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IFC 3.1?

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INTRODUCTION

The International Finance Corporation (IFC) is in the process of a considerable transformation, designed to grow its operations and expand their development impact. By 2030, the Corporation has committed that 40 percent of annual own-account commitments will be in International Development Association (IDA) and fragile and conflict-affected states, requiring a quadrupling of annual program delivery in those countries. In addition, the corporation has promised to invest more heavily in climate-friendly projects, as well as focus more on projects with the potential for significant development outcomes.

IFC's board and leadership understand that meeting these goals requires a change in the way that the corporation operates, and a number of recent reforms will help it to deliver. But while these reforms are a welcome start, the IFC will have to change further if it is to meet its targets and reach its development potential. This paper discusses the rationale and elements of that change agenda, focused on ensuring the IFC best serves its ultimate clients.

The traditional focus of the corporation is reflected in who it views as its customer. "Clients" in IFC parlance are companies, financial institutions, or other private enterprises. The IFC usually only refers to "client countries" in the context of technical assistance operations.[1] In order to scale the corporation's impact, the IFC should embrace the idea of dual clients for its investments: companies and countries. Companies would remain the recipients of project financial support, but low- and middle-income countries and the people in them are the ultimate clients, and sectoral transformation in service of sustainable development should be the IFC's goal. That is the goal that the reforms proposed in this paper are designed to meet.

The next sections discuss the need for reform and the IFC's existing reform efforts as well as some specific proposals for policy change at the corporation to help deliver on a transformative agenda.

MOTIVATION FOR REFORM AND RECENT REFORM EFFORTS

While the IFC has backed many hundreds of successful projects, its traditional model (largely reactive, focused on firms as clients) has struggled to achieve transformative impact in the countries and sectors where that is a plausible goal:

- The reactive model considerably limits the number of firms the corporation works with. The IFC is reliant on repeat clients for more than half of its commitment volumes.[2]

- IFC struggles to find new clients in poor and small countries in particular, in part because the existing pool of formal firms operating at scale in those countries is so small. In sub-Saharan Africa, outside of South Africa, there are only approximately 183 firms with revenues greater than $500 million, and even a large country like Ethiopia only has 43 firms which employ more than 500 people.[3] Total net foreign direct investment (FDI) into low-income countries (LICs) and lower-middle-income countries (LMICs) in 2017 was an average of less than $2 billion per economy, with a median net flow of just $375 million.[4] To quote the mid-term review of the World Bank Group's Private Sector Window (PSW) focused on IFC deals in IDA countries, "deal origination in PSW-eligible markets does not come easy."

- The portfolio is considerably concentrated in two sectors where there are existing large firms: banking and infrastructure.[5] In those sectors in poorer countries, there is a growing problem of development finance saturation. In 2016, looking at IDA-country deals with financing information in the World Bank's Private Participation in Infrastructure database, 61 percent of finance was provided by multilateral and bilateral institutions and public financing institutions in the countries home to the investment. This problem will intensify as development finance institutions including the IFC are planning to double volumes in poorer countries.[6]

- Few project sponsors offering investment opportunities and development finance saturation in in poorer countries help explain why IFC's investments remain concentrated in countries where it is macroeconomically irrelevant. The largest investment totals are in India, China, Russia, Turkey, and Brazil, where IFC inflows are worth a few percentage points of total FDI flows. Meanwhile the share of IFC investments in IDA countries fell from 29 percent 2000–17 to 24 percent in 2019.[7]

- While the considerable majority of individual IFC projects have delivered development impact, it is much harder to find evidence of systemic impact at the sector level even in the largest business lines of infrastructure and finance. There is no relationship between IFC investments in electricity generation in a country and subsequent electricity consumption, nor between transmission and distribution investments and electricity access, nor between IFC investment in the finance sector and subsequent increases in account ownership or the number of bank borrowers.[8] In part, this will reflect the fact that in a primarily reactive financing model, it appears IFC involvement is not usually necessary for the project to go ahead, so that summed project development impact is considerably larger than IFC-specific impact.[9]

