UNITED NATIONS ECONOMIC COMMISSION FOR EUROPE

Financing for Development
UN/ECE Regional Conference
In co-operation with the EBRD and UNCTAD
6-7 December 2000

INTERNATIONAL FINANCIAL INSTITUTIONS AS PARTNERS OF THE PRIVATE SECTOR

Background Paper for Special Session II on The Role of Official Assistance in Creating the Conditions for Sustainable Development

prepared by

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International Financial Institutions as Partners of the Private Sector

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Since the World Bank and the International Monetary Fund were launched at Bretton Woods more than 50 years ago, and the regional development banks in subsequent decades, the world economy has changed in important respects. In considering the role of the IFIs two changes are of particular significance. First, "globalisation" implies that foreign trade and private capital now play a far greater role in economic development than before. Second, the poor performance of statist models of development has led to a re-examination of the role of the state and motivated a strong shift towards private, market-based approaches. As a result of these changes, the private sector and private international finance have become prime agents of economic development.

In this article, we discuss how the IFIs can pursue their mandates by creating the conditions for the right kind of market-oriented growth and by forming partnerships with the private sector. We argue that partnership with the private sector calls for significant adjustments in the *modus operandi* of the IFIs as well as for clear principles of engagement. IFIs must complement and catalyse private finance, they must not displace it. A clearly defined approach to supporting private sector development will carry the IFIs well into the 21st century.

1. A world of private capital flows

World financial markets have witnessed profound changes over the last few decades. This has included the strong growth of private capital flows to developing countries. Net long-term private flows rose from US$ 48 billion in 1980 (58 per cent of total flows) to an estimated US$ 239 billion in 1999 (82 per cent of total flows).[2] The share of net official flows has correspondingly declined. If capital flight were taken into account net private flows would, however, be smaller. Private capital flows contribute not only to filling the savings-investment gap in developing countries. They also reduce dependencies by diversifying funding sources and, especially in the form of strategic investment, have played a more direct role by transferring technologies, market-oriented behaviour, management skills and distribution channels. Gross flows are therefore as important as net flows in assessing the impact of private capital flows on recipient countries.

There have been negative experiences, such as collusion of foreign investors with bureaucracies in search of competition restraints and privileges, or the downgrading of value-added components in enterprises acquired by foreigners. Short-term capital

[1] Chief Economist and Director of Transition Strategy, respectively, at the EBRD. An earlier version of this paper was published under the authorship of Nicholas H. Stern and Hans Peter Lankes in European Investment Bank, International Financial Institutions in the 21st century, vol.3, no.2, 1998, pp.102-14.

[2] Source: *Global Development Finance,* World Bank, 2000. For simplicity, we adopt that publication's definition of developing countries here, which encompasses the transition economies of eastern Europe and the former Soviet Union.

flows have proved footloose. But there is a mounting body of evidence that foreign direct investment (FDI), in particular, has contributed positively to development and growth.[3]

It is important to recognise that private capital flows remain focused on a small number of developing countries. For example, FDI flows to the top ten recipient developing countries constituted 74 per cent of the total in 1997 although these countries account for only about half of the total population of the developing world.[4] On the other hand, Africa in particular stands out as one region that relies almost entirely on official flows for external finance. Many countries in the Commonwealth of Independent States (CIS) are in a similar position.

The composition of these private flows has seen a marked change over the last two decades. While earlier flows were composed largely of commercial bank debt flowing to the public sector, recent years have witnessed a sharp increase in the level of private sector portfolio flows and direct investment, both of which had contributed little during the 1980s. For example, in 1980 debt flows constituted 89 per cent of private capital flows, whereas FDI constituted 9 per cent and portfolio equity was almost non-existent. In 1999 by far the largest share of net private flows into developing and transition economies was in the form of foreign direct investment (80 per cent of total private flows), followed by portfolio equity (12 per cent) and bonds (10 per cent). As a whole, the group experienced a small net outflow of commercial bank lending. The characteristics of these different types of financing vary on a number of important dimensions, including maturity, risk-sharing, managerial involvement, technology as well as volatility.

