

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**REVIEW OF THE INTER-AMERICAN DEVELOPMENT BANK'S
ORDINARY CAPITAL AND FUND FOR SPECIAL OPERATIONS
RESOURCE REQUIREMENTS**

March 10, 2009

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Abbreviations

AfDB	African Development Bank
ALL	Average Lending Level
CABEI	Central American Bank for Economic Integration
CAF	Corporación Andina de Fomento
CDB	Caribbean Development Bank
COF	Country Office
CPF	Corporate Performance Framework
DSA	Debt Sustainability Analysis
ECD	Early Childhood Education
FSO	Fund for Special Operations
GCI	General Capital Increase
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Country
HLF	High Level Forum on Aid Effectiveness
IDA	International Development Association
IFF	Intermediate Financing Facility
KCP	Knowledge and Capacity Building Products
LAC	Latin American Countries
LPGS	Liquidity Program for Growth Sustainability
MDB	Multilateral Development Bank
MDG	Millennium Development Goal
NLF	New Lending Framework
NOF	New Operational Framework
NSG	Non-Sovereign Guarantees
OC	Ordinary Capital
PBL	Policy-Based Loan
PPP	Public Private Partnerships
PSFG	Public Sector Financial Gap (PSFG)
SEDLAC	Socio-Economic Database for Latin America and the Caribbean
SLL	Sustainable Lending Level
TELRR	Total Equity to Loan Ratio
TFFP	Trade Finance Facilitation Program
ULA	Unused Lending Authority
VPP	Vice-Presidency for Private Sector, VPP
VPS	Vice-Presidency for Sectors
WEO	World Economic Outlook

Executive Summary

- **The purpose of this document is to seek guidance from the Board of Governors with respect to a general increase in the resources of the Bank and additional analyses that may be useful to inform the discussion.** This document provides Management's analysis of the financing capacity needed to fulfill the IDB's development mission over the medium term and the corresponding level of capital required to support it. A General Capital Increase (GCI) is not expected to increase the Bank's lending capacity in the short term and thus would not help meet clients' demand during the current financial crisis.
- **The Bank has a proven track record as a development partner of the Region.** The last GCI in 1995 represented an investment by shareholders of \$1 billion of paid-in capital to the Ordinary Capital (OC) which has generated financing of \$93 billion for development programs and policies. A further \$1 billion contribution to the Fund for Special Operations (FSO) permitted \$5.1 billion of additional concessional financing for the poorest countries of the Region.
- **Latin America and the Caribbean has shown advances in the last five years on meeting the Millennium Development Goals, yet the development challenges for the Region are significant.** More than 190 million people live in poverty, with more than 65 million of them in extreme poverty. Pervasive gender inequality limits job opportunities. Enrollment in secondary education for secondary-age students is low. The maternal death rate is high compared with other regions of developing countries. About 8% of children under age five are underweight. More than half of the employed population work in the informal sector with no social security coverage. Unequal access to water and sanitation is prevalent, with the poor and rural populations having much lower levels of access to these services.
- **As a regional development bank with a mission to accelerate social and economic development, the IDB has the knowledge and capabilities to make a significant contribution.** For this purpose, five strategic priority sectors for the Bank's work have been identified: (i) social policy for equity and productivity; (ii) infrastructure for competitiveness and social welfare; (iii) institutions for growth and social welfare; (iv) competitive regional and global international integration; (v) protecting the environment and responding to climate change. Additionally, reforms conducted in the last few years, through the Realignment, have considerably renewed the Bank's organizational, human resources, risk management, and development effectiveness capabilities.
- **To fulfill this mission, the Bank needs to have sufficient scale and scope.** Throughout the last fifteen years, the scale of the Bank relative to the Region has been shrinking, while demand has increased. The document provides assessments of the Bank's scale with respect to the Region's GDP and level of economic development, the strategic priority sectors mentioned above, the Bank's counter-cyclical role, and non-sovereign guaranteed products.
- **The lack of sufficient concessional resources to meet demand under a framework of debt sustainability is significant for the poorest countries of the Region. The Bank's annual average resources available for concessional lending to these countries has declined substantially during the period 1994-2008.** This decrease is partly the result of

the implementation of HIPC-related debt relief, which was financed without contributions from shareholders. If no measures are taken, the value of the FSO will continue to decline until it is depleted. The gap left by the Bank has not been filled by other Multilateral Development Banks, with the result that the poorest countries in the Region have seen their overall access to development finance decline.

- **Although the global financial crisis has exacerbated the problem, the shortfall is independent of it.** The crisis has increased the demand for financing in the Region. At the same time, access to external finance is constrained by the retreat of investors from emerging markets and the large debt issuance by developed countries. While it is impossible to predict how long the financial crisis will last, this tightened credit market is likely to continue at least over the short term. In this context, MDBs are seen as the single most important source of financial resources to maintain development programs, particularly those that benefit the most vulnerable.
- **In order to help our borrowing member countries face the crisis, the Bank has committed to a strong counter-cyclical response.** The Liquidity Program for Growth and Sustainability (LPGS) created last November is designed to finance loans to maintain the flow of credit to the real economy. The Bank also expanded the Trade Finance Facilitation Program (TFFP) to mitigate the impact of the crisis on trade flows. The Board of Directors approved in 2008 the balance of resources under the lending limits of the 2005-2008 New Lending Framework, and Management is proposing to front-load the Bank's financing capacity by approving up to \$12 billion in 2009. This strong counter-cyclical response curtails the Bank's lending capacity in 2010 and beyond.
- **Management is continuing to explore ways to increase counter-cyclical lending in the short term by examining possible co-financing alternatives from third parties.** In addition, Management is actively pursuing reforms to improve the Bank's risk management capabilities and improve the efficiency with which we use the Bank's existing economic capital by enhancing our capital adequacy framework in accordance with best industry standards.
- **With respect to the Bank's medium-term capacity to achieve a scale consistent with the Region's demands, this document presents three scenarios for ordinary capital requirements.** These scenarios correspond to annual Sustainable Lending Levels of \$12 billion, \$15 billion, and \$18 billion. The analysis shows that the Ordinary Capital increase requirements for each scenario would be \$75 billion, \$127 billion, and \$180 billion, respectively.
- **This document also presents financial analysis for one scenario for the FSO.** This analysis indicates that a \$1.070 billion increase in the FSO resources would be required in order to fund a demand scenario that totals \$4.9 billion in concessional resources between 2010 and 2020, while maintaining a prudent liquidity level above the \$300 million minimum. Management will review other scenarios for the FSO to leverage more funding in light of the financial crisis, its persistence and effects on the poorest countries of the Region.

