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PRIVATE SECTOR DEVELOPMENT STRATEGY

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Glossary

ADB:	Asian Development Bank
CABEI:	Central American Bank for Economic Integration
CAF:	Corporación Andina de Fomento
CPSD Strategy:	Country Private Sector Development Strategy
EBRD:	European Bank for Reconstruction and Development
IFC:	International Finance Corporation
IIC:	Inter-American Investment Corporation
LAC:	Latin America and the Caribbean
MIF:	Multilateral Investment Fund
PRI:	Private Sector Department of the Inter-American Development Bank
PSD Strategy:	Private Sector Development Strategy
PSD Matrix:	Private Sector Development Matrix
PSCC:	Private Sector Coordination Committee
SME:	Small and Medium Enterprises

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PRIVATE SECTOR DEVELOPMENT STRATEGY

EXECUTIVE SUMMARY

The Private Sector Development Strategy (PSD Strategy) provides a roadmap for the IDB Group intended to strategically focus its private sector development activities. Its objective is to deepen and complement the essential role of the private sector in promoting economic growth and generating income by creating jobs that contribute to sustained poverty reduction.

The obstacles to private sector development are well known. Many of them are beyond the capabilities of firms to resolve because they fall in the realm of public policy. Weak state institutions limit government's ability to create and maintain a favorable business climate and to reinforce the social benefits of private sector activity. At the same time, market failures limit the ability of private enterprises to achieve socially desirable outcomes. For its part, the public is increasingly disenchanted with macroeconomic stabilization and reforms that have not led to sustained growth, and openly questions the costs of these pro-market policies. New policy alternatives are needed that promote the private sector as both a catalyst for sustainable growth and enhanced standards of living.

Working with its financial and non-financial instruments, the IDB Group can increase the effectiveness of public and private sector contributions to development. The IDB Group can support governments in providing public goods, regulating markets, promoting positive externalities, overcoming market failures, and building consensus on growth-with-equity development policies. However, the potential to stimulate change *only* through public interventions is necessarily limited. Given the widespread financing constraints faced by firms, the IDB Group must also engage in direct interventions at the firm and investment level.

To achieve its development objectives, the Private Sector Development Strategy offers a comprehensive approach for the IDB Group's various private sector windows. The strategy proposes four interrelated strategic directions:

- ◆ Development of an enabling environment for business,
- ◆ Financial support for specific private sector projects,
- ◆ Leveraging developmental impact in underserved markets, and
- ◆ Engaging the private sector in dialogue and action.

During implementation of the strategy four areas of activity or "action areas" would be monitored regularly to insure sound implementation and to enhance impact. These areas of activity are:

- ◆ Country focus
- ◆ Internal coordination and joint action
- ◆ Broadening the scope of action
- ◆ Strategic partnerships

These specific areas will support the broader long-term strategic priorities identified for the IDB Group, which, in turn, are based on the strategy's assessment of the current trends and characteristics of the private sector in the region. This overarching strategy, after it has been endorsed by each one of the IDB Group members, will be used as a guide for the specific strategies of each member and may help guide future organizational changes.

The implementation of the Private Sector Development Strategy will require a reassessment of operational activity and may require adjustments, at both the operational and organizational level. Accordingly, the proposed steps for implementation, monitoring and evaluation are designed to ensure that this process preserves organizational flexibility, strengthens institutional comparative advantages, and takes advantage of synergies within the organization.

I. Introduction

- 1.1 The policymaking environment for private enterprise is complex and dynamic, combining public and private interests with a range of instruments and institutions. Over the past 15 years, the IDB Group¹ has increased its private sector focus in Latin America and the Caribbean through the creation of the Inter-American Investment Corporation (IIC) in 1989, the Multilateral Investment Fund (MIF) in 1993 and the IDB's Private Sector Department in 1994. At the same time, the public sector operations of the IDB Group have also increasingly focused on aspects of private sector development through investment and policy reform loans, technical cooperation, and non-financial activities that promote competitiveness, modernization of the state, financial and capital market development, and small and medium enterprises (SMEs). In this setting, the Private Sector Development (PSD) Strategy offers a cohesive approach that sets priorities for the IDB Group.
- 1.2 The PSD Strategy is part of the IDB Group's overall approach to sustainable development in the region. It can contribute in important ways to the goals of economic growth, better stewardship of the environment, and poverty reduction. This document presents a roadmap for the IDB Group's interventions to promote private sector development. The document defines the objective of the strategy (Section II) and describes the characteristics of the private sector in the region and the nature of existing constraints (the "demand side" - Sections III and IV). It then details how this strategy fits into the existing framework of IDB strategies and examines similar strategies of comparator institutions, the main areas of intervention pursued to date and the menu of instruments used, and reviews some basic lessons learned from the accumulated experience (Section V). Proposed strategic priorities are discussed in Section VI, while Section VII defines the action areas that support those priorities. Finally, Section VIII provides a brief overview of the implementation and methods that will be used to monitor progress and evaluate the effectiveness of the PSD Strategy. An annotated bibliography can be used as a reference to supplement the discussion presented in the document.

II. Purpose of the Strategy

- 2.1 The central objective of the Private Sector Development Strategy is to support the contribution that the private sector can make to overall economic development and to poverty reduction. To provide this support, the strategy seeks to clarify and reinforce the coherence and complementarities of the many different activities undertaken throughout the IDB . By ensuring consistency and orientation the strategy will enhance the impact of IDB Group interventions As such, the strategy provides the framework within which the menu of activities, instruments, projects, methodologies and organizational patterns will be reviewed in light of the region's current development. Further, it identifies approaches that are likely to increase the value-added of IDB Group activities.

¹ References to the IDB Group are to Inter-American Development Bank (IDB), the Inter-American Investment Corporation (IIC), and the Multilateral Investment Fund (MIF).

- 2.2 The Private Sector Development strategy presents the strategic direction and action areas that will guide IDB Group activities in coming years and has been prepared with the active participation of each member. Given the vast differences among borrowing member countries, the strategy proposes that specific private sector development action plans be prepared at the country level. Thus, one of the central proposals is for the IDB Group to implement this strategy through specific Country Private Sector Development (CPSD) Strategies, as inputs to the regular programming process.

III. The Role of the Private Sector in Economic and Social Development

a. The Private Sector in Latin America and the Caribbean

- 3.1 In recent years, Latin America's private sector has accounted for nearly 90 percent of overall economic activity. Although there are differences among countries, the composition of productive activity in the private sector is mainly focused on services, which account for some 61 percent of production, while manufacturing accounts for roughly 31 percent and agriculture makes up the remainder. Private sector exports are highly concentrated and generally limited to a few major products, in capital intensive natural resource industries or in-bond firms (*maquiladora*) that have accounted for a large number of new jobs in the past decade, but with low value added. For the most part, the private sector is dominated by microenterprises, which make up about 90 percent of all private firms (SMEs make up 8 percent and the remaining 2 percent is made up of large firms). The prevalence of microenterprises contributes to the high degree of informality or large number of unregistered firms found in the region. Small and medium enterprises account for between 20 and 40 percent of all private sector jobs and 10 percent of business activity in most countries in the region, while the informal sector accounts for over half of economic activity.²
- 3.2 Despite significant progress during the last decade, the countries of Latin America and the Caribbean continue to perform poorly. Per capita income increased at an annual rate of only 1.5 percent during the 1990s, total factor productivity decreased at an annual rate of 0.62 percent during the period, and the region had a low ranking in international competitiveness classifications.³ The region's infrastructure is characterized by relatively low investment levels, low savings and poor coverage and quality. The average saving rate in Latin America is nearly 17 percent of GDP, that is, half of that of the Asian developing countries, and much lower than that prevailing in other emerging economies. The lack of savings, accompanied by weak institutions and distortionary public policies, has prevented Latin American private financial markets from growing, and limited the

² Informality is prevalent in many countries, ranging from 20 percent of GDP in the more developed economies to almost 70 percent in the least developed, with an average for the region of 41 percent.

³ The World Economic Forum "Global Competitiveness Report" shows that Chile, at number 28, is the highest ranked country in Latin America and the Caribbean, while most other countries are clustered between positions 40 and 60. Half of the Latin American economies in that survey have competitiveness indicators that are lower than would have been expected from their income levels, implying that their growth is impaired by a poor business environment.

expansion of the basic infrastructure and services that are needed for private sector-led development.

- 3.3 Very few Latin American and Caribbean economies have created jobs and wealth commensurate with their potential. As a result, poverty remains endemic. On the other hand, inflation is no longer a problem and governments throughout the region have improved their fiscal positions compared to previous decades. Yet, macroeconomic instability (in the form of periodic debt crises, exchange rate volatility, and high real interest rates) remains all too familiar.⁴
- 3.4 The context for private sector development has changed dramatically in the past decades. The wave of reforms in the 1980s and 1990s aimed to improve the efficiency of markets by opening economies to international competition through lower trade barriers, expanding access to international capital, shifting ownership of assets to the private sector, and stabilizing economies. As a result of these policy changes, the environment for firms has become more dynamic and challenging. Numerous SMEs exited the markets following structural changes like trade liberalization; in part, owing to poor access to factor markets, especially the absence of long-term capital and new technologies needed to develop competitive advantages. Many of these firms were concentrated in labor-intensive industries like footwear, furniture and clothing. At the same time, the technology gap with more developed countries has limited the ability to boost labor productivity. Some countries, such as Argentina, Colombia, Mexico and Brazil, have been more successful in raising relative productivity, but others, like Jamaica, Peru and Uruguay, have fallen behind. The evidence suggests that past reforms were not sufficient to close the productivity gap with developed economies, although growing competitive pressure will undoubtedly contribute to a convergence to international patterns of efficiency.
- 3.5 The lackluster performance of the private sector in the region can also be attributed in large part to a poor business climate. Surveys from various sources show that the general business environment in the region is in the “least friendly” category.⁵ The cost of doing business remains persistently high in many countries, and the public institutions needed to support a dynamic private sector continue to be inadequate. High transactions costs result from weak credit frameworks, unwieldy bureaucratic procedures that promote corruption, and cumbersome labor laws. Weak public institutions fail to deliver the legal, educational, health, and infrastructure services that are required to do business. The combined effect of these factors on business is increased uncertainty and risk, shortened investment horizons, the limited availability and high cost of financing (both external and domestic), reduced worker productivity, and, in general, more difficulties and lower profits for businesses attempting to pursue commercial opportunities.

⁴ For instance, Latin America has the highest frequency of credit crunches, an indicator of net flows to the private sector defined as the difference between the rate of growth in the stock of credit to the private sector and the interest rate on loans. This indicator currently is at the same level as that of the transition economies, more than three times that of the East Asian nations and almost five times that of the developed countries.

⁵ Batra et al., 2003.

- 3.6 Furthermore, the increasing interdependence of markets and the ease with which resources (particularly financial resources) can be moved around the world have intensified global competition. Thus, the Latin American and Caribbean private sector has become more vulnerable to competition from places like China, India and Eastern Europe, which are better able to attract investments and, as a result, are eroding some of the region's competitive advantages. In order to maintain sustainable rates of economic growth that can have an impact on reducing poverty, the next few years should be devoted to a special push to further the development of the private sector.
- 3.7 Many countries lack the necessary conditions for self-regulating markets to provide a complete solution to the problems of underperforming economies. Policymakers are looking for a middle ground between government intervention and the marketplace that avoids the costs of market and non-market failure. Public policy toward the private sector plays a fundamental role in defining the mix of government intervention and the market. Ideally, the private sector should be central to a country's overall development plan (which should be driven by local conditions and needs, and created in consultation with local actors and their development partners). While individual country strategies for private sector development must be developed locally, a cohesive framework that promotes business growth should guide them.
- 3.8 Today, in spite of greater macroeconomic stability, there is a widespread feeling of disappointment as public opinion is decidedly unconvinced of the merits of market reforms.⁶ In general, there is a search for new solutions to sustain the early growth performance. While new policy alternatives have not been forthcoming, the private sector, which is the main source of growth, remains far from reaching its potential in most countries.

b. What is the Private Sector?

- 3.9 It is important, however, to define what the private sector is before discussing ways of promoting its growth. The Development Assistance Committee of the OECD provides a generally accepted definition of the private sector as:

A basic organizing principle for economic activity where private ownership is an important factor, where markets and competition drive production, and where private initiative and risk-taking set activities in motion.⁷

- 3.10 The private sector encompasses all economic activities that do not involve production by the public sector and includes all for-profit firms regardless of size, activity (goods, services, or financial), or location (urban or rural), and institutions specifically established to serve the private sector such as industry associations. The boundary

⁶ For example, data from *Latinobarómetro* show that 70 percent of the region's population feels that privatization has not been beneficial (Shirley, 2003).

