

## SECTION I. THE EXTERNAL CONTEXT

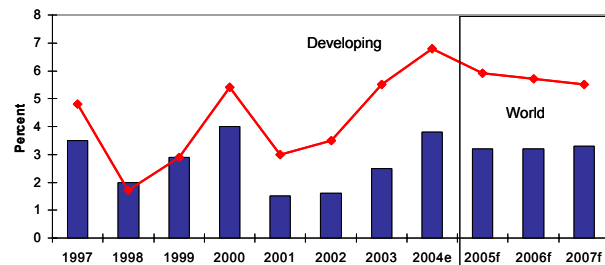
1.1 **Overview.** The external environment today for IFC can be characterized as one of great contrasts in an era of globalization. There have been unprecedented levels of overall growth in developing countries, but with great disparities in country progress and progress within countries. Substantial challenges remain in Africa, the Middle East and frontier countries, while middle income countries also have extensive poverty, investment shortages, particularly in infrastructure, and challenges of sustainable growth. International financial flows are at record levels, but the finance is primarily available for low risk countries and companies. It is now widely recognized that a vibrant and strong private sector is key to reducing poverty and improving people's lives in developing countries, but the development needs are immense and the efforts in private sector development must be accelerated. Critical for increasing the success of the private sector is improvement in the investment climate, including measures to reduce impediments for the private sector posed by corruption, implementation of public-private structures, and greater efforts to meet international standards in corporate governance, environmental and social activities. IFC is particularly well positioned to take a leadership role in the current environment. It has a solid track record of investments, leadership in sustainability and an extensive and growing capability in technical assistance and advisory work. It is the largest development institution focused on the private sector and part of the leading global development organization, the World Bank Group. Such a global, multi-faceted institution is what is required today.

1.2 **Strong Economic Growth in Developing Countries, but Challenges Remain.** Despite a modest slowdown since 2004, developing countries continued to enjoy strong economic growth in 2005, with average GDP increase estimated at 5.9%<sup>1</sup>, outperforming high income countries growing at 3.2% (Chart 1.1). The growth was not only coming from the so called BRICs countries (Brazil, Russia, India, and China) which have received so much attention, but was broad-based, including Africa and MENA with growth rates around 4.5% over the last two years (Chart 1.2). Although the pace of growth is expected to slow down in 2006, developing countries are expected again to expand more rapidly than high income countries.

1.3 The trend of more developing countries participating in world markets and in many cases becoming drivers of world economic growth heralds a new globalization era. However, as some countries have enjoyed the benefits of the favorable conditions for developing countries, others have been left further behind, creating a bipolar situation both at a global level and at the country level.

**Chart 1.1**

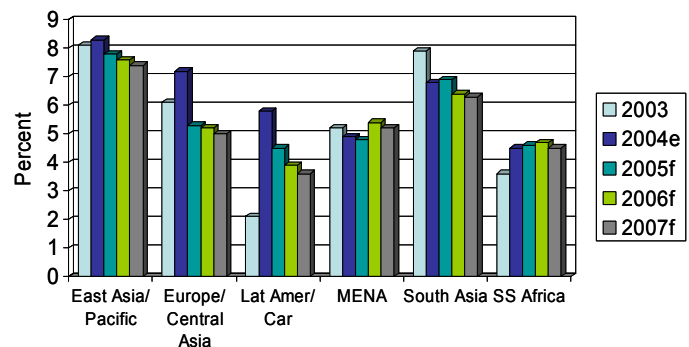
**GDP Growth, 1995 Constant USD**



Source: Global Economic Prospects 2006

**Chart 1.2**

**Annual GDP Growth Rates, by Region**



Source: Global Economic Prospects 2006

<sup>1</sup> Global Economic Prospects 2006.

**1.4 Widening Gap: Africa as the Development Priority.** While some countries have experienced real growth, the number of poor in Sub-Saharan Africa has doubled over the past two decades. Entrepreneurs face more regulatory obstacles on the continent than in any other region. According to the 2005 IFC/World Bank Doing Business Report, of the twenty countries with the most difficult business conditions, 80% are in Sub-Saharan Africa. In 2005 the G8 leaders pledged to support Africa's development and called for international coordination of increased assistance to Africa at the summit in Gleneagles, Scotland. The World Bank Group's response, the Africa Action Plan, recognizes the importance of a vibrant private sector as one of the key elements to strengthen the drivers of growth and development.

