

INTER-AMERICAN DEVELOPMENT BANK

Washington, D.C.

February 10, 2000

Mr. Chairman:

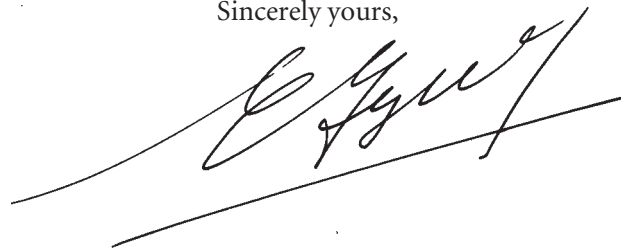
Pursuant to Section 2 of the By-Laws of the Inter-American Development Bank, I transmit to you the Annual Report of the Bank for 1999, which the Board of Executive Directors submits to the Board of Governors.

The Report contains a brief summary of the economic situation of Latin America and a review of the Bank's activities in 1999.

In addition, the Report contains a description on a country-by-country basis and a regional basis of the Bank's various operations—loans, guarantees, financings for small projects and technical cooperation—on behalf of Latin America's development; a summary statement of the loans approved in 1999; a series of tables of selected data on the region; the financial statements of the Bank, and its general appendices.

Complying with Article III, Section 3(a), of the Agreement Establishing the Bank, the Report contains separate audited financial statements for its various sources of funds. For the ordinary capital resources, these are presented pursuant to the provisions of Article VIII, Section 6(a), of the Agreement; for the Fund for Special Operations, in accordance with the provisions of Article IV, Section 8(d), of the Agreement; for the Intermediate Financing Facility Account, complying with Section 5(d) of Resolution AG-12/83 of the Board of Governors; for the Social Progress Trust Fund, pursuant to Section 5.04 of the Agreement signed between the Government of the United States and the Bank; and for the Venezuelan Trust Fund, in accordance with Article VI, Section 24, of the Agreement signed between the Government of Venezuela and the Bank.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'E. Iglesias', is written over a horizontal line. The signature is fluid and cursive.

Enrique V. Iglesias

Chairman, Board of Governors
Inter-American Development Bank

TABLE I. TEN YEARS OF OPERATIONS, 1990-99
(In millions of U.S. dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
CAPITAL										
Subscriptions (End of Year)										
Ordinary Capital	40,994	41,063	54,174	54,198	60,864	66,399	80,895	87,557	94,219	100,881
Fund for Special Operations	8,702	8,704	8,667	8,649	8,675	9,751	9,679	9,572	9,643	9,646
Other Funds	1,172	1,191	1,207	1,256	1,324	1,313	1,352	1,329	1,406	1,468
Total	50,868	50,958	64,048	64,103	70,863	77,463	91,926	98,458	105,268	111,995
BORROWINGS¹										
Outstanding (End of Year)	17,273	19,656	21,390	23,424	25,198	26,338	26,629	27,331	32,511	38,784
Gross Annual Borrowings	1,830	3,428	5,074	3,941	955	2,746	4,250	5,569	5,761	8,865
OPERATIONS										
Loans and Guarantees Authorized (Cumulative)²										
Ordinary Capital ³	35,021	39,223 *	43,818	49,608	56,242	63,512	66,088	68,739	79,742	88,226
Fund for Special Operations	10,475	11,040	11,381	11,756	12,269	13,011	13,363	13,580	14,273	14,663
Other Funds	1,499	1,556	1,571	1,607	1,621	1,636	1,648	1,722	1,735	1,726
Total	46,995	51,819	56,770	62,971	70,132	78,159	81,099	84,041	95,750	104,615
Loans and Guarantees Authorized (Annual)⁴										
Ordinary Capital ³	3,315	4,734 *	5,534	5,492	4,698	6,437	6,376	5,680	9,364	9,061
Fund for Special Operations	517	625	459	423	543	795	374	283	686	417
Other Funds	49	60	30	48	14	16	16	85	13	8
Total	3,881	5,419	6,023	5,963	5,255	7,248	6,766	6,048	10,063	9,486
Loan Disbursements (Annual)⁴										
Ordinary Capital ³	2,129	2,804	2,781	3,336	2,626	4,255	3,696	4,958	6,085	7,947
Fund for Special Operations	329	296	387	381	400	541	600	493	535	430
Other Funds	49	51	27	15	14	23	20	17	15	10
Total	2,507	3,151	3,195	3,732	3,040	4,819	4,316	5,468	6,635	8,387
Loan Repayments (Annual)⁴										
Ordinary Capital	1,069	1,440	1,504	1,788	2,099	2,852	2,287	2,244	1,946	1,988
Fund for Special Operations	229	340	299	270	301	288	289	285	283	289
Other Funds	77	108	70	43	35	38	36	40	29	29
Total	1,375	1,888	1,873	2,101	2,435	3,178	2,612	2,569	2,258	2,306
Loans Outstanding										
Ordinary Capital	17,728	19,260	20,098	22,179	24,478	26,581	26,028	27,301	32,635	38,552
Fund for Special Operations	5,747	5,716	5,818	5,932	6,043	6,284	6,547	6,734	6,827	6,955
Other Funds	489	432	378	337	303	271	241	209	189	164
Total	23,964	25,408	26,294	28,448	30,824	33,136	32,816	34,244	39,651	45,671
Nonreimbursable Technical Cooperation Authorized (Annual)⁵										
Fund for Special Operations	48	99	41	87	77	90	87	88	64	47
Other Funds	9	41	10	17	34	25	26	21	53	44
Total	57	140	51	104	111	115	113	109	117	91
FINANCIAL HIGHLIGHTS										
Income										
Loans										
Ordinary Capital	1,418	1,675	1,620	1,864	1,916	1,977	2,012	2,044	2,085	2,582
Fund for Special Operations	126	158	128	126	138	131	135	135	135	133
Investments										
Ordinary Capital	449	529	547	482	337	654	431	455	520	576
Fund for Special Operations	74	61	59	54	37	49	31	27	27	23
Net Income										
Ordinary Capital	341	394	382	395	369	521	364	415	393	568
Fund for Special Operations ⁶	47	131	85	88	89	84	82	77	95	103
Reserves (End of Period)⁷										
Ordinary Capital	3,711	4,062	4,360	4,758	5,303	5,969	6,072	6,307	6,867	7,436
Fund for Special Operations	539	539	552	534	534	531	628	598	424	445
ADMINISTRATION										
Administrative Expenses										
Total - All Funds	206	222	257	275	295	333	334	348	341	335

