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Multilateral Development Banks and Private Sector Financing: The Case of IFC

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The Case of IFC

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Abstract

The paper examines the role of the multinational development banks in private sector financing with a particular focus on the International Finance Corporation (IFC). The aim of the paper is to bring to focus, in an analytical manner, the past activities and operations as well as the problems and prospects of the Corporation. Simple econometric analysis is also being carried out to test a number of hypotheses regarding IFC finance such as whether IFC finance is an addition to or a substitution for private capital flows as well as the relationship between IFC finance and growth in IFC finance-recipient countries and regions. The central conclusion of the paper is that the Corporation plays a rather significant role in development financing in many developing countries, although its role as a catalyst in private sector financing needs to be re-examined in view of the mixed findings reported in the paper. Granger-causality tests seem to suggest that there is no clear evidence regarding its role as a catalyst in the area of private sector financing. The results are mixed and region specific, thus leaving little room for generalization. Finally, the paper discusses areas where in the case of IFC reforms are most needed, particularly in the light of recommendations included in the Meltzer Report.

Keywords: IFC, private sector financing, multinational development banks, causality tests

JEL classification: F33, O19

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1 Introduction

The present paper examines the role of the multinational development banks (MDBs) in private sector financing with a particular focus on the International Finance Corporation (IFC), the private sector arm of the World Bank Group, which was established in 1956 to provide equity and loan finance to the private sector. Regional multilateral development banks too have units that perform a similar role. It is notable that hitherto a discussion of the activities and portfolios of these multilateral development banks in private sector financing has been mainly confined to their respective annual reports. Few or no concerted efforts (outside the banks' annual reports) have been reported in the literature on this issue, despite the growing need for it to be critically analysed. Along these lines the aim of the present paper is to bring to focus, in an analytical manner, the past activities and operations as well as problems and prospects of the IFC. IFC's portfolio, sectoral and regional allocation of its lending and equity finance, etc. will also be highlighted (section 2). Simple econometric analysis will also be undertaken to test a number of hypotheses regarding IFC finance such as whether IFC's financing is additional or substitute to private capital flows as well as the relationship between IFC finance and growth in IFC finance-recipient countries and regions (section 3). Finally, areas which need reforms will also be discussed, particularly in the light of recommendations (which were finally rejected by the US Treasury) included in the report by the US Congress' International Financial Institution Advisory Committee's Report of March 2000 (section 4).

2 IFC finance: trends, features and key issues

2.1 Origins, objectives and IFC's role in private sector financing

IFC was founded in 1956 to act as the private arm of the World Bank with the main aim to promote development through catalysing private sector investment in developing countries. It is owned by 175 member-countries and shares commercial risks with sponsors and other financial partners when they are not yet prepared to invest independently. IFC invests in private enterprises that benefit the economy, promote a sound environment and social well-being, and are examples of good business for other entrepreneurs. IFC is also trying to mitigate country risk and advises governments independently as well as private sector companies in the context of a transaction (IFC 2002a).

According to IFC:

> the IFC, a part of the World Bank Group, fosters sustainable economic growth in the developing world by financing privates sector investment, mobilizing capital in the international financial markets, and providing technical assistance and advice to governments and businesses (IFC 2002a).

Furthermore, '… IFC's mission is to promote sustainable private sector investment in developing countries, helping to reduce poverty and improve people's lives' (IFC 2001a).

IFC acts as both a commercial and a public entity. IFC argues that it invests principally on a commercial basis, but as a public entity does so where market failures exist, complementing and catalyzing funding from private financial markets rather than competing with them. IFC also acts in part on a non-commercial basis, where its shareholders believe its experience and expertise make it the most appropriate institution for supporting the delivery of certain public goods.

According to IFC, the Corporation's recent role as the private sector arm of the World Bank Group is characterized by (IFC 2002b):

- A *primary focus on frontier markets*. This means a focus on countries where there is little or no foreign capital flow, especially debt capital, or areas and sectors within a country where there is very limited capital availability. IFC argues that it tries to act as a catalyst to help companies implement investment plans and to provide the risk mitigation that enables investors to proceed with plans they otherwise would not implement, given perceived risks. At the same time, the relative scarcity of good investment opportunities in many frontier markets requires IFC to complement its investment work with extensive technical assistance, and to transfer know-how and best practices from more developed areas. IFC also supports governments' efforts to develop SMEs, improve the investment climate, and undertake privatizations.

- A *counter-cyclical role in non-frontier markets*, when their access to alternative sources of financing dries up. Capital flows to emerging markets are expected to remain depressed and volatile for the foreseeable future. Private sector companies in many countries, even those with good access to financing in the mid-1990s, may have only very limited or sporadic access to private financing over the medium term. In view of the above, IFC can play an important counter-cyclical role in those countries. Such a role will be particularly important in countries—many of them middle-income—which depend on cross-border flows to finance their investment needs.

- *Provision of support to international companies increasingly reluctant to invest in developing countries* (e.g., infrastructure).

- *Increasing emphasis on high-impact sectors*. IFC currently seeks to emphasize sectors that contribute disproportionately to development, where 'spill-over' effects in addition to the economically productive use of capital are significant. These have included domestic financial markets, infrastructure, information and communications technology (ICT), and social sectors.

- An increasingly important role in *providing know-how to domestic companies in developing countries* for a full range of technical knowledge (for example, on financial issues, accountancy, marketing and technology), and to both domestic and international companies in areas related to sustainable development (corporate governance, environmental management and local community development), and can help companies compete effectively in world markets. International companies also seek IFC's know-how and experience in frontier markets. IFC's know-how services are often 'bundled' with its investments, where they can be an important part of strengthening a project's long-term viability.

2.2 IFC's portfolio

Recent years have witnessed an expansion of IFC's portfolio and activities (see Table 1). Three hundred and four projects in total were approved in the 1998 fiscal year. Since then, mainly due to the impact of the Asian financial crisis, the number of approved projects declined to 240 projects in the fiscal year 2001. Compared to previous years, total financing over the period 1997-2001 increased substantially to reach almost US$7 billion in 1997, and then to follow a declining trend during the period 1998-2001. Total committed portfolio reached almost US$22 billion in 2001 and the number of firms involved in IFC's financing activities was 1,378 the same year.

