

Luis Alberto Moreno



The Decade of Latin America and the Caribbean: A Real Opportunity



Inter-American Development Bank

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The statements, assertions, and opinions in this book are, certainly, my own and do not necessarily represent the institutional position of the Inter-American Development Bank.

Luis Alberto Moreno

Washington, D.C., September 2011



Acronyms and Abbreviations

AIP	Deep integration area (Área de Integración Profunda)
BRIC	Brazil, Russia, India, and China
CARICOM	Caribbean Community Secretariat
CDC	Centers for Disease Control and Prevention
CIVETS	Colombia, Indonesia, Vietnam, Egypt, Turkey, and South Africa
CRED	Centre for Research on the Epidemiology of Disasters
DPT	Diphtheria/pertussis/tetanus
ECLAC	Economic Commission for Latin America and the Caribbean
EU	European Union
FDI	Foreign direct investment
FSO	Fund for Special Operations
G-20	Group of Twenty: 19 countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States) plus the EU
GDP	Gross domestic product
HIV/AIDS	Human Immunodeficiency Virus / Acquired Immunodeficiency Syndrome
ICT	Information and communication technology
IDB	Inter-American Development Bank
IDB-8	IDB's Eighth Capital Replenishment
IDB-9	IDB's Ninth General Capital Increase
IFPRI	International Food Policy Research Institute
IIRSA	South American Regional Infrastructure
IMF	International Monetary Fund
INTAL	Institute for the Integration of Latin America and the Caribbean
ITU	United Nations International Telecommunications Union
LAC	Latin America and the Caribbean / Latin American and Caribbean
MERCOSUR	Common Market of the South

MIF	Multilateral Investment Fund
OAS	Organization of American States
OECD	Organisation for Economic Co-operation and Development
PAHO	Pan American Health Organization
PISA	Program for International Student Assessment
PPP	Purchasing power parity
R&D	Research and development
RICYT	Network of Science and Technology Indicators
SIEPAC	Central American Electrical Interconnection System
SMEs	Small and Medium Enterprises
UNASUR	Union of South American Nations
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations Children's Fund
UNODC	United Nations Office on Drugs and Crime
WEF	World Economic Forum
WHO	World Health Organization

Foreword

Latin America, Luis Alberto Moreno writes in this important new book, “is undergoing a transformation”—one that promises to make the 2010s “the decade of Latin America and the Caribbean.” As president of the Inter-American Development Bank since 2005, Luis Alberto himself has been both an important force in this transformation and one of the most prominent and persuasive voices in highlighting and explaining it to the rest of the world. He celebrates the region’s widespread embrace of sound economic management and smart focus on opportunity and inclusion, along with its deep and abiding commitment to democracy.

As I often say, few people would have believed you if you had predicted these developments just a few decades ago. And as Luis Alberto makes very clear in these pages, balancing his optimism with a call for responsibility and a warning against complacency, if we work together to sustain and advance them, the outlook for our hemisphere is undeniably positive.

Latin America and the Caribbean has always had outsized importance for the United States, even if the headlines in Washington do not always capture it. The region’s story in recent years—of political transition and a broad commitment to democratic development; of pragmatic leaders who have turned a once-troubled region into one of dynamic 21st-century economies and societies; of active and constructive new players on the global stage—makes that importance greater than ever.

It is central to our economic interests, as we work to rebuild our economy and renew our competitiveness for a new time. It is central to our security and global strategic interests, as we work to design to a 21st-century architecture of cooperation with our partners. It is central to the advancement of our core values, as we work together to support democracy and human rights around the world. It is central to the vitality of our society and culture, as the growing connections between our peoples make us all more dynamic and innovative.

I call this the power of proximity—not just geographic proximity, but also the proximity of our global economic interests, of our challenges at home and what it will take to overcome them, and of our values and cultures. And it is because of this power of proximity that a commitment to equal partnership built on mutual

respect, common interests, and shared values, a pledge made by President Obama at the very beginning of his administration, has so much potential for all of us in the Americas. We in the United States are committed to this partnership because we know it is as essential to our own interests and well-being as to the interests and well-being of peoples and societies throughout our hemisphere. The power of proximity means win-win solutions, and it also means that no country in this hemisphere can overcome its challenges or seize its opportunities without a commitment to equal partnership.

The Inter-American Development Bank has been long been central to this partnership, helping us define the right path forward and then move along it together. Luis Alberto is absolutely right that while we should celebrate how far we have come, we cannot be complacent. Fortunately, in these pages, he gives us a roadmap for continued progress, a blueprint for the decade of Latin America and the Caribbean. It is one that addresses both our greatest opportunities and our most acute challenges, from strengthening education, encouraging innovation, and promoting universal opportunity to bolstering democratic institutions and fostering clean growth—what he calls the long list of unfinished business.

Luis Alberto has been one of my best teachers on the region, explaining both how we have gotten here and where we need to go. I share his view: now is an extraordinary moment. But it is also a moment of urgency—urgency when it comes to seizing this opportunity, urgency when it comes to building the kind of partnership that can guarantee security and opportunity for all of our citizens. For if we seize the opportunity he highlights, we can look forward to not just a decade of Latin America and the Caribbean, but a century.

Hillary Rodham Clinton
Secretary of State
United States of America
Washington, D.C., September 2011

We need a new way of looking at Latin America and the Caribbean, with a perspective that emphasizes the region's strengths without neglecting its weaknesses, that focuses on opportunities without ignoring risks. We need a way that promotes long-term development without forgetting that the situation still demands prudent, disciplined public policies.

Unlike traditional literature about the region, the following chapters contemplate a future borne of the optimism inspired by our peoples' capabilities and structural changes in the world, free from conventional skepticism, yet with the realism of one who has witnessed positive economic cycles followed by deep crises.

Rooted in this viewpoint, for several months now I have maintained, both publicly and privately, that the 2010s should be considered the decade of Latin America and the Caribbean. This view has grown out of dialogues with my colleagues on the Board of Executive Directors of the Inter-American Development Bank (IDB) and with the Bank's professional staff, as well as through ongoing exchanges of experiences and ideas with high-level officials, businesspeople, and academics from our hemisphere and other regions that I have visited in my capacity as president of the IDB.

By "the decade of Latin America and the Caribbean" I mean that in the coming years the region's recent gains will be locked in and the average citizen will be more prosperous than ever before in the history of the hemisphere. Practically speaking, it means that if average growth rates remain close to 5 percent per year—as has been the case recently—per capita income could double by 2025. Such a jump would significantly reduce income inequality and, hopefully, eradicate once and for all the extreme poverty that still affects one in eight people in Latin America and the Caribbean.

This forecast notwithstanding, we need to be clear that success is not guaranteed, the conditions in the countries of the region are not homogeneous, and public policies must take into account the distinctive features of each economy. At the same time, a window of opportunity has opened and must be taken advantage of. To do so, the region must continue its reforms and overcome obstacles that remain significant. One such roadblock is low productivity, which limits the region's

capacity to compete against goods from other parts of the world, and to maintain or expand sectors that produce high value added products. Another disadvantage is that the region lags in infrastructure, which significantly impairs integration efforts and requires stepped-up construction of roads, ports, and airports, in a framework of probity and good practices. A third hurdle is informal employment, which affects the quality of jobs and creates two classes of citizens—one with access to the social safety net and one that cannot aspire to good health care or a decent retirement pensions.

And we must not forget the need to narrow the immense income gaps that make inequality one of our worst hindrances. The list also includes decreased citizen security, poor quality of education, and increased vulnerability to natural disasters, which have taken a significant material and human toll.

I do firmly believe, however, that these obstacles can be overcome, as the countries of Latin America and the Caribbean have shown me when faced with the gusting winds of the international crisis. In other words, the events that inspired this book unfolded in early September 2008. Although it was impossible to know at the time, the top banking institutions in the world were on high alert as the global financial hurricane was coming to a head. With the real estate bubble bursting in the United States a few months earlier and the loss in value of several mortgage backed securities, seemingly sound and long-standing companies were facing serious problems.

Without entering an analysis of the factors that exposed weaknesses, excesses, and abuses that are still apparent at different latitudes, at that time there was a concern that the region might lose ground after one of its best-performing periods in recent times. From 2003 to 2008, for example, annual growth averaged almost 5 percent, propelling nearly 40 million people out of poverty and into the middle class. These and other gains were now in jeopardy.

The concern was understandable. After all, over its 50-year history the IDB had witnessed how turbulence in international financial markets could affect the Latin American and Caribbean region, taking an enormous toll on the hemisphere's social and economic indicators.

The catastrophe ensues. In 2009, gross domestic product (GDP) in Latin America and the Caribbean contracted by nearly 2 percent, as in most countries around the world. The drop in export revenue and the decrease in remittances and tourism affected the region's economic growth rate, in an environment in which businessowners and consumers had less confidence. But despite this hiccup, the

crisis had much less of an effect on Latin America and the Caribbean than many had feared, and the setback in poverty rates was minor (ECLAC, 2010a).

What happened? The emergency was averted mainly because the governments in the region were able—albeit in different ways—to adopt countercyclical programs that limited the recession’s social impact and included higher public spending or lower interest rates.

And that it not all. Unlike other areas of the world, the region’s banking sector weathered the crisis virtually unscathed by the problems that challenged dozens of institutions. Foreign exchange emergencies, so typical in the past, were conspicuous only by their absence. Accordingly, the countries of the region were able to fulfill their commitments as usual, allowing financing channels to be quickly reestablished.

Even more striking still was the region’s remarkable economic recovery. Bolstered by rallying global trade and domestic consumption, GDP in Latin American and Caribbean countries grew nearly 6 percent in 2010—the second-fastest rate among the world’s main geographic blocks.

What happened was not luck or the result of some unknown factor. A look at the policies adopted in many of the region’s countries reveals that they had been unquestionably stronger for several years from both a macroeconomic and institutional standpoint. Factors explaining the financial storm’s limited toll in the region include the general improvement of the countries’ fiscal positions, the relatively high level of international reserves, lower public debt, greater exchange rate flexibility, and more independent central banks.

Many of the achievements are also the expression of greater democratic maturity, the result of decades of progress, clearly revealed in the quality of the decisions adopted. Thus, while some countries in the Arab world face major turbulence in their struggle to realize political transformation that leads to greater openness, the Latin American and Caribbean nations continue to move forward with reforms in a context of freedom and transparency. There are more than a few challenges ahead and the list of pending issues is long, but the overall trend is undeniably positive.

These circumstances have created a positive outlook for Latin America and the Caribbean to continue down a path of sustained growth in the coming years, thanks to new trends in world development and the strengthening of the region’s institutions. The strong demand for commodities exported by many of the region’s countries to Asian markets, coupled with higher domestic consumption, create a particularly favorable starting point.

The message here is that we must stay the course with institutional reforms, building better national, regional, and local governments, while expanding democracy. Only sound public management will enable the opportunities enjoyed by entrepreneurs—small and large—to reach their full potential and enhance the quality of life of the estimated 600 million inhabitants of Latin America and the Caribbean.

I firmly believe that such a leap is possible. Substantiating that vision is the purpose of this book, which examines the progress made and the work that remains to be done. Now, more than ever, in Latin American and Caribbean we have a real opportunity to overcome the obstacles that prevent us from reaching even greater levels of well-being. Fertile ground does not necessarily guarantee a good crop. It is important to know how to plant the seeds, pull up the weeds, and carefully water the plants to reap the fruit.

Helping with this effort is precisely why the IDB exists. Over its 50-year history, the Bank has been instrumental in promoting projects that have helped to improve our society. Our stronger financial capacity, as a result of the Ninth General Capital Increase approved in 2010, together with the improvements underway in strengthening our programs and internal processes, will enable the Bank to continue to help the countries of the region make this the decade of Latin America and the Caribbean.

Washington, D.C.
September 2011



CHAPTER I

A Regional Economy on the Move



The future will be much more than an extension of the recent past. Behind the reality lies the real possibility that, after so many failed attempts, the region will make the leap forward
that it needs and deserves.

A Regional Economy on the Move

In the course of my professional career, I have had the opportunity and privilege of observing first-hand the evolution of the Latin American and Caribbean (LAC) region. I have traveled often within the region in my various jobs, especially since becoming president of the Inter-American Development Bank (IDB) in October of 2005. Benefitting from a steady stream of research reports of all kinds and ongoing contact with people of many different nationalities and occupations, I have had an excellent vantage point for assessing the stark contrasts between the recent past and the present.

The fact that the LAC region is undergoing a transformation is beyond question, but sometimes it is hard to recognize. In many LAC cities, it is possible to find progress and problems, as well as social advances and continued inequality coexisting side by side. Despite these differences, and knowing that there is a long way to go before just and equitable progress is achieved, a glance back at the recent past shows just how far the region has come.

When the Crises Seemed Never-Ending

To start with a fairly recent example, I recall times of high inflation that long typified several of the LAC economies. Young people today are surprised to hear that the price of certain items would change daily, or that people would race to currency exchange offices to buy dollars with their paychecks, to guard against such fluctuations. It seems odd now, but this was considered the best way to fend off inflation.

In 1985, for instance, the region's annual inflation rate was 159 percent; by 1990, it had risen to 1,189 percent (Sáinz, 2006). The numbers were so large that new currencies were introduced frequently. Of course, this not only confused foreign visitors, but also hit the very poor, as both had to struggle with different banknote denominations, not to mention the difficulties it caused for banks, businesses of all kinds, and the region's economy in general.

Nor should we forget the hardships of the debt crisis that struck in 1982 and shook all the LAC countries' economies to their very foundations. The region had rapidly accumulated debt since the mid-1970s due to the abundant resources resulting from an increase in oil prices, but Mexico's declaration that it would suspend debt payments in the second half of 1982 created such uncertainty in the markets that credit lines to the region were sharply curtailed.

Overnight, terms such as "adjustment program" and "austerity measures" became part of the everyday vocabulary of people in the LAC region, who felt the impact of government budget and payroll cuts. The shrinkage led to a rise in interest rates, and nations began to experiment with more open trade practices and privatization, marking the abrupt end of the import-substitution model.

As a consequence, the growth that the region had been experiencing came to a halt. Regional growth stagnated from 1982 to 1990, and per capita income declined. As other regions around the world continued to progress, the gap between LAC and the rest of the world dramatically widened. Latin American GDP, which had represented 7.8 percent of the world total in 1980, was just 6.4 percent 10 years later.

Table 1

Worldwide GDP Growth by Decades, 1961–2000

(in percent)

	Average annual growth			
	1961-1970	1971-1980	1981-1990	1991-2000
Sub-Saharan Africa		3.7	1.9	2.3
North America		3.3	3.2	3.4
LAC	5.4	5.6	1.3	3.2
East Asia and the Pacific	8.9	4.7	5.2	3.1
Europe and Central Asia	4.8	3.1	2.4	1.9
Middle East and North Africa		8.5	1.8	4.0
South Asia	4.4	3.0	5.4	5.2
European Union	4.8	3.1	2.4	2.2

Source: World Bank (2011), *World Development Indicators* (WDI).

All this occurred with the context of limited democratic freedoms. For many years, military regimes were more the rule than the exception in the LAC region. Even in countries where citizens had the right to vote, concepts such as decentralization and regional and local elections were unheard-of. These shortcomings in the region's political system narrowed the private sector's maneuvering capacity and hindered integration, because business links were limited, economic infrastructures were poor, and air connections were scarce. In addition, grave violations of human rights during dictatorships left tragic wounds that have not fully healed.

Fortunately, one unforeseen consequence of the economic recession of the 1980s was the gradual dismantling of dictatorships. With the return of democracy, a renewed focus on development issues spread across the region. Many countries saw a massive turnover of decision makers, the vast majority of whom came with stronger academic backgrounds and the desire to do things better.

The macroeconomic adjustment programs adopted in response to external crises were key for economic recovery, allowing countries to reduce inflation substantially to single-digit levels starting in 1999. Nevertheless, global financial turbulence in the 1990s again exposed the region's economic fragility. Fairly frequently, we witnessed how a particular problem in one country would curtail lending for all, so as to exacerbate countries' abilities to meet obligations in a timely manner. This triggered a vicious cycle of devaluation, capital flight, and occasional bankruptcies in the banking and industrial sectors, which in turn led to government bailouts.

It is important to highlight that these circumstances resulted in the emergence of "open regionalism," exemplified by integration agreements and trade pacts that although limited, increased trade and opened doors for the transfer of labor and investments, without creating barriers for the rest of the world. Likewise, foreign direct investment (FDI) posted steady growth, initially as a result of the sale of public assets, and later through the emergence of new opportunities.

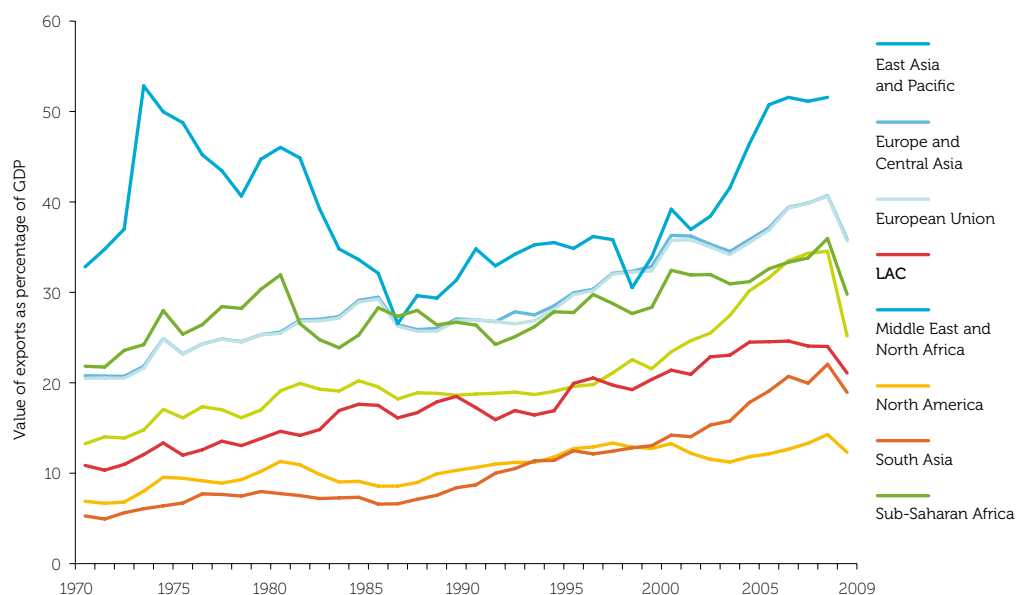
The Leap Forward at the Turn of the Century

The story began to change much more decisively at the turn of the new century, based on a series of fortunate coincidences. Notably, an enabling global environment supported growth in exports and trade amid abundant international liquidity at historically low interest rates. No less important were the high volumes of remittances sent home by people from the region living abroad.

The dynamics of world GDP, and particularly China's role as a strong commodity importer, had an important impact on the price of many primary goods. Although the most extreme case was hydrocarbons, which reached twice the 1973 and 1979 levels in real terms, the food sector also saw substantial price increases from 2003 onward. As a result, exports of goods from Latin America and the Caribbean grew 145 percent between 2002 and 2008.

Figure 1

Exports of Goods and Services, by Region, 1970–2009



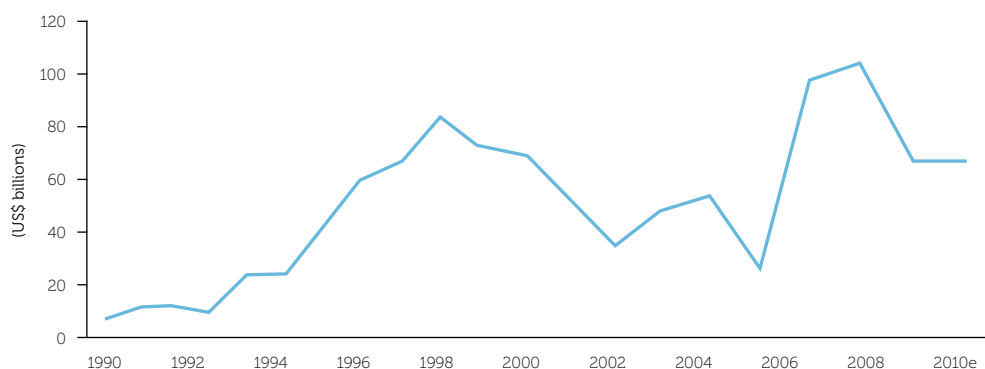
Source: World Bank (2011). *World Development Indicators* (WDI).

Moreover, the LAC region benefitted from an ample supply of financial resources. Although it was not the first time—a similar situation had occurred in the 1970s in a different inflationary context—the countries of the region in general avoided increasing their debt levels, and actually improved their debt profiles in terms of cost and maturities. The public and private sector also took steps to issue bonds domestically in local currency, thereby reducing vulnerability to external shocks.

The improved macroeconomic environment of the 1990s also made the Latin American and Caribbean economies more attractive to FDI, not only for extractive industries, but also for the development of the diverse national markets. In the last two decades, FDI in the region has trended strongly upward, reaching a record level of \$96.743 billion in 2008 (ECLAC, 2010a).

Figure 2

Foreign Direct Investment in Latin America and the Caribbean, 1992–2010



Note: Data for 2010 are estimated.

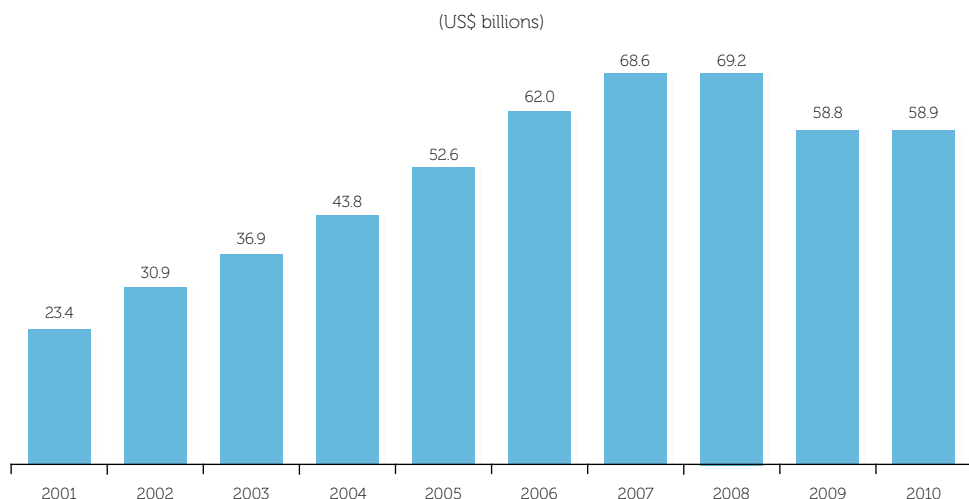
Sources: World Bank (2011). *World Development Indicators* (WDI).

ECLAC (2010b). *Foreign Direct Investment in Latin America and the Caribbean 2009*.

Another important factor was the large increase of cash transfers from emigrants. Remittances rose from \$23.4 billion to \$69.2 billion between 2001 and 2008 (IDB, 2011a). These resources came to represent 2 percent of Latin American and Caribbean GDP, even surpassing FDI volumes in some years.

Figure 3

Remittances to Latin America and the Caribbean, 2001–2010

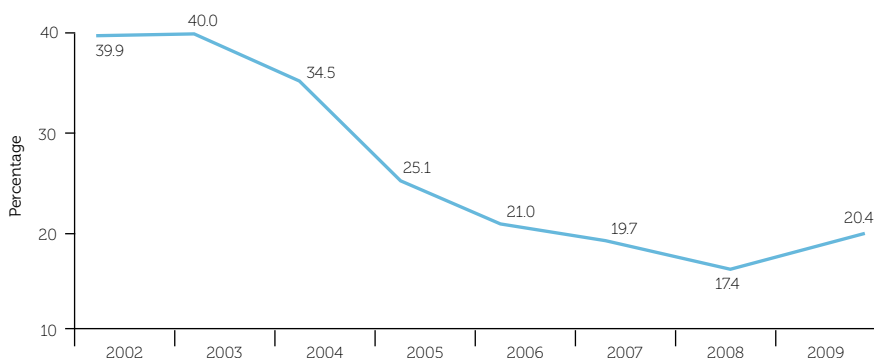


Source: IDB (2011a). *Remittances to Latin America and the Caribbean in 2010: Stabilization After the Crisis*.

The good news did not end there. While part of the external price boom enabled increased public spending, LAC's fiscal balance showed marked improvement, as did its level of international reserves, while public debt indicators declined steadily. Thus, between 2002 and 2009 the external debt to GDP ratio fell from 39.9 percent to 20.4 percent.

Figure 4

Total External Debt as Percentage of GDP in Latin America and the Caribbean, 2002–2009



Source: ECLAC (2010c). *Statistical Yearbook for Latin America and the Caribbean 2010*.

The figures illustrate the convergence of these elements. Between 2003 and 2007, LAC experienced an average annual growth rate of 5 percent, the second highest in the region's history, second only to the period between 1967 and 1974 when it was one percentage point higher. Per capita income, in turn, saw average annual growth rate of near 4 percent between 2003 and 2007, while unemployment fell below 8 percent from 2007 onward.

Perhaps the most significant manifestation of this progress was the reduction in poverty from 221 million people in 2002 to 180 million in 2008 (ECLAC, 2010a). Whereas the poverty rate in 1990 was 48.3 percent, by 2008 it had fallen to 33 percent.

Amid such strong performance, there were also calls for prudence. A study conducted by the IDB's Research Department (2008) sought to put these achievements in perspective, reminding the LAC countries of the importance of limiting their spending, and saving for the time when economic winds could change direction. The warning seemed appropriate, given the volatile nature of commodity prices, which previously created booms followed by busts.

Response to the Crisis

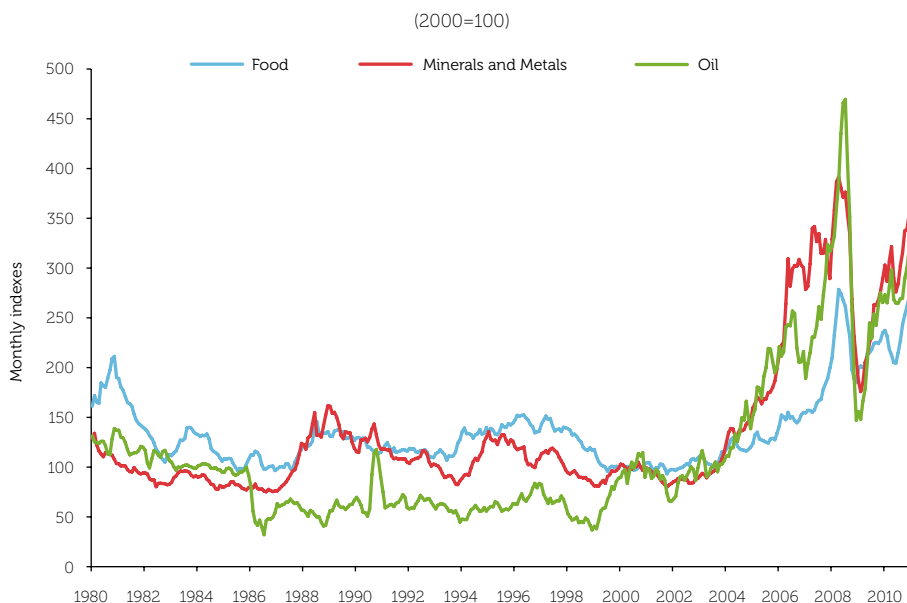
No one anticipated that the warnings of a potential change in the direction of the wind would be put to the test so soon. First, the bull market for prices of certain farm products began to wane, followed by a sharp decline in oil prices, which had peaked at nearly \$150 per barrel in July 2008 (Figure 5).

The situation began to cause problems in different parts of the hemisphere. Rising food prices led to public unrest in some LAC countries and an overall jump in the region's price indexes. At the time, several international institutions, including the IDB, were concerned that these conditions would increase poverty rates, affecting the most vulnerable communities. Meanwhile, there was the possibility that regional disparities might increase, given the different situations of the countries, some rich in natural resources and others having less natural wealth or arable land.

Adding to these concerns was the deteriorating economic climate in the developed world. When the real estate bubble burst in the United States, property prices there and around the world plummeted and arrears rates mounted, revealing that a significant portion of mortgage loans had been approved for people who were unable to repay them.

Figure 5

Commodity Price Index, 1980–2010



Source: UNCTAD (2011). UNCTADstat.

The problem only grew when it was found that these mortgages were used to construct new investment mechanisms that had been acquired by investors and institutions around the world. Once this reality set in, there was a virtual halt to the negotiation of these derivatives and an implicit loss in their value, given that it was nearly impossible to ascertain the soundness of each one individually.

This phenomenon severely impacted a range of financial entities. Many ceased their lending operations, or reduced them to a minimum to preserve their available funds, while others stopped lending to other banking institutions, given the widespread lack of confidence in the soundness of the system.

In response, authorities in the most developed countries undertook unprecedented rescue schemes. Not only were massive lines of short-term credit opened to maintain liquidity through loans or the purchase of securities, but fresh resources were also injected in return for an equity stake in the entities in question. This resulted in the partial de facto nationalization of dozens of banks in the world's main financial centers and the liquidation of others.

The LAC region watched the crisis unfold in the developed economies with concern, but from a certain distance. Unlike the experiences of many developed

countries, the countries in the region saw few cases of poor investments or funds lost to the real estate debacle.

As a result, growth projections were initially revised slightly downward. The “decoupling” thesis was trending at the time, and it was believed that a recession in the wealthier countries would not significantly impact the performance of the emerging economies. Fortunately, the LAC financial markets were not very innovative in the area of derivatives, and the region’s banking institutions had been subject to stringent regulations.

Nonetheless, the collapse of Lehman Brothers in mid-September 2008 set off a global alarm. Falling commodity prices showed that the boom had ended, while international credit lines, abundant until then, were drastically curtailed. The uncertainty also led to a drop in manufacturing orders and consumption that, although felt more keenly in the nations directly affected by the crisis, spread rapidly to every corner of the globe.

The impact was not insubstantial. In the last quarter of 2008 and the first quarter of 2009, GDP of the Latin American and Caribbean region contracted by more than 3 percent, which put an end to the expansion cycle that had prevailed until then. Yet, unlike previous episodes of international economic turmoil, this time the region showed unprecedented strength in the face of the crisis. The region’s macroeconomic policy response was essentially countercyclical, especially in those countries with sounder economic foundations.

