554-NI	35,000	2001
Panama	Program to Foster Competitiveness	1410/OC-PN	7,000,000	2002
Regional	Microenterprise Recovery Post-Mitch	ATN/ME-6303-RG	12,900,000	1998
Regional	Microfinance Recovery after Natural Disasters	ATN/ME-7048-RG	1,000,000	2000
Regional	Innovation Initiative - Facilitating Sustainable Links	ATN/ME-7625-RG	\$482,500	2001

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