

I. EXTERNAL ENVIRONMENT

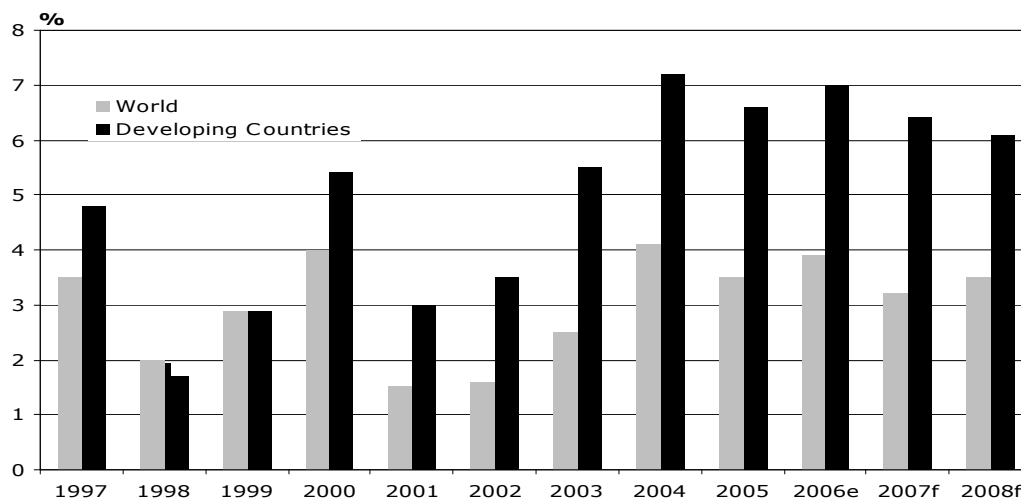
OVERVIEW

1.1. The external environment today poses unprecedented opportunities and challenges for IFC. Developing countries are growing at record levels, with their highest capital flows to date, yet poverty is persistent, there is growing concern about those not participating in global growth, and great gaps remain in the availability of financing. Physical and social infrastructure needs are still very great, with access to basic services still not available to many. A strong private sector is now recognized as a key to sustained levels of growth and poverty alleviation. Yet for the private sector to function successfully, much work is required to address needs in such areas as the business environment, public-private cooperation in infrastructure, environmental and social activities, governance, and micro, small and medium enterprise (MSME) development. International development finance institutions can assist companies in developing countries with critical financing and can provide the global expertise and knowledge to address many of the critical needs. With private sector development as a priority for the World Bank Group, and as the first and leading private sector development financial institution, IFC must seize these opportunities to improve lives in its client countries.

CONTINUED STRONG GROWTH IN DEVELOPING COUNTRIES

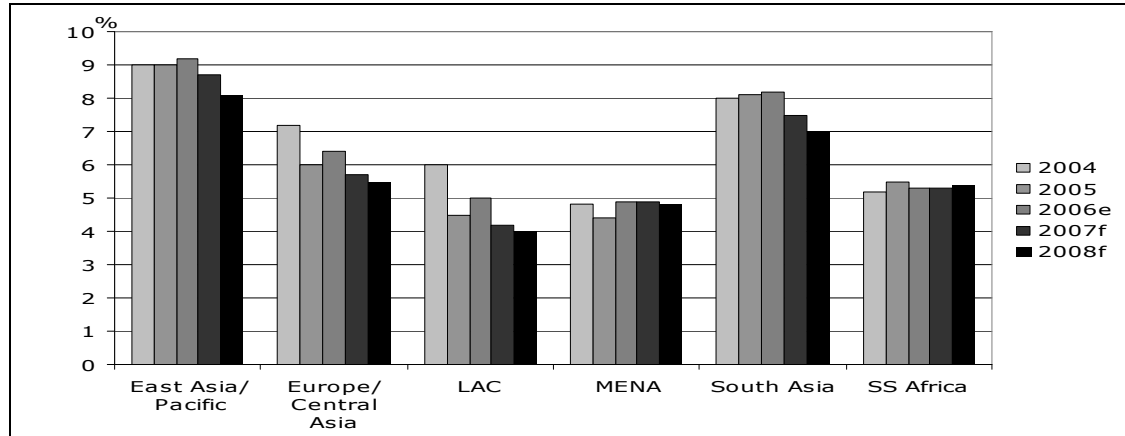
1.2. Developing countries have shown strong growth and at a higher rate than the high-income countries particularly over the last four years. The average gross domestic product (GDP) growth rate in developing countries in 2006 is estimated at 7.0%, with the world growth rate at 3.9% (Chart I-1). Whilst the East Asia and South Asia regions remain the highest growth areas, growth in the other regions, including Sub-Saharan Africa, has also been relatively strong, generally over 5% (Chart I-2). If current trends continue, growth in 2007 will likely remain in the recent range, with some slight tapering off due to possible slowing of export growth in many countries, rising interest rates, maturing of the business cycle, and lower commodity prices.

