THE FUTURE OF THE INTER-AMERICAN DEVELOPMENT BANK AND ITS CAPITAL ADEQUACY IN THE CONTEXT OF THE WORLD ECONOMIC CRISIS AND ITS IMPACT ON LATIN AMERICA AND THE CARIBBEAN

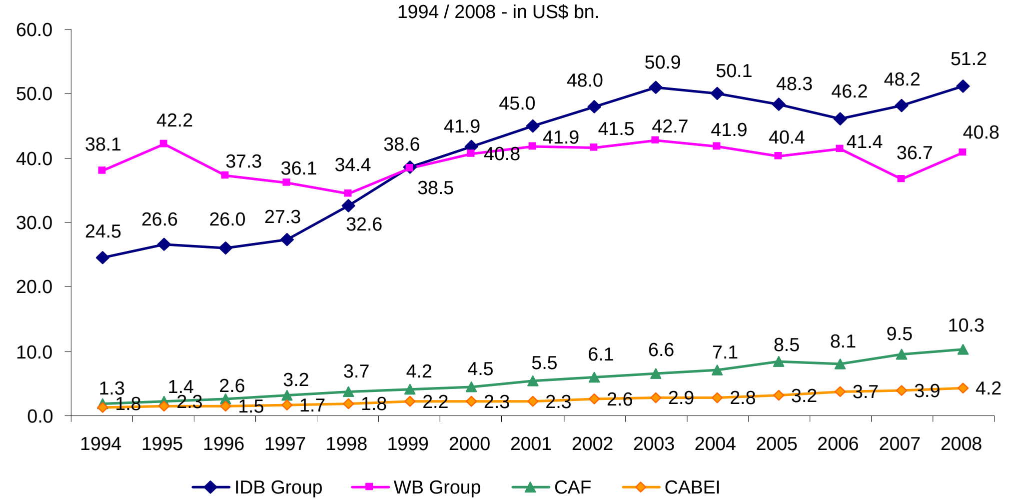
The undersigned have been asked in January 2009 by President Luis Alberto Moreno of the Bank to prepare a preliminary report and recommendations on the above subject, to be presented for discussion at the Board of Governor's annual meeting in Medellín, Colombia. (*Terms of Reference in Annex 1*).

We are pleased to respectfully present for discussion this summary report to the Governors and the Board of Executive Directors.

Michel Camdessus	former head of the French Treasury and former Managing Director of the International Monetary Fund
Roger Ferguson	former Vice Chairman of the U.S. Federal Reserve Board and present chairman and C.E.O. of the TIAA-CREF pension fund
Francisco Gil Díaz	former Finance Secretary of Mexico and present Executive President of Telefónica Mexico-Centroamérica
Pedro Pablo Kuczynski (chair)	former Prime Minister and Finance Minister of Peru, and former chairman of First Boston International
Jorge Londoño Saldarriaga	President and C.E.O. of Bancolombia
Dr. Antonio Palocci	M.D. and former Finance Minister of Brazil

1. The Inter-American Development Bank this year is celebrating its fiftieth anniversary. The Bank was created in order to promote development and give the borrowing countries of Latin America and the Caribbean an equal voice with the countries putting up the bulk of the guarantee capital that supports the borrowings of the institution in the capital markets. The scheme has worked well over the years and the Bank has played a major role in the build-up of social infrastructure in large and small countries as well as supporting reform during the crises that buffeted the region. In the last 10 years the Bank has been the largest multilateral lender to Latin America and the Caribbean (Graph 1).

Graph 1: Outstanding Portfolio - Ordinary Capital
1994 / 2008 - in US$ bn.



Note: IDB Group includes IDB and IIC. WB Group includes IBRD and IFC

2. The financial arrangements at the heart of the institution have been successful. A relatively small amount of paid-in capital has generated a large amount of lending. There has never been a call on the guarantee capital. As the recent report to the Executive Directors states in its first paragraph: "Resources from the Bank's last capital increase in 1995 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. An investment by shareholders of $1 billion of paid-in capital to the Ordinary Capital has generated financing of $93 billion for development programs and policies. A further $1 billion contribution to the Fund for Special Operations (for the poorer countries) permitted $5.1 billion of additional concessional financing for the poorest countries of the region."

