Growing Business or Development Priority?

Multilateral Development Banks' Direct Support to Private Firms

Guillermo Perry
Non-Resident Fellow
Center for Global Development

April 2011

Growing Business or Development Priority?

Multilateral Development Banks' Direct Support to Private Firms

Guillermo Perry
Non-Resident Fellow
Center for Global Development

April 2011

The Center for Global Development is grateful for contributions from the Norwegian Ministry of Foreign Affairs in support of this work.

© 2011 The Center for Global Development
1800 Massachusetts Ave NW, Third Floor
Washington DC 20036
202-416-4000

www.cgdev.org

Contents

1. Introduction 1
2. Stylized facts: Overview of MDB direct support to the private sector in developing countries 4
3. Rationale for MDBs' direct support to private firms in developing countries 11
4. Stated goals, strategic guidelines, and evaluation procedures 18
5. Does MDBs' support to private firms actually focus on poorer countries and SMEs? 23
6. MDB direct support to private firms in priority sectors and activities 29
7. Financial and advisory products offered to private firms 33
8. Is MDB direct support to private firms pro- or countercyclical? 44
9. Risk analysis, risk management, specialization, and organizational structure, ... 50
10. Synergies between MDBs' support to governments and private firms 52
11. Conclusions and recommendations 55
References 61

Boxes

Box 1. MDBs' Stated Priorities in Private Sector Operations 19
Box 2. IFC Strategic Guidelines 20
Box 3. MDBs' Developmental Impact Evaluation Methodologies and Procedures 21
Box 4. AfDB's and EBRD's Private Sector Operations in Lower-Income Countries 24
Box 5. MDB Programs That Support Microfinance and SMEs 27
Box 6. Programs/Instruments for the Infrastructure Sector 31
Box 7. Support Activities on Environmental Issues 32
Box 8. IFC's Financial Products 34
Box 9. Some MDBs' Local Currency Financing Initiatives 38
Box 10. Advisory Services 40
Box 11. IFC Package of Crisis Response, 2009 47
Box 12. Other MDB Crisis Response Programs 48

Figures

Figure 1. MDB Lending to Private Firms 5
Figure 2. MDBs' Equity Investments, Guarantees, and Risk Management Products to Private Firms in Developing Countries 6
Figure 3. MDBs' Development-Related Operations (DRE) to Private Firms in Developing Countries 6

Figure 4. Distribution by Regions of MDBs' DRE to Private Firms in Developing Countries 7
Figure 5. Distribution by Sectors of MDB Operations to Private Firms in Developing Countries 8
Figure 6. Loan Approvals to Private Firms by Individual MDB 9
Figure 7. Equity Investments and Guarantees to Private Firms by MDBs 10
Figure 8. Domestic Capital Markets Development 16
Figure 9. Distribution by LICs and MICs of MDBs' Operations to Private Firms 23
Figure 10. Participation of Private Sector Operations in Favor of Microfirms and SMEs 25
Figure 11. Fraction of Loans and Equity Investments in Favor of MSMEs through Intermediaries: EBRD and IFC 26
Figure 12. Trends in Operations to MSMEs: IFC and CAF 26
Figure 13. Sector Composition of Loans by MDBs 29
Figure 14. Sectoral Composition of Equity Investments by MDB 30
Figure 15. Composition of Total Financial Support to Private Firms by Type of Financial Products 35
Figure 16. Loans in Local Currency 37
Figure 17. Advisory Services as a Percentage of Financial Operations with Private Firms (2009) 42
Figure 18. IFC, IADB, and AfDB Advisory Services 42
Figure 19. IFC, IADB, and AfDB Composition of Advisory Services 43
Figure 20. Cyclical Components of MDB Loans to Private Firms, Developing Countries' GDP Growth, and EMBI 44
Figure 21. Summary Scorecard 59

Table

Table 1. Loan Distribution by Maturities and Income Group Country (years) 36

Growing Business or Development Priority? Multilateral Development Banks' Direct Support to Private Firms

Guillermo Perry[1]
CGD, April 2011

1. Introduction

There have been several studies on the multilateral development banks' (MDBs') role in support to poor and middle-income countries.[2] These studies have covered a variety of topics, such as: MDBs' actual contribution to development and the effectiveness of their operations;[3] the adequacy of their policy prescriptions and their instruments;[4] the rationale for official lending to middle-income countries that have regular access to private capital markets;[5] and the

[1] This paper benefited greatly from Nancy Birdsall's and other CGD colleagues' comments and contributions during its elaboration and from feedback from heads of the MDB, heads of private sector operations at the MDB, and a selected group of experts that met in November 2010 at a roundtable sponsored by CGD concerning a first draft. Adriana Sabogal and Victor Saavedra, from Fedesarrollo, provided excellent research assistance. As usual, however, the views expressed here represent only the author's conclusions, and any factual mistakes that may remain are my exclusive responsibility.
[2] See, for example, Perry, G., CGD (2009); Birdsall, N., Rodrik, D. and Subramanian, A. (2008); Birdsall, N., and Hakim, P. (2007); Birdsall, N. (2005); Meltzer, A (2000), Lerrick, A. (2006); Gurria, J.A., and Volcker, P. (2001); Gurria, J.A. et al. (2002); Einhom, J. (2001) and (2006).
[3] As part of a more general literature on aid effectiveness.
[4] Especially with respect to the so-called Washington Consensus policies and the structural adjustment loans.
[5] Most criticisms to MDB lending to middle-income countries refer to traditional lending to governments, arguing that most middle-income countries had ample access to private markets and MDBs were just competing with or displacing them. Critics rarely made explicit to what extent their arguments extended to MDB lending to private firms. Clearly, they would equally apply to lending to large corporates that had almost as much access to private markets as sovereigns, but certainly not to medium-size and small firms that did not. See, for example, Meltzer, A. (2000); Lerrick, A. (2006); Einhorn, J. (2001) and (2006).

adequacy of their governance structures.[6] However, most of these studies focus on MDBs' governance and lending operations and advice to governments; rarely have they examined what the MDBs, or their "private sector arms," actually do in directly supporting private firms,[7] nor do they discuss the developmental rationale of these actions.

This omission may have been justified when direct lending and technical assistance to private firms constituted a marginal fraction of MDBs' operations with sovereign governments. However, before the recent global crisis, these activities had been growing at a rapid pace, whereas lending to governments was either stagnant or contracting in net terms,[8] and thus operations with the private sector had ceased to be a marginal activity of MDBs. This has been particularly the case of the European Bank for Reconstruction and Development (EBRD) since its inception, but the International Finance Corporation (IFC) grew to represent more than a third of the total World Bank Group financial operations. Direct operations with private firms were also increasing rapidly until 2008 in the Inter-American Development Bank (IADB) group, the Corporación Andia de Fomento (CAF), the Asian Development Bank (ADB), and the African Development Bank (AfDB).

The crisis brought with it a renewed demand by governments to borrow from MDBs, but this will be for sure just a temporary phenomenon. As the crisis receded and many developing countries' governments regained full access to private capital markets, those demands began faltering again, and MDB lending to sovereigns is returning to the previous stagnating or diminishing trends. On the contrary, MDB operations in direct support of private firms in developing countries, which receded in aggregate terms in 2009 and were on occasion displaced to a secondary priority during the crisis,[9] are returning to rapid growth

---

[6] Bradford, C. (2003); Birdsall, N. (2007).

[7] Normally, financial support without sovereign guarantees to publicly owned enterprises, and even to local or regional governments, is classified together with operations in support to the private sector, as they represent similar risks. This convention is followed here, as it is difficult to disentangle them from available data sources.

[8] Disbursements lower than amortizations, including prepayments.

[9] As discussed in Section 8 below, MDBs established crisis response packages at the end of 2008, in support of both governments and private firms. The latter included strengthening trade finance, bank capitalization and restructuring, microfinance institutions, and ongoing infrastructure project special lines or funds. Further, there was an unusually high level of cooperation in these programs, especially with respect to IFC's Global Trade Finance initiative, bank restructuring in Central and Eastern Europe and action plans in Africa. However, overall lending to the private sector fell in real terms in 2009, partly in response to reduced demand and partly to the higher priority given to lending to governments by some MDB boards in response to developing countries' governments' requests.

and will continue to increase their share in overall MDB activities. Thus, it seems timely to examine closely the rationale and effectiveness of such operations.

This is especially the case because, although many observers and stakeholders would easily accept the potential developmental role of MDB lending for public sector activities in areas such as education, health, and infrastructure, the use of public funds in support of profit-making firms might be in their eyes a more contentious proposition. It might be more challenging to demonstrate, conceptually and empirically, the developmental impact of MDB lending to the private sector of developing countries. Indeed, defenders of MDB lending to middle-income countries argue that even if some of these countries may have access to private markets, MDB involvement helps governments solve coordination issues and take full advantage of externalities, as well as focus attention and maximize the impact on poverty reduction and global goods. Such arguments would be admittedly less clear a priori for MDB direct support of private sector activities. After all, MDBs were until recently advising developing countries against using public national development banks to lend directly to private firms and recommending privatizing, liquidating, or transforming these institutions into nonbanking developmental agencies.

On the other hand, there are also arguments in favor of these trends. Many would argue that, after all, development has proven to be mostly private sector-led and that helping the private sector in developing countries overcome financial constraints and other market failures, as well as regulatory hurdles, and helping firms be more productive and competitive, could give a major push to economic growth and poverty reduction in these countries. This might be especially the case if there are synergies between what MDBs do with governments to improve the investment climate in developing countries and their direct support to private activities.

It seems thus fruitful to open up a debate on these trends. The following section present stylized facts about the growing importance of MDB direct support to private firms in developing countries. The remaining sections present a preliminary discussion of the following questions: Should international official funds, such as those of MDBs, be allocated in direct support of private sector activities in developing countries? If so, to which countries, firms, and activities, and under what conditions? In other words, what are the market and government failures and externalities that justify MDBs' direct support to private firms, and what should be their priorities in these activities in order to maximize development impact? What would seem to be the most adequate financial and nonfinancial instruments to support deserving private sector activities? Should

MDBs lend in foreign or domestic currencies to private firms? Should their lending be countercyclical with respect to business and private capital flow cycles? How could the MDB community exploit synergies and strive for a productive balance in support of public and private activities in developing countries?

I should emphasize the tentative character of this analysis. I do not attempt to offer final answers, but rather to stimulate debate by discussing the arguments in favor of these activities of MDBs, the priorities that should be derived from such arguments, and a comparison of them with MDBs' actual practices, within the limits imposed by available evidence.

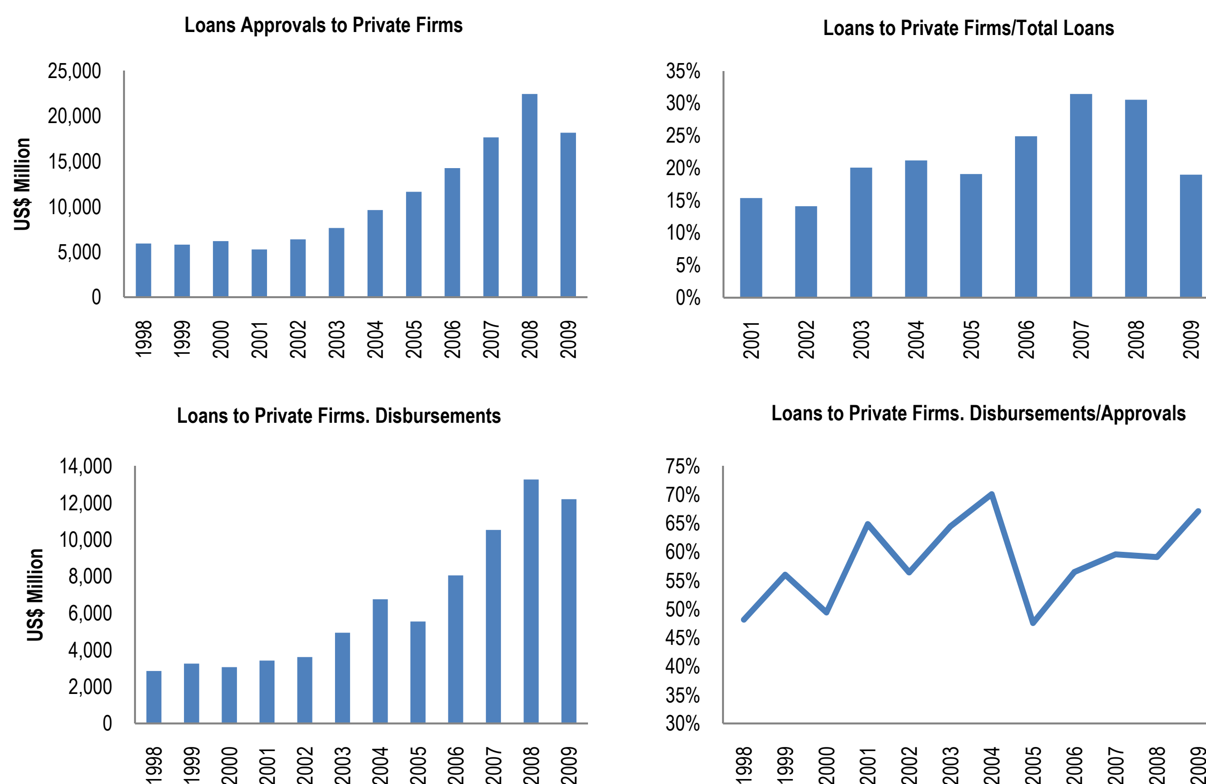
2. Stylized facts: Overview of MDB direct support to the private sector in developing countries

Aggregate trends

MDB financial support to private firms in developing countries has been increasing at a fast rate.[10] Figure 1 shows how approved loans increased from below US$6 billion at the end of the 1990s and early last decade to more than US$22 billion in 2008. They dropped to around US$18 billion in 2009, but are recovering their upward trend as the effects of the international financial crisis recede. Further, such approvals represented an increasing fraction of total loans up to 2008: from around 13 percent in2001 and 2002 to nearly 30 percent in 2007 and 2008. This fraction dropped significantly in 2009, as loans to governments showed a sharp increase (and those to private firms an important decrease) in response to the global crisis. However, as already mentioned, previous trends are recovering as the crisis recedes. Actual loan disbursements to the private sector in developing countries also increased significantly, from almost US$3 billion in 1998 to US$13.3 billion in 2008, dropping to US$12.2 billion in 2009. The disbursement to approval ratio has oscillated around 70 percent on average

[10] Aggregate figures compile IFC, EBRD, ADB, AfDB, IADB, and CAF direct operations in support of the private sector in developing countries. Most of these MDBs include in this category support to publicly owned firms and even to subnational governments without sovereign guarantees I exclude the European Investment Bank (EIB) as its operations benefit mostly developed countries. Ialso exclude bilateral official direct operations in support of the private sector in developing countries, which has also been growing at a fast rate.

Figure 1. MDB Lending to Private Firms

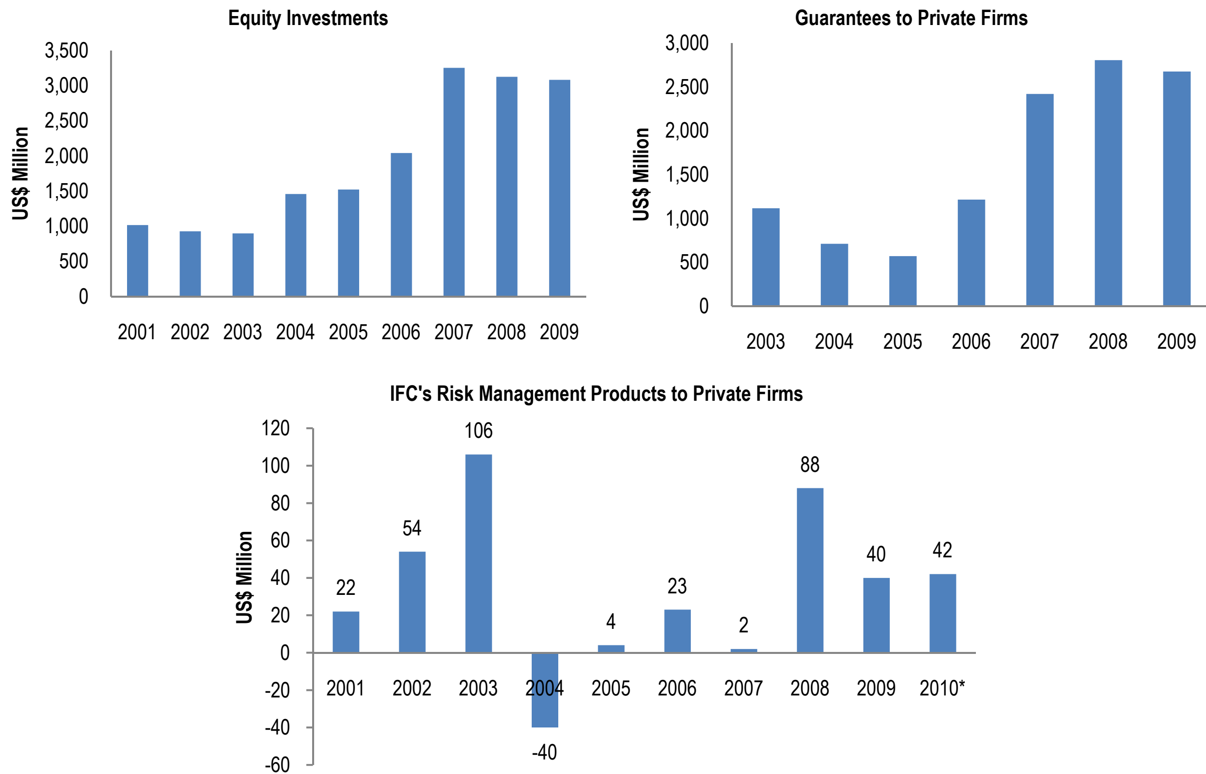


Note: Loan approvals include IFC, IADB (including IIC),CAF, EBRD, ADB, and AfDB; loans to private over total loans includes IFC, WB, IADB (including IIC), ADB, AfDB, EBRD, CAF; disbursements and disbursements over approvals includes EBRD, IIC, ADB, IFC, and IADB
Source: MDB Annual and Financial Reports.

Figure 2 shows that other financial operations with private firms in developing countries have also increased at a fast rate. Equity investments increased from less than US$1 billion in 2001/2003 to around US$3 billion in 2007/2009. Guarantees jumped from around US$500 million in 2004/2005 to US$2.6 billion in 2009. Risk management products have been offered in much smaller volumes and show no clear trend.

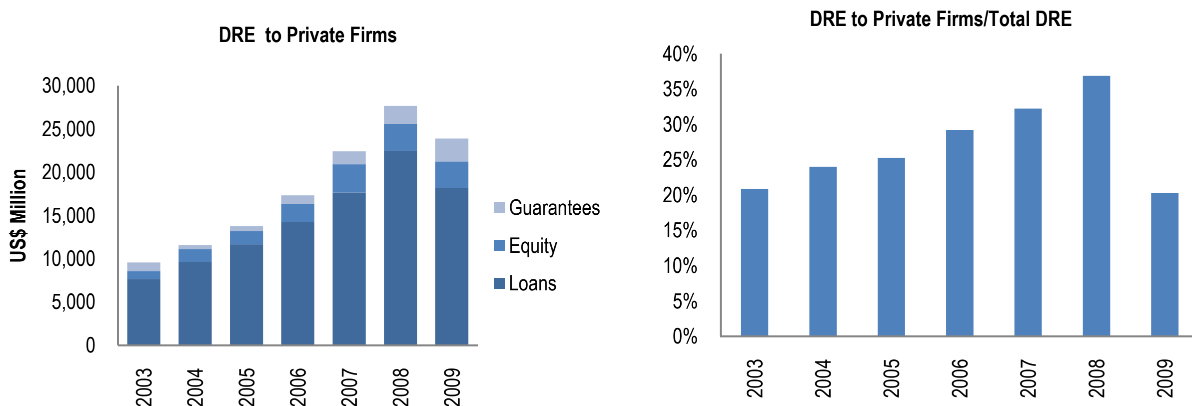
Adding up these operations, total financial operations in support of private firms in developing countries increased from US$9.6 billion in 2003 to US$27.7 billion in 2008, and from 21 percent in 2003 to 37 percent in 2008 as a fraction of their total development-related operations (DRE) (Figure 3).The bulk of these operations continue to be represented by loans, around or above 80 percent in most years, though that fraction was reduced in 2009 as loans dropped significantly during that year, while guarantees continued to increase and equity investments decreased only modestly.

Figure 2. MDBs' Equity Investments, Guarantees, and Risk Management Products to Private Firms in Developing Countries



Note: Equity Investments includes IADB, IFC, ADB, EBRD, CAF, AfDB; Guarantees includes AfDB, ADB, IADB, EBRD, and IFC; RMPs include only information from the IFC
Source: MDB Annual and Financial Reports.

