

Private Sector Development Strategy



Private Sector Development Strategy

Asian Development Bank

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Abbreviations

ADB	-	Asian Development Bank
BOT	-	build-operate-transfer
COS	-	country operational strategy
DMC	-	developing member country
PRG	-	partial risk guarantee
PSD	-	private sector development
PSO	-	private sector operations
SME	-	small and medium-sized enterprise
TA	-	technical assistance

NOTE

In this report, "\$" refers to US dollars.

The need for a strategy

Why a strategy now

Support for private sector development (PSD) is an integral part of the Poverty Reduction Strategy¹ recently adopted by Asian Development Bank (ADB). Development of a strong and dynamic private sector is crucial to long-term, rapid economic growth, a necessary condition for sustained poverty reduction. ADB now needs to articulate a strategy to define how it can more effectively promote private sector-led growth in support of its vision of an Asian and Pacific region free of poverty.

Articulation of a PSD strategy is also timely as the region is facing serious challenges that require immediate attention. For instance, the recent financial crisis has discouraged private capital flows into the region at a time when the need for private capital is increasing. The corporate and financial sector restructuring now beginning in the region is a resource-intensive exercise. Privatization programs, planned and underway, cannot be funded from domestic sources alone. New markets are beginning to open up, as barriers to entry are lowered in the previously highly protected banking, securities, and insurance subsectors, as well as pension fund management—as in the People's Republic of China and India. A pressing challenge for the region is the need to regain the confidence of investors and lenders, foreign as well as domestic. ADB's developing member countries (DMCs) need assistance to catalyze resumption of private investment in the region.

1 R179-99: Fighting Poverty in Asia and the Pacific The Poverty Reduction Strategy of the Asian Development Bank, 9 November.

In the wake of the crisis, there has been renewed appreciation of the private sector's development role as an engine of growth. Experience has shown that, when properly regulated and operating under competitive market conditions, the private sector can generally use resources more efficiently than the public sector. Private sector entities can deliver goods and services to meet growing demands and create job opportunities in the process. Public sector involvement in the productive sectors is often unsustainable, especially if it is at the expense of social sectors where it is truly needed. While government should shift away from commercial business, it has to develop a strong capacity to create and sustain the legal and market institutions needed to enable and regulate private sector activities. Creating the enabling environment for domestic and foreign private investors and shifting the role of government from owner-producer to facilitator-regulator, and the large adjustment costs associated with such a shift, are big challenges for which the DMCs need ADB's continued and intensified support.

Why a comprehensive strategy

Support for PSD is not new to ADB (*Appendix 1*). ADB's first loan was a line of credit to a Thai development finance institution for onlending to small and medium-sized enterprises (SMEs) in the private sector. The indirect financing of private enterprises through government-guaranteed loans to development finance institutions has increased over the years and has been an important mode of ADB assistance for PSD. In addition, other modes of ADB public sector assistance have contributed significantly to PSD. In most DMCs, policy dialogue, technical assistance (TA), and project and program loans have been used to help create a conducive environment for the private sector. Such support for PSD has covered a range of sectors: finance and capital markets, agriculture, industry, trade, and infrastructure. In the 1980s, ADB added direct private sector operations (PSO) to provide direct assistance to private enterprises through equity investments² and loans without government guarantees.³

2 R38-82: Revision 2, Final: Equity Investment Operations by the Bank, 10 February.

3 R93-85: Lending to the Private Sector Without Government Guarantees, 9 September.

Two lessons have been learned from the direct and indirect financing of private enterprises. First, the right policy environment is vital for the long-term viability of these businesses. While ADB has assisted DMCs in developing an enabling environment for the private sector, the Asian financial crisis has called for more comprehensive DMC efforts with ADB support. Second, ADB assistance, if combined through the public and private sector windows to address development challenges, can provide synergistic solutions resulting in greater benefits for the host DMC. Such a combination requires public sector assistance to pay more systematic attention to private sector interests and concerns, and private sector assistance to promote development impacts in their activities.