A. Introduction

1. This document is Management's review of the financing capacity needed to fulfill the IDB's development mission over the next decade and the corresponding level of lending resources required to support it, both in the Ordinary Capital (OC) and the Fund for Special Operations (FSO). The purpose is to seek guidance from the Board of Governors for the Bank to explore a General Capital Increase and a replenishment of the FSO. The document contains analytics, based on both backward and forward looking data, on the scale of available Bank resources relative to the needs of the Region. We consider the needs of the Region both in terms of regular medium-term development finance and counter-cyclical support and we take a specific look at the needs of the poorest countries.
2. For information related to the above, two issues are noted. First, could the Bank leverage more its existing capital? The Bank is reviewing the policies that determine the Bank's financial capacity to optimize capital use. Second, are there short-term measures that can expand our financing capacity during the current crisis? The Bank has taken measures to provide more counter-cyclical resources to our borrowing member countries, and is exploring alternatives to mobilize additional resources from third parties.
3. In addition to this document, the Board of Governors will be presented with an independent analysis and recommendations on the same topics by a High Level Commission, formed at the request of President Moreno, and presided by the former Prime Minister of Peru, Pedro Pablo Kuczynski and integrated by Michel Camdessus, Antonio Palocci, Roger Fergusson, Francisco Gil and Jorge Londono.
4. The purpose of these efforts is to start a conversation on what should be the right financial size of the Bank for the next decade. Some key questions follow from this analysis: (i) is there a case to initiate formal discussions to pursue an increase of the Ordinary Capital and Fund for Special Operations? (ii) what additional analysis should be prepared to inform the discussion, including country by country in-depth analysis? (iii) what other issues should be considered to complement the discussion on capital requirements?

B. The Eighth General Increase in the Resources of the Bank

1. The Bank's last capital increase took place in 1995¹. The 8th GCI allowed the IDB to become the largest source of development finance in Latin American and the Caribbean (LAC), currently providing more than 50% of multilateral financing to the Region. Among the results achieved with the resources leveraged by the last GCI are: (i) enhancement of human capital through financing of \$30 billion for social programs (education, health and poverty) that have contributed to the Millennium Development Goals (MDG); (ii) fixed capital formation that

¹ The Eighth General Increase in the Resources of the Bank (Document AB-1704), included an increase in the Ordinary Capital (OC) and Fund for Special Operations (FSO)

increases both access to public services by the poor and the competitiveness of businesses through \$29 billion of financing for infrastructure; (iii) strengthening of public institutions through \$16 billion in loans that have contributed to improve fiscal balances in the, increased protection of rights, and more effective and efficient delivery of services; and (iv) environmental protection and enhancement programs with loans totaling \$2.5 billion that have contributed to improved environmental management. With respect to the specific lending targets set by the Board of Governors, 50.4% of the cumulative volume of lending and 49.3% of the number of projects were for social programs² -- 10 percentage points above the 40% target for volume set by the Board of Governors and marginally below the 50% target for number of projects. About 38% of the cumulative volume of lending was for Group II countries - three percentage points above the 35% target.³

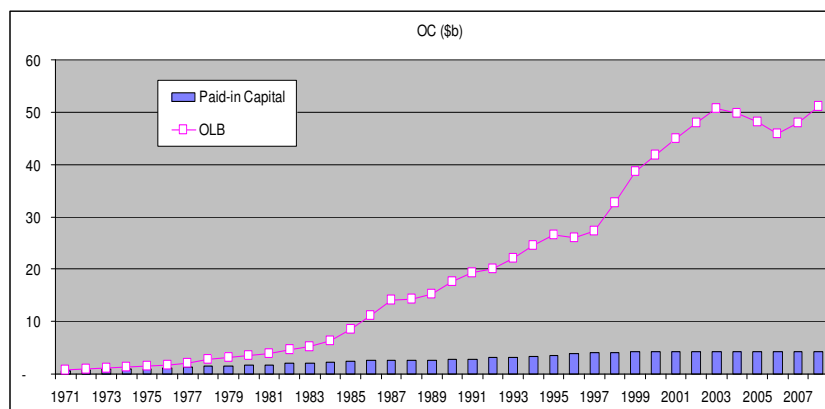
2. During the period since the last GCI, the IDB has demonstrated comparative advantages embedded in its identity and capacities as a regional institution manifested through: (i) an understanding of the Region's countries, their needs and circumstances ; (ii) a convening role, assembling key players to help in the solution of problems that demand close regional focus and coordination; (iii) the capacity to tap into regional networks and experiences that allow for knowledge sharing within the region; and (iv) an active role in supporting regional integration and developing regional public goods.
3. Resources from the 8th GCI have enabled the Bank to support an average of \$6.6 billion of loans and guarantees each year, with cumulative disbursements over the period of \$80 billion.⁴ An investment by shareholders of \$1 billion of paid-in capital to the OC has generated financing of \$93 billion for development programs and policies. A further \$1 billion contribution to the FSO permitted \$5.1 billion of additional concessional financing for the poorest countries of the Region. This shows that the Bank is able to leverage many times over resources for development financing from a relatively small amount of paid-in capital. Figure 1 below shows the relationship between paid-in capital and outstanding loan balances (OLB) since 1971.

² Cumulative figures exclude Non Sovereign Guaranteed Lending. When included, cumulative volume is 44.8% and number of operations is 44.6% for social programs.

³ Group II countries consist of Belize, Bolivia, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, Paraguay, Peru, and Suriname

⁴ Unless otherwise specified, all figures in this document are in United States dollars (US\$).

Figure 1



4. In the current context, where the global financial crisis has become a world economic crisis, with developed countries issuing record amount of debt to finance stimulus packages, developing countries will face increased difficulty to access predictable and affordable finance. As we have seen, the Bank has a proven track record to be an effective and efficient mechanism to transfer much needed resources to countries where the effects of the current economic downturn can be exponentially damaging.

C. Lending Trends relative to the economic size of the Region

1. The Bank has become smaller relative to the Region's financing needs. This conclusion comes from analyzing the relative scale of the IDB's operations today compared to trends for the period 1983-2008. Measured in real terms, IDB lending displayed an upward trend beginning in the debt crisis of the early 1980s and until the Emerging Market financial crisis of late 1990. Afterwards, this trend reversed. The Bank's current disbursements relative to the average share of gross public and private capital formation for the 1983-2008 period has fallen. The same is true for other indicators as well. The IDB's record high disbursements in 2008 fall short of historical trends by \$2-5 billion. This result holds true isolating the effects of the relative large size of Brazil and Mexico, or isolating the effects of the largest seven countries in LAC. Table 1 presents a summary of these findings.

