THE IDB

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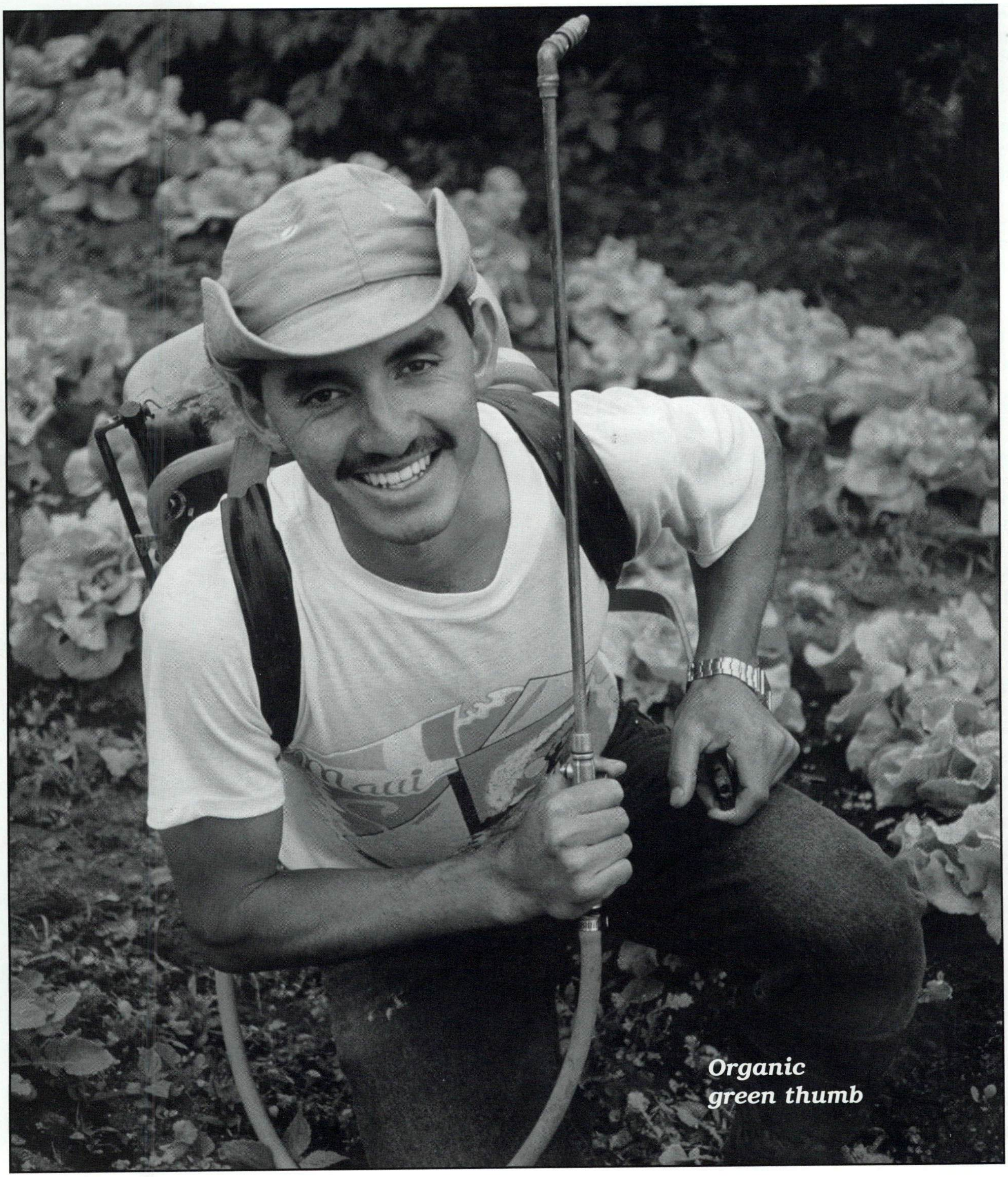
Taking stock of 1996



Organic green thumb

The risks of decentralization ■ Which reforms next?
Bolivia's local leaders ■ Myths of the bloated state

THIS MONTH

COVER PHOTO

Organic green thumb

Henry Guerrero, a vegetable farmer in Zarcero, Costa Rica, uses an organic insecticide he makes by boiling and fermenting seven insect repellent plants. Guerrero belongs to an IDB-funded cooperative that lends to local farmers. (*IDB photo by David Mangurian*).

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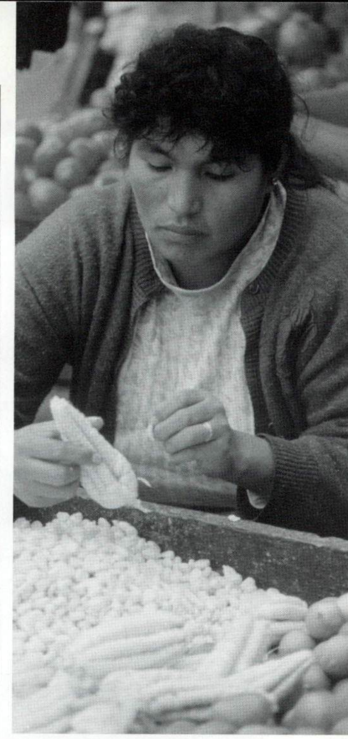

The Bank at a glance

The Inter-American Development Bank is an international financial institution established in 1959 to help accelerate economic and social development in Latin America and the Caribbean. The Bank has 28 member countries in the Western Hemisphere and 18 outside of the region.

In its 36 years of operations, the IDB has helped to finance projects that represent a total investment of more than $206 billion. The Bank has also fostered a more equitable distribution of the benefits of development and has been a pioneer in financing social projects.

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A new look at 'reform fatigue'

Have the economic reforms of the last decade been worth the effort?

In one form or another, this question continues to dominate public debate over economic and social policy in Latin America. Frustrated by persistent unemployment and a perception that the reforms have not improved the lives of the poor, many interest groups recently have criticized the economic reform programs that most of the region's governments currently embrace. In some countries, labor unions staged strikes and opposition political parties took to the streets to protest reform policies.

It is appropriate to ask whether the "major surgery" of macroeconomic reform has been worth its considerable pain. After all, the region's economic growth has still not regained its pre-1980s levels, despite recent signs that Argentina and Mexico have recovered from the peso crisis of 1995 and that the region as a whole is continuing to grow (see page 4).

And no one disputes the fact that reform policies have been followed by a difficult period of adjustment. Federal and provincial governments have dismissed workers and scaled back programs to meet stricter budget objectives, and companies in many sectors have also trimmed payrolls in an effort to compete with foreign producers. This combination of slow recovery and painful adjustment to liberalized markets has understandably led to a feeling of "reform fatigue."

Given the discontent, one might expect opposition political parties to be calling for a wholesale abandonment of market-oriented reforms. But this is almost nowhere the case. On the contrary, voters have made it clear that they value the low inflation, stability and gradual economic reawakening that has followed market reforms. They don't want those gains to be squandered.

In fact, a closer look at the most frequent sources of discontent shows that voters want new kinds of reform, in new areas, rather than a simple reversal of the financial and trade liberalization that has already taken place.


DAVID MANGURIAN—IDB

Rather than turn back the clock, voters want new reforms in areas such as justice, law enforcement and schools.

For example, as evidence of the poor performance of the region's public schools continues to mount, people are clamoring for radical reforms in the way education systems are funded and managed. Faced with repeated evidence of official corruption, financial mismanagement and criminal impunity, they are calling for an overhaul of justice and law enforcement systems.

