

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**PRIVATE SECTOR DEVELOPMENT
STRATEGY: FOSTERING DEVELOPMENT
THROUGH THE PRIVATE SECTOR**

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ACRONYMS AND ABBREVIATIONS

BNDES	Brazilian National Bank for Economic and Social Development
CCLIP	Conditional Credit Line for Investment Projects
CPD	Country Program Document
CS	Country Strategy
CSR	Corporate Social Responsibility
GCI-9	Ninth General Capital Increase of the Inter-American Development Bank
GDP	Gross Domestic Product
GMC	Global Multisector Credit
ICT	Information and Communications Technology
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IIRSA	Initiative for the Integration of the Regional Infrastructure of South America
LAC	Latin America and the Caribbean
LEG	Legal Department
MDB	Multilateral Development Banks
MIF	Multilateral Investment Fund
MSME	Micro, Small and Medium Enterprise
NSG	Non-Sovereign Guaranteed
OC	Ordinary Capital
OLB	Outstanding Loan Balances
OMJ	Opportunities for the Majority Initiative
OVE	Office of Evaluation and Oversight
PBL	Policy Based Loan
PCG	Partial Credit Guarantee
PPP	Public-Private Partnership
PSD	Private Sector Development
PSDS	Private Sector Development Strategy
PSO	Private Sector Operations
RMG	Office of Risk Management
SCF	Structured and Corporate Finance Department
SG	Sovereign Guaranteed
SME	Small and Medium Sized Enterprises
SOE	State-Owned Enterprises
TFFP	Trade Finance Facilitation Program
US\$	United States Dollar
VPC	Vice Presidency for Countries
VPP	Vice Presidency for Private Sector and Non-Sovereign Guaranteed Operations
VPS	Vice Presidency for Sectors and Knowledge

I. OBJECTIVE

- 1.1 The Agreement Establishing the Inter-American Development Bank (IDB or Bank) defines the Bank's purpose as "to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively."¹ To implement this purpose, the Bank shall, among other aspects "promote the investment of public and private capital for development purposes" and "encourage private investment in projects, enterprises, and activities contributing to economic development and to supplement investment when private capital is not available on reasonable terms and conditions".² Although the Agreement Establishing the Inter-American Development Bank became effective in 1959, this mission remains fully relevant today as the Bank implements its ninth capital replenishment.
- 1.2 The Ninth General Capital Increase in Resources of the IDB (GCI-9) outlines two overarching objectives under the Bank's new institutional strategy: reducing poverty and inequality and achieving sustainable growth. Alongside these overarching objectives are two strategic goals that are essential to achieve its mission: address the special needs of the less developed and smaller countries and foster development through the private sector.³
- 1.3 In context of the latter strategic goal of fostering development through the private sector, under GCI-9 the Bank's Board of Governors mandated the development of a Private Sector Development Strategy (PSDS)⁴. The objective of the PSDS is to maximize development impact of the IDB's private sector activities by capitalizing on its comparative advantages in a manner consistent with its institutional goals. Following the mandate laid out in GCI-9, with the objective of maximizing development impact, the PSDS emphasizes an integrated approach accounting for the full range of Bank-supported activities that contribute to development through the private sector including public sector/sovereign-guaranteed operations, as well as private sector/non-sovereign guaranteed operations. As such, the main thrust of the PSDS is to promote development through the private sector and not pursue private sector development per se⁵. The aim is to increase the development impact of private sector activities as a source of robust and sustainable growth, expand employment, and improve the lives of the poor. The Bank supports these goals with a wide range of activities, including: financing infrastructure projects with private and NSG public owned partners, supporting corporate social responsibility, helping small scale firms and entrepreneurs become more competitive, developing new opportunities to reach poorer segments and increasing social inclusion, among other initiatives. Also mandated under

¹ Agreement Establishing the Inter-American Development Bank, Article I, Section 1

² Ibid, Article I, Section 2(a) (i) and (ii)

³ "Report on the Ninth General Capital Increase in the Resources of the Inter-American Development Bank" (AB-2764), May 2010, paragraphs 3.5-3.11.

⁴ Ibid, paragraph 3.31.

⁵ Ibid, paragraphs 3.31-3.33.

GCI-9 was the development of a strategy for the Bank's non-sovereign guaranteed (NSG) operations⁶, which culminated in the creation of an internal NSG Business Plan; the strategic elements of which are included in this PSDS. The NSG Business Plan will be modified to ensure that all of its elements are consistent with the final version of the PSDS and then it will be submitted to the Board of Executive Directors for approval after the PSDS receives its final approval.

- 1.4 The PSDS addresses activities supported by the IDB. The two other members of the IDB Group, the Multilateral Investment Fund (MIF) and the Inter-American Investment Corporation (IIC), which also target the private sector, have separate governing authorities and capital funding mechanisms, and thus are not subject to GCI-9 or Bank strategies. However, as reflected in the charters of both the MIF and the IIC, their activities complement and supplement, respectively, the activities of the IDB⁷ and as such their activities and business plans⁸ are broadly consistent with this PSDS and are a vital component for promoting development through the private sector and for the achievement of the overarching goal and strategic objectives outlined in paragraph 1.2.
- 1.5 This PSDS, which was expanded and edited based on comments received through the two periods of the public consultation process, lays out a diagnosis of the key challenges facing development through the private sector and proposes five general areas for IDB intervention. Given the integrated nature of the Bank's work with the private sector, an exclusive relationship does not exist between the PSDS and a single Bank department. Rather, close collaboration among both public sector/sovereign-guaranteed operations carried out under the Vice Presidency for Sectors and Knowledge (VPS) and the Vice Presidency of Countries (VPC) and private sector/non-sovereign guaranteed operations carried out under the Vice Presidency for Private Sector and Non-Sovereign Guaranteed Operations (VPP) was pursued throughout the preparation and drafting of the PSDS and will be critical for its successful implementation.
- 1.6 **Linkages to GCI-9 Priority Sectors and Strategies.** In order to make the new institutional strategy operative and achieve the overarching objectives, the GCI-9 defines the following priority areas: (i) social policy for equity and productivity; (ii) infrastructure for competitiveness and social welfare; (iii) institutions for growth and social welfare; (iv) competitive regional and global international integration; and (v) protect the environment, respond to climate change, promote renewable energy, and ensure food security. These

⁶ Ibid, paragraph 3.31.

⁷ The Agreement Establishing the Multilateral Investment Fund II calls for the MIF to “complement the work of the Bank, the IIC and other multilateral banks” while the Agreement Establishing the Inter-American Investment Corporation calls for the IIC to “supplement the activities of the Inter-American Development Bank”.

⁸ The IIC's work from the financial, operational and developmental perspectives is governed by a strategic process formalized through the approval by its Board of Executive Directors of a three-year Business Plan. The current 2011-2013 Business Plan (CII/GA-60-5) is broadly consistent with the PSDS.

priorities are being translated into strategies that reflect current knowledge, specify critical challenges, and identify priorities in each sector.

- 1.7 There is a strong interdependence between the PSDS and each of these strategies and priorities. The emphasis on building human capital present in the Strategy on Social Policy for Equity and Productivity is a critical input for private firms to improve their productivity and generate long-term increases in real wages that are essential for sustained poverty reduction. As identified in the Institutions for Growth and Social Welfare Strategy, for firms to compete successfully, countries in the region need to overcome the disadvantages of small company size, attract foreign investment, and access global markets. The Strategy on Competitive Global and Regional Integration broadens the scope of integration, highlights the role of infrastructure, institutional strengthening and capacity development (i.e. hardware and software elements) and a mix of the Bank's sovereign and non-sovereign products to support the achievement of its goals.
- 1.8 The Institutions for Growth and Social Welfare Strategy, in addition to defining a focus on SME development, establishes that releasing institutional constraints to growth has much to do with understanding the environment in which the private sector operates. This Strategy emphasizes the role of effective regulatory capabilities for the development of credit and financial markets, which help to reduce systemic risks and expand access to needed capital. Finally, the region and its private sector must be prepared to address the serious economic impacts of climate change by promoting clear climate change adaptation measures in key economic sectors. The Integrated Strategy for Climate Change Adaptation and Mitigation and for Sustainable and Renewable Energy (CCS) promotes the development and use of a range of public and private sector financial and nonfinancial instruments for strengthening Latin America and the Caribbean's institutional, technical, and financial capacity to address climate change, including a *Private Sector Climate Change Operational Program* encompassing the four private sector windows of the IDB Group.

II. BANK ENGAGEMENT WITH THE PRIVATE SECTOR AND LESSONS LEARNED

A. Definition of PSD and PSO

- 2.1 A significant part of the IDB's total lending and non-lending activities are directed towards the private sector and channeled through two major types of activities: (i) private sector development; and (ii) private sector operations.
- 2.2 **Private Sector Development (PSD)** projects are classified as loans or grants with sovereign guarantees that: (i) have a direct beneficiary that is a private sector firm (e.g., through multi-sector credits, matching grants, business development services); (ii) offer technical assistance; or (iii) support regulatory, institutional or administrative reforms that assist private sector activity. PSD projects are processed through the Bank's Sovereign Guaranteed operations managed by VPC and VPS.
- 2.3 Examples of PSD are SG projects that help to: (i) improve the quality of the institutions, rules and regulations that affect the business climate and investment potential; (ii) improve creditor rights and property rights to enhance access to finance; (iii) provide long-term

funding to the banking system to expand access to finance for SMEs via Global Multisector Credits and Financial Sector Programs; or (iv) offer technical support to enhance productivity and innovation in the region. Other SG projects that more indirectly impact the private sector which would *not* be considered PSD would include general public education and health projects, economic research, food security initiatives, and cultural programs.

- 2.4 PSD operations also fund other types of programs that benefit the private sector. Among these are programs to raise firm productivity with technical assistance to upgrade marketing capabilities, improve production processes, and apply international quality standards. Market access issues have been addressed by trade policy reforms and harmonization measures across countries, along with investment and export promotion activities, such as one-stop shops and electronic documentation for customs. PSD efforts have also guided the development and design of concession programs and Public-Private Partnerships (PPPs). Support for science and technology advancement also has provided significant benefits to the private sector through increased innovation and technology transfer. The IDB's PSD activities have been further broadened to include support for collaborative business development models (such as cluster programs), public private dialogue, and business climate reforms. These loan, grant and technical assistance operations have been targeted to specific sectors of activity, types of firms (principally SMEs and microenterprises), and geographic areas.
- 2.5 **Private Sector Operations (PSO)** are non-sovereign guaranteed operations that: (i) provide direct loans, guarantees, technical assistance and (in the case of IIC and MIF) equity to private sector firms; (ii) provide indirect funding for private firms through local financial institutions or investment funds; and (iii) provide loans and guarantees to eligible state-owned enterprises (SOEs) without a sovereign guarantee. These PSO activities are based on market pricing and are managed by VPP.
- 2.6 Each window of the IDB Group's private sector and NSG operations involved in the provision of PSO products and services for their defined (and sometimes overlapping) niches within the following constituencies: microenterprises, small- and medium-sized enterprises, large companies in infrastructure and industry, financial institutions of all sizes, eligible SOEs and base of the pyramid operations that interact with nearly all of these constituencies. PSO projects provide financial additionality to commercial credit markets by offering longer tenors aligned with market pricing and risk mitigants such as partial credit guarantees (PCGs), trade finance guarantees and subordinated debt that make projects more attractive to private sector creditors, as well as underlying private investors. IDB-financed operations also provide comfort to private investors regarding regulatory and institutional frameworks underlying such investment. The IDB also adds non-financial additionality by maintaining high environmental, corporate governance and integrity standards and supporting operations designed to break the barriers to social inclusion through market mechanisms. These elements, along with the IDB's preferred creditor status "umbrella", help to catalyze private investment through mobilizing private lenders alongside the IDB.