¹ Medium and long term borrowings, excluding net premiums or discounts

² Net of cancellations. Includes currency translation adjustments.

³ Net of Private Sector participations.

⁴ Based on original amounts in U.S. dollar equivalent.

⁵ Includes Small Project financing.

⁶ Income before Technical Cooperation expense and loan write-offs.

⁷ Includes accumulated translation adjustments.

* Includes loans totaling \$1,711.8 million which were conditionally authorized under resolutions which did not enter into effect until January 1992.



COSTA RICA—Workers install pipes in the powerhouse of the Angostura hydroelectric project in Turrialba. This project is part of the IDB's Third Power Development Program, which also includes a wind-powered project, network extensions, and an energy-efficiency commercialization project.

LATIN AMERICA AND THE CARIBBEAN IN 1999

The economies of Latin America and the Caribbean experienced difficult times in 1999. External conditions continued to be adverse, with long depressed terms of trade (except for oil-exporting countries) limiting capital inflows. The two phenomena stemmed from the trends that began with the Asian crisis in 1997 and Russian crisis in 1998, which both had major repercussions in Latin America. By 1998, growth throughout Latin America had dropped to a meager 2.3 percent, compared with 5.3 percent the previous year. Growth in 1999 reached only an estimated 0.3 percent. In several economies in the region, external shocks were compounded by fiscal, exchange rate, and financial vulnerability. Measures therefore had to be taken to limit domestic demand in order to preserve macroeconomic stability in the medium term. In all these cases, however, the policy responses produced rapid results and practically all the economies affected by the crises are now in the recovery stage. This is expected to be reflected in a 3-4 percent growth rate for the region as a whole in 2000. This rapid response was possible thanks to the current structural policy framework, which remained intact during the crisis. Moreover, several countries strengthened their fiscal and financial reform policies and deepened their privatization strategies, which helped offset the fiscal problems and maintain the flow of foreign direct investment to the region.

The International Setting

The Asian crisis, which began in 1997, led to a contraction of prices for basic commodities that contin-

ued to affect many Latin American and Caribbean countries in 1999. Prices for copper, coffee, wheat, soybeans, and sugar dropped over 25 percent in the aggregate, compared with the averages for 1997. Of these items, only copper saw a slight price increase in 1999 over the previous year. In general, however, although metal prices began to recover partially in mid-1999, the basket of basic agricultural commodities dropped even further compared with 1998 prices. These trends translated into new declines in the terms of trade for many countries in the region. Argentina was a representative case, with an approximately 4 percent decrease in 1999. Oil-exporting countries alone experienced recovery in their terms of trade because of the close to 40 percent increase in crude oil prices over 1998 pursuant to the agreement reached by OPEC to reduce production.