In the midst of the emergency, governments instituted measures to counteract the downward cycle. This included programs to increase spending on public works and job creation, and strengthening the social safety net by using conditional cash transfer (CCT) programs.

In some cases, taxes were temporarily suspended to spur consumption or support specific productive activities. Such strategies, equivalent to nearly 2 percent of regional GDP, were made possible by improved institutional capacity, the cushion created by existing savings, and sensible management prior to the emergency.

Central banks used the tools at their disposal, including lowering the federal funds rates aimed at reducing the cost of loans. Slowed inflation provided ample room for significant rate reductions. An effort was also made to provide liquidity in local and foreign currency, as well as modify bank reserve requirements.

As these events played out, the IDB reacted swiftly. Measures were approved in record time to immediately increase the flow of resources to the LAC region, with special emphasis on the poorest countries hit hardest by the crisis. Given

the magnitude of the emergency, the IDB generated the necessary liquidity at a time when the International Monetary Fund (IMF) was experiencing limited lending capacity, and strengthened its capability to approve loans and disbursements, so as to ensure a greater flow of resources to the region. Faced with heightened demand, the IDB struck a balance in the country-by-country allocation of lending resources, giving priority to the neediest countries in the region, increasing the availability of concessional resources and grants, and keeping the prices of its instruments to a minimum, so as to lighten the financial burden on the region.

The measures enabled the Bank to approve \$15.623 billion in loans in 2009, outpacing its 2008 approvals by 39 percent. The results were also positive in terms of disbursements, which reached a historic high of \$11.907 billion by the end of the period, representing a 56 percent increase over the previous year. The volume of net flows to the region was \$6 billion, or around \$3.4 billion more than in 2008. In turn, projected net flows to the poorest countries were \$1.363 billion, a 153 percent increase over 2008.

The combined effect of these actions and the country stimulus programs in a less uncertain environment, along with the normalization of the financial markets, led to a significant improvement in the situation over the course of 2009. Both private consumption and investments increased gradually in the region, and commodity prices began to rise beginning in the second quarter.

Despite such measures, the GDP of the LAC region contracted by 1.7 percent, the worst rate since a 2.5 percent decrease in 1983. Per capita income also declined 2.9 percent, and poverty slightly increased by 0.09 percent, associated with higher unemployment, which rose from 7.3 percent to 8.1 percent (ECLAC, 2010d).

However, these results were not as poor as expected, mainly because the social costs, although varying from country to country, were far below those of other parts of the world, where unemployment doubled. At the same time, the fiscal effort did not fundamentally weaken the countries of the region. The negative balance in public finance went from -0.4 percent of GDP in 2008 to -2.9 percent in 2009 and -2.4 percent in 2010, with public debt again accounting for a decreasing share in 2010 (ECLAC, 2010d).

What is most striking is that, with the recovery of the global economy, and especially Latin America's leading export markets, the region made up for lost ground in 2010. Economic growth after the 2009 contraction was 5.8 percent in the region, an outstanding performance when compared to the economic growth in other areas of the world. Additionally, per capita income in the region rose

4.7 percent, which helped reduce the poverty rate to 32.1 percent—the lowest in history—and unemployment to 7.6 percent (ECLAC, 2010d). However, growth has not been uniform across the board; several countries have shown robust recovery, while others have advanced more slowly.

Despite such disparity, progress has continued in 2011. The most recent IMF and Economic Commission for Latin America and the Caribbean (ECLAC) estimates have cited economic growth of 4.5 to 5 percent, which could bring unemployment rates below 7 percent—an unprecedented level in recent times. While the pace of inflation has slightly accelerated owing to international circumstances, various central banks have adopted measures to moderate domestic consumption, while charting a course with a long-term vision.

Table 2

Selected Macroeconomic Indicators for Latin America and the Caribbean, 2001–2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Central government overall result (% GDP)	-3.1	-2.8	-2.9	-1.8	-1.0	0.1	0.4	-0.4	-2.9	-2.4
Central government public debt (% GDP)	44.9	58.2	57.3	50.9	42.8	35.8	29.9	28.5	29.9	28.5
Nonfinancial public sector public debt (% GDP)	50.1	65.0	62.7	55.8	47.6	40.5	33.5	31.9	33.5	31.7
Inflation (CPI annual variation)	6.1	12.2	8.5	7.4	6.1	5.0	6.5	8.2	4.7	6.2

Source: ECLAC (2010d). *Preliminary Overview of the Economies of Latin America and the Caribbean 2010*.

The Changing International Environment

Had there not been a profound shift in the rates of economic growth of the countries around the world, these outcomes would likely have been very different. From

1950 to 1980, the contribution of Australia, North America, and Western Europe to global GDP remained relatively constant at around 50 percent. But from the 1980s onward, a fundamental reconfiguration occurred: the share of these three areas fell to under 40 percent, while the share of Asia, excluding Japan, more than doubled to over 36 percent.

A different measurement, taken to support the G-20 discussions, yielded a similar result, reporting that the share of emerging markets and developing countries in global GDP increased 10 percent in the first decade of the 21st century, to 47.1 percent, with the balance coming from the industrialized nations. According to projections based on IMF forecasts, this is expected to become a majority share by 2013, and some say it could happen sooner (INTAL, 2010).

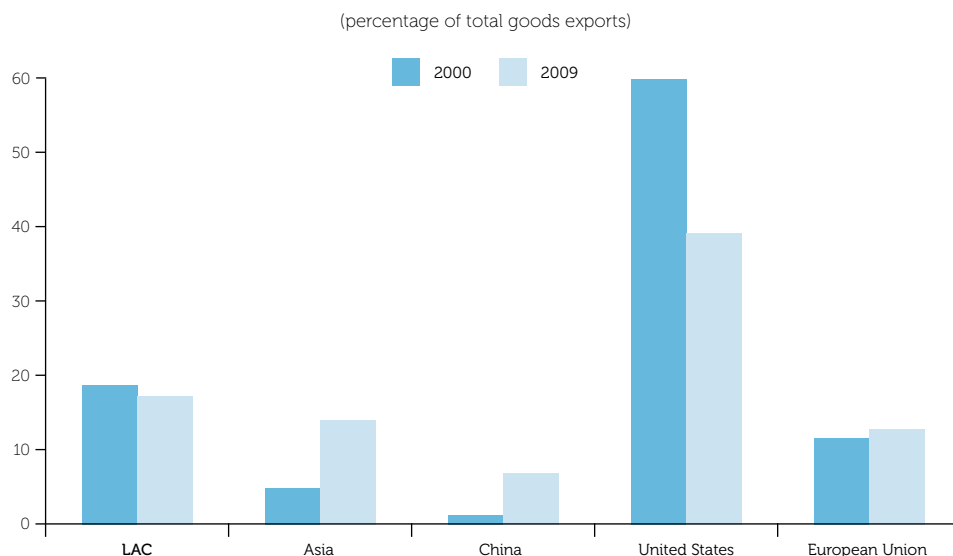
Long-term simulations show that similar conditions will continue. While it is always risky to forecast 40 years into the future, the prediction is that the engine of world progress may not run the same as it did in the second half of the last century. In an attempt to identify the countries most likely to contribute to global growth, a number of acronyms have become popular for forecasting economic growth on a global level. The best known are the BRIC—Brazil, Russia, India, and China—and CIVETS—Colombia, Indonesia, Vietnam, Egypt, Turkey, and South Africa.

Regardless of the countries on these or other lists, the message is the same: the most robust economies will not be those that have achieved the highest levels of development. Factors such as changing consumption patterns, aging of the population, and a potential decrease in the number of inhabitants are now used to explain likely future scenarios. These changes do not mean higher income areas will become poorer, but that the distance between the rich and the poor will narrow substantially.

A similar outlook should apply in the LAC region because the new patterns entail an expansion and reformulation of trade and investment flows that has already been occurring since the start of the 21st century. Between 2000 and 2009, for example, the sum of imports and exports from Asia increased from 9 percent to nearly 20 percent of the region's total trade. The main drivers initially were Japan and South Korea, but China has since clearly overtaken all others, and India has begun to take its place in the picture.

Figure 6

Destinations of Latin American and Caribbean Goods Exports, 2000 and 2009



Source: ECLAC (2010e). *Latin America and the Caribbean in the World Economy 2009–2010: A Crisis Generated in the Centre and a Recovery Driven by the Emerging Economies*.

These relationships have also been strengthened with the signing of free-trade agreements, the opening of embassies and country offices, and rising inflows of FDI. For these reasons, I have maintained that the time has come to strengthen South-South channels. This includes increased public forums and avenues for dialogue, improved ports and road infrastructure, development of shipping routes, and more frequent air routes between two increasingly closer zones. A notable example of this new strategic vision for positioning LAC in the global marketplace is the recent initiative of Chile, Colombia, Mexico, and Peru to create a “deep integration area” (AIP, or *Área de Integración Profunda*) to strengthen regional cooperation and jointly seize the opportunities of trans-Pacific integration.

Part of the rationale behind such changes has to do with the projected rise in demand for commodities and manufactured goods in the emerging economies. The middle class, comprised of 250 million people in the developing world in the year 2000, is projected to reach 1.2 billion worldwide by 2030 (although some estimates are higher). Because most of this expansion will be in Asia, the message for LAC is clear: we must meet the needs of a region that will buy increasingly more minerals, hydrocarbons, and food to supply populations that are able to consume more.

No case illustrates this better than China, which in 1990 was a virtual nonentity in the region's foreign trade, and now represents more than 7 percent of its exports. China's gain has been accompanied by increased business activity. At the beginning of the new century, China ranked seventh among the world's largest exporters, and in 2009 became the world's leading export power. In LAC, Chinese producers and consumers have found a great provider of supplies.

Consequently, ties will intensify. Exports from the region to China, which were 1 percent of the total in 2000 and 7.6 percent in 2009, could reach 19.3 percent by 2020, overtaking the European Union (EU). FDI is also projected to rise above expectations, as Asia's interest grows in extractive industries and in securing food sources from the LAC region, with its arable land and the world's most abundant water resources.

There is also great confidence in the future trade opportunities with India, where population growth will be faster than China, and where increasing urbanization is evident. The opportunities do not end there. As the African economy takes off, LAC will have new opportunities for the promotion of business ventures and trade of goods with greater value added.

At the same time, one cannot overlook the potential of integration with the region. Great strides have been made in recent decades, but much remains to be done. Although intraregional exports increased from 13.1 percent of total exports in 1990 to 20.4 percent in early 2008, these indexes are lower than those within the EU or among the parties of the North American Free Trade Agreement (ECLAC, 2010c).

Among the reasons why greater progress has not been made in regional integration, experts cite the lack of political will and the need to deepen existing frameworks with much more aggressive tariff-reduction programs. Of no less importance are the lack of well-developed transportation infrastructure, which causes problems in overland transportation of goods and delays in customs, and the control mechanisms in place between neighboring countries that sometimes regard each other with apprehension because of existing border disputes.

The Outlook

Looking ahead, the outlook amidst these new realities is promising. If LAC can maintain average GDP growth near the 4.8 percent gains recorded between 2003 and 2008, the total value of current output would double in 15 years, and per capita income would double in about two decades. But if that rate goes to around 6 percent, as occurred in 2010, these results would come even sooner.

This scenario is fully feasible in light of the transformations taking place around the world. Because development never occurs at a steady pace, some years will be better than others, but the stage is set for progress. The challenge, therefore, is to institute policies that can turn this opportunity into a reality while avoiding the excessive spending and borrowing of the past that caused booms to be short-lived. The key here is to take advantage of the gains already made, and to keep moving forward. Even though LAC has sounder financial, monetary, and fiscal institutions than it did two decades ago, the macroeconomic problems have not been entirely overcome. Issues such as overheating of economies, revaluation of certain currencies, excessive public spending, and overborrowing must be closely monitored.

To this end, the LAC region's macroeconomic policies will likely face a dual challenge; first, how to make productive use of the revenue from natural resources in this favorable external environment and second, how to increase capital inflow. The region possesses 10 percent of the world's oil reserves, more than 40 percent of copper and silver deposits, and more than 25 percent of arable land. This abundance of wealth creates an opportunity to develop a more competitive and diversified economy, unlike the commoditization of the past. The key to realizing this opportunity will be making judicious decisions to save during the good times, so that countercyclical programs can be financed during the bad times.

Commodity prices are inherently volatile, since unforeseen events such as natural disasters or armed conflicts can cause supply problems for a given product, usually reflected immediately in its price. If this scenario also includes high demand, the challenge for commodity-exporting nations is to design mechanisms to prevent such shocks from adversely affecting their economies with the same force.

In commodity pricing, the creation of stabilization funds is a promising development, smoothing out fluctuations in revenue intake and financing long-term initiatives to make an economy more productive. Such measures also help take pressure off the exchange rate, which tends to appreciate in response to a sudden rise in export revenue. The so-called "Dutch disease" is a leading concern of central bankers and finance ministers in countries with substantial hydrocarbon, mineral, or food resources that use floating systems to price currency. Although all antidotes tested so far have yielded only partial results, one of the most effective measures is ensuring that the LAC countries save for emergencies. With careful planning, part of the income could be invested to remove bottlenecks to new infrastructure and to develop more effective policies to diversify a country's productive capabilities and address social needs.

In such an environment, the massive inflow of capital should not be overlooked. Although FDI declined sharply in 2009 due to the global economic crisis, it recovered swiftly in 2010 from \$80.376 billion to \$112.634 billion (ECLAC, 2010b). The opportunities in extractive industries and the advantages of reaching a growing number of consumers help explain the real substance of what has occurred, with the potential for continued growth in the medium and long term.

A more stable legal framework is another factor, especially in those economies seeking a firmer foothold in the global marketplace. At the same time, a number of institutions, including the IDB, have warned of the risk of an unforeseen increase in resources directed into portfolio investments in LAC or the purchase of certain types of assets. The abundance of cheap money, together with a shift in the region's risk profile, mean that speculative investment flows could spike, with the accompanying danger of creating bubbles in areas such as real estate or stocks, supported by exchange rate appreciation. Consequently, the IMF and other institutions recommend defensive measures that include administrative controls such as withholdings or higher reserve requirements.

Such warnings stem from the brighter outlook for the region, since a sustained increase in growth brings its own new challenges. Some uncertainty still remains as to what may happen, but there is no doubt that an optimistic scenario is most likely, as has been evidenced by performance in the first half of 2011. The main reason is that the Asian countries are not self-sufficient enough to generate the commodity supply required both to feed their population and to secure energy inputs to meet growing demand. Although debate continues on how lasting this demand will be, clearly the planet's center of gravity is shifting towards the Asia-Pacific region. With this understanding comes the realization that the IDB must be better equipped to sail in stronger currents and avoid past errors, including dependence on too few products or markets. Building new partnerships is also essential to seizing opportunities as they arise, with the objective of furthering economic and social development.

Fortunately, I can bear witness that the new paradigms are well understood in Latin America and the Caribbean. The region's governments, business sector, and most of its citizens understand that the future will be much more than an extension of the recent past. They also recognize that behind the reality lies the real possibility that, after so many failed attempts, the region will make the leap forward that it needs and deserves.



CHAPTER II

Social Advances: Between Light and Shadow



Locking in necessary gains and making rapid inroads on entrenched problems give reason to hope that the cycle of prosperity in the second decade of the 21st century will enable all inhabitants in LAC to make a much-deserved **leap towards solving social issues.**

Social Advances: Between Light and Shadow

Since I began to follow closely the social conditions in the Latin American and Caribbean (LAC) region, I have had the same mixed feelings. On one hand, I look at the numbers and find that the region has made great progress, despite the known difficulties and occasional backsliding. On the other, I speak with people from all walks of life, visit rural and urban areas, and realize that we still have a long way to go for all to have the same opportunities.

It is unacceptable, for example, that one in eight inhabitants in the region is considered indigent, meaning that he or she does not have sufficient income to afford enough food on a daily basis. It is also discouraging to observe the very significant difference in the quality of life of rural and city dwellers, the wide disparity between countries, and the undernourishment that affects millions of children, depriving them of a better future.

Fortunately, I can knowingly say that the successes in this area far exceed the failures. Today, the average inhabitant of the region is healthier and more educated than ever before. Gender disparity has decreased dramatically, while services to vulnerable populations are growing steadily. Perhaps that is why levels of satisfaction with life index rankings are comparable to those in the world's wealthiest regions, such as North America, Oceania, and Western Europe.

Consequently, a high level of optimism exists. Generally, surveys show that people in the region see themselves as better off over time, even though they may not feel as positive about what is happening in their countries. Meeting these expectations for the almost 600 million people who live in the region is one of the main challenges facing our leaders.

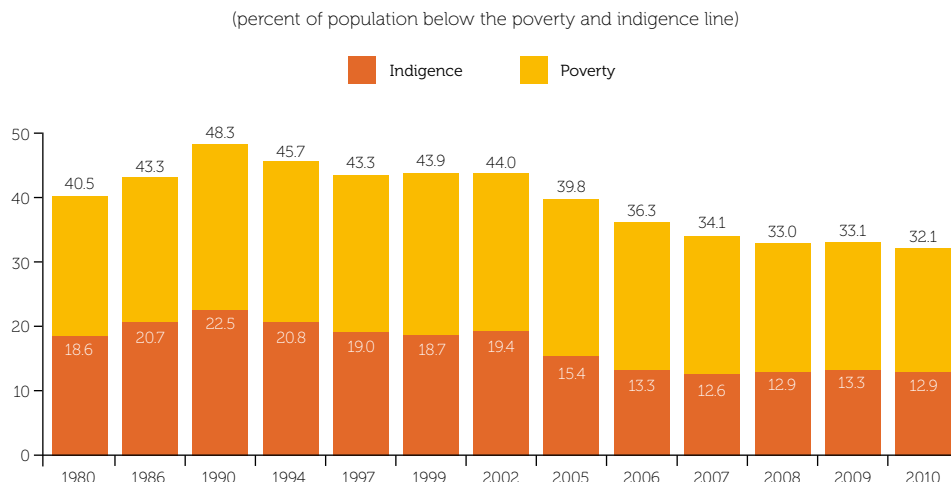
Poverty in Retreat

If anyone has doubts about the validity of the term “lost decade” when discussing what happened in the 1980s in the LAC region, one needs only to look at the numbers. In 1980, the poverty index in the region was 40.5 percent of the population, and the indigence rate was 18.6 percent. Ten years later, those indicators were 48.3 percent and 23.5 percent, respectively. In that short period, 64 million people

living in the region joined the ranks of those earning less than two dollars a day, expressed in purchasing power parity (PPP).

Figure 7

Poverty and Indigence in Latin America and the Caribbean, 1980–2010



Source: ECLAC (2010a). *Social Panorama of Latin America 2010*.

In 1990, the LAC region embarked on a long and sometimes bumpy journey that has not always been fruitful or uniform among countries. Both the constraints of public budgets and the external shocks that have affected the capacity of economies in the region to generate good jobs have made it difficult to achieve significant progress. In 2002, for example, the poverty rate was 44 percent, equivalent to 221 million Latin American and Caribbean people.

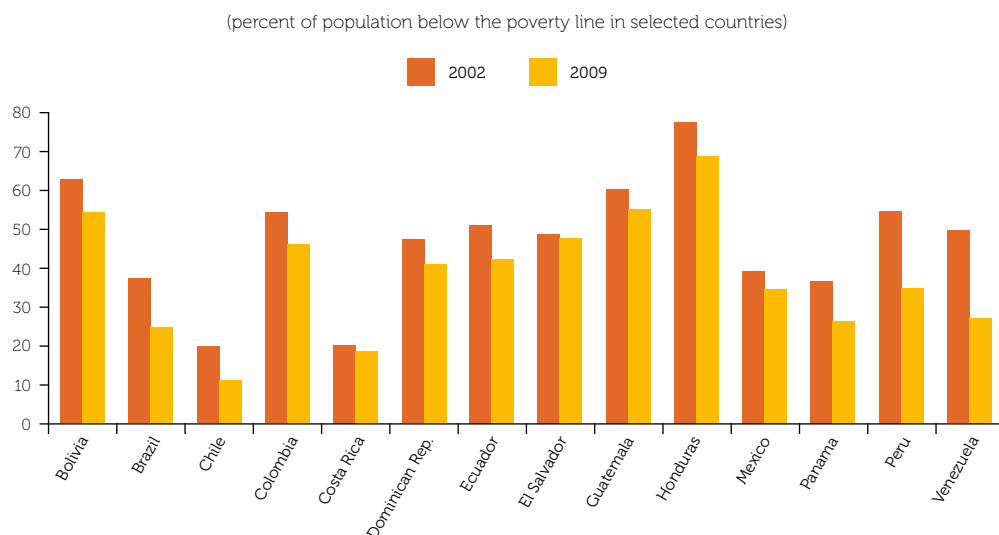
And then things began to change. By 2010, the total population living in poverty had dropped to 180 million, with the poor decreasing to 32.1 percent, and extremely poor to 12.9 percent of the population (ECLAC, 2010a). In other words, if a few decades ago one of every two LAC people lived in poverty, now only one in three does.

Nevertheless, the fact remains that this has not been a continuous process. Between 1990 and 2002, the average rate of reduction in indigence was 0.26 percentage points per year, while the rate of decline in total poverty was 0.36

percentage points per year, not to mention the variations from country to country. However, between 2002 and 2008, the rate of decline increased to 1.08 and 1.83 percentage points, respectively (ECLAC, 2010g).

Figure 8

Poverty in Latin America and the Caribbean, 2002 and 2009



Note: The 2009 period corresponds to the most recent survey available between 2006 and 2009.

Source: ECLAC (2010b). *Millennium Development Goals. Achieving the Millennium Development Goals with Equality in Latin America and the Caribbean: Progress and Challenges*.

The levels of poverty reached in recent years are the lowest in the region's history and show that transformations are possible in relatively short periods of time, raising hope about what can be achieved through sustained medium- and long-term efforts. But in the meantime, the factors that led to such a significant decrease are worth examining.

First, the victory over inflation is noteworthy. Price index increases were brought down to single-digit levels consistently after having exceeded 1,000 percent per year in some Latin American and Caribbean countries in the 1990s. As a result, it has been possible to protect the purchasing power of the most vulnerable people in the region. It is no wonder that rising prices are said to be the most regressive tax there is, since they reduce available income and affect the capacity of a state

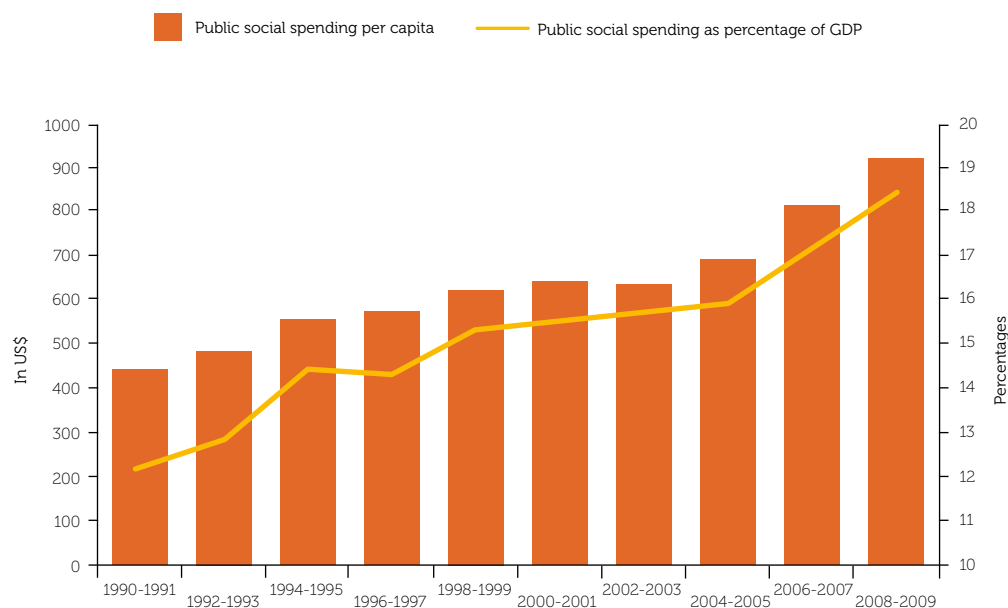
to generate wealth. Reducing inflation significantly over the last 15 years has been no small feat.

The relative stability on the inflation front has been coupled with an improved growth rate, which has increased to annual averages of more than 4 percent over the same period. Consequently, the unemployment rate dropped from over 10 percent in 2000 to 7.6 percent in 2010 and has been trending down even further in 2011, with a joint ECLAC/ILO study indicating that it could go under 7 percent, a level not seen in recent history.

The sustained increase in gross domestic product (GDP) made it possible to strengthen government budgets. In turn, public social spending increased from 12.2 percent of regional GDP in 1990 to 18 percent in 2008, and has remained close to that level ever since. Spending per capita increased from 440 to 885 (in constant 2000 U.S. dollars) over that same period. Although at times concerns have been raised about the sustainability of this effort, it does seem possible that it will be maintained over the long term, in view of the region's improved economic outlook.

Figure 9

Public Social Spending in Latin America and the Caribbean, 1990–2009



Source: ECLAC (2010a). *Social Panorama of Latin America 2010*.

Among the programs implemented in recent years to fight poverty and marginality, the most successful have been the conditional cash transfer (CCT) programs implemented in the LAC countries. Via a monthly stipend, a family ensures the use of a specific nutritional or health plan or commits to sending children to school. This assistance not only improves average income but also lays the foundation for the subsequent generations to have better opportunities as they enter the job market.

In 2009, there were CCT programs in 17 countries of the region, benefiting 22 million families, at a cost of around 0.25 percent of GDP (ECLAC, 2010g). While various studies have demonstrated that these programs are very useful in the short term, their ability to prevent the cycle of poverty—one of their ultimate objectives—is still unclear, and various aspects of the programs require improvements (IDB, 2011b).

CCT programs have been adopted throughout a period of extraordinary transformation in the demographic dynamics of the region. The rate of population growth has slowed substantially. Between 1950 and 1955, women had an average of 5.9 children; this average fell to 2.4 between 2005 and 2010, which reflects a notable decrease in the dependency ratio within the household.

Figure 10

Fertility Rates in Latin America and the Caribbean, by Five-Year Period, 1950–2015

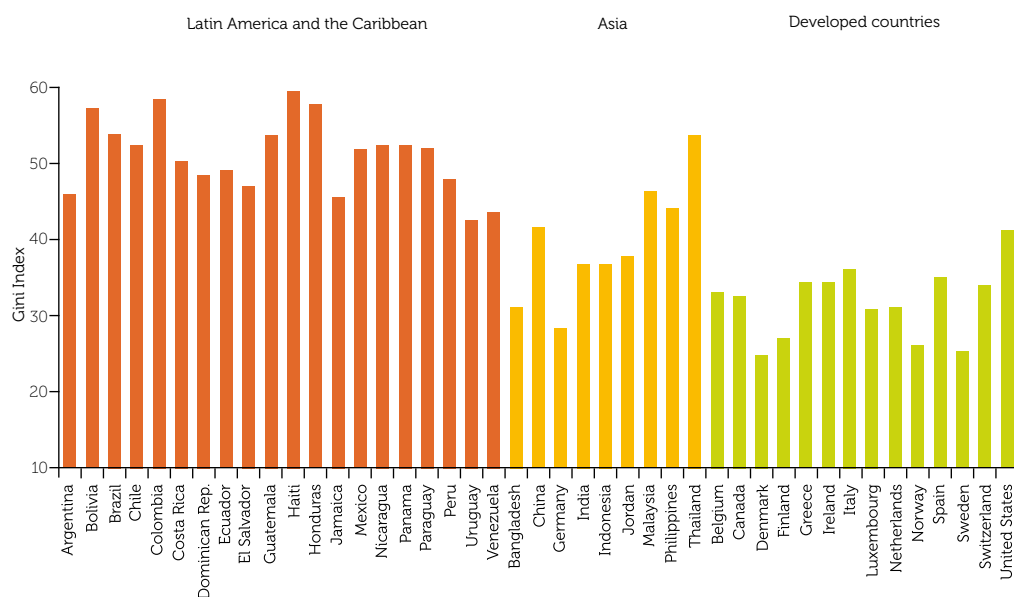


Source: ECLAC (2008). *Demographic Change and Its Influence on Development in Latin America and the Caribbean*.

These changes result from several factors. For one, growing urbanization affects family size. Nearly 8 out of 10 inhabitants in LAC, one of the highest rates in the world, live in urban centers. No less important is the increase in school attendance by girls, as well as the growing participation of women in the workforce.

Recent estimates indicate that the population growth rate between 2035 and 2040 will be only 0.3 percent, less than a third of the current rate. At the same time, the age pyramid will change dramatically. For example, children aged 0 to 14, who accounted for 27 percent of the total population in 2010, will make up only 18 percent in three decades. By contrast, the share of people older than 65 will increase from 8 to 19 percent over the same period (ECLAC, 2010c). These changes mean that the average household size is becoming smaller with a declining dependency rate and with income distributed among fewer people. This “demographic dividend,” as specialists call it, will produce favorable results in LAC for several decades until the share of older adults increases.

Against this backdrop, it should be taken into account that changes in the poverty rate are associated with both income growth and income distribution. The first, better known as the “growth effect,” is responsible for 85 percent of the advances made between 1990 and 2008 (UNDP, 2010). Income distribution has been slower, and has placed LAC as the most unequal region in the world (IDB, 2011b). Although some progress has been made recently, as reflected in the change in the Gini coefficient from 0.55 to 0.52 between 2002 and 2008, more effective policies are urgently needed to close the existing gaps. The implied social and economic costs of waiting are considerable. The deep inequalities in the region slow down economic growth and impose limitations on social and intergenerational mobility, and have negative implications because these contribute to a rise in crime (IDB, 2011b).

Figure 11**Gini Index in Different Parts of the World, Selected Countries**

Notes: The most recent data available for the selected countries in Asia and LAC fluctuate between 2005 and 2008, with the exception of Haiti (2001) and Jamaica (2004). The most recent data available for the selected developed countries were recorded in 2000.

Source: World Bank (2011). *World Development Indicators* (WDI).

The reality of specific population groups also must be taken into account. Poverty affects 81 million children, meaning there are twice as many children in extreme poverty as adults. At the same time, poverty affects women much more than men and rural residents more than residents of urban areas. The plight of indigenous and Afro-descendent groups is no less serious, with rates of indigence up to six times higher than the average.

