CAF Corporate Strategy: CAF 2030

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I. Evolution of CAF and need for a long-term strategy

A. Evolution since 1970

CAF has transformed since its establishment in 1970. It has more than tripled its membership from five countries to 18, becoming a full-fledged Pan-American institution. In the process, it has increased its lending volume six-fold, from $2 billion in 2000 to $12 billion in 2013.

CAF has also greatly diversified the composition of its lending; the share of the original member countries was only half of total approvals in 2013. CAF's credit rating has been steadily upgraded to AA-, higher than all of its borrowers, despite zero guarantees from developed countries. The size of its staff has risen much more modestly, growing from 250 in 2001 to 528 in 2012.

CAF's transformation has made it the seccond largest development partner in Latin America. It has surpassed the World Bank with double the lending volume (of IBRD) in 2013. It has narrowed its gap with the IaDB. In seven of its 18 member countries in 2013, CAF was the largest lender, and in another four countries the second largest. It lags behind IaDB and WB mainly in Brazil and Costa Rica and significantly behind IaDB in Mexico. Controlling for Mexico, CAF was the largest development partner in 2010 and 2011; CAF and IaDB had similar lending volumes in 2013 (see Figure 1).

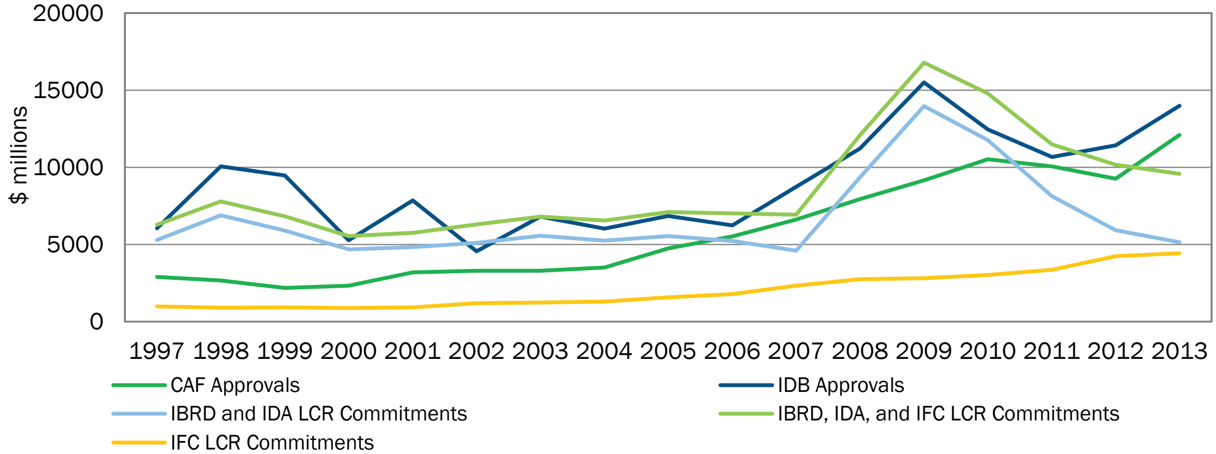
CAF has been the largest lender in infrastructure for more than a decade in Latin America and has been steadily increasing its lending to this sector. It has also played an important role in lending to the financial sector and recently surpassed IaDB in approval volume. CAF's lending to the social and environmental sectors has not seen a corresponding increase.

B. Key success factors

CAF's steady ascendance as a leading regional development partner is explained by a number of distinguishing characteristics that set it apart from other regional and global development institutions.

First and foremost is its ownership and funding. Unlike the World Bank and IaDB (as well as the African and Asian Development Banks), CAF's shareholders are all from within the region (with a very small percentage held by Spain and Portugal). It also does not rely on donor countries from outside the region for periodic replenishments to sustain a concessional lending window (similar to IDA or the African and Asian Development Funds). Given its shareholders and borrowers and lack of external donors to influence its policies and decisions (such as replenishment discussions), there is a strong sense of solidarity and trust between the institution and member countries—a characteristic shared by only one other major regional institution, the European Investment Bank (EIB). As a result, CAF borrowers have a strong sense of ownership of the institution. CAF is very much seen as it now describes itself, the development bank of Latin America.

Figure 1: Excluding Mexico, CAF has been the second largest development partner in the region since 2005 (the largest in 2010 and 2011)



Source: AF Annual Reports 2000-2013, World Bank Annual Reports 2000-2014 (including financial appendixes), Inter-American Development Bank Annual Reports 2000-2013

Second, the fact that its shareholders (owners) are also the borrowers allows CAF to focus its activities on a limited set of issues and topics that are considered most important by the members. There is no pressure to add agenda items that are of interest mainly to outside parties. This has permitted CAF to focus on and specialize in areas like infrastructure and financial intermediation, offer high quality expertise to its borrowers, and compete with much larger institutions (like IaDB and World Bank) despite its relatively modest staff size.

Third, CAF does not have a sitting, resident Board. Its Board normally meets only once a quarter. This permits the senior-most economic policy makers (ministers of finance or central bank governors) to be members of the Board and attend its meetings. As a result, the Board members focus mainly on strategic matters and normally make decisions on the spot, without having to revert to their headquarters as at most other development institutions. CAF Board has also delegated to the President the operational and day-to-day managerial decisions.

Fourth, CAF's top management has ready access to the top decision makers in borrower countries, including heads of state and ministers responsible for economic management. This not only makes CAF's management more knowledgeable about the issues of most concern to the senior policy makers, but also helps resolve complex issues concerning its work by directly talking to the decision makers.

The aforementioned authorizing environment, sharp focus in its operational work, and the compact size of the institution has in turn created a virtuous cycle of rapid decision making and low transaction costs. This in turn reinforces its borrowers' feeling that CAF is their own institution that delivers faster than other multilateral development partners. These advantages must be preserved in its future corporate strategy.

C. Need for a new strategy

CAF's success, particularly since 2010, underpins the need for formulating a long-term corporate strategy. CAF has now completed its transformation from a modest-sized, sub-regional lender focused on the ANDEAN region to the leading, full-fledged Pan-American development institution. In addition to its leadership in lending for infrastructure development and financial intermediation, CAF is also more proactive in facilitating regional cooperation, an important but largely unfulfilled political goal of the region. As CAF ramps up activities in the two largest economies, Brazil and Mexico, both relatively new members, the Bank could soon surge ahead of IaDB in terms of total lending volume. These developments require and position CAF to also become a leader and trusted partner on Latin America's overall economic development and related policy issues; it could fill the gap resulting from the decline in the World Bank's engagement in the region. All these factors require CAF to step up its analytic and policy work so as to supplement its financial assistance with relevant knowledge products and services.

A second reason to formulate a new strategy is the need to take account of the accelerating pace of change in the structure and evolution of the global economy and the underlying mega-trends that will likely have a major impact on the long-term evolution of Latin America. These include the: i) accelerating pace of globalization; (ii) rise of emerging markets, particularly in Asia; iii) increasing competition for natural resources; iv) innovation and technological advances; and v) increasing adverse impact of climate change; vi) a narrowing time window during which Latin America will still enjoy the demograhic dividend, which will disappear well before 2050. These trends and their implications are elaborated upon in Chapter II.

A third reason is the need for CAF to do more to support its member countries in enhancing their overall economic performance to achieve higher growth and prosperity. As discussed in Chapter III, Latin America's past economic performance can be at best described as mediocre. Many countries—including Argentina, Brazil, Mexico, and Venezuela—appear to be mired in the middle-income trap. East Asia has been surging ahead, and during the past decade, Africa's economic growth has exceeded that of Latin America. Disparities between the rich and the poor in Latin America, while narrowing, are still the highest in the world. Perhaps partly because of this, many Latin American cities suffer from a high degree of violence. There is an urgent need for the policy makers to take a critical look at what is holding back their economies and societies and formulate remedial strategies and policies.

These strategies and policies will need to recognize that the vast majority of Latin Americans have joined the middle-class.[1] Centennial Group's model anticipates that by 2030 over 80 percent of the population will be classified as middle class or higher (and 94 percent by 2050), compared to 64 percent today. These people will have a different set of values and will be much more demanding in terms of quality and effectiveness of public services and governance standards. The traditional model of development assistance, which was conceived to eliminate absolute poverty, will need to be adapted to focus much more on the needs of the middle class. As a trusted development partner and a leading lender, CAF has both an opportunity and an obligation to help Latin America significantly improve its economic performance, including to meet the aspirations of the growing middle class, and retain an important role in the fast-changing global economy.

Finally, there is the need to incorporate the increasing consensus amongst development economists that while economic and productivity growth are fundamental, two other objectives must be integral to all development efforts: inclusion and environmental sustainability. As of today Latin America suffers from the highest disparities in the world. As such, adoption of inclusive growth has to be given equal importance as economic and productivity growth. And, given the rising global concerns about climate change, Latin America must make its own contribution to this global commons as an integral part of the global community. These two additional objectives cannot be treated as optional add-ons to economic growth but have to be an integral part of all CAF's corporate activities. Development of a new long-term corporate strategy will permit the incorporation of economic growth, inclusion, and environmental sustainability in a systematic manner in CAF's future activities.

1. Per capita income of between US$10-100 per day (in PPP terms)

II. Global mega-trends: Implications for Latin America and CAF

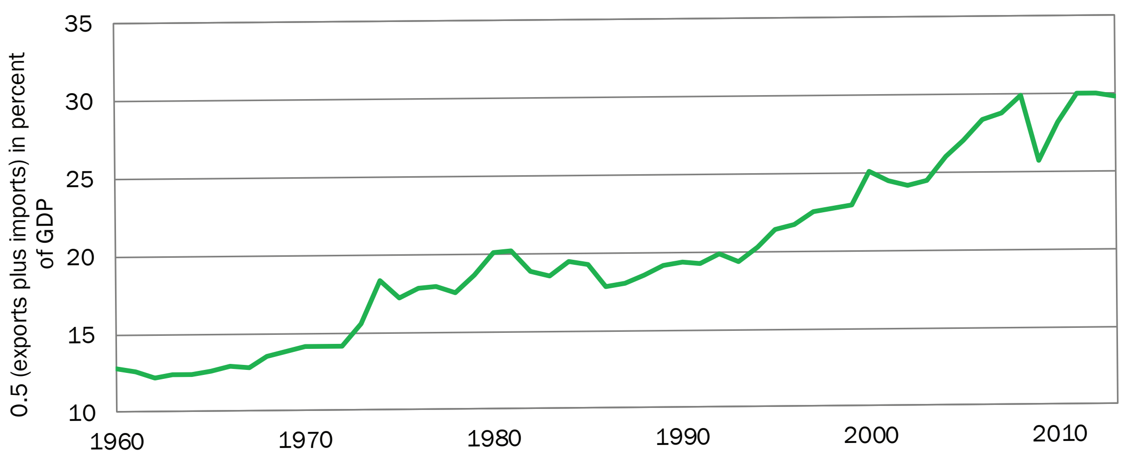
Individual countries and regions cannot insulate themselves from the global mega-trends. These mega-trends have to be taken into account when designing the long-term development strategy for Latin America as well as CAF. While Latin America cannot change the basic direction of these trends, it can leverage them for its benefit.

