

The World Bank's Private Sector Development Initiative

April 28, 2005

Symposium Summary

On April 21 The Bretton Woods Committee held a symposium to review the World Bank's Private Sector Development (PSD) initiative. The PSD initiative, formed three years ago, was based on the premise that domestic capital formation is the most powerful engine for growth and the source of major resources for development. At that time, The Bretton Woods Committee assembled a private sector working group to evaluate the new Bank initiative. The group gave the policy a strong endorsement, noting that countries that have achieved self-sustaining growth have invariably depended on a vibrant private sector to hasten to their advance.

The PSD initiative bridged an important ideological divide at the Bank between those who argued that the Bank's sole focus should be poverty reduction and others who argued that the best way to alleviate poverty is by promoting economic growth. The PSD strategy showed that the goals cannot be viewed as alternatives, but are in fact mutually reinforcing policies.

Michael Klein, Vice President, Private Sector Development, The World Bank

Klein enumerated the elements of "private sector development" including: investment climate and general business environment issues; privatization process and policies, including some issues of state-owned assets management; corporate governance; and corporate social responsibility.

Klein described how the move to the PSD strategy ended a period of "poverty fundamentalism" at the Bank, in which all efforts were focused on providing services directly to poor people. This narrow vision ignored the notion that escape from poverty was dependent on people having jobs and incomes, not just better services.

The Bank Group's agenda for improving the investment climate in the private sector development area has become prominent since its inception. Perhaps this is best illustrated by the annual *Doing Business* report, which benchmarks 145 countries, ranking key measures of an open business environment. Benchmarks in the *Doing Business* report demonstrate that countries in Latin America and Africa typically have the most complicated, least business-friendly environments. On the other end of the scale are the Nordic countries whose policies are geared toward facilitating capital formation, and enhancing businesses' ability to provide jobs, generate income, etc.

The Bank's system of country benchmarking provides the basis for a constructive conversation with governments that can immediately translate into reform. *Doing*

Business differs from other similar reports because it only examines how governments treat domestic firms, unlike similar reports that focus on the treatment of foreign firms

Instruments and Activity Levels in the World Bank Group

In the PSD work of the Bank, improving the investment climate has spawned a significant increase in studies and analysis, diagnostics, and policy-based lending. The PSD strategy also encompasses new thinking about how private solutions can be brought into the delivery of services to poor people. This involves the concept of “output-based aid,” in which aid agencies provide support (for example) to purchasers of electricity rather than funding the construction of the power plant itself, leaving that to the private sector and private capital markets.

Microfinance

There are two lessons illustrated by the entry of microfinance into developing countries. Market factors must trump social factors in instituting successful programs. The goal of microfinance is to offer a product that is cheaper than what moneylenders provide, and then to expand access. While a noble objective, microfinance is a business proposition based on the notion that poor people, as with everything else, will pay more per unit of service than rich people.

In order for microfinance to flourish, interest rate caps must be abolished. Interest rates need to be on the order of forty to fifty percent per year. While this may seem high, credit cards in the United States often have penalty rates of twenty three to twenty five percent. For microfinance institutions to succeed and expand credit, the market must be allowed to flourish.

Joint SME IFC/IDA program in Africa

In a pilot program, the World Bank has brought IDA and the IFC together to help meet Africa’s need for both concessional financing and private sector discipline and delivery mechanisms. Seven countries are taking part in this pilot program, although progress is slow in large part because of policy problems in the institutions.

Allocation of IDA funds (70/30 percent grant/loan mix) is the biggest issue. Recipient countries also adamantly defend their right to “their money,” blocking its use for private sector solutions. Where a regional based approach might bring about good results, the Bank often faces a logistical nightmare trying to implement seven different SME programs in seven countries while dealing with seven governments. In other instances, IDA funds for SME projects should perhaps be distributed to sub-sovereign entities without a guarantee, reducing government involvement in the decision making process and increasing efficiency.

If the IDA Deputies agree, there may be a change in the allocation mechanism so that a certain percentage of IDA resources would go for non-sovereign projects. As an

incentive, additional IDA funds would be available to those borrowers that improved their business environment.