These lessons indicate the need for ADB to articulate a comprehensive, bankwide PSD strategy. ADB's existing private sector strategy focuses mainly on its direct nongovernment-guaranteed assistance through PSO. The strategy proposed in this paper goes beyond that and addresses the more complex challenge of how ADB's public and private sector operations can both better promote private sector-led growth. This strategy articulates, for the first time, a systematic and coherent framework for ADB's PSD efforts. However, detailed discussion of PSO-specific operational issues (e.g., approval processes, prudential limits, local currency financing, and TA for PSO) are not included in this paper. These issues will be addressed in a separate Board paper.

Private sector and poverty reduction

It is widely accepted that the private sector is needed and better suited for sustaining rapid growth. And the Asian experience shows that growth is the most powerful weapon in the fight against poverty. Growth creates jobs that use labor, the main asset of the poor. As growth proceeds, private sector employment becomes the major source of economic support for the majority of workers and their families. Thus, improving labor market operations is an important element of strategies to promote pro-poor growth and reduce poverty. It also helps allocate a country's human capital resources to their most productive uses, enhancing general economic welfare, and encouraging further growth and development. Well-designed labor

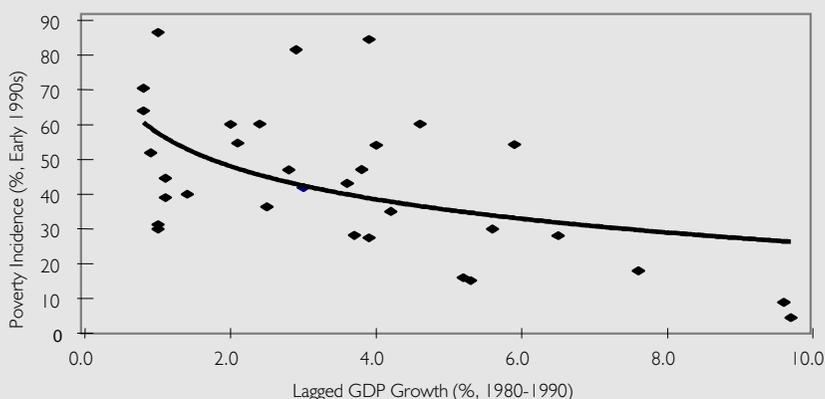
market policies help societies make growth more equitable by smoothing income fluctuations and broadening access to human capital development and employment opportunities. However, it is also important to recognize the linkages across factor markets (labor, capital, and land). Thus, an integrated approach to the removal of distortions in different factor markets is essential for sustained success in the fight against poverty.

Growth also increases the tax base that enables government, acting on good governance principles, to finance labor market programs and provide basic social services. Health and education services, in particular, give the poor a better chance to increase their productivity and earning capacity. Transparency and accountability in government are crucial to ensure that such social expenditures are effective and can reach the poor.

Data for several developing regions in the world illustrate that poverty incidence at any point in time is largely a reflection of a country's previous economic growth performance (*Box 1*). This important relationship between poverty reduction and growth is exemplified more clearly by the experiences of developing countries in Asia. In East Asia, for example, poverty incidence decreased following growth acceleration in the 1980s and early 1990s. By contrast, also in East Asia, the negative growth resulting from the 1997 financial crisis led to a rise in poverty incidence in the affected countries. Indeed, no country or region in the world has successfully reduced poverty in a no-growth environment.