3. In terms of disbursements, the lending of the last fifteen years has focused on three areas: i) 40 per cent for social programs, particularly poverty eradication, water and sanitation, education, health and environmental improvement; ii) 38 per cent for infrastructure investment, particularly energy and transportation, including private investment supported by the Bank facility for direct lending without sovereign guarantees (up to 10 per cent of ordinary capital lending), and iii) the balance for support of institution-building and reform in areas such as the judiciary and the rule of law, tax administrations, public sector financial planning and the administrative decentralization. As a result of these efforts, led by a number of governments and supported by other multilateral institutions such as the World Bank, the Andean Development Corporation (CAF), the Central American Bank for Economic Integration (CABEI) and the Caribbean Development Bank, the majority of populations in the region today live in countries that have low external debts, solid domestic financial systems and are closer to meeting the Millennium social goals than most other emerging economies. And all this is being achieved in a democratic setting, in sharp

contrast to the authoritarian environment fifty years ago, when the Bank was founded.

4. As recently as a year ago, before the full effect of the financial crisis in advanced economies, the larger borrowing countries of the Bank relied primarily on private capital markets, both domestic and international, for their financing needs and it looked as if the Bank and other multilateral institutions faced a declining role. This prospect has now been completely reversed: as a result of the well-known financial problems in the United States and elsewhere, short-term financing for Latin America, such as commercial paper and trade credit, has all but dried up; medium and longer-term capital market access has also been sharply curtailed. After a realignment of the organization of the Bank in 2006, including a reduction and renewal of 20 per cent of the staff, the Bank has responded quickly. From average annual approvals of $6 billion in 2004-2006, approvals rose to $9 billion in 2007 and $11.5 billion in 2008 and are expected to reach, approximately up to $18 billion in 2009, with an estimated $400 million new trade financing facility. Disbursements have followed, with a lag, a similar trend and are expected to reach approximately up to $10 billion in 2009.

5. Yet, a significant gap remains between these achievements and the minimum capital requirements of countries at a time when growth is collapsing, as the unofficial forecasts by the prestigious Washington-based Institute for International Finance make clear.

Real GDP percent change

	2007	2008e	2009f	2010f
Latin America	5.4	4.3	-2.2	2.2
Argentina	8.7	6.5	-2.4	-0.6
Brazil	5.4	5.5	1.7	3.0
Chile	5.1	3.5	1.0	4.0
Colombia	7.5	3.1	1.1	3.2
Mexico	3.2	1.8	-4.4	1.5
Peru	8.9	9.2	3.2	5.0
Venezuela	8.4	4.9	2.0	1.0

e = estimate, f = IIF forecast
Source: Institute of International Finance

6. The last capital increase was almost fifteen years ago. The “purchasing power” of the capital -paid-in and callable- of $100 billion in 1995, is now approximately half of it. At the same time, the borrowing needs of Latin America and the Caribbean countries from multilateral sources have at a minimum doubled. There is therefore a serious risk that the present expansion of IADB lending, including the concessional Fund for Special Operations for the poorest countries, will come to a sudden stop in the year 2010, before the financial horizon of the world clarifies.

7. The Commission has discussed various alternative interim scenarios. These include selling part of the most creditworthy loan portfolio (five borrowing

countries have "investment grade" ratings, although at the lower end of the investment range); selling subordinated debt privately to major investors such as sovereign wealth funds; syndicating out to private lenders part of new loans to sovereign borrowers; upgrading the creditworthiness of Latin American capital contributors to the Bank through guarantees from highly-rated shareholders. These are all very interesting ideas. They would take time to implement. The Commission believes that in this period of uncertainty, it is essential to stick to fundamentals: preserve the AAA rating of the Bank bond issues, which enables the callable capital to support a large but prudent lending program without ever calling on the shareholders, rich or poor; avoid temporary and short-lived solutions that could jeopardize the formula that has worked well for fifty years: avoid significant cash calls on member countries and at the same time promote lending programs that focus on fundamental reforms, particularly in social services and infrastructure. The most promising proposal in order to face the present unusual international circumstances is that of Canada to double its authorized capital in the Bank by an additional US$4 billion in non-voting shares. This would increase the borrowing power of the Bank by the same amount and enable a significant level of lending to continue in the year 2010, after the peak of $18 billion likely to be reached in the present year. As noted in para.13 below, without a capital increase loan commitments in 2010 would fall to about $6 billion, a sharp reduction at a time when the effects of the international financial crisis are still likely to be affecting the borrowing countries of the Bank. As shown on the table on page 4, economic recovery in borrowing countries in 2010 is likely to be modest, so that the need for Bank assistance will continue to be substantial. The Commission hopes that other non-borrowing countries can follow the example pioneered by Canada.