Figure 3. MDBs' Development-Related Operations (DRE) to Private Firms in Developing Countries



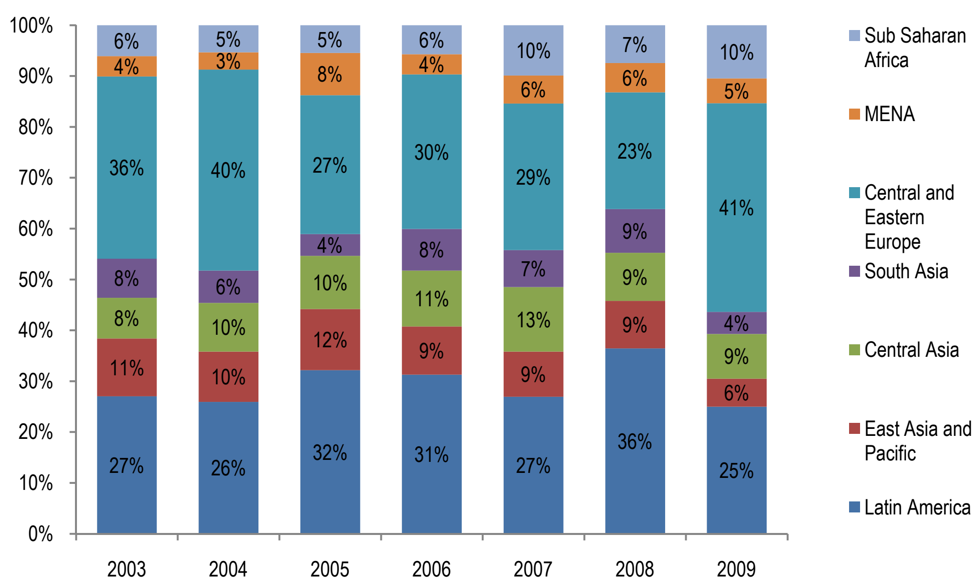
Note: DRE includes equities, guarantees, and loans of the IFC, EBRD, ADB, AfDB, CAF, IADB.
Source: MDB Annual and Financial Reports.

Distribution by Regions and Sectors

Figure 4 shows the distribution by regions of total MDB financial operations (loans, equity investments, and guarantees) in support of private firms in developing countries. It can be observed that MDB financial support to private firms was highest in Central and Eastern Europe and Latin America (jointly between 56 percent in 2004 and 66 percent in 2009), partly reflecting the high levels of EBRD lending to private firms in Central and Eastern Europe and the combined efforts of the IADB group and CAF in Latin America. Central, South, and East Asia had a joint participation of about one-fourth of private operations, remaining relatively stable between 2003 and 2008, though it decreased to 19 percent in 2009. Sub-Saharan Africa, North Africa, and the Middle East had a lower participation, reaching a peak in 2007 of 16 percent. The share of financial support to Sub-Saharan firms increased from around 5 percent at the beginning of the decade to about 10 percent in more recent years.

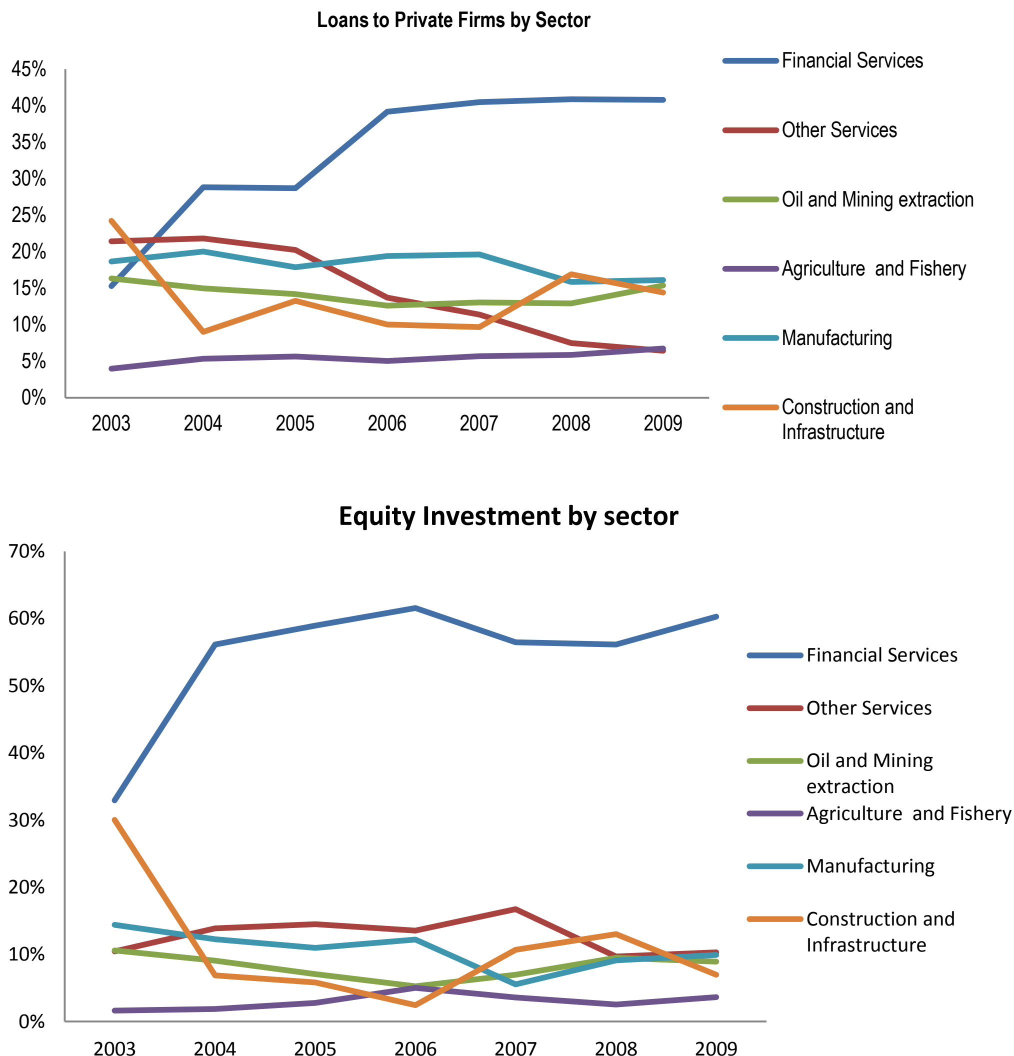
Figure 5 shows the distribution by sectors of MDB financial support to private firms in developing countries. Firms in the financial services sector have received more than 40 percent of loans and equity investments. The fraction of loans approved to financial services firms has had an upward trend (from 15 percent in 2003 to more than 38 percent since 2006), while their participation in total equity investments increased from 33 percent in 2003 to above 55 percent in

Figure 4. Distribution by Regions of MDBs' DRE to Private Firms in Developing Countries



Notes: Includes ADB, AfDB, IADB, CAF, EBRD, and IFC. DRE includes equities, guarantees, and loans.
Source: MDB Annual and Financial Reports.

Figure 5. Distribution by Sectors of MDB Operations to Private Firms in Developing Countries



Notes: Operations includes equities, guarantees, and loans of the IIC, IFC, EBRD, and ADB.
Source: MDB Annual and Financial Reports.

recent years. In 2009, firms in manufacturing, oil and mining, and construction and infrastructure received around 15 percent each of loan approvals and around 10 percent each of equity investments. Other services and agriculture and fisheries firms obtained 5 percent each of loan approvals in 2009, with other services participation coming from higher fractions and agriculture and fisheries from lower fractions in previous years. Of these two sectors, other services has received the higher fraction of equity investments (around 10 percent in 2008/2009) and agriculture and fisheries the lower (3.6 percent in 2008/2009).

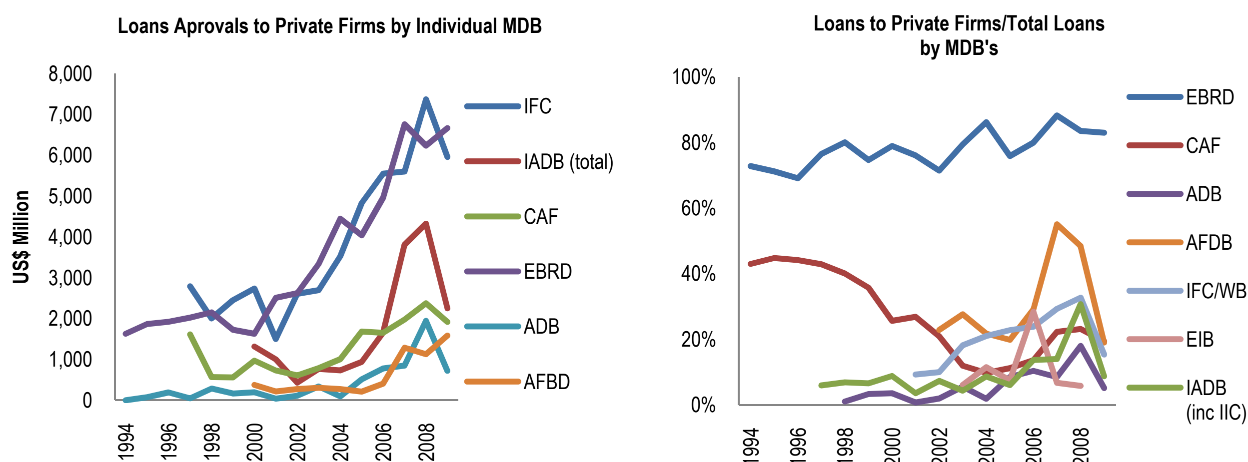
Similarities and differences among MDBs

IFC and EBRD are by far the largest MDB players in financial support to private firms in developing countries.[11] Thus, previous trends reflect mostly the activities of these two agencies. However, most of the others share in them, with some minor differences.

To begin with, loans to private firms increased significantly in all of them during the last decade, though total growth is explained primarily by IFC and EBRD performance (Figure 6). Points to be noted include the sharp peak in 2008 in most MDBs and subsequent reduction in 2009, except for EBRD and AFDB, for which approvals were higher in 2009 than in 2008. Also to be noted are the larger volumes of approvals of loans to private firms by the two Latin American regional and subregional MDBs (CAF and IADB) as compared to their counterparts in Asia and Africa, though ADB and AfDB operations with private firms have also increased sharply in recent years, and they intend to increase significantly such lending in upcoming years.[12]

The share of total loans to private firms compared to total loans, however, differs widely by institution. For purpose of comparison, loans by IFC are compared to total operations of the World Bank Group and, in the case of IADB, the sum of direct operations with private firms through four different channels (the Inter-American Investment Corporation (IIC), the Multilateral Investment

Figure 6. Loan Approvals to Private Firms by Individual MDBs



Source: MDB Annual and Financial Reports.

[11] As noted, EIB is excluded because it lends mostly to firms in developed countries.

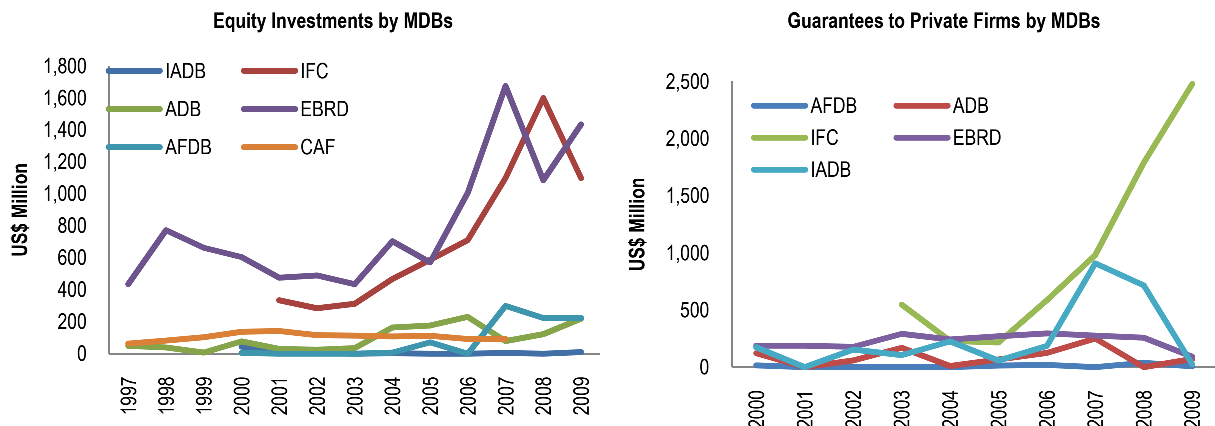
[12] As stated in official documents and stakeholders' agreements and ratified by both ADB and AfDB representatives at the CGD Roundtable in November 2010.

Fund (MIF) and the Corporate Finance and Opportunities for the Majority Departments at IADB) is compared to total IADB Group operations.

EBRD lending is highly concentrated in the private sector (above 80 percent in recent years, from around 70 percent in the mid-1990s), while in other MDBs the shares are below 50 percent, though with large recent increases in some of them: the private share in the World Bank Group increased steadily from 9 percent in 2001 to 33 percent in 2008, but dropped to 15 percent in 2009; in AfDB, it went from 23 percent in 2002 to a peak of around 50 percent in 2007/2008, but declined sharply to 19 percent in 2009; in IADB, it went from 6 percent in 1997 to 31 percent in 2008, and dropped to 9 percent in 2010; in ADB, the share was more unstable, but also peaked in 2008, at 18 percent, to drop back to 5 percent in 2009. CAF shows a different trend: its private sector loans amounted to nearly 45 percent in the mid-1990s, but this participation dropped steadily to 10 percent in 2004, increased again and peaked at 23 percent in 2008, then fell back to 19 percent in 2009.

Equity investments are more concentrated than lending in IFC and EBRD, though they have also increased significantly in recent years at ADB and AfDB. The Latin American regional MDBs appeared more cautious than their regional counterparts in this area, contrary to what happens with lending operations to private firms. The recent total MDB increase in the use of guarantees to support private firms is wholly explained by a sharp increase at IFC. Other MDB use of guarantees in support to private firms continues to be very limited (Figure 7).

Figure 7. Equity Investments and Guarantees to Private Firms by MDBs



Source: MDB Annual and Financial Reports.

3. Rationale for MDBs' direct support to private firms in developing countries

Rationale and priorities

MDB direct support to private firms in developing countries can be justified as long as such firms are financially constrained (in the sense that lack of sufficient access to external funds limits their investment levels), and MDB direct support proves to be an efficient way to lift such financial constraints. In such a case, MDB direct support to private firms would have a significant developmental impact, as it would lead to higher growth and faster poverty reduction. Further, supporting investments by financially constrained firms in activities with high positive externalities (such as in environmental protection, public infrastructure, social sector activities, and development of new financial products and exports) would have an additional development impact bonus.

There is considerable evidence that many firms are in fact financially constrained in developing countries.[13] According to available evidence, the existence of such a constraint and its impact on private investment levels vary by country, sector, size, and other characteristics of firms.[14] Thus, for example, large firms, firms owned by multinationals or part of large domestic conglomerates, as well as firms engaged in exports, tend to be less financially constrained. By sectors, firms in mining and oil and in financial services sectors generally tend to be less financially constrained. As expected, firms in countries with deeper and more liquid domestic financial markets tend to be less financially constrained.

Small and medium enterprises (SMEs) have been found to be more financially constrained than large firms, even in developed countries, though differences in access tend to be much larger in developing countries.[15] Such findings have led to the popular notion of "the missing middle" in developing countries: the real sectors in those countries are characterized by a huge number of microfirms—often informal—and a few large firms, while large numbers of often dynamic SMEs dominate the spectrum in developed countries. The "missing-middle" phenomenon in developing countries is associated with frequent low growth of total factor productivity and is usually explained as a

---

[13] Arbeláez, M.A, Perry, G., and Becerra, A. (2010); Bond S., and Meghir, C. (1994); Brown, J. S., Fazzari, S.M., and B. Petersen (1998); Cincera, M. (2002); Delgado, C. (2004).

[14] Arbeláez, M.A., and Echavarría, J.J. (2002). Arbeláez, M.A., and F. Villegas (2004); Delgado, C. (2004). Loayza, N., and Gallego, F.(2000).

[15] IFC (2009).The SME Banking Knowledge Guide: Advisory Services/Access to Finance. IFC (2009). Advisory Services/Access to Finance Highlights Report 2009.

consequence of the fact that large firms have much better access to domestic banks and capital markets and to cross-country financial services, and microfirms' needs are partly attended by specialized nonbank microfinance institutions, while SMEs' financial needs have been often left hanging in between. The observation that formal SMEs constitute a larger share of firms and output in developed countries as compared to middle-income countries and especially to low-income countries, while informal microfirms (usually characterized by lower productivity than formal SMEs) constitute a larger share of firms and output in middle-income countries and especially in low-income countries, suggests that enhanced access to formal financial services by SMEs is associated with higher levels of formalization of firms and with overall higher productivity growth.[16] Accordingly, available studies have also found a larger growth impact in lifting financial constraints to SMEs.[17]

Further, financial constraints are often specific: most financially constrained firms are more constrained by lack of access to risk capital and long-term funds (equity and long-term debt) than by access to short-term funds. However, this is not always the case, as often small firms have also serious problems with access to sufficient working capital.

Available studies have also shown that financial constraints vary over time, according to both domestic business cycles and variations in international financial markets. Thus, access to trade finance may become severely restricted in particular periods. Further, firms in different countries or sectors are subject to a variety of specific risks (currency, commodity price, climate, natural disasters, security, demand volatility, liquidity risks) and for them lifting access constraints to specific forms of insurance, risk management financial products (RMPs), or indexed debt maybe as or even more important than access to normal lending.[18] This may be the case even for large corporations in many developing countries. It could also be the case especially for firms in the natural resources sectors, whether in mining, agriculture, forestry, fisheries, or tourism.

It follows from the observations above that MDB direct support to private firms could have a larger developmental impact in countries with less access to international financial markets and less developed domestic financial markets, and when it focuses on nationally owned firms, especially on those that are not

---

[16] IFC (2009). The SME Banking Knowledge Guide: Advisory Services/Access to Finance. IFC (2009).Advisory Services/Access to Finance Highlights Report 2009.

[17] Arbeláez and Perry, op. cit.

[18] See Perry, G., CGD (2009). Beyond Lending: How Multilateral Banks Can Help Developing Countries Manage Volatility.

part of large conglomerates, and particularly on micro, small, and medium enterprises (MSMEs). It also follows that providing or facilitating access to financial services in bad times (e.g., having a countercyclical role) would have a much larger impact than in good times.

Developing long-term financial markets in domestic currencies

A key issue is whether such support would be more effective if it focused on strengthening domestic financial intermediaries or directly supporting financially constrained real sector firms. Strengthening domestic financial intermediaries and agencies would be the best way to help relieve financial constraints for most private firms in the long run. It is also the more efficient way to reach more firms in the short term, especially with respect to MSMEs.

In the long term, lifting financial constraints and providing insurance and risk management products depend on success in developing deep domestic financial markets and sound integration with international financial markets. These, in turn, depend on many other factors, such as a sound macroeconomic management, efficient and credible institutions (especially related to property rights protection, contract enforcement, corporate governance, and lifting information asymmetries) and a positive investment climate (low cost of doing business, policy predictability, etc.). Specific financial sector institutions are key: investor and creditor rights, credit bureaus, disclosure requirements, prudential regulation and supervision, settlement and clearance systems, and so forth. MDBs devote important resources to policy advice and financial support to governments in all these areas. For the purpose at hand, an increase in the amount and quality of resources devoted to support adequate domestic or regional governmental financial sector institutions and policies should probably be the main long-term priority of MDBs' indirect support to private sector development.

However, it must be recognized that building deep and sound financial markets and financial integration takes time and is part and parcel of the overall development process. Thus, MDB direct financial support to private firms in developing countries, especially to financial intermediaries and other private financial agencies, may be justified in developmental terms as a complement to supporting sound governmental financial sector institutions and policies.

Available studies[19] have shown that increasingly large banks are focusing on SME finance, especially in developed countries but also in middle-income

[19] E.g., IFC (2009).

countries, as access of larger firms to deeper domestic capital markets and international private markets drives down portfolio growth and margins in this traditional segment. In doing that, they normally set separate units within the bank and use extensively statistical scoring methods and information technology and exploit synergies by offering a wide portfolio of bank and group products and services (deposit, saving, and payment services; trade finance; leasing and factoring; consumer lending for owners; insurance services) that are of great value to SMEs. Retail banks are in this way driving down unit costs and obtaining profitable operations in attending SMEs. At the same time, the most successful microfinance nongovernmental organizations (NGOs) are entering the SME market from below, often converting to banks. Thus, the "missing middle" is beginning to fade out, and MDB technical advice and direct support to both groups of institutions may help to accelerate the closing of existing gaps. However, the role of other nonbanking financial institutions (e.g., those specializing in leasing, factoring, and microfinance, including micro-insurance), will likely remain key for MSMEs access to finance in many developing countries for a long time, and thus should also be supported by MDBs.