One last element to keep in mind is the risk to progress achieved posed by factors such as external shocks, which in the past have prevented the LAC region from maintaining a sustained growth rate, with the known consequences on stability and employment.

Also significant is the possibility of increases in commodity prices, which while benefitting most countries of the region, substantially curtail the purchasing power of low-income families. For example, price adjustments involving foods and

fuels during the first half of 2008 presented a warning that is best not forgotten, especially given recent trends.

Finally, the quality of employment must be emphasized. Despite the drop in unemployment rates, formal job creation in the region has been very slow. This prevents the population from gaining full access to social security and thwarts any real progress in the fight against poverty.

Education: A Glass Half Empty and Half Full

Clearly, offering adequate and equal education is crucial to overcome the region's social development lag. Few public policy efforts are as rewarding as training younger generations, giving them tools to make their way in the job market and seize opportunities offered by a more modern and diverse economy in a context of increasing globalization.

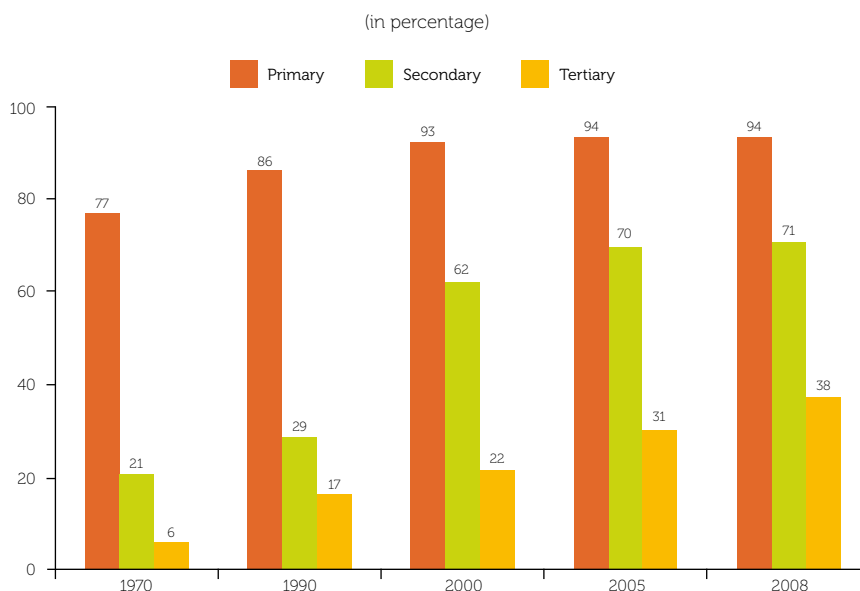
The LAC region has made a remarkable effort in this regard. To cite one example, the illiteracy rate for people over the age of 15, which was around 20 percent of the population three decades ago, stood at 8.3 percent in 2010 (ECLAC, 2010c). A specific effort to increase coverage at all levels has proven fruitful.

Net primary school enrollment rose from 77 percent in 1970 to 94 percent in 2008. This evolution implies that many LAC countries have reached the goal of providing universal education coverage, despite significant setbacks. At the preschool level, several countries of the region have expanded access to centers that provide early childhood education and care. However, the available information, although limited, points to deep deficits in several areas, as well as wide discrepancies between countries, income levels, and educational levels of parents (IDB, 2011b).

Secondary school coverage has also shown significant improvement, though much remains to be accomplished. Between 1970 and 2008, the share of young people enrolled at this level rose from 21 to 71 percent. Progress has also been made in tertiary education, but on a smaller scale. In 2008, 38 percent of young people were enrolled in technical schools or universities, compared to 22 percent in 2000. It is worth noting that although this indicator is far superior to the 6 percent reported in 1970, it confirms that faster improvement is required.

Figure 12

Net Enrollment Rates in Primary, Secondary, and Tertiary Education in Latin America and the Caribbean, 1970–2008



Note: The rates for the tertiary level correspond to the gross enrollment rates.

Source: ECLAC (2009a, 2010c). *Statistical Yearbook for Latin America and the Caribbean*.

All of these are positive signs. In short, more children and young people attend educational institutions at all levels than ever before in the region. In addition, students enter the system at a younger age and remain in school longer, thus completing higher grades. The gender gap that existed in the past has nearly disappeared. In fact, women have begun to attain higher education levels than men, according to several indicators. These changes are so great that, for example, in some countries nearly half of the university students come from families in which neither parent has higher education degrees.

These gains do not mean that the task is completed. Latin America and the Caribbean lag other areas of the world with similar income levels, regions where young people remain in the education system as much as four years longer, as is the case in certain parts of Asia (Barro and Lee, 2000). In terms of educational mobility, the LAC countries also fall short, reflecting not only the problem of income disparity, but also of unequal access to opportunities for advancement (OECD, 2010).

There are also great disparities between socioeconomic levels and between rural and urban areas. These gaps are wider still for indigenous or Afro-descendant populations. In addition, alongside countries in the region that have achieved significant progress, others fall far below average; these differences could limit those countries' future income or growth potential. Illustrative examples are plentiful. While only 2 of every 100 children in the wealthier strata fail to complete primary school, 12 of every 100 in the poorest strata fail to do so. Compared to 96 percent in the cities, the completion rate for primary level children in rural areas drops to 85 percent (ECLAC, 2010c).

The situation worsens in secondary school where work opportunities and the need to help financially support the household compete with the alternative of remaining in school. Family tradition is one important factor in influencing the choices to eventually delay or finish the higher grades.

As a result, while 83 percent of children from the wealthiest one-fifth of households complete secondary school, only 25 percent of the poorest one-fifth of households do. This indicator is very similar for rural youngsters. The rate is even lower for students in indigenous populations (ECLAC, 2010g).

The differences are even greater in higher education. Research shows that for every 27 students from high-income households who complete five years of studies, only one low-income student manages to do so (ECLAC, 2010g).

In terms of quality of education, the results of academic testing in LAC countries, administered by the Program for International Student Assessment (PISA) of the Organisation for Economic Co-operation and Development (OECD), show that the competencies of Latin American and Caribbean students fall far below the average for students in other continents.

Furthermore, performance differences linked to socioeconomic factors are substantial. Lower-income students and residents of rural areas have not developed basic competencies to perform well in the measured subjects (language, mathematics, and science).

Digital competency is another issue worth mentioning. As information technologies become more widely available, the general gap observed in the LAC region is more extreme for low-income students. It is three times more likely for a high-income household to have a computer than for a low-income household. An even wider gap exists with respect to Internet access. Having fully equipped educational institutions is key to closing these gaps.

Given the situation, the education sector in the region has a dual agenda. On one hand lie the usual challenges of increasing coverage, improving access, preserving the progress of past efforts, and ensuring that students complete the various education cycles. On the other hand is the issue of quality, as international measurements show students in Latin American and Caribbean countries falling well below the averages in developed countries in areas such as language comprehension and mathematics. Thus, goals must not only include the optimization of traditional methods, but also the improvement of teacher training and the acquisition of new resources such as information and communication technologies.

The importance of education is undisputed. For example, while the informality rate in the region stands at 73 percent for those with an incomplete primary education, this rate drops to 32 percent for those who completed secondary school and to 14 percent for those who finished university. Moreover, the average difference in monthly income from one extreme to another is six fold, further illustrating that completing more years of schooling is a good personal investment.

It is impossible to ignore the evolving context in which such analyses are conducted. Although public spending on education has increased steadily throughout the last two decades, it is still too early to assess the impact. To the extent that new strategies can be adopted without losing sight of the importance of quality, an improving economic climate may produce more and better jobs for millions of young people who are now attending educational institutions with the goal of creating a better future for themselves.

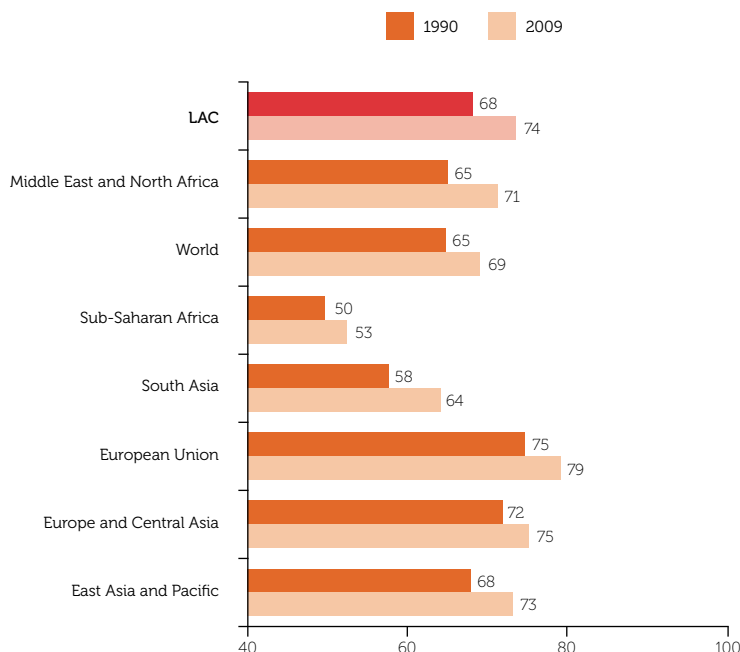
Health: A Healthier Region

Without doubt, the transformation in the LAC region over the last few decades has not been simple. Multiple circumstances—both political and socioeconomic—have prevented the region from achieving its full potential. But in the midst of this scenario, one not lacking in failures, progress made in the health area is clear: the region has experienced a very rapid improvement in a relatively short time.

Today, Latin American and Caribbean people have the highest longevity rates and the lowest infant mortality rates when compared with other parts of the developing world (World Bank, 2011). Although significant inequalities remain in terms of access to quality health care within and between countries, the achievements of the last few decades are not small and deserve to be highlighted.

Figure 13

Life Expectancy at Birth and Mortality Rates in Different Regions of the World



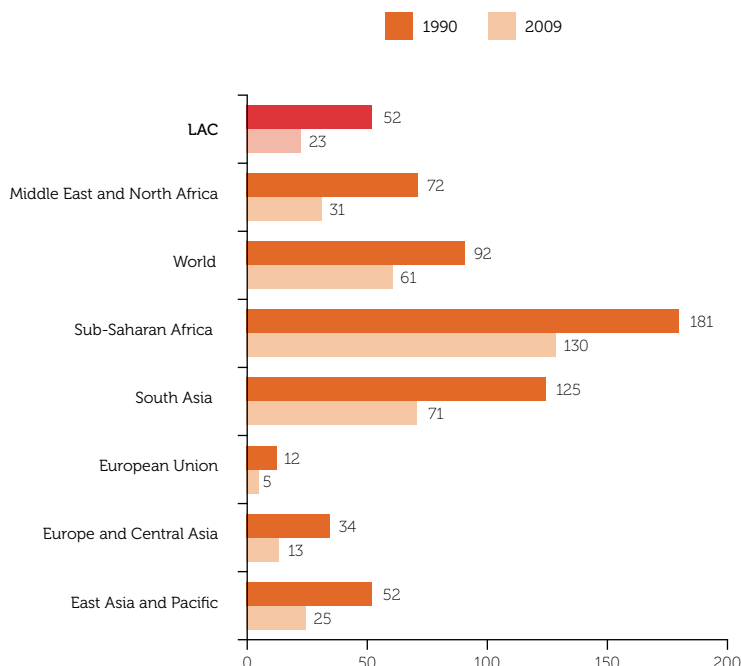
Source: World Bank (2011). *World Development Indicators* (WDI).

The statistics are clear. In 1960, average life expectancy in the region was 56.2 years. By 2010, it had risen to 74.5 years. This progress has been related to the reduction in deaths among infants and children under age five, from 150 per 1,000 half a century ago to 23 per 1,000 in 2008. Although the under-five mortality rate is higher than rates in Europe or North America, it is nearly half the world's average, and falls well below rates in Africa and Asia (Ávila, 2009).

Various factors have played a role in improving these survival rates, including reductions in birth rates, better access to education, increase in public investment in health promotion and prevention programs, and advances in medicine.

Figure 13a

Under-Five Mortality Rate per 1,000 Live Births



Source: World Bank (2011). *World Development Indicators* (WDI).

All these factors have clearly had an impact on improving health indexes. For example, the number of health care professionals per 100,000 inhabitants has grown from 0.33 in 1960 to more than 0.9 today.

But the promotion of preventive policies is no less important. Immunization campaigns are an example: 93 percent of children were immunized against measles in 2007, close to 17 percent higher than in 1990. The DPT (diphtheria/pertussis/tetanus) immunization campaign had similar results: in 1970 less than 10 percent of the child population was covered, compared with over 90 percent in the most recent study (Ávila, 2009).

Also significant is the reduction in maternal mortality rates, as a result of an increase in prenatal care, now covering 95 percent of pregnant women. The proportion of deliveries attended by specialized personnel also rose, to 86 percent in 2008, 14 percent above the share 18 years earlier (ECLAC, 2010a).

Table 3**Selected Health Indicators for Latin America and the Caribbean, 1990 and 2008**

Indicators	1990 (%)	2008 (%)
Prenatal care coverage (at least one consultation)	83.6	95.0
Share of deliveries assisted by specialized health care workers	72.0	86.0
Maternal mortality rate	71.2	66.9
Share of children age one inoculated against measles	76.3	93.0
Contraceptive prevalence rate	59.5	69.6

Note: The contraceptive prevalence rate is the percentage of married women aged 15 to 49 who use, or whose sexual partners use, any form of contraception.

Source: ECLAC (2010a). *Social Panorama of Latin America 2010*.

The LAC region has also made great progress in reducing undernourishment. The number of undernourished children decreased from 21 percent of children below age 5 in 1970 to 7.2 percent in 1997 (UNICEF, 1998). The indirect reasons for this improvement, among others, are better care practices, better access to health care services and water and sanitation services, and, on a basic level, increased involvement of women in decisions about their own education and use of monetary resources.

Another achievement, which at the same time is a challenge, has to do with developing systems that have increased health care coverage. In some cases, more than 90 percent of the population has insurance coverage. For example, Colombia offers coverage through a combination of a state-subsidized benefits system and a contributory system that is supported by businesses and employees. To a greater or lesser degree, the fiscal effort made by governments of the region—ranging from 0.2 percent to 1.8 percent of GDP (IDB, 2011b)—has been reflected in improvements in health indicators, although these efforts may contribute to maintaining the high rates of informality by removing citizens' incentives to enter the formal sector.

Despite this progress, substantial variation remains in access to quality basic health care services, both within and among countries. Health inequity hits the most vulnerable groups hardest: women, who are also generally the ones responsible for the health of their families; children; minority ethnic groups; and rural dwellers.

At the same time, disease characteristics have changed fundamentally. Fifty years ago, the main causes of death were related to infectious/contagious diseases. Today, the most common threats are diabetes, cardiovascular conditions, and cancer. Tuberculosis, to cite one case, is actually a lesser threat, since the mortality rate associated with this disease is one-third of that recorded two decades ago. Although these shifts in diseases are to be expected, given the aging population and increasing urbanization, risk factors for chronic illnesses are especially high in the region. However, these conditions affect people of all income levels, and increasingly the poor, in a disproportionate way.

Contrary to what many might think, cardiovascular diseases are already responsible for 68 percent of the disease burden in LAC, and—in all countries—the poorest of the poor are at higher risk of developing chronic illnesses (IDB, 2011b).

HIV/AIDS deserves special mention. According to the World Health Organization (WHO), two million Latin Americans may have been infected. Although the growth curve seems to have flattened, there is cause for concern: the use of condoms and access of the affected population to antiretroviral drugs remains low. The prevalence of the epidemic in the Caribbean calls for even more attention, since this area has the second highest incidence in the world, just below that of sub-Saharan Africa; HIV/AIDS in the Caribbean is one of the main causes of death among people aged 15 to 49 (UNAIDS, 2009, 2010).

As some of these achievements are consolidated, the region faces other types of challenges. Growing obesity rates are a cause for concern, as is the high impact of mental illness and addiction resulting from depression, alcoholism, or consumption of hallucinogenic drugs. There are also those who cite fear of crime as an affliction, given that violence is a main cause of death among young people.

Without getting into this debate, it is important to consider the challenges arising from the gradual aging of the Latin American and Caribbean population, a phenomenon that other parts of the world are also experiencing. People older than 65, a group that comprises less than one-tenth of today's population in the region, will account for one-fifth of the population by the middle of this century. For this reason, although the balance in terms of health in the region is very positive, challenges still remain.

Table 4**The Aging of the LAC Population, 1990–2050**

Indicators	1990	2000	2010	2030	2050
Population aged 65 and older	206,160	283,831	394,650	826,530	1,392,010
Percentage of people aged 65 and older	4.8	5.7	6.9	12.2	19.3
Percentage of people aged 75 and older	1.6	2.1	2.7	4.9	9.1
Median age of the population	27.2	27.8	30.2	35.4	40.3
Aging index	13.1	17.8	24.7	59.2	112.1

Notes: The aging index is the ratio of the population aged 65 and older to the population under age 15. Data for 2010, 2030, and 2050 are estimated.

Source: ECLAC (2009b). *Latin American and the Caribbean Demographic Observatory No. 7: Population Protection*.

There is still a great deal to be done to strengthen the health care systems in the region. A deliberate effort should be made to improve integrated primary care. Also, there is still too much focus on treating and curing, while healthy lifestyles and preventive care are not encouraged enough. As a result, the direct costs to the health care systems are rising rapidly. Increased investment in promoting health and prevention is certainly part of a cost-efficient agenda, one that requires an intersectorial response, including broad participation of public and private sector partners.

The potential areas of cooperation between these two sectors range from education, aimed at changing behavior and lifestyle, to new technologies geared toward extending prevention protocols to broader segments of the population, as well as introducing digital medical records systems.

The Improved Status of Women

The news has been repeated so often that it no longer has the same impact: a nation of the LAC region has elected a woman as president, something historically unusual but now more and more common. This fact is only one example of the growing participation of women in the labor market in a wide range of fields.

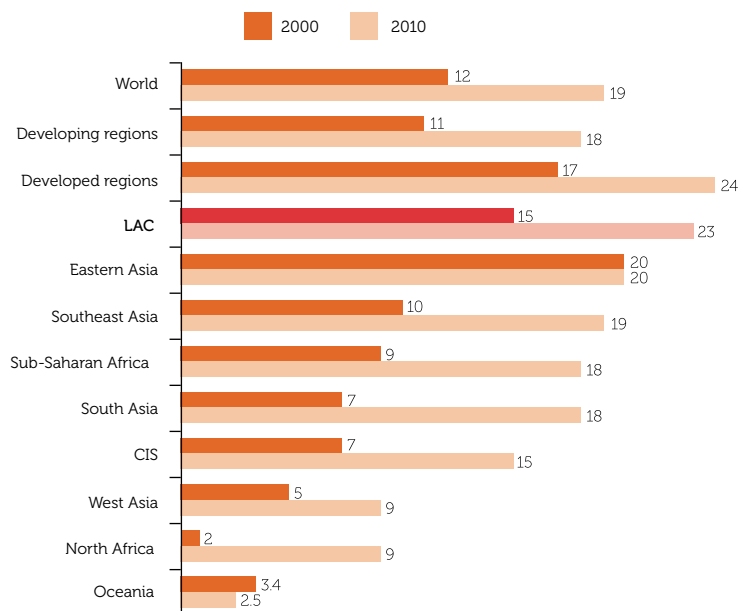
Such a change is the direct result of improvements in gender equality in education. The figures provide evidence not only that parity in schooling has been achieved— compared with 1960 data when the proportion of males to females in school was substantially higher—, but also that in much of the region, women now outnumber men at all levels of education.

The entry of millions of women into the workforce has had an impact on the makeup of the job market, which was 53 percent female in 2010, compared with 38.2 percent in 1990. Other measurements show that the share of gainful employment for women in the nonagricultural sector rose to 42 percent in 2007, six percentage points higher than in the previous decade (ECLAC, 2010c).

Fundamental changes have also occurred in the political arena. In 2010, women in LAC held 23 percent of the seats in national parliaments, twice the 1990 level but still low (UN, 2010). The index of women in ministerial cabinets was close to 30 percent in Latin American countries and 20 percent in Caribbean countries (ECLAC, 2007).

Figure 14

Percentage of Seats Won by Women in Unicameral National Parliaments or in the Lower Chamber in Different Parts of the World, 2000 and 2010



Source: UN (2010). *Millennium Development Goals 2010 Report*.

All of these positive developments show that transformations are accelerating, although there is still a long way to go. For example, the proportion of women without their own income dropped from 43 percent in 1994 to 32 percent in 2008 (ECLAC, 2010g), but even this rate is three times the rate for men in the same year. It is therefore not surprising that the incidence of poverty and extreme poverty is higher for households headed by women.

This high incidence is cause for concern because in the urban Latin American and Caribbean areas, the share of such households jumped from 22 percent in 1990 to 31 percent in 2008. In addition, despite laws to promote gender equality, women, on average, earn 85 percent of what men earn for equivalent jobs. This gap has been narrowing, but calculations suggest that parity will not be achieved until 2015 (ECLAC, 2010g).

Attempts have been made to address some of this lag through quota laws in force in 12 of the region's 33 nations (Payne et al., 2006). Although such decisions are not without controversy, progress has been more definite in countries that have adopted such regulations.

While these gains are significant, undesirable trends persist. One is violence against women. Recent data from 15 countries show that up to 40 percent of women have been physically abused by their husband or partner, 60 percent have been victims of emotional violence, and 47 percent have experienced some type of sexual abuse (ECLAC, 2010g).

What Can Be Done

In conclusion, looking at the social landscape of Latin America and the Caribbean, one is left with mixed feelings. On one hand, we feel satisfaction at having made an undeniable leap forward. Not only is the share of the poor and extremely poor the lowest in the region's history, but the inhabitants are healthier and more educated than ever. On the other hand, we feel frustrated at finding ourselves a very long way from eradicating poverty or ensuring that a poor young person has the same opportunities to attend university and complete professional studies as a person who is economically better off.

A number of IDB programs have shown that there are ways of narrowing the gap. A case in point involves Mesoamerica, where inequality translates into six centimeters—the average height difference between a poor five-year-old child and one whose parents belong to the upper-income levels.

This difference is due to undernourishment, of course, but it can also be attributed to the absence of basic mother-and-child health care services and medicines that eliminate parasites and protect against illnesses that stunt normal growth.

The difference lies in more than just height. In a five-year-old child, each additional centimeter of height is associated with greater cognitive development and school advancement, and eventually with the ability to find a good job and earn a higher wage. Over a lifetime, those six centimeters can stretch into a yawning gap.

Narrowing that equity gap is the main objective of Salud Mesoamérica 2015, an innovative public-private partnership that focuses on reproductive and mother/child health, nutrition and immunizations, and actions to fight malaria and dengue fever.

CCT programs, which are regarded as the most frequent and successful social protection solution implemented by the region, have a similar objective. In Colombia, *Familias en Acción* is an initiative that has been supported from the start by the IDB and other multilateral institutions. With more than a decade of investment in human capital, it seeks to break the generational transmission of poverty.

The numbers are very encouraging: 5 percent poverty reduction in urban areas, and 12 percent in rural areas. Household per capita consumption in Colombia has increased by 10 percent, and families' diets have become more diverse and nutritious. Reductions of 9 percent in the chronic undernourishment rate in children under seven have been recorded in rural areas. The frequency of growth and development checkups for children between ages three and seven has increased substantially, to 44 percent in urban areas and 20 percent in rural areas, among other documented benefits.

The IDB supports a good number of similar programs in other countries of the region. Beyond this initial focus, the task now is to meet the future challenges of integrating with other initiatives and helping their beneficiaries gradually climb out of poverty.

Such examples, taken together with recent developments, are reasons for optimism. Locking in necessary gains and making rapid inroads on entrenched problems give reason to hope that the cycle of prosperity in the second decade of the 21st century will enable all inhabitants in LAC to make a much-deserved leap towards solving social issues.





CHAPTER III

Institutional Progress: A Silent Revolution



Changes continue to unfold with the increasing awareness that a region with such great possibilities for progress must adapt its institutions to meet **new and old challenges alike.**

Institutional Progress: A Silent Revolution

Although increasingly rare, it still happens: sometimes, when I travel outside the Latin American and Caribbean (LAC) region and talk about the transformations taking place throughout the region, I am confronted by the skeptic of the day, who doubts my assessments and claims that nothing that I have said regarding a better future is possible, “because everything remains the same.” According to the skeptics, the positive changes I speak of are not meaningful and are nothing more than short-lived economic prosperity that will end up vanishing, in the not-too-distant future, in a dust cloud of inefficiencies.

The rationale I hear most often on such occasions is that the institutions governing policy, the justice system, or the management of the state are the same ones that enabled the excesses of the past. From this perspective, the structures are inadequate or so imperfect that they weaken the capacity of both citizens and societies to develop.

Nonetheless, for every one of these examples, I can cite several more that corroborate that not everything remains the same. In fact, a closer look at what has happened in the LAC region in recent years shows that a silent revolution has taken place that cannot go unnoticed.

This is what happened, for instance, when the international financial crisis hurricane made landfall in late 2008. Based on the global market volatility in the past, the region feared a major contraction. Yet the effects ended up being quite manageable. Not only did the banking sector weather the storm virtually unscathed, but treasuries and central banks were also able to react in time: the former by adopting countercyclical plans and programs, and the latter using stimulus measures, such as guaranteeing the necessary liquidity to operate financial institutions properly and reining in interest rates.

This response was possible thanks to prior reforms, including enhancing the supervision of the financial systems, introducing stabilization funds to manage spikes in commodity prices, and establishing mechanisms to ensure greater autonomy in central bank decision making. While it is true that multilateral institutions such as the Inter-American Development Bank (IDB) also did their part to support member countries with an ambitious lending program, their efforts would have had limited

success had they not been complemented by a strengthened institutional framework that enabled a rapid recovery once the winds began to pick up speed.

By mentioning this example, I am not implying that the work is done. Clearly, there are still many inadequate standards, institutions plagued by problems, and obsolete procedures in the institutions of Latin America and the Caribbean. But there is also an increased awareness that changes are needed to break persistent bottlenecks, and that discussions regarding the best way to do so must take place in an increasingly democratic context, where regional and local authorities also play leading roles when appropriate.

While a few decades ago one could speak of an initial wave of reforms characterized by the removal of barriers to foreign trade and the inflow of private capital to certain sectors, now there is a continuous flow of improvements, given the growing awareness that a region with so much potential for progress must upgrade its institutions to meet both old and new challenges.

Reforms at a Glance

To understand today's reality, it is necessary to consider the situation 30 years ago. Then, LAC countries were very different, with economies protected and confined by barriers based on the import-substitution model, and where economic freedoms were hard to come by. The discretionary power of the governments of those days, either to determine international trade matters, or to bar the private sector from certain endeavors, was extreme.

And, as if that were not enough, restrictions were even greater in the political arena. In 1980, only one-third of Latin America's countries were governed by democratically elected presidents. That situation not only hindered the renewal or orderly transition of leadership, but also limited open discussion of the policies tested.

The concurrence of various factors caused such systems to begin to break down in the early 1990s. On one hand, the debt crisis exposed the shortcomings of a system that had been propped up on increased borrowing in an attempt to close the gap between public spending and revenues. On the other, growing concerns in the West regarding freedom and respect for human rights ramped up pressure on dictatorships. Moreover, the example of some countries that decided to reduce the level of regulation, privatize certain monopolies, or commit to international trade ended up striking a chord in the region.

To greater or lesser degrees, the confluence of the above-mentioned factors, as well as the drive to promote development, led almost all countries in the region to adopt a series of measures that, in some cases, led to the rapid reestablishment of political freedoms, including the right to vote and be elected, and the return to a democratic system.

Although these improvements were not made concurrently or in the same manner in every country, over time the changes were indisputable. By 1992, democratic winds were sweeping the region, and a series of new constitutions had been adopted, providing citizens with more guarantees.

The economic front also saw its share of radical innovations. For example, the average tariff on imports in LAC fell from 55 percent in 1985 to 10 percent by 2000. At the same time, there was a major injection of private capital either for the acquisition of state-owned enterprises, or competing in areas that had until that time been off limits.

Underlying these events, which in some cases produced what could be considered spectacular results, other reforms should be discussed. Not all reforms had similar scopes or achieved the same purposes, but what makes them stand out, in general, is that they were intended to make improvements, despite the unpopularity of certain decisions.

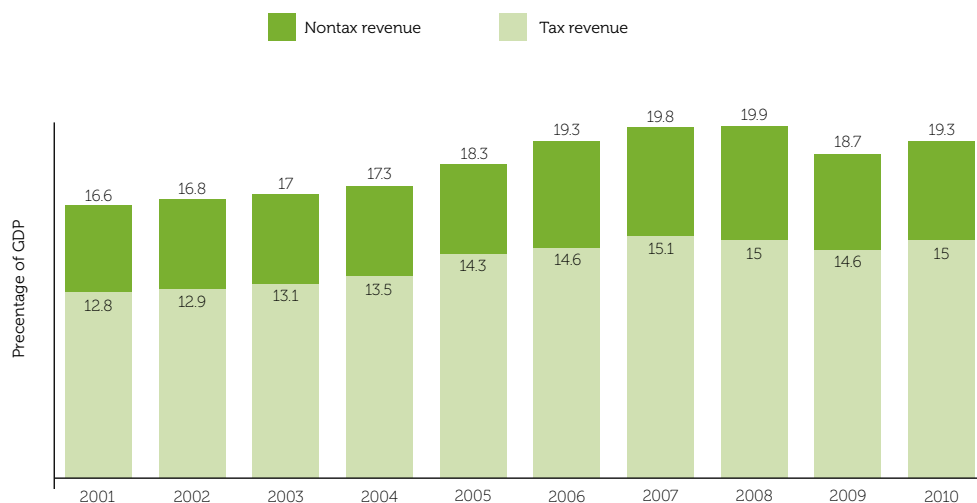
This was the case with public administration. A glance at the figures substantiates the reduction in payroll costs and the increase in support for projects intended to build meritocracies, as in the case of tax agencies. The results have been mixed. Some cases have proven to be true success stories, while problems of low autonomy and technical training continue to be experienced in other cases, without disregarding incidents of political clientelism, patronage, and political influence. Nonetheless, the reform process continues, and, to the extent that accountability improves and public scrutiny intensifies, it will be possible to bring about an increasingly capable body of civil servants.