The contraction in capital inflows to the region also deepened in 1999. After peaking in 1997 at \$80 billion, net capital inflows dropped to \$72 billion in 1998, and totaled only an estimated \$50 billion in 1999. The decline in private capital was even more pronounced, but was offset in part by funding from multilateral financial institutions. The most volatile component of the capital flows was portfolio investments. Foreign direct investment remained stable at about \$40 billion, undoubtedly attracted by the structural policy framework and the commitment on the part of the governments to medium-term macroeconomic stability.

The shortage and instability of the supply of financial resources for Latin America was also reflected in the interest rates for external bonds. Although at no time in 1999 did the spreads for Latin American

bonds drop to the levels they had reached in the wake of the Russian crisis in August 1998, they occasioned temporary concerns regarding yield potential with the devaluation of the Brazilian *real* in January 1999. The spreads declined subsequently, but have remained at levels substantially higher than during the Russian crisis. It is important to note that although the *fluctuations* in the spreads have been very similar among the various countries in the region—and, in fact, among emerging economies as a whole—their *relative* values have not experienced any major changes. Thus, international financial contagion did not prevent the markets from recognizing differences in the relative country risk, apparently associated with their macroeconomic fundamentals and prospects.

Despite these adverse external conditions for Latin America, it should be pointed out that the international economy performed well in 1999, mainly due to the sustained growth of the United States' economy, which, as discussed below, led to differences in regional performance. Other factors in the sound worldwide economic growth were consolidation of the European Union, vigorous recovery of some of the countries most affected by the Asian crisis, and renewed confidence in the Japanese economy.

Natural Disasters

Several countries in the region continued to struggle with the aftermath of natural disasters that had occurred in 1998, and some were struck by new ones. The impact of Hurricane Mitch in 1998 greatly hindered potential growth, especially for Honduras. Ecuador experienced several volcanic eruptions, just as it was recovering from the devastation of the 1998 El Niño phenomenon. In 1999, climate adjustments to the previous year's El Niño resulted in excessive rainfall in Mexico and Central America, leading to serious flooding and loss of homes, crops, and livestock. In September 1999, Hurricane Floyd swept through the Bahamas, causing extensive damage. In December 1999, after a period of continuous heavy rains, Venezuela was hit by the worst flooding and mudslides in its history, with tens of thousands of casualties and incalculable losses in productive infrastructure and housing.

Domestic Policy Response

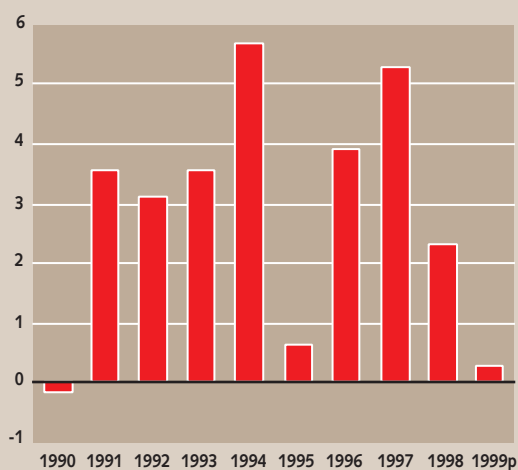
The combination of low international prices for basic export commodities and the decrease in the supply of financing implied a doubly severe adjustment for many countries in the region, again highlighting the vulnerability associated with the dependence on basic commodities and external savings. Due to the shortage of resources for financing, imports had to drop by \$25 billion compared with the previous year, despite the fact that exports from the region increased by approximately \$15 billion in 1999, substantially improving the balance of trade in the region. The external current account deficit thus decreased from \$89 billion in 1998 to \$56 billion in 1999. This external adjustment was equivalent to 2 percent of GDP for the region, representing a sizeable improvement. In addition, several countries had to use part of their international reserves to offset deficits in their balance of payments. However, the reduction in international reserves in the region as a whole, estimated at some \$7 billion, was substantially lower than the \$13 billion loss incurred in 1998.

The contraction in imports resulted from efforts to contain domestic demand through higher interest rates, more austere fiscal policies, and higher exchange rates. Consequently, the policies could not play a countercyclical role in the countries most seriously affected, as would have been desirable to stabilize economic growth and employment.