8. The Commission fully realizes that there is bound to be resistance to the notion of a general capital increase, albeit one that consists largely of guarantees and of limited actual cash transfers. The United States, at 30% the single largest shareholder of the Bank, is at present facing many demands on its budgetary resources, both for guarantees and for actual cash transfers. In the case of the Bank, the fifty-year historical record of the guarantee or callable capital is particularly notable, since there has never been even a hint that it might be called, even in the worst financial crises that Latin America has faced, particularly the so-called "debt crisis" of 1982-1989.

9. The Commission has no doubt that there is a strong case for a substantial increase in the coming years in Bank lending both in ordinary capital resources and in the concessionary Fund for Special Operations for smaller and poorest countries. Two essential pre-conditions must be met to support the capital increase necessary for this expansion:

   (i) A lending program that continues to address and emphasize more that in the past the major priorities in most of the borrowing countries: tackling social inequality and poverty through redistributive policies that favor those with the least access to education and employment opportunities; improving basic infrastructure in order to enhance competitiveness and to reduce logistics costs and bottlenecks (in conjunction with private investment); and to take the reform of state institutions, especially the judicial system and the control of the environment, to a new and higher level of commitment and efficiency. The "New Operational Framework" (October 2008) by emphasizing internal efficiency within the Bank, will materially assist in achieving such a program.

(ii) Continuing to assure the shareholders that the financial controls over their capital are of the highest standard. The financial crisis has affected the value of the Bank´s investment portfolio of around $16 billion at the end of 2008. Such portfolio includes $4.2 billion of asset-backed and mortgage-backed securities (ABS/MBS), which according to Bank´s accounting practice of mark-to-market required by U.S. GAAP, has generated $1.9 billion losses since July 2007, with only $79 million of those losses realized. It must be noted that more than 90% of the losses are on the ABS/MBS portfolio, all of which were AAA at the time of purchase (by Bank policy). The established policy, in effect since 1997, intended to mitigate interest rate risk and focus mainly on credit quality. The Commission believes that the Bank must reassess and update such a relevant policy.

10. The staff of the Bank has prepared various sensitivity analyses of overall lending levels over the period 2010-2020. A key assumption, which the Commission endorses, is that the level of lending should increase in the medium term from an annual average of about $6 to 8 billion in 2004-2008 to about $12 to 18 billion in the decade 2011-2020 *(see table*), in current dollars.

11. While it is difficult to predict U.S. dollar inflation in the midst of the present turbulent period, an assumption of a possible 3% annual CPI inflation in the next decade is not unreasonable, given the monetary expansion underway. At such a rate, a lending level of about $15 to 18 billion in 2015 would be equivalent to approximately 100 per cent higher in real terms that the average lending levels of the last five years 2004-2008. A capital increase of $150 billion from $100 billion today to $250 billion at the end of the capital increase would represent a real increase by 2015 over the last five years of 115 per cent. It is important to remember that the last five years were a period of unusual buoyancy in world capital markets, and therefore that the expected increase in overall lending capacity of the Bank would in fact be quite modest in relative real terms.

12. The Bank, as the other multilaterals, relies on a small amount of paid-in capital, averaging 4 per cent in the last 30 years, augmented by retained earnings. Today the sum of the two, about $19.4 billion, is 37% of the outstanding loans, in line with the World Bank ant the other multilaterals. What sustains the borrowing power of these organizations, more that their cash and reserves, is the callable capital. In the case of the Bank, a 50-year record shows that the capital has never been called, despite the political and financial upheavals of that long period.

