
Support to SMEs and Financial Access/Supervision Sector Framework Document

CAPITAL MARKETS AND FINANCIAL INSTITUTIONS DIVISION,
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SUPPORT TO SMES AND FINANCIAL ACCESS/SUPERVISION SECTOR FRAMEWORK DOCUMENT

CAPITAL MARKETS AND FINANCIAL INSTITUTIONS DIVISION

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ABBREVIATIONS

ALIDE	Asociación Latinoamericana de Instituciones Financieras para el Desarrollo [Latin American Association of Development Finance Institutions]
BNDES	Brazil's National Economic and Social Development Bank
BIS	Bank for International Settlements
CAF	Andean Development Corporation
CMF	Capital Markets and Financial Institutions Division
DEM	Development Effectiveness Matrix
EBRD	European Bank for Reconstruction and Development
ECLAC	Economic Commission for Latin America and the Caribbean
EIU	Economist Intelligence Unit
ESCO	Energy service company
FATF	Financial Action Task Force
FELABAN	Federación Latinoamericana de Bancos [Latin American Federation of Banks]
FOGAPE	Fondo de Garantías para Pequeños Empresarios [Guarantee Fund for Small Business Owners]
IAIS	International Association of Insurance Supervisors
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LAC	Latin America and the Caribbean
MIF	Multilateral Investment Fund
MILA	Mercado Integrado Latinoamericano [Latin American Integrated Market]
NSG	Non-sovereign guaranteed
OECD	Organization for Economic Cooperation and Development
OMJ	Opportunities for the Majority Sector
OVE	Office of Evaluation and Oversight
PCR	Project completion report
PDB	Public development bank
PDFPs	Productive-development financing policies
PPP	Public-private partnerships
SCF	Structured and Corporate Financing Department
SFD	Sector Framework Document
SG	Sovereign guaranteed
SMEs	Small and medium-sized enterprises
TFP	Total factor productivity
TREFI	The Receivable Finance Infrastructure
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
WBES	World Business Environment Survey

I. ACCESS TO FINANCE IN THE CONTEXT OF THE BANK'S SECTOR AND INSTITUTIONAL STRATEGIES

A. The Support to SMEs and Financial Access/Supervision Sector Framework Document in the context of the sector strategies in force

- 1.1 This Sector Framework Document (SFD) has been prepared in accordance with the Strategies, Policies, Sector Frameworks and Guidelines at the IDB (document GN-2670-1), in order to set out the Bank's targets for the Support to SMEs and Financial Access/Supervision sector (hereinafter, "the sector") and to guide its work on operations, dialogue, and knowledge generation with countries, their governments, and private borrowers. This Support to SMEs and Financial Access/Supervision SFD covers the seven elements to be included in sector frameworks. Once approved, the sector strategies on: (i) Development of Capital Markets in Latin America and the Caribbean; (ii) Business Development; (iii) Financial Markets; and (iv) Microenterprise Development will cease to be in effect, as will the Subloan Interest Rates Sector Policy (operational policy OP-709), as stipulated in document GN-2670. The content of the latter Policy (OP-709) that is considered relevant was incorporated into the present document.
- 1.2 The Bank will prepare an update to this SFD three years after its approval. This is a flexible document that will enable the Bank to address the diversity of challenges and contexts faced by the 26 borrowing member countries, and it will govern the Bank's financing for operations with and without sovereign guarantee in the sector. This SFD is also adaptable to each country's specific conditions and preferences as regards the design and implementation of projects in the sector.

B. The Support to SMEs and Financial Access/Supervision Sector Framework Document as part of the Sector Strategy on Institutions for Growth and Social Welfare

- 1.3 This SFD is consistent with the "Sector Strategy on Institutions for Growth and Social Welfare" (document GN-2587-2), the scope of which includes enhancing small and medium-sized enterprises' (SMEs) productivity and growth by taking a holistic approach to supporting SME development from both the supply of financing and helping transform SMEs into creditworthy and competitive businesses. This strategy considered limited access to finance to be one of the key factors constraining productivity and growth in the private sector in the region, affecting SMEs in particular. To overcome this limitation, the need has been identified for the Bank to support countries in the region in constructing well regulated and supervised financial systems that: (i) increase resilience to internal and external shocks; (ii) reduce information asymmetries; and (iii) expand the credit frontier. In turn, this strategy stressed the importance of the Bank's combining this support with targeted interventions, using instruments tailored to the situation in question, so as to enhance productive SMEs' access to finance.

- 1.4 This SFD also dovetails with a number of other strategies, namely the Sector Strategy to Support Competitive Global and Regional Integration (document GN-2565-4), by fostering closer integration of the productive sector in Latin American and Caribbean (LAC) countries into the global economy. Additionally, it ties in with the Strategy for Sustainable Infrastructure for Competitiveness and Inclusive Growth (document GN-2710-5), by helping create a favorable institutional context for infrastructure investments and private sector participation; and with the Integrated Strategy for Climate Change Adaptation and Mitigation, and Sustainable and Renewable Energy (document GN-2609-1), by supporting institutional capacity building, and providing technical and financial support to countries in the region to address the risks arising from climate change and, where possible, mitigate its causes. Given that access to finance cuts across several sectors, this SFD refers to topics that involve the agriculture, trade, labor, innovation, transport, energy, and climate change sectors, which are dealt with in more detail in the respective SFDs already approved (operational policies OP-2001, OP-2003, OP-2006, and OP-2007) or due to be completed by 2015, so as to ensure the consistency of all Bank interventions in the various sectors. During SFD implementation, the Bank will seek to adapt interventions to each country's specific needs and demands, and to the features of each client, bearing in mind the region's geographical, social, and cultural diversity. This SFD is therefore strategic and indicative rather than restrictive, while the specific features of interventions in each country will build on the respective Sector Notes and Country Strategies, pursuant to country demand.
- 1.5 This SFD establishes that the Bank's activities will aim to boost productivity in LAC economies by facilitating their productive sectors' access to finance.¹ To this end, it will seek to: (i) expand the frontier of finance for the productive sector; (ii) develop capital markets and risk management instruments; and (iii) implement and strengthen rules and institutions for the effective management of macrofinancial risks. The operational policies and instruments to achieve this target are discussed in this document. Part of the methodological principles applied here is a holistic approach to the problem of SMEs' access to finance. This approach is based on the premise that SMEs exist in a wider context of productive relationships, and there is a two-way relationship between SMEs' productive development and the productive environment in which they operate (OECD/ECLAC, 2013). This leads to the conclusion that in order to understand the dynamics of SMEs an analysis and review of policy measures affecting the productive sector's access to finance as a whole is the best starting point. It is also important to highlight that while SMEs account for a significant share of employment in LAC economies, the

¹ This document is centered on financing for the development of the productive sector. The productive sector is understood to mean all ventures that produce goods and services and whose decisions generally reflect private interests. In particular, consistent with the Strategies, Policies, Sector Frameworks, and Guidelines at the IDB (document GN-2670-1, Annex II), this SFD limits itself to issues of SME productivity and, more specifically, the obstacles they face to accessing finance, together with financial supervision issues. In parallel, through various units, the Bank is working on other financial issues, including financial inclusion.

approach in this SFD focuses on their contribution to the economy's aggregate productivity. A further methodological principle applied here is that the proposed operational activities will be based on an analysis of the latest global evidence, where this is adapted to the relevant local conditions in each of the region's countries.

- 1.6 The following section sets out the findings of international studies on the efficiency of policies and programs in the sector. Section three identifies the sector's development in the region and the challenges it faces according to the latest research. Section four analyzes lessons arising from the Bank's work in the sector, based on the recommendations of the Office of Evaluation and Oversight (OVE), Development Evaluation Matrices (DEM), and project completion reports (PCRs). The Bank's comparative advantages in the sector are also identified. Section five defines the principles of action that guide the Bank and its client countries towards achieving the sector's proposed target for the next three years.

II. INTERNATIONAL EVIDENCE ON THE EFFECTIVENESS OF POLICIES AND PROGRAMS IN THE SECTOR AND IMPLICATIONS FOR THE IDB'S WORK

A. Productivity is a key determinant of economic growth and welfare

- 2.1 According to the existing literature, the differences in levels of economic growth between countries and regions are primarily due to productivity (Solow, 1957).^{2,3} Productivity is a measure of the efficiency with which inputs are used to obtain a given set of outputs. In economies at their productivity frontier, resources are allocated to the most productive sectors (allocative efficiency) and, within those sectors, to the most productive enterprises (productive efficiency).⁴ At the aggregate level, more efficient transformation of factors of production allows economic

² There is a broad consensus that differences between countries in terms of per capita income cannot be entirely explained by differences in factor accumulation, but that total factor productivity also plays an important role (IDB, 2014; Jones and Romer, 2010; Easterly and Levine, 2002; Klenow and Rodriguez-Clare, 1997).

³ For example, Ruprah et al. (2014) show that declining total factor productivity largely explains the per capita gross domestic product (GDP) gap between Caribbean countries.

⁴ Conceptually, in an economy operating at its production possibility frontier, productive resources are allocated efficiently, in that it is not possible to reallocate productive factors or methods to increase output in one sector without reducing it in another. This situation of allocative efficiency implies—in the presence of a diversity of companies—that resources are also distributed efficiently between companies (productive efficiency) (Syverson, 2011).

activity to expand.⁵ In turn, these gains are distributed to economic players and, with better income distribution conditions, also reach the population through higher income levels (UNIDO, 2007). Productivity therefore plays a key role not just in economic growth, but above all, in welfare.⁶ Indeed, in contexts where there are better income distribution conditions, the higher levels of per capita income resulting from economic growth will enable access to better standards of nutrition, health, housing, etc. contributing to reducing levels of poverty and extreme poverty (IDB, 2010).

- 2.2 There is a broad set of factors that determine an economy's productivity. These include: (i) the human capital's level and quality of education and training; (ii) the functioning of labor markets; (iii) the capacity to generate, transmit, and absorb knowledge;⁷ (iv) the institutional context in which economic agents operate; (iv) the scope and quality of infrastructure (energy, transportation, logistics, telecommunications, etc.); and (v) fiscal policy (IMF, 2013b; IDB, 2010). This document focuses on the role of access to finance as one of the key determinants of the allocation and efficiency of factors of production in the economy (see Figure 1) and, therefore, of increased productivity.⁸

⁵ The empirical evidence shows that: (i) in contrast to other regions, over the last three decades per capita GDP in LAC countries has not converged with that of the most advanced countries due to stagnant productivity growth (IDB, 2014; Daude and Fernandez Arias, 2010); and (ii) this stagnation is the result of negative structural change, as factors of production have moved towards sectors with lower marginal productivity and increased informality (MacMillan and Rodrik, 2012), on top of an innovation deficit (IDB, 2014; Daude, 2010). In particular, reallocation of resources towards informal sectors has a negative effect, as these companies' marginal productivity is less than that of formal companies (Busso et al., 2012a). Reversing these trends by acting on the determinants of productivity and structural change is therefore fundamental to achieve sustained growth in living standards in the region.

⁶ In line with the international evidence, recent studies by the IDB show that productivity plays a positive role in job creation. For example, Crespi and Zuniga (2012) show that introducing new technologies at the firm level maximizes firms' performance, thus increasing employment. However, it should be noted that although these studies offer evidence of positive effects on jobs, some indicate a slight shift towards jobs requiring higher qualifications (Crespi and Tacsir, 2012).

⁷ Knowledge generation, transmission and adoption is an essential factor in boosting an economy's productivity, as has been widely recognized in international literature (IDB, 2014 and 2010; Syversson, 2011). The relationship between productivity and innovation will be addressed in depth in the Innovation, Science, and Technology SFD that is being prepared. The present SFD shows that access to finance is crucial for the productive sector to have the necessary resources to develop innovation processes and also support new firms and technology-based companies, the operation and survival of which is significantly affected by the lack of access to finance, their higher risk profiles, and uncertainty regarding the techniques used by commercial banks.

⁸ The other factors are addressed in the Agriculture and Natural Resources Management (OP-2001); Education (OP-2002); Integration and Trade (OP-2003); and Labor (2006) Sector Framework Documents, already approved, and the documents pending approval dealing with transportation; innovation, science and technology; environment and biodiversity; and decentralization.

B. Access to finance is crucial to raising productivity levels

- 2.3 The relevance of access to finance and development of financial systems as a key determinant of the productivity dynamic has been widely documented.⁹ The literature offers empirical evidence that: (i) there is a causal relationship between the level of development of the financial system (taking access to finance as its key variable) and economic growth (Beck et al., 2000; Rajan and Zingales, 1998), this being one of the most important variables for economic convergence (Aghion et al., 2005); (ii) development of financial systems has a fundamental impact on total factor productivity (TFP), more than on factor accumulation (Arizala et al., 2013; IDB, 2010); (iii) more developed financial systems facilitate better allocation of capital towards projects with higher returns (Galindo et al., 2007); and (iv) more developed financial systems improve TFP by creating incentives for innovation and research and development (Aghion et al., 2010), facilitating access to markets and to higher value-added segments (Manova and Yu, 2010), and by softening the impact of volatility and macroeconomic shocks¹⁰ (Cavallo et al., 2013; Aghion et al., 2005).
- 2.4 To conclude, the empirical evidence supports the hypothesis that access to finance is a determinant of the productivity dynamic. This takes place through: (i) promoting the efficient allocation of savings to the most productive investments, improving the allocation of factors in the economy; (ii) enabling the financing of companies to allow them to invest in technology, develop research projects and innovation, and access new markets; and (iii) raising the incentives for companies to invest over the long term, grow, formalize, and adopt corporate governance best practices. In effect, a properly working financial system is able to select the potentially most productive projects and firms and redirect the economy's resources towards them, thereby fostering the efficient allocation of these resources.

⁹ For example, in the case of Latin America, Beck et al. (2000) showed that if the region's average financial depth (31%) were to increase to the levels of East Asia (70%), annual productivity growth in the region would increase by one percentage point, reducing the differences in productivity growth between the two regions by 60%. Greenwood et al. (2013) estimated that if the countries of Latin America were to reach Luxembourg's level of financial development, their TFP would increase by 17% and their GDP by 85%. Arizala et al. (2013) found that, depending on industries' financing requirements, annual TFP growth could accelerate by 0.6% if the development of the financial system increased by one standard deviation.

¹⁰ Access to finance during systemic financial crises can be a fundamental factor in firms' survival (Aghion et al., 2005). In less developed financial systems, the lack of information about project quality can cause an inefficient allocation of credit and lead to more productive firms being eliminated to save less productive ones that have better connections to credit markets. Volatility can affect productivity in other ways. For example, offering incentives to investors to adopt "more malleable technologies" that allow them to adapt more readily to frequent and abrupt changes in relative prices, but at the expense of preventing discovery or use of more efficient production methods. This investment allocation effect is stronger in economies with less developed financial markets, as firms have fewer opportunities to diversify risks (Cavallo et al., 2013).

C. Determinants of access to finance

- 2.5 The most important factors determining an economy's access to productive finance include: (i) its productive structure;¹¹ (ii) its institutional and regulatory environment;¹² (iii) levels of certainty¹³ and information asymmetry;¹⁴ and (iv) transaction and scale costs.¹⁵ Combined, these factors cause a series of market failures. The most relevant include: (i) incomplete markets, (ii) externalities and public goods;¹⁶ and (iii) coordination failures and strategic behaviors by agents.¹⁷ How optimal or not the equilibrium reached is will depend on the severity of the market failures.
- 2.6 Suboptimal equilibria usually manifests itself in: (i) inefficient financial sectors that provide little finance to the productive sector or at high cost;¹⁸ (ii) incomplete and underdeveloped capital markets, risk management instruments, and insurance;¹⁹ and (iii) weak macrofinancial institutional, supervisory, and regulatory frameworks.