⁷ OECD 1994.

between private, for-profit institutions and private not-for-profit organizations is fluid and part of a continuum.

c. The Private Sector, Economic Growth, and Poverty Reduction

- 3.11 Private enterprises flourish when public policies, institutions, and activities provide an attractive and equitable environment for private activities. All too often in the region, however, the private sector is able to grow in spite of, rather than because of, the national business climate. Thus, promoting private sector development requires finding a good balance between the complementary functions of the state and the private sector. In such an environment, private investment would typically exceed public investment and growth in private investment could be interpreted as an improvement in the business climate. Private investment through the 1990s has been approximately three times as large as public investment. Not surprisingly, the private sector has also created many more jobs than the public sector. For example, data show the Mexican private sector accounted for 87 times more employment growth in the period 1989-98 than did the public sector, which includes state-owned enterprises; while in Uruguay, the figure was nearly 5 times greater.⁸
- 3.12 Because of the relative size of the private sector in practically all economies, sustained increases in per capita GDP (i.e. economic growth) requires the sustained growth of private enterprises. This is particularly germane in the present environment of weak public finances that impede most governments from undertaking the investments that would be required to support this economic growth. Equally important, the private sector provides the most efficient means to identify and capitalize on new technologies, products and markets that boost productivity.⁹ In the longer term, economic growth is a function of new technologies, which raise productivity and, in turn, boosts per capita output.
- 3.13 However, the causal relationship between economic growth and poverty reduction is not clear cut and has given rise to some controversy. Some observers claim that growth, at least in its early stages, actually leads to a worsening of income distribution and, in the extremes case, an increase in poverty. Yet, there is also increasing evidence that growth improves the situation of people at all levels of income in about the same proportion.¹⁰ Clearly, economic growth results in higher employment, income and government revenues, providing the resources to finance programs to address social needs and improve living conditions for the poor. From this we can conclude that sustained economic growth is a necessary condition for reducing poverty.¹¹ Since, as already shown, the private sector accounts for a significant share of national output, and hence

⁸ Pfeffermann, 2000

⁹ If the fraction of the population that works remains constant, raising GDP per capita implies that output per worker (labor productivity) must rise at the same rate. Though some observers point out that the region is lagging in technology investment, even in LAC the private sector adapts technology to economic activity.

¹⁰ Dollar and Kraay, 2001.

¹¹ See the IDB's Sustainable Economic Growth Strategy (GN-2227-1).

economic growth, and since increased growth plays an important role in reducing poverty, a strategic focus on private sector development is key to creating employment opportunities for the poor.

- 3.14 The economic growth record of Latin America and the Caribbean has been disappointing, and poverty remains a persistent problem. In the 1990s, average annual per capita income growth in Latin America reached only 1.5 percent. At this rate, it would take about a century for the region to reach average income levels similar to current levels in the developed world. Moreover, advances in poverty reduction would be clearly insufficient. Low and volatile rates of economic growth during the 1990s has led to an increase in the number of people living in poverty (with incomes under US\$2 per day in purchasing power parity). That number now reaches more than a third of the total population. In order to meet the Millennium Development Goals of halving the poverty by 2015, economic growth in Latin America and the Caribbean will have to increase at an average annual rate of 3.8 percent, well above the historical average (2.1 percent).¹²
- 3.15 However, economic growth alone may not suffice to raise the living standards of the poor in the absence of complementary and effective poverty reduction programs. Opportunities for achieving social inclusion and equity are also necessary to create the stability needed for sustained growth. Economic and social development policies should promote sustainable growth, and include activities targeted to the poorest segments of the population. Some targeted interventions that favor the poor include investments in human capital and infrastructure, and improved access to financing.¹³ Targeted actions to enhance the capacities of the poor are required to encourage stronger economic growth.
- 3.16 Some of the measures that must be considered to promote pro-poor growth are: (i) direct inclusion of the poor in economic activities, contributing to their employment, income and productivity, and to reducing their vulnerability; (ii) economic growth as the means of generating resources in society and enhancing productivity, employment and income; and (iii) redistribution so that resources generated in society from growth are invested meaningfully for the poor, especially in human resource development.

d. Business as a Partner in Development

- 3.17 The private sector can play a much broader in development. The benefits of private participation in achieving development goals can be improved in three ways. First, attracting private participation in the delivery of goods and services will enhance operational efficiency and coverage. Second, by using the private sector to produce services on behalf of the public sector. Thirdly, by using the private sector as a partner in socially and environmentally responsible development.
- 3.18 In the process for operating profit-making firms, private industries can also contribute to overall economic development, and often do so in harmony with the goals of multilateral

¹² Besley, H, and R. Burgess, 2003.

¹³ The IDB's Strategy for Poverty Reduction and Promotion of Equity (GN-1894-7) emphasizes the importance of targeted interventions.

development institutions and the public sector. In particular, private enterprises can produce goods and services that are needed to enhance the quality of life of the population, such as public services, housing and the like.

- 3.19 In addition to creating enabling conditions for private sector growth, governments can also use public funds to contract the private provision of public services, helping to expand their coverage and, in the process, result in greater accountability and improved operational efficiency. In turn, the private sector, acting as a contractor in government-financed projects, has an opportunity to further its own development and feed a virtuous cycle of economic development. The Bank contributes to the development of the private sector through its procurement activities for financing public projects. It must also use its leverage to promote those firms that engage in responsible behavior (for example, by complying with legislation, international agreements and Bank Group's policies and safeguards dealing with corruption, child labor, and environmental stewardship, among others).
- 3.20 In the course of their regular business activities, many firms are concerned with the well-being of the population and, particularly, with that of the communities and the environment in which they are located. In many cases, they invest in the health and education of their employees and poor persons as well as in community and environmental protection projects. Governments and multilateral institutions must take advantage of these situations in which their developmental goals coincide with those of the private sector and seek to leverage scarce resources to enter into development partnerships.

IV. Issues Facing Private Sector Development

a. Market Failures and Government Failures¹⁴

- 4.1 An underlying theme for private sector development policies is that private markets allocate resources in a powerful and efficient way such that all levels of society can benefit. However, markets do not operate in a vacuum and at times market failures arise that require government interventions to improve their functioning and social outcomes.¹⁵ The government must also establish the “rules of the game” that ensure competitive markets and provide an appropriate legal and regulatory framework, a stable macroeconomic environment, and a robust social and physical infrastructure (health and education as well as roads, communications, etc.). These “rules” must also mitigate the

¹⁴ Here, the term “government failure” refers to problems that occur when states fail to regulate appropriately and do not have effective institutions to support needed public activities (infrastructure, education, public health, among others).

¹⁵ Market failures can arise from several sources, including the negative externalities of private actions (such as pollution), positive externalities that result in free-rider problems or underinvestment (as with public goods), lack of complete markets, asymmetric information (which distort market prices), or excessive market power (such as monopolies and oligopolies). These problems inhibit the ability of the market pricing mechanism, which is central to private sector development, to adequately reflect economic costs and benefits.

negative impacts on the environment, health, and labor that are sometimes associated with private enterprise. In some cases, where markets fail to form because an individual firm cannot capture the gains from its activities, the government can encourage the formation of markets through targeted, and limited, interventions.

- 4.2 Of course, the public sector is not immune to problems. The often-criticized inefficiencies of government bureaucracies can hamper private initiative through red tape and delays. In Latin America and the Caribbean, it requires an average of 74 days to file the required paperwork to start a business compared to only 10 days in high-income OECD countries -- at a relative cost that is 7 times greater as a share of per capita national income.¹⁶ Additionally, the government's unique role in allocating budget resources and issuing permits and licenses, as well as its potential for the selective legal enforcement of rules and regulations create ample opportunities for corruption. Bribery, kickbacks, and other unproductive rent-seeking behavior serve as a tax on private activity that affects all members of society and distorts the allocation of productive resources. The absence of transparency and credibility that accompanies these non-market activities hamper a country's business climate.
- 4.3 Addressing institutional weaknesses, the related high costs of doing business, and improving the coordination of public-private interactions, make up the major part of a second generation reform agenda. Weak institutions (poorly defined property rights, weak collateral frameworks, legal systems that do not support effective contracting and burdensome regulation) remain a substantial hindrance to private sector development. Unfortunately, institutional underdevelopment undermines the effectiveness of the very real progress that has been made during the first generation of reforms (macroeconomic stability, trade reform, and privatization) and has even called into question the validity of reform programs.¹⁷

b. Scale of Firms, Informality, and Poverty

- 4.4 The smaller scale of production and widespread informality are characteristic of the business sector of many countries. Because of their scale, smaller firms are often more adversely affected by high bureaucratic costs than larger firms, and are more likely to remain in the informal, unregistered economy or exit the market when adverse changes occur. Moreover, informality places significant constraints on a firm's growth, reducing access to financial and other inputs, limiting access to public services and narrowing the kind of contracts or investments that they can make. The size of the informal sector can be a proxy for the quality of the business climate, since a poor climate acts as a deterrent to formalization. Small firms have lower productivity than their developed country counterparts and limited possibilities to expand and grow. Furthermore, there is a

¹⁶ Data from the Doing Business database of the World Bank Group.

¹⁷ It has been estimated that in the 1990s the region carried out almost 80 percent of the margin of reform available in trade and about 60 percent in financial markets, but only 25 percent and 30 percent in taxes and privatization respectively. In labor markets the net use was basically 0 percent, i.e. no use of the margin of reform. Lora et al. (2004).

widening technology gap between smaller and larger firms in the region, which is detrimental to the long-run competitiveness of smaller firms.¹⁸

- 4.5 The legal system is a critical factor underlying the growth of businesses of all sizes from microenterprises, to SMEs, to large corporations. Evidence indicates that where creditor rights cannot be enforced effectively the amount of credit available to the private sector suffers. An appropriate legal framework defines agreements between businesses and facilitates contract enforcement and dispute resolution, thereby improving access to finance. This allows businesses to grow as objective, “arm’s length” transactions permit them to move beyond the circle of family, friends, or neighborhood acquaintances in which they initially operate. For smaller firms, the absence of legal enforcement and unregistered property rights raise the cost of financing and limit their ability to invest and grow.
- 4.6 Informality is closely linked with poverty and has corrosive effects on the market incentives needed to sustain economic growth. Many Latin American and Caribbean economies, especially the lower income countries, offer no strong incentives to become formal, especially for micro- and small and medium-sized enterprises. Failure to attract firms to formal market activities results in foregone tax revenues and serves to undermine the quality and coverage of public services (such as roads and education) and inhibit the transparency and confidence in markets (as firms pursue tax- and regulatory-avoidance strategies to survive). The close link between informality, low growth and poverty suggests that efforts should be focused on low-income countries or low-income regions within countries where these conditions are most prevalent.

c. Capital Constraints on Private Sector Growth

- 4.7 In general, the region suffers from the limited financial resources available and limited access to credit and equity for firms of all sizes. The ratios of credit to the private sector to GDP are often substantially lower than for countries at similar income levels in other parts of the world.¹⁹ Interest rates and interest spreads are high, reflecting a perception of high risk on the part of lenders and a combination of inefficient and non-competitive intermediation. A good financial system that finances private sector development effectively satisfies a wide range of financial needs, from those of the smallest businesses to those of the largest, at affordable and competitive terms.

¹⁸ On average, the productivity of Latin American SMEs is less than 40 percent that of the larger firms in the region, while in Europe and the United States it reaches 65 percent. See European Commission (2000) and Peres and Stumpo (2000).

¹⁹ On average, the ratio of credit to the private sector to GDP was below 30 percent in the 1990s, roughly a third of the size of the average credit markets in East Asia and the developed countries, while net interest margins in 2001-2002 were 5.8 percent in Latin America, 3.1 percent in Asia and 2.5 percent in the developed countries, making money more expensive. In addition, capital markets are considerably underdeveloped. The value of stocks traded with respect to GDP averages less than 5 percent in Latin America, while it exceeds 50 percent of GDP in the emerging economies of Asia and the OECD countries.