Box 1: Economic Growth and Poverty Reduction

Differences in economic growth across the world's developing regions, as well as across countries (*see chart below*), largely explain the differences in poverty incidence. To illustrate, during 1987–1993, poverty incidence in East Asia (excluding the People's Republic of China) decreased significantly from 23 percent to 14 percent, and the number of poor people declined from 109 million to 74 million, following over 6 percent real per capita income growth during the 1980s. In South Asia, where income per capita was growing annually at about 3 percent during the 1980s, poverty incidence dropped slightly from 45 percent in 1987 to 43 percent in 1993, although the number of poor people rose from 480 million to 515 million. By contrast, in Latin America and the Caribbean, where per capita income contracted in the 1980s, poverty incidence increased from 22 percent in 1987 to 24 percent in 1993 and the number of poor people increased considerably from 91 million to 110 million. Similarly, in Sub-Saharan Africa, where the growth of income per capita turned negative in the 1980s, poverty incidence remained high at 39 percent and the number of poor people increased markedly from 180 million to 219 million.



Sources: Pernia, E.M., and M.G. Quibria, 1999. "Poverty in Developing Countries." In *Handbook of Regional and Urban Economics*, edited by Cheshire P. and E.S. Mills. Amsterdam: North-Holland; and World Bank. 1996. *Poverty Reduction and the World Bank: Progress and Challenges in the 1990s*. Washington, DC: The World Bank.

In all countries, where direct poverty reduction and social safety net programs are necessary to address poverty, budgetary spending typically involved in these programs would be difficult without economic growth. Poverty support programs have a stronger constituency when the economic pie is growing. Alternative funding from foreign aid or borrowing could help, but is not sustainable in the long run.

Of course, both the level of growth and its pattern (or how the benefits of growth are distributed) matter for poverty reduction. The extent of participation of the poor in a growing economy is key. However, East Asian countries have shown that growth can lead to a decline in poverty despite a rise in inequality. During 1993–1998 in Viet Nam, for example, poverty declined substantially due to rapid growth, and despite a rise in inequality (*Box 2*). The case is clear that the contribution of growth to poverty reduction was significant and robust. There are, of course, cases where the rise in inequality exceeded growth and the poverty situation worsened, as in Thailand during 1975–1986 and rural People’s Republic of China during 1985–1990. The ideal case was seen in Malaysia (1973–1989) and Indonesia (1978–1984), where the growth and distributional effects reinforced each other and led to an even stronger impact on poverty reduction.

The private sector can also affect poverty in other ways. For example, private investment in infrastructure projects that are properly regulated can relieve pressure on public budgets and, thus, enable governments to redirect more resources to social spending. Private sector participation in infrastructure can also improve the delivery efficiency of essential services and extend these to the poor. Experience has shown that efficiency gains from privatizing utilities can benefit all income classes. But with effective regulation that ensures appropriate tariff policy, lower-income groups tend to gain relatively more than higher-income groups, improving the distribution of income.⁴ Concessions can be designed such that bidders are required to provide service to poorer areas (e.g., through public standpipes charging low lifeline tariffs for water supply), with the associated cost to be borne by government in the form of lower concession revenues. Public-private partnerships with features such as this can help address poverty, as governments recognize that such activities must be underwritten by the public budget, and as private companies realize the value of collaborative investing, both in terms of community relations and financial returns. Such an approach makes the subsidy to the noncost-recovering activity transparent and best represents good

4 Chisari, O., A. Estache, and C. Romero 1997. *The Distribution of Gains from Utility Privatization and Regulation in Argentina*. *Public Policy for the Private Sector* 12 (December): pp. 33-36.

Box 2: Growth, Inequality, and Poverty

Both the level of growth and its pattern (or how the benefits of growth are distributed) matter for poverty reduction. In fact, changes in poverty reduction can be broken down into two components: economic growth and distributional changes. The results of this breakdown for six East Asian countries follow. The growth component is not only always positive (as one would expect from the growth record of these countries), but is also generally much larger than the redistribution component.