¹¹ A weak productive structure, biased towards informality and relatively low value added sectors, primarily agriculture and services, and with a relatively high prevalence of micro and small enterprises (Ruprah, et al. 2014; Levy, 2012; Busso et al., 2012b). These characteristics have a negative influence on the financial system's capacity to finance the most productive activities. This is due to the fact that small and informal sectors are less conducive to the generation of accurate, verifiable credit information and generate higher transaction costs for financial intermediaries.

¹² The institutional and regulatory structure in key aspects for productive and financial development is relatively fragile. Despite the gains made in this respect, there is a broad range of possible improvements to the environment in which the financial system operates (IMF, 2012). These include: (i) handling macrofinancial risks, particularly those of a systemic nature; and (ii) guaranteeing efficient property registration and contractual compliance, together with agile and relatively inexpensive access to market competition (Djankov et al., 2008, La Porta et al. 2007).

¹³ Incomplete information can lead to situations in which the risk premiums involved are so high that they exceed the rate of return on projects, and therefore, produce an equilibrium in which these risks are not financed.

¹⁴ Asymmetric information is the basis on which phenomena of moral hazard and adverse selection arise.

¹⁵ Transaction and scale costs underlie the existence of public goods and externalities.

¹⁶ The existence of externalities means certain activities offer an insufficient private return to be financed by the private sector.

¹⁷ Situations in which agents' strategic behavior leads to suboptimal equilibria.

¹⁸ The financial system's essential role in developing economic and productive activities has been noted extensively in economic literature. Schumpeter stated that long-term financing was essential for entrepreneurs to be able to access the physical capital and technology needed for "productive combinations." Along the same lines, Keynes said that entrepreneurs' investment decisions were based on the possibility of accessing sufficient resources in the short term and on the possibility of financing their short-term obligations through long-term issuances with satisfactory conditions (Freitas, 2009).

¹⁹ Incomplete markets are one of the classic causes of inefficient resource allocation.

- 2.7 Suboptimal equilibria arising in the presence of market failures create room for public policy.²⁰ The policies that will be examined below have been widely used to minimize the effects of the factors discussed above and the corresponding market failures in the levels of optimal market equilibria.

D. Policies to promote access to finance: International evidence and experience

- 2.8 The policies implemented around the world to overcome market imperfections and promote access to productive finance can be classed in two main groups: (i) institutional and regulatory reforms for access to finance and to raise productivity; and (ii) productive-development financing policies (PDFPs).
- 2.9 Both groups differ in their degree of transversality and how long it takes for them to take effect. While the institutional reforms are mainly horizontal and can be characterized as public goods,²¹ PDFPs are more vertical, and can be geared towards a particular segment of firms defined by their size (for example, the SME sector), technology, age, sector, gender, or any combination thereof (see Figure 3). For their part, as amply described in the institutional literature, institutional reform takes longer to mature (Rodrik, 2013b; Williamson, 2000). The international evidence on the impact of both sets of policies and the lessons learned that can be used to improve their design and implementation are discussed below.

1. Institutional and regulatory reforms to enhance access to finance and productivity

- 2.10 Institutional and regulatory reforms aiming to improve access to finance can be grouped according to whether their specific objectives are: (i) improving the management of macrofinancial risks; or (ii) improving the functioning of contracts, information, and financial markets to enhance market competition and efficiency and reduce perceived risks of financing.
- 2.11 Reforms to enhance macrofinancial risk management. Macrofinancial instability has serious consequences for credit flows and the ability of firms to finance long-term projects (Aghion et al., 2005). Indeed, episodes of financial instability produce hysteresis in the financial system, and tend to have a lasting effect on how risk is perceived and managed (Bernanke, 1983). Therefore, macrofinancial stability is

²⁰ Specifically referring to the banking system and to financing for productive activities, since commercial banks are subject to market activities, information asymmetry and moral hazard strongly determine the evolution of bank credit and its characteristics. In situations where these factors are greater, credit becomes scarce, expensive, and short-term. Thus, financing for productive activities requires additional financing resources, generally mobilized by the public sector. Accordingly, the existence of special credit systems is a characteristic shared by financial systems in both developed and developing countries (Freitas, 2009).

²¹ Nevertheless, it is to be expected that the lifting of financial restrictions achieved through institutional reform will mostly benefit firms suffering the greatest restrictions on access to finance. The groups of companies in which there are constraints to more efficient use of factors of production due to input and output market restrictions may be of different sizes and in different sectors, although they are mainly upper segment SMEs (medium-sized firms) and firms in the services sector (Busso et al., 2012b).

crucial for the system to have reliable sources of funding and for the business sector to be able to access financing at a reasonable cost and with sufficiently long maturities.²²

- 2.12 The importance of financial reforms for promoting financial stability and productivity growth has been widely reported in the literature.²³ In this regard, the specialist literature highlights the importance of developing integrated macrofinancial and fiscal risk management frameworks (IMF, 2012 and 2013b). Essential elements of this management framework are: (i) consolidating microregulation and implementing macroprudential regulation (compliance with Basel regulatory standards, IOSCO, IAIS); (ii) developing monetary policy instruments, for example for the management and regulation of systemic liquidity risk (BIS, 2010); (iii) improving the counterpart risk management infrastructure (payments systems, settlement and clearing houses, etc.); (iv) regulating the role of new key financial actors such as pension funds and sovereign funds (BBVA, 2014; IDB, 2013b); and (v) establishing integrated frameworks for the management of public assets and liabilities that address the whole range of macrofinancial risks, including contingent liabilities and those associated with natural disasters (IMF, 2012).
- 2.13 Policies to enhance information and the functioning of contracts and financial markets. The problems of information and contract execution hinder the tasks of selection and monitoring, and asset recovery, driving up financing costs. The proper functioning of financial markets requires institutions that promote an environment of credible and accessible information facilitating credit and investment decisions by banking institutions or capital market agents (pension funds, investment funds, etc.) that are as fully informed as possible, so as to enhance their capacity to identify projects with the best risk/return profile. At the same time, the proper functioning of the financial markets depends on institutions able to guarantee effective and efficient enforcement of financial contracts in order to reduce borrowing costs or make collateralization-based financing feasible (for example, structured financing) so as to facilitate long-term finance. The problems of information and contract enforcement are most severe in environments with a high level of informality in the economy, where economic operators lack incentives to disclose a portion of their income, workers, or assets. Under such circumstances, financing costs may be high and, given the importance of access to finance in

²² As Turner and Minoiu (2013) have recently shown, the financial systems in which financing contracted the least during the 2008-2009 financial crisis were those in which institutions were better capitalized and had stable sources of funding.

²³ See a review of the effects of financial reforms on productivity in Norris et al. (2103). See also studies linking financial reforms to improvements in factor allocation in the economy in Larrain and Stumpner (2013) and Buera and Shin (2012).

- boosting productivity and reducing informality, a perverse cycle of low finance, low productivity, and high informality may be generated.²⁴
- 2.14 In order to trigger a virtuous cycle between finance and productivity, it is necessary to implement a series of reforms, including: (i) improving institutions and regulations aimed at generating and disseminating information, such as credit bureaux, rating agencies, and accounting reporting standards, to improve the capacity of the system to evaluate firms; (ii) introducing regulation to ensure financial transparency and raise levels of competition and consumer protection, which generate incentives among market entities to improve their techniques for selecting good projects; (iii) availability of mercantile and bankruptcy regulations and institutional structures able to guarantee enforcement of financial contracts, and the flexible, economical, and secure handling of guarantees to minimize the costs associated with breach; and (iv) developing the legal and technological infrastructure for capital markets and the mechanisms necessary to promote long-term relationships between sources and uses of financial resources (e.g. by ensuring proper protection of investors' rights). The work of international organizations has played a key role in helping countries identify and implement reforms in these areas (IDB, 2013b and 2010; IFC, 2010).
- 2.15 There is ample empirical evidence showing that firms' access to finance is directly related to improvements in the institutions responsible for the functions listed above and which, therefore, promote fuller exchange of information, better investor and creditor protection, and better contract enforcement guarantees and efficiency (Djankov et al., 2008, La Porta et al., 2007).²⁵ It is important to note that the effects of these institutions vary depending on the country's level of development. In less developed countries, where contract enforcement mechanisms are weaker, the evidence shows that protecting creditors' and investors' rights is less relevant to promoting access to finance than mechanisms to promote information exchange (Djankov, et al., 2007). In turn, when contract enforcement mechanisms are more solid, the strengthening of creditors' and investors' rights has a much bigger role in explaining improved access to finance through the capital markets (Acemoglu and Johnson, 2005).
- 2.16 In conclusion, the lessons learned and international evidence suggest that reform policies aimed at boosting productivity need to take into account:

²⁴ Studies by Gendelman and Rasteletti (2012), Morón et al. (2012), and Caro et al. (2012) found that increased access to finance is related to a higher degree of formality, given that compliance with tax and contracting legislation is generally a requirement for access to credit. Thus it is more likely that companies will meet costs of formalization once bank credit is more widely available at lower cost.

²⁵ For example, using the difference-in-differences method, Araujo et al. (2012) estimate that Brazil's introduction of a new insolvency law in 2005 improved firms' access to finance by 23% and cut its cost by 8%. However, the literature also includes other studies showing that the lack of a judicial system effectively ensuring efficient and predictable contract enforcement limits the effects of these reforms in terms of improving productivity and access to finance (Ponticelli, 2013).

- a. The importance of managing macrofinancial risks to promote the predictability and confidence necessary for long-term investment through solid and integrated financial infrastructure that strengthens the country's balance sheet (companies, financial institutions, and the public sector).
- b. The complementarity between the institutional reforms mentioned above, which advises an integral approach to financial reforms to boost productivity. Not only are macrofinancial reforms and financial contract efficiency highly complementary, but there are strong complementarities between the two typologies, for example, between reforms to improve protection of creditors' and investors' rights and reforms to make contract enforcement more efficient and effective.
- c. The importance of taking into account the institutional context and the country's level of development to sequence reforms properly and evaluate their effects. On this latter point, ideas and consensus-building between the main political, economic, and social stakeholders play a decisive role in overcoming the existing political/institutional equilibrium (Rodrik, 2013).

2. Productive-development financing policies (PDFP)

- 2.17 As mentioned earlier, in addition to the institutional framework, the intrinsic characteristics of the productive structure (firm size and type, level of capitalization, sector, etc.) affect the possibilities for accessing finance.²⁶ PDFPs aim to expand the financing frontier for the productive sector. Where these policies are successful, they create the conditions for improvements in the productive structure. This is due to the fact that access to credit facilitates the transition towards technologically more efficient firms, with higher levels of capitalization, operating in more productive sectors, and connected to global value chains (Maskus et al., 2012; Catão et al., 2009; Alfaro and Hammel, 2007).
- 2.18 PDFPs can be divided into three groups of policies and instruments depending on whether they are intended to: (i) boost the supply of financing to the productive sector; (ii) strengthen the productive system and help structure demand for finance; or (iii) boost supply and structure demand for finance, building on the integration and strengthening of value chains.
- 2.19 The first set of policies includes programs aimed at boosting the supply of credit to the productive sector as a whole. These programs are designed for cases in which productive firms exist but are underserved by the market. This problem is typically observed in SME sectors that require medium and long-term finance to incorporate or develop technological innovations or start businesses in sectors that generate

²⁶ For example, in those productive structures with a significant presence of small or rural firms, where information and transaction costs are higher, thus raising the risk of adverse selection, there tends to be more rationing of finance. In the case of the rural sector, in particular, various studies highlight the difficulty of accessing finance faced by agents in the sector, and the impact greater access could have in terms of productivity and income (Guirking and Boucher, 2006; Petrick, 2005; Foltz, 2004; Feder et al., 1990; Carter, 1989).

positive externalities in areas such as technology or renewable energy. The inability of the private sector to finance these sectors is normally rooted in a combination of two factors: (i) lack of long-term liabilities; and (ii) high perceived risk of assets.²⁷ Productive-development financing programs offer potential private sector financiers a set of financing instruments they can combine with their own resources to resolve the problem of financing.

- 2.20 The financing instruments offered by PDFPs include: long-term financing, credit insurance, agricultural insurance, public guarantee systems, structuring of ad hoc guarantees, support setting up a specialized platform for sector analysis and analysis of specific projects (generally technology projects), channeling of resources and seed capital support, investment funds, venture capital funds, angel investors, etc. Programs of this type have been implemented in a number of countries and regions with various levels of development.²⁸ In general, the impact evaluations on these programs have been positive.²⁹ For example, when Larraín and Quiroz (2006) evaluated the Fondo de Garantías para Pequeños Empresarios [Guarantee Fund for Small Business Owners] (FOGAPE) in Chile they found there to be a 14% increase in the probability of small businesses obtaining a loan from banks taking part in the program when this guarantee existed. In Colombia, Eslava et al. (2012) found that companies that had been beneficiaries of Bancóldex credit resources had achieved growth in output, employment, and productivity of over 34%, 19%, and 22%, respectively. The main lessons learned on this type of policy include: (i) implementing mechanisms guaranteeing support to the most productive projects and companies to ensure policy effectiveness; (ii) achieving greater coordination between public instruments and a context of dialogue and consensus with private initiatives giving support; (iii) implementing monitoring mechanisms for participating companies using criteria that make it possible, for example, to identify

²⁷ On this topic, it is worth noting that in recent years lending tools and new technologies have been developed to partially mitigate the information asymmetries that hinder the valuation of credit risk by commercial banks. This new generation of mechanisms makes it possible to distinguish between different types of firms. In particular, promising techniques exist based on psychometric tests (similar to those used by human resources departments and agencies) to evaluate credit risk based on entrepreneurs' skills and ethics. These instruments, coupled with other banking downscaling techniques, enable a better flow of credit to underserved sectors, where productivity may be constrained by the lack of financial resources. Something similar happens in capital markets when special exchanges are set up to serve innovative small businesses that do not necessarily meet the criteria for a listing on established markets.

²⁸ More recently, in the wake of the international financial crisis, some countries have stepped up this type of program considerably. This responds to the need to support companies to mitigate the effects of economic volatility, not only in terms of short-term financing needs, but also in relation to medium and long-term investments (such as those in research and development), which tend to follow a procyclical pattern in response to credit constraints (Aghion, et al., 2005).

²⁹ Arraíz et al. (2010) evaluated the Fondo Nacional de Garantías de Colombia [National Guarantee Fund of Colombia] and found the intervention to have had a positive impact on the size of participating companies, both in terms of employment and the percentage of output exported. Bonilla and Cancino (2011) evaluated the impact of the Programa de Capital Semilla [Seed Capital Program] in Chile and found that participating firms had increased their turnover and headcount. Machado et al., (2010) found that companies taking part in the Tarjeta BNDES [BNDES Card] program in Brazil had increased their number of employees by 10%.