Agencies devoted to managing government budgets have also made progress. The modifications include the introduction of mathematical parameters for spending limits, the fiscal deficit, and regional and municipal debt. Efforts are also under way to ensure the sustainability of public finance and propose corrective actions in the long term. There is a marked trend in commodity-exporting nations to promote stabilization funds directed towards saving part of the windfall revenue generated by unexpected price increases.

The subject of taxes has been at the forefront, manifested by the increase in the average number of approved reforms between the last decade of the 20th century and the first decade of the 21st. That said, it is likely that the greatest changes started in 1990, with the introduction of basic modifications such as the abrupt reduction of marginal income tax rates for both individuals and legal entities. At the same time, the modernization of indirect taxes was promoted through the adoption and/or expansion of the value-added tax, making this the leading source of fiscal revenue.

Figure 15

Tax Revenue in Latin America and the Caribbean, 2001–2010



Note: Data for 2010 are estimated.

Source: ECLAC (2010d). *Preliminary Overview of the Economies of Latin America and the Caribbean 2010*.

This transformation is hard to detect at first glance, since the LAC region's tax collection rate has remained close to 15 percent of GDP (ECLAC, 2010d). Consequently, pressure has increased to intensify the tax collection effort and improve revenue systems. It is also important to highlight the trend towards more transparent and universally applied tax systems, though not by any means considered consistent throughout the region.

Another reform area worth mentioning is sector policies. After the debt crisis of the early 1980s, the privatization of a large number of utilities in the region came hand in hand with the formation of regulatory commissions entrusted with supervision and oversight, as well as with consumer protection. The learning curve was steep, but in general, institutions are more professional and avoid measures that affect competition.

Something similar can be said about the institutions responsible for the financial sector. Considering that the credit business lies increasingly with the private sector, a robust regulatory framework is crucial for preventing potential abuses and banning risky practices that could jeopardize the soundness of the system.

Although the modifications adopted early on did not prevent banking crises, they taught us valuable lessons with the passage of time, both within the region and elsewhere, that have translated into stronger regulations. This was corroborated during the 2008 debacle, which led to the nationalization, in whole or in part, of dozens of financial institutions in wealthier economies. This was not experienced in institutions operating in the LAC region where many of the riskiest practices had already been banned, and substantially higher capital and leverage requirements were in place.

The list of reforms also included modifications to pension systems and social safety nets that ensured financial sustainability and expanded their coverage. In practice, some countries have favored individually funded plans, while others have maintained pay-as-you-go (PAYG) systems. A third group has opted to maintain both systems, giving the beneficiary the choice of selecting the best option.

The efforts described have clearly improved the fiscal balance, although the gradual aging and increased life expectancy of the LAC population will surely require additional reforms. Conversely, the high level of informal employment has precluded the possibility of increasing the likelihood of retirement pensions for the average worker in the region; only one-third can expect to receive a pension check upon retirement.

Lastly, initiatives pursued at the judicial system level should be considered. The region's judicial branches, in general, have improved in terms of independence and institutional strengthening (WEF, 2010). There has also been progress in modernizing labor, criminal, and civil judicial processes. Yet much remains to be done. In 2008, only 36.5 percent of the Latin American and Caribbean people said they trusted the judicial branch, while only 30.9 percent believed that laws were applied impartially (Latinobarómetro, 2008).

This is but a brief account of accomplishments. Again, it is necessary to reiterate that the task is not complete, and that a more precise assessment should consider specific national and regional realities. However, it should be recognized that change is under way, and those who assert that everything remains the same are mistaken. As the LAC region continues its process of integration into the global economy, new needs will arise, but the countries in the region are receptive to change and prepared to do things differently.

Decentralization on the Rise

One of the region's most powerful historical legacies, passed on from colonial times, is centralized control. Although a few federal systems exist, until relatively recently, the standard practice in the region involved allocating resources and appointing the officials to spend them from the capital from a central authority. Nevertheless, these rules changed in the mid-1980s, when responsibilities and public funds were increasingly turned over to regional and local governments, the majority of which were freely elected.

The genesis of the process is evidently political. While democracies were taking root in the region again, reforms were promoted to increase autonomy in subregions and municipalities. To cite just one example, in 1980, mayors in only seven countries were elected by popular vote; just 15 years later, those appointed by the central government were a minority (Payne et al., 2006).

Of course, while the objective of this process is to bring local leaders closer to the citizens, to whom leaders must be accountable, this has not occurred without missteps. Cases of corruption or ignorance of the basic rules of budgetary allocation and management have increased. Along with successes, there have also been major failures.

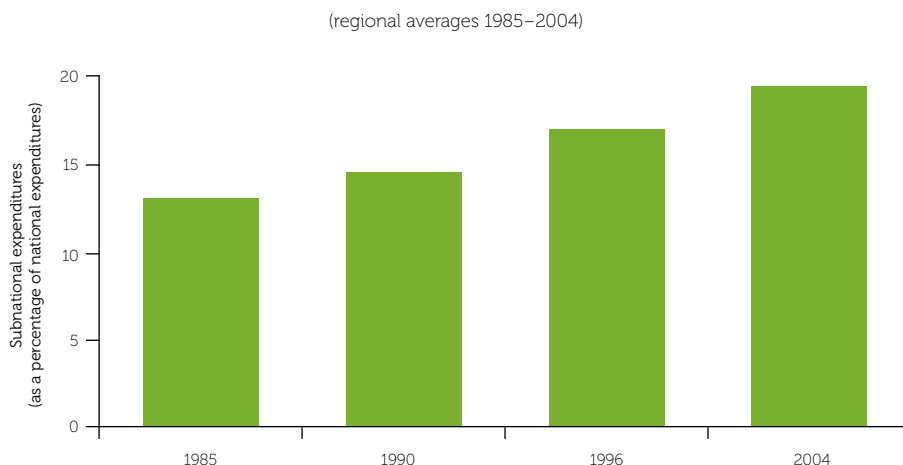
Such problems should not be considered weaknesses in the decentralizing effort. In fact, a considerable learning process is occurring, and it is indisputable that the deepening of democratic roots in LAC has a great deal to do with these events.

The change has not been only political, however. In terms of resources, a process is under way to allocate an increasing share of public spending to subnational entities. For a selected group of LAC countries, this share rose from 13.1 percent of total budget execution in 1985 to 19.3 percent in 2004.

The sources of these resources are varied. In some cases, they come from a specific share of state tax revenues, and in others, from the transfer of revenues such as taxes on gasoline and alcoholic beverages (Lora, 2007).

Figure 16

Fiscal Decentralization Trends in Latin America and the Caribbean



Note: Based on comparable information available for a group of 17 countries of the region.

Source: Lora (2007). *The State of State Reforms in Latin America*.

This rise in assigned resources has been coupled with increased responsibilities for the subnational entities that receive them, primarily the municipalities. At first, these responsibilities mainly included the management of urban programs, such as waste management, roadway paving and maintenance, transportation, and water service. More recently, and in varying ways, programs focused on education, health care, housing, electricity, and the rehabilitation of certain roads have been turned over to local authorities.

One of the most common problems is the disconnect between responsibilities assigned and funds provided. This has hindered delivery of various services and has diluted responsibilities among different levels of government. In this sense, despite the steep learning curve, the decentralization process remains on track.

There is room for subnational entities to obtain additional resources. Traditionally, property taxes or levies on commercial or industrial activities have been the main source of revenues for municipalities. Other resources include taxes

on automobiles and fines for traffic violations. In some cases, gasoline surcharges have been authorized to finance roadway development programs. The overall result is that financial autonomy has increased, even though collections often remain insufficient, and transfers from the central administration are needed to ensure the performance of regional and local government systems.

Allowing subnational entities to take on debt has been one of the most complex undertakings. On one hand, opening this door has enabled the financing of larger-scale programs, with a rapid impact on the welfare of the population. On the other hand, excesses have taken place: in some cases, debt has risen so much that it has outpaced the borrowers' ability to pay. Consequently, it has been necessary to enact laws or other measures to adjust parameters, as well as to reward or penalize the fiscal performance of decentralized entities.

Despite the time it has taken, the process continues to move forward. Many examples of immature systems have given rise to corrective actions. Certainly, the subnational governments in the region today face many challenges that are similar to those that the national governments faced decades ago. Beyond the mistakes made, decentralization is a reality in Latin America and the Caribbean. Though not entirely consistent, the countries of the region are generally moving in the same direction, with the objectives of involving citizens in public management and, whenever possible, furthering democratic societies that are more committed to their future.

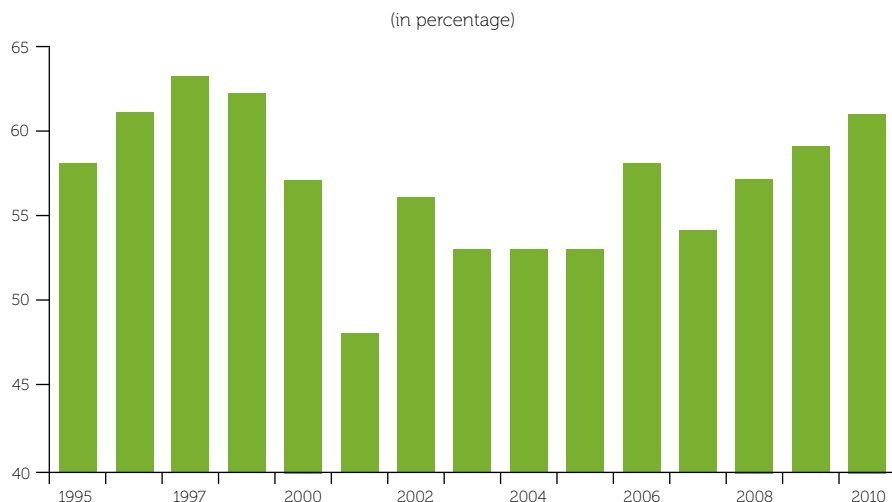
The Consolidation of Democracy

The LAC region's experience in recent decades has shown that the democratic system not only guarantees effective exercise of civil rights, but also is the best framework for establishing open, inclusive, and cooperative societies. Thus, in 2010, support for democracy in the region increased for the fourth consecutive year. The proportion of those polled (Latinobarómetro, 2010) who considered democracy superior to any other form of government reached 61 percent, the highest rate of this century, up seven percentage points from 2007. At the same time, supporters of authoritarianism fell to 15 percent from a high of 19 percent in 2001. Also, 77 percent of respondents agreed that democracy is the best system of government, despite its problems, compared to 64 percent in 2003.

This survey provides as further evidence that the rights to vote and to be elected are firmly rooted in the region, so much so that these events no longer generate big

Figure 17

Support for Democracy in the Countries of Latin America, 1995–2010



Source: Latinobarómetro Corporation (2010). *Informe Latinobarómetro 2010*.

headlines beyond the expected coverage of the results of a change of municipal, regional, or national administration.

This was certainly not the case in the 1970s. In 1977, for example, only three Latin American and certain Caribbean countries had functioning democratic systems. Beginning with each country's return to democracy, progress has been intense and sustained. Despite moments of great instability in some countries during this shift—including the use of force in some cases—difficulties have been resolved within existing constitutional frameworks.

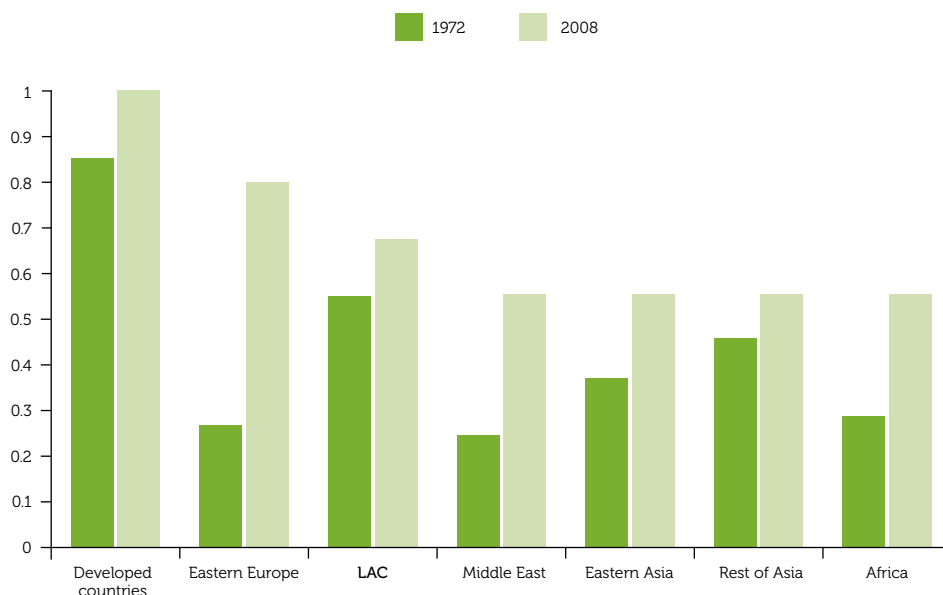
The citizens of the region increasingly opt for peaceful means to resolve conflict. There is a general acceptance of the results coming from the polls and, in many cases, high levels of voter turnout. In just one decade and amidst originally challenging economic circumstances, it has been necessary to create or restore institutions, and to correct and modernize existing systems.

In general, various metrics confirm that, compared to four decades ago, LAC countries have experienced undeniable progress in political rights and civil liberties. The consolidation of democracy has been accompanied not only by citizen participation in the electoral processes, but also by policy changes in the

multilateral institutions that have links to the continent. A typical example is the Inter-American Democratic Charter adopted by the Organization of American States (OAS) in September 2001. This charter made it clear that there was no room for de facto governments, and emphasized that countries choosing to continue on that path would be subject to convictions and sanctions by the hemispheric community.

Figure 18

Index of Political Rights and Civil Liberties, Global Regions, 1972–2008



Source: Freedom House (2008). *Freedom in the World 2008*.

Although at first glance an outside observer might think that the evolution of democracy in Latin America and the Caribbean has been limited to restoring the presidential system, a closer examination reveals that profound changes have taken place in the democracies of the region in recent decades.

A useful sidebar: it is important to recall that there are two democratic systems of government in the region, each with very different origins and challenges. One is the presidential system, in place in most Latin American countries, and the other

a parliamentary system, followed by most Caribbean nations, particularly those of English descent.

That said, it should be noted that the region's various efforts to strengthen democracy, including the issuance of new constitutions and the enactment of new legislation, are taking place in a political environment trending towards decentralization. Most LAC nations have addressed issues ranging from electoral mechanics to methods to strengthen the party or solve the perpetual dilemma of financing political campaigns.

It was generally believed that existing frameworks had to be adapted to each country's new economic, social, and political realities. This assumption went hand in hand with either substantial constitutional reforms or completely new versions of constitutions drafted by assemblies called by popular vote. Although separation of powers among the executive, legislative, and judicial branches have generally been maintained, changes in the redistribution of the workload, with variations by country, have recently taken place. In some cases, the executive branch now has more responsibilities than before, while in other cases, its functions have been reduced. In a couple of nations, the unicameral model has replaced the bicameral model for the legislative branch. The judicial branch has been given greater autonomy, including the authority to create new institutions, such as courts that specialize in a variety of matters.

In addition, there is a clear trend towards political, administrative, and fiscal decentralization, which aims to increase citizen participation. An element of this is the transition from a weak interventionist state to a much stronger regulatory state, with autonomous authorities like central banks and regulatory commissions. All of this is complemented by charters of fundamental civil liberties that establish constitutional rights and protection mechanisms such as the writ of amparo. At the same time, election systems have undergone major changes. Commonly, presidential elections undergo more than one round of voting, depending on factors such as the share of votes won by each candidate in the first round, and whether the number of votes exceeds a predetermined threshold. But clearly, the most notable change has been the trend toward presidential reelection, as evidenced in almost two-thirds of LAC democracies. In the majority of cases, there is the possibility of reelection for only one additional period in office, normally following the first term. This is something of a novelty in the region. This adaptation has also coincided with the shortening of the average presidential term (Payne et al., 2006).

The parliamentary election process has also been modified, either through minimum thresholds or through voting systems. The purpose of such reforms has been to avoid excessive fragmentation of political parties so as to promote larger, and more solid voting blocs. Since various combinations of formulas have been tried from country to country, there is no collective system. Nonetheless, all attempts have sought to increase accountability and bring members of the legislative branch closer to the electorate.

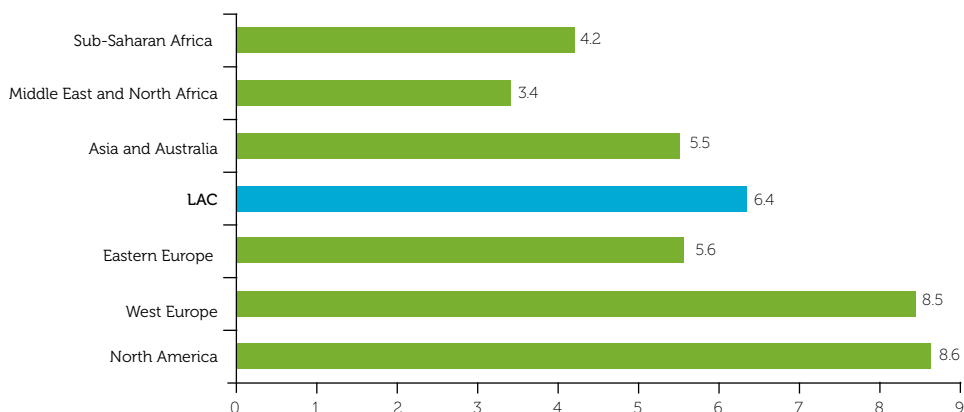
One of the most complex issues has been the strengthening of political parties as organized structures with political platforms. Countless formulas aimed at the internal democratization of parties have been tried to help render more transparency in the processes of identifying candidates and resolving disputes on specific matters.

The same is happening with political financing in the LAC region. Clearly, a mixed system is emerging, where, under an increasingly strict regulatory framework, contributions from the public budget based on votes are combined with private contributions. Oversight of this area has become the responsibility of new election authorities with the power to impose sanctions for violations. Unmistakably, democracy is not a static concept in LAC. In recent decades, efforts have been made either to correct perceived failures or to strengthen mechanisms that ensure transparency and participation.

The publication of indicators based on opinion surveys by *The Economist* and Latinobarómetro, for example, illustrates the recent advances of democracy in the region. The Democracy Index for 2010, compiled by the *Economist Intelligence Unit* (EIU) of the Economist Group, which measures the state of democracy in 167 countries around the world, ranked Latin America and the Caribbean as having the third-highest index level, after North America and Western Europe. The index focuses on five general categories: electoral process and pluralism, civil liberties, functioning of government, political participation, and political culture.

Figure 19

Democracy Index Average by Regions, 2010



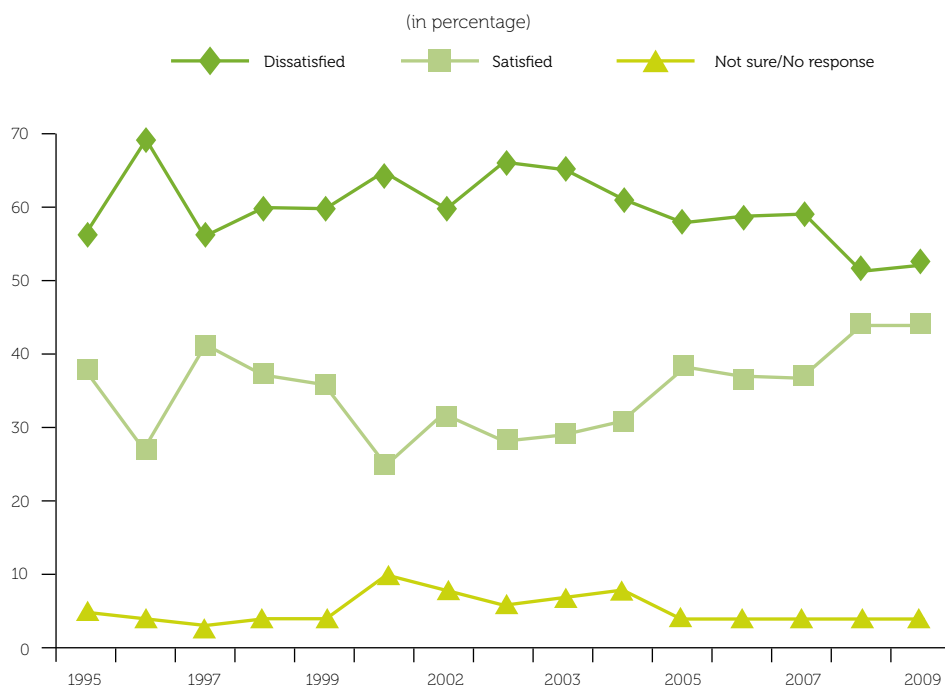
Source: EIU (2010). *Democracy Index 2010: Democracy in Retreat*.

The Latinobarómetro survey measures levels of satisfaction with democracy in Latin America and the Caribbean. Despite the fact that the majority of the respondents were dissatisfied with democracy, since 2003 the level of dissatisfaction fell from 66 to 52 percent. During the same period, satisfaction with democracy rose by 16 points to 44 percent in 2010. In other words, although the balance of negative and positive responses remains in the red, the gap between the two has narrowed significantly.

A look at the changing confidence in various institutions is equally revealing. In contrast to the Catholic Church, which has consistently been the institution with the most satisfactory ratings, at close to 70 percent—the worst ratings in 2010 were garnered by the legislative branch, the judicial system, and political parties, with 34 percent, 32 percent, and 23 percent, respectively. The executive branch, however, did not fare too poorly, receiving a 45 percent satisfaction rate, ahead of banks and private enterprise.

In addition, confidence in the state has only mounted. The share of those who believe that the state can solve all problems has doubled to 17 percent, while that of those who believe it can solve most problems is 29 percent.

In contrast, the percentage of those who believe it can solve only a few problems has fallen steadily to 28 percent. Against this backdrop, some final reflections should be made. This public support for democracy and its institutions should provide further incentive to continue legitimizing and strengthening needed reforms.

Figure 20**Satisfaction with Democracy in Latin America, 1995–2009**

Source: Latinobarómetro Corporation (2010). *Informe Latinobarómetro 2010*.

Having stated this, the achievements should be a shared source of satisfaction, given that they have been attained through a collective effort. One must not forget that, not long ago, many people, both within and outside the region, relegated LAC countries to an inescapable fatalism, in which societies—despite certain periods of apparent improvement—would be trapped in a vicious circle of low economic growth, insufficient social development, and, above all, a demonstrated incapacity for self-governance under legitimate standards. However, reality indicates that this forecast for the future of Latin America and the Caribbean, which has now arrived, did not have to be that way.

Nevertheless, this progress should not lead to complacency, but rather it should stimulate further improvements to democracy in the region. If the challenge of the recent decades was to expand and consolidate the systems selected by popular

vote, then, closing the door to a return to authoritarianism, the greatest challenge in this decade is to enhance the quality of democratic institutions.

Beyond the transformations of the State and its structures towards more efficient and modern systems, the democracies in most of the LAC countries still suffer from serious problems that limit their ability to achieve their full potential. The political party systems in many of the countries remain weak, and they are incapable of coalescing strong groups that can effectively express the varied political viewpoints within societies. Instead, there has been a predominance of “patronage” practices, in which any meaningful collective effort has been subsumed by structures that merely serve to further personal ambitions.

Likewise, party financing needs to combine formulas that allow for the effective funding to achieve their missions with systems that ensure transparency and accountability, moving from shade to sunlight, thus building society’s confidence in political parties.

Another pending task is the profound reform of justice systems. While numerous efforts have been made in this direction in recent decades, the remaining challenges are significant, in a key area for consolidating the rule of law.

Beyond the ethical imperative of having a high-quality justice system throughout the region, the current situation, in which various countries lack a secure and predictable judicial framework, not only limits the effective exercise of rights, but is also a drag on growth and development. In other words, these shortcomings also have an economic price, through lower investments and higher operating and transaction costs.

Along this same line, the persistent state of corruption erodes the quality of democracy and prevents the broadening of development horizons. Aside from its part in the illicit diversion of public resources for private purposes, corruption undermines the competitiveness of the region’s economies, seriously distorts the allocation of resources, and ultimately represents a glass ceiling limiting the medium- and long-term prospects for progress.

Despite advances in a variety of areas, such as the recognition of citizens’ access to public information as a right in Mexico, efforts to combat corruption in the region have often suffered from an overemphasis on investigation, focusing more on identifying cases of corruption than on attacking its root causes. Moreover, this approach adopted by law enforcement systems often constitutes an excessive burden for public figures and entities attempting to carry out honest actions, while at the same time it fails to prevent instances of abuse.

This situation makes it clear that, while much has been accomplished, much more work remains to be done. The successful changes that have been made should serve as a launching pad for further reforms, which are essential to strengthen and sustain the roots of democracy in Latin America and the Caribbean.



CHAPTER IV

The New Realities



The growth of the middle class, the emergence of a new business class reflected primarily in the rise of the *multilatinas*, and the expansion of South-South trade are undeniable expressions of a new reality in Latin America and the Caribbean.

There is no question that a swift and positive transformation has swept across the Latin American and Caribbean (LAC) region in recent years. Macroeconomic and social progress indicators alike reveal that the region is doing better and has achieved a greater weight in the global context. These improvements have been accompanied by institutional reforms pursued within a democratic framework.

However, behind the numbers and assessments lie other aspects that need consideration. Economic growth, combined with the reduction in poverty and improved distribution of income, have produced an expansion of the middle class. This development is very significant, given the role of the middle class as an engine of growth, and its implications for strengthening social cohesion and mobility (UNDP, 2010).

Moreover, the structural reforms of the 1990s, which in some cases produced discouraging results, brought greater competitiveness to various sectors, removed barriers to entry, and led to the emergence of a new business class. Today, we find ourselves with a private sector that has changed its way of doing business. It is less dependent on the state and operates within a framework of global competitiveness. Whereas the scope of business was previously confined to local and national markets, it is now increasingly common to cross national borders.

Something similar is taking place in the markets for goods. Today, far more LAC exports are bound for other regional partners or for emerging economies around the world. These new patterns will become even more evident in years to come, reflecting the structural change in global growth drivers, and a surge in domestic demand on the part of consumers, who have become more prosperous and confident about the future.

The Emerging Middle Class

In addition to changes in household size and composition associated with lower fertility and dependency rates and greater participation of women in the workforce, general economic growth and poverty reduction have brought about a wide ranging increase over the last 15 years in the average income of LAC households.

Although experts use different parameters to define and measure the middle class—based either on absolute values or on a range of values above or below a country’s median income—various academic studies show that this population group has expanded significantly.

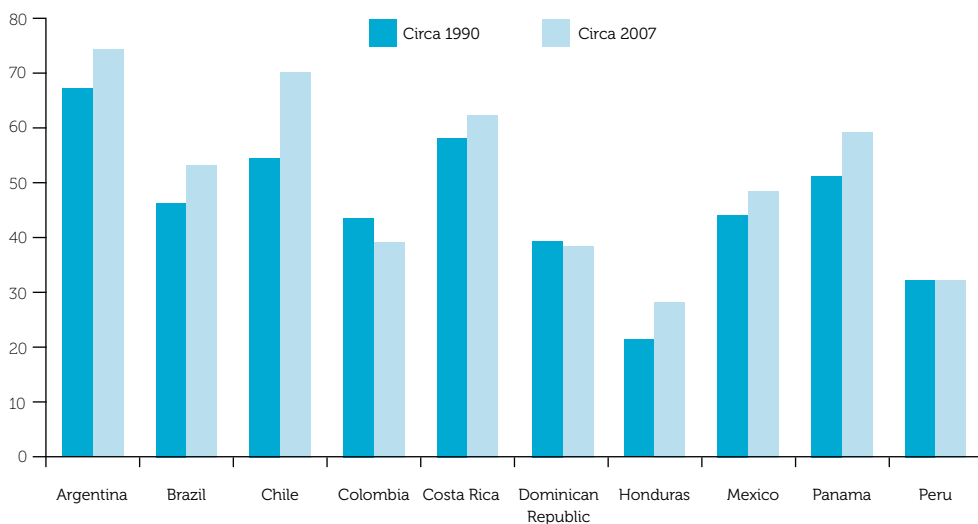
This expansion is important because, as some experts have asserted, a growing middle class brings greater stability to societies, generating new drivers of progress. Not only do new consumption patterns emerge, but educational levels rise as well, fostering social mobility and paving the way for greater innovation and entrepreneurship.

Equally important is the associated strengthening of domestic demand, which can lead to a greater variety of productive structures and a virtuous cycle of skilled employment and expansion of wealth. Moreover, in the case of Latin America and the Caribbean, progress has fomented confidence in democratic systems, which also has political implications.

The middle strata in LAC expanded by an estimated 56 million households between 1997 and 2007 (Franco, Hopenhayn, and León, 2011). Notwithstanding substantial differences from country to country, the significance of the trend is noteworthy.

Figure 21

Percentage of Middle-Class Households in Selected Latin American Countries, Circa 1990 and 2007



Source: Franco, Hopenhayn, and León (2011). "Crece y cambia la clase media en América Latina: una puesta al día."

A study conducted by Homi Kharas (2010) for the OECD defines the middle class as those households with daily expenditures between \$10 and \$100 per person, adjusted for purchasing power parity (PPP) in the different countries studied. Given this definition, in 2009, 1.845 billion people would have been considered members of the world's middle class, with some 181 million living in Central and South America. Europe accounted for 36 percent and North America for 18 percent of the total, and the emerging economies were home to nearly half of the middle class.

Estimates suggest that in the near future, more and more people will see a substantial increase in their purchasing power, which will give them greater access to consumer goods and enable them to also invest in education and fixed assets. To the extent that emerging economies can maintain a steadier pace of growth than their industrialized counterparts, with annual growth rates topping 6 percent, this trend will accelerate.

A document prepared by the Goldman Sachs Economic Research Group (2008), for example, finds that the number of people earning between \$6,000 and \$30,000 per year could rise by 2 billion by the year 2030. Kharas (2010) likewise calculates that the middle class, as he defines it, will grow to 3.249 billion by the year 2020, and to 4.884 billion by the year 2030. This will mean a fundamental change in patterns of spending and natural resource use, and will raise environmental and even policy questions. Kharas also asserts that middle class spending will increase to \$55.6 trillion (in 2005 dollars) by the year 2030, more than 2.5 times the current figure.