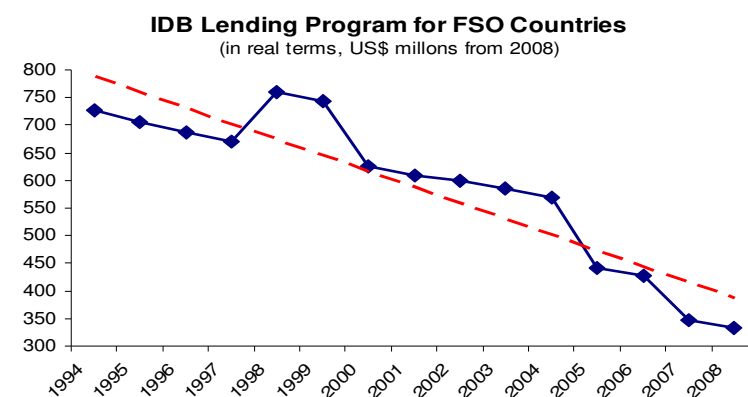
Table 1

Gaps between actual 2008 IDB Disbursements and: (in 2008 \$ billion)	
Disbursements trend for 1983-1999	3.5
Disbursements trend for 1983-2008	1
Average gross public and private capital formation between 1983-2008	4.6
Average public capital formation between 1983-2008	4.4
Average gross external debt between 1983-2008	2

Source: IDB staff calculations.

- There is also a significant gap if the analysis is restricted to the five poorest countries of the Region that depend upon resources from the Fund for Special Operations (FSO). When measured in *real terms* (2008 dollars), the annual average resources available for concessional lending decreased substantially during the period 1994-2008, as shown in the Figure 2 below. The decrease is more marked after implementation of IDB-07 relief and, if no measures are taken, will continue until the FSO is depleted.

Figure 2



Source: IDB staff calculations.

- Other MDBs that provide concessional resources in the Region have not filled the gap left by the decline in the IDB's assistance. As a result, the overall level of assistance available to the Region's poorest countries has declined. The fact that in 2007 debt relief was carried out without contributions from IDB shareholders restricted the availability of resources for future lending. IDB resources will continue to be constraint under the current concessional framework, which is an unwelcome and unfortunate outcome given the persistent lags in the poorest countries in LAC, and the responsibility that the IDB has as the largest development bank in the Region.

D. Demand for Bank lending before the crisis

1. After the 2001-2002 crisis, when capital flows poured into developing countries, the demand for Bank lending decreased. This was a consequence of both the increasing access to financial markets of emerging economies, and the fact that the Bank's business model did not address the needs of the Region. Both from a client, financial product and knowledge perspective, the Bank did not seem attractive enough to many of the key development actors in the Region. Also, the Bank's organizational structure was too centralized to be responsive enough to a more sophisticated and demanding client base.
2. For these reasons, in 2006, the Board of Executive Directors decided to upgrade the Bank's capabilities by approving a realignment of the Bank's organizational structure and operational processes, accompanied by a renewal of Bank staff. Also in 2006, the Board of Governors decided to expand the reach of the Bank's support to private sector and sub-national borrowers. Though these reforms are less than two years old, they have allowed the Bank to achieve the following results: (i) record high approvals in the Regular Program and FSO of \$8.8 billion in 2007 and \$11.3 billion in 2008, which underline the strength of demand from clients well before the current global financial crisis began to affect the Region, (ii) record high disbursements of \$7.1 and \$7.6 billion in 2007 and 2008, respectively, demonstrate the Bank's ability to turn ideas into projects and assets; and (iii) loan processing time was cut in half to seven months.
3. Demand for the Bank's products is strong, with operations in recent years reaching record levels. Approvals showed a significant increase in 2007 and 2008. Figure 3 shows the growth in approvals for 4-year averages. The total 4-year average in approvals increased from \$5.9 billion for 73 projects in the period 2002-2005 to \$8.6 billion for 100 projects in 2005-2008. Figure 4 shows the total yearly approvals since 2004 and the projected approvals for 2009. The increase in demand was concentrated in investment loans. Approvals in infrastructure doubled between 2005 and 2008, almost tripled in water and sanitation, and increased by 30% for sub-national governments. The poorest countries in the Region accounted for 38% of approvals in 2008 compared with 28% in 2005.

Figure 3

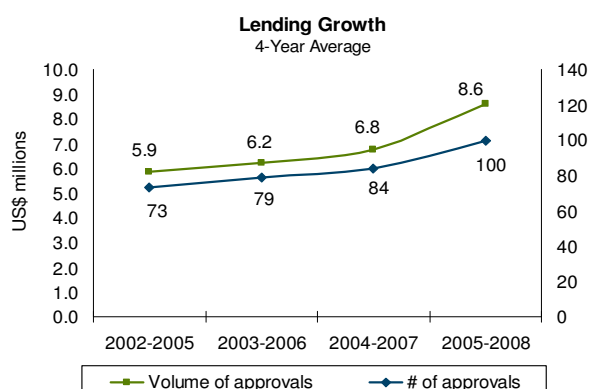
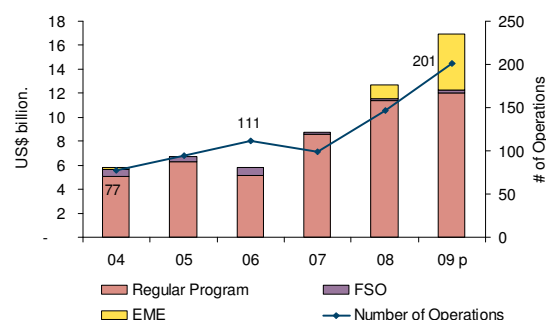


Figure 4



4. It is worthwhile to note that this increase has taken place during a period of high growth and improved access by countries in the Region to international capital markets. This suggests that the Region's demand for development finance is still growing, and that the Bank's renewed products provide financial and non-financial value to borrowing countries. The realignment also gave the Bank a renewed human resource base, a critical mass of technical specialists and a much stronger presence in the field. It has also reinforced the Bank's risk management and development effectiveness capacities, allowing the Bank to better support the countries' achievement of development results.

