

Achieving sustainable economic growth is necessary to reduce poverty and promote higher standards of living for all people in the region. Growth provides the flow of resources needed for employment and income generation, and for financing programs to alleviate poverty. Increased competitiveness, a key component of sustainable economic growth, is also closely linked with poverty reduction. Low levels of per capita income in most of the countries of the region imply that significant increases in productivity will be needed to achieve a substantial reduction in poverty. Competitiveness is also intimately linked to the environment because improvements in productivity are only sustainable if they lead to the preservation and improvement of the natural resource base. The objective of SDS activities to support economic growth, competitiveness and private sector development is to contribute increased per capita GDP and income growth in the countries of the region, under conditions that lead to an improved quality of life and lower poverty while preserving or improving the natural resource base.

Over the past decade, the countries of Latin America and the Caribbean undertook wide-ranging structural reforms that liberalized trade and capital markets, privatized enterprises in a wide range of sectors, diversified exports and promoted foreign and domestic investment in the local credit and capital markets. These economic policies led to banking sector reforms that had a profound impact on the development of the financial sector. Considerable progress was also made in restructuring financial services, broadening regulation and supervision, and reducing market-distorting measures, such as high interest rates and public sector intervention. Likewise, the region has made major efforts to foster investments in infrastructure, including the introduction of modern regulatory regimes and the creation of a favorable climate for private investment. Though private participation has provided net overall welfare gains in most areas (the success story of telecommunications being the clearest

example), public perception in Latin America is not favorable. A reason for this is that the benefits of reform have not always reached low-income populations. In addition, the relatively recent reforms have delivered less spectacular results than originally expected. Moreover, economic growth and the pace of reforms slowed in the last five years, and the region began losing ground in rankings of competitiveness and business climate. After an initial surge in the late 1990s, private sector investment in infrastructure declined by US\$60 billion between 1998 and 2003.

Institutional and structural reforms placed too much emphasis on measures with low up-front costs, such as privatization, and less on strengthening labor market institutions and legal and judicial systems or ensuring that the benefits of the reforms were broadly shared. Although the initial monetary measures to reduce inflation were successful and paved the way for renewed growth, the lack of consistent fiscal policies made those efforts unsustainable in many countries. The region's financial markets are still underperforming relative to their development potential. Specifically, financing and credit are still unavailable to large segments of the economically active population. Also, inefficient intermediation and very high risk premiums imply that the cost of capital is often too high and hinders competitiveness. This is particularly true of bank lending to small and medium enterprises, which are the largest contributors to production and employment in the region.

Macroeconomic instability has had a negative impact on market growth and nowhere is this more visible than in the continued decline of financial markets. The transformation of securities and financial markets remains the key to sustainable development. In order for securities markets to assume their role in the development of savings and investment, the region needs the introduction of international standards of corporate governance. Many countries have begun to move in this direction by implementing accounting and auditing reforms.

Commercial law, especially that related to contract enforcement, has also been a stumbling block. Difficulties enforcing contracts under current civil law structures means that entire areas of financial services do not function correctly. Specifically, the inability to perfect collateral hinders lending to SMEs and inhibits the growth of mortgage markets. Redressing this problem would entail financial and commercial legislative changes as well as changes in the civil legal structure and its institutions.

The region needs to become more resilient to crises if the current recovery is to be sustainable. This can be achieved through better fiscal management; deepening domestic financial intermediation and extending it to SMEs; and improvements in the business environment and governance of public and private institutions.

Demand for infrastructure services in the last decade has been stymied by slow economic growth. Yet, the challenge of how to satisfy this demand remains. In particular, the demand for infrastructure services needs to be met within the constraints of existing institutional conditions, social and environmental requirements, and the paramount need to keep fiscal deficits in check. To overcome these challenges, governments, businesses, and consumers must recognize that the provision of infrastructure services requires long-term commitments. The task at hand is not only to promote social acceptance of private sector participation in infrastructure services, but also to improve the efficiency and sustainability of services provided by public sector entities. In the first instance, it implies dealing with the tariff and subsidies structure for infrastructure services in such a way as not to jeopardize economic stability. An equally challenging situation involves the need to undertake reforms of the legal system in order to secure the reallocation of property rights implied by the reforms, which must be recognized and addressed creatively.