Table 1
IFC operations and resources, 1997-2001
(millions of US$)

OPERATIONS	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Investment commitments					
Number of projects [a]	–	–	228	210	205
Total commitments signed [b]	5,558	5,138	3,688	3,909	3,931
For IFC's own account [b]	2,402	2,699	2,890	2,379	2,732
Held for others	3,156	2,439	798	1,530	1,199
Investment approvals					
Number of projects	276	304	255	259	240
Total financing approved [c]	6,722	5,905	5,280	5,846	5,357
For IFC's own account [c]	3,317	3,412	3,505	3,505	3,742
Held for others	3,405	2,493	1,775	2,341	1,615
Total project costs	17,945	15,726	15,578	21,136	16,427
Investment disbursements					
Total financing disbursed	5,110	4,291	3,296	3,307	2,370
For IFC's own account	2,003	2,054	2,102	2,210	1,535
Held for others	3,107	2,237	1,194	1,097	835
Committed portfolio [d]					
Number of firms	1,046	1,138	1,280	1,333	1,378
Total committed portfolio [b]	18,992	20,608	21,685	22,168	21,851
For IFC's own account [b]	10,512	11,448	13,364	13,962	14,321
Held for others	8,471	9,160	8,321	8,206	7,530
RESOURCES AND INCOME (millions of US$)					
Capitalization					
Borrowings	10,123	11,162	12,429	14,919	15,457
Paid-in capital	2,229	2,337	2,350	2,358	2,360
Retained earnings	2,503	2,749	2,998	3,378	3,723
Operating income	432	212	249	380	241
Net income	432	246	249	380	345

Notes: Certain prior period amounts have been reclassified to conform to current period presentation;

[a] Includes first commitment to projects in the fiscal year. Projects involving financing to more than one company are counted as one commitment. Figures maintained for commitments prior to FY99 do not compare;

[b] Includes loan guarantees and risk management products for FY 1999-01;

[c] Includes loan guarantees and risk management products for FY 1997-01;

[d] Total committed portfolio and held for others include securitized loans.

Source: IFC (2001a).

2.3 Sectoral allocation of IFC projects and activities

IFC's projects range across many sectors: financial services, infrastructure (including communications technologies, power, water and sewerage, and transportation), oil, gas and mining, food and agribusiness, social services (including private health care and education), chemicals and petrochemicals, and hotels and tourism.[1]

The financial sector attracted about 40 per cent of IFC commitments on average during the period 1999-2001 followed by infrastructure (13 per cent on average), transport and other infrastructure (7.5 per cent), power sector (6 per cent), information communication technologies (5.5 per cent) and social sectors (2 per cent). The above priority sectors attracted almost 70 per cent of IFC's commitments in the fiscal year 2001 (see Table 2).

Recent years have also witnessed a growing emphasis on behalf of IFC on SMEs and SME-related projects. Indeed, as Table 2 seems to suggest, IFC investment commitments associated with SME-related projects increased significantly during the period 1999-2001 from US$1.5 billion in 1999 to almost US$2 billion in 2001 with the share of the relevant sector increasing to almost 20 per cent in 2001 compared to 13 per cent in 1999.[2]

Table 2
IFC investment commitments by sector

	Fiscal year 1999		Fiscal year 2000		Fiscal year 2001	
	US$ million	%	US$ million	%	US$ million	%
Financial sector	1,170	40.5	747	31.5	1,154	42.6
Infrastructure (excl. ICT)	244	8.5	471	19.8	334	12.3
Power sector	82	2.9	237	9.9	141	5.2
Transport & other infrastructure	162	5.6	234	9.9	193	7.1
Information communication technologies	51	1.8	88	3.7	294	10.8
Social sectors	37	1.3	24	1.0	106	3.9
Total priority sectors	1,502	52.0	1,330	56.0	1,888	69.6
SME-related projects	370	12.8	349	14.7	521	19.2

Source: IFC (2002b).

1 IFC specifies certain criteria for a project to be financed by IFC. The project must be (i) technically and financially viable, (ii) economically competitive, (iii) beneficial to the local population and (iv) environmentally and socially sound.

2 IFC's support for the SME sector is increasingly focused on: (i) working through and with local financial intermediaries to provide access to financing for smaller companies; (ii) creating new local financial intermediaries such as microfinance institutions, venture capital funds, leasing companies and others; (iii) providing funding from the SME capacity building facility to scale up global best practice institutions; and (iv) providing technical assistance and advisory support through project development facilities, which assist SMEs by developing local SME service providers, preparing project feasibility studies, accessing financing, and obtaining a broad range of management and technical assistance including post-financing. This approach has replaced that of direct financing, which in IFC's experience has proven an expensive and ineffective way to reach smaller companies.

2.4 Regional allocation of IFC lending

Turning to the regional allocation of IFC investment commitments, both the Latin America and the Caribbean and the Middle East and North Africa regions attracted half of IFC's commitments in 2001 (26 per cent and 25 per cent, respectively) followed by the Asia and the Pacific region (20 per cent), Sub-Saharan Africa (16 per cent) and Europe and Central Asia (13 per cent) (see Table 3).