Small and medium-sized companies, many of which are hampered by inconsistent government rules and excessive bureaucratic interference, want efficient and transparent regulatory entities that will give small players a fighting chance against large conglomerates. And the lingering specter of bank failures and financial service fraud is prompting broad-based demand for more effective government supervision of these sectors.

According to the 1997 edition of the IDB report *Economic and Social Progress in Latin America*, these so-called "second-generation" reforms, which must also include the areas of taxation and labor law, are crucial to expanding the gains of earlier reforms. "The untapped potential of all of these reform areas offers scope for raising the region's long-term growth rate above 5 percent," Ricardo Hausmann, the IDB's chief economist, writes in the introduction to the report.

Perhaps more significant in the short term is the effect that these new reforms could have on public perception—and the continued political viability—of existing reform programs. Public opinion about the fairness of privatizations and other market reforms depends largely on how well the gains are administered. That, more than any other factor, will determine whether people think the last 10 years have been worth the effort.

—Paul Constance

DAVID MANGURIAN—IDB

Like the skyline of São Paulo, Latin America's economies are growing.

LATIN AMERICA

The region posts solid gains

But this year's 5 percent growth is not sustainable

by Eduardo Lora

Latin America and the Caribbean will achieve a growth rate of 5 percent in 1997, substantially surpassing last year's 3.6 percent, according to the latest IDB estimates. The region's economic growth in 1997 will tie the 1994 level, which was the highest since before the debt crisis of the 1980s.

The growth forecasted for 1997 means that average per capita income will rise by 3 percent.

Argentina, Chile, Mexico, Peru and some of the smaller economies will post growth rates near or better than 6 percent. Brazil's economy will grow only 4 percent this year, but even this will contribute to an overall improvement over last year's growth levels.

On another bright note, inflation in Latin America during 1997 may drop to an average of 12 percent (weighted by the population of each country), or a median rate of 9.5 percent—the lowest level in several decades. In 1996 the weighted average inflation was 18.5 percent, and in 1995 it was 27.7 percent, not to mention average rates above 100 percent in previous years.

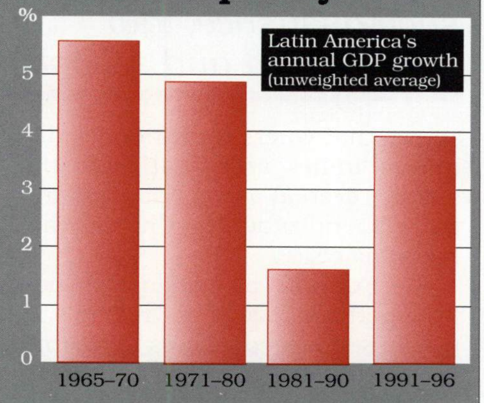
Has Latin America turned the corner? Perhaps, but the region is still burdened by chronic weaknesses in some key areas, and this year's performance should be greeted with caution, not euphoria.

In fact, there are signs that this year's 5 percent growth rate may not be sustainable. According to estimates in the 1997 edition of the IDB report *Economic and Social Progress in Latin America*, the region's potential for sustainable growth is probably closer to 4 percent, assuming that current economic policies and institutional frameworks remain unchanged. This said, it must be recognized that Latin America has come a long way. The potential for sustainable growth today is much greater than a decade ago. The IDB has estimated that structural and macroeconomic reforms carried out by the region's governments in the past 10 years have added two percentage points to the region's long-term, sustainable economic growth. These reforms have also contributed substantially to alleviating macroeconomic problems that resulted from past price instability and fiscal turmoil.

Latin America's fiscal situation has improved considerably. In fact, most Latin American countries have fiscal deficits below 3 percent of GDP, thus meeting the conditions for fiscal discipline set by the European Union's Maastricht Treaty. Not only are fiscal deficits in Latin America smaller than those of developed countries when they are measured as a percentage of the gross domestic product, but also when they are measured with respect to tax revenue, which obviously is much more modest in Latin America than in the industrialized world.

Finally, it is remarkable that Latin America has achieved fiscal discipline even as it advances rapidly toward democratization and decentralization in areas such as the provision of social services and fiscal and tax administration. It could be assumed that these changes would put serious pressures on the public treasury, but that has not prevented a major fiscal consolidation, as mentioned above.

Growth has recovered, but not completely



The writer is senior research economist in the IDB's Office of the Chief Economist.

Reforms and booms. Given these favorable developments, why is there a need for caution? As explained in the report, stabilization and reforms completed by many countries in recent years have produced spending and credit booms in excess of what local economies could absorb, in spite of the better framework for growth created by these very same reforms.

The high rate of growth for the region in 1997 could be partly influenced by this temporary overabundance of spending and credit. Such financial booms lead to financial, external and fiscal vulnerabilities. Banks become overextended and take on excessive risk. External debt increases at an unsustainable rate, while the real exchange rate appreciates and exports lose competitiveness. With abundant external financing and tax resources, governments tend to increase spending. However, those means of financing may prove to be temporary, and the deficits unsustainable, forcing painful corrections.

Another reason for caution is decentralization, which still could become a factor in the destabilization of public finance. In a number of countries, systems of fiscal transfers to the regions tend to reinforce procyclical public spending and facilitate excessive indebtedness of state and local governments.

Towards long-term growth. According to the report, Latin America faces three great challenges: consolidating macroeconomic stability, completing structural reforms, and substantially elevating the level of

Latin America's three main tasks:

- *Insist on prudent monetary and fiscal policies.*
- *Complete structural reforms.*
- *Improve education.*

education of its work force. By doing so Latin America can sustain a 6 percent growth rate that would significantly reduce poverty and inequity.

It is generally accepted that success in consolidating macroeconomic stability depends on maintaining prudent monetary and fiscal policies. But this is easier said than done in countries where financial systems are weak or poorly regulated, or when fiscal institutions do not allow room for maneuver during critical periods. Indeed, while prudent monetary and fiscal policies may appear less urgent to countries that are in the midst of a fiscal boom, this is when they are most needed.

Latin American fiscal institutions, despite their success in reducing deficits, even in the face of growing democracy, are not immune from weaknesses. The region's fiscal institutions should be designed in order to prevent public spending from increasing during booms and during elections, as is now conspicuously the case.

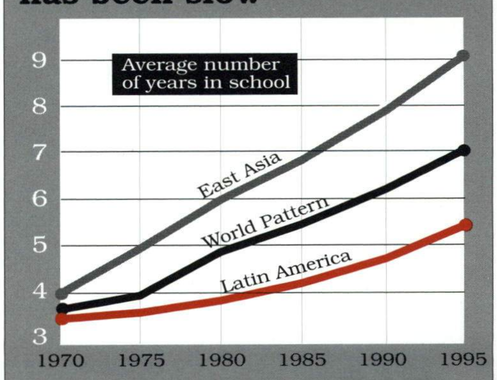
Fiscal institutions must also be reformed by putting in place transparent budget controls that cannot be manipulated by governments, and which must be scrutinized by independent referees who do not take part in spending decisions. But consolidating macroeconomic stability is not enough. The region's structural reform process is also incomplete. Countries have not advanced at the same pace, and some are far behind. The IDB estimates that if the reforms now being carried out are completed in the areas of trade and financial liberalization, improved tax collection and reduced state participation in areas better performed by the private sector, sustainable annual economic growth in the region could reach 5.5 percent.