Country	Period	Decline in Poverty Head-Count Index (percent)	Growth Component (percent)	Redistribution Component (percent)	Residual (percent)
People's Republic of China (rural)	1985-1990	(2.1)	2.4	(4.1)	(0.4)
	1990-1993	2.2	5.9	(3.3)	(0.4)
Indonesia	1970-1978	3.8	7.6	(2.7)	(1.1)
	1978-1984	26.7	18.5	3.4	4.8
	1984-1995	23.6	22.4	(3.1)	4.3
Malaysia	1973-1989	19.1	16.4	3.9	(1.2)
Philippines	1985-1988	5.0	5.2	(0.3)	0.1
	1988-1991	(1.2)	2.9	(4.1)	0.0
	1991-1994	1.7	0.8	1.0	(0.1)
Thailand	1975-1986	(1.9)	6.1	(11.0)	3.0
	1986-1992	10.0	10.0	(1.5)	1.5
Viet Nam	1993-1998	20.8	30.7	(7.6)	(2.3)

Note: Declines in poverty are presented as positive entries; negative numbers indicate increasing poverty.

Sources: Ahuja, V., B. Bidani, F. Ferreira, and M. Walton, 1997. *Everyone's Miracle? Revisiting Poverty and Inequality in East Asia, Directions in Development*, Washington, DC: World Bank; for all countries except Viet Nam, and for Viet Nam, World Bank estimates based on VLSS93 and VLSS98, as reported in the Joint Report of the Government-Donor-NGO Working Group, *Viet Nam Development Report 2000: Attacking Poverty*, 1999.

public policy. Cross-subsidies are neither transparent nor sustainable. Although they can be useful for helping the poor in situations where better means of transferring resources to the poor do not exist, there can and should be better instruments that, over time, can be developed and used to replace cross-subsidies.

Private provision of goods and services with public financing can also be well-suited to the social sectors, as another form of support for poverty reduction, where the private sector can sometimes be engaged on a contractual basis to operate not-for-profit social facilities, like schools and health clinics. With proper regulation, private sector management is often more efficient than public administration and can deliver better and more innovative service at a lower cost. In many countries, health services are provided by the private sector but with public financing. In addition, the private sector can, and often does, supply for-profit social services to the higher income groups— for-profit hospitals, higher education, etc.—freeing up government resources for the needs of lower income groups. Clearly, the private sector can play some modest role in poverty reduction. However, it is neither in a position to provide noncost-recovering social services on its own balance sheet, nor to engage in not-for-profit activities without compensation. Thus, the private sector cannot be expected to undertake extensive poverty interventions on its own.

The strategy

Overview

Identifying the private sector as the key to sustainable, rapid growth, the PSD strategy aims to help expand and strengthen private sector participation in the development of the DMCs. The strategy is designed to provide a systematic and coherent framework within which ADB will seek to promote the private sector to support growth and reduce poverty. Comprising the strategy are three thrusts of ADB's PSD efforts. These will be pursued primarily in four priority operational areas that can make the greatest impact on the private sector's contribution to pro-poor growth. While the strategy will guide ADB's PSD activities across the region, it will be operationalized at the country level as part of ADB's operational strategy for individual DMCs. To make the strategy work, ADB will need to institute internal changes relative to its operational orientation, its mix of staff skills, and its processes and procedures.

In formulating the strategy, five factors have been considered: (i) ADB's overarching objective of poverty reduction; (ii) the development challenges facing the region; (iii) the private sector-related activities of other multilateral development agencies, particularly those operating in the region and with which ADB must coordinate its activities (*Appendix 2*); (iv) ADB's own institutional strengths (*Box 3*); and (v) lessons learned from ADB's existing PSD activities. The strategy recognizes that ADB's financial and human resources are limited, so that its PSD assistance must look for leveraged interventions and must be selective and strategically focused.