In the case of the Sub-Saharan Africa region, IFC's focus in 2000-01 was mostly on the financial sector, infrastructure projects, SMEs and tourism businesses with a total committed portfolio above US$1.8 billion in 2001 as compared to US$1.5 billion in the previous year.[3]

Asia and the Pacific attracted more than US$6.5 billion in 2000-01, with most of the IFC commitments directed to the financial sector and SMEs (sectors particularly affected by the recent financial crisis in the region). A number of projects were approved in the above sectors for China, Indonesia, the Philippines, Thailand and South Korea among others. At the same time, IFC's commitments in South Asia increased substantially in 2001 with a particular emphasis on new products to new clients in new sectors.[4]

In Europe and Central Asia, IFC's committed portfolio exceeded US$3.6 billion in 2000 to decline slightly to US$3.3 billion in 2001. Growing emphasis was given to sectors and countries in the region with the most acute need to advance the pace of private sector development.[5]

Turning to the Latin America region—the main recipient of IFC's investment commitments in recent years—IFC's portfolio ranged between US$8.5 billion and US$9 billion in the 2000-01 period. Priority was given to those businesses where private sector participation can provide a visible impact on living standards such as housing finance, health, education and infrastructure.[6]

Finally, in the case of the Middle East and North Africa region (the other major recipient of IFC's financing in recent years), IFC invested mainly in infrastructure (Egypt, Morocco), small information technology companies (Egypt), large capital market investments (Syria) as well as institution-building investments in the financial sector (Algeria). IFC committed almost US$1 billion in 18 investments in the 2001

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[3] Specific projects included an eco-tourism project in Tanzania, expanding telephone service in Ghana, agreement to finance the Chad-Cameroon oil pipeline project, financing 12 hotel projects in the region etc.

[4] Examples include a student loan programme with NIIT Ltd., a leading IT company in India, supporting a trade enhancement facility in Bangladesh, supporting microfinance institutions in India etc.

[5] Examples of recent IFC projects in the above region include the strengthening of capacity building in Tajikistan, revitalizing a neglected copper firm in Bulgaria, supporting pharmaceutical companies in Croatia and financing (on a joint basis with the government of Finland) sustainable forest management practices in north-west Russia, among others.

[6] Specific projects included the financing of education projects in Brazil, Argentina, Mexico, Peru and Uruguay, improving conditions for mortgage borrowers and lenders in Mexico and Peru, supporting microfinance institutions in Mexico, etc.

fiscal year. It is notable that, for IFC, this was a record level of loan syndications for the region, partly due to the commitment of a number of sizeable infrastructure investments. The total committed portfolio reached US$1.6 billion in 2001.

Table 3
IFC commitments by region ($millions)

	$ millions	%
Sub-Saharan Africa	642	16
Asia and the Pacific	784	20
Europe and Central Asia	510	13
Latin America and the Caribbean	1,017	26
Middle East and North Africa	956	25
Global	22	
Total	3,931	

Source: IFC (2001a).

2.5 Discussion of IFC's products and services

IFC has a variety of products and services. They include the following:

– *Equity and quasi-equity*: IFC buys shares in project companies, other project entities, financial institutions, and portfolio or private equity funds. It generally subscribes to between 5 and 20 percent of a project's equity. It will not normally hold more than a 35 percent stake and is never the single largest shareholder in a project. Through quasi-equity instruments, IFC invests through products that have both debt and equity characteristics.

– *Loan and intermediary services*: IFC finances projects and companies through *A-loans*, which are for IFC's own account. IFC does not accept government guarantees. Maturities of A-loans generally range between 7 and 12 years at origination, but some loans have been extended to as long as 20 years. Finally, IFC makes loans to intermediary banks, leasing companies, and other financial institutions through credit lines that result in further on-lending. These credit lines are often targeted at small businesses.

– *Syndicated loans, or B-loans*: IFC broadens its impact by mobilizing loans from other financial institutions that are willing to lend to projects only with IFC's participation. Along these lines, syndicated loans, or *B-loans*, are an important part of IFC's finance products. Through this mechanism, financial institutions share fully in the commercial credit risk of projects while IFC remains the lender of record.

– *Guarantees and risk management*: Loan and bond guarantees and standby financing allow IFC's clients to use IFC's credit to help them secure financing from international capital markets. IFC offers credit enhancement structures for debt instruments. IFC's risk management services enable clients to access derivatives markets through IFC as an intermediary.

- *Advisory services*: IFC's advisory services are designed to improve the investment climate in member countries and the business practices of companies in which IFC invests. They play an increasingly important role in the way IFC approaches its investment activities. IFC undertakes a wide array of financial market advisory assignments, specializing in securities markets and banking and credit institutions. Another newly created and jointly managed unit, the Small and Medium Enterprise Department, focuses on business environment issues, capacity building, and the development of innovative financing techniques.

- *Technical assistance*: Technical assistance further complements IFC's investment activities by providing advice and training to governments and private companies. Cumulative contributions to IFC-managed technical assistance programmes reached US$582 million in 2001, compared with a cumulative total of US$525 million at the end of 2000 (fiscal years). 71 per cent of the above technical assistance programmes were supported by donor countries, about 20 per cent by the World Bank Group and 10 per cent by donor institutions (IFC 2001a).

2.6 Evaluating IFC's effectiveness

Recently IFC published the cumulative findings from four years of evaluating IFC's investments. It draws from evaluations of 176 randomly-selected IFC operations that were approved in 1991-94 and evaluated in 1996-99. The results of the evaluation process became available from the Annual Review of IFC's Evaluation Findings (2001). The main findings seem to suggest that:

- IFC's operations have generated substantially greater benefits for others—customers, employees, suppliers and taxpayers—than they have for the owners and financiers of the projects;

- IFC's effectiveness—how well IFC does its job throughout the project cycle—is strongly associated with positive outcomes. When IFC's effectiveness was consistently good, it achieved good development results in 91 per cent of cases, and good development *and* investment results in over two-thirds of cases.

- Among IFC's strategically important sectors, infrastructure projects yielded significantly better than average development results. Similarly, investments in targeted high-risk countries performed better developmentally. This finding, according to IFC, may not hold for the future, as fewer countries currently are designated high-risk, and they may be more challenging environments in which to work.

Obviously, the above relatively satisfactory findings need to be assessed on the basis of the evaluation criteria that IFC is employing to evaluate its activities. In what follows we discuss the IFC's evaluation approach in detail as well as further findings related to specific performance indicators.