Chart I-1: Real GDP Growth (in 2000 Constant Dollars)



Source: *Global Economic Prospects 2007*

Chart I-2: Annual GDP Growth Rate



Source: *Global Economic Prospects 2007*

GREAT CHALLENGES REMAIN

1.3. **Many Remain in Poverty.** Whilst many developing countries have enjoyed an expansion of their share in the world economy, great challenges remain. About 2.7 billion people still live on less than \$2 a day. *Global Economic Prospects 2007* estimates that, based on current growth trends, the number of people living on less than \$2 a day should fall by 800 million to around 1.9 billion by 2030. However, the actual level of poverty reduction achieved will depend on how successful countries are in marshalling the policies and resources that can maximize the potential for growth.

1.4. **Concerns About the Underserved.** Over the last year there have been growing concerns expressed within the development community and elsewhere about countries and populations that may not be fully participating in global growth. The poorest country in 2002 had a lower per capita income than the poorest country in 1980¹. The Africa region remains of great concern, with its recent higher growth levels still below those needed to address the enormous development needs it faces. There are significant levels of poverty in other regions too, with for instance a quarter of the population in Latin America living on less than \$2 a day and nearly 440 million people in South Asia living in extreme poverty. Poverty extends beyond the poorest countries to poor regions within growing countries and urban poor populations. In some cases, the urban population or areas with good trade access have benefited from global growth, whilst the rural population has not benefited nearly as much.

PRIVATE SECTOR CRITICAL FOR GROWTH AND POVERTY ALLEVIATION

1.5. **Private Sector Is Key to Development and Creating Opportunity.** Effective markets encourage innovation and growth, by allocating resources efficiently. They also improve people's lives by creating opportunities for employment and access to better services. The private sector remains a major focus of the development community as an essential driver of growth and poverty reduction. The visibility and the impact of the *Doing Business Report* and new multilateral programs such as the Investment Climate Facility for Africa illustrate the momentum for a greater role of the private sector.

¹ *Global Economic Prospects 2007*.

1.6. Support from Global Investment. One indication of the growing strength of the private sector in developing countries is the substantial growth of international investment. Net capital flows to the private sector in developing countries hit a further record high at about \$530 billion in 2006, driven by the increase in foreign direct investment (FDI), portfolio equity and commercial bank flows (Chart I-3). The growth of flows as a percentage of gross national product (GNP) is less dramatic (Chart I-4), but even from this viewpoint, they are beginning to reach or surpass the high levels of the mid-1990s. These flows in part reflect improved fundamentals in developing countries and opportunities for investment in the private sector. They also have benefited from several years of easing monetary policy, high incomes among oil exporters, and high savings rates in fast-growing economies, all of which helped keep long-term interest rates low and the flow of private capital high. Emerging market benchmark spreads declined to under 200 basis points during 2006², partly reflecting global liquidity concentrating on a limited set of proven investment vehicles in emerging markets. Emerging market stock returns have also outperformed most developed markets. The Institute for International Finance forecasts continued growth in foreign direct investment in 2007, but foresees a modest reduction in the levels of portfolio equity and net debt flows.