Education holds the key. Despite the importance of structural reforms, the main obstacle to economic growth in the medium term is deficient educational systems.

According to the report, educational reforms will not come easily, but they will yield substantial benefits. If in the next 10 years the average level of schooling in Latin America is increased from the present five years to 6.8 years, sustainable growth could be raised by at least one percentage point, according to estimates derived from several studies. If improvements in the quality and extent of schooling are combined with the completion of structural reforms, the region's sustainable economic growth rate could increase to 6.5 percent per year.

Education is the key, not only in accelerating economic growth, but also in alleviating poverty and inequality in Latin America, which now has the most unequal distribution of wealth in the world.

Progress in education has been slow



Source: 1997 *Economic and Social Progress in Latin America*, IDB.

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DAVID MANGURIAN—IDB

Honest management of public money requi

DECENTRALIZATION

Municipal money managers

Local governments take on financial responsibility

by Ricardo Hausmann

Most of the world knows that Latin America has become a stronghold of democracy in the last decade, with all but one of the region's countries claiming freely elected governments and national legislatures.

But few foreign observers understand the extent to which the democratic process has reached down into the region's local governments as well. After decades in which most local officials were hand-picked by remote federal governments as a form of political patronage, cities, towns and villages across the region are now asserting their right to elect—and hold accountable—their own leaders. "City Hall Is Becoming A New Power Center All Over Latin America," announced *The Wall Street Journal* recently in a front-page story. Indeed, while only three countries in Latin America elected their mayors by popular vote in 1980, 17 do so at present, while in seven other countries these officials are appointed by elected municipal councils.

Contrary to the popular assumption, local officials generally do not squander resources.

This change is part of an unprecedented process of decentralization of authority that has paralleled the economic and political reforms adopted by most Latin American governments in the last decade. The abolition of controls on trade, production, and financing has restored decision-making independence to businesses and private individuals at the microeconomic level. Macroeconomic stabilization has successfully created an environment conducive to such decisions by helping to dispel inflation-related uncertainty while reducing financial and exchange rate instability.

As a result, political parties and voters have begun to reassert their right to determine how public resources are used to solve local and regional problems. Under pressure from voters, central governments have shown a growing willingness to decentralize tax and revenue mechanisms. This has placed unprecedented amounts of money in the hands of city and municipal governments, which have also accepted responsibility for delivering services such as education, health and sanitation, and for building and maintaining a wide range of local infrastructure projects.

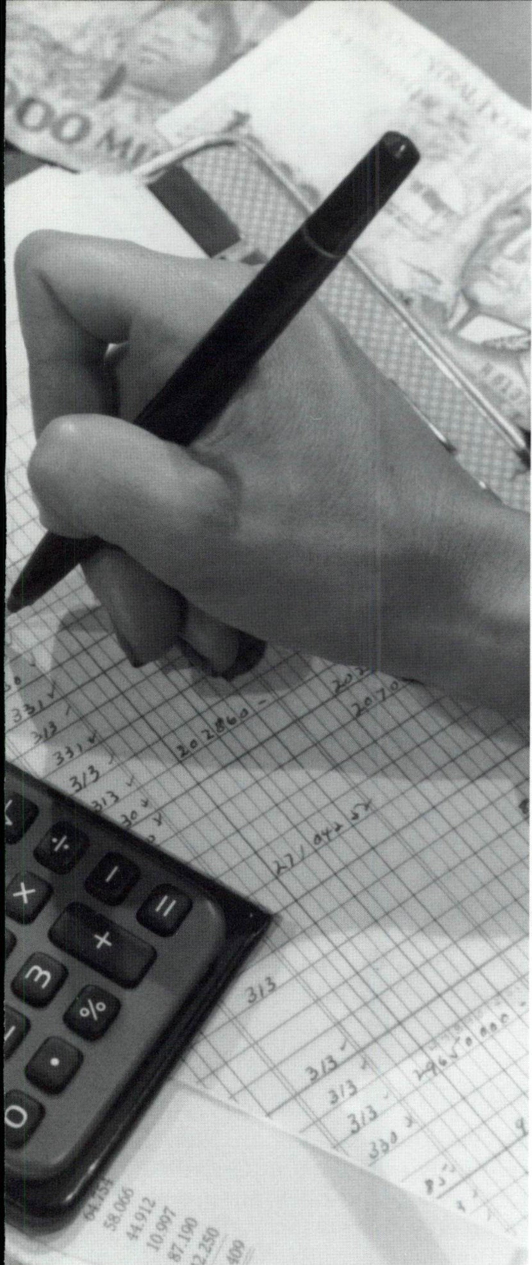
Formula for disaster? Not long ago, this pattern would have alarmed many economists, who have often argued that localized, collective decision-making tends to undermine fiscal discipline and create perverse incentives for the participants. In essence, the assumption is that local officials either squander resources in pursuit of short-term agendas or demand government money in the expectation that others will pick up the tab.

However, Latin America has shown signs that it can keep a firm grip on these tendencies, which are an inevitable by-product of any democratic system. In fact, public fiscal management and performance have been improving in most Latin American countries, even as governments decentralize and become more democratic. Many Latin American countries have fiscal deficits that are lower than the average among industrialized countries. How can this be explained?

The 1997 edition of the IDB report *Economic and Social Progress in Latin America* takes an in-depth look at this apparent contradiction. Based on case studies from several regional countries, the report concludes that the extent to which fiscal discipline is preserved in a politically decentralized environment depends on the manner in which the public decision-making process is organized.

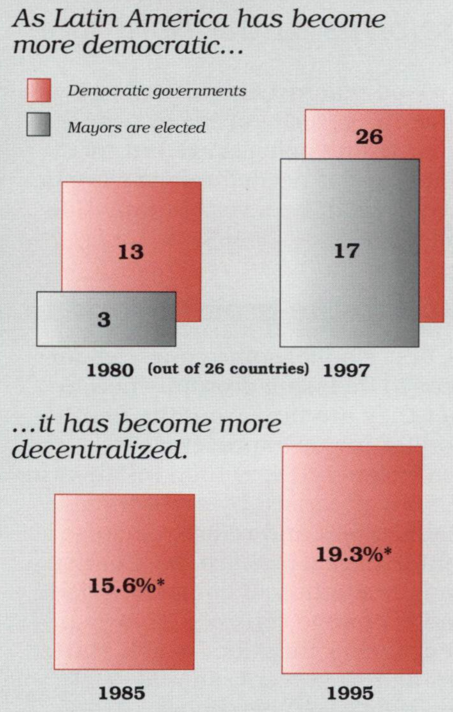
More specifically, success depends on the rules and institutions that govern budget decisions and electoral systems, because such

The writer is the chief economist of the Inter-American Development Bank.



es transparency and strict rules.

Democracy boosts local budgets



**Percent of national expenditures spent by local governments.*

Source: 1997 Economic and Social Progress in Latin America, IDB.

rules determine how societies handle the contentious process of allocating public resources. In a decentralized, democratic context this process faces four basic challenges.

First, budgetary institutions must sift through the divergent and frequently contradictory preferences of the electorate. Second, various societal interest groups have to be discouraged from trying to make everyone else foot the bill for their own particular "wish lists." Third, politicians and bureaucrats must not be allowed to twist the decision-making process in such a way as to benefit themselves at the expense of the commonweal. And finally, budget institutions must find ways to overcome short-term thinking in favor of credible commitments to pursuing policies with long-term benefits.