Table 5
Growth Projections for the Global Middle Class

	2009	%	2020	%	2030	%
North America	338	18	333	10	322	7
Europe	664	36	703	22	680	14
Central and South America	181	10	251	8	313	6
Asia Pacific	525	28	1,740	54	3,228	66
Sub-Saharan Africa	32	2	57	2	107	2
Middle East and North Africa	105	6	165	5	234	5
World	1,845	100	3,249	100	4,884	100

Source: Kharas (2010). "The Emerging Middle Class in Developing Countries, 2010."

Although the bulk of this growth will be concentrated in Asia, Latin America and the Caribbean will also gain ground. An interesting analysis by Mauricio Cárdenas, Homi Kharas, and Camila Henao (2011) reveals that the size of the LAC middle class—defined as people with incomes between \$10 and \$100 per day, adjusted for PPP in the various countries analyzed—will undoubtedly expand over the next decades, but that this increase will be primarily determined by the average rate of economic growth, rather than by the redistribution of policies. This is not to say that decreases in inequality indices are not relevant, but that the size of the pie—assuming no unusual changes—is much more significant than how the pie is sliced.

According to Banco Santander, the absolute figures do not lie; the banking group estimates that in seven economies in the region (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Uruguay) the middle class swelled from 174 to 242 million persons from 2000 to 2010, while the ranks of the poor fell from 166 million to 139 million. If current trends continue, in 2020 three out of every four households would fall into the middle class, seven percentage points higher than today (Luzón, 2011).

Along these lines, household income should continue to increase if positive growth projections for the region's countries over the next few years are realized. In an optimistic scenario, both the middle and affluent classes will gain ground, locking in social progress and creating a virtuous cycle that would permit new gains in the fight against poverty.

However, even this vision does not hide a disquieting reality, namely, the vulnerability of the middle classes in Latin America and the Caribbean given the scarcity of social safety nets or mechanisms to prevent downward mobility in the event of job loss or illness.

One of the key lessons of the crisis of the late 1990s was that the region's more developed countries witnessed the emergence of the so-called “new poor,” a term describing people whose income disappeared on account of hyperinflation, exchange rate disturbances, or GDP contractions.

The Emergence of a New Business Class

The structural reforms of the 1990s, which in some cases produced discouraging results, brought greater competitiveness to various sectors, removed barriers to entry, and led to the emergence of a new business class. In Brazil, Colombia, and Peru, among other countries, business associations changed their stance toward

trade liberalization from one of fierce opposition to one of explicit support, understated at times but nevertheless visible. The new generation of business people in the LAC region is not only more educated and less reliant on government, but also more connected to the world in a setting of global competitiveness.

Demographic trends have also helped in this regard. Countries in Latin America have a higher percentage of educated young people, based on total population, than developed countries. Looking purely at age, a more educated younger generation means a significant advantage in times of swift technological change.

The new business class has been nurtured by dynamic intellectual exchange. In previous decades, especially during the crisis at the turn of the millennium, many LAC workers emigrated to the financial, industrial, and academic hubs of the developed world. For example, nearly 10 percent of Colombian workers with postgraduate degrees left the country in the late 1990s. One decade later, many returned with fresh ideas and new contacts. Others have remained abroad but have served as enablers for import-export companies. Although this diaspora represented significant flight of human capital, it also created connections that today have become a novel, and all but unexpected, competitive advantage.

In some countries, public policies are aimed at promoting intellectual exchange. For example, the new Chilean fund created for study abroad allows beneficiaries to remain abroad longer. According to Alejandro Foxley, Chile's former foreign minister, "it is important to take a long range view of these opportunities (...). Most Indian students stay in the United States for 10 years or so and then return to their country with an impressive skill set, much more creative, and with many more international contacts" (Oppenheimer, 2010).

All of this is happening in the midst of a profound transformation. A growing tide of foreign direct investment (FDI) is flowing from emerging countries into every continent in the world. According to estimates by the United Nations Conference on Trade and Development (UNCTAD), in 1992 just 8 percent of the world's nearly 35,000 transnational companies were based in developing countries, whereas in 2008 this figure—out of a total of 82,000 companies—had risen to 28 percent.

Such change is related to capital flows, which are increasingly reaching emerging economies. Whereas in 2007 emerging economies received just a third of global FDI flows, in 2009 they received half. This change does not come as a complete surprise considering that emerging countries have the highest growth rates, expanding middle classes, and a considerable interest in taking advantage of their natural resources.

Even more surprising is that a good portion of FDI flows come from the developing countries themselves. Developing countries contributed 5 percent of all FDI in 1990, compared with 12.9 percent in 2007 and 20.8 percent two years later (UN, 2010). In other words, a major shift is taking place in the composition of global investment flows in terms of both origin and destination.

The LAC region has been part of this shift. Average annual FDI flows to the region increased from \$66.796 billion between 2000 and 2005 to \$103.376 billion between 2006 and 2010 (ECLAC, 2010b). Although the global crisis led to sizeable declines in the months following the September 2008 collapse of Lehman Brothers, data show that FDI flows rebounded 40 percent in 2010 to \$112.634 billion and may break historic records in 2011.

Against this backdrop, it is important to highlight the role of Latin American based multinationals, better known as *multilatinas*, which comprise a large number of businesses with a growing presence in various countries in the region. This is not a new phenomenon. Indeed, some firms have been launching operations in other latitudes for over a century. What is new is the magnitude of capital flows and the rising number of firms that are deciding to open offices in different cities, or buy existing businesses in different countries.

Nowadays, it is common to find a chain store that operates in several capital cities, a cellular provider that operates in the central and southern reaches of the region, or services stations in several countries that operate under the same brand name, to cite just three examples. What is revolutionary is that these companies might now be headquartered in Mexico City, Santiago, or São Paulo.

Without discounting the individual examples in the past, this transnational trend is relatively recent. Experts contend that because many of the region's economies were protected until the early 1980s, many firms chose to focus on their respective national markets. The effect was not only to stifle competition, but also to lead to the perception that barriers to entering other markets were prohibitive. According to the scholar Álvaro Cuervo-Cazurra (2008), it took some major companies half a century to take the first step—a period that has been significantly shortened in recent years.

I am in personal contact with hundreds of people running companies of every size and I can say with confidence that the vast majority have plans to expand to other LAC countries and to other continents.

In many cases, the process begins with offering products for sale in a neighboring country, followed by the opening of a field office and the installation or

purchase of productive infrastructure. Companies can also partner with local firms or franchises.

The new mindset of the private sector in Latin America and the Caribbean can be attributed in part to a company's desire to expand its potential market. Considering the cultural similarities shared by the different countries in the region, it is typically easier to take the first step within the region than in other areas of the world. For example, shared language and similarities between respective legal frameworks can lower the start-up costs of launching operations in another country.

Also, companies in the region have the capacity to be flexible and navigate what is often a complex universe of regulations, involving not only national but local authorities. Just as important is the example these companies set, since the burgeoning presence of the *multilatinas* has had a snowball effect, motivating more business executives to look for opportunities.

But beyond these reasons lies an interest in increasing sales and profits, and in achieving the critical mass needed to compete internationally. Specialists such as Javier Santiso (2006) have identified five general reasons for companies to go international, including access to technology, resources, markets, strategic assets, and a more diversified client base. Indicators demonstrating higher-than-average investment returns tend to weigh in on this decision.

In addition, there are two other factors. The strong performance of the Latin American and Caribbean economies has enabled firms that are operating in the region and around the world to generate more internal cash, producing the money they need to make purchases or scale up operations. Meanwhile, development of the capital market has opened the door to new stock or long-term bond issues at low interest rates. That relatively lower cost of funds, the result of lower risk premiums, has opened up new growth prospects for firms.

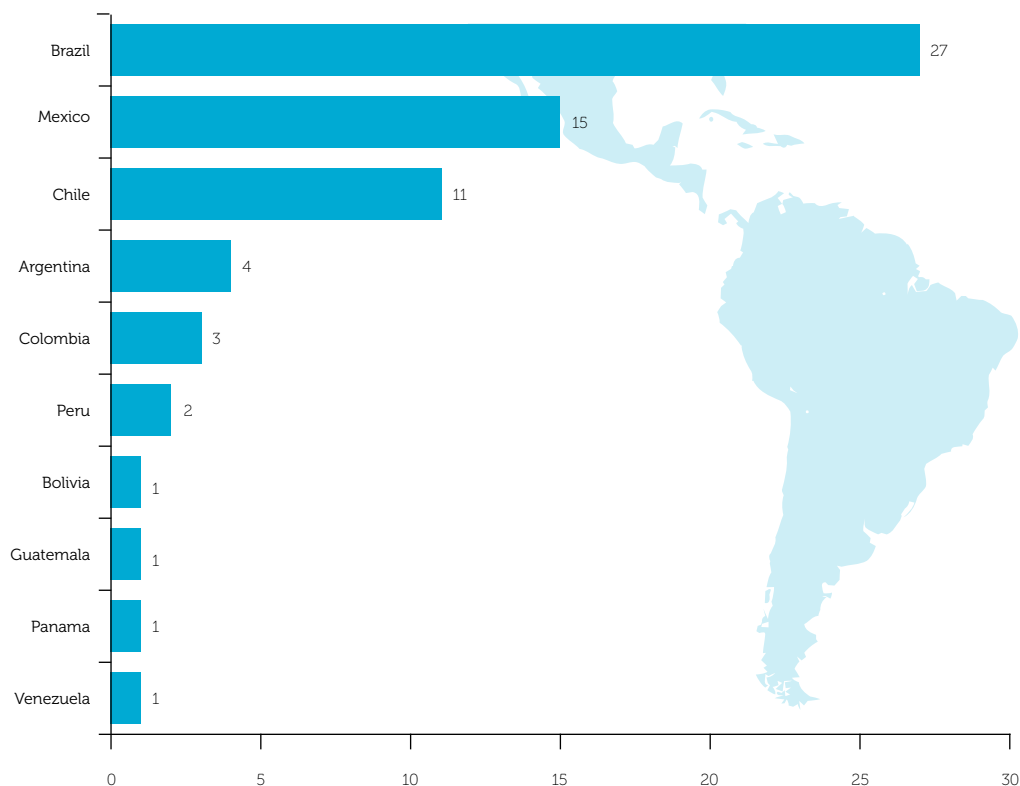
It is also noteworthy that the number of LAC countries with firms that are establishing offices outside of their countries of origin has grown. Whereas at one time the list was almost exclusively limited to Argentina, Brazil, and Mexico, it has recently expanded and now includes Chile, Colombia, Peru, and Venezuela. There are also examples of firms based in Costa Rica, Ecuador, El Salvador, Guatemala, and Panama—among other countries—that have decided to cross borders. Sales volumes might vary from one country to the next, but what is remarkable is the drive to expand operations, which has become more widespread in the region.

This focus has led to an increase in the region's investment assets. According to UNCTAD, capital investments by Latin American and Caribbean firms in

countries other than those where their headquarters are based rose to \$643 billion in 2009 (UNCTAD, 2010). Excluding capital from the region's financial centers, the amount was \$349 billion, a threefold increase over the amount at the beginning of the decade.

Figure 22

Number of *Multilatinas* in the Latin American and Caribbean Region, by Country of Origin, 2010



Source: América Economía (2011). "Ranking *Multilatinas* 2011."

According to ECLAC (2010b), LAC countries have experienced a significant increase in FDI over the last two decades, continuing a process characterized by three phases. The first of these occurred in the early 1990s, with the opening of trade, privatization of state enterprises, and deregulation of economies, with flows that were still low but growing, averaging close to \$3.0 billion per year. Later, between 1997 and 2003, this figure doubled to \$6.8 billion.

However, the real leap occurred between 2004 and 2010, when the median figure reached \$26.5 billion. In 2010 it reached a historic high of \$43.108 billion. Due to this massive increase, the region's share of FDI originating in developing countries rose from 6 percent in 2000 to 17 percent in 2010 (ECLAC, 2010b).

Given these dynamics, along with the region's bright economic outlook, development of capital markets, and the desire for market expansion, the private sector is expected to keep growing, with *multilatinas* gaining market share not only in the LAC region but also around the world.

The challenge is not easy, but the examples cited show that there is a high potential for establishing conglomerates that will strengthen the region's productive base, help its business sector adopt higher standards, and demonstrate that beyond the economies that will benefit from good commodity prices, there are firms ready to compete and develop the methods and technologies needed to expand in a world of opportunity.

Greater Integration and Cooperation

The business sector boom experienced in the LAC region has been paralleled by a boom in foreign trade, with exports rising from \$119 billion in 1980 to nearly \$900 billion in 2010 (ECLAC, 2010d). This expansion has come about in the context of impressive growth in international trade. In fact, the region's exports have grown more slowly than those of Asia or even Africa, especially in the new millennium. But that fact does not detract from the region's achievements, especially given the shift in trade flows to different markets.

While developed countries are buying a smaller percentage of Latin American and Caribbean goods, countries from the region, as well as other emerging economies, are gaining an ever-larger share. Much of this evolution can be attributed to the ratification of agreements that have deepened integration and which differ radically from the experiments of half a century ago, when an inward-oriented growth model was adopted. For the last 20 years, the prevailing model has been one of "open regionalism," characterized by fewer barriers to entry and additional preferential treatment for regional countries or for specific partners as a result of bilateral agreements.

In practical terms, this means that trade restrictions have generally eased, while tariffs have decreased on average from 40 percent in 1985 to about 9 percent today, and they continue downward (IDB, 2009b). The present multipolar approach has

been accompanied by unilateral openness, regional integration plans, free-trade agreements with partners around the world, and multilateral negotiations in the framework of the World Trade Organization (WTO), to which the vast majority of LAC countries belong.

It is now common practice for bilateral and even regional agreements to go beyond trade in goods. Agreements are increasingly negotiated to encompass what are known as second-generation areas such as services, investment, phytosanitary standards, intellectual property rights, and government procurement.

The confluence of these factors has much to do with the rise in exports. But perhaps the most remarkable development has been in intraregional trade, which has grown nearly tenfold since 1990, from \$18 billion to almost \$180 billion in 2010, representing about 19 percent of total billings (ECLAC, 2010d).

This growth has been somewhat faster than growth around the world, where a structural transformation has also taken place. Between 1990 and 2008, South-South trade between emerging economies grew at an average annual rate of 13 percent to about \$2.9 trillion. As a result, the share of these flows in overall global trade increased from 9 percent to 18 percent during this period. In the case of LAC, South-South trade accounts for close to 30 percent of total foreign trade, and Asia's share has grown to nearly 9 percent. Africa and the Middle East account for 1.7 percent and 1.1 percent, respectively. The contribution of the United States—still the LAC region's main trade partner—declined from 60 percent to 40 percent during the period in question, while Europe's share has remained relatively stable at about 13 percent (ECLAC, 2010e).

The single most dramatic development has been the increase in sales to China, a country that bought less than 1 percent of the region's exports at the dawn of the new millennium but rose to 8 percent in 2010. Most telling, in 2009 sales to the United States and Europe slid by 26 percent and 28 percent, respectively, while sales to China climbed by 5 percent (ECLAC, 2010f). China has become one of the five largest markets for over half of the region's economies, including the more heavily populated ones.

The increasingly significant presence of China in Latin American and Caribbean trade is the result of the region's growing vitality. Between 2000 and 2009, the region's import and export trade grew faster with China than did the trade of any other region, with annual rates in excess of 20 percent (ECLAC, 2010f).

This, in turn, was the result of increased commodity sales, which have quadrupled since the 1990s. Products such as oil, copper, soybeans, coffee, bananas, iron, and steel are being shipped in ever-growing volumes across the Pacific Ocean.

The result has been that commodities have come to account for almost 40 percent of the region's export basket, after having fallen to 26.7 percent in the late 1990s. This figure is still less than in 1981, when commodities accounted for 52 percent of the region's exports, but given global trade patterns, many analysts predict that it will continue to rise.

There is a growing concern that these developments could lead to a decline in sales of semi-manufactured and industrial goods, or that sales in primary inputs will grow much faster than manufactured goods due to a combination of larger volumes and higher prices. In this scenario, authorities must implement policies to prevent excessive appreciation of local currencies amid global turbulence in this area.

New opportunities in South-South trade will also be crucial for the LAC region. The higher growth rates forecast for the emerging economies will entail a redrawing of international trade flows, an opportunity that Latin America and the Caribbean should seize. Possibilities include forging stronger regional ties by deepening integration initiatives such as the Andean Community (CAN), the Caribbean Community Secretariat (CARICOM), the Central American Common Market, and the Common Market of the South (MERCOSUR). In addition, agreements between individual countries and groups of countries should be pursued in order to boost the volume of business.

Furthermore, it is important to mention the increasing trend of free-trade agreements negotiated between LAC countries and Asia. More agreements, together with rising investment flows, should make for stronger ties between these two regions, which are separated by thousands of miles, but joined by the Pacific Ocean. LAC countries should also continue efforts to diversify not only exports but also destination markets. Such diversification will involve pursuing opportunities in Africa, Central and Eastern Europe, the Middle East, as well as Asia beyond India or China.

To meet these objectives, greater efforts to develop the region's export sector and carry its products to all areas are required. Initiatives must focus on the expansion, deepening, and convergence of existing trade agreements, as well as the financing of interventions to help lower shipping, logistics, and supply chain costs.

The growth of the middle class, the emergence of a new business class reflected primarily in the rise of the *multilatinas*, and the expansion of South-South trade are

undeniable expressions of a new reality in Latin America and the Caribbean that has created profound change and that promises even greater progress.

Beyond the figures that illustrate these broad trends are millions of people with substantially higher incomes, who work at firms that operate in countries other than their countries of origin, and who stand to benefit from growing ties among LAC countries, as well as with nations in other parts of the world. The number of individuals who benefit from this trend will surely increase in years to come, as strong winds of progress sweep across this part of the world.



CHAPTER V

Ongoing Challenges



The challenge in this opportunity is to undertake the structural transformations needed to chart a better course.

The vast majority of signs marking the route for the Latin American and Caribbean (LAC) region point in the right direction. The right mix of internal and external circumstances should allow growth to be much greater in the coming years than in the recent past, and the countries of the region should be able to consolidate and extend the progress made so far this century in the fight against poverty.

However, the fact that the winds are favorable does not eliminate the possibility that things may not turn out as many hope if effective policies are not adopted and if barriers to more rapid progress are not recognized. Skeptics point out that this is not the first time in history that a confluence of positive events has come together. During the 20th century, there were numerous examples of favorable conditions that led people to believe that many LAC countries were poised to leap into prosperity. But those expectations ultimately dissolved in the face of the complacency that sometimes accompanied prosperity. Temporary booms served as excuses to put off reforms or as occasions for greater spending (sometimes lavish spending) that turned out to be unsustainable when the prices of certain products dropped or promising markets closed.

Consequently, the current challenge is not only to remember and learn from those lessons, but also to undertake the structural transformations needed to chart a better course. Only then will it be possible for the positive figures that should complement this decade to be maintained beyond 2020. In other words, the objective is not only to do well now, but also to lay the groundwork so that strong performance is more the rule than the exception in the future. Only through responsible decision making will the region be prepared to withstand the storms that will no doubt return periodically—the road to development is not straight and smooth, rather it is strewn with obstacles and hazards that must be negotiated.

Ongoing efforts must therefore be made to lock in gains and build on them. The region has shown a serious commitment to maintaining macroeconomic stability, laying the foundation needed to meet other structural challenges, no less complex, on a firm footing.

Among the many challenges the LAC region must face is low productivity, which prevents more rapid growth, coupled with low levels of competitiveness. Improving the productivity infrastructure, enhancing integration, and better enabling the region's economies to innovate and adapt technologically, not to mention continuing to improve the investment climate, are complementary high priorities.

Continuing to advance the pending social agenda is also important. Marked income gaps and unequal access to better services and opportunities affect social mobility and stand in the way of building more just and prosperous societies. Efforts to improve the quality and relevance of the educational system are essential in this regard, as are efforts to curb informal employment. The issues of violence, crime, and justice also deserve special attention.

The region's vulnerability to the effects of climate change and natural disasters make becoming better prepared to prevent and counteract the impacts of global warming an urgent priority. That preparation includes the promotion of sustainable development strategies and cleaner technologies.

Any of these issues—along with potential political setbacks or setbacks in the preservation of the climate for peace—can dash today's opportunities. It is therefore a good idea to identify the hazards, determine how to address them, and respond to the questions they elicit.

Implicit in all this is the continued consolidation of better government at the regional, national, and local levels. Sound governance is essential to meet these challenges effectively and ensure that the region makes the most of arising opportunities.

The Challenge of Productivity

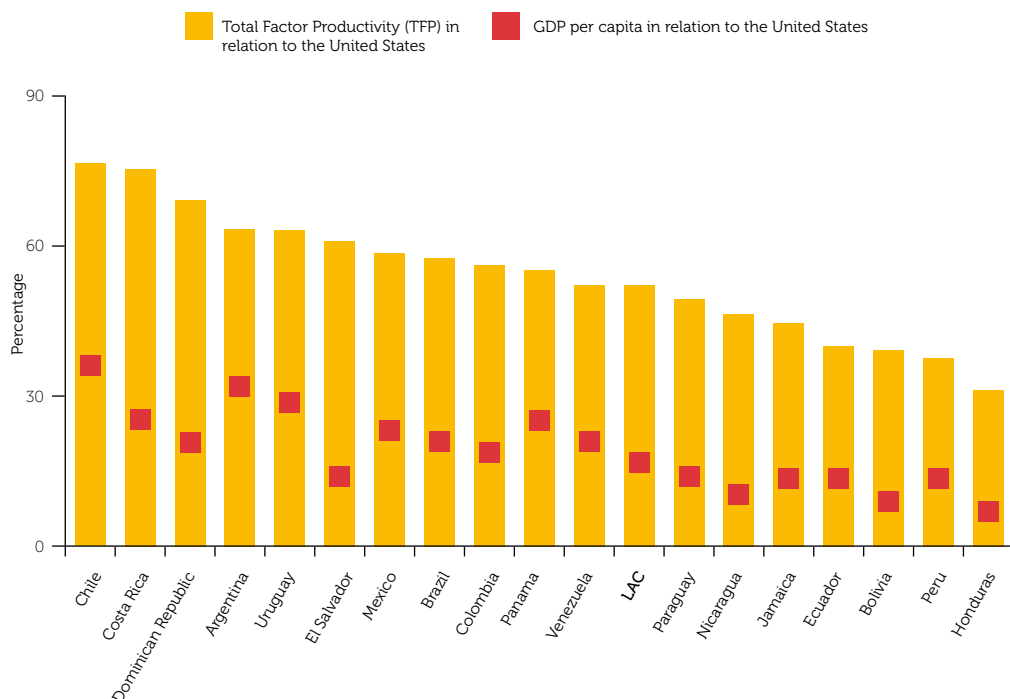
Over the past 15 years, LAC countries have seen improvements in their economic and social indicators. Between 1994 and 2008, the region's GDP increased at an average annual rate of 3.4 percent, the population grew annually by 1.4 percent, and per capita income rose by 1.9 percent per year. From a long-term perspective, however, growth in the region has lagged that of both developed and other emerging economies.

For example, in 1960 the annual income of the average Latin American was one-quarter that of someone in the United States, while currently it is only one-sixth. In comparison, several Southeast Asian countries that were considerably behind the LAC region in 1960 are now close to being classified as high-income countries.

Contrary to popular belief, low levels of investment are not necessarily responsible for this weak performance. Low and slow productivity, more so than barriers to accumulation of the factors of production, better explains the LAC region's low income in comparison with those of developed economies, and its sluggishness with respect to other emerging economies.

Figure 23

Relative Productivity in Latin America, 2005



Source: IDB (2010a). *The Age of Productivity: Transforming Economies from the Bottom Up*.

According to estimates from a major study published by the Inter-American Development Bank (IDB, 2010a), the productivity of Latin America and the Caribbean is not quite half of its potential. Closing that gap would eliminate most of the difference in per capita income between the region and more developed countries. As an example, simulations conducted by the IDB's Research Department indicate that if the region were to employ its current physical and human capital

resources with the same productive efficiency as the United States, per capita income would double and the region's relative income would be one-third that of the United States.

The IDB study describes a region consisting of few highly productive companies, and countless businesses with extremely low productivity levels. One of the region's challenges is to increase the percentage of companies that achieve average productivity. Simply increasing the number of companies that meet that mark could double aggregate productivity. This alone would be enough to close the current gap. This is just one of the study's conclusions that invite the rethinking of policies in place in the region.

The same study also points to the services sector—particularly the broad subsector of retail trade—as primarily responsible for the aggregate productivity problems. In fact, agricultural productivity has grown at a brisk pace, but the percentage of the LAC labor force still working in farming is relatively small. The number of workers employed by the industrial sector decreased as productivity in that sector dropped. This means that the largest share of the working population works in the service sector—the one having the most productivity problems—, which has devastating consequences for aggregate productivity. Given the productivity issues, export-driven growth strategies might be incomplete.

Low productivity in the region has many causes. The IDB study also found strong evidence that high transportation and logistics costs, informality in business and labor, limited access to credit, discriminatory tax regimes, and lack of innovation are at the root of the region's slow productivity growth. These factors create a double barrier to productivity growth, since they not only prevent productive enterprises from growing in size, but also hinder less productive ones from becoming more productive.

The barriers to productivity growth are relatively easy to identify. Designing and implementing a coherent policy mix that would bring about a country's productive potential is much more complex and involves immediately applying corrective measures and adopting long-term strategies. The latter is not easy because it is coupled with the elimination of privileges and the introduction of new approaches.

The good news is that the bottleneck is not necessarily the lack of resources but rather the will to apply effective policies and to reform institutions based on successful experiences in other parts of the world. Accordingly, work needs to be done to reduce transportation costs, something that extends far beyond not having adequate infrastructure and includes poor regulation, weak operating systems, and the lack of competition in the supply of services.

At the same time, it is necessary to continue to deepen the region's financial markets, since access to credit is still limited. The fact that LAC came out of the global financial crisis nearly unscathed is an incentive for lenders to increase their activity and target their resources at sectors and companies that can increase their efficiency.

Another area worth highlighting is the payment of taxes. Despite successive reforms, completing the necessary tax forms notably takes an average of 320 hours each year in LAC, compared with 177 hours in high-income countries (IDB, 2010a). Simplifying these convoluted procedures that encourage tax evasion and delay tax collection efforts is imperative.

Improvements need to be made on the social front as well, especially with respect to public health and pension systems. It is also urgent to review strategies targeting small and medium-sized enterprises, where the vast majority of private sector activity in the region is concentrated.

Making the necessary changes is fraught with difficulties; however, the rewards are undeniable. Productivity is the key to increasing both real wages over the long term and the incomes of households that do not form part of the salaried sector. At the same time, increasing wages and other sources of income is essential to sustainably reduce poverty in the region.

The Competitiveness Issue

A complementary way to view the challenges that the Latin American and Caribbean region faces in providing for sustained increases in productivity over the coming years is to analyze its competitive position within the global economy. Indices vary on this point, and measure different variables. However, the best known of these, conducted by the World Economic Forum (WEF), looks at this as the set of institutions, policies, and factors that determine a country's degree of competitiveness (WEF, 2010).

Some of these variables change slowly over time. Even changes in countries' scores illustrate this, with shifts in a country's ranking tending to be only moderate from one year to another. This indicates the potential of the countries to increase their productivity in the coming years.

The position of the LAC countries in this ranking reflects the magnitude of the challenges ahead. Only 2 out of 22 Latin American and Caribbean nations included in the classification are in the top 50 of the 133 countries considered, with Chile being the most competitive at number 30. Recent macroeconomic improvements

in the region have led to overall upward movement in the rankings. However, it is precisely in the microeconomic area and the quality of institutions that the LAC countries are farthest behind the highest-ranked countries. This relative weakness is also clear in their scores for business sophistication and innovation capacity.

Table 6

Global Competitive Index Rankings in Latin America and the Caribbean, 2010–2011

(selected countries)

Country	Ranking 2010-2011
Chile	30
Barbados	43
Panama	53
Costa Rica	56
Brazil	58
Uruguay	64
Mexico	66
Colombia	68
Peru	73
Guatemala	78
El Salvador	82
Trinidad and Tobago	84
Argentina	87
Honduras	91
Jamaica	95

Source: WEF (2010). *The Global Competitiveness Report 2010-2011*.

Efforts must be made to make the economies more competitive and to remove obstacles to increased productivity, and these efforts require public-private collaboration. Indeed, the public sector controls many of the variables that impede or stimulate growth and investment; however, the private sector provides the information regarding which of these constraints are the most significant at the national, sectorial, and regional levels, as shown by the recent IDB study on productivity (IDB, 2010a). Companies, both small and large, compile the data on bottlenecks and on what is needed to step up innovation and investment.

The most competitive countries gather input from the private sector and capacities in the public sector through institutions such as competitiveness councils, which help ensure that public-private interaction generates quality information for policy decisions, while demonstrating sufficient transparency to avoid having the process co-opted by the interests of sectoral or individual firms. This makes it possible to eliminate ineffective regulations and bureaucratic roadblocks and create business promotion programs to provide companies the public goods they need to invest and grow.

In Latin America and the Caribbean, there are already national and subnational institutions fulfilling this mission, though there are only a few and they are recently formed. The most successful of these institutions have increased the levels of trust between public and private actors in the region and have learned that a pro-competitiveness consensus is not a *zero-sum* game, but rather a win-win affair.

LAC countries also face major challenges in terms of doing business. After an intense period of reforms over the last two decades, various analyses suggest that the zeal for reform seems to have cooled in the region, despite recent advances in countries such as Peru and Colombia. This slowdown in terms of improving the business climate is having a negative effect on growth potential. In many cases, excessive regulations provide perverse incentives for businesspeople and workers to stay out of the formal sector, rendering public policies ineffective.

Small informal businesses are deciding not to expand, since they would in effect be penalized by the high costs of formalization. This keeps their productivity low, due to the lack of scale and minimal access to formal credit and technical assistance. This is, in short, a vicious circle, one that must be broken quickly by implementing clear policies that provide more cost-effective incentives.