The flow of private capital to the transition economies of eastern Europe and the former Soviet Union has reflected the same broad trends. In a distinct sequence, official funding, FDI, non-guaranteed public and private debt, dedicated equity funds and finally direct local stock and money market investments entered the market successively at 1-2 year intervals.[5] At the start of transition, official capital flows increased sharply, while private flows were negligible. Private flows began to exceed net official flows in 1993 and by 1997 they accounted for US$ 58 billion in the seven largest recipient countries.[6] This represented 19 per cent of aggregate net private flows into developing countries, slightly more than their share in developing country GDP (a little under one sixth) and almost twice their population share (about one tenth).[7] These flows subsequently declined following the financial crisis in Russia.

The level and commitment of private capital flows depends crucially on perceptions of risks and returns. These, in turn, depend not only on basic endowments and opportunities but also on the ability to respond to opportunities in an effective,

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[3] See successive *World Investment Reports*, UNCTAD, Geneva.

[4] These ten countries are China, Brazil, Mexico, Indonesia, Poland, Malaysia, Argentina, Chile, India, and Venezuela.

[5] See Hans Peter Lankes and Nicholas Stern, “Capital flows to eastern Europe and the former Soviet Union”, EBRD Working Paper 27, February 1997.

[6] Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia, and Slovak Republic. Data from the Institute for International Finance.

[7] Source: *Global Development Finance: Analysis and Summary Tables*, World Bank, March 1998

market-oriented fashion, or more generally the 'investment climate' in recipient countries. The investment climate includes macroeconomic stability, structural reforms and the institutional infrastructure which underpins the market economy (financial institutions, reliable business practices, legal and regulatory framework, tax system etc.). It also includes political stability and consistent, transparent, responsible and "market friendly" behaviour from the authorities. Equally important is the development of human capital and of physical infrastructure, both of which are vital ingredients for the success of enterprise investments.

One reflection of the importance of the investment climate is that the level, location, and motive for FDI into the transition economies are all strongly associated with progress in transition. For instance, leaving out the three oil and gas economies of Central Asia (Azerbaijan, Kazakhstan and Turkmenistan), the rank correlation coefficient for 23 countries between the EBRD's average indicator of transition in 2000 and cumulative FDI per capita over the period 1989-2000 is 0.92.[8] This provides strong support for the conclusion that it is the reform process which opens opportunities for profitable investment and which, through its impact on risks and returns, motivates investors to take advantage of them. It also suggests that direct equity investors have carefully evaluated the economic environment and made informed choices.[9]

2. The role of IFIs in the changing market place[10]

In general terms the objectives of IFIs have always been poverty alleviation, economic growth and protection of the environment.[11] Traditionally, IFIs have promoted these objectives by working with governments and government agencies. This reflects the ideas and the capital structures which prevailed at the time of their creation. Broadly speaking, the IFIs have pursued these objectives with loans for public sector projects or programmes, technical assistance, and policy-based lending. IFI loans have generally been made to, or guaranteed by, the borrowing states.

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[8] See *Transition Report 2000*, EBRD, London, for the EBRD's indicators of transition. The measure referred to here is the average of scores, on a scale from 1 to 4, along eight dimensions of transition, including large and small enterprise privatisation, enterprise restructuring, price liberalisation, trade and foreign exchange regime, competition policy, banking reform and development of securities markets and non-bank financial institutions. For an empirical analysis of the relation between motives for FDI and progress in transition see Lankes, H.P. and A.Venables, "Foreign direct investment in economic transition: The changing pattern of investments", *Economics of Transition*, Volume 4 (2), 1996, and EBRD, *Transition Report 1996*.

[9] Causality also runs the opposite way, from FDI to progress in transition. FDI can have a variety of benefits for the transition process, in particular for successful restructuring and improvements in corporate governance, but also more broadly by educating officials, managers and workers in the recipient countries. At this stage in the transition process it seems reasonable to suppose that the dominant effect is from transition to FDI.

[10] See also Jacques de Larosière's Per Jacobsson lecture entitled "Financing development in a world of private capital flows: the challenge for MDBs in working with the private sector" which was given on 29 September 1996 at the Annual Meeting of the World Bank and IMF

[11] See, for example, the Development Committee Report of the Task Force on MDBs, "Serving a changing world", Washington D.C., March 1996. It identified that the role of MDBs should involve reducing poverty, promoting effective government and a strong civil society, protecting the environment, investing in infrastructure and utilities and encouraging private sector development.