- More broadly, there is little sign of (potential) impact across client countries in these sectors. If anything, the trend in private participation in infrastructure in developing countries as a whole, or IDA countries in particular, has been negative since 2010.[10] Meanwhile the micro, small and medium enterprise finance gap is estimated at $5 trillion in low- and middle-income countries,[11] or about 264 times the IFC's total outstanding portfolio in finance and insurance.[12]

- The pressure to expand financing volumes under a primarily reactive model has been a force behind inappropriate use of (sometimes subsidized) resources to back deals that go against principles endorsed by the Bank Group. For example, unsolicited power deals accounted for an average of 37 percent of the megawatts IFC co-financed between 2015 and 2019.[13] This happened despite the guidance on unsolicited projects produced by the World Bank Group which notes they "face many challenges, ranging from explicit allegations of misuse of public resources, corruption, fraud and poor quality of the resulting infrastructure assets and/or services, to lack of competition."[14] The first two power projects supported by subsidies from the IDA PSW were both awarded non-competitively.[15] Subsidy use in these cases distorts, rather than creates, markets.

- Again, a focus on firms as clients rather than countries as clients has been a factor in support for projects with significant negative social and environmental impacts and slow response to concerns raised about those projects.[16]

Focusing on country and sectoral development needs and challenges, rather than on meeting the financing requirements of a comparatively small set of existing project sponsors, is the way that the IFC has demonstrated greatest impact in the past, and is the key to scaling both investment and impact in the places and the industries where there is the greatest need for the IFC's support. The corporation has undergone an important evolution towards that model under the IFC 3.0 strategy, re-orienting to a more deliberate and systematic approach to market development.[17] There are a number of elements to this reform including:

- Introducing IFC Country Strategies and country private sector diagnostics, strengthening collaboration with the World Bank on those strategies. The strategies will build off country diagnostics and evolve to propose specific projects that IFC can design from the ground up in response to identified development challenges for the country.[18] They will help drive country-driven budget allocation.

- Recognizing the upstream business development as a vital tool and hiring 200 staff primarily tasked with expanding opportunities for private investments through creating, incubating, or shaping high-impact projects.

- Committing to a specific focus on climate (with a goal of 35 percent of finance being climate related) and exploring a role in the support of other investments that might have considerable international spillovers including around pandemic response.

- Creating the Economics and Private Sector Development Vice Presidential Unit and introducing the Anticipated Impact Measurement and Monitoring (AIMM) framework, which embeds discussion of development impact, including spillovers beyond IFC's investment on structure and functioning of the market, into the project design and decision-making process as well as providing a tool to monitor performance during the life of the project.

- Committing to greater transparency and use of competition in the use of subsidies as well as caps on subsidy use.

- Moving towards a stronger safeguard system including greater independence, more rapid response, and remediation, as part of a comprehensive response to the External Review of IFC's/MIGA's Environmental and Social Accountability.[19]

The IFC should complete its evolution towards an institution dominated by a proactive project initiation approach that aims at global integration in IDA countries and global public goods in IBRD countries. That would allow for the possibility of working with more new project sponsors in a wider range of sectors. It would reduce the risk of development finance saturation and allow for a greater concentration of resources in the economies and sectors that could benefit from IFC support the most. In addition, by taking a strategic approach to investments that considers sectoral constraints as well as investments with considerable spillovers, the IFC considerably increases the chance that its financing leads to measurable development impact at the sectoral level. This would see project impact and IFC impact more closely aligned. And a deliberate approach of trying to maximize development impact (and minimize harms) should help target financing including subsidies to more efficient uses in projects with the potential for considerable positive development returns.