E. LAC development challenges and the Bank's Strategic Priorities

1. By any measure, the development challenges in LAC are significant, despite the advances of the last five years. Although progress towards meeting the Millennium Development Goals (MDGs) has been positive for the Region as a whole, its unevenness among the different indicators points to the structural challenges that remain.⁵ Among the clear areas of progress, extreme poverty has fallen from 22.5% in 1990 to an estimated 12.9% in 2008, and primary school enrollment is close to 95% (although the quality is very low).
2. The progress is not equal in all areas. Some indicators provide a view of the remaining challenges: (i) gender inequality is still pervasive in terms of job opportunities; (ii) the share of workers in unstable jobs is high (33%); (iii) enrollment in secondary education for secondary-age students is low (result of high dropout rates and over-age), at 67%; (iv) the maternal death rate is 130 deaths per 100,000 live births, still too high when compared to other emerging regions; (v) 8% of children under age five are underweight; and (vi) urban and rural disparities in several fronts exacerbate the inequality of opportunity that

⁵ Progress toward meeting the MDGs is updated by UNDP. The latest report was published in late 2008 with data mostly for 2007, and is available at http://www.undp.org/mdg/basics_ontrack.shtml. Reports for individual country progress are also found in that website.

prevails. This inequality is especially visible in access to basic services. While 92% of urban populations have access to water, this number is only 73% in rural areas. The same disparities hold true for sanitation. As a whole, more than 40 million people require access to water and 30 million to sanitation to meet the MDG targets.

3. As we look to the next decade, the Region's challenges will center on the need to maintain and strengthen macroeconomic stability while, on one hand, tackling the traditional structural factors that account for low productivity growth and persistent inequality of opportunities; and, on the other hand, charting a growth path consistent with the renewed concerns of protecting the environment and dealing with climate change.
4. To address these challenges, in October of 2008, Management submitted to the Board of Executive Directors a description of a New Operational Framework (NOF) (GN-2494), to update the strategic framework that guides the Bank's operations. The Region's challenges center on tackling the structural factors that account for persistent inequality of opportunities, and charting growth paths consistent with preserving the environment and combating the threat of global warming:
 - a. **Social policy for equity and productivity.** Because economic growth is an essential input for sustained poverty reduction, LAC needs social programs that contribute to make countries' labor markets perform more effectively. The challenge is to create jobs with higher wages and social security coverage, and to augment gender equality and combat discrimination. Increasing equality of opportunities in education, with better access and higher quality that augment the Region's productivity, and in the labor market to reduce income inequality and poverty are at the core of the Region's policy agenda.
 - b. **Infrastructure for competitiveness and social welfare.** A strong focus on investments in infrastructure to enhance countries' physical capital is essential to raise households' welfare, future productivity, income and consumption. Access to water and sanitation, reliable and sustainable sources of energy, telecommunications, and to centers of economic activity through transport networks are key to reduce poverty, eradicate illnesses, and enhance productivity.
 - c. **Institutions for growth and social welfare.** Strong and effective institutions are also determining factors of a country's development gains. There is ample evidence that the countries that have benefited more from economic reforms are those that have advanced the most in implementing successful institutional reforms. The general welfare of society, characterized by freedom from violence and crime, access to social programs, and the provision of basic services all require institutions that are capable of effectively executing public policy.

- d. **Competitive regional and global international integration.** Trade integration has exposed countries to more intense competitive pressures and detonated forces to increase static and dynamic efficiency. Nevertheless, trade performance is still lackluster when compared with that of other emerging regions, with exports still dominated by low value added commodities. The traditional agenda of integrating the Region through transportation and telecommunications networks and trade agreements needs to be expanded to new issues associated with the provision of regional public goods, trade in services like technical know-how and financial flows, and protection of investments and intellectual property, among others.
 - e. **Protecting the environment and responding to climate change.** Latin America and the Caribbean shares with the rest of the world the responsibility of developing a sustainable relationship with the environment and dealing with climate change. The challenges here are vast because the processes that modify the world's climate and degrade its natural environmental are characterized by uncertainties and large externalities, often extending their effects beyond national borders. To be effective, in many cases interventions need to be implemented at the regional or global level, requiring policy coordination and cooperation between countries.
5. The achievement of these goals will require further investments in development programs. These needed investments are likely magnified in light of the deepening global crisis that is affecting the Region. This crisis can very well lead to a new lost decade, where the gains of the last 15 years in social indicators, sustainable growth, improved opportunities, better employment, education and access to health are lost in a short span of time given the magnitude and depth of the downturn.

F. IDB Resource Requirements to Address the Region's Development Challenges

1. As demonstrated above, the Bank's presence in the Region has been shrinking. Considering the challenges and the priorities identified below, the Bank needs to have a scale and a scope of operations that will enable it to be an effective instrument of social and economic development. While it is reasonable and indeed desirable to expect MDBs' operations to cover a reduced share of borrowing member countries' financing needs as they develop, it is reasonable for shareholders to expect that MDBs have adequate resources to make a relevant contribution to the development of the Region. Resource requirements are discussed by analyzing several variables. The document provides assessments of the Bank's scale with respect to the Region's GDP and level of economic development, the strategic priority sectors discussed above, the Bank's counter-cyclical role and non-sovereign guaranteed products. Finally, it makes an assessment of the needs of the poorest countries in the Region, and the limited capacity of the FSO to meet them.

1. Analysis based on projections of country demand

2. This document makes an overall assessment of country demand based on a hypothesis of the relationship between aggregate Gross Domestic Product (GDP) and economic development to demand for the Bank's products. If the OC increase and FSO replenishment are pursued, these analyses will have to be complemented by a specific country-by-country assessment of demand. In 1995, at the time of the Bank's last GCI, the LAC Region comprised an aggregate economy of just under \$1.8 trillion in terms of annual Gross Domestic Product, GDP. By 2008, the Region reached an aggregate GDP of about \$4.4 trillion. Table 2 presents estimates constructed from a country by country basis, and yields an aggregate GDP of almost \$9.5 trillion by 2020⁶, meaning that the size of the Region's economy could be 430 percent greater than in 1995. If we project that the annual average of loan approvals and disbursements relative to the domestic economy for the period 2009-2020 will be in line with the period 1983-2008 on a country by country basis, the results show an increase slightly above 300 percent for each. If we further consider that countries' need for development finance diminishes as their economies become more developed, a modified analysis would yield a smaller projected growth in the demand for IDB than that relative to the domestic economy. In this adjusted case, the estimated increases for the region as a whole range between just over 250 percent and almost 290 percent, as seen in Table 2 below.