Each year IFC evaluates a random sample of investments that have reached early operating maturity (typically five years following approval by which time the projects have been established and built up a track record of operating performance). Within statistical limits the sample is representative of each year's entire approvals. First, selfevaluations of the investments in the sample are undertaken by IFC's investment department staff. They complete the research and analysis necessary to rate each investment on 11 indicators. Using corporate guidelines, they rate each indicator on a four-point scale: unsatisfactory, partly unsatisfactory, satisfactory, and excellent. Next, the Operations Evaluation Group (OEG) conducts independent research, verifies each rating to ensure that evaluation standards are applied consistently throughout IFC, then synthesizes its findings in each year's annual review. The *Annual Review 2000* is based on evaluations conducted during 1996-99 of investments approved during 1991-94. It also draws on findings from previous annual reviews as well as four years of OEG evaluation research.

Each of the 11 performance indicators used in IFC's evaluation process relates to one of three outcome ratings:

- *Development outcome*: a project's contribution to a country's economic development and improved living standards;

- *Investment outcome*: an investment's contribution to IFC's profitability; and

- *IFC's effectiveness*: how well IFC does its job throughout the project cycle.

IFC's effectiveness is evaluated on the basis of achieving good development *and* investment outcomes i.e. 'win-win' outcomes. 'Win-win' operations are the ones that simultaneously foster development and are sufficiently profitable relative to their risk to contribute to IFC's own sustainability for supporting development.

Two-thirds of the evaluated operations had successful development outcomes. Development outcome ratings are a judgmental synthesis of six indicators.

The following findings are reported from IFC's Operations Evaluation Group, from highest- to lowest-rated indicator:

- *Living standards*: IFC's operations have generated substantially greater benefits for others—customers, employees, suppliers, and taxpayers—than they have for the projects' owners and financiers. This outcome is measured by the difference in projects' economic (social) and financial (private) rates of return. For 102 investments in which analysis was possible, OEG estimated that they generated net present values of approximately US$1.4-1.6 billion in direct net benefits in developing countries, US$0.9 billion more than that received by the owners and financiers.[7]

- *Private sector development*: Three-quarters of IFC's projects have contributed to the development of local private sectors through linkages supporting other private enterprises, demonstration effects, privatizations, or regulatory changes.

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7 For example, a mine in an isolated area has considerably improved the standard of living for 3,000 local inhabitants by providing well-paid jobs, housing, health care, schooling, better communications and amenities.

- *Environmental impact*: Two-thirds of operations, including many whose profitability for their owners fell short, met IFC's high standards for environmental sustainability.[8]

- *Growth of the economy*: About two-thirds of evaluated projects yielded tangible benefits to the economy. For example, a project to modernize the production facilities of a beverage company allowed it to respond efficiently to an unforeseen increase in consumer demand and at the same time realize economies of scale, as labour productivity increased.

- *Project business success*: This indicator, reflecting whether a company earned an attractive profit on its investment, was the lowest-rated. When a project's financial returns are less than the cost of capital, the business success is rated less than *satisfactory.* This was the rating for about half of the projects.[9]

- *Company business success*: Notwithstanding the success or otherwise of their projects, a higher proportion of companies, particularly those that were established enterprises with proven expertise, remained clearly viable despite concerns.

2.7 Results versus IFC's strategic objectives and priorities

As already mentioned, IFC's strategy in recent years focuses on (i) high-risk or low-income countries and 'frontier' regions or sectors within countries; and (ii) targeted sectors (mainly financial markets and infrastructure). More precisely:

- In targeted sectors, the evaluation results were mixed. Infrastructure projects performed better, but some credit lines to financial institutions lacked a clear IFC role or contribution to needed capacity-building.

- In low-income countries, there was no discernible difference in performance of IFC's operations other than on average poorer environmental impacts.

- Operations in countries that were regarded by institutional investors as high-risk at the time of approval (i.e. 1991-94) had a significantly higher proportion of 'win-win' outcomes than projects in other countries.[10]

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8 For example, an IFC investment in an expansion project helped reduce effluent and air emissions from a wood pulp and paper company's existing operations. Moreover, bio-mass from the plant was used as a coal replacement at an adjacent power station.

9 This finding is fully consistent with the results of a recent survey, conducted by an independent consulting firm, of multinational companies operating in the same regions as IFC. Based on ratings standards that mirror those IFC uses, the firm judged the companies' projects as financially successful in 44 per cent to 74 per cent of cases, depending on the region. IFC achieved project business success rates of between 35 per cent and 63 per cent across these same regions, but in a higher-risk mix of countries.

10 Furthermore, the OEG looked at all of IFC's equity investments approved between 1985 and 1995 and found that IFC had significantly better returns in countries that were high-risk at the time of investment approval.

Needless to say, the above evaluation results are not based on an independent external evaluation and, hence, the findings should be accepted with caution and the reservation that any other internal assessment deserves.

2.8 The profitability issue

A key issue for IFC seems to be related to the improvement of its profitability. It has been correctly argued that the impact of the global slowdown and the crisis in Argentina have put pressure on IFC's profitability and have highlighted the need to focus on improving the IFC's profitability as a top priority. In view of the above, IFC goes further by arguing that it is rather important to ensure that IFC's partners experience their investments as profitable opportunities, and that IFC continues to provide a positive signal to other investors that good business can be done in developing countries, in particular when their apprehension about investing in emerging markets has increased.

Two further arguments have been put forward by IFC recently on the profitability issue: first, *replicability*, i.e. if the projects do not earn a return corresponding to what private investors can earn on other investments, IFC projects will not be replicated and nothing sustainable will have been created, and second, *crowding out*, i.e. if IFC accepts, for otherwise viable projects, a lower return for itself, the IFC would be crowding out the private financial market and hinder its development (Lysy 2001).[11]

The OEG also stresses the importance of profitability for IFC on the basis that there is a close correlation between projects' business success and their development outcomes, and better quality investments should translate into a stronger development impact for IFC. The OEG argues that improving profitability will require in particular continued efforts to work out problem investments, as well as to ensure that good quality new investments are booked by IFC, and that improvements in efficiency continue to be sought. In the same vein, it has been argued that if IFC is not profitable, its financial capacity could be eroded, and a negative signal would be sent about good business to be done in developing countries (IFC 2002b).[12] In view of the above arguments, the OEG's annual review has recently recommended that the current top priority for IFC is strengthening profitability.