Chart I-3: Net Medium / Long-Term Capital Flows to Private Sector in Developing Countries

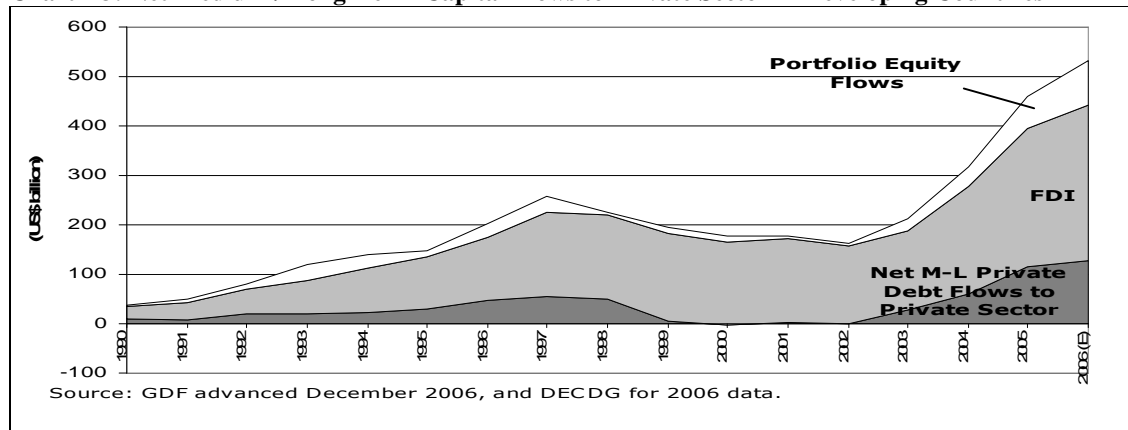
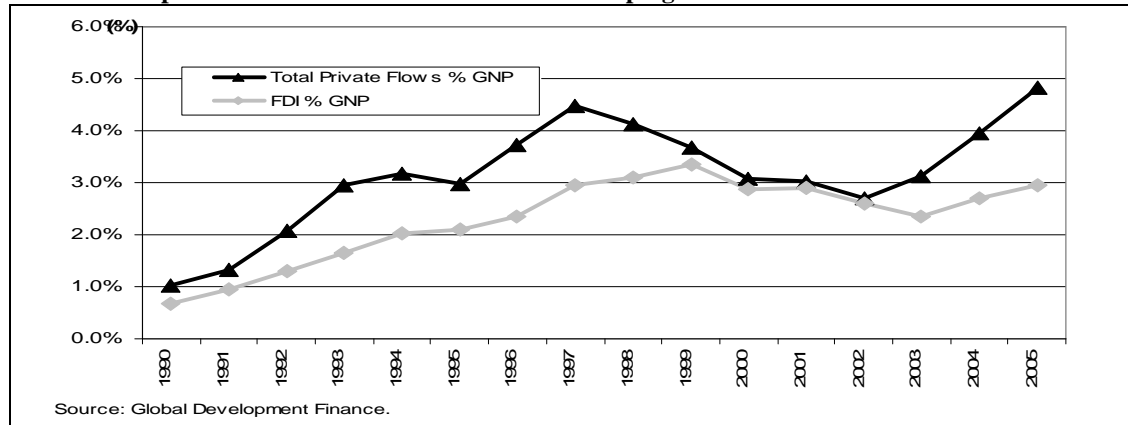


Chart I-4: Capital Flows to the Private Sector in Developing Countries as % of GNP



² JP Morgan Emerging Market Global Index.