Table 2
GDP Growth Adjusted Projections of IDB Loans
(in US\$ billions)

	Approvals		Disbursements	
	Average 2009-2020	percent increase 09-'20 vs. '83-'08	Average 2009-2020	percent increase 09-'20 vs. '83-'08
CAN	6.7	358.3	4.6	356.5
CCB	0.9	267.6	0.4	146.9
CID	5.6	291.1	4.0	241.6
CSC	8.3	245.0	6.2	213.9
Total	21.5	288.0	15.2	252.6

Source: IDB staff calculations.

2. Analysis based on priority sector needs

3. The document provides information on the resource requirements needed to make headway on the Bank's institutional priorities and the Millennium Development Goals (MDG). In this context, the Bank aims to address the structural and new challenges facing the Region in a manner that is consistent with the principles of ownership, alignment accountability and results that emanate from the Paris Declaration on Aid Effectiveness, by aligning Bank resources to country

⁶ Growth has been, and is expected to continue to be, somewhat lower in the Southern Cone region relative to all the other regions in which the Bank is divided. This is a result of higher per capita income in the Southern Cone countries, and the fact that relatively richer countries tend to grow at more moderate rates.

priorities, improving the impact of its interventions, and accounting for the results achieved.

4. To gauge demand estimates for IDB financing, the document looks at investment needed in the region to address some of its most pressing development challenges, areas where development finance is most useful. Table 3 below provides a summary of the investment needs of the Region in some sample sectors and subsectors.

Table 3

Priority Sector	Investment Estimates 2010-2020 (2008 \$ billion)
Agriculture and Tourism	550
Water and Sanitation (universal coverage)	71.6
Energy	550
Education (MDG targets, amount to 2015)	9
Climate Change	50
Transportation (1.5% of GDP \$ 2008)	700
Identity and Property Registration	5
Sub-national government strengthening	25
Conditional Cash Transfer Programs	120

Source: IDB staff calculations. These calculations rely on data and assessments made by the United Nations Development Program and the Economic Commission for Latin America and the Caribbean for the Region

5. As described above, the Bank has renewed its strategic priorities and defined work in five sectors that will guide its activities for the next decade. Given the estimated needs of the Region, the assessment of what lending levels, on average, over the next decade would allow the Bank to play a relevant development role in LAC are based on IDB's capabilities (particularly its knowledge base and technical personnel), country needs and absorption capacities based on political and institutional contexts. It also assumes that the IDB would continue to provide about half of the total multilateral financing to the Region.
6. Table 4 below provides an estimate of feasible annual lending levels for each of the Bank's strategic priority sectors. Management is working on complementing these estimates with specific targets for outputs and outcomes to be achieved through Bank supported interventions

Table 4

NOF sector	\$ 2008 billion (range)
1. Social policy for equity and productivity	3 – 4
2. Infrastructure for competitiveness and social welfare	5 – 6
3. Institutions for societal welfare	4 – 6
4. Environment and climate change	1 – 2
5. Integrating into the world economy	0.5 – 0.6
Total	<u>13.5 - 18.6</u>

3. Analysis of needs for the Fund for Special Operations

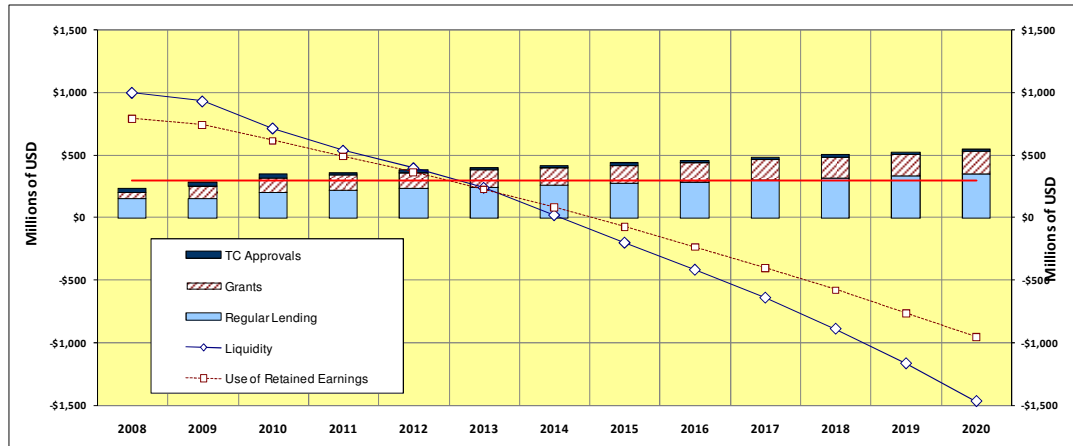
7. The Bank will need concessional resources to support its poorest countries in responding to the crisis and in addressing their development challenges. The development needs of the Bank's FSO countries in the medium-to-longer term require that the Bank have the financial muscle to respond effectively. The current capacity of the FSO to respond to demand from countries is very limited. These constraints have been exacerbated as a consequence of the debt relief granted to FSO countries out of Bank resources without further contributions by shareholders of the Bank. If a replenishment of FSO resources is pursued, Management will need to undertake additional analysis that should include assumptions of the effects of a prolonged slowdown of the world economy on the Region's poorest countries.
8. If we determine demand for FSO by looking at execution capacity and debt sustainability, current sustainable lending levels for the FSO are considerably below capacity for the seven countries. Table 5 below shows the level of FSO resources that the seven countries with access to them would need and be able to absorb given their current execution capacity. The estimates for the five poorest countries take into account their absorption capacity and within the framework of debt sustainability as determined by the IMF's Debt Sustainability Analysis (DSA), and for the two C and D1 eligible countries it is based on levels of concessional support received since 2000. These numbers are well above the current capacity of the Bank to provide concessional resources.

Table 5

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Loans and TC	223	239	255	270	282	296	310	324	339	355	371
Grants (Haiti)	118	123	129	134	141	147	154	161	168	176	184

9. Figure 5 shows what happens to the FSO under its current capital level (including China's \$125 million contribution) and with the existing policies, if this projected demand is met. It assumes that the six eligible countries receive blend financing in the current proportion, that Haiti receives grant financing throughout the period, and that the non-reimbursable technical cooperation program continues to be financed out of the net income of the FSO. In this scenario, FSO resources would be depleted by 2014, and its liquidity will fall below the minimum level of \$300 million by 2013.