Box 3. Institutional Strengths of ADB

The Asian Development Bank (ADB) has distinctive strengths that make it an effective development partner for its developing member countries. It is headquartered in the region and focuses exclusively on the region. Thus, it is able to develop a close understanding of the region's needs. In addition, regional members constitute a majority of its shareholding structure. This gives greater ownership of ADB's strategic orientation by the region. At the same time, the presence of nonregional members provides global perspectives to help tackle regional development issues. ADB's broad cross-country and multidisciplinary expertise enable it to facilitate the dissemination of best practices and lessons learned across the region. Its status as a multilateral institution, whose operations are open to scrutiny by all member countries, makes it effective in the role of an impartial adviser and honest broker in facilitating reform and investment. ADB undertakes, under the same roof, grant-financed technical assistance, public sector lending, and private sector finance; thus, if various departments of ADB work well together, it can easily deliver synergistic solutions to development challenges. Also, because of the size of the development challenges, it is important that ADB be part of the cooperative and inclusive approach to assistance.

Strategic thrusts

Under the strategy, ADB will utilize the capabilities of both its public and private sector operations to deliver synergistic solutions to problems that impede private sector growth in the DMCs and the contribution of the private sector to poverty reduction. In public sector operations, the strategy has two thrusts: (i) to support DMC governments in creating enabling conditions for business, and (ii) to generate business opportunities in ADB-financed public sector projects. The third thrust is in PSO: to catalyze private investments through direct financing, credit enhancements, and risk mitigation instruments. All of ADB's instruments for advice and financing will be used to pursue PSD outcomes targeted by the three strategic thrusts (*Table 1*).

The three thrusts of the strategy are mutually reinforcing when brought to bear on a development challenge. Such has been the experience of ADB. In Bangladesh, for example, there was a need to develop fresh power supply without relying on government funding. ADB responded by providing TA, first, to create the right environment for the entry of private investment (sector restructuring, regulatory framework, tariff reform), and then, to prepare a build-operate-transfer

Table I. Three Strategic Thrusts: Targeted Outcomes and Instruments

	Public Sector Operations		Private Sector Operations
Strategic Thrusts	Creating Enabling Conditions	Generating Business Opportunities	Catalyzing Private Investments
Targeted Outcomes	<ul style="list-style-type: none"> • Sound macroeconomic policy • Appropriate competition policy • Investment and trade liberalization • Legal and judicial reform • Public administration reform • State enterprise reform • Tax reform • Product markets reform • Financial sector reform • Capital market reform • Pension and insurance reform • Labor and land markets reform • Sound environmental and social standards • Reform of infrastructure and other sectors • Good physical, social, and technological infrastructure 	<ul style="list-style-type: none"> • Private sector participation in Asian Development Bank (ADB)-financed public sector projects through contacts for <ul style="list-style-type: none"> - supply, - construction, - management, - concession, and - leasing • ADB-designed model build-operate-transfer and other types of projects with poverty reduction impacts • ADB-supported privatization programs 	<ul style="list-style-type: none"> • Private sector projects with development impacts and/or demonstration effects • Priority to be given to <ul style="list-style-type: none"> - infrastructure facilities, - financial institutions, - investment funds, - specialized financial institutions for small and medium-sized enterprises and microenterprises, and - pilot health and education projects
Instruments to Use	<ul style="list-style-type: none"> • Policy dialogue • Economic and sector work • Program loans • Sector development loans • Project loans • Technical assistance • Cofinancing • Partial credit guarantees 	<ul style="list-style-type: none"> • Technical assistance • Program loans • Sector development loans • Project loans • Cofinancing • Partial credit guarantees 	<ul style="list-style-type: none"> • Loans without government guarantees • Equity investments • Hybrid instruments • Cofinancing • Partial risk guarantees • Partial credit guarantees

(BOT) power-generating project for international competitive bidding. The winning bidder was to be supported by ADB with direct loan, cofinancing, and guarantee facilities to catalyze the project.

ADB's experience has shown that creating the enabling conditions to open a sector to private investment may not be sufficient to attract entrants. Sometimes, a model project is needed to provide demonstration effects, and funds have to be catalyzed to actually make the project happen. By the same token, a single private sector project, made possible with ADB support, may achieve little if it cannot be replicated without ADB support because the enabling conditions are not in place. ADB recognizes the two sides of this equation and will have to tackle the twin challenges in tandem.