FURTHER EVOLUTION

The IFC's investment rationale has been primarily built around ameliorating failures in the market for finance, and its analytical and advisory work around fixing government failure—Inefficient or excessive government regulation or service provision. Both are valid roles, but we have seen that they have, first, largely constrained the institution to investing in projects which project sponsors are already available and primarily seek finance as an input from the IFC and, second, limited the organization's ability to explore a wider range of potential projects that might need launching or incubating to reach the investment stage.[20] Existing reforms will help shift IFC to a new model, but they should go further, building on examples of past success in creating markets and revitalizing sectors.

The IFC should use the analytical and engagement work underpinning the new country strategies, alongside expanded upstream staffing, to more actively seek out and develop specific sectoral opportunities where there is the potential to demonstrate if new economic activities can be profitable and spur development.

That will certainly include work in the IFC's existing primary areas of focus: financial sector expansion (support for a new mortgage market, as it might be) and support for sectoral development in infrastructure. The IFC's role in electricity in In Kenya and Uganda may provide an example to build on: the Bank Group worked together on sector reform and development, commercializing and strengthening the capacity of electricity companies, tariff and regulatory reform, and capacity building. The IFC also provided support for investments. National connection rates for electricity more than doubled during 1990–2014, along with improvements in consumption and financial viability. Both the Kenyan and Ugandan electricity companies are now listed on the Nairobi stock exchange.[21]

But perhaps the greatest opportunity for a new approach is in the sectors outside of these largest existing IFC portfolios, in particular industry, agriculture, and non-financial services, and in particular regarding export industries and those with a large global public good spillover.

In many IDA countries, where the IFC has the scale to be a major country partner in overall private sector development, strategies should be based around the ambition to build diversified and competitive export sectors, integrating into global supply chains. IFC's current focus leaves it largely absent from agriculture, manufacturing or service exporting industries (with some notable exceptions including recent projects around the cashew nut value chain in Cambodia and Cote d'Ivoire). But export-led growth appears to have been an important element in the success of many economies with particularly rapid development over the past few decades, including the East Asian "miracle" countries.[22]

In an environment of coordination and information failures there is a role to support the diversification and upgrading process necessary to participate in international markets.[23] "Miracle" countries coordinated complimentary investments and provided financial and technical support to encourage exports.[24] IFC could play a far greater role in providing its own analysis, financial, and technical support to export-led strategies in IDA countries.

The complex web of enabling factors that underpin export competitiveness and integration into global supply chains in a particular sector calls for a fine-grained analysis at the sectoral or sub-sectoral level going beyond broad categorizations and aggregations (measures of "human capital," national business rankings).[25] This analysis could help uncover both opportunities but also constraints that might be relieved by a separate IFC investment project and/or a concurrent World Bank (or other donor) activity.[26]

In some (perhaps many) cases, the analysis might conclude that structural factors preclude potentially competitive investments, but even in these cases detailed analysis will help build up a picture of which structural factors are most problematic.[27] This work should feed into IFC country strategies that lay out priorities for sector development and propose specific investment programs to be designed with the support of the corporation, rather than simply listing the current project pipeline.[28]

Subsequently, the IFC should work with client governments, domestic and international firms, and entrepreneurs, to develop these potential investments—both in tradeable industry and complimentary infrastructure—that could be delivered by the private sector. In some circumstances, this might involve working with (and/or helping to reform) national development banks, which (much like the IFC itself) tend to be focused on micro and SME finance alongside infrastructure[29] In others, it might involve incubating and spinning out project sponsor vehicles (providing a considerable and long-term stream of technical assistance and (where appropriate) finance to local entrepreneurs with the capabilities and ambition to scale their business).

With the leverage of financing, the IFC could ensure outside project sponsors were (where possible) selected using open, transparent and competitive/level playing field approaches and met minimum due diligence standards for IFC financing rather than opaque and non-competitive approaches that may support favoring connected firms or individuals.[30] In the case of manufacturing, service industries and agriculture this might involve cooperation with governments to put in place tax or other incentives along with a guarantee of IFC financing at scale (assuming firms pass reasonable profitability and due diligence hurdles).