A. Globalization

For the past century, a key driver of long-term growth has been globalization in international trade, capital, labor flows, and exchange of ideas, which have been facilitated by rapid increases in connectedness among key economies in the world.

World trade (defined as one-half of the sum of exports and imports) as a share of world GDP rose from less than 15 percent in 1960 to 25 percent in 2000 and more than 30 percent in 2013 (Figure 2).

Figure 2: The share of trade in world GDP has doubled



Source: World Development Indicators

The net inflow of world foreign direct investment, which had also risen steeply during the 1990s, has exhibited a seesaw pattern since 2000, when it stood at four percent of world GDP. UNCTAD projects that FDI flows could rise from $1.45 trillion in 2013 to $1.6 trillion in 2014, $1.7 trillion in 2015 and $1.8 trillion in 2016.[2] Global gross capital flows (equity and debt together) soared from single-digit percentages of world GDP to more than 20 percent on the eve of the Great Recession of 2007-09.

Despite the temporary setbacks caused by the Great Recession, further globalization of trade, investments, and capital flows is expected to continue. In the past fifty years, countries that have embraced globalization (such as East Asia) have exhibited superior economic performance. This has major lessons for Latin America as economies are less open to the rest of the world than East Asia. This must change in order for Latin America to achieve superior economic performance. It follows that Latin America must do more to internalize implications of globalization in its economic strategy and policies. CAF should help its

2. UNCTAD (2014)

borrower countries to become more open to each other and to the world economy and encourage greater trade and foreign direct investment.

B. Innovation and technological advances

Innovation is widely recognized as a key source of growth for all economies irrespective of their income level. While there is considerable debate about the pace of future change, it is clear that the technological frontier will continue to expand. Knowledge and innovation will drive the performance of some countries and a lack of it will hinder progress in others. The big opportunity for Latin America is to catch up with North America and Europe. At the country level this may often mean leapfrogging to the best existing technologies that are new to the region. While Latin America does have a number of high-productivity firms, an important source of productivity growth will be bringing its lowest-productivity firms to the level of its highest. Knowledge will also affect performance beyond pure technological advances. Innovation—so-called inclusive innovation—can be important for inclusive growth and social development.

Information and communication technology will continue to make communication easier and cheaper. This has clear economic dimensions, but also political ones. Mobile phones in Kenya, for example, have not only opened banking to millions who were previously excluded but also accelerated communication that can crystallize greater aspirations of the people.

Given the increasing importance of innovation and new technologies to the region's economic and social development, CAF's future operations should also emphasize them as appropriate in its future country assistance programs.

C. Rise of emerging markets and Asia

Major shifts are taking place in the global economy and they will affect Latin America's future. The global economy no longer depends on the American or European consumer alone, but also on the Asian investors and consumers. Structural growth in developing countries has decoupled from high-income countries, but business cycles have not. Developing countries' contributions to global investment growth are now higher than that of high-income countries. At the same time, cyclical upswings and downswings in growth in developing and high-income countries remain highly synchronized.

Latin America must seize the opportunities created by the trade, investment, and consumption shifts associated with growth in a multipolar world, such as growing global trade, new sources of investment, and fast-growing consumption in emerging markets. It must join the group of fast-growing emerging economies that are converging with today's advanced economies.

Various studies by the Centennial Group and other parties suggest that by 2050 emerging market economies (as classified today) are expected to account for about two-thirds of global output, very different from the situation just a few years ago when the G-7 economies generated two-thirds of world GDP. The sharpest growth is expected in Asia, which could account for half or more of global GDP in 2050. In reaching that share of the global GDP, Asia is expected to account for the bulk of global savings and investment and a fast rise in world trade and consumption (assuming that China will continue to encourage and promote domestic consumption over exports and domestic investment). While the G-7 countries will continue to have a much higher GDP per capita than Asia and also have a large share of world trade, it appears clear that from now on incremental growth in global GDP, investment, and trade will be in the emerging markets, particularly in Asia.

These dramatic changes in the geographic structure of the world economy have fundamental implications for Latin America. Historically, Latin American economies have been closely intertwined with North America and Western Europe. While maintaining these historic and mutually beneficial ties, Latin America has to develop stronger trade and investment links with Asia and other emerging markets worldwide. Such business ties do not develop overnight and require years of sustained efforts. While private companies will have the primary responsibility for such market development efforts, governments would have the lead responsibilities in two critical areas: achieving bilateral or multilateral trade and investment protection agreements with Asian countries and developing infrastructure projects to reduce shipping costs and logistical hurdles across the Pacific. Such efforts have to start now in order to bear full fruits by 2030. CAF can have a major role to play in these two areas of government responsibility, and also in promoting Latin America-Asia business ties. In addition, it can encourage and facilitate Latin American firms' integration into the global supply chains that account partly for East Asia's success.

D. Competition for natural resources

The expected increasing affluence of Asians, Latin Americans, and Africans will intensify competition for scarce natural resources (energy, minerals, water, and fertile land), especially if they emulate current Western lifestyles. Global supply may not readily accommodate changes in demand of this magnitude, especially for non-renewable raw materials. Concerns about the sustainability of economic growth are not new. They date back to Malthus and re-emerge whenever growth is rapid. Today there is a backdrop of rising prices for food, fuel, and other raw materials (until two years ago). The new equilibrium will surely be found in a combination of adjustments: price increases to reduce demand and increase supply; new technologies to reduce unit consumption and/or substitute with more plentiful, renewable resources; and recycling to minimize waste.

Commodity prices have also become more synchronized and have been on a steep upward trend. The post-2005 commodities boom was one of the largest on record, and the movement of energy, metal, and agriculture prices is much more tightly linked than in the past due to increasing globalization of commodity and financial markets. Also, given increased synchronization of business cycles, commodity price fluctuation will continue. Commodity demand is high, but technological progress continues to increase the efficiency of resource use, and energy and food use per unit of global GDP continues to decline. Overall, real commodity prices are expected to suffer periodic downswings.

For Latin America and CAF's future support, these trends present two important opportunities. First, as a continent rich in minerals and other natural resources (including arable land and water), the region (together with Africa) will remain a major supplier of minerals to the rest of the world for an extended period, generating financial resources to invest in the future. And second, it could become an even larger exporter of agricultural products to the world. At the same time, Latin America must develop strategies to manage the risks associated with the periodic down cycles. And, over the longer term the region must diversify its economies to reduce the current reliance on commodity exports. Economic diversification of the region's economies should become a basic tenet of CAF's long-term strategy.

E. Climate change

Climate change issues are critical to the future development agenda. Global warming is leading to climate change throughout our planet. The changes are difficult to quantify with a high degree of confidence, but certain to have an adverse impact on most countries. The increased frequency of severe weather events and increased coastal flooding are probably manageable over the next two decades. Beyond that, however, there is much greater uncertainty and clear risks of catastrophic developments.

Despite these uncertainties, by now there is broad consensus amongst most international scientists and environmental economists that the effects of climate change could threaten human lives and damage the social capital and the fruits of development that both advanced and developing countries have accumulated over the centuries. All other international development partners are working to mainstream climate change issues into their development cooperation policies and strategies. The OECD has developed policy guidance to integrate climate change adaptation into development cooperation (OECD, 2009).

Given CAF's standing in the region, it has to join in such global efforts. At the same time, CAF has to recognize that environmental sustainability and climate change related issues are complex. They require specialized expertise. Also, some other institutions working in the region (such as the World Bank) have large dedicated staff devoted full-time to this field. Instead of duplicating their work, CAF would should focus its work on a few selected aspects in which it can develop the necessary expertise.

Beyond the immediate needs for investments in climate-resilient infrastructure and adaptive agricultural technologies, preservation of rain forests and development of strong and flexible institutions capable of dealing with the challenges posed by climate change is a high priority in every country in the region.

F. Demographic dividend

The region is currently at the peak of its demographic dividend. The rapid rate of growth of population in previous years, on account of reduced infant and old-age mortality, has been central in this regard. On this basis the dependency ratio remains relatively low, ensuring the well-being of both the young and the old. However, in the more recent past, fertility rates have plummeted. This reflects significant changes in attitudes, likely induced by a higher share of the middle class in society, improved education for women, and a larger participation of women in the labor force. On the basis of the changing demographic conditions, the dependency ratios have started to increase. Thus over the medium-term Latin America will need to focus on this change in the local conditions, which will have considerable consequences for savings and investment. Moreover, as demographic conditions change in the rest of the world due to the rapid aging of the population expected everywhere (with the exception of Sub-Saharan Africa), the availability of foreign savings would also decline, even with increased levels of income world-wide.

G. Emergence of a large middle class

Another important global mega trend of this century is the emergence of a large, in many instances even a dominant, middle class in emerging market economies; this would be particularly so in Latin America and Asia. As we have seen earlier in today's developed economies, emergence of a large middle class has far reaching economic, social and even political ramifications.

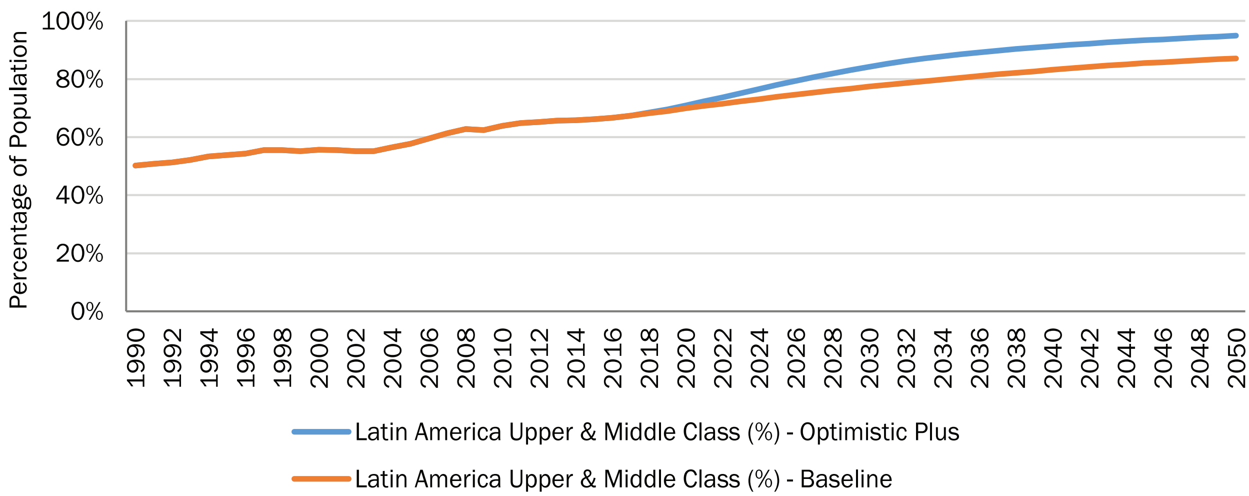
Centennial Group's estimates suggest that the emerging market economies are poised to see an explosive growth in the number of people who may be classified as belonging to the middle class (per capita income of between $10 and $100 a day in PPP terms). Latin America and Asia will lead this trend. Indeed, in the past fifteen years, Latin America has already witnessed an unprecedented growth in its middle class as a result of robust economic growth and a welcome reduction (though still modest) in the disparities thanks to the success of the poverty alleviation programs in Brazil and Mexico. In 1990, people classified as middle class already comprised almost 50 percent of Latin America. By 2014, that number had risen to about 65 percent, the highest of any developing region (though the absolute number of middle class citizens was higher in Asia).