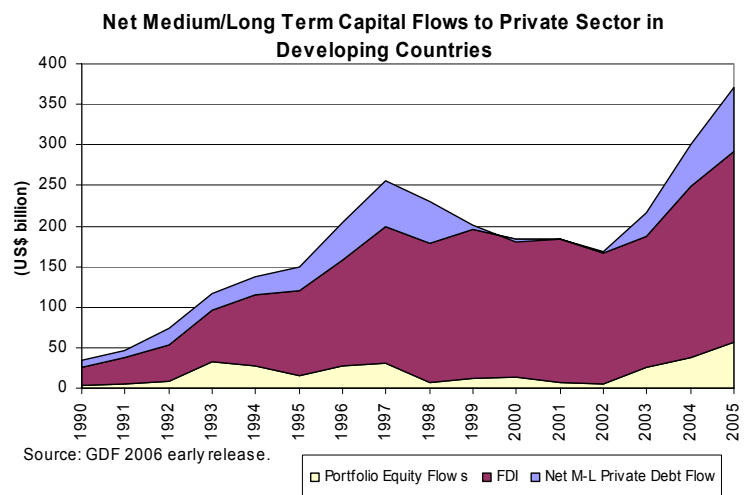
**1.5 MENA .** Countries in the Middle East and North Africa (MENA) region also have significant and widely varying needs. In this respect, the MENA countries can be grouped into three broad categories: i) countries with a lot of liquidity, but often with unsophisticated financial markets, which can benefit from TA and be a source of South-South transactions; ii) reforming countries with significant investment and TA needs; and iii) post-conflict countries which require substantial TA and foreign investment activity. Across the region there are large unemployment issues, particularly youth unemployment, and the region has low levels of foreign direct investment.

**1.6 SMEs.** Small and medium enterprises (SMEs) in developing countries continue to face particularly high constraints due to poor access to finance and other institutional obstacles. Yet thriving SMEs are important for development, they contribute significantly to local labor markets and they are a source of entrepreneurship and vibrant and competitive market activity. Investment climate and finance issues not only hinder SME growth but also affect the levels of informality in economies, which has impacts on country productivity and the social divide between formal and informal parts of the economy.

**1.7 Poverty and Investment Needs in Middle Income Countries.** Poverty and social challenges are still major issues in middle income countries. The total population living on less than \$1 a day in middle income countries is about 317 million, and 1,043 million on less than \$2 a day<sup>2</sup>. Socio-economic problems such as high unemployment, wide-spread social exclusion, large income inequality and inadequate social infrastructure are also present. Middle income countries continue to have great investment needs, such as in infrastructure. World Bank estimates, however, indicate governments are vastly under-funding infrastructure, which has serious implications for growth and poverty reduction. Private sector investment in infrastructure in developing countries, which reached over \$100 billion per year in the late 1990's, is also not filling the gap, having dropped to about \$60 billion per year.

**1.8** The private sector in middle income countries also faces growing issues related to meeting international standards in such areas

**Chart 1.3**



<sup>2</sup> Calculation based on the most recently available Poverty Data for each country using 2004 population

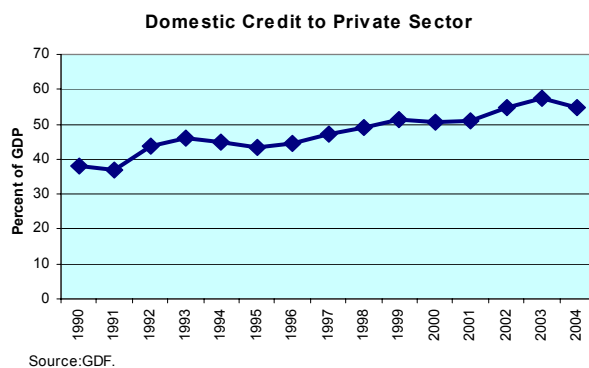
as corporate governance and environmental and social activities. These are important to accelerate the pace of growth, to minimize adverse effects on populations, promote social inclusion and provide access to product and financial markets.