Each of these pressures, if unchecked, can undermine the credibility and equity of the resource-allocation process and lead to runaway fiscal deficits. Although there are many ways to control these tendencies, case studies in Latin America indicate that most successful approaches pair an emphasis on transparency in the budget-making process with a set of systematic safeguards against deficit spending.

The public as watchdog. Transparency can be improved at a basic level through rules that mandate public hearings and frequent disclosures of proposed budget plans. More fundamentally, however, the transparency of the budget process depends on the strength of local democratic institutions. Active civic groups, clear rules for the financing of elections and political parties, a free and competitive press and an independent judiciary are all crucial to exposing and thereby discouraging lobbying or corruption in the budget-making process. When local democracy is weak, important areas of public life escape social scrutiny, interest groups exert undue influence, and opportunities for deficit spending increase.

Transparency alone will not guarantee fiscal discipline, however. For that, most successful regional governments have instituted three broad kinds of safeguards in the form of spending rules.

▶ Rules that prevent local governments from relying too much on central government tax revenues to finance local projects. Governments should tie such projects to locally collected revenue from taxes on property, gasoline, toll roads and similar sources.

▶ Rules that ensure stability in local government revenues. Transfers of national tax revenues to local coffers should not be based on simple percentages of total revenues, since these are subject to periodic business cycle fluctuations that can lead to sudden drops and deficits. A better approach is to link national revenue transfers to cost reimbursements.

▶ Finally, effective budget policies that place strict limits on local governments' ability to borrow funds. In the past, many subnational governments that were allowed to borrow overindebted themselves, on the assumption that the national government would bail them out in the event of a default.

Although most of the region's local governments are only beginning to develop expertise in the complex art of resource allocation, these twin emphases on greater transparency and stricter budget rules are resulting in impressive early results.

Checking a turbine in Chile.

REFORM

Same tune, different steps

The key is to make the right reforms at the right time

by Daniel Drosdoff

Attempting to generalize about the economic picture in Latin America can often seem like trying to flatten out a balloon. When one country is booming, another falls into a crisis or correction.

Take Argentina and Mexico. Both now boast strong economies, with growth rates driven by rapid export and investment growth, besting last year's regional average of 3.6 percent. Memories of capital flight and recession following the devaluation of the Mexican peso in 1994 have dimmed.

But as these two countries forge ahead, mighty Brazil, which accounts for half the South American land mass and population, is lagging. Its strong currency and large external deficits raise fears that Brazil could be headed for another round of monetary instability. And then there's the special case of Venezuela, where the cost of living rose 100 percent in 1996, compared with the regional average of 11 percent.

Can any sense be made out of this potpourri of performances?

The uneven growth and inflation rates become more understandable if we recognize that countries go through clear cycles of reform, expansion, correction, and post-correction, as described in the 1997 edition of the IDB report *Economic and Social Progress in Latin America*. Country by country, the cycles differ in intensity but the patterns remain similar.

If managed correctly, cycles need not be a cause for alarm, says the report. They are natural, evolutionary processes that accompany major stabilization and reform efforts. The problems arise when the cycles and their root causes are ignored.

Good macroeconomic policies reduce the severity of the cycles. But if the wrong policies are put in place, and if needed reforms are delayed, it can be a very bumpy ride indeed.

Laying the groundwork

At first glance, some countries appear to be losing ground when in fact they are preparing the foundation for major improvements.

Venezuela's very high inflation in 1996 was caused by an economic stabilization and reform package that included a sharp devaluation and elimination of domestic price and exchange controls. This year, Venezuela's inflation, which started out at 100 percent, should settle down to 30–40 percent.

The country's reform program, called *Agenda Venezuela*, is founded on three fundamental changes: labor reform, pension reform, and privatization.

The IDB report points to Venezuela as a case study of how failing to carefully manage the ripple effects of a major reform can bring about the need for yet another stabilization program. The country's adjustment program, which began in 1989, ended in 1994 with recession, bank crises, and re-imposition of exchange controls. The ensuing period of economic instability could have been avoided if the country had managed the preceding, reform-induced "boom" more cautiously.

Chile: the cycle slayer

Chile stands out as a country that has conquered the cycles. It began its reforms more than 20 years ago, and its growth rate, which last year reached 7 percent, is the highest in Latin America. In 1996, inflation fell, real wages rose 4.5 percent, and the country's savings rate now stands at 30 percent.

Today, Chile is much less vulnerable to economic shocks, such as when the price of copper, the country's chief export, fell last year. The economy shrugged off the reversal and continued its pace-setting growth.

Two mature reformers

Bolivia and Uruguay are also at a relatively advanced stage in the reform cycle, and both are growing at rates of 4 percent annually.

Bolivia's recently completed privatization and pension reform programs, and the eventual completion of the natural gas pipeline to Brazil, will help boost the country's rate of growth and its efforts to reduce the gap in per capita income with wealthier neighbors.

Uruguay's challenge is to follow through on its present program of de-indexation, pension reform and government downsizing. Despite its relative stability, Uruguay's inflation was more than double the regional average in 1996, a problem that is gradually being corrected.

The challenge of Brazil

Brazil faces yet a different set of challenges. The country is now in its third year of a reform process that succeeded in reducing inflation from 5,000 percent in 1994 to 11 percent in 1996. Today, Brazil is seeing a sharp upswing in domestic spending, with the result that the current account deficit increased from balance in 1993 to 3.3 percent of GDP in 1997—typical signals of the expansion phase in the cycle identified by the IDB report.

Brazil's underlying vulnerability in the correction cycle was illustrated by the quick-trigger sell-off response of the Brazilian stock market to the "monsoon effect" caused by the monetary troubles in Thailand. In contrast, Argentina, Chile, and Mexico felt the Asian financial crisis to a much lesser degree.

Brazil has reduced fears of a banking crisis by tightening credit, which in turn is cooling off the economy, a move that reduces the danger of a sharp cyclical swing further down the road. The main challenge for Brazilian policymakers is to address the fiscal imbalance that has accompanied stabilization.

Prospects for Brazil's reform effort remain bright. With reserves of around $60 billion and a massive privatization program gaining momentum, the country is well positioned to complete its reform process while keeping up a growth rate as good as or better than Latin America's average.

Bumpy road in the Andes

The economies of Colombia and Ecuador are showing many of the characteristics associated with the stress and correction phases of the adjustment process. The governments of both countries have already applied policies to reduce inflation and have carried out significant structural reforms.

As residents of both countries increased their holdings of domestic currency, spending increased and a bank lending boom resulted. Investment grew rapidly, especially in Colombia, where new oil fields attracted capital.

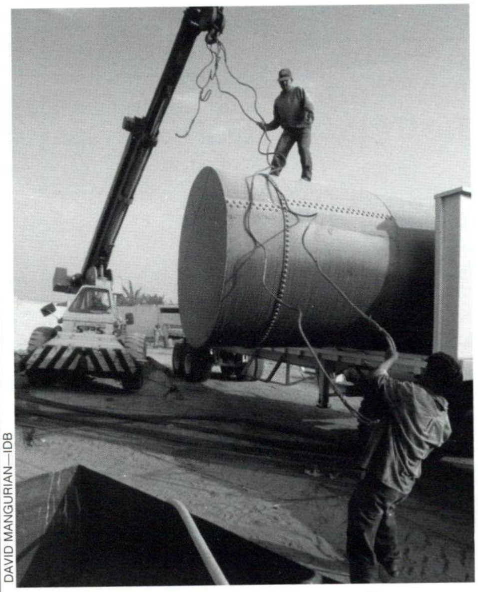
But in 1996, the bank lending boom slowed, real interest rates rose dramatically, and investment demand slumped. Ecuadorian and Colombian authorities had to correct fiscal imbalances just as private demand was weakening, a double blow to economic growth.