Firms in nontradable sectors would benefit especially from access to domestic currency debt (and to currency derivatives). This would be the case for most firms delivering infrastructure and public and social services, as well as for firms in construction, internal commerce, finance, etc. Most MSMEs would also benefit more from access to debt denominated in domestic currency, as they are located primarily in nontradable sectors and have no access to currency derivatives.

Access to long-term debt in domestic currencies, at reasonable interest rates, is crucial not only for individual firms in nontradable sectors: lack of such access often has severe macroeconomic consequences. Indeed, faced with major exogenous shocks, whether real (terms of trade, demand for exports) or financial (sudden stops, financial contagion), developing countries often have to adjust through sharp corrections in the current account of their balance of payments.[20] Such adjustments usually take place through a contraction in aggregate demand, caused by both the negative income effect of the exogenous shock (and frequently required procyclical fiscal adjustments) and a significant depreciation of the exchange rate. Depreciation is in theory expected to bring about compensatory expansionary effects through increased exports and reduced imports. However, currency depreciations have often had net contractionary

[20] The following discussion draws from Perry, G. (2009), CGD.

effects in developing countries as a consequence of their negative impacts on the balance sheets of both government and corporations,[21] which tend to be overexposed to currency risk. These negative balance sheet effects are a direct consequence of large open currency mismatches.

Those mismatches, in turn, are ultimately a consequence of insufficient development of domestic currency capital markets. Governments and large firms often face the dilemma of either financing their investments at high interest costs and short maturities in domestic currencies or of benefiting from the significantly lower interest rates and longer maturities available in international markets in foreign currencies, though incurring risky currency mismatches in their balance sheets.[22] Of course, imprudent macro and financial policies often exacerbate this problem, by inducing economic actors to undertake excessive levels of foreign currency-denominated debt (whether external, or domestic in the case of dollarized economies). But, at least since the Asian and Russian crises, both governments and corporations have become aware of the potentially devastating costs associated with excessive open currency risks and have significantly reduced their overall indebtedness ratios, tilted their debt composition toward domestic currencies, and used currency swaps, when available, to cover open exposures.[23] In doing so, they benefited from the exceptionally favorable external environment between 2003 and mid-2008.

However, the extent to which countries can implement such policies is limited by the size, depth, and efficiency of domestic currency markets. As a consequence, developing long-term capital markets in domestic currencies has become a major priority for most developing countries. There have been important, though highly unequal, advances in this area. Some emerging market economies, including Chile, Mexico, South Africa, and some countries in Asia and Central Europe, have developed long-term and relatively low-cost domestic currency and currency swap markets and have managed to substantially eliminate currency mismatches and open exposures in the balance sheets of governments and large corporations.[24] Policies promoting low inflation and flexible exchange rates and regulatory and market infrastructure reforms have been behind many of these success stories.[25] But for most developing countries the road to efficient long-term domestic currencies capital markets is likely to be

[21] Calvo, G. and Talvi, E. (2005); Cavallo, E. and Frankel, J. (2007).
[22] The so-called original sin dilemma; see Eichengreen, B., Hausmann, R., and Panizza, U. (2003).
[23] See, for example, IADB Annual Report (2007) and BIS (2007).
[24] Perry, G., 2009, CGD. Chapter IV: Dealing with Currency.
[25] See, for example, De la Torre, A. and Schmukler, S. (2006).

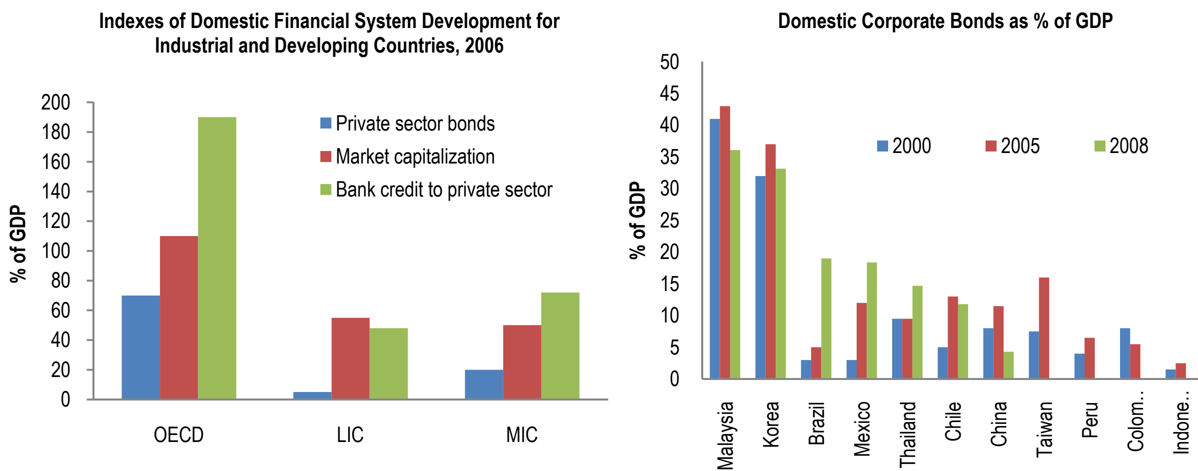
long (as evidenced by the low indexes of domestic capital market development for low- and middle-income countries shown in Figure 8 below) and to leave governments and firms heavily exposed to currency risks along the way.[26]

Thus, MDBs should concentrate on helping to develop long-term domestic financial markets in domestic currencies, but because this takes time, they should complement such efforts by directly lending in domestic currencies to financial sector firms in developing countries and other firms in nontradable sectors, in particular to SMEs, whether directly or indirectly through domestic financial institutions.

The choice of financial instruments

Further, as already mentioned, in specific sectors and cases, firms may benefit more from enhanced access to specific insurance and RMP products or indexed debt, than to normal debt instruments. The choice of financial instruments focused on specific financial constraints or risks could make a huge difference in developmental impact. Most firms will benefit more from increased access to equity and long-term debt in domestic currencies than to short-term debt or to debt in foreign currencies.

Figure 8. Domestic Capital Markets Development



Source: Author's elaboration based on BIS and IFS data.

[26] Some countries have attempted to short cut building monetary credibility and domestic long-term capital markets by giving up their currencies and permitting the de facto "dollarization" of their domestic capital markets. De facto dollarization has often led to substantial financial instability, and many countries have been "dedollarizing" their financial systems since the Asian and Russian crises (Fernández Arias, E. and Levy Yeyati, E. 2005; Levy Yeyati, E. 2006).

SMEs appear to require, in addition, a wider portfolio of financial instruments, as, given their lack of collateral, they may benefit especially from access to financial leasing, factoring, and guarantee funds. Smaller firms also often need to access a variety of other financial services, such as payment, deposit, saving, and insurance services. These are key issues, whether in choosing which financial intermediaries to support (and for what purposes) or in the design and priority given to MDBs' specific financial instruments.

The added bonus of supporting firms in sectors and activities with high externalities

In addition, as mentioned above, lifting financial constraints (or other forms of support) may have a larger developmental impact in activities with large potential externalities. Thus, priority given to private firms involved in health and education services, public infrastructure, and other public services maybe warranted. Also, priority given to firms rendering environmental services, or reducing pollution levels, as well as to those introducing new exports, products, or technologies, would be justified.

Confronting actual policies and practice with these priorities

Given that it is difficult to assess the direct developmental impact of MDB support to private firms (although some of them have rightly begun to attempt to measure this impact, as discussed in section 4 below), it is useful to review, first, to what extent policy statements correspond to these principles and, more specifically, if actual operations reflect these orientations. Thus, the following section begins by an examination of explicit policy goals and focus and attempts to measure developmental impacts and use them as a guide for actual operations. Then I look at the distribution of operations by middle- and low-income countries, as a proxy for the level of domestic financial sector development and financial integration, and review actual focus and practices with respect to MSMEs in some MDBs (section 5). I also examine sectoral priorities and, in particular, what MDBs are doing in supporting domestic financial intermediaries and specific deserving sectors (section 6). I then discuss briefly to what extent MDBs are diversifying their financial products according to actual needs (section 7). Finally, I examine to what extent MDBs' support to private firms appears to be procyclical or countercyclical and, in particular, how they responded to the special challenges of the recent crises (section 8).

4. Stated goals, strategic guidelines, and evaluation procedures

MDBs show an increasing recognition of the need to guide their direct support to private firms by explicit consideration of their potential developmental impact in setting overall priorities, defining strategic guidelines for their involvement with particular countries and sectors, selecting projects, and evaluating the results of their operations. EBRD led the way[27] by devising the so-called Transition Impact Methodology as early as 1997. EBRD was created with the specific goal of helping its beneficiary countries to transit from socialist centralized to private market economies, which explains both the focus of its impact methodology and the high percentage of operations supporting private firms since its inception. IFC then followed with the Development Outcome Tracking System (DOTS), and other MDBs followed its approach, with some variations. Priorities and criteria adopted by these MDBs largely coincide with conclusions from the analysis presented above. These are welcome developments, though it is not yet clear how much they actually influence the composition and design of operations, as discussed in the following sections.

MDBs generally emphasize their goal of focusing on poorer countries or regions, SMEs, and particular sectors (especially financial services, infrastructure, and social sectors) or activities (e.g., environmental concerns) in their direct support to private firms in developing countries. As an example, IFC stated priorities are supporting firms and institutions in “frontier markets” (low-income countries, fragile states, and poor regions in middle-income countries); in infrastructure, health, and education services and in the food supply chain; and in addressing environmental concerns and developing local financial markets with a focus on SMEs (Box 1). In a similar vein, IADB’s current strategic goals are to address the special needs of the less developed and smaller countries and to foster development through the private sector by helping develop financial markets and expanding access to credit for the private sector, with special emphasis on MSMEs.

[27] See section 4.1.2 in Grettve, A. *Review of Development Effectiveness Measuring and Reporting in IFC and Its Comparator Organizations*, June 2007. http://www.ifc.org/ifcext/devresultsinvestments.nsf/AttachmentsByTitle/Review+of+Development+Results/$FILE/Review_of_Development_Results_FINAL.pdf.

Box 1. MDBs' Stated Priorities in Private Sector Operations

IFC

1. Strengthening the focus on frontier markets (IDA countries, fragile and conflict-affected situations, and frontier regions in middle-income countries)
2. Building and maintaining long-term client relationships with firms in developing countries, using the full range of IFC products and services, and assisting their cross-border growth.
3. Addressing climate change, and ensuring environmental and social sustainability activities.
4. Addressing constraints to private sector growth in infrastructure, health, education, and food supply chain.
5. Developing local financial markets through institution building, the use of innovative financial products, and mobilization, focusing on micro, small, and medium enterprises.

EBRD

Fostering the transition toward open market-oriented economies and promoting private and entrepreneurial initiative in the Central and Eastern European countries. According to the latest Capital Resources Review undertaken in 2010, key priorities to be pursued by the EBRD over the medium term within its overall mandate to promote transition to market economies and private and entrepreneurial initiative include:

1. Building stable financial sectors
2. Diversifying economies
3. Tackling energy efficiency, climate change, and energy security
4. Accelerating transition in infrastructure
5. Applying the lessons of the crisis.

IADB

Priorities established by the GCI-9 Report for the recent (ninth) capital increase: (i) projects in small and vulnerable countries (increase lending to this group from the 27 percent baseline to 35 percent by the end of 2015); (ii) projects that address poverty reduction and equity enhancement (increase the lending volume for poverty reduction and equity enhancement from 40 to 50 percent at the end of 2015); (iii) projects that address climate change, sustainable energy, and environmental sustainability (increase lending to climate change initiatives, renewable energy, and environmental sustainability from 5 to 25 percent at the end of 2015); (iv) projects that promote regional cooperation and integration (increase lending to support regional cooperation and integration from 10 to 15 percent at the end of 2015). IIC has traditionally focuses, in particular, on supporting SMEs that have difficulty obtaining medium- and long-term financing from other sources. Expanded support to IIC will be provided through subordinated, long-term loans of at least US$500 million. Governors also determined moving from the 10 percent statutory ceiling on nonsovereign guarantee (NSG) to prudential risk limits based on a risk management approach by 2015. On a transitional basis, until December 31, 2012, the Bank will cap these operations to an amount such that risk capital requirements for NSG operations will not exceed 20 percent of total Bank equity.

Sources: IFC Road Map FY10-FY12. Creating Opportunity in Extraordinary Times; EBRD and IADB information to authors.

Because of its original purpose of supporting the transition from centralized planning to private sector-led economies, EBRD's stated priorities are by necessity broader: "supporting private clients whose needs cannot be fully met by the market, promoting entrepreneurship and fostering transition toward open

and democratic market economies, covering a broad array of sectors, such as the financial sector, energy, agribusiness, MSMEs, municipal & environment infrastructure, natural resources, property, shipping, telecoms, informatics & media, and transport."[28]

Also, MDBs increasingly explicitly include developmental impact considerations as part of their publicized criteria for selecting countries, sectors, and clients. Strategic guidelines also normally include a consideration of the particular MDB strength in supporting the specific sector challenges and of synergies with its own (or its MDB group) direct support to the government. See, for example, IFC explicit strategic guidelines in Box 2.

Box 2. IFC Strategic Guidelines

Country/Sector Strategy	i) What are the key development challenges in the sector? What are the needs of the business in the country/sector/market concerned? ii) Which of these challenges or needs is IFC best qualified to take on, either on its own or with the World Bank or other partners? How is IFC currently addressing those needs, e.g., through financing, advisory services, or a combination of both? iii) What is IFC's country/sector strategy? Is there any programmatic approach for the sector/department? What is IFC trying to achieve, e.g., in terms of sector development, market penetration, or standards setting? iv) What is the WBG strategy for the country and the sector concerned?
Strategic client/ Project selection	i) Why do we want to work with the client in this particular project? ii) How will this particular client help IFC achieve its strategic priorities and play a developmental role in the country/sector? iii) How does this project fit with the WBG strategy for the country or sector?

Source: IFC's Role and Additionality: a Primer. May 7, 2009. Author's emphasis.

As already mentioned, MDBs have developed or are developing systems of evaluation of developmental impact (or the transition impact in the case of EBRD) of their support to private firms, which are applied together with the evaluation of financial performance, sustainability of projects, and other criteria (conformance with safeguards, risks, and returns for the MDBs, etc.). These evaluation procedures are applied both when selecting projects and afterwards, often through their independent evaluation offices.

[28]www.ebrd.com/pages/homepage.shtml.

The pioneer in this area was EBRD, which devised its Transition Impact Methodology (EvD) in 1997 and rolled out its Transition Impact Monitoring System to monitor and report on the transition impact of all its operations since 2003. According to its mandate to foster transition in previously centrally planned economies, EBRD's EvD evaluates the "transition impact" of every project, as well as its impacts on environmental and social aspects.

Since 2005, IFC has reported the developmental impact of its operations using DOTS. The World Bank's Independent Evaluation Group (IEG) reviewed and has been using this methodology in its evaluations of IFC performance. As an example, IEG found that 71 percent of all projects active in IFC portfolio from 2000 to 2005 were rated high with respect to developmental outcomes, using this methodology. According to that evaluation, the remaining 29 percent did not meet these IFC standards.[29] IEG also found a strong correlation between financial performance and developmental outcome of projects, which suggests that giving emphasis to developmental impact does not necessarily pose a dilemma with respect to the financial soundness of the MDB portfolio.[30]

These evaluation systems, as well as the evaluation systems of AfDB (ADOA), IADB (DEM), and ADB are briefly summarized in Box 3. All MDBs participate in an Evaluation Cooperation Group, which has issued "good practice standards" for private sector operations, to which all of them now conform.

Box 3. MDBs' Developmental Impact Evaluation Methodologies and Procedures

EBRD EvD Evaluation of Transition Impact: The evaluation of *transition impact* focuses on the broader effects that the project has on the sector and economy at large. Three key areas covering seven transition impact indicators, which are used by the Bank during screening and approval of projects, are applied when evaluating transition impact in Bank projects:

1. Project's contribution to the structure and extension of markets
2. Project's contribution to market organizations, institutions, and policies that support markets
3. Project's contribution to business behavior.

EvD assigns a rate to the *short-term verified transition impact* of a project that can be checked at the postevaluation stage. A rating is also assigned to the *longer-term transition impact potential* that can be realized later on. EvD then reviews the risk that the project may not realize its full transition potential and assigns a rating of *Low*, *Medium*, *High*, or *Excessive risk.* EvD also evaluates **Environmental and Social impacts.**

(Box continues on next page)

[29] IFC (2009). IFC's Evaluation Framework for Investments.

[30] IFC (2009). Annual Portfolio Performance Review.

Box 3 (continued)

IFC's DOTS measures the development results of IFC's investments, advisory services, and active operations continually throughout the project lives. This systematic tracking allows IFC to monitor projects, learn from what does and does not work, and improve its performance.

DOTS includes:

- An **overall development outcome rating**, that is assigned to every project in the IFC's portfolio at least once a year
- **Industry-specific standard indicators** that measure the development reach of IFC's investments on stakeholders.

To consider a project developmentally successful, it has to (i) be financially sound, (ii) provide benefits to stakeholders beyond the project financiers and not rely on subsidies, protection, or other distortions, (iii) meet IFC's social and environmental performance standards, and (iv) have a broader impact on private sector development. Performance of those four components, which is in turn informed by achievement of project-specific indicators, is rated on a 4-point scale (excellent, satisfactory, partly unsatisfactory, or unsatisfactory). The **overall development outcome** is rated on a 6-point scale. This evaluation framework has been endorsed by the Evaluation Cooperation Group (ECG), an alliance of MDBs established to harmonize performance indicators and evaluation methodologies, and strengthen the use of evaluation for greater effectiveness and accountability.

AfDB ADOA: In 2009 a revised Additionality and Development Outcome Assessment (ADOA)—after a pilot phase of one year—was established taking into consideration four types of impacts on overall economic performance (household benefits, infrastructure, government ,and macroeconomic resilience), as well as environmental and gender and social effects and business success and private sector development and demonstration effects. In each category a set of specific indicators has been developed (e.g., on employment, poverty, balance of payments, and tax revenues for the first two categories).

IADB's DEM: In March 2008, the IADB introduced a new development effectiveness framework for nonsovereign guaranteed operations. The central instrument is the Development Effectiveness Matrix (DEM), which contains 7 performance areas, including up to 30 indicators. Five of these performance areas relate to Development Outcomes, including the IDB's Strategic Objectives, and two are concerned with IDB's additionality. Up to 6 of the 30 indicators are sector-specific performance indicators to measure the project's contribution to the company's business success and the development of its sector. A 5-scale rating system (Excellent, Good, Satisfactory, Partially Unsatisfactory, or Unsatisfactory) is used to provide ratings to: (i) each of the indicators, (ii) the seven performance areas, and (iii) the overall project. Throughout the project cycle, the development effectiveness of the project is estimated, monitored, and evaluated based on the DEM tool. The IICs uses a similar tool called DIAS.

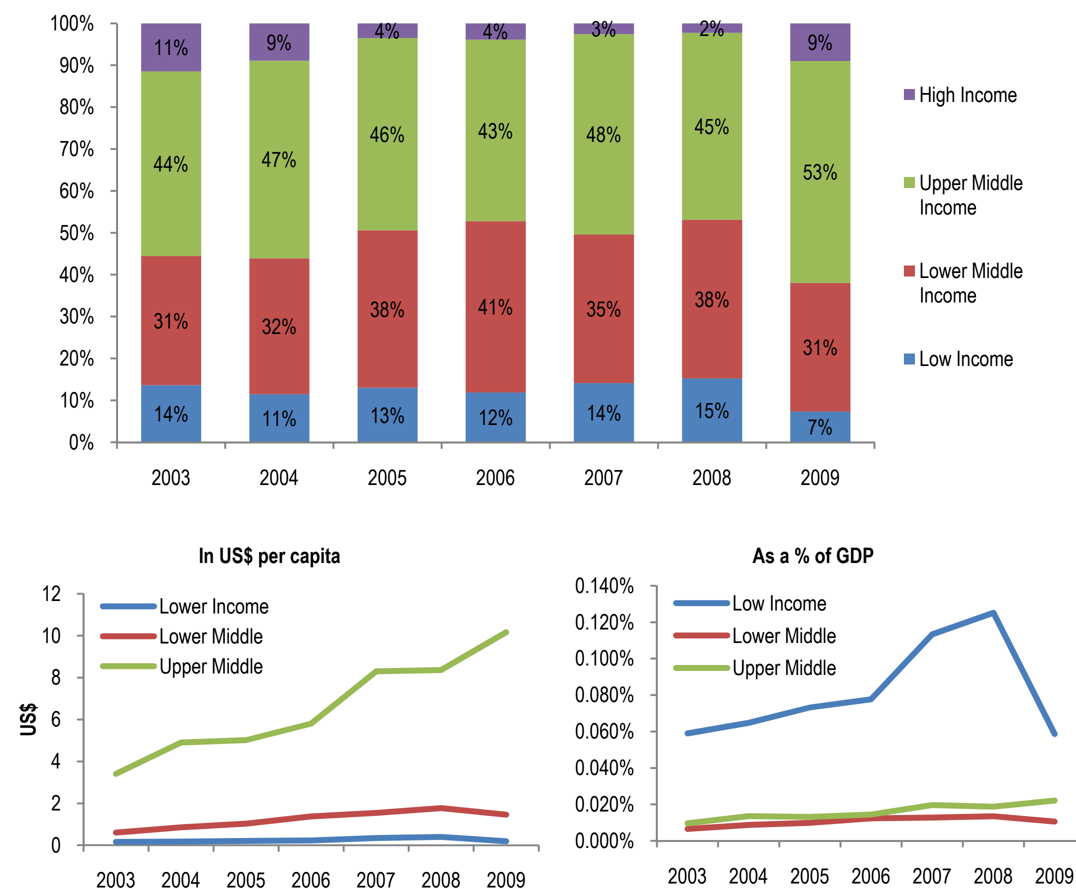
ADB: In 2009, ADB introduced a more systematic approach for development effectiveness monitoring and reporting of its private sectors operations. Standardized lists of indicators for the development impacts, outcomes, and outputs of private sector operations were prepared, including both a "long list" of desired indicators and a "minimum list" of required indicators.