**1.9 Private Sector as Engine of Growth.** For many countries today, private sector development has become a central theme in the development agenda. Sustained economic growth is critical for job creation and poverty reduction. In addition, a thriving, private-sector led economy is probably the best defense against corruption, as economies with broad private sector participation, active competition and clear rules have less scope for corruption. The private sector also has much to contribute to other government goals, via tax revenue, reaching out to local communities, setting international standards and working with government to extend infrastructure access.

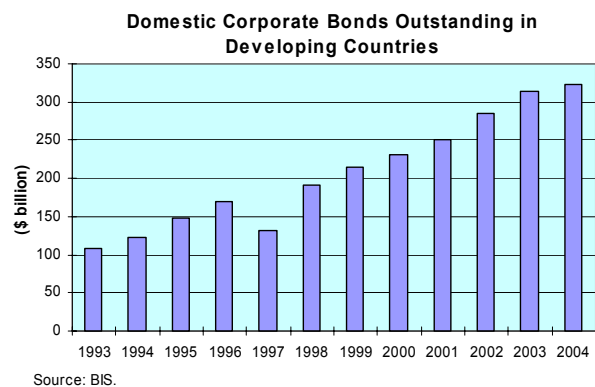
**1.10** International private sector financial flows play a major role in financing growth. Net private medium/long term capital flows to the private sector in developing countries reached a record high, estimated at \$375 billion, during 2005<sup>3</sup> (see Chart 1.3), exceeding the level attained in 1997. Both bond flows and bank lending to the private sector continued to grow. These flows significantly exceed international government loans and aid. Indicative of the overall liquidity in financial markets, sovereign international bond spreads in developing countries declined to historically low levels at 183 basis points in early March<sup>4</sup>.

**1.11** Domestic banking systems in developing countries have also continued showing improvements, with better asset quality, higher return on assets, and higher levels of domestic credit<sup>5</sup> (Chart 1.4). Domestic bond markets have also expanded, with more sovereign and corporate bond issuance in local currencies contributing to a deepening of the financial markets (Chart 1.5). A stronger domestic financial services sector is strongly associated with improved growth and enhanced poverty reduction, and can also improve income distribution. Other important parts of the financial services sector from a development perspective include SME finance, microfinance, housing finance and securities market development.

**Chart 1.4**



**Chart 1.5**



**1.12 Long-term Capital Availability Still Limited for the Higher Risk Clients.** Despite the strong growth in international and domestic finance, there remain significant limitations for companies with respect to access to finance. In the case of international finance, most loan syndications go to non-frontier countries (see Chart 1.6). In addition, the greatest portion of international bank lending to the private sector in all developing countries is primarily in short to

<sup>3</sup> Global Development Finance 2006 early release.

<sup>4</sup> JP Morgan Chase EMBI Global Index.

<sup>5</sup> IMF Global Financial Stability Report.

medium term maturities (see Chart 1.7)<sup>6</sup>. Long-term international lending is still difficult to obtain for many companies unless there is support from an international financial institution like the IFC. For international syndicated lending with maturity of five years or longer, more than half of the deals in 2005 were supported by the participation of an official international financial institution. Access to long term finance is also generally far more limited for companies outside the top tier of corporate and financial institutions in developing countries. In the case of domestic finance, the capability to issue domestic bonds continues to be quite limited to certain countries and top tier companies, while long-term finance from domestic banking sectors remains underdeveloped in a great many of IFC's client countries.

Chart 1.6

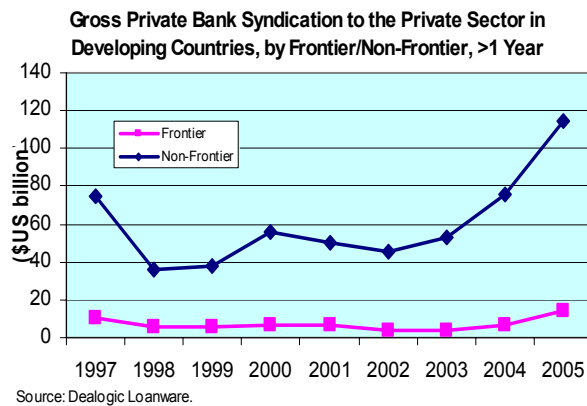
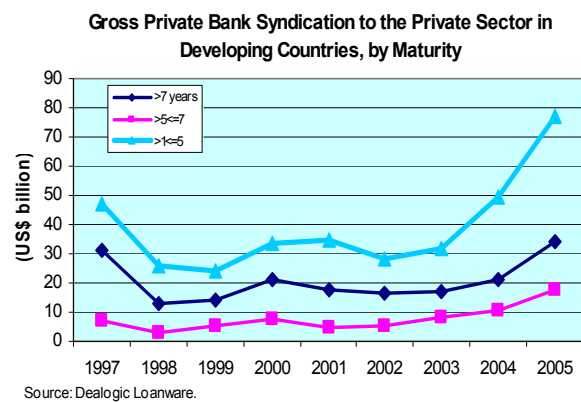
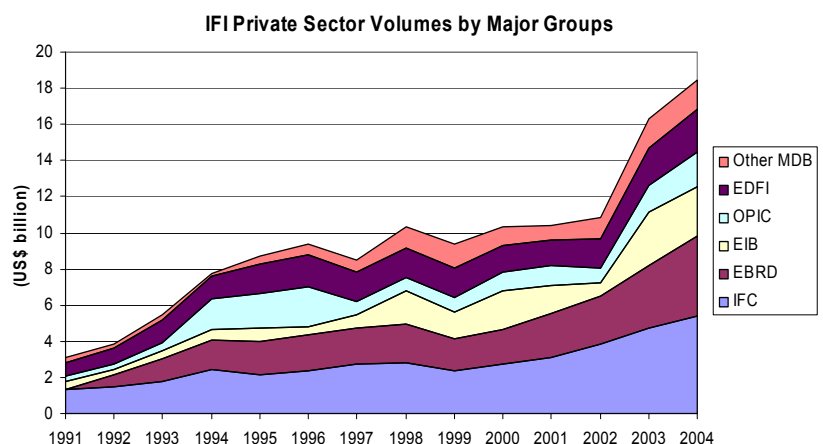


Chart 1.7



**1.13 IFI Finance Growing, Enhancing Private Flows.** International financial institutions (IFIs) have continued to increase support to the private sector in developing countries, to help extend the reach of private finance to higher risk and innovative projects. As shown in Chart 1.8, IFI flows to the private sector have reached significantly higher levels in the last few years, and preliminary data for 2005 indicate a continuing strong trend. Of particular note in the last year has been the increased use of alliances to improve performance, especially among the European institutions. In addition, there have been increased activities involving the IFIs and public sector agencies for TA and other funds, such as support for IFI private sector and infrastructure programs in Africa by the European Union and the Japan Bank for International Cooperation. IFIs are also providing a more varied set of product offerings, including new approaches in trade finance, equity and local currency financing.

Chart 1.8



**1.14 Need for Effective Public-Private Cooperation.** Investment climate issues remain a critical barrier to investment in many of the countries and sectors where finance remains scarce. This continues to be evident from the World Bank's and IFC's investment climate work such as in the

<sup>6</sup> Calculation based on Dialogic Loanware.

*Doing Business* reports and Investment Climate Surveys, and in the IEG evaluations of IFC activities (see Box 3.5). Solutions to these issues require effective changes in government policies. In infrastructure, independent private provision has become difficult, especially in certain sectors such as water and power where there are great social sensitivities and limited potential to support foreign currency-denominated loans. Yet the investment requirements go beyond the capabilities of many governments. More innovative projects need to be developed that combine aspects of private discipline and private finance with public support to address the social issues.