- when to “graduate” companies and when to withdraw support, or when to make adjustments to the program, etc., (iv) ensuring that the supply of finance meets development impact (positive economic return) and financial sustainability (positive financial return) criteria, and that for cases in which financial sustainability is not achieved, but there is a positive development impact, the fiscal costs relative to its impacts are considered; (v) aiming to ensure that interventions are systematic and leverage resources to provide benefits for institutions and markets; and (vi) evaluating programs and disseminating lessons learned (IDB, 2010 and 2014; World Bank, 2014a; OECD/ECLAC, 2013).
- 2.21 The second set of policies and instruments comprises those interventions aimed at strengthening the productive system as a whole, although they tend to focus on the SME segment. They are normally implemented to create incentives for individuals and firms to adopt or modify behavior patterns (for example, in relation to entrepreneurship, innovation, investment, partnerships, staff training, integration in global value chains, etc.), by supplying them with business services and grants, generally contingent on cofinancing (Rivas et al., 2010). Although the aims of these policies and mechanisms go beyond promoting access to finance (such as, encouraging entrepreneurship, innovation, adoption of technology, enhancing production processes, improving human capital), in the case of the particular area addressed here, these policies help organize, structure, and induce demand for finance. One of the causes of the financing gap is that a large number of companies, especially those in the SME segment, have difficulty formulating suitable business plans. And in those cases where they are able to formulate them, they are often unable to generate a collateralization structure that enables them to access finance (Tulchin, 2007).
- 2.22 In this regard, among the various goals of strengthening business services (many of which are not necessarily linked to financing), this has begun to be perceived as an effective additional way of improving access to finance (OECD/ECLAC, 2013). In particular, these services help by: (i) sending a positive signal to financial institutions about the quality of the potential client’s plan; (ii) improving the quality of key information about potential clients’ credit risk; and (iii) improving clients’ ability to pay insofar as they receive support on sensitive activities for the conduct of their business (Rivas et al., 2010).
- 2.23 A study of international experiences jointly structuring business services and credit programs, such as Canada’s Business Development Bank and USAID’s Small Business Administration, has shown that in some situations, it may be appropriate to design and execute these programs jointly in a consistent way (Dawson, 1997), as required by the timing sequence and the context of the intervention. This is equally valid for the region. An analysis of data from private firms in the region found that the demand for business services increases when the firm has either received a loan or recently applied for one (IDB, 2013c). Recent studies by the IDB show the benefits of taking a comprehensive approach that links technical

- assistance to firms with financing instruments, as well as the advantages of linking both elements in the context of firms that are part of a cluster or value chain.³⁰
- 2.24 The third set of policies and instruments refers to programs designed to address the needs of a group of interrelated companies through their participation in a single value chain. Value chain financing is an area of growing interest for public policy (see, for example, USAID, 2008). This type of program differs from conventional financing in that it goes beyond a specific perspective or target population (such as agricultural finance) or type of financing (such as microfinance), to address a value chain and its actors in a crosscutting way, and also includes different types of financing.
- 2.25 Joining and remaining in a value chain normally requires an investment of some kind (e.g., certifications, equipment, infrastructure). However, many firms face barriers preventing them from accessing the finance they need to make the required investment. This is particularly important in the case of agricultural producers and SMEs, due to information asymmetries, the lack of collateral, and geographical dispersion (Fernandez-Stark and Gereffi, 2012).³¹ To overcome these limitations, value chain lending programs may take a variety of forms, such as: (i) stimulating the flow of finance directly from buyer to supplier (e.g., through anchor company lending programs, supplier development programs); and (ii) incentivizing the supply of finance by banks (e.g., through specific lines of credit and guarantee arrangements).³² Indeed, a company's belonging to a value chain can be leveraged to incentivize an increased supply of finance, as banks can use the purchase contract as collateral, and benefit from the information participants in the chain have about each other, both of which are factors reducing risk of nonpayment.
- 2.26 Financing through value chains is generally associated with other services,³³ such as technology transfer and supply of equipment by the buyer, training and assistance on the development of business plans, which in turn contributes to improving firms' profitability and their quality as borrowers (IFC, 2012). In order to eliminate

³⁰ See IDB (2011a). The initial findings of an impact evaluation on the "Lending Program for Productive and Job Development in the Province of San Juan" (AR-L1022) show there to be a positive correlation between this type of intervention and increased productivity among companies in the treatment group relative to those that are not. In particular, it found that companies in the program saw 15% more export growth and 75% more sales growth than those that were not.

³¹ For example, lack of finance can hinder investments in infrastructure and equipment for irrigation, cold chain, logistics, adoption of better technology and quality standards. This severely limits access to national and international value chains (Chilavert, 2012; Miyata et al., 2009).

³² In relation to the impact of these policies, Arráiz et al. (2013) showed Chile's Programa de Desarrollo de Proveedores [Suppliers Development Program] to have had a positive impact both for suppliers (in terms of sales, number of employees, and sustainability) and for the anchor company (in terms of sales and exports), and that the latter had benefited from the former's gains. The IDB (2011a) showed the productive gains made by firms in chains participating in the program compared with those that did not.

³³ Hence it is important to coordinate with other interventions, such as those promoting learning and innovation, technology transfer, adoption of, and compliance with, manufacturing and quality standards, technical training, etc. (Pietrobelli and Staritz, 2013).

- bottlenecks along the value chain, these programs can also help to finance investments in transportation infrastructure (for example, rural roads) and logistics (storage centers, cold chain, etc.), energy supply, phytosanitary services (in the case of agricultural chains), etc.³⁴
- 2.27 One significant feature of PDFP implementation is the role public development banks (PDBs) have played and continue to play. This has been crucial and is widely documented (IDB-CMF, 2013; BNDES, 2009).³⁵ International experience shows that public banks are more effective at this role when: (i) they are given a clear mission and mandate; (ii) they are geared towards second tier arrangements; (iii) they complement the role of commercial banks, and do so cost-effectively;³⁶ and (iv) they operate in the framework of clear, high quality rules, and according to international standards that ensure strong and transparent corporate governance.
- 2.28 In particular, it is worth noting the privileged position of PDBs in simultaneously dealing with financing instruments, risk management, and technical assistance resources, all of which are necessary to implement PDFPs. In many countries in the region, PDBs are playing a prominent role in structuring and coordinating financing strategies aimed at promoting investments in economic sectors or market segments in which there are multiple risks and/or barriers keeping financing supply and demand apart. An example of these financing strategies includes those promoting investments in technological changes that not only lead to higher productivity among firms, but also environmental and social benefits, such as many of the financing strategies supporting green investment or low carbon projects. In these cases, PDBs mesh various financial and nonfinancial instruments together to overcome the risks and barriers faced by the financing of these investment projects, mobilize sources of national and international finance, and coordinate and drive various public and private actors to promote development of the market for this type of project (Smallridge et al., 2013).
- 2.29 Multilateral lenders have been important partners for countries in structuring productive-development financing programs, providing technical and financial

³⁴ The IDB Agriculture and Natural Resources Management sector framework (operational policy OP-2001) reported one of its lessons learned to be that multisector interventions at the rural level involving different government agencies have problems with execution and achievement of objectives. Productive chain financing projects in rural areas should therefore avoid incorporating interventions in other services and should be implemented through individual programs and/or projects, with execution mechanisms that minimize transactions costs between public sector institutions, in a way consistent with the principles and guidelines of the Agriculture and Natural Resources Management Sector Framework Document.

³⁵ Based on a review of international literature, Araujo et al. (2011) point to three roles for public development banks: (i) promoting economic development, by facilitating access to finance for sectors that are unserved or underserved by commercial banks, due to higher risk and lower returns (for example, in the agriculture sector) or longer maturities (for example, sectors with a high content of technological innovation); (ii) fostering regional development, by facilitating access to finance for key sectors of the regional economy; and (iii) expanding the economy's liquidity, acting countercyclically to episodes of loss of confidence or credit crunches.

support, generating knowledge, and building channels for dialogue and exchange of experience between countries (IDB-CMF, 2013). In this role, these institutions have agreed to follow a series of guiding principles to ensure the additionality of interventions focused on the private sector and ensure the maximum leverage of the sector's resources. These guiding principles are: (i) additionality (interventions must respond to a market failure); (ii) crowding-in (where possible, interventions should catalyze market development and mobilization of private sector resources); (iii) sustainability (interventions are expected to contribute to their customers' commercial viability); and (iv) promoting standards of conduct among customers (for example, standards of corporate governance, transparency, and integrity, social and environmental standards) (EBRD, 2012).

- 2.30 Another particularly important point regarding PDFPs concerns the SME segment. This segment is particularly relevant to boosting productivity and transforming the productive structure (apart from the implications for job creation that this may have). In productive structures with a broad participation of SMEs—whose productivity is notably lower than that of large companies—the economy's aggregate productivity tends to be lower (IDB, 2010; OECD/ECLAC, 2013). The reasons why restrictions on access to finance particularly affect SMEs include (IDB, 2005): (i) absence of a track record of conduct and internal procedures for generating quality information about their activities and functioning, and greater reluctance to share information;³⁷ (ii) limited capacity for administrative and financial management; (iii) lower levels of capitalization and ability to post collateral; and (iv) fixed costs of intermediation and prudential regulation, which discourage financial institutions from serving this segment.³⁸ Restrictions on access to finance are even more severe in the case of SMEs run by women. Various studies have found that such firms face higher interest rates and collateral requirements.³⁹ In response to these difficulties, many SMEs opt out and turn to their own

³⁷ New technologies and tools hold out the possibility of alleviating restrictions relating to information asymmetries through alternative risk assessment models based on the entrepreneur's characteristics or their transaction history or digital footprint. Along with the psychometric tests mentioned earlier, it is also worth noting that models based on big data, which rate risk using a client's reputation on social networks, and through their transaction history, for example, in relation to their cell phone usage pattern.

³⁸ For example, regulation based on Basel II weights the risk of loans to SMEs above those to large companies, incrementing the cost of capital for financial institutions serving this segment. The new regulations proposed in Basel III have tried to solve this problem.

³⁹ For example, see Demirguc-Kunt, et al. (2008 and 2013); Bardasi et al. (2007); Ellis et al. (2007); and Narain (2007).

- resources—if they have any—or other sources of finance, for example, from their suppliers.⁴⁰
- 2.31 Restrictions on access to finance limit SMEs’ capacity to invest in projects (technology, processes, market integration) that boost their productivity. In particular, restrictions on access to finance prevent productive firms from scaling up and generating more aggregate productivity by absorbing resources of firms with lower marginal productivity of capital. They also represent a serious limitation on innovation, entrepreneurship, and the creation of new start-ups, from which projects with greater relative productivity may arise (IDB, 2014).⁴¹ This situation is not conducive to structural change and the efficient allocation of factors towards more productive projects and activities, given that incumbent firms with high levels of capitalization or wealthier entrepreneurs have better access to finance, rather than projects developed by the most able entrepreneurs or those with the best ideas (Albuquerque and Hopenhayn, 2004).
- 2.32 As conclusions from the review of the literature and international experience on PDFPs, the following main points emerge:
- a. Good diagnostic assessments are needed to allow policies and financial instruments to be tailored to the context of the intervention, the problems it aims to solve, and the severity of the existing market failures.
 - b. The importance of the completeness of the PDFP’s design and execution for this type of public policy to be effective, taking into account factors influencing financing supply and demand, based on the crowding-in principle and participation of the private sector.
 - c. Complementarities exist between PDFPs and other productive-development policies, which makes leveraging different policies to achieve greater impact advisable.
 - d. Mechanisms need to be implemented that guarantee support for the most productive firms and projects to ensure these policies are effective. Such mechanisms include public-private dialogue to identify the most important obstacles and design interventions that have the best chance of success, and

⁴⁰ Nontraditional sources of funding include peer-2-peer funding platforms and collective funding (crowdfunding) platforms. These platforms encompass models connecting credit applicants and investors directly or through an intermediary (usually banks) and, in most cases, allow the parties to freely define the terms and conditions of the loan. The *Cumplo* platform in Chile is the first of this type in Latin America and uses a collective funding model in which several persons offer all or part of the loan under the requested conditions in a reverse auction system. The loans are underwritten by mutual guarantee societies, which are financial institutions that receive contributions from the State through the Corporación de Fomento de la Producción [Production Development Corporation], so as to enable SMEs to obtain finance on better terms.

⁴¹ The Innovation, Science, and Technology Sector Framework Document will address innovation and entrepreneurship in more detail. In their study on development and innovation systems, Cassiolato and Lastres (2005) note the role that public policy can play in promoting the financing of innovative activities, given the shortfalls in how this segment is served by commercial banks.

mechanisms for evaluation, continuous learning, and dissemination of the lessons learned on PDFP.

- e. Maximum leverage of private sector resources needs to be achieved, while maintaining the intervention's level of effectiveness, which is the necessary condition for minimizing its fiscal cost.
- 2.33 Particularly relevant for this SFD are the conclusions of the literature review and the lessons learned on PDFPs targeting the SME sector. This business segment tends to be the hardest hit by constraints on access to finance. At the same time, taking the productivity of SMEs in other regions as a reference, there is evidence that this business segment has the potential for productivity improvements in the region (OECD/ECLAC, 2013).
- 2.34 Targeting interventions on projects and firms with the highest growth potential is a priority for public policy effectiveness. However, the international literature shows that interventions targeting SMEs do not always yield productivity gains.⁴² On the contrary, if the interventions are not well targeted they can cause distortions in the allocation of resources from projects and firms with growth potential to firms with little chance of raising their productivity sufficiently to offset the cost of the intervention. In the most extreme case, this could result in a loss of aggregate productivity (Buera et al., 2013; IDB, 2010). Bearing in mind the decisive role of access to finance for productivity, it is crucial that the financial system allocate the economy's resources to the potentially most productive projects and companies.
- 2.35 Given that the high costs involved often make it difficult to discriminate between firms that have productive potential and those that do not, it is important to complement the firm size criteria with others. This will enable PDFPs to be better targeted and more effective. These criteria include: (i) firms' time horizon (new firms not only face greater constraints in accessing finance due to their greater comparative risk, but their marginal productivity gains tend to be larger than those of established firms, and they help bring competition into the market),^{43,44} and (ii) the capacity to generate positive externalities and spillovers, both from the individual characteristics of the firm or project (for example, regarding technological innovation) and the characteristics of the sector in which they operate (for example, the renewable energy sector). In order to ensure the expected impact is achieved, these policies must also: (i) have clear selection criteria; (ii) have a monitoring and evaluation design; (iii) establish clear rules and mechanisms to

⁴² For an exhaustive review of the international literature on impact evaluations of SME promotion programs, see Acevedo and Tan (2010).

⁴³ For example, Acemoglu et al. (2013) evaluated the policy of innovation and technology adaptation in the United States and concluded that social welfare is increased if support is channeled to new entries rather than incumbent firms.

⁴⁴ In accordance with the international evidence, Ruprah et al. (2014) analyzed the differential in productivity and sales of firms in the Caribbean according to their age and found that younger firms had larger expected margins of gain for both factors.

suspend aid or reallocate it to other companies if the objectives are not met; and (iv) be implemented by institutions with a clear mandate and good technical capacity.

III. MAIN CHALLENGES IN THE REGION AND PROBLEMS THE BANK SEEKS TO ADDRESS

- 3.1 Major reforms have taken place over the last two decades to improve access to finance in the region. Key reforms undertaken include: (i) liberalization of the financial sector (creating incentives for the entry of foreign capital and entities);⁴⁵ (ii) improvements in macro-management and prudential regulation (giving the system greater stability); and (iii) pension system reform (involving a changeover to a funded system in most countries) (IMF, 2012). The greater depth and diversity of the financial markets is largely due to these reforms.⁴⁶
- 3.2 However, the effect of these reforms has not been sufficiently strong to enable levels of access to finance in the region to converge with those elsewhere. Indeed, the gap with the OECD, for example, has widened.⁴⁷ In this regard, the World Bank (2013) found that while average bank assets for LAC-7⁴⁸ countries had grown by just 5% (rising from 39% of gross domestic product (GDP) in the period 1990-1999 to 44% over the period 2000-2009), these had increased by 26% for G-7 countries (rising from 97% to 123%), (see Figure 4). Levels of access to finance in the region are below even what would be expected in view of its countries' per capita GDP (World Bank, 2013). However, on this point it is particularly necessary to highlight the wide variations among the countries in the region. For example, over the period 2000-2009 Chile had levels of credit to the private sector that corresponded to its

⁴⁵ Foreign banks have acquired a growing presence in the region. Latin America and the Caribbean (with the exception of Brazil) and Eastern Europe are the regions with the highest penetration of foreign banks, when compared even with Asia, China, and the advanced economies (Claessens and Van Horen, 2013). Bank concentration has also increased: in the LAC-7 (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela), just five banks account for 65% of loans and 68% of deposits (World Bank, 2014). However, the literature in fact shows that competition in the region's banking system did not decrease over the decades of the 1990s and 2000s (Azoategui et al., 2010). Additionally, studies by the IDB (2005) concluded that there was no evidence that greater concentration had increased borrowing costs or reduced levels of credit in Latin America and the Caribbean. One explanation is that financial liberalization and technological innovation reduced the sector's barriers to entry but did not lead to greater market power (IDB, 2005), while countries made progress on the design and implementation of regulations to foster competition and protect consumers (de la Torre et al., 2012).