- 4.8 There is evidence that most large firms in the region are able to obtain financing and, until recently, some were even able to access the New York and European financial markets. For their part, microfinance institutions, with the pivotal assistance of the IDB, have developed special lending modalities tailored to their clients and have begun to grow. Small and medium sized enterprises, however, have few options for funding. Collateral-based lending is largely underdeveloped in the region, which makes it difficult or impossible for companies to leverage their assets to finance their businesses. As a result, business growth is curtailed and new business opportunities remain untapped. A further consequence is that lender risks are high, (owing to weak creditor rights) which is reflected in high interest rates and large spreads between borrowing and lending rates.
- 4.9 In addition to shallow and narrow domestic financial and capital markets, the region suffers from volatility in its access to international capital flows. Traditionally, the region has been more dependent on debt financing intermediated through the banking system. Capital market instruments, largely sovereign bonds, have recently gained importance, while foreign direct investment, which was on the rise in the 1990s, has declined more recently along with the global decline in investment activity.²⁰ As a result, the region finds itself with the imperative of mobilizing its domestic financial resources to provide necessary investment financing. Additionally, raising local currency funds will reduce the currency mismatch many firms face when borrowing abroad for projects that generate local currency earnings. The nascent private pension fund and institutional investor market shows promising signs, but is still too limited to provide a significant share of the region's annual investment spending. The contribution of pension funds and other institutional investors is potentially significant in some countries.²¹

V. The Role of the IDB Group in Private Sector Development

a. Strategic Framework

- 5.1 The overarching goals of the IDB Group are promoting sustainable economic growth, poverty reduction and social equity. The Private Sector Development Strategy seeks to enhance the development impact of the IDB Group's private sector activities to reach those overarching goals. This section explains how the strategy fits into the existing IDB strategies and provides an overview of the private sector development strategies of major peer institutions. It also summarizes the major areas of IDB Group intervention and the instruments used, and draws some basic lessons from its accumulated experience.

²⁰ Foreign direct investment in the region has been very volatile and in 2003 it will reach levels of US\$25 billion, well below the peak of US\$75 billion in 1999. In 2001 it was the same as in Asia/Pacific (including China), but by 2003 it is expected to be only one third.

²¹ For instance, pension fund assets in Chile are almost 50 percent of GDP. They reach almost 10 percent of GDP in Mexico, but are growing very fast, while in the United States pension fund assets are about 55 percent of GDP. Mutual funds are potentially important in Brazil, where they reach 18 percent of GDP, while insurance funds account for close to 14 percent of GDP in Chile. Nevertheless, pension funds are constrained by very strict investment rules as to allowable investments.

- 5.2 **IDB Group Strategies:** The Private Sector Development Strategy establishes a framework for IDB Group work in this area. This strategy is part of a larger framework of strategies that cover social development, modernization of the state, regional integration and competitiveness. Additionally, the IDB has two core strategies that encompass sustainable economic growth, and poverty reduction and promotion of social equity. These strategies, however, do not address the changes needed within the IDB Group to attain strategic coordination in its private sector operations.
- 5.3 The common denominator of the IDB's strategies is their focus on macroeconomic stability, basic infrastructure, human capital, and technology as the foundations of growth and poverty reduction efforts in the region. Also emphasized is the IDB Group's role in providing financing where access to credit is difficult, particularly for investments in infrastructure, and micro, small and medium-sized firms. In addition, the Competitiveness Strategy highlights the main structural issues that affect the private sector; namely, (i) strengthening the legal and institutional framework in which financial systems operate; (ii) developing financial regulatory agencies; (iii) strengthening capital markets; (iv) strengthening property rights over assets (particularly the assets of the poor) such as land and housing; and (v) developing microfinance systems and other alternative institutions to expand access to credit²². The strategies also uniformly call for greater coordination of efforts among the main public and private actors, as well as efforts to promote the creation of associations among firms in order to enhance productivity.
- 5.4 These strategies also highlight the IDB Group's role as a catalyst for private sector activity. Actions include support for promoting dialogues and cooperation between the public and private sectors. The strategies also mention the potential for private support for strategic goals such as expanded regional infrastructure by leveraging private resources, social inclusion through greater corporate social responsibility, and improved environmental standards with the adoption of ISO 14000 standards. Equity concerns, as they relate to private sector activity, are incorporated the IDB Group's multi-year plan to support private lending in lower income countries.²³
- 5.5 Among the other IDB strategies that touch on private sector development, several merit special attention. The Enterprise Development Strategy for SMEs (1995) addressed the challenges faced by small and medium enterprises in the new business environment of the 1990s. The strategy identifies the instruments and conditions needed to improve SME competitiveness in local and international markets. National strategies were developed in 13 Latin American and Caribbean countries between 1995 and 1998 as part of the implementation of the strategy.²⁴ This exercise made it possible to incorporate the perspective of firms into IDB Group operational programming and to increase the number of SME-related projects. It also made it possible to establish a general vision of

²² This strategy forms the basis for the actions envisaged under the first strategic direction (see section VI)

²³ The C&D Action Plan for Private Sector Development provides a multi-year plan for IDB Group activities related to private sector development in C&D countries (see GN-2193 and GN-2193-5, the first annual report on the Action Plan).

²⁴ The countries were Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, and Uruguay.

national policies supporting the SME sector and to create new mechanisms of dialogue and coordination between public and private sector institutions, resulting in a fruitful exchange between countries of the region. The Microenterprise Development Strategy (1997) targets the microenterprise sector, examining policy and regulatory issues, requirements for financial and nonfinancial services, and improved access to low-income and disadvantaged microentrepreneurs. Other relevant strategies include the Capital Markets Development Strategy (1995) and the Financial Markets Strategy (1999) that address topics like prudential regulation and supervision, local capital market deepening, expanded access to capital by smaller businesses, competition in financial services, and regional harmonization, among other topics. The Environment Strategy (2003) and the Environment and Safeguards Policy (as of March 2004 under consideration by the Board) offer guidelines that can be used to support the environmental responsibility of firms. The Report of the Working Group on MIF Strategy established the strategic priorities for MIF projects, focusing on four areas of activity; microenterprise, small business, financial sector and market functioning. It also recommended new procedures to increase the efficiency of MIF project identification, preparation and implementation.

- 5.6 **Comparator Institutions and Their Approaches:** The IDB Group's main comparator institutions are the World Bank (WB), the International Finance Corporation (IFC), the Asian Development Bank (ADB), and the European Bank for Reconstruction and Development (EBRD). Each has developed strategies of their own for private sector development that feature institution-wide approaches. These documents concur on the importance of private sector development to foster economic growth and reduce poverty. They call for a greater country focus in the provision of services and lending with approaches tailor-made to differing local circumstances.
- 5.7 The World Bank's Private Sector Development Strategy (2002) covers the activities of the IFC and MIGA as well as SME activities carried out by the World Bank Group.²⁵ Among its strategic actions, it highlights activities to improve investment climates, emphasizing a systematic approach to data gathering through standardized survey instruments as part of the regular analysis in the preparation of country strategies. The World Bank's strategy also emphasizes financing of firms, including rural credit and microfinance, with a focus on small and medium businesses and farms. It also features private infrastructure finance with appropriate regulatory safeguards, and an incipient effort to finance private participation in social services. The strategy implementation calls for a country focus and consultations at the local level. In addition, the strategy defines the roles and functions of the various entities that make up the World Bank Group. Coordination among these entities was further improved in May 2003 with the creation of a Vice-Presidency for Private Sector Development, charged with coordinating investment climate activities, improving policy dialogue and serving as a central contact point for the private sector.

²⁵ The World Bank Group's private sector development strategy ("Private Sector Development – Directions for the World Bank Group") was released on April 16, 2002. An implementation progress report was released on June 30, 2003, describing the actions taken so far.

- 5.8 The World Bank’s private sector development strategy is complemented by the IFC’s strategic directions report.²⁶ Noting the retreat of investors from the region, and exposure constraints on its portfolio in some countries, the report recommends that the IFC should be more proactive in business development and improving capacity-building activities. The priorities identified are (i) frontier markets through work on investment climates and advisory work, (ii) high-impact sectors such as financial markets, infrastructure, health and education which have a greater impact on development, (iii) SME support through local financial intermediaries, technical assistance, and links with larger firms, and sustainability (environmental, social and governance issues). These areas are identified as those where the IFC already has expertise and comparative advantage. Attention is also paid to incentives and human resource issues as part of efforts to build managerial and staff accountability. In terms of the high-impact sectors, the IFC will use its resources for activities that have greater developmental impact, such as from spill-over effects. In this regard, IFC activities will broaden to include new innovative uses of funds, such as joint financing with the World Bank, and new areas of financing such as trade finance facilities, microfinance, housing, and health.
- 5.9 The Asian Development Bank’s strategy (2000) emphasizes the application of its existing public and private sector instruments in several strategic areas. For public sector operations, the strategy has two thrusts: (i) to support governments in creating enabling conditions for business, and (ii) to generate business opportunities in ADB-financed public sector projects. For private sector operations, the aim is to catalyze private investment through direct financing, credit enhancements and risk mitigation instruments. The strategy emphasizes that public sector operations should “Think Private Sector Development” in order to generate business opportunities for the private sector, while private sector operations should “Think Development Impact”. In the pursuit of the strategic areas, the ADB focuses on: (i) governance in the public and private sectors (public sector governance, commercialization and privatization, corporate governance); (ii) financial intermediation (financial institutions and markets, local currency financing, investment funds, small and medium enterprises); (iii) public-private partnerships (physical infrastructure development, social infrastructure development, agriculture and rural sector development); and (iv) regional and subregional cooperation. These were identified as areas in which ADB’s operational track record shows underlying strength.
- 5.10 Of the comparator institutions, only the EBRD does not have a specific document dedicated to its strategy for private sector activities. This reflects the fact that the EBRD invests mainly in private enterprises. In relevant terms, the EBRD’s private sector development activities includes: (i) country strategies for each country, which includes a private sector section, and (ii) sector specific strategies (agribusiness, energy, natural resources, property, shipping and transport) which cover the public and private sectors, depending on the subject.

b. Instruments Available to the IDB Group

²⁶ IFC Strategic Directions, March 11, 2003.

- 5.11 Many of the IDB Group's financial and nonfinancial instruments are directed to the private sector. Public sector activities, for example, are a central part of efforts to improve the business climate in the countries of the region. The IDB Group supports these programs with public sector borrowers (with sovereign guarantees) through investment loans, sector loans, and technical cooperation operations (reimbursable and nonreimbursable). The IDB Group has also been deepening its long-standing involvement with the private sector (without government guarantees) in order to leverage additional financial resources for the region.²⁷ These steps include loans, guarantees, and capital investment through equity and quasi-equity, which require participation from private sector investors.
- 5.12 **Without Sovereign Guarantees:** The IDB Group provides direct and indirect *loans* to firms to meet their longer-term financing needs. Direct loans finance a portion of the costs of expanding existing operations, greenfield projects, working capital, and trade financing. These loans are directed toward micro-, small-, medium- and large-scale businesses in all sectors, including infrastructure. The IDB Group has also successfully channeled funds indirectly to micro-, small- and medium-size enterprises through on-lending by local financial institutions. These financial institutions (including commercial banks, financial corporations, and leasing companies) intermediate resources to firms that do not have access to suitable sources of funding. They perform a crucial function when other sources of credit are unavailable and help firms to remain viable.
- 5.13 *Guarantees* are also used to help generate new sources of funding for project finance and to deepen local capital markets. In project financing, guarantees on credit and political risk provided by the IDB Group can offer comfort to lenders and help raise much-needed long-term financing. Additionally, guarantees can support access to local capital markets as an alternative to cross-border financing. Supporting local private sector bond issuances, for example, can build up liquidity and, ultimately, a secondary market for trading that can tap a new pool of capital for private sector investments, while avoiding generating foreign currency liabilities for domestic firms and banks.
- 5.14 The IDB Group also makes *equity* investments in firms where there is a clear need to support the capital structure of companies. By providing the right type of financial support for private sector projects, the concomitant enhancement to operating capacity, corporate governance, and environmental protection enable companies to tap the capital markets through the issuance of shares and other equity obligations. Equity investments are largely made through regional, country-specific, and sector specific private equity funds. Quasi-equity investments are the chosen vehicle when appropriate. Expanding share ownership through equity investments is another tool to broaden access to markets

²⁷ In the Agreement Establishing the Inter-American Development Bank, the institution was authorized to carry out private sector lending and guarantee operations (see, e.g., Art. I, Sec. 2(a)(i) (promoting the investment of private capital for development purposes); Sec. 2(a)(iii) (encourage private investment in projects, enterprises and activities; supplement private investment when private capital is not available); and Sec. 2(b) (Bank shall cooperate with private sources supplying investment capital)).

both for individual investors and firms. The IDB Group can help companies achieve these goals.