B. History of Bank support for development through the private sector

- 2.7 Private Sector Development (PSD).** PSD activities have evolved considerably since the approval of IDB-8, successfully positioning the Bank as the lead multilateral institution in the Region. In the period from 2004-10, these activities totaled US\$10.8 billion in 90 separate loan operations. PSD operations promote development through the private sector by working primarily with governments based on the Bank's programming dialogue with public authorities. In general, these operations focus on addressing specific market or institutional failures. Among the most important are programs designed to improve access to finance with more efficient and inclusive financial markets. For example, Global Multisector Credit Operations (US\$6.4 billion over the 2004-2010 period) have provided significant financial resources to private enterprises. In addition, the IDB provides technical and financial support to improve the regulation of financial markets and strengthen supervisory capacity of public institutions. More recently, through the Liquidity Program for Growth Sustainability, the IDB gave financial support to offset the negative effects of the international financial crisis.
- 2.8 Private Sector Operations (PSO).** Over the years, the IDB's PSO have built a base of accomplishment and effective performance. In the past 16 years, private sector loans and guarantees of the IDB's NSG window have grown rapidly, especially following the 2006 mandate expansion⁹. PSO approvals of US\$1.1 billion in 2010, which was down from the peak years in 2007 and 2008, were still up dramatically when compared to when the NSG operations first started in 1996 at the time of the Bank's eighth capital replenishment (IDB-8)¹⁰. Overall during the period of IDB-8, PSO lending and guarantees were US\$9.8 billion in 233 projects, equivalent to 8 percent of the Bank's total approvals in dollar terms. During the same period, IIC approved 536 transactions for \$3.5 billion.
- 2.9 *Historical PSD and PSO activities:*** As illustrated in the Graph 1 below, PSO approvals averaged 14 percent of Bank approvals over the past seven years, fluctuating from 8 percent of the overall lending approvals in 2004 up to 24 percent in 2007 and then back down to 9 percent in 2010. In dollar terms, PSO approvals were US\$2.2 billion in 2007 and US\$3.1 billion in 2008, due partly to greater private sector delivery of infrastructure projects and the IDB's expansion into new sectors, including to publicly-owned entities without a sovereign guarantee through PSO. In 2009, PSO lending dropped to US\$1.3 billion as SG lending increased to provide support to member sovereigns during the crisis. In 2010, PSO lending was relatively flat despite the greater number of projects approved because the average dollar size of transactions declined slightly. At the same time, PSD lending averaged 18 percent of approvals during the 2004-10 period. The composition of PSD lending includes: (i) support to private sector beneficiaries through financial

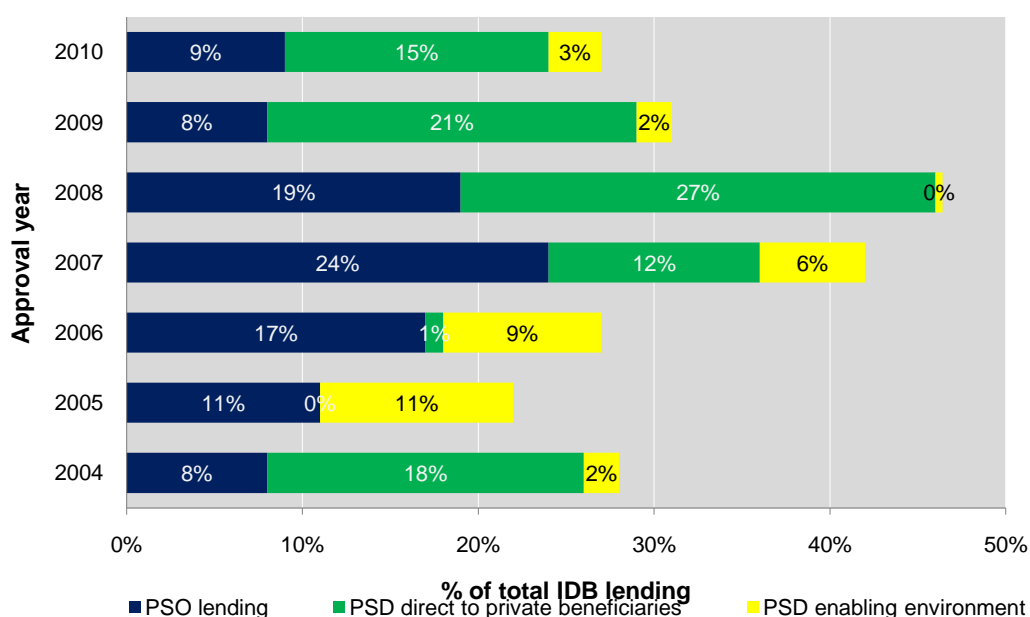
⁹ CA-466-1, "Proposal to Expand the Scope of the Bank's Financing Without Sovereign Guarantee under the 10 Percent Authority—Revised Version", dated March 31, 2006 and approved by the Board of Governors through Resolution AG-05/06 dated April 5, 2006.

¹⁰ AB-1704, "Report of the Eighth General Capital Increase in the Resources of the IDB", 1994.

intermediaries via Global Multisector Credits, Financial Sector Programs and Liquidity Program for Growth Sustainability, science and technology loans, and integration projects that have direct benefits to the private sector; and (ii) PSD enabling environment loans.

- 2.10 In sum, the PSD and PSO activities have had impressive growth during IDB-8. In the past seven years, support for PSD and PSO lending and guarantees reached US\$16.6 billion, representing 32 percent of overall Bank lending. In addition, the IDB provided technical assistance to support NSG activities amounting to US\$27.1 million or four percent of overall nonfinancial assistance during the period. Nonetheless, the totals only tell part of the story. The measure of the effectiveness of the IDB's activities is best illustrated by the joint actions that the new organizational structure of the Bank has fostered resulting from the Bank's reorganization.

Graph 1: PSD and PSO lending as Percentage of Total IDB Approvals



C. Integrated approach to development through the private sector

- 2.11 Achieving better development outcomes through public interventions alone is sometimes limited by fiscal constraints and weak institutional capacity. On the other hand, stand-alone operations with the private sector may have a limited impact in removing sector- or country-wide constraints or may leave economies of scale unexploited or may produce negative externalities under sub-optimal regulatory frameworks. For these reasons, the GCI-9 states that the PSDS should take into account the “full range of activities that contribute to development through the private sector” (GCI-9, paragraph 3.32). In practical terms, this means that consistent cooperation and action between the PSD and PSO sides of the Bank are necessary to optimize the development effectiveness of private sector activities.
- 2.12 Critical to this integrated approach will be the following: (i) recognizing that each country has a unique set of issues to address, there will be early joint VPC, VPS and VPP upstream

efforts to identify market and institutional failures that need to be addressed during the Country Strategy process using a consistent methodology of analysis; (ii) consistent VPC and VPP communication through bimonthly calls to Country Representatives and the annual Country Programming Document process; and (iii) enhanced collaboration between NSG and SG teams to deepen sector analysis and knowledge, as well provide feedback on key market and institutional impediments identified during the NSG project preparation and execution process.

D. Success stories of PSD and PSO collaboration

- 2.13 There are several recent examples of successful PSD and PSO collaboration that address key market and institutional shortcomings and which could serve as models for future work. The following are a few examples:
- 2.14 **Private sector development and competitiveness.** In order to foster sustainable economic growth and enhance competitiveness in the Caribbean, the IDB, in partnership with the Canadian International Development Agency (CIDA) and the UK Department for International Development (DFID), established the Compete Caribbean program (AT-1474). This program includes technical assistance and investment funding to promote productive development policies, business climate reforms, clusters and SME development activities, all within a comprehensive private sector development framework. The project was conceived and led by VPS with the active participation of VPP. The project is designed not only to facilitate the business climate, but also to provide technical assistance for eligible private sector entities, which could generate potential leads for PSO projects. Execution of the project currently involves active personnel participation from both VPS and VPP.
- 2.15 **Access to Finance for Small Producers.** Collaboration between MIF, OMJ and VPS has accelerated with such projects as the regional operation FOPEPRO (RG-M1169) and (RG-L1029), a project originated with MIF equity, loan and technical cooperation and further strengthened with an OMJ loan which is financing a Fund for Small Producers in four Central American countries and four Andean countries. Sector experts from VPS were involved in the design and structuring of OMJ's loan to FOPEPRO, bringing both technical skills and market knowledge to the Project Team. VPS provided an assessment of the Fund managers' market track record, validation of the Fund's objectives and instruments and a comprehensive review of the Fund's investment guidelines. The MIF and OMJ teams ensured that the project remained focused on the low-income, target beneficiaries and advanced what is becoming a new, sustainable business model for future such operations throughout the region.
- 2.16 **Housing sector.** In the beginning of 2008, in light of changes in global financial markets and the advent of the subprime crisis in the United States, Sociedad Hipotecaria Federal (SHF), the Mexican Government's Housing Finance Agency, requested that the IDB evaluate ways to support the lower-middle income housing finance market in Mexico. The IDB undertook a broad consultation process with several key actors of the Mexican housing finance industry including commercial banks, non-depository mortgage providers and SHF. IDB's response was twofold: 1) to work through the SG lending program to: (i) support the liquidity strength of SHF as the key institution in Mexico's housing finance sector through a Conditional Credit Line for Investment Projects (CCLIP) for up to US\$2.5

billion for the development of efficient and inclusive mortgage markets in Mexico; and (ii) approve the first global credit program for mortgage market development (PR-3327) for up to US\$500 million; and 2) to work through the NSG lending program for a loan and partial credit guarantee for the Mexico Housing Finance Support Facility (PR-3338) and a loan for the Infonavit Mezzanine Finance Facility (PR-3339). These operations were approved by the IDB's Board of Executive Directors in November 2008.

- 2.17 **Global and Regional integration.** The Bank has provided continuous operational support to regional countries with loans and technical cooperation projects aimed at building capacities to negotiate and implement trade and economic integration agreements, promoting the institutional capacity to export and attract foreign investment, and financing a wide range of trade facilitation and customs modernization measures. In order to facilitate cross-border trade, INT has developed INTradeBID, which is an on-line tool that gathers together a set of applications to help users understand, analyze and utilize different trade agreements. It is the most comprehensive resource center available for supporting trade for companies in Latin America and the Caribbean (LAC). At the same time, the IIC has a training program, FINPYME Export Plus, which is designed to provide technical assistance for selected SMEs to increase their competitiveness and participation in international trade. The IIC uses the INTradeBID tool as part of the training to teach their SME clients which countries are the most efficient to export to.
- 2.18 **Renewable energy.** In order to mobilize the considerable resources necessary to create Eurus, the largest wind farm (250 MW) in LAC, the Structured and Corporate Finance Department (SCF) used the Clean Technology Fund (CTF) to facilitate raising \$600 million in new investment and \$345 million in debt. Eurus will reduce the emissions of CO₂ by 600,000 metric tons per year, and is one of the first private self-supply projects under the new renewable energy regulations in Mexico. The success of the Eurus investment plan depended on a high level of cooperation among IDB private and public sector departments. Specifically, private sector investment officers received crucial technical support from public sector departments in key areas such as the regulatory framework, wind analysis, renewable technologies and environmental impact, including studies related to birds and bats. In addition, technical consultants were also made available to private sector staff, thereby greatly facilitating the launch of the Eurus project.

E. Lessons learned

- 2.19 **Previous PSDS.** The Bank's previous Private Sector Development Strategy (GN-2270-1) was approved by the IDB Board in January 2004. This strategy proposed four inter-related strategic directions: (i) development of an enabling environment for business; (ii) direct and indirect financial support for specific private sector projects; (iii) leveraging developmental impact in underserved markets such as SMEs and informal companies, especially in poorer, smaller countries; and (iv) engaging the private sector in dialogue and action. The four action areas for implementation included: (i) country focus; (ii) internal coordination and joint action; (iii) broadening the scope of action; and (iv) strategic partnerships. All of these broad concepts remain valid and many of the specific recommendations were implemented, such as expanding partnerships to leverage public and private resources to support development. However, a few of the suggestions fell short in implementation, including the proposal to prepare Country Private Sector Development Strategies for each country over a period of three years.