Based on the current trends, by 2050, as much as 95 percent of Latin Americans and almost all of the East Asians would be classified as either middle class or upper income (Figure 3). There will be almost no absolute poor by today's standards in these two regions. The total number of middle and upper income persons could approach 2.3 billion in East Asia and 730 million in Latin America. This will be truly transformational compared to the situation only a generation ago. In other words, by 2050, Latin America will be the region predominantly populated by the middle or upper income citizens. Even by 2030, such citizens will account for between 80-85 percent of the total population.

This dramatic increase in the middle and upper income citizens will have a fundamental impact on the economic and social values and on the political dynamics of the region. Middle class societies put greater value on education, have stronger work ethics, and tend to both spend more and save more in absolute terms because of their much higher disposable incomes. As a result, the growth in their numbers also leads to stronger and more sustainable economic growth, resulting in a virtuous cycle. These citizens also demand better social and municipal services, better housing and more efficient public transport. Socially, they put much greater premium on well-paying jobs and quality of life, including rule of law, public safety, green spaces and better environmental quality. And politically, they demand greater honesty, transparency and accountability.

These potential developments have fundamental implications for CAF's long-term strategy. Fundamentally, CAF's fundamental mission should be to meet the emerging needs of Latin America's fast-growing middle classes.

Figure 3: Latin America's upper and middle class, 50% of the population in 1990, could reach 95% of the population by 2050



Source: Centennial Group

As is befitting for the premier development institution of one of the richest developing regions of the world, CAF should become the first multilateral development institution in the world to explicitly acknowledge the middle-class citizens as its primary cliental. This will make it the trailblazer amongst the development institutions. In due course, the other development institutions focused on Eastern Europe, Central Asia and East Asia will be obliged to follow it lead. The time to start this transformation is now.

III. Latin America: Past economic performance and main challenges

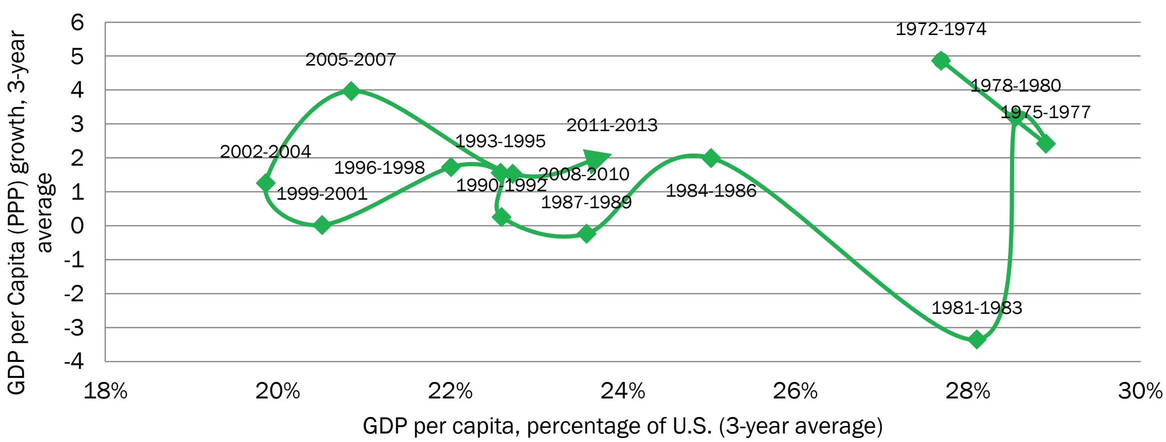
A. Past economic performance

Latin America is arguably the most naturally endowed region of the world. With fertile lands, generally moderate climate with sunshine, and abundant water resources, it stands in contrast to most developing regions (including Africa, Asia as well as the Middle East) which are increasingly threatened by water stress and shortages. In addition, the Amazon has the largest remaining rainforests in the world, a major natural defense against the threat of global climate change. Environmental degradation, while an important issue (particularly the unfortunate pace of deforestation in the Amazon), is moderate relative to other major regions of the world. Latin America's oceans and their fauna are highly regarded throughout the world. Mineral resources are being intensely explored and sought after by developed and developing countries alike.

The region enjoys a number of other crucial advantages that have facilitated economic development and social progress over two hundred years of independence and self-government. More recently, the region has benefited from democratically-elected governments. With only three languages dominating the landscape and common cultural elements among many countries in the region and with Europe and North America, the continent has the advantage of being diverse but with common bonds.

These natural advantages, the benefits of migration, and proximity and close business ties with North America and Europe made Latin America the most prosperous developing region by a wide margin by the late 1970s. Helped by an oil and commodity price boom, Latin America was widely regarded as the region with the greatest promise (Asia was not only the poorest region then, but also judged as both socially and politically fragile). Latin America had enjoyed economic growth above the global average. By 1980, most Latin American economies had become middle-income. But, in more recent decades, Latin America has not kept up its previous pace.

Figure 4: Latin America has diverged from the US in the past 40 years



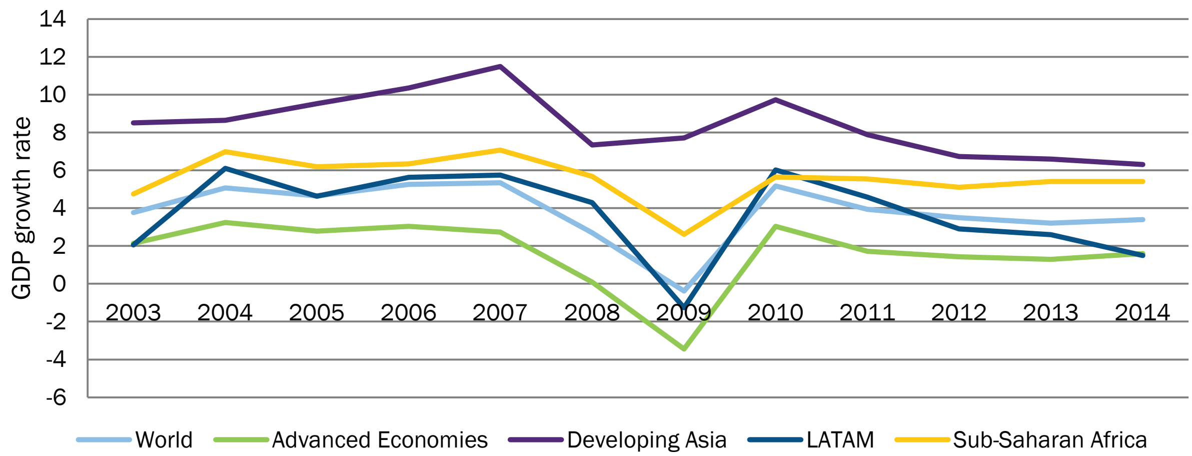
Source: Centennial Group

Latin America's growth performance since 1975 has lagged behind other regions (except Africa), even as global growth accelerated in the period. In 2013 Latin America had a per capita income level of PPP US$ 12,700, compared to a global average of PPP US$12,100. Latin America's income level, again in PPP dollars, is estimated at only 24 percent of that of the United States in 2013, compared to 28 percent in 1975. Instead of converging with the United States, Latin America has regressed somewhat during the past 40 years, despite the major boom in commodity markets during the past decade (see Figure 4).

The more dynamic newly industrialized countries (NICs) in Asia in particular have not only caught up with the region but also left it behind (Figure 5). It may be argued that Latin American economic performance was affected by the transition to more democratic regimes during the 1980s. However, the fact is that, with few exceptions, Latin America has tended to implement more effective structural reforms in democracy than under authoritarian regimes.

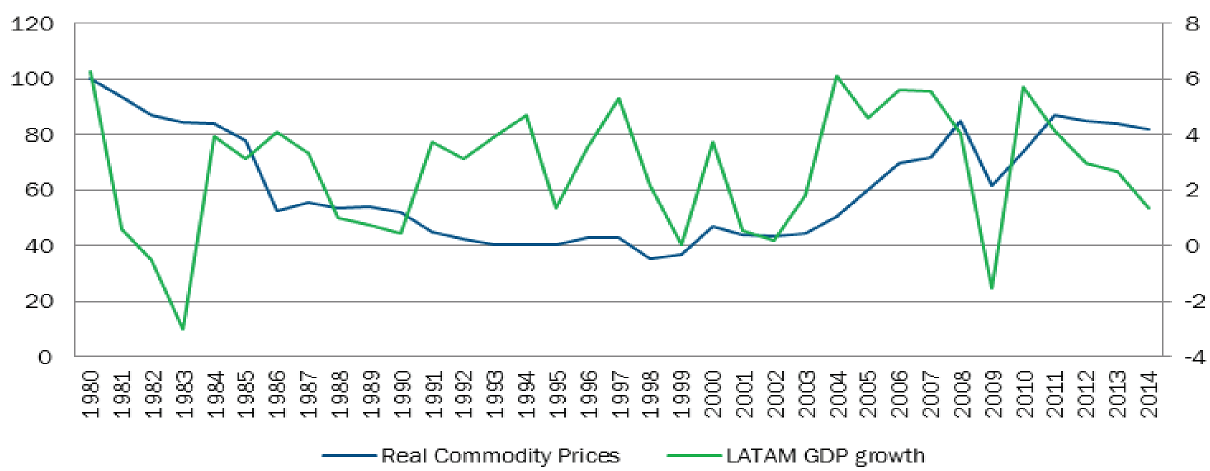
Overall, Latin America's performance over the past four decades paints a sobering picture. It is steadily losing its position as the world's most advanced and prosperous developing region. For example, in 1950, Latin America accounted for 7.8 percent of global GDP (on a PPP basis). In 2008, it had 7.9 percent (Maddison, 2004). Latin America's share in global GDP declined from around 8 percent in 1980 to 5 percent in the mid-1980s and rose again to 8.0 percent in 2011 before declining to 7.4 percent by 2014. The growth has been highly co-related with the ups and downs in commodities prices (Figure 6).