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[11] It is notable that issues of profitability are currently in the heart of the agenda for IFC in view of the fact that the average overall return on equity (ROE) that IFC has earned over the period 1997-2001 (fiscal years) was 6.4 per cent , well below the ROE of US investment banks/security houses (11.2 per cent) and of most European banks (8.2 per cent) (Lysy 2001).

[12] There is also a need for some clarification with regard to IFC's profitability. IFC's consolidated income includes expenditures on activities undertaken in line with IFC's developmental mandate, but without commercial compensation. Examples include IFC's work in capacity-building for SMEs, participation in World Bank Group advisory efforts to improve the investment climate, management and delivery of technical assistance (including overseeing technical assistance activities funded by donor trust funds), and for economic and environmental work above and beyond what would be required purely for risk management (IFC 2002b).

3 Evaluating IFC finance: what the data really tell us

In this section we evaluate IFC's private finance by using data from a number of sources regarding its private capital flows, GDP growth rates and per capita income in recipient countries. We use two types of empirical analysis. First, we use simple correlation analysis among a number of crucial variables, namely IFC finance and other private capital flows, as well as IFC finance and GDP per capita in recipient countries. The purpose of this simple, albeit important, statistical analysis is to test IFC's own conclusions and statements regarding the features as well as impact of IFC capital on its recipients (see previous section). Second, since correlation analysis is indicative only of the degree of correlation among the variables in question, we also conduct Granger-causality type tests within a panel of 59 recipients of IFC capital flows for which data are available over the period 1980-2000, but also by region, to explore the direction of causation between the economic relationships under investigation.

3.1 A focus on frontier markets?

The first assumption we tried to test is related to the IFC's hypothesized focus on frontier markets (see section 2). More precisely, according to IFC, a primary focus on frontier markets means a focus on countries where there is little or no foreign capital flow. We tried to test the above assertion by analysing data on IFC flows in order to investigate whether there exists a negative correlation between the access of a country or a region to capital flows (measured as total net FDI's share in GDP) and IFC's own net investment in that country or region (the share of IFC finance in GDP). Data cover the period 1980 to 2000.[13] Initially we started with 126 countries, but almost half of them were dropped from the statistical analysis due to lack of data. At the end, 59 countries representing all geographical regions (although with a different degree of representation) remained in the final sample.

Correlation statistics regarding the relationship between total net FDI share in GDP and the share of IFC finance in GDP are reported in the first column of Table 4. The results concerning the above relationship are rather mixed. In 30 out of 59 countries in the sample, a negative correlation was found between the two variables, thus confirming a 'focus on frontier markets'. For the remaining countries in the sample (29), however, a positive correlation seems to exist, thus not supporting the theory of a focus on markets with little or no capital. It is also notable, that with a few exceptions (Uganda, Turkey, Uruguay, Tunisia, Togo and Malaysia), in the majority of cases the degree of correlation is also very low.

Does the picture change if we focus on regions instead of countries? The bottom part of Table 4 reports correlation analysis results between the same variables but this time for each region. A focus on countries with little or no capital is confirmed only in the case of the East Asia and Pacific region (though with only six countries being included in the final sample due to data problems) and Latin America (18 countries in the sample). For the remaining four regions (Sub-Saharan Africa, South Asia, Middle East and North

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13 The data on IFC capital flows comes from the OECD-DAC (online database). The data on FDI and GDP, GDP per capita and GDP growth are obtained from World Bank (2001).

Africa and Europe and Central Asia) the emerging sign is positive, thus rejecting hypothesis on the focus on frontier markets.[14]

Table 4
Correlation analysis results

Country	Correlation coefficients between	
	FDI capital flows & IFC finance	GDP per capita & IFC finance
1. China	-0.271	-0.081
2. Fiji	0.255	-0.079
3. Indonesia	-0.305	0.589
4. Malaysia	-0.468	-0.223
5. Philippines	-0.005	0.168
6. Thailand	-0.131	0.076
7. Cyprus	0.072	0.320
8. Hungary	-0.201	-0.418
9. Turkey	-0.579	0.733
10. Argentina	0.284	0.194
11. Barbados	0.113	0.074
12. Bolivia	0.302	-0.178
13. Brazil	-0.283	0.178
14. Chile	0.088	-0.363
15. Colombia	-0.032	-0.005
16. Costa Rica	-0.368	0.124
17. Dominican Republic	-0.154	0.120
18. Ecuador	-0.040	-0.004
19. El Salvador	0.124	0.277
20. Guatemala	-0.008	-0.261
21. Honduras	-0.081	-0.068
22. Jamaica	-0.058	0.289
23. Mexico	0.063	0.323
24. Panama	0.139	0.398
25. Paraguay	-0.237	0.683
26. Peru	0.201	0.140
27. Uruguay	0.438	-0.216
28. Jordan	-0.261	-0.028
29. Morocco	0.368	-0.063
30. Tunisia	0.504	-0.202
31. Bangladesh	0.209	0.381
32. India	-0.291	0.039
33. Nepal	0.244	0.751
34. Pakistan	-0.113	0.185
35. Sri Lanka	-0.117	-0.168
36. Benin	0.359	0.798
37. Cameroon	-0.055	-0.256
38. Congo, Rep.	-0.147	0.043
39. Côte d'Ivoire	-0.054	-0.230
40. Gabon	0.082	0.397
41. Ghana	0.451	-0.443
42. Kenya	-0.105	0.361
43. Madagascar	-0.400	0.052

Table 4 continues

14 Again, it is notable that in the case of South Asia, Europe and Central Asia and Middle East and North Africa regions, five, three and three countries are included, respectively. The exception is Sub-Saharan Africa with 24 countries being included in the region.