- 5.15 The IDB Group provides fee-based *advisory services* to firms and projects, including restructurings, financial engineering, and searches for joint partners.
- 5.16 **With Sovereign Guarantees:** In financial terms, much of the IDB Group’s work to support reforms of the business environment entails long-term changes in public sector institutions, improved delivery of public services, and changes in the legal and regulatory framework. These reforms are supported through loans guaranteed by the member government.
- 5.17 Among its *loans* to the public sector, the IDB Group provides long-term funding for investment projects in infrastructure and other areas requiring capital investments.²⁸ In order to further improvements in the business climate, these activities can be combined with piecemeal reforms, such as assessments of the legal issues in road maintenance decentralization or contracting private firms for road repairs. In addition, global credit lines are provided to second-tier banks that on-lend to the private sector for fixed assets, permanent working capital and export credit. These credit operations help to expand access to capital, lower the cost of intermediation, and promote improvements in the legal framework for financial markets. The most comprehensive tool, however, is policy-based lending. These large-scale investments assist governments in fostering reforms. These loans typically disburse over a short period of time and support deep reforms in areas that affect the business environment, including financial, trade, commercial and judicial regulations.
- 5.18 **Technical Assistance:** The IDB Group provides reimbursable and non-reimbursable technical assistance. The IDB’s technical assistance supports private sector development by restructuring and modernizing the public sector, supporting investment sector reform, promoting regional trade and integration, and supporting micro and small businesses, among other activities. These resources are leveraged with counterpart funds from partners to help build local capabilities and skills. Some funds are provided on a grant basis, targeted to small interventions that pilot new approaches or play a critical or catalytic role in improving the environment for private sector growth and investment. Others are repaid on a contingent basis or are reimbursable.
- 5.19 Technical assistance is especially powerful when used to develop projects that result in lending operations and to enhance and accompany them during project execution. Technical cooperation can introduce reforms at an early stage, testing them to enable their adaptation to local realities, and helping to build the support needed for broader reform programs. Specific expertise needs to be provided to enable countries to identify and remedy weaknesses. Technical assistance can initiate improvements in the business environment that may later be imposed as “conditionalities,” under a policy-based operation. For example, a technical cooperation project could result in an analysis of

²⁸ Other lending instruments include project preparation loans, innovation loans, multi-phase program loans, and emergency loans.

problems in the commercial law framework, and provide support for redrafting legislation and to build consensus. Then, a later policy-based operation could include in its conditions the implementation of the recommendations of the technical cooperation operation.

c. Areas of Current IDB Group Action²⁹

- 5.20 Over the years, the IDB Group has devoted considerable resources to improving the investment climate by eliminating regulatory barriers to private sector participation and competitiveness in the economy. These efforts have included lending for improving financial market supervision; generating the infrastructure needed for an adequate functioning of the private sector; fostering the development of adequate and solid financial and capital markets; providing direct financing and capital for private sector companies; and supporting local public and private institutions in order to develop and provide financial and business development services for micro, small and medium enterprises, among others. Complementing these actions there have been a host of nonfinancial activities that promote dialogues, publicize good practices, and improve the skills and abilities of policymakers in specific areas. These activities are directed to four broad areas: (i) developing an *enabling environment for business* by lower transactions costs and improving government and market efficiency, (ii) improving *access to financial resources*, (iii) supporting *business growth and the capacity of firms* with operations that improve the productive efficiency of the firm, and, (iv) *access to knowledge and technical assistance* to promote private sector led development.
- 5.21 **Enabling Environment for Business**³⁰: The private sector environment in the region is high cost and does not provide incentives that reward entrepreneurship and efficiency. In other words, it is disabling to private sector activity. This situation is the fundamental problem faced by businesses in Latin America and the Caribbean. During the first half of the 1990s, the IDB Group used structural reform loans to support liberalization and opening of the region's economies, as well as to establish the basic pillars of a regulatory and institutional market framework. Today, there is a wide range of policy, regulatory, and investment activities that can improve a country's business climate. Individually or in combination, these operations lower the *cost of doing business* and *improve market efficiency*. Improvements in the climate for private sector activity have indirect, positive impacts on the expansion of businesses, employment and exports.
- 5.22 IDB Group interventions aid financial market development; improve the provision of infrastructure services; lower barriers to international markets; promote trade and investment opportunities; and improve competition rules. At the same time, the IDB Group provides assistance to define sustainable fiscal policies and safeguard

²⁹ An exhaustive list of these areas of activity can be found in other relevant strategies, such as the Sustainable Economic Growth Strategy (GN-2227-1) and the Competitiveness Strategy (GN-2243-1) and the details of the support provided by the Bank Group since 1990 can be found in the four volumes cited in the Bibliography at the end (Microenterprises, Small and Medium Enterprises, Infrastructure and Financial Markets).

³⁰ For details on IDB Group support see "Investment Climate: IDB Group support since 1990".

macroeconomic stability when exogenous factors, like natural disasters or shifts in capital flows, impact the economy. IDB Group operations have also targeted legal reforms and institution building. These include aid to bank and securities markets supervision, pension and insurance market reforms, developing adequate regulatory frameworks for insurance markets, and restructuring social security pension systems. Housing finance has been directed to forming mortgage instruments as well as the provision of credit to finance housing. The IDB Group also assists countries in the economic analysis of the effects of existing laws and regulations on the private sector, together with recommendations for reform. Beyond direct financing, the IDB Group provides policy advice to governments, disseminates information about good practices, and provides support for strategies, conferences, and publications on key issues.

- 5.23 **Access to Financial Resources:** Underdeveloped financial markets are a feature of the economies of Latin American and Caribbean. As a result, providing financing to firms has been a major part of IDB Group efforts to improve *access to capital*. The IDB Group has provided significant support for financial reform and market deepening in the region. This support has contributed to the implementation of reforms and the provision of credit whose ultimate goal was enhancing private sector development and participation. Direct and indirect lending to the private sector and equity investments totaled nearly \$18 billion during the 1990-2002 period, close to 20 percent of the IDB Group's total financing.³¹
- 5.24 The IDB Group provides credit directly to firms as well as indirectly through second-tier institutions, providing special financing facilities that enable them to extend credit to small and medium-sized firms, exporters and others. Investments in another type of intermediary, equity funds, are demonstrating the role for risk capital for small and medium-sized firms. The IDB Group has played a leading role in the development of Latin America's approach to microfinance, providing direct and quasi equity, to build the capital base of numerous NGO microlenders so that they could become regulated financial institutions, opening the way for commercial capital funding sources and the development of a broader base of financial services for microenterprise. Multi-sector credit programs have increasingly become more relevant, as demonstrated by the larger loans approved, especially to Brazil and Mexico.
- 5.25 **Business Growth and the Capacity of Firms:** These activities are focused on *non-financial* interventions that have a direct impact on the *operational efficiency* of firms through improvements in factor productivity. Since 1990, nearly US\$3 billion have been directed to these activities. Projects cover various categories, such as enterprise development, technical support to firms, business clusters, human resource development, innovation and technology, quality enhancement, and programs to foment private sector provision of production and marketing services. Largely aimed at SMEs, these activities channel support to firms through intermediary institutions and firms that provide training; marketing services, advise on distribution and technology; assistance for the development

³¹ The funds approved were around \$1.4 billion per year, but they were not evenly distributed, experimenting considerable increases with financial crises. The average size of the operations was approximately \$100 million, with individual operations ranging widely from \$78,000 to \$1.2 billion.

of enterprise networks, tools for developing effective business strategies and other management assets. The IDB Group also provides assistance to encourage technology transfers and innovation through the application of information technologies like e-commerce, the promotion of technology parks and incubators, and by enhancing intellectual property protection as a means to stimulate innovative private sector activity. IDB Group activities also support the upgrading of skills by building capacity for the continuous training of workers, the use of worker skill standards, and labor certifications.

- 5.26 **Access to Knowledge and Technical Assistance:** The IDB Group offers a wide-range of nonfinancial services ranging from advisory services to work on good practices in development to seminars and conferences that engage major actors in the area of private sector development. These activities cover topics related to lending and investment operations, as well as areas that highlight innovations and new topics that are not yet in the mainstream of public policy making. When providing nonfinancial services, the IDB Group often works with partner institutions, including private firms, to identify topical areas, finance actions, and bring its message to a wider audience both within and outside the region. The services are intended to (i) help forge consensus among the many public and private institutions, both nationally and regionally, (ii) support capacity building among policymakers, (iii) identify state-of-the-art practices for improving the business climate and catalyzing economic growth and poverty reduction, and (iv) provide practical business advice to client firms that benefit from financial support from the IDB Group.

d. Lessons Learned

- 5.27 The long-standing and broad experience of the IDB Group with interventions directed at promoting private sector development provides a solid basis for an analysis of what has worked well and what may need improvement. This section identifies key weaknesses and strengths of IDB Group activities and is based on reflections by management, as well as the evaluations carried out by the IDB's Office of Evaluation and Oversight in recent years.

1. Weaknesses

- 5.28 Most of the IDB Group's disadvantages in engaging and working with the private sector can be traced back to the evolution of the various units charged with this work and the fact that their guidelines have emerged piecemeal. The unit to be created was the Inter-American Investment Corporation in 1989, mostly to fill the void in financing for SMEs, then came the Multilateral Investment Fund, created in 1993 to promote private sector participation in economic activity and in 1994 the Private Sector Department was created within the Bank to finance projects in areas where the public sector was retrenching. Furthermore, the public sector arm of the Bank had been involved in direct and indirect private sector finance with government guarantees and loans and technical assistance to governments for the improvement of the business climate. This fragmented development and the very specific focus of each member, either corporate, project, program or technical assistance finance, has conspired against an integrated and broad approach to private sector development. The major weaknesses that have evolved are the following:

- Insufficient dialogue with stakeholders and lack of a single voice in the Bank Group.
- Insufficient engagement with the private sector in activities unrelated to transactions.
- Fragmented image and communication as a result of the dispersion of interlocutors.
- Lack of synergies across the IDB Group as the IDB Group fails to capitalize on opportunities to learn from the experiences made at different levels and for joint action on issues and projects.
- Lack of uniform performance measurement criteria in projects done by different units.
- Timing and confidentiality problems due to the nature of private sector activities, that require fast turnaround and confidentiality to protect the competitive position.

2. Strengths

5.29 The IDB Group can build on a number of strengths in the area of private sector development. It has a long-standing record of credibility and continuity with governments on the formulation and implementation of policy agendas. With its exclusive focus on Latin America and the Caribbean, it has greater understanding and a longer institutional memory than other organizations that deal with the region. With this perspective comes a concern for broader issues, such as equitable growth, social inclusion, and environmental concerns that might otherwise be overlooked. Over the past fifteen years, the IDB Group has also built an important body of experience with the private sector. The IIC, the MIF and the Bank's Private Sector and Sustainable Development Departments interact directly with private sector clients and the IDB's Regional Operations Departments do so on many occasions as well.

5.30 As a result, the IDB Group currently has *comparative advantages* that can be used to enhance its contribution to development. Needless to say, these advantages can and should change over time and the IDB Group should continue to develop them while seeking new ones in order to enhance its effectiveness. Among the current, are the ones following:

- A close relationship with the member countries and access to public sector officials that influence private sector activities (ministry officials, regulators, parliamentarians, local officials)
- A long-term commitment to its borrowing member countries, including during challenging times.
- A deep country knowledge, as well as access to a network of institutions and enterprises that benefit from its programs.
- The capacity to provide financing for longer tenors than available in most markets and to leverage additional private resources.
- Instruments to mitigate political risk through IDB Group participation in projects.
- The ability to induce responsible private sector behavior toward society and the environment.
- The ability to commit to operations that private economic agents might not engage in, especially in the area of the provision of public goods.

- Long-standing effort on micro, small and medium-sized firm issues through lending, advisory work and knowledge tools.
- The ability to convene the major actors, both public and private, to engage in meaningful dialogue and consultation at a regional, national, and local level.
- Capability to provide grants for demonstration projects, that can be used to test innovative methods, introduce new development approaches and build broadly based support for needed changes.
- The ability to disseminate best practices in developing countries that can provide insights into how to implement private sector policies.
- The ability to initiate and implement, with public and private partners, private sector development policies in ways that would otherwise not be available for most countries and individual enterprises.

VI. Strategic Directions for IDB Group Support

- 6.1 The Private Sector Development Strategy recognizes the essential role of the private sector in promoting growth and poverty reduction. Private enterprises create jobs, generate income and are a main engine of economic growth providing the revenue base necessary for government-funded services and, in some cases, providing investment and management skills to government-supported activities. Thus, they are a key to sustained poverty reduction. However, there are important constraints. While the obstacles to private sector development are well known, many are beyond the reach of firms to resolve by themselves because they fall in the realm of public policy. Weak state institutions limit the government's ability to create and maintain a favorable business climate and to reinforce the social benefits of private sector activity. At the same time, market failures limit the ability of private enterprises to achieve socially desirable outcomes. For its part, the public is increasingly disenchanted with macroeconomic stabilization that has not led to sustained growth, and openly questions the market reforms. Therefore, new policy alternatives are needed that promote the private sector as an engine for sustainable growth and better living conditions.
- 6.2 The IDB Group is uniquely positioned to respond to these challenges. Working with its existing financial and nonfinancial instruments, the IDB Group can increase the effectiveness of both the public and private sectors' contributions to development. The IDB Group can support governments in providing public goods, regulating markets, promoting positive externalities, overcoming market failures, and building consensus on pro-growth development policies. However, the potential to stimulate change *only* through public interventions is necessarily limited. Given the widespread financing constraints faced by firms, the IDB Group must also engage in direct interventions at the firm- and investment-project level.
- 6.3 These interventions must consider the four forms of the relationship between the private sector and the IDB Group: as direct *client*, as *beneficiary* of an enhanced environment for business, as *supplier* of goods and services in projects financed by the Bank Group and as a *partner* in development. It must also be taken into account that interventions aimed

only to direct clients have strong impacts on the client but that the impact on the economy as a whole is limited. The IDB Group must also support the private sector at large, not only those firms that happen to be a direct client. This strategy builds on these areas.

- 6.4 In its undertakings, whether through the provision of financing, technical assistance, or other services, the IDB Group must consider the public interest as well as those of individual businesses. This means taking into account the impact of a specific transaction on the broader needs for legal and institutional changes, while considering legitimate business opportunities for the private sector when supporting public sector operations.
- 6.5 The IDB Group must also carefully justify its interventions. The rationale for IDB Group interventions is based on their positive developmental impact and the “value added” (or additionality) brought by its participation in a project or activity. On the one hand, developmental impact requires accounting for the potential benefits in growth, employment generation, improvements in the environment, gains in exports, and improved tax base among myriad other effects that are known to make a positive contribution to sustainable, equitable growth and poverty reduction. Additionality, on the other hand, describes what the IDB Group’s participation in a project or program adds to the developmental impact. These benefits may include demonstration effects from innovative projects, enhanced social and environmental outcomes, more efficient regulatory institutions, or greater leveraging of private sector resources than otherwise would be possible. In this sense, IDB private sector projects are not justified solely on their financial rate of return, but encompass broader economic and social concerns.



- 6.6 To achieve its development objectives, the Private Sector Development Strategy offers a comprehensive approach for the IDB Group’s various units. The strategy proposes four inter-related *strategic directions*:
- development of an enabling environment for business,
 - financial support for specific private sector projects,

- leveraging developmental impact in underserved markets, and
- engaging the private sector in dialogue and action.

Needless to say, these strategic directions are not mutually exclusive, on the contrary, they complement each other to support private sector development. The extent of their implementation in a given country will be determined by the individual country strategies. These directions will be implemented through four *action areas* that can be monitored during the implementation of the strategy. Those areas are:

- country focus,
- coordination and joint action of the IDB Group,
- broadening the scope of action, and
- strategic partnerships.

a. Development of an Enabling Environment for Business

- 6.7 The Private Sector Development Strategy recognizes that both *market* and *government* failures must be addressed. While the goal of assisting countries in promoting the efficiency of markets and compensating for market failure is operationally complex, if successful it could greatly enhance the effectiveness of the IDB Group as a development institution. Further, by promoting private sector development, the IDB Group will contribute to the commitments made at recent Summits, including the Millennium Development Goals. The IDB Group should reinforce its work on capacity building and institutional reform, public and private, to fully address constraints on private sector development, and seek greater coordination in the use of its various financial and nonfinancial instruments to affect change.

Development of an Enabling Environment for Business

The IDB Group will intensify its work on the identification and elimination of barriers to private sector-led development based on collaboration and transactions with the public and private sector and in coordination with other multilateral institutions.

- 6.8 The private sector development activities of the IDB Group should mainly address issues at the country level and, where feasible, at the subnational and regional level. For example, the IDB Group can build on the country-level business climate diagnostics carried out by other institutions, while using its own links with government authorities and private sector leaders to forge a consensus on policy reforms and investment choices.³² In the case of the enabling environment, poor quality or missing public goods

³² In designing programs to support an enabling environment, care must be exercised to maximize effectiveness and the use of resources. In this regard the IDB Group must consider the activities and

will often be the prime focus of IDB Group dealings with the public sector. However, these efforts should also address the host of micro level reforms needed to eliminate legal and institutional barriers to a properly functioning private sector. In addition, technical assistance and advisory services will be a priority for getting the enabling environment right, drawing on international and regional experiences.

- 6.9 Furthermore, as part of the enabling environment for business, the institutional and technical capabilities of governments to interact with the private sector and to design support programs, must also be developed. This is key in order to develop a better understanding of the needs of the private sector, but also to decrease the potential for capture by interest groups.

b. Financial Support for Specific Private Sector Projects

- 6.10 A complementary priority to that of improving the business climate is providing direct and indirect financial support for private sector investment and helping to mobilize resources from other sources. The IDB Group has an important role to play in providing financing to firms when markets fail due to structural inefficiencies or during cyclical downturns, nevertheless this financing must not be used as a substitute for correcting the failures of the business climate, which must always be the first priority. Of particular importance are infrastructure investments and the financing for smaller-scale enterprises. A higher level of productive investment is constrained by the limited range of debt and equity instruments, as well as the volume, tenor and price of financing resources available. The IDB Group will continue to add value by bridging this resource gap, supporting transactions that mitigate project risk, and helping to develop local capital markets that address private sector investment needs. The IDB Group will continue to use direct support instruments, such as equity and its variants, debt, contributions to investment funds, guarantees, and other market instruments to improve access to capital, in addition to its indirect instruments with sovereign guarantee, such as the multisector credit operations and other means to attract other sources of financing.

Financial Support for Specific Private Sector Projects

Investment and financing transactions will continue to be a central focus of IDB Group operations as the region works to improve its legal and regulatory framework, increase macroeconomic stability, and enhance the institutions needed to deepen its financial and capital markets.

c. Leveraging Developmental Impact in Underserved Markets

studies already undertaken by other institutions, particularly the World Bank, and build upon them. Joint or coordinated interventions with these institutions are also a must.

- 6.11 Owing to the importance of smaller scale firms and the specific problems of informality, which are related to the pervasiveness of poverty in the region, special priority will continue to be given to smaller enterprises. Also in keeping with its social development mandates, the IDB Group will pay special attention to the issues of poorer, smaller countries where limited domestic markets and a weaker institutional base further complicate private sector development. Furthermore, special attention will be given to lesser developed regions within countries, particularly rural areas, where the private sector presence is particularly strong but it is poorly served in terms of financial and infrastructure services. IDB Group resources should be used to leverage their impact on generating sustainable development led by the private sector through their positive effects on the income of the poorest and access to capital resources needed for sustained economic growth. In this regard the IDB Group should focus on pilot and innovative projects that have demonstration effects for other actors, leverage significant capital resources, and produce positive, measurable benefits for lower income groups, wherever they happen to be located.
- 6.12 Furthermore, there may be times during which sectors or firms that would normally have access to financial markets are precluded by prevailing conditions from accessing those markets. Under these circumstances the IDB Group should put in place programs to serve these sectors or firms while the adverse conditions remain in effect. In this regard, it will be important to distinguish between structural and circumstantial problems and between endogenous and exogenous causes of the problem.

Leveraging Developmental Impact in Underserved Markets

The IDB Group will focus on smaller scale firms and on the issues related to informality, while addressing the special needs of small, low-income countries. It must also address the needs of markets that are underserved due to temporary adverse circumstances.

d. Engaging the Private Sector in Dialogue and Action

- 6.13 There is no single, reproducible process to achieve private sector development that can be applied in all cases, all regions, all countries, all industries or all firms. Each solution must be tailor-made to the institutions, actors and markets that define the initial conditions. Nonetheless, it is clear that private sector development occurs most effectively when business, government and civil society work together with a common vision. A consensus on the goals of private sector development requires dialogue and consultation among the actors that is informed by lessons learned from international and national experience. A consensus among public and private actors will be fundamental to the success of the next generation of policy and institutional reforms. As stated in the Millennium Summit Declaration: “Goals cannot be imposed—they must be embraced. Each country must identify its own particular goals, its own path to development, and make its own commitment through dialogue with its citizens.”

Engaging the Private Sector in Dialogue and Action

Using its experience and commitment to the region, the IDB Group can convene the private sector, public sector, civil society, and international institutions in dialogues that forge a common vision and identify joint actions for private sector development. The IDB Group can encourage socially and environmentally responsible behavior in the private sector, engage it as a partner in development by undertaking joint projects, and promote issues of common interest that further economic and social development.

- 6.14 The private sector, with its command of financial, human and physical resources, can have an impact on development that goes beyond its market role in the supply and demand for goods and services. Private sector behavior influences economic development and sustainable growth by building confidence in the market system and supporting social and economic stability. These relationships normally fall under the banners of corporate governance and corporate social responsibility. Corporate governance issues range from narrow concerns of how to make corporate management respond to the interests of shareholders, to the broader ones like transparency, conflicts of interest, corruption, adherence to the rule of law, and ensuring an arms-length relationship between government and business. Corporate social responsibility deals with the relationship of the firm with society and the environment. The stakeholders in a firm extend beyond its shareholders and creditors, to include customers, suppliers, employees, community, civil society, government and the environment.³³
- 6.15 Good corporate governance and social responsibility allow firms to tap financial markets and earn the goodwill of consumers and other stakeholders. This has a positive impact on the way the general population perceives the private sector and contributes to the firm's development, to its capacity to contribute to economic and social development and, in general, to social and economic stability. Responsible corporate behavior must be encouraged by the IDB Group, governments and civil society. Working together, they can promote good business behavior and seek ways to improve how companies behave and govern themselves. The IDB Group will promote these issues and others that broaden and deepen the dialog between the public and private sectors through its lending and convening powers³⁴.

³³ In this regard, traditional corporate governance could be considered a subset of corporate social responsibility or even of the broader concept of sustainability, that looks not only for responsible behavior and use of resources, but for their sustainable use, a concept promoted by the IFC and the private sector organization World Business Council for Sustainable Development, among others.

³⁴ An example of the later is the annual conference on Corporate Social Responsibility organized by the Bank and the many efforts to promote ethical behavior that have been promoting adoption of good practices throughout Latin America and the Caribbean.

VII. Defining the Action Areas for Private Sector Development

- 7.1 Implementation of the Private Sector Development Strategy involves a wide range of units within the IDB Group. For this reason, areas of activity or joint action areas are defined across institutional divisions with joint actions that are consistent with strategic directions. The regular dialogue and monitoring which is associated with these action areas provides a good opportunity for fine-tuning and will help the IDB Group to build a “brand name” for its private sector activities in the region. This image should highlight the IDB Group as a proactive institution that seeks to maximize its positive developmental impact and the additionality of its actions.

a. Country Focus

- 7.2 *A central tenet of the Private Sector Development Strategy is that, in order to be effective, policies, programs and projects must be tailored to local conditions in an integrated fashion.* To combine actions on private sector development across the various parts of the IDB Group will require the joint development of strategic priorities as part of country programming. These priorities should be based on private sector assessments undertaken for each country to be carried out jointly by the various operational arms of the IDB Group. The Country Private Sector Development (CPSD) Strategy will propose an integrated package of activities and operations by country, which includes a clear assignment of responsibilities among IDB Group members and coordination and complementarities with the actions of other multilateral and bilateral donors.³⁵
- 7.3 The CPSD strategies will assess the business climate, develop priorities for intervention, and provide a mechanism for consultation with public authorities and the private sector. This consensus building will ensure that the action areas are identified and prioritized in a way that reflects the common goals of the public authorities and the private sector. The CPSD strategies will outline how the various IDB Group instruments will be applied in a coordinated fashion with ongoing open dialogue and consultation with the private sector. The CPSD strategies will provide a mechanism to address the specific problems of lower income groups within countries. In addition, the strategy can serve to identify pro-poor reforms that are most likely to have immediate and positive effects on low-income groups in each country. For example, in many countries access to services such as the titling of property or the formalization of a microenterprise can be extremely cumbersome and expensive, causing a significant loss of income in wasted time. Also the existence of labor market rigidities can serve to deter firms from employing low skill workers, who tend to have low income. Furthermore the preparation process will identify the need for capacity building efforts to better integrate the efforts of both public and private sectors and promote and enforce the latter’s responsibilities to comply with environmental and social performance and safeguards. The IDB Group could make these types of reforms central to improving public sector efficiency and, by doing so, assist the private sector

³⁵ As explained in the section on implementation, the CPSD Strategy need not be a stand-alone document.

and provide tangible evidence of the benefits of reform to often overlooked sections of the population.