Most companies in the region are formal or informal micro, small or medium enterprises. This varied group of businesses accounts for a significant share of total economic activity, jobs, and income in the region. Unfortunately, these enterprises face serious barriers to market entry because of their size and lack of access to factor markets, financing, and final markets for goods and services. Lack of access is made worse by a limited entrepreneurial capacity to combine available factors efficiently and create profitable long-term sustainable businesses. Relatively lower productivity and competitiveness in relation to larger enterprises and international competitors compound problems.

Improvements in productivity and competitiveness, and hence, economic growth and development, are critically dependent on technological innovation and investments in education, science and technology. Indeed, patterns of trade and economic growth are largely governed by innovation and technology. According to a ranking compiled by the World Economic Forum, the countries of the region rank in the bottom half with respect to technology. Total annual expenditures for research and development (R&D) for all the countries of the region is US\$11.5 billion—half of what countries like South Korea spend. As a percent of GDP, regional investment in R&D is 0.6 percent, compared to between 2.5 and 3 percent in the industrialized nations. The countries of the region also lag well behind others on such measures as private sector participation in R&D, number of patents issued, network readiness, and the existence of a policy environment supportive of innovation.

The international experience shows that no country has developed successfully in the absence of universal quality education, particularly in basic sciences. In spite of considerable efforts by the governments and the Bank, the results fall far short of expectations and needs. In addition, labor force preparedness is at the forefront of concerns about the ability of countries to compete in the global economy and labor markets exhibit increasing returns to highly skilled workers.

The information revolution took off quickly in developed countries, but much of the rest of the world, including the countries of Latin America and the Caribbean, continue to lag behind. This so-called “digital divide” between rich and poor countries is further exacerbated within developing countries by gaps between groups of people with access to information and communication technology and those without. Geographic, social, economic, and technical factors combine in many countries to hamper the supply of national and international connectivity. As a result, telecommunications infrastructure is concentrated in a few main cities. Technical, economic and political barriers have deterred investment and contributed to relatively high prices, hindering the availability of information and communication services for the poor.

SDS addresses issues of sustainable economic growth, competitiveness and private sector development, primarily through the activities of the Private Enterprise and Financial Markets Subdepartment and the recently created Education, Science and Technology Subdepartment.

THE PRIVATE ENTERPRISE AND FINANCIAL MARKETS SUBDEPARTMENT (SDS/PEF)

SDS/PEF includes the Infrastructure and Financial Markets Division, the Micro, Small and Medium Enterprise Division, and the Environment Division. The Subdepartment coordinates the implementation of the private sector development strategy, as well as several related initiatives.

The Business Climate Initiative

[www.iadb.org/businessclimate/sitio/i_home.htm]

The aim of the Business Climate Initiative is to assist concerned governments in improving the conditions that allow private sector investment to thrive. A good business climate is one that provides a sound legal and regulatory framework for

enterprises, promotes competition, strengthens governance, overcomes bureaucratic inefficiencies, and improves access to key financial and infrastructure services.

The Corporate Social Responsibility Initiative (CSR)

[www.csramericas.org]

The CSR initiative includes research projects, the incorporation of CSR practices into Bank operations, financing projects to promote responsible behavior, activities to enhance the social and environmental responsibility of the Bank itself, and the dissemination of best practices. One of the highlights of these efforts is the organization of annual conferences on social responsibility, which bring together representatives of governments, multilateral agencies, private enterprises, foundations, and business networks and associations to address CSR practices in the region and develop effective and sustainable CSR principles. The results of these conferences are published in annual Proceedings and reported, together with other Bank activities, in the Bank's CSR website. It is expected that during the next 12 months, the Bank will produce its first Sustainability Report, which will detail Bank practices and support for sustainability projects and report on its own activities to become a better corporate citizen.