Loan Level Scenarios with Associated Capital Increase Levels, 2010-2020

Scenario	Annual Lending Level			Corresponding Capital Increase
	($ current billion)			($ current billion)
	2009	2010	2011	
Current situation	18.0	6.0	6.0	-
Base Case	18.0	8.7	8.7	-
Scenario 1	18.0	6.0	12.0	$ 74
Scenario 2	18.0	6.0	15.0	$126
Scenario 3	18.0	6.0	18.0	$178

Source: (Review of the Inter-American Development Bank´s Ordinary Capital and Fund for Special Operations Resource Requirements Version of Feb 27, 2009)

13. It is worth noting that a capital increase along the lines noted would represent cash paid-in over four years of $6 billion, of which half would come from Latin American and Caribbean borrowing countries themselves; the balance would come from the United States, European countries and new members from Asia such as China and Korea. Obviously, the amount of the possible capital increase, the amount which would be paid in, and the ensuing lending program, are subjects for debate and discussion. The Commission believes that the subject is important and urgent. There are no shortcuts. In this day and age, financial engineering cannot be a substitute for basic decisions which, at small financial cost, could make a substantial difference to the economic prospects of a significant region of the world.

14. Aside from financial considerations, the crucial issue underlying the request for a substantial capital increase and an increase in the Fund for Special Operations is whether the Bank and the borrowing countries can put the additional resources to good use. While the Bank, as the other multilateral development banks, provides a minority of capital investment for social progress and infrastructure, it plays a very important role in promoting policies that reduce social inequality, improve welfare and increase economic efficiency. In this regard, the progress in incomes and basic services in most Latin American and Caribbean countries is notable, as seen in the table below.

LATIN AMERICA AND THE CARIBBEAN: PROGRESS TOWARDS MEETING THE MDGs	Halve between 1990 and 2015, the proportion of those whose income is less than $1/day	Halve between 1990 and 2015, the proportion of those who suffer from hunger	Ensure that by 2015 children everywhere (girls and boys) complete primary schooling	Reduce by two thirds, between 1990 and 2015, the under-five mortality rate	Halve between 1990 and 2015, the proportion of those w/o access to safe drinking water	Halve between 1990 and 2015, the proportion of those w/o access to safe drinking water, urban	Halve between 1990 and 2015, the proportion of those w/o access to safe drinking water, rural
Argentina	24%	-23%	1%	**69%**	**67%**	**67%**	**57%**
Bolivia	42%	36%	66%	**68%**	**100%**	**111%**	**78%**
Brazil	127%	67%	59%	**76%**	**94%**	**114%**	**13%**
Chile	150%	100%	63%	**79%**	**100%**	**0%**	**90%**
Colombia	45%	35%	38%	**75%**	**25%**	**100%**	**-9%**
Costa Rica	92%	67%	50%	**61%**			
Dominican Republic		0%	41%	**79%**	**138%**		**147%**
Ecuador	78%	75%	29%	**89%**	**163%**	**178%**	**154%**
El Salvador	63%	17%	23%	**81%**	**103%**	**108%**	**77%**
Guatemala	61%	-88%	13%	**80%**	**162%**	**182%**	**157%**
Haití		55%		**68%**	**42%**	**50%**	**31%**
Honduras	50%	9%	23%	**55%**	**0%**	**75%**	**-48%**
Mexico	107%	0%	54%	**81%**	**144%**	**164%**	**117%**
Nicaragua	76%	20%	11%	**97%**	**60%**	**-22%**	**63%**
Panama	-9%	-38%	53%	**48%**	**40%**		**19%**
Paraguay	19%	33%	51%	**47%**	**79%**	**137%**	**29%**
Peru	90%	143%	42%	**97%**	**77%**	**55%**	**75%**
Uruguay	18%	114%	6%	**53%**			
Venezuela (Bolivarian Rep. of)		-127%	27%	**31%**			

Source: ECLAC, Panorama Social 2008

15. Another key priority is infrastructure, where there is an increasing role for the private sector through concessions, where private investors build and operate regulated facilities such as roads, ports, airports and power generation and distribution. Such a system relieves stretched government budgets and also introduces higher standards of efficiency. The Bank has been supporting such investments through its private sector window, but this is limited to 10 per cent of outstanding loans. As part of the capital increase exercise, the Commission believes that the existing limit should be reviewed, with the objective of substantially increasing it.