Figure 5: Latin America's growth is trailing that of the NICs



Source: IMF WEO and Centennial Group

Figure 6: There is a strong correlation between GDP growth and commodity prices in Latin America



Source: IMF, 2014

B. Mired in the middle-income trap?

The inability of the Latin American economies to sustain high growth and close the productivity and income gaps with developed countries during the past forty-plus years suggests that many countries have become mired in the "middle-income trap." For example, Mexico's economy grew at an average annual rate of about 6.6 percent over the 30 years from 1950 to 1980 but slowed to an average annualized rate of 2.4 percent in the subsequent 30 years. Likewise, Brazil's growth averaged about 7.1 percent a year from 1950 to 1980 but slowed to an average of 2.0 percent from 1980 to 2000, in spite of the emergence of world-class companies such as Embraer.

Their performance is in sharp contrast to that of many Asian economies. Asia's stronger performance can be explained by its much higher savings and investment rates, export orientation, better human capital development, higher global competitiveness and ease of doing business. Latin America's fundamental problems also arise from too much emphasis on ideology, on the left and right, rather than a pragmatic approach to economic management.

C. Main challenges

Latin America has the clear potential to do better. A scenario for convergence with economic growth averaging 6 percent per year between now and 2050 can be envisaged[3]. Such a growth rate can be achieved if most, if not all, Latin American economies join Chile, Colombia, Panama, the Dominican Republic, and Peru and become converging economies along the lines of East Asian economies. To achieve such superior performance Latin America needs to address a number of structural issues. The most critical issues, many of which CAF could help resolve, are summarized below.

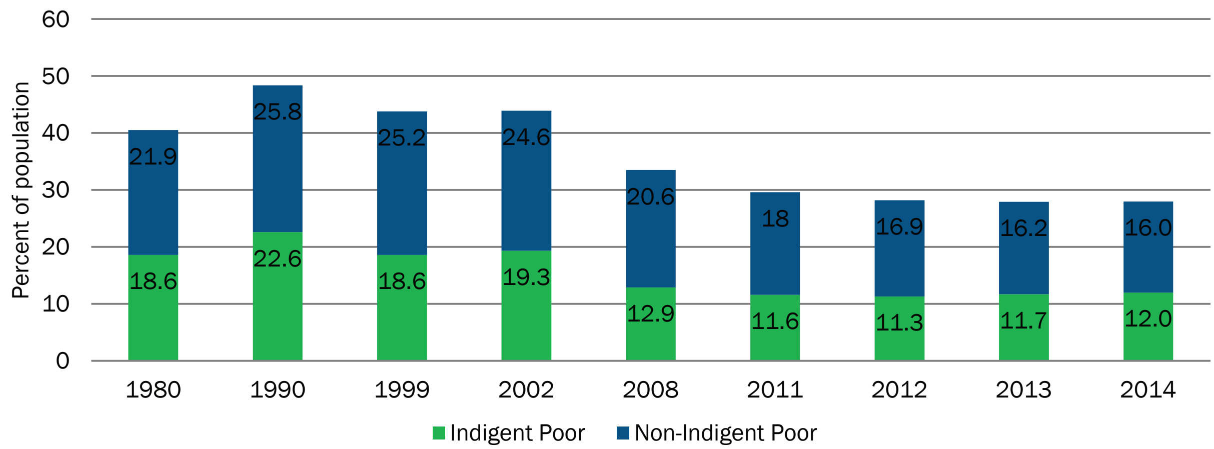
Poverty and disparities

While the region may be stuck in the middle-income trap, Latin America's socio-economic structure has changed favorably. In recent years there has been a strong emergence of the middle class, particularly in countries like Brazil, Chile, Mexico, and Peru. Today, the middle class – which can provide an impetus for growth in ways other than consumption demand—constitutes about 60 percent of the population of Latin America. The region has been effective in reducing poverty, helped by the external commodity-led boom of recent years. Poverty levels have declined, as illustrated in Figure 7. According to CEPAL, the number of poor people declined from 225 million in 2002 to 164 million in 2013. Half of the decline has been among the indigent poor. The decline is even more dramatic in terms of percentages of total population. In 1990, when the region was starting to come out of the slow growth period, about 48 percent of the population was poor, of which 22 percent were indigent. As of 2013, CEPAL showed a poverty level of 28 percent, of which 11 percent are indigent (Figure 7).

The picture on inclusion is murkier. In recent years the region has shown a reduction in income disparities, as measured by the Gini coefficients. One of the most recent and comprehensive studies in this area[4] shows that inequality declined unambiguously in 14 of 17 countries studied—the average Gini coefficient for the region fell from 0.55 in the late 1990 to 0.50 in the late 2000s. However, the coefficient is still significantly larger than the 0.40 value observed for Asian (including South Asia) countries. Income and wealth remain highly concentrated. Politically and socially, the current situation is unsustainable. With significant numbers of Latin Americans not fully integrated into the mainstream economy and society and with current high degrees of informality, the benefits of economic growth have not reached many citizens,

3. Background paper number 6
4. Lustig et al, *Deconstructing the Decline in Inequality in Latin America*, United Nations Development Programme, April 2013.

Figure 7: Latin America has made gains in reducing poverty and indigence (percent of population)



Source: ECLAC

leading to disillusionment. Only significant progress toward a more inclusive society can lead to realistic prospects of sustained and sustainable growth over time for Latin America.

There is now a growing consensus that over the longer term there is no trade-off between growth and equity. Achieving a more inclusive society will go far beyond combating poverty and involve the removal of numerous structural inequities, widening access to quality education and other public services including rural infrastructure, breaking the dominance of entrenched vested interests, and ensuring jobs and financial security to those who are today left at the margins of society.

Informality

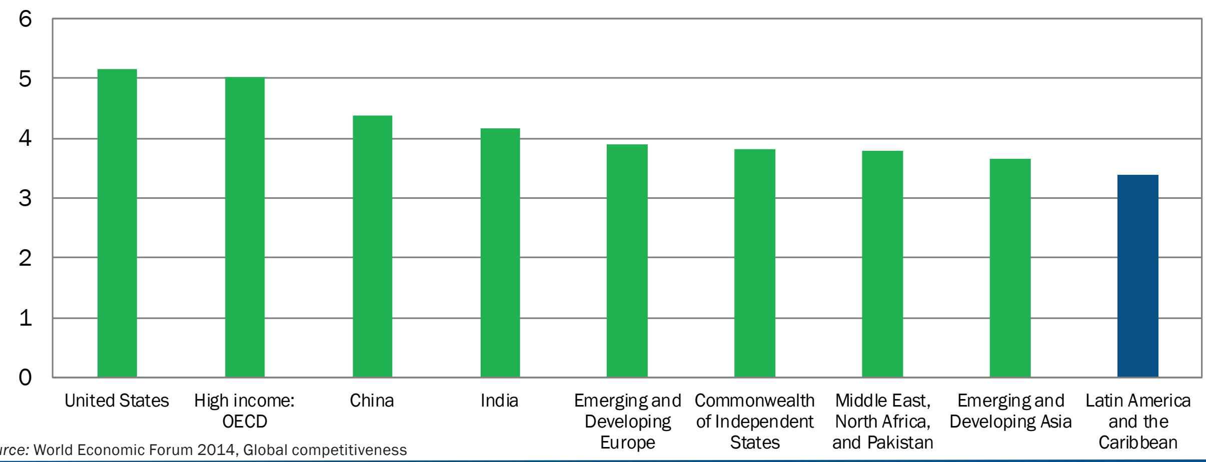
Informality is a major economic and social issue in most Latin American countries. High rates of informality are a sign of major problems in domestic policies (labor policies, tax structure, roles and behavior of lower-level civil servants) and institutional framework (corruption and tax avoidance). Government red tape, as well as unintended effects of government incentives, such as free social security benefits, contribute to growing informality.

As informal firms tend to stay small in order to avoid being noticed, their productivity is low because they do not reap any benefits of scale, they have either limited or no access to credit, they are less likely to train their employees and to adopt new technologies, and they have limited access to government services. This is compounded by the widespread prevalence of tax evasion by the informal sector, which hampers the government's capacity to spend on infrastructure and human capital. The empirical evidence suggests that this can have, as has been found in Mexico, adverse consequences for both growth in GDP and the buoyancy of the tax system. The combination of these elements leads to a vicious cycle that explains the strong negative correlation between informality and economic development. Until major parts of the region's informal sector are brought into the mainstream economy, their productivity and economic growth is likely to remain mired in the current low-level equilibrium. On the other hand, a reduction in informality can lead to higher productivity, which is crucial for the region's productive transformation.

Access to quality education and rural infrastructure services

Most analysts agree that high-quality education can make a significant contribution to a country's development. Education boosts earnings and stimulates economic growth. It is a powerful tool for moving people out of poverty, reducing disparities in access to resources, and fostering democratic governance by creating an informed citizenry that can make good decisions. Unfortunately, the education provided by most Latin American public schools—from pre-school to graduate school—fails to meet the needs of countries or students. Poor and minority students, who are principally those enrolled in public K-12 schools, are particularly ill-served.

Figure 8: Quality of education in the Latin America and Caribbean region ranks lower than every region of the world, except Africa



Source: World Economic Forum 2014, Global competitiveness

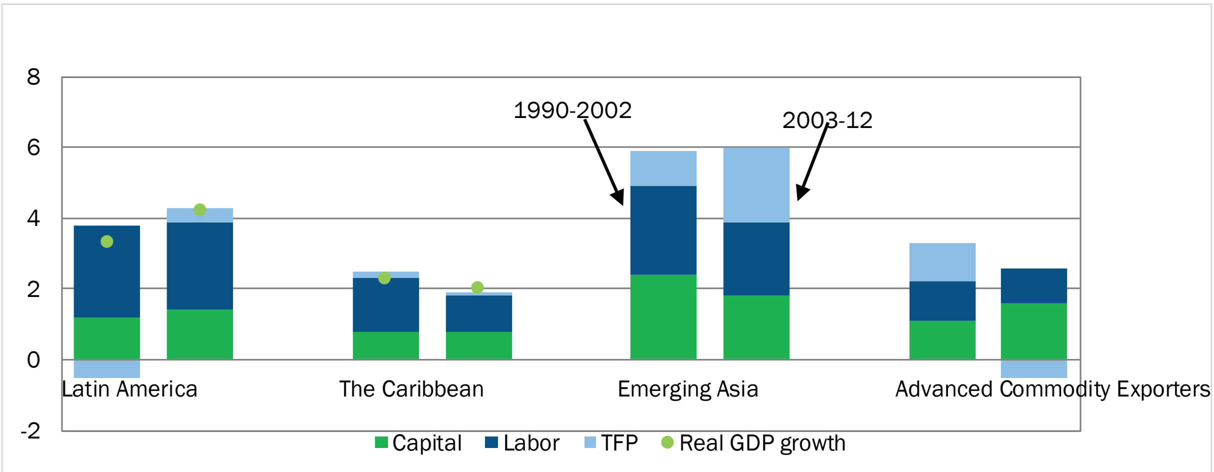
To be sure, the region has made real progress. In virtually every country, governments have increased spending on education—building schools, adding teachers, raising salaries, and enrolling more children. These efforts have clearly expanded the quantity of education (in terms of the number of children attending school), but there is little evidence that they have improved the quality of education (measured by scores on achievement tests). Figure 8 shows that the quality of education in the Latin America and Caribbean region ranks lower than every region of the world, except Africa. If education is to play its role in promoting growth and inclusion in Latin America, governments need to move beyond their historic emphasis on expanding enrollments to an emphasis on expanding learning.