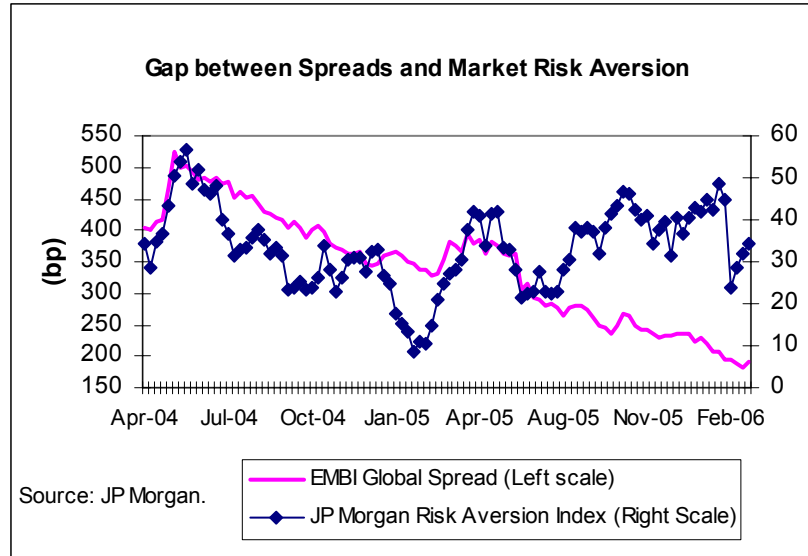
**1.15 Need for Advice to Develop Projects and to Meet International Standards in Corporate Governance, Environmental and Social Activities and Anti-Fraud and Corruption.** Companies in higher risk environments or sectors often need assistance to develop projects, work with governments or develop innovative project structures. They also often need assistance in corporate governance and environment and social dimensions. These issues have become critical for companies seeking local support and export opportunities, and seeking to enhance their ability to raise capital. In the most recent IFC Client Survey, environment, social and corporate governance factors showed the largest gain as reasons clients chose IFC. Clients also valued IFC's technical assistance and advisory services and those who received TAAS along with investments are far more satisfied, and show greater inclination to engage with IFC again, than those clients who did not receive TAAS.

1.16 An area of increasing importance for private sector companies is meeting evolving international standards in anti-fraud and corruption. The corrosive effects of corruption on growth are well documented and corruption is also among the major constraints hindering the private sector as reported in the World Bank's investment climate assessments. Leaders in the developing world, including senior management of private sector corporations, are increasingly taking this issue seriously. For instance, over ninety companies from both developed and developing countries have signed the recent World Economic Forum-sponsored principles under the *Partnering Against Corruption Initiative (PACI)*.

**1.17 Market Risks Remain.** The continued overall buoyant growth and access to international finance in developing countries is subject to a number of significant risks, as world inflation is slowly increasing and global interest rates are set to rise. There are already indications that current interest rate spreads for developing countries may not be sustainable (see Chart 1.9). High oil prices are harming low-income oil importers, while possible lower commodity prices may impede commodity-exporting countries. Global imbalances in current accounts and capital flows also pose risks to the stability of financial markets and global trade.

1.18 Other risk factors that could reverse the current global picture include unstable political situations in some areas of the world, potential threats from perceived increasing inequality, as well as the threat of global pandemics such as avian flu.

Chart 1.9



**1.19 Implications for IFC.** The ascendancy of the private sector in the development agenda, coupled with the complexities and challenges of the current environment, has broad implications for IFC. Development institutions with the means and experience to promote the private sector are becoming essential to help developing countries move forward. But these institutions also need to be prepared to address issues beyond traditional private sector finance:

- To provide expertise for clients on sustainability and corporate governance issues, and more broadly to provide leadership in global standard-setting, including private sector approaches to making advances in anti-corruption issues.
- To engage with both governments and the private sector on the critical improvements needed in the investment climate.
- To work with government and private participants to develop innovative public-private structures in infrastructure and the social sectors.
- To be pro-active in developing projects in difficult climates, providing needed technical assistance and expertise.

**1.20** This is where IFC can play a leadership role. It has a long and successful track record in private sector investments and has a program for enhancing its strengths through greater client focus and decentralization, through expertise in corporate governance and sustainability and through development of extensive technical assistance capabilities. It is the largest development institution focused on the private sector, with extensive global presence. In addition, it is associated with the pre-eminent global development institution with unparalleled expertise and presence in developing countries, the World Bank Group. Such a global, multi-faceted institution, which plays the role of catalyst for progress through the private sector, is what is required today.

**1.21** Given the immense development needs, leveraging partners will be critical, starting with closer work with the World Bank and MIGA to scale up impact, and also leveraging partners in the financial markets, such as the Equator Principle Financial Institutions, as well as donors and other IFIs. IFC must also continue to focus on better serving its private sector clients – its primary development partners – with continuous improvements in operational effectiveness.