There might also be a role for the use of subsidy mechanisms. Paul Collier, Neil Gregory, and Alexandros Ragoussis propose a model where having created a diagnostic of sectors most likely to develop clusters of firms in the near term the IFC provides subsidies to firms investing in those sectors through an open call for proposals and pro-active invitations to firms.[31] Competition is a particularly powerful tool to solve asymmetric information problems linked to providing subsidized finance—firms know the subsidy they require to execute a project, while investors do not.[32] Firms would be invited to apply for subsidized finance to create businesses in a particular cluster, with the firm submitting the proposal which requires the lowest subsidy as a proportion of IFC's investment (potentially alongside hurdle conditions including due diligence and employment creation) selected to receive the subsidy.

It should be noted that "picking (sub-)sectoral winners," as proposed above, has a distinctly mixed record in developing countries.[33] This speaks to the reality that any process of export diversification and integration into global supply chains will be one of searching as much if not more so than planning, and will require a high tolerance for failure in an environment which supports learning by doing.[34] This will likely reduce the corporation's average returns, but also speaks to the benefits of partnering with national development banks, alongside other development finance institutions, to diversify that risk. IFC could play a valuable role in developing performance criteria for continued or evolved support to a sector/industry in terms of early investment performance as well as drawing lessons from failure for future investments. The "traditional" (reactive) projects that remain in the IFC's portfolio should provide both market intelligence and an additional level of diversification.[35]

In larger, wealthier countries where IFC's investment activities will be comparatively marginal in scale compared to the overall economy, the institution could nonetheless play a valuable role in support of transformation and development in subsectors where there are particularly large global spillover benefits. This might include energy, low-carbon cement/construction, pharmaceutical production and migration/international education.[36] A similar combination of analysis of (sub-)sector/country specific constraints, technical assistance and support for firms through open and/or competitive approaches could prove transformational.

In some cases, this strategy might involve cross-country initiatives to back investments, building on the example of the World Bank Group's Scaling Solar. Under that initiative, the Bank Group works together to help countries prepare solar power projects, bid out tenders and provide finance to bidders. Recent Scaling Solar activities included working with Zambia's Industrial Development Corporation to competitively auction two large scale projects that garnered the lowest solar tariffs in Africa at the time (although note that use of subsidies may have created unrealistic expectations that these tariffs could be easily matched). In the area of international education/migration, the IFC might build on the model of the US Development Finance Corporation's investment in Prodigy Finance, which provides loans to finance MA courses, or work with governments and sponsor firms on creating skills partnerships which provide training to potential migrants in developing countries to help them meet the skills requirements of sponsoring firms in richer countries.

CONCLUSION AND POLICY RECOMMENDATIONS

The IFC has promised to significantly ramp up operations, in particular in the poorest countries and in the delivery of global public goods. It intends to do so by taking a far more proactive approach to project development. This is both necessary and beneficial: necessary to scale the pipeline of projects, and beneficial because it is likely to increase the development impact of those projects. This paper suggests pushing further and faster in the direction that the corporation is already travelling. Helping client countries to develop sectors alongside helping client firms deliver projects will allow for more transformative impact. The IFC should:

- Further develop sectoral analytical capacity and upstream project development including an expanded effort around enterprise surveys, constraints analysis, and development of specific industry expertise including firm management capacity.

- Move further toward a pro-active investment approach and fully embed investment decisions in country-sector strategies agreed in dialogue with client countries—in IDA countries towards export-led competitiveness, in IBRD toward global public goods. Work more closely with national development banks including on reform efforts. Consider incubating and spinning out project sponsor vehicles in select cases with a specific effort to identify local entrepreneurs with the capabilities and ambition to operate at scale.

- Shift the portfolio mix in IDA countries towards investment in tradeable manufacturing, services, agriculture and agro-processing, alongside infrastructure and services prioritized on their contribution to trade competitiveness and global value chain integration. Shift the portfolio mix in IBRD countries towards global public good provision including renewable energy, low-carbon construction and transport, pharmaceutical capacity, support for skilled labor mobility.