Table 4 (con't)
Correlation analysis results

Country	Correlation coefficients between	
	FDI capital flows & IFC finance	GDP per capita & IFC finance
44. Malawi	0.366	-0.037
45. Mali	-0.316	0.438
46. Mauritania	0.145	-0.465
47. Mauritius	0.089	-0.608
48. Mozambique	0.117	-0.005
49. Nigeria	-0.211	-0.026
50. Rwanda	0.374	-0.233
51. Senegal	0.231	0.410
52. Seychelles	0.157	0.305
53. Sierra Leone	-0.091	0.456
54. South Africa	-0.508	-0.837
55. Swaziland	-0.150	-0.030
56. Togo	0.529	-0.414
57. Uganda	-0.873	-0.086
58. Zambia	-0.016	0.226
59. Zimbabwe	-0.007	-0.180
Regions		
East Asia and Pacific	-0.242	0.444
Europe and Central Asia	0.162	0.395
Latin American and Caribbean	-0.165	0.354
Middle East and North Africa	0.314	-0.125
Sub-Sahara Africa	0.234	0.414
South Asia	0.181	0.496

3.2 IFC capital flows and other foreign private finance: complements or substitutes?

A very central question in the present paper is whether IFC finance leads (and hence encourages or catalyses) other forms of foreign private finance or merely passively follows them. To test the above relationship we again use data on IFC capital flows to countries/regions (the share of IFC finance in GDP) as well as data on other private capital flows (the share of FDI from other sources in GDP) over the 1980-2000 period for the same group of 59 countries for which data are available. We conduct Granger-causality tests within a panel (see Attanasio *et al.* 2000 as well as notes to Table 5, for further details), over the same period for our panel of 59 countries. Results are reported in Table 5, and the emerging conclusion is that other private finances in the form of FDI do Granger-cause IFC finance but IFC private finance does not cause other FDI flows.

We also try to explore the direction of causation between the two variables within a panel of regions instead of countries. The results reported in Table 5 seem to suggest no causality between the two variables, namely IFC finance and FDI flows. In view of the disproportionate representation of countries in the five regions due to data problems, however, we conduct the same exercise for two regions, Latin America and Sub-Saharan Africa, for which a substantial number of countries are included in each region (18 and 24, respectively). Granger-causality test results for Latin America (Table 5) seem to suggest that IFC finance leads other forms of foreign private finance.

However, the above conclusion is region specific. Indeed, our Granger causality test for the Sub-Saharan Africa region suggests that FDI flows do cause IFC and not vice versa.[15]

Table 5
Causality analysis results

	Current and lagged (first-differenced) FDI values in IFC finance equation	Current and lagged IFC finance in (first-differenced) FDI equation	Current and lagged values of economic growth in IFC finance equation	Current and lagged IFC finance in economic growth equation
Panel of 59 countries	-0.2958 *	0.0022	0.4088 **	-0.0009
	(0.1326)	(0.0032)	(0.2124)	(0.0077)
Panel of 5 regions	0.1819 *	-0.0014	1.3948 *	0.0065
	(0.5287)	(0.0081)	(0.4134)	(0.0052)
Latin American region	-0.3198	0.0139	0.8706	-0.0098
	(0.2715)	(0.0086)	(0.5934)	(0.0132)
Sub-Saharan African region	-0.2521	0.0037	-0.0152	0.0302 *
	(0.1594)	(0.0069)	(0.0966)	(0.0145)

Notes: Standard errors are the figures reported in parentheses: * = significant at 5% significance level; ** = significant at 10% level.

Within this framework, IFC finance is deemed to have causal effect on the first-difference of FDI if (in column 1) the reported estimate is jointly significant. Also, FDI would be deemed to have causal effect on IFC if (in column 2), the estimate is significantly statistically. IFC is said to cause economic growth if (in column 3) the coefficient is significant. Finally, economic growth would be driving IFC flows if (in column 4), the coefficient of economic growth is significant.

3.3 IFC finance and growth: what causes what?

It would be of equal importance for us to know whether IFC finance leads economic growth or passively responds to economic growth. Initially, we conducted simple correlation analysis to shed some light on the correlation between IFC flows (the share of IFC finance in GDP) and GDP per capita for our panel of 59 countries.16 The correlation statistics reported in column 2 of Table 4, suggest a positive and varying degree of correlation in 30 countries in the sample. For the other half of countries in our sample (29), the emerging relationship, as expected, is negative with a varying degree of correlation. Correlation analysis by region was also undertaken and the results are reported in the bottom part of column 2 in Table 4. With the exception of the Middle East and North Africa region, there exists a clear positive correlation between the two variables in all regions with the degree of correlation ranging between 35 per cent (Latin America) and 49 per cent (South Asia).

In view of the descriptive nature of the above type of analysis, however, Granger-causality tests were also carried out to explore further the IFC finance-growth relationship. In columns 3 and 4, first row of Table 5, we report the Granger-causality

15 However, the results should be treated with caution in view of the low significance of coefficients for both regions.

16 The data on FDI and GDP, GDP per capita and GDP growth are obtained from World Bank (2001). GDP per capita is based on purchasing power parity (PPP). Annual percentage growth rate of GDP at market prices is based on constant local currency. Aggregates are based on constant 1995 US dollars.

test results for our panel of 59 countries. The emerging conclusion is one-way causality, with the direction of causation running from GDP growth to IFC finance (IFC's finance share in GDP) and not vice versa. The above finding is also confirmed within the context of our panel of regions (see columns 3 and 4, second row of Table 5).

Finally, in line with our previous methodology, we tested the above relationship for the Latin America and Sub-Saharan Africa regions which are better represented (18 and 24 countries, respectively) compared to the other geographical regions. Results related to the Latin American region (columns 3 and 4, third row of Table 5) seem to suggest lack of any causality between the two variables, however. In the case of Sub-Saharan Africa (columns 3 and 4, fourth row, Table 5), IFC finance does cause growth and not vice versa, thus clearly indicating that causality between the two variables is region specific. The finding for the Sub-Saharan Africa region is quite interesting though since it indicates a positive role for IFC finance in the region and a clear potential for a much more significant role in the future.