The challenge to Ecuadorian and Colombian policymakers, says the IDB, is to manage the correction to minimize the likelihood of a major economic downturn.

Correction in Peru

As in the case of Brazil, Peru is contending with previous overspending and a troublesome current account deficit, now at 6 percent of GDP.

The correction is likely to be short-lived, and the Peruvian economy is showing little sign of stress. Money demand continues to rise and capital flows remain high. But there is concern that Peru may undergo an inflated boom in bank lending, thus becoming vulnerable to a correction so severe it could destabilize the financial system and derail otherwise impressive economic accomplishments. The country's growth is expected to hit 4.5 percent in 1997, earning it a place with Argentina, Bolivia, Mexico and Uruguay as a solid achiever in the reform process.


DAVID MANGURIAN—IDB

Building a fishmeal plant in Peru.

Cycles in the Caribbean

Jamaica is another example of the reform, boom, and correction cycle. When inflation in that country reached 80 percent in 1991, the government began a stabilization program that cut price rises in half the subsequent year. Inflation now stands at 15 percent.

As in Colombia and Ecuador, a rise in the demand for Jamaican bank deposits helped finance a domestic lending boom, which in turn supported an expansion of domestic spending that brought the current account deficit to nearly 8 percent of GDP in 1996.

Jamaica is now undergoing a correction, marked by high real interests rates, problems in the financial system, and recession.

Taming the cycles

The IDB report draws two principle conclusions from the region's experiences with the cycle of post-reform expansion, deceleration, correction, and post-correction.

First, countries at an early expansion stage following reform and stabilization should take preemptive action to ensure that the recovery does not cause financial stress. A nation's fiscal position should be strong enough in the expansion to ensure that large deficits will not emerge when the boom ends, thus avoiding the need for a disruptive fiscal contraction.

Secondly, a country's banking system should be kept under a watchful eye during the process of reform, recovery and expansion. If weaknesses should appear, the state should intervene early to prevent a major crisis.

If corrections are made early and decisively, disruptive crises can be avoided, and the "cyclical" dynamics that often follow the reform process will become less important, enabling governments to concentrate on improving prospects for long-term stable growth.

Change in the classroom

Reforms cannot be imposed

Can development banks reform education in their member countries?

Absolutely not, says Claudio de Moura Castro, a Brazilian economist and the IDB's chief education advisor.

Institutions such as the IDB and the World Bank can encourage education reform, they can provide technical expertise, and they can finance reform projects. In short, they can add "kindling" to a reform "fire."

But only government, local officials, teachers and parents can actually light and sustain such fires, according to Castro.

During a recent speech at IDB headquarters, Castro reflected on lessons learned in two decades of observing and participating in education reform projects in several Latin American countries.

He said the failure of many education reform projects can be traced to a few basic mistakes that appear obvious in retrospect:

- Giving more priority to building schools than to structural reforms, teacher training and textbooks.
- Not providing strong, well-trained managers at the grassroots level and political support at the top of education ministry hierarchies.
- Carrying out overambitious reform projects, backed exclusively by the top management or the executive branch of governments, that attempt to "hammer through" changes without the support of mid-level bureaucrats and teachers' unions.

Education projects supported by development banks have succeeded in cases where the reform process was already getting under way, impelled by strong leadership and local participation. "Banks should bet on the winning horses," Castro said. "Unless the customers [of a reform project] are committed, you don't go anywhere."

Despite these limitations, Castro said development banks such as the IDB still play a vital role in preparing the way for reform programs. They do so by giving visibility to politically sensitive reform issues that local elected officials are hesitant to address, by placing conditions on loans in order to encourage the adoption of reforms, and by serving as a conduit for technical expertise that is often not available to government officials.

For more information on reforming the delivery of social services, go to http://www.iadb.org/sds/soc/eng/soce10del.htm.

WILLIE HEINZ—IDB

The impetus for educational reform must c

Local officials taking charge

Making it work in Bolivia

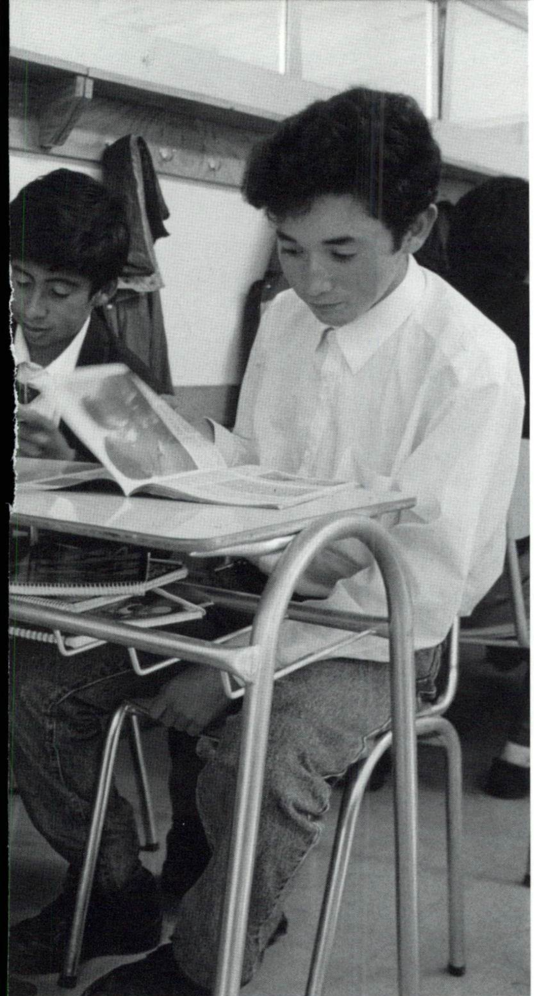
What happens when you give fiscal power to the people? In 1994 and 1995 Bolivia's national legislature decided to find out. It passed two laws that essentially transferred responsibility for setting budget priorities, deciding on infrastructure investments and monitoring public expenditures from the central government to lower units of government, including the country's 311 municipalities.

The effect of the laws was striking and, in the opinion of many local observers, irreversible. After decades of near total dependence on federal handouts and marginal authority over local decisions, municipal leaders suddenly found themselves in charge of 20 percent of national tax revenues and wholly responsible for all infrastructure related to health, education, culture, sports, roads and irrigation.

Although it is still too early to gauge the full impact of this change, Judith A. Moe, an IDB consultant and Canadian policy analyst, presented an overview of the laws' successes and remaining challenges in a recent seminar at IDB headquarters.

One of the most immediate positive impacts of the laws has been to force a more equitable distribution of government revenues. Before the laws were adopted, 91 percent of so-called "coparticipation" funds (national tax revenues destined for local expenditures) went to the politically influential metropolitan zones of La Paz, Cochabamba and Santa Cruz, while 9 percent went to the rest of the country. Today, those percentages stand at 68 and 32, respectively.