Sources: IFC (2009). Evaluation Framework for Investments and IFC's Annual Portfolio Performance Review 2009; EBRD: Evaluation Policy of the EBRD October 2006; Annual Evaluation Overview Report for 2008. AfDB and IADB communication to authors.

5. Does MDBs' support to private firms actually focus on poorer countries and SMEs?

As observed above, most MDBs explicitly propose to focus their direct support on private firms in poorer countries and regions, as suggested by our analysis in section 3. To what extent do they actually do it? Figure 9 shows a classification by low- and middle-income countries of MDB direct support to private firms. MDBs' private operations have concentrated on middle-income countries: 80 percent on average during 2003-2009. Low-income countries' participation was relatively stable between 2003 and 2008 (between 11 and 15 percent), but fell to 7 percent in 2009. In per capita terms, upper-middle-income countries have received a much larger and increasingly higher support. However, MDBs' support to private firms has represented a higher and increasing (except in 2009)

Figure 9. Distribution by LICs and MICs of MDBs' Operations to Private Firms



Note: Includes ADB, AfDB, IIC, EBRD, and IFC.
Source: MDB Annual and Financial Reports; World Development Indicators (World Bank).

Box 4. AfDB's and EBRD's Private Sector Operations in Lower-Income Countries

AfDB:

AfDB establishes annual targets for new private sector operations in LICs, MICs, and regional operations. In the last two years the targets for LIC' (40 percent in 2008 and 2009) were slightly surpassed: 42 percent in 2008 and 43 percent in 2009. Disaggregating regional operations into LICs' and MICs' final beneficiaries, the total share of private sector operations in LICs for 2009 actually reached 70 percent.

EBRD:

In 2004, EBRD launched the **Early Transition Countries (ETC)** Initiative to increase its impact in the region's lowest-income and least advanced transition countries, which originally included the CIS-7 (Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan). Mongolia was added in 2006, Belarus in 2009, and Turkmenistan in 2010. The ETC Initiative has developed specific financial instruments targeted at local enterprises to fund equity investments, including the Direct Lending Facility to finance long-term loans directly, the Medium-sized Co-financing Facility to co-finance loans with local commercial banks, and the Non-Bank Microfinance Facility to lend to microfinance institutions. These instruments account for one-third of EBRD transactions in the ETCs.

Annual transaction numbers are increasing five-fold to almost 100 transactions per year in these countries. The share of ETC operations in overall Bank activity has also been rising (from 8 percent of Bank- wide transactions in 2003 to 27 percent in 2009).

Within the ETC region, the priorities include increased private investment in the lowest-income countries (Central Asia and Mongolia); a significant prioritization of the financial institutions sector, further innovation of financial products (including a new dedicated mezzanine capital instrument as part of DIF); development of local currency loans to insulate vulnerable ETC banks, MFIs, and local private enterprises from foreign exchange volatility; and emphasis on improving the investment environment.

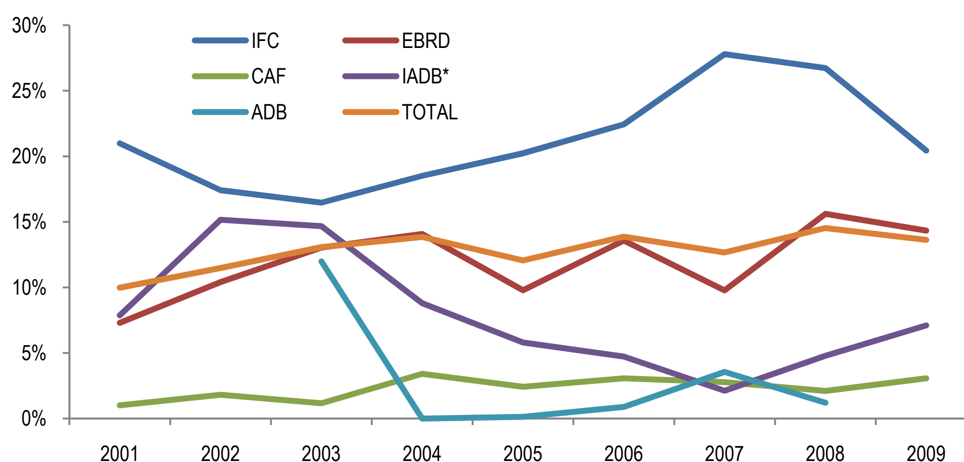
Source: AfDB, Mid-Term Review of the 2008–2010 Business Plan for Private Sector Operations and EBRD information to authors.

proportion of GDP for low-income countries. This is specially the case of the AfDB, whose share of private sector operations in low-income countries reached43 percent in 2009 and up to 70 percent when regional operations are disaggregated into low-income countries and middle-income countries (Box 4). It should be noted that AfDB has the highest fraction of its country clients among low-income countries.

Also as noted, most MDBs have the explicit goal of focusing on serving microfirms and SMEs, in agreement with our suggested priorities. Because an important part of their support to such firms is not direct, but through financial intermediaries or NGOs, available information does not permit full appreciation of the extent of MSMEs' indirect benefits from MDB operations in most cases. Figure 10 shows such figures for some of the MDBs, derived from special communication to the authors, which average close to 15 percent of their total

private sector operations, on a slightly increasing trend, though with large differences among individual MDBs. Overall participation of MSMEs in IFC operations had an upward trend from 2002 up to 2008 from around 15 percent to nearly 30 percent (though it was coming from a high 25 percent in 2001), but dropped to less than 25 percent in 2009. MSME participation in private sector operations has been lower and more variable at EBRD: between 7 percent and 14 percent. The share of MSMEs in CAF and ADB private sector operations has also been increasing, though it is much lower (below 5 percent). At IADB it has been trending upward from 2007 onward (to around 6 percent in 2009), after a sharp decline from 15 percent in 2002/2003 to 2.5 percent in 2007. This trend at IADB is related to the high growth of the Corporate Finance Department in these years, as IIC, MIF, and the Opportunities for the Majority Department focus almost exclusively on SMEs or microfinance institutions.

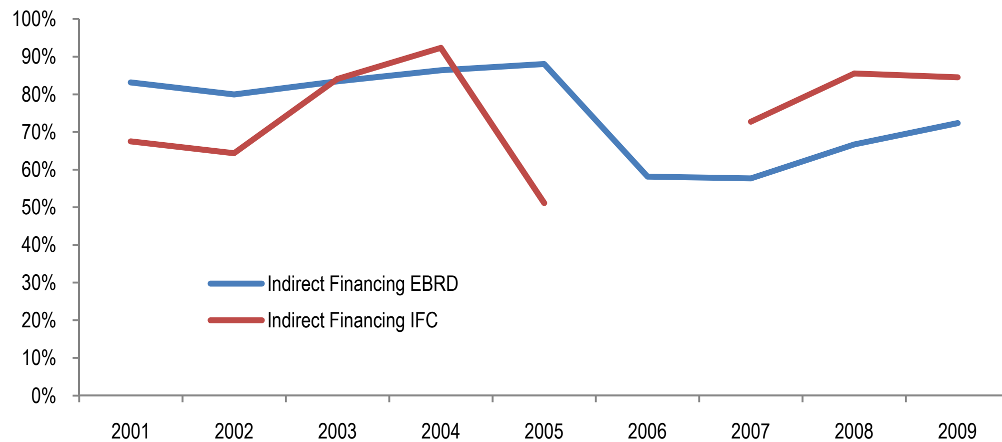
Figure 10. Participation of Private Sector Operations in Favor of Microfirms and SMEs



*IADB annual value of loans for SMEs excludes indirect financing (financial intermediaries).
Source: EBRD's Annual Reports, IFC's Annual Portfolio Performance, and CAF and IADB information to authors.

Figure 11 shows the evolution of the participation of direct and indirect (through financial intermediaries) support to MSMEs in the case of EBRD and IFC. It shows in both cases a higher participation of indirect loans (though declining in the case of EBRD) and equity investments in MSMEs and lower values and very high volatility in direct ones.

Figure 11. Fraction of Loans and Equity Investments in Favor of MSMEs through Intermediaries: EBRD and IFC

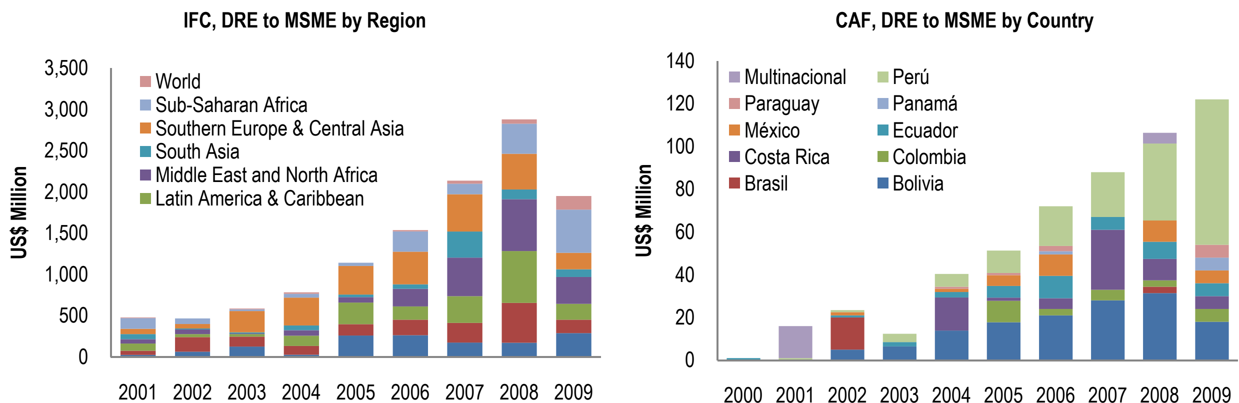


Source: EBRD's Annual Reports; IFC communication to authors.

Figure 12 shows the trends of total MSME operations in IFC and CAF by regions and countries, respectively. IFC's operations in favor of MSMEs have concentrated in the Middle East and North Africa and Latin America and Caribbean regions, though in recent years there has been a large increase in the share of Sub-Saharan Africa. In the case of CAF, Bolivia and Peru have received the largest shares of support to MSMEs. There has been, thus, a modest trend toward increasing the share of poor regions or countries in operations in favor of MSMEs in these two cases.

MDBs seek to broaden access to financial and other services to microfirms and SMEs through a variety of instruments, intermediaries, and partners.

Figure 12. Trends in Operations to MSMEs: IFC and CAF



Source: IFC and CAF requested information.

Instruments include equity investments, loans, guarantees, grants, and a wide diversity of advisory service programs, both for microfirms and SMEs and for financial and nonfinancial institutions and NGOs that serve them.

Intermediaries include banks, leasing, securitization companies, guarantee funds, and specialized microfinance institutions in which MDBs have an equity stake or which they finance or guarantee to on-lend to or guarantee microfirms or SMEs financial operations, as well as investment or venture capital funds in which MDBs have invested. They also include firms and NGOs that render commercialization, training, business management, and other services to microfirms and SMEs. Some MDBs also provide direct financing and support for SMEs through a number of loan and equity facilities. Box 5 offers a brief description of some micro and SME support programs by MDBs.

Box 5. MDB Programs That Support Microfinance and SMEs

IFC:

In addition to providing financial support, IFC gives guidance to banks that want to begin strategic engagements with the SME market, helping them to understand the special characteristics of this market and to innovate with financial and nonlending products (deposits and savings, transactional services, and advisory services) and scoring techniques. IFC developed the SME banking CHECK Diagnostic Toolkit, which enables the conduct of comprehensive assessments of financial institutions' performance in more than 100 competencies and identifies potential areas of improvement for IFC portfolio banks.

EBRD:

Finance: Sustainable provision of finance and financial services to local SMEs through financial institutions.

Policy Dialogue: Focus on improving the business climate for MSMEs generally, with a priority on addressing policies and regulations that create impediments to accessing and providing finance for MSMEs.

Business Support: The TurnAround Management and Business Advisory Services (TAM/BAS) Programme focuses on assisting and improving the management skills of SME entrepreneurs.

AfDB:

The Bank generally channels its support to MSMEs through financial intermediaries, using lines of credit in local currencies or guarantee facilities combined with grant resources for technical assistance and capacity building. It also supports MSMEs by assisting business associations and other business development services. It further looks for opportunities to develop local linkages to industrial projects in areas such as training of local labor, upstream development of local supply-chain SMEs, and downstream development of processing industries to increase the value-added and local content of the exported goods. Through a new "World-Class Partners Initiative," the Bank seeks to identify strong development partners through which the Bank can derive economies of scale.

(Box continues on next page)

Box 5 (continued)

ADB:
The MSME strategy focuses on: (i) creating a policy environment conducive to microfinance, (ii) developing financial infrastructure, (iii) building viable institutions, (iv) supporting pro-poor innovations, and (v) supporting social intermediation. On the supply side, the strategy focuses on building financial systems that can grow and provide financial services on a permanent basis to an increasing proportion of the poor, and promoting pro-poor innovations. On the demand side, the strategy supports investments in social intermediation.

CAF:
CAF finances MSMEs indirectly, through alliances with different entities such as development banks, financial institutions, microfinancing entities, credit guarantee systems, risk capital funds, and official organizations (such as official development banks). It includes the development of alternative financing mechanisms (factoring and financing of productive chains, among others).

IADB:
SMEs: IADB supports SMEs through multisectoral and global credit programs for second-tier financial institutions, which channel the resources to qualified intermediary financial institutions, which in turn provide medium- and long-term loans (under market conditions) available to SMEs for restructuring and expanding their businesses. Second-tier institutions are usually public development banks. While most intermediary financial institutions are private sector banks, the distribution channels have expanded in recent years to include other intermediaries in order to reach the targeted sectors, particularly microenterprises. The private intermediary assumes the risk of repayment by MSMEs and is therefore responsible for selecting projects and firms to be supported. These programs are demand driven, although careful analysis is made beforehand of the market gap that is expected to be covered with IADB support. . From 1990 to 2005, 7 percent of IADB's total lending and 48 percent of Bank funding of private sector activities were channelled through these operations.

Microfinance: In 1978, IADB was the first MDB to provide loans without sovereign guarantees for microcredit projects., which allowed small NGOs, mostly SMEs themselves, to test, until then, unproven credit schemes (An Inside View of Latin American Microfinance, edited by Berger Marguerite, Goldmark Lara, Miller-Sanabria Tomas, Inter-American Development Bank). IADB was also a pioneer in promoting policies and investing in projects in order to convert microfinance NGOs into regulated banks (upgrading) and in promoting the shift of banking institutions' focus into SME downscaling.

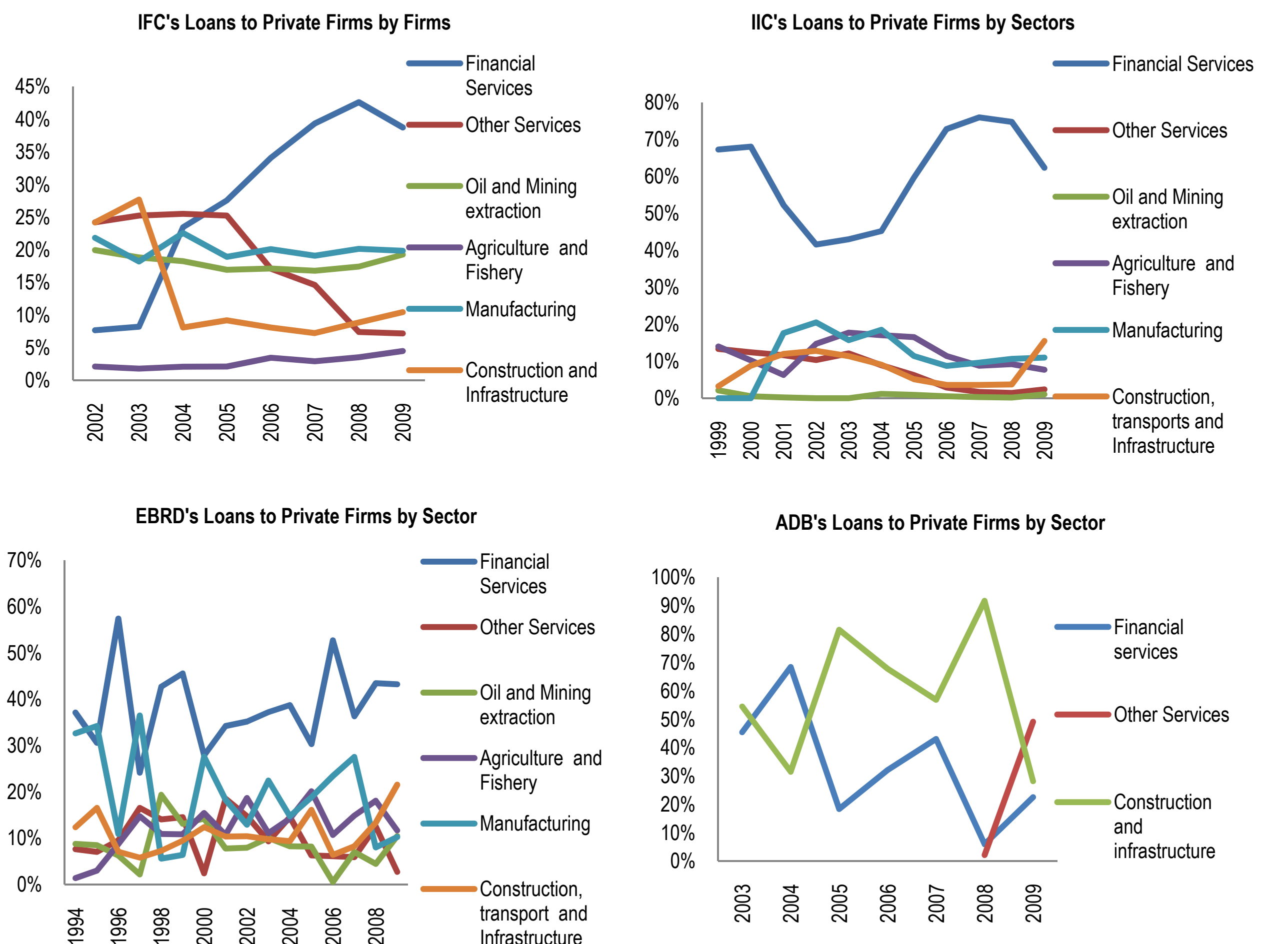
Technical assistance: In 2008, the Technical Assistance and Strategic Partnership (TAS) was created within IIC to provide nonfinancial value-added services to SMEs through direct technical assistance and strategic programs. The new division will provide support in a way that involves strategic partnerships with the public and private sector donors and partners to leverage IIC's financial resources and expertise. TAS will initially focus on four strategic and complementary programs: advice on financial matters, renewable energy and energy efficiency, promotion of good and sound practices for governance of family-owned SMEs, and general consulting services.

Source: EBRD: Micro, Small and Medium-Sized Enterprises Strategy (2006); ADB: Microfinance for the Poor: Microfinance Development Strategy (2000); AfDB: Strategy Update for the Bank's Private Sector Operations (2007). CAF Annual Report (2009); IFC: The SME Banking Knowledge Guide (2009); IADB: communication to authors.