4 Criticism, recommendations and the way ahead

Of particular relevance to the present paper is the Meltzer Commission's recommendation regarding private sector financing from the MDBs, and in particular about the future of IFC. The Meltzer Report recommends that private-sector involvement by the development institutions should be limited to the provision of technical assistance and the dissemination of best practice standards. Investment, guarantees, and lending to the private sector should be halted. The Commission's view for IFC in particular, is that the Corporation should be merged into the World Bank (the 'world development agency'), to more closely integrate its function into the Bank's activities. Equivalent changes should be made at the regional agencies. The IFC should also become an integral part of the redefined 'world development agency'. Its capital base would be returned to shareholders as existing portfolios are redeemed. The U.S. share of the IFC's US$5.3 billion capital is US$1.3 billion (Meltzer Report 2000).

Another wave of criticism of IFC's activities came from *The 50 Years is Enough!* campaign at the spring meetings of the World Bank and IMF in April 2000. The campaign urged the abolition of the Corporation, charging that:

> They pay almost no attention to who actually benefits from the profits that they claim to generate. They support Domino's Pizza in South Africa and cable television in Brazil. They invest in breweries in Romania, Russia, Tanzania and the Czech Republic, expensive private schools in Pakistan and Uganda, and luxury hotels in Egypt, the Maldives, Vanuatu, Costa Rica and Mexico.

The IFC's reaction, through its IFC's NGO relations team, to the above was that:

> IFC, through advice and direct investments, seeks to reduce poverty by helping direct private resources toward activities that benefit the poor by growing businesses that earn their way and empower and employ people. It said that the IFC plans further work on promoting environmental, social and corporate governance standards.

Alex Wilks of the Bretton Woods Project argues that:

> ... despite various strategy and policy restatements over the years the IFC still appears to operate without any clear methodology for estimating or evaluating development impacts. Moreover, the IFC has no mechanism in its project cycle to articulate the intended development impact of a given project. Without such a mechanism, the IFC is unable to factor development effectiveness into either project design or implementation. Thus, on the evidence available outside the institution it is hard to conclude that it has a clear approach to selecting projects that will maximize benefits for poor people and the environment (Wilks 2000).

Some observers think that closer cooperation between IFC and the World Bank in drawing up country assistance strategies, designing sector strategies, and crafting the private sector development strategy may help the IFC to support sectors and initiatives that are most appropriate for the poorest. This is basically the argument behind the recommendation of the Meltzer Commission for IFC. Others fear that the Bank and IFC together will persuade governments to privatize strategic sectors, regardless of whether this is the best option for the poorest. There is also concern about conflicts of interest. Where the IFC has merged departments with those in the World Bank, the same group of people will be advising governments on privatization and regulation strategies as well as discussing private sector investment plans in the same sector (Wilks 2000).

On the basis of the detailed discussion of IFC's activities, portfolio, evaluation procedures and strategic priorities, as well as our econometric analysis in section 3, our view is that the above criticism of IFC's investment activities is devoid of sound arguments for IFC's work. Furthermore, Meltzer Report conclusions about IFC are not based on an in-depth discussion of IFC activities, contrary to what is the case in the Report regarding the World Bank, the IMF, the WTO and the BIS.

The IFC has taken a number of efforts since 1998 to address many of the issues of particular importance for the institution. For example, sustainability has recently emerged as a key priority for IFC, and an increasingly important way in which IFC can support member countries' sustainable development efforts and add value to clients. Examples include concentrated efforts to ensure that large projects are no longer carried out on an 'enclave' model, but are closely 'linked' to the local economy: this, according to IFC, broadens the benefits of these investments, and at the same time reduces risks for investors. IFC further argues that IFC's ability to help firms in the management of environmental, social and governance risks as well as responding to demands for IFC's expertise in local capacity building and extending benefits to local communities, increasingly differentiate the IFC from other lenders. Its expertise in these areas enables it to take on large, risky projects which others avoid (IFC 2002b).

Furthermore, on the basis of the evaluation findings regarding IFC investment activities (see section 2), the OEG of IFC recommends that it should:

- Enhance measurement of its performance against its mission by introducing a system that tracks the development of its portfolio and investment outcomes and IFC's operational effectiveness. As it relates to development outcome measures, this system's measures and IFC's evaluation methodology should be closely aligned;

- Pursue a corporate objective that focuses on achieving successful investment outcomes *and* development outcomes. To this end, strategies and strategy-linked budget allocations should consider investment and development results patterns by sector and country risk/income group;

- Expand training programmes for core investment and development skills in project screening, appraisal, and structuring, and project supervision. Such training programmes should strengthen the rigour of economic analysis and the appraisal of sponsors, markets and competition. They also should increase the profitability of equity investments, for example through greater use of quasi-equity in financial structuring; and

- Extend credit lines to financial intermediaries in projects in which IFC's role is strong and it can contribute to needed capacity building that is identified at appraisal (OEG 2000).

On the basis of the discussion of IFC's activities as well as recent efforts undertaken by IFC (see section 2), our own view is that the Meltzer Report is not entirely right in its recommendation for the merger of IFC with the WB: IFC's semi-independent status gives it flexibility, comparative advantage, and a distinct role regarding private sector financing which will be lost in the case of a merger with the World Bank.

Our empirical analysis in section 3 suggests, however, that IFC's claim regarding 'a focus on frontier markets' is not fully supported by available data. Our correlation analysis suggests that this is the case in only half of the countries included in the sample. A focus on countries with little or no capital is confirmed, however, in the case of the East Asia and Pacific region and Latin America. Furthermore, in view of the Granger-causality tests employed in the previous section, there seems to be no clear evidence regarding IFC's role as a catalyst in the area of private sector financing. The results are again mixed and region specific, thus leaving little room for generalization. Finally, a positive growth effect of IFC finance was found in the case of the Sub-Saharan region, which has not been confirmed, however, in the rest of the regions.

Nevertheless, even in view of the rather mixed results above, it would be fair to say that IFC has played an important role in the area of private sector financing in many developing countries and this should be continued in view of depressed capital flows, volatility of private finance, macroeconomic instability, etc. in international capital markets.

