Annex III

PRIVATE SECTOR DEVELOPMENT ACTIVITIES OF THE WORLD BANK GROUP[1]

World Bank Group PSD activities – historical trends

Private sector development has been at the center of the World Bank Group's activities since the beginning. In the Bretton Woods world of pervasive capital controls the World Bank focused on its special ability to move funds across heavily controlled borders. This resulted in on-lending operations to the private sector in developing countries. The IFC was set up in 1956 to help promote cross-border capital flows without government guarantee in support of private investment. The ICSID was set up in 1966 to provide international facilities for conciliation and arbitration of investment disputes.

During the 1960s and 1970s, as state-led development and import substitution policies were pursued world-wide, the WBG started to focus on "development" rather than promotion of private capital and investment. IDA was established in 1960 and the bulk of the Bank's lending went to public sector agencies. After the 1982 debt crisis starkly revealed the failure of state-led development and import substitution policies, the WBG shifted emphasis towards macro-economic stabilization and opening up economies to trade and foreign investment. Adjustment lending with conditions on general policy reform grew in importance. FIAS, the foreign investment advisory service was created in 1986, and MIGA, the Multilateral Investment Guarantee Agency in 1988. In a parallel development, the liberalization of cross-border capital flows spread across all OECD countries and some developing countries during the 1980s, laying the ground for the subsequent rise in private capital flows.

The WBG's focus on stabilization and openness was gradually complemented by an emphasis on what later became to be called private sector development. Following the reorganization of 1987 "private sector development" became one of several "programs of special emphasis". The Bank's lending program shifted away from areas where private firms could find private financing. Disenchantment with the performance of on-lending operations of Bank loans to private firms led to the "Levy report" of 1989 and the subsequent decline of such operations. Towards the end of the 1980s the Bank's disappointing work on state-owned enterprise reform shifted attention to privatization.

In the 1993 re-organization of the Bank private sector development became an organizational principle with the creation of private sector development divisions and departments throughout the Bank. With the establishment of the Finance and Private Sector Development (FPD) vice-presidency in the re-organization of 1993 the Bank tried

[1] This section is based on the PSD strategy background paper: "Private Sector Development Activities of the World Bank Group", SecM2001-0305, May 8, 2001

to take on a more activist role again. On-lending operations, particularly to SMEs, were again promoted. So-called "second generation" reform projects were initiated focusing on detailed reform of markets, including technology and competition policy rather than broad macro-policy frameworks. In 1999, a new SME department was created as well as several new joint Bank/lFC departments.

At the same time, the Bank Group started paying greater attention to institutional development and to addressing the social costs of PSD-interventions, such as privatization-related labor retrenchment. There was also increased concern about environmental and social sustainability issues. Issues of transparency and corporate governance also started getting highlighted, especially after the East Asian crisis.

All in all, the trend in IBRD/IDA has been to emphasize policy reform and to withdraw from direct support to enterprises and individual investments that the private sector might be better placed to undertake. IFC has emerged as the main instruments for direct assistance to private firms. This trend is reflected in all sectors of the WBG's work, albeit in varying degrees. Over the last two decades, there has been a shift in lending and guarantee activities from IBRD to IFC and MIGA. The share of lending/guarantee products by IFC and MIGA in total Bank Group financial products has increased more than seven times over this period--from 3.3 per cent in 1980 to 25 per cent in 2000.

WBG lending and guarantees for PSD has doubled in real terms. since 1980.[2] Much of this increase is due to the expansion in IFC investments and MIGA guarantees. IFC investments increased four and a half times in real terms between 1980-2000 and, by FY2000, accounted for 56 per cent of total World Bank Group lending and guarantees for PSD. MIGA, non-existent in 1980, accounted for 25 per cent of the Bank Group's financial support to PSD. IBRD lending for PSD has declined in real terms and in FY2000, was about one-third the level in FY80. This is somewhat compensated by the doubling of real IDA lending for PSD over the same period. Still, in FY2000, IBRD and IDA lending for PSD together amounted to only one-sixth of the Bank Group's PSD oriented lending and guarantees (Figure 1). World Bank Group financial support for PSD has increased at a faster rate in recent years than total lending and guarantees. As a result, the share of total lending and guarantees going in support of PSD almost doubled between FY95 and FY00; from 16% to 30% (Figure 2).

2 See "Private sector development activities of the World Bank Group" , SecM2001-0305, May 8,2001, page 4 and Annex 3 for a description of the methodology underlying these estimates.

Figure 1

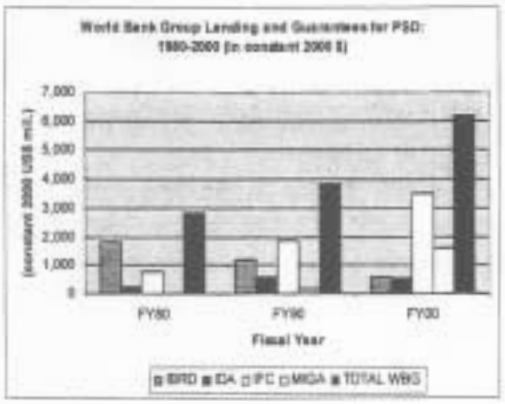
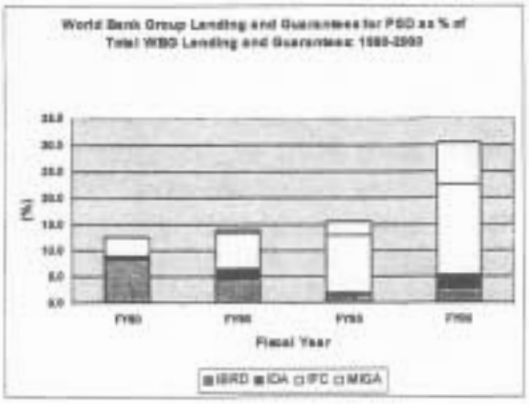


Figure 2



Present PSD activities of the World Bank Group

Financial interventions

IBRD/IDA lending project: Several lending operations of IBRD and IDA support private sector development. A recent portfolio exercise identified about 260 active Bank projects with substantial PSD components. These accounted for $6.5 billion in committed lending; this is 6% ofthe total committed loans of the Bank. About 60 ofthese projects are classified as PSD projects in the Bank's project classification scheme. The rest are categorized under other sectoral or thematic heads but have significant PSD components.

PSD-related interventions fall into four categories based on their objectives: a) improvements in business environment; b) privatization; c) direct assistance to enterprises; and d) social funds.

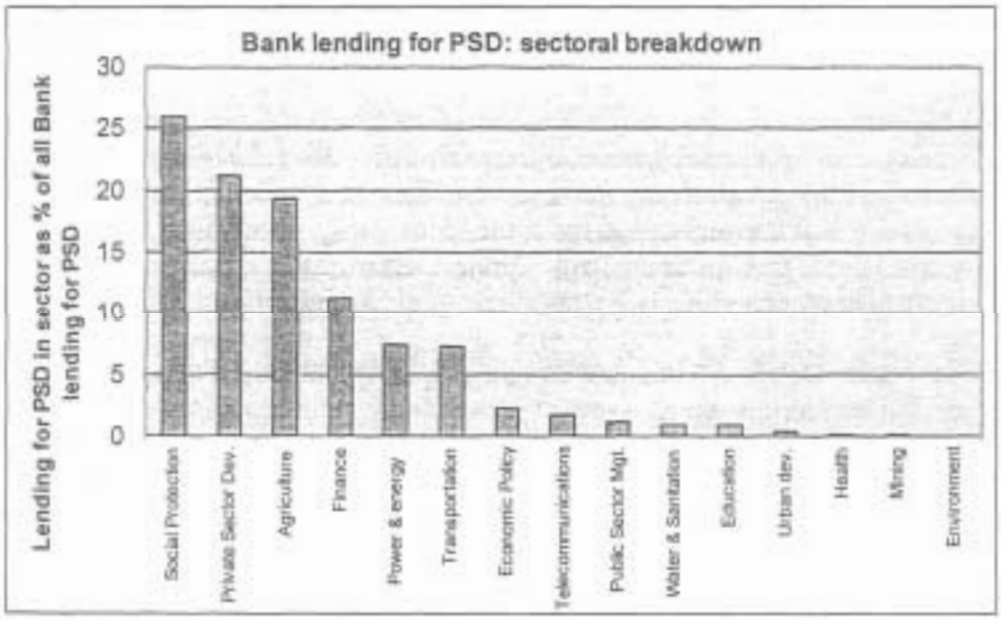
Business environment related interventions relate to deregulation and enhancement of competition, legal and regulatory framework for PSD, property rights and corporate governance, and development of institutions related to PSD. The spectrum of privatization actions supported include management contracts, leases, concessions, BOTs and outright divestiture. Direct assistance to private firms include lines of credit to financial institutions which then on-lend to private companies, provision of technical assistance such as business advisory services, matching grants facilities, project financing facilities for infrastructure projects and guarantees. Finally, social funds typically support small projects in infrastructure, social services, training and micro-credit. They support the PSD agenda by developing alternative, non-governmental delivery mechanisms.

PSD activities are carried out all over the Bank. Almost all sectors of the Bank have some PSD activity. However, private sector approaches are more common in some than in others. Projects with PSD components under three sectoral categories, i.e., social protection, PSD and agriculture, account for roughly two-thirds of all Bank PSD-related loan commitments (these estimates are for the end of the first quarter of 2001). Projects

in finance, electric power and energy, and transportation account for another quarter of loans committed (Figure 3).

IFC investments: IFC attempts through its investments to help develop the private sector through innovative projects which demonstrate the viability of various types of investments and investment structures. By doing so, it seeks to stimulate further private sector growth as others emulate these activities. IFC investments go to a variety of sectors but some sectors dominate. At the end of FY00, IFC's total committed portfolio (including guarantees and risk management products) stood at $13.8 billion, 4.5 per cent higher than in FY99. About two-thirds of this was concentrated in three sectors: financial sector, which includes financial services and collective investment vehicles, infrastructure and manufacturing.

Figure 3



The financial sector is the fastest growing area of IFC involvement; end-FY00 commitments to this sector was about double that at end-FY96, while overall IFC commitments was only 38 per cent higher. Other sectors which have grown recently include infrastructure and the social sectors. Investment in infrastructure has increased rapidly as more and more countries opened up infrastructure sectors to private participation. Investment in the social sectors have grown at an annual compound rate of 23% during FY96-00; however this is from a small base and these sector still accounted for only 0.8% of IFC's commitments at the end of FY00. Sectors which have grown relatively slowly during FY96-00 are chemicals and petroleum, oil, gas and mining, and food and agribusiness. Textiles and tourism have actually declined. Manufacturing in general remains important in IFC's portfolio (17.2 per cent of end-FY00 commitments) but is a declining business line.

IFC's latest strategy, articulated in the 2000 paper *IFC: Strategic Directions* signaled a change in its strategic focus. It calls for a move towards areas with high multiplier effects, i.e., whose impact goes well beyond the capital investment. It calls for increased intervention in frontier countries (high risk/low income countries with very limited access to foreign capital and/or undeveloped domestic financial markets) and in frontier regions or sectors within other countries. Five sectors of emphasis were identified: domestic financial institutions, infrastructure, information technology and communications, SMEs and the social sectors (health and education). IFC lending patterns had started changing even before the *Strategic Directions* formally endorsed the change in strategic focus. Approvals to targeted sectors had increased significantly during the 1990s, from 46 per cent in 1990 to 78 per cent in 2000. Much of this increase relates to financial markets. However, during the same time, IFC's investments got increasingly concentrated in the relatively low-risk countries. The proportion of approval (by volumes) going to high-risk countries declined from 52 per cent in 1990 to 28 per cent in 1999 before rising to 40 per cent in 2000.[3]

Lending priorities are changing within sectors. For example, in the financial sector, the emphasis has shifted from creating specialized financial institutions to more broad-based efforts at promoting efficient, competitive and innovative local financial markets. Credit lines are declining in importance and emphasis is shifting to providing institutional support to strengthen financial institutions. In the area of SME support, there is a shift from direct investment support to SMEs to "wholesaling" SME support through financial intermediaries.

MIGA guarantees: MIGA's activities have expanded significantly in recent years. By the end of FY00, MIGA had 152 member-countries, up from 121 at the end of FY94. 69 countries, including 28 IDA-eligible countries, have benefited from MIGA guarantees by FY00 compared to 26 in FY94. By March 31,2000, i.e., in just over ten years of its existence, MIGA had underwritten nearly 300 projects covered by over 450 individual guarantees. The number of guarantees issued per year nearly doubled from 38 in FY94 to 72 in FY99 before dropping to 53 in FY00. The amount of new guarantees issued has more than tripled between FY94 and FY00, from US$372 million to US$1.6 billion. Gross exposure was $4.4 billion at the end of FY00.

MIGA's guarantee portfolio has diversified over time. The share of the top 10 countries, on a net exposure basis, dropped from 73 percent in FY94 to 48 per cent in FY2000. The share of the top five countries dropped from 51 percent to 33 percent over the same period. The combined share of financial, manufacturing, and mining sectors was about 62 percent in FY00, down from 87 percent in FY94. The sectoral diversification reflects the growing importance of infrastructure projects, particularly in the power and telecommunications sectors.

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[3] The decline till 1999 happened largely because some of the most important IFC clients, such as Argentina and Brazil, ceased to be high-risk countries during this period.

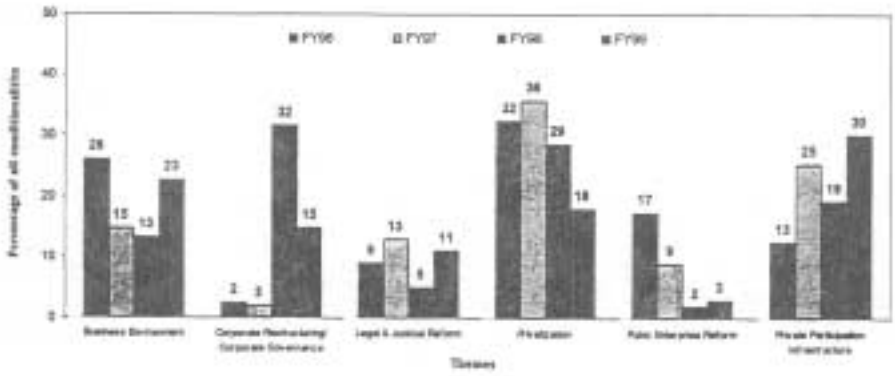
Adjustment lending

In the 1980s, the Bank emphasized the need to establish macroeconomic incentives for private sector development through macroeconomic stability and appropriate relative prices. In the late 1980s and early 1990s, the reform agenda expanded to emphasize the microeconomic and institutional reforms that could build markets, improve their functioning, remove government constraints, and better integrate policy reforms. In the middle to late 1990s, as developing countries faced the increasing challenges of globalization and the liberalization of trade and capital flows, the Bank responded by helping countries adopt measures to enhance competitiveness and global integration, good corporate governance, corporate restructuring, and debt work-outs. Private participation in infrastructure increased significantly as a part of adjustment lending involving the privatization of infiastructure enterprises, sectoral reforms to allow new private entry, and development of regulatory frameworks and institutions. By contrast, the privatization of non-financial and non-infiastructure enterprises and public enterprise reforms, once important components of adjustment operations, steadily declined in importance in the late 1990s (see Figure 4).

There is growing emphasis in PSD-related adjustment loans on borrower ownership, institutional development, capacity building and addressing the social costs of reforms. It is also being increasingly recognized that many PSD reforms require an implementation period longer than that provided by a single quick-disbursing adjustment loan.

Figure 4

PSD Conditionalities in Adjustment Lending, FY96-99



Non-financial activities

The World Bank Group is involved in a wide range of non-lending activities related to PSD issues. Historically, the most important of such activities had been advisory services (to governments, private sector institutions and firms), economic and sector work, research and training. Arbitration, standard setting and ratings have emerged as an important area in recent years. As the Bank Group increasingly recognizes the potential for synergy in working with partners, partnerships and consultations with the private sector have also become important. Another growing area of the Bank Groups' non-lending work on PSD issues is knowledge management and knowledge sharing. Some of the traditional areas of the Bank Group's work, such as advisory services, is also assuming greater importance as the Bank transforms itself into a knowledge organization. Provision of training to external clients is taking on a new character with increased focus on institutional capacity building (see box for examples of PSD-related non-financial work of the WBG).

Examples of World Bank Group's non-financial activities	
Advisory services • Foreign Investment Advisory Services • MIGA's Investment Marketing Services * Privatization-related advice • SME project development facilities • Corporate governance related advisory work ***Arbitration, standard setting and ratings*** • International Center for Settlement of Investment Disputes • Work on insolvency regimes • Corporate governance component of ROSC initiative • Environmental and social safeguards *ESW,* ***diagnostic assessments and research*** • Economic and sector work • Private sector assessments • SME country mapping exercises • Corporate governance assessments	***Research*** • DEC research on PSD issues • RPED program in Africa region • ECA region studies on post-privatization performance • IFC Economics Department research on PSD issues ***Training, capacity building and knowledge dissemination*** • PSAS-offered training courses • WBI training courses • Training provided by other departments on PSD topics ***Partnerships and Consultations*** • International Forum for Utility Regulation • Collaboration with OECD on corporate governance • Land and Real Estate Initiative • Business Partners for Development • Private sector consultations

No comprehensive review has been done of the content, relevance and effectiveness of the Bank's ESW work on PSD issues. However, there are indications that, while the Bank has done several pieces of useful ESW, in many cases PSD-related ESW work has been inadequate. A recent OED review of the treatment of PSD issues in 15 Country

Assistance Evaluations found that, while the Bank's PSD-related ESW/AAA was generally very relevant and of good quality, there are many cases of insufficient ESW which lowered the quality of the Bank's strategy and lending work.

Addressing sustainability issues

In addition to its work on environmental and social safeguards, the World Bank Group is increasingly working on harnessing the role of the private sector in promoting sustainable development. The concept of a "triple bottom line" that recognizes the financial, environmental and social aspects of business, is gaining popularity in the private sector. The Bank Group, which has moved from a do-no-harm approach to a more proactive stance on sustainable development, is trying to further this trend through a number of activities.

IBRD/IDA activities in this area include lending projects that address the environmental implications of privatization, and development of environmental guidelines and regulatory framework for the private sector. IFC has embraced the "triple bottom line" principle. It's *Strategic Directions* Paper states that IFC will "seek to use its base of pioneering experience to influence the actions of its private sector investment partners and to create demonstration models for others to emulate". IFC will continue to provide leading edge expertise in project structuring for environmental and social sustainability in IFC's direct investments, expand the scope of this influence in projects with specific environmental objectives, and share knowledge on environmentally and socially sustainable development. Examples of IFC activities in promotion of sustainability include establishment of the Renewable Energy and Energy Efficiency Fund to promote investments in environmentally friendly technologies, and the launching, in 1998, of the "Good Practice Manual: Doing Better Business through Effective Public Consultation and Disclosure".

Outcomes of PSD activities

Crowding in or crowding out

WBG activities have been designed to complement and support private investors rather than displacing them. For IBRD countries, loans are falling rapidly as a share of total private lending to such countries. During the 1990s, a higher proportion of IFC's investments have gone to high-risk countries than is the case with private FDI flows (35% vs. 28% during 1990-98). However, there have been cases where the Group has lent or invested in countries or firms that might have had access to commercial markets, or had written political risk insurance that might have been provided by private insurers.

Portfolio quality

Recent QAG ratings indicate that Bank projects with PSD components have tended to perform better than the average Bank project. At the end of the first quarter of 2001,

about 9% of active Bank projects with PSD components (about 260 projects) were classified as being "at risk", compared to about 14% for all Bank projects. However, a QAG review of the quality at entry of 14 PSD projects found quality to be poorer than for the average Bank project. An recent OED review of 76 completed IDA projects with PSD components found 86% of the projects to have satisfactory outcomes, 55% to be sustainable and 37% with a substantial institutional development impact – roughly the same proportions as all completed Bank projects in IDA countries. The projects with business environment components had the highest rate of satisfactory outcomes while PPI projects were the most likely to be sustainable and had the highest rate of substantial institutional development impact

A recent OED review of 15 Country Assistance Evaluations (CAE) looked at broader development impact rather than judging projects on whether they achieved their stated goals. It found that many PSD projects paid inadequate attention to basic policy reform to remove fundamental constraints to PSD. Thus, like most Bank projects, the PSD projects has had moderate development impact.

The majority of IFC's operations have satisfactory development and investment outcomes. An evaluation of 176 randomly-selected operations, approved during 1991-94, showed that two-thirds of the operations had a successful development outcome while about 60 per cent had a satisfactory investment outcome. IFC's portfolio has traditionally achieved respectable rates of return in the order of 8 per cent. Given that IFC also supports subsidized development activities, these returns are close to the commercial cost of capital for IFC's portfolio, which is presumably in the order of 10 per cent.

A recent evaluation of 52 MIGA projects (accounting for 75 per cent of all MIGA projects approved between FY90 and FY96) suggest that by and large MIGA interventions have achieved their intended outcomes. In particular, MIGA has been quite effective in fulfilling its primary mandate, i.e., catalyzing investment flows to the client countries.(4)

Evaluations of past SME projects reveal mediocre results, especially for those operating in a poor investment climate. Evaluations of IFC's direct financing of SMEs suggest that such financing is costly and ineffective in meeting the needs of the clients. Projects supported by the project development facilities are heavily subsidized and reach a very small number of relatively firms. The cost effectiveness of these interventions remains unclear and has not been rigorously evaluated. IFC has recently changed its strategy for supporting SMEs. There is, for example, a shift to "wholesaling" SME support through financial intermediaries, moving away from direct investment support to SMEs. The results of this shift in strategy have not yet been evaluated.

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[4] Its average "Investment-Exposure" ratio, i.e., the ratio of total investment facilitated by MIGA assistance to MIGA's own exposure in the project, is 6.73, higher than the originally expected ratio of 4.48 for these projects.

Organization and staffing

Units dealing with PSD. The bulk of the Bank's core PSD projects are task-managed by the regional PSD units which typically have responsibility for financial sector projects and, in some cases, for infrastructure projects as well. In addition, several other parts of the Bank have units focusing on PSD issues (such as WBI, DEC, and the legal vice-presidency) or small clusters of people working on these issues. In 2000 a new set of experiments started, integrating for the first time organizational units of the Bank and IFC, the global product groups for oil and gas, mining and information and communication technology, the SME department, the private sector advisory services and a combined IFC-PSD department for East Asia.

PSD sectorfamily. The Bank's PSD sector family now consists of about 200 staff, about 160 of whom are located in the central department, i.e. Private Sector Advisory Services (PSAS), and in the six regional PSD units. PSAS serves as the Secretariat to the PSD Sector Board and its Director chairs the Board. There are staff in various sector families, especially where PSD work has been mainstreamed, who spend considerable time working on PSD-related issues but are not mapped into the PSD sector family. Although the basic topics of the Bank's PSD work has remained fairly constant during the 1990s as well as the skill set associated with them, this has not led to the development of a set of experienced "PSD staffers", who work on similar topics across all networks. Co-ordination of PSD-related topics across networks remains minimal and staff anywhere in the Bank are free to apply PSD approaches in their area using professionals whom they chose. One reason for this state of affairs is that there is no "natural" PSD instrument in the Bank.

While this state of affairs has been positive for innovation, in some cases established ways of doing things may have slowed the adoption of desirable PSD approaches. New approaches may have been tried but in an unsystematic manner, leading often to a compromise in the quality of projects. The dispersed nature of PSD activities has also led to "migration" of activity. For example, when debates in the PSD and financial sector "family" went in favor of basic financial sector reform and against on-lending operations to the private sector, on-lending to large and small firms managed by the PSD/FSD families fell. However, rural development continued with SME lending and Human Development created social funds which lend to small firms.

Thematic groups. The knowledge management work in the PSD sector family is carried out largely by the thematic groups (TGs) in the family in collaboration with the anchor unit, PSAS. Following a recent consolidation of thematic groups, there are now two such groups reporting to the PSD sector board: a) Business Environment; and b) Private Provision of Public Services. In recent years, the work of these groups have been severely constrained by lack of budgetary resources.

PSD sector board. Attempts have been made to betterco-ordinate PSD activities by introducing the sector board in 1997. Yet, the introduction of the sector board was meant primarily to co-ordinate activities between the various PSD units in the Bank, not among

networks. Even in its more narrow area of focus the PSD sector board has barely started to function for various reasons, most recently the budget cuts of FY01. The sector board's ability to co-ordinate, for example, staff assignments has been complicated by the joint Bank-IFC units under its purview - the PSD/IFC East Asia department, the SME department and the private sector advisory services department.