Creating enabling conditions

ADB uses public sector operations to help DMC governments establish the right conditions for business and a policy environment conducive to pro-poor growth. Reforms that spur entrepreneurial development and stimulate foreign and domestic private investment are designed to enlarge the private sector's role in the economy. As the transition occurs, the government must reduce its presence as owner-producer and concentrate more on facilitating and regulating private sector activities to ensure markets work and to protect public interest. This shift in the government's role will make government a neutral and objective regulator, and free public resources (such as those used to support loss-making state enterprises) that can then be redirected to basic education, health services, and social safety nets. In many DMCs, growth and, ultimately, poverty reduction depend on such a shift.

One of ADB's strengths lies in conducting policy dialogue with government on needed reforms. Under the PSD strategy, the reform agenda will seek to achieve the following: stable macroeconomic management; investment, trade, and price liberalization; reduced barriers to competition; well-functioning financial and capital markets; flexible labor and land markets; good physical, social, and technological infrastructure; equitable tax systems; and legal and judicial systems that protect property rights, enforce contracts, and provide for dispute resolution. Improving the business environment for SMEs will be part of the reform agenda. In addition, the policy

agenda will include measures to enable DMCs to maximize the benefits of globalization (e.g., increased trade and capital flow) and minimize the risks associated with it (e.g., sudden and disruptive movements of short-term capital). This will require, for instance, the introduction of regulatory frameworks to strengthen market institutions and establish social protection programs, including social safety nets and labor laws that protect workers. Measures may also be considered to regulate short-term speculative capital flows and encourage more stable, long-term investment.

Specific policy advice on these areas of reform will be based on economic and sector work. In addition, TA will be provided to governments to formulate the regulatory and institutional frameworks needed to make markets work better and to build the capacity of market regulatory authorities. ADB will also support policy and institutional changes to encourage private sector participation in key sectors through program and sector development loans as well as by linking project investments to progress in needed reforms.

An adequate physical environment is also important for the private sector. ADB will help governments build infrastructure facilities such as ports, roads, telecommunications, and power plants needed to enable the private sector to undertake business efficiently. Where found desirable based on benefit-cost analysis, the location of such facilities can deliberately be chosen to influence the flow of private investment to less-developed (and poverty-stricken) areas of a country.

Recent events in the region underscore the need for greater attention to labor market issues. The Asian financial crisis bared the vulnerability of people living close to the poverty line. Indeed, a stable macroeconomic environment is important for the welfare and protection of the poor. This justifies ADB's involvement in financial sector reform issues from a poverty perspective. Experience in some DMCs indicates that distorted and fragmented labor markets generate inequality of labor incomes. To address this problem, ADB and the DMCs must be committed to effective labor market policies to generate private sector-led employment. Improved labor market policies can be achieved through policy dialogue and project interventions in active and passive labor programs. Dialogue on labor market policies may include the elimination of labor distortions, and the reform of

discriminatory codes and practices. Active labor market programs include employment services (e.g., job brokerage and counseling) and redeployment and training programs. Passive labor market programs cover unemployment, injury and disability insurance, income support, and labor standards. Through these labor market interventions, ADB can enhance the role of the private sector in promoting employment and contributing to poverty reduction in the region. However, some labor protection policies (e.g., occupational safety legislation) may, in the short run, lead employers to substitute capital for labor on the margin, or to move production facilities to countries with less stringent labor laws. The situation should improve as corporate responsibility becomes more widely accepted and the playing field for labor becomes more even across countries.