- 7.4 In addition to the CPSD Strategy, other instruments may also be developed as needed to address regional or local issues. The process of consultation is expected to promote consensus-based approaches to identify, analyze and design projects that address weaknesses in the business climate. These would involve simultaneous policy dialogues with the public and private sectors, private sector advisory councils³⁶ to advise the IDB Group and other means to build strategic frameworks that foster consistency in policies across political cycles. Such participatory programs could also extend to actions at the sector, local or national level to identify “agents of change” in the public and private sector who can promote policies that enhance the entrance of firms into international markets and identify the policy reforms necessary to reduce the cost of doing business. The resulting agendas and action plans will serve as guides for IDB Group activities, improve coordination with other international agencies, encourage the sequencing and coordination of efforts within the public and private sector of borrowing countries and ensure compatibility with national and private sector development plans and programs.

b. Coordination and Joint Action for the IDB Group

- 7.5 *To be effective, the IDB Group will favor coordinated and sustained interventions that, when appropriate, are executed jointly by its various organizational units.* Owing to the complexity and dynamics of private enterprise, the IDB Group should pursue a collaborative and strategic approach to its various facilities and interactions with its partner institutions and increase its capacity to respond, in a timely fashion, to the needs of the private sector. Not only are its operations diverse (firm level, project development, and business climate), with a variety of actors (public, private sector, and institutional), but the timing and effectiveness of support is critical to success. These elements underscore the need for internal coordination within the IDB Group’s operational units and to maximize the comparative advantage of each of the units and of the synergy involved in joint action.
- 7.6 Many of the component parts of a private sector strategy are in place. The core of a successful private sector strategy at the country level is a coordinated program to identify barriers to private sector development, galvanize support from the member country for eliminating these barriers, and prioritize issues for policy and other measures (see Country Focus). At a minimum, implementation of the Private Sector Development Strategy will require significant coordination and, in some cases, joint action between the public and private arms of the IDB Group in order to bring to bear a coherent program for private sector development.

³⁶ Private sector advisory councils are composed of representatives of the private sector and its associations, and the local Bank representative. Their purpose is to exchange ideas about IDB Group policies and, in particular, about its activities in support of private sector development in the country.

- 7.7 While each unit will implement its own specific task, the IDB Group has to do much better than in the past in terms of acting as a team. Each of the units has specialized knowledge in some areas of private sector development and all will have to be tapped in order to produce an effective and efficient country assessment and CPSD Strategy. It is envisaged that the CPSD Strategy will require separate interventions by several of the units, but for these interventions to be effective, they will need to be sequenced properly and their execution coordinated. Furthermore, some of the interventions may require actions on the part of several of the units at the same time. Coordination will be of the utmost importance but design and execution will also require joint action.
- 7.8 In this regard, the implementation of the Private Sector Development Strategy may require both organizational changes in the IDB Group and programmatic changes in the emphasis and mix of work. Proper incentives for coordination and joint action should also be considered.

c. Broadening the Scope of Action

- 7.9 *The IDB Group should be empowered to work in all sectors of private activity with its lending, investment and technical assistance. Individual transactions will be carried out by the unit or units of the IDB Group which are most suited, with due attention to the need for coordinated and joint action as outlined above.* Specific steps will include seeking the expansion of *sector eligibility requirements* to include all sectors not prohibited under the charters for each IDB Group entity. Additionally, the IDB Group will review its lending programs to gauge areas where new instruments or extension of existing ones are warranted. Of course, IDB Group interventions must be justified because of the comparative advantage of the intervention *vis a vis* other sources of finance, their desirable development impact and additionality, as well as their financial and economic feasibility. Furthermore, projects should be consistent with the needs and priorities identified in the IDB Group's *country-focused approach* to its programming and operations.
- 7.10 *Technical assistance* will assume an important role in the strategy's implementation. For example, work on dialogue and consensus building can be supported strategically with the use of technical assistance for demonstration projects that move the dialogue forward into action, to be followed by larger operations to implement the full reform process. Technical assistance can provide timely support to move forward quickly with conditionality or key stages in policy-based and credit line operations. Because of the extra effort needed for project identification and monitoring relative to the size of the investment in smaller firms, technical assistance, grants and advisory work can be used for pilot projects and testing new cost-effective approaches. In general, early stage innovative projects will be carried out with technical assistance with cross-departmental project teams. Lessons learned from these projects can be mainstreamed into IDB Group operations once they have been designed and tested. Project team leaders will use the CPSD Strategy to ensure that the different divisions and different departments coordinate activities effectively.

- 7.11 The Country Focus of the Private Sector Development Strategy requires nonfinancial activities that support the policy dialogue with government and private sector representatives. A well-designed research agenda should contribute to the national policy debate and consensus building, while also providing inputs for the design and evaluation of projects. Analytical studies, best practice reviews, technical assistance and consultation on the design and implementation of national strategies, policy dialogue, and seminars and conferences are an integral part of the strategy. Collectively, these activities can be highly influential in molding public opinion and serving as a catalyst for change and they should be part of the IDB Group's coordinated efforts on private sector development. As well, they can identify new areas of IDB Group intervention in corporate governance, social and environmental responsibility, secured transactions, to name a few.
- 7.12 The IDB Group will build its *private sector knowledge base* by assigning resources to the diagnosis of obstacles to private sector development; reviews of institutional mechanisms to overcome identified weaknesses and their effectiveness; and identify standards for measuring the outcomes and effectiveness of programs.
- 7.13 The lessons learned in the design and execution of projects and from research activities will be systematically disseminated both within and outside the IDB Group. It is incumbent on the IDB Group to more fully realize the development impact that can be achieved by extensive dissemination of information about its private sector activities. To reach poverty-reducing growth levels requires new norms and practices in both the public and private sectors. Sharing best practices, the lessons of experience and fostering region wide dialogue is a role that maximizes the IDB Group's comparative advantage as a development institution, building on its understanding and depth of relationship with the region. Steps include the explicit incorporation of academia, civil society groups and others to discuss reform efforts. Additionally, to increase transparency and promote best practices, the process of consultation on specific investment projects must continue to be supported through the provision of information, transparent service standards, and service-quality surveys as part of project design.

d. Strategic Partnerships

- 7.14 *The IDB Group will use its financial and nonfinancial instruments to leverage private and public sector resources in a manner that is consistent with its goals and mandates as a multilateral institution.* In its financial operations, the IDB Group will explore opportunities to leverage public and private funds in operations that may include both public and private borrowers (move away from the strict dichotomy of public vs. private) with transparency and accountability. In addition to financing projects and programs in the private and public sectors, the IDB Group can enter into partnerships with the private sector to promote development issues. The IDB Group will seek out strategic relationships with private sector stakeholders, including research and knowledge building, entering into issue-oriented partnerships, establishing partnering agreements on specific topics, the formation of private sector advisory councils, and other nonfinancial

efforts. For instance, the IDB Group may join forces with an industry to promote regulations that, while enhancing their business prospects, also contribute to the country's development. It may also promote projects that involve both the public and private sectors, for instance taking advantage of the social responsibility of a firm or group of firms and that of the government to promote community development or environmental protection projects. The IDB Group should pursue actively these opportunities to enter into partnerships with the private sector to promote economic and social development.

- 7.15 Collaboration with other multilateral, regional and bilateral institutions will be enhanced. The experiences of CAF, CABEI and the World Bank Group can provide important lessons for IDB Group interventions. In all areas, strategic partnerships will be sought both in project and nonfinancial services. These collaborations will be used as a further tool to leverage both the financial and knowledge resources of the IDB Group.

VIII. Implementation, Monitoring and Evaluation

a. Implementation

- 8.1 The implementation of the Private Sector Development Strategy will require a reexamination of operational activities and an accompanying review of the institutional structure of the IDB Group. The four strategic directions outlined in the strategy will guide that process of change. Implementation of the strategy will not be a one-time event but will require adjustments, review and readjustments at both the operational and organizational level. Accordingly, the proposed steps for implementation, monitoring, and evaluation are designed to ensure that this process preserves organizational flexibility, strengthens institutional comparative advantages, and capitalize on of synergies within the organization.
- 8.2 To some extent, the strategic directions are not new for the IDB Group; rather they represent a recommitment to its underlying institutional mandates. In those areas, the IDB Group will continue to apply its instruments to foster dynamic, private sector-led growth through lending, equity investment, guarantees, advisory services and other nonfinancial services. This section highlights those activities that require changes to existing practices or instruments.
- 8.3 In practical terms, implementation of the strategy will be tailored to each country through the CPSD strategies and will evolve over time in line with the experience acquired by the operational units. The CPSD strategy will be reviewed by the PSCC as will the overall implementation of the various initiatives cited in the private sector development matrix, which will serve as the guide for the review process and will be updated as needed (see Annex). The matrix offers a comprehensive approach to coordinating the many actions in the IDB Group in a manner aligned with the action areas identified in the strategy: (i) country focus, (ii) coordination and joint action of the IDB Group, (iii) broadening the scope of action, and (iv) strategic partnerships. The specific outputs listed in the action areas will give support to the long-term, broader strategic directions identified for the

IDB Group, which, in turn, are based on the strategy's assessment of the current trends and characteristics of the private sector in the region.

- 8.4 **Country Focus:** The CPSD strategies will be developed as part of the regular country programming process and will be an input to the regular programming documents. These inputs will be prepared using available information from the IDB Group, national sources, other bilateral and multilateral sources, as well as new research and information to be gathered as needed. Each CPSD strategy must be integrated into an overall IDB Group strategy for the country, as it will be supported and support the actions of the public and private sector operations of the IDB Group. In the near term, as a transition to the stage when the new CPSD exercise can be done at the same time as the Country Programming Paper, and while the IDB Group reassesses its operational processes and organizational structure, some private programming exercises may need to be carried out in an isolated but well-coordinated fashion. It is expected that one stand-alone CPSD strategy will be prepared in every region every year, and one more per region, per year, will be prepared as an input to the Country Programming Process.³⁷ It is expected that after three years, all CPSD strategies will be highlighted in the Bank's Country Strategy, and the Country Policy Dialogue documents that are the central elements of IDB Group coordination with borrowing member governments. These actions will be reviewed by the PSCC and coordinated with other IDB Group-wide initiatives that may arise, such as the Business Climate Initiative, whose studies and those of other institutions are expected to be a vital input for the CPSD strategies. Also, given that some of the aspects of private sector development, in particular direct lending operations, are not amenable to programming at discrete time intervals, they will have to be undertaken in a more flexible, continuous process of programming within the framework set by the CPSD strategy.
- 8.5 Furthermore, the private sector's involvement in the programming process may introduce changes in the current process that deal mainly with the public sector and will have to be consulted with the respective governments and coordinated with other Donors. The Country Offices will have an important role to play in this process, particularly in cultivating the IDB Group relationships with the private sector and increased responsibilities for project supervision, which may require strengthening their capabilities.
- 8.6 **Coordination and Joint Action for the IDB Group:** Under the current institutional and organization setting, the PSCC will be the focal point for following-up on the implementation and overall success of the private sector development strategy. In order for coordination and joint action to work better, each of the relevant departments and private sector entities will assign one professional to oversee the implementation of its respective responsibilities under the strategy. Particular attention will be devoted to coordination between the private and public sector units of the members of the IDB Group. Each Country Office will also nominate one professional to be the private sector

³⁷ The actual number of strategies per region could vary depending on the numbers of countries in the region.

development specialist in charge of interacting with all departments and organizational units on private sector issues. This network of staff will form a cross-departmental team that is the core of the coordination effort. In addition, the PSCC will be given authority for reviewing individual country private sector strategic input to the programming process, which will lay out the specific actions to be carried out in each country.