Figure 5



4. Analysis of needs for non-sovereign guaranteed (NSG) financing

10. LAC suffers from limited access to credit and equity. The ratios of credit to the private sector to GDP in the region was lower than 30%, roughly a third of the size of the average credit markets in East Asia and developed countries. Funding shortcomings in the Region are caused by: (i) a relatively shallow domestic financial and capital markets when compared to other emerging market; (ii) high volatility in its access to international capital flows, the more traditional source of funds; (iii) lack of equity for firms in the region, due to a relatively poor business climate, inadequate incentives for cross-border flows, and the lack of well developed and profitable exit mechanisms for investors.
11. For private sector operations, the Bank seeks to complement the financing of private financial intermediaries and the capital markets through the provision of partial credit guarantees, extended loan tenors, subordinated debt and equity. These instruments are complemented by mobilization of third party resources under the Bank's B Loan program. The Bank has also expanded its reach to fund projects for public entities (e.g., state-owned banks or utilities, and municipal entities) that can receive funding without the benefit of a sovereign guarantee. This type of funding accounted for 40% of NSG approvals in 2008. The Bank can also play a unique role in providing objective advice to public sector borrowers regarding structuring of transactions, training of managers and staff, providing environmental and regulatory advice, among many other value-added aspects. This advice and funding can extend to Public-Private Partnerships (PPPs),

12. Looking forward, the demand for NSG funding from both private and public sector borrowers is likely to grow along with the region. In the most conservative scenario, in which the share of NSG approvals with respect to the Region's GDP remains constant between 2008 and 2020, NSG approvals would rise from US\$ 3.3 billion to US\$ 7.1 billion per year. To understand if this is a reasonable assumption, we need to address the question of whether or not there would be more demand for NSG financing as economic growth revives. Available evidence makes a strong case that the Bank's NSG financing is complementary, rather than a perfect substitute, for private capital. Analysis of data from 1995-2008 indicates a positive association between economic development (approximated by GDP per capita in LAC) and NSG financing as a percentage of GDP. These data would suggest that when the region's per capita growth rises, so does the demand for NSG financing.

5. Analysis based on needs for counter-cyclical financing

13. Tight markets for sovereign and non-sovereign guaranteed credit during the current economic downturn highlight the importance that counter-cyclical financing capacity at the IDB has for borrowing member countries. Shareholders expect the IDB to continue to play a counter-cyclical role in concert with the IMF and other MDBs.
14. To have an effective counter-cyclical capacity, the Bank needs to be able to provide enough resources to diminish the impact of a credit crunch on both the public and private sector. There are two analyses that can be used to assess the size of a counter-cyclical response to a crisis. Table 5 shows elements of both. The first part of the table shows the scope and magnitude of public sector financing gaps generated by a sudden stop in market financing to the public sector. To finance these gaps, and assuming that the Bank continues to provide half the MDB financing to the Region, and maintaining the level of IMF quotas constant, for the public sector in small and medium countries would require some \$30 billion in IDB additional lending capacity while the sudden stop continues. This number is even greater if we look at the large countries in the region. The financing gap doubles when considering a sudden stop that also affects the private sector and that requires public sector funding to on-lend to the private sector.
15. The second part of Table 6 shows the additional resources needed to finance gaps generated by an economic slowdown. It is based on econometric analysis of the determinants of lending by MDBs. This analysis reveals significant counter-cyclical behavior, given that in the typical developing country the share of MDB disbursements (relative to private disbursements) significantly increases during growth downturns and decreases in upturns. In general, MDB lending in a downturn amounts for one-tenth of GDP slowdown on impact and moderates slightly over time. The example in the table depicts a growth slowdown of some 4% during 3 years (so that, for instance, the rate of growth falls from 8 to 4% in year one, stays low for three years and recovers the 8% level in year four) can be expected to lead to an expansion of MDB debt stock of one point of annual GDP

by the end of the slowdown. Given that the region as a whole has an aggregate GDP of around \$4.4 trillion in 2008, the application of these numbers suggests some \$44 billion of additional MDB lending accumulated during a three year downturn, or about \$15 billion annually, to be divided between the IDB and other development banks. Considering that the IDB is accountable for about half of all MDB financing to the Region, this suggests counter-cyclical lending of about \$7.5 billion.

Table 6

Sudden stop Scenario (2009-2010) – w/o roll-over of private financing	
	<i>Public Sector Financial Gap</i>
Large countries	\$258bn.
Medium countries	\$49bn.
Small countries	\$10bn.
Counter-cyclical financing Scenario	
Additional amount needed if regional GDP falls by 4% during 3 years.	\$44bn. of <u>additional resources</u> in 3 years financed by MDBs (IDB - 50% → \$7.5bn. yearly)

16. Although the Bank cannot address this level of resources now and probably in the future, it needs to be prepared to both provide programs that diminish the impact of these shocks, and to do so beyond the crisis event. The reason for this last point is that after a crisis, during which countries contract short-term debt in the form of emergency financing, demand for MDB financing tends to increase, as amortizations of this more expensive debt come due and countries are looking to return to sustainable fiscal scenarios.

G. The Effects of the Global Financial Crisis

1. Since the second half of last year, the global financial crisis accelerated demand for financial support from the Bank, adding to the long-term development objectives of the institution the need to act counter-cyclically in coordination with other international financial institutions. The duration of the international financial crisis is impossible to predict, as are the magnitude of its effects in the Region. We know, however, that the financial crisis is reaching the region much faster and with more severe consequences than those anticipated until recently, and that some countries are falling into a deep recession. The region's GDP growth fell from the 2002-2007 average of 5.5% to 4.5% in 2008, and is expected to continue to fall. The latest estimates from the World Bank show that GDP growth would be less than 0.3% in 2009. Borrowing member countries are being impacted through a reduction in credit to governments, firms and households, a decline in demand for the regions' exports, lower prices for some exports such as oil, metals and basic grains, and a reduction in remittances and possibly foreign direct investments.