In many countries in the region (particularly the Andean countries) the challenges of the more distant rural areas and dispersed small communities with the highest incidence of poverty is compounded by the fact that the deficit in infrastructure is concentrated in these very areas. Better connecting these communities to markets through rural roads and access to electricity is critical as is the operation of rural schools and health centers. Access to safe water is a prerequisite to improve health among the poor and improve nutrition and morbidity of young children.

Growth and productivity

Sources of growth studies have consistently come to the conclusion that the main differences between Latin America and other parts of the world have been the region's negligible, and sometimes even negative, trend growth of productivity. In addition, the region's investment and savings rates are much lower than the fast-growing East Asian economies. Overall, the region's total factor productivity (TFP) has not caught up to the frontier; instead, TFP has deteriorated, especially relative to emerging East Asian economies. Some estimates show that its growth is about one-third the level of the East Asian economies. Enhancing the contribution of TFP is perhaps the single most critical element needed to accelerate growth and convergence of the region in the future.

Figure 9: Extra growth in East Asia is explained entirely by the larger value of TFP growth



Note: Simple average of countries within each group.
Source: IMF, 2013

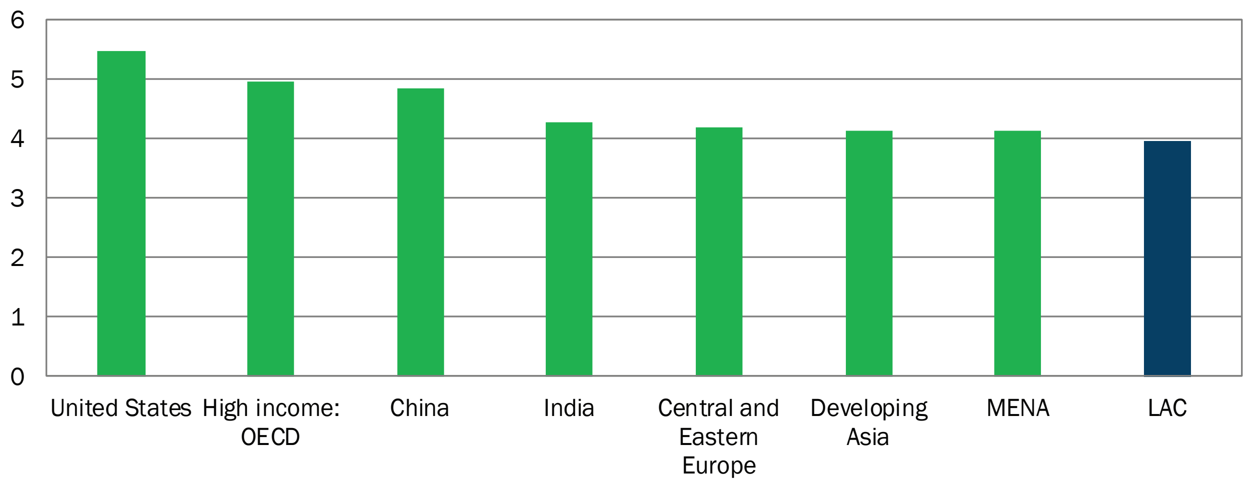
The contribution of factor accumulation—both capital and quality adjusted labor—are quite similar for both regions and account for about 4 percent GDP growth. The extra growth in East Asia—6 versus 4 percent—is explained entirely by the larger value of TFP growth in Asia (Figure 9). In this regard, it is useful to examine more closely the factors that are driving or hindering TFP growth. The fundamental question is which polices and incentives may have generated weak incentives for TFP growth in the past and need to be reversed in the future. While this agenda is very country-specific, it has some common elements for the region as a whole that are highlighted below.

The first element is a lack of incentives that would encourage firms to gradually move toward the technological frontier, allowing them to reduce their cost for the same level of output. This is likely to require a substitution in the production process. For example, increased access to information technology when the cost of that technology is being reduced and capabilities are being enhanced is a key factor behind TFP.

A second element influencing the level of TFP is the ability of firms to adapt to unexpected shocks, which is called "microeconomic flexibility." This may be an important element because many countries in the region have experienced episodes of negative TFP changes. The evidence suggests that the microeconomic inflexibility of the region is higher than in the US economy, due to heavy regulations in the labor markets, the existence of poor competition, a weak business environment (which precludes quick but smooth adjustments), and barriers to trade (through various protectionist policies), all of which may have important quantitative impacts on the levels of TFP.

A third element behind TFP growth, and closely connected with microeconomic flexibility, is the contribution of factor reallocation from less to more productive activities and sectors. Reallocating capital and labor to equalize their productivity is essential, particularly when the difference is caused by the lack of factor mobility or impediments for firm entry. There is stronger heterogeneity of firm productivity in Latin America than in the advanced economies and it has been estimated in various studies (notably by CAF) that by reallocating resources in manufacturing from sub-par firms to more innovative firms, output gains of about 60 percent could be achieved. That is why this report urges focus on several main obstacles to micro-economic efficiency in the region: i) increasing competition, openness, and business environment; ii) reducing disparities and informalities; iii) eliminating the infrastructure gap; iv) increasing investment and savings; v) a more enlightened role of government and industrial policies; and vi) more inclusive credit policies.

Figure 10: Strengthening the competitive environment is paramount to increase firms' incentives to improve micro-efficiency and adopt new technologies



Source: World Economic Forum, 2014, Global competitiveness

Micro-economic efficiency: competition, openness, and business environment

Three main factors drive productivity growth. First are incentives for firms to gradually move toward the technological frontier, allowing firms to either reduce costs or produce more. Second is the ability of firms to adapt to unexpected shocks. And third, is the contribution of *factor reallocation* toward more productive activities and sectors (Figure 10).

In most countries in the region—including the two largest economies, Brazil and Mexico—policies need to be geared to the promotion of greater competition, both in internal markets and with the rest of the world. All Latin American countries must give the highest priority to enhancing domestic competition, starting with the dismantling of monopolies—whether public or private—and enforcement of well-structured competition laws.

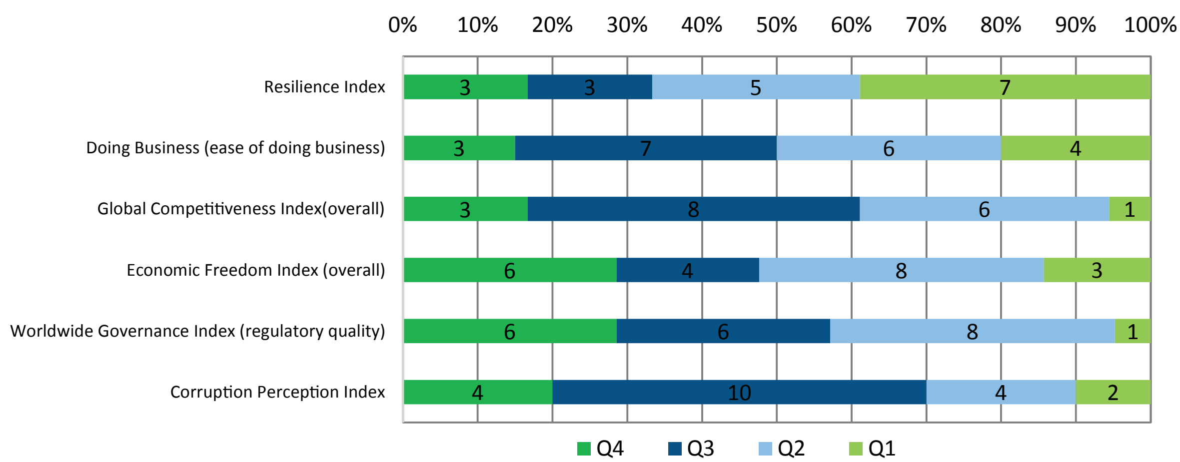
Competition: Strengthening the competitive environment is paramount to increase firms' incentives to improve micro-efficiency and adopt new technologies. An open trade regime is critical. Equally important is the pressure from internal competition—to be achieved by the entry of new firms or the growth of small ones (informal sector). In many Latin American countries lack of entry by domestic players can be pervasive. Many incumbents try to put explicit or implicit pressure on central, regional, or local authorities to increase the cost of entry through selective administrative barriers. Currently, this is an important source of rent-seeking and government capture.

Openness to regional and global markets: In parallel with increasing competition from domestic sources, there is a need to facilitate much greater openness to other countries by dismantling remaining barriers to trade and investment with the global economy as a whole. In this area, while many Latin economies have made significant progress—particularly Chile, Colombia, Mexico, and Peru—much more remains to be done. Specifically, the larger countries in Mercosur have engaged in restrictive trade policies. Protectionist policies with seriously deleterious effects in the medium term have been frequently used as substitutes for appropriate macroeconomic policies, with adverse effects on growth.

Improved regional cooperation will help economies specialize in the context of the larger regional market. Enhanced intra-regional trade would help to overcome the relative small size of Latin American economies (with the exception of Brazil and Mexico). Trade within the region would allow local firms to take advantage of their superior knowledge and understanding of the needs of customers in the neighboring countries compared to the competitors from other continents.

In parallel, Latin American economies must also pursue continued diversification of export markets beyond North America and Europe and of export products beyond the dominance of commodities and fuels (except in the case of Mexico and possibly, Brazil). Latin America must also gradually have closer ties with the world's fastest growing regions, mainly Asia and Africa. Increasing the region's focus on Asia and other emerging markets should be an integral part of Latin America's long-term growth strategy and that of CAF.

Figure 11: The majority of Latin American countries rank in the bottom half of various global indexes in terms of the quality of their business environment



Source: Centennial Group International, 2014; World Bank, 2014, Doing business; World Economic Forum, 2014, Global competitiveness; Heritage Foundation 2014; World Bank, 2014, Governance indicators; Transparency International, 2014

Business environment: The majority of Latin American countries rank in the bottom half of various global indexes in terms of the quality of their business environment (see Figure 11). The region performs particularly poorly when it comes to the ease of doing business, global competitiveness, and corruption. Only three Latin American countries (Brazil, Mexico, and Chile) rank in the top 25 worldwide on the FDI Confidence Index.