- 2.20 **OVE evaluations.** In 2005, the Office of Evaluation and Oversight (OVE) presented to the IDB Board an evaluation review of nine years of PSO operations, specifically, the direct lending to the private sector through the Bank's private sector department now known as the Structured and Corporate Finance Department (SCF)¹¹. OVE's evaluation report recognized the broad PSO accomplishments in the key objectives of the Bank's lending to private sector, which were: (i) timely delivery of the committed infrastructure through the Bank financing as well as provision of committed services to the general population and companies based on satisfactory quality standards, (ii) a high level of additionality, particularly financial, but also in non-financial areas as improving environmental, social and corporate governance standards; and (iii) a high number of pioneer operations with high demonstration effects. In addition, OVE has also provided regular evaluations for both the IIC since 2001 (e.g., most recently, CII/RE-11 in 2010) and the MIF since 2002 (e.g., most recently, MIF/RE-3 in 2010). These evaluations have highlighted the outstanding contribution made by both institutions through its respective operations.
- 2.21 While OVE has not evaluated Private Sector Development per se, they have reviewed two of the SG instruments for financial sector reform: (i) Global Multisector Credit (GMC) operations for lending to second tier government banks for on-lending to SMEs; and (ii) Policy Based Loans (PBL) for financial sector reform. In a review of GMC operations over the 1990-2005 period (RE-336), OVE found that GMCs, which historically have been the Bank's de facto "largest private sector tool" in terms of lending volume, have provided fast-disbursing funds on a counter-cyclical basis, thereby injecting liquidity to second tier banks and ultimately to SMEs. While OVE has not conducted a comprehensive review of financial sector PBLs, they did review the effectiveness of financial sector PBLs in five country program evaluations and found that in the case of Peru and Honduras, the PBLs "contributed substantially to the resilience of the sector to withstand external shocks" (RE-354).
- 2.22 **OVE recommendations.** At the same time, OVE identified a series of areas requiring changes for PSO and PSD activities and made recommendations in a range of areas, which can be seen in Annex I. Since these evaluation reports were presented, the Bank has made significant strides in meeting many of the recommendations.

¹¹ OVE, "Evaluation of Bank's Direct Lending Program to Private Sector 1995-2003" (RE-303), 2005. The Opportunities for the Majority Initiative (OMJ) was created in 2007 and as such was not included in OVE's evaluation. In addition, the expansion of the scope of NSG financing (CA-466-1) was approved in 2006 and therefore this OVE evaluation does not cover these activities.

III. DIAGNOSIS

A. Why doesn't the private sector flourish more in LAC?¹²

- 3.1 Private sector development is an essential pillar for sustained economic growth and poverty reduction. Some 90 percent of all economic activity in LAC is created by the private sector, as are nine out of every 10 jobs.¹³ However, the region has suffered low income growth relative to developed countries and particularly when compared to the fast growth economies of East Asia. For example, income per capita in LAC was almost one-quarter of the United States in 1960 while today it is only one-sixth. In contrast, several East Asian countries, which in 1960 had average per capita income levels well below those of LAC, are now approaching the ranks of the high income countries¹⁴.
- 3.2 Evidence shows that the main foundation for improved growth outcomes is improved productivity at the firm level. In the past, the region's productivity growth has lagged other parts of the world as economies relied more on accumulating labor and capital, and less on technological or managerial innovations that raise productive efficiency (Daude y Fernández Arias, 2010, IDB, 2010). The typical country in LAC has a productivity level of roughly half that of the US (IDB, 2010). Unlike other regions, the gap between the standard of living in the region and more advanced nations has not been reduced, and lagging productivity is a major cause of this disparity (IDB, 2010). There are also signs of structural deficiencies as the trends in LAC show a smaller productivity gain from the movement of labor to higher productivity sectors ("between sector" gains); and a secular decline in the relative productivity of the service sector – a large and important segment of economic activity (IDB, 2010). The productivity analysis also points out significant differences within countries when firm size is considered¹⁵. The productivity of Latin American SMEs is less than 40 percent that of the larger firms in the region, while in Europe and the United States it reaches 65 percent ((European Commission, 2000) and (Peres and Stumpo, 2000)). More troubling is the evidence that some LAC economies have entered into a low productivity trap where many SMEs lack incentives to formalize, invest and create better jobs (Levy, 2008, 2010). Productivity is also a social issue because it is the key to long-term increases in real wages, as well as to increases in incomes for households outside the wage-earning sector. Increases in wages and other sources of

¹² While this diagnostic is based on the Strategy for Institutions for Growth and Social Welfare, it uses relevant elements from the Strategy for Competitive Global and Regional Integration; the Strategy for Climate Change Adaptation and Mitigation and, Sustainable and Renewable Energy; and the Strategy on Social Policy for Equity and Productivity.

¹³ Estimate based on data for 2008 or latest year available as reported in the *Social Panorama of Latin America 2009*, Table 17 Statistical Analysis, Economic Commission for Latin America and the Caribbean (ECLAC).

¹⁴ "Development in the Americas 2010. "The Age of Productivity: Transforming Economies from the Bottom Up." (DIA 2010)

¹⁵ A more detailed analysis that builds upon the DIA 2010 regarding SME finance and development is present in the Strategy for Institutions for Growth and Social Welfare.

income, in turn, are the essential ingredient for sustained reductions in poverty in the Region.

B. Factors behind low productivity

- 3.3 Why is productivity of LAC economies (and firms) lagging relative to other regions? A significant part of the answer can be attributed to the fact that the private sector in LAC faces many barriers that impede investment, firm expansion, job creation, and sustainable growth. In addition to deficits in basic productive infrastructure, some of those barriers result from *institutional failures*, which can worsen outcomes when the “rules of the game” are not well established, owing to, for example, such factors as excessive bureaucracy, legal frameworks with poorly defined property rights, unreliable enforcement capabilities and inequitable tax or customs regimes. In addition, corruption diminishes the potential for development through the private sector by contributing to market and institutional failures and discouraging investment and job creation. The lack of clear rules adds to the costs incurred by firms, which can make them less competitive and less likely to invest and grow. Similarly, *market failures* can lead to less desirable social outcomes. For example, financing gaps may arise when lenders fail to provide credit for otherwise sustainable businesses. Information asymmetries can limit the ability of prices to adequately reflect economic costs and benefits. Market failures may cause firms to underinvest, fail to mitigate negative environmental effects from their activities, or devote too little to research, development and innovation. In order to organize the diagnostic in a framework that addresses challenges in the region, the main factors behind low and stagnant productivity growth are grouped in the following categories:

1. Limited access to financial services and capital markets

- 3.4 Latin America’s financial systems are largely bank-based, with relatively less reliance on capital markets to provide long term debt and equity. Despite this reliance on bank loans, bank credit as a share of GDP is relatively low compared to OECD countries or other developing regions such as East Asia (Stallings and Studart, 2006). Periods of macroeconomic volatility in LAC have had deep and long lasting effects on the supply and demand of credit. As a consequence, there is a bias towards short term credit which impedes investment in capital projects and compels firms to continually roll over debt. In many LAC surveys, finance is viewed as an important binding constraint to firm growth and productivity improvements. The relative shallowness of Latin American financial markets accounts, in part, for the wide dispersion in productivity among firms (IDB, 2010).
- 3.5 SMEs are particularly affected by limited access to finance. In fact, most SMEs face credit constraints with 80% of these firms underserved (IFC, 2010). This represents a formal SME credit supply/demand gap that ranges between US\$125-155 billion, being the vast majority of demand in local currency. As a result, SMEs rely on internally generated resources (self-finance) and/or less secure and higher cost informal sources of finance and therefore they are less able to fund productivity-enhancing investments, and their profitability is constrained. It is not surprising, then, that evidence shows that when firms are less credit constrained, they have higher profits and productivity (Guirkingier and Boucher (2007) and McKenzie and Woodruff (2006)). Credit constraints result from a range of factors that limit financial institutions ability to assess and price risk owing to asymmetric information and the opacity of accounting information on firms. Weak creditor

rights and enforcement mechanisms that lower the costs to firms of non-payment, as well as the absence of innovative financial products (insurance, factoring and leasing) are also critical factors. Another constraint is lack of adequate secured transaction frameworks throughout the entire LAC region, which consistently presents obstacles to lenders who might otherwise be willing to operate in the SME market. The lack of systems that facilitate the efficient and inexpensive creation and uses of mortgages and security interests in tangible and intangible property has a disproportionate impact on the availability of credit for SMEs. SMEs usually have very limited assets to offer as security in restrictive, unreformed frameworks and also cannot offer financial institutions various other lines of business, such as significant payrolls, that might otherwise make them candidates for unsecured lending.

- 3.6 Access to financial services is also very limited at the bottom of the pyramid. It is estimated that only 35% of all households in LAC have bank accounts, 10-25% use credit services, less than 1% use insurance products, while for microenterprises, it is estimated that only about 5-8% have access to credit from financial institutions (Honohan, 2008; Tejerina, et. al. 2007; Navajas et. al. 2005). For households this limited access requires them to depend on cash for payment and transfer services, implying greater insecurity and higher transaction costs. Limited access to deposit services complicates consumption smoothing, risk management and poverty reduction while the virtual inability to purchase formal insurance makes households and firms vulnerable to external shocks that can result in the loss of assets or one's livelihood.
- 3.7 Another systemic approach to tackling the funding gap is to support the development of local capital markets. Long term debt in domestic currencies, at reasonable interest rates, is crucial not only for individual firms, but the absence of these domestic markets can have severe macro-economic consequences as major exogenous shocks often have to adjust through sharp corrections in the current account (Perry, 2009). In addition, high dollarization of financial systems may be responsible for macroeconomic volatility (Galindo et al, 2005). As a consequence, developing local capital markets in domestic currencies has been identified as a major priority for many developing countries (Perry, 2010). This is particularly evident in LAC, where corporate bond markets, while growing, still lag behind many developing countries. In the same way, access to equity in the region is limited to a small percentage of firms in the region. This, in turn, affects the cost of borrowing and the alternatives to finance new innovative firms.

2. Inadequate infrastructure for competitiveness and global and regional integration

- 3.8 The region's infrastructure is characterized by relatively low investment levels and poor coverage and quality. Inadequate infrastructure is inhibiting LAC's ability to grow, compete and reduce poverty (World Bank 2005). Many Latin American firms deem infrastructure as a serious problem that negatively impacts their productivity. Investment surveys conducted by the World Bank suggest that the lack of infrastructure, particularly in

transportation and electricity, is seen as a serious impediment by many Latin American entrepreneurs. At the same time, global competitiveness is increasingly determined by non-traditional factors, such as transport and logistics costs, private standards for market access or connectivity and interoperability of telecommunications networks¹⁶. In addition, the region is realizing only 50 percent of its intra-hemispheric trade potential due to imperfect trade integration architecture (*software*) as well as the regional infrastructure gap (*hardware*).

- 3.9 There is a close connection between improving transport infrastructure and other policies to foster trade and integration. Global and regional integration has the potential to help countries and firms in the region to: (i) overcome the disadvantages of small market size; (ii) attract foreign direct investment (FDI); and (iii) access the global marketplace at a faster pace. However, bringing tariffs down, as most of the countries in the region have done in the last few decades, will not by itself be sufficient to maximize the positive effects of trade on productivity. Transport costs must be reduced to allow stronger import competition, greater export opportunities, and faster and more efficient resource allocation among firms. In addition, LAC countries are facing a growing digital divide due to a very low access to broadband, measured by low availability and high costs, which leaves individuals and firms disconnected from external markets. There is significant room in LAC to bridge the digital divide and to bring transport costs down in line with costs prevalent in the developed world. The DIA 2010 concludes that an agenda to tackle this challenge should give priority to improving the efficiency of ports and airports and to reshaping the regulatory framework to promote investment and competition.
- 3.10 Poor infrastructure also operates as binding constraint to deepen productive integration in the region. Firms, in general, and SMEs, in particular, are embedded in dense networks of transactions and inter firm linkages, both upstream and downstream. These multiple linkages are important determinants of firm growth within a specific region or country. These inter-firm linkages can facilitate access to global markets, knowledge transfer, finance and other resources that otherwise would not be available to local firms. It has been observed that operating in clusters and networks enhances a firms' potential to benefit from interacting with global value chains. However, inter-firm linkages are not as developed in LAC as in other regions such as Asia, where the main international production network hub is located (Yusuf et al., 2004).
- 3.11 In the past few years, there has been increased government interest in PPPs as a means of financing large-scale infrastructure projects throughout Latin America and the Caribbean, particularly in the transportation sector, such as roads, railways, and ports, as well as in the energy sector, including generation, transmission and distribution. Governments have also noted that PPPs could also expand to social and non-traditional sectors, such as education health and provision of services. At the same time, SOEs play a key role in supporting many of the areas that impact the productivity of the private sector and thus ultimately

¹⁶ Strategy to Support Competitive Global and Regional Integration.

impact development in the region, for example in the sectors of transportation, energy and water and sanitation. Nevertheless, the practical reality is that PPPs are not a “silver bullet” to solve all the difficulties inherent in financing and executing infrastructure projects. There are a number of obstacles that, in addition to institutional capacity aspects, inhibit the expansion of PPPs in the region, including the lack of projected ready to be implemented and the complexity of implementing transparent procurement procedures.