Since 1995 there has been significant growth in Africa and cause for optimism. Debt levels as a share of GDP are coming down and trade as a share of GDP is increasing, leading to a new optimism in Africa that did not exist ten years ago.

Other Issues

Klein noted that increased trade is another important catalyst for development, and that gains from trade sometimes exceed those from aid. However, he cautioned about the notion of leveraging aid to pressure government on trade liberalization. The trade-offs are too complex.

Klein highlighted two debates that continue to smolder within the Bank, and for which no clear answer has emerged. Some developing countries are increasingly able to access capital markets for sovereign borrowing, decreasing IBRD's utility. The question has arisen of sub-sovereign lending and what form that might take.

The second concern pertains to IDA countries, whose chronic over-indebtedness has given rise to the grants versus loans debate, and the importance of imposing discipline where grants are concerned. Skeptics wonder if only grants are employed, who will perform the financing side? Perhaps the private sector will, but perhaps not, and maybe there should also be loan instruments available.

IDA deputies are currently examining a broad spectrum of issues and considering the extension of IDA support in some instances without a counter sovereign guarantee. This would enable some countries to use a mix of lending and grants, as opposed to pure grants in a way that doesn't create public sector debt and therefore is not a repeat of the HIPC-type problem. IDA Deputies will discuss this in mid-2006.

***Ted Moran, Director, Landegger Program in International Business Diplomacy,
Georgetown School of Foreign Service***

There are two polar views about how best to eradicate poverty. One insists that poverty eradication can be achieved by increased aid flows that will provide medicines, clean water, food, education, and empowerment for the poor, especially women,

increased funding for HIV/AIDS, etc. This approach is simple, direct, full of good sense, and comparatively easy to sell politically.

The opposite view holds that poverty is eradicated by stimulating economic growth, and this becomes possible by improving the business climate, stimulating investment, liberalizing trade policies, funding and privatizing infrastructure, and building capacity in investment, regulatory, and FDI promotion agencies. The view and approach is more complicated than the first and less direct, and is therefore a harder sell politically in this era of suspicion, fears, and anxieties about globalization.

The new leadership of the Bank must remember that the two approaches are not mutually exclusive and that they overlap in many ways. The Bank remains dominated by the first approach and, in Moran's view, must shift its focus, efforts and resources to eradicate poverty by promoting stronger economic growth. The Bank's new president could have an enormous impact in advancing this goal by simply shifting course slightly.

How to do this? Moran argues that new programs are not necessary, although some pruning may help. Instead, the Bank must realign its priorities. Some erroneously argue that the Bank lacks focus and has no real priorities. To the contrary, each country director and team has at least twenty "number one" priorities! The real contribution of the new president will be to decide and enforce what are the true "number one" priorities.

The Bank should build on what Michael Klein and his PSD team have done thus far. Their initiative has added great value, specifically with their innovative use of benchmarking. Calibrating the investment climate has enabled the Bank to develop a flexible tool to compare countries objectively and address specific problems.

Doing Business is filled with levelheaded advice on judicial regulatory and investment reform. The PSD team must not allow "the best to become the enemy of the good" and should search for clear, feasible principles with an eye to implementation and integration into national systems.

In addition, FDI promotion policies and the role of the Foreign Investment Advisory Service (FIAS), the IFC, and MIGA all have a much bigger role to play, a point worth mentioning in the Bretton Woods Committee's policy advice to the new Bank president.

Regarding SMEs and support for the private sector, policies in developing countries should be size-neutral. A small enterprise should not be prioritized for access to credit, either microfinance or bank credit, by virtue of its size. Policies must be established and applied across the board. Companies should be rewarded because they have systems that work and they are good. Big is not necessarily bad.

Three facts emerge from research to support a shift in the World Bank Group's agenda to policies that stimulate economic growth:

- There is strong evidence to show that trade and investment reform, when taken together, enhance growth.
- Even the poorest developing countries can achieve progress through trade and investment reform by following the same prescription as the mid-income countries.
- There is a path up for poor countries through investment promotion, trade liberalization, and regulatory reform that walk poor countries up toward higher levels of development, however it doesn't happen overnight.