Imbalances in Infrastructure

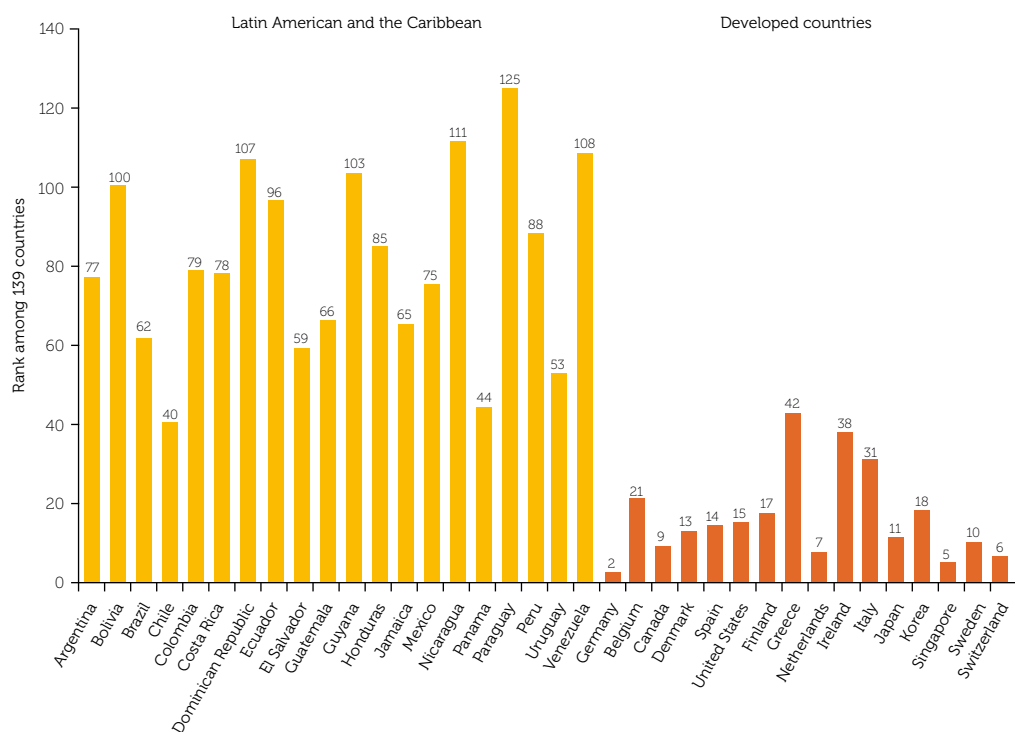
The issue of infrastructure debt comes up repeatedly in casual conversations as well as in formal presentations made by people in the public and private sector. It typically relates to the effort that the LAC countries need to make to improve their infrastructure. The general impression of the region's inhabitants, and of its visitors, is that there is significant debt in the region, that debt is increasing rather than decreasing, and that it seriously affects the competitiveness of companies and the quality of life of the region's citizens.

The impressions of debt and its effects are both correct and incorrect. The contradiction stems from the fact that progress has not been uniform across the areas that compose infrastructure; circumstances differ in terms of coverage of electricity services, water supply and basic sanitation, telecommunications, and the conditions of roads, ports, and airports.

Even so, the pace of infrastructure debt accumulation in the LAC region was particularly slow during the last two decades of the 20th century, resulting in a widening of the gap between the region and other continents. The fiscal adjustments that became necessary following successive crises sparked by the foreign debt debacle in 1982 led to deep cuts in public investment. Thus, public investment in infrastructure fell from the equivalent of 3 percent of GDP in 1980 to less than 1 percent at the beginning of the 21st century (Andrés et al., 2010). In recent years, budgets have again increased along with fiscal strengthening resulting from higher growth rates, but not resolutely.

Figure 24

Global Competitiveness Index (2010–2011), Infrastructure Pillar



Source: WEF (2010). *The Global Competitiveness Report 2010–2011*.

Privatization of services companies and the influx of foreign capital into the LAC region led many planners to believe that the latter would offset government action, something that occurred only partially. This is not to say that the influx of private investment should be overlooked. Between 1990 and 2007, \$474 billion in private resources was invested in infrastructure, allocated among 1,243 projects. Of that amount, 47 percent was earmarked for telecommunications, 30 percent for energy, 18 percent for transportation, and 5 percent for drinking water. However, the rate of influx of resources has been decreasing and it is at less than one-third of the peak recorded in the last decade of the 20th century (IDB, 2009).

The importance of this investment is obvious but worth revisiting. Numerous studies show that high-quality infrastructure helps companies become more productive and more competitive internationally. At the same time, it helps leverage the benefits of trade liberalization, favoring both consumers and emerging new businesses. Progress on this front has positively affected health and education and has helped to reduce the income disparity among regions and among segments of the population.

The gains from increasing investment in infrastructure would be remarkable. Calderón and Servén (2004) have maintained that the region's economic growth would increase by 2.6 percent if all the LAC countries were to measure themselves against the Latin American nation leading in this area. Conversely, if the benchmark were South Korea, the increase in GDP of some countries could exceed 5 percent annually.

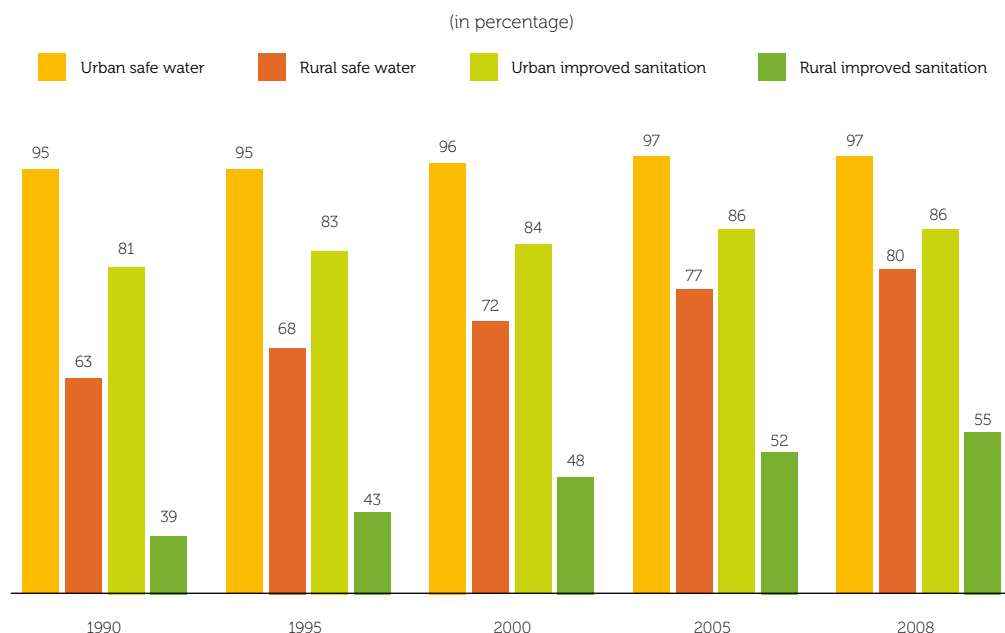
One of the explanations for this has to do with the heavy burden of logistics costs, which range between 18 percent and 34 percent of regional output, compared with an average of 9 percent among OECD countries (Barbero, 2010). Understandably, the LAC region lags other regions in the WEF figures in this area, only ahead of sub-Saharan Africa.

Each area of infrastructure should be briefly reviewed due to their particular characteristics. First, it is impossible to ignore the progress made in access to water and sanitation services. The region's rate of access to clean drinking water rose from 85 percent to 93 percent between 1990 and 2008, according to WHO/UNICEF standards. Likewise, access to sanitation rose from 69 percent to 85 percent (IDB, 2010b).

The high rates of coverage hide substantial variation in availability of services from country to country and within a given country. The high rates also obscure differences in access, continuity, and quality between urban and rural areas, and among income groups within cities (IDB, 2007).

Figure 25

Trends in Urban and Rural Access to Improved Water and Sanitation in Latin America and the Caribbean



Source: IDB (2010b). *Drinking Water, Sanitation, and the Millennium Development Goals in Latin America and the Caribbean*.

More needs to be done to improve this situation. According to IDB analyses, an investment of approximately \$39 billion will be needed between 2011 and 2015 to achieve universal coverage (IDB, 2010a).

There has also been rapid progress in the access to electricity: coverage rose from 42 percent in 1971 to 70 percent in 1989, and it is now close to 93 percent (Ávila, 2009). In fact, in many countries in the region, the entire population has access to electricity, although calculations suggest that close to 50 million people are still in the dark.

These improvements are largely due to the development of interconnected systems that have increased service quality and efficiency, including a decrease in payments evasion, known as black losses. Perhaps most notable is the use of cleaner methods of generating power: the construction of large hydroelectric plants made it possible to reduce reliance on thermal plants. In some areas, hydroelectric generation accounts for 85 percent of the power supply (IDB, 2009).

Climate change has required greater electricity supply cushions. Severe droughts have affected river flows, leading to energy rationing in many countries, requiring offsets by new investments.

Rapid action is needed in this area based on the fact that global energy consumption is expected to increase by approximately 50 percent over the next two decades; the LAC region will be no exception (IDB, 2008b). The increase in demand will require additional resources and efforts to optimize both generation and consumption. IDB calculations suggest that the region could avoid one-third of that increase by adopting regulatory measures and policies that encourage energy savings (IDB, 2008b).

Joining forces is necessary and is the logic behind the Central American Electric Interconnection System, known as SIEPAC. Its design and development involved the participation of numerous public and private entities and includes the construction of 1,788 kilometers of 300-megawatt transmission lines. The initiative, which is close to completion and has been supported by IDB loans, links all Central American countries from Guatemala to Panama, and should enable net savings of \$1.16 billion, a more robust and capable energy supply, and savings of up to 23 percent in generation costs, a large part of which will directly benefit users.

Another area that warrants attention in the region is telecommunications, where, as in other parts of the world, a rapid change has occurred. Thanks in large part to private sector investments, the LAC region is catching up to other regions much faster than expected. Nevertheless, there are substantial differences in access to telecommunications from country to country associated with income, infrastructure, education, and quality of regulation (IDB, 2010b).

Mobile telephony is particularly important. The pace of adoption has been unparalleled among technologies, reaching penetration rates of nearly 90 percent in 2008, compared with less than 30 percent in 1998. In fact, the number of cell phones operating in the region is the second highest in the world—ahead of Europe but behind Asia, which has a much larger population.

The number of broadband connections in the region increased to approximately 34 million in 2009, according to data from the United Nations' International Telecommunications Union (ITU, 2010). However, the penetration rate is still low because, among other reasons, charges are relatively high and high-speed networks are not available in all communities. There is hope that the “digital divide” will continue to narrow, as smartphones are becoming more popular.

Table 7

Information and Communication Technology (ICT) Subscriptions per 100 Inhabitants, OECD Countries and Latin America and the Caribbean

	Subscriptions per 100 inhabitants			
ICT	OECD 1998	OECD 2008	LAC 1998	LAC 2008
Mobile	25.7	114.8	3.4	86.3
Fixed	51.1	43.8	18.1	21.1
Internet	4.7	27.3	0.8	6.9
ICT	OECD 2000	OECD 2008	LAC 2000	LAC 2008
Fixed broadband	1.1	24.7	0.03	6.2
ICT	OECD 2002	OECD 2008	LAC 2002	LAC 2008
Mobile broadband	0.03	29.7	0.0	1.9
	Number of personal computers per 100 inhabitants			
ICT	OECD 1998	OECD 2006	LAC 1998	LAC 2006
Computers	24.8	54.4	5.5	11.3

Source: IDB (2010c). *Science, Technology, and Innovation in Latin America and the Caribbean: A Statistical Compendium of Indicators*.

This is essential, as modern-day commercial and social dynamics increasingly rely on ubiquitous connectivity and high data capacity. However, it will not occur unless the public and private sectors partner to bring broadband service to many additional citizens, companies, and regions.

Notwithstanding pending needs, progress in telecommunications and the radical change experienced by the region compared with the situation a couple of decades ago has unfortunately not been mirrored by the transportation sector. There is a significant lag in the development of highways and there are obvious bottlenecks in ports and airports due to an increase in the transport of cargo and passengers. The outlook is even more concerning in the railway sector, where the total number of kilometers of track has fallen from the total 40 years ago.

Added to those problems is the deficit in urban highways and streets, given the increase in the number of vehicles. It is not surprising that traffic jams are more

the rule than the exception in large cities, and that the trend is toward further deterioration. In terms of mass transit, conditions are quite mixed. Although some LAC cities have tried out new systems, progress is slow.

Without a doubt, the most complex issue is highways, because of the scale of the required works and the costs involved in making up lost ground. Various indicators evidence the enormous challenges: highway density is low and the percentage of paved roads is less than half of those in middle-income countries, and one-third of the rate in South Korea (Fay and Morrison, 2005).

Table 8

Paved Roads and Highway Density

	Paved roads (%)		Highway density (km/km ²)		Paved highway density (km/km ²)	
	1995	2006	1995	2006	1995	2006
Latin America (15)	22	29	0.17	0.17	0.02	0.03
U.S.	61	65	0.69	0.71	0.42	0.46
OECD (9)	85	86	1.74	1.82	1.29	1.40
High-income (4)	84	91	1.74	2.23	0.17	0.33
Middle-high income (4)	74	80	0.74	0.86	0.02	0.02
Low-income (4)	19	36	0.08	0.11	0.03	0.01

Notes: Latin America: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay; OECD countries: Belgium, Czech Republic, Denmark, Finland, France, Japan, New Zealand, Switzerland, and the UK; high-income countries: Cyprus, Israel, Singapore, and Slovenia; middle-high income countries: Kazakhstan, Latvia, Letonia, and Mauritius; low-income countries: Afghanistan, Mauritania, Nigeria, and Pakistan.

Source: IDB (2010c), *Science, Technology, and Innovation in Latin America and the Caribbean: A Statistical Compendium of Indicators*.

Poor road conditions and increased traffic translate into lower competitiveness indices and increased accident rates, which leads to greater loss of human life. In the past, efforts were made to overcome this problem through the concessions or through public-private partnerships. These ventures have not always gone as expected, as evidenced by a high rate of contract renegotiation and legal disputes. This is not to say the private sector does not have a role in the transportation sector. In fact, certain successes have made progress possible and should be replicated. However, these facts should not lead to the belief that the government's role can be fully replaced. Indeed, calculations by specialists show that to reduce the current gap, LAC countries would have to double or even triple the share of resources allocated to infrastructure for at least two decades, equivalent to 6 percent of GDP.

In addition to increasing allocations to infrastructure, it is important to learn to spend smarter. It is typical in the region for works to end up costing much more than originally estimated, as a result of a lack of detailed plans and proper project structuring and management. More efficient systems, along with an increase in government budgets and the targeted investment of private capital, are therefore needed to eliminate the many bottlenecks affecting infrastructure.

Untapped Potential of Small and Medium Enterprises

In the economies of Latin America and the Caribbean, small and medium enterprises (SMEs) are a major, though underdeveloped, source of jobs, productivity gains, and long-term dynamic growth. In the LAC region as a whole, SMEs represent a smaller proportion of total businesses, and have lower productivity than in other countries with similar income levels.

An increase in the proportion of productive formal SMEs in the region would have a significant positive effect on economic growth and living standards (IDB, 2010a). Well-designed policies and programs to support productive SMEs could contribute to long-term dynamic growth and to the creation of more and better jobs, to the extent that resources flow to the most productive businesses. Accordingly, correcting the market distortions and failures that limit the productive growth of SMEs must be an essential element in policies and programs for boosting regional productivity.

In recent years, the region has witnessed greater macroeconomic stability and sustained growth in production and income, but productivity gains have lagged in economies that have placed greater emphasis on capital accumulation and labor, and less on technological and management innovation that could boost production efficiency (Daude and Fernández-Arias, 2010; IDB, 2010a).

One factor that contributes to low productivity is a scarcity of the dynamic, productive SMEs that can be found in developed economies. In terms of the distribution of different sized businesses, LAC suffers from “the missing middle,” that is, those that fall between large and very small businesses, with few SMEs proportionally and generally employing fewer workers than in developed economies. In the manufacturing sector, for example, smaller businesses with lower average productivity dominate the productive spectrum.

A variety of limitations inhibit the growth of productive SMEs. For example, the data indicate that when businesses have restricted access to credit, their earnings and productivity are lower (McKenzie and Woodruff, 2006; Guirkingier and Boucher,

2007), and the reality is that most SMEs in the region face credit constraints. A recent analysis shows that nearly 80 percent of SMEs are underserved by the financial markets (IFC, 2010). Limited access to credit is the result of various factors, such as the limited ability of the financial institutions to evaluate risk associated with such loans; a lack of creditor rights and enforcement mechanisms; and the absence of innovative financial products (capital, insurance, factoring, and leasing). In part, this is the consequence of underdeveloped lending markets and a limited range of financial instruments. Structural factors that include volatile growth patterns, the displacement caused by fiscal demand for funds, and low domestic savings rates restrict financing.

In addition, innovation in the financial markets is limited by the lack of a robust regulatory system and weak corporate governance practices. These factors, coupled with the high costs of acquiring information and exercising property rights, reduce the market's ability to increase available financing.

SMEs also face structural obstacles, such as their small size and the consequent lack of economies of scale and limited reach. Transaction costs weigh more heavily on smaller companies, affecting their profitability and growth potential. Lastly, there are major flaws at the market and government levels that limit SME growth. The former are due to the presence of externalities, coordination problems, lack of markets (insurance against macro instability and catastrophic events), and asymmetrical information that affects the yields of factors of production. Thus, the markets do not properly reflect economic costs and benefits. The latter can be caused by poorly designed interventions that distort the markets, or by the co-opting of regulatory or policy processes by individual interests. A new generation of productive development policies could address these issues, through specific, targeted programs to promote more effective outcomes.

LAC countries have seen a resurgence of such policies in recent years. While these policies have left behind certain characteristics central to the region's old industrial strategies (such as import substitution), they have reintroduced many of the unresolved challenges. The basic objectives are still to increase average rates of growth and productivity, and to implement structural changes that allow for the development of sectors that make it easier to incorporate knowledge and develop strong links with global markets. One recent development has been the territorial approach and an emphasis on overcoming the many problems with coordination, which often keep countries, and particular regions within a given territory, in a state of low productivity.

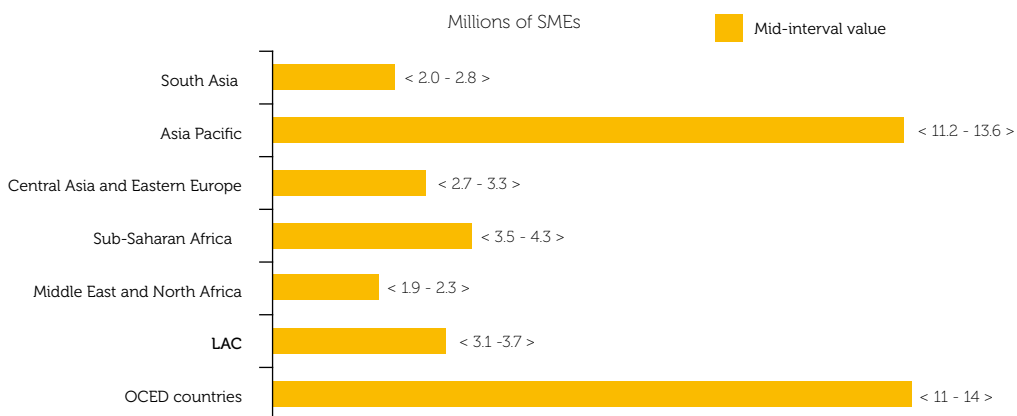
These trends are joined by a third factor that is now widespread: the decentralization of policy towards subnational units. This longstanding trend in large countries with federal systems, such as Argentina, Brazil and Mexico, has been deepened and embraced by other countries with a traditionally centralist form of government. At the same time, the transfer of responsibilities has led to broad interest in the institutions needed to design and implement local development policies and instruments at the subnational level.

In the case of countries with a federal tradition, the debate revolves around adapting existing structures to these new roles. For countries with a centralist tradition, the interest stems from the need to create new institutions capable of taking on the roles needed to promote local economic development. Such is the case in Colombia and Peru, where functions are gradually being decentralized to regional governments, at the same time as national governments are helping to develop instruments to enhance local competitiveness.

In short, SMEs have the potential to become a major engine of growth and job creation in the LAC region. This will require strategies and actions to enhance business productivity by expanding access to financing, improving the business climate, and establishing incentives for formalization, such as designing and implementing modern productive development programs that address the issue of competitiveness at the national and subnational levels.

Figure 26

Total Formal SMEs (five or more employees) in the World, by Region



Source: IFC and McKinsey Database (2010).

The Urgency of Innovation

To innovate is “to change something, to introduce something new,” while innovation is the “creation or modification of a product and its introduction into a market.” Specialists add that innovation does not refer only to tangible goods but also to services, production processes, and marketing and organizational methods.

Regardless of the definition, innovation is certainly essential in today’s world, primarily because the common denominator in all societies that have made significant strides in recent decades is their capacity to innovate, to more efficiently produce a good, or to reach the market with a novel item or service.

Pressure on this front has only increased in recent years. First, as a result of global competition, any product can be distributed anywhere in the world relatively quickly. Second, the globalization that has accompanied the telecommunications revolution has led consumers to demand similar quality, removing market segmentation instantly.

This same revolution has made it possible to circulate ideas and knowledge more quickly than ever before, in extraordinary amounts and with amazing quality. This has created what has been called—for a good reason—the knowledge economy. For that reason, if LAC countries wish to maintain a diverse production base and increase their involvement in the international economy in a balanced way, they must innovate more.

Solutions to major challenges such as climate change, access to clean energies, and health care developments increasingly involve a substantial technological component. To no less an extent, trade, public services, transportation, and the full range of services that suffer from chronic productivity stagnation in Latin America and the Caribbean could find innovation to be their solution for needed modernization.

Responding to these challenges, both the public and private sectors recognize that investment in knowledge and innovation is critical to increasing production and developing economies (IDB, 2010c). Available data show how the region continues to lag others. Although LAC has the necessary resources to improve this situation—such as researchers, universities, and innovative firms—it is limited by poor coordination and lack of financing, among other barriers (IDB, 2010d).

Much remains to be done in the region to improve innovation. To begin with, spending on innovation by the private sector is equivalent to only 0.5 percent of private sector gross income, and it is one-quarter of private sector investment in the OECD countries (IDB, 2010c). Moreover, most of those resources are used to

purchase imported technology, mainly machinery and equipment. This practice, along with the lack of properly trained personnel, can result in a lower-than expected return on investment, which affects the potential for a company or country to compete effectively.

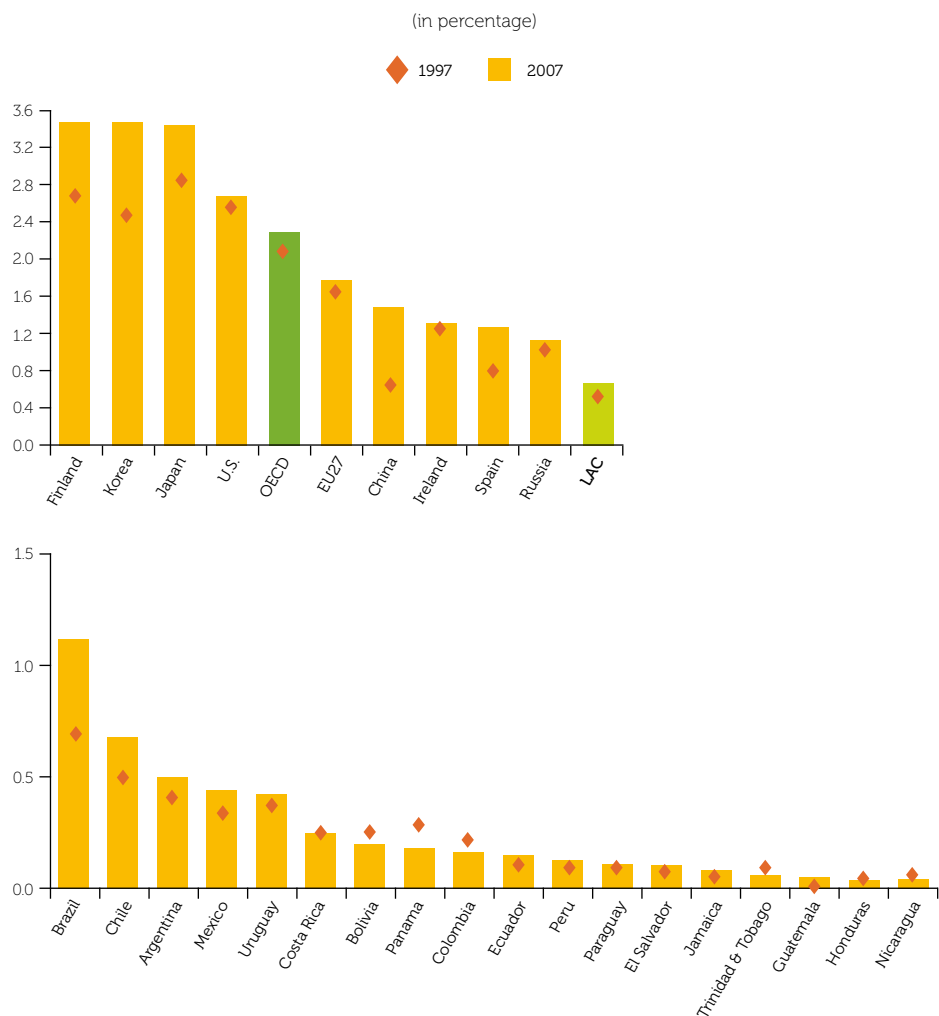
In contrast, advanced economies focus most of their public and private efforts on research and development (R&D), an area in which LAC has much ground to cover. There is movement in that direction, however. According to a report from the Network of Science and Technology Indicators (RICYT, 2010), in Latin America and the Caribbean spending on R&D increased from \$9.5 billion to \$26.8 billion between 2002 and 2008 (current U.S. dollars).

However, that jump is not enough to compensate for a historical lag. R&D spending was 0.62 percent of GDP in 2008, the highest since such statistics were first collected, but this is still a far cry from the typical 1.5 percent to 3 percent spent in developed nations or in emerging economies experiencing greater growth (RICYT, 2010).

Measured as a portion of world investment in R&D, LAC's investment in current dollars increased from 1.6 percent to 2.3 percent between 1999 and 2008. Adjusted by purchasing power parity (PPP), it rose to 3 percent, just 0.2 percentage points higher than it was nine years before. In contrast, Asia represents 34.8 percent of the total; the United States and Canada, 35.3 percent; and Europe, 24.9 percent (RICYT, 2010).

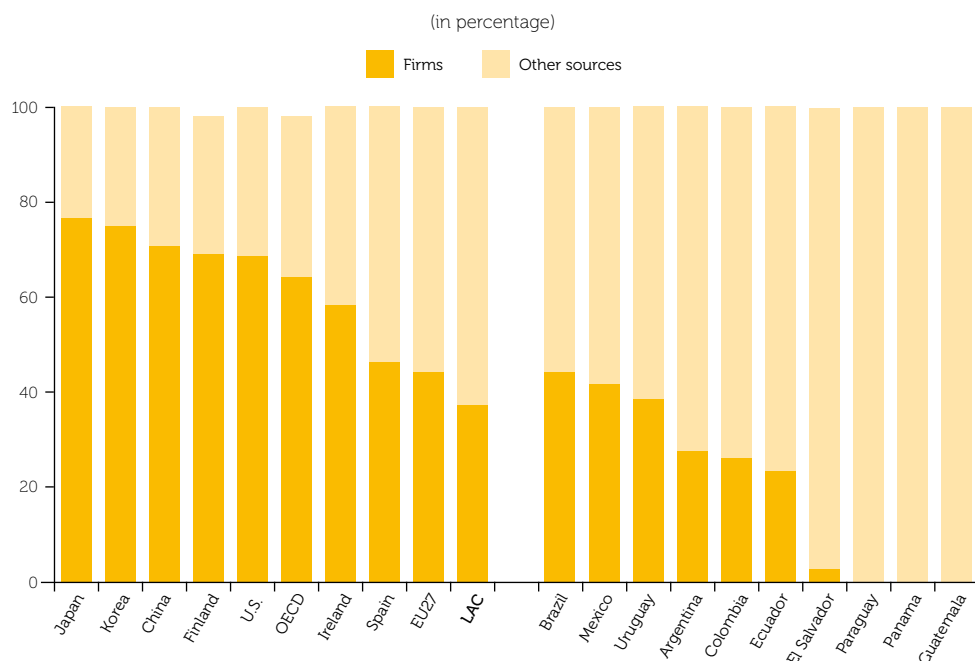
Figure 27

R&D Expenditure as a Percentage of GDP, 1997 and 2007



Notes: There are two scales, one for each group of countries. The nearest available data to 1997 for El Salvador and Guatemala are from 1998, for Honduras from 2000, for Jamaica and Paraguay from 2001, and for Brazil from 1996. The latest data available for Bolivia, Jamaica, and Nicaragua are from 2002; for Chile, Honduras, and Peru from 2004; and for Mexico and Paraguay from 2005. Data for LAC are provided in the RICYT database and are estimates. Data for Korea exclude R&D in the social sciences and the humanities. Data for the United States exclude capital expenditure. Data for Ireland (1997), OECD, and EU27 are from the OECD database and are based on Secretariat estimates or projections derived from national sources.

Source: IDB (2010c). *Science, Technology, and Innovation in Latin America and the Caribbean: A Statistical Compendium of Indicators*.

Figure 28**R&D Expenditure by Funding Source, 1997**

Note: Government, higher education, private nonprofit, foreign, and other are combined to form "other sources." Not all categories have been reported in all cases; regardless, they were collapsed into "other sources." Data for LAC are from the RICYT database and are estimates. Data for EU27 and OECD are from the OECD database and are based on secretariat estimates or projections based on national sources. Earliest available data for China, Korea, Ireland, OECD, and Spain are from 2006 and for Mexico and Paraguay from 2005.

Source: IDB (2010c). *Science, Technology, and Innovation in Latin America and the Caribbean: A Statistical Compendium of Indicators*.