THE INFRASTRUCTURE AND FINANCIAL MARKETS DIVISION (SDS/IFM)

[www.iadb.org/sds/ifm/index_ifm_e.htm]

SDS/IFM is a source of expertise, leadership, and innovation in support of the Bank's lending and technical assistance activities in the fields of infrastructure investment and management, and the development and reform of financial and capital markets.

SDS/IFM has an established role in providing technical support to the Bank's regional departments, particularly in promoting the creation of innovative financial tools.

Infrastructure

[www.iadb.org/sds/ifm/site_404_e.htm]

Major areas of work relating to infrastructure include energy, water and sanitation, transportation, transnational projects, and competition issues. SDS/IFM has organized important workshops and conferences on these topics, including recent workshops on the sustainability of power sector reform, conferences on financing water and sanitation services, and meetings on competition policy in infrastructure services. Publications in this area include books on topics such as privatization, competition policy in regulated

industries, the integration of natural gas markets, and power sector reform. SDS/IFM has also published technical and best practices papers on topics such as cross subsidies in public services, infrastructure financing, case studies on potable water supply, liberalization of the gas sector, and the political economy of reform and private sector participation in infrastructure.

Series of Conferences on Infrastructure Investment

Huge infrastructure investment needs in the region (estimated at US\$40 billion per year for the next 10 years in 2000) cannot be financed through public budgets without affecting macroeconomic stability, inflation and public deficits. The recuperation of Latin American credibility before the international financial community requires the utmost attention. Mobilizing the required financial resources cannot be done without a significant participation of the private sector. Various initiatives address these challenges. In 2004 the Bank launched a series of conferences (which took place in Washington, D.C., Lima, Madrid and Tokyo) and publications aimed at promoting investments in infrastructure in the region. The Bank's strategy is to set up a sustainable institutional framework that allows the private sector to operate, take risks and undertake new initiatives, and the public sector to fill the voids and to engage in public-private partnerships that do not have the flaws that led to the failure of some state-owned enterprises.

Water and Sanitation

As part of its work related to the Millennium Development Goals, SDS/IFM is carrying out analytical work to increase service coverage and improve efficiency in the water and sanitation sectors. Key challenges are pricing, rigid management, poor commercial practices, and political interference, which, together, have had a negative effect on the performance of water projects, resulting in low efficiency, poor quality of service, and poor coverage. The Bank's challenge is to promote a renewed commitment on the part of governments (including municipalities) to ensure the long-term sustainability of services and remove the obstacles preventing the success of water and sanitation services.

Political Economy of Reform

An innovative line of work for SDS/IFM has been the analysis of the political economy of reform, as well as policies (such as subsidies). This research, which has been applied

to infrastructure, involves case studies and technical papers that offer new insights on the reform process for policymakers. From a methodological point of view, the work provides a mapping of special interests, looks into the expected impact of reforms, and studies how improvements to the reforms can address the concerns of groups that would lose as a result of the reform. Institutional analysis is also a crucial part of this line of work.

Financial and Capital Markets

[www.iadb.org/sds/IFM/site_405_e.htm]

Major areas of work in financial and capital market development include banking supervision; pension fund and insurance market reform; and the development of financial and securities markets, intermediaries and instruments. Publications included books dealing with capital market development, financial crises, financial disclosure, pension reform and financial risk management. Technical and best practices papers were published on topics such as building effective banking systems, developing government bond markets, financial intermediation, pension reform, and securities regulation.

Banking Sector

In the context of the preparation and implementation of Basle 2, SDS/IFM has fostered the institutional dialogue between the public and private sectors (i.e., supervisors and banks) to discuss the timely issues of capital adequacy, banking supervision, credit shortage, costs, and volatility. These events and related publications are intended to favor the development and implementation of an adequate regulatory and supervisory framework in the region, and stimulate access to financing, particularly for small and medium enterprises.

Capital Market Development

Several initiatives in the area of capital market development were undertaken during the last 10 years, including a first ground-breaking strategy for capital market development in the region. More recently, a symposium was held to complement the Bank's private sector lending activity for capital market development. The symposium led to the publication of a book entitled *Focus on Capital*. An important highlight of work in this areas is the creation of a Latin American and Caribbean Public Debt Management Specialists Forum whose main objective is to build a general framework for

government debt management that fosters continuous sharing of experiences across countries as well as technical discussions. The ultimate goal of this effort is to improve debt management as well as its cost-effectiveness, and favor the development of capital markets.

Pension Reform

The special challenges of pension reform in small economies was the topic of a symposium held in Barbados in June 2003, which was convened by the Caribbean Development Bank (CDB) and the Inter-American Development Bank. Pension and insurance officials and experts from 17 English-speaking island nations gathered at the CDB's Barbados headquarters. Analysts discussed the issues confronting virtually every nation; namely, the rise in the share of the aged population. The three-day dialogue has yielded a new book, *Workable Pension Systems: Reforms in the Caribbean*. The publication offers a definitive update on the political, demographic and regulatory status of public pensions in small island nations and in some comparable economies.

Significant analytical work has also been undertaken to review the experience of Latin American countries. A pension reform forum (*Transition Issues and Deepening Reforms*) was held at the end of 2004 during which international pension experts discussed the achievements and shortcomings of pension reforms in the region during the past decade. The experts recommended the adoption of new measures to make retirement systems more sustainable and equitable. Case studies of pension reform in Argentina, Bolivia, Chile and Mexico showed that the privately managed systems adopted in these countries had mixed results. However, this does not necessarily lead to a negative conclusion about introducing the funded pillar to correct imbalances in the public pay-as-you-go system. A publication on these topics is expected for early 2006.

Regional Financial Sector Forum

This initiative is aimed at strengthening financial sector stability and development in the region. Its main objective is to develop a regional focus on the key issues for supporting sustainable financial sector development. Forum participants include senior officials with responsibilities in the design and implementation of financial policies in the region. The first meeting of the Regional Financial Sector Forum focused on the institutional structure for regulation and financial supervision. The second meeting dealt with corporate governance. Two meetings dealing with insurance and financial sector development in the region are expected to take place in 2005.

THE MICRO, SMALL AND MEDIUM ENTERPRISE DIVISION (SDS/MSM)

[www.iadb.org/sds/mic/index_mic_e.htm]

SDS/MSM works to expand economic opportunities in Latin America and the Caribbean by promoting the conditions necessary for the growth and development of micro, small and medium enterprises. Major areas of work include microfinance, the policy and business environment for micro, small and medium enterprises; business development services; social entrepreneurship, and local economic development. SDS/MSM also manages the Social Entrepreneurship Program, and prepares operations on behalf of the Multilateral Investment Fund.

Microenterprise

SDS/MSM has published several books on topics such as microfinance and poverty, credit unions, entrepreneurship and business development services. Technical and best practices research papers included topics such as case studies on microfinance downscaling, micro-leasing, village bank programs, microfinance guarantees, and business registration reform. The Division also publishes the magazine *Microenterprise Americas* and a quarterly bulletin entitled *Microenterprise Development Review*. Additionally, SDS/MSM has sponsored various workshops on social entrepreneurship, competitiveness, sources of funding for microfinance and entrepreneurship.

The Social Entrepreneurship Program

[www.iadb.org/sds/mic/publication/gen_159_4053_s.htm]

The Social Entrepreneurship Program had its genesis in the Small Projects Financing Program established by the Bank in 1978. With its creation, the IDB became the first multilateral development bank to lend directly to private nonprofit organizations without a government guarantee. The overall goal of the program is to promote social equity and the economic development of poor and/or marginalized groups. To that end, the Bank finances small projects that provide financial, business, social and/or community development services to the targeted population in an efficient and sustainable manner. The program has been a major contributor to the development and strengthening of nongovernmental organizations in the region and to their efforts to improve the livelihoods of low-income people. The program is highly competitive and supports initiatives that have high levels of innovation and additionality as well as a clear demonstration effect.

The Inter-American Microenterprise Forum

[www.iadb.org/foromic/index.cfm]

SDS/MSM sponsors and coordinates this annual forum in a different country of the region each year. Each forum includes panels and roundtable sessions on specific topics in the areas of microfinance, business development services, business climate, and social entrepreneurship. During each event the Bank recognizes institutions and individuals for their outstanding performance in the areas of microfinance, social entrepreneurship and business development services. This is the culmination of a regional competitive process and involves the presentation of Inter-American Awards for Excellence in each field.

The MIF General Program

Under this program, SDS/MSM prepares projects related to microenterprise and small business development in the areas of remittances as a development tool, reducing regulatory burdens on small businesses, and small business networks and supply chains, which are financed by the Multilateral Investment Fund. The microenterprise projects tend to be focused on innovation, financial regulation and supervision, development of entrepreneurship, and strengthening of microfinance institutions.

The MIF Line of Activity

In order to support the sustainable expansion of microfinance and its integration into mainstream financial and capital markets, SDS/MSM prepares projects that channel resources provided by the Multilateral Investment Fund to selected microfinance institutions. Through this program, the Bank supports specialized microfinance institutions (banks, finance companies, NGOs, cooperatives) that are committed to profitability and to operating under commercial conditions. These projects provide nonreimbursable technical assistance to develop new products, reach new clients, improve risk management, upgrade information systems, and/or strengthen human resource capacities.

Microfinance Regulatory Support

This program finances demand-driven and customized technical assistance to modify and adapt regulatory and supervisory frameworks in order to make them more conducive for microfinance. The program's objective is to promote a regulatory

environment that enables and encourages financial institutions to offer services to low-income entrepreneurs, and support bank supervisory authorities in modifying existing regulations to accommodate microfinance into the country's financial sector.

Small and Medium Enterprise

[www.iadb.org/sds/mic/index_mic_e.htm]

Within the context of strategies for business development and competition, the IDB Group is continuing on the path initiated in the 1990s to improve the business environment, increase lending for financial services and business development, and promote private sector participation in policy design and implementation. SDS/MSM has supported this development through best practices, research papers and technical support to Bank and MIF operations, while fostering political and academic debate with public and private institutions in the region.

Currently, SDS/MSM works to advance knowledge in two main areas: (i) fostering SME competitiveness and (ii) promoting local economic development. In line with these areas, SDS/MSM has focused its recent work on two main topics: clusters and value chains, and entrepreneurship.

Promotion of Clusters and Value Chains

Recent empirical and theoretical evidence show that small and medium enterprises that cooperate and undertake joint actions have a competitive advantage with respect to isolated firms because of their higher collective efficiency. For this reason, during the last few years, the IDB Group has actively promoted cluster and value chain projects in the region.

SDS/MSM has contributed to this line of work by preparing case studies about successful experiences, collecting lessons learned from a wide range of international practices, and disseminating these materials through workshops, seminars and the annual Inter-American Microenterprise Forum.

Measuring the results and impact of these projects is key to taking advantage of lessons learned and to allow for a continuous improvement in the design and execution of cluster and value chains initiatives. Thus, the recent focus of the Division's research has been in developing evaluation capacity for all the projects' stakeholders, including the IDB Group.

Entrepreneurship

[www.iadb.org/sds/mic/publication/gen_159_3806_e.htm]

Entrepreneurs and their businesses are the key players in today's development model. However, much work remains to be done in this area in Latin America and the Caribbean. SDS/MSM has contributed to developing a framework to define economic and cultural incentives in order to increase the rates of business creation and growth. This framework takes into account the business environment and the process of creation and early development of new firms. The Division has also produced several publications about the role of entrepreneurship in emerging economies, and best practices in designing entrepreneurship programs and policies to foster the creation of dynamic new enterprises in the region.

THE EDUCATION, SCIENCE AND TECHNOLOGY SUBDEPARTMENT

To address challenges in the scientific and technological innovation fields, the Bank recently created a new subdepartment within the Sustainable Development Department in order to highlight the importance of these topics and better focus its efforts to improve labor productivity and international competitiveness in the region. The Education, Science and Technology Subdepartment houses the Information Technology for Development Division and the Education Unit, thus consolidating activities dealing with science and technology. The subdepartment is responsible for planning, developing, implementing and managing the Bank's science and technology for development activities, as well as for providing technical support to the regional operations departments in these areas. It is also responsible for providing analytical and technical support in higher education and basic scientific research.

Science and Technology

[www.iadb.org/sds/SCI/site_27_e.htm]

The Bank has been active in promoting progress in science and technology in Latin America and the Caribbean. It has accomplished this indirectly through its lending and technical assistance resources, whereby it has helped to introduce scientific and technological advances and assisted in modernizing economic activities and institutions. The Bank has also provided direct assistance through loans for advanced and technical education and the development of science and technology. The Bank may support institutions and activities other than those that have traditionally received support in the field of education, in the following fields of activity: (i) development of a scientific and

technological policy in the member countries to fit their economic and social development plans; (ii) creation of demand for applied research services and personnel; (iii) support for basic and applied research; (iv) establishment of technological research institutes and standards bureaus; (v) avoidance of the emigration of talent; (vi) support for multinational or regional institutions; and (vii) transfer of technology.

Work in the area of science and technology includes the implementation of the strategy, as well as development of technical papers dealing with biotechnology and agriculture. Activities will be reinforced by the use of resources such as the Korea Fund for Technology and Innovation.

THE INFORMATION TECHNOLOGY FOR DEVELOPMENT DIVISION (SDS/ICT)

[www.iadb.org/sds/ict/site_5928_e.htm]

SDS/ICT helps to match the needs of countries in the area of information technology for development with the resources and capabilities of the Bank. In order to accomplish this, the Division operates through a matrix organization involving sector and multi-sector projects. This approach enables it to integrate its involvement in sector projects with increasing requests from countries for multi-sector IT for development projects. SDS/ICT provides technical support for project development and other Bank activities in the information technology for development field; offers strategic and technical advice to governments on how to make better use of available information technologies; and develops cooperation and co-financing arrangements to support research activities, studies, training, seminars, technical assistance and pilot projects. Thus SDS/ICT makes available to public officials and political authorities a series of innovative and emerging e-governance and e-government solutions as means to improve the efficiency, transparency and accountability of public administration. SDS/ICT also promotes the adoption of e-business to enhance private sector productivity, efficiency, market penetration, and competitiveness, particularly in the case of small and medium enterprises. It also promotes linkages between public and private institutions in the region and with institutions in nonborrowing countries. Finally, SDS/ICT prepares strategic analyses of needs, priorities and opportunities in borrowing member countries.

E-Government

[www.iadb.org/sds/ICT/site_6198_e.htm]

The countries of Latin America and the Caribbean recognize the potential of information and communication technology as a tool for carrying out the institutional transformation of public administrations, as well as raising the level of trust between citizens and the government in order to mobilize public, private and civil society resources to achieve development objectives. Within the appropriate institutional framework, SDS/ICT can contribute significantly to promoting efficiency, effectiveness and transparency in carrying out and providing public services. Countries have been evolving government-wide approaches in public administration (i.e., e-government) in order to balance the need for standards and flexibility in the innovative deployment of information and communication technologies. Public sector use of these technologies enhances country capacity to formulate public policies and establish a regulatory structure to ensure that growth of the knowledge economy contributes to carrying out a democratic process that leads to efficient, equitable and sustainable development.

Through its ICT in Governance Program Program, SDS/ICT promotes consensus on outcome, outputs and indicators to measure development effectiveness in this area and, thereby, facilitate appropriate matches in e-government between the increasing and changing needs of each country and the resources of the Bank. These efforts are carried out through the creation of alliances with other institutions and governments; the promotion of regional dialogues among institutions on the different aspects of e-government; and the promotion of regional cooperation to strengthen democracy through the expansion of e-government capabilities.

Work in this area also includes the publication of an e-government manual, promoting legislative information networks and a study on the role of information and communication technology in building trust in government.

E-Business

[www.iadb.org/sds/ict/site_6211_e.htm]

ICT-4-BUS is a program sponsored by the IDB and the Multilateral Investment Fund to improve the competitiveness, productivity, and efficiency of small and medium enterprises in Latin America and the Caribbean by improving their business processes and expanding their access to new ICT solutions and services. ICT-4-BUS provides funds for development and implementation of ICT pilot projects, which test innovative ICT applications for SMEs, mainly in the areas of value chain integration, workplace productivity and efficiency, and market penetration. In so doing, the program seeks to facilitate a match between the offer of ICT applications and services with the specific

demands of and needs of SMEs. The pilot projects have to demonstrate the technical feasibility and commercial viability of proposed ICT services and solutions for the benefit of SMEs in the region.

Work on e-business includes the publication of a quarterly electronic newsletter, an e-business manual for small and medium enterprises, and a best practices evaluation of the ICT-4-BUS program.

THE CHALLENGES AHEAD

One of the greatest challenges that the region faces in order to overcome lackluster economic growth and widespread poverty lies in the establishment of a healthier *business climate* and a reduction in the size of the informal economy. Measures that address these issues should be structured in such a way that micro, small and medium enterprises benefit as much as larger ones and multinational companies. Many workers and enterprises in Latin America and the Caribbean are pushed into informality by the high costs of complying with laws and regulations. The challenge that the region faces is to reduce fiscal and regulatory burdens in order to increase formality. Reforms should endeavor to establish the “rules of the game” that ensure macroeconomic stability, competitive markets, appropriate legal and regulatory frameworks, and a robust social and physical infrastructure. These rules of the game must also mitigate negative impacts on the environment, health, and labor that are sometimes associated with private enterprise.

It is important to establish a positive relationship between the State, markets and society. Despite major improvements, the movement toward market economies has not been accompanied by the development of effective regulatory capacity (to promote competition and protect societal interests), adequate consensus mechanisms or the effective rule of law. At the same, fiscal problems have led to the abandonment of policies and institutions to promote and support the productive sectors. There has been little progress toward fiscal reforms to broaden the tax base and shift the tax burden to make it more equitable. There is still a lack of confidence in basic economic rights and in the ability of governments to provide public services and basic infrastructure. Regulatory and supervisory institutions often lack the necessary independence, objectivity or technical capacity to monitor the behavior of public agents and scrutinize transactions between the State and economic agents.

Challenges in the *financial markets* sector fall into several major areas: general financial services, banking, capital markets, private pension systems and insurance. In

the area of general financial services, actions should concentrate on bringing into the economic mainstream those economic units that are not contributing their full potential. This can be achieved by providing incentives to reduce informality, addressing business climate and competitiveness issues, deepening supervision and regulation, empowering public financial intermediaries to enforce laws, revising the legal and judicial laws that govern commercial contracts, improving the cultural sensitivity of corporate governance, and fostering the adoption of international standards of governance.

In the *banking* area, the challenges are to broaden banking services to reach a larger number of clients. This can be achieved through legislative reforms to foster and enforce commercial contracts, and by ensuring that public and national development banks operate efficiently. The main challenges in the area of *securities markets* include impediments to supply and widespread listing on capital exchanges and impediments to demand and extensive purchasing of issues. Factors that affect debt markets also need to be considered, including fiscal deficits, central bank and pension reforms, and other macroeconomic topics.

Political legitimacy and consensus building are important challenges in *pension reform*. In some countries there is a need to strengthen the dialogue on pension reform and to work closely with public pension systems in order to smooth out irregularities and provide greater old age security. A key aspect will be to expand coverage and contributions using positive incentives. There is also the need to redress constraints to the private pillar, including widening investment possibilities and reducing administrative costs, and reviewing and developing ways to instill confidence in the pension system, including broad government reforms and protection of pension assets. To promote a sound securities market, it is important to nurture a continuous increase in the number of investors, including *insurance* companies. The creation of instruments for complete markets is crucial.

There are several general challenges in the area of *infrastructure* that require attention in the near and medium term. They pertain to the scope of regulation, public investment and fiscal prudence, subsidies and redistribution, contracts in a weak legal environment, and the role of public-private partnerships. In developing countries, inadequate regulation is a consequence of poor financial conditions and the need to attract private investors to meet the requirements of underserved populations, and thus regulation is not, as is the case of developed nations, a means of stimulating efficiency gains. As a result, developing countries must keep in mind the trade-offs between efficiency gains and attracting private investors. Fiscal prudence in public investments

calls for transparent government accounting, clear criteria for ensuring that publicly owned companies do not add to the fiscal deficit, and economic criteria for public-private initiatives. Municipalities also require institutional strengthening, because it is at the subnational level that many public and private investment decisions will have an impact. The challenge with respect to subsidies and redistribution is to find ways to defuse opposition from groups that would see their taxes rise or cross-subsidy transfers decrease, and by providing short-term compensation to those groups who prefer the status quo. The region has undergone a relatively high renegotiation rate on concession contracts, largely because weak legal environments result in a lack of contract enforcement. In countries with high redistribution pressures and imperfect property rights protection, contracts *and* governance require a joint design reflecting the relevant constraints, thus the growing popularity of public-private partnerships.

In addition to these generalized challenges, the infrastructure sector faces serious challenges in the area of energy supply security and with respect to the decentralization of water and sanitation regulation. Several factors, such as the anticipation of government intervention to cap prices during periods of scarcity, large time-to-build of generating facilities and differential creditworthiness on the demand side, conspire against the effectiveness of artificially designed short-term markets to induce timely capacity additions in electricity. The supply of gas has been affected by political events. Centralized supervision of water and sanitation faces problems of asymmetrical information and technological heterogeneity, which complicates the use of comparative regulation.

The main challenges for *microenterprises* in the coming decade are: strengthening their human capital, greater entry into the formal economy, access to business development services and adequate financing. The existence of a business environment that stimulates the proper operation of markets and promotes formalization, as well as a greater participation of the private sector in support of microenterprises, will be key factors for this sector. Many of the hurdles facing *small and medium enterprises* in the region coincide with those of microenterprises. Nevertheless, SMEs face additional challenges, including the fact that they tend to be family-owned. This means that their capacity and skills are generally limited to those of the owner or entrepreneur. An important challenge facing SMEs is the need to enhance competitiveness in increasingly global markets.

Access to the Internet and other *information and communication technologies* will enable the people of Latin America and the Caribbean to gain more effective access to government services, carry out financial transactions, access education services,

participate in electronic commerce, and communicate efficiently. To accomplish this, continued progress needs to be made toward strengthening the social, economic and political adjustment mechanisms that enable individuals, organizations and countries to make and implement decisions. Factors such as political stability, macroeconomic governance, transparency and accountability of national and local administrations, the rule of law, physical infrastructure, and basic literacy pave the way for and, at the same time, are stimulated by a more effective deployment of information and communication technologies across the region.

Similarly, successfully addressing these challenges depends on strengthening the commitment to the *development of science, technology and innovation systems* in the region. The ability of nations to create, adapt and assimilate technology is key to increased productivity, competitiveness, and economic growth, as well as improved equity. This requires increased investment in science and technology infrastructure and the development of adequate regulatory frameworks to promote innovation. The existence of highly qualified and technologically proficient staff is also necessary to efficiently integrate technology into productive processes. The development of national innovation systems with strengthened and consolidated institutions that facilitate the interaction of these elements, should occupy an increasingly important place in the development agenda of the countries of the region. Innovation is understood to be a crucial source of improved business competitiveness and worker productivity.