In most cases, the new money has come as a relief to municipalities that had long sought funding for specific infrastructure projects. But many smaller municipalities have been overwhelmed by the sudden infusion of funds. Lacking experienced financial managers and



ne from students, teachers and parents.

well-designed development plans, some communities have spent money on "vanity" investments such as parks and sports facilities, instead of attending to more urgent educational and production needs. The challenge has been to adapt Bolivia's financial control mechanisms to the country's diverse local conditions and to train municipal officials and workers.

Bolivia's government has responded by expanding programs to train municipal officials and help local governments design coherent development plans. More recently the government has instituted "cofinancing" incentive programs that allow municipalities to obtain additional funds if they can show that a local investment project complements regional or national priorities. Officials at all levels are also debating how to improve the effectiveness of local "Comités de Vigilancia," volunteer bodies that represent local community groups charged with making sure that funds are spent properly and that projects reflect local priorities.

PUBLIC SPENDING

Governments getting leaner

The challenge is to reduce in the right places

Latin American governments lately have made enormous efforts to downsize in their quest for fiscal balance, greater private investment and overall efficiency.

But a little appreciated fact is that even prior to the latest wave of reforms, the public sector in Latin America was proportionately much smaller than in the world's industrialized nations. Today, it is smaller still.

"In sharp contrast with the industrial economies, where public spending has generally risen throughout recent decades, government spending in Latin America declined as a share of national income during the 1980s," according to *Economic and Social Progress in Latin America*, whose 1997 edition was recently issued by the IDB's Office of the Chief Economist.

According to the report, Latin America's public sector typically spends about a quarter of a country's gross domestic product, compared with 50 percent in a typical advanced industrialized country. However, despite the steady pace of privatizations, Latin American countries still typically spend 6 percent of their GDP on public investment. In industrialized countries, where the private sector plays a more important investment role, the corresponding figure is less than 2 percent of GDP.

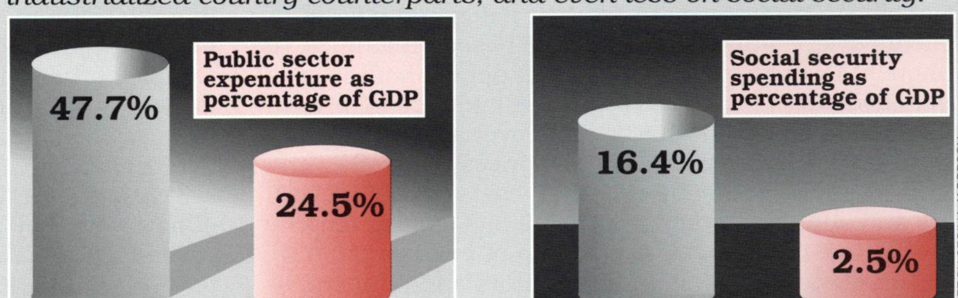
The single greatest difference between developing and industrialized countries in public sector spending is social security. This one item accounts for roughly 15 percent of GDP in an advanced industrial country compared with only 2.5 percent of GDP for the typical Latin American country.

The lower level of spending on social security in Latin America mainly reflects the region's much younger population, a factor that will pose a major challenge for social security systems as the population ages in the decades to come. The lower social security spending also reflects the large number of informal sector workers, and the governments' relatively limited ability to raise revenue.

"In this sense, thinner is not always better," says Michael Gavin, the IDB's lead research economist.

Smaller budgets can have social costs

Latin American governments spend half as much as their industrialized country counterparts, and even less on social security.



Consolidated public sector expenditure as percentage of GDP, 1990-95
Source: IDB calculations based on IMF figures.

Social security payments % of GDP, 1990–1995

IDB CHART BY CECILIA JACOBSON

DAVID MANGURIAN—IDB

Traders on the floor of BOLPROES check the latest grain prices.

EL SALVADOR

Selling beans via cell-phone

On one busy day in San Salvador last April, some US$1.7 million worth of fertilizers and pesticides changed hands.

Actually, a few slips of paper changed hands. The 12,000 metric tons of fertilizer and 37,500 liters of pesticide were nowhere to be seen, because the sales took place at the Bolsa de Productos Agropecuarios (BOLPROES), El Salvador's fledgling commodities exchange.

Standing before a wall-sized whiteboard covered with scrawled prices, a group of business-suited traders shouted bids for standardized lots of fertilizer while consulting with clients over cellular phones. The bids that matched offers for each lot resulted in contracts that would later be settled by brokers representing buyers and suppliers from around the country.

The raucous bidding was music to Sandra Munguía's ears. The youthful general manager of BOLPROES said the record-setting session was evidence that producers and consumers of agricultural commodities in El Salvador were starting to understand the real value of using an exchange.

Since BOLPROES opened for trading in 1995, Munguía has spent much of her time trying to convince the agricultural community of just that.

The exchange was created by a group of 100 Salvadorian business concerns that wanted to bring greater efficiency, predictability, quality and transparency to the sale of commodities such as coffee, beans, rice, wheat, corn and fertilizers. Most Salvadorian farmers still sell their produce to middlemen who come to their fields and offer a price based on a quick visual appraisal of the crop. These middlemen, known as "coyotes," typically pay low prices that reflect the high costs of dealing with small lots along a lengthy chain of middlemen, distributors and retailers.

"Farmers know they lose money to the 'coyotes,' but they are used to the convenience of being

DAVID MANGURIAN—IDB

Exchange chief Munguía.

paid on the spot, and they don't like the idea of submitting their products for quality testing," said Raúl Saca, a commodities trader for CORCEPRO S.A., in San Salvador.

In order to sell through BOLPROES, producers must first provide a sample of their product for testing and classification by a certified laboratory. Red beans, for example, are classified on the basis of how long they must be cooked. Other crops are tested for humidity, impurities and broken grains.

Once a sample has been classified, a producer can offer lots for sale through a trader registered at BOLPROES, who buys and sells contracts for the lot in exchange for a small percent of the transaction value. Traders guarantee payment to the producer at the contract price, regardless of subsequent fluctuations in a crop's market value.

"This has clear advantages for the producer," said Saca. "Since all the middlemen are eliminated, the final price tends to be higher," regardless of the quality grading assigned to a lot. The system even benefits producers who aren't selling through the exchange. The latest contract prices are listed in local newspapers, giving farmers a benchmark they can refer to when negotiating with a "coyote."

BOLPROES is attractive to industrial buyers because it gives them an accurate idea of the quality of the commodity they are buying. A substantial percentage of grain sold through traditional means is ultimately found to be unusable—a loss that must be assumed by the buyers.

Despite these advantages, Munguía has had a tough time convincing skeptical producers and buyers. Her efforts were boosted in 1996 when a portion of a $1.667 million grant from the IDB's Multilateral Investment Fund (MIF) was used to strengthen BOLPROES and similar commodity exchanges in Costa Rica, the Dominican Republic and Nicaragua.

—Reported by David Mangurian

JAMAICA

Work begins on hospital upgrades

An Italian firm has begun refurbishing three hospitals in Jamaica as part of a long-term effort to improve the provision of medical services in that country through a broad reform of the health sector.

The firm, Rizanni de Eccher, is constructing new buildings to house hospital departments and improving existing support services and infrastructure, such as laboratories, sewage treatment, electrical power and roadways in Kingston Public Hospital, St. Ann's Bay Hospital and Mandeville Hospital.

Renovations of two other hospitals are also being carried out as part of the IDB-financed program, which includes the procurement of biomedical equipment and the training of 16 different categories of health personnel.