2. The retreat by investors from risk is leading to the biggest slump in capital flows to emerging and developing countries in history. Furthermore, as developed countries emit debt to finance stimulus plans and bail-out programs, developing countries find themselves crowded-out of the already constrained international capital markets. Year-end 2008 numbers indicate a 47% decline in the volume of international bank lending to the region, down to US\$40 billion in 2008 versus US\$77 billion in 2007. Similarly, proceeds from capital markets issuances directed to the region reached roughly US\$50 billion via 456 deals in 2008, a 38% decline from US\$79 billion raised via 530 deals during the comparable 2007 period. This marked the lowest volume recorded since 2002, when issuances dropped to US\$22 billion. This drying up of credit markets is likely to continue, causing increased fiscal pressures on the public sector, already facing the likelihood of greater demand for public services.
3. Most countries in the Region do not have resources to ensure continued funding for social protection and structural development programs. This has placed countries in a more vulnerable position as they deal with this crisis, which comes on the heels of earlier 2008 crises dealing with food prices and energy. The current financial crisis threatens economic development in the Region, and could both undermine the gains of the last years in reducing poverty, and delay countries' needed investments in critical public goods like climate change. In LAC economies, as in other emerging and developing regions, the consequences of the crisis go well beyond economic contraction or reductions in growth. It has consequences that can lead to a humanitarian crisis of large proportions. In this context, MDBs are seen as the single most important source of financial resources to maintain development programs, particularly those that benefit the most vulnerable.

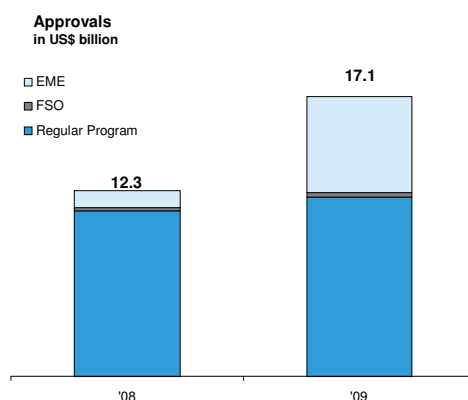
H. The Bank's Response to the crisis

1. In September 2008, as liquidity in financial markets contracted, demand for IDB loans surged. This demand will be even greater in 2009, as the region is quickly entering a recession, slowing economic activity, increasing unemployment, and as a consequence more people are falling into poverty.
2. To respond to the crisis the Bank has taken three special measures. First, to mitigate the effects of the crisis on growth and employment in the region, the Board of Governors approved a modification to the Emergency Lending requirements in order to implement Management's proposal to create the Liquidity Program for Growth and Sustainability (LPGS) in November 2008. This is a program of up to \$6 billion, created within the Bank's emergency lending category, to finance loans aimed at maintaining the flow of credit to the real economy, offsetting, in part, and on a temporary basis, shortfalls in normal credit flows to the region.
3. Second, the Bank expanded the Trade Finance Facilitation Program (TFFP) from \$400 million to up to \$1 billion, to complement the LPGS and alleviate the impact of the crisis on the LAC Region due to a scarcity of trade flows. As a

demonstration of the relevance of trade finance programs and their countercyclical role during times of financial crisis, both the number of guarantees outstanding and the outstanding guarantee amounts have increased significantly since June of 2008, as the global credit crisis deepened. Outstanding guarantee amounts increased by more than 50% between July and September of 2008.

4. Third, the Bank approved the balance of resources available for both Investment Loans and PBL under the lending limits established in the 2005-2008 New Lending Framework (NLF) (Resolution AG-1/02, as amended by Resolution AG-5/05). And in response to borrowers' requests, Management has recommended front-loading the 2009 regular lending program, which would mean approval of up to \$12 billion, as shown in Figure 6 below. Current projections show that the combination of these two measures could result in record level disbursements to the region of up to \$13 billion. This would substantially accelerate the usage of our remaining lending capacity⁷.

Figure 6

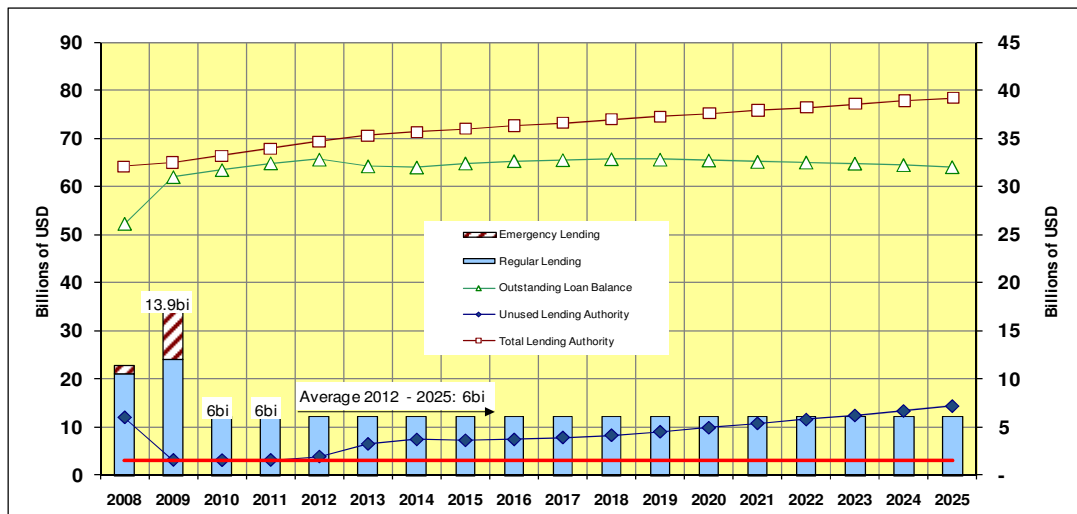


5. Demand for the 2009-2010 period exceeds the Bank's capacity, both in terms of approvals and disbursements. As of January 1st, the combined 2009-2010 pipeline already exceeded by far our lending capacity for the period, with operations for a total amount in excess of \$25 billion. Disbursement projections for 2009, excluding operations under the LPGS, total \$13.2 billion; of this total \$7.8 billion is for operations already in the active portfolio. Our headroom is \$13.4 billion less a buffer of \$3 billion, and projected reflows of principal in 2009 and 2010 are of about \$10 billion. This means that the Bank, under its current financial policies, could support gross disbursements of about \$20 billion during the 2009-2010 period. Thereafter, disbursements could not exceed principal repayments that by 2011 are estimated to be of about \$6 billion.

⁷ Because the 2005-2008 NLF represented the most recent decision by the Board of Governors regarding lending limits, the total limits specified in the NLF for a four-year period were also considered in proposing the size of the 2009 lending program, but under current circumstances, the policy lending limit is the actual constraint. The Board of Executive Directors will submit a proposal to Governors that would extend the overall lending ceiling of the 2005-2008 for a four-year period.