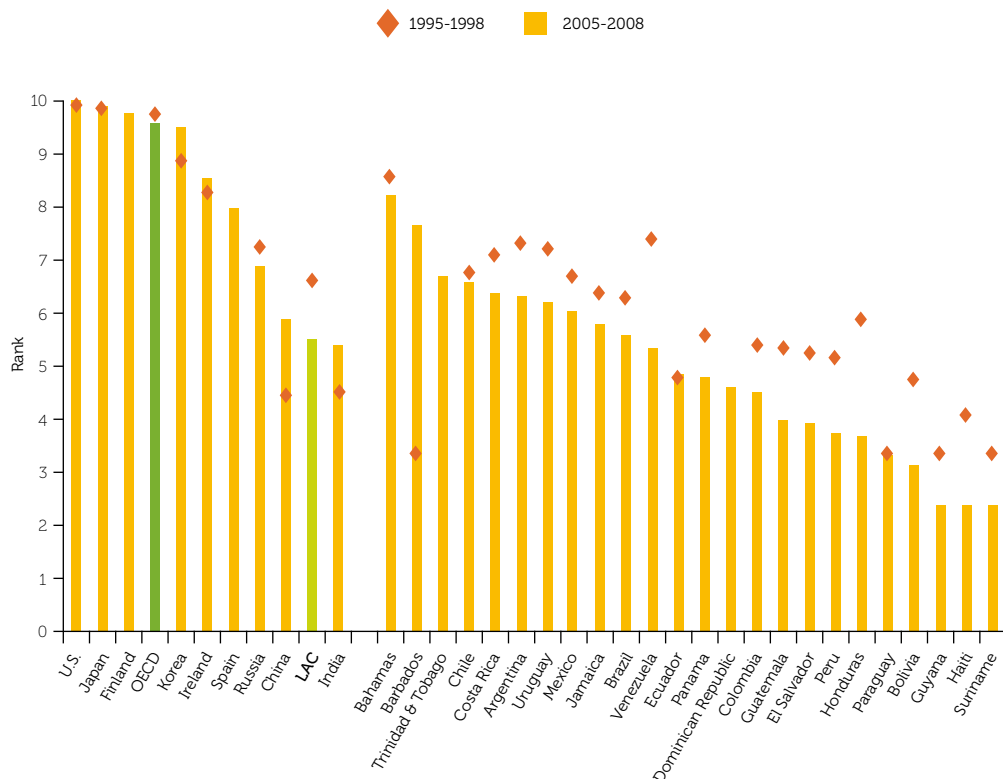
This is accompanied by a structure dominated by public funds. In Latin America and the Caribbean, two-thirds of R&D funding comes from state coffers, while in more developed regions the government contribution is close to 30 percent (RICYT, 2010). In other words, the majority of the efforts there comes from the private sector, so those investments have primarily practical, profitable applications.

Some positive developments should be acknowledged. For example, according to RICYT, the number of researchers in LAC increased from 81,000 in 1990 to 339,000 in 2008 (RICYT, 2010), although the problem of having a very small minority working in companies persists, and the number of scientific publications doubled in the last decade, particularly in agricultural sciences and biology. This fourfold spike is much larger than the increase reported worldwide. In spite of this, in proportion to the total world investment, the region is still low at less than 5 percent.

Unquestionably, much remains to be done, with respect to both R&D spending and in the productivity of those resources. At the same time, new methods are needed to promote public-private partnerships.

Figure 29

Normalized Country Rank, Patents per 100,000 Inhabitants, 1995–1998 and 2005–2008



Source: IDB (2010c). *Science, Technology, and Innovation in Latin America and the Caribbean: A Statistical Compendium of Indicators*.

Progress in South Korea is a perfect example of what is needed. In 1980 South Korea filed 33 patent applications with the United States Patent and Trademark Office. Argentina, Brazil, and Mexico—the three Latin American countries with most resources allocated towards R&D—filed 188 such applications. However, two and a half decades later, those figures were 13,700 and 569, respectively (IDB, 2010d). Even though the figure in LAC demonstrates some progress, it is clearly at a much slower pace than in other parts of the world.

Despite this complex and sometimes discouraging landscape, there are reasons for optimism. The immensely positive results of investing in innovation in the region are beginning to be well documented; a rigorous IDB study analyzes the effects that government stimulus policies in Colombia had on business innovation from 1995 to 2007. It finds that programs providing incentives for innovation have had a lasting effect on raising business productivity. Another recent study indicates that when businesses introduce new products, there is an increase in jobs, which is contrary to the traditional view that technological innovation can reduce the workforce (IDB, 2011c).

Perhaps the main source of optimism is that nearly all LAC countries have agendas geared toward promoting innovation, particularly R&D, persuaded that the current lag must be reduced to improve the productivity and development potential of all the people in the region.

Argentina provides evidence of this drive. Not only has an important transformation taken place through the creation of an R&D ministry, elevating innovation into government policy, but also the results of the initial phase of an IDB-financed program have been highly encouraging. Between 50 and 70 percent of the 1,500 small and medium-sized enterprises supported by the program made innovations and improvements to products and processes, while a group of researchers with more than 4,000 projects increased their scientific production by 35 percent. At the same time, medium-scale scientific equipment was upgraded, and specialized personnel and researchers returned to the country with upgraded skills, resulting, as a byproduct of this trend, in an enhanced capacity in environmental management.

Argentina is not a unique case; in several other economies, the issue of technological innovation is now a presidential priority, as evidenced in Colombia and, more recently, in Peru.

The Burden of Inequality

Inequality has numerous negative manifestations in Latin America and the Caribbean. Recent studies show that the incidence of violent crime is increasing and it is one of the main obstacles to development (UNDP, 2010). Violence also perpetuates poverty, deepening existing pitfalls, as noted in indicators as diverse as rates of teenage pregnancy and school enrollment. Inequality also breeds corruption, rent seeking, lack of transparency in decision making, and arbitrary policies.

Furthermore, violence affects economic performance. On one hand, it affects the quality of institutions and their efficiency, while on the other it reduces potential demand and excludes millions of people from consumption channels. Growth rates in LAC therefore tend to be relatively low in cyclical upswings, compared with those in other regions of the world, further widening the gap. Accordingly, it is correct to say that inequality is not only unjustifiable from an ethical and moral standpoint, but also because it affects growth and economic development.

The available data speak volumes; in 2010, with average annual per capita incomes of around \$12,000 in PPP in seven major countries in the region (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Uruguay), average annual earnings for the poorest 10 percent of the population was a mere \$1,675, rivaling Bangladesh. By contrast, the wealthiest 10 percent earned an average of \$48,500 per year, on par with the most prosperous regions on the planet (Luzón, 2011).

In addition, in the LAC region there is inequality of opportunities, not just inequality in outcomes. In other words, a large proportion of the income differential relates to ethnicity, birthplace, or parental education. This fact jeopardizes social mobility and makes resolving the region's most acute problem more complicated.

Although complex, this state of affairs does not mean that the battle is lost. The region's governments are increasingly aware of the need to redouble efforts to build more egalitarian societies. This desire is one of the basic reasons behind the conditional cash transfer (CCT) programs targeting some of the most vulnerable groups, including children, the elderly, and impoverished families. It is also important to emphasize strategies aimed at adequate early childhood development that include education for parents of children under the age of six, focusing on nutrition and early stimulation.

Notwithstanding the increase in school enrollment rates, international tests show that the level of teaching in the region is inadequate in math, science, and language. Apart from cognitive factors, the lag has to do with the length of the school day, the duration of the school year, teacher training, and the quality of facilities.

Reforming teaching methods requires not just money and new policies, but also skills of persuasion, given the strength of teachers' unions and their reticence to change.

To the list of pending issues, it is important to add the challenges confronting the youth, including an unemployment rate far above the average and high incidences of violence, drug use, and sexually transmitted diseases. Educational opportunities

need to be expanded so that high school graduates have greater possibilities for accessing university or technical education.

For adults, training plays a very important role. Not only do new skills need to be taught, but also retraining should be offered to those who want to acquire special skills or who are looking for other lines of work.

Expansion of social security coverage plays a fundamental role in addressing inequality. Experts have recommended adopting a universal support system financed through general taxes rather than payroll taxes, which tend to prolong informal employment.

In addition to such measures, specific policies should be adopted to promote social inclusion of both women and indigenous or Afro-descendant communities. In a region with many gaps, few are wider than the ones affecting these segments of the population.

Close attention to food security is also key, given the rising prices of commodities, in general, and of food in particular. Although Latin America has vast tracts of arable land and abundant water resources that could be used to expand the agricultural frontier, some Central American and Caribbean nations are at risk of shortages that must be identified in time, since up to 70 percent of calorie needs are met by imported foods in the most extreme examples. Lower-income populations in urban areas may also be affected, one more reason to promote agriculture and scientific research in this field.

This situation has set off alarms, with the recent uptick in commodity prices. According to the World Bank, in February 2011 the food price index reached levels higher than the 2008 peak, 47 percent above the level recorded in June 2010 (World Bank, 2011). These numbers are disturbing considering that nearly one billion people around the world are vulnerable to such fluctuations. In the case of the LAC region, one out of every 10 inhabitants could have difficulty acquiring sufficient food, since the region's poorest households spend 40 to 70 percent of their monthly budget on food.

These risks are forcing authorities to adopt policies to guarantee adequate supplies and services, and to establish mechanisms to prevent the current gaps in accessibility from becoming even greater. Beyond the specific strategies, the general message is that inequality must be fought on multiple fronts, and with a wide array of instruments. Until this is done, achieving equity will be unfinished business for many LAC countries.

The Burden of Informal Employment

While unemployment in LAC countries has been decreasing, falling to just above 7 percent by late 2010, the level of informal employment in the region does not appear to have dropped. The portion of the labor force not protected by government regulations—the most common definition of the problem—is rising.

According to ECLAC estimates, by 2005 slightly more than half of the nonfarm workers in LAC's 15 largest economies were employed informally, which is three percentage points above the 47.5 percent observed in 1990 (Tókmán, 2007). Of those, 55 percent were self-employed, while one-third were working for microenterprises employing fewer than five people. Other analyses, such as those of the World Bank, place the level of informality at around 55 percent, with a similar distribution for workers in those categories (Perry et al., 2007).

Table 9

Informal Employment in Latin America, 1990–2005

(percentage of nonfarm employment)

Year	Microenterprises	Domestic service	Self-employed	Total informal employment
1990	15,2	5,7	26,6	47,5
2000	15,7	5,6	27,9	49,7
2002	16,3	5,6	28,3	50,2
2005	16,7	5,8	27,8	50,3

Note: Based on surveys of households in 15 countries.

Source: Tókmán (2007). *Informalidad, inseguridad y cohesión social en América Latina*.

Such statistics mean that one in two LAC residents does not have full access to social security services, including health care and, especially, pensions. This situation hits the more disadvantaged classes particularly hard. In the poorest decile of the population, informal employment is above 75 percent.

Informality in employment is a particularly complex phenomenon because it includes people who are in that category by choice, as well as those who are there due to exclusion. Thus, alongside the independent professional who elects not to be an employee on payroll but who earns an income comparable to that of employees doing equivalent work, there are independent taxi drivers and street vendors who are barely able to meet their daily needs. This classification can also include the small-business owner who hires laborers but who lacks the capacity or the interest to manage a staff of permanent employees, no matter how small.

Surveys show that most informal workers, especially wage earners, would prefer to become formal employees, although they fear losing benefits such as certain health or education subsidies available to the unemployed. In contrast, companies perceive few advantages and high costs as a result of following regulations requiring the registration of employees and compliance with legislation. In addition, government supervision is limited, which leads to the coexistence of two systems that share some common ground but sometimes operate independently.

This situation is not good. As stated in a World Bank report, informal employment is a reflection of underdevelopment (Perry et al., 2007), with all that that implies. In other words, it perpetuates the existence of different classes of citizens, which translates into greater inequalities in income distribution and higher poverty rates. Thus, the phenomenon acts as a liability to the economy that, far from diminishing, has had an increasing impact in recent years. Various studies have shown that formalization and productivity normally go hand in hand; thus maintaining the status quo is not advisable.

The possible causes of this situation are many, as are the policy solutions. Specialists recommend labor law reform geared toward loosening the rigidities that seek to ensure worker stability and welfare but exclude the majority of the population from those benefits.

Social protection systems should be redesigned to cover all citizens, especially the most vulnerable. Minimum health care coverage and the possibility of participating in individual pension savings plans should be included. At the same time, it is advisable to reduce entry barriers so that companies can join the formal sector, both through smaller contributions and through incentives that may include credit opportunities. It is also necessary to address tax issues as well as to improve government supervision to combine different tools for reducing the impact of high rates of informality on productivity, equity, and social progress in the region.

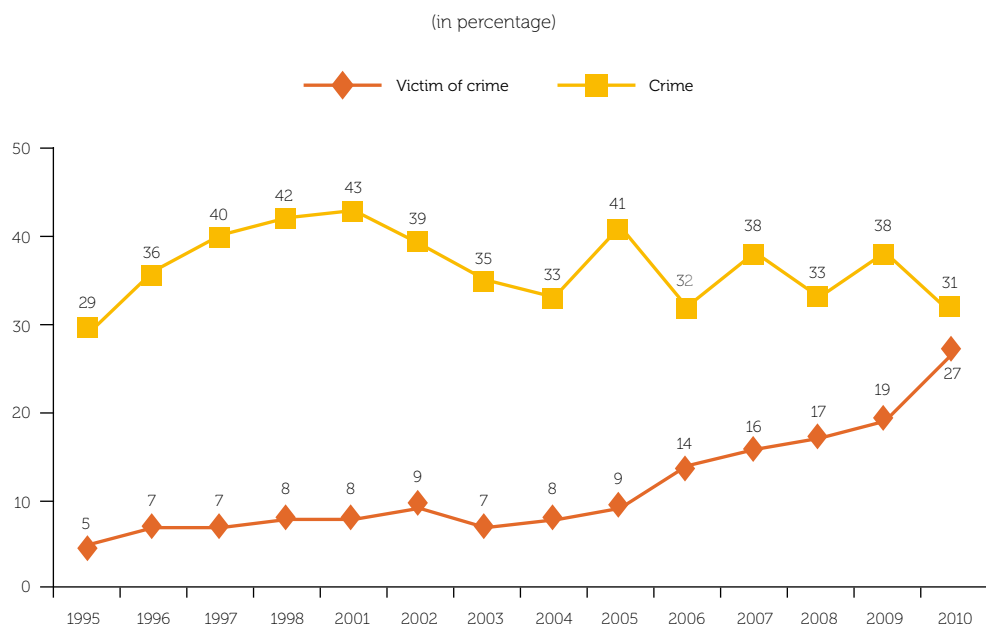
Such formulas, however, are not easy to implement. Political, cultural, and legal obstacles must be overcome to solve this pressing and worrisome problem.

Violence and Crime: A Leading Concern

For the first time since it began compiling data, Latinobarómetro reported in 2010 that 27 percent of the region's inhabitants identified crime as the biggest problem in their country. Not only is that proportion vastly higher than the 5 percent recorded in 1995, it also surpasses unemployment as the top concern of survey participants, which was unheard-of before.

Figure 30

Crime and Victimization Rates in Latin America, 1995–2010



Note: Respondents answered the questions "In your opinion, what is the country's biggest problem?" and "Have you or a relative been assaulted, attacked, or been the victim of a crime in the last 12 months?"

Source: Latinobarómetro Corporation (2010). *Informe Latinobarómetro 2010*.

That finding may appear contradictory in light of the victimization rate. In response to a question about whether the respondent or a relative had been assaulted or attacked in the past 12 months, 31 percent of people said yes, which is

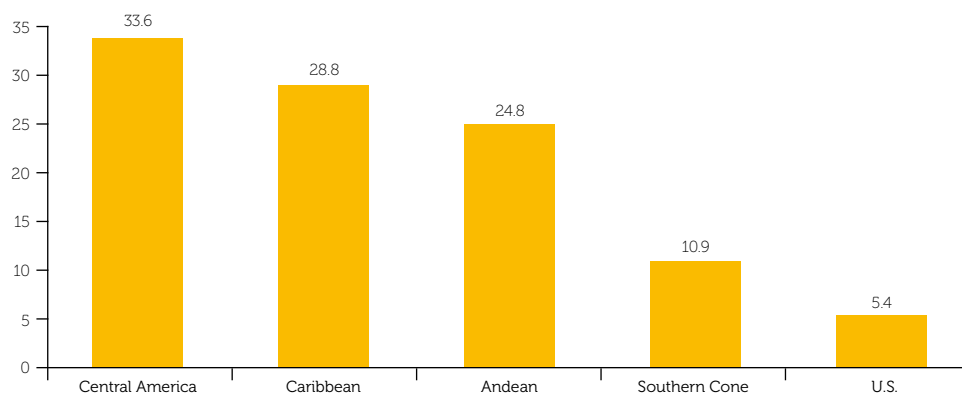
10 percentage points less than in 2005. At the same time, 58 percent maintain that their country is increasingly unsafe, a rate that has remained relatively stable but is still high. Another high figure is the 90 percent of survey participants who were afraid of being victims of crime, revealing a significant climate of fear.

Of the proposed solutions, 56 percent of respondents think that the number of police officers on the streets should be increased, while 40 percent feel that punishment for crimes should be harsher, and 28 percent believe the judicial system should be strengthened. The responses reveal that the issue of security is part of daily life in LAC countries, and that the population has concerns and is concurrently proposing initiatives to deal with this high priority problem.

That the problems raised are serious and demand a response is undeniable. Apart from undermining social peace and progress, insecurity is regressive, scares investors, and increases the operating costs of the private sector. However, solutions are slow to take hold because they involve a mix of factors ranging from police action and justice, to an emphasis on education and the promotion of opportunities for the youth, and with results that may take several years to bear fruit.

Part of the difficulty in making a diagnosis is the poor quality of data. Except for those on homicides and violent deaths, there are doubts about the veracity of official statistics, and only a fraction of minor crimes are reported to the authorities.

Figure 31
Murder Rate per 100,000 Inhabitants



Sources: Ministries of borrowing countries, 2009–2010; U.S. Department of Justice; U.S. Census Bureau.

Various investigations have determined that theft and robbery account for three quarters of all incidents of crime, but they are not always documented.

Thus, there is a very significant objectivity problem. According to figures from the Pan American Health Organization (PAHO), the LAC region has a homicide rate of 26 per 100,000 inhabitants, the highest in the world. Violence is the leading cause of death for LAC inhabitants between 15 and 44 years of age. Between 70,000 and 90,000 people in the region are killed each year by firearms, a rate three times higher than the global average (OAS, 2007).

These figures mask the fact that the problems are largely concentrated in a handful of countries and even in specific urban areas. Among the factors spurring the deterioration are the presence of drug trafficking, the proliferation of gangs, youth unemployment, domestic violence, limited rehabilitation programs in prisons, and a lack of preventive action by the authorities.

Based on data from the U.S. Department of Justice, Central American countries have the highest murder rate per 100,000 inhabitants (33.6), more than 25 percent greater than the regional average of 26.3 per 100,000 inhabitants, and almost four times higher than the world's average of 8 murders per 100,000 inhabitants. The Centers for Disease Control and Prevention (CDC) of the United States estimates that the overall rate of war-related deaths for sub-Saharan Africa is 52.9 per 100,000, and regards any disease with a prevalence of more than 10 cases per 100,000 inhabitants as an epidemic. The murder rate in Medellín is 87 per 100,000 and in Ciudad Juárez, 229 per 100,000, far exceeding the benchmarks for epidemics and even war.

But rates are just part of the story. These figures represent lives lost. In absolute numbers, during 2010, 4,005 persons were murdered in El Salvador, 6,236 in Honduras, and 6,502 in Guatemala. To put these figures in perspective, Hurricane Katrina's death toll was 1,832. Homicides in these three countries in one year caused the same number of fatalities as nine Hurricane Katrinas.

The magnitude of the problem requires much more than a single solution. Differentiated actions are needed, coordinated among various agencies and levels of government, transcending the local level in many cases and rising to the regional, national, and international levels. These actions include the strengthening of public policies and development of programs to enhance institutional coordination, prevention programs that emphasize at-risk youth, and improved justice and rehabilitation systems. Another part of the solution will be better information, enabling authorities to target the most intractable areas, to quickly identify criminal behaviors that develop over the years, and to improve their capacity to respond to

violent incidents. No less important is the role of citizen participation, which is crucial to providing feedback to those responsible for addressing the problem and proposing solutions to a challenge that must be viewed from many angles (Alda and Beliz, 2007).

These efforts have to be based on recognizing that there is both organized crime and disorganized crime. In other words, attention cannot be focused only on large criminal organizations, as threatening as they may appear, because, among other reasons, there are links between the two that cannot be ignored.

Put simply, maintaining an adequate number of well-trained police officers and increasing the workforce supporting them are as important as strengthening the justice system and as encouraging participation in community work in low-income neighborhoods. No less relevant is the role of the media, both in terms of awareness campaigns and news coverage of difficult topics.

At the same time, it is necessary to implement prompt and effective systems of justice. Impunity is an enormous obstacle in attempting to overcome the problem of insecurity and tarnishes the legitimacy of the institutions involved. In short, the various links in this chain must all work efficiently to combat the problem.

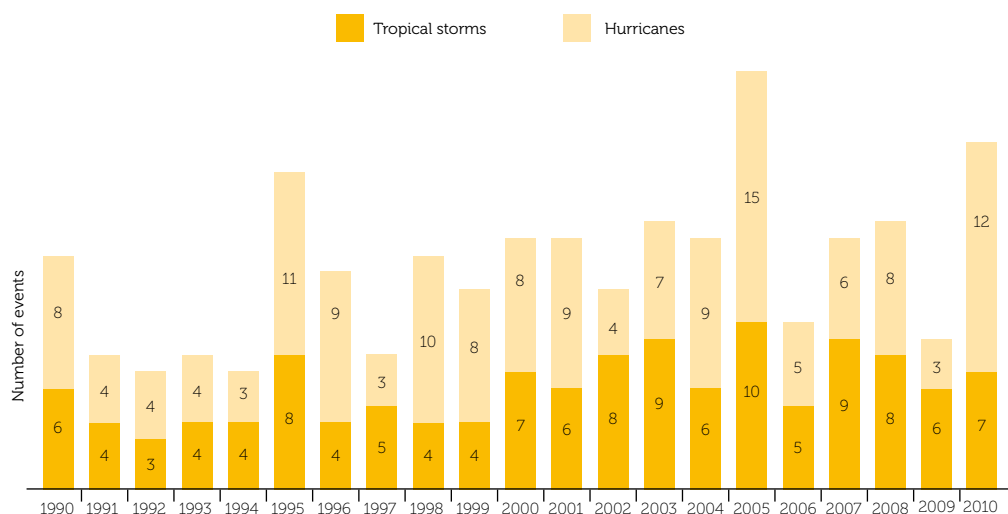
The increased sense of security in some LAC countries that have improved their indicators is clear evidence that security is not a lost battle. Alongside the worrisome breakdown are successes that should be analyzed and ultimately replicated, since sharing experiences is essential in a region that must continuously try new strategies against a changing enemy.

One project worth mentioning focuses on reducing the rate of domestic violence and the proliferation of youth gangs by strengthening the preventive and community work of Nicaragua's police force. The program was concentrated in the country's 15 largest territories and included the creation of territorial action plans and school counseling offices, as well as the adoption of a preventive model for psychosocial risk. As a result, the growth in reports of crimes committed by adolescents under the age of 18 fell from an annual increase of 23 percent in 2006 to 12 percent in 2010. Added to this was a reduction in the number of gangs and the social rehabilitation of a large number of their members.

Despite such successes, the precariousness of peace and citizen security constitutes one of the biggest development challenges for the LAC region. Violence and crime threaten the consolidation of democratic processes, affect the business and investment climate, and, in the end, make social cohesion impossible.

Figure 32

Hurricanes in the Caribbean, 1990–2009



Source: Unisys Corporation (2011). Unisys Weather Information Systems.

In a democratic state, violence creates the need to build management capabilities that should include civil society, the business world, the media, and government agencies responsible for prevention and control. In short, the work is complex and requires integrated, cross-sectional, multidimensional responses.

The Challenges of Climate Change and Natural Disaster Mitigation

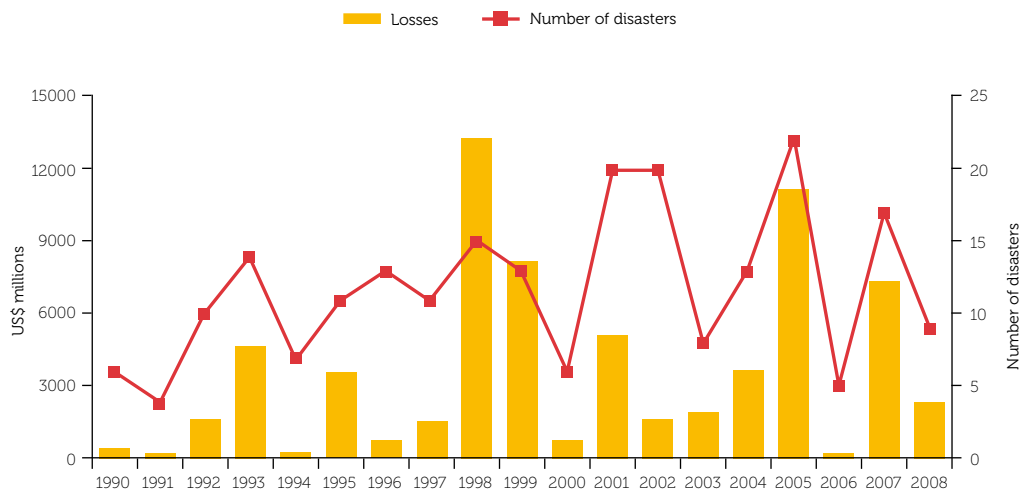
The natural disasters that occurred in LAC in 2010 reminded the world that the region is particularly vulnerable to tragedies caused by nature; this is certainly nothing new. A study by the IDB (2000) calculates that during the last century, 1,243 natural disasters claimed 431,856 lives. Of that total, one-third was caused by floods, one-quarter by hurricanes, one-fifth by earthquakes, and the rest by droughts, landslides, or volcanic eruptions.

Accurately measuring the dollar value of such occurrences is difficult. A study by the IDB (2000) indicates \$20 billion in damages attributable to natural disasters between 1990 and 1999, but that figure could be a low estimate. It would have been exceeded by the events of 2010 alone when, in addition to the earthquake

in Haiti, the LAC region witnessed a strong earthquake in Chile, hurricanes in the Caribbean, and severe flooding in Colombia, Venezuela, and Brazil.

Figure 33

Economic Losses from Natural Disasters in Latin America and the Caribbean, 1990–2008



Source: Centre for Research on the Epidemiology of Disasters (CRED), 2009. EM-DAT. The International Disaster Database.

The explanation for the region's vulnerability is clear. Latin America sits on at least four active tectonic plates and is located along the Pacific Rim, where a significant amount of the planet's seismic and volcanic activity takes place. But that is not all. Because of its mountainous terrain and complex watershed systems, landslides and flooding are common. Tropical storms and hurricanes are frequent throughout the region, particularly in the Caribbean and the northwest part of Central America.

The recurring El Niño phenomenon exacerbates climate variability in the form of severe droughts, flooding, and strong winds throughout the hemisphere. Because of polarization of the annual rainfall pattern, droughts and forest fires occur regularly in some places, while torrential rains, landslides, and flooding occur in others. Experts estimate that climate change is likely to increase the intensity of heavy rains and the frequency of droughts in dry regions.

Such events represent significant threats to the region's economic stability. In many cases, catastrophes have affected the growth of various countries, influencing fiscal stability and exacerbating social and political tensions. In some cases, reconstruction processes have made it possible to correct flaws and take corrective action against potential future effects, but the flow of resources is not always guaranteed and there are not always institutions in place that are capable of doing the work.

The risks are multiplying. Over the past half century, the majority of the LAC population has settled in urban areas. This process has been rapid and haphazard, resulting in less room for planning. It is common to find the poor in the most dangerous areas, such as hillsides or flood-prone flatlands. Thus, relatively minor events end up causing severe loss of life and property.

Such realities force a methodical approach to the problem. It is not only a question of assessing natural threats, but also of analyzing the vulnerability of specific populations and additional risks. This process should be complemented by surveillance and alert systems that cover hypothetical situations. That work must go hand in hand with mitigation and prevention efforts, which can include infrastructure works, land-use planning regulations, and building codes, in addition to economic incentives and education and awareness programs.

Part of responsible governance includes transferring risks by obtaining insurance to cover public infrastructure and private assets, as well as creating disaster funds that can be used to respond promptly in the event of a catastrophe. It is also essential to work on preparedness by establishing not only early warning and communications networks, but also institutions that can respond promptly in the event of a disaster with shelter and evacuation plans. When the worst occurs, LAC countries should be prepared. Emergency response teams should be in place to provide humanitarian aid as well as cleanup services, temporary repairs, and restoration of basic services. There should also be a process established to assess damages and request funds for the immediate and longer-term needs of those affected by the disaster. Only in this way will it be possible to carry out sound reconstruction that includes rehabilitating the affected areas and revitalizing sectors that need support.

Such principles become more urgent in the indisputable presence of global warming, which has led to an increase in average temperatures. For Latin America and the Caribbean, this means a change in rainfall patterns, which are becoming more extreme: rainy seasons and droughts alike will become more severe. It is also

important to consider the rise in sea level, the melting and potential disappearance of glaciers, and the greater intensity and strength of hurricanes.

The effects of climate change threaten to undermine the long-term efforts to ensure sustainable development, and will affect, disproportionately, the most vulnerable groups of society such as the poor and those living in indigenous communities. Therefore, it is critical for the LAC countries to address these vulnerabilities and to design adequate adaptation measures in key economic sectors such as agriculture, water resource management, and urban development. A lack of action could have significant negative consequences on the region's economic sustainability.

In terms of agriculture, the International Food Policy Research Institute (IFPRI, 2009) estimates that Latin America and the Caribbean needs \$1.2 billion in annual funding through the year 2050 to prepare this sector for the effects of climate change. The direct economic impact of climate change on agriculture in the region could be significant. A study carried out by ECLAC (2009c) in Chile, Colombia, Ecuador, Paraguay, and Peru indicates that the effects could severely threaten agricultural productivity of these countries, given that 66 percent of the continent could be affected by land degradation.

To ensure the long-term sustainability of the forests and biological resources, it is crucial to implement adequate adaptation measures to maintain or increase agricultural productivity (through changes in production practices), as well as to protect the land and its natural ecosystems. Genetic and biotechnological research is essential to prepare for and respond to challenges such as rises in temperatures, increases in droughts, and threats from plagues and other illnesses. The development and implementation of instruments for the protection and management of risks (such as insuring producers against disastrous events) and financial innovations (e.g., short- and long-term financing) are critical to satisfying the needs for working capital and to ensuring food security in the region.