- 8.7 Furthermore, project teams working on private sector initiatives and projects will continue to seek inputs from non-departmental staff to ensure an effective exchange of knowledge and experience, while mechanisms to encourage participation in joint project teams and other collaborative activities will be examined and implemented by Management. Among these initiatives will be a review of the additionality and development impact criteria used in private sector activities among the various members of the IDB Group. Also, a review will be made of the incentives and organizational changes needed for staff to carry out joint activities. Management will report on these activities as outlined in the private sector development matrix (see Annex).
- 8.8 **Broadening the Scope of Action:** The steps necessary to widen the areas of activity may require a further review of eligibility requirements and existing instruments to assess their adequacy. As a first step, the private sector development strategy advises moving forward with a proposal to broaden sector eligibility criteria for private sector operations. Given the renewed focus on SMEs, the IDB Group should also examine all its instruments, including grants, technical assistance, guarantees, and credit and investment facilities, to identify potential synergies and complementarities in their use across organizational units. Pilot projects that take advantage of these synergies will be designed with multidisciplinary teams in the 2004-2005 period. From their initial design, these projects will focus on how to mainstream these activities in IDB Group operations.
- 8.9 Finally, the IDB Group will evaluate existing best practices for corporate governance and social responsibility for private sector activities and promote them in its operations.³⁸ This approach will also include an examination of IDB Group practices in its own operational activities that engage private sector providers, such as its procurement procedures. To help mitigate risk, the IDB Group can lead by example on issues of corporate governance. Firstly, the private sector lending units will continue to promote good corporate governance standards and good practices for social and environmental responsibility as part of any transaction and/or partnerships with private firms. Secondly, procurement procedures and policies of the IDB Group should promote responsible behavior and preclude purchases, both on account of IDB Group financed projects and

³⁸ This can be done in line with the practices of other comparator institutions. For instance, the IFC has issued the Equator Principles on social and environmental issues to be considered in project finance, that, as of September 2003, have been adopted by over 16 international banks accounting for 70 percent of project finance lending. See Equator Principles, International Finance Corporation, 2003. www.ifc.org/equatorprinciples.

for its own account, from firms that are deemed to engage in irresponsible behavior (the actual determination to be detailed in the procurement policies of the IDB Group).³⁹

- 8.10 **Strategic Partnerships:** In light of the potential for productive partnerships with the private sector, the IDB Group will examine two main areas: (i) the use of public-private partnerships in the provision of services in projects and programs, and (ii) building policy dialogue with the private sector to promote important items in the development agenda of the IDB Group and its borrowing member countries. The IDB Group will prepare guidelines on these types of interactions that identify the types of partnerships and establish safeguards to address the inherent risks associated with private sector operations.
- 8.11 During the next seven years, the IDB Group will endeavor to carry out joint private-public policy dialogues in at least three countries every year and to establish or strengthen private sector advisory councils in at least three new countries every year. These councils will make every effort to have at least one meeting every year and support the development of policies, strategies and products of the Bank Group. These activities will be closely coordinated with other activities involving public-private policy dialogues with the government, private sector and other actors. Furthermore, a biannual event of consultation at an international level will be carried out in the fringes of the Annual Meeting of the Bank and the Corporation.
- 8.12 To follow up on these activities the IDB Group will prepare a Private Sector Partnership Report that will highlight the type and nature of the interactions with the private sector, lessons learned and good practices, and measure their effectiveness in achieving developmental goals and additionality.

b. Monitoring and Evaluation

- 8.13 The monitoring and evaluation of the implementation of the private sector development strategy should assess several aspects. At the narrowest level, evaluation and monitoring must ascertain how and to what extent the *outputs* proposed have been undertaken and are consistent with the action areas of the strategy. At the level of *results*, the evaluation should determine whether these individual activities, policies, projects, programs or institutional changes have achieved the strategic directions put forth by the strategy. Finally, at the broadest level, there should be measurement of the overall *effectiveness* of IDB Group interventions in supporting private sector-led development in the region. This latter measurement is the most difficult to assess accurately because multiple factors contribute to private sector development, many of which are independent of IDB Group actions. In addition there are long lags before the impacts of action appear in measurable indicators. As such, the time required for broader changes to become apparent must be

³⁹ These procedures and policies will take into consideration those that are already in place in comparator organizations (like the World Bank and the Asian Development Bank) as a result of the efforts of the multilateral development institutions task force on harmonization of procurement procedures, in particular on environmental and socially responsible procurement (ESRP).

taken into account in the evaluation. A full evaluation of the strategy implementation will be carried out five years after its approval.

- 8.14 **Strategic Directions:** The overall strategic directions proposed in the strategy are not amenable to easy measurement as individual, specific outputs; instead, they can be assessed by two main approaches—quantitative measures and surveys. For example, leveraging developmental impact can be assessed with data on the portfolio of IDB Group lending, on the scale of firms, the level of income the beneficiary countries and whether or not additional resources were attracted. Direct financing of private sector projects can be evaluated based on a comparison of baseline information from earlier years in terms of the volume, sector coverage, and types of instruments.
- 8.15 Perhaps the most difficult strategic directions to assess will be “the enabling environment” and “engaging the private sector in dialogue and action.” For these areas, regular surveys and qualitative assessments should be carried out. The Bank should select indicators based on their relationship to the specific strategic direction identified in this strategy. These measures can include data from surveys of stakeholders and beneficiaries in IDB Group-led activities, as well as more general information from various surveys on business climate. The most well-known of these surveys are the World Economic Forum indices of growth and competitiveness, although many other surveys also exist that examine: (i) costs of specific business transactions, (ii) quality, coverage and cost of infrastructure services, (iii) effectiveness of public sector institutions, and (iv) access to and use of technology, among a host of other issues.⁴⁰ While the advantages of these systems are their broad coverage, which allows comparisons with countries from outside the region (providing a basis for international benchmarking), they are aggregate measures. As such, it is not realistic to attribute changes in the indicators directly to the private sector activities of the IDB Group. Yet these measures can still provide an indication of the trends and levels in the critical variables.
- 8.16 **Action Areas and Outputs:** The Action Areas of the PSD Strategy can be assessed both by the completion of outputs cited in the PSD Matrix (included as an Annex to this document), as well as by other ongoing efforts of the IDB Group. Each output of the PSD Matrix will require different tools and level of detail in its evaluation. The central output will be the CPSD Strategies, which are intended to reinforce the country focus of IDB Group actions. The CPSD Strategy can be assessed in terms of the number prepared, the quality of the reports, and their timely integration into the Country Programming process. Furthermore, the CPSD Strategies are expected to serve as a vehicle for joint action within the IDB Group and dialogue and consensus building at the country level. Therefore, the preparation process for the CPSD Strategy should be examined along with the coordination with other donors and the status of its proposed outputs and activities. At the broader level of strategic directions, the CPSD Strategies should improve the enabling

⁴⁰ The Global Competitiveness Report currently covers 21 countries in the region, and the following areas of economic performance: i) general indicators; ii) macroeconomic environment; iii) technological innovation and dissemination; iv) information and communication technologies; v) general infrastructure; vi) public institutions (contracts and laws); vii) domestic competition; viii) development of clusters; ix) corporate strategies and operations; and x) environmental policy.

environment, bring focus to direct support to private sector projects, and help engage the private sector in dialogue and action.

- 8.17 Other outputs of the PSD Matrix are more likely to be measured simply in terms of the process and the resulting product, and not as much for their impact on the broader strategic directions. For example, the assignment of staff as liaisons on private sector development issues can be easily quantified and its impact on internal coordination and joint action can be assessed; however, their impacts on the broader strategic areas are more indirect and harder to measure. Similarly, although strategic partnerships can be reported and their objectives assessed and evaluated, their correlation with changes in the enabling environment are less robust.
- 8.18 Finally, the IDB Group can measure and monitor its other financial and non-financial activities that back the strategy's action areas. These include conferences and seminars, best practice publications and research, lending and investment products, and organizational changes that improve joint action and coordination, among others. The IDB Group can track these efforts as part of its continuing effort to assess the extent to which the strategic directions of the private sector development strategy guide the use of resources in operational and non-operational activities.

IX. Risks in Implementation,

- 9.1 Working with the private sector has benefits, as well as risks in different forms, such as program, credit, political, social and environmental and risk derived from corporate behavior, that may introduce obstacles for the effective implementation of the strategy.
- 9.2 There are different ways through which these risks can be mitigated. First of all, the preparation and regular review of Country Strategies and Private Sector Strategies should ensure that the IDB Group's programming is balanced and structured within a framework of sound public governance. As well, IDB Group actions should directly promote an enabling environment that provides a legal and regulatory environment that supports competitiveness, a transparent financial system, and a legal system that enables contracts to be honored.
- 9.3 Second, the IDB Group may increase its exposure to credit risk not only from transactions with firms and projects, but also with governments. Situations with high levels of debt service payments, whether these are public or private, will need to be carefully monitored and analyzed to enhance the ability to pay. The IDB Group must therefore continue to ensure the adequate mitigation of risks in its portfolio through appropriate diversification, maintenance of high asset quality and performance, among other measures. The recently established office of Private Sector Credit Risk Assessment has a critical role to play with regard to mitigation of the credit risk incurred in private sector operations.
- 9.4 Thirdly, in direct financing to the private sector, there is the expectation that the IDB Group will help to mitigate the political risk, either through explicit guarantees or through

the umbrella provided by its participation in financing. As all private projects are subject to risks derived from Government actions or inactions, governments that are shareholders and sometimes borrowers of the members of the IDB Group, this financing may expose the members to conflicting interests when disputes arise between private sector borrowers and Governments. The selection and structuring of private finance projects should carefully consider this potential and include the measures to mitigate the potential conflict of interest.

- 9.5 Fourth, the observance of appropriate safeguards will help mitigate the environmental and social risks in implementing projects undertaken under the umbrella of the Private Sector Development Strategy. The IDB Group should consolidate the set of social and environmental safeguards, in line with international best practice and IDB environmental, safeguard and social policies and make sure projects comply with these safeguards and policies.
- 9.6 Fifth, in order to mitigate the risks of irresponsible behavior, projects should comply with internationally accepted norms and expectations of behavior. To this end, guidelines for project teams on corporate governance and corporate social responsibility are needed to ensure the promotion of these issues across the various windows of IDB Group activity. Furthermore, as the development of the private sector is also served by their participation in public sector projects, some of which are financed by the Bank, the Bank Group must ensure that it promotes responsible firm behavior in its procurement policies.
- 9.7 The programming and project preparation and review processes will have to consider these risks and include the proper mitigants to minimize their potentially negative impact, whenever possible. This will be particularly important as the eligible sectors are expanded and new risks are faced.

X. Follow-up and Accountability

- 10.1 This Private Sector Development Strategy is designed to guide the activities of the members of the Bank Group over the next several years. It is an overarching strategy for the Group and cannot substitute for the more specific strategies of its members. Nevertheless, for each of the members to prepare its own individual strategies, there is a need for a common denominator and common strategic direction. This strategy should facilitate and ensure that the individual strategies are compatible and all follow the same objectives, to maximize the joint impact of the separate interventions.
- 10.2 Furthermore, this strategy is being developed at a moment when all its members are undertaking reviews. The MIF is in a replenishment exercise with a review of its strategic framework, PRI and the IIC are searching for ways to enhance their efficiency and effectiveness and the IDB Group as a whole is in the process of examining better ways to increase the synergy of its parts working together. By virtue of its nature as an overarching Group Strategy, this document cannot be very explicit on individual actions.

- 10.3 Even though the strategy has been prepared to be as resistant as possible to changes, it is envisaged that as decisions are reached, this document may have to be revised, particularly if the decisions imply major organizational changes. In the meantime, it is expected that each of the members will endorse this strategy and prepare its own strategies or business plans, to implement and complement this overarching strategy and to comply with overall goals and mandates⁴¹. Also, as these decisions are made it will be possible to allocate responsibilities and assign tasks between the different members to achieve maximum impact.
- 10.4 The responsibility for the implementation of the strategy rests with the management of the individual members, unless some other organizational arrangements are decided as part of the review process mentioned above.

⁴¹ The most recent mandate emanating from the extraordinary Summit of the Americas is the tripling of lending, through the financial system, for SMEs. Another relevant mandate is the applicable parts of the Millennium Development Goals.

Annotated Bibliography

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This report presents the Bank's strategy for supporting the development of small and medium enterprise in Latin America and the Caribbean. Most countries in the region are undergoing reforms that are opening their economies to greater international competition. However, domestic factor markets are not adequately developed to ensure the successful adaptation of SMEs to this new competitive environment. Unlike larger firms, which can more easily absorb the transaction costs, SMEs are at a disadvantage and require specific compensatory assistance.