In many countries, the domestic policy response to the external shocks began with the decision to significantly increase interest rates, to prevent a drop in international reserves or depreciation of the currency. In certain cases, this phase had already occurred in 1998, while in others it followed the devaluation of the Brazilian *real* in January 1999, as a reaction to the potential impact of this measure on the balance of trade, especially in Brazil's neighboring countries, and on the availability of external credit. The increased interest rates proved insufficient in overcoming the long-lasting effects of the external shocks, however, due to their adverse impact on fiscal accounts and the stability of the financial sectors.

In a second phase, the typical policy response consisted of launching a fiscal adjustment program, either through spending cuts or by approving measures to strengthen tax revenues. Fiscal adjustment

Real GDP Growth, Latin America 1990-99
(In percent)



Source: IDB, official statistics and estimates.

TABLE II. THE EXTERNAL ENVIRONMENT
(In percent)

	1998	1999(p)
Real GDP Growth		
Developed Economies	2.2	2.8
Developing Economies	3.2	3.5
Growth of Import Volume		
Developed Economies	4.8	5.9
Developing Economies	-1.3	1.1
Short-term Interest Rates		
US Dollar	4.9	5.4
Deutschemark	3.5	2.7
Yen	0.2	0.0
Primary Commodity Prices (% Change)		
Oil	-32.1	27.7
Food	-12.7	-12.4
Beverages	-15.2	-18.4
Metals	-16.3	-8.7

Source: IMF, *World Economic Outlook*, October 1999.

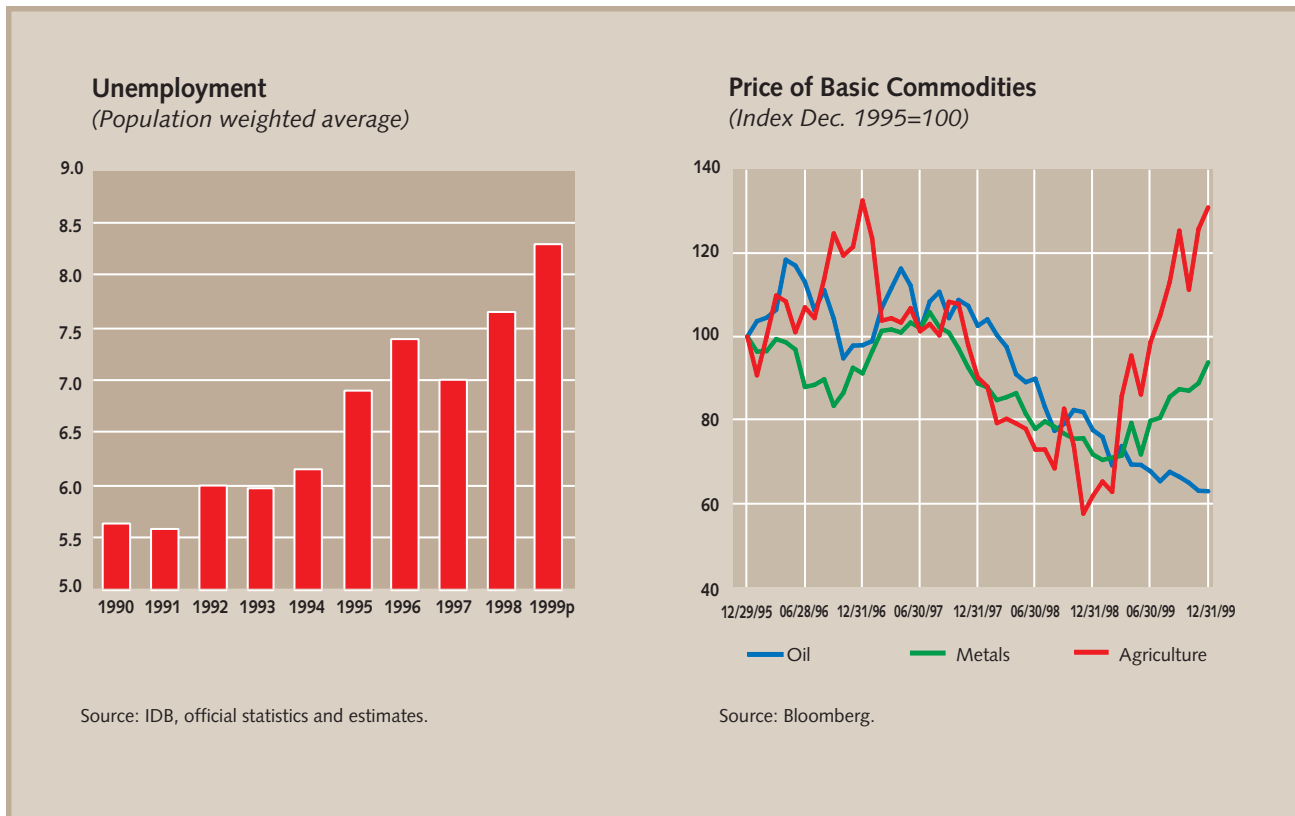
tended to strengthen the decrease in demand, but was necessary as a means of restoring confidence and moderating pressure on interest rates, given the need to finance the fiscal deficits. Chile was one of the few countries that had the option of adopting an expansive fiscal policy that allowed it to contain the recessive impact of the difficult international situation. Efforts to reduce the fiscal deficit were hindered in many countries by low export prices, reduced domestic spending (with consequently lower tax receipts) and higher domestic interest rates, which increased debt servicing. Fiscal deterioration in certain countries was exacerbated by problems in the financial sectors and spending on reconstruction of areas affected by natural disasters. Thus, despite significant adjustment efforts, the fiscal deficit in the region as a whole remained practically unchanged with respect to 1998.