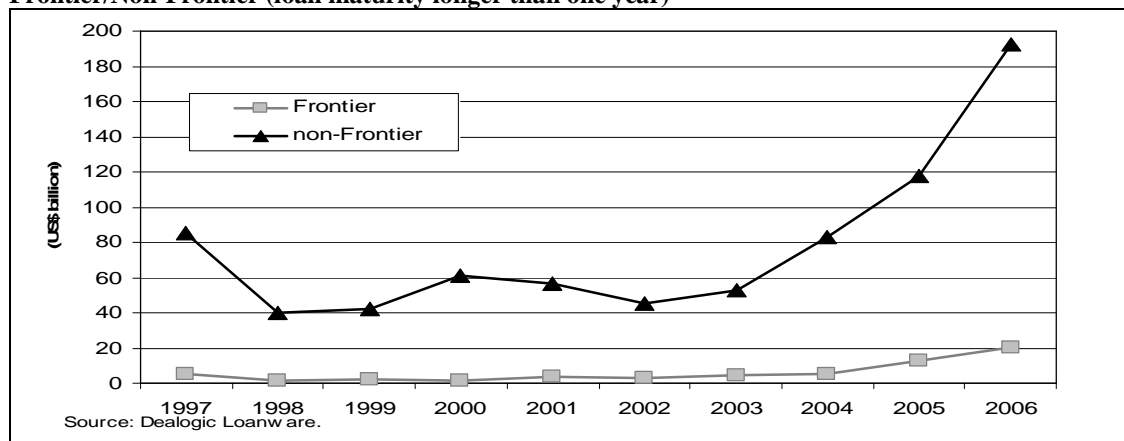
1.7. Private Capital Flows Exceed ODA. Private sector flows have now become one of the most important sources of external financing in developing countries. Net official development assistance (ODA) disbursements were \$105 billion in 2005, significantly less than private capital flows. Furthermore, much of the recent increase in ODA has been due to debt relief, which alone accounts for nearly 70% of the increase between 2004 and 2005³. Most of the ODA flows have been concentrated in Sub-Saharan Africa.

1.8. Expanding Emerging Market Companies: South-South. Another indication of the growing strength of the private sector in developing countries is the rise of companies from developing countries that have gone beyond their national boundaries. Although most of them are relatively small, a number have obtained global reach rapidly⁴, driven by a combination of opportunities in markets outside the home country, domestic market constraints, and the search for natural resources. South-South FDI is estimated to have reached about 37% of global FDI in 2003⁵. However, many companies encounter significant challenges in going outside their home markets. These include the need to adopt world-class environmental, social and corporate governance standards; difficulties establishing credibility in new environments; and difficulties obtaining credit.

PRIVATE SECTOR NEEDS

1.9. Availability of Long-Term Capital – Better but Not Sufficient. Despite the high level of international finance to the private sector in 2006, companies are still facing limitations in obtaining financing that meet their needs. International loan syndications are still mostly going to non-frontier (lower risk) countries (Chart I-5). Countries with the greatest access to international loan markets in recent years have been Brazil, Chile, China, Hungary, Mexico, Poland, Russia and Thailand. Similarly, the availability of finance with long-term maturities to developing countries is very much less than the availability of finance with shorter maturities.

Chart I-5: Gross Private Banks Syndications to Private Sector in Developing Countries, by Frontier/Non-Frontier (loan maturity longer than one year)



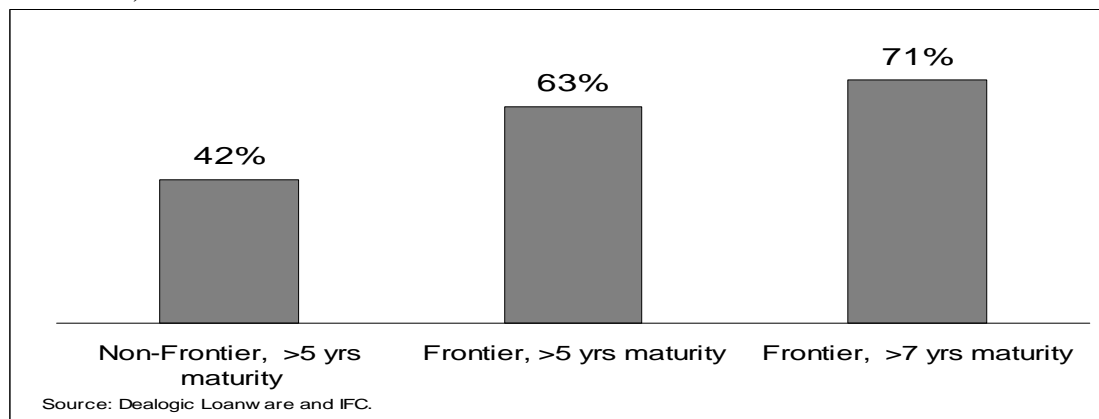
³ "Aid Architecture: An Overview of the Main Trends in Official Development Assistance Flows", IDA/SecM2007-0103.