It is also true that until very recently, IFC's primary focus has been on emerging markets. Therefore, critics of IFC may be partly right in the sense that by doing so, IFC seems to have neglected low-income countries. Furthermore, and in relation to the previous point, IFC's claim regarding an emphasis on high-impact sectors is debatable, at least for the poorest of developing countries. More precisely, it could be well argued that financial markets, infrastructure and ICT are not necessarily the most important impact sectors in economies bedevilled with famine, conflict, epidemics, etc. as compared, say, to substantial improvements in agriculture (an area IFC rather seems to neglect). Having said this, however, it would be rather fair to argue that currently IFC is moving towards the right direction (and balance) in view of its growing attention and focus on high impact sectors in both middle and low-income countries. At the same time, it has been trying to assess performance by also looking at the development impact of its projects in developing countries.

In our view, a key problem of IFC seems to be the conflict of interest between two rather different objectives, i.e. improving its profitability (absolutely reasonable objective for a semi-private bank like IFC) and at the same time strengthening its developmental impact (of crucial importance if IFC wants to be identified as a development bank with a mission ‘to promote private sector investment in developing countries, which will reduce poverty and improve peoples' lives’ (IFC 2001a). Our own view is that IFC should give more focus to its developmental role, trying at the same time to operate with reasonable profits. There are a number of arguments, however, against the above recommendation, some of them already mentioned in section 2. It has been argued, for example, that IFC invests on a parallel basis with other financiers, always taking a minority position, and generally only providing 20-30 per cent of the financing needed. The returns IFC earns are tied to the returns on the project with adjustment only for the nature of the risks for IFC’s share in the investment package (i.e. equity vs. loan, senior loan vs. junior loan etc.). Furthermore, the returns that IFC’s B-loan partners earn are quite explicitly tied to the returns IFC earns on its A-loans.[17] Along these lines, to argue that IFC supported projects should earn a return less than what private financiers could earn on 100 per cent private projects would be to argue that either IFC (along with its B-loan partners) accepts a sub-par portion of the project returns (which has not been IFC policy), or the IFC funded-projects are sub-par projects (i.e. they do not earn a return commensurate with the risk). Neither should be the case, however, according to IFC (Lysy 2001).

Lysy (2001) has recently argued that IFC should concentrate on areas of demonstrated competitive advantage. It has been particularly argued that IFC’s competitive advantage derives from its unique status as a global multilateral institution and the value of IFC’s involvement in an investment stems from this. Along these lines, IFC needs to build the skills that are important to the exploitation of the above competitive advantage and to seek projects where this competitive advantage is most important.

The discussion of IFC activities and investment projects in the present paper as well as the empirical analysis of the previous section seem also to suggest that at present, the main recipients of IFC’s investment are mostly middle-income countries and emerging markets. In view of that, IFC should try to re-direct its emphasis on low-income countries with weak prospects for private sector financing rather than to emerging and middle-income countries with better prospects and chances to attract private capital.

Overall, our view is that IFC plays a rather significant role in development financing in many developing countries, although its role as a catalyst in private sector development needs to be re-examined in view of the mixed findings reported in the previous section. Moreover, there is growing evidence that the IFC is now moving to new directions and sectors and this change of orientation will soon reveal some positive effects on the poverty reduction front. In view of the above, we do not personally think that IFC should be merged with the World Bank as the Meltzer Commission suggests. IFC is different in many ways from the other Multilateral Development Banks and we do not agree with the Meltzer Report that IFC should not retain its independence and

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17 See the discussion of IFC products and services above for a definition of A-loans and B-loans.

flexibility. Having said this, there are, however, important challenges for IFC to meet. These include, *inter alia*:

- Africa's share in IFC's investment commitments should be increased in view of the severe economic difficulties, weak financial systems and the rather poor prospects on the poverty reduction front. It is notable that in the fiscal year 2000, 80 per cent of IFC's approvals were in targeted sectors, and 40 per cent were in high-risk or low-income countries. However, our view is that IFC approvals in Africa and in low-income countries should be increased in line with the mission of IFC for poverty reduction.

- Until very recently, the share of IFC projects related to the social sector (education, health etc.) has been unacceptably low (about 2 per cent of the total). Although there is a clear indication from IFC's recent budget that the above share will increase in the near future, it is absolutely vital that future increases are sustainable and have the highest possible development impact.

- Related to the previous point, IFC also needs to define its strategic approach more clearly to promote poverty reduction and sustainable development. For a rather large group of low-income countries, emphasis on the financial sector and infrastructure (IFC's so-called 'high-impact sectors') is not necessarily what is needed at the moment. Financial markets, infrastructure and ICT are not necessarily the most important impact sectors in an economy bedevilled with famine, epidemics, etc. which, in the first instance, may have favoured measures to improve agriculture (an area IFC seems rather not to focus on at the moment).

- Need to reduce substantially its involvement in projects with rather ambiguous (or even minimum) development impact, such as hotel projects in middle-income countries and instead to re-direct its financing, expertise, efforts and products to projects with high development impact in low-income countries (particularly in the education and health sectors, microfinance institutions, housing, etc.).

- As the discussion of the profitability issue seems to suggest, there is a clear need to improve IFC's performance evaluation criteria by placing more emphasis on the developmental impact of projects rather their profitability outcomes.

- Last, but not least, organizational changes—like absorbing the private sector development department and activities of the World Bank—may be necessary if the IFC is to perform its important role more efficiently. Needless to say, IFC's possible expansion also raises budget issues and adjustment of donors' policy towards that option.

Finally, a number of fruitful avenues of research could be opened regarding future work in this important, though neglected, area. Obviously, the empirical analysis that was carried out in the present study, though important, is at this stage indicative only of the trend and the nature of IFC's capital flows to countries/regions. At the same time, our tentative conclusions, based on rather mixed empirical findings regarding the relationship between IFC finance and other private capital flows, should be treated with some degree of caution. A much more appropriate analysis for future work in this interesting area should involve, *inter alia*, the development and estimation of an allocation model for IFC capital flows (clearly beyond the scope of the present paper and also in view of data availability problems). Similar work on other private sector arms of multinational development banks could also be undertaken so that useful conclusions concerning the role of the above institutions in the area of development financing can be drawn.

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