Generating business opportunities

ADB's public sector projects can be formulated in such a way that they provide specific opportunities in which the private sector can participate. Such opportunities may include model private sector projects that are designed to include poverty reduction impacts. Indeed, ADB has long been involving the private sector as suppliers and contractors in the implementation of its public sector investment projects. Under the PSD strategy, ADB will take deliberate steps to ensure that, in its public sector projects, where appropriate, business opportunities are generated for the private sector, particularly for the domestic private sector. This will be done in various ways. When preparing a public sector project, ADB will explicitly consider the scope for private sector participation, and include the nature and timing of this participation in the project design. For example, a state-owned sewerage treatment plant being processed for ADB financing can be required to subcontract its operation and maintenance to a qualified private sector entity to be selected on a competitive basis. Investment opportunities may also be created by considering the private sector alternative to a government-proposed investment project, as was the case with the Colombo port project approved in 1999.⁵ In support of government efforts to encourage private sector participation in key

5 Loan 7153/1689-SRI: South Asia Gateway Terminals Private Ltd. for the Colombo Port, loan for \$35 million and equity investment of \$7.4 million, approved on 11 May 1999.

sectors in more DMCs, ADB will continue to support privatization programs and prepare model BOT-type infrastructure projects that can be competitively bid to the private sector. As a rule, ADB must ensure that its public sector investments do not crowd out the private sector, and that ADB and DMC governments explore all possible opportunities to ensure private sector participation where this can be done effectively and efficiently.

Catalyzing private investments

ADB provides direct financial assistance to private sector projects through PSO. While ADB's participation is usually limited, it leverages a large amount of funds from commercial sources to finance these projects.⁶ ADB is viewed as a neutral long-term investor committed to the highest standards of corporate conduct; its presence is seen as a source of comfort by other lenders and investors. To facilitate mobilization of commercial debt finance for cofinancing, ADB will intensify the use of two instruments to mitigate perceived sovereign risks: the complementary financing scheme and the partial risk guarantee (PRG).⁷ ADB's role in sovereign risk mitigation is now much more critical as the crisis-affected DMCs try to regain the confidence of foreign investors and lenders. Where appropriate, ADB's partial credit guarantee, which provides comprehensive protection to lenders, will also be used to mitigate credit risks and stretch the maturity of commercial loans in local currency for long-gestating private sector projects. Aside from contributing finance that is not available on reasonable terms elsewhere and catalyzing funding from other financiers, ADB's involvement can, more importantly, exert influence on project design and implementation so that environmental and social concerns are addressed more effectively. ADB can also selectively attempt to encourage sponsors to incorporate project components that, for instance, extend essential services to the poor with government support.

6 The leverage achieved in PSO is around \$8 of funding commitments from others for every \$1 committed by ADB.

7 A paper on PRG is under preparation for consideration by the Board during the first quarter of 2000.

ADB will seek to catalyze private sector projects that deliver specific development impacts and related demonstration effects in line with ADB's strategic priorities and country-specific operational strategies. While ADB's participation helps ensure successful project launches, ADB also benefits from the insights it gains into the workings of the private sector and the constraints the sector faces. The resulting institutional learning at the project level provides an important complement to ADB's macroeconomic and sector policy work to create enabling conditions. The individual ADB-assisted private sector projects themselves are also a potentially important influence on and input to policy. They can (i) pilot test the sufficiency of the enabling environment in a sector and open the sector to private sector involvement by providing demonstration effects, (ii) provide a template for other investors to replicate, and (iii) pioneer experimental projects that could provide the basis for a policy framework for private investment in a new sector.

As a multilateral development institution, ADB does not finance private sector projects based solely on their financial viability. Projects must have clear development impacts and/or demonstration effects that go beyond the benefits captured in the financial rate of return. ADB assistance to the project, whether in the form of offshore or local currency financing, must be (i) catalytic (leveraging ADB's financial resources by attracting other investors and lenders), or (ii) additional (complementing, not substituting for commercial sources of finance), or (iii) adding value (influencing project design or structure to make it more environmentally or socially friendly, create more jobs, impart better skills or technology, or raise the standards of corporate governