



Mid-term Evaluation of IDB-9 Commitments

Assessment of IDB-9's Private Sector Development Framework

Background Paper



Inter-American Development Bank
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Office of Evaluation and Oversight

1350 New York Avenue, N.W.

Washington, D.C. 20577

www.iadb.org/evaluation

ABSTRACT

This background paper assesses the actions of the Inter-American Development Bank (IDB, or Bank) related to private sector development (PSD) that were mandated under the Ninth General Capital Increase in Resources (IDB-9). It finds that Management has taken the necessary formal steps to address most of the requirements: preparing a new PSD Strategy; drafting a Non-Sovereign Guarantee (NSG) Business Plan; creating guidelines for specific sectors, beginning with small and medium-sized enterprises; reviewing the NSG guidelines for entities with public participation; gradually expanding NSG prudential limits; supporting the Inter-American Investment Corporation with subordinated lending; adapting the public-private mix to country requirements; adopting measures to improve coordination among PSD and private sector operations windows; and taking steps to enhance NSG development effectiveness. The major area not yet addressed is the integration of NSG operations in Country Strategies and programs.

The paper also finds, however, that these steps do not yet provide an appropriate and effective way to achieve the underlying objectives of IDB-9 with regard to the IDB Group's support for development through the private sector. The strategic documents do not lay out an effective and operationally relevant strategy to ensure substantial value-added in IDB's support for the private sector. Such a strategy would need to recognize and build on the drivers of productivity gain and economic growth: fostering entry, creating new markets, and supporting competition and innovation. These drivers depend both on public sector initiatives to improve the business environment and on private sector response, and thus an effective strategy has important implications for the sovereign guarantee (SG) and NSG sides of the Bank and for the IDB Group as a whole.

One significant challenge relates to coordination between the two sides of the Bank and among the private sector windows of the Bank Group. Despite repeated attempts by Bank Management to strengthen this coordination, it remains a major challenge. Indeed, the analysis finds that operations with coordinated SG and NSG actions and integrated objectives are rare. Limited coordination has resulted in significant lost opportunities—and not only in infrastructure, where improved collaboration would bring clear gains (as in operations involving public-private partnerships and concessions). Coordination could enhance the Bank's additionality in financial sector operations as well, with improvements of financial markets regulation concomitant with second-tier support or the set-up of facilities with client financial institutions. OVE also finds that, despite some progress, the accomplishment of the IDB-9 requirements pertaining to development effectiveness is still a work in progress.

Going forward, it is critical for the Bank to forge an institution-wide shared vision for the private sector, while leveraging the potential for collaboration of the public and private sides of the Bank. The paper suggests some structural options and incentive-related steps in that direction.

PREFACE

The Inter-American Development Bank (IDB) is in a period of rapid change, responding to both the economic dynamism of the Region it serves and the increasing competition in the international financial marketplace. Over the past decade, countries in Latin America and the Caribbean have gained greater access to alternative sources of finance and an increasingly ability to generate and share knowledge among themselves. Like other multilateral development banks, IDB is seeking to adapt to this changing international landscape by ensuring that it is responsive to borrowing countries' needs and putting strong emphasis on effectiveness in its use of scarce resources.

In 2010 the IDB's Board of Governors approved the 9th General Capital Increase of the IDB (IDB-9). The IDB-9 Agreement laid out a series of reforms intended to strengthen the strategic focus, development effectiveness, and efficiency of the IDB to help it remain competitive and relevant in the years ahead. As part of that Report, IDB's Office of Evaluation and Oversight (OVE) was charged with conducting a midterm evaluation—to be presented to the Board of Governors in March 2013—to assess IDB's progress in implementing those reforms. The full evaluation is available at www.iadb.org/evaluation.

This paper is one of 22 background papers prepared by OVE as input to the IDB-9 evaluation. It seeks to determine whether one portion of the IDB-9 requirements has been implemented fully and effectively and to offer suggestions to strengthen implementation going forward. The overarching goal of this paper and the entire evaluation is to provide insights to the Governors, the Board, and IDB Management to help make IDB as strong and effective as possible in promoting economic growth and poverty reduction in Latin America and the Caribbean.

ABBREVIATIONS AND ACRONYMS

CAF	Corporación Andina de Fomento (Andean Development Corporation)
DEO	Development Effectiveness Overview
EBRD	European Bank for Reconstruction and Development
EN	Energy sector
FM	Financial markets sector
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IDB-9	Ninth General Capital Increase in Resources
IFC	International Finance Corporation
IFD	Institutions for Development Department
IIC	Inter-American Investment Corporation
LAC	Latin America and Caribbean
LTFP	Long-Term Financial Plan
MIF	Multilateral Investment Fund
NSG	Non-sovereign guarantee
OMJ	Opportunities to the Majority Initiative
OVE	Office of Evaluation and Oversight
PBL	Performance-based loan
PCG	Partial credit guarantee
PPP	Public-private partnership
PS	Private firms and SME development sector
PSD	Private sector development
PSO	Private sector operation
RM	Reform/modernization of the state sector
SCF	Structured and Corporate Finance Department
SG	Sovereign guarantee
SMEs	Small and medium-sized enterprises
TR	Transport sector
VPC	Vice-Presidency for Countries
VPP	Vice-Presidency for Private Sector
VPS	Vice-Presidency for Sectors

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This background paper was prepared by a team comprising Jose Claudio Pires, Claudio Frischtak, Simon Lodato, Tulio Cravo, Caio Piza, and Jose Luis Guasch, under the guidance of Cheryl Gray. All background papers were thoroughly reviewed and discussed within OVE and shared with IDB Management for comments. The other background papers and the full IDB-9 Evaluation can be found at www.iadb.org/evaluation.

EXECUTIVE SUMMARY

This background paper assesses the actions of the Inter-American Development Bank (IDB, or Bank) related to private sector development (PSD) that were mandated under the Ninth General Capital Increase in Resources (IDB-9). The requirements outlined in IDB-9 set the strategic goal of development through the private sector. The Bank was to submit a new PSD Strategy; finalize a Non-Sovereign Guarantee (NSG) Business Plan; create guidelines for specific sectors, beginning with small and medium-sized enterprises (SMEs); review the NSG guidelines for entities with public participation; gradually expand NSG prudential limits; support the Inter-American Investment Corporation (IIC) with subordinated lending; adapt the public-private mix to country requirements; improve coordination among PSD and private sector operations (PSO) windows; and, finally, enhance the contribution NSG operations make to development. The goal was to increase the development impact of private sector activities “by capitalizing on the IDB’s comparative advantages, in a manner consistent with its institutional goals.”

To conduct the assessment, the Office of Evaluation and Oversight (OVE) divided these actions into three analytic categories: (i) strategic focus and guidelines, (ii) development effectiveness, and (iii) coordination. OVE’s assessment draws upon a review of official documentation related to IDB-9; evidence from structured interviews with IDB Management and technical staff; analysis of the IDB Group’s portfolio of sovereign guarantee (SG) and NSG loans, partial credit guarantees, and technical cooperation; and a survey of staff that OVE conducted in October 2012. MIF and IIC are not governed by IDB-9 and generally fall outside the scope of analysis in this document (except as regards coordination).¹

Strategic focus and guidelines

The Bank has taken most of the formal steps to address the IDB-9 requirements: adopting the required strategy documents and guidelines, undertaking efforts to enhance collaboration, and working to improve the framework to measure development effectiveness. Constraints to private sector development are properly identified in key documents—the PSD Strategy, the NSG Business Plan, and the Guidelines to SMEs. These documents discuss the factors behind low productivity in the private sector, detail the Bank’s efforts to foster financial inclusion and develop local and regional capital markets, and indicate the need for Bank efforts to overcome inadequate infrastructure. Furthermore, the revised NSG Guidelines relax previous requirements regarding private sector ownership to facilitate public-private partnerships (PPPs) and enhance subnational lending.

However, the documents lack a compelling framework and “road map” for the IDB Group’s PSD-related initiatives and lending policies. They do not answer the most critical questions—under what circumstances firms maximize their contribution to development; how to align private objectives and public interest; and how to use the

¹ MIF is being separately assessed by OVE in its Second Independent Evaluation, to be completed in early 2013.

Bank's comparative advantages to help countries and firms maximize the benefits of more open and competitive markets. As a result, the new strategies have not significantly influenced the way projects have been prepared. OVE's survey of Bank staff confirmed that they have limited knowledge about and a skeptical view of the PSD Strategy and its impact on country dialogue and project selection and design.

Economics literature emphasizes that growth and development in a market economy results from the actions of and interactions between the public and private sectors. Public sector institutions set the rules of the game, while firms help to unleash productive forces that lead to innovation and productivity gains. The development impact of firms increases when entry (and exit) barriers are lowered or removed and market failures addressed, and when the business environment supports competition and innovation. Firms may be "nudged" to enter markets, challenging existing monopolies and making them more competitive. Thus a two-pronged approach is important to PSD: the positive impact of the private sector on development is enhanced when both newcomers and innovators are able to enter and challenge incumbents, and when the policy regime supports entrepreneurial effort and ensures a level playing field by removing policy and regulatory barriers to mobility and growth and discouraging rent-seeking activities.

This framework has an important implication for the Bank's PSD activities: the largest impacts are likely to result when public (SG) and private (NSG) sector operations are coordinated to, on the one hand, enhance the business environment through improved policies and regulations while, on the other hand, supporting a supply response by firms by helping to address market failures and encourage entry. This approach hinges on a far closer collaboration among and integration of the different parts of the Bank, including its private sector windows, than currently exists.

Development effectiveness

Although it is still too early to assess the results of projects approved after IDB-9, analysis of recent Development Effectiveness Overviews (DEOs) and of the design of recent projects shows some improvement between 2008 and 2012. Of the OVE sample of 141 PSD and PSO projects approved during 2008-2012, 43% identified market failures, and the percentage increased over the period from 24% in 2008 to 52% in 2010. Of the sampled projects, 23% proposed clear solutions to overcome such failures, also with a slight improvement over the period. Two-thirds of the projects provided outcome indicators, and every project that provided at least one outcome indicator also provided a baseline for at least one indicator. The 2011 DEO was far better at understanding Bank PSD contributions and identifying examples of high-impact private sector projects—particularly the relatively rare instances of Bank public-private coordination—than the 2010 DEO.

Coordination

Problems of overlap and lack of coordination among PSD and PSO windows—on both the public and private sides in the Bank, and among the various private sector windows in the Bank Group—are frequent, despite Bank Management's repeated attempts to address

them. The various private sector windows have overlapping mandates, particularly in financial markets and SMEs. Yet the analysis finds that operations with coordinated SG and NSG actions and integrated objectives are rare. For a very small proportion of projects, individuals from other windows were part of the project team, and project documents mentioned previous related operations undertaken by other windows.

In addition, NSG lending has not yet been incorporated into Country Strategies and programs. OVE reviewed 21 Country Strategies approved during 2007-2012, 15 before and 6 after IDB-9. In only five cases (two before and three after IDB-9) was the development of the private sector an integral part of the Country Strategy. It can be argued that private sector operations are opportunistic in nature and cannot be programmed, but this view can lead to a low-level equilibrium: the public sector programs its lending operations without focusing on the constraints that limit private sector response, while the efforts of the NSG side of the Bank center on searching for clients on an ad hoc basis, often irrespective of what they contribute to competition, innovation, and productivity gains in areas where a supply response is needed. Limited coordination has resulted in significant lost opportunities—not only in infrastructure, where improved collaboration would bring clear gains (as in operations involving PPPs and concessions)—but also in other sectors. Coordination could enhance the Bank's additionality in financial sector operations as well, with improvements of financial market regulations concomitant with second-tier support or the set-up of facilities with client financial institutions.

Suggestions going forward

These findings lead to several suggestions for Bank actions. The Bank needs to forge an institution-wide shared vision for the private sector. This vision should be based on a well-conceived *framework*, a way of thinking about development and the role of the private sector, and a *strategy*—with diagnosis, objectives, follow-up actions and resource needs, identified risks, and indicators to monitor progress—that is internally consistent and can guide Bank Group action. The Country Strategy should assume an increasingly prominent role at the country level as the key document that defines, with country counterparts, the roadmap to development, bringing together and integrating SG and NSG projects.

With regard to incentives and organization, OVE believes that the Bank is under-leveraging its most important internal asset: the potential for collaboration among the public and private sides of the Bank. The broad complementarity of public action and private forces in the process of development should be reflected in the cooperation of the SG and NSG parts of the Bank. In this sense, the Bank needs to establish clear and unambiguous guidelines, structure, incentives, and mechanisms.

The current structure and incentives in the IDB Group are inefficient and ineffective in encouraging coordination and synergy. In OVE's view, the Bank should consider two structural options for better coordination:

- ***One option would be to fully integrate the private sector windows***—starting with the Structured and Corporate Finance Department (SCF) and the Opportunities to the Majority Initiative (OMJ)—and “collapse” them into the sectoral departments. In this model, there would be only one division per sector, and the sector manager would be in charge of delivering the Bank’s sector program using the full scope of available SG and NSG instruments to support national and subnational governments, state enterprises, and private firms. Critical knowledge (such as on PPPs), currently fragmented, would be concentrated. Sectoral leadership with overarching responsibilities would be the key to public-private integrated efforts.
- ***Another option would be to merge the private sector windows into a single entity*** (inside or outside the Bank) while simultaneously ensuring coordination by assigning power, resources, and a full mandate to a Country Manager or Representative or equivalent, who—in close cooperation with governments—would be in a position to integrate Bank Group efforts and commitments in both public and private dimensions. It would be the Representative’s role to balance volume and quality in both the public and private sides of the Bank, recognizing that it takes time to develop a full portfolio of projects. For most countries, the Country Manager or Representative would be decentralized and would have the local knowledge, contacts, and standing inside and outside the Bank to deliver a strong country program, using and effectively coordinating all Bank Group resources while responding to country needs and government requests.

Each of these approaches is likely to have certain advantages in particular dimensions—flexibility, autonomy, the use of IDB’s capital base, and development effectiveness (which is most critical, as it is the *raison d’être* of the IDB Group). In addition, the structural models of other multilateral development institutions should be explored before making decisions on structure.

If a structural solution based on either strong sectoral or country leadership is not feasible in the short to medium term, it may be necessary for the Bank to focus its attention on designing an incentive regime that explicitly recognizes the importance of and gains from public-private cooperation, ensuring that it goes beyond ad hoc and informal engagements. It should be understood, however, that incentives tend to follow structure, and structural change will be important for long-term progress.

I. INTRODUCTION

A. IDB-9 requirements

- 1.1 This background document reviews the actions mandated by the Governors of the Inter-American Development Bank (IDB, or Bank) under the Ninth General Capital Increase in Resources (IDB-9) to guide the Bank's work on private sector development (PSD). The IDB-9 actions addressed in this document are summarized in Table 1.

Table 1. IDB-9 Actions Related to Private Sector Development

Action summary	Citations from IDB-9 Report	Paragraph
Set strategic goal: development through the private sector (PSD)	[Help remove] barriers [faced by the private sector] that impede investment, firm expansion, job creation, and sustainable growth. Barriers result from market failures that limit the ability of price mechanisms to adequately reflect economic costs and benefits, which lead to undesirable social outcomes. Similarly, policy failures can worsen outcomes when the “rules of the game” are not well established, owing to excessive bureaucracy and legal frameworks with poorly defined property rights (R3.29). The main thrust [...] is to promote development through the private sector and not pursue private sector development per se. Emphasize an integrated approach with the aim of maximizing development impact (R3.31).	R3.29, R3.31
Formalize PSD strategy	[A] Private Sector Development Strategy for the IDB-9 [...] will be submitted to the Board of Executive Directors before the end of Q4 of 2010 [and] will reflect the NSG Strategy (R3.31).	R3.31
Improve coordination among PSD operational windows	Seek a better coordination of its private sector operations across the different operational windows. Country strategies and country programming should fully incorporate private sector development and private sector operations (R.3.33).	R3.33
Develop guideline: access to finance	Following the presentation of said strategies, Management will present guidelines for specific sectors [or themes]. [One of] the first [three] guidelines to be presented [by the first quarter 2011] will be on access to finance, particularly for SMEs (R3.20).	R3.20
Formalize NSG strategy	[A] NSG Strategy [is] to be prepared by Management (VPP), before the end of Q3 of 2010 and updated within the framework of the Institutional Strategy. The strategy aims to increase the development impact of private sector activities by capitalizing on the IDB's comparative advantages in a manner consistent with its institutional goals (R3.31).	R3.31
Enhance NSG development effectiveness contribution	Enhance development effectiveness of NSG operations [by aligning] them with overall corporate priorities, identify[ing] and address[ing] market failures that justify support from the Bank and respond[ing] to the needs of less developed countries, taking into account available in-house expertise. The Bank will report on the contribution of private sector activities to the lending priorities, outcomes and outputs of the [results framework] for IDB-9, within the analysis to be provided annually in the Development Effectiveness Overview (DEO) (R.3.33).	R3.33

Action summary	Citations from IDB-9 Report	Paragraph
Review guidelines: NSG lending to entities with public participation	Review the guidelines for NSG lending to public, municipal and semipublic (autonomous state) entities to facilitate public-private partnerships, foster joint ventures and avoid potential regulatory arbitration (R.3.33).	R3.33
Gradually expand NSG prudential limits	Gradually move from the 10% statutory ceiling on NSG lending set by the Governors to prudential risk limits based on a risk management approach. On a transitional basis, until December 31, 2012, the Bank will cap NSG operations to an amount such that risk capital requirements for NSG operations will not exceed 20% of total Bank equity calculated in the context of the Bank's capital adequacy policy. As of January 1, 2013, limitations on NSG operations different from such 20% shall be established by the Board of Executive Directors, subject to the Bank's NSG Strategy and capital adequacy policy (R.3.33).	R3.33
Support IIC through subordinated lending	Expand support to the Inter-American Investment Corporation (IIC) through a subordinated, long-term loan of at least \$500 million, aimed at strengthening the IIC's ability to finance small and medium enterprises in the region (R3.33). [An additional, senior loan to the IIC is not mentioned in the Report, but is reported by Management as part of the follow up to the IDB-9 commitments.] Any loans or guarantees to the IIC will not count as part of risk capital requirements for NSG operations due to the related-entity nature of such operations (Footnote 18).	R3.33
Adapt public-private mix to country requirements	[Enable] countries to decide the public-private mix that best suits their development strategies. The new prudential limits for NSG lending will be applied with flexibility at the country level while preserving consistency with the overall framework (R.3.33).	R3.33

- 1.2 The requirements shown in Table 1 were included in IDB-9 because they pertain directly to the IDB-9 objective of “promoting development through the private sector.” The IDB-9 Report identifies the following specific objectives: reducing poverty and inequality, fostering sustainable growth, providing preferential support to the less developed countries in Latin America and the Caribbean (LAC), and promoting development through the private sector. Private sector development figured as one of the priority areas in IDB-9 because of the role it can play in economic development.
- 1.3 In fact, the Agreement establishing IDB defines its purpose as follows: “to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively.” According to the IDB-9 Report, the private sector creates on average 90% of all jobs in LAC countries. Therefore, support for the private sector and private sector development is an effective tool to promote the Region's economic development, which in turn has the potential to drive social development and improve the lives of the poor.

- 1.4 The Bank has been supporting private sector development since its foundation. Initially it did so through operations to enhance competitiveness and access to credit, with the intermediation of public bodies and under SG operations. In 1994, under IDB-8, the Bank launched a program of direct lending to the private sector to encourage provision of infrastructure. At first this mandate included a limitation of 5% of commitments in the IDB lending program; then, in 1998, the ceiling on private sector operations (PSOs) was changed to 5% of outstanding loan balances. In 2001, this ceiling was raised to 10%. IDB-9 aims to build on and expand these earlier efforts to make development through the private sector a main objective of the Bank.

B. Methodology

- 1.5 To evaluate the implementation of the IDB-9 PSD requirements, OVE divided the required actions into three categories:
- *strategic focus and guidelines*: relevance to the Region's needs; consistency with the Bank's comparative advantages; and appropriateness, timeliness, and efficiency of implementation;
 - *development effectiveness*: identification of key constraints in the design of Bank support; influence of constraints on the Bank's lending portfolio, quality of implementation, and likely results; and
 - *coordination*: impact of IDB-9 PSD requirements on coordination among private sector windows and between SG and NSG windows of IDB.
- 1.6 The assessment benefited from previous evaluations by the Office of Evaluation and Oversight (OVE) related to NSG lending.² For this exercise OVE (i) reviewed all documentation related to the IDB-9 requirements; (ii) analyzed the IDB Group's portfolio of PSO and PSD operations; (iii) analyzed a sample of IDB's PSO and PSD loans; (iv) conducted structured interviews with selected IDB Group staff; and (v) gathered additional information from IDB staff through an online survey (see Box 1). These data are discussed in the Boxes throughout the evaluation report. A more comprehensive and detailed analysis of the same data is available in [Annex B](#).

² See OVE (2012) *2011 Evaluability Review of Bank Projects*, RE-397-1; OVE (2005), *Evaluation of the Bank's Direct Private Sector Lending Program 1995-2003*, RE-303; OVE (2011), *Evaluation of the Bank's Non-Sovereign Operations with Sub-national Entities: 2007-2010*, RE-402; OVE (2012) *Evaluation of the Opportunities for the Majority Initiative*, RE- 414; OVE (2012), *Fourth Independent Evaluation of the SCF Expanded Project Supervision Reports*, RE-332. The findings of several Country Program Evaluations were also relevant to this evaluation.

Box 1. Evaluation instruments

Documentation review. OVE reviewed documentation related to IDB-9: private sector strategies and business plans, Sector Guideline for SME Finance and Development Programs, Development Effectiveness Overview reports, and Country Strategies and Programs.

Portfolio analysis. For the portfolio analysis (see Annex A), OVE reviewed PSD and PSO loans and technical cooperation in the IDB Group. It included all approved projects from five windows of the IDB Group—SCF, OMJ, IFD, MIF, and IIC—between January 2006 and June 2012. IFD operations were included in the analysis only if they were clearly aimed at improving the enabling environment for private sector operations. The universe consisted of 1,763 projects, with 1016 technical cooperation operations, 17 partial credit guarantees (PCGs), and 730 loans,^a of which 81% were non-sovereign guarantee (NSG) operations and 19% were sovereign guarantee (SG) operations.

Analysis of a project sample. The sample analysis (see Annex A) consisted of 79% of the universe of selected loans approved by three windows of IDB—SCF, OMJ, and IFD—in 2008-2012, totaling 141 loans.^b The sample included operations in five sectors—energy (EN), financial markets (FM), reform/modernization of the state (RM), private firms and SME development (PS), and transport (TR). The analysis of the project sample assessed the degree of coordination among IDB windows and the rationale, additionality, and evaluability of individual projects.

Structured interviews with staff. OVE conducted structured interviews with staff of the IDB Group private sector windows to help shed light on the extent of implementation of the IDB-9 requirements and how they changed the Bank's modus operandi and affected coordination between SG and NSG and among the various IDB private sector windows.

Online survey. OVE conducted an online survey of Bank staff to elicit their perceptions of the Bank's coordination and implementation of the IDB-9 requirements regarding PSD. Over 500 staff members from three vice presidencies—the Vice-Presidency for Countries (VPC), Vice-Presidency for the Private Sector (VPP), and the Vice Presidency for Sectors (VPS)—were asked to answer the survey, and the response rate was 70% (see background paper describing the IDB staff survey).

^a The projects were downloaded from the IDB's system "OPUS" in July 2012. From this universe, 25 projects were excluded as they had been cancelled at some point.

^b The 77 Trade Sector loans were dropped from the sample because 75 of them represent Trade Finance Facilitation Program operations and do not have documentation available for a desk review. The universe of PSD projects considered in this evaluation is restricted to IFD projects.

II. FINDINGS

A. Strategic focus and guidelines

- 2.1 OVE was asked to address two questions: whether the IDB-9 requirements were fully implemented and whether they were implemented effectively.

1. Extent of implementation

- 2.2 OVE found that IDB has taken all necessary formal steps to address the IDB-9 requirements pertaining to strategic focus and guidelines. To increase the development impact of private sector activities "by capitalizing on the IDB's comparative advantages, in a manner consistent with its institutional goals,"³ the

³ See IDB-9 Report p. 15.

Bank was required to submit (i) a new Private Sector Development Strategy (done by Q1 of 2011); (ii) a NSG Business Plan (done by Q4 of 2012); (iii) guidelines for specific sectors, beginning with SMEs (done by Q1 2011); and (iv) a new NSG Lending Policy that reviewed the guidelines for NSG lending to public, municipal, and semipublic entities (done by Q1 of 2012). These documents are now available to guide IDB actions.

2. Effectiveness of implementation

- 2.3 With regard to the strategic focus for PSD, OVE sought to determine whether IDB has been able to put forth a compelling framework—a way of thinking about development and the role of the private sector that is able to guide IDB’s decision-making and ensure value-added.

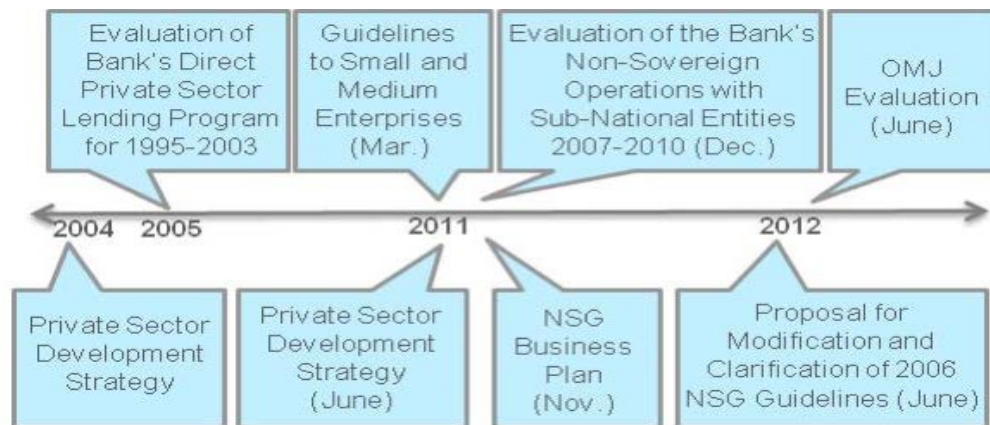
a) Historical context

- 2.4 To provide perspective on this question, it is useful to understand the historical context. In 2004 the Bank approved a PSD Strategy that, among other things, emphasized the importance of the business environment for the dynamism of the private sector.⁴ However, it lacked specifics and guidance for PSD and PSO operations. Not surprisingly, its impact was limited; an evaluation of the loan proposals in the following years reveals that generally no mention was made of the Strategy in shaping or orienting NSG project content.⁵ After a hiatus of nearly seven years, spurred by the Cancun Declaration, the IDB-9 report, and OVE evaluations, IDB produced several important documents that placed greater emphasis on the private sector as an instrument for development (Figure 1).

⁴ The Strategy specified the following as key objectives: the development of an enabling environment for business; direct and indirect financial support for specific private sector projects; leveraging developmental impact in underserved markets such as SMEs and informal companies, especially in poorer, smaller countries; and engaging the private sector in dialogue and action.

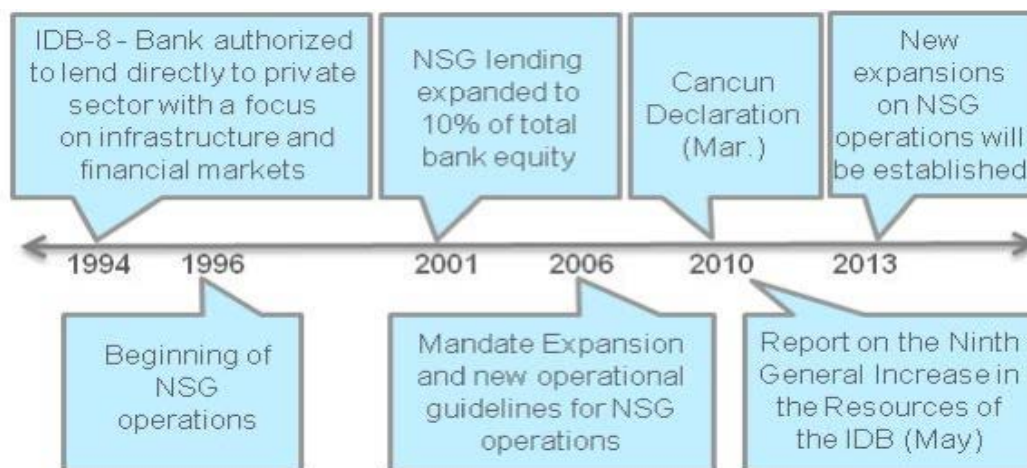
⁵ OVE found that only 28 out of 141 projects (23%) analyzed as a sample of PSD and PSO loan documents approved from 2008 to 2012 mentioned at least one of the private sector development strategies (2004 or 2010).

Figure 1. Document landmarks



- 2.5 Although the key documents with respect to PSD clustered in the post-Cancun years, the Bank had already taken some major strategic and policy shifts—above all, the 2006 “mandate expansion” a decade after the beginning of NSG operations, with corresponding new operational guidelines (Figure 2).

Figure 2. Strategy and policy



- 2.6 From an institutional perspective, the mandate expansion was followed in 2007 by the establishment of the Opportunities to the Majority Initiative (OMJ) and the renaming and strengthening of the Private Sector Department, which became the Structured and Corporate Finance Department (SCF). As a result, private sector development became the direct object of five distinct IDB Group windows (see Box 2)—four NSG windows (IIC, MIF, OMJ, and SCF) and one SG department (Institutions for Development, or IFD).

Box 2. IDB Group Private Sector Windows

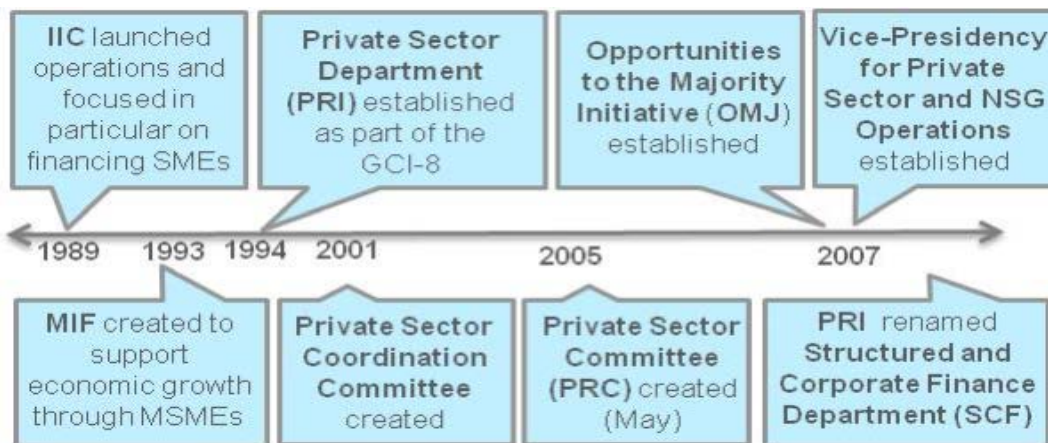
The IDB Group carries out its private sector development work mainly through Institutions for Development (IFD), Structured and Corporate Finance Department (SCF), and Opportunities for the Majority (OMJ). This effort is complemented by the Inter-American Investment Corporation (IIC) and the Multilateral Investment Fund (MIF), which are part of the IDB Group but separate and independent institutions.

- IFD offers SG loans and technical cooperation; its work focuses on development of capital markets and financial institutions and on promoting increased productivity and competitiveness at the national, regional and local levels, with an overall emphasis on improving the business environment and with special emphasis on technology and innovation.
- SCF is the largest private sector arm of the IDB and is responsible for financing second-tier financial institutions and private sector firms using NSG operations.
- OMJ is also a private sector arm of the IDB and focuses on private sector initiatives that promote the inclusion of the population at the “bottom of the pyramid” through market-oriented initiatives.
- IIC complements the activities of the IDB with a focus on NSG lending to SMEs.
- MIF supports the private sector in developing, financing, and executing innovative business models that benefit entrepreneurs and poor and low-income households; it is a laboratory for testing pioneering, market-based approaches to development.

There is significant sectoral overlap in the support provided by these private sector windows, particularly in the areas of financial markets and SME support, as discussed in detail in Annex A. The portfolio analysis indicates that IFD, SCF, IIC, and MIF devote significant effort and financial resources to operations in the financial sector (see Annex B in the hyperlink, Tables 1.a-6.b). IFD has 35% of its operations and 56% of its resources in that sector. Financial markets is an important object for IDB’s NSG operations, accounting for 27% of operations and 25% of lending resources. IIC operations in the sector represent 37% of the operations and 66% of the portfolio value. SME support is also an area of overlap for all windows but SCF. MIF concentrates 78% of its operations and 69% of its lending in this sector, and IIC focuses on support to SMEs. IFD and OMJ also have a significant number of operations and resources in this sector.

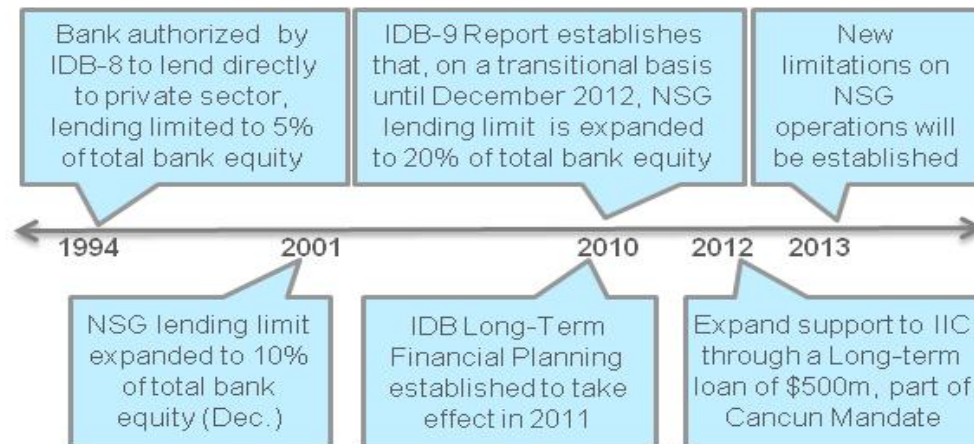
- 2.7 In fact, the creation of the Private Sector Coordination Committee in 2002 and the Private Sector Committee in 2005, superseded in 2007 by the new Vice Presidency for the Private Sector (VPP), was to a significant extent a response to problems of functional overlap and associated inefficiencies (Figure 3).

Figure 3. Institutional buildup



- 2.8 Increasing resource allocation to NSG lending and related activities is evidence that the Bank Group is giving increasing importance to PSD (Figure 4). Possibly the most significant signal is the proportion of IDB capital (equity) allocated to NSG operations, which was limited to 10% of Bank outstanding loans and guarantees prior to IDB-9 but was increased under IDB-9 to a limit of 20% of total Bank equity, calculated in the context of the Bank's capital adequacy policy. The 2011 IDB Long-Term Financial Plan (LTFP) specifically allocated and "ring-fenced" resources for the private sector. Thus the 2013 LTFP allocates (in projected approvals) US\$9.5 billion to the public sector and US\$2.5 billion to the private sector (including US\$500 million to be transferred to IIC).⁶ NSG lending, particularly to C&D countries, has grown in recent years (see Box 3, Annex A, and Figures 9-10 in Annex B in the hyperlink), while SG PSD lending has declined.

Figure 4. Shifts in resource allocation



**Box 3. IDB Group PSD and PSO Lending (2006-2012):
Increased Focus on C&D Countries and NSG Operations**

During 2006-12, the IDB Group approved a total of 1763 PSD and PSO operations: 747 loans and PCGs, and 1016 technical cooperation operations. IDB originated 44% of the lending and guarantee operations, IIC 41%, and MIF 14%. MIF was responsible for over 62% of the 1016 technical cooperation operations, and IDB for about 32%.

The proportion of PSD and PSO lending as percentage of total lending for the IDB Group in 2006-11 decreased from 30% in 2006 to 18% in 2011, mostly driven by the fall in SG PSD lending (from 23% in 2008 to about 5% in 2011), which was not fully offset by the increase in NSG lending, from 7% in 2006 to 13% in 2011.

There was a definitive shift over the period in the amount lent to C&D countries. SG lending in A&B countries peaked in 2008-2009 and has been contracting since, while NSG lending to these countries has been decreasing since 2007. Figures for C&D countries, however, show a sharp increase in NSG lending for the whole period, while SG lending increased more recently, driven mainly by the rise in investment loans and performance-based loans (PBLs) since 2009. The numbers presented in this box are discussed in Annex A and presented in Annex B in the hyperlink (Figures 1-10).

⁶ A subordinated loan to IIC of US\$500 million to support SMEs is one of the IDB-9 requirements for PSD. Aside from the loan to IIC, the remainder is not strictly speaking a fixed amount, but a target for private sector operations that is taken quite seriously.

2.9 The logic of ring-fencing resources to the private sector could be explained in a number of ways—including the fact that public sector demand is many times higher than what the Bank is annually programming, so if it were left to bureaucratic processes alone, the private sector would naturally be crowded out. Yet this ring-fencing approach has a number of unintended consequences. First and foremost, the private sector demand-driven logic (“the private sector cannot be programmed”) is turned on its head: since 2011, resources are in danger of being pushed to expand lending in ways that are not always commensurate with effective private sector demand, potentially compromising the quality and increasing the risks of lending operations.

b) Identifying and addressing constraints to private sector development

2.10 On the whole, key documents—the Private Sector Development Strategy, the NSG Business Plan, and the Guidelines for SME support—identified the PSD development constraints well (Figure 5). The PSD Strategy in particular dedicated an entire section to identifying the factors behind low productivity in the private sector.

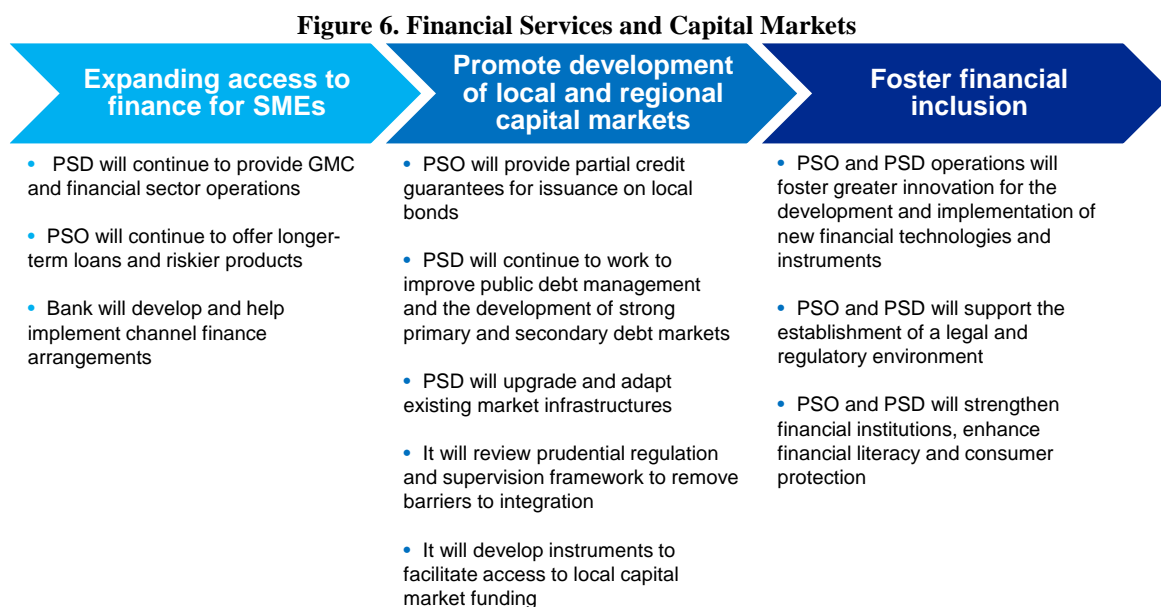
Figure 5. Major constraints identified

Key Documents	What are the key constraints?
1. Private Sector Development Strategy	<ul style="list-style-type: none"> • Limited access to financial services and capital markets • Inadequate infrastructure for competitiveness and global and regional integration • Poor enabling environment and high levels of firm informality • Limited innovation and technological development capacity • Low skill levels of workers and management • Social exclusion and missed opportunities for sustainable development through the private sector
2. NSG Business Plan	<ul style="list-style-type: none"> • Limited availability of cross-border long-term finance • Limited financial market development • Weak local financial markets • Legal constraints to private ownership
3. Guidelines to SME	<ul style="list-style-type: none"> • Credit limitations to SMEs caused by weak creditor rights and enforcement mechanism, among other things • Inadequate business climate for growth • Limited innovation capacity • Scarce data about SMEs • Institutional gaps and barriers such as bureaucracy

2.11 It is worth examining the PSD Strategy on the approach to removing key constraints. Figures 6-10 summarize the major constraints to PSD development in

LAC and the approach to removing these constraints or dealing with them that is set out in the PSD Strategy.

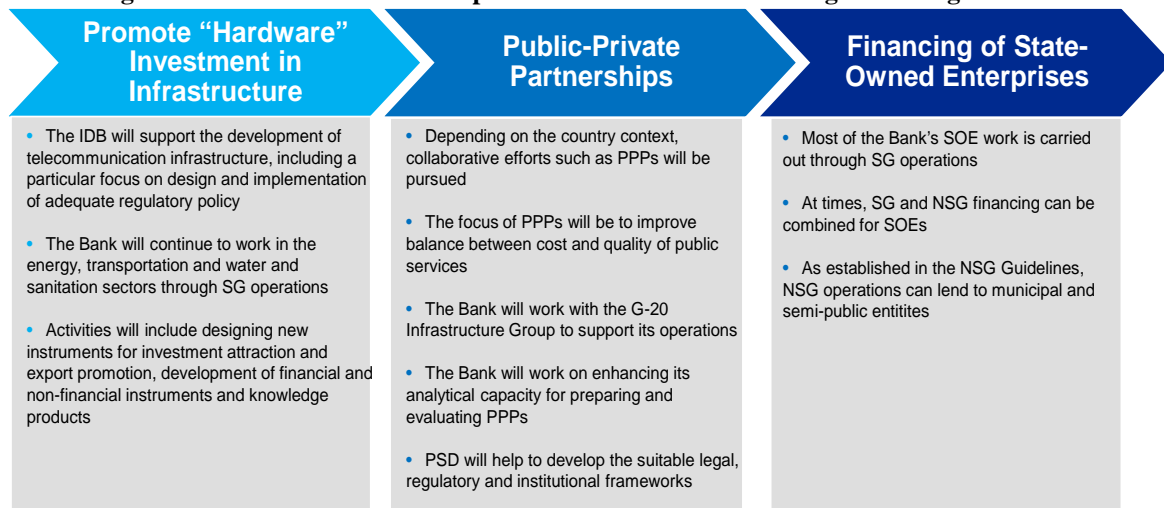
- 2.12 Figure 6 details how the Bank intends to expand access to finance for SMEs, promote development of local and regional capital markets, and foster financial inclusion. Although the proposals seem reasonable in principle, the Bank does not identify how they will be prioritized and carried out to achieve the stated objective. Moreover, although the Bank is committed to promote SMEs—because they are an effective instrument of job creation and income generation—the approach to fostering SME development is fragmented. In fact, looking back at the NSG Business Plan (Figure 5), there is an excessive emphasis on finance as a constraint. Finance is important, but it is not necessarily a binding constraint to SME development; the challenge is how to integrate different support delivery mechanisms and improve the business climate to ensure that SMEs are able to access markets without facing bureaucratic and other hurdles. The new Guidelines to SMEs emphasize that effectiveness depends on combining finance, technical assistance, training, and the integration of SMEs around clusters or into value chains headed by larger firms. Nonetheless, the Bank is still heavily focused on supplying finance.



- 2.13 Figure 7 shows the Bank’s approach to overcoming the constraint of inadequate infrastructure for competitiveness and integration. The Strategy does indicate specific sectors in which the Bank will focus its infrastructure initiatives, and it seems to be aware of individual country limitations regarding both hardware investment and public-private partnerships (PPPs). Although the Bank’s proposed solutions seem stronger than those in other areas, the document does not address the fact that, with fragmented knowledge and efforts, the Bank is not well structured to support PPPs. Further, the document is mute on the nature of the intra-Bank cooperation required to provide support for a “suitable legal,

regulatory, and institutional framework,” not only for PPPs (see Box 4) but more generally for infrastructure investment by the private sector.

Figure 7. Infrastructure for Competitiveness and Global and Regional Integration



Box 4. The Importance of SG/NSG Integration: PPPs

The infrastructure sector is a good example of the importance of intra-Bank coordination to integrate SG and NSG operations. Consider an infrastructure project (i.e., a project in transport, electricity, water and sanitation) that will be done as a PPP. The financial and economic success of the project depends not only on its “private” characteristics (which indicate whether it is or is not bankable), but also on key public dimensions: oversight and regulatory institutions, an appropriate legal and normative framework, and civil servants with the capacity and knowledge to prepare the PPP and handle the project at different stages. All such activities are supported by the SG side. In addition, public sector investments may be required before or in parallel to the execution of the PPP to provide certain externalities (e.g., feeder roads for highway PPPs). Thus, to secure the highest level of benefits for the country, both SG and NSG operations need to be articulated, ensuring on the one hand that key public elements are in place while, on the other, that private sector firms are stimulated and supported to respond.

A PPP is a strategic alliance and contractual relationship between the public and the private sectors in which the private sector provides improved and needed infrastructure services. The critical elements of a PPP framework are the sector policies; the legal, regulatory, and institutional framework; and key government entities (such as line ministries/subnational governments, ministry of finance, interministerial committees, and PPP and regulatory units). These entities should establish the roles and responsibilities of the public and private sectors; the appropriate filters and procedures for approving projects, including the project eligibility criteria; the financial platform/instruments for the public sector to fulfill its obligations; the management of contingent liabilities; and conflict resolution mechanisms. It has thus proven critical for the success of PPP programs to have an appropriate framework that provides transparency and establishes the rules of the game for all parties, safeguards the public interest, and attracts the financial resources, investments, and service-delivery management skills of the private sector.

- 2.14 The Board reviewed the operational guidelines applicable to the IDB’s NSG operations in relation to public, municipal, and semipublic entities to facilitate both PPPs and the contribution of IDB’s NSG operations to achieve the growth projections in the IDB’s LTFP. Overall, the new guidelines introduce important changes:

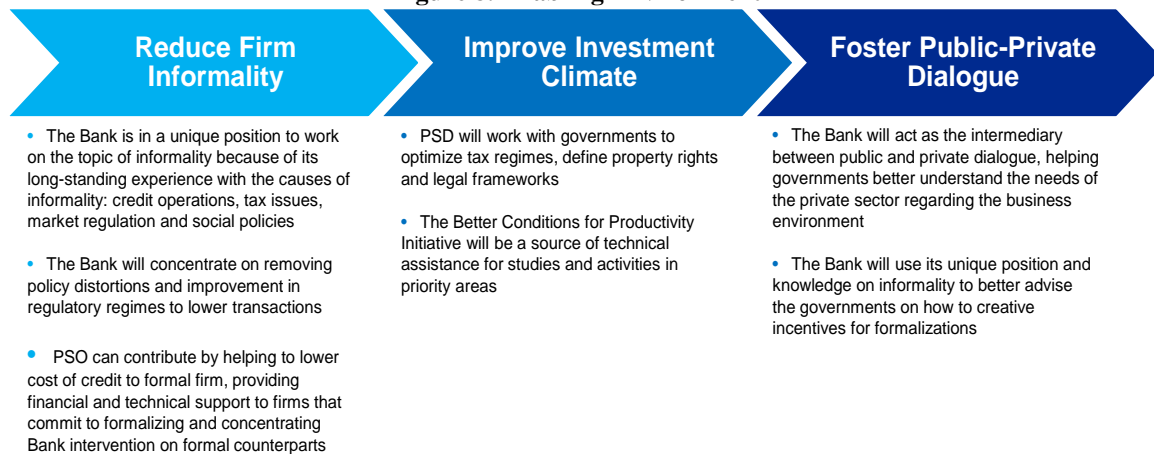
- They relax the constraints of “country eligibility” by including the category of nonmember country as the ultimate beneficiary of the IDB’s financing; this harmonizes the IDB’s approach with that of other multilateral development institutions, including IIC, and thus helps attract foreign investment to LAC.
- They include as target borrowers “any entity regardless of the degree of private or public sector ownership.”
- They treat PPPs as a structure and not a type of borrower, considered on a case-by-case basis for the Board approval. This means that the ownership of a borrower entity should not be a determining factor in assessing whether the Bank should finance a PPP.
- Finally, they provide that borrowers under this category do not need to follow public procurement practices if they can demonstrate that they have duly established commercial procurement practices.

2.15 The new NSG Lending Policy changes modestly address OVE’s recommendations to Management to either enhance the Bank’s support to PPPs or increase lending to subnational authorities.⁷ It relaxes the previous requirements that financing should be provided only to entities with majority private-sector ownership. However, the policy falls short of addressing such other issues as the absence of a specific institutional unit charged with this agenda and the lack of sufficient complementary grant resources to nurture the market and increase the competitiveness of SCF loans.

2.16 Figure 8 summarizes the approach to improving the enabling environment for the private sector, reducing firm informality, improving the investment climate, and fostering public-private dialogue. The Bank’s initiatives are commendable. However, removing major barriers and improving the investment climate will require that the Bank engage with borrowing countries in a more structured and frequent dialogue on the policy and regulatory environment. There is no compelling evidence that the Bank is moving in this direction; in this respect, no matter how important the constraints flagged and the approach suggested, the document remains a statement of intentions—and thus, strictly speaking, it is not a strategy.

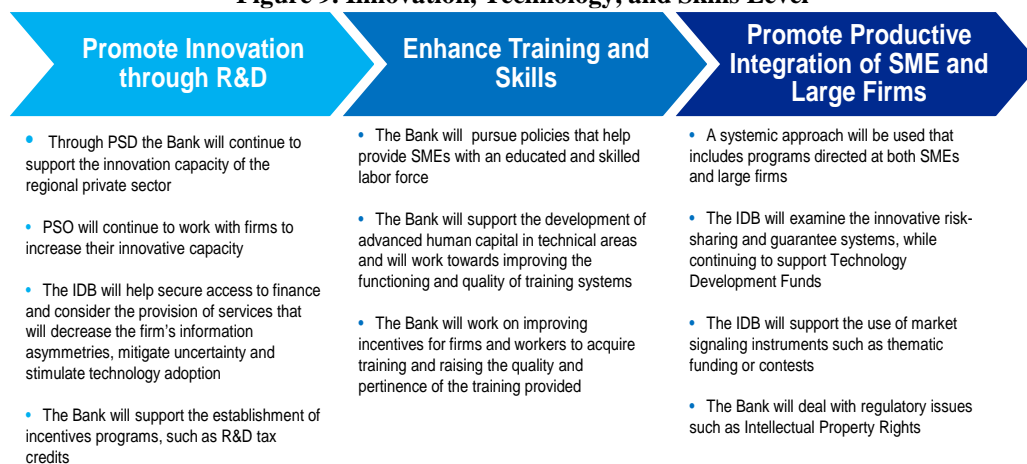
⁷ OVE’s “Evaluation of the Bank’s Non-Sovereign Operations with Sub-national Entities: 2007-10,” RE-402.

Figure 8. Enabling Environment



2.17 Figure 9 shows the Bank's approach to enhancing innovation capacity and building human capital. The Bank's Strategy is comprehensive in the types of issues it addresses—from quality of training to improving the business climate and incentives for research and development. However, the Strategy itself lacks the depth and the detailed action plan necessary to tackle such issues. In the larger countries, the challenge is to transform a national system of science and technology—historically supported by IDB—into a firm-driven national system of innovation. In smaller countries, the critical issue is one of choice among approaches and instruments to optimize the resources allocated to technology development and skill acquisition. And for both large and small countries, the Strategy does not make clear what aspects of the economic incentive regime need to be changed and in what direction to nudge firms toward innovation.

Figure 9. Innovation, Technology, and Skills Level



2.18 Finally, Figure 10 illustrates how the Bank proposes to use the private sector as an instrument for social inclusion. The Bank's Strategy is lacking in specifics, while

the statement referring to OMJ's role is not grounded in evidence.⁸ Despite the overall intent to improve corporate governance and increase social responsibility through a combination of PSO and PSD activities, there is no guidance to make this intent effective.

Figure 10. Social Inclusion through the Private Sector



c) Need for a deeper framework

2.19 The identification of constraints to development is useful, but ultimately the Bank needs a framework on which to base its strategy—a way of thinking about development and the role of the private sector as well as the comparative advantages and potential contributions of IDB. The absence of such a framework has been the major *conceptual* obstacle to IDB's responding to the IDB-9 mandate to promote PSD as an instrument for development.

2.20 A potentially useful starting point for such a framework is a simple concept: the development of the productive forces in a market economy depends on the formation of markets, which results from the interaction of the public and private sectors. Public sector institutions set the stage or rules of the game; firms (generally private sector) provide the resources or endowments on the basis of which trade takes place. The development impact of firms tends to be increased when entry (and exit) barriers are lowered or removed and market failures addressed; firm mobility unleashes the forces of innovation by instilling competition, making markets denser, and ensuring that trades lead to efficient prices. Firms may be indeed “nudged” or supported to enter markets, making them more competitive, and challenging existing monopolies. At the same time it is necessary to ensure a “level playing field”—a supportive business

⁸ See OVE's “Evaluation of the Opportunities for the Majority Initiative,” June 2012, RE- 414.

environment—for which it is critical to remove policy and regulatory barriers to mobility and growth.⁹

- 2.21 Thus the importance of the two-pronged approach to PSD: in principle, maximizing the positive impact of the private sector on development hinges on both the ability of newcomers and innovators to enter and challenge incumbents, and a policy regime that at least is not inimical to entrepreneurial effort—that is, rules and institutions that are supportive of firms that compete openly and are not engaged in rent-seeking activities.
- 2.22 By helping governments to design appropriate policies and regulations while providing support for new entrants and innovators of all sizes, the Bank Group could be instrumental in transforming the landscape of countries by helping to mobilize the forces of entrepreneurial activity—injecting dynamism in markets, creating employment, generating income, and benefitting consumers. To state that the IDB Group has numerous instruments to support sound projects is tantamount to saying that the different parts and windows of the Bank Group could function as a well-coordinated body, with mechanisms that effectively draw on resources from different parts of the Bank to match complex situations. The Bank is uniquely qualified for projects that demand public *and* private sector action, because it has staff who are knowledgeable on the logic, approach, and requirements for both public and private sector operations; on projects that require a combination of finance, technical assistance, and knowledge transfer; on projects that would not be undertaken outside the realm of a regional development Bank with global connections; on projects, in sum, whose additionality goes beyond the financial realm, with significant externalities (see Box 5). This is the rationale for Bank intervention.

Box 5. Analysis of IDB Project Sample: Bank's Additionality is Primarily Financial

OVE's evidence based on the project sample analysis indicates that the Bank's additionality is primarily of a financial nature. Table 9 in Annex B in the hyperlink shows that in 82% of the operations (116 projects), the Bank provided financial additionality. In 61 cases (43% of the total) the Bank added value by providing better tenors or other financial terms than those available in the market at the time of project approval. OVE also found evidence of resource mobilization in 54 projects (38% of total).

OVE identified nonfinancial additionality in 44% of the projects. This additionality was very diversified (see Annex B, Table 10), with the most frequent contribution of both windows (SG and NSG) being environmental safeguards (11% of the projects). IFD contributed to the improvement of the regulatory framework (23% of SG projects), while NSG windows contributed to corporate governance and also to improved access to new products and services (12% and 6% of NSG projects, respectively).

The Bank's financial additionality has increased consistently since 2008. Nonfinancial additionality showed an important increase between 2008 and 2010 (from 36% to 52%) and a reduction in 2010-2011. (Tables 21 and 22 of Annex B in the hyperlink show the evolution of financial and nonfinancial additionality by year).

⁹ An extensive literature shows the positive correlation between innovation, competition, and economic growth. See, for example, Baumol, W. J. (2002), *The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism*. Princeton University Press.

- 2.23 IDB has historically taken a relatively benign or low-profile approach to PSD-related policy reform. Rarely has the Bank pressed for an improved regulatory environment for the private sector in infrastructure, even when such an initiative would attract investment, thereby freeing resources for the production of public goods such as preventive health care or primary education. In underusing its abilities to interface with and influence public sector institutions engaged in defining the policy regime within which the private sector operates (the “business environment”), IDB has missed opportunities to make its PSOs more effective. In addition, the evidence from the analysis of a sample of projects indicates that operations with coordinated SG and NSG activities and integrated objectives are relatively rare (see Box 6).

Box 6. Level of coordination among IDB windows pursuing PSD

OVE looked for evidence of “attempts at coordination” during project design in two forms: (i) a member of another window was part of the project team (“Team” in table below);^a and/or (ii) the project loan proposal mentioned one or more operations, undertaken by other windows, that preceded or complemented it (“Reference”). A low proportion of sampled projects met these criteria in PSD and PSO operations related to SMEs and financial markets.

Coordination by window between 2008 and 2012									
	SMEs				Financial Markets				Total
	None	Team	Reference	Both	None	Team	Reference	Both	
SCF	54%	8%	33%	4%	73%	5%	20%	3%	100%
IFD	75%	6%	13%	6%	76%	10%	10%	3%	100%
OMJ	27%	60%	0%	13%	30%	60%	0%	10%	100%
Total	53%	22%	18%	7%	68%	14%	14%	4%	100%

Seven percent of PSD and PSO projects that support SMEs both included team members and mentioned projects of other windows in the loan document. OMJ met the coordination criteria more often (13%), followed by IFD (6%) and SCF (4%). Financial markets projects had a lower level of coordination, with 4% meeting both criteria—3% in OMJ and 3% in IFD and SCF. OVE’s analysis found evidence of coordination only in projects approved in 2008 and 2009, suggesting a decrease in the degree of coordination since 2010. SCF presents a particular decline from 13% in 2008 to 0% in 2011(see Table 11 in Annex B).

^a The percentage of joint project teams (VPS and VPP) was one of the indicators suggested by Management to track progress regarding to “exploit synergies between PSD and PSO” in the action area of “enhanced coordination within the IDB”. See “Summary Private Sector Strategy 2011-2020, Table III, page 18, GN-2518-12.

- 2.24 Private sector operations have also been relatively autonomous in the Bank’s programming process and have not generally been meaningfully included in country programming documents. This IDB Group-wide view has led to a low-level equilibrium trap: the public sector programs its lending operations without focusing on constraints that limit private sector response, while the NSG side of the Bank responds not by structuring demand to match the supply-side efforts but by searching for clients on an ad-hoc basis, often irrespective of supply-side

mechanisms or arrangements supportive of PSD (see Box 8 and Annex A). Moreover, limited information on the private sector landscape and growing pressures to reach targets for PSOs can lead to adverse selection, with borrowers being firms unable to access markets or even government funding (as in the case of the Brazilian Rede Group power distribution companies, now in receivership).

- 2.25 Some of IDB's comparative advantages were identified in the IDB-9 Report and the PSD Strategy: being a trusted partner, having country and regional focus and knowledge, being able to disseminate good practices and offer financial and nonfinancial products, and—according to Bank stakeholders—being able to de facto protect investment in regulated sectors (thereby providing an implicit insurance) and, through its reputation, grant a seal of approval for borrowing firms. But this foremost comparative advantage of having instruments and being able to mobilize resources to support both public and private entities in synergistic ways was not highlighted as it should have been.
- 2.26 The Development Effectiveness Overview (DEO) 2011 noted that relatively few operations appear to use these advantages to their fullest. OVE's analysis of the project sample corroborated that there are only a few instances of collaboration within the SG and NSG parts of the Bank, and across the SG/NSG divide (see Box 7).

Box 7. Extent of NSG/SG Collaboration in Addressing Market and Government Failures

OVE analyzed 34 projects that identified the undersupply of a semipublic good as a market failure to determine the level of coordination with the Infrastructure and Environment Sector, which supports the execution of and supervises the IDB's operations related to energy, transport, and water and sanitation. In these projects—of which 5 were SG operations (competitiveness, infrastructure, and rural financial programs) and 29 NSG infrastructure programs—29% (3 SG and 7 NSG projects) reached out to the infrastructure division that is the primary repository of expertise on these issues in the Bank, with an increasing trend from 2008 (one of 4 projects) to 2011 (6 of 12 projects) (see Annex B in the hyperlink, Tables 14 and 15).

None of the 9 NSG projects that identified fragile institutions and/or regulatory distortions reached out to the IFD/ICS, the SG window responsible for preparing the Bank's sector policies, strategies, operational guidelines, and programs in institutional capacity (e.g., regulation and business climate) (see Annex B, Table 12).

Finally, of the 22 NSG projects that addressed market failures and/or asymmetric information in the credit market, 1 (about 5% of the total) coordinated with the relevant IFD division to tackle the problem in the loan document. This single project was approved in 2008 (see Annex B, Table 15).

- 2.27 And finally, OVE's survey of Bank staff suggests that some staff have a skeptical view of, though also limited knowledge about, the PSD strategy (see Box 8).

d) Conclusion

- 2.28 In conclusion, while the Bank did meet the documentary requirements of IDB-9, it did not fulfill the requirements in the most fundamental sense of producing pieces that address the basic problems of PSD as an instrument for development and devising a strategy capable of contributing in a decisive way to

transformational changes by using the Bank's endowments and advantages in the most effective way possible.

Box 8. A Staff View of the PSD Strategy

The October 2012 OVE survey of staff from three vice presidencies (VPC, VPS, and VPP) revealed limited knowledge of the PSD Strategy, a somewhat skeptical view of the impact of the document, and a belief that it would be used only sporadically for core Bank work. OVE contacted 505 staff members and received feedback from close to 70%. Only staff working on PSD issues in VPP and VPS and staff in VPC were asked about the PSD Strategy. From VPC, 16% had read and knew the PSD Strategy; 24% believed it would have a prominent influence in helping select and design new operations in 2013-15. In addition, 7%, 5%, and 3% of VPC staff used it regularly in the last year for country strategies and programming, country dialogue, and project preparation, respectively. From VPS, 4% had read and knew the document, 14% believed it would have a prominent influence, and fewer than one-fifth believed it would be used in lending projects, technical cooperation, analytical work, or country dialogue. Finally, among the staff from VPP, 20% had read and knew the document and 17% believed it would have a prominent influence in helping select and design operations in 2013-15.

B. Development effectiveness

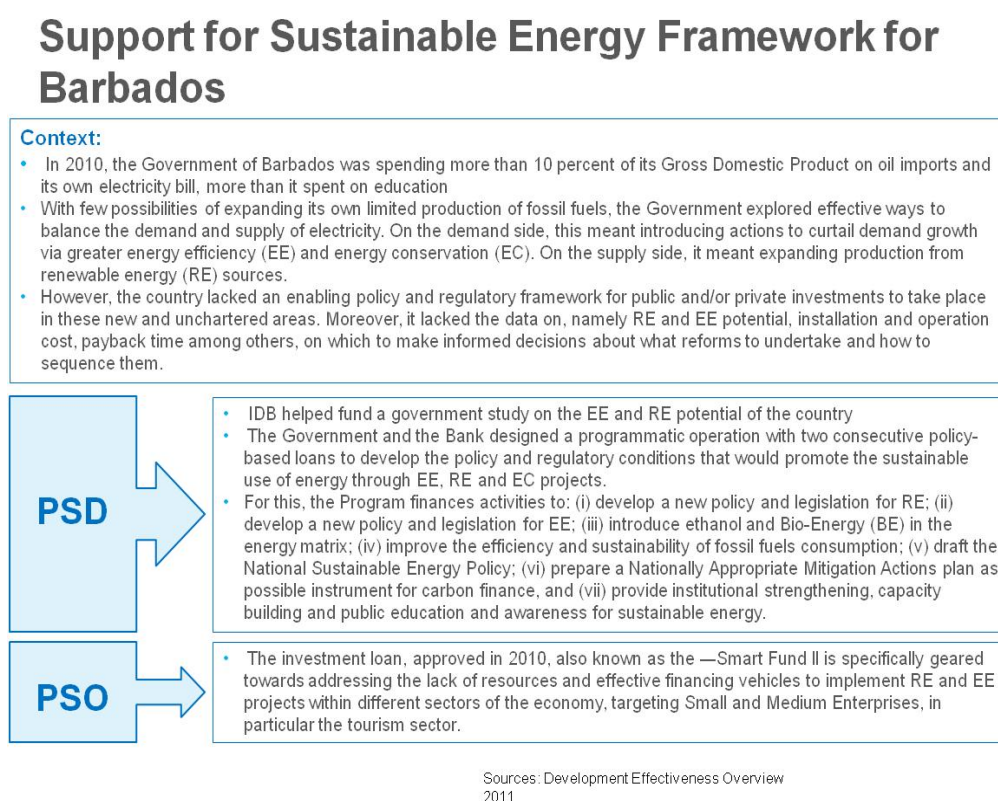
- 2.29 IDB-9's requirements pertaining to development effectiveness are that Country Strategies and programs fully incorporate private sector operations; that development effectiveness be enhanced by aligning NSG operations with overall corporate priorities, identifying and addressing market failures that justify support from the Bank, and responding to the needs of less developed countries; that available in-house expertise be taken into account; that the DEO report annually on all of this; and that countries be able to decide the public-private mix that best suits their development strategies.
- 2.30 To assess to what extent Bank Management had implemented the IDB-9 requirements, OVE conducted a desk review of a sample of SG and NSG operations approved from 2008 to 2012, of projects reported in the DEO, and of Country Strategies approved from 2007 to 2012.¹⁰ It is of course too early to do a thorough assessment of the results of PSD and PSO projects approved since IDB-9.
- 2.31 This analysis suggests that full achievement of the IDB-9 requirements pertaining to development effectiveness is generally moving in the right direction but is still a work in progress. Projects reported in the 2010 DEO failed to present a compelling picture of a positive Bank impact on private sector development. In fact, PSD did not appear to have any relevance in the discussion of development effectiveness; and where the private sector entered explicitly, the lending portfolio seemed to be at odds with Bank directives on climate change. The projects reported in the 2011 DEO represent a material improvement over the ones reported in 2010. Projects seem to vary in quality, from projects such as the Global Credit for Microfinance Support in Ecuador, a solid but not particularly

¹⁰ The desk review covered projects approved between 2008 and 2012, two years before and about two years after IDB-9. A before-and-after analysis based on a two-year interval allowed OVE to investigate whether there was any change in projects' design and execution.

innovative example, to the São Paulo Rodoanel project, in which it is unclear how much additionality the IDB brought to the operation.

- 2.32 Interestingly, the 2011 DEO (appropriately) singles out as successful those projects that were based on “a comprehensive sector diagnosis supported by the Bank that allowed for the design of innovative solutions.” This is the case not only for infrastructure (with four apparently solid examples, including Support for Sustainable Energy Framework for Barbados, detailed in Figure 11), but also the Program to Support Global Export Services in Uruguay (which not only identified barriers but advanced a comprehensive approach to removing them) and the Agri-Food Health and Safety Program adopted by the Dominican Republic with IDB support.¹¹

Figure 11. The Case Study of the Barbados Project



- 2.33 In the sample of projects OVE reviewed, 43% (61 of 141 projects) identified market failures. This percentage increased over time, from 24% in 2008 to 52% in 2010 (see Annex B in the hyperlink, Table 16).¹² Projects that originated in IFD

¹¹ Often-cited instances of public-private (SG-NSG) cooperation, signaling the importance of joint upstream work, include the Panama Canal Operation and that of ICE (Costa Rica). Other relevant examples are the Uruguay Entrepreneurship Initiative and the Salvadoran legislation, which allowed for projects to be financed on a non-recourse (to balance sheets) basis.

¹² As the number of sampled projects in 2012 is very small (5 projects), they were omitted from the analysis.

were slightly better in identifying market failures (46%) than those that originated in SCF (44%) or OMJ (40%), though all divisions improved their performance from 2008 to 2012. In recent years project officers appear to be more aware of the importance of flagging market failures or imperfections and resulting externalities when identifying and designing a project.

- 2.34 Only 23% of sampled projects clearly proposed solutions to overcome market failures, though this also improved slightly over time. OMJ had the best results (36%), followed by SCF (22%) and IFD (21%). A breakdown by sectors shows that the Bank was better at addressing market failures in infrastructure (45%)—transportation (70%) and energy (33%)—and SMEs (40%) than in agriculture (20%) and financial markets (11%)¹³ (see Annex A).
- 2.35 Two-thirds of the projects provided outcome indicators, and every project that provided at least one outcome indicator also had a baseline for at least one of the indicators. Among the windows analyzed, OMJ performed best, with 73% of their projects defining outcome indicators, followed by IDF (68%) and SCF (64%) (see Annex B in the hyperlink, Tables 22-25). Disaggregating by sector, transportation and energy showed better performance, with 80% and 76% of projects, respectively, having outcome indicators. Only 63% of financial market projects proposed outcome indicators in the loan document (see Annex B, Table 26).
- 2.36 An important constraint on PSD lending activities is the narrowness of instruments, which biases the lending portfolio toward larger companies—typically dominant incumbents in their sector that are willing and able to absorb high transaction costs and the foreign exchange risk associated with IDB loans. First, none of the private sector windows in the IDB Group has a well-developed loan product in local currency.¹⁴ Loans are made in U.S. dollars, with the borrower having to assume any foreign exchange risk. Second, IDB—unlike the IIC—is not allowed to take equity or quasi-equity (convertibles) positions. Third, IDB tends to furnish limited technical assistance as a complement to its loans, which would be an important element to attract higher-impact clients. This would be an additional reason for SCF and MIF, as well as IIC, to work in a more integrated fashion.

C. Coordination

- 2.37 The IDB-9 requirement pertaining to coordination was that the Bank must “seek a better coordination of its private sector operations across the different operational windows.” As noted in the discussion above on strategic focus and guidelines, OVE identified coordination as a recurring weakness.

¹³ Most of the market failures outlined by the projects are related to problems of externalities (e.g., public and semipublic goods) and asymmetric information in credit markets.

¹⁴ The Bank is working to develop NSG instruments in local currency. OVE’s evaluation of OMJ (RE-414) verified one case of an NSG loan (Mi Banco in Peru).

- 2.38 The requirement in the IDB-9 Report focused exclusively on coordination among the different operational windows; however, previous OVE evaluations suggest that it is necessary to assess coordination among the different operational windows *and* between PSO and PSD operations, undertaken respectively by the NSG and SG parts of the Bank.¹⁵ This additional perspective is helpful because, in many instances, the effectiveness of both public and private sector operations depends on closer coordination to enable exploring synergies in the form of larger externalities captured, greater private sector response, and overall better quality of operations.
- 2.39 This assessment has found little indication of cooperation between the public and private sides of the Bank, and among the different private sector windows. This has resulted in significant missed opportunities, not only in infrastructure operations—where improved coordination would bring clear gains (as in operations involving PPPs and concessions)—but also in other sectors, for example, to enhance Bank additionality in financial sector operations (as in the improvements of financial markets regulation concomitant with second-tier support or the set-up of facilities with client financial institutions).
- 2.40 The key elements for effective coordination are a shared vision, aligned incentives, effective mechanisms, and importantly, someone with the power and willingness to ensure that cooperation takes place. Individual and informal initiatives, and even periodic meetings, are insufficient to ensure effective coordination. IDB-9 calls not for occasional cooperation, but rather for “an integrated approach to the private sector” with the premise that “the Bank will seek a better coordination of its private sector operations across the different operational windows. Country strategies and country programming should fully incorporate PSD and PSO.”¹⁶
- 2.41 There are three moments during the lending cycle when stakeholders could voice their opinions regarding the quality of a project: at the eligibility meeting; at the credit committee; or, far less likely, at the pre-closing meeting. In theory, staff from NSG and SG departments and from different operational windows are present at these meetings. However, there were conflicting interviews with staff on whether these meetings have deliberative value or whether they are entirely “executive” in nature. Additionally, there is a monthly private sector coordination meeting, though it is unclear whether this has significant value-added beyond knowledge sharing and origination tips. Box 9 provides staff perspectives on coordination.

¹⁵ See OVE (2012), “Evaluation of the Opportunities for the Majority Initiative,” RE-414, and OVE (2005) “Evaluation of the Bank’s Direct Private Sector Lending Program 1995-2003,” RE-303.

¹⁶ See IDB-9, para. 3.33 and (ii).

Box 9. Coordination –A staff view

The October 2012 OVE Staff Survey indicates that 23.8% (46 of 193) of those surveyed have never been part of a mixed team. Of those that have been in such a team, 27.5% (53 of 193) worked in mixed teams of a different vice-presidency and 48.5% in teams of the same vice-presidency. In terms of the interaction of VPS with SCF, 2 out of 11 staff from capital markets and financial institutions reported having teamed up with SCF (18%); 1 out of 8 from competitiveness and innovation (12.5%); and 21 out of 122 from infrastructure and environment (17.2%). While 75.3% (131 out of 174) of staff surveyed are familiar with the possibility of double-booking, 48% (62 out of 130) believe that there are enough incentives for staff to participate in projects led by another division.

- 2.42 At the document level, the PSD Strategy acknowledged problems of coordination: “Consistent cooperation and action between PSD and PSO sides of the Bank are necessary to optimize the development effectiveness of private sector activities.” It suggested that the SG and NSG sides of the Bank work together to identify market and government failures, that the VPP and VPS institute a bimonthly call, and the SG and NSG teams enhance their cooperation in sector analysis and the knowledge parts of projects. The NSG Business Plan also agreed that coordination was a shortcoming by identifying it as a strategic objective and suggesting increased VPP and VPS dialogue—although, of course, problems of coordination go beyond VPP and VPS, and cannot be effectively addressed without the direct involvement of VPC—and ensuing structural changes, making either the sector or the country the focal point for mobilizing Bank wide resources and delivering products.
- 2.43 While acknowledging the lack of coordination is an improvement over previous private sector strategy documents, the proposed solutions are insufficient. Increased dialogue would help coordination of operations, but the strategies do not detail how this dialogue should take place and do not suggest anything beyond “periodic meetings” and memoranda of understanding, such as the one signed between the Bank and IIC, revealing that the Bank Group remains without effective coordination mechanisms.¹⁷
- 2.44 In 2005 OVE identified issues in coordination between SG and NSG operations, and also flagged issues in coordination among private sector windows, “creating friction, inefficiency and conflict [among different parts of the Bank].... Though in theory it ought to be possible to improve synergy between the different parts of the Bank, the absence of a common diagnostic and shared vision is an impediment to such coordination and rationalization moves.”¹⁸ That evaluation suggested that “the Bank should explore ways of forging an institution-wide shared vision, starting with a common diagnostic and effective division of work to seek out synergies in intervention approaches and feedback on experiences.”

¹⁷ See GN-2591-6, Memorandum of Understanding between IADB and IIC on Principles for Inter-Institutional Cooperation and Coordination in Private Sector and NSG Operations, October 2012.

¹⁸ See OVE (2005), “Evaluation of the Bank’s Direct Private Sector Lending Program 1995-2003,” RE-303.

- 2.45 The new documents created following IDB-9 do not effectively address these issues, which were clearly flagged seven years ago. The NSG Business Plan is the only document to mention them, identifying “Advancing Coordination among the Private Sector Windows of the IDB Group” as a strategic objective. However, the document does not provide direct suggestions or operational guidance for this strategic objective, but notes that “the intent is to enter into a more comprehensive cooperation and coordination agreement by the end of Q2 2012.” This agreement has yet to take place.
- 2.46 Finally, OVE found that NSG operations have not generally been incorporated into Country Strategies or country programs (see Box 10)—despite the fact that this was one of the IDB-9 requirements for enhancing development effectiveness.

Box 10. The Extent of Inclusion of PSD and NSG Lending in Country Strategies

OVE conducted a review of 21 Country Strategies approved during 2007-2012, 6 before and 15 after IDB-9. In only five (Barbados and Peru before IDB-9; Peru, Jamaica, and Trinidad and Tobago after IDB-9) was the development of the private sector an integral part of the Country Strategy. In Peru (2012), the NSG lending operations were explicitly connected to the Country Strategy to strengthen Peru’s foothold in the global economy and enhance its competitiveness, through improvements in the business environment and increased investment in innovation and development. Jamaica’s Country Strategy (2010) focused on competitiveness/business environment as a priority. Trinidad and Tobago’s Country Strategy (2010) also defined PSD as a priority, although it did not mention important topics such as the business environment.

III. SUGGESTIONS GOING FORWARD

- 3.1 These findings lead to several suggestions for actions going forward. With regard to strategy, the Bank needs to forge an institution wide shared vision for the private sector. The vision should be based on a well-conceived *framework*, a way of thinking about development and the role of the private sector, and a *strategy*—with diagnosis, objectives, follow-up actions and resource needs, identified risks, and indicators to monitor progress—that is internally consistent and can guide Bank Group action. If development through the private sector means working to make markets more effective mechanisms of resource allocation and use, and building up an economic and social infrastructure for the benefit of citizens and consistent with the public interest, this means that the Bank needs to refocus its attention on (i) improving the overall business environment and addressing sectorwide issues, which would bring the largest welfare gains; and (ii) complementing those efforts by addressing market failures and supporting firms that enter new markets, challenge incumbents, and promote innovation. It is by increasing competition and by removing policy and regulatory barriers to entry, expansion, and exit that the largest productivity gains will come about.
- 3.2 The Bank could usefully devote increased energy and resources to inform the public policy dialogue and help strengthen private sector contributions to development. PBLs would be appropriate instruments, though positive changes in the business environment could also be achieved through investment loans.

- 3.3 The Country Strategy could assume an increasingly prominent role as the key document to help countries define the roadmap to development, bringing together and integrating SG and NSG projects, the public and the private sector. The Bank should progressively move away from ad hoc, opportunistic transactions, ideally building a PSO portfolio that better supports the Country Strategy. More resources and lead time will be required for upstream work.
- 3.4 The Bank could select corporate clients with a renewed emphasis on supporting businesses that bring clear positive externalities to the sectors. To move in this direction, the Bank needs to allocate more resources up front to allow it to more effectively search for partners and proactively structure deals.
- 3.5 The Bank should explore changes in the way it does business:
- Providing local currency lending instruments, as many companies engaged in high-impact activities cannot effectively hedge against foreign exchange exposure;
 - Allowing the IDB private sector windows to take equity positions, to expand the target market to include firms that might have the greatest transformational potential; and
 - Providing greater flexibility (and commensurate funding) to furnish technical assistance as a way to attract higher-impact clients. This would be spurred through effective integration—and eventual merging—of the Bank Group’s windows for supporting the private sector (discussed below).
- 3.6 “Ring-fencing” resources for the private sector in the context of the LTFFP does not seem to be the most effective way of guaranteeing a significant role for the private sector. At most, the LTFFP should be an *indicative exercise* when it comes to steering resources to private sector operations. The importance and relevance of the private sector operations in the Bank have less to do with absolute lending amounts and more to do with addressing market and government failures and supporting firms in their role of creating new markets, instilling competition, and spurring productivity gains—and these could be regarded as key eligibility criteria for Bank support. Indeed, continuing reforms in policy and regulatory frameworks often depend on the private sector’s responding to the first generation of reforms, and Bank support for firm response could thus also have a high payoff from a public interest perspective.
- 3.7 Perhaps most importantly, efforts are needed to enhance collaboration across NSG windows and between the NSG and SG parts of the Bank Group. As this paper has argued, the Bank is underleveraging its most important internal asset: the potential for collaboration of the public and private sides of the Bank. The broad complementarity of public action and private forces in the process of development should be reflected in the cooperation of the SG and NSG parts of the Bank. In this sense, coordination among different parts of the Bank is of paramount importance, and the Bank needs to establish clear guidelines, structure, incentives,

and mechanisms. The Bank might want to consider two structural options when it comes to coordination:

- ***One option would be to fully integrate the private sector windows—starting with SCF and OMJ—and “collapse” them into the sectoral departments.*** In this model, there would be only one Bank unit per sector, and the sector manager would be in charge of delivering the program, using the full scope of available instruments, both SG and NSG, to support national and subnational governments, state enterprises, and private firms. Critical knowledge (such as on PPPs), currently fragmented, would be concentrated. In this model, sectoral leadership with overarching responsibilities would be the key to public-private integrated efforts.
- ***Another option would be to merge the private sector windows into a single entity (inside or outside the Bank) while simultaneously ensuring coordination by assigning power, resources, and a full mandate to a Country Manager or Representative or equivalent, who—in close cooperation with governments—would be in a position to integrate Bank Group efforts and commitments in both public and private dimensions.*** It would be the Manager’s or Representative’s role to balance volume and quality in both the public and private sides of the Bank, recognizing that it takes time to develop a full portfolio of projects. For most countries, the Country Representative would be decentralized and would have the local knowledge, contacts, and standing inside and outside the Bank to deliver a strong country program, utilizing and effectively coordinating all Bank Group resources while responding to country needs and government requests.

3.8 Each of these approaches is likely to have advantages along certain dimensions—flexibility, autonomy, the use of IDB’s capital base, and development effectiveness (which is most critical, as it is the *raison d’être* of the IDB Group). Other multilateral development institutions have other approaches that would be worth exploring in some depth (see Box 11) before making decisions on structure.

3.9 If a structural solution based on either strong sectoral or country leadership is not feasible in the short to medium term, it may be necessary for the Bank to focus its attention on designing an incentive regime that explicitly recognizes the importance and gains from public-private cooperation, ensuring that it goes beyond ad hoc and informal engagements. It should be recognized, however, that incentives tend to follow structure, and structural change will be important for long-term progress. The basis for a new incentive regime could be the following:

- The objectives, targets, and rewards of both managers and officers would need to explicitly recognize the developmental importance of collaboration and its clear corollary: joint upstream work to prepare lending and technical assistance operations that allow for public initiatives on the policy and regulatory front, and private investments that work in synergy. Complementarity should also be sought between SG and NSG investment operations, on the presumption that in many instances public investments “crowd in” private investments.

- Although many believe that private sector operations are normally opportunistic in nature, in fact there is ample room to create a “shadow NSG program,” a medium-term deal flow incorporated in the Country Strategy and informed annually by joint public-private upstream work. The process of country programming itself would need to accommodate this new reality, with VPC and VPP actively involved, inputs flowing both bottom-up and top-down, and the country program driven both by country demand and by supply-side considerations based on knowledge and best practice. In any case, Country Strategies would need to incorporate and integrate the SG and NSG dimensions, and would need to have a standing that would make them the paramount document for the Bank Group as a whole.
- Project quality and results, as assessed independently, should be the basis for rewards in terms of career advancement and recognition in the Bank. Managers and investment officers need to be accountable for more than numerical lending targets, but ultimately for the development effectiveness of the projects they lead and are responsible for. In this regard, cooperation—which reduces project risks and improves project quality—should be an outcome of ex-post accountability, and incentives for collaboration should be tied to projects and their performance.

3.10 Finally, Bank Directors and Management need to recognize that the impetus to do more with less has its risks, and may compromise the quality of the Bank’s products. It has been noted that significant upstream work needs to be carried out by both the public and private sector sides of the Bank; and if cooperation and effective coordination of efforts are to be rewarded, it should start with a loosening of the resource constraints for projects that approach development from a sectorwide or comprehensive perspective. The quality and numbers of staff and consultants, and the amounts of administrative budget and other resources, need to be congruent with the objective of making IDB the premier development institution, capable of bringing forth innovative, high-quality projects, which profit from having under the same roof experts on the public and private sectors, working in tandem, exploiting synergies, and ensuring that private investments and public sector initiatives are mutually reinforcing and lead to positive development outcomes.

Box 11. A Brief Assessment of Alternative Institutional Models: IBRD, EBRD and CAF

IBRD, EBRD, and CAF display three different types of institutional structures as they relate to operations, coordination, integration, and the relative emphasis of public and private sector operations.

IBRD is structured into two separate and legally autonomous institutions with their own capital base, strategies, portfolios, and structure. The World Bank focuses exclusively on SG lending to the public sector, while the IFC exclusively provides NSG lending to the private sector.

Advantages. The two institutions are fully autonomous, with their own strategies, objectives, and capital bases. By having two distinct and separate mandates, each institution can pursue its own objectives without necessarily facing multiple operational interfaces.

Disadvantages. The separate nature of the organizations makes effective collaboration difficult. Bank-Group-wide initiatives such as integrated country strategies, global sector practice groups, and cross-cutting sector leaders in finance and infrastructure, for instance, have led to marginal improvements. Yet the desired synergies and complementarities have yet to be realized. The cultures are quite different, with IFC being transaction-oriented while the World Bank emphasizes the overall development strategy and policy environment.

EBRD has a private-sector commercial focus, with a mandate to foster the transition from socialist to market-based economies in countries committed to and applying the principles of multiparty democracy and economic pluralism. It is structured as a single institution with a focus on NSG lending to the private sector, and to a lesser extent to government enterprises. It does provide SG loans to public sector entities—about 12% of total lending. The windows for SG and NSG are the same, with the same unit undertaking both types of operations.

Advantages. The single focus on private sector lending (transition support mandate) has rendered issues of coordination practically irrelevant. Moreover, the integrated structure—in which the same unit can carry out both types of operations—has proven very effective.

Disadvantages. While the structure and performance conforms to the institution's mandate, the business-oriented focus may limit the development effectiveness of operations.

CAF has an organizational structure similar to EBRD's. SG and NSG operations are handled by the same sectoral vice presidencies, namely Infrastructure and Productive Sectors and Finance. CAF's approvals are relatively balanced—approximately 55% NSG and 45% SG in 2011, with 52% directed to the productive sector (including services), 31% to infrastructure, 9% to social sectors and the environment, and 8% to structural reforms.

Advantages. The integration of both types of operations and the flexibility in the choice of financial instruments are significant advantages, particularly as they are not subject to a target or cap. CAF can respond to changing needs and demand for infrastructure PPPs and other projects involving public and private integration. Moreover, CAF's project preparation protocol calls for mixed NSG/SG teams. Finally, the process of designing country assistance strategies and establishing project pipelines is integrated, reducing issues of coordination.

Disadvantages. There remain questions regarding the nature of investments (with economic rates of return sometimes questioned) and limited allocations for reforms geared at improving the policy environment or addressing environmental and social issues. CAF's lower reliance on technical assistance may affect the development effectiveness of its operations.

LIST OF PERSONS INTERVIEWED

Staff	Division	Title
Ana Maria Ortiz	IFD/IFD	Sector Manager
Carlos Rakowczyk	SCF/SAU	Structure and Corporate Finance Principal Specialist
Claudia Franco	FIN/FIN	Principal Technical Leader Head Client Services
Dana Martin	OMJ/OMJ	Research Planning and Administrative Principal Specialist
Daniel Fonseca	SCF/FMK	Private Finance Operations Lead Specialist
Edson Mori	SCF/CFI	Structure and Corporate Finance Sr. Specialist
Esteban Diez Roux	INE/TSP	Transport Principal Specialist
Flora Painter	IFD/CTI	Division Chief Competitiveness and Innovation
Gaston Astesiano	INE/INE	Sector Senior Advisor
Hans Schultz	SCF/SCF	General Manager
Henry Moreno	INE/WSA	Water and Sanitation Economics Lead Specialist
Ichiro Toda	SCF/PMU	Structure and Corporate Finance Lead Specialist
Jean-Marc Aboussouan	SCF/INF	Division Chief Infrastructure
John Graham	SCF/INF	Structure and Corporate Finance Principal Specialist
Jorge Ducci	INE/WSA	Water and Sanitation Economics Lead Specialist
Jose Seligman	CSC/CSC	Operations Principal Specialist
Juan Ketterer	IFD/CMF	Division Chief Capital Markets and Financial Institutions
Laura Fan	FIN/TRY	Head of Funding Principal Specialist
Leandro Alves	INE/INE	Division Chief Energy
Lori Kerr	VPP/VPP	Private Finance Operations Advisor
Lourdes Gallardo	OMJ/OMJ	Opportunity for the Majority Specialist
Martin Chrisney	IFD/CMF	Private Sector Development Principal Specialist
Nathaniel Jackson	VPP/VPP	Private Finance Operation Sr. Advisor
Nikolay Kolev	FIN/TRY	Consultant
Orlando Caballero	IIC/FIM	Division Chief finance and Strategic Planning
Pedro Farias	IFD/ICS	Modernization of State Principal Specialist
Rachel Robboy	SCF/PMU	Unit Chief Portfolio Management
Soren Elbech	FIN/TRY	Division Chief Treasury-Treasurer
Steven J. Puig	VPP/VPP	Vice President
Steven Reed	IIC	Deputy General Manager
Tomas Serebrisky	INE/INE	Sector Economic Principal Advisor

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ANNEX A

PRIVATE SECTOR DEVELOPMENT PORTFOLIO AND SAMPLE ANALYSES

INTRODUCTION

1. This annex (i) presents an analysis of the IDB's Group portfolio on private sector development, and (ii) examines, based on an analysis of a sample of projects approved by IDB from 2008-2012, the extent to which Management addressed the IDB-9 requirements of better coordination among the different IDB Group windows and better development effectiveness of projects pursuing private sector development. The data in this annex are complemented by figures and tables in [Annex B](#).

PORTFOLIO TREND ANALYSIS

A. Methodology

2. The portfolio analysis focuses on the IDB Group's private sector operations (PSO) and private sector development (PSD) project lending, partial credit guarantees (PCGs) and technical cooperation projects (TCs). The portfolio analysis is undertaken for the period 2006-2011, focusing on PSOs and PSD operations. The analysis is based on data retrieved from OVEDA and includes the number of projects and amounts approved for PSD and PSO operations.¹⁹ The data are disaggregated by departments, instruments, groups of countries, and SG and NSG operations. This assessment is complemented by the project-level analysis of a statistically significant sample of PSD and PSO operations to assess project development effectiveness.
3. The IDB Group's PSD and PSO operations classified as PS (Private Firms and SME Development) provide direct support to firms (IIC, MIF, SCF, and OMJ) or support SMEs' development through improvements in the business environment in which the firms operate (MIF and IFD). For instance, both SG and NSG windows have provided indirect financing to private firms through local financial institutions, but only the SG window supports reforms that improve the environment in which the financial institution operates. Thus, projects classified as PS might have a different nature and focus on SMEs, depending on the window of the IDB group that originated the project.

B. IDB Group Lending Portfolio and TCs in Support of Private Sector Development

4. From 2006 to 2011, the IDB group approved a total of 1667 PSO and PSD operations with a direct bearing on or aimed at private sector development: 740 loans and PCGs and 927 TCs.

¹⁹ As mentioned in the main document, the PSD operations analyzed were those of IFD.

- Of the total, 36% were undertaken by IDB (IFD, SCF, and OMJ), 43% by MIF, 21% by IIC.
 - Of the loans and PCGs, IDB originated 40%, IIC 46%, and MIF 14%. By amount, US\$19.6 billion was approved for these operations, of which IDB was responsible for 89%, IIC for 10%, and MIF for 0.6%
 - Of the TCs, MIF was responsible for over 66%, IDB for 33%.
5. PSD and PSO lending as percentage of total lending for the IDB Group decreased sharply with the economic crisis of 2008 and in 2010, and has partially recovered since. There has been a steady decrease in the amounts approved for A&B countries and a strong shift toward C&D countries (See Annex B, Figures 1, 2, 3, and 4.)

C. IDB's Private Sector Development Portfolio by SG and NSG Operations

6. In value terms, the share of SG lending to PSD with respect to total SG lending by the Bank has declined from 25% in 2006 to 5% in 2011. NSG lending to PSO operations has been more volatile: it peaked in 2008, fell sharply in 2009 and 2010, and recovered somewhat in 2011 (Figure 5).
7. In terms of numbers of PSO operations, the share of NSG increased from 20% to 40%, while PSD's SG operations dropped from nearly 40% in 2006 to 25% in 2011 (Figure 6).
8. SG lending in A&B countries was dominated by CCLIPs and peaked in 2008 and 2009 during the financial crisis. SG lending in C&D countries has been dominated by investment loans and PBLs (Figures 7 and 8).
9. For NSG lending, investment loans have been the dominant instrument in A&B and C&D countries, with a sharp increase in C&D in 2011 (Figures 9 and 10).

PORTFOLIO SECTOR ANALYSIS

A. IDB Group Support of PSD Activities by Sector

10. The IDB Group's SG operations in support of the private sector are concentrated in three sectors: Financial Markets (FM), Private Firms and SME Development (PS), and Reform/Modernization of the State (RM).²⁰ These sectors accounted for 76 SG private sector-related operations between 2006 and 2011, representing 82.6% of total SG PSD lending (see Table 1.a. and Table 1.b).

²⁰

The other sectors supported by SG loans are Urban Development and Housing (DU), Industry (IN), Social Investment (SI), Science and Technology (ST), Trade (TD), and Transport (TR).

11. For NSG operations, the Energy (EN), FM, and Trade (TD) sectors are responsible for more than 80% of IDB operations, with a total of 153 operations approved in the period 2006-2011 (Table 2.a).
 - The sectoral distribution of NSG projects is driven mainly by SCF, which is the main IDB NSG window (Table 3).
 - OMJ has most of its operations and loan amounts in four sectors: PS, Agriculture, Housing, and FM (Table 4.a and 4.b).
 - MIF's loan operations are concentrated in three sectors, PS, Agriculture, and FM. PS has a disproportional representation on MIF's portfolio, with 83 projects (78% of MIF operations) (Table 5).²¹
 - IIC has 37% of its loan operations and 66% of its lending resources in the Financial Services sector (Table 6.a and 6.b). It is important to mention that IIC has a different sector classification from IDB, and its financial services operations target primarily SMEs.
12. In sum, the portfolio analysis indicates that all windows—IDB (IFD), SCF, IIC, and MIF—devote significant effort and financial resources to operations in FM, and all except SCF directly support operations in SME.
 - IFD (SG) has 34.78% of its operations and 56% of its resources in FM
 - For IDB's NSG operations, FM accounts for 27% of the number of operations and 25% of lending resources.
 - IIC has 36.84% of its operations and 66% of the portfolio value in FM.
 - MIF has 78% of its operations and 69% of its lending in SME, and IIC by nature supports SMEs.
13. The indication that many windows of the Bank are supporting the same sector is discussed in greater depth in the project analysis to investigate the extent to which this is a sign of overlap or complementarity.

ANALYSIS OF PROJECT SAMPLE

14. OVE conducted a project-level analysis of a sample of projects from IDB's portfolio to assess whether the Bank is addressing the IDB-9 requirement of better coordination among the different IDB Group windows. OVE's analysis of the IDB portfolio consists of 79% of the universe of loans and PCGs approved in the period

²¹ The other sectors supported by MIF loans are EN, Social Investment, FM, and Health.

2008-2012,²² totaling 141 operations. The sample covers the five sectors that represent 79% of the number of Bank loans and PCGs—EN, FM, RM, PS, and TR.²³ OVE also assesses to what extent the projects improved their development effectiveness. To provide evidence on this, OVE analyzed the design of individual projects, by verifying their rationale, additionality, and evaluability.

A. Assessing coordination

15. The significant overlap among IDB Group windows supporting SMEs and financial markets suggests a need for coordination among windows in their interventions on these sectors. The identification of government and/or market failures also makes relevant the issue of coordination.
16. OVE looked for evidence of “attempt at coordination” during project design phase, using two proxies: (i) a member of another window was part of the project team; and/or (ii) the project loan proposal mentioned one or more operations, undertaken by other windows, that preceded or complemented it. While aware of the limits of this approach, OVE considers this evidence as a valid indication of coordination as it is more likely that there was interaction among two or more windows of the Bank. OVE adopted a “strong” and a “weak” assessment of coordination. In the former, coordination is found if both the team composition and loan proposal criteria are satisfied, and in the latter coordination is found if at least one of these aspects is verified. A caveat of these proxies is that they do not provide information about the intensity of the coordination.

B. Coordination in Overlapped Sectors across IDB Windows: SMEs and FM

17. A very significant proportion of projects in the sample neither incorporated individuals of other windows in the project team nor mentioned previous related operations undertaken by other windows.
18. Regarding SME-related operations, OVE found a low level of coordination across SG and NSG windows of the IDB Group.
 - **Two criteria.** Only 7% of PSD and PSO projects that supported SMEs simultaneously (“Both”) included team members (“Team”) and mentioned correlated projects of other windows²⁴ in the loan document (“Reference”).

²² As the number of sampled projects in 2012 is very small (5 projects), they were left out of the analysis.

²³ The sample selection was based on sector representativeness. Initially it covered over 85% of the loans approved by the Bank, but Trade sector operations (TFFP) had to be dropped because the loan documents prevent a in-depth desk review analysis. Based on the universe of 177 projects, OVE analyzed 141 projects. The sample size of 141 projects is statistically significant to the universe at 1.0% level, with a margin of error of 3.7%.

²⁴ The windows considered in the analysis: for SMEs, IFD, SCF, OMJ, IIC, and MIF; and for FM, IFD, SCF, OMJ, and IIC.

OMJ performed better at meeting this “attempt at coordination” criteria (13%), followed by IFD (6%) and SCF, with only 4% (Table 7).

For FM, only 4% of projects met both criteria. Here again, OMJ performed better (10%), followed by IFD and SCF (only 3%).

Finally, OVE’s analysis found evidence of coordination only in projects approved in 2008 and 2009, suggesting decreasing coordination since 2010. Particularly, SCF presents a consistent decline from 2008 to 2011, from 13% to 0% (Table 11).

- **One criterion.** Projects supporting SMEs show uneven results: only 6% of the projects originated by IFD and 8% of those originated by SCF²⁵ incorporated at least one team member of another window that also works with SMEs; however, 60% of projects originated by OMJ did, but no OMJ project documents referred to related operations. Of the operations originated by the IDB’s NSG windows only 5% showed evidence of coordination with IIC and MIF.

19. Results were better for projects in FM, with 32% of IDB’s projects presenting evidence of coordination with at least one of the other windows that support the sector. However, this percentage hides mixed results regarding SG-NSG coordination: 23% of projects originated by IFD are including team members from IIC and/or IDB’s NSG windows, and 35% of the projects originated by NSG windows are including team members from at least one of the other windows that supports FM (Table 12).
20. It is not possible to identify a trend in the evolution of coordination for FM operations, since the levels of coordination evolved randomly from 2008-2011. The exception is SCF, which presents a consistent decline in coordination from 2008 to 2011, from 50% to 13% Table 11).

C. Coordination in Addressing Government and Market Failures

21. OVE also analyzed the IDB project sample to learn the level of collaboration between NSG windows and IFD when projects identify fragile institutions and/or regulatory distortions. None of the 9 NSG projects that identified these types of distortion reached out to IFD/ICS, the SG window responsible for preparing the Bank’s sector policies, strategies, operational guidelines and programs in institutional capacity (e.g., enhancing regulation and business climate).
22. OVE analyzed the extent to which projects that identified the undersupply of a semipublic good as a market failure coordinated with the Infrastructure and Environment Sector (INE), which supervises the IDB’s operations related to energy, transport, and water and sanitation. Of 34 such projects (5 SG, 29 NSG),

²⁵ In the portfolio analysis the number of SCF projects that support SMEs is zero. In the analysis of project sample some SCF projects are classified as SMEs as this analysis considers indirect support for SMEs.

29% (3 SG, and 7 NSG) reached out to INE. In fact, this coordination increased consistently from 2008 (1 of 4 projects) to 2011 (6 of 12 projects) (Tables 13 and 14).

23. Finally, one project (about 5%) of the 22 NSG projects that addressed market failures and/or asymmetric information in the credit market coordinated with the relevant IFD division to tackle the problem in the loan document. This single project was approved in 2008 (Table 15).

ASSESSING DEVELOPMENT EFFECTIVENESS

A. Identifying and Addressing Market Failures

24. Of the 141 projects (61 out of 141) analyzed in the sample, 60 (43%) identified market failures. This percentage increased from 24% in 2008 to 52% in 2010 and decreased slightly to 48% in 2011 (Table 16). All divisions improved their performance in this area.
25. Projects originated in IFD presented better results in identifying market failures (46%), followed by SCF (44%) and OMJ (40%).
26. Only 23% of the sampled projects identify solutions to address market failures. OMJ had the best results (36%), followed by SCF (22%) and IFD (21%). From 2008, while OMJ and SCF improved, IFD took the opposite direction.
27. A breakdown by sectors shows that the Bank is performing better in clearly addressing market failures solutions in infrastructure (45%)—TR 70% and EN 33%—and SMEs (40%) than in agriculture (20%) and FM (11%) (Tables 18, 19, and 20).

B. Financial and Nonfinancial Additionality

28. OVE finds that the Bank's additionality is primarily financial: in 116 of the operations (82%), the Bank provided financial additionality (Table 9). In 61 cases (43%) the Bank added value by providing better tenor or other financial terms than those available in the market at the time of project approval (43%). OVE also found evidence of resource mobilization in 54 projects (38%). OVE identified nonfinancial additionality in 44% of the projects (Table 10).
29. The Bank's financial additionality has increased since 2008, while nonfinancial additionality rose between 2008 and 2010 (from 36% to 52%) and fell during the period 2010-2011 (Tables 20 and 21).

C. Outcome Indicators

30. Of all the projects analyzed, 67% provide outcome indicators, and every project that provides at least one outcome indicators also indicates a baseline for at least one of

the indicators. Among the windows, 73% of OMJ projects define outcome indicators, followed by IDF (68%) and SCF (64%) (Tables 22, 23, 24 and 25).

31. Disaggregating by sector, TR and EN showed a better performance, with 80% and 76% of the projects, respectively, having outcome indicators-for example, reduction of travelling time or provision of electricity to a specific underdeveloped region. For FM projects, only 63% proposed outcome indicators in the loan document, and they struggled to define outcome indicators that allow observing the development impact on the final beneficiaries, depending more on output indicators (Table 26).

D. Mentioning the Private Sector Development Strategy

32. Finally, OVE found that only 28 out of 141 projects (23%) mentioned at least one of the Private Sector Development Strategies, 2004 or 2010. OVE uses this criterion as an indication of the PSD presence in the project design.

Management Comments

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Mid-Term Evaluation of IDB-9 Commitments
Background Paper: Assessment of IDB-9's Private Sector Development Framework
Management Response

I. INTRODUCTION

- 1.1 Management welcomes the opportunity to comment on the review of the Bank's work related to private sector development (PSD) as mandated under the Ninth General Capital Increase in Resources (IDB-9). Management broadly agrees with the Background Paper's findings and suggestions.
- 1.2 Management valued the opportunity to meet with OVE to have a frank and productive dialogue and is pleased to see that many of its comments on the first draft have been taken into consideration in the final document.

II. OVERALL FINDINGS AND SUGGESTIONS

- 2.1 Among the many important findings of the review, Management especially welcomes the recognition that all the IDB-9 requirements have been fulfilled. Management notes OVE's acknowledgement that the Multilateral Investment Fund (MIF) and the Inter-American Investment Corporation (IIC) are not governed by IDB-9 and thus fall outside of the scope of this analysis, except as regards to coordination, as mentioned in Annex A of the report. Management concurs with OVE's recommendation to restructure and consolidate the private sector windows, although notes that in order to properly implement the recommendation, the IIC and the MIF, which were not subject to this evaluation, would also have to be considered.
- 2.2 Other suggestions that Management considers particularly useful relate to: i) the inclusion of more information regarding potential private sector activities in Country Strategies; ii) the value of developing new local currency Non Sovereign Guarantee (NSG) lending instruments; iii) the value of taking equity positions; and iv) greater flexibility and availability of resources to furnish technical cooperation to attract high-impact clients.
- 2.3 While Management welcomes the overall quality of the review, it would like to point out a few issues that could have been further substantiated to better support some of the paper's findings and suggestions:
 - i. The review could have benefited from the incorporation of other key aspects of the Bank's private sector activities, such as: i) non-financial additionality (e.g., social and environmental standards, corporate governance, corporate social responsibility); ii) leveraging of third party resources through co-lending and technical cooperation funds; and iii) knowledge generation through demonstration effects of projects.
 - ii. Upstream PSD work on business climate and regulatory framework to reduce market impediments is very valuable. However, this work does not necessarily

convert into specific NSG projects and as such, it is difficult to create what the paper calls a “shadow NSG program”.

- iii. Management agrees with OVE’s findings that there is room for continued improvement in the area of collaboration and can demonstrate that collaboration has indeed increased markedly since the Realignment and even more so, since the GCI-9 approval. The formulation of the Broadband Initiative, Compete-Caribbean as well as the dialogue with the six Private Sector Consultative Groups are a few of the many examples that illustrate the Bank’s recent efforts towards greater collaboration across VPP, VPC and VPS.
- iv. Regarding coordination among all four private sector windows, Management believes that the paper would be strengthened by including in the scope of the evaluation aspects of coordination related to strategy development as well as the identification and dissemination of best practices and knowledge, where ample cross-window efforts have already taken place. Regarding OVE’s reference to the Bank’s coordinated efforts to support Small and Medium-Sized Enterprises (SMEs), Management would like to highlight that, while not covered by the evaluation, the MIF and IIC, in particular, have been very careful to ensure that they work in complementary segments of the SME spectrum, with the MIF generally working with the small business and microenterprise sectors and the IIC supporting larger SMEs.
- v. Additionally, Management would like to clarify that the mandate of the Institutions for Development (IFD) Department’s is much broader than the review suggests. In addition to offering sovereign guaranteed (SG) loans and technical assistance to support knowledge generation and dissemination to build institutions in the public sector, IFD, through the recently created Competitiveness and Innovation Division (CTI), focuses on promoting increased productivity and competitiveness, with special emphasis on technology and innovation (See GA-232-38) and addressing market failures in order to promote PSD.
- vi. With regard to public private partnerships (PPP), the ongoing VPP and VPS collaboration is worth noting. Opportunities for PPPs are identified in Country Strategies as well as during the annual programming exercises. Management believes that it is worth noting that the MIF has actively supported PPPs in the region with technical assistance operations to strengthen the institutional structures as well as the regulatory and legal environments for PPPs at the national and subnational level have catalyzed \$671 million in private investments in recent years. Private investments over the life of these PPP agreements are projected to reach \$4 billion. MIF partnered with the Infrastructure Department (INE) to create an innovative facility, aimed at financing other types of assistance and services for PPP projects to achieve private sector financing and provide a demonstration effect of the PPP model.
- vii. Management concurs with the need to increase and complement financing with other forms of nonfinancial assistance. Indeed, the Bank has taken many steps in that direction in recent years and would have appreciated more guidance from the

review on what is and is not currently working and on ways to improve. For example, IFD is helping governments encourage private sector innovation, such as through the recently launched initiative to accelerate the penetration, use and adoption of broadband services. SCF, for its part, often provides non-reimbursable technical assistance during project preparation.

III. LOOKING FORWARD

- 3.1 Management considers OVE's review useful in its efforts to continue to enhance the effectiveness of its work with the private sector, and in particular, as part of the larger discussion on how the Bank delivers on private sector development and private sector operations.