3. Poor enabling environment and high levels of firm informality

- 3.12 In order for firms to grow, invest and create jobs requires an enabling environment that offers both micro-economic stability and the necessary support institutions. The demand for policy, legal and institutional reform that underlie a favorable business environment is well documented in surveys like Doing Business and the World Economic Forum’s Competitiveness Indices where only a few countries from the region rank in the top quartile. These diagnostics have led to a demand for policy actions to, among other things, reduce legal and regulatory barriers that adversely affect enterprise expansion. Issues such as inadequate property rights, outdated incorporation law, ineffective bankruptcy procedures, cumbersome permitting and registration, weak investment and commercial codes, are among the many topics that affect a firm’s operations. To address all of these issues is rarely a one-shot deal. Rather, reforms require strong commitment by the authorities; a dialog between the government and the private sector; and measures at both the national and local levels.
- 3.13 A corollary to a poor enabling environment is widespread firm informality observed in LAC. Informality is a persistent feature of the region’s economies ranging from 20 percent of GDP in upper, middle-income economies to almost 70 percent in the least developed, with a regional average of 41 percent. By comparison, informality in Asia averages 26 percent according to Schneider¹⁷. In general, there is a positive correlation with formal activity and firm size, so that informality predominates among the smallest firms¹⁸. For example, many microenterprises are profitable to the degree that they evade the costs of complying with tax, labor and regulatory requirements borne by formal firms with which they often compete. Firms also exhibit varying forms and degrees of informality related to their level of regulatory compliance¹⁹. A main policy concern for LAC is that the presence of informality dampens incentives for firm creation, growth and exit, and thereby weakens the shift of resources to their most productive use. There are two main channels for this informality effect. First, informality limits access to productivity-enhancing services, in particular finance and access to legal recourse. Greater credit availability can make a major contribution to formalization as became clear in the Brazilian recent experience (see Box below). Second, the presence of informal firms undercuts profitability of formal firms.

¹⁷ Schneider (2002).

¹⁸ Perry (2008); Nicoletta et. al, (2010).

¹⁹ McKinsey (2009).

Box 1: Brazil and the Challenges of Reducing Informality in LAC

Between mid-2004 and the first half of 2008, formalization in Brazil—as measured by the share of urban workers with a formal labor contract—rose from 38 to 45 percent of the urban labor force. It is difficult to single out one specific policy response responsible for this trend. Instead, it is likely that a set of mutually reinforcing policies contributed to generate a virtuous cycle. Evidence suggests that the introduction of SIMPLES (a program that consolidated multiple taxes and social security contributions into a single payment and reduced taxes for eligible small firms) has had positive effects on formalization (between 6 and 13 percentage points according to the DIA 2010). However, this may not be enough if, by becoming formal, firms also face other additional costs or cannot access the benefits of formalization. Catao, Pagés and Rosales (2009) find strong evidence of a credit-formality-productivity link in Brazil. Formalization rates increase more in industries with a greater need for external funding when the supply of credit increases. The relationship between financial deepening and formal employment is stronger in sectors that rely more on credit. In this sense, Brazilian policies, regulations and programs aimed at expanding access to finance may have played an important role in setting up the conditions for reducing informality.

The IDB is exploring new innovative approaches based on rigorous evaluation techniques to reduce informality and increase credit to smaller enterprises. In Colombia, the IDB is funding an experiment to use training to encourage firms to formalize in Restrepo, Bogota; while a similar effort to increase formalization in Guatemala is also being pursued. On the credit side, the IDB, using the MAP program, has partnered with the Entrepreneurial Finance Lab, CIPPEC in Argentina, and local Banks in Peru and Argentina, to study the use of new credit evaluation techniques based on psychometric indicators that promise to widen credit access to new segments where collateral and information are scarce.

4. Limited innovation and technological development capacity

3.14 Despite recent improvements, innovation efforts in LAC remain extremely low when compared to those of more developed countries and regions. Apart from the accumulation of productive factors, economic growth depends on improvements in their quality and greater innovation in their use. For firms, innovation means the transformation of ideas and knowledge into new economic advantages such as higher productivity growth, new market opportunities, and higher market shares (IDB, 2010). In particular, once externalities are taken into consideration, previous research reports that innovation activities explain up to 75% of the differences in productivity.²⁰ When relating Research and Development (R&D) expenditure to GDP per capita, it is striking to compare developments in Korea and LAC over the last 30 years. In 1974, Korean and LAC R&D investment and GDP per capita were roughly equal. By 2007, Korean investment in R&D was approximately five times

²⁰ Griliches, Z., (1979).

R&D levels in LAC, while Korean GDP per capita was doubled that in LAC.²¹ Moreover, in LAC very little R&D efforts are carried out outside the public sector.²² When national R&D efforts are overwhelmingly concentrated in the public sector, its impact on industry productivity growth and national competitiveness can be less substantial as the private sector often does not have enough absorptive capacity to assimilate the new knowledge into production.

- 3.15 Insufficient investment in innovation activities contributes to large productivity gaps of SMEs in the region.²³ An array of challenges lead SMEs to systematically under-invest in innovation and firm upgrading²⁴: (i) firms may be unable to effectively appropriate the benefits of their innovation and, thereby, recoup R&D costs; (ii) SMEs are less able to benefit from the systems of intellectual property protection; (iii) the risky nature of innovation and the asymmetric information make financing difficult, especially for young and innovative SMEs with high growth potential, where the risk of bankruptcy is higher and, in case of insolvency, the values of intangibles is lower; (iv) SMEs lag behind in the process of technology diffusion because they lack specialized skills needed for technology searching, have a lower inclination to experiment with riskier technologies, and face relatively higher costs for hardware and software, connectivity, and adaptation of information and communications technology (ICT) to new business practices; and (v) coordination failures between SMEs hamper inter-firm collaboration that could otherwise promote innovation by speeding-up technology diffusion and avoiding the duplication of research costs.
- 3.16 As a consequence, many firms often take a “wait and see” strategy that slows technology diffusion. In addition, in terms of adoption of ICT, firms in the region also face constraints in the adoption process related to the limited quality and coverage of telecommunications infrastructure; regulatory issues that raise connectivity costs; and the lack limited ICT literacy. Finally, financial and capital markets do not provide the financial instruments needed to make technology adoption more attractive to smaller firms.

5. Low skill levels of workers and management

- 3.17 An insufficient supply of skilled workers limits the degree of specialization, raises costs, and reduces flexibility of firms in responding to market opportunities in LAC. Training and

²¹ Calculations based on RICYT and World Bank World Development Indicators, accessed April 2010; and Lederman, D. and L. Saenz., (2005).

²² The majority of R&D is financed by the business sector in countries such Korea (75 percent), China (69 percent), the United States (66 percent), whereas in LAC less than half (37 percent) of R&D funding comes from the business sector (OECD, 2010).

²³ Innovation surveys indicate that small firms in LAC show a productivity which is just one third of the larger firms. While 70% of the large firms can be considered as innovative, this proportion drops to just 25% in the case of the small firms. Moreover, while 30% of large firms invest in R&D, less than 10% of the firms in the small segment do.

²⁴ Here we follow a comprehensive definition of innovation as “the implementation of a new or significantly improved product (good or service), or production process, a new marketing method, or a new organizational model in business practices, workplace organization or external relations” (OECD 2005).

education are widely recognized to be key engines of productivity growth. There is ample evidence documenting a causal link between investing in worker training and increases in productivity at the firm level, although the majority of studies are for OECD economies (OECD, 2004). Nonetheless, a growing body of evidence is documenting such relationship in developing economies as well (World Bank, 2010).

- 3.18 Despite this positive link, the incidence of training is low, particularly in SMEs, and much lower in Latin America than in other developing economies. There are important market and policy failures in the market for training provision, which affect SMEs disproportionately, ranging from fear of poaching of trained employees by competitors, the disruption of business created by staff unavailability due to training attendance, informational gaps of firm owners and management of SMEs, lack of access to finance to fund training, or large fixed costs of entry into training activities for smaller firms. A wide variety of schemes have been put in place around the world to overcome such failures. Industrial countries tend to rely on tax incentives for firms and workers. In LAC, the model of choice has been the direct provision of training to workers via national training institutes financed with payroll taxes. In addition, a myriad of private, mostly unregulated, providers offers specific training services to firms and workers. Despite these efforts, the region suffers from the poor quality and suitability of training in the Region, which impacts directly on the productivity and growth of SMEs. Training contents are supply-driven with little relation to the needs of markets or firms. There is little quality control, monitoring and evaluation to insure appropriate quality standards and returns. The vocational training system operates separately from the education system with few opportunities to promote higher educational attainment for adults.
- 3.19 Managerial talent is also in scarce supply, further hampering the ability of firms to compete in increasingly globalized markets. In addition, there are fundamental issues related to inflexible labor codes and other direct and indirect labor costs that fall heavily on SMEs. These factors, some of them expression of market and institutional failures, inhibit the dynamism needed for private sector to be a successful source of long-term, dynamic growth in LAC.

6. Social exclusion and missed opportunities for sustainable development through the private sector

- 3.20 As seen throughout the region, social exclusion contributes to inequality of opportunities and outcomes. For example, analysis of individual access to credit by gender and ethnicity based on special modules in household surveys in Guatemala, Mexico and Panama show that women and indigenous people have a significant gap, particularly among formal institutions. Their participation as employees in the formal sector, especially at decision level positions, is very limited. Recent studies in the region show that women entrepreneurs are over-represented in microenterprises and small firms and under-represented in medium to large firms, and concentrated in fewer economic sectors.
- 3.21 Whether based on gender, ethnicity or other factors, social exclusion also leads to a misallocation of economic resources owing to the missed opportunities to tap markets and harness talents and skills. For example, lower income segments can benefit from private firms and financial institutions that bring them lower cost, higher quality goods and services. These private sector actors can bridge gaps in access to housing and basic services

-- like water, energy, and transport -- as well as health and banking services. Furthermore, greater opportunities for work and entrepreneurship for women and ethnic minorities can expand incomes, reduce poverty, and accelerate growth²⁵.

- 3.22 Firms can also catalyze economic growth when they adopt better governance and socially responsible behaviors. Improvements in corporate governance are a cornerstone for market functioning and should include measures that increase transparency, address conflicts of interest, and corruption. Opportunities also exist for greater attention to the social and environmental consequences of a firm's activities. The stakeholders in a firm extend beyond its shareholders and creditors, to include customers, suppliers, employees, community, civil society, and the government. The bottom line is that good corporate governance and social responsibility allow firms to both tap financial markets and earn the goodwill of consumers and stakeholders, essential elements to their longer term growth and survival.
- 3.23 Finally, in many cases necessary markets do not develop because of structural factors; thereby, preventing societies from reaching socially desirable outcomes. As an example, the incidence of natural disasters is higher for developing countries, especially those that are geographically smaller. Natural and man-made disasters generate significant losses in physical and human capital that often affect the poorest segments of the population most. Yet, markets for risk mitigation and financial instruments that reduce vulnerabilities and mitigate the negative impact of disasters on the population are still not commonplace. An effort to create these markets and the financial instruments to reduce risks and/or mitigate the effects of shocks will help reduce volatility and poverty in the region. Similar examples exist where innovative or pilot projects can be developed with private sector support to demonstrate the feasibility of new technologies, improved business practices, or explore new market opportunities.

IV. AREAS FOR BANK INTERVENTION

A. Priority areas for Bank intervention

- 4.1 Defining the priority areas of focus for the PSDS cannot be done in isolation. The Bank has completed both phases of its public consultation process, the results of which can be seen in Annex III. The public consultation process included focused consultation with key stakeholders, civil society, policy makers and recognized experts in the areas prioritized in

²⁵ For instance, micro-simulations done for Chile show that if the female labor participation rate were close to the regional average, about 15 percent of total poverty and 20 percent of extreme poverty would be eliminated, and average per capita income would increase by 10 percent (IDB, World Bank, SERNAM 2007). [Source: Inter-American Development Bank, World Bank and SERNAM. 2007. *Como Capitalizar el Potencial Económico de Chile Ampliando las Opciones Laborales de las Mujeres.*]

the PSDS, as well as solicited comments through the Bank's website. In parallel to the consultation process, management conducted a thorough assessment of the Bank's comparative advantages, which combined with the consultation feedback produced the final set of focus areas for the PSDS.

- 4.2 **IDB's comparative advantages.** As the primary regional multilateral development bank in LAC, the IDB can build upon a number of comparative advantages in the area of development through the private sector. One of its primary advantages is its ability to develop complementary public and private operations. It has a long-standing record of credibility and continuity with LAC governments on the formulation and implementation of policy agendas, especially during challenging times. With its exclusive focus on Latin America and the Caribbean, it has deep country knowledge, as well as access to a network of institutions and enterprises that benefit from its programs. With this region-wide perspective, the IDB is able to build on lessons learned throughout the region. Moreover, over the past two decades, the IDB Group has built an important body of tacit knowledge about the private sector, working with all sizes of firms through lending, guarantees, advisory work and knowledge projects.
- 4.3 In addition to these broad comparative advantages, the IDB is attempting to differentiate its specific sector strengths vis-à-vis other multi-lateral development banks operating in the region. This effort includes feedback from client surveys as well as a general comparison of the Bank's work vis-à-vis its MDB peers in the region. These efforts will help to ensure that the Bank's efforts are primarily directed towards areas in which they have a comparative advantage. The IDB will also continue to cooperate with its peer MDBs working in the region both on PSD projects as well as co-financing with PSO projects.
- 4.4 **IDB priority areas.** Based on the responses from the two consultation phases, the diagnostic in Chapter III²⁶ and the finalized assessment of the Bank's comparative advantages, the following list of priority areas and topics provide the organizing principles for the PSDS. One key principle for the definition of these areas recognizes the fact that private sector development is closely linked to *productivity growth*. Productivity growth, which ultimately occurs at the firm level, requires an integrated approach that recognizes the multidimensional nature of the problem. A second key principle is the concept of *Bank additionality*. All PSD and PSO projects need to provide a rationale for the Bank's role in financing by addressing an identified market or institutional failure. The priority areas and topics are outlined in Table 1 below.

²⁶ It is important to note that this diagnostic is consistent with the diagnostic for the Institutions for Growth and Social Welfare Strategy and SME Guidelines. As a consequence, the Guidelines for SMEs will provide a more detailed range of PSD activities and interventions that are fully consistent with those spelled in this Strategy.

Table 1: Priority Areas and Topics for IDB intervention		
Area	Problem Addressed	Type of Bank Operational Response
Enhancing Access to Finance and Investment	Financing gaps and underdeveloped markets including weak regulatory and supervisory systems for financial and capital markets	<ul style="list-style-type: none"> • Reduce funding gaps • Promote funding for SMEs, including supply chain finance • Promote development of local and regional capital markets • Support the development of new financial services • Reduce vulnerability to internal and external shocks
Infrastructure for competitiveness and global and regional integration	Large fixed costs of entry, natural monopolies, weak regulatory frameworks for private investment, financing gaps, externalities (such as appropriability, asymmetric information), and undersupply of public goods (such as trade and investment facilitation services)	<ul style="list-style-type: none"> • Promote “hardware” investment in infrastructure, particularly transport, energy, telecommunications, and water and sanitation • Improve the legal and institutional framework for PPPs • Improve regulatory frameworks for utilities. • Support the “software” of trade, investment and investment facilitation • Support of export value chains
Enabling Environment for Private Sector Development	Institutional failures (such as excessive bureaucracy, rent seeking, corruption) undersupply of public goods (such as competition and consumer protection framework), and coordination problems	<ul style="list-style-type: none"> • Modernize regulatory framework for SME activities • Promote formalization by easing business registration and work on tax systems and simplification of procedures • Lower cost of doing business (bankruptcy law, firm registration, greater legal certainty, hiring workers, etc) • Foster Public-Private dialogue
Enhancing innovation capacity and building human capital for productivity	Coordination failures, undersupply of public goods (such as intellectual property protection), externalities (such as benefits of labor pooling, knowledge spillovers, increasing returns to scale for intermediate goods), asymmetric information and appropriability of ideas.	<ul style="list-style-type: none"> • Improve institutional capacity to supply business development services • Promote SME and large firms productive integration • Improve managerial capacity • Enhance training and skills • Support the provision of advanced human capital • Promote innovation through R&D • Develop instruments to finance innovation
Social inclusion and other opportunities for development through the private sector	Social exclusion (gender, ethnic, and other types), incomplete markets, and vulnerabilities to shocks	<ul style="list-style-type: none"> • Reach poorer segments of the population with goods and services • Increase social inclusion • Support corporate governance and greater social responsibility

B. Enhancing access to finance and investment

- 4.5 **Expanding access to finance for SMEs.** Although it can only meet a limited portion of the SME funding gap, the IDB Group will continue to target micro, small and medium-scale firms through the provision of financial and technical assistance resources, as well as mobilization of private lending that complements IDB's lending. As part of the GCI-9 deliverables, VPS (with support from VPP) has prepared Guidelines to support SME finance and development. These guidelines support IDB operational work by describing tools and techniques to improve the design, implementation and evaluation of SME projects. IDB Group efforts in the SME space will also draw upon the extensive experience of the IIC²⁷, the indirect lending experience of SG operations, NSG experience in on-lending through private FIs, as well as new approaches developed by MIF and OMJ. At the same time, the IIC, MIF, OMJ and SCF can benefit from the PSD work that targets SMEs, thereby leveraging synergies and creating a virtuous cycle among these activities.
- 4.6 In terms of IDB financed projects, PSD will continue to provide global multisector credit and financial sector operations that ultimately enhance access to financial services by SMEs. Other PSD interventions to stimulate direct private sector lending include improving financial system regulation, property registries, creditor rights protection, secured transactions frameworks, and enhanced credit information systems²⁸.
- 4.7 PSO operations will continue to target direct and indirect funding for SMEs and fill funding gaps not met by private financial intermediaries by offering longer term loans and riskier products such as subordinated debt and, when appropriate, financing to support development equity. The IIC will continue to be the primary window to provide direct loans, guarantees, technical advisory services and equity financing to SMEs. The IIC will also continue to provide indirect financing to SMEs through local financial institutions. The IIC and OMJ will collaborate in providing support to SMEs with base of the pyramid models. SCF also serves the SME market via local financial institutions, by targeting under-served markets. The MIF will continue its efforts to reach the micro and small enterprise market not only through the provision of grants to stimulate investment and lending in this sector, but also through the promotion of mainstreaming of micro and small enterprise lending and financial services through banks, microfinance institutions and other financial intermediaries, as well as investments in and capacity building of venture capital funds.
- 4.8 An additional means to supply funding to SMEs is through channel finance, which is an integrated solution that bundles several players in an industry supply chain and provides the financing for the entire supply, inventory and sales cycles. The underlying "soft assets"

²⁷ The IIC was created specifically to promote development through the private sector with a mandate focus on SMEs. IIC's stated long-term vision of "Think SME, Think IIC" is included in the IIC 2011-2013 Business Plan approved by the IIC Board of Executive Directors.

²⁸ See "IDB Institutions for Growth and Social Welfare" and "SME Guidelines" for a more detailed range of examples of PSD activities and interventions.

of SMEs can be financed by receivables and inventory within a given supply chain, thereby providing recurrent short term financing that operates through an entire operating cycle without tying up “hard assets” as collateral. The Bank should develop and help implement financing arrangements in sectors that offer this potential (such as agribusiness and technology), thereby enabling SME clients to reduce the credit approval cycle time, increase the amount of their facilities and extend the tenor and reduce financing costs. Furthermore, recent research also shows that clusters and supply chains benefit when financial services accompany the provision of non-financial services (Navas-Alemán, et al., 2011). The Bank will continue to explore this kind of synergy between its different products.

- 4.9 **Promote development of local and regional capital markets.** PSD can support the development of these markets through identification of the key structural impediments to building capital markets and through long term engagements with the primary stakeholders who will benefit from this development. One key area of a well functioning local capital market is the development of pension funds that can make investments in long-term projects such as infrastructure. PSO can support this process through providing partial credit guarantees for issuance on local bond markets to enable local institutional investors to access long term domestic currency debt. In the same line, PSD can continue working with key stakeholders to enhance public debt management and the development of strong primary and secondary debt markets that help reduce the cost of debt, develop financing alternatives for long term investments, and support broader capital market development. The Latin American and the Caribbean Debt Management Group (LAC Debt Group) supported by the IDB provides a distinctive platform for policy dialogue and harmonization in this area.
- 4.10 While it could be said that significant progress has been made in the region in key areas for financial and local capital market development (such as regulation and supervision, investment and pension funds and market infrastructures) in the last few years, there is still a fair amount of room for improvement in the areas of market liquidity, risk transfer mechanisms and access to capital markets by medium-sized firms. Based on a vision of local capital markets as an integral part of a regional and worldwide financial network, PSD can work on an expanded agenda for capital market development that includes: (i) upgrading and adapting existing market infrastructures (such as modernization of clearing and settlement platforms); (ii) reviewing prudential regulation and supervision framework to remove barriers to integration, without compromising market security and investor protection (such as technical assistance for the integration of stock exchanges and the corresponding regulatory harmonization); and (iii) developing instruments to facilitate the access of the higher-end sector of the SMEs segments to local capital market financing.
- 4.11 **Foster Financial Inclusion.** PSO and PSD operations will continue to support broad access to financial services by fostering greater innovation for the development and implementation of new financial technologies and instruments, supporting the establishment of legal and regulatory environment; strengthening financial institutions and enhancing financial literacy and consumer protection.

C. Infrastructure for competitiveness and global and regional integration

- 4.12 Given the importance of the infrastructure sector and the enormous financing shortfalls, this sector will receive a significant part of the Bank's total SG and NSG lending, working at both country and regional levels. The Bank will continue to work in the energy, transportation and water and sanitation sectors through SG operations. Moreover, the IDB will support the development of telecommunication (especially broadband) infrastructure, including a particular focus on the design and implementation of adequate regulatory policy to foster competition and ICT adoption.²⁹ In addition, PSD will provide early stage work with governments for promoting PPP infrastructure projects, helping to develop the suitable legal, regulatory and institutional frameworks for attracting private sector sponsors and investors. PSO operations will also continue to focus investment on these four infrastructure sub-sectors, primarily through SCF's infrastructure division. While the opportunistic (demand driven) nature of PSO operations will provide the general framework for action, there will be an enhanced coordination in order to identify opportunities to promote key infrastructure for integration and trade, particularly in the area of transportation. In the same way, there will be special focus in funding and promoting efficient and sustainable sources of energy. PSD projects will also support access to the global marketplace by working to remove market distortions that prevent internationalization of firms and supporting the provision of public goods and services. The beneficiaries will include individual firms, but also will target regions, sectors and firms that are linked via clusters or value chains, with a particular focus on productive small and medium firms. Activities will include designing new instruments for investment attraction and export promotion; development of financial and non financial instruments; and knowledge products that support greater productive integration in the region.
- 4.13 **Public-Private Partnerships (PPPs).** Depending on the country context, collaborative efforts such as PPPs will also be pursued and, when appropriate, will be included as part of the Bank's country program. PPPs involve the private sector in aspects of the provision of infrastructure assets or of new or existing infrastructure services that have traditionally been provided by the government. The main benefit derives from an improved balance between the cost and quality of a public service rendered through these models versus traditional procurement (i.e., improved value for money). Thus, the potential benefits generated include: higher quality of public services; improved risk transfer and distribution between the public and private sectors; an efficiency gain from the mobilization of private sector investment and innovation capacities; on time delivery of assets and start-up of operations; and improved capacity to recuperate costs through tariffs and tolls.
- 4.14 At the same time, these projects pose a set of risks and challenges for the governments. The first set of risks are fiscal, especially for small and vulnerable countries that face fiscal constraints, since PPPs carry a set of assumptions, such as project costs, internal rates of

²⁹ This is consistent with the Strategy on Competitive Global and Regional Integration and the Integrated Strategy for Climate Change Adaptation and Mitigation and for Sustainable and Renewable Energy

return, demand for the services and macroeconomic indicators, that when not correctly forecasted may lead to additional public expenditures through compensations and contract modifications (including termination), and even a reversal of the value for money criteria. Also, there is the political risk attached to having private entities offering public services, as well as a financial risk if markets are not able to fund successful bidders or are not attracted to the project or country. Thus, the evaluation and quantification of all the risks related to PPPs, including legal, technical, financial, political, social, environmental and economic, have to be carried out, introducing risk allocation and mitigation measures.

- 4.15 To address the risks and achieve true value for money, the IDB has been involved in the promotion and financing of PPPs by responding to different needs ranging from strengthening the institutional, legal and regulatory framework, supporting the technical preparation of projects, providing technical assistance and knowledge, and providing financial support in accordance to the needs of each sector, while ensuring that there are proper incentives to attract private sector participation. For example, the transportation and private sector teams of the Bank have participated in a variety of innovative PPP financing ranging from public sector risk mitigation for the IIRSA Norte Highway program in Peru to fully-private credit wraps for local currency bond issuances for Chilean highways. The IDB has also participated in the structuring of projects, like the PPP Facility co-financing with IFC and BNDES. Other IDB efforts have included helping to define the business environment for PPPs by country through the Infrascopes, which was developed by the MIF working with the Economist Intelligent Unit. MIF has also supported a number of projects to strengthen the capacity of the agencies responsible for PPPs in the region. The Bank is also working with the G-20 Infrastructure Working Group, which will generate a series of reports focusing on infrastructure investment needs and PPPs ranging from institutional strengthening to project structuring, procurement, execution and monitoring.
- 4.16 Looking forward, the Bank will work on enhancing its analytical capacity for preparing and evaluating PPPs (including project preparation, procurement issues, risk allocation and mitigation, fiscal impact, analysis of contingencies, and their use in non-traditional sectors), disseminating evaluations and best practices, as well as improving internal coordination to maximize development impact in this area. The Bank will also work on a VPS/VPP coordinated basis to expand its PPP capacity on a project or program-specific basis, working with VPC to assess countries' needs and the Bank's capacity to provide development additionality. Depending on the country context, collaborative efforts such as PPPs will also be pursued and when appropriate, be included as part of the country programs. In addition to the traditional PPP sectors of transportation and energy, the Bank will also look at opportunities to support renewable energy and social infrastructure projects such as schools and hospitals. These efforts will be combined with PSD that address legal, institutional and regulatory issues to establish the basis for effective partnerships, ensuring that the proper incentives exist to attract private sector participation. PSO will consider financing private participation when needed in the various concession, leasing, and contracting models that are deployed.
- 4.17 **Financing of State-Owned Enterprises (SOEs).** While most of the Bank's work with SOEs is carried out through the SG operations, on a selected basis this work can also be done through NSG operations based on criteria as established in 2006, when the IDB's

Board of Governors authorized the expansion of the Bank's NSG financing, including lending to public entities without a sovereign guarantee (CA-466-1 and Resolution AG-05/06). In those instances when NSG operations finances SOEs, careful attention must be paid to ensuring that the project as structured is creditworthy on its own right and meets the Bank's development objectives and additionality criteria.

- 4.18 In some specific cases, the Bank has provided both SG and NSG financing to SOEs, for example the loans to ICE en Costa Rica. Or these efforts have been complementary, such as a PSD to develop a Sustainable Energy Framework for a country that enables NSG financing of state-owned energy companies. In the case of Corporate Governance of SOEs, the Bank is participating with OECD in the creation of the Latin American Network of SOEs to develop and disseminate best practices in corporate governance of SOEs.
- 4.19 Looking forward, VPP will submit to the Board of Executive Directors by the fourth quarter of 2011 a review of the NSG Operational Guidelines for lending to public, municipal and semi-public (autonomous state) entities, including a mapping of eligible SOEs and excluded entities. This review, which will be coordinated with VPS and VPC, will propose how NSG lending to these entities can facilitate working with SOEs and PPPs, fostering joint ventures and avoiding potential regulatory arbitration.

D. Enabling Environment for Development through Private Sector

- 4.20 **Reduce Firm Informality.** The Bank is in a unique position to work on the topic of informality, given its long-standing experience with credit operations, tax issues, market regulation, and social policies – all of which are part of the multidimensional causes of informality among firms. Through PSD, the Bank will concentrate on removing policy distortions that contribute to informality and the improvement in regulatory regimes to lower transactions and informational costs for activities related to business creation, expansion and exit³⁰. PSO can contribute to reducing informality by helping to lower the cost of credit to formal firms, providing financial and technical support to firms that commit to formalizing and concentrating Bank intervention on formal counterparts to promote formalization of informal firms. However, experience in several countries has shown that formalization is solved not just through the reduction of costs and regulatory burdens.
- 4.21 **Improve investment climate.** In order to work towards overcoming policy distortions and improving the investment climate, PSD will work with governments to optimize tax regimes, define property rights and legal frameworks (including better bankruptcy rules), and improve reliability of courts and enforcement. The Better Conditions for Productivity Initiative (based on the experience and lessons learned from the Business Climate Initiative) is expected to continue to be a source of technical assistance for studies and activities in priority areas aimed at improving the business environment and implementing more effective productive development policies in Latin America and the Caribbean.

³⁰ See IDB Institutions for Growth and Social Welfare and SME Guidelines for a more detailed range of examples of PSD activities and interventions

Business Climate PSO financing can be a catalyst to demonstrate the viability of projects under institutional frameworks improved by PSD interventions.

Box 2: The IDB's Business Climate Initiative Experience

To address constraints to businesses and the causes of informality, the IDB has designed interventions that are both pragmatic and provide measurable results. In that way it sustains these reforms over time. Efforts have included MIF grants, sector loans, technical cooperation activities, and the Business Climate Initiative. Under the BCI from 2003-2007 the Bank financed policy dialogues between the public and private sectors, diagnostic evaluations, and legal reforms to improve specific aspects of the business climate (bankruptcy, legal incorporation). Starting in 2008, the Bank continued this work with \$2.3 million in Trust Fund resources from the Spanish Government to launch the program “Mejora del Ambiente Productiva” (MAP, www.iadb.org/map). The MAP has been used to fund the design and implementation of innovative activities that identify policy lessons on how to improve the enabling environment with a focus on SME access to finance; issues of informality; legal framework for businesses; and productive development policies. The proposals for MAP funding are reviewed collaboratively by VPS and VPP and so far 14 activities have been financed.

E. Enhancing innovation capacity and building human capital for productivity

- 4.22 Through PSD projects, the Bank will continue to support the innovation capacity of the regional private sector. A systemic approach will be used that includes programs directed at both SMEs and large firms. Interventions are designed to provide firms with adequate resources and, at the same time strengthen institutions and networks.³¹ PSO will continue to work with firms to increase their innovative capacity³².
- 4.23 In order to support innovation by SMEs, the IDB will focus not only on securing access to finance, but will also consider the provision of services that will decrease the firm's information asymmetries, mitigate uncertainty, stimulate technology adoption and provide SMEs with an educated and skilled labor force. On the side of financing, the IDB will examine the use of innovative risk-sharing and guarantee systems, while continuing to support Technology Development Funds (TDF) programs and the financial support for ICT adoption throughout the region. With regard to technology diffusion, the IDB will work towards redesigning and augmenting the coverage of technology extension programs focused on SMEs in the region, with a particular focus on ICT.
- 4.24 Large firms enjoy competitive advantages to innovate, advantages that emerge from their ability to *partially* overcome some of the market failures that hinder innovation in SMEs.

³¹ See Strategy on Social Policy for Equity and Productivity, Institutions for Growth and Social Welfare Strategy and SME Guidelines.

³² Examples include: MIF's work with youth training and skills development and certification, IIC's work in targeting SMEs productivity gaps and training, and OMJ's support to firms in developing or expanding innovative “Base of the pyramid” business models.

Certainly, given their size³³, scope and abundance of complementary assets, they are more able to appropriate some of the benefits of innovation and to get access to external funding for their innovation investments. In this context, to further support the expansion of innovation activities in large firms the Bank will support the establishment of *incentives programs*, such as R&D tax credits³⁴. These programs can also constitute a powerful tool to improve the quality of MNEs activity in the region and therefore increasing technology transfer and associated spillovers. However, beyond volume, an important challenge for large firm innovation relates to *direction* of technological change. The IDB will support the use of market signaling instruments, such as “*thematic funding*” or “*contests*”, which may steer large firm capabilities towards the fulfillment of socially desirable goals.

- 4.25 Strengthening institutions that define and implement business development programs continues to be a priority area for the Bank. It implies also dealing with regulatory issues such as Intellectual Property Rights (IPRs), standardization, bioethical regulation and competition regulation. It is equally crucial to foster the generation of networks between institutions, universities and firms and promoting effective public-private partnerships. Linkages between SMEs and Large firms may be built through the implementation of supplier development programs, which should focus not only on information sharing (or matchmaking), but also on providing technical assistance to build absorptive capacities by SMEs or the setting of technological consortiums for pre-competitive research.
- 4.26 In terms of workforce skills, the Bank will support the development of advanced human capital in technical areas and will work towards improving the functioning and quality of training systems by addressing financing and institutional problems, improving incentives for firms and workers to acquire training, and raising the quality and pertinence of the training provided. This will require assessing skill gaps in countries and sectors, updating training contents to better match the needs of firms, particularly in sectors with high growth potential, introducing standardized measurements of attainment, and creating an evaluation culture to assess the impacts of different training policies and programs on skills, employment prospects and productivity of workers.³⁵

F. Social Inclusion and Other Opportunities for Development through the Private Sector

- 4.27 The Bank will also pursue new opportunities to reach poorer segments of the population, increase social inclusion, and develop innovative markets and products that have positive developmental benefits. In particular, the IDB will continue to work through private sector entities to target neglected segments like the poorest groups in society, where poverty is

³³ To the extent that R&D expenditures are sunk-cost investments, size has a cost-spreading incentive effect.

³⁴ Large firms normally benefit from tax incentives more than SMEs because their corporate tax rate is usually higher than in SMEs.

³⁵ In this aspect, the PSDS will benefit from the emphasis defined in the Strategy on Social Policy for Equity and Productivity regarding the functioning of labor markets and building human capital. The Labor Markets Unit is already working on a research agenda to expand the Bank knowledge regarding training and employability in LAC.

compounded by the lack of access and high price of goods and services. Greater inclusion will be supported with interventions aimed at gender and/or ethnic issues, while attention is also given to lagging regions in countries. To address the negative consequences of market failures the Bank will identify innovative and replicable strategies that address social equity and environmental issues. In particular, PSO will increase funding for private sector investments in renewable energies, energy efficiency, recycling industries, biofuels, clean energy technologies, carbon finance, biodiversity, and conservation. PSD will continue to focus on complementary environmental and climate change policies and necessary institutional changes to make market-based solutions feasible. Likewise, PSD activities can support financial markets for risk instruments that emphasize those risks most relevant to the private productive sector, such as commodity price, natural disaster, and credit.

Box 3: The Opportunities for the Majority Initiative Experience

In 2008, the IDB Board approved the implementation phases of Opportunities for the Majority (OMJ) in order to develop market-based solutions to provide low-income communities access to affordable high-quality basic goods and services, as well as to generate opportunities for low-income families to improve their livelihoods. OMJ, working collaboratively with many other IDB Group units, has positioned the IDB to play a major role in improving the lives of individuals at the base of the socio-economic pyramid in the region. Three years later, OMJ's growing private sector operations portfolio and pipeline has shown that the poor can be served through innovative and inclusive business models that apply sustainable strategies to bring real development solutions to their communities; in other words, market forces are responding. Some early lessons learned include: a) the importance of reaching scale through existing platforms and distribution networks; b) sustainable engagement is accomplished when a service or product delivered by a company is coupled with payment mechanisms that are aligned with the customers' desires, needs and ability to pay; and c) the value of using funds to catalyze innovation and new investments in early stage companies serving the Base of the Pyramid customers.

- 4.28 Another area that enhances development through the private sector is the promotion of Corporate Social Responsibility (CSR), which encourages private sector companies to go beyond good corporate governance to promote the well-being of a larger set of stakeholders. Taking advantage of its comparative advantages as an MDB, the IDB will continue to play a key role in fostering CSR. PSD operations will develop the policy environment for CSR and also compliance, reporting and accountability; while PSO operations will support CSR through promotion and advocacy, including an annual region-wide CSR meeting on the topic.

V. EXECUTION OF THE STRATEGY

A. Focus efforts on GCI-9 Priority Sectors and Lending Targets

- 5.1 **GCI-9 lending targets.** PSD and IDB's PSO operations will be guided by lending program targets provided in GCI-9. As outlined in GCI-9, lending targets are an expression of the

Bank's highest priorities and mandates. Expressed as a percentage of overall lending by 2015, the Bank's lending program targets comprise: (i) small and vulnerable countries (35%); (ii) poverty reduction and equity enhancement (50%); (iii) climate change, sustainable (including renewable) energy, and environmental sustainability (25%); and (iv) regional cooperation and integration (15%). As required under GCI-9, overall Bank progress towards these lending priorities will be reported annually to the IDB's Board of Executive Director through the annual Development Effectiveness Overview (DEO).

- 5.2 Moreover, in meeting these targets the Bank will have continuous improvement and innovation in its products and services. Some of the main areas that will support the implementation of the PSDS, such as work on addressing country needs, expanding products and services, and improving operational quality and targeting.

B. Addressing Country Needs

- 5.3 Since the market and institutional failures are different for each country, the IDB's private sector activities will build on country-specific information as defined and implemented through its country strategies, thereby conforming to both GCI-9 mandates and OVE (RE-319) recommendations. This will ensure that operations are tailored to the institutions, actors, and markets that set the initial conditions in each country.
- 5.4 **Country Strategies and Country Programming.** As part of the preparation process for the development of Country Strategies, VPS, with input support from VPP, expects to prepare sector notes that focus on strategic challenges, binding constraints and alternatives for promoting development through the private sector (with emphasis on the SMEs). As part of this process, discussions with Governments are particularly important to identify priority sectors, institutional challenges, and the best means for intervention within each country. Moreover, to align Bank activities in order to meet the goal of development through the private sector, a private sector diagnostic should be an integral part of the Country Strategy and Country Program exercises. VPS and VPC, in coordination with VPP, will work together to operationalize a process --including sector notes and KCPs -- to support a policy dialogue and consultation with relevant stakeholders that is tailored to the challenges of each country.
- 5.5 As a starting point for background information, sector notes can draw upon previous work done under the Business Climate Initiative and the MAP (Better Conditions for Productivity Initiative) that have been providing country diagnostic, knowledge and best practices to improve the investment climate including analysis of financial systems, legal and regulatory frameworks for investment, action plans to reduce informality, governance and competition law and policy reviews, among other topics. The knowledge generated under these initiatives for several countries can provide a useful point of departure for analyzing key market and institutional failures in a given country.
- 5.6 In order to receive better information about the specific institutional and market failures in each country, VPP is creating, on a selected basis, private sector advisory groups in a few countries in the region. These advisory groups would draw on expertise from think tanks, local chambers of commerce and competitiveness councils thus allowing the Bank to have a better understanding of some of the most pressing problems the private sector faces in each country and how to best address those problems. Based on this analytical work, the IDB Country Strategies could also identify development objectives and expected results

aimed at addressing low productivity and lack of access to finance and investment issues. Through the annual Country Programming Documents (CPDs), the Bank would then implement the Country Strategy using a broad set of financial and non-financial products what would allow the design of well-suited projects (considering both PSD and PSO) to address those issues³⁶.

- 5.7 **Facilitate Public/Private Policy Dialogue.** The IDB has had an important role in facilitating dialogue between public and private sector actors on development priorities. Therefore, the IDB will continue acting as a facilitator of policy dialogues, seeking to broaden the discussions between the public and private sectors, providing diagnostic evaluations, and designing reforms as needed, particularly in the areas identified to promote productivity and enhance access to finance. Among these areas particular attention will be given to dialogues on PPPs and Bank support to SOEs.

C. Expanding products and services

- 5.8 **Advisory Services.** One of the strategic objectives of the PSD Strategy is to expand the delivery of advisory services. Both PSD and PSO have long utilized technical assistance to complement financial products, as well as on a stand-alone basis in order to achieve development results. PSD projects can be funded to help address key institutional or market failures, help to make the business and investment climate more attractive and to help develop the local capital markets.
- 5.9 Technical assistance has been a significant part of PSO operations, particularly for the MIF and the IIC. The MIF is the largest grant facility in the region while the IIC established the Technical Assistance Strategic Partnerships (TASP) business unit in 2008 specifically tasked with both expanding sources of donor funding, as well as designing, implementing and monitoring technical assistance activities. Looking forward, technical assistance resources have significant potential for SCF and OMJ, particularly in terms of fostering opportunities for lending, as well as facilitating better project design and additional development impact of lending operations through complementary technical assistance projects. This type of technical assistance would be particularly useful for innovative climate change projects and social and poverty-targeted areas.
- 5.10 Closely related to the topic of technical assistance are advisory services. As mentioned in GCI-9, the Bank will study the possibility of providing advisory services under a fee-based scheme that would be focused on core competencies that are consistent with the development nature of the Bank. So as not to compete with private consulting firms, IDB would focus on areas where it has unique status and experience as an MDB to deliver high quality and unbiased advisory services. This could include public private partnerships, environmental sustainability, climate change, and corporate social responsibility, among

³⁶ The IIC has agreed to support this process by providing areas of opportunities under the priority sectors identified under the Country Strategy.

others. To that end, VPP is currently coordinating the preparation of a proposal related to the provision of advisory services, which is expected to be discussed with the Bank's Board of Executive Directors.

- 5.11 **Risk Management Products.** There is considerable room for the IDB to expand innovative risk management products that would lower overall volatility of risks for both governments and private sector clients. Existing products, such as contingent credit facilities (CCF) for natural disasters should be expanded, while new initiatives will need to be analyzed in greater detail, including financial and legal implications. One significant risk area that has been identified is currency risk, and therefore expanded local currency initiatives will be explored more systematically. For individual projects, an enhanced local currency financing product would enable PSO teams to originate more projects for which local currency is an appropriate product. For example, the IIC is contemplating expanding their local currency initiative in Colombia and Mexico. For countries that do not have their own currency swap markets (i.e., most of the countries in the region), investing in local currency initiatives that retain currency risks on a global basis and thus reduce risk on a portfolio basis, thereby lowering costs to the user, could be explored on a regional LAC basis. Another local currency option, which is available for the VPP windows that have the capacity to invest in equity, i.e., the IIC and the MIF, is to make equity investments in funds that offer local currency lending but do not hedge their loans. For example, the MIF has made an equity investment, a subordinated loan and provided technical assistance to LOCFUND, which provides local currency loans to local FIs that in turn lend to micro and small enterprises (MIF/AT-759). Additionally, VPS will continue refining the framework for providing ex-ante integrated financial solutions to help reduce the negative impact of natural and man-made disasters as well as mitigating the impact in public finances.
- 5.12 **Development Equity.** The Bank's Charter permits the Bank to provide loans and guarantees of loans, in addition to technical support, but does not include equity. Although the IDB can offer subordinated debt, the amortizing requirement of this product does not carry with it the benefits of equity. Equity investment, however, may be highly developmental since: (i) it fills a gap generated by the slow development of risk-sharing financial instruments, which raises the cost of borrowing for new projects and firms, especially in lower income and middle income countries; and (ii) equity capital drives and sustains innovation, which plays a crucial role in private sector-led growth. Companies that have a higher capacity for innovation, require risk- and scale-appropriate equity investments to grow. Start-up and expansion capital thus facilitates development more directly than debt products and loan guarantees. These investments are also expected to have substantial demonstration effects. The VPP is currently exploring strategic options for the deployment of development equity in order to enable the Bank to become more involved in this critical space.
- 5.13 Because of the development impact of equity, Management will explore various options including: (i) expanding MIF's financial capacity to support local managers and venture capital funds investing in local SMEs; (ii) expanding the IIC's capacity for investing in VC funds and/or companies once they have graduated from the MIF seed capital, to give continuity to the IDB Group's support for venture capital in the region; and (iii) expanding IIC's capacity to managing equity investments similar to its role vis-à-vis the China Equity Fund, however, for this purpose, solely using third party funds to make equity investments

in PSO projects. IDB Ordinary Capital could be added to supply long term subordinated debt. Another potential model could be similar to the IFC's Asset Management Company, which leverages funds from Sovereign Wealth Funds and "impact development funds" to co-invest in IFC equity investments.

D. Improving Operational Quality and Targeting

- 5.14 **Focus on Country Strategy priority sectors.** Following the analysis conducted for the Country Strategies, both VPS and VPP will focus their origination efforts for PSD and PSO projects respectively in the priority sectors agreed with the Governments. Given the opportunistic nature of PSO projects, if there are no available projects in the priority sectors and a project with high development impact and relevance is identified, PSO may pursue looking into developing that project.
- 5.15 **Focus on gender and diversity.** As indicated in the GCI-9, tackling cross-cutting gender issues is part of the Bank's strategic engagement with the region. The PSDS contributes to this goal and is consistent with the Operational Policy on Gender Equality in Development (GN-2531-10). For example, private sector development projects can offer women, indigenous and Afro-descendants populations better opportunities, increasing their financial inclusion, fostering a more diverse workforce and management teams and supporting higher growth of their SMEs. The Bank is already promoting innovative projects to address these challenges and create non-financial additionality. Some examples include creating human capital funds targeted to traditionally marginalized African descendant and indigenous populations, promoting women in business by an integrated approach that addresses their particular needs in terms of business development technical assistance including professionalizing the sales force of women promoters through improving distribution and marketing strategies, venture capital and networking opportunities, or supporting indigenous communities participation in sustainable tourism projects. In order to ensure progress in gender and diversity, management will be tracking these metrics for specific GCI indicators. In addition, the Bank's ESHS requirements may include equal or special treatment on gender issues for safeguard purposes.
- 5.16 **Reduce the risk of fraud and corruption.** The potential for private sector development is reduced by the presence of fraud and corruption. The Bank's PSD efforts to improve the business and investment climate will help reduce legal uncertainty and limit discretionality that contribute to fraud and corruption. In its PSO activities, the Bank will work to reduce such risks through prevention efforts including integrity due diligence. These prevention efforts, which identify and reduce the risk of fraud and corruption, contribute to the Bank's additionality.
- 5.17 **Development effectiveness scoring.** Another key focus of PSD and PSO is to ensure that all projects are able to demonstrate high development effectiveness and transparent criteria for Bank additionality, including social and environmental sustainability and reduced integrity risk. Over the last few years, the IDB has made significant progress in upgrading the guidelines for development effectiveness methodologies for both public and private sector projects, as well harmonization with MDB peers. In order to further improve benchmarking scores, particularly in the implementation stage, the IDB will continue to expand self-evaluation activity, which will help to ensure the high quality of the various return calculations included. Management-led discussions with project teams will draw out

more useful and practical lessons learned as well as giving the completed development effectiveness tools a much higher profile. The IIC will continue to use and improve its comprehensive evaluation system, including the DIAS, which covers ex-ante assessment, tracking thorough the life of the project and independently validated ex-post evaluations.