The EBRD is somewhat different. Its later foundation and the special circumstances of this foundation pointed to a rather specific objective, namely to foster the transition of its countries of operations to open market economies. The founders took it that the transition would indeed raise living standards over time as well as expanding basic choices and rights of the population.

In the new economic environment, the importance of IFIs and bilateral aid as sources of funds has decreased. While private flows are rising, official flows are constrained by tight budgets following fiscal laxity in the 1970s and 1980s. As budgets get squeezed, official aid, both bilateral and multilateral, has been a vulnerable target. Furthermore, the collapse of centrally planned economies and the poor performance of heavily distorted economies in Africa, Latin America and the Middle East have led to a re-examination of the role of the state in economic development. As a result, there is a growing understanding among developing countries that to achieve market-oriented economic growth, they must create the conditions in which a strong private sector can flourish.

Since the importance of IFIs as a source of funds has decreased while the potential role of the private sector has increased, a central challenge for IFIs is to find ways of fostering development through expanding opportunities for the private sector. They should view the private sector as a prime *vehicle* for the achievement of development goals. In so doing they must seek to ensure that the poor participate in the growth process and that growth is environmentally sustainable. There are two complementary ways in which the IFIs can pursue these objectives:

i) they can help governments create the conditions for the right kind of market-oriented growth;

ii) they can become participant investors, working with the private sector to expand and improve private capital flows.

The first of these embodies some of the more traditional IFI roles. This involves promoting macroeconomic stability and ensuring the provision of the necessary physical, institutional, legal and regulatory infrastructure. While these basics are crucial to investment and growth, participation in growth requires adequate provision for health and education, which in turn enhance growth itself. Poverty alleviation, however, calls for more than fostering participation. It also involves protecting those who are not in a position to provide for themselves by establishing a social safety net. In the past, the IMF, the World Bank and regional IFIs have played a major role in the establishment of macroeconomic stability, in the assistance with tax, legal and sectoral reform and in the creation of a social safety net through policy-based lending.[12] These are all areas that continue to be important for market-oriented growth.

[12] It should be remembered that, while the IMF has always been directly concerned with macroeconomic stability, the World Bank transformed itself from an infrastructure bank to a development bank in the years of the Presidency of Robert McNamara (1969-82), with structural adjustment loans appearing only at the end of that period.

The second approach represents territory that has been less well explored by the IFIs. The IFIs must ask how they can assist more directly in establishing the conditions for the expansion of the private sector. In doing so, they must recognise the increasing - and understandable - reluctance of governments to provide sovereign guarantees; a reluctance that stems from the pressures on public finances and the requirement for hard budget constraints if market-based incentives are to function effectively. While recognising that there will be important projects (particularly environmental and some infrastructure) for which sovereign guarantees will be necessary, the IFIs should support this resolve and avoid sovereign guarantees wherever possible. This means the IFIs must find new ways of operating; ways that harness private sector finance for broader development goals. The way to do this is for IFIs to work in *partnership with the private sector* and to become *participants in the investment process*.

3. IFIs as participants in the process of private sector development

Partnership with the private sector implies that IFIs must, in important respects, act and think like the private sector and subject themselves to the shifting opportunities and constraints of the market. The challenge, which we discuss in the next section, is to combine such an approach with the active pursuit of IFI public policy objectives. But it is clear that creativity and flexibility are of the essence in responding to market needs and IFIs will have to develop their expertise in a number of aspects of banking which have, so far, been less familiar to them.

There are also a host of other practical implications of partnerships between IFIs and the private sector that will need to be considered. It is likely, for instance, that procedures of most IFIs would have to adapt to the flexibility and confidentiality required of private sector operations. This does not always sit easily with public sector accountability. A move away from sovereign guaranteed lending will also call for a new risk culture and the know-how required for the analysis of commercial risk.