The region's performance is uneven when assessing specific indicators of the business environment. It performs fairly well when evaluating trade, but falls short in infrastructure and labor. Slightly over half of Latin American countries rank in the top half globally when measuring ease of trading across borders, trade freedom, and logistics performance. However, the extensiveness and efficiency of the region's infrastructure is below the global average. The region's labor performance is very poor according to the

Economic Freedom Index and the Global Competitiveness Index. Only three Latin American countries rank in the top half worldwide in terms of labor market efficiency.

Crime and violence

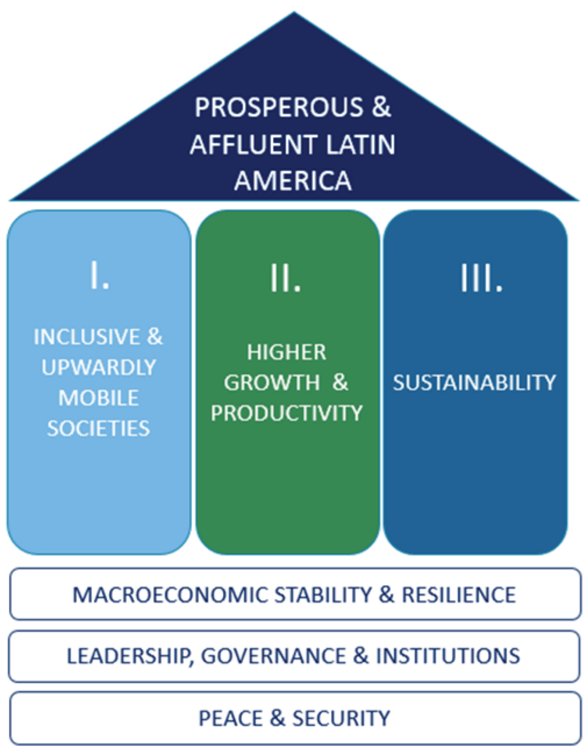
Ironically, even though Latin America has long been the best-off emerging region of the world, most countries in the region suffer from some of the highest rates of crime and violence, particularly in large metropolitan areas. Lack of personal safety is a widespread concern. Distrust of officials responsible for law and order is a common concern, as is drug smuggling and related corruption. Without a resolution of these problems, the vision of an affluent, peaceful, and well-governed Latin America will remain a distant dream. Despite its importance to Latin America it is not clear that CAF can effectively intervene directly in this area. However, its efforts in promoting productive, livable cities would help.

IV. Helping achieve higher, more inclusive and sustainable growth: CAF mission and vision 2030

A. Three complementary objectives

Historically, in postulating long-term growth prospects, economists have tended to focus on three sources of growth: labor (human development, demographics), capital deepening (investment level), and productivity growth (or technological progress). These three sources of growth are mutually reinforcing and can lead to robust economic growth.

Figure 12: Strategic framework—Three complementary objectives



More recently, policy makers worldwide have recognized that focusing on growth alone is not enough. To ensure robust growth over the longer term and sustain political support, two additional policy objectives are now considered equally important: promoting inclusion and well-being of all segments of the society and ensuring environmental sustainability. It is not enough to simply add on to the growth agenda some token elements to acknowledge the latter two objectives. Instead, countries must adopt integrated policies and strategies that help achieve all three objectives simultaneously.

This report postulates a strategic framework under which the Latin American countries will pursue three mutually reinforcing and intertwined objectives so as to achieve and sustain long-term prosperity in Latin America as the ultimate goal. These are:

1. Encourage inclusive & upwardly mobile societies;
2. Enhance growth and productivity;
3. Ensure sustainability.

These complementary objectives are at the core of the strategic framework depicted in Figure 12. Realizing the three objectives will require tackling the fundamental issues and constraints that have hobbled the region's economies in the past as discussed in the previous chapter.

B. Corporate mission and vision of CAF in 2030

In order to deliver fully on its name (Development Bank of Latin America) and to remain the leading development partner of Latin America, the following statements are suggested.

Corporate mission

CAF is the bank for Latin America's resurgence. Its basic mission is to help member countries achieve their long-term development objectives, meet the rising expectations of the growing middle class, and promote inclusion, economic resurgence, sustainability, and quality of life across the region.

CAF in 2030

CAF is recognized by both policy makers and the business community as the premier development institution in the region, and as the leading development partner for its member countries.

CAF is the largest source of development finance in the region and supplements its financial assistance with knowledge services and resources from other development partners, public and private. Its knowledge services include assistance for regional, national, and sectoral policy and institutional reforms. In parallel to its country-specific operations, CAF promotes regional public goods and strategic, as well as transformational regional and sub-regional initiatives.

To support higher, more inclusive and sustainable economic growth in member countries, CAF is focused on a limited set of issues and sectors:

- Developing the infrastructure and energy sectors;
- Promoting entrepreneurship, innovation, private sector development, and the creation of productive jobs;
- Deepening the financial sector and facilitating universal access to financial services;
- Enhancing sustainability and adaptation to climate change, with priority on preserving rain forests and reducing the carbon footprint;
- Accelerating regional cooperation and integration and strengthening links between Latin America and Asia and Africa;
- Identifying and supporting transformational projects and initiatives of strategic importance to the region

CAF derives its competitive advantage from being the most agile, responsive, and client-oriented development institution in the region. CAF has the lowest transaction costs, quickest decision-making, and most cohesive regional governance of all comparative institutions, and it enjoys strong political support of member countries and legitimacy as their institution. CAF is the preferred employer for development professionals in the region, which allows CAF to attract and retain staff embodying world-class expertise and professional depth in its areas of focus.

These advantages combined with its superior credit rating have enabled CAF to continue to expand its operations at attractive rates in response to growing demand from public and private clients.

V. CAF: Strategic focus and operational priorities 2030

To realize the above vision of CAF by 2030 and to uphold its responsibilities as the premier development institution of Latin America, CAF has to focus on the areas that will best help address the key challenges faced by the region (as discussed in chapter III). It should also contribute towards achievement of all three overarching objectives discussed in chapter IV.

It follows then that the three overarching strategic objectives of the region should also form the three pillars of CAF's strategic focus. However, instead of tackling the entire policy and institutional agenda for Latin America's resurgence, CAF should focus primarily on areas in which CAF either already has or can reasonably develop a comparative advantage with the financial and human resources likely to be at its disposal.

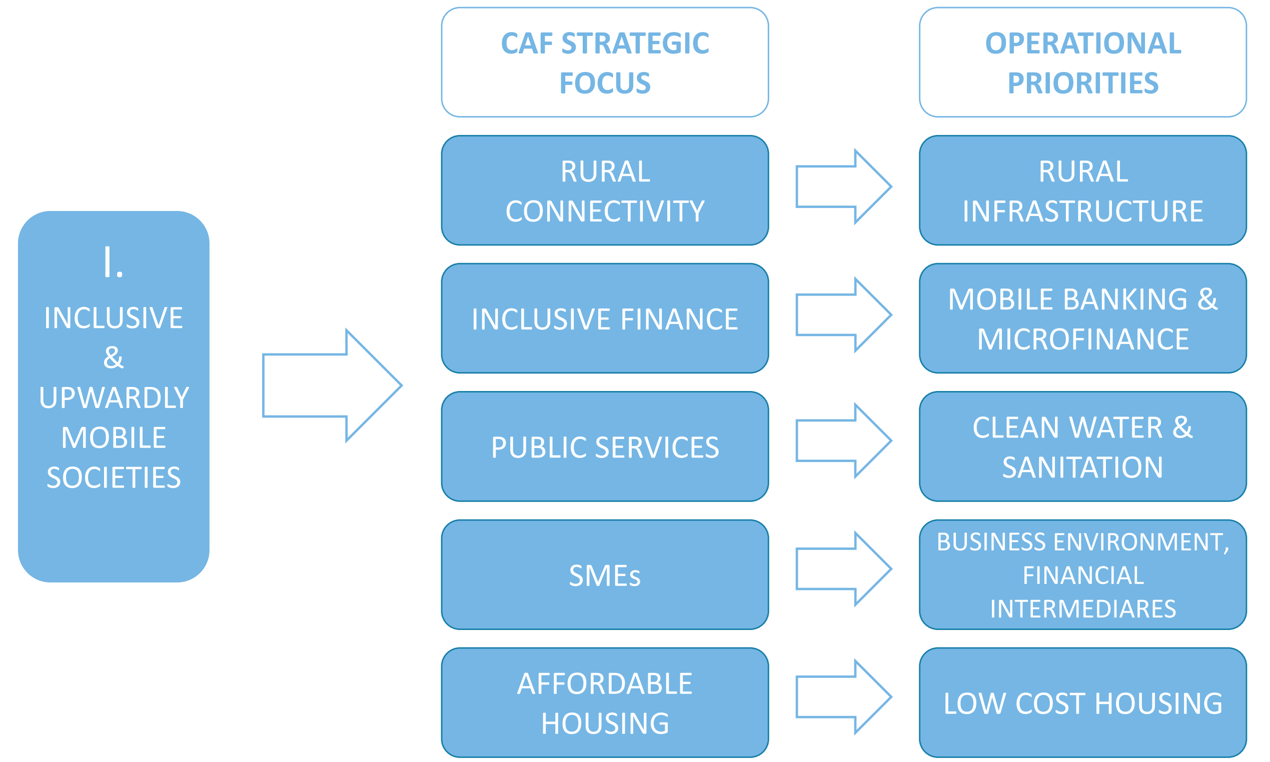
The framework for economic resurgence of Latin America rests, as shown in Figure 12, on the foundations of peace and security, governance and leadership, and macroeconomic resilience. These are prerequisites for the success of policy actions necessary to achieve each of the three objectives. However, work in these areas is not consistent with CAF's traditional comparative advantages. They are most consistent with the mandate and capacity of CAF's development partners (OAS, IMF, and World Bank), with the exception of governance and institution building at the sectoral level. As it is, the addition of new activities recommended below will pose a major challenge to the institution. Actually, even within the boundaries of the agenda suggested above, CAF's activities could become unwieldy.

To ensure that CAF will remain its member countries' development partner of choice, it must be seen as the institution with the best staff expertise, the lowest transaction costs and fastest decision-making capacity. This in turn requires that CAF does not scatter its resources too widely. Therefore, even within the focused agenda, CAF should further concentrate its operational activities on a limited number of priorities. The proposed strategic focus and operational priorities of CAF for the next 15 years are discussed in the following sections.