6. MDB direct support to private firms in priority sectors and activities

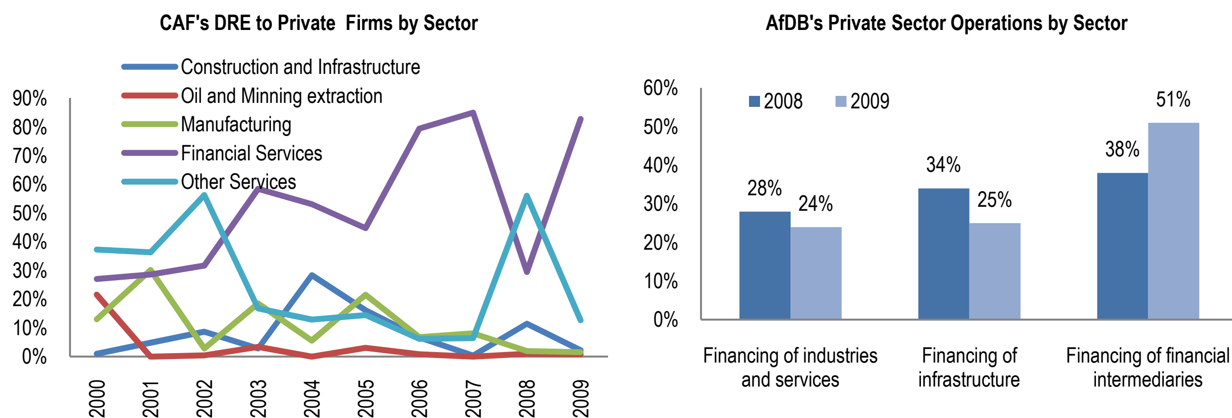
As mentioned above (Figure 5), MDB support to private firms is highly concentrated in financial services firms. This is partly a consequence of the emphasis on attending MSMEs through financial intermediaries. Loans to financial sector firms represent more than 60 percent of all loans to private firms at IIC and CAF, over 50 percent in AfDB, and more than 40 percent at IFC and EBRD. The fraction of loans approved to financial services firms has had an upward trend at IFC (from 7 percent in 2002/2003 to around 40 percent in 2007/2009) and EBRD (from about 30 percent to 40 percent, but with high volatility), CAF, and AfDB, but has had a downward trend in the case of ADB, from a peak of 75 percent in 2004 to around 20 percent in 2009 (Figure 13).

Figure 13. Sector Composition of Loans by MDBs



(Figure continues on next page)

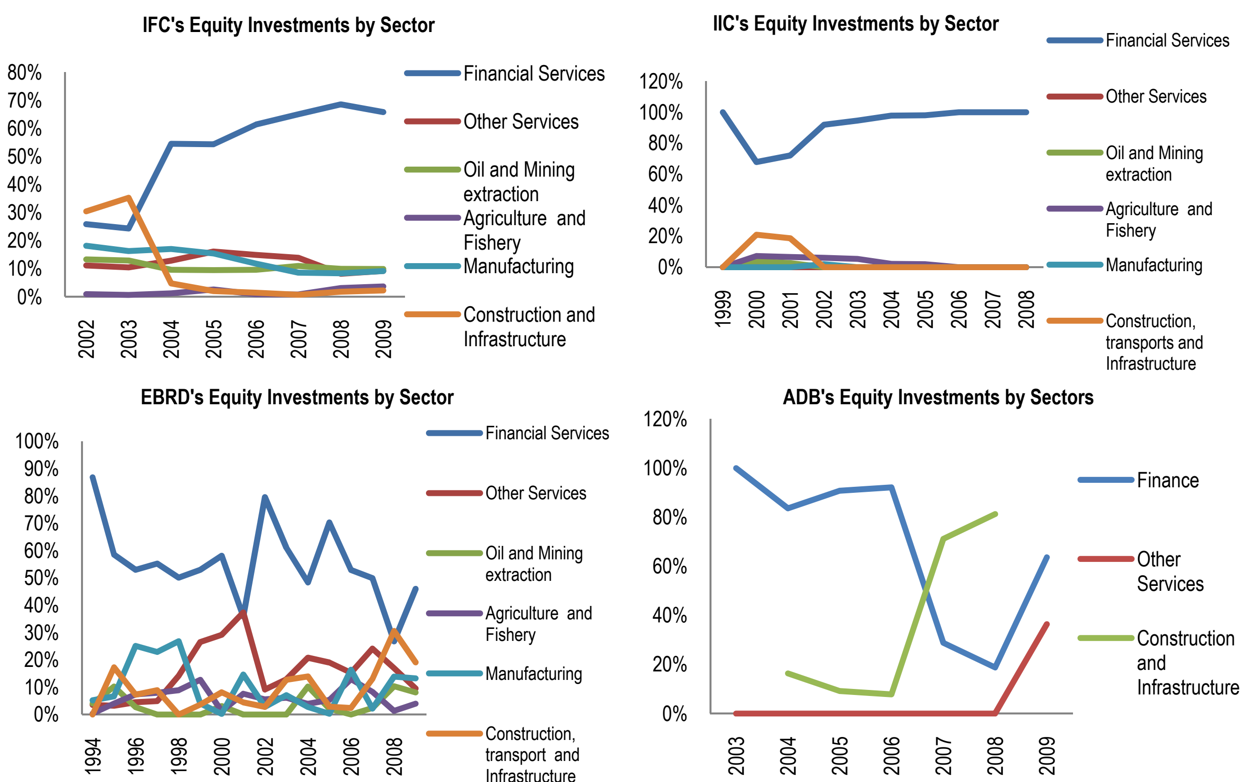
Figure 13 (continued)



Source: MDB Annual Reports, AfDB: Mid-Term Review of the 2008-2010 business plan for private sector operations, CAF communication to authors.

The share of the financial services sector in equity investments is even higher in most MDBs: almost 100 percent at IIC, around 60 percent at IFC and IADB, and more than 40 percent at EBRD. The trend has been increasing at IFC, stable at IIC, and decreasing at ADB and EBRD (Figure 14).

Figure 14. Sectoral Composition of Equity Investments by MDB



Source: MDB Annual Reports.

There are more significant differences in other sectors. For example, manufacturing and oil and mining come second and third in loan approvals at IFC, while construction and infrastructure come second at EBRD, CAF, and AfDB and, during most of the period, first in the ADB portfolio. Equity investments in infrastructure firms also command a larger share at EBRD and ADB (displacing the financial sector as the main recipient in the latter case in recent years).

As examples, Box 6 shows the variety of instruments and activities through which MDBs support private firms in infrastructure, and Box 7 summarizes their growing environmental protection programs.

Box 6. Programs/Instruments for the Infrastructure Sector

EBRD:

- Cofinancing from commercial banks and other international financial institutions (IFIs) for projects on water supply, waste management, heating systems, and public transport.
- Initial Public Offerings (IPO)
- Public-Private Partnerships (PPPs)
- Technical assistance

IFC:

- Infrastructure Crisis Facility: an initiative to help bridge financing gaps in privately funded or public-private partnership infrastructure projects
- Reduction in commercial bank exposure to particular projects
- Concentration on renewable energy for the energy sector
- Carbon Delivery Guarantees.
- Advisory for implementing public-private partnerships

AfDB:

Finances PPPs and assistance for capacity building in support of PPPs. In particular, the NEPAD-Infrastructure Project Preparation Facility (IPPF) supports the preparation of high-quality country or regional infrastructure projects and the creation of an enabling environment for private participation in infrastructure.

CAF:

Loans, guarantees, and equity investments in local and regional infrastructure funds and directly to large projects by private firms or public utilities without government guarantees.

IADB:

- Supports the whole spectrum of public-private infrastructure projects and firms, including creditworthy state-owned enterprises at the national and subnational levels, with and without sovereign guarantees from the central government.
- Supports central and local governments in designing, implementing, and financing PPPs.

Source: IFC and EBRD Annual Report 2009; AfDB: Strategy Update for the Bank's Private Sector Operations (2007) and information to authors; ADB: Annual Report 2009 and Strategy 2020 (2008).

Box 7. Support Activities on Environmental Issues

IFC:
IFC supports financial institutions and firms with projects in clean production, energy efficiency, and renewable energy. Advisory services complement IFC's investments in this area with capacity-building and knowledge management initiatives. In FY08, IFC significantly expanded this focus, supporting 44 investments that involve energy efficiency and renewable energy. IFC launched the carbon delivery guarantee, a new product that allows companies producing and selling carbon credits to access more buyers by mitigating risk. With resources provided by the Global Environment Facility and other donors, IFC oversees a diverse portfolio of more than US$200 million that is helping make climate-friendly innovations commercially viable by reducing costs and removing barriers to market development.

EBRD:
EBRD launched the Sustainable Energy Initiative (SEI) in 2006 in response to the rising importance of energy efficiency and climate change mitigation. SEI projects cover industrial, power, and municipal infrastructure energy efficiency as well as the renewable energy sector and carbon market development. Since its launch, SEI total investments reached €5.2 billion across 300 projects in more than 27 countries of operations, for a total project value of nearly €30 billion. The total reduction in carbon emissions achieved by these projects is estimated at 30 million tons per annum. EBRD also supports environmental sustainability through the projects it finances and through its extensive Technical Cooperation program helping achieve good practice and, where possible, adopt best available techniques in areas including environmental management, pollution control, biodiversity, and sustainable resources use.

AfDB:
During 2009, the Bank approved the Climate Risk Management and Adaptation (CRMA) Strategy as a follow-up to the Clean Energy Investment Framework (CEIF) for Africa. The CEIF set the agenda for mainstreaming clean energy options by promoting investments in accessing cleaner energies and strengthening energy efficiency in all sectors. The CRMA Strategy on the other hand seeks to: (i) improve the effectiveness of Bank-financed investments by reducing their vulnerability and promoting their resilience to climate variability and (ii) ensure sustainability by building countries' capacities and knowledge to adapt to climate change.

ADB:
ADB engaged an advisory group of internationally recognized eminent persons, and drafted corporate priorities for action to provide strategic guidance to operations. ADB completed climate change implementation plans to guide operations in its five subregions and approved more than 40 new grant-financed programs, which leveraged over US$600 million in low-carbon, climate-resilient investments. A climate change coordination unit was established. ADB also supports The Future Carbon Fund, which provides up-front financing for post-2012 carbon credits.

CAF:
CAF offers five environmental support programs to clients:

- Biodiversity Program (BioCAF): Contributes to supporting conservation of important species and support ecosystems; promotes mechanisms and tools for biodiversity-based products and services and other natural resources (e.g., green markets, biotrade, and biotechnology)

(Box continues on next page)

Box 7 (continued)

- Program to promote sustainable development financial institutions: the program seeks to foster the internalization of environmental management principles and practices in the region's financial sectors
- Latin American Carbon, Clean and Alternative Energies Program (PLAC+e): Contributes to reducing global warming and promotes the use of clean and alternative energy in Latin America by undertaking and financing innovative projects
- Cleaner Cities and Industries Program: (i) environmental urban management, (ii) implementation of clean production techniques in enterprises, and (iii) promotion of clean production financing incentives and mechanisms. Disaster Risk Management Program (PREVER): Support for projects and activities concerning (i) El Niño-related risk management and vulnerability reduction; (ii) adaptation and vulnerability to climate change; (iii) contingent treatment in response to disasters; and (iv) risk prevention from the municipal perspective.

IADB:

IADB has created the Green Energy Program (GEP) in order to facilitate small and midsize investments in green energy projects and programs throughout Latin America and the Caribbean. The GEP is designed to support the development, construction, and operation of creditworthy projects that:

- Contribute to the diversification of energy supply
- Reduce dependence on imported fossil fuels
- Reduce greenhouse gas emissions and environmental footprint of energy generation
- Reduce consumption and growth in energy demand.

Technical assistance funds are available for feasibility studies, environmental impact assessments, market studies, and economic analyses.

IIC:

IIC supports financial institutions in developing and implementing environmental risk management policies and procedures, understanding how managing environmental and social risks can enhance their own portfolios, and communicating to its clients the business case for improving operating efficiency and environmental performance and thereby becoming more competitive in domestic markets and globally.

Source: IFC Annual Report 2009; AfDB Annual Report 2009 and information to authors; ADB Annual Report 2009; EBRD: www.ebrd.com and information to authors; CAF: CAF Environmental Strategy (2008): IADB: direct communication to authors.

7. Financial and advisory products offered to private firms

Financial products

As mentioned above, private firms and especially SMEs require improved access to a variety of financial services: long-term loans, especially in domestic currencies; guarantees; leasing and factoring; equity; RMPs. Some MDBs, notably

IFC, have significantly diversified their portfolio of financial services for private firms (Box 8).

As indicated in section 2, equity investments and guarantees to private firms have increased rapidly in real terms and represented jointly about 20 percent of MDBs' total financial operations with private firms in 2008 and 24 percent in 2009.

Box 8. IFC's Financial Products

A-loans: IFC offers fixed and variable rate loans to private firms or projects. Maturities vary from 7 to 12 years. IFC also finance intermediary banks, leasing companies, and other financial institutions through credit-lines for further on-lending to SMEs or specific sectors.

Syndicated loans (B-loans): IFC offers to commercial banks and other financial institutions the opportunity to lend to IFC-financed projects that they might not otherwise consider.

Equity finance: IFC takes equity stakes in private sector companies and other entities such as financial institutions and portfolio and investment funds in developing countries.

Quasi-equity financing (C-loans): IFC provides a full range of quasi-equity products with both debt and equity characteristics to private sector projects (convertible debt and subordinated loan investments).

Equity and debt funds: IFC promotes foreign portfolio investment by establishing and investing in a wide range of funds (private equity and debt funds).

Structured finance: IFC has developed products that provide clients with forms of cost-effective financing. Products include credit enhancement structures for bonds and loans through partial credit guarantees, risk-sharing facilities, and participation in securitizations.

Financial intermediaries: IFC uses its full range of financial products to provide finance to a wide variety of financial intermediaries because this allows extending its long-term finance to more companies, especially to SMEs and microfinance entrepreneurs.

Risk management products (RMPs): RMPs or derivatives are available the IFC's clients solely for hedging purposes. IFC's role is to bridge the credit gap between its clients and the market.

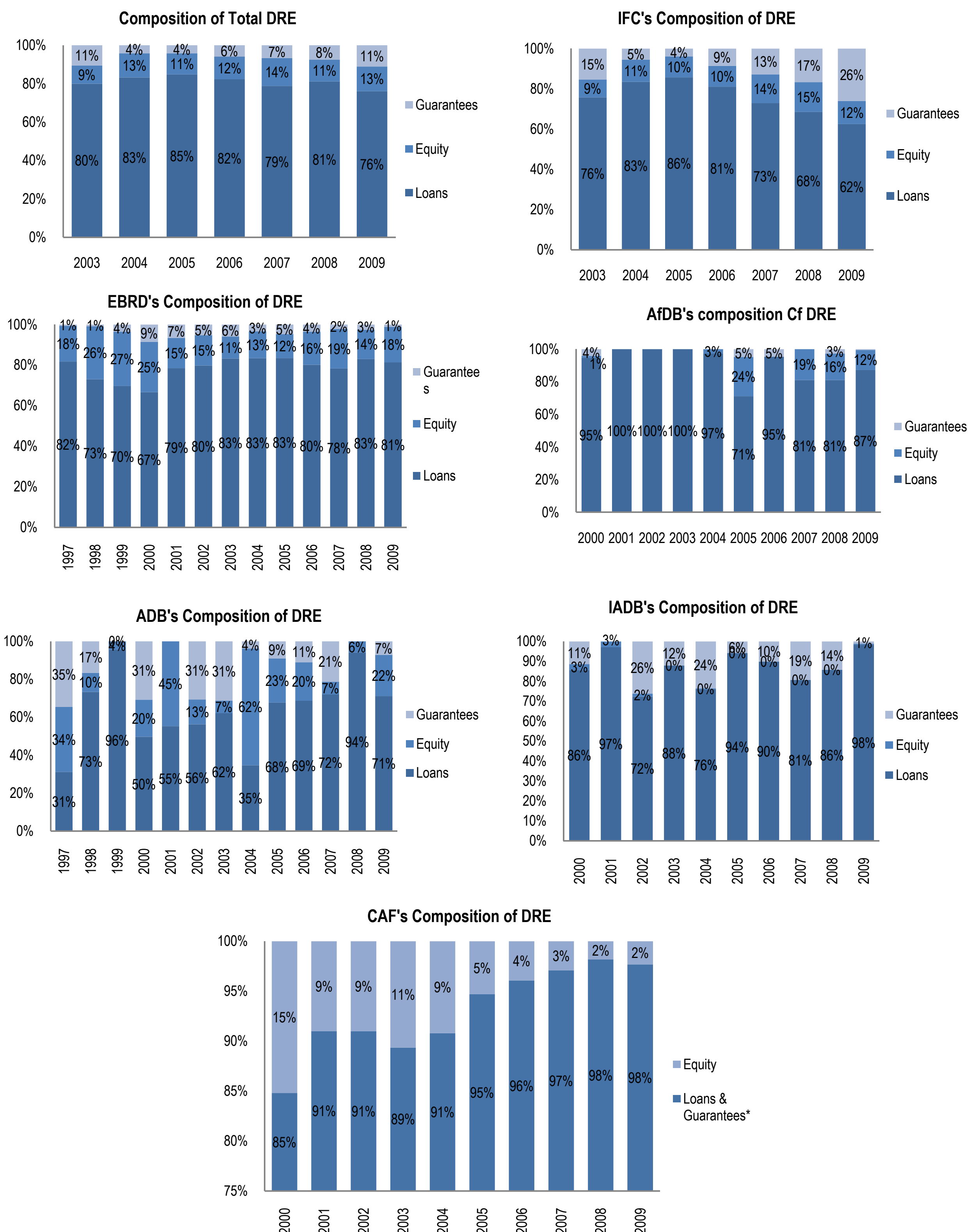
Local currency financing: IFC provides local currency debt in four ways: (i) loans from IFC denominated in local currency; (ii) risk management and swaps; (iii) credit enhancement structures that allow clients to borrow in local currency from other sources; and (iv) credit lines from local financial institutions.

Subnational finance: IFC provide states, municipalities, provinces, and companies with financing and access to capital markets, without government guarantees. It also finances nationally owned enterprises operating in natural monopoly infrastructure sectors.

Trade finance program (TFP): The program offers confirming banks partial or full guarantees to cover payment risk on letters or credit, trade-related promissory notes and bills exchange, bids and performance bonds, advance payment guarantees, and suppliers' credits for the import of capital goods. In addition, IFC also provides funding banks for short-term pre-export financing.

Source: www.ifc.org.

Figure 15. Composition of Total Financial Support to Private Firms by Type of Financial Products



Source: Annual and Financial Reports of MDBs; IADB and CAF information to authors.

The share of equity and guarantees in total financial operations with private firms has become larger in IFC (38 percent of total in 2009) than in other MDBs, though it was larger in the past at ADB (69 percent in 1997 and 51 percent in 2000, versus 29 percent in 2009). EBRD share was 19 percent in 2009, having had a peak of 34 percent in 2000. The share of equity and guarantees in total financial operations with private firms at AfDB was just 12 percent in 2009, having achieved a peak of 29 percent in 2005. It was only 14 percent in 2008 and 1 percent in 2009 at IADB, after a peak of 26 percent in 2002 (Figure 15). In CAF it has come down from 15 percent in 2000 to just 2 percent in the last two years.

As expected, most MDB financial support to private firms is of a long-term nature: long maturity debt or equity investments. Table 1 shows that average debt maturities are between seven and eight years for IFC, IADB, and CAF (being somewhat less, around six years, at IIC within the IADB Group). They are clearly higher for low- than for middle-income countries at EBRD, but not in the other MDBs. CAF (not in Table 1 due to lack of comparative data) appears as an exception, as it lends high volumes short term to financial intermediaries, which could have a high developmental impact only in times of sudden stops or financial crisis.

Table 1. Loan Distribution by Maturities and Income Group Country (years)

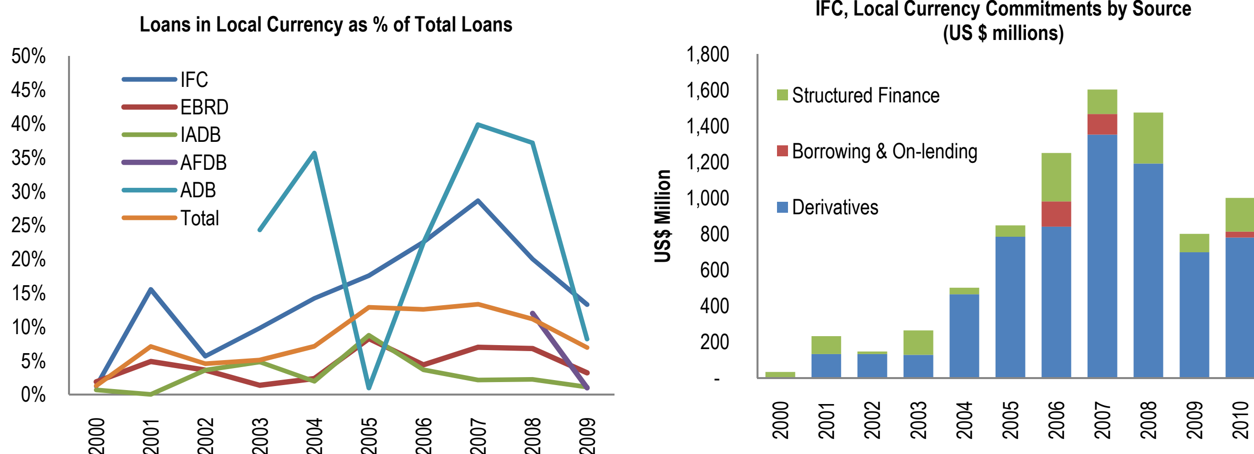
	Total	LIC	MIC	HIC
IFC	7.9	7.4	8.1	n/a
EBRD	7.37	11.01	6.42	9.83
IIC*	5.99	5.97	5.97	
IADB	7.58	n/a	n/a	n/a

*IIC: does not use the World's Bank's development indicators (HIC, MIC, and LIC); instead, it uses four groups of countries (A, B, C, and D) differentiated by GDP size. Large economies are Groups A and B; smaller economies are Groups C and D. We took A and B as MIC and C and D as LIC.
Source: IFC, EBRD, IIC, and IADB information to authors.