⁴⁶ Consistent with this process: (i) local currency bond markets increased their volume of issues and extended yield-curve maturities; (ii) stock exchanges increased their number of listed instruments and derivatives of some currencies have appeared; (iii) pension funds have become major players; and (iv) financial infrastructure, particularly that related to securities settlement and payment clearing systems, have been modernized (World Bank, 2013).

⁴⁷ For example, in the LAC-7 countries, average bank assets over the period 2000-2009 came to 44% of GDP, well below the levels observed in G-7 countries (123%) and Asia (84%).

⁴⁸ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

per capita GDP. Over the same period, the Central American countries⁴⁹ and the Dominican Republic reached 40%, below the level of other groups of countries (de la Torre, 2012), (see Figure 5).

- 3.3 These variations show that each country in the region has specific features. Those of the Caribbean countries in particular should be noted, where the financial sector has a significant presence, accounting for roughly 15% of GDP. Unlike the poor regional average in financial system indicators, the Caribbean countries have a level of assets similar to that of the developed countries. For example, in 2010 the asset level in Trinidad and Tobago was 83.7% of GDP, in Guyana 99.2% and in Barbados 143.4%. In contrast with the regional trend, from 1995 to 2010, the Caribbean countries experienced growth in the level of assets of around 110%. Lastly, deposits account for a large share of total assets, giving the banking system greater liquidity. For example, in 2010 in Trinidad and Tobago deposits were 68% of total assets, in Belize 77%, and in Guyana 84% (Ramsaran, 2013). However, as we will show later, despite the improved relative performance of financial system indicators in the Caribbean countries, access to finance for the private sector, particularly SMEs, is far from the levels found in the most developed countries.
- 3.4 The factors that help explain this gap in access to finance in the region compared with other regions include: (i) numerous financial crises that have affected the region since the 1970s, which have undermined agents' confidence in the financial sector, limiting the expansion of the deposit base, growth potential of intermediation,⁵⁰ and the availability of medium and long-term finance; and (ii) lower comparative levels of growth and transformation of the region's productive structure, which is still characterized by the high presence of informality, microenterprises, and the size of the agricultural sector that is technically backward or inefficient.^{51,52}
- 3.5 Although, as mentioned, there is a wide degree of variation in the level of access to finance between countries in the region, it is nevertheless possible to identify a series of common challenges. The most important from this SFD's standpoint are: (i) improving the efficiency and scope of banking credit intermediation to the productive sector, to foster technological change and market access for more productive companies; (ii) developing the capital market and risk management instruments, to promote financing of long-term investments and projects, and increasing companies' risk diversification capacities; and (iii) strengthening macrofinancial regulation and supervision, its institutional framework, and its

⁴⁹ Belize, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

⁵⁰ In the LAC-7 countries the deposit base does not exceed 33% of GDP, while in OECD countries it is 110% of GDP and in Asia 73% (CAF, 2011).

⁵¹ Other lines of research emphasize elements of economic policy, such as institutional capacity, the degree of opposition from interest groups, to explain the gaps in the level of financial development between countries (see, for example, Becerra et al., 2012).

⁵² Although these factors are not entirely exogenous to the financial system, the specific reference here is to the exogenous component of the relationship between these factors and the financial system.

instruments, to allow integrated and comprehensive macrorisk management, yielding lower risk premiums on investments without compromising the stability of the system (IDB, 2005 and 2010; de la Torre et al., 2012).

- 3.6 These challenges and the policies to tackle them are mutually interconnected in many ways, as they are highly complementary. However, to simplify the analysis, they are presented here separately.

A. Improving the efficiency and scope of bank credit intermediation to the productive sector

- 3.7 The banking system's capacity to channel savings into productive activities efficiently is an essential element for the functioning of the economy. Bank credit to the private sector in the region has grown by barely one percentage point since the 1980s, and is currently around 30% of GDP. This value is significantly below that in advanced economies (100%), South-East Asia (71%), and other emerging economies such as China (117%) and India (40%),⁵³ (see Figure 6). In turn, the relative weight of credit to businesses as a share of total bank lending is 60%, six percentage points lower than in 2000. Thus, although credit to the business sector has been growing since 1990, it has done so more slowly than in other regions, and has mainly focused on consumer credit—involving simpler and shorter-term lending—rather than productive credit (de la Torre et al., 2012). However, in some countries in the region, bank credit to the productive sector has been growing at considerable rates. Such is the case of Brazil, where credit to businesses (particularly industry) grew at an average annual rate of 17% from 2003 to 2009 (BNDES, 2009).
- 3.8 With a few exceptions, credit to the productive sector in the region is well below that corresponding to the structural characteristics of the countries' economies (level of per capita GDP, population size and profile, etc.). Moreover, compared with other regions, credit intermediation to the productive sector is at higher lending rates and with high net spreads (close to 8%, compared with spreads of 2% in OECD countries and 3% in Asia).
- 3.9 This situation has negative consequences for firms' operation and growth. Just 36% of firms use credit to finance their working capital (in the Caribbean this figure is barely 20% of registered companies), compared with 38% in Asia and 48% in Europe. What is more, just 20% of the region's firms use credit to finance investments, compared with 40% in Asia and Europe, while 30% of firms state that a lack of access to credit is a significant hindrance to their operations.⁵⁴ In response to these difficulties, some firms opt out and turn to their own resources—if they

⁵³ However, there are marked asymmetries between the countries of the region: for example, The Bahamas, Barbados, and Guyana have values above the regional average, with 82%, 67%, and 47%, respectively (Holden and Howell, 2009).

⁵⁴ Holden and Howell (2009) show that access to credit is even more limited in the Caribbean. According to Global Competitiveness Report data, in 2009 the average score obtained in this category for Latin America was 2.8 points (out of a total of seven), while the average score in the Caribbean was 2.65.

have any—or other sources of finance.⁵⁵ In the LAC-7, 56% of firms are financed from internal resources (WBES, 2011). In the case of new companies, 80% of seed capital comes from personal or family savings (Kantis et al., 2004). Faced with an inefficient intermediation system, self-financing is the best response for companies, even for highly productive ones. This excessively limits and delays their ability to take advantage of new business opportunities, particularly those requiring long-term projects or investments in intangible assets.

- 3.10 SMEs and young firms (particularly those run by women)⁵⁶ are particularly affected, as are firms in relatively riskier sectors and those with less collateral (such as new-technology intensive firms). Less than 15% of total credit in the region is destined for SMEs, and the differential in the conditions of access to credit for SMEs and large companies is bigger than in other world regions⁵⁷ (OECD/ECLAC, 2013), (see Figure 7). Although there has been progress in recent years in terms of the expansion and adaptation of banking instruments for these business segments (Beck et al., 2010), the high degree of informality in the economic structure, and the higher cost of project selection and monitoring methods in this segment compared to others (such as consumer credit or leasing) create disincentives for bank credit, limiting the benefits in terms of aggregate productivity that can be derived from the growth of the most productive SMEs.
- 3.11 Regarding the relationship between the informal sector and access to finance, studies conducted in the region show that the high degree of informality of SMEs is a key barrier to accessing finance through the banking system. The informal nature of a company means it is not possible to demonstrate that it exists, or its financial statements may not properly reflect the reality of the company, making it hard to properly evaluate projects for financing and their associated risk (ECLAC, 2011; Kulfas, 2009). As a result, few SMEs in the informal sector have access to, or even apply for, financing. For example, in Chile, only 12% of informal SMEs report having applied for commercial bank credit, compared to 32% of formal SMEs (Ministry of the Economy of Chile, 2014). In Argentina, Bebczuk (2010) found that 9.4% of informal companies had applied for financing, compared to 23% of formal enterprises. In turn, in cases in which a bank extended credit, it had done so to the individual, not the business (since the business is not formalized, its existence cannot be proven). The informal sector, which accounts for 60% of employment in

⁵⁵ In line with international trends, other sources of finance have arisen in the region, such as private investment and venture capital funds, and credit unions. However, their share of the total volume of credit remains small (for example, loans granted by credit unions in OECD countries came to 5% of GDP, while in LAC-7 countries they came to under 1%). In view of the constraints on credit from banking intermediation and other sources, firms have also resorted to suppliers and the private sector.

⁵⁶ Only half of firms set up by women survive after three years in Latin America and the Caribbean (MIF, 2013).

⁵⁷ Around 19% of SMEs in the region use bank credit to finance working capital, compared with 29% of large companies.

LAC, is a clear challenge for the countries in the region,⁵⁸ particularly for increasing the productive sector's access to finance. The countries in the region are making an effort to increase the level of formalization of companies and workers. For example, the “*Simples*” project in Brazil—a joint effort of the federal, state, and municipal governments to cut red tape and reduce taxes—had a significant impact on the formalization of companies (Arroio and Scerri, 2014; Fajnzylber et al., 2006).

- 3.12 Credit constraints, in turn, are significantly greater in the case of firms run by women (Piras, et al., 2013). Recent surveys show that firms in the region owned by one or more women: (i) have less access to finance in all categories of firm (IFC-McKinsey, 2011); and (ii) face collateral requirements that exceed the value of the loan (for example, in Paraguay and Costa Rica, this may be as much as 369% and 267% of the loan, respectively). The surveys also show that, for women, access to finance is the most important barrier to starting a business (EIU, 2013); and that regulatory (for example, in relation to land holding and ownership rules) and cultural barriers (women are less likely to finance their businesses from loans than men) exist, limiting access to finance (Piras et al., 2013).
- 3.13 To confront the challenge of improving the scope and efficiency of banking intermediation, the countries in the region have adopted different policies to reduce intermediation costs and the information problems that cause them. In keeping with the international evidence (Section II), these policies can be subdivided into two groups:
 - a. Institutional reform policies aimed at reducing the transaction costs associated with financial contracts. In this regard, the region's main relative shortcoming is in terms of institutions dedicated to strengthening contract enforcement, protecting creditors' rights, and promoting the efficient recovery of assets after default (World Bank, 2013; BBVA, 2014).⁵⁹ Estimates suggest, for example, that if the level of performance of the region's institutional environment were to reach that of the OECD countries, the region's (average) ratio of credit to GDP would rise by 13 percentage points (BBVA, 2014). It is also important to continue advancing the

⁵⁸ For a more in-depth discussion of informal employment in LAC, please see the Sector Framework Document on Labor (document GN-2741-3), Inter-American Development Bank, 2013. According to that document, the causes of the high level of informality are multidimensional and include: (i) little value placed on the benefits provided by social security compared to the contribution amount; (ii) high costs associated with compliance with labor laws and tax regulations; (iii) insufficient capacity to absorb those costs among companies with low productivity and low-income persons; (iv) insufficient state oversight capacity; and (v) a high proportion of unsalaried jobs are subject to problems relating to inconsistent schedules and inertia, which are barriers to the workers in those jobs contributing to social security when they have to make their contributions without automatic deductions by their employers. See also in that document more information on the Bank's lines of action in this area and its support for the countries in the region.

⁵⁹ A financial reform with this as its backbone was approved in Mexico in 2014 and introduced measures to make recording and recovery of credit contract guarantees, and insolvency proceedings more efficient.

mechanisms to promote the exchange of high quality credit information,⁶⁰ improve loan selection processes (new IT or psychometric tools),⁶¹ and credit market competition.

- b. PDFPs addressing the problems discussed in Section II that limit the growth of certain sectors and types of firm. Public banks play a central role in policies of this kind. After a long period of restructuring, in which the region's public banks lost their excessive weight in the financial market (dropping from around 70% in 1970 to close to 15% in 2010),⁶² they have gained in importance over the last decade, as they have strengthened their balance sheets, governance structure, and mode of operation^{63, 64} (IDB, 2013). The new programs and instruments promoted include: (i) partial credit guarantee and mutual guarantee funds;⁶⁵ (ii) programs to finance productive chains and expand credit to suppliers;⁶⁶ (iii) renewable energy, energy efficiency and energy services (ESCO) financing programs;⁶⁷ (iv) programs combining business development services with access to financing, and (v) programs serving low income groups underserved by markets (for

⁶⁰ Public credit registries exist in Argentina, Bolivia, Brazil, Chile, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Paraguay, Peru, and Venezuela. On the private side, there are over 30 firms operating credit registries in the region.

⁶¹ See Klinger et al. (2013a and 2013b) for a review of efforts on new credit selection and evaluation techniques.

⁶² This process has been particularly strong in the region, although it is common to other countries worldwide (from 50% to 15%, approximately) (IDB, 2014).

⁶³ Public banks currently operate through a combination of “second tier” models using commercial banks’ distribution networks and risk management capability, with “first tier” models, similar to those of traditional commercial public banks, in which the credit risk is assumed directly by the public bank. There are also public banks that combine the two models.

⁶⁴ From among the different experiences of the countries in the region, the particular case of public banks in Chile and Brazil should be mentioned. Their strong performance has been due to the decisive steps taken by both countries to improve corporate governance and strengthen regulation, with positive results in the public banks (Stallings and Studart, 2006).

⁶⁵ For example, the FOGAPE program in Chile was evaluated with positive results for both its achievements in terms of additionality or new credit generated, greater income for beneficiary firms, and increased financial and fiscal sustainability (Larraín and Quiroz, 2006).

⁶⁶ For example, the NAFINSA program in Mexico promotes access to, and strengthening of, supply chains through a factoring service to alleviate small producers’ (who have less collateral or a shorter credit history) liquidity constraints. The program has technology infrastructure to facilitate coordination, training for participating companies, and refinancing of participating financial institutions as second tier lenders. To date the program has served over 10,000 SMEs. As an example of expanding credit to suppliers, the IDB Group’s Inter-American Investment Corporation (IIC) grants loans to firms, among other things, to strengthen their supply chains. This is the case, for example, of the company Exportadora Subsole de Chile, which through a FINPYME loan, granted finance to over 100 local suppliers, combined with a technology transfer and advisory program on sowing, harvesting, quality, and marketing.

⁶⁷ For example, in Colombia Bancóldex has developed an energy efficiency program in the tourism sector and hospitals combining credit facilities to encourage investors to enter the energy efficiency field, with guarantees covering the risk of not meeting the estimated energy efficiency returns, thus reducing project and credit risk.

example, women entrepreneurs).⁶⁸ To date there have been relatively few evaluations on this type of program in the region, particularly due to the high cost and limited access to information. However, those that exist, particularly those relating to public development banks, show clearly positive results in terms of productivity gains.⁶⁹ The success of PDFPs will increasingly depend on the capacity to develop tools or mechanisms to discover new formulas with which to stimulate credit markets, using a blend of instruments to enhance the coordination between public and private actors in the market so that interventions are as effective as possible while minimizing their fiscal cost. This all suggests that interventions should be designed so as to minimize the subsidy element necessary to overcome the market failures the intervention addresses. In any event, the intervention and corresponding subsidies must be present only during the time the market failure is active. Additionally, the success of these interventions will be tied to the implementation of mechanisms that identify and eliminate financial and regulatory barriers that could be introducing distortions in the efficient distribution of the financial system's resources, such as regulations and financial system practices that implicitly or explicitly create disincentives for providing financial services to women.⁷⁰

B. Developing the capital market and risk management instruments

- 3.14 The incipient development of the majority of capital markets in the countries in the region represents a major constraint on the productive sector's access to finance in general and that of SMEs in particular.⁷¹ This is due to several factors: (i) the lack of disintermediated lending mechanisms puts undue pressure on bank capital, leading to an equilibrium in which commercial banks overfinance large companies and infrastructure projects that would normally be financed through capital markets; (ii) the savings accumulated in institutional investors cannot flow towards the financing of productive activities, particularly in medium-sized business sectors, due to a lack of securitization instruments for banking assets; (iii) the lack of a set

⁶⁸ For example, the San Juan Development Agency in Argentina, and more recently Banco Produzcamos in Nicaragua, have implemented mechanisms to combine the financing of business plans and training with access to credit, as mechanisms to act simultaneously on the supply of and demand for credit.

