I. INTRODUCTION

1.1 This Background Paper accompanies IFC's Road Map, FY09-FY11 and forms the foundation for IFC's proposed strategy in the Road Map. This Background Paper is divided into seven sections. Section II discusses the external environment. Section III provides important information on IFC's progress - in development impact, World Bank Group Cooperation, advisory services, measurement, the equity strategy, risk management and the Corporation's five priorities. Section IV presents IFC's proposed approach to climate change, which will be discussed with the Board at a Technical Briefing towards the end of February. Section V presents the regional strategies and Sections VI and VII show frontier regions in non-IDA countries and the Corporate Scorecard, respectively. Readers are encouraged to read both documents together and to take into account the rich information presented in this document when reviewing the proposed IFC strategy in the Road Map.

II. EXTERNAL ENVIRONMENT

OVERVIEW

2.1 A strong private sector is now widely seen as the engine of growth and job creation as well as an agent of opportunity. Yet the private sector remains weak in many of the neediest countries and its benefits are not reaching large parts of the population even in the more advanced developing nations. Many of the challenges can best be met by a combination of public and private solutions, and as a member of the World Bank Group, IFC is well placed to play a leadership role in the development of a strong private sector.

2.2 This will require IFC to advance in frontier markets and sectors during a time when the global economy faces significant risk. At the same time, IFC may be asked to play a greater counter-cyclical role. The Corporation is also being asked to place an increasing effort on addressing global public goods, such as climate change. Thus the demands on IFC's capabilities and resources are expected to be substantial, and the Corporation must focus on those key priorities where it provides the greatest impact, while soundly managing the risks it faces.

ROLE OF PRIVATE SECTOR DEVELOPMENT

2.3 **Private Sector, Growth and Poverty Reduction**. A strong and vibrant private sector is a critical agent for growth, as well as job and wealth creation. Sustained growth in turn is closely associated with poverty reduction: fast growing developing countries are also reducing poverty most quickly[1]. Over the past several years, the role of the private sector in development has been increasingly recognized as critical. Governments have also recognized the importance of creating the necessary foundations for successful businesses, such as functional infrastructure and regulatory reforms that create a supportive environment. The joint IFC/World Bank Doing Business report shows that more governments have undertaken private sector reforms to catalyze growth, through simplified business regulations, strengthened property rights, eased tax burdens, increased access to credit, and reduced cost of trade. Also importantly, openness and a dynamic export sector – achievable by effective public policy making and vibrant private enterprises – have attracted renewed attention as a key for growth and employment.

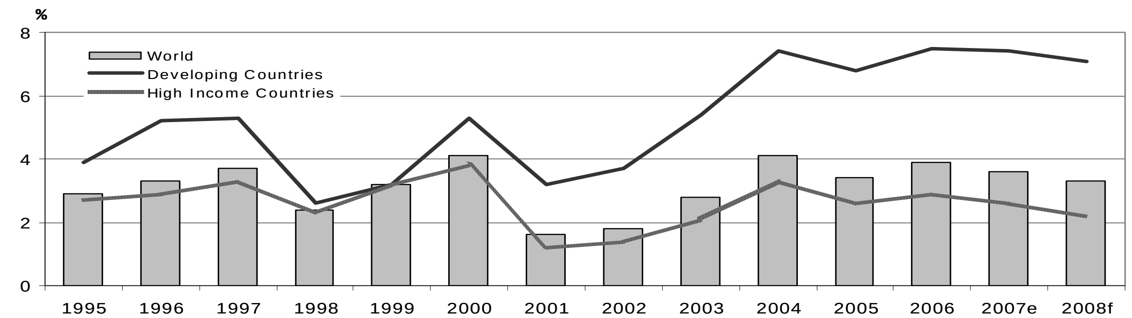
GLOBAL ECONOMY WITH UNCERTAINTY

2.4 **After Strong Growth, Heading to Slowdown**. After an extensive growth period, the global economy shows clear signs of slowing down. In 2007, the sub-prime crisis triggered a credit crunch in the U.S., severely reducing liquidity. High energy prices and faltering home values have made highly-indebted U.S. consumers tighten their spending, leading to a potential fall in consumption,

[1] Finance and Private Sector Development publication, "Private Sector Development for the Poor", October 19, 2007.

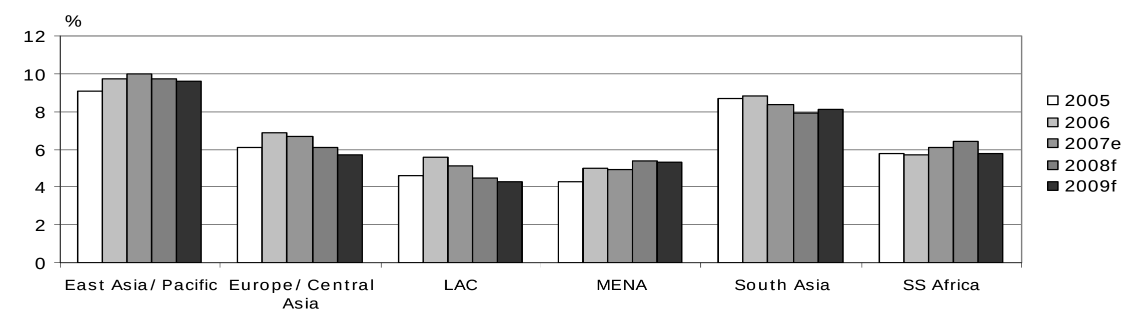
an overall slowdown of the U.S. economy and prospects for weaker global demand. As a result, the average world Gross Domestic Product (GDP) growth rate in 2007 at 3.6% is estimated to be somewhat lower than in 2006 and will continue to decelerate into 2008. The only high growth area thus far has been in developing countries. The growth rate for developing countries in 2007 is estimated at 7.4%, following the high growth level of 7.5% in 2006, while the combined growth rate in 2007 for High-Income Countries was 2.6%, down from 2.9% in 2006 (Chart II-1)[2]. Two developing regions showed higher growth rates than in 2006: East Asia again grew strongly to reach 10% and Sub-Saharan Africa grew strongly at 6.1%. Other developing regions also saw firm growth albeit a moderate slowdown in 2007 (Chart II-2).

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



Source: Global Economic Prospecs 2008.

Chart II-2: Annual GDP Growth Rates by Region



Source: Global Economic Prospecs 2008.

2.5 **Private Capital Flows Peaked with Slowdown in Sight.** The strong growth in developing countries continued to attract capital flows over 2006 and 2007. Private to private capital flows reached $620 billion in 2006[3], and are expected to have reached a peak in 2007. According to UNCTAD, Foreign Direct Investments (FDI) to Africa surged, though mostly concentrated in the oil and gas sector[4]. Private equity funds investing in developing countries raised $33.2 billion in capital commitments in 2006, a 29% increase over 2005 and more than five-fold increase over the amount raised in 2004, with Africa experiencing the highest growth, although there was concentration on South Africa[5]. By contrast, net Official Development Assistance (ODA) fell by 4.5% in 2006 to $104.4 billion, after the exceptionally high 2005 ODA amount driven by debt relief[6]. Private capital flows in 2008 are expected to be in similar ranges but somewhat lower than in 2007[7].

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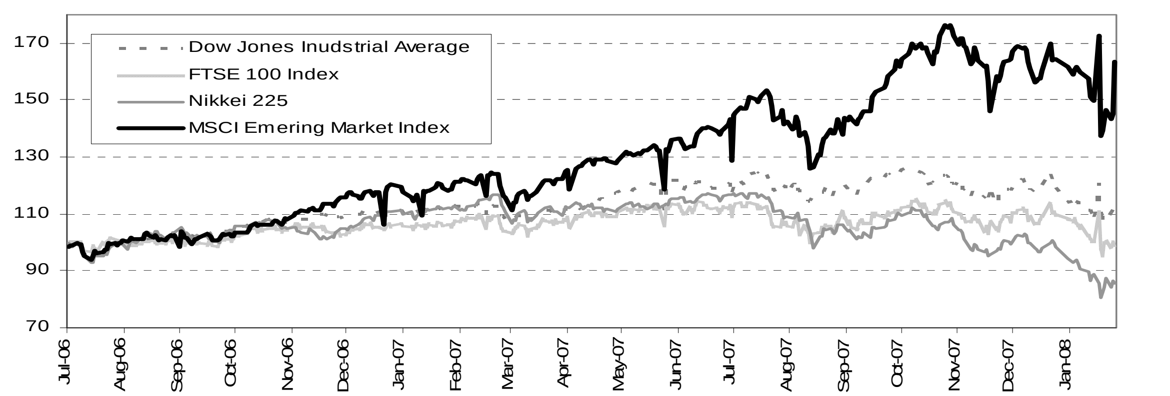
[2] Global Economic Prospects 2008.
[3] IFC estimates based on DECDG data.
[4] UNCTAD, World Investment Report 2007.
[5] Fundraising Statistics for Emerging Markets Private Equity 2006, Emerging Markets Private Equity Association.
[6] OECD, December 10, 2007.
[7] Institute of International Finance.

2.6 **Much Uncertainty Ahead Despite the Resilience Developing Countries Have Shown.** Developing countries have so far shown resilience despite the financial market turmoil. Emerging market equity indices have outperformed mature market indices in October and November. Sovereign spreads have moved more moderately than spreads on high yield securities in developed countries (JP Morgan EMBI Global Index). This reflects significant improvements in fundamentals in developing countries, with improved policies, strong external financial positions, and strong domestic demand. Nevertheless, the outlook for the global economy and developing countries remains uncertain and contains considerable downside risk. For example, high commodity and food prices are creating inflationary pressure, casting a shadow over the growth prospects in developing countries. The increased volatility in the financial markets may trigger corrections in some countries, particularly those with large current account deficits or with a domestic banking sector with a high level of international borrowing. In the globalizing world, a shock in one part of the world can travel to other parts of the world faster than ever, as was seen in the sudden share price fall in January across the globe (Chart II-3). Indeed, tightening of credit markets has already been observed in countries in which IFC operates, and these are signs that liquidity is diminishing. The Bank for International Settlement (BIS) also reports that in as early as the third quarter of 2007, bond and note issuance in emerging economies declined more severely than in developed countries, with East Asia and emerging Eastern Europe affected most[8].

Chart II-3: Stock Indices Price (July 2006 = 100)



Source: Bloomberg.

UNMET CHALLENGES AND NEEDS

2.7 **Persistent Poverty and Uneven Development.** Strong growth in developing countries has brought down the percent of people living in poverty since 1990. However, progress has been far from even, with large regional disparities. Poverty was rapidly reduced in East Asia, but in South Asia the decline was not as rapid. In Sub-Saharan Africa, poverty levels rose from 41% in 1981 to 46% in 2001[9]. Middle Income Countries (MICs) are still home to a significant share of people in poverty. In addition, the unemployment rate is still very high in developing countries and is worsening in some, while developed countries enjoyed a declining unemployment rate, from 6.4% in 2005 to 6.1% in 2006[10]. With respect to income distribution, although developing countries have seen overall positive income growth, income inequality has increased for many countries over the past two decades[11].

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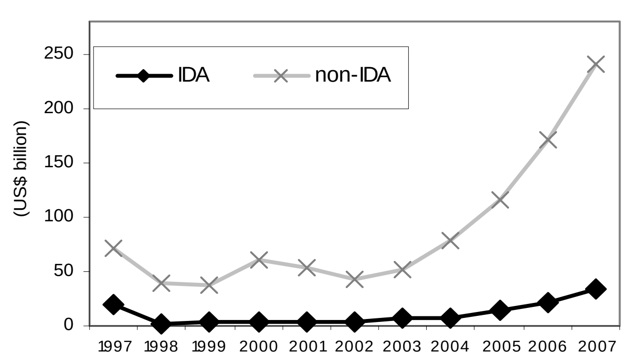
[8] Bank of International Settlements, Quarterly Review, December 2007.
[9] The World Bank, PovertyNet.
[10] United Nations, World Economic Situation and Prospects 2007.
[11] IMF, World Economic Outlook 2007, “Globalization and Inequality”.

2.8 **Large Financing Gaps and Unmet Private Sector Needs.** Across developing countries, huge investment needs remain for the areas critical to support growth. For example, Merrill Lynch estimates that $1 trillion per annum are needed for infrastructure investment in developing countries over the next three years. The financing gap remains large, estimated at 7–9 % of GDP compared to current spending at 3–4 % of GDP[12]. In the telecom sector, there is a 3-billion connections gap for both fixed and mobile telephone connections. A power crisis is still a reality in many lives in developing countries. Water as a scarce resource is increasingly becoming an issue, with greater innovation being requested to address supply problems[13].

2.9 **More Capital Needed.** Despite the buoyant private capital inflows, there are tremendous underserved investment needs in developing countries. International loan syndications are still mostly going to non-IDA countries (Chart II-4). Syndications to IDA countries have started to flow in since 2005, but over 80% of volume is in India, Indonesia and Nigeria. Where greater finance is now available it is still largely for lower risk projects, e.g. natural resource projects and top blue chip companies. In the banking sector, liquidity is already more constrained due to the recent financial sector turmoil.

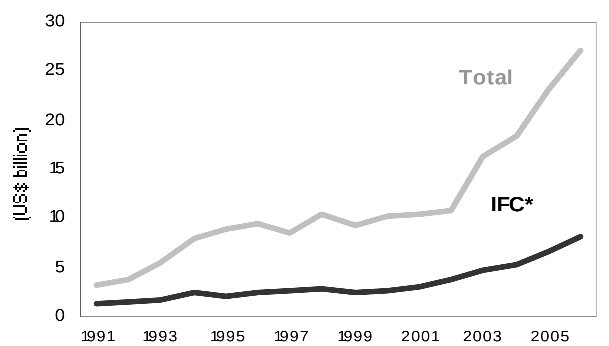
2.10 **Other Development Challenges.** Many other issues pose further development challenges. Climate change has become a major issue as countries face increasing pressure to mitigate greenhouse gas emissions and prepare to adapt to its impacts. Concerns remain over lack of access to clean water, sanitation and basic education, as well as public health issues including malaria, tuberculosis, and HIV/AIDS and nutrition. As many as 2.4 billion people are living without sanitation and 1.1 billion without clean water[14]. Lack of good governance, corruption and weak legal/judicial systems also hamper development. There remains an enormous need to improve business climate and access to finance for small and medium enterprises. Attention to global energy, food, and water security is increasing due to increased demand as well as supply constraints.

Chart II-4: Gross Private Bank Syndication to the Private Sector in Developing Countries, by IDA/Non-IDA Countries (loan maturity longer than one year)



Source: Dealogic Loanware.

Chart II-5: IFI Private Sector Volumes



Source: Annual Reports, IFC

** For the purpose of this chart, IFC's FY07 data is shown under 2006 and similarly for the other years.*

2.11 **Large Demands for International Financial Institutions.** Such needs and investment shortfalls can only be fulfilled with more private sector participation to supplement government efforts. Sharing knowledge of successful development approaches is also important. In many cases, the combined public and private solution is key, and International Financial Institutions (IFIs) are

[12] World Bank Group Infrastructure Action Plan Implementation Update, Technical Briefing, November 27, 2007. PPIAF, PPI Project Database.

[13] "Water Resources Sector Strategy: Strategic Directions for World Bank Engagement", The World Bank.

[14] The World Bank.

central in such efforts. IFIs are increasingly offering a mix of finance, knowledge and innovation, standard setting, and policy improvement. Demands for the unique competences that IFIs offer are increasing given the large unmet private sector needs.

2.12 **Private Sector IFIs Continued to Respond.** Private-sector oriented IFIs continued to scale up their activities (Chart II-5) The IFIs' private sector investment activity in developing countries increased to $27 billion in 2006 with bilateral European institutions showing the fastest growth. IFC's total share among IFIs increased in the Africa and Middle East and North Africa regions in 2006 to 39% and 59% respectively, from 31% and 34% in 2005. Regional development banks such as the Asian Development Bank and the African Development Bank expanded their private sector operations significantly. Innovation continued, with increased equity investments, climate change-related energy programs, and trade finance programs. New partnerships were formed, such as between Citibank and the Netherlands Development Finance Company, Overseas Private Investment Corporation, and Commonwealth Development Corporation. Many IFIs have enhanced their ties with China by forging cooperation agreements, developing energy programs, inviting China to membership, or organizing high profile meetings. Preliminary estimates indicate yet another year of strong growth for private sector IFI activities in 2007.

IMPLICATIONS FOR IFC

2.13 **Changing Needs.** The changes in the global landscape have many implications for IFC's operations. First, the great challenges for people in poverty in developing countries, their unmet needs, and the increasing importance of private sector development present substantial opportunities for IFC to assist the private sector, to create opportunities for people to escape poverty and improve their lives. This continues to drive IFC to enhance its effectiveness in private sector development. It also requires IFC to keep on addressing the investment needs in frontier markets while continuing its innovation in adding value by offering integrated investment and advisory services.

2.14 Second, the increased uncertainty to the growth prospects of developing countries is pointing to a need for IFC to be prepared for operating in a counter-cyclical mode. In financial markets, the full magnitude of the recent crisis is yet to unfold, the possibility of problems in a key financial system remains. In many markets in which IFC operates, the tightening of credit conditions has already been observed. While IFC is ready to play its counter-cyclical role (as discussed in the IFC Road Map, FY09-11), there are challenges in the areas of capacity and risk management, and in the magnitude of the next downturn which may significantly impact IFC's ability to address demand on multiple fronts – advancing in the frontier to serve people in poverty while also supporting the private sector weather counter-cyclical conditions.

2.15 Third, the issue of climate change has become more widely recognized. The focus is now on actions toward adaptation and mitigation, for which collaboration between the private and public sectors in both developed and developing countries will be required. This presents a new set of challenges and opportunities for IFC.

2.16 **IFC Response.** IFC, as a member of the World Bank Group and as a leader and innovator in private sector development, must respond to these changes, and continue addressing the unmet needs in its markets. The uncertainty of the global economy may call for IFC's counter-cyclical role, while IFC will simultaneously assist the underserved and continue innovating in climate change-related activities. Playing such multiple roles would require focusing on key priority areas, prudent risk management, and leveraging the World Bank's strengths in the private sector. Demand for IFC services is expected to continue to increase. In this environment, choices must be made, and IFC will focus on areas where it provides the greatest additionality and development impact.