Despite the constraints under which IFIs inevitably operate, there are nevertheless good reasons why the private sector would often have an interest in teaming up with them. IFIs bring a number of strengths to such partnerships. First, they are endowed with a capital structure that helps them to absorb many of the risks associated with taking a lead in high risk environments.[13] Second is the relationship they have with governments in developing countries that enables them to reduce political risks for a project in a way which commercial banks cannot. This relationship also means that a government will often have more confidence in a project if an IFI - which has a duty to protect its members' interests - is acting with a private partner. A third strength which IFIs have is their knowledge of, and experience in, these regions. Finally, this experience and their access to technical assistance mean they can mitigate the risks involved in project development. Without the project development support of IFIs, many projects would never get off the ground.

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[13] This includes their preferred creditor status (which mitigates rescheduling or default risk), their conservative gearing ratio and their strong shareholder support in both industrialised and recipient countries.

4. Operational principles guiding partnerships with the private sector

Recognising their resource limitations the IFIs must be selective in their approach. They must build on their strengths to expand the frontiers of private sector development and not simply displace the private sector in activities it is well-prepared to undertake on its own. And they can be effective in this task only if they themselves set an example of sound and well-run institutions. Thus they require clear operational principles.

We see three principles which should govern the activities of IFIs in this area. At the EBRD we call them transition impact, sound banking and additionality. Any project we select must meet all three criteria. They ensure that our activities make a broad contribution to the transition process. Closely related to the transition criteria is the promotion of sound environmental practices, a principle strongly grounded in the EBRD's mandate.

First and most importantly, IFI projects should have a wider development or transition impact. This is in fact more than an operating principle, it is the basic purpose of the IFIs. If the investment projects supported by IFIs are to facilitate private sector development, they should be appraised in relation to their influence both on the investment climate - discussed above - and on the ability of enterprises and financial institutions to respond to it.[14] Each IFI has to develop methods which focus on its own mandate. For the EBRD, this is the promotion of the transition process, but analogous methods can be developed for other objectives.

The public and private sector projects supported by IFIs can have a number of qualitative characteristics that serve to advance private sector development. The key foundations of a market economy are the markets themselves, institutions and policies that support and promote markets, and market-based conduct, skills and innovation. Project selection and design should embody an assessment of project impact along these qualitative dimensions, in addition to traditional economic rate of return criteria and an analysis of environmental impacts. Box 1 provides a more detailed breakdown or "checklist" of transition impact.

Second, sound banking. The financial return to the IFI should be commensurate with the risk. Sound market-oriented development cannot be promoted by investments which are commercially unsound. By ensuring their projects are financially sound and viable, IFIs set an example and establish important standards in accounting, disclosure and corporate governance. The rigorous application of this principle also ensures the financial health of the institution itself. This is crucial for credibility. IFIs must show their shareholders that they are running a tight ship and using resources effectively if the continued support of shareholders is to be justified.

A third key principle of IFI involvement is additionality. The privileges enjoyed by IFIs – including, above all, their capital base – would often allow them to displace

[14] The dividing line between the "climate" in which private agents act and the ability to respond is not always clear cut (i.e., some issues could be placed on either side of the divide), but it is nevertheless a helpful distinction for some purposes. The analysis of transition impact which follows focuses primarily on the ability to respond, but also covers some aspects of the investment climate.

private funding or provide an unfair competitive advantage to their private partners. This cannot be the objective of IFI support. Instead they should stimulate the private sector into operating in areas or in manners in which it would not otherwise be ready to operate. IFI additionality can arise in two ways: the IFI contributes financing which is not available on reasonable terms elsewhere; and its involvement exerts a profound influence on the generation, design and implementation of a project. Good project design will help achieve both sound banking principles and development or transition impact.[15]

Meeting the three criteria does not necessarily imply seeking to maximise each in every project. What is important is that they are satisfied by the portfolio of activities as a whole. Sometimes the pursuit of particularly safe investment opportunities is warranted if it enables the IFI to take riskier positions elsewhere. Trade-offs may also exist between limiting the cost of developing projects and enhancing their transition or development impact. Again, the most sensible approach would be to consider the characteristics of the portfolio as a whole rather than individual projects.