To effectively manage water resources, governance must be improved through the design of appropriate institutional frameworks, policies, and activities to reduce vulnerability to climate change. This requires the adequate practices of water resource management inside a clear institutional framework; the transversal integration of adaptation methods in water management practices, addressing the risks that climate change poses for national and local development plans; and improved information and knowledge management, given that water resource management affects other sectors such as energy, health, and food security.

In the area of urban development, given that three-quarters of the LAC population live in urban areas, cities should integrate the management of the possible impacts of climate change and the obvious disaster risks into urban planning. To increase their resilience to these looming hazards, LAC cities should also prepare action plans focused on adaptation methods that include an analysis of the added dangers faced by the urban population, adequate land-use planning, effective water resource management, risk management, the application of appropriate construction codes, and the identification of financial mechanisms and methods of risk transfer.

It is critical for governments and the public to be aware of the risk of ignoring the warnings of the effects of climate change. In the past, resource constraints hindered more decisive preventive action. But now that the LAC region is more prosperous, the programs that have been designed must be stepped up to take on these challenges and avoid the worst when nature shows a less friendly face.

Final Thoughts

The list of priorities for the LAC region is both long and complex. In light of the fact that the region is experiencing a confluence of favorable conditions, a greater effort is essential to break tight bottlenecks that, as a whole, prevent more rapid and equitable growth and banish hopes of building more just societies.

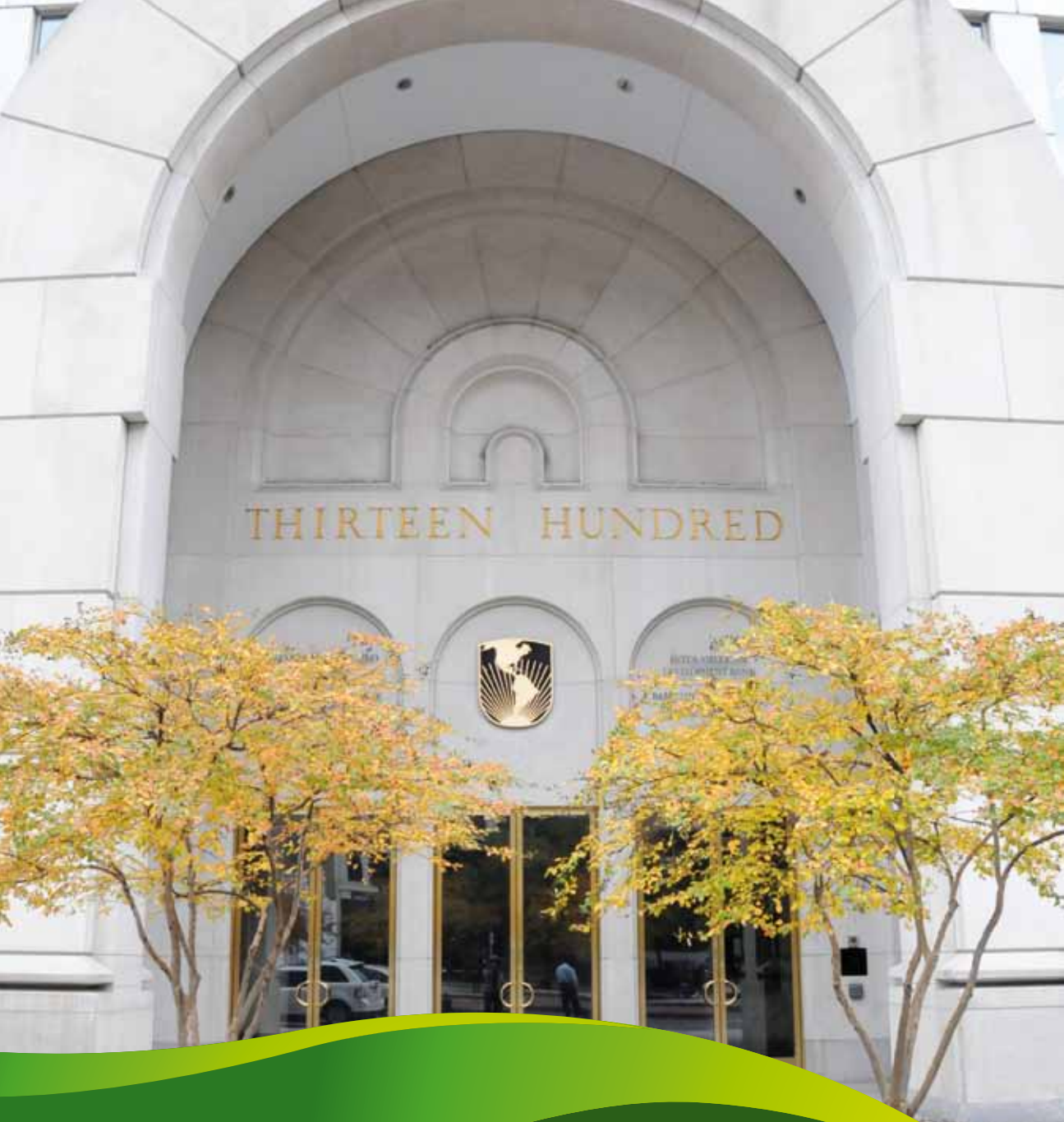
LAC countries must prepare the soil so that today's plentiful seeds will fall on fertile ground. Otherwise, there is a real risk that the boom will pass before they make the necessary transformations to increase productivity, boost competitiveness, modernize infrastructure, combat informal employment, buoy SMEs, promote innovation, eradicate violence, mitigate the effect of natural disasters, and radically reduce inequality. Wasting this opportunity would be unforgivable.





CHAPTER VI

The Bank the Region Needs



By significantly boosting lending capacity, the Ninth General Capital Increase will enable the IDB to respond better to the region's challenges and opportunities.

The Bank the Region Needs

More than five years have elapsed since I became president of the Inter-American Development Bank (IDB), thanks to the confidence placed in me by its member countries, both inside and outside the hemisphere. I felt tremendous pride upon being given a second five-year term in July 2010, particularly because this was a sign that the changes we had made over the previous term were on the right track. Thanks to those changes, today our institution is much stronger and more responsive with the means to support the region on its crucial march towards prosperity.

It is no exaggeration to say that the work I have done since I first took office has been the most satisfying of my career. I do not wish to downplay the work I did during the period when I had the honor and privilege of serving my country in different capacities, but working for the welfare of the Latin American and Caribbean (LAC) region as a whole has imposed on me the clear purpose of doing everything I can to make the ideal of social justice and progress, to which the region's inhabitants so aspire, a reality sooner rather than later.

We play an essential role in the region in pursuing that goal. Let us not forget that the IDB is not only the leading individual source of financing for the countries in its area of influence, but also a hub for advisory services, knowledge, and analysis to promote successful experiences and policies for locking in the gains made in numerous areas. During the course of its more than 50-year history, the institution has made fundamental contributions to supporting its member countries, yet I am confident that its work in the years ahead will be even more relevant. That, at least, is our goal.

With new forms of financing and abundant liquidity in the global economy, it makes sense for someone to question the relevance of multilateral institutions like ours. However, if recent events prove one thing, it is that when alarms about global stability are sounded, institutions like the IDB are vital. Their role is not only limited to crises, but also to everyday business. Along with emergency measures for what is urgent, there is also what is important. And what is important is to continue supporting the countries in their efforts to overcome poverty and promote sustainable growth with equity, through actions of high strategic value. Thus, the region requires an institution whose involvement over the next decade can translate into substantial

support for growth and equity through public or private operations, with technical support based on leveraging its comparative advantage: experience, good practices, innovation, and ongoing investments for the development of knowledge.

Consolidating a Bank at the Service of the Region

It may seem a distant memory, but the Agreement Establishing the Bank was ratified in 1959. One of the Board of Governors' first decisions was to set the new institution's level of capital at \$1 billion, of which \$150 million was earmarked for the Fund for Special Operations (FSO). That level has been readjusted on successive occasions since 1959 to enhance lending capacity and, accordingly, to increase the IDB's scope of action.

There is no need to delve into each such occasion here, but it is worth noting that each amount approved was greater than the one before. That progression made a significant leap in 1994, when the \$40 billion Eighth Capital Replenishment (IDB-8) made us the largest source of development financing for the LAC region. The IDB's ability to act, coupled with its comparative advantage as a regionally owned institution, has been essential in making it the key partner in our countries' development initiatives.

The numbers clearly illustrate how this move by the Bank's member countries paid enormous development dividends. The \$1 billion investment in 1994—the amount actually paid in (the remainder was callable capital)—translated into \$93 billion in programs and projects in the region. Likewise, the subsequent US\$1 billion contribution to the FSO made it possible to provide \$5.1 billion in additional concessional financing to the most disadvantaged countries.

Throughout the IDB's more than 50 years, its operations with respect to loans and technical cooperations have contributed to implementing a wide range of economic and social development projects and programs. During this period, the IDB invested one-third of total lending in social development areas. It initiated its loan portfolio in 1961 with financing for the Water and Sanitation Master Plan of Arequipa, Peru, which not only supported construction, but also created an autonomous and financially self-sufficient company. Thus, the IDB was a social sector pioneer, an innovation at the time because, once it was demonstrated that such projects could be financed and that investments could be recovered, other international agencies, which had been focusing their operations exclusively on the productive sectors, became interested.

The social sectors portfolio has covered a wide spectrum of financial, cooperation, and technical support efforts in the fields of health, education, job market development, innovation for social inclusion, gender-related areas, ethnic issues, and poverty reduction. The current agenda includes enhanced work in these fields, particularly support for conditional cash transfer (CCT) programs, which are considered the region's most frequent and successful solutions in the area of social protection.

The IDB has also actively participated in infrastructure financing, having become a leader in the electrical power and transportation sectors, which are crucial to supporting productive sector competitiveness. Almost 14 percent of the total volume of resources approved since the establishment of the IDB have been used to support the development of the electricity sector, with financing for important infrastructure projects such as Itaipú—on the border between Brazil and Paraguay—and Salto Grande, in the middle course of the Uruguay River. More recently, it has supported the SIEPAC project, which is emblematic for the IDB, as it is financing not only the construction of infrastructure for almost 1,800 kilometers of a 300-MW transmission system, but also the creation of MER, a regional electricity market.

Regarding transportation, the IDB has accumulated broad experience in supporting high-impact projects that provide passenger and cargo services. Successful projects have been financed at the urban level, including those in Curitiba, Brazil, and Santiago de Cali, Colombia. The IDB has also participated in building internal and regional integration highway systems, including the Initiative for the Integration of South American regional Infrastructure (IIRSA) and the Mesoamerica project.

One of the IDB's hallmarks is promoting institutional development, supporting both structural reform and sector initiatives in the countries. With the introduction of sector- or policy-based loans in the mid-1990s, the IDB supported efforts in the areas of public sector modernization, financial reform, and private sector promotion. Successful experiences include the series of loans for reforms carried out by the Peruvian government during the last decade. Institutional support activities have drawn on the conviction that improving the technical and administrative capacity of the agencies responsible for guiding development is as important as channeling financial resources to the countries. Programs to improve citizen security are an innovation arising from this institutional capacity approach.

Throughout its history, the IDB has also been working hand in hand with the region's private sector. These activities have increased in recent years, fostered by

a favorable business climate and decisions that have made it possible to expand the range of loans beyond the national or regional public spheres. In this context, investments in entities devoted to microfinance, such as Bancosol in Bolivia and Financiera Calpia in El Salvador, have been successfully supported.

It is worth noting the breadth and diversity of technical cooperation operations. Since their creation, these instruments have been just as significant as loans in promoting development, and have been essential to the process of transferring knowledge and experience to the country or the beneficiary entity.

This demonstrates that the Bank has been an optimal tool, given the high leveraging of its paid-in capital and the particular development impact of its projects. In hindsight, the 1994 increase seems to have been not only an economic imperative, but also a wise policy move enabling the IDB to offer the support Latin America and the Caribbean needed.

Those same considerations proved valid once again in 2009, when discussions began about a new capital increase. At the time it was believed that, given our accountability both to the region and to our institutional model, a capital increase was the only way to respond to the changes and needs in LAC.

Debate was intense, as is typical in such processes. However, at the IDB's Annual Meeting of the Board of Governors in Cancun in March 2010, an agreement was reached to infuse an additional \$70 billion into the IDB's Ordinary Capital, bringing the total to \$170 billion—, thereby confirming its status as the largest regional development bank in the world. By significantly boosting lending capacity, the Ninth General Capital Increase (IDB-9) will enable the IDB to respond better to the region's challenges and opportunities.

This new stage has just begun and ratifies our core objectives of reducing poverty and inequality and fostering sustainable growth. To this end, an enhanced institutional strategy has been formulated that envisages providing preferential support to the less-developed countries in the region, while also promoting the private sector.

But that is not the only goal. The capital increase was not intended just to make the IDB bigger but, above all, to make it better. This means undertaking a series of reforms in the management model with a view to increasing efficiency and accountability, while ensuring the highest ethical and risk management standards. The decisions made have raised accountability to unprecedented levels and should put the IDB on the leading edge of multilateral institutions in this regard.

This plan entails not only keeping up past efforts, but also developing new programs and instruments that promote higher quality and more relevance in the interventions the countries implement with the IDB's support.

Strategic Agenda and Vision

In order to provide support for the region's continued social and economic development, the IDB needed greater financial capacity for a much larger annual lending program. To use additional resources effectively, however, a new institutional strategy was needed—one that sets out a clear vision of the Bank's priorities and how to achieve them, while identifying its comparative advantages and formulating plans for its implementation.

The IDB's main structural advantage is perhaps its cooperative like arrangement, in which borrowing regional members hold a majority of the voting power. Over time this structure has consolidated the IDB's role as a trusted partner driven, first and foremost, by constituents' development needs and aspirations. In addition to these intrinsic characteristics, the Bank has key comparative advantages: a strong country focus; coordination of public and private sector operations; diversification of financial and nonfinancial products that allow the Bank to be more responsive to a country's needs and more consistent in supporting development over time; and the knowledge and capacity needed to facilitate trade and regional integration.

According to the Agreement Establishing the Bank, the institution's objective is "to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively." This mission remains every bit as relevant today because in the coming years, two key components will define development in Latin America and the Caribbean: reducing poverty and inequality, and achieving sustainable growth. These are the overarching objectives of the Bank's new institutional strategy.

The first goal is important not only because of the unacceptable degree of inequality in the LAC region, but also because of growing evidence that inequality across a broad range of areas hampers economic and social development. The second objective is essential for improving quality of life, given the many challenges ahead.

In addition, the IDB needs to focus on two strategic objectives that tap its comparative advantages and are essential to its mission: addressing the special needs of smaller and relatively less developed countries, and promoting development through the private sector.

Just as the LAC region lags in several areas when compared to the developed world and the most dynamic emerging economies, wide income gaps also exist within the region. Countries such as Bolivia, Guatemala, Guyana, Haiti, Honduras, Nicaragua, and Paraguay have per capita GDP that is just one-quarter of the region's average, while their poverty rates are nearly double. Accordingly, support for those nations' efforts to accelerate development will continue to be a priority.

At the same time, promoting private sector activity is vital for sound, sustainable growth. Because that sector creates 90 percent of jobs in Latin America and the Caribbean, promoting entrepreneurial endeavor, particularly among small and medium-sized enterprises, can be a very effective tool for improving living conditions.

The development of specific strategies to complement these goals will lead to concrete programs. In IDB-9, the governors of the Bank established sector targets and priorities to focus efforts on social policies that foster equality and productivity, infrastructure to encourage competitiveness, institutions dedicated to growth and social welfare, competitive integration both regionally and globally, as well as mechanisms to protect the environment, respond to climate change, and ensure food security.

With regard to social policies for equity and productivity, the starting point is a recognition that—to reduce poverty and inequality in a sustainable manner—LAC countries need new social programs that promote equal opportunities regardless of labor status, ethnic origin, or gender. The focus must be placed on increasing the quality and relevance of education, improving health outcomes, protecting households against risks, and redistributing income effectively while fostering labor productivity gains.

The LAC region needs social programs that contribute to improving labor market performance; corroborated by the capacity to generate higher-paying jobs and better social security coverage are some examples. To achieve these goals, the IDB will continue to work toward well-articulated safety nets; labor market improvements such as higher productivity and increased social security coverage; better and more equitable education; equity in health outcomes; and cross-cutting gender and diversity solutions.

Improving the infrastructure for productivity and social welfare is no less important. To close the gap between this region and other emerging markets and to ensure sustainable growth, increased investment in productive infrastructure is necessary. Transportation, is especially critical, given the large positive externalities associated with lower transport costs; a denser network would

achieve balanced regional development and help break the geographic isolation of entire communities.

Access to sustainable sources of energy and to low-cost telecommunications would raise labor and capital productivity and directly benefit LAC households. Competitive firms can create and sustain jobs with higher labor productivity, but basic infrastructure is needed to enhance competitiveness in a globalized world. In this framework, the Bank plans to head an agenda to expand broadband access in the region to educational, health, commercial, and public and private services in general, for which this connectivity could be used. Investment in infrastructure in critical areas, such as access to water and sanitation, is also essential to raising basic household welfare.

Amid this landscape, it is also important to promote institutions for growth and social welfare that are vital to development. There is ample evidence that the countries that have benefited the most from economic reforms are those that have advanced the furthest in implementing successful institutional reforms. Successful decentralization in delivering social services requires subnational institutions to exist and operate under a framework of transparency and accountability.

To develop credit and financial markets, it is essential to have effective regulatory capacity, which directly influences the emergence of sound private sector institutions. Effective, socially equitable tax systems are equally important, as are properly functioning citizen security institutions, critical to democracy and social welfare.

Another defining element is competitive global and regional international integration. In the late 1980s and early 1990s, the region began to pursue a dynamic multipolar strategy for economic integration. Over the past two decades, most countries have either implemented multilateral and regional trade agreements or pursued unilateral trade liberalization programs.

Despite considerable progress, trade performance in Latin America and the Caribbean is still lackluster compared with the OECD and Asian countries. To take full advantage of the benefits of opening markets, investments are needed in areas such as management and harmonization of standards of origin, customs procedures, and sanitary and technical standards, as well as stronger trade-related institutions. In addition, convergence mechanisms between existing bilateral and regional trade investment agreements are needed. The IDB will seek to expand its traditional agenda to include new issues associated with trade in services, such as technical know-how and financial flows.

It is also crucial to protect the environment, respond to climate change, promote renewable energy, and guarantee food security. In light of its strength as a source of development financing, the IDB aims to have a strong presence in these areas. In particular, it can help countries better understand these phenomena, design policies necessary for the transition to a green economy, and enhance institutional capacity to implement those policies.

To do this, the Bank has been gaining technical expertise and building its capacity in this sector. Local interventions to protect vulnerable populations from drastic deteriorations in well-being will be critical in the coming decade. To reduce carbon emissions in the region, effective institutional and regulatory regimes are needed to allow for investments in sustainable transportation, alternative fuels, sustainable energy (including renewable energy), and energy efficiency.

The LAC region needs to adapt to the repercussion of climate change in priority sectors such as water supply, agriculture, and energy. To improve food security, enhanced agricultural productivity is also essential.

Specific themes within these five priorities have strategic value for the region and therefore for the IDB over the next decade. Areas of emerging demand and business development for the IDB are: social safety nets and systems; early childhood care; quality primary and secondary education; performance of labor markets and informal employment; gender and diversity issues; access to drinking water and sanitation; expanded access to financial services; more efficient tax systems; citizen security; trade in services; food security; greater agricultural productivity; prevention and effective management of natural disasters; and mitigation of the effects of climate change.

These areas of emerging demand are expected to use a substantial part of the incremental resources from the new capital increase. Additional lending capacity is crucial to deepening the IDB's expertise, because a critical mass of projects must be undertaken to establish a widely recognized track record and generate cross fertilization of experiences among projects and countries.

By way of a conclusion to the proposals made in this chapter, I would like to stress that achieving the target of building a region that is better for all requires decisive support from multilateral banks. The IDB will continue to play an essential role, not only because of its 50-year-plus track record of working in the region, but also because of its increased financial capacity and vast store of knowledge. The IDB-9 not only allows the Bank to expand its lending capacity, but it also includes in its mandate specific actions and targets to make the institution more effective.

Ultimately, we must build on our achievements to ensure that the IDB—and this cannot be emphasized enough—only gets better with time. The idea is for the Bank to become an institution that not only serves the lofty goals of its members, but is also decisive in making the dreams of the people of Latin America and Caribbean aspiring for a better future become a palpable reality—hopefully sooner rather than later.





CHAPTER VII

A Unique Opportunity



The reward, if we follow through, will be more equal and forward-looking societies with powerful tools to combat and eradicate poverty.

A Unique Opportunity

In the preceding pages I have sought to convey the sense that a new day is dawning for the economic and social outlook of the Latin American and Caribbean (LAC) region. Although it must be said that this promising perspective is not a certainty, it represents a unique opportunity for the region. To take advantage of it, we need to understand the fundamental shifts taking place across the planet and to continue the fruitful process of change and reform that has already brought benefits but needs to be expanded and deepened.

Therefore, now is not the time for celebration but for preparation and thorough analysis as a prelude to action. While recognizing that a new era has begun, we cannot forget the long list of unfinished business.

That said, it cannot be denied that having emerged intact from the global financial crisis, the region's socioeconomic prospects now look very encouraging. Midway through 2011, forecasts for growth in the LAC countries exceed those for the developed world; the region's financial, monetary, and fiscal institutions are in much better shape than they were two decades ago; many of the LAC countries have an abundance of the natural resources the world needs; and social policy has produced important outcomes through the use of increasingly effective tools.

Recently strengthened institutional capacity has passed the test of the latest international crisis, after the tough lessons from the end of the last century. Almost throughout the region, countries adopted countercyclical policies that reduced the social cost of the economic slowdown, something that was possible thanks to a remarkably strong fiscal position and the presence of independent central banks, which were able to use the tools at their disposal. Added to this is the presence of a solid, well-regulated financial system that has continued to perform in a context of relative price stability and acceptable interest rates.

Moreover, new institutions and policies have been created, enhancing government capacity to support human capital development and provide a social safety net for low-income families. Today, advances in reducing structural poverty, progress on education and health, and increased access to services are plain to see. There is a long way to go, but we are making progress.

Without overlooking the diversity of economic and political conditions in the LAC region, the outlook is very encouraging. In various forums I have expressed my firm belief that this is the decade of Latin America and the Caribbean. I hope I have shown in the preceding chapters why this is so.

We need to look at the region's development potential in a new light, putting pessimistic prejudices about its fate behind us. For too long we have believed the region to be doomed by geography, history, isolation, or external dependence. Intellectuals of different backgrounds confirmed this diagnosis with each crisis or setback. From this perspective, a sustainable improvement in quality of life for the people of Latin America and the Caribbean was unattainable in the short or medium term.

Fortunately, many of these traditional explanations have been reevaluated. To paraphrase the economist Albert Hirschman, we must, once and for all, leave behind the "failure complex" of the past.

A look at current events reveals tensions of two kinds that cannot be ignored. The first concerns the protests that have been taking place since early 2011 in the Arab world, where citizens have been demanding political change. In some cases these demands have resulted in regime change and transitional governments. In others, the uprisings were brutally suppressed or required a response from the international community.

Comparisons are odious but it must be noted that these risks are absent in the Latin American and Caribbean countries because democracy is a reality there. That is not to say that our systems are perfect or tension-free, but the dark age of authoritarianism is truly behind us. The region includes democratically elected governments of various political stripes that have taken a broadly pragmatic approach and adopted policies that have generally proven effective. We are more democratic today than at any time in our history, and we respect civil and political rights better than any other region of the developing world.

Indeed, our region has much to teach those setting out today on the road to democracy. We have much to contribute by demonstrating how we were able to put an end to our troubles and put our tensions behind us, and how we were able to achieve consensus based solutions within our societies.

The second development is occurring in Asia: the movement of hundreds of millions of people from the countryside to the cities. This immense, internal urban migration is a challenge for the governments of many countries. Almost overnight, the need has arisen to provide infrastructure for a growing population. Even under normal circumstances, that is a monumental task.

Once again, this pressure is substantially less in the countries of Latin America and the Caribbean, in this case because the ratio of our urban to our total population is among the highest in the world, a phenomenon that took root several decades ago.

Still, the uncontrolled growth of our cities has not been trouble-free. Problems with crime, squalor, pollution, inequality, transportation, housing, and infrastructure abound in our region's urban areas. Yet our countries have made great efforts to meet a wide range of needs, as demonstrated by universal access to clean drinking water and power services. We have much to learn from regions with some of the best-run cities and highest quality of life, but we have made progress.

We still face macroeconomic challenges, but our financial, monetary, and fiscal institutions are now better prepared to confront these challenges. From the medium-term perspective there has been strong progress on social issues: development in this regard has outpaced economic growth and has done so at a more sustainable level.

The progress made on a number of fronts is incomplete and in some cases still just beginning. It is nonetheless real because it has started to bear fruit: the population is healthier and better educated than ever before and has wider access to public goods and services. School enrollment rates and women's participation in the labor force have increased, and many people can now look to the future with optimism. Conditional cash transfer (CCT) programs have transformed social policy for the better.

Budgets are more transparent and real progress has been made on assessing their impacts. As a result, the continuity of effective public policy measures is now less vulnerable to the ups and downs of the electoral process.

Strong economic performance in recent years has expanded the middle class, whose newest members are a testament to social mobility. Rising income in this population segment is associated, in turn, with faster economic growth, greater stability, and higher-quality government.

The growth of the middle class, together with the widespread use of information technologies and structural reforms, has also given rise to new, more professional businesses, less reliant on government and more globally connected. There is no clearer expression of this progress in the private sector than the emergence of the *multilatinas*. The contribution of these companies both to deepening integration and to establishing the region's place in the world is increasingly apparent.

I am not just referring to trade integration. Closer ties have also taken the form of the transfer of good practices among LAC countries. This new form of South-South

cooperation extends to many fields, including social policy, energy, nonrenewable resource management, and public security programs.

In this case, we must also consider the demographic window of opportunity represented by a population with an average age of 27, younger than in other parts of the world. This fact should enable the region to meet the social spending needs both of children and of those nearing retirement, due to the increases in tax revenue and private savings that will be generated by the economically active population.

The positive factors outlined above are distributed relatively uniformly across Latin America and the Caribbean. In the context of global macroeconomic imbalances, however, there are also a number of factors that sharpen the existing disparities among the countries of the region and result in the uneven distribution of opportunities.

Three key factors distinguish the countries of the region and shape their differing abilities to adapt to the conditions of international markets: first, whether they are net commodity exporters; second, how closely they depend on the developed markets and their economic cycles; and third, their ability to attract foreign direct investment under prudent economic policies. Countries positioned well in terms of these factors can take advantage of the commodity price boom in the context of countercyclical policies to build up savings against future imbalances and create conditions for sustainable growth. The boom thus presents an opportunity, allowing such countries to achieve fiscal balance and to make progress toward realizing the economic, social, and cultural rights embedded in the constitutions of all LAC countries.

By contrast, countries that are net commodity importers or that primarily depend on developed economy markets face challenges of another kind, but they can also rely on the strength of recent progress. For this reason, the IDB must redouble its efforts to support the most vulnerable countries. With the infusion of new capital, the Bank now has the resources and the tools to do so.

To reiterate, opportunities are no guarantee of success. Reaping the decade's rewards will depend on the actions taken, with the knowledge that there are obstacles in the road ahead. Steady progress must be made, therefore, to build and achieve higher levels of productivity and to develop sustainable social security, health, and pension systems that minimize distortions in the labor market caused by informal employment.

Other top priorities are to reduce violence and crime; strengthen regulatory, security, and justice institutions; expand social and production infrastructure;

improve education quality and relevance; and implement the sustainable development agenda, including climate change considerations and the deepening of strategies for mobility and social equity.

Improving food security is another piece of unfinished business, one that will require stepping up use of agricultural, fishing, and forestry resources, rather than merely pushing back the frontier by adding more arable land at the expense of our forests. More investment, improved research and development, and greater access to credit are essential elements in this urgent agenda.

If we could single out one imperative for the LAC region, it would be substantive improvements in education systems. Here the priorities are to enhance early childhood education, put skilled teachers in the classroom, and better equip young people to navigate the school-to-work transition. Improving education quality and equity to close social divides is the preeminent challenge for the region.

Another point I must not fail to mention is the region's vulnerability to the forces of nature. Earthquakes, hurricanes, torrential rains and floods, and landslides are a constant threat, calling for enhanced disaster preparedness and response capacity and a better understanding of the challenges posed by climate change.

It is clear that in the coming years everyone will once again be called upon to work hard and give his or her best. Ultimately, the goal is to make this decade a prosperous one for the region, the first of many such decades to come. This will be possible only if we are able to put to good use the wealth generated by exploiting our vast natural resources, with the knowledge that some are indeed finite. And this means we must concern ourselves with productivity, which should be not just our goal, but our daily obsession.

The reward, if we follow through, will be more equal and forward-looking societies with powerful tools to combat and eradicate poverty. This dream, which at times may seem utopian, is achievable only if we understand that we hold destiny in our hands. Then we will be putting the fruits of progress within the reach of the 600 million people of Latin America and the Caribbean who aspire to, and deserve, a better future.

In December 2010, when Mario Vargas Llosa was in Stockholm to receive the Nobel Prize for Literature in recognition of his outstanding body of work and lifetime devoted to writing, he made remarks worth reflecting on. In his acceptance speech, Vargas Llosa said the region is on "the right road, and if it stays on it, combats insidious corruption, and continues to integrate with the world, Latin America will finally stop being the continent of the future and become the continent of the present."

It is this goal—of hastening fair and equitable progress for all the region's inhabitants—that drives and inspires us. And with support from all, it is this goal that we will achieve.

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 In these pages, Luis Alberto Moreno gives us a roadmap for continued progress, a blueprint for the decade of Latin America and the Caribbean. It is one that addresses both our greatest opportunities and our most acute challenges, from strengthening education, encouraging innovation, and promoting universal opportunity to bolstering democratic institutions and fostering clean growth—what he calls the long list of unfinished business. 



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