- Move further toward tolerance of failure by de-emphasizing returns as a project success measure and including incentives for groundbreaking deals in new sectors/ industries alongside development of metrics that encourage rapid exit from failing approaches or investments.

- Use subsidies solely in the selective, competitive, support of investments proactively chosen based on potential impact on sectoral development outcomes.

- Adopt a "first do no development harm" strategy: eschew projects that are not developed using best practice, including a soft ban on unsolicited projects that create government liabilities, and more fully integrate social and environmental safeguarding into the project development process and strengthen the independent oversight of safeguard policies and remedial action.

Much of the IFC's portfolio will remain reactive and non-competitive. But to the extent it can move further towards approaches that involve cooperation with host governments, and that are market making, transparent and competitive (in particular regarding subsidy use) the corporation's development impact will considerably increase.

In support of this agenda, IFC's shareholders should accept a proactive approach, which will involve a larger staff headcount and operating budget alongside potentially lower returns. They should also give the corporation the scale to play a significant role in global public good provision, potentially enabled by a climate-dedicated capital increase.[37] A larger IFC overall could simultaneously better absorb the risks of larger, more diversified portfolio in lower-income countries.

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ENDNOTES

1 https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/faqs
2 https://www.cgdev.org/sites/default/files/Kenny-Can-USDFC-Compete-Formatted.pdf
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4 https://www.cgdev.org/sites/default/files/Kenny-Can-USDFC-Compete-Formatted.pdf
5 https://cgdev.org/publication/inside-portfolio-international-finance-corporation-does-ifc-do-enough-low-income
6 Existing expansion plans of DFIs suggest a total LIC/LMIC portfolio from the IFC, US DFC and European DFIs of $146 billion up from $67 billion today—more than a doubling of the portfolio size. https://www.cgdev.org/sites/default/files/Kenny-Can-USDFC-Compete-Formatted.pdf
7 https://www.cgdev.org/blog/making-international-finance-corporation-relevant
8 https://www.cgdev.org/sites/default/files/WP562-Kenny-IFC-Development-Outcomes-Full.pdf
9 Vinod Thomas et al. (Feb. 11, 2008). Independent Evaluation of IFC's Development Results 2008. 42556. Independent Evaluation Group. Note also Enterprise survey and other evidence points to a considerable number of constraints beyond (and often ranked higher) than finance for potential IFC clients. For large firms in particular political instability and access to electricity rank more often as biggest constraints and informal sector competition, corruption and taxes are listed nearly as often. https://www.cgdev.org/sites/default/files/Kenny-Can-USDFC-Compete-Formatted.pdf
10 https://ppi.worldbank.org/en/visualization accessed 5/25/2021.
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19 https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/cao-policy-consultation
20 As suggested by Mazzucato and Pena with regard to state investment banks, their role is (should be) " more about market creating/shaping rather than market-failure fixing." Mariana Mazzucato & Caetano C.R. Penna (2016) Beyond market failures: the market creating and shaping roles of state investment banks, Journal of Economic Policy Reform, 19:4, 305–326.
21 https://ieg.worldbankgroup.org/evaluations/supporting-transformational-change-poverty-reduction-and-shared-prosperity
22 Aiginger, K., & Rodrik, D. (2020). Rebirth of industrial policy and an agenda for the twenty-first century. *Journal of Industry, Competition and Trade*, 1–19
23 H. J. Chang Forward in J. Felipe Development and Modern Industrial Policy in Practice: Issues and Country.
24 Industrial Policy: Can We Go Beyond an Unproductive Confrontation? A Plenary Paper for ABCDE (Annual World Bank Conference on Development Economics) Seoul, South Korea 22–24 June 2009
25 The building blocks of economic complexity Cesar A. Hidalgo and Ricardo Hausmann. The World Bank Group's IEG has previously complained that IFC country diagnostics "still generally reflect a standardized approach to private sector issues. With a few exceptions, private sector interventions are viewed primarily as a response to a government policy of improving the business climate, with evidence largely from the Doing Business reports and Enterprise Surveys on the binding constraints for the private sector." https://ieg.worldbankgroup.org/evaluations/scd-cpf
26 This might be thought of as the sectoral equivalent of a 'constraints to growth' type analysis. Hausmann, R., Rodrik, D., & Velasco, A. (2008). Growth diagnostics. *The Washington consensus reconsidered: Towards a new global governance*, 324–355.
27 Gelb et. al. suggest industrial labor costs in Africa are high relative to productivity, suggesting the need for complimentary strategies to reduce the relative gap: regional integration, efforts to improve electricity provision and upgrade skills Gelb, A., Ramachandran, V., Meyer, C. J., Wadhwa, D., & Navis, K. (2020). Can Sub-Saharan Africa be a manufacturing destination? Labor costs, price levels, and the role of industrial policy. *Journal of Industry, Competition and Trade*, 1–23.
28 "There is relatively little discussion of private sector strategic priorities... IFC programs were not adequately reflected in results frameworks, where concern about potential accountability based on a portfolio dependent on private sector demand seems to have outweighed the potential of the results framework in providing strategic focus to the programs for support through IFC investments and advisory services.... CPFs reflect mostly ongoing programs, highlighting the difficulty of planning ahead under their business models." https://ieg.worldbankgroup.org/evaluations/scd-cpf

29 A recent survey of national development banks suggests many are focused like the IFC on Infrastructure and MSME finance. IFC itself is a minority shareholder of Colombia's Financiera de Desarrollo Nacional. It Is clear there Is a considerable opportunity to reform and strengthen such Institutions as part of an export-led development strategy. https://documents1.worldbank.org/curated/en/977821525438071799/pdf/2017-Survey-of-National-development-banks.pdf

30 Weiss (Industrial policy in the twenty-first century) summarizes some of the lessons of industrial strategy design and history, including the need for clear performance criteria for success or otherwise of an intervention and transparency regarding who receives government support and that support should be for broad activities (such as R&D or labour training) or sectors (like electronics) rather than to individual firms to avoid distorting competition and establishing monopolies

31 Collier, Gregory, & Ragoussis, 2019. Pioneering Firms in Fragile and Conflict-Affected States: Why and How Development Finance Institutions Should Support Them.

32 Open standard offers akin to those offered by the US Title XVII innovative energy loan guarantee program might also be possible: providing set financing terms to entrepreneurs that pass a hurdle test in terms of the innovation of their production (new to the country or region) and basic due diligence in terms of competency and likely financial sustainability.

33 In Ethiopia, for example, a 2002 government strategy based around export growth in particular manufacturing sectors was followed by a decade of decline in manufacturing as a percentage of value added as a whole and sluggish growth in the promoted subsectors. Meanwhile the flower industry, untargeted, nonetheless became a major export success. Gebreeyesus, Mulu Working Paper Industrial policy and development in Ethiopia: Evolution and present experimentation.

34 Ricardo Hausmann and Dani Rodrik argue there is a role for government interventions that support learning what an economy is good at producing. "[T]here is great social value to discovering that cut flowers, soccer balls, or computer software can be produced at low cost, because this knowledge can orient the investments of other entrepreneurs." Hausmann, R., & Rodrik, D. (2002). Economic Development as Self-Discovery (Working Paper No. 8952). https://doi.org/10.3386/w8952

35 Fernandez-Arias, E., Hausmann, R., & Panizza, U. (2019). *Smart Development Banks* (No. 9780). Inter-American Development Bank.

36 Green transition, industrial policy, and economic development René Kemp and Babette Never. See also Aiginger, K., & Rodrik, D. (2020). Rebirth of industrial policy and an agenda for the twenty-first century. *Journal of Industry, Competition and Trade*, 1–19

37 https://www.cgdev.org/sites/default/files/Kenny-Morris%20Note-ClimateCapitalIncreaseWorldBankIFC.pdf

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