Inter-American Development Bank, 1997, *Microenterprise Development Strategy* (GN-1938-3), Washington, DC

This document puts forward the rationale, objective and main components of the Bank's microenterprise strategy. It outlines the problems that the Bank is seeking to address, the strategic directions for Bank investment and other activities in the sector, and presents a concrete program of action to carry out the strategy over the next five years.

Inter-American Development Bank. 1997. *Capital Market Development Strategy* (GN-1870-2), Washington, DC

While acknowledging that domestic financial systems differ greatly within the region, the Bank's capital market strategy recognizes that there are common themes and challenges. The document proposes that the Bank adopt a dedicated capital market strategy aimed at (a) raising the level of savings and improving its composition; (b) enhancing the economic efficiency of capital markets, and (c) promoting the harmonization and integration of the region's capital markets.

Inter-American Development Bank, 1999, *Financial Market Strategy* (GN-1948-3), Washington, DC

The document proposes that primary emphasis continue to be placed on the banking system; due to its critical role in facilitating payments, providing liquidity and credit, and in the transmission of monetary policy, the banking system will continue to be the backbone of the financial sector. Nevertheless, increasing attention must also be placed on the development of capital markets and risk management systems to support financing needs where bank loans and guarantees are not appropriate.

Inter-American Development Bank. 2003. *IDB Group Activities Supporting Micoenterprises (1990-2002)*. Sustainable Development Department. Washington, DC.

Inter-American Development Bank. 2003. *Apoyo a la Pequeña y Mediana Empresa (1990-2002)*. Sustainable Development Department. Washington, DC.

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Inter-American Development Bank. 2003. *IDB Group Support for Financial Markets (1990-2002)*. Sustainable Development Department. Washington, DC

Series of four volumes describing the activities and strategies of the IDB Group in support of the private sector.

Inter-American Development Bank. 2002. *Competitiveness: The Business of Growth, Social and Economic Progress in Latin America and the Caribbean, 2002 Report*.

“Analyzes how Latin American and Caribbean countries use factors of production (credit, labor, infrastructure and new technologies) and finds serious deficiencies and baffling paradoxes. For instance, the report notes that as a consequence of the paucity of credit and the deficit in key infrastructure sectors such as transportation, energy and telecommunications, Latin America’s largest firms are much smaller than their counterparts in industrialized nations and Southeast Asia. Their stunted growth limits the number of jobs they can create, an effect that is amplified at the level of small- and medium-size enterprises, which have even less access to loans and face greater obstacles in coping with inefficient ports, unreliable electricity suppliers, and unresponsive telecommunications systems.”

Inter-American Development Bank. 2002. *The Challenge of Being Relevant: The Future Role of the IDB*. Report of the External Advisory Group (EAG) CA-446. Washington, DC

Includes the findings and recommendations of the External Advisory Group (EAG) with the purpose of assisting the Board of Governors in preparing for the meeting scheduled in Fortaleza. This document is the result of an extensive nine-month effort to reflect on the future role of the IDB vis-à-vis the Region’s evolving needs and a changing international environment.

Inter-American Development Bank. 2002. *Development Effectiveness Report*. Office of Evaluation and Oversight, OVE, RE-260. Washington, DC.

This report looks at the historic evolution of the concept of development, and of the instruments seen as most effective at promoting it, including the empirical evidence regarding development results in the region associated with IDB interventions. It also examines the extent to which IDB interventions are designed to demonstrate results.

Finally, it offers some suggestions for improving the design, monitoring and evaluation of Bank interventions to sharpen the focus on results.

Inter-American Development Bank. 2002. *Guía operativa para programas de competitividad para la pequeña y mediana empresa*. Washington, DC.

Guidelines to assist project teams in the preparation of competitiveness projects for SMEs

Inter-American Development Bank, 2003, *Strategy for Poverty Reduction and Promotion of Equity* (GN-1894-7), Washington, DC

Offers a multi-faceted view of poverty that includes various interrelated aspects: a level of income and assets insufficient to cover basic needs; inability to avoid and confront adverse events that affect income or assets; low level of human capital; high level of vulnerability and exposure to social problems; and restrictions on political and social participation under equal conditions.

Inter-American Development Bank, 2003, *Sustainable Economic Growth Strategy* (GN-2227-1), Washington, DC

Presents multi-dimensional lines of action to facilitate growth rates of income and per capita GDP under conditions that lead to an improvement in the population's quality of life, a reduction in poverty, and the preservation or improvement of the natural resource base.

Inter-American Development Bank, 2003, *Competitiveness: A Strategy Document*, Washington D.C.

Elaboration of a renewed strategic framework for improving competitiveness in Latin American Countries.

Inter-American Development Bank. 2003. IIC External Review Group. Report to the Board of Executive Directors. *IDB Group: Toward a realignment of private sector activities in support of Latin America and the Caribbean*. Corrected version, CII/GN-180-7. Washington, DC.

Report prepared by the External Review Group to consider the future strategic direction and development of the Corporation, as well as the overall approach of the Bank Group to the private sector in Latin America and the Caribbean

Inter-American Development Bank. *Good Jobs Wanted*, Social and Economic Progress in Latin America and the Caribbean, 2004 Report.

Critical analysis by way of a rigorous examination of the functioning of labor markets over the past decade, and the ways and extent to which they have been affected by macro and socio-economic conditions. Topics of the Report include the employer-worker dynamic, the new profile of the supply of labor, the impact of structural reforms, and the

role of technology and institutions. The Report provides a clear and precise diagnosis of the problems at hand—a critical step toward prescribing the most effective solutions.

Multilateral Investment Fund. 2000. *Report of the Working Group on MIF Strategy* MIF/GN-56. Washington, DC

This report established the strategic priorities for MIF projects, focusing on four areas of activity: Microenterprise, Small Business, Financial Sector and Market Functioning. It also recommended new procedures to increase the efficiency of MIF project identification, preparation and implementation.

World Bank Group References

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Batra, Geeta, Daniel Kaufmann and Andrew H.W. Stone. 2003. *Investment Climate Around the World: Voices of the Firms from the World Business Environment Survey*. World Bank, Washington DC.

A book describing the results of a comprehensive survey (over 10,000 firms in 80 countries) on the impact of the investment climate on firm performance. "Econometric analysis of responses to the survey point to a strong association between corruption, financing, regulatory and tax constraints, policy uncertainty and protection of intellectual property rights with firm-level performance"

Batra, Geeta, and Syed Mahmood. 2001. *Direct Support to Private Firms: Evidence on Effectiveness*. Washington D.C.: Private Sector Advisory Services, World Bank.

Programs involving direct support to private firms in developing countries, are in many ways similar to the activities of venture capitalists. Thus, it is not surprising that the record of public support to private firms in developing countries has been mixed with many projects demonstrating poor returns.

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Biddle, Jesse, and Andrew Stone. 2001. "Using Business-Government Consultation to Promote Market-Oriented Reforms: When and How." *Background note for PSAS Clinic, When and How to Use Business-Government Consultation to Promote Market-Oriented Reforms, February 1, 2001*. Washington D.C.: Private Sector Advisory Services, World Bank.

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How more effective aid can make an important contribution to greater poverty reduction in laggard regions.

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Documentation of income distribution and living standards in Latin America, how the pattern may have changed during 1990s, and consideration of options available to policy makers to redress the inequalities existing in their countries.

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Holden, Paul and Sarath Rajapatirana, 1995, *Unshackling the Private Sector, a Latin American Story*. World Bank, Washington, DC.

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A book resulting from the background papers commissioned for the World Bank's Private Sector Development Strategy discusses "the design of public policy that promotes an appropriate balance between competition and regulation. It places special emphasis on the means by which private initiative is channeled into socially useful directions, particularly job creation and basic service delivery for poor people".

Martinez Peria, Maria Soledad, and Ashoka Mody, 2004. *How Foreign Participation and Market Concentration Impact Bank Spreads: Evidence from Latin America*. World Bank, Washington D.C.

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Pfefferman, Guy P. 2000. *Paths Out of Poverty: The Role of Private Enterprise in Developing Countries*. Washington D.C.: International Finance Corporation.

Competition, deregulation, liberalization, and open trade all work to weaken the nexus of privilege and cozy arrangements that perpetuate poverty in many countries. To curb poverty, private enterprise also requires the proper support from the state. Private enterprise and the state interact in a myriad of ways that do not lend themselves to simple generalizations.

Ravallion Martin and Shaohua Chen. 2001. *Measuring Pro-Poor Growth*. World Bank, Washington, DC.

“A better measure of “pro-poor growth” is the mean growth rate of the poor, which is consistent with a theoretically defensible measure of the level of poverty, namely the Watts index. The proposed measure of pro-poor growth can be readily derived from a “growth incidence curve” giving rates of growth by quartiles of the distribution of income.”

Shirley, Mary. 2003. *Why is Sector Reform so Unpopular in Latin America?*, Draft prepared for Conference on Sector Reform.

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World Bank. 2003. *Doing Business in 2004: Understanding Regulation*. Washington, DC.

".....the first in a series of annual reports investigating the scope and manner of regulations that enhance business activity and those that constraint it. New quantitative indicators on business regulation and their enforcement can be compared across more than 130 countries, and over time".

World Development Report 2004: Making Services Work For Poor People. World Bank, Washington D.C.

Investigation of how countries can accelerate progress towards the Millennium Development Goals by making services work for the poor.

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AusAid. 2000. *Private Sector Development Through Australia’s Aid Program*. Canberra, Australia: Australian Agency for International Development.

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Besley, H, and R. Burgess. 2003. *Halving Global Poverty*. Journal of Economic Perspectives 17:3: 3-22.

“This paper builds an agenda for confronting global poverty. It emphasizes that, even though much remains to be done, the evidence base for assessing intervention is at an all time high. Economics offers the means of moving beyond the consensus embodied in the Millennium Goals to generate concrete and effective pathways to poverty reduction”

Bigsten, Arne and Jorgen Levin. 2001. *Growth, Income Distribution and Poverty*, Scandinavian Working Papers in Economics, Goteborg University, Sweden.

“This paper reviews the recent literature dealing with the relationships between economic growth, income distribution, and poverty. It generally fails to find any systematic pattern of change in income distribution during recent decades. Neither does it find any systematic link from fast growth to increasing inequality. Some recent empirical evidence has tended to confirm the negative impact of inequality on growth, on the other hand.”

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“Countries with heavier regulation of entry have higher corruption and larger unofficial economies, but not better quality of public or private goods. Countries with more democratic and limited governments have lighter regulation of entry.”

European Commission. 2000. *European SME Observatory, Sixth Report, [Office for Official Publications of the European Communities](#)*, Luxembourg, 2000.

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Uses estimates derived from tax data to estimate the size of informal sectors in countries around the world

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Annual survey of competitiveness indicators for over 100 countries.

Annex

Private Sector Development Strategy Matrix of Action Areas

Action Areas	Goal	Output/Indicators
1. COUNTRY FOCUS	<i>Effective policies, programs and project tailored to local conditions in an integrated fashion</i>	<ul style="list-style-type: none"> 1.1 CPSD Strategies in 2 countries per region per year 1.2 Strengthened Country Offices
2. Coordination and Joint Action for IDB Group	<i>IDB Group will favor sustained interventions that are coordinated among its various organizational units</i>	<ul style="list-style-type: none"> 1.1 Strengthened PSCC 1.2 Private sector liaisons appointed 1.3 Study on incentives for joint, collaborative actions by project staff 1.4 Report consolidating <i>additionality</i> and <i>developmental impact</i> for IDB Group.
3. Broadening the Scope of Action	<i>The IDB Group should be empowered to work in all sectors of private activity with its lending, investment and technical assistance. Individual transactions will be carried out by the unit or units of the IDB Group which have the greatest comparative advantage, while procedures will be streamlined with due consideration to issues of confidentiality involving the private sector</i>	<ul style="list-style-type: none"> 1.1 Document on sector eligibility for private sector operations 1.2 Guidelines for project teams to promote the adoption of best practices in corporate governance and social responsibility for private sector activity. 1.3 Review of the procurement policies and procedures of the Bank to ensure development of responsible private firms
4. Strategic Partnerships	<i>Financial and non-financial instruments to leverage private and public sector resources in a manner that is consistent with its goals and mandates as a multilateral institution</i>	<ul style="list-style-type: none"> 1.1 Guidelines for project teams on strategic partnerships with private sector. 1.2 Private Sector Advisory Councils set up or strengthened in 3 countries per year, with at least 1 meeting each per year. 1.3 Biannual international consultation meeting 1.4 Report on Partnerships and their effectiveness