⁴ World Investment Report 2006: FDI from Developing and Transition Economies: Implications for Development.

⁵ Global Development Finance 2006.

1.10. Long-Term Finance Often Involves IFIs. Where long-term finance is available, it is often due to support from international financial institutions (IFIs) like IFC. For example, nearly two-thirds of cross-border loan syndications to frontier countries with maturities of five years or longer involved IFIs or export credit agencies (ECAs) in 2006, and for maturities of seven years or longer the rate of IFI/ECA participation was 71% (Chart I-6). Even in non-frontier countries, over 40% of long-term flows were supported by IFI/ECA participation. Thus, IFIs are already critical partners in the growth of private capital flows, and the current large volume of flows in part reflects the success of IFI support.

Chart I-6: Extent of IFI/ECA Participation in Commercial Bank Syndications to Developing Countries, 2006



1.11. Second-tier Companies Have Less Access. Obtaining adequate international or domestic credit often remains difficult for second-tier companies both in frontier and non-frontier countries and for companies engaged in innovative products or activities, such as South-South investment. An examination of international bond and syndicated bank financing in five large middle-income countries over the last five years indicates that only a small percentage of the companies in these countries are accessing these international financial markets⁶.

1.12. Challenges of Private Sector Development. There are a number of issues that are crucial to enhancing private sector development in developing countries:

- *Infrastructure.* Insufficient infrastructure in developing countries remains a great concern, limiting access to basic services such as steady electricity supply or clean water. Today developing countries face annual investment needs in infrastructure ranging from 5.5% to 9.0% of GDP⁷, well beyond the capacity of the public sector. Governments and development agencies are focusing more on supporting this segment, with the private sector becoming an important partner either in public-private partnership (PPP) schemes or in independent projects. This is an area where advice from IFIs can be very important and constructive.
- *MSMEs.* Micro, small and medium enterprises remain a key concern for development, and they are often particularly important in frontier countries. These businesses often

⁶ Based on issues from India, China, Russia, Brazil and Mexico from 2001-2005.

⁷ Public-Private Infrastructure Advisory Facility (PPIAF) Annual Report 2006.

struggle with excessive regulations and have difficulties gaining access to finance, markets and business expertise. A combination of financial and advisory services is often necessary.

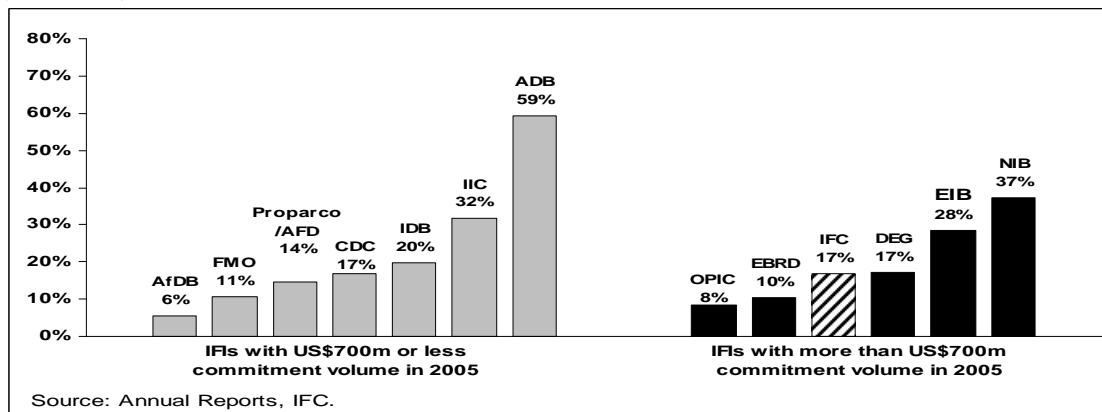
- *Environment, Social and Governance Issues:* There is increasing awareness of environmental issues globally, in particular relating to global climate change. This is a very good time to work with clients to address these issues with innovative projects. For example, there are untapped opportunities to invest in renewable energy technology⁸. Setting standards in corporate governance has also become increasingly important as it allows companies to access better finance.
- *Extending Opportunity to the Underserved.* Extending the reach of the private sector to help the disadvantaged has gained greater attention recently, reflecting the greater focus on groups left behind by global growth. Special programs – on investment climate, advisory services, finance, linkage, infrastructure, and specific sectors – may be tailored to help address these issues.