A. Promoting inclusive & upwardly mobile societies

Higher growth and productivity will not only lift the income level and well-being of most segments of the society, but will also generate additional resources for funding programs and projects specifically tailored to promote inclusion and reducing disparities. To promote inclusion and reduce disparities directly, CAF should concentrate on the following policy areas: i) accelerate provision of basic infrastructure services needed by the less well-off segments of the society, particularly rural and remote areas: ii) promote universal access to the basic financial services to facilitate higher savings, reduce cost of payments services, and enhance availability of credit to the poor and entrepreneurs in the informal sector (see Box 1); iii) ensure universal access to clean water and sanitation; iv) promote SMEs through improvements in business climate, installation of e-government, greater access to credit, and elimination of opportunities for rent-seeking; and v) promote affordable housing and focus on converting and incorporating (but not

Figure 13: **Inclusive growth—Strategic focus and operational priorities**



Box 1: **Financial services required by the poor**

In most countries the poor require four financial services:

Depository services: A safe, readily accessible, and reliable depository for savings, as a substitute for cash stowed under the mattress. This is arguably the most important service all poor people need, especially in fragile economies.

Payment and transfer services: Efficient, low-cost, and reliable national, sub-regional and international payment and transfer services that facilitate the sustained growth of trade and RMC integration in global value chains.

Credit services: The growth of micro, small, and medium enterprises (MSMEs) is stifled by lack of affordably priced financial services—particularly (but not only) long- and medium-term credit, working capital, trade finance letters of credit, and guarantees.

The problem usually cited is the mismatch between the predominantly very short-term financial deposits and the longer term tenor of credit that these enterprises require.

The poor face difficulties getting even short-term credit without documented collateral such as land and housing. Commercial banks do not find it profitable to make and collect small loans. This explains the appeal of innovations, such as micro-credit institutions and borrowers' clubs as well as the promise and potential of more widespread use of mobile banking.

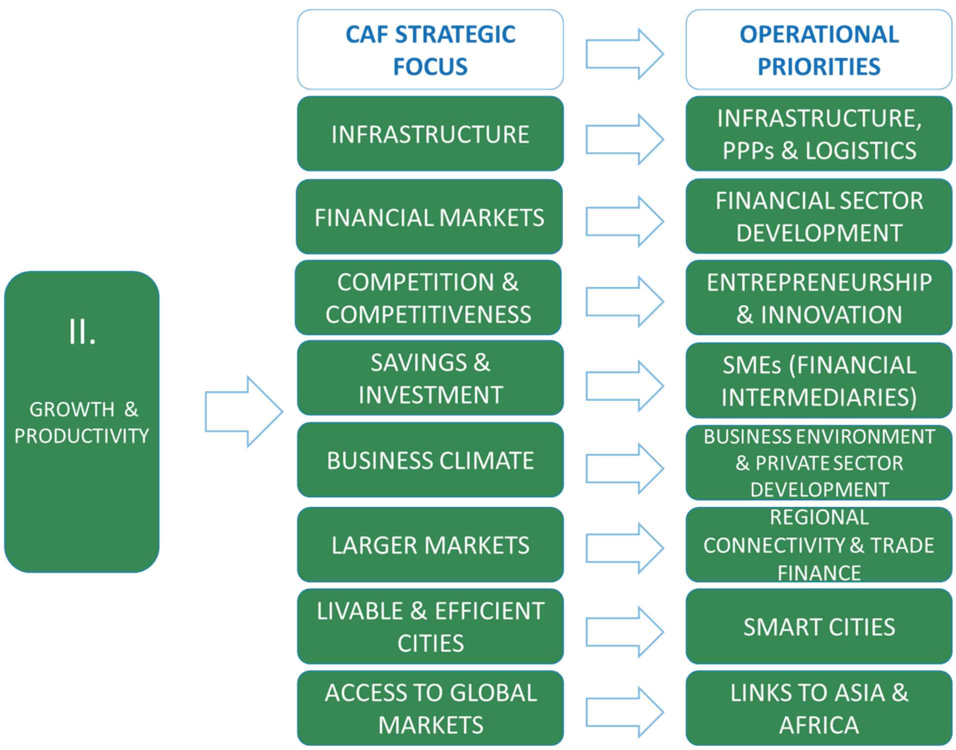
Insurance services: Even small but unpleasant financial surprises can create severe problems for the poor, as few of them have access to formal insurance and must self-insure. Some African countries (such as Ethiopia) are piloting programs that offer insurance against, for example, crop failures, floods, or other natural disasters.

eliminating) favelas and shanty towns without necessarily lending for housing finance. These areas of focus and the related operational priorities are shown in Figure 13.

B. Enhancing growth and productivity (productive transformation)

As discussed in detail in the section on micro-economic efficiency, enhancing growth and productivity is of the essence. In this regard, CAF will need to focus on the following specific policy areas: i) tackling existing infrastructure gaps and improving the quality and efficiency of infrastructure services; ii) developing deeper and more robust financial sectors; iii) creating stronger and more open links with the global markets to promote competiveness (and higher TFP) in order to access the best technology and management knowhow; iv) facilitating higher investment and savings[5]; v) improving the business climate to promote entry and exit of enterprises and facilitate investment; vi) enlarging the markets for domestic producers by opening up also to the regional markets by accelerating regional cooperation and integration; vii) developing smarter (and greener) cities; and viii) facilitating links to Asia and Africa. These areas of focus and the related operational priorities are shown in Figure 14.

Figure 14: Growth and productivity—Strategic focus and operational priorities

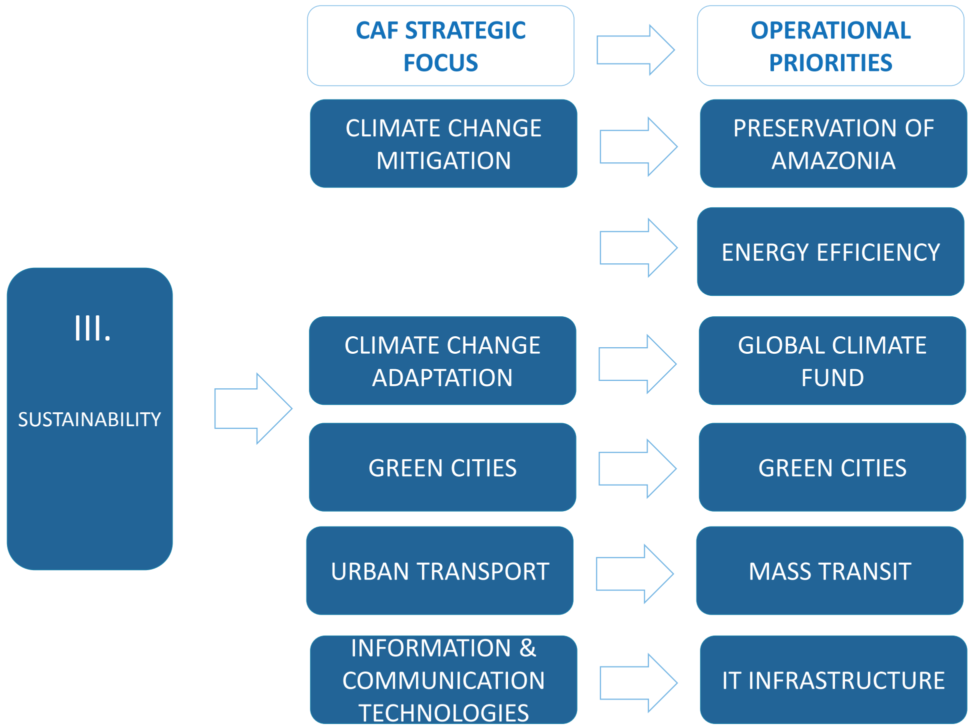


C. Ensuring sustainability

This third CAF objective will require a combination of policy and regulatory actions as well as higher levels of investments in two distinct areas: climate change mitigation and climate change adaptation. In areas related to climate change mitigation, as explained earlier, CAF should remain much more selective by focusing on the preservation of the rain forests (Amazonia) and energy efficiency. For the region to play

5. For a more detailed discussion see chapter 3.

Figure 15: Sustainability—Strategic focus and operational priorities



its part in managing this global common, Latin America could focus on three types of actions: i) prudent husbanding and management of its vast rainforests (which act as the lungs of our entire planet); ii) reduction of carbon emissions; and iii) other priority mitigation measures agreed by the global community of nations under the auspices of the UN. For adaptation to inevitable climate change, CAF could assist the region in taking actions in three policy areas: i) create greener and smarter cities (green housing); ii) create urban transport; and iii) promote information & communication technologies (including IT infrastructure). Elimination of the current subsidies to fossil fuel producers and consumers could be an early step. These areas of focus and the related operational priorities are shown in Figure 15.

While the key policy areas highlighted under each pillar are of paramount importance for that specific strategic objective, they would often also contribute to the achievement of the other two objectives. For example, creation of smarter and greener cities is critical not only for enhancing the productivity of the entire economy, but also for improving the quality of life of all urban dwellers and contributing to the greening of the economy. Similarly, improvements in the quality and efficiency of basic public services, including supply of clean water and sanitation, will not only serve the basic needs of the less well-off people but also improve economic efficiency and lead to better environment.

The above is a daunting policy and institutional agenda for the next 15 years. But so are the challenges that the region must tackle to lift its performance to the next level. Fortunately, not all countries will be starting from the same level. Many countries have already made a good start in the past decade in many of these policy areas.

Still, CAF must not endeavor to tackle the full agenda in every country. Instead, it should continue the approach that has led to its past success: pursue a focused and selective agenda that is consistent with its areas of expertise and of course the needs of each country.

VI. CAF: Main business lines and instruments

Based on our desk review, we foresee the following six main business lines as CAF's main focus in the future.

A. Infrastructure

CAF is the largest multilateral lender for infrastructure development in Latin America. Infrastructure is also CAF's biggest business. Under the proposed corporate strategy, support for infrastructure development is expected to remain dominant both in terms of volume of lending and in terms of number of operations. This business will, however, undergo a number of subtle but important changes. There will be a more balanced mix of rural and urban infrastructure projects, with increased emphasis on operations aimed at enhancing inclusion by connecting the poor and remotely-located people to markets in the rest of the economy. Larger infrastructure projects will be increasingly based on public-private partnerships. In addition to supporting physical transport links, there will be greater attention to logistics. CAF will be more proactive in identifying and supporting regional projects, particularly those designed to reduce transport and logistics costs of trade with Asia. All future projects will be designed to reduce their carbon footprint. Projects based on fossil fuels (power generation, transport) will undergo an explicit analysis of risks likely to arise from climate change and will incorporate risk mitigation measures. Finally, CAF should agree with national authorities on a few economically viable high visibility strategic infrastructure projects that will receive priority attention from both the national authorities and CAF to expedite their preparation and implementation and then apply the lessons learned more widely. These strategic projects could be seen as flagship projects demonstrating CAF's concrete contributions to the region's development.

B. Private sector development, entrepreneurship and innovation

Support for private sector development, with a special emphasis on small and medium enterprises, is essential to generate jobs, promote entrepreneurship and create upward mobility. These more agile enterprises could be important links in global supply chains and enhance competitiveness. They could also be sources of innovation. CAF support to SMEs should be increased many-fold. In addition to providing financial and technical support (through domestic financial intermediaries), CAF should re-double efforts to support improvements in the business environment, and encouragement of e-government to reduce petty corruption. Finally, CAF should take the lead in identifying policy and institutional reforms that will facilitate Latin American firms to participate more actively in the global supply chains, not only in manufacturing but also in agriculture and services. Here CAF's knowledge products may be as or more valuable as its financial assistance.

CAF should also increase its efforts to promote foreign direct investments beyond the traditional flows into commodity related activities. This is important to help diversify the economies and reduce their reliance on global commodities markets. A useful instrument to facilitate this diversification and overcome constraints in the mainstream economies would be selectively supporting development of export promotion or special economic zones as done successfully by South Korea and China.

C. Financial sector development and intermediation

Historically, CAF's support to financial institutions in the region has exceeded that of both the World Bank and IaDB. Again, financial intermediation should remain a major business for CAF. The proposed corporate strategy suggests that CAF should build on its experience and expand its support to also include broader financial development (non-bank institutions, leasing companies, local capital and bond markets).

Another new area should be inclusive finance, with a determined effort to promote universal access to basic banking services and crop insurance. Mobile banking is coming of age in many other countries; CAF should take the lead in spreading it across Latin America. Finally as mentioned below, trade finance could be a fast growing business for CAF, as it has been for the International Finance Corporation (IFC).

D. Urban development (productive, livable and green cities)

This is potentially a large-growth business line. Latin America is the most urbanized of developing regions, even compared to East Asia. Very soon, as much as 85-90 percent of a typical Latin American economy's output will come from urban centers. Consequently, the future competiveness of the economies will depend heavily on well-functioning and livable cities. Equally important, the vast majority of urban residents will be middle class or upper-middle class (perhaps over 90 percent by 2050). Experience elsewhere demonstrates that such income groups expect and demand more habitable, safer and well-functioning cities. We recommend that CAF develop specialized expertise in this area to demonstrate to its stakeholders that, in additional to helping resolve today's problems, CAF is also anticipating and getting ready to address tomorrow's challenges.

E. Integration into global economy

CAF is already recognized as the development institution that has given much greater priority to regional cooperation and integration (more than the two Washington based institutions). Even though the practical outcomes so far have been meager, given the importance of opening up of trade and investment flows within Latin America as well as to the rest of the world, CAF must redouble its efforts.

Clearly, physical connectivity is the bedrock of regional cooperation. CAF can take the lead in doing fresh analytical work so as to develop a roster of high-payoff, regional energy projects as well as transport and economic corridors. It should then identify prominent regional statesmen to champion these projects. If asked, CAF should take the lead in the financing and implementation of the projects. In addition to the physical assets, attention needs to be given to the improvement of logistics and the removal of behind the border barriers. In addition, as already mentioned, CAF could provide a much higher volume of trade finance.

Finally, CAF should take a leadership role in developing closer links with fast-growing Asian and African economies. In this regard, CAF knowledge products and CAF platforms for exchange of views and networking between policy makers and business leaders could prove very useful.

F. Sustainability and climate change

This is a relatively new field for CAF. Its activities to promote sustainability and climate change mitigation and adaptation need to be ramped up. But, instead of focusing just on stand-alone environmental projects, CAF's greatest contributions may be in internalizing the implications of climate change for its operations in the traditional fields like infrastructure. Similarly, support for smart cities and urban (mass) transport would also make the biggest contribution to the greening of Latin American economies.

Beyond such mainstreaming of environmental concerns in CAF's traditional activities, the institution should develop freestanding environmental projects and knowledge products in a few highest-priority areas: protection of rain forests, carbon trading and energy efficiency. Given the complexity of this work and its relatively recent development, it may be advisable that this new business line have its own dedicated staff at this initial stage so that it is not overshadowed by CAF's established businesses with much larger lending volumes.

G. CAF instruments

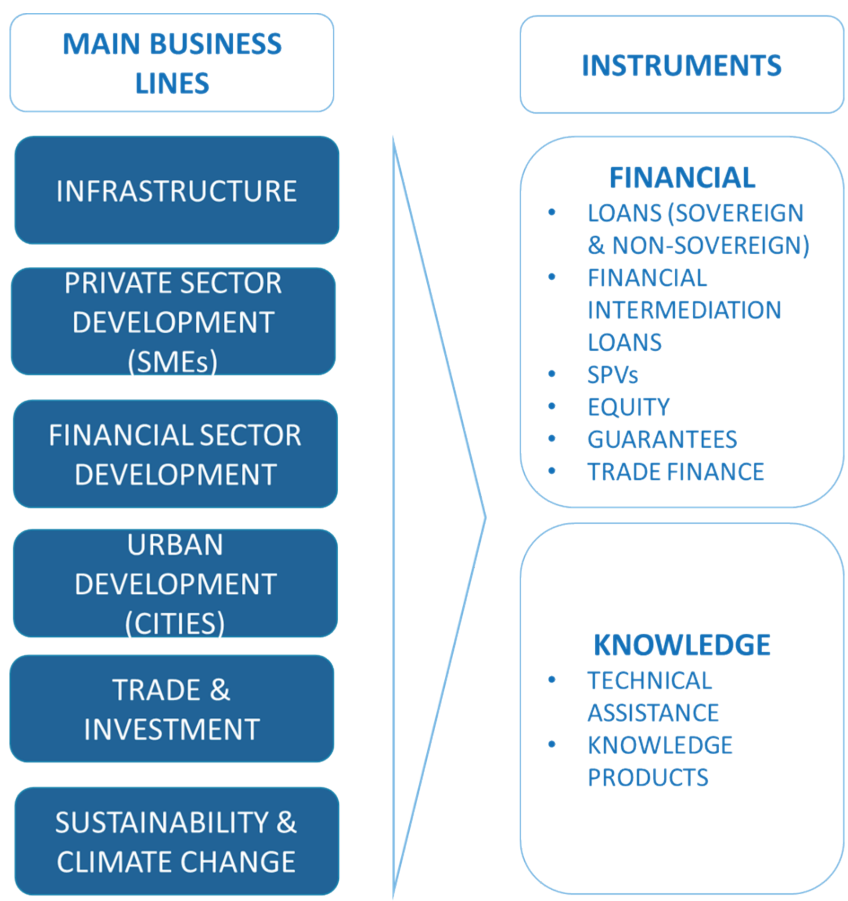
CAF already has a wide array of instruments. They are quite similar to the instruments deployed by other institutions in the region and include:

- Loans
- Financial intermediation loans
- Trade finance
- Equity
- Guarantees
- Special purpose vehicles (SPVs)
- Technical assistance
- Knowledge products: 1. Region wide 2. Thematic 3. Country specific

CAF will need to deploy its full array of instruments to respond to the diversity of the region and the proposed rich mix of its operations. The exact blend will vary by country and over time depending on the objectives of CAF's strategy for the country, the size and depth of the country's financial system, the quality and needs of local institutions (beneficiaries), and the objectives and design of individual CAF operations.

In support of its overall country strategy, CAF will emphasize knowledge generation and dissemination, as well as policy dialogue advice and technical assistance to borrowers (Figure 16).

Figure 16: Main business lines and instruments



VII. Implementing the strategy: Roles and resources

A. Roles

As CAF fulfills the mandate of the leading development partner in the region and addresses the new more focused agenda, its assistance will extend beyond financing of physical assets. To leverage its impact beyond individual investment and technical assistance projects, CAF will have to put greater emphasis on knowledge products and engage in policy dialogue on broader (sectoral or economy-wide) reforms. This will in turn mean that CAF will play a role in four areas:

Financial and technical assistance: Project-based financial and technical assistance to borrowers throughout the region will remain the bedrock of CAF operations. The current set of CAF instruments for its financial assistance are in line with those in other institutions and considered adequate at this time. But over time, as its support to private sector entities increases, CAF may need to identify and pilot additional lending instruments. CAF should incorporate knowledge work into project design and its support to project implementation, including the transfer of lessons of experience in other countries and regions. CAF staff is already providing such know-how to its borrowers. In the future, such assistance will become widespread.

Fostering innovation and scaling up: CAF should “champion” entrepreneurship and innovation and aim to become a leader in promoting and supporting entrepreneurs interested in scaling up innovative ideas and solutions. Support for innovation and scaling up should be a hallmark of all of CAF’s work. For example, recent technological breakthroughs allow basic financial services to be provided economically even to the smallest customers in remote locations. CAF could identify and support innovative business models that can provide near-universal access to basic financial services at a low cost, help reduce the costs of transferring remittances, and help informal businesses (including those run by women or businesses in agriculture). CAF should support local Latin American companies joining global value chains, including in agriculture. As a follow up to the Youth Forum held a few years ago in Singapore, CAF could sponsor (or organize) a platform to bring together budding entrepreneurs and potential investors from around the region.

Knowledge and policy dialogue: A major recommendation of this report is that CAF should scale up its knowledge products. This would involve three major instruments. First and foremost, as discussed above, CAF would embody knowledge in its projects. Second, CAF should engage in free-standing policy dialogue both at the sectoral and economy-wide level where policy reforms are necessary to realize the full benefits from its lending operations. Third, CAF should expand its free-standing publications on topics and issues of regional significance. These products should be designed to help shape the thinking of policy makers throughout the region. To disseminate them widely, CAF could organize platforms for discussion with the key opinion makers in the region by expanding such events in the region despite challenges involved in getting senior policy makers to meet in neighboring countries.

Partnership: As emphasized throughout, CAF should sustain its role as the leading development partner of its member countries. Further, in order to maximize the development impact in member countries, CAF should identify and prioritise value-adding strategic partnerships with other development institutions. CAF already works in partnerships with other development institutions, both multilateral (World Bank, IaDB) and national (e.g., BNDE). These partnerships are clearly of mutual benefit for both lending and knowledge work. They will become even more important as CAF further expands both the size and breadth of its operations. CAF should also seek synergies by strengthening partnerships with sub-regional development institutions. Finally, and importantly, CAF should proactively seek and build closer partnerships with the private sector to leverage its own financial assistance with much larger volumes of private finance.

B. Resources: Need for a business plan

The proposed strategy is ambitious but absolutely necessary for CAF to help the region make a break from past complacency and move up to a path of higher, more inclusive and sustainable growth. Effective implementation will require resources—financial as well as human—well beyond those currently at CAF's disposal.

In each of the business areas suggested above, CAF should aim to have the best (and most practical ideas) and a critical mass of staff expertise. When it comes to staff capabilities, CAF should adopt policies and practices (including with respect to location of staff) to attract and retain the very best talent in each selected field. In-house expertise could then be supplemented with the use of consultants, particularly in highly-specialized, technical areas.

To have realistic estimates of the financial and human resources necessary to implement the above corporate strategy, it will be necessary to develop a long-term Corporate Business Plan. This should be done as soon as the management and the Board approve this strategy.