6. The strong counter-cyclical response has curtailed the Bank's capacity to respond to our borrowers' demands in 2010 and beyond, unless and until measures to increase lending capacity are adopted. In fact, as illustrated in Figure 7 below, a regular lending program of \$12 billion and LPGS of \$5.1 billion in 2009, with net flows of \$9 billion, would reduce the Sustainable Lending Level (SLL) to \$6 billion for each year as of 2010. In order to maintain a \$3 billion buffer, as depicted by the solid straight line, the aggregate amount of disbursements for 2010 and 2011 would have to remain below \$12 billion.

Figure 7



7. Although the global economic crisis has exacerbated the problem of Bank capacity, this shortfall of resources is independent of it. The crisis has merely accelerated the timing of the resource shortfall.

I. Optimizing the use of Bank Capital

1. Three considerations are at the core of the Bank's prudent lending limitations: (i) a limitation on loans outstanding imposed by the Agreement Establishing the Bank (the Charter); (ii) a policy limitation on net borrowings and loans outstanding; and (iii) a minimum capital adequacy level based on risk management considerations.
2. With the approval of the 8th GCI, the Bank has operated under a sustainable lending level (SLL) approach for determining the amount of resources that the Bank can supply to the region on an annual basis. The SLL is the amount of lending that can be maintained indefinitely without violating the above mentioned limitations. Since its introduction, the SLL calculations have varied between \$6.7 and \$8.0 billion per year. The SLL has been used to support decisions by Management and the Board on the amount of lending that the Bank can sustain for a given level of capital.

3. Up until 2007, the Bank's annual lending program has mostly varied between \$4 billion and \$7 billion annually, i.e. at levels lower than the projected SLL. After the Board of Directors approved a realignment of the Bank in December 2006, the Bank's lending program grew to a level above the SLL. Furthermore, by the third quarter of 2008, with a global financial crisis in full swing, Management responded with a major counter-cyclical effort for 2008 and 2009. As a result of this response, the Bank's lending ability, according to the SLL, would have to be significantly curtailed for 2010 and beyond, to an amount of \$6 billion p.a., which is lower than the average lending program in the past several years. Furthermore, disbursements in 2010/2011 would have to be limited not to exceed \$12.0 billion so as not to violate the policy limits.
4. With respect to the Bank's prudential policy limits, they have been in place for a long time. The borrowing limitation is consistent with that at all the other MDB's that, with the exception of the IBRD, limit either gross or net borrowings to the callable capital of their non-borrowing members. The IBRD de facto has net borrowings that do not exceed the callable capital of its OECD-DAC member countries.
5. In the framework of the NOF, even before the aggravation of the crisis, Management was actively pursuing reforms to improve the Bank's risk management capabilities with the aim to efficiently use its existing capital in a more integrated fashion across the different risks it faces, by enhancing its capital adequacy framework. The new Risk Management Group has been working on enhancing our capital adequacy framework in accordance with best industry standards. This will allow us to have a better analytical instrument to separate and assess the different risks the Bank faces.

J. Short-Term Co-Financing Options.

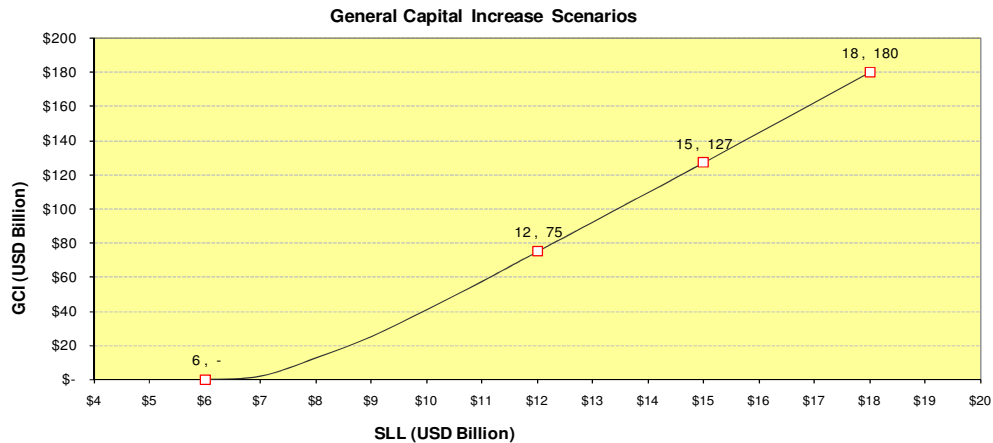
1. Management is continuing to explore ways to increase counter-cyclical lending in the short term by examining possible co-financing alternatives from third parties. Bank lending could be channeled through the following instruments: (i) loans under the already existing LPGS. The size of the program could be expanded to reach more of our clients that require and can absorb additional resources; (ii) emergency loans to give budget support in conjunction with an IMF program; and (iii) loans to support social protection. Management is preparing a proposal for a new program for social sustainability which would finance loans with terms similar to those of the emergency lending facility.

K. General Capital Increase Scenarios

1. As part of the GCI analysis, Management has considered three capital increase scenarios that support various annual lending volumes. The SLLs considered were \$12 billion, \$15 billion, and \$18 billion. The analysis shows that the respective Ordinary Capital increase requirements for each scenario would be \$75 billion, \$127 billion, and \$180 billion, respectively.

2. There are several important assumptions behind these scenarios: (i) there is no change to the financial terms or disbursement profile of the Bank's lending products; (ii) the current capital adequacy framework applies; and (iii) there is no change to the Bank's client mix. Figure 8 shows the relationship between lending levels and the needed GCIs.

Figure 8



3. Complementary to the analysis done on the Ordinary Capital of the Bank, Management also conducted a medium to long-term analysis on the FSO. The point of departure for this analysis is an update of the base case scenario presented at the time of IDB-07 relief that incorporates the \$125 million from China's contribution to the FSO and extends the projection horizon until 2020, from the original 2015.
4. The medium- to long- term strategy for the FSO assumes a level of demand (as presented in Table 5) that is higher than the supply ability of the FSO as seen in Figure 5. Consequently, Management has identified certain measures that could be adopted before raising new funds, in order to optimize the use of resources already available in the FSO, thereby reducing the financing gap. These measures include: reductions in the administrative expense share of the FSO; and Technical Cooperation (TC) no longer financed out of the FSO net revenues.
5. Notwithstanding these measures, the financial analysis indicates that a \$1.070 billion increase in the FSO resources would be required in order to fund the medium- to long-term strategy demand scenario that totals \$4.9 billion in concessional resources between 2010 and 2020, while maintaining a prudent liquidity level above the \$300 million minimum. Other scenarios will be prepared by Management that take into account the effects of a prolonged slowdown on the FSO.