Center for Global Development

CGD NOTES

IDA Gets a Private Sector Window

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Those who watch IDA (the World Bank's International Development Association, which provides concessional lending to poor countries) have focused much attention on the quantum leap forward in IDA's 18th replenishment, which, for the first time, blends donor grant contributions with market-issued debt, secured by IDA's loan assets. With this innovation, IDA achieved its largest lending capacity in history—$75 billion.

But on April 11, IDA broke more new ground. It established a private sector window (PSW) with $2.5 billion in resources. For the first time, IDA will use public funds to catalyze private investments in poor countries, in addition to concessional lending to their governments. This is an idea proposed three years ago by Clay Lowery, visiting fellow here at CGD.

The World Bank partners in this effort—the IFC (International Finance Corporation), MIGA (Multilateral Investment Guarantee Agency), IDA, and their executive directors—should be commended for a well-conceived, careful, yet bold creation. It responds to stakeholders' desire to target the most challenging markets and tolerate risk. Success is defined as real development impact, using a robust results framework that includes outcomes for beneficiaries but also careful measurement of "additionality," the additional private investment that is mobilized thanks to the intervention of the PSW—in other words, what would not have occurred without the intervention. The heightened risk appetite is clearly seen in the financial arrangement between IDA and the PSW: the full value of the PSW will be deducted from IDA's capital in calculating IDA's sovereign lending capacity.

The PSW takes an approach that may appear obvious but is, in reality, trailblazing—it combines and amplifies risk-sharing and other tools across different the parts of the World Bank Group (WBG) for increased impact and probability of success. These include project development and firm capacity support, project-based guarantees, currency risk-sharing, and a public-private blended finance facility to help bring projects to commercial viability. Shared first loss coverage will be added to MIGA's political risk insurance. And the sovereign side of the WBG is to adapt its approach to country diagnostics and reform priorities to support PSW success in agreed sectors. Such collaboration has been rare to date, wasting what is the principal comparative advantage and strength of multilateral development banks (MDBs) and hobbling their ability to invest in frontier markets.

But is all this collaboration enough for real impact on private sector growth and development in the world's poorest and most vulnerable countries? It is hard to say at this point. Caution is certainly warranted given that MDB risk mitigation instruments have been around for a long time but still represent less than 5 percent of total MDB lending. Internal problems within MDBs complicate review processes and create staff incentives to stick to conventional loans. On the investor/firm side, issues of product complexity and slow delivery limit uptake.

Fortunately, there is scope within the PSW framework for future adaptation—e.g., new tools—in response to evidence, experience, and the needs of new markets. Going forward, the merits of four additions or modifications should be considered as the PSW begins operations and builds an evidence base.

The familiar MDB private sector principle of minimizing the use of subsidies and market distortions is embodied in the PSW. Subsidies are defined in a transactional sense—PSW subsidies are to be used to make projects with social returns viable that would otherwise be too risky or too costly. But a transaction-by-transaction approach should not be equated with making markets. We have seen that multiple MDB-supported transactions in the same sector do not necessarily change underlying market conditions and spur activity after MDB support ends. The use of scarce subsidy resources should therefore meet a more demanding test: they should target market-making impact and not just transaction viability. Such impact beyond the scope of the transaction itself could be judged by whether key market actors change behavior and business models, offer new products and services, and serve new customers; whether relevant activity is sustained, replicated, or scaled; and whether new players enter markets.

Second is the question of the extent to which subsidies should be deployed in the form of grants. The PSW offers expanded technical assistance grants to help build pipelines of bankable projects and strengthen firm capacity. But these do not directly address what is often the most fundamental problem: the absence of business models that work in poor countries. This problem has to be addressed by incentivizing innovation. Indeed, supporting innovation should be at the center of any effort to promote private sector development in poor countries. New business models, new product/service delivery channels, new payment systems, and new technologies are essential to achieve success in poor countries where the business models of advanced countries often do not succeed.

Grants at both the firm and market level are essential tools in supporting innovation for two main reasons: (1) almost by definition, non-grant risk-sharing tools are hard to construct for innovative models where there is great uncertainty on both the demand and supply side, and where some degree of failure is both inevitable and instructive; and (2) even if they could be estimated, the scale of first mover costs and risks is often too large to be borne by any individual firm or transaction. Examples of such first mover costs and risks include a lack of market infrastructure for new product/service delivery or payment; the costs of marketing and building demand for new products/services; and the costs of filling information and skill gaps to understand the behavior and preferences of new customers (e.g., women entrepreneurs) and how to serve them.

Third, to incentivize private investors seeking favorable risk-adjusted returns, the subsidies contemplated in the PSW so far largely target risk. They aim to partially protect firms and investors from failure. As Owen Barder and Theo Talbot of CGD have pointed out, it makes good sense to think instead about rewarding firm success. Ensuring revenue streams for firms in markets with development impact could provide incentives with a wider and longer-term market impact. Advance market commitments for example, establishing a prespecified payment for a well-defined outcome, have been used effectively in the health sector. Such commitments can help markets reach a commercially viable size, promoting sustainability after these payments end. They should be considered as an option in MDB private sector windows.

Finally, innovation does not happen initially at scale. It has to be piloted with a tolerance for failure and an ability to adapt to real-time data feedback. The emergence of "innovation labs" in the development finance world, including other parts of the World Bank, reflects that reality. The PSW as it is currently conceived lacks such a lab. This would seem a missed opportunity for a window that is focused on the most difficult markets. The balance sheet of the lab could be separated from that of the PSW, providing an additional way to manage heightened risk. The purpose of the lab would be to provide a stream of successful pilots that the PSW could take to scale.