In recent years, the IDB's support for health care improvement in Jamaica has moved from financing physical works to developing management capacity, including the establishment of a Health Reform Unit within the Ministry of Health in 1995. Earlier this year, the Bank approved a loan to help finance a broad program of policy reforms to secure the considerable health gains the country has made over the past quarter century.

A major aim of the reform program is to develop a national health insurance plan to achieve a more equitable and sustainable health financing system. The reform will also include decentralization of the provision of health services in which four regional authorities will be responsible for administering public hospitals and health centers.

The new program will also strengthen the ability of the Ministry of Health to set policy, carry out regulatory functions and improve human resource management.

WILLIE HEINZ—IDB

Hospital under construction.

ARGENTINA

Severance pay as venture capital

While economists and politicians argue over how best to reduce unemployment, people like Mónica Lomé and Carlos Alberto Ramoda of Buenos Aires, Argentina, are helping to solve what remains one of Latin America's most daunting problems.

The two met while employed at a private health insurance company in the 1980s. "I was his secretary for 10 years, and that's how we came to know each other," Lomé recalls with a smile. "Eventually we got married." In 1995, in a wave of corporate downsizing that followed the introduction of market-oriented reforms, Mónica and Carlos Alberto were laid off. Like most long-term employees, they received significant severance packages.

"Finding yourself out of work after years of depending on a single company poses both a problem and a challenge," Ramoda said. He and Lomé saw it mostly as a challenge, so they decided to use their severance pay as start-up capital for a clothing firm.

There was only one problem. Lomé and Ramoda knew plenty about health insurance, but little about running a business. What they needed was professional training.

Then they learned about a microenterprise project that is part of a broader Program to Support Productive Reconversion. Carried out by Argentina's Ministry of Labor and Social Security, through its Employment and Labor Training Office, the program has been financed with the help of the IDB.

Lomé and Ramoda were able to choose from among some 6,000 public and private business training institutions that had been selected through international open bidding, and settled on a program that offered 120 hours of instruction in business planning, accounting and management for small enterprises. By paying a nominal fee, they could also consult an expert on questions about their particular business. As such, they joined the 2,255 microentrepreneurs benefitting from the program.

Today, Lomé and Ramoda are building their business and working the trade fair circuit, where they exhibit merchandise and make agreements with manufacturers and retailers.

Like other first time business owners, they still have a lot to learn. But they're employed, and are optimistic about the future.

—Reported by Amanda Palermo

AMANDA PALERMO

Lomé and Ramoda exhibit their wares in Buenos Aires.

INFORMATION ON IDB PROJECTS

More details about these projects, including press releases, project summaries and related papers, are available electronically through the IDB's Internet home page (http://www.iadb.org). Check under the Press Services, Publications and Project Documents sections.

IDB Projects, a monthly compendium of planned projects and related opportunities to supply goods and services, is also available on the home page, under the Business Opportunities heading. For a sample copy of the print edition of *IDB Projects,* call (202) 623-1397, or fax x1403.

LOANS

Argentina. . .$370 million to support efforts to increase productivity and employment opportunities for youth from low-income families.

The program will finance job training, career orientation and the establishment of vocational training councils. Approximately 9,000 training courses, designed to respond to the private sector skill needs, will be offered to around 180,000 beneficiaries. A network of employment offices will improve the services of intermediation, orientation, and placement support for approximately 400,000 persons.

The program will also finance scholarships for low-income students, with the goal of reducing the school dropout rate for those between the ages of 13 and 19.

The total cost of the program, which will be carried out by the Labor Ministry and the Education Ministry, is $637 million.

Argentina. . .$96 million to improve tax administration and foreign trade oversight by strengthening the Federal Public Revenue Administration.

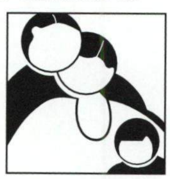
The program will address one of the root causes of Argentina's public deficit: tax evasion, including social security contributions and foreign trade levies.

The legal and regulatory framework governing tax and customs administration will be reviewed and adjustments will be proposed.

Procedures to simplify and better monitor taxpayer compliance and foreign trade will be instituted. The program will also fund the development of communications and information systems that will support revenue collection and management.

The total cost of the program is $192 million.

Brazil. . .$180 million to the state of Rio de Janeiro to upgrade low-income neighborhoods in the Baixada Fluminense region of the Rio de Janeiro metropolitan area.



In addition to financing improvements in infrastructure for services such as basic sanitation, street paving, and recreation, the program will provide technical assistance to the governments of four participating municipalities so they will be better equipped to organize and operate services and establish financial control systems.

Approximately 360,000 low-income persons are expected to benefit from the program, which will cost a total of $300 million.

Costa Rica. . .$16.6 million to help modernize the state and promote greater private sector participation in infrastructure and finance.

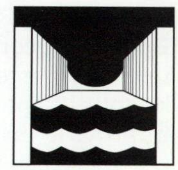
The resources, which will finance technical assistance, include an IDB loan of $12,650,000 and three grants totaling $4 million from the Multilateral Investment Fund, an autonomous fund administered by the IDB.

The MIF resources will be used to:

- ▶ Open up banking and insurance to private investment and strengthen the institutional framework for these two sectors.
- ▶ Promote securities market development, including strengthening of the National Securities Commission.
- ▶ Establish a sound regulatory and institutional foundation to develop a concession system as an instrument for infrastructure sector development.

The total cost of the program is $24,830,000.

Panama. . .$45 million to support reform of the water supply and sanitation sector, improving the efficiency and quality of the service.

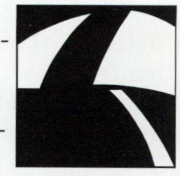


The resources will help finance the restructuring of Panama's water and sanitation operating agency, the Instituto de Acueductos y Alcantarillados Nacionales, in order to bring in the necessary private sector financing and management.

This agency will be transformed into a mixed corporation, with 51 percent of the stock owned by a strategic private investor who will operate water and sanitation service in metropolitan Panama City.

The total cost of the program, to be carried out by the Ministry of Planning and Economic Policy and the new mixed corporation, is estimated at $65 million.

Uruguay. . .$25 million for the construction, operation, and maintenance of a 132-kilometer highway linking Montevideo with Punta del Este, as



well as other access roads.

The project is the first approved for Uruguay from the Bank's Private Sector Department, and it is also Uruguay's first highway concession granted to the private sector to operate a formerly public facility.

After completion of the project, 90 percent of the highway between Montevideo and Punta del Este will be a two-lane toll road in either direction. The latter city is a tourism center that produces a major share of the country's foreign exchange earnings.

MULTILATERAL INVESTMENT FUND

Paraguay. . .$1,260,000 to support job skills training for rural youth.

The resources will support a variety of short courses for approximately 1,300 young people between the ages of 15 and 30, with special emphasis on the agricultural sector and on providing technical, entrepreneurial, and life skills designed to integrate youth into the productive sector of the economy.

INTER-AMERICAN INVESTMENT CORPORATION

Dominican Republic. . . A $2.5 million loan and a subordinated loan of $500,000 to Banco Intercontinental S.A., for a credit line for leasing operations targeted to small and medium-sized companies.

Peru. . .$3 million loan and a $3 million investment in Banco BANEX to benefit the country's small and medium-sized companies in the industrial, fishing, manufacturing, mining, construction, chemical, energy, tourism and agribusiness sectors.

Regional. . .$10 million equity investment in South America Private Equity Fund Coinvestors, L.P., which provides long-term capital to medium-sized companies in South America by coinvesting with an existing fund sponsored by the Overseas Private Investment Corporation (OPIC).

Regional. . .$5 million equity investment in Fondelec Essential Services Growth Fund, L.P., a firm that invests a minimum of 75 percent of its resources in Latin America and the Caribbean. The targeted investment areas are electricity, gas, water, and wireless communications projects. The capitalization of this eight-year fund is $100 million.

BONDS

Yen...a 30 billion yen dual-currency issue under the Bank's Euro Medium Term Note Program. Daiwa Europe Ltd. was the lead manager on the issue, which was priced at 100 percent and pays a semiannual coupon of 4.15 percent. Though denominated in yen, the issue is repayable in dollars.

Lira...300 billion Italian lira issued under the Euro Medium-Term Note Program. Caboto Holdin SIM SpA, and Deutsche Morgan Grenfell were the lead managers on the issue, which was priced at 101.296 percent with a maturity date of Oct. 2, 2007.

PEOPLE

Alberto Yagui has been named the IDB's alternate executive director for Peru and Colombia. He was most recently the president of Peru's Comisión Nacional Supervisora de Empresas y Valores.

Antonio Soruco Villanueva, formerly the principal advisor to the Bank's executive director for Bolivia, Paraguay and Uruguay, has been named alternate executive director for the same countries.

Hiroshi Toyoda was appointed manager of the Private Sector Department. He had been IDB executive director for Japan and a group of European countries.

Antonio Vives has been named deputy manager of the Bank's Sustainable Development Department. He was chief of the Infrastructure and Financial Markets Division of the same department.

IN PRINT

Economic and Social Development in the XXI Century, edited by Louis Emmerij, 579 pp.

What new directions will development take in the next century? A distinguished group of experts on economic development debated this question in late 1996 at a symposium at the IDB's headquarters in Washington, D.C. This volume brings together their views on such topics as macroeconomic stability, savings, human resources, employment, equity and the role of the state.

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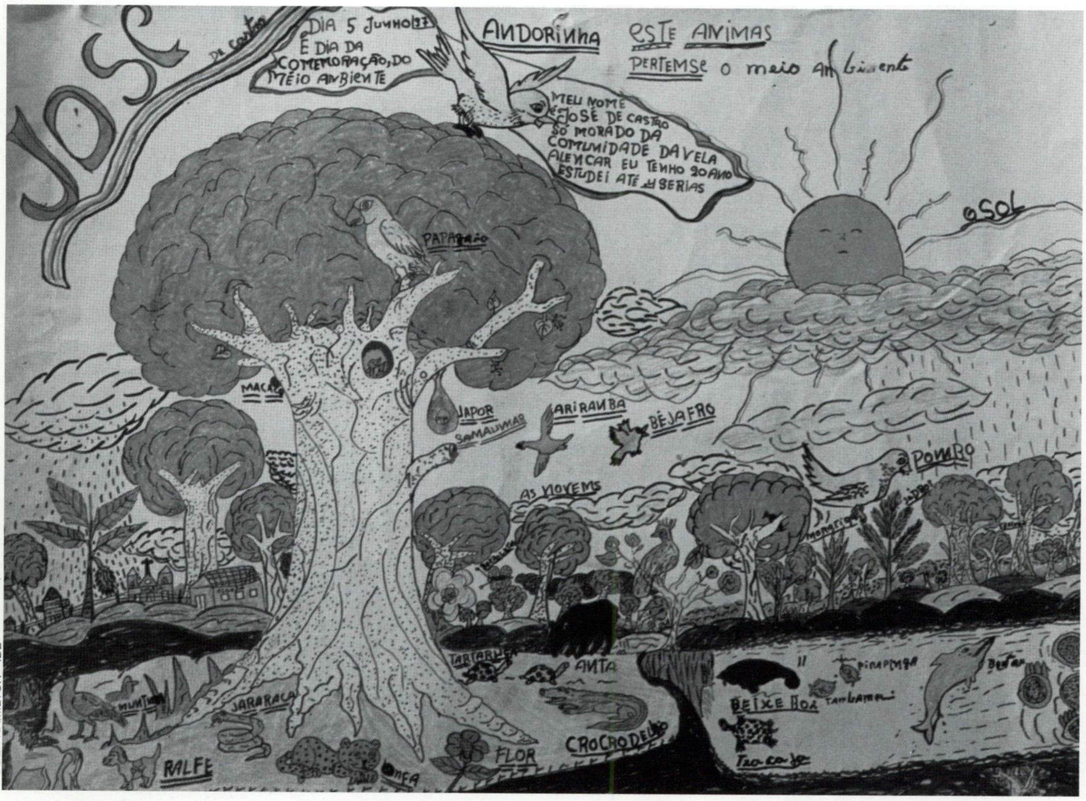
POSTSCRIPT

With this issue, *THE IDB* bids farewell to Samuel Silva, associate editor and a valuable part to our efforts to report on the IDB and Latin American development. He leaves for Miami to become U.S. correspondent for *América Economía*, a premier business publication that covers the region.



ROGER HAMILTON—IDB

A mighty tree takes center stage in a poster prepared for Earth Day in the Amazon.

ENVIRONMENT

Window on the Amazonian world

Art explains unique natural ecosystem

"The turimá tree needs light, air, soil and water," Ednelza M. da Silva told an audience of friends and neighbors gathered in a little schoolhouse. "The insects, birds and fishes eat the tree's fruit. Man eats the fish. So man must not cut down the tree that feeds us all."

Da Silva was one of nearly a dozen students in the Amazonian community of Vila Alencar, 600 kilometers west of Manaus, participating in a poster competition, one of the highlights of Earth Day ceremonies. Although naive in execution, the posters were true to art's most primordial purpose: to make sense out of the world and communicate to others. The students drew what they knew—pink dolphins, red monkeys, lumpy sea cows, prehistoric-looking fish placidly feeding on fruit, bright flowers and trees of a kaleidoscope of forms. They showed the warmth of the sun's rays, the rain falling from the clouds, the fish foraging in the flooded forest. They also drew people and domesticated animals, but on the same scale as the natural plants and animals.

The drawings depicted a very complex and special environment. All the plants and animals in this part of the Amazon must adjust to the annual ebb and flow of the mighty river. During the low water months, the people plant cassava and corn in the clearings and catch fish where the receeding waters leave them concentrated and exposed. In the other half of the year, dry land practically disappears, and life becomes more difficult.

Called a *várzea*, or flooded forest, the unique ecosystem surrounding Vila Alencar is part of a reserve managed by the Mamirauá Civil Society, a nongovernmental organization that received funding from the IDB-supported National Environment Program.

It so happens that Earth Day in the Amazon falls in the middle of the high water season. The schoolhouse, its floor boards almost lapped by the brown water, was ringed by dugout canoes and aluminium skiffs, like horses tied to a hitching post.

The audience applauded as Da Silva finished, and others stood up to take the floor, some speaking confidently, using dramatic gestures, others shyly, their voices barely audible. The audience strained to see every detail and murmured agreement with the interpretations offered.

Then the ceremony ended, and the people set out for home in their skiffs and dugouts, past the turimá trees, laden with fruit.

—Roger Hamilton

ROGER HAMILTON—IDB

Ednelza M. da Silva: art as ecology textbook.