⁶⁹ For a review of impact evaluations in this area see Maffioli and Rodriguez (2013).

⁷⁰ The empirical evidence for Latin America and the Caribbean shows there to be a gender gap in the aggregate indicators of access to finance. Recent studies show that financial regulation has—or can have—a role in: (i) creating implicit or explicit disincentives to provide financial services to women; and (ii) replicating and/or strengthening biases existing in other parts of the country's regulatory and legal framework and which may be having a negative influence on the provision of financial services to this group. Reform processes, and policies and programs to expand access to finance, must be aware of these types of regulatory barriers and identify and eliminate them.

⁷¹ Brazil's Securities and Futures Exchange was ranked by the Futures Industry Association in 2005 as having the fifth highest trading volume in the world. Even so, the low level of development of the domestic private bond market limits the prospects for the productive sector to access long-term finance (Macedo and da Silva, 2013; Pinto et al., 2013).

of insurance and risk management instruments, which contributes to the overall increase in risk premiums; and (iv) SMEs lack one of the main incentives to entrepreneurship: the possibility of realizing the value of the company through a public offering (Ketterer, 2014). In turn, capital markets' low level of development limits the possibility of mitigating macroeconomic shocks from the banking sector, stemming from the nonfulfillment of loans to the productive sector. More developed capital markets could help mitigate this risk, although additional research is needed on this point.

- 3.15 Although the region's fixed income markets have grown substantially over the last two decades, this growth has been slower than in OECD countries or Asia, and these markets remain relatively small (33% of GDP in LAC-7 countries, compared with 56% in Asia and 112% in the OECD),⁷² (see Figure 8). Moreover, growth in these markets has been driven mainly by public bonds, while private bonds have had only very limited scope: they account for less than 10% of bonds by value in countries in the region and only a handful of companies have issued bonds, compared to the norm in more advanced countries.⁷³ The most positive factor regarding fixed-income markets has been that, in some countries, the growth of longer-term issues of domestic public debt in local currency has helped construct a reference curve for corporate debt.⁷⁴ For their part, variable income securities markets (shares, etc.) are still small and relatively illiquid (the value of shares in the region's exchanges is less than 40% of GDP, compared with levels of over 100% of GDP in the OECD countries and Asia) and, except in the largest countries, derivative markets are almost nonexistent, or at best incipient (CAF, 2011).⁷⁵
- 3.16 Some of the factors that stand out among the main constraints on capital market growth in the region include: (i) the small size of the markets in comparison with large international markets, which makes it difficult to benefit from economies of scale and competition in the necessary technology and market infrastructure (trading, clearing, and settlement systems for listed instruments, an attractive pool of companies, etc.);⁷⁶ (ii) high operating and regulatory costs, limiting companies' access to capital markets; (iii) the strategies of the main institutional investors (pension funds and mutual funds), concentrated in public bonds and buy and hold strategies, which limits both the depth and liquidity of the system; (iv) scant

⁷² The heterogeneity of the LAC-7 countries should be noted: whereas bond markets in Peru and Colombia are very small (15% and 23% of GDP, respectively), Brazil's is 40% of GDP and in Chile's is larger than that of the Asian countries (59%) (de la Torre et al., 2012).

⁷³ Between 2000 and 2010, only 19 companies issued bonds in LAC-7, compared with 432 in the OECD countries.

⁷⁴ Between 1990 and 2000 maturities increased one year for private bonds and 35 months for public bonds, while the share of national corporate bonds in foreign currency dropped from 33% to 25% (LAC-7).

⁷⁵ It is worth bearing in mind the uneven levels of development across the region: in Brazil and Chile levels of capitalization in the securities markets exceeded 100% of GDP, while in Paraguay, Uruguay, and Venezuela these were below 10%.

⁷⁶ This restriction is less severe in Brazil and Mexico, which are precisely those economies in which the capital markets have developed fastest.

presence of other key institutional investors, particularly insurance companies;⁷⁷ and (v) the persistence of largely obsolete securities market ownership and organizational structures.

3.17 The development of capital markets and risk management instruments in the region needs to be framed by a comprehensive strategy, based on a public-private partnership (PPP), aimed at improving firms' growth opportunities, particularly among medium-sized companies, and enabling the securitization of structured investment projects. Policies in this area can be grouped along three complementary dimensions:

- a. Strengthening the institutional, regulatory, and capital market infrastructure framework to develop intermediaries and instruments to finance long-term projects. The main actions highlighted by international organizations (IMF, 2013 a and b; G-30, 2013) include: (i) development of institutional investors, particularly pension funds and sovereign wealth funds,⁷⁸ through regulations creating incentives for investment policies consistent with long-term profitability;⁷⁹ (ii) setting up a solid and transparent PPP framework; (iii) developing instruments such as securitization, mutual funds, exchange-traded funds (ETFs), infrastructure bonds, mortgage bonds, etc.; and (iv) improving the regulatory environment (particularly as regards accounting and auditing standards) and market infrastructure, particularly in the secondary market (trading, deposit, clearing, and settlement).
- b. Policies to raise the private sector's participation in capital markets, particularly among medium-sized companies. To create incentives for this, the public sector can help overcome the sunk costs and risks of the initial stages of growth in private participation in capital markets. The actions that have proven most effective in this regard include:⁸⁰ (i) use of risk mitigation measures during initial project phases, such as different types of guarantee (partial, first loss, or counter-guarantees) to cover the various types of risk (credit, project-specific, macroeconomic, or political);⁸¹ and (ii) incentives to

⁷⁷ Expenditure on insurance premiums is lower than in other regions (2% of GDP compared with 3.7% of GDP in many OECD countries) and has remained stagnant since the mid-1990s (Beck and Demirguc, 2009).

⁷⁸ See Lerner (2012) and IMF (2012) for a view of the potential of sovereign wealth funds for productive investment.

⁷⁹ This calls for investment policies that avoid procyclical behavior, establish performance measures and long-term remuneration policies, and following corporate governance policies based on transparency and professionalization (McKinsey, 2010, IMF, 2012).

⁸⁰ For a review of Korea's experience financing SMEs through capital markets, see Park et al. (2008).

⁸¹ For an analysis of the various alternative courses of action from the viewpoint of multilateral agencies, see the Bank's Policy on Guarantees approved in 2013.

foster SMEs' access to stock markets or to corporate debt markets⁸² (through training, reducing listing costs,⁸³ tax incentives, etc.).

- c. Stimulate the integration of the region's capital markets to generate economies of scale in infrastructure and the pool of companies, and raise markets' attractiveness and ability to compete with the major international players. This needs to be understood as the first step towards broader financial integration. Progress therefore needs to be made on regulatory, exchange, and fiscal harmonization in key areas.⁸⁴ Private impetus is crucial to this process, particularly in the case of stock exchanges, clearing and settlement entities, and securities depositories. In this regard the development of the Latin American Integrated Market (MILA) project is highly significant. This initially brought together stock exchanges in Chile, Colombia, and Peru (Mexico has expressed its intention to join soon), and the initial progress in the early stages of the project has been towards regulatory and supervisory harmonization.⁸⁵

C. Strengthening macrofinancial regulation and supervision and their institutional framework and instruments

- 3.18 Macrofinancial regulation has traditionally focused on providing a prudential framework guaranteeing financial stability. This role continues to be vital in view of the serious and lasting effects of banking crises on access to finance and productivity. In parallel with this task, as the recent financial crisis has shown, macrofinancial regulation also has a strategic role to play in protecting a model of sustained development, based on appropriate management of macro risks and economic growth.⁸⁶ In particular, in the new international scenario, it is even more necessary to make headway on a regulatory framework and tools for action to address idiosyncratic or systemic shocks.⁸⁷ Obviously these measures will be more important in some countries and regions than others. For example, in Central America and in the Caribbean, banking supervision and regulation mechanisms

⁸² The MIF has also built up a considerable amount of operational and analytical experience in this field. A review of the projects and best action alternatives can be seen in BME Innova (2013 and 2014), which reviews international experience in stock markets and corporate debt markets.

⁸³ Legal costs and the cost of rating risks are often the most difficult to overcome.

⁸⁴ These include: standards for issues, the existence of liquid currency pair markets; fiscal treatment, market infrastructure (for the whole cycle: orders, transactions, clearing, settlement, securities deposit), and regulatory and supervision coordination.

⁸⁵ In this regard, a second phase of the project aims to culminate in a harmonized supervision standard and the inclusion of private actors such as stock exchanges and securities deposits, to give the initiative greater impetus, so as to achieve more solid integration. This phase is complemented by the possible entry of Mexico in the Latin American Integrated Market (MILA) in the context of the Pacific Alliance.

⁸⁶ Financial crises show the importance of monetary authorities' actions as the first line of crisis response (for example, through liquidity lines), and the restrictions deriving from the absence of exchange rate policy (IMF, 2012).

⁸⁷ See IMF, 2013b.

constitute the most significant core structural reform for promoting sustained growth (IMF, 2013c; Swiston and Barrot, 2011).

- 3.19 The region has made considerable headway on the introduction of a prudential regulation and financial supervision and regulation framework. For example, in Brazil, the convergence of domestic prudential regulations with the standards set by the BIS and the move towards the adoption of the Basel III principles have made the country's banking system more sound (BNDES, 2009; World Bank, 2014). However, room for improvement exists in various spheres (World Bank, 2013; IDB, 2012a), including: (i) some countries have not yet implemented capital regulation following the Basel I principles and, in others, certain areas of Basel II have yet to be implemented (particularly those relating to risk-based supervision and regulation of financial conglomerates); (ii) developing and/or consolidating (depending on the country) regulation and macro/micro prudential instruments aimed at preventing ex ante and ex post systemic risk; and (iii) improving financial transparency to increase market credibility and discipline.
- 3.20 The main lines of action can therefore be divided into two groups:
- a. Institutional and regulatory strengthening to improve macrofinancial risk management and control. The main measures recommended by the various international bodies (BIS, 2012; IMF, 2013b) and the specialist academic literature include: (i) the development of comprehensive macrofinancial and fiscal risk management strategies centering on comprehensive management of public assets and liabilities (explicit and contingent, including natural disasters) as essential mechanisms for preventing systemic risks and improving sovereign ratings; (ii) stimulating micro- and macroprudential regulation aimed at protecting against risks deriving from systemic crises (regulation of systemic entities, countercyclical management of financial risks, etc.); and (iii) reinforcing financial transparency (including improvements in internal and external audit systems and the system for enforcement of international bodies' anti-money laundering, transparency, and fiscal information exchange recommendations).
 - b. Policies and instruments to improve the capacity of the region's economies to weather external macrofinancial shocks that may endanger firms' ability to grow. These mechanisms include: (i) developing instruments to tackle systemic liquidity crises, particularly in dollarized countries with no lender of last resort (IDB, 2012a); (ii) establishing clear and efficient procedures for the reorganization of the banking system under systemic crisis conditions; and (iii) risk-based supervision.

IV. LESSONS LEARNED FROM THE BANK'S EXPERIENCE IN THE SECTOR

A. Reports from the Office of Evaluation and Oversight (OVE)

4.1 In order to identify the lessons learned from the Bank's interventions in the sector, various documents were analyzed, including the evaluations of institutional and sector strategies, country programs, and sector programs.⁸⁸ The main conclusions and recommendations of these studies are:

- a. It is essential to recognize the engines of increased productivity and economic growth, and identify the origin of obstacles to them. In particular, studies focusing on the private sector and SMEs highlighted that, in order to modify the sector's structural conditions, interventions need to take place at the systemic level as well as at the firm or sector level, and that they need to be tailored to the specific features of the problems affecting these companies. Thus, in order to identify effective public policy solutions to remove the existing obstacles, it is necessary to: (i) strengthen collaboration between agencies and ministries with competencies in the areas requiring intervention; (ii) strengthen collaboration between the public and private sectors, as the latter can help identify the causes of development problems and find solutions to them; (iii) focus interventions on overcoming the obstacles found; (iv) identify the tool or set of tools that can be implemented in each situation; and (v) use the most cost-effective combination of tools in each case.
- b. Access to credit promotes economic growth. For example, a 20% increase in credit penetration in the region in the 1980s corresponded, on average, with a 1% increase in per capita GDP between 1990 and 2005. Despite the region's progress in the financial arena, OVE's 2007 report highlighted a series of barriers to increasing access to credit. First of all, credit to the private sector is expensive, scarce, and short term.⁸⁹ Focusing on SMEs in particular, the report indicated that 75% of credit granted was for working capital and had a term of less than five years. This was so even when adequate security and information were provided, and the client had a favorable credit history. Second, capital markets were small, illiquid, and concentrated on a small number of issuers. Third, banking supervision frameworks lagged behind those of other developing regions. Although multisectoral global credit projects have provided support to the region's countries to expand the credit frontier, OVE pointed out that it was necessary to reformulate and create instruments tailored to the region's new situation, while also paying attention

⁸⁸ The recommendations have been taken from the following documents: IDB (2013a); IDB (2002a); IDB (2002b); IDB (2007); Raw (2012); Pires (2013); Puerta (2013); Soares (2013); Soares and González Diez (2013).

⁸⁹ IDB (2007) points to weaknesses in bank intermediation as being among the causes of high information and transaction costs, along with contract enforcement difficulties, inadequate security, informality, and the poor quality of projects submitted for financing.

to building financial infrastructure to incorporate segments underserved by the market (such as medium-sized firms), developing capital markets, financial services innovation, strengthening the role of second tier banks as representatives of innovative financial products, improving the solvency of productive firms, and institutional strengthening (for example, in the risk management and evaluability areas) accompanied by more technical assistance, and the dissemination of good practices in the region (IDB, 2007). The report also indicated the need to foster collaboration between IDB Group windows targeting the private sector, in particular as regards the exchange of diagnostic assessments and information on firms, financial intermediaries, topics of common interest, development of products, project evaluation, for example.

- c. The trend in the development of markets for financial services and other business development support services for SMEs has been favorable (IDB, 2002b). In particular, OVE has found the results of IDB Group activities relating to the construction of more appropriate infrastructure for SME finance (including improvements in property registers, procedures to offer collateral or guarantees) to be positive and that they were on the right path to develop SME credit. It also found that other areas of SME support, such as quality certification, alternative dispute resolution, and ecoefficiency, seem to have opened up effective areas of action (IDB, 2002b).
- d. Financial reform and capital market projects have been highly relevant for the development of the private sector (IDB, 2002a).
- e. OVE identified that development promotion projects through the private sector had a medium level of nonfinancial additionality in 44% of the evaluated sample, where the contribution to improving the regulatory framework, corporate governance, and access to new products and services were the most significant aspects (Pires, 2013).
- f. Interventions must be evaluable. This includes those focused on reforms and institutional strengthening, given that their development effectiveness can and should be demonstrated. In its evaluation of projects related to development promotion through the private sector, OVE highlighted that over the period 2008-2012 the percentage of projects identifying market failures had risen from 24% to 52%. In the sample, 23% of projects proposed clear solutions to overcome these failures, and two thirds of projects offered outcome indicators and gave a baseline (Pires, 2013).
- g. It is necessary to bolster the Bank's dissemination work to support productive development in the countries of the region and their business sector. It is therefore important to continue with the creation, systematization, and strategic dissemination of knowledge, including impact evaluations and the Bank's lessons learned in the sector. As with operational matters, in this

task it is essential to strengthen the collaboration between the various sectors and divisions, and between the Bank's public and private areas.

B. Results of the Development Effectiveness Matrix (DEM)

- 4.2 In sovereign guaranteed (SG) operations, the DEM score of the sector's projects has been improving significantly, rising from an average of 5.7 points in 2009 to 8.3 points in 2012 (Table 1). Since 2011 all the sector's projects have been rated as highly evaluable. Non-sovereign guaranteed (NSG) operations in the sector between 2011 and 2013 had a high degree of evaluability, scoring above the Bank's average.