Finally, in spite of efforts in recent years to increase lending and guarantees in domestic currencies, their share in financial operations with private firms is still modest in most MDBs, having peaked on average about 13 percent from 2005 to 2007 and dropping to less than 10 percent in 2009 (Figure 16). IFC has been significantly ahead of the group in this area, as loans in domestic currencies grew rapidly from 2004 to 2007, reaching more than 27 percent of loans to private firms in 2007, though this share was reduced to less than 15 percent in 2009. ADB has shown large annual variations in its share of domestic currency loans and guarantees within its overall direct support to private firms (ranging from less than 10 percent to more than 30 percent during the last six years). The share of

local currencies in private sector operations peaked at just 10 percent in AfDB in 2008 and near 8 percent in EBRD and IADB in 2005 and represented less than 5 percent in EBRD in 2009 and around 2 percent in AfDB and IADB in 2009.The figure also shows that most loans in domestic currencies in IFC are swapped back to dollars through derivatives, and a lower percentage represent structured finance operations or are funded by issuing bonds in local currencies.

Figure 16. Loans in Local Currency



Source: IFC, CAF, EBRD, and IABD information to authors; AfDB: Mid-Term Review of the 2008-2010 Business Plan for Private Sector Operations; ADB information to authors.

Most MDB domestic currency finance operations are fully matched through the use of currency derivatives and direct funding in domestic currencies. As a consequence, these operations have been mostly limited to middle-income countries that already have developed local domestic currency financial and derivative markets; in other words, to those that need it the least. Even in these cases, MDBs can facilitate access and reduce costs by separating currency risk from credit risk, and keeping only the latter in their balance sheet.

Box 9 summarizes local currency finance initiatives. The more ambitious initiatives have been the IFC Match program, recently suspended, and the TCX, which is a global currency hedge fund promoted by the Netherlands Development Finance Company (FMO). These two initiatives have attempted to exploit the diversification benefits of pooling currency risks over a large number of currencies. Thus, they do not have to be limited to countries with well-developed local currency and derivatives markets.

Box 9. Some MDBs' Local Currency Financing Initiatives

IFC and the WB: IFC has been a pioneer in offering domestic currency finance, mostly using currency derivatives and direct funding in domestic currencies. The MATCH program was an initiative to extend local currency finance to frontier markets (those with underdeveloped local domestic currency financial and derivative markets), by retaining and pooling currency risks in its balance sheet. It was discontinued in FY10 as a result of the global crisis that led to higher currency volatility. IFC is presently considering an investment in the TCX fund, which grants local currency financing to shareholders. In addition, the World Bank Group has launched the Global Emerging Markets Local Currency Bond Program (GEMLOC) to help develop local currency bond markets so they can attract more local and global institutional investors. GEMLOC has three separate but complementary parts: a private investment manager, Pimco, that develops and manages investment strategies to promote institutional investment in emerging market local currency bonds; a new private sector-led global index that tracks emerging market local currency bonds and serves as a new benchmark for the asset class, developed by IFC in cooperation with the leading index provider, Markit; and advisory services provided by the World Bank to strengthen local bond markets in emerging economies to help enhance their investability and attract new investments.

EBRD: EBRD's local currency financing platform includes single currency revolving credit facilities, cross-currency interest rate swaps, domestic bonds, Eurobonds, promissory notes (typically short-term instruments issued in countries that were signatories to the Geneva Convention on Bills of Exchange and Promissory Notes of 1930), and participation in the Currency Exchange Fund (TCX). At the institutional level, the Private-Public Sector Working Group on Local Currency Development has been established comprising representatives of the EBRD; EC; ECB; IMF; World Bank; IFC; EIB; national authorities of Austria, Italy, Hungary, Romania, and Serbia; and officials from banks active in the region.

In the Early Transition Countries, the ETC Working Group on Local Currency Lending is exploring options in order to enable more local currency lending in Armenia, Azerbaijan, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Turkmenistan, and Uzbekistan, whether by taking local currency risk directly or by further engaging the EBRD's risk-sharing partners.

AfDB: AfDB is developing the capacity to provide longer-term financing through lines of credit in local currencies or guarantees, subordinated debt, and equity (securitization of debt). Member of TCX.

ADB: ADB contributes to the development of regional bond markets through local currency bond issuances. Besides bond issuances, ADB raise funds through cross-currency swaps to fund local currency needs.

IADB: IADB is also considering a US$100 million facility in the TCX fund, in addition to its direct local finance deals. One example of local currency lending was the Colombian "peso" deal closed at the end of 2005. The structure of the deal included a successful IIC bond issue in the Colombian capital market for an exact amount placed through negotiations with five local leasing companies. Through the MIF the IADB together with other investors supports the Locfund aimed at providing funding in local currency to microfinance institutions in the region.

CAF: CAF has carried on a limited number of operations in domestic currencies, backed with local funding. It is presently studying alternative ways to increase domestic currency operations.

Sources: IFC: www.ifc.org; EBRD: Local currency financing presentation, EBRD Treasury, May 2010; AfDB: Strategy Update for the Bank's Private Sector Operations (PSD), ADB: www.adb.org.

TCX's total capital amounts to US$699 million (July 2010), consisting of (i) aggregate paid-in equity capital of US$471 million, (ii) a first loss tranche of US$128 million, and (iii) a subordinated nonconvertible tier 2 loan of US$100 million. It has 21 investors, among them several MDBs (AfDB, EBRD, IADB, European Fund for Southeast Europe, OPEC Fund for International Development), bilateral aid agencies (the French Agency for Development, Belgian Investment Company for Developing Countries SA/NV, Compañía Española de Financiación del Desarrollo, Development Bank of South Africa, Dutch Ministry of Foreign Affairs, the Netherlands Development Finance Company, Japan Bank for International Cooperation, Kreditanstaltfür-Wideraugbau (KfW), StatensInvesteringsfond for Næringsvirksomheti Utviklingsland [NORFUND] PROPARCO), and a few global private banks. In its initial phase, TCX will offer currency hedges only to their investors' approved loans (up to six times their paid-in capital), so that they can offer loans denominated in domestic currencies of the same maturity of their usual foreign currency loans, keeping only the credit risk while TCX takes the currency risk. As of December 31, 2009, TCX had hedged US$362 million in long-term local currency loans in 25 developing country currencies and had total exposure of US$635 million in 37 currencies. TCX's plateau swap capacity at current capitalizations levels is around US$2-3 billion in nominal terms.

Advisory Services

As mentioned, MDBs also offer a wide variety of advisory services to private firms and to financial intermediaries and other agencies that finance micro and SME firms. Normally, advisory services are funded by donor countries (mainly through trust funds) and from MDBs' own resources.

Box 10 below summarizes the advisory service program priorities of some MDBs. As an example, IFC advisory services are focused on five areas: access to finance, corporate advice, environmental and social sustainability, investment climate, and infrastructure advisory. In turn, the first of these priorities have three key components: (i) building bank and nonbank financial institutions, with emphasis on banks that serve SMEs or provide microfinance, housing finance, insurance, and sustainable energy finance; (ii) improving financial infrastructure, such as credit bureaus, securities markets, collateral registries, payment systems, and remittances; (iii) improving the legal and regulatory framework to help develop and improve the enabling environment for increasing access to finance. IFC also helps its partner financial institutions by improving risk management in

the areas of governance, asset-liability and liquidity management, capital adequacy, and credit risk.

Box 10. Advisory Services

IFC:

Access to finance: Providing advisory services to government bodies, its investment clients, and other private and public sector enterprises to create a broader, deeper, and more inclusive financial system for the underserved in emerging economies

Corporate advice: Helping large companies include local small and medium enterprises in their supply chain; advising companies, countries, and sectors on their corporate governance

Environmental and social sustainability: Developing and testing innovative environmental and social business model in biodiversity, carbon finances, cleaner technologies, corporate social responsibility, sustainable energy, and sustainable investing

Investment climate: Helping client countries implement reforms to improve their business environment and encourage and retain investment, thus fostering competitive markets, growth, and job creation

Infrastructure advisory: Advising national and municipal government on how to structure private sector participation in basic infrastructure projects.

EBRD:

Since its inception in 1993, the TAM Programme and subsequently the complementary BAS Programme have been valuable instruments for the promotion of good management in the SME sector and providing consultancy advice at the enterprise level:

- TAM provides turnaround management advice to mid-size companies: TAM supports the introduction of international best practice in small and medium-size enterprises that have the potential to become future leaders in their markets through the introduction of international advisors from developed countries with 15-20 years' professional experience in the relevant sector. TAM projects typically last around 18 months. The program also carries out seminar and training activities promoting international best practices by disseminating successful case studies to entrepreneurs.
- BAS works to develop the local consulting sector and its support to smaller companies: the program acts as a facilitator for the use of local, private sector consultants by MSMEs to obtain a diverse array of services. By helping individual enterprises to engage with local consultants on narrowly based, specific projects with a rapid payback, it stimulates demand and the understanding of the potential benefits of using external consultants. It also directly increases the supply and quality of local advisory services through targeted market development activities. BAS-supported projects typically last around four months.

IADB:

Through IIC, the IADB group supports the institutional strengthening and capacity building of SMEs through the Technical Assistance and Strategic Partnerships Division (TAS) on issues such as corporate governance, process improvements, and environmental policies.

(Box continues on next page)

Box 10 (continued)

The institutional strengthening of financial intermediaries comes in the form of nonreimbursable technical assistance through the FOMIN's Small Enterprise Financing Fund, which seeks to promote the development and adoption by financial intermediaries of lending models that are suitable to the unique characteristics of MSMEs. In this program, IADB provides resources to strengthen its clients' institutional capacities so they can expand their lending operations within their segments. Successful FOMIN initiatives include support to the ProCredit Network to expand its portfolio in Honduras, Colombia, and Mexico; and support to the Venture Capital (VC) ecosystems in Brazil with IADB group deployment of technical assistance resources for private sector operations.

AfDB:

AfDB participates in the Private Enterprise Partnership in Africa (PEP Africa) that was established in 2005 by IFC. PEP Africa works in partnership with multilateral agencies, governments, and the private sector to deliver programs and advisory services that improve the investment climate, mobilize private sector investment, and enhance the competitiveness of private enterprises in Africa. Since 2005, PEP Africa has provided more than US$171 million in program support toward advisory services that promote private sector development in Africa. PEP Africa currently manages more than 85 programs in 24 countries across Sub-Saharan Africa. In addition, AfDB in partnership with the government of Japan launched in 2005 the Fund for African Private Sector Assistance (FAPA) to build capacity for private sector development. FAPA's pillars of intervention are: creating an enabling environment, strengthening financial systems, building competitive infrastructure, promoting the development of MSMEs, and promoting trade.

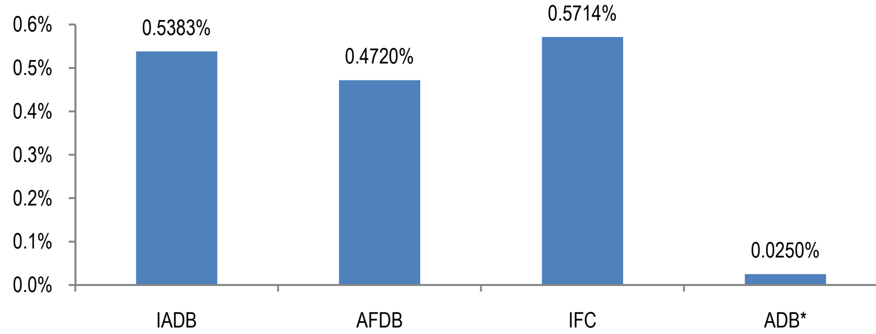
Source: www.ifc.org and A2F–Highlights Report (2009). EBRD: www.ebrd.com; IADB and AfDB: information to authors.

As another example, EBRD brings advisory services for MSMEs through two complementary programs called TurnAround Management (TAM) and Business Advisory Service (BAS), which aim to provide MSMEs with guidance from experienced business advisors and consultants. The areas of assistance include restructuring of businesses, improving enterprises' products, reducing operating costs, advising on local and export markets, and helping to develop business planning skills.

Figure 17 shows that advisory services typically represent around 0.5–0.6 percent of the value of financial operations with private firms in most MDBs (though it represents less than 0.1 percent in the case of ADB). This share has tended to increase recently in several MDBs. Figures 18 and 19 show the composition of advisory services in IFC, ADB, and the IADB Group. IFC's actual expenditures have been concentrated in access to finance (mostly SME, microfinance, and housing finance support), environmental and social sustainability, and investment climate (roughly 29 percent in each) and somewhat less (14 percent) in infrastructure advisory. IADB's and AfDB's advisory services have been more concentrated in access to finance (above 70

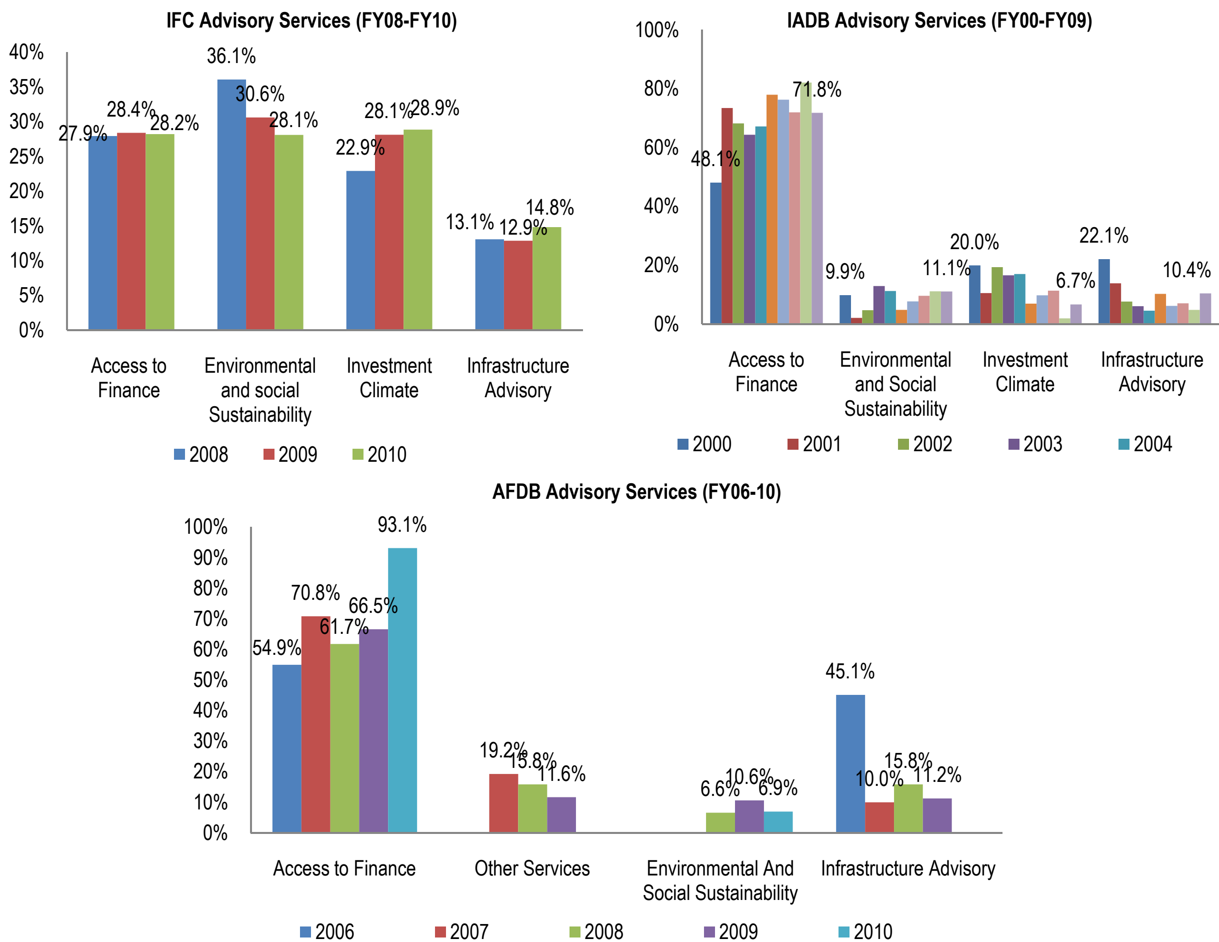
percent in recent years), with slightly rising expenditures in environmental and social sustainability support in both cases.

Figure 17. Advisory Services as a Percentage of Financial Operations with Private Firms (2009)



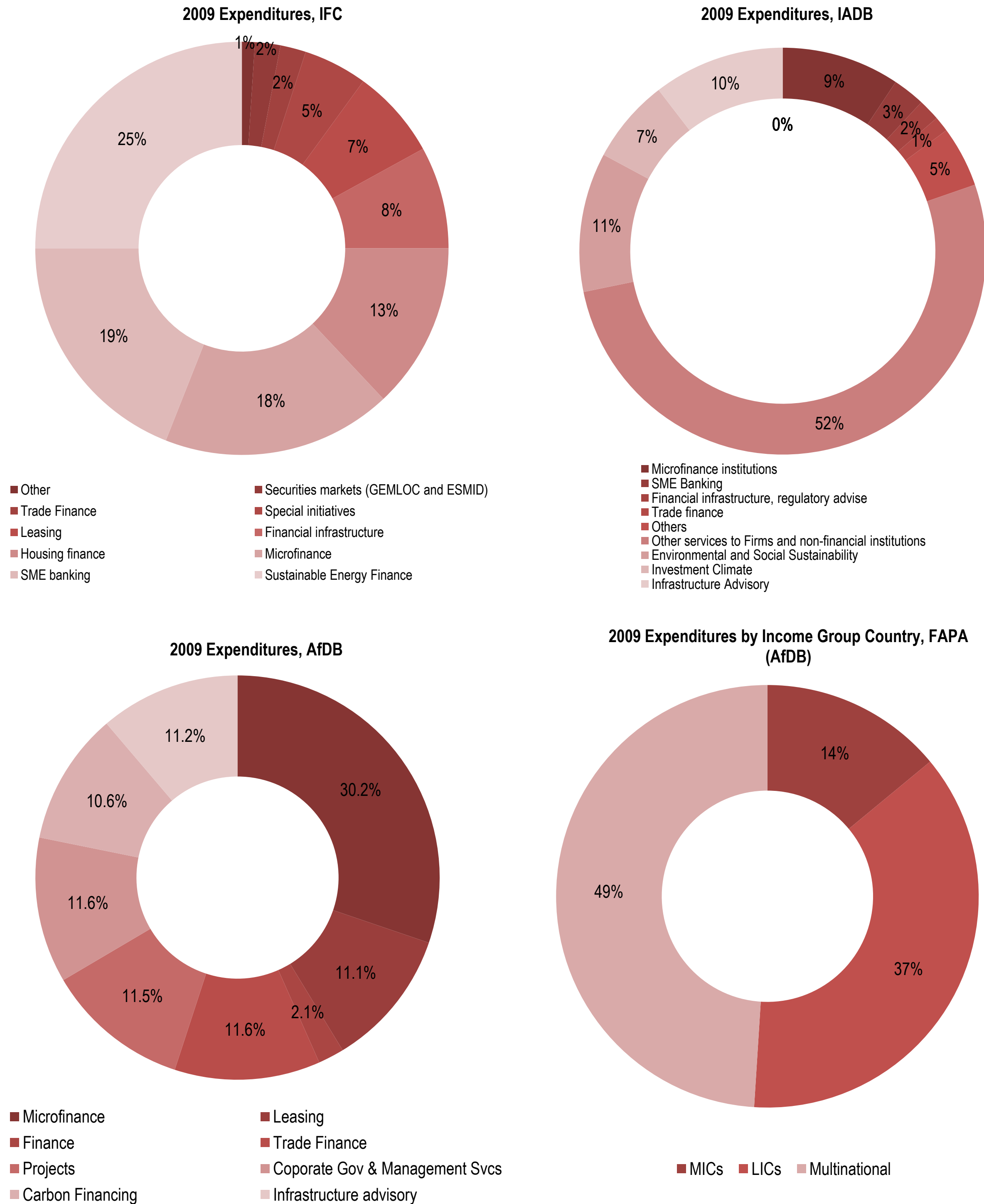
Note: ADB's advisory services correspond to 2007.
Source: IFC advisory services/access to finance. Highlights Report 2009; AfDB, ADB, and IADB information to authors.

Figure 18. IFC, IADB, and AfDB Advisory Services



Source: IFC, AfDB, and IABD information to authors.

Figure 19. IFC, IADB, and AfDB Composition of Advisory Services

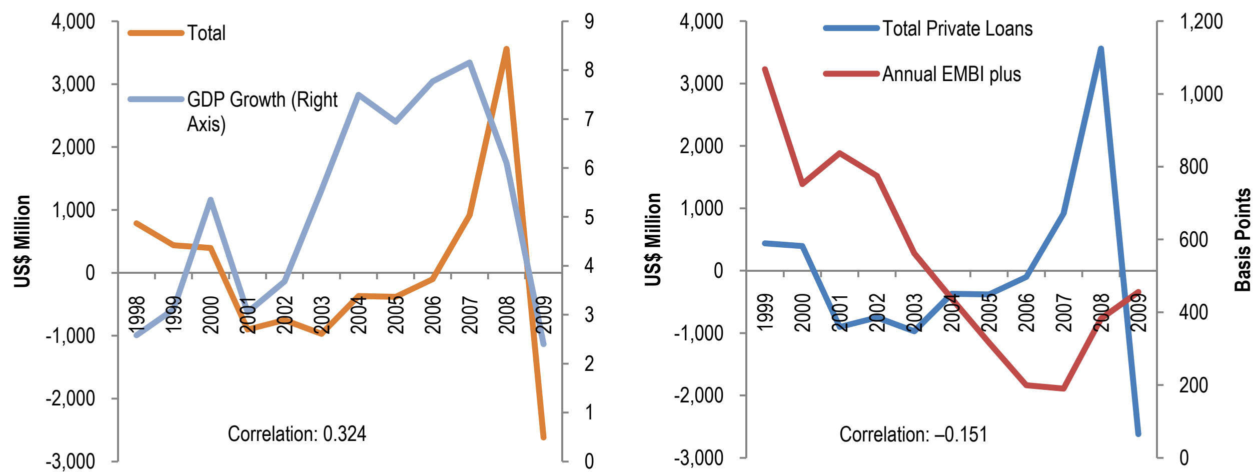


Source: IFC advisory services/access to finance. Highlights Report 2009; IADB and AfDB information to authors.

8. Is MDB direct support to private firms pro- or countercyclical?

When procyclicality is measured by the correlation between the MDB cyclical component of lending values and the cyclical component of either clients' GDP growth or private capital inflows[31] (as is the standard practice), MDB aggregate operations (and especially lending approvals—Figure 20) appear to have been strongly procyclical in aggregate terms during the last decade. ADB and AfDB appear to be partial exceptions to this rule (see correlation coefficients for individual MDBs in the lower panel of Figure 20). Lending disbursements and equity investments were still procyclical, though less so, and guarantees showed an upward trend independent of the economic cycle and the situation of private international markets.

Figure 20. Cyclical Components of MDB Loans to Private Firms, Developing Countries' GDP Growth, and EMBI



Cyclical Components of MDB Loans to Private Firms and Regional GDP Growth

EBRD	AfDB	ADB	CAF	IFC
0.1244	-0.2699	-0.067	0.6337	0.4303

Cyclical Components of MDB Loans to Private Firms and Regional EMBI

EBRD	AfDB	ADB	CAF	IFC
-0.2405	-0.0719	-0.0168	-0.4506	-0.3568

[31] Cyclical components are obtained by detrending the corresponding series through the use of a Hodrick-Prescott filter.

Naturally, this procyclicality is largely demand driven: firms demand more resources from both private and public sources during good times than during bad times. In particular, the sharp aggregate drop during 1999 in MDB lending to private firms observed in Figure 6 (with EBRD and AfDB being notable exceptions) was essentially demand driven.

However, as discussed in section 3 above, firms' financial constraints are more binding in bad times, so the developmental impact of MDB lending to private firms is much larger in bad times. Hence, MDB lending should be countercyclical, at least measured with respect to the behavior of private capital flows and it has not been so, as indicated in panel 2 of Figure 20, which plots and measures the correlation between the cyclical component of MDB lending to private firms with that of developing countries EMBI, a good indicator of the degree of tightness of private capital markets.

No doubt countercyclical lending is more easily said than done; incentives in MDBs to restrain lending, vis-à-vis high and profitable demand in good times, is just not there, with respect to lending to either sovereigns[32] or to private firms. MDBs function too much like private banks in this regard. It would take a major change in culture and risk management policies to achieve a reversal of current incentives.

In addition, the apparent strong procyclicality of some MDBs lending to private firms may also be because often their direct support to private firms has been inversely related to demands for support to governments. During difficult times (like in 1999-2002 or, even more pronounced, during 2009), governments have demanded higher levels of support from MDBs and tended to crowd out MDB lending to private firms, at least in some cases. Often during such periods, MDB managers have had to defend avoiding sharp reductions in lending to private firms against explicit requests of the authorities that control their boards, to focus on lending to sovereigns at the expense of lending to private firms, if it is needed.[33] This has been specially the case in MDBs in which lending to private firms is a low fraction of total lending (thus EBRD was an exception to the general trend of reduction in lending to private firms in 2009) and when there isn't a separate institution that specializes in supporting private firms. But even in the latter case, group decisions favor lending to governments. Thus, during the last crisis IFC had to continue making large transfers to IDA, reducing its already weakened capacity to support private firms countercyclically, and

[32] See G. Perry: "Beyond Lending: How can MDBs help developing countries reduce volatility?" CGD, 2009.

[33] Communication to authors from managers and directors of some MDBs.

demands for capital increases centered at the World Bank and IADB, leaving aside IFC and IIC.

On the contrary, during booms (as in 2003–2008), several middle-income country governments used their easy access to cheap private funds to reduce their borrowings, and often to pay back multilateral debt, while urging MDBs to use their spare capacity in increasing support to private firms.

As mentioned above, during periods of crisis there are differential requirements by type of countries (those that suffer more from reduced access), activities, size of firms (microfirms and SMEs can more readily be cut off from credit access),and types of financial instruments (equity and long-term finance tend to dry out and, on occasion, trade finance lines are interrupted).

Access to equity for recapitalization of banks and firms that undergo severe shocks to their balance sheets becomes of paramount importance, especially as at such a time raising equity funds in the local or international market becomes harder. As in these periods assets tend to be undervalued, MDBs investing in sound firms, that find it temporarily harder to access private capital markets, often can realize large profits when they later sell back their equity in good times. Thus, it becomes financially profitable to do the right thing at the right moment. IFC made huge gains from its equity investments during the 1999–2002 period of crisis and stress in most of the developing countries. It is thus encouraging that some MDBs (notably EBRD, ADB, and AfDB) actually increased or kept the level of equity investments during 2009 (Figure 7). For the same reason, it is encouraging that some MDBs offered increased access to recapitalization funds, mostly to banks, during 2009.

Similarly, investing and lending to sound firms that need to restructure debt and avoid fire sales of temporarily distressed assets become especially valuable at these times. Some MDB established specific programs to deal with such problems during 2009, including debt and asset recovery programs.

Further, in periods of tighter access to private funds, partial credit guarantees by MDBs become much more valuable. It is thus also encouraging that the use of guarantees in support of private firms actually increased in 2009 in some MDBs, notably at IFC.

Finally, there are two other areas in which help during times of crises becomes more valuable. One is trade financing, which is often cut at the time of a major disturbance in private financial markets (as happened in some developing countries during the late 2008 and during 1998/1999). Most MDBs offered increased access to trade finance lines during the recent crisis. The other one is infrastructure: some sound private infrastructure projects that are in the financial

closing period when a crisis strike may find their access suddenly curtailed. MDBs' enhanced support to these activities becomes especially valuable during such periods. Some MDBs also offered enhanced access to special funds for such projects during the last crisis.

Several MDBs designed comprehensive crisis response packages during late 2008 and early 2009 in support of private firms containing most of these elements, often through Joint Action Plans with IFC leadership, as in the case of support to trade finance in Africa and to restructuring banks in emerging Europe (Boxes 11 and 12).

Box 11. IFC Package of Crisis Response, 2009

Debt & Asset Recovery Program (DARP): DARP invests directly in businesses that need to restructure debt and in pools of distressed assets and indirectly through instrument funds targeting pools of distressed assets and companies.

Microfinance Enhancement Facility (MEF): IFC and the German Development Bank KFW launched the Microfinance Enhancement Facility, a short- to medium-term facility of up to US$500 million. The MEF was expected to provide financing to more than 100 strong microfinance institutions in up to 40 countries

Trade Finance Programs (TFPs): IFC developed a coordinated initiative that brings together governments, development finance institutions, and private sector banks to support trade on developing markets: the Global Trade Liquidity Program (GTLP).

Capitalization Fund (CF): The CF is a global equity and subordinated debt fund that aims to support banks considered vital to the financial system of an emerging market country. The fund provides Tier I and Tier II capital to emerging markets banks, as well as advisory services aimed at strengthening private sector development and improving their economic and financial performance.

Targeted regional responses (TRRs): Regional initiatives aim to coordinate responses by individual institutions, catalyze action and investment from other stakeholders, and provide targeted support to the sectors and countries most affected. For example, The Joint Action Plan for Africa was a regional initiative to support Africa for the next two to three years after the crisis. It consists of programs to facilitate trade, strengthen the capital base of banks, improve infrastructure and microfinance lending, and promote agribusiness companies.

IFC advisory services (AS): In terms of access to finance, IFC helped financial institutions assess and quantify critical risks and take action to mitigate crisis impact. In terms of business enabling environment in emerging countries, IFC expanded its advice on regulatory simplification, including assistance on the Doing Business agenda, trade logistics and business tax reform; insolvency; and investor aftercare.

Infrastructure Crisis Facility (ICF): This facility bridged the financing gap for private or public-private partnership infrastructure projects. The ICF comprises loan financing trust, equity facility, and advisory facility.

Source: www.ifc.org.

Box 12. Other MDB Crisis Response Programs

EBRD:
The EBRD's countries of operations were especially hard hit by the global financial crisis. EBRD responded by increasing its private sector investment by 50 percent and actively participating in a major crisis response initiative:

The Vienna Initiative: The Vienna Initiative was an unprecedented joint action plan by Western and Eastern governments and authorities, Western banking groups and their Eastern subsidiaries, the IMF, and European institutions to support stressed governments and firms in the region. The EBRD played a major role in its inception. The IMF and the EU provided macro support; the ECB added liquidity; and the EBRD, EIB, and the World Bank jointly committed to deliver €24.5 billion in support of banking sectors in 2009-1200 under the Joint IFI Action Plan. As of end-August 2010, total delivery under the initiative exceeded E€27 billion.

Main areas of support were:

- *The financial sector response package:* strengthening bank balance sheets and ensuring their capacity to continue lending for trade and to the real economy, especially to SMEs, by providing equity and debt finance (including recapitalization and refinancing needs) that was otherwise not available on the financial market, in coordination with IFC and other international financial institutions; €6.8bn has been disbursed to the financial sector alone by the EBRD as a part of the Joint Action Plan.
- *The enterprise response package:* the Corporate Support Facility provided quick-disbursing financing to help companies weather the impact of the crisis and opportunities to strengthen and extend transition impact through loan conditionality – for example, by linking the financing to improvements in energy efficiency, environmental impact, and corporate governance standards.
- *Trade finance:* The EBRD Trade Facilitation Programme, with a budget up to €1.5 billion, virtually doubled existing trade finance support.

AfDB:
AfDB strategic measures adopted cofinancing arrangements with other cooperating partners, as in the case of the Global Trade Liquidity Program (GTLP) administered by the IFC, to ensure that trade finance would continue to flow into Africa. It further adopted flexible responses such as frontloading of resources and restructuring projects to deliver resources where they were more needed, through the establishment of the US$1.5 billion Emergency Liquidity Facility (ELF) and a US$1.0 billion Trade Finance Initiative (TFI).

ADB:
ADB's crisis-related assistance to the private sector aimed to rebuild business confidence by providing incentives for private investment and facilitating trade financing. ADB expanded its Trade Finance Facilitation Program (TFFP), increasing its overall exposure limit to US$1billion from an initial US$150 million. The number of transactions supported by the TFFP was 616, year-to-date (YTD) 31 October, 2010. Transactions in LICs represent 13 percent of all TFFP transactions YTD 31 October 2010; 87 percent of TFFP transactions were for MICs for the same period.

(Box continues on next page)

Box 12 (continued)

CAF:

CAF strengthened its commitments to the region's public and private financial systems by timely increasing the volume of financing to this sector. CAF also provided support to investment programs framed within each government's own anticrisis strategy. From a sectoral perspective, the institution continued supporting areas of strategic interest, by financing mainly implementation of infrastructure and social development projects.

IADB:

IADB created and financed the Emergency Liquidity Facility (ELF), which during the 2008 credit crisis provided a countercyclical infusion of liquidity to battered microfinancial markets for up to US$20 million. In the aftermath of the financial crisis, MIF and IIC helped establish the MICROFINANCE Growth Fund (Migrof), which made available up to US$165,000 for microfinance institutions by leveraging other private and public partners.

Through the IADB's Liquidity Program for Growth Sustainability, VPP helped to channel resources to financial institution in order to support lending activities and restore credit flows to companies. Nine banks in El Salvador have benefit thus far through US$113.5 million disbursed. And, in March 2009, the Board approved a US$300 million loan to support private sector activities in the Dominican Republic.

Sources: EBRD: www.ebrd.com and Annual Report 2009; ADB: Annual Report (2009); AfDB: Annual Report (2009); CAF: Annual Report (2009); IADB: information to authors.

Some of the crisis responses facilities appear to have had less use than what was expected. This seems to have been the case, for example, for trade finance and bank recapitalization estimated needs. Thus, for example, AfDB reports that initial demand for the trade finance initiative lines was around the allocated resources (US$1 billion), but as financial markets recovered some of the initial requests did not materialize. By July 15, 2010, US$485 million had been approved (US$285 million against the AfDB direct line of credit (LOC) and US$200 million against the Global Trade Liquidity Program) and US$235 million had been disbursed (US$135 million against the AfDB direct LOC and US$100 million against the GTLP).[34]

Several factors can account for the gaps between actual disbursements and expected needs. First, the impact of the crisis on domestic banks in developing countries was actually milder than predicted in several regions, notably in Asia, Latin America, and Africa. Second, trade demand finance dropped sharply as imports from developed countries and overall global trade collapsed. It might also have been the case that the sheer availability of lines of credit for trade often made their use unnecessary. Liquidity cushions often have that effect: lenders

[34] In addition, AfDB helped the Cocoa Board of Ghana secure syndication of finance to purchase and export the 2009 cocoa harvest.

become more confident in their presence. In some cases, it could also have been the case that actual implementation was slow, so real enhanced access to these facilities became effective when the worst impact of the crisis began to recede or was over. More likely, the explanation could be a combination of these factors.

On the other hand, certain facilities provided for both sovereign and private borrowers ended up being used more by private firms. An example is the AfDB Emergency Liquidity Facility, which received demands for US$180 million from private financial institutions and none from sovereigns. The former appear to have been able to meet their liquidity needs by resorting to AfDB's regular operations, which carried a lower cost.

9. Risk analysis, risk management, specialization, and organizational structure

The trend toward an increasing share of direct operations with private firms has important implications for MDBs' risk culture, risk management, and organizational structure. MDB lending to sovereigns has been a very low-risk activity, given their de facto preferred creditor status. There have been very few cases of open defaults on MDB loans to sovereigns or of disguised refinancing to avoid such a potential outcome.[35] This explains why many MDBs had not developed a culture of risk taking and risk management of their portfolio, nor the capacity to do adequate risk analysis and risk management, until relatively recently. It also helps explain why MDBs have been so hesitant in taking risks other than credit risks (for example, currency or commodity price risks) in which there is no preferred creditor status, a position that has significantly limited their potential development contributions by lending in domestic currencies and helping sovereigns manage public and macro risks.[36]

Lending to or investing in private firms without government guarantees[37] implies taking much higher risks, as MDBs do not have a preferred creditor status in such cases. As a consequence, it demands enhanced capacities for risk analysis and risk management and, overall, a major change in MDB culture.

MDBs that used to lend mainly to sovereigns, and that are increasing their support to private firms through a unique organizational structure, have had

---

[35] Statutory regimes normally prohibit straight MDB refinancing to governments, but on occasion they have extended new loans to avoid incentives for default arising from highly negative net disbursements to cash-stressed sovereigns.
[36] See, for example, G. Perry, CGD, 2009.
[37] Or in public firms, agencies, or subnational governments without sovereign guarantees.

significant difficulties in developing an adequate culture of risk taking for dealing with private firms and enhanced capacities for risk analysis and risk management. This may not have been an important problem when MDBs' direct lending to private firms was a small fraction of their lending to sovereigns, but it is certainly now when that share is above 20 percent of their total portfolio in some cases and will be an increasing percentage in the future. Further, the influence of their pervasive excessively conservative risk-taking culture frequently biases their operations with private firms against the desired priorities (MSMEs, low-income countries, infrastructure and social sectors, domestic currency lending, RMPs, equities, guarantees, countercyclical lending), as such priorities usually require taking even higher risks. Several MDB managers and directors of private sector operations complain about the schizophrenic attitude of their boards, which on the one hand ask them to lend more to the private sector attending to these priorities, but on the other hand promote a culture of conservative risk taking in order to keep high ratings or avoid the need to hold higher reserves.[38]

Of course, those MDBs that were created to lend exclusively (as IFC or IIC) or primarily to private firms (as EBRD) have had to develop since their inception stronger capacities for risk analysis and risk management and an altogether different financial culture. This is especially notable in comparing IFC with the World Bank: IFC is used to risk taking and risk management and has a much stronger culture of financial innovation, in contrast to what happens at the World Bank.[39]

However, this option also has its drawbacks. It requires a minimum size of operations and broad country coverage, in order to take advantage of economies of scale and potential benefits of risk pooling. It also requires a significant dedicated capital base. Probably because of these reasons, only the World Bank Group operates with private firms fully through an autonomous agency: IFC. IADB tried this approach with IIC, which ran into difficulties partly because of its small size, low capital base, and low potential of risk diversification, and has since opted for a complex hybrid structure, keeping IIC but growing mostly through three specialized units within IADB.

In addition, having an autonomous agency makes it more difficult to maximize potential synergies between operations of support to governments and to private firms, an important issue that I discuss below.

[38] An issue that came out repeatedly at the CGD Roundtable on October 7, 2010.
[39] Perry, G. (op. cit.).

10. Synergies between MDBs' support to governments and private firms

Convergence of developing countries to developed countries' income levels requires progressively stronger private sector development. In the last analysis, thus, economic development is about private sector development. Few economists would disagree today with this statement. However, it is also widely recognized that the public sector has a key role to play in private sector development by creating a sound investment climate (protection of property rights, contract enforcement, macro stability, adequate availability of public infrastructure and skills, etc.), and helping solve market and coordination failures, through adequate production of public goods and regulation. Meanwhile, it must avoid crowding out the private sector through excessive or inadequate taxation and overregulation.

In practice, most of what MDBs do in supporting sovereigns is geared, directly or indirectly, to private sector development, except perhaps for programs whose primary purpose is reducing poverty and inequality or protecting the environment. And it can be argued that, even in these cases, such actions enhance the long-term sustainability of private sector development.[40]

In this perspective the key questions become: (i) what is the proper balance between MDBs' support to sovereigns and direct support to private firms? and (ii) how can MDBs better exploit the potential synergies in their support to sovereigns and direct support to private firms, and at the same time avoid potential conflicts of interest?

Balancing support to governments and private firms

It can be argued, on one extreme, that in the long term what matters is an adequate investment climate and, thus, that MDBs should focus on helping governments create adequate frameworks for private sector development. However, it can also be argued that building efficient and responsive governments takes time and meanwhile private developing economies may forgo investment and growth opportunities because of financial and other

[40] There is a growing literature arguing that high inequality and poverty are by themselves major drawbacks for growth, as they lead to lower levels and efficiency of investment in physical and human capital and higher levels of crime, violence, and social and political instability. See, for example, Easterly, W.: Inequality does reduce growth (2002); López, J.H., and Perry, G. (2008). Inequality in Latin America: Determinants and Consequences, World Bank; World Development Report, Equity and Development (2006); Perry, G., Arias, O., López, H., Maloney, W., and Servén, L. (2006).Poverty Reduction and Economic Growth: Virtuous and Vicious Circles." World Bank.

constraints that maybe partly alleviated through MDBs' direct support. Thus, MDBs would do the right thing in helping simultaneously to improve the functioning of governments and supporting directly worthy private initiatives that would otherwise be impaired for a long time.

It was argued in section 3 that this is precisely the rationale for MDBs' two-track approach in helping develop domestic financial markets: on the one hand, helping governments design and enforce adequate regulatory systems and overall institutions and policies that would facilitate sound long-term domestic financial development, and on the other, directly supporting the development of private financial intermediaries and new financial products. A similar argument can be made with respect to private participation in infrastructure: helping governments improve regulations and contract design, while at the same time helping private firms overcome financial and other type of constraints, may maximize the impact of MDBs' actions in favor of adequate infrastructure in developing countries.

There are two further practical reasons for such a combined approach. One is that the mere presence of stronger and better managed firms may create incentives and domestic lobbying in favor of economic and institutional reforms, adequate regulations, and overall government efficiency and responsiveness.[41] This political economy argument seems especially important in sectors such as finance and infrastructure that require more elaborate regulations. Of course, firms can also engage in rent seeking, and MDBs' role would be to support their claims for better regulations and other public actions, while discouraging rent-seeking activities.

The other practical reason is that being directly involved with firms permits a deeper knowledge of regulatory and investment climate problems and opportunities, and thus could lead to improved advice to governments. It can also lead, however, to conflicts of interest, an issue that is further discussed below.

Still, what is the proper balance between operations in support to governments and direct support to private firms? The precise answer to these questions may differ from country to country and over time. It can be argued, for example, that Africa needed an initial MDB concentration in support of building good governments, as poor governance and policies in many if not most countries were essentially blocking private sector development. However, now that some progress in this area has been achieved in several countries and good

[41] Rodrik, D., and Haussman, R. (2005).

terms of trade have created conditions for incipient private sector development, while high risks and low access to finance remain major limitations, it seems to make sense to shift to a larger share of MDB direct support to private firms. This is precisely the argument behind AfDB's strong recent shift toward direct financing of private firms.[42] Similarly, it can be argued that in transition economies, where the initial goal was precisely creating or recreating a private economy, MDBs had to concentrate their support in helping the rapid development and strengthening of private firms. This was the rationale behind EBRD's unusually high share of direct operations with the private sector since its inception.

Further analysis and discussion of these issues of balance seem urgently required, as most MDBs are in the process of sharply increasing their share of operations in favor of direct support of private firms.

Maximizing potential synergies

The answer to the second question posed above (how to maximize potential synergies in MDBs' support to sovereigns and to private firms, while at the same time avoiding potential conflicts of interest) has to do with organizational structure, procedures, and organizational culture. It is easier to maximize potential synergies when the same group of people is in charge of both operations with governments and with private firms in each country, or at least in each region. However, as I discussed above, there are strong reasons for having specialized groups and independent procedures to deal with private sector operations, either through an autonomous organizational structure, such as IFC or IIC, or through one or more separate vice-presidencies or divisions, as happens in most MDBs. When this is the case, establishing adequate coordination procedures to take advantage of potential synergies becomes of paramount importance and is a more demanding task the more autonomy is given to the agency or division in charge of direct operations with private firms.[43]

A further complication has to do with potential conflicts of interest. Though this potential problem is presently underscored in most MDBs, it cannot be neglected. There is no doubt that dealing both with governments and private firms may create incentives on occasion for advising on a policy or regulation

---

[42] President Kaberuka's intervention at the CGD's Roundtable on October 7, 2010.

[43] Thus, in the case of the World Bank Group, in addition to having a common Board overseeing IFC operations and participation in joint committees, World Bank policy requires joint Country Assistance Strategies and consultation procedures. Further, a few years back the World Bank opted for unifying technical support in private and financial sector development under one vice presidency at the World Bank, whose head also acted as Chief Economist for IFC.

that is self-serving to MDBs' equity or debt interests in particular firms of sectors. In the past, consideration of this potential problem led in some MDB to attempt establishing "Chinese walls" between units and staff dealing with governments and with private firms. Such a practice, of course, while minimizing potential conflicts of interest, would also minimize potential synergies.

Recognizing this dilemma, and the advantages of specialization discussed above, most MDBs have opted for either a separate autonomous agency or specialized internal units dealing with private sector operations (or, more broadly, with operations without sovereign guarantees), and attempt to take advantage of potential synergies through adequate coordination procedures.

11. Conclusions and recommendations

MDBs' direct support to private firms increased rapidly as a percentage of their total financial support to developing countries in the last decade: it reached nearly 35 percent in 2008, from less than 20 percent at the beginning of the decade. Though its share in MDBs' financial operations dropped in 2009 (except for the EBRD), largely as a result of crowding-out effects from sharply increased demand by sovereigns as a consequence of the global crisis, it is already growing again, as sovereigns moderate their own claims on MDBs' resources *paripassu* with regaining and improving their access to private capital markets. Such a trend would be seen by many as just the consequence of MDBs' efforts to keep in business, as demand for their services from sovereigns decline. Even if this is the case, this trend is likely to stay, and the development community must provide answers to the questions of why public multilateral resources should be supporting private firms in developing countries in increasing magnitudes, which firms should MDBs focus on, and through which financial instruments.

This paper takes the position that MDBs' direct support to private firms can be justified in developmental terms if it is effective in lifting existing investment financial constraints for otherwise dynamic firms in developing countries and in helping firms manage the higher risks and volatility usually found in developing economies, as doing so would contribute to accelerating overall private investment, economic growth, and poverty reduction in the developing world. Further, the developmental effect in doing so would be more effective if they further focus on activities that have significant positive externalities.

This framework suggests that MDBs' support to private firms should focus, first, on developing deep, long-term domestic and regional financial markets, as

this would be the way to lift existing financial constraints for most domestic firms in the long run and give them access to adequate financial services and risk management products. In particular, focusing on supporting local and regional financial and nonfinancial intermediaries willing to service MSMEs, which are likely to be more financially constrained and subject to financial risks than larger firms, makes sense both as a long-term and short-term priority, as it is both difficult and costly for MDBs to reach MSMEs directly.

Other firms and activities that should receive particular attention are those engaged in building and operating public infrastructure and public services, both because of high potential positive externalities and needs for long-term financial resources and risk management products, which are commonly more difficult to obtain than short-term funds in underdeveloped local financial markets. Also because of high externalities, firms engaged in social and environmental service activities and firms innovating in new products or technology should constitute a special priority.

These arguments imply that, in aggregate terms, one should see more focus on firms in countries with less developed local financial markets (which are usually the lower-income-per-capita countries), as such firms are more likely to be financially constrained and without access to risk management products. They also suggest that we should see a high priority in helping microfirms and MSMEs achieve access to financial services, as such firms are usually more financially constrained than large firms. In sectoral terms, priorities should be, first, in developing domestic currency financial markets (to gradually overcome existing financial restrictions and to channel funds to MSMEs) and, second, in other sector and activities with considerable positive externalities, such as public infrastructure, education, health, environmental protection, and development of new products and exports.

This framework further suggests that one should observe an emphasis in providing and developing risk capital and long-term debt instruments, domestic currency debt and guarantees, financial services adequate for MSMEs (leasing, factoring, guarantee funds), and risk management products. Providing and developing domestic currency debt and guarantees is critically important for MSMEs and for most firms providing infrastructure, social, and environmental services (more generally, those engaged in nontradable activities) that have no capacity to absorb currency risks.

Finally, as financial constraints vary with business cycles and with conditions in the international financial markets, one should expect MDBs'

aggregate financial support to private firms to be highly countercyclical, with respect to both local and international business cycles.

MDBs that directly support private firms have been increasingly adopting explicit priorities coherent with this view, and some of them have developed and use systems of evaluation of developmental impact of their operations. As it is difficult to judge how well these systems operate or to evaluate directly MDBs' developmental impact, in this paper I rather asked the question to what extent MDBs' operations in support of private firms actually follow the above-mentioned priorities.

To begin with, all MDBs claim to give special priority to firms in low-income countries. Such a priority is partially reflected in the fact that MDB operations with private firms represent a higher proportion of GDP in low-income than in middle-income countries, though either absolute or per capita terms approvals are concentrated in middle-income countries. As can be expected, AfDB has a larger share of operations in low-income countries.

Second, efforts to increase the share of operations on behalf of MSMEs (either directly or through financial intermediaries) are especially evident in the figures provided by IFC. At IADB, IIC, MIF, and the Opportunities for All Department are mostly dedicated to MSMEs, but the total IADB operations with private firms, as well as of those of other MDBs, do not show a special or increasing focus on MSME's, notwithstanding the variety of support programs established in their favor.

In sectoral terms, most of MDB financial operations (and advisory services) with private firms are concentrated in financial intermediaries, as expected, though it is difficult to judge to what extent this support actually leads to building deeper and broader domestic financial markets and developing new financial products. Operations with firms in infrastructure services come second in some MDBs, being first in the case of ADB. ADB's low level of financial support to private firms, and its concentration in infrastructure services, may respond to the higher level of development of Asian local and regional financial markets and to the extremely high priority given to public infrastructure by most Asian countries. There has been an increasing attention to environmental protection in most MDB's, but support to private firms in social sectors is negligible. There is no evidence on especial support to the development of new exports.

Most MDBs concentrate in long-term debt (CAF appears as an exception, as it has a high level of short-term operations with financial intermediaries), as expected, but only IFC offer a significant volume of credit guarantees and only

IFC and EBRD have considerable equity investments. In addition, MDBs offer of RMPs is quite modest and volatile and, in spite of recent efforts, loans and guarantees in domestic currencies continue to be much lower than foreign currency loans and guarantees. Further, these operations have been concentrated in middle-income countries with relatively higher domestic currency capital market development, that is, on those that need less support from MDBs in this and other respects, as a consequence of internal policies that discourage or prohibit taking currency risks in MDBs' balance sheets.

This shortcoming is a reflection of excessively conservative financial practices and the fact that currency risks can be effectively diversified only at a global level, and even so currencies of developing countries maybe highly correlated during financial crisis, as happened in late 2008 and early 2009. Thus, only IFC has been in a position to attempt to offer domestic currency loans to "frontier markets" through global pooling of currency risks, through the late Match program, which was abandoned during the recent crisis. TCX, a global currency hedge fund promoted by FMO, has emerged as a potential way out of these difficulties, and some MDBs are presently members of TCX (EBRD, AfDB, and IADB), and IFC is considering joining it.

Another shortcoming has been the high procyclicality of aggregate lending by MDBs to private firms (with partial exceptions of AfDB and ADB), measured either with respect to clients cyclical components of growth or the cyclical component of private markets flows and spreads. This is both a reflection of conservative financial policies and stakeholders who promote lending to private firms in times of boom (when sovereigns need less resources) and crowding it out in times of crisis. Solving this problem will probably require both financial and governance reforms that give private sector representatives some say in the aggregate management of MDB operations with private firms. In the recent crises most MDBs established comprehensive and well-designed support packages, and cooperation among them reached unusually high levels. This is a most welcomed development that may indicate a change in previous trends of strong procyclicality. However, some of the components of these packages were available somewhat late in the game, suggesting that crisis response packages must be designed ex ante and form part of the permanent array of instruments of MDBs.

Figure 21 below offers a tentative summary scorecard measuring how consistently MDBs' actual practice in direct support to private firms follows the priorities derived from the arguments advanced in this report. The glass can either be seen as half full or half empty. Readers can find arguments in the

previous analysis either to support or oppose present trends of increased MDB direct operations with private firms in developing countries.

However, as this trend is likely to continue, it may be more constructive to focus the debate on what should be improved. According to previous conclusions I would recommend the following agenda for future action:

Figure 21. Summary Scorecard

CRITERIA	AVERAGE RANK	BEST PERFORMERS*
Increasing attention to LICs, though still a high concentration in MICs	D	AFDB
Growing focus on MSMEs, though percentages still low in most MDBs	C	IFC
High concentration in domestic financial sectors; but, how much contribution to financial-sector development?	B	IFC / EBRD
Low shares in infrastructure and social sectors. Increasing support to environmental protection activities	C, E B	ADB/CAF none IFC/EBRD
Concentration in long-term debt, but small shares in equity and guarantees in most MDB's	B	IFC/EBRD
Low shares of lending in domestic currencies and offer of RMP's.	D	IFC / ADB
Generally procyclical lending, though progress in response to the recent crisis	D B	ADB, AFDB IFC, EBRD/ IADB, AFDB
Progress in development impact evaluation, but still modest influence	B	EBRD, IFC/ AFDB

Note: Best/Second Best in relative terms.

1. Increase the share of MDB lending to private firms in domestic currencies, as well as the share of equity investments, guarantees, and risk management products in their overall financial operations with private firms.
2. Reduce the procyclicality of MDB lending to private firms and enhance the ex-ante design of crisis-response programs.
3. Deepen efforts to help MSMEs increase their access to finance
4. Continue focusing on financial intermediaries, but make sure that such MDB support has significant impact on domestic financial development.

5. Increase support to firms in infrastructure and social sectors and to those introducing new products, exports, or technologies. Strengthen current trends to support environmental protection activities.
6. Enhance the influence of development impact evaluations in actual decision making, improve capacities for risk analysis and risk management and coordination procedures to ensure synergies between operations in support to sovereigns and to private firms.

Achieving the objectives set out in this report would require important changes in the highly risk-averse culture that still dominates in some MDBs and demand enhanced capacities for risk analysis and portfolio risk management. This challenge, as well as taking full advantage of synergies between operations in support to sovereigns and private firms, while avoiding conflicts of interest, is very demanding in terms of organizational structure and procedures. They also require more interagency cooperation, especially to take advantage of potential global risk-pooling benefits. Responsibility for such changes lies not only with MDB management, but equally or even more with stakeholders, who often give management conflicting instructions and promote the maintenance of inadequate incentives and an excessively risk-averse culture.

References

ADB (Asian Development Bank). 1990–2009. *ADB Annual Reports*. Mandaluyong City, the Philippines.

———. 2008. "Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008–2020," Mandaluyong City, the Phillipines.

African Development Bank (AFDB). 2003–2009. *AFDB Annual Reports 2003–2009.* Tunis-Belvedère, Tunisia.

Arbeláez, M.A, G. Perry, and A. Becerra. Forthcoming. "Structure of Financing and Financial Restrictions of Companies." Corporación Andina de Fomento (CAF), Bogotá, Colombia.

Arbeláez, M. A, and J. J. Echavarría. 2002. "Credit, Financial Liberalization and Manufacturing Investment in Colombia." Research Network Working Paper R-450. Inter-American Development Bank, Washington, DC.

Arbeláez, M.A., and F. Villegas. 2004. "Colombia. Diagnóstico de la Estructura de Financiamiento del Sector Real y Obstáculos que Impiden que estas Empresas Acudan al Mercado de Valores." Mimeo, Anif-Fedesarrollo y Banco Interamericano de Desarrollo, Colombia.

Berger, M., L. Goldmark, and T. Miller-Sanabria, eds. 2006. *An Inside View of Latin American Microfinance.* Washington, D.C.: Inter-American Development Bank.

Birdsall, N. 2005. "Debt and Development: How to Provide Efficient, Effective Assistance to the World's Poorest Countries." Center for Global Development, Washington, DC.

Birdsall, N. 2007. "Do No Harm: Aid, Weak Institutions, and the Missing Middle Africa." Working Paper 113, Center for Global Development, Washington, DC.

Birdsall, N., D. Rodrik, and A. Subramanian. 2008. "How to Help Poor Countries." In *The Development Economic Reader*, Giorgio Secondi, ed. Oxford: Routledge.

Birdsall, N., and P. Hakim. 2007. "Poverty and Inequality in Latin America: How the U.S. Can Really Help." CGD Brief. Center for Global Development and Inter-American Dialogue, Washington, DC.

Bank for International Settlements (BIS), Committee on the Global Financial System. 2007. "Financial Stability and Local Currency Bond Markets." CGFS Paper 28, Bank of International Settlements, Basel, Switzerland.

Bond, S., and C. Meghir. 1994. "Financial Constraints and Company Investment." *Fiscal Studies* 15 (2): 1–18.

Bradford, C.I., Jr. 2003. "Anticipating the Future: A Political Agenda for Global Economic Governance." Brookings Institution, Washington, DC.

Brown J., S. Fazzari, and B. Petersen. 1998. "Financing Innovation and Growth: Cash Flow, External Equity, and the 1990s R&D Boom." *Journal of Finance* 64 (1): 151–85.

Corporación Andina de Fomento (CAF). 2001–09. *CAF Annual Reports 2001–09.* Caracas, Venezuela.

———. 2008. "CAF Environmental Strategy," Secretariat and Business Communications Office, CAF Publications, Caracas, Venezuela.

Calvo, G., and E. Talvi. 2005. "Sudden Stop, Financial Factors and Economic Collapse in Latin America: Learning from Argentina and Chile." NBER Working Paper 11153. National Bureau of Economic Research, Cambridge, MA.

Cavallo, E., and J. Frankel. 2007. "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops, or Less? Using Gravity to Establish Causality." RES Working Paper 1063. Inter-American Development Bank, Washington, DC.

Cincera, M. 2002. "Financing Constraints, Fixed Capital and R&D Investment Decisions of Belgian Firms." NBB Working Paper 32. National Bank of Belgium, Brussels, Belgium.

De la Torre, A., and S. Schmukler. 2006. *Emerging Capital Markets and Globalization: The Latin-American Experience.* Palo Alto, CA: Stanford University Press.

Delgado, C. 2004. "Inversión y Restricciones Crediticias en Colombia en la Década de los Noventa." *ESPE* 47:8–55. Banco de la República, Bogotá, Colombia.

European Bank for Reconstruction and Development (EBRD). 1994–2009. *EBRD Annual Reports 1994–2009.* London, United Kingdom.

Economic Commission for Latin America and the Caribbean (ECLAC). 2009. "Social Panorama of Latin America 2009." Santiago, Chile.

Eichengreen, B., R. Hausmann, and U. Panizza. 2003. "Original Sin: The Pain, the Mystery and the Road to Redemption." Paper prepared for "Currency and Maturity Match-making: Redeeming Debt from Original Sin," Inter-American Development Bank, Washington, DC.

Einhorn, J. 2001. "The World Bank Mission Creep." *Foreign Affairs* 80 (5): 22–35.

———. 2006. "Reforming the World Bank: Creative Destruction." *Foreign Affairs* 85 (1): 17–22.

Fernández-Arias, E., and E. Levy Yeyati. 2005. "Introduction to Dollarization." Special Issue, *Journal of Economic Policy Reform* 8 (4): 239–40.

Grettve, A. 2007. "Review of Development Effectiveness Measuring and Reporting in IFC and its Comparator Organizations." IFC, Washington, DC.

Gurria Treviño, J. A., and P. Volcker. 2001. "Report on the Role of Multilateral Financial Institutions in Middle-Income Countries." Carnegie Endowment for International Peace, Washington, DC.

Inter-American Development Bank (IADB). 2000–2009. *Inter-American Development Bank Annual Reports 2000–2009*.

———. 2007. "Annual Report: Living with Debt." Washington, DC.

International Finance Corporation (IFC). 1990–2009. *IFC Annual Reports 1990–2009*. IFC, Washington, DC.

———. 2009. *The SME Banking Knowledge Guide: Advisory Services/Access to Finance.* World Bank Group, Washington, DC.

———. 2009. *Advisory Services/Access to Finance Highlights Report 2009.* World Bank Group, Washington DC.

Inter-American Investment Corporation (IIC). 1998–2009. *IIC Annual Reports1998–2009.* IIC, Washington, DC.

Lerrick, A. 2006. "Has the World Bank Lost Control?" In *Rescuing the World Bank: A CGD Working Group Report & Selected Essays*, ed. Nancy Birdsall, pp. 117–132. Washington, DC.: Center for Global Development.

Levy Yeyati, E. 2006a. “Liquidity Insurance in a Financially Dollarized Economy.” NBER Working Papers 12345. National Bureau of Economic Research, Cambridge, MA.

———. 2006b. “Financial Dollarization: Evaluating the Consequences.” *Economic Policy* 21 (45): 61–118.

Meltzer, A. 2000. *Report of the International Financial Institution Advisory Commission.* Prepared for the U.S. Congress. Washington, DC.

Perry, G. 2009. *Beyond Lending: How Multilateral Banks Can Help Developing Countries Manage Volatility*. Center for Global Development, Washington, DC.

Perry, G., and J. H. López. 2008. “Inequality in Latin America: Determinants and Consequences.” Policy Research Working Paper 4504. The World Bank, Washington, DC.

Perry, G., O. Arias, J. H. López, W. Maloney, and L. Servén. 2006. *Poverty Reduction and Economic Growth: Virtuous and Vicious Circles.*” Washington, DC: The World Bank.

Rodrik, D., R. Hausmann, and A. Velasco. 2005. “Growth Diagnostics.” John F. Kennedy School of Government, Harvard University. Boston, MA.

GROWING BUSINESS OR DEVELOPMENT PRIORITY? MULTILATERAL DEVELOPMENT BANKS' DIRECT SUPPORT TO PRIVATE FIRMS

Guillermo Perry

Copyright © 2011 Center for Global Development
ISBN 978-1-933286-64-8

Center for Global Development
1800 Massachusetts Ave. NW
Washington DC 20036

www.cgdev.org