Flexibility - both in terms of attitudes and instruments - is also needed in other respects. The activities of IFIs must change as countries develop and finance becomes more widely available to different segments of the market. This process of constant change should be key to IFI participation in the investment process. They must, in a sense, lead the way and open opportunities for private investment flows to follow and not prolong their involvement once sufficient private capital is available. We have seen this very clearly at the EBRD where we graduate our activities from one market segment to another as alternative sources of finance develop in some areas, and new, as yet unexplored opportunities, become practical possibilities.[16]

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[15] IFIs must have clear policies on how additionality is to be assessed. At the EBRD we have established a two-part "additionality test" which is carefully applied in our project selection process. (i) EBRD *pricing* is pressed upwards relative to the "market". Relevant evidence on the market includes interaction with the client, knowledge of funding requests from commercial banks, and reactions from competing funding sources. (ii) *Other terms* are pressed that influence a project's design or functioning in ways that are crucial for wider transition or development impact. Depending on circumstances, EBRD adopts a strong stance regarding issues which include governance, procurement, the environment, and the regulatory framework. Clear negotiating positions along these lines help ensure that IFIs do not compete with the private sector, but complement and catalyse it.

[16] The importance of IFIs operating at the frontiers of private activity is developed further in Jacques de Larosière (1996).

Box 1: A checklist for transition impact

While in principle the impact of projects could be appraised with the help of sufficiently sophisticated cost-benefit analysis (CBA), in practice conventional CBA is ill-suited to capture the diffuse benefits of structural and institutional change and learning. However, the impacts embodied in these qualitative characteristics are intertwined with those captured in the analysis of economic rates of return and environmental benefits and the three analyses should be taken together in assessing projects (and in practice, it is fairly straightforward to avoid double-counting).

Contributions to competitive market structures

- A project or series of projects can *promote greater competition* in its sector of activity by creating a market or by altering the structure of an existing market. Increased competitive pressure is likely to improve the efficiency with which resources are used, demands are satisfied, and innovations are stimulated.
- A project can also help to *increase competition in other markets*. There are two important ways in which markets can be extended and their functioning improved by projects: through interactions of the project entity with suppliers and clients and through project contributions to the integration of economic activities into the national or international economy, in particular by lowering the cost of transactions.
- To be effective, the contributions to the structure and extent of markets must be sustained. This can be achieved through projects which have a *strong demonstration effect* and, if necessary, through IFI support for more than one project in a particular sector of a country ("clustering" of projects).

Contributions to institutions and policies that support markets

- A project may result in *increased private ownership* through privatisation or new private provision of goods and services (including, importantly, the entry of new small businesses). This can generally be expected to strengthen market-oriented behaviour, innovation and entrepreneurship. Private ownership is also complementary to, and often a condition for, competitive markets.
- The process of investing in a project can contribute to the *reform of policies*, governmental institutions and practices that serve to enhance the investment climate though a project-related policy dialogue and the ability of IFIs to mitigate certain types of political risks. Examples include: improvements in the functioning of regulatory institutions and practices and contributions to laws and practices that protect or strengthen private ownership and the open economy. This is particularly relevant where not only the project entity benefits, but also other investors.
- The IFI can also take an active approach to the restructuring of problem projects in order to *establish and enforce standards of due legal process* with regard to creditor and shareholder rights and ensure that "market exit" works. This may imply consciously galvanising creditor interests in restructuring situations, co-chairing or participating in debt negotiations and debt-equity swaps, calling on loan security, engaging in high-profile court cases, and seeking to state the IFI's position publicly.

Contributions to market-based conduct, skills and innovation

- A project can contribute directly to providing and *improving commercial skills* and technological know how. Commercial skills can include accounting, banking and finance, management, marketing and procurement. Skill transfers are often complementary to other project impacts such as institution building and expanding market competition.

- The transfer of skills and technology can have a particularly strong impact on development or transition by showing other enterprises what is both feasible and profitable and thereby *inviting replication*. Examples of demonstration effects relevant to development or transition are: (i) products and processes which are new to an economy, (ii) ways of successfully restructuring companies and institutions and (iii) new methods and instruments to finance activities
- By *strengthening corporate governance*, a project can foster more effective private ownership of enterprises, and thereby enhance the legitimacy and functioning of the market economy and of private property. Demonstrating effective approaches to corporate governance can be particularly important in transition economies, where there is little recent experience with private ownership. Measures to strengthen private domestic financial institutions can be complementary to more effective corporate governance.