ROLE OF IFIs

1.13. Growth of IFIs to Support Private Sector Development. The greater focus on the private sector has increased the importance and growth of private sector development institutions. Private sector-oriented IFIs provide financing and advisory services that can address the critical private sector needs and extend the reach of global growth beyond what private finance can provide alone.

1.14. IFIs have significantly increased their levels of commitments to the private sector in developing countries in recent years (Chart I-7 and Chart I-8) with total commitments exceeding \$23 billion in 2005.

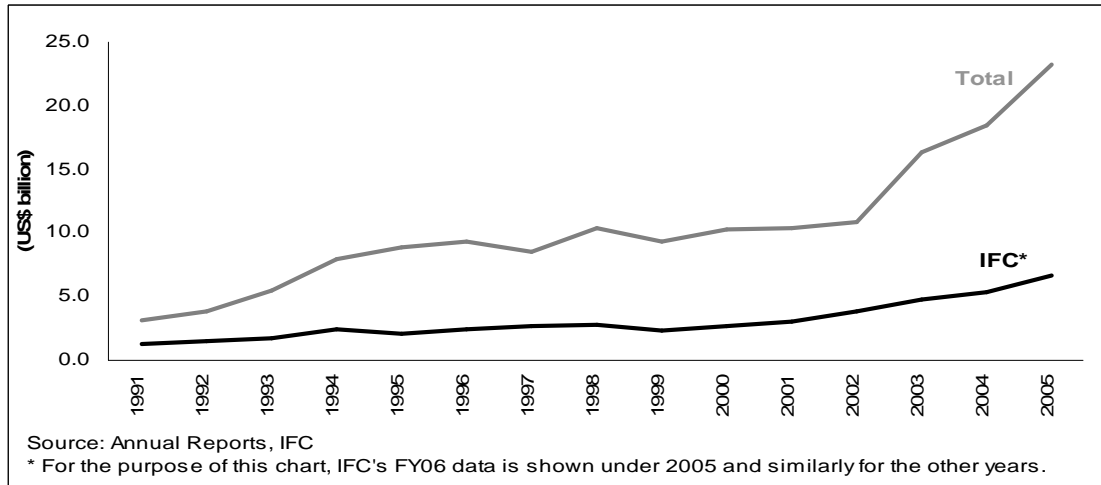
Chart I-7: IFI Private Sector Commitments – Compound Annual Growth Rate over a 5-year Period (2000-2005)⁹



⁸ “Climate change: beyond weather”, UBS Research Focus.

⁹ AFD (Agence Française de Développement), AfDB (African Development Bank), CDC (Commonwealth Development Corporation), DEG (Deutsche Investitions- und Entwicklungsgesellschaft mbH), EBRD (European Bank of Reconstruction and Development), EIB (European Investment Bank), FMO (Financierings-Maatschappij voor Ontwikkelingslanden), IDB (Inter-American Development Bank), IIC (Inter-American Investment Corporation), NIB (Nordic Investment Bank), OPIC (Overseas Private Investment Corporation), Proparco (Promotion et Participation pour la Coopération économique).

Chart I-8: IFI Private Sector Volumes



1.15. Preliminary estimates indicate similar high levels of finance occurred in 2006, with growth at both multilateral and bilateral development institutions. IFC's share of the total IFI finance is about 30%, with a slight decline in recent years as a number of IFIs have grown their activity more rapidly than IFC.