- 5.18 **Evaluability of PSD and PSO projects.** Responding to the mandate of GCI-9, as of January 1, 2011, all Bank SG and NSG projects are now scored for evaluability and all projects have to meet a minimum overall threshold score. Now all SG and NSG³⁷ projects will include an Evaluability Score as a part of the DEM, in addition to the Project Score. The Evaluability Score seeks to measure the quality of the information provided and to demonstrate expected results in measureable terms. In addition, VPP will provide input for drafting the CS and CPD results matrices, as well as their respective DEMs.

VI. RESULTS FRAMEWORK

- 6.1 The PSDS is aligned with the Bank's Results Framework (RF) for GCI-9 and thus will allow the Bank's shareholders and stakeholders to monitor PSO and PSD activities to ensure that they are making significant contributions towards helping the Bank to achieve its sector priorities. Table 2 below presents the Results Framework output goals for the IDB taken from GCI-9 (AB-2764 Annex I).

³⁷ All SCF, OMJ and IIC projects have an evaluability score. The MIF is also enhancing its evaluation framework and evaluability assessment tool to assess the alignment of MIF projects with its "Access Framework" and GCI-9 sector priorities, as applicable, as well as the quality of the project's logical framework.

Table 2: Bank Output Contribution, 2012-2015

	Baseline 2005-2008	Estimated IDB Outputs 2012-2015
Social Policy for Equity & Productivity		
3.1.5 - Individuals benefited from program to promote higher labor market productivity	n/a	600,000
3.1.6 - Number of jobs added to the formal sector	129,000	160,000
Infrastructure for competitiveness & Social welfare		
3.2.1 - Households with new or upgraded water supply	1,500,000	2,770,000
3.2.3 - Km of inter-urban roads build or maintained/up-graded	22,000	53,000
3.2.4 -Km of electricity transmission and distribution lines installed or up-graded	2,000	1,000
3.2.5 - Number of households with new or upgraded dwellings	n/a	25,000
Institution for growth and social welfare		
3.3.1 - Micro/Small/Medium productive Enterprises financed	220,000	120,000
Competitive regional & global integration		
3.4.3 - Number of cross border and transnational projects supported	26	22
3.4.4 - Number of international trade transactions financed	561	1000
3.4.5 - Mobilization volume by NSG financed projects/companies	\$25.3 billion	\$31.2 billion
Protecting the environment, responding to climate change, promoting renewable energy, and enhancing food security		
3.5.1 - Percentage of power generation capacity from low-carbon sources over total generation capacity funded by IDB	91%	93%
3.5.2 - Number of people given access to improved public low-carbon transportation systems	n/a	8,500,000
3.5.4 - Climate change pilot projects in agriculture, energy, health, water and sanitation, transport and housing	n/a	10
3.5.6 - Farmers given access to improved agricultural services and investments	n/a	5,000,000

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ANNEX I: OVE RECOMMENDATIONS AND BANK RESPONSES

OVE Recommendations for PSO	Bank Responses
Forge institution-wide shared vision, starting with a common diagnostic and effective division of work to seek out synergistic interventions and feedback on experiences (RE-303)	The PSDS is part of the Bank's shared vision and diagnostic for achieving development through the private sector, with the Vice Presidency for Countries, the Vice Presidency for Sectors and the Vice Presidency for Private Sector and Non-Sovereign Guaranteed Operations all having synergistic divisions of work and expertise.
Promote partial credit guarantees (PCGs) and other local capital market interventions to develop capital markets; develop local currency vehicles; foster wholesale facilities ¹ (RE-303)	PCGs have been used to promote issuance of local bonds in Mexico, Peru and Chile and remain an important product for PSO, the utilization of which are expected to be encouraged in the future.
Achieve demonstration effects by replicating successful models; target a discrete set of subsectors to foster learning; and publicize successes and positive experiences (RE-303)	A key component of the OMJ model is to replicate the successful use of "platforms" to serve low income markets in the region; the infrastructure division of SCF is targeting three key subsectors: transportation, energy and water & sanitation; the private sector windows are upgrading their websites to further publicize successes and best practices.
Shorten approval times and reduce transaction costs for clients (RE-303)	Changes to the approval system for NSG projects have resulted in some process improvements, but not in reduced cycle times for infrastructure and corporate finance projects, primarily because of increased time for environmental reviews.
Improve evaluability of projects, particularly for development effectiveness determinations (RE-303)	All NSG (as well as SG) projects will include evaluability as part of their DEMs, starting in January 2011

¹ Wholesale facilities could include a guarantee facility to a bank that would allocate a portion of the IDB guarantee exposure to several underlying projects or a risk sharing arrangement with a bank for projects that meet pre-set criteria.

OVE Recommendations for PSD	Bank Responses
Closely connect GMC activities with other activities of the Bank targeted to private financial intermediation, including private sector windows (RE-336)	VPP and VPS will improve coordination through mechanism such as joint missions and joint evaluations of the banking sector
Reinforce TA work for second tier banks in risk administration, innovative financial products and lending to PPPs (RE-336)	VPS is analyzing its lending and TA work to financial intermediaries to identify specific market and regulatory failures in order to improve the effectiveness of these instruments in terms of development outcomes. This work will guide the decisions for technical support in the future including support for institutional capacity building and the design of new financial instruments.

ANNEX II: MDB/BILATERAL EVALUATION REPORTS ON PRIVATE SECTOR DEVELOPMENT

Promote Productivity

Public-Private Partnerships (PPPs): The Asian Development Bank (ADB) has been very active in PPPs over the 1988-2008 period, with 38 loan and equity projects totaling \$3.9 billion supporting PPPs, plus 73 technical assistance projects supporting the identification and preparation of pilot projects and PPP frameworks. According to a recent evaluation study (ADB 2009), there are a number of important lessons to be learned in this sector: 1) PPPs are not a universal solution to the underlying problems of sector investment and performance problems. The respective costs and benefits associated with traditional public sector procurement and the use of PPP modalities have to be clearly established through public comparator analysis and value for money analysis; 2) PPP development requires sustained policy dialogue and support for the suitable legal, regulatory, and institutional frameworks and assistance in the development of PPP pathfinder projects.

Private sector participation is not a substitute for reform or government effort; on the contrary, many PPP modalities require prior sector restructuring and tariff reforms to be effective; 3) PPP modalities have to be carefully chosen to address specific sector development needs. For example, the power sector has received significantly more private investment than the transport and water sectors due to better potential for cost recovery and less resistance to private sector participation. Nevertheless, this does not mean that PPPs for other sectors is without prospects. With appropriate modalities, support of capacity development, and political commitment to sector reforms, PPP has proven feasible in other sectors as well; 4) PPP strategy should be implemented at the country strategy level (including sub-national projects), with a PPP mapping exercise that identifies key legal and regulatory gaps that need to be filled; and 5) PPP advisory work should be expanded to support pre-feasibility studies, marketing, fiscal and financial analyses, and procurement support.

Access to Finance

Lending to MSMEs through Financial Institutions: The IFC IEG evaluation of “Financing MSMEs through Financial Intermediaries FY 1994-2006 (IFC 2007) found that IFC’s strategy to provide indirect support to MSMEs through specialized financial intermediaries and for providing institutional capacity building to the FIs “has been relevant and effective in terms of both development outcomes and investment returns.” For on-lending to Micro-Finance Institutions (MFIs), the IEG noted that an important success driver is a specific and supportive regulatory framework that allows deposit taking, establishment of branches to achieve reach and scale, and reliance upon competition to set reasonable interest charges. IEG also suggested that MFIs can transition out of donor dependency and become profitable and sustainable if they: 1) develop a large savings deposit base in local currency; and 2) expand the scale and scope of services to include small enterprises as well as micro-entrepreneurs.

Regional and Domestic Capital Market Development: ADB has made capital markets development one of the core operational priorities of its Strategy 2020. An ADB evaluation study (ADB 2008) found that the most effective market interventions in this area were part of a long term engagement integrated with government reforms that were supported by all relevant stakeholders. Advisory work was primarily in two categories: (i) development of regulatory

frameworks (e.g., establishing the legal basis for securities operations, strengthening the capacity of regulatory authorities, improving the governance and self-regulation of stock exchanges, and upgrading disclosure standards); and (ii) fostering the development of domestic debt markets (e.g., corporate bond markets, primary markets for government securities, fostering local credit rating agencies, and supporting efficient clearing and settlement systems.) The evaluation study recommended they: (i) improve the selectivity of capital markets projects through careful assessments of capital markets potential and identification of long term strategies to address binding constraints in this sector; (ii) carefully consider the costs and benefits of capital market development; (iii) adhere to international standards and principles whenever possible, such the International Organization of Securities Commissions (IOSCO) standards for regulatory frameworks; and (iv) ensure that relevant public and private stakeholders be involved in the formulation of any capital market reforms.

ANNEX III: SUMMARY FROM THE PSDS PROFILE CONSULTATION PROCESS

Summary from the Second Public Consultation Process March 18 – April 16, 2011

The objective of the public consultation was to get feedback from key stakeholders such as companies, civil society, policy makers, and experts in the areas prioritized in the Private Sector Development Strategy (PSDS), with the purpose of enriching the design and contents of the strategy.

There was a two-phase consultation process: phase one for the Strategy Profile and phase two for the Strategy Proposal document.

- The **first phase** lasted 30 days, and was conducted through the Bank’s website. It focused on the Private Sector Development Strategy Profile authorized by the IDB’s Board of Executive Directors and was open from January 21, 2011 to February 19, 2011.
- The **second phase** of the consultation process lasted 30 days and was conducted through the Web but complemented through face-to-face meetings and videoconferences. It focused on the draft of the Private Sector Development Strategy. The second phase was open from March 18 to April 16. Two face-to-face meetings took place on March 24 and 26, 2011, in conjunction with the Bank’s Annual Meeting in Calgary, Alberta, Canada and another public consultation took place on April 11, in Washington DC. A series of videoconferences were conducted on April 14 with private sector businesses, associations and labor organizations in the country offices of El Salvador, Panama and the Dominican Republic.

The comments from the second phase of consultations are summarized below:

No.	Topic	Summary of Comments from Public	Bank’s comments
1	Enabling environment	Countries need to create an environment of trust and have the proper laws to incent private sector investment	Agree. This point is developed in paragraph 4.19
2	Access to Finance for SMEs	SMEs lack access to long-term loans	Agree. The Bank is working through both PSD and PSO to provide long-term funding for SMEs. See 4.5-4.7
3	Export-led growth	There is not enough support for small countries to export and compete in international markets	The Bank works to support export capacity through regional integration efforts, firm training and export guarantees.
4	Infrastructure PPPs	The Bank should train public employees about planning and executing PPP projects	Agree. This point is developed in 4.14

5	Climate change	The PSDS should talk more about what it intends to do in the area of climate change	The Bank has a separate but coordinated strategy entitled “IDB Integrated Strategy for Climate Change Adaptation and Mitigation, and Sustainable and Renewable Energy”
6	Local capital markets	The Bank needs to support the development of both local and regional capital markets, particularly corporate debt markets	Agree. The document mentions this in 4.8
7	Informality	Need to find strategies to reduce the costs of operating in the private sector There are not enough incentives to formalize	Agree. The IDB is working on various strategies to help firms formalize. See 4.18 and Box 1.
8	Education and training	Companies need well educated managers and employees to hire Companies need education for how to run their businesses and also for corporate governance	Agree. The Bank supports both education at the primary and secondary levels, as well as labor training The Bank offers technical advisory support for business skills for SMEs, as well as promoting corporate governance
9	Physical security	The impact of violence is widespread and hurts economic and social growth The cost of providing private security forces is high both in cost and under-utilization of human resources	The Bank deals with security issues as a significant component of its “Sector Strategy for Institutions for Growth and Social Welfare.”
10	Social exclusion	The social exclusion of women and indigenous groups hurts economic growth and social equity Last category of “missed opportunities” is too nebulous	Agree. The Bank is committed to social inclusion projects and mainstreaming. See 5.15. Agree. We changed the title of the last category to “Social Inclusion”.

11	Transparency	The Bank should promote the adoption of fair and transparent rules and procedures for public procurement	Agree. The bank supports transparency initiatives for PPPs (4.14) and for its own procurement (5.16)
12	Communication	Need for more publicity about what the Bank is doing	Agree. The Bank is working on a communications strategy to better convey the scope of its activities in the region