While the selection and design of projects with one or more of the above characteristics should be a fundamental principle guiding IFI support of investment projects, the potential impact does not end at this point. Rather, the experience of investing and operating investment projects can and should inform the policy dialogue with governments. A challenge for the IFIs is to strengthen the mechanisms through which this feedback from private sector experience to government policies, institutions and behaviour takes place.

5. Forms of partnership and sectoral considerations

IFI collaboration with the private sector can take a wide variety of forms. There is no obvious limitation on the financial structure of interventions, which can range from straight equity to quasi-equity instruments and debt, underwriting and guarantees. Intervention can also take the form of introducing financial instruments to capital markets, for instance through IFI treasury departments. We cannot discuss these different forms of intervention in detail here, but it is useful to consider particular sectoral challenges and possible IFI responses.

Development or transition impact can be achieved in most sectors of economic activity. In each case, the strength and value of impacts is determined by context. It is obvious, for instance, that a demonstration effect is particularly valuable where the technique, behaviour or product to be demonstrated is relatively new to the "audience" and there is scope for replication. In many cases, it is immaterial whether the vehicle for IFI impact is a candy factory or the national power grid. In fact, the EBRD's experience has shown that cooperation with foreign and local investors in the general industrial and services sectors can have far-reaching benefits in terms of the functioning of markets, market-oriented behaviours and institutions. Nevertheless, because of the strategic role played in any economy by the financial system and the infrastructure these sectors can offer particularly interesting challenges for IFI involvement.

Partnerships in the financial sector

IFIs can help build financial institutions by putting in place the funding needed to implement projects or strengthen their capital base by investing in them. This is a vital task in the transition but also in a broader development perspective. A market economy requires a well-functioning financial sector. It fulfils the crucial task of

financial intermediation, i.e. collecting savings and allocating them to fruitful investment. But it also takes steps to ensure that borrowers recognise the obligation to pay and will be in a position to repay, thus imposing hard budget constraints in the economy at large. Strengthening local financial institutions is therefore a priority in any developing country.

At the EBRD the collaboration with banks, which has taken the form of co-financing, credit lines, equity and mezzanine finance or syndications, has proved extremely fruitful. We are working directly with 188 local banks in our countries of operations (66 of them on an equity basis), and we have worked with more than 100 international banks through our syndications programme in the past seven years. While we bring capital to all these investments, our involvement provides different benefits for different partners. To international banks we provide an umbrella of political comfort derived from our long-term relationships with governments and our preferred creditor status. To local banks we provide much needed medium-term capital and we can assist in their institutional development.

An area that is receiving increasing attention is the reform of social security systems, and in particular the involvement of the private sector in providing for old-age income security. Pension reforms that introduce privately managed individual retirement accounts will have a broad impact on how economies operate. Successful reform depends on the existence of a solid private pension fund management sector, on capital markets that fulfil some basic conditions (regarding liquidity, depth, and diversity of instruments), and on reliable regulation. In working with the private sector (in addition to providing advice at the policy level) IFIs can support such reforms by strengthening the institutional basis for their implementation and thus increasing public confidence in them. Both the EBRD and the IFC have invested in pension fund management companies to ensure that funds are professionally managed, prudent investment guidelines are followed, a level playing field is maintained, acceptable service levels are offered and accounts are transparent. A similar role can be played by IFIs in other non-bank financial institutions, such as insurance and mutual funds.