1.16. IFIs have been strengthening their approaches to private sector development in a number of ways over the last year. Alliances among the European institutions have been particularly prominent. A joint financing vehicle between the European Investment Bank (EIB) and numerous European bilateral private sector development institutions has entered its second round of financing, and other examples of coordination involve the European Bank for Reconstruction and Development (EBRD), EIB, Financierings-Maatschappij voor Ontwikkelingslanden (FMO), Deutsche Investitions-und Entwicklungsgesellschaft mbH (DEG), and the European Union. On the product side, equity investments have become more prominent. A number of the multilateral development institutions are also undertaking reorganizations to increase their country focus and bring staff closer to clients, including the Inter-American Development Bank (IDB) and the African Development Bank (AfDB).

1.17. **Advisory Services.** Private sector support has also been an increasing focus for a number of agencies providing advisory services in developing countries. Among IFIs, EBRD is particularly prominent in providing advisory services to private companies to support access to finance for MSMEs and infrastructure development. Aid agencies such as the United States Agency for International Development (USAID), the United Kingdom Department for International Development (DFID), and the European Commission also have programs for private sector support in areas such as finance, investment climate, infrastructure and small and medium enterprise (SME) capacity building.

1.18. **Growing Importance of Private Donors.** In recent years, the role of private philanthropic foundations in international development has drawn significant attention, as their aid has grown in importance in comparison to ODA. IFC is partnering with some of them. For example, the Bill and Melinda Gates Foundation, with IFC, has committed to spend \$2.6 million to conduct research on the business models that provide the best service in

the health sector in Africa. A number of foundations are also collaborating in areas of SME development, education, and gender. These changes could have a significant impact on how IFIs do business in developing countries, particularly with respect to funding and collaborating in advisory services.

IMPLICATIONS FOR IFC

1.19. With strong developing country growth but great development challenges remaining, and with an ever-greater role for the private sector in meeting these challenges, there is a clear need to find ways to help develop the private sector and extend its impact to more countries and people. The level of support in developing countries is not yet sufficient. IFC, along with other IFIs, is responding to the challenges by providing financial and advisory services beyond what the markets would provide on their own. These services need to be focused on addressing the serious challenges facing the private sector, such as in infrastructure, capital markets development, investment climate, international standards, and MSME development.

1.20. As IFC reviews its strategy in an environment with many growing and strengthening private and public providers of finance and advisory services, it must consider carefully where its comparative advantage lies and how it can focus its activities to maximize its contributions. In this regard, the characteristics that differentiate IFC are important:

- Strong and well-established credit culture and history of innovation
- Position as the largest private sector development institution
- Global expertise and reach
- Extensive field-based technical capabilities beyond finance, in such important areas as environment and social analysis, corporate governance, investment climate, public-private partnerships and project development
- Integration within the World Bank Group

1.21. Taken together, these characteristics are unique in the global development arena. IFC's strategy, as discussed in this paper, seeks to leverage these strengths and focus on investment and advisory activities that will yield the highest levels of development impact and do the most to create opportunity in client countries.

RISKS

1.22. There are a number of risks that could affect the environment described in this chapter. Global macroeconomic factors could lower the availability of private sector finance in developing countries and/or slow the pace of growth: (i) higher interest rates could reduce liquidity in the market; (ii) certain large global current account imbalances may go through a substantial correction; and (iii) downward pressure expected on commodity prices could weaken countries that are dependent on commodity exports. There are also risks from potential increases in protectionism. Beyond these macroeconomic risks, there are other growth risks, such as avian flu and climate change, as well as from sudden changes in the political landscape in post-conflict countries that could leave these states even more fragile. Similarly, world geopolitical change could hamper world growth and influence the appetite for market risk. As the recent sudden decline of global stock prices has shown, one important

risk characteristic in today's globalizing world is that a shock in one part of the world can travel to other parts of the world faster than ever.

1.23 It is difficult to predict the impact of these risks on IFC's growth outlook, its portfolio and its income. Should there be abrupt adverse changes in the external environment IFC is prepared to resume its counter-cyclical role, as it did in the late 1990s in Asia and early 2000s in Latin America. This allows IFC to mobilize scarce capital for the private sector in difficult times and ensure adequate liquidity in impacted economies. It is also important for IFC to remain engaged with clients throughout the cycle to manage risks and support continued access to capital.