16. In sum, the Commission believes that a significant increase in both the Ordinary Capital and the Fund for Special Operations are justified. The last increases were implemented about fifteen years ago: their effective real purchasing value has fallen in half with the passage of time. While the larger economies in the region have enjoyed a bonanza in export earnings and an unprecedented access to capital markets until early 2008, these exceptional circumstances have now ended. In order to re-start growth, all countries in the region will need to attract new capital inflows. The Bank, as the largest development lender to the region can, together with the other multilateral development institutions, be especially effective in helping to kickstart this process, especially in two high priority areas: improving social conditions for the large mass of the population that still live in poverty, and

supporting the massive investment in physical infrastructure which is essential for the next stage of growth in the region.

17. In its fifty-year record the Bank has shown that its financial structure has been sound despite the vicissitudes of many of its borrowing countries. A relatively modest cash capital has made possible a significant volume and quality of development lending. This pattern should be continued. Obviously, at some point in time there will be a sunset when more mature Latin American and Caribbean economies no longer need official sources of capital, but the present international crisis has for now postponed that sunset. The Commission strongly supports a capital increase. We are not advocates; we merely put our combined long experience in historical perspective.

Annexes: 1. Terms of Reference of the Commission.

ANNEX 1

IDB ´s PRESIDENT HIGH LEVEL COMMISSION

Terms of Reference

I. Background

The President of the Inter-American Development Bank has named a High Level Commission to advise him on the short, medium and long term strategy for the Bank to respond to the financial requirements of its borrowing countries.

The current capital of the Bank is US$100 billion. The fund balance of the Fund for Special Operations is US$5.8 billion.

The region has gone under a major structural transformation since 2005, which increased the demand for Bank´s financial and non-financial products. Moreover, the crisis has increased the financial needs of the Region. 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.

II. Membership of the President's High-Level Commission

- Michel Camdessus (France)
- Roger Ferguson (US)
- Francisco Gil Diaz (Mexico)
- Pedro-Pablo Kuczynski (Peru-Chair)
- Jorge Londoño (Colombia)
- Antonio Palocci (Brazil)

III. Products

The Commission will analyze possible Bank's capital scenarios for the years ahead in the context of the constraints of market financing mechanisms for borrowing countries. In view of domestic demands in all countries, the Commission will evaluate the arguments for and against a major capital increase to be considered in the coming year.

In its analysis, the Commission will take the following into consideration:

a. Size of the Bank

The last general increase in the resources of the Bank was agreed in 1994, almost fifteen years ago. During that interval, the GDP of Latin America and Caribbean borrowing countries has doubled. As the largest borrowing countries accessed capital markets, it was logical for the Bank to grow slowly and in fact shrink in relative terms. Now this access has been much more difficult and the static capital base of the Bank will hinder a more active role from 2010 onward.

b. Speed and Size of the Response to the Crisis

The recovery from the crisis will take time that is difficult to predict. The Bank through its several facilities plans to increase significantly its lending in calendar year 2009. This is the proper response to a financial and economic deterioration of as yet unknown magnitude.

c. Lending priorities and modalities

The financial crisis_has severely curtailed market lending mechanism for the financing of essential international trade, for investment in basic infrastructure, and social sector needs. Among the subjects to be reviewed is an increase in the possible use of guarantees for capital market financings and lending to the public sector to support social programs and poverty alleviation, review of existing trade financing through the Bank facilities, lending through the private sector window for basic infrastructure. It is also important to review the potential for cooperation with other financing partners in several of these high-priority areas. Another high-priority subject is the adequacy of concessional lending facilities for smaller poorer countries.

The Commission shall submit a preliminary report by March 27, 2009, prior to the Annual Meeting of the Board of Governors to be held in Medellin, Colombia

The Commission's final report shall be submitted by April 30, 2009.

IV. Meetings

The High Level Commission shall meet twice during the first quarter of 2009. Members of the Commission shall present the preliminary report to the Board of Directors in March 2009, and to the Annual Meeting of the Board of Governors in Medellin.