The third component of the adjustment often consisted of exchange rate correction, a measure that many countries initially avoided to prevent inflationary pressures, additional problems in their financial sector, and higher finance charges on their external

debt. Subsequently, Brazil, Chile, Colombia and Ecuador abandoned controlled exchange-rate systems to allow freer exchange market adjustment, with a view to relieving the pressure on interest rates and gaining control of monetary policy.

Having made fiscal and exchange-rate adjustments, most of the countries in the region are now moving into the final stage of the adjustment process. Sustainable reductions in interest rates are being observed and domestic credit is expected to be reactivated to feed domestic investment and demand. However, several countries have only just entered this stage, since their credit-generating capacity is still being affected by portfolio quality problems, capital constraints in the financial system and a lack of confidence on the part of investors.

It is important to note that, with few exceptions, macroeconomic policies have not had the leeway they needed to implement countercyclical policies. The commitment of most countries to fiscal and monetary stability enabled them to keep inflation rates under control. Only in one country was in-



flation above 30 percent, and in several countries it decreased considerably, even in the face of major increases in the exchange rate. In fact, average inflation dropped to 6.1 percent, the lowest rate since the early 1970s, reflecting overall performance in the region. With the sole exception of Ecuador, where the external shocks were compounded by natural disasters and political difficulties, in no other case was there a systemic banking crisis—even though many countries had to address problems in isolated institutions—or any instances of default on external obligations.

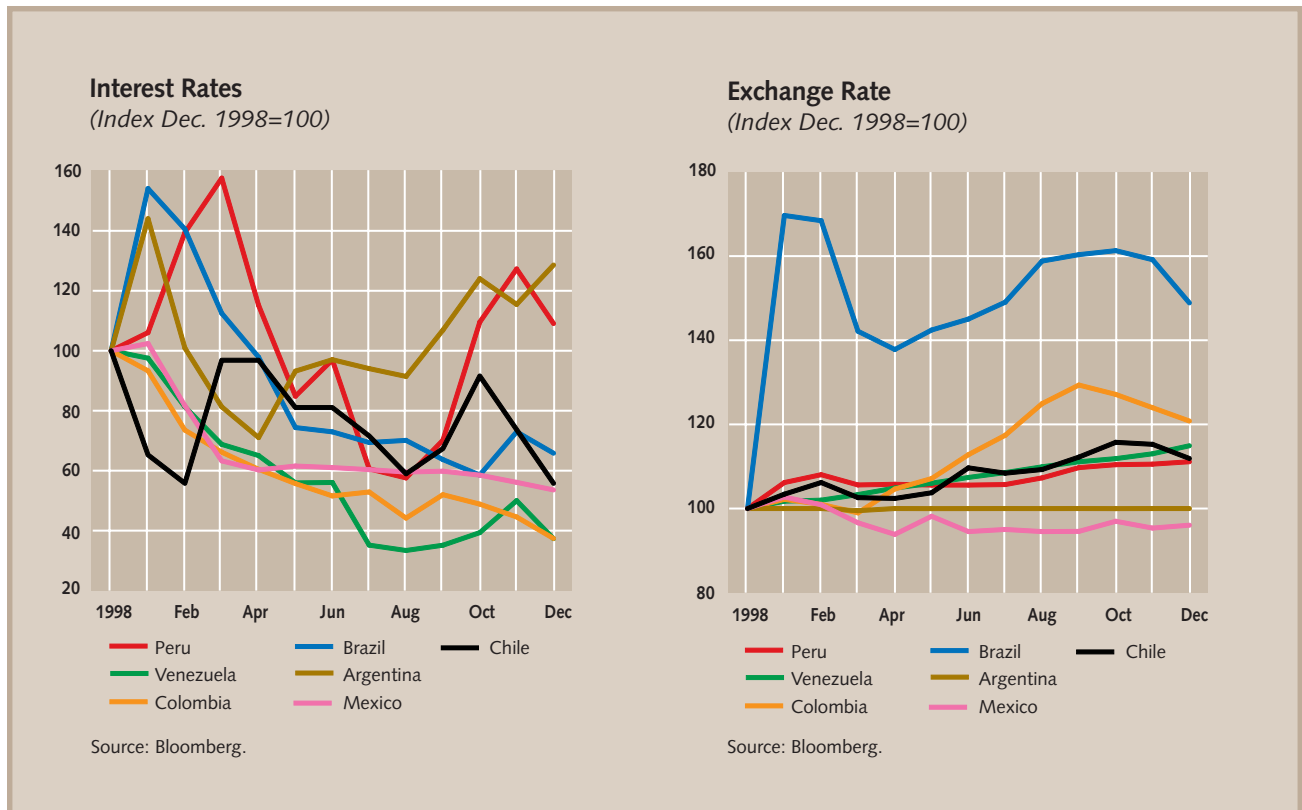
Even more importantly, most of the countries continued to deepen the structural reforms instituted in earlier years. Of 14 countries evaluated by the Bank, 10 promoted major fiscal or tax reforms in 1999, seven were discussing significant reforms in their social security systems, four had furthered the privatization process, and four were discussing major labor reforms. The review observed an additional 25 cases of reforms in the financial systems, in legislation to promote competition, in the health sector,

and in other areas of economic and social policy in those countries. The commitment to macroeconomic orthodoxy and the reform process was fundamental in maintaining the high levels of foreign direct investment flowing into the region and in producing rapid improvement in the prospects for growth in most of the countries.

Macroeconomic Performance

Latin America as a whole experienced growth in 1999 estimated at 0.3 percent, two points less than 1998 and the lowest rate in the 1990s. In the first few months of the year, recessive conditions were present in almost all the economies of South America, except Peru, and growth declined in Mexico and several Central American countries. In the second quarter, recovery began in Brazil and growth resumed in Mexico.

Both Mexico and the Central American and Caribbean countries were stimulated by vigorous



growth in the United States, but some of them also experienced natural disasters. While Costa Rica, the Dominican Republic, and Nicaragua achieved outstanding growth rates, Jamaica stagnated and Honduras saw its economic activity decline.

The most severe impact of the crisis occurred in the South American countries. Colombia, Ecuador and Venezuela experienced sharp contractions in economic activity, due primarily to external conditions. Argentina, Paraguay, and Uruguay also saw drops in their GDP, due in part to speculative pressures, but mainly to the decrease in their exports of goods and services to Brazil. By contrast, despite fears at the beginning of the year, Brazil avoided a contraction of GDP. Bolivia and Peru registered growth of 2.5 and 3.8 percent, respectively.

The impact of the crisis on labor markets was particularly adverse in 1999. The unemployment rate in Latin America climbed to 8.3 percent, the highest figure in the decade and similar to figures recorded in the 1980s at the most critical point in the debt crisis. While Chile, Colombia and Venezuela experi-

enced especially sharp increases in unemployment, in Mexico the unemployment rate dropped to its lowest level in the last decade.

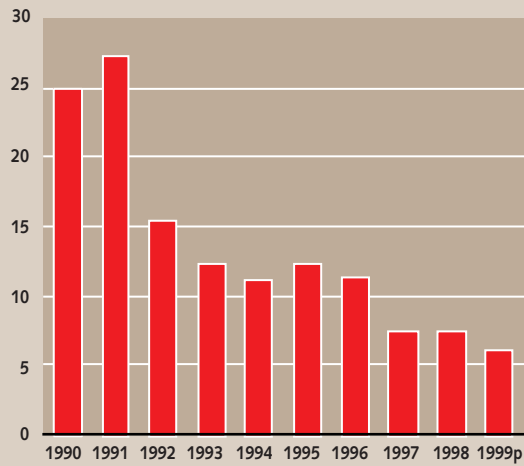
Prospects for the Future

Despite the low indicators for 1999, current prospects for growth are good, and in some of these countries there are already clear signs of reactivation. Projections from various sources point to growth rates of 3 to 4 percent throughout the region in 2000, on the assumption that a favorable external environment is maintained. The ability of the Latin American economies to respond to the recent crisis contrasts with the prolonged period of recession and stagnation during the crisis of the 1980s, when confusion reigned about macroeconomic management and structural policies clearly lacked a horizon. The current situation is radically different.

The main risks the Latin American economies now face are of external and internal origin. The in-

Median Rate of Inflation

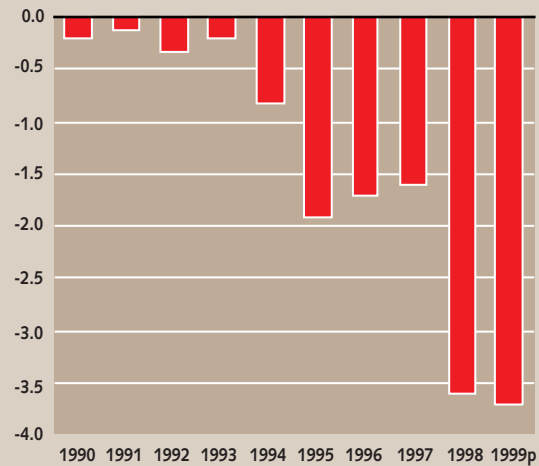
(Dec.-Dec. percent change in CPI)



Source: IDB, official statistics and estimates.

Central Government Fiscal Balance

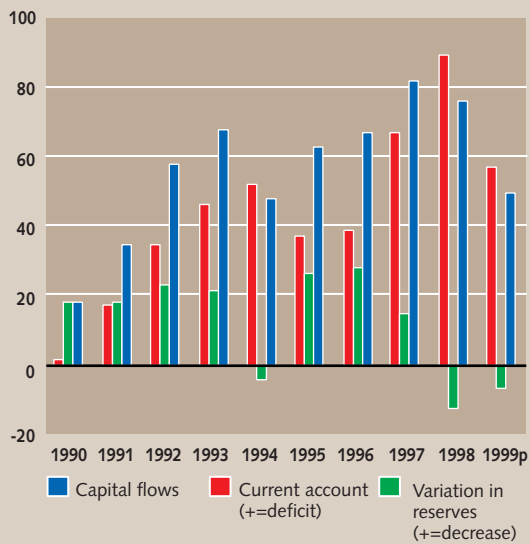
(Percent of GDP)



Source: IMF, WEO, October 1999.

Capital Flows

(In billions of U.S. dollars)



Source: IMF, WEO, October 1999.

ternational financial scenario may take another downturn if the expected interest rate increases in the United States give rise to a sudden correction in securities markets or a loss of appetite for Latin American paper on the part of international investors. The prospects for Latin American exports, which are essential for recovery in the region, will depend on stable growth in the larger economies worldwide. Although none of these risks can be dismissed, the predominant opinion among international analysts is that the international economic situation will be stable and that growth in the United States will be about 3.4 percent and in the European Union, about 3 percent.

External conditions will continue to be crucial for Latin America because the fiscal, financial and exchange policies in the countries of the region have not yet built up a line of defense against shocks of external origin. Fiscal vulnerability stems mainly from low levels of public savings during periods of high growth, rigid budgetary structures, and bias in the structure of public debt toward short-term obligations. Many countries are therefore taking mea-

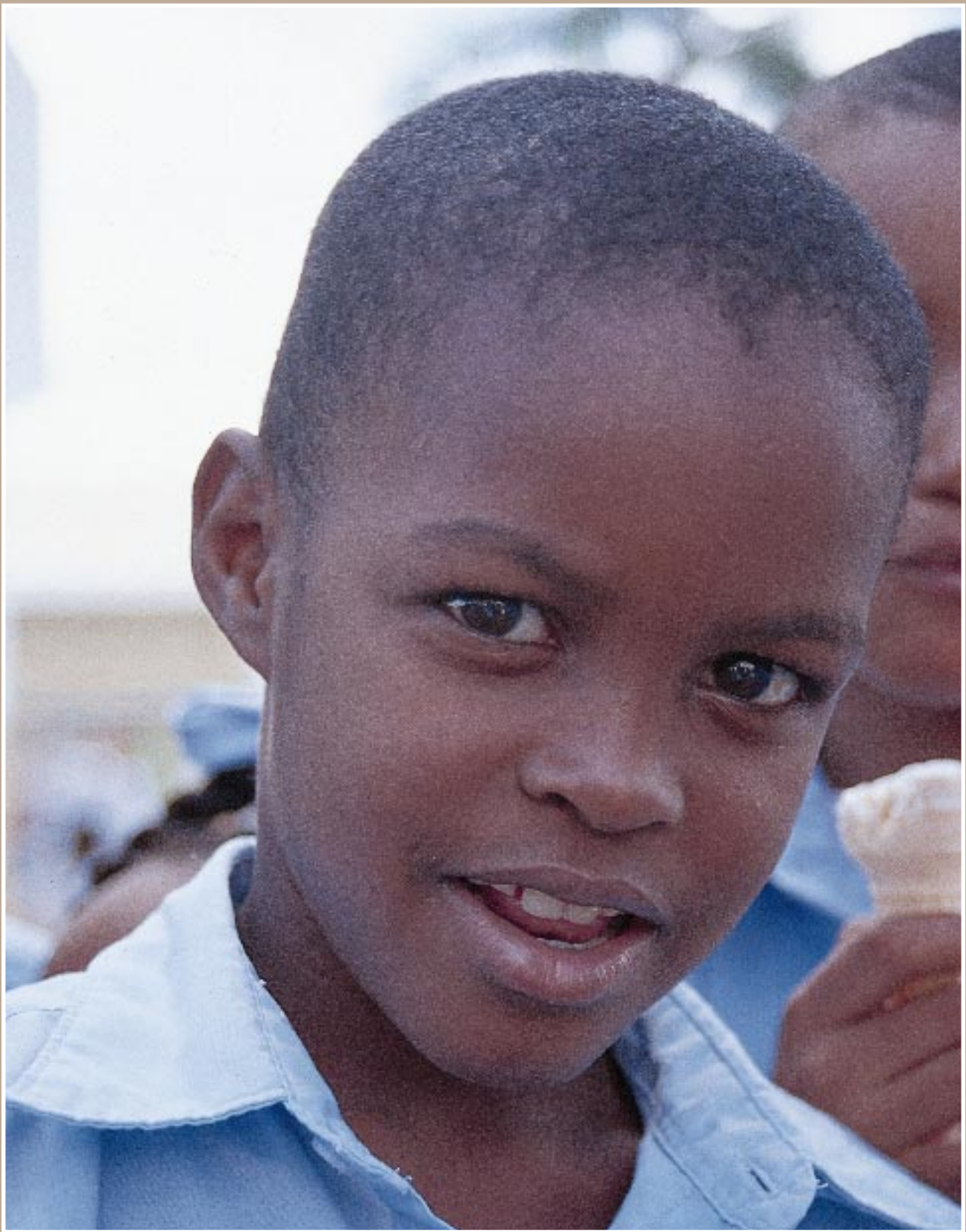
asures to extend debt maturities, as in the recent efforts by Argentina and Mexico and announcements by Brazil to the same effect.

Internally, several countries in the region still suffer from serious shortcomings in their regulatory and oversight frameworks and lack solid institutions to protect deposits. The maturity and currency structure of outstanding balances in many banking institutions undermines their stability and exposes them to fluctuations in interest and exchange rates. Since capital market development and integration with the international financial system remain incipient throughout Latin America, these risks are not yet adequately mitigated.

The inequality in evidence in Latin American society is one of the most pronounced in the world, and is one truly formidable barrier to the region's advancement. Widespread social and economic inequities is

the outgrowth of unequal distribution of assets, notably land and human capital, and differences in access to opportunities. There can be no sustained economic growth without social advancement. The notion of socially responsible economic policy is key to achieving more equitable development in the region. Such a policy means creating and evening out opportunities, looking at the distributional implications of all economic policy measures, not just those specifically designed to protect the poorest, averting economic crises, and fostering adjustment with equity.

There is ample reason for viewing the region with optimism, however, since it has demonstrated its capacity to recover rapidly from external shocks and has continued the process of strengthening its macroeconomic and structural policy frameworks, preserving domestic economic and political stability and winning confidence abroad.



DOMINICAN REPUBLIC—Using a loan granted by the IDB in 1991, the Dominican Republic carried out a program to improve the quality of basic education that has made it possible to repair and maintain classrooms in over 800 schools, to train 7,000 teachers, and procure equipment and teaching material.