A further area where IFIs can play an important role is in promoting the availability of equity and especially venture capital. Equity is widely sought after in developing economies, particularly by small and medium-sized enterprises. IFIs are well placed to participate in funds and help attract institutional investors, such as pension funds and mutual funds, into these countries. In this way they can also help to strengthen nascent capital markets. By being early in the game and showing good management and professionalism, they can provide a strong demonstration effect.[17]

Partnerships in the infrastructure sector

The financing of infrastructure has been a traditional focus of IFI activity. An efficient infrastructure is of crucial importance to private sector development. However, the financing needs here are particularly large. Given that most countries are today facing

[17] Capital markets development can also be supported by a variety of other means. At the EBRD, for example, we are working to improve the legal basis for share ownership; by participating we help launch share privatisations; we are improving accounting and registry procedures, and we are ourselves issuing benchmark bonds in the local currencies of some of our countries.

severe budgetary constraints, this funding has become difficult to raise from traditional methods. Infrastructure is becoming more commercially oriented, an approach that can lead not only to the strengthening of operations, and improvements in efficiency, but also opens up access to private finance. Private funding with no recourse to the sovereign introduces important market disciplines which control costs, provide revenues and allocate risks. At the same time, private involvement calls for a strong and reliable regulatory framework, which remains a key challenge in many developing countries. While the potential for private involvement varies across sectors (being greater for example in telecommunications and power than in roads), there is significant scope for expansion in all sectors. Despite a rapid increase in recent years, private funding for infrastructure still represents only around 10% of the total in developing countries.

When looking at private sector involvement in infrastructure, the starting point in most countries and sectors is a public monopoly which is either national or local in scope. Keeping this in mind, one can distinguish three levels at which infrastructure can become commercially oriented. At the very basic level authorities can begin to operate the public sector in a manner which reflects more closely the ways the private sector operates. This means paying close attention to revenues, costs and market demands. It also involves creating a governance structure which provides clear goals, makes management responsible for performance and allows them independence to carry out their tasks. This may involve bringing in a private sector partner on an advisory basis. Alternatively, governments can seek the limited entry of new private providers through various forms of public/private partnerships. This approach involves more active private sector participation, usually as an operator. Potential areas include independent power plants, cellular telephone networks, toll roads, municipal services, ports and airports. The basis for this involvement is usually some type of concession. The third alternative is for governments to opt for full privatisation of some public services.

Both the IFC’s and the EBRD’s experience show that IFIs are well placed to develop financing structures which encourage such private sector participation: structures which are simple, cost-efficient and can be easily replicated. Careful design and innovative use of the wide variety of IFI instruments are key to succeeding in this area. Risk allocation is also key. IFIs should not only share the general project risk with private partners (through equity or non-recourse debt), they should also assume those risks that they are well placed to mitigate. These tend to include general economic and political risks and risks arising from shifts in regulatory regimes.

The difficulties involved in structuring and implementing such projects must not be underestimated. Not only do they require strong political backing from countries, they often require the enactment of specific legislation or the introduction of the necessary regulatory environment to support them. Furthermore, these are often complex projects to develop and certain costs tend to be front-loaded. Nevertheless, it is precisely this complexity, in which political, regulatory and commercial elements are interwoven, which creates the scope for valuable contributions by the IFIs.

6. Concluding remarks

The new focus on market-oriented economic development is here to stay. So too are the private capital flows. The task of the IFIs must be to facilitate these processes. The IFIs have the potential to further expand the frontiers of private sector development. To do this they must continue to adapt. They must build on their strengths. In this article we have tried to explain how. The IFIs must continue to work with governments, but they must also go beyond this and participate directly in the private investment process.

Private markets and private flows are powerful forces. The availability of a strong and dynamic partner in the development effort represents a great opportunity for the IFIs. The IFIs can help harness these forces. In so doing, it is crucial that they subject projects to clear principles of selection and design. It is also crucial that they work together. The tasks are immense and each IFI has its own strengths. They must exploit their comparative advantages to the benefit of the countries in which they work. While competition among IFIs can yield benefits (such as innovations in operations), it is important that this competition is constructive. Where competition does take place, it is important that all IFIs should work to achieve the same high standards in terms of project impacts on development or transition, additionality and conformity with sound banking principles. Competition by dropping standards not only results in departures from an IFI's mandate, but it also prevents other IFIs from fulfilling their role. Clearly, with their broadly similar shareholder bases the IFIs should not undermine or weaken each other’s conditionality.

Ultimately, IFIs may not be needed. The fact that they are no longer necessary will be a clear sign of their success. That time has not yet come: IFIs still have important goals and the means to achieve them.