Table 1: Average evaluability of sector projects (SG and NSG)

Dimensions evaluated	2009		2010		2011		2012		2013	
	Sector	Bank	Sector	Bank	Sector	Bank	Sector	Bank	Sector	Bank
SG	5.7	5.7	5.4	6.8	8.3	8.2	8.7	8.7	8.3	8.8
NSG	n/a		n/a		9.2		8.9		9.2	

Source: Development effectiveness matrices for sector projects.⁹⁰

- 4.3 Despite the results obtained, challenges remain in terms of impact evaluations. Although there is considerable evidence of the positive effect of access to finance on productivity (see Section II), in the context of IDB operations it is necessary to continue advancing in the design of methodologies and the collection and systematization of information enabling adequate counterfactuals to be constructed to evaluate the impact of the sector's projects. This will allow the Bank to expand its knowledge base on the results of its work.

C. Lessons learned from project completion reports (PCRs) and disbursement parameters⁹¹

- 4.4 **The Bank has been a strategic partner in the region.** The Bank has responded to LAC countries' development needs through operations in the sector. In fact, the operations analyzed formed part of the countries' development plans, and the majority complemented existing public policy programs in execution, for which there was already a budget allocated by the government. In turn, this guaranteed continuity and stability in the execution of operations. Similarly, the Bank played an important role in facilitating the public-private dialogue essential for the success of the interventions. The operations analyzed fostered various public-private partnership mechanisms to identify and overcome barriers to the productive sector's access to finance and for the establishment of participatory strategic planning

⁹⁰ SG and NSG operations use different metrics and are not directly comparable.

⁹¹ The lessons are based on the detailed analysis of 11 projects, including a documentary review (loan proposals, loan contracts, results matrices, risk matrices, final and midterm evaluation reports and/or PCRs, and project monitoring reports) and structured interviews with the project team leaders concerned.

processes, in which the private sector contributed to identifying barriers to access to finance and the public sector was active in implementing solutions.⁹²

- 4.5 **Synergies between financial and nonfinancial instruments to address the challenge of access to finance.** In general, programs have adopted the most appropriate mix of financing instruments to address the market failure identified. For example, programs based on guarantees and structuring of trusts and investment funds have proven to be mechanisms with a solid capacity for leverage and adaptation to the financial context in the country supported. Moreover, technical assistance has been an important complement and support for access to finance. Among other things, technical assistance has made it possible to strengthen firms' ability to prepare projects for financing and improve the financial and management techniques, thus contributing to reducing information asymmetries and transaction costs in the financing operation. It has also been important in building the institutional capacity of the executing unit and related institutions, and strengthening the corporate governance of public development banks.
- 4.6 **Adaptation of interventions to the context.** Changes in public policy priorities have sometimes led to changes in the critical path of program activity planning and implementation. Through an active dialogue with the authorities, during both the program preparation and execution phases, the Bank has successfully redefined its activities to match them to the changing realities of the intervention context, through Operating Regulations or other analogous regulatory instruments available for this purpose.⁹³
- 4.7 **Institutional analysis of the executing agency.** The Bank's Institutional Capacity Assessment System (ICAS) is a tool enabling very precise fiduciary analysis. However, in financial access programs for the productive sector, this analysis has had to be complemented by specific studies of the sector such as: eligibility processes, risk evaluation, and business management, analysis of technical profiles necessary for supervision and execution, and development of complementary institutional strengthening programs to bolster impact evaluation methodology application capacity.⁹⁴ To this end, it is necessary to have a broad institutional analysis tool that can identify more precisely the areas for improvement and Bank support necessary for effective execution of this type of program.
- 4.8 **Generation of knowledge in the sector.** Within the programs, conducting studies on productive sectors has proven to be an effective way of encouraging investment by financial institutions. This analysis may be complemented by meetings between key stakeholders, in both the productive sector and from financial institutions (general managers, risk-area managers), in order to disseminate the conclusions of this type of analysis and generate confidence in commercial banks.

⁹² AR-L1003, AR-L1022, BR-L1016, CO-L1082, UR-L1020.

⁹³ AR-L1003, BR-L1016, CO-L1082, ME-L1119, NI-L1046, PR-L1062.

⁹⁴ CO-L1082, ME-L1055.

- 4.9 **Evaluability of interventions.** The limited information available and the restrictions on access to databases on beneficiary company's financial operations represent an obstacle for conducting impact evaluations. Nonetheless, the Bank has been actively identifying solutions to these barriers. For example, the *a posteriori* reconstruction of relevant data, such as employment and salary levels and volume of exports of firms with similar characteristics to those targeted by the intervention offers a solution in cases where the necessary information is unavailable. One of the lessons learned from the programs analyzed is the importance of the project executing unit having mechanisms to generate its own information, in order to make measurements, and thus facilitate evaluations. As part of its institutional strengthening efforts the IDB has made a major effort to build these capacities, right from the program design phase.

D. The Bank's comparative advantages in the sector

- 4.10 Through its public and private areas, and the various sector divisions and private sector windows, the Bank has been strongly committed to promoting both structural and specific improvements to eliminate barriers constraining access to finance for the productive sector in the region. These actions have been accompanied by a series of programs to improve conditions in the private sector; to provide credit, investments, and risk mitigation instruments; develop and deepen capital markets; provide technical assistance and knowledge services; and promote productive development in the region. In the course of this work the Bank has developed and consolidated a number of comparative advantages. These include:
- a. **The Bank has been a strategic partner in the region.** Through its SG and NSG operations the Bank has a long track record of partnership with governments and the private sector in the region. Given its role as a strategic partner, its capacity to provide financial and nonfinancial resources, and its extensive knowledge of the challenges constraining economic growth, the Bank acts as an honest broker and/or catalyst, helping the public sector formulate policies to facilitate access to finance, programs to bolster business capacities, and programs to promote private sector development in key sectors of the LAC economy. The Bank also acts as a partner alongside entrepreneurs, sponsors, and not-for-profit organizations in projects supporting the region's productive development. Its knowledge of the region, and offices in all borrowing member countries, make daily contact on operational and public policy issues possible—including the identification, design, and execution of its SG and NSG operations.
 - b. **Synergies between financial and nonfinancial instruments to address the challenge of access to finance.** The Bank has a range of complementary instruments promoting the provision of public goods, stimulating the supply of credit, capital, and financing instruments (such as guarantees and

insurance), and lending to, and investing in, productive companies.⁹⁵ Given that access to finance also depends on firms' ability to attract capital, the Bank has nonfinancial instruments to build the capacity of firms in terms of their ability to formulate good projects and, in general, their technical, management and innovation capacity. For their part, sovereign guaranteed instruments can be used to address macroprudential risks, foster a business environment conducive to private activity, and help establish the regulatory frameworks necessary for financial, capital, and insurance markets to operate. Support is also given to public financial institutions intermediating credit resources to the private sector to overcome market failures. In turn, non-sovereign guaranteed activities promote the provision of credit, subordinated debt, access to capital, and use of risk-management instruments to cater to segments not served by the market.⁹⁶ In particular, efforts are being made to reduce gaps (mainly the lack of finance under appropriate terms and conditions) and overcome limited experience with financing instruments through a combination of instruments and mitigating mechanisms that are undersupplied by the market. Through its five windows—the Structured and Corporate Financing Department (SCF), the Opportunities for the Majority Sector (OMJ), the Inter-American Investment Corporation (IIC), the Multilateral Investment Fund (MIF), and the Capital Markets and Financial Institutions Division (CMF)—it has experience developing the financial ecosystems necessary for flexible and resilient markets. In all cases, the IDB Group relies on the provision of technical assistance and use of donor funds as key tools with which to help its public and private clients develop their institutional capacities.

- c. **Leveraging financial and nonfinancial resources.** The Bank has financing instruments allowing it to secure additional financial resources from donors, other multilateral banks, bilateral agencies, and the private sector. Equally important is its capacity to promote social and environmental best practices that help reduce risks, increase the economic and social impact of its interventions, and attract partners who value the Bank's additionality in ensuring compliance with safeguards. This means that its innovations not only lead to better productive outcomes, but also good practices in terms of

⁹⁵ By way of illustration, Figure 10 shows in more detail a series of financial and nonfinancial instruments used by the various windows of the IDB Group, classified by the type, size, and sector of the beneficiaries of those instruments.

⁹⁶ SME support is an integral activity in IDB Group operations through both its NSG and SG windows. Between 2011 and year-end 2013, the OMJ and SCF windows provided financial support to 341,849 SMEs. On current trends, over 500,000 SMEs will be supported in 2015. The windows have used a range of instruments including partial credit guarantees, capital investments, direct loans and loans to financial institutions to extend lines of credit or financial products aimed at SMEs. For its part, in 2012 alone the IIC managed to reach US\$378.9 million in loans to SMEs. In all, 82% of its active portfolio comprises SME loans or investments, and the target is to reach 85% in the coming years. Its FINPYME credit program, aimed at smaller SMEs through loans of between US\$100,000 and US\$600,000, was scaled up to reach over 2,000 SMEs.

their environmental and social results. Moreover, it has instruments with which to mitigate credit and policy risks, and enable other sources of funding to be attracted, particularly in the case of its NSG operations, and thus widen the range of sources and increase the amounts of funding for productive projects and companies.

- d. **Innovation capacity.** The Bank's track record shows it has considerable capacity to design and implement innovative solutions to the region's financing problems. The Bank has extensive experience providing small productive firms with financial and nonfinancial support, innovations on inputs to supply chains and foreign trade, development of new credit techniques and instruments allowing credit to expand to productive sectors, (especially those techniques based on big data and credit scoring techniques), development of new instruments for diagnosing the status of access to finance (dashboard of key indicators and toolkit for their implementation at the national and subnational level), the use of seed capital and alternative sources of finance (such as crowdsourcing platforms), and establishment of capital markets. The Bank has the capacity to combine the range of tools to offer a more comprehensive, higher impact product.

Box 1. Promoting new credit technologies and techniques

New tools and technologies offer the potential to alleviate constraints relating to information asymmetries through alternative risk assessment models based on the entrepreneur's characteristics, transaction history, or digital footprints. This is an area in which the IDB is supporting the region's countries. For example, in partnership with the Entrepreneurial Financial Lab, the IDB is supporting the development of a risk assessment methodology based on psychometric tests that complement traditional credit risk calculations. The MIF is also promoting the implementation of The Receivable Finance Infrastructure (TREFI) platform, which aims to improve the availability of credit to SMEs from their suppliers, by means of a risk-management system based on supplier information to predict firms' credit risk. In this model, a trustee buys the SMEs' accounts payable at a discount from the suppliers, while the TREFI manages the risk assumed between the supplier and the trustee.

Box 2. Access to finance for women entrepreneurs

The IDB supports the region's countries' efforts to expand access to finance for women entrepreneurs. For example, the Women entrepreneurship Banking (weB) program works with financial institutions that support financing models for firms run by women. Through its Line of Activity for Promoting Small Enterprise Financing, the MIF devotes nonreimbursable technical cooperation resources to transfer knowledge on effective financing models for SMEs set up or run by women, and to train investment officers or credit managers on these products and services. For its part, through its beyondBanking program, SCF channels resources into lines of credit, partial credit guarantees, and risk-management products to strengthen liquidity and extend the terms of financial institutions aiming to expand loans for this underserved customer group.

- e. **Qualified teams and technical know-how:** The Bank has a team of professionals with expertise and experience in fields relating to this SFD, and a balanced distribution between Headquarters and the Country Offices to promote country dialogue. In order to reinforce this capacity, the Bank will seek to strengthen its technical team to provide technical assistance on insurance issues, and devote more resources to designing methodologies and conducting impact evaluations, so as to generate knowledge on the effect of the Bank's interventions in various areas, including the gender perspective.⁹⁷ The Bank's human capital resources facilitate the design of comprehensive multidisciplinary programs helping raise productivity and boost economic growth through better access to finance. The ability to create multisectoral teams enables efforts of various Bank sectors to be leveraged, both SG and NSG, together with those of other national and international institutions, to provide an effective solution to the region's productivity issues, in keeping with the characteristics of the situation concerned.⁹⁸ A key factor in the effective utilization of this capacity is the provision of technical assistance to strengthen the regulatory capacity of public entities, improve entrepreneurs' business and technical capacities, and incorporate new knowledge in business' activities through instruments that raise their productivity, and at the same time, broaden the social and environmental benefits.⁹⁹ The IDB Group as a whole has the capacity to finance and manage both large and

⁹⁷ The details of how these objectives are to be achieved will be presented during budget discussions.

⁹⁸ In particular, the Bank has incorporated specific incentives for multisectoral work (for example, through the possibility of double-booking operations), and will continue to step up this mode of working. Since 2009, 18 programs of this type have been approved, for a total of US\$1.8 billion, including interventions on access to finance, business development services, provision of productive and road infrastructure, etc.

⁹⁹ Technical cooperation operations have supported: (i) sector studies; (ii) demand structuring studies; (iii) regional public goods; (iv) methodologies and information collection systems; (v) strengthening of management, monitoring, and evaluation instruments; (vi) exchange and dissemination of project design and management good practice; (vii) strengthening of national, subnational, and other institutions responsible for sector policies; and (viii) business development services, including support to firms on the design of investment projects.

small-scale projects that interact directly with the region's private sector. Lastly, the Bank has generated a critical mass of knowledge on the financing of productive sectors that it shares with its clients in the design of their operations and through its publications, websites, and events.¹⁰⁰

- f. **Collaboration networks:** Since its creation the Bank has been building a huge collaborative network with a variety of public and private entities, civil society associations, and universities.¹⁰¹ These networks include those set up under the Regional Public Goods Program and thematic networks such as the Latin American Financial Network, the Network of Central Banks and Finance Ministries, and participation in multilateral forums such as the network of multilateral agencies working on corporate governance topics, evaluation of impact of operations with the private sector, etc. These collaborative networks have served as a channel for dialogue with the region, other multilateral organizations and donor countries, and help bring the Bank's analytic and operational work to a wider audience. Through these networks the Bank has helped step up the dialogue and strengthen intra-regional and multilateral cooperation. In particular, the Bank has actively supported South-South cooperation for the creation of regional public goods in those cases where the development challenges or opportunities can be addressed more effectively and efficiently at the regional level.
- g. Bearing in mind the comparative advantages described, there are areas of intervention in the sector where the Bank's contribution has less value added. These will therefore not be addressed by the Bank in this SFD. This is either because commercial banks are more efficient, or the market failures are of limited relative importance for the Bank's objectives in the sector. Such areas

¹⁰⁰ The most relevant include: "Unlocking Credit" (IDB, 2005); "The Age of Productivity" (IDB, 2010) and "Políticas e Instituciones para el Desarrollo Productivo" [Policies and Institutions for Productive Development] (IDB, 2014) in the series "Development in the Americas"; "Public Development Banks: Toward a New Paradigm?" (IDB-CMF, 2013); "The Role of National Development Banks in Catalyzing International Climate Finance" (Smallridge et al., 2013); and impact evaluations on programs in the sector in Chile (Bonilla and Cancino, 2001), Colombia (Eslava et al., 2012), Costa Rica (Torres et al., 2003) and México (Calderón et al., 2013). The Bank has also been very active in promoting exchange of knowledge between countries and generating learning opportunities for program executing agencies, through: (i) regional workshops; (ii) field visits taking in several countries; and (iii) organization of and participation in international seminars in the sector. Notable among these are the annual Regional Dialogue meetings on key topics for the sector, which bring together major public, private, and academic stakeholders; regional events organized together with the Asociación Latinoamericana de Instituciones Financieras para el Desarrollo [Latin American Association of Development Finance Institutions] (ALIDE).

¹⁰¹ This network includes more than 2,000 civil society and business associations, which have received MIF support, and the network of private banks, firms that have invested in equity, and the more than 1,000 firms that have worked in the Bank's private sector (SCF and OMJ) and IIC. It also includes the main stakeholders in the sector with which the Bank has been working closely, such as national development banks, regulatory and supervisory bodies, the Caribbean Development Bank, the Federación Latinoamericana de Bancos [Latin American Federation of Banks] (FELABAN), ALIDE, and the Asociación de Supervisores Bancarios de las Américas [Association of Banking Supervisors of the Americas] (ASBA).

include: consumer finance and credit cards, and reform to financial arrangements for pension funds. In the case of the latter, the Bank is working on the pensions area from its Labor Markets Unit. However, the reforms to pension funds' financial arrangements have less priority in this particular sector framework, given that it is aimed at supporting SMEs, and financial access and supervision.

V. TARGET, PRINCIPLES, DIMENSIONS OF SUCCESS, AND LINES OF ACTION THAT WILL GUIDE THE BANK'S OPERATIONAL AND RESEARCH ACTIVITIES IN THE SECTOR

A. The Bank's main goal and principles for its work in the sector

5.1 The Bank's main goal in the sector is to raise the productivity of the economies in the region by facilitating the productive sectors' access to finance—through its sovereign and nonsovereign guaranteed instruments. To achieve this target, the proposed lines of action and operational activities respond to the diagnostic assessment given in Section III and the Bank's comparative advantages identified in Section IV. The SFD also presents knowledge and dissemination activities, which are the basis for the generation of future innovations in the sector. Interventions will be designed to include measurable objectives relative to a baseline, specifying the appropriate methodology to evaluate their expected impact, in accordance with the Development Effectiveness Matrix for Sovereign Guaranteed and Non-sovereign Guaranteed Operations (document GN-2489), promoting access to information on interventions in the sector. Lastly, the Bank will design interventions according to the specific conditions in each country and the working principles in the sector. These principles, deriving from the analysis of the international evidence (Section II) and the lessons learned (Section IV) include:

- a. **Additionality of interventions.** Interventions must respond to a market failure or weaknesses in market institutions. They should therefore help provide finance where markets do not or where markets are underdeveloped and/or implement mechanisms to mitigate or transfers risks.
- b. **Development outcomes.** Interventions must aim to raise beneficiary firms' productivity while complying with high environmental, social, and governance standards; and they should promote social welfare and development objectives.
- c. **Subsidy minimization.** In cases in which the private sector would not be able to finance an investment in the public interest because of a low return or excessive risk, the subsidy to encourage the private sector to make the investment should be the minimum possible.
- d. **Tailoring of financing policies and instruments.** The policies and financing instruments will be tailored to the characteristics of the country context, the

problems it addresses, and the severity of the market or institutional failures that exist.

- e. **Completeness of design and execution of policies.** Interventions must take into account the complementarities between policies, and the existence of complementarities and subsidiarity between the public and private sectors. Public sector support to the private sector should, as far as possible, catalyze market development and the mobilization of private sector resources (crowding in).
- f. **Policy targeting.** To enhance development effectiveness, interventions should aim to benefit projects and potentially productive firms in the segment or sector addressed, and at the same time produce demonstration effects to encourage the scale-up of activities. Box 3 sets forth some of the guidelines for better targeting of interventions in this regard, based on the literature analyzed and international best practices. The knowledge activities envisaged in Dimension 1 will enable progress to be made towards a methodology with detailed criteria for targeting interventions, the outcomes of which will be presented in the update to this SFD.

Box 3. Targeting of interventions.

Objectives. The interventions in the sector are to be aimed at identifying companies with the most capacity to grow and improve the economy's productivity. Logically, companies' potential productivity is only imperfectly observable ex ante. Also, the pursuit of higher returns implies, by definition, higher risk or likelihood of error.

Mechanisms. Some principles and mechanisms that are headed in the direction of achieving the objectives of the interventions in the sector and reducing the information and institutional constraints mentioned above include:

- **Simplicity.** Bringing about more productive companies requires the use of appropriate instruments (insurance, guarantees, credit, technical assistance, etc.) and intermediaries (ad hoc funds, financial institutions, first and second tier public banks, etc.). The available instruments obviously depend on the degree of market development (for example, the greater or lesser presence of venture capital funds, insurance market, etc.). These instruments and combinations thereof can be complex. Therefore, the design should aim to achieve the simplest combination of instruments with which to fulfill the objectives.
- **Robust diagnostic assessments** of the country's business and financial context, making it possible to determine which sectors offer opportunities for growth and what new firms have growth potential.
- **Dialogue with the private sector and academia.** The capacities of the private sector and universities to identify new opportunities are crucial. The public sector's ongoing dialogue with these sectors makes it possible to identify sectors of activity or instruments that it is worth supporting to complement private sector efforts.
- **Project selection (screening) technologies.** Although, by definition, the risk of mistakes cannot be eliminated, interventions need to be based, to the extent possible and depending on each situation, on competitive selection processes that create incentives for private entities to reveal prices and information (for example, through guarantee or credit auctions or competitions and proposals for technical assistance). The use of new technologies by financial intermediaries (psychometric tests, etc.) also helps discriminate between projects, particularly in contexts of weak institutional frameworks.
- Continuous improvement based on **effective and transparent monitoring and evaluation.** The monitoring and evaluation of programs must be robust and have consequences. Formal mechanisms introducing clauses disqualifying entities with poor results or undesirable behaviors from benefiting again or when ineffective programs fail to make the necessary improvements.

g. **Institutional strengthening.** Interventions should promote the adoption of standards of governance, transparency and integrity, and technical, environmental and social standards in institutions in the countries of the region to avoid institutional failures.

h. **Evaluability.** The interventions will seek to include evaluation methodologies enabling the effectiveness of the actions to be determined.¹⁰²

¹⁰² See Sector Guidelines for Small and Medium Enterprise Finance and Development Programs (OP-580-2).

- i. **General points concerning operations:** In keeping with the Development Effectiveness Framework (document GN-2489), interest rates on subloans applicable to all loan operations to be carried out by the Bank to back SMEs and access to financing should be such that operations are economically profitable based on the application of cost-benefit methodologies used by the Bank to analyze projects.

B. Dimensions of success, lines of action, and activities

- 5.2 The knowledge and capacities of the Bank's public and private sectors are different and complementary. To maximize the development impact of the IDB Group's interventions, coordination between the SG and NSG entities needs to be stepped up. To this end, closer coordination will be sought between the windows through mechanisms promoting: (i) information sharing (diagnostic assessments, studies, impact evaluations, databases, etc.); (ii) working together on the development of sectoral analysis and knowledge products; (iii) harmonizing development impact indicators and sector monitoring; (iv) reconciling priorities and mechanisms of action; and (v) promoting joint actions, for example to contribute to improving the institutional and regulatory framework.
- 5.3 **Dimension 1. Regulations, instruments, and institutions for the effective management of macrofinancial risks implemented and strengthened.** The actions will improve and strengthen regulations and instruments to ensure the effective management of macrofinancial risks. They will also promote competent institutions with strengthened and transparent technical capacities. To achieve these objectives, the following lines of action are proposed:
- 5.4 **Lines of action:** improve and strengthen (i) regulation and supervision; (ii) instruments; and (iii) institutions for proper macrofinancial risk management. To fulfill these lines of action, financing is proposed for the following operational and knowledge activities:
 - a. **Operational activities:** (i) macro- and microprudential reform (compliance with Basel, IOSCO, and IAIS regulatory standards); (ii) strengthening the regulatory framework to expand the regulatory perimeter, and enhance the financial and fiscal transparency and corporate governance of banks, firms, and market institutions (exchanges, etc.) and others; (iii) comprehensive public asset and liability management frameworks; (iv) monetary policy instruments, particularly those intended to prevent systemic liquidity crises; and (v) institutional strengthening of the competent authorities.
 - b. **Knowledge activities:** (i) studies on the implementation of Basel requirements; (ii) macroprudential regulation (including Basel III) methodology and studies of impact on productivity; (iii) position paper on methodological aspects in the study and evaluation of financial programs (including general equilibrium models, regression models using panel data, and impact assessment studies); (iv) analysis of company insolvency and

bankruptcy laws in countries in the region; and (v) country-level plans for the implementation of international money laundering standards (FATF).

5.5 **Dimension 2. Capital markets and risk management instruments developed.**

The regulatory reforms will address the need to facilitate long-term financing through the development of capital markets and risk-management instruments. To achieve this objective, the following lines of action are proposed:

5.6 **Lines of action:** (i) improve financial contract information and functioning; (ii) promote market interconnection; (iii) develop risk-management instruments; (iv) facilitate financing of long-term projects; and (v) “crowd in” private sector investments in less developed markets. To fulfill these lines of action, financing is proposed for the following operational and knowledge activities:

- a. **Operational activities:** (i) improved financial contract enforcement (primarily credit registers, greater transparency, increased competition, guarantee law, bankruptcy law, regulations on the use of collateral, real estate and movable property registers); (ii) strengthening the regulatory framework: regulation of institutional investors (pension and sovereign wealth funds), PPPs, regulation of securities and insurance markets, corporate debt, facilitation of access to capital markets for SMEs (negotiable bonds); (iii) development of new credit risk assessment tools in the financial sector; and (iv) support for financial integration.
- b. **Knowledge activities:** (i) methodology and studies of impact of institutional reforms (contract enforcement and creditors’ rights) on productivity; (ii) technical studies to support strengthening of the Latin American Integrated Market (MILA); and (iii) risk assessment methodologies and design of integrated disaster risk management plans.

5.7 **Dimension 3. Financing frontier for the productive sector in the region expanded.**

The interventions will allow the financing frontier for the productive sector to be expanded, facilitating financing for technology adoption, improving the management of productive businesses, innovation, and market access. Infrastructure or infrastructure service provision interventions will be consistent with the Strategy for Sustainable Infrastructure for Competitiveness and Inclusive Growth (operational policy OP-1012), while those interventions relating to climate change adaptation or mitigation will be consistent with the Integrated Strategy for Climate Change Adaptation and Mitigation, and Sustainable and Renewable Energy (operational policy OP-1011). These interventions will also comply with the sector objectives and guidelines in the Agriculture and Natural Resources Management, Transportation, Energy, Water and Sanitation, and Tourism Sector Framework Documents, as stated in paragraph 1.4, and will be carried out in coordination with the relevant Division. The monitoring and evaluation plans for operations will include monitoring of interest rates over the life of the operation. To achieve the objective of this dimension, the following lines of action are proposed:

5.8 **Lines of action:** (i) actions which aim to guide the supply of finance towards the productive sector (particularly SMEs, startups, and young companies), or improve the terms on which credit is provided; (ii) actions to strengthen the productive system and conditions of demand for finance (productive development services for companies in order to improve their productive capacity and access to finance);¹⁰³ (iii) financing for value chains; and (iv) other groups and segments with productive not completely served by the market, such as companies run or owned by women. To fulfill these lines of action, financing is proposed for the following operational and knowledge activities:

- a. **Operational activities:** (i) global credit programs with a particular focus on SMEs, startups, and young companies, and companies run or owned by women, including, for example, refinancing credit insurance, agricultural insurance,¹⁰⁴ guarantee funds, support for seed capital and angel investors, and capital finance in general; (ii) support to productive development through public and commercial banks; (iii) support to commercial banks for the financing of productive firms, financing for the adoption of green technologies, and trade facilitation with credit and other financial instruments; (iv) provision of technical assistance to the private sector to improve access to credit and productivity-enhancing technologies, techniques, and good practices; (v) multisector value-chain support programs: financing, business services, and market access (including infrastructure to support value chains such as logistic, transportation, irrigation, and energy infrastructure); and (v) improving financial contract enforcement (credit register, improved transparency, increased competition, guarantee law, bankruptcy law).
- b. **Knowledge activities:** (i) methodology to define criteria for selection and targeting of productive firms, particularly with respect to SMEs; (ii) design of impact evaluation methodologies on financing interventions for productive development; (iii) impact evaluation studies on productive development financing interventions; (iv) environmental and social benefit monitoring and evaluation strategies and systems for PDB-financed projects; and (v) studies supporting operational activities, on the region's productive sector, and on SMEs' characteristics, conditions, and constraints in order to better target interventions.

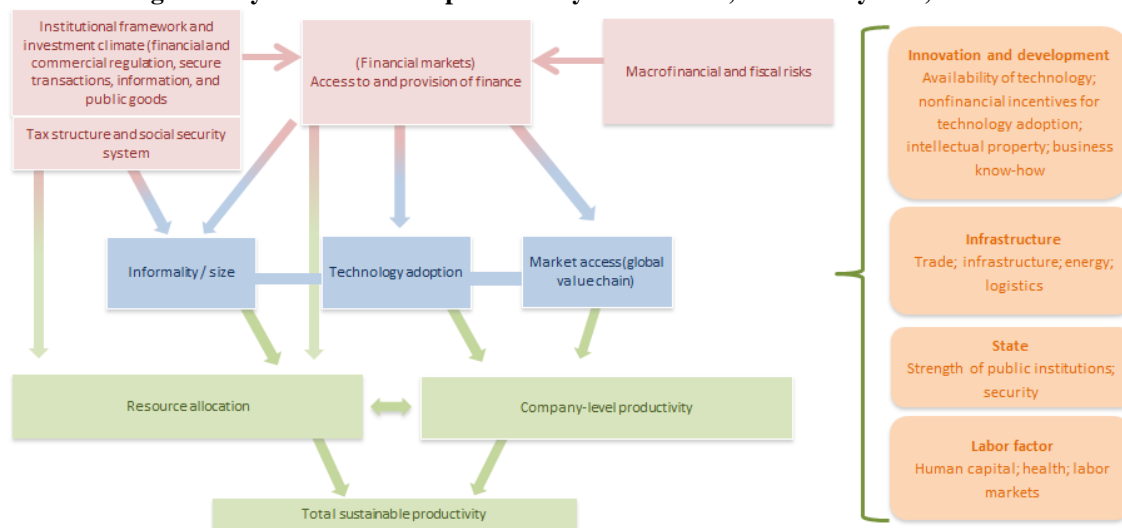
¹⁰³ Interventions involving services to strengthen business, technology, and innovation capabilities will be carried out in keeping with the Sector Strategy for Institutions for Growth and Social Welfare (document GN-2587-2) and the Innovation, Science, and Technology Sector Framework Document.

¹⁰⁴ These interventions will be carried out in keeping with the sector guidelines and objectives established in the Agriculture and Natural Resources Management Sector Framework Document (operational policy OP-2001).

FIGURES AND TABLES

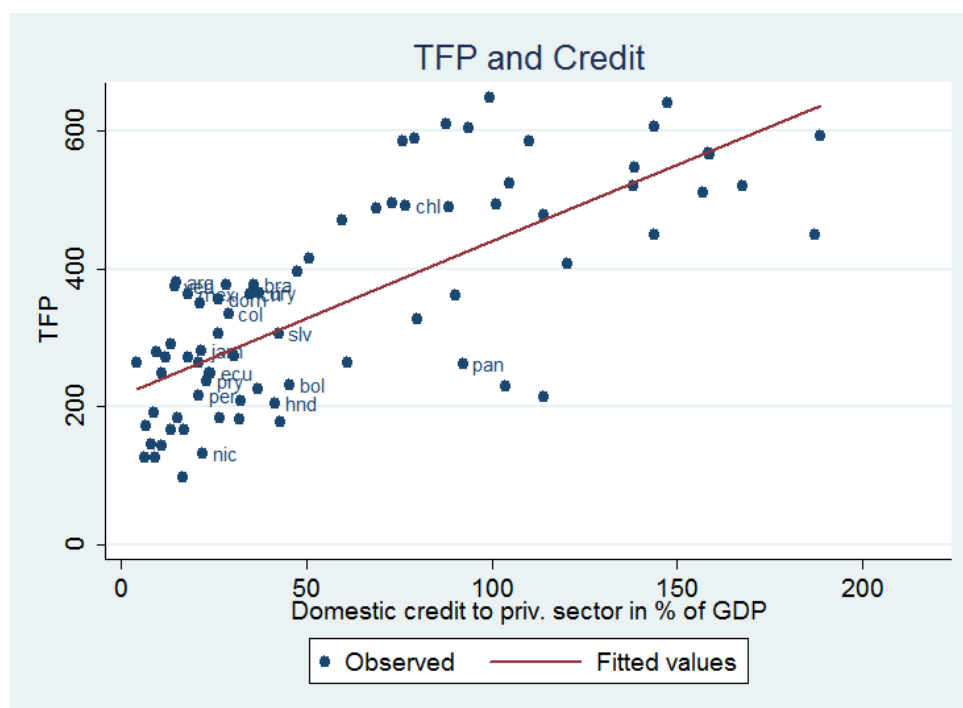
A. FIGURES

Figure 1. Systemic vision of productivity: institutions, financial system, and other factors



Source: IDB.

Figure 2. Access to finance and increase in TFP, on average (2000-2008)



Source: IFD/CMF calculations based on WDI (World Bank) and Daude and Fernández-Arias (2010).

Figure 3. Policies for promoting access to finance

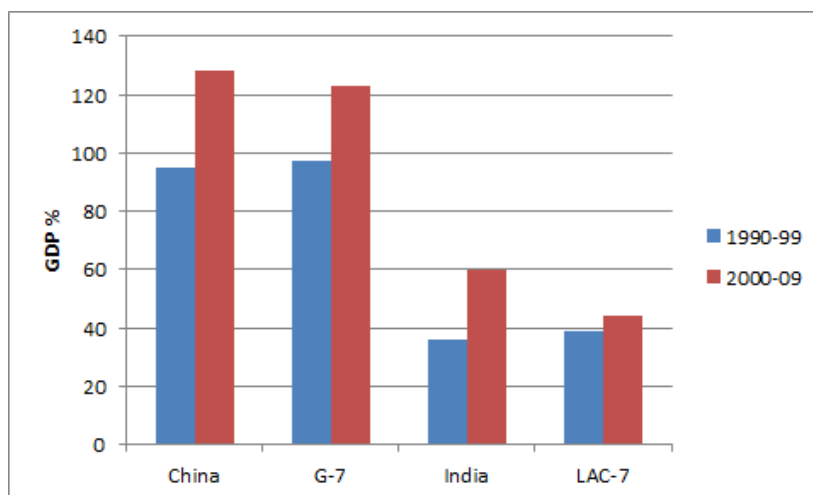
Type Purpose	Horizontal	Vertical*
Public Goods	<ul style="list-style-type: none"> •Strengthening business and bankruptcy regulations and institutions •Strengthening competition •Integrated public asset and liability management frameworks •Public-private partnerships 	<ul style="list-style-type: none"> •Micro- and macroprudential regulation •Financial transparency •Monetary policy instruments •Counterpart risk management infrastructure •Strengthening capital market regulations and institutions •Facilitating access to capital markets by SMEs and firms in specific sectors
Market interventions*	<ul style="list-style-type: none"> •Global credit programs •Long-term financing •Credit insurance •Seed capital •Angel investors •Guarantee systems •Technical assistance to enhance entrepreneurship, improve productive processes and access to finance •Innovation: finance and technical assistance 	<ul style="list-style-type: none"> •Value chains and territorial arrangements: credit, guarantees, insurance, technical assistance •Agricultural insurance •Guarantee systems for specific sectors (e.g., agriculture, technology) •Seed capital and angel investors for specific sectors (e.g., technology) •Technical assistance to enhance entrepreneurship, improve productive processes, and access to finance •Infrastructure financing •New IT or psychometric tools to evaluate loan proposals

■ Institutional and regulatory reforms for access to finance
■ Financing policies for productive development

* "Vertical" includes policies and instruments for the financial sector and real sector of the economy. "Market interventions" include policies and instruments affecting prices in a way that discriminates between economic agents.

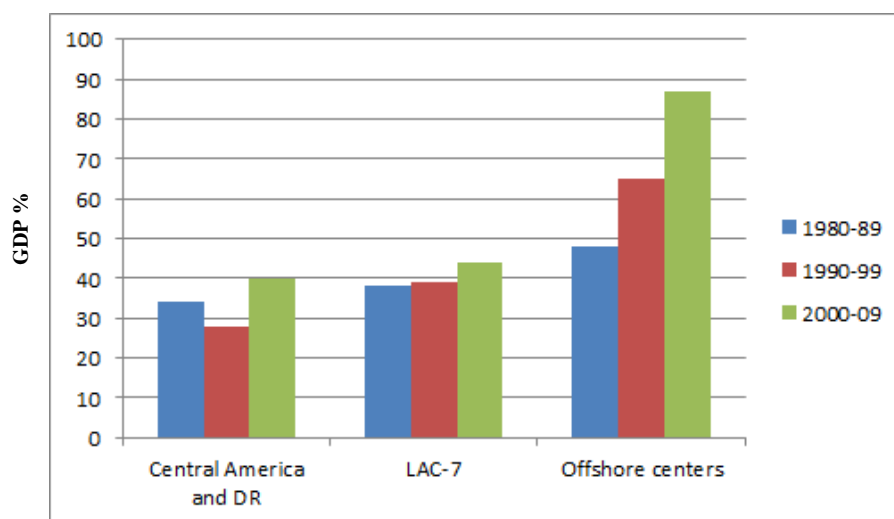
Source: IDB.

Figure 4. Comparative evolution of bank assets (1990-2009)



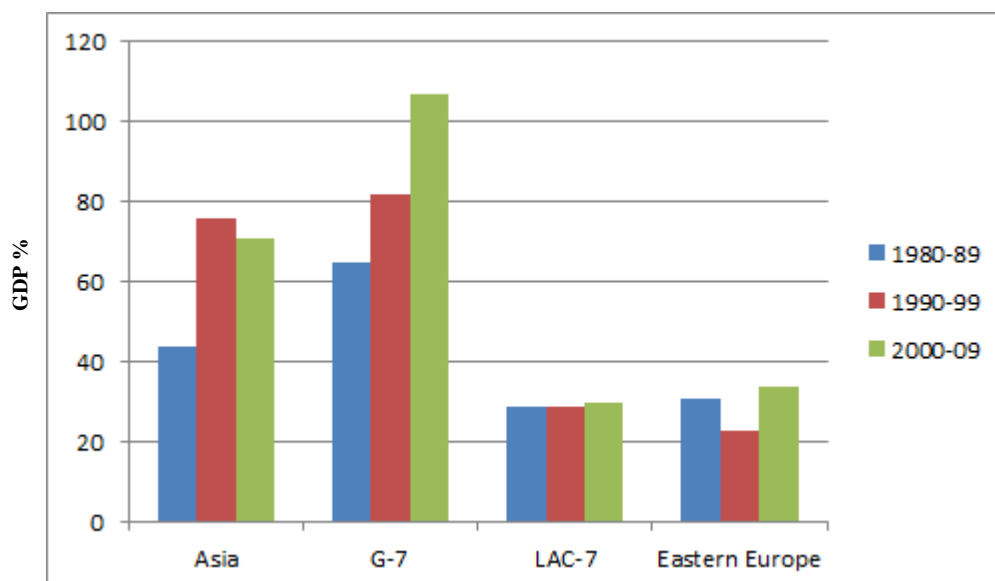
Source: IDB, based on World Bank data (2013).

Figure 5. Total bank assets as a % of GDP (LAC, 1980-2009)



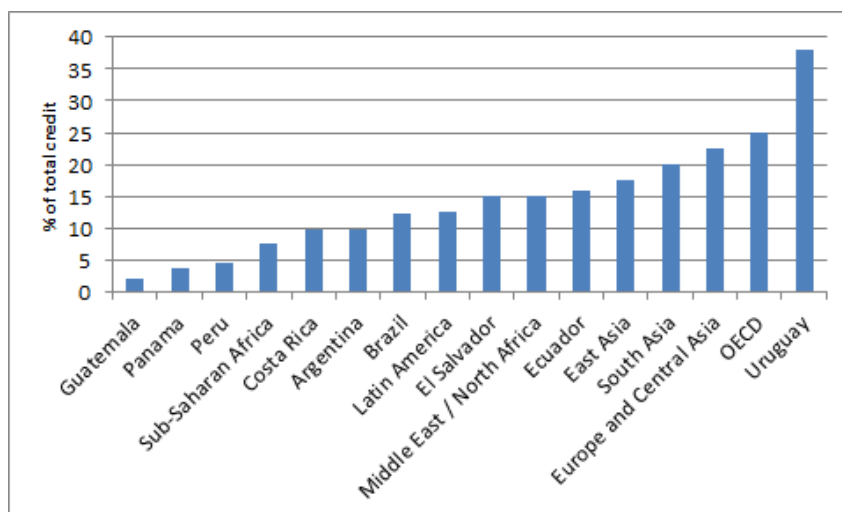
Source: IDB, based on de la Torre et al. (2012).

Figure 6. Bank credit to the private sector (1980-2009)



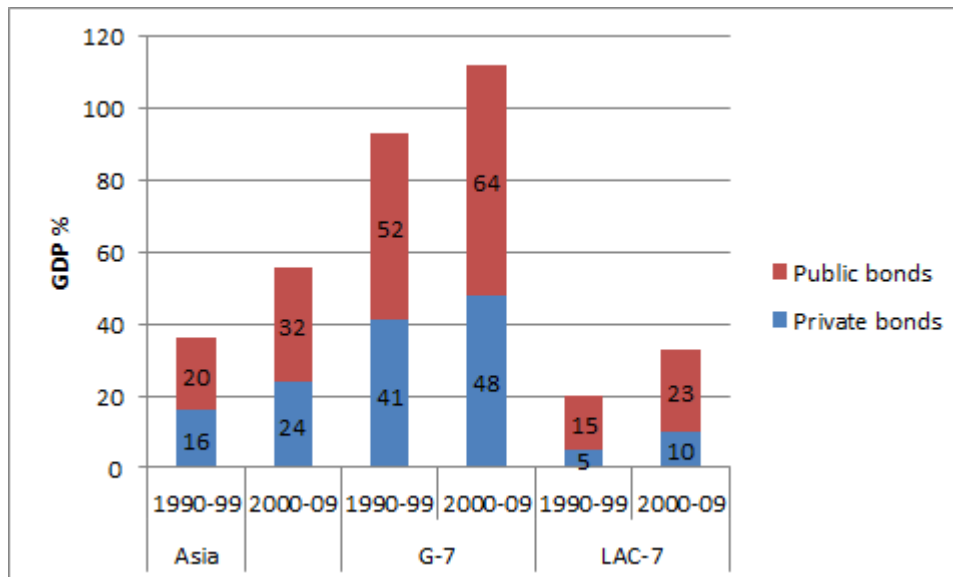
Source: IDB, based on de la Torre et al. (2012).

Figure 7. Credit to SMEs as a % of total credit (2010)



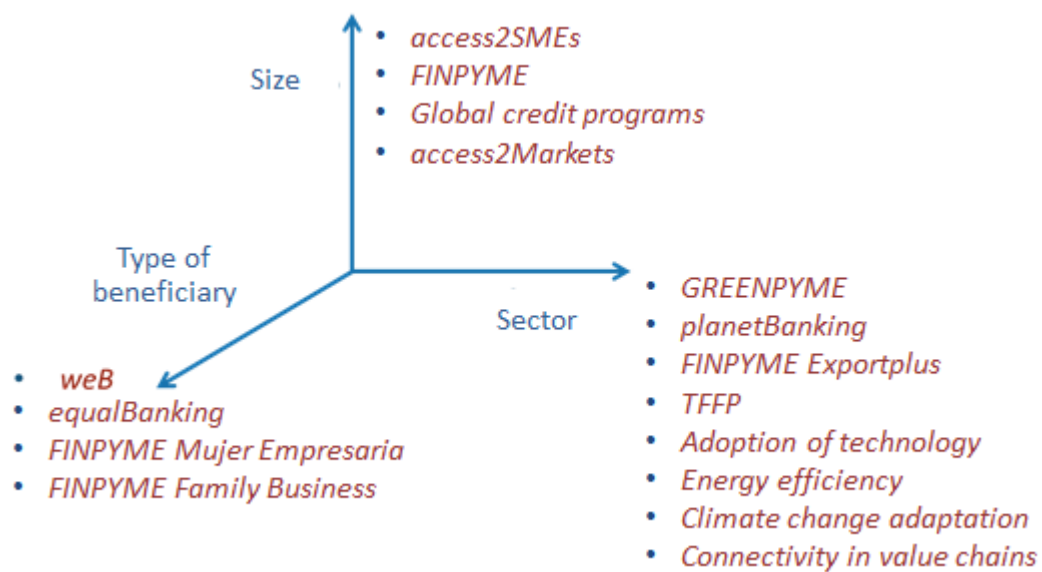
Source: IDB, based on OECD-ECLAC data (2013).

Figure 8. Size and composition of the bond market, as a % of GDP (1990-2009)



Source: IDB, based on de la Torre et al. (2012).

Figure 9. Some instruments used by the IDB Group in promoting access to finance



Source: Prepared by authors.

B. TABLE

Table 1. The SFD's challenge, dimensions of success, lines of action, and operational activities

Challenge	Dimensions of success	Lines of action	Operational activities
Strengthening macrofinancial regulation and supervision, its institutional framework and instruments	Regulations, instruments, and institutions for the effective management of macrofinancial risks implemented and strengthened.	<ul style="list-style-type: none"> – Actions to improve and strengthen regulation and supervision, instruments and institutions, for proper macrofinancial risk management. 	<ul style="list-style-type: none"> – Macro and microprudential reforms (complying with Basel, IOSCO, and IAIS regulatory standards). – Strengthening the regulatory framework to expand the regulatory perimeter, financial and fiscal transparency, and improve the corporate governance of banks, firms, and market institutions, etc. – Comprehensive frameworks for the management of public assets and liabilities. – Monetary policy instruments, particularly those intended to prevent systemic liquidity crises – Institutional strengthening of competent authorities.
Developing the capital market and risk management instruments	Capital market and risk management instruments developed.	<ul style="list-style-type: none"> – Reforms to improve financial contract information and functioning, promote market interconnection, develop risk-management instruments, facilitate financing of long-term projects, “crowd in” private sector investments in less developed markets. 	<ul style="list-style-type: none"> – Improve financial contract enforcement (primarily through credit registers, greater transparency, increased competition, guarantee law, bankruptcy law, regulations on the use of collateral, real estate and movable property registers). – Strengthening the regulatory framework: regulation of institutional investors (pension and sovereign wealth funds), PPPs, securities and insurance market regulation, corporate debt, development of new risk evaluation instruments in the financial sector, facilitating SMEs' access to capital markets (negotiable bonds). – Financial integration.
Improving the efficiency and scope of bank credit intermediation to the productive sector	Financing frontier for the productive sector in the region expanded.	<ul style="list-style-type: none"> – Actions aiming to guide the supply of financing towards the productive sector (particularly SMEs) or improve conditions of this supply. – Actions to strengthen the productive system, management of productive firms, and conditions of demand for finance – Finance for value chains – Finance for other groups and segments with productive potential not served by the market, in particular firms run or owned by women 	<ul style="list-style-type: none"> – Global credit programs, with a particular focus on SMEs, startups, and young companies, and firms run or owned by women including, for example, refinancing of credit insurance, agricultural insurance, guarantee funds, seed capital support and angel investors, and capital finance in general. – Support to productive development through public and private banks. – Support to commercial banks for the financing of productive firms, financing for green technology adoption, and trade facilitation through credit and other financing instruments – Provision of technical assistance and knowledge services to private firms to improve their management and access to credit and productivity-enhancing technologies, techniques, and good practices. – Multisectoral programs of support to value chains: financing, business services, and access to markets. – Improve financial contract enforcement (credit registers, greater transparency, increased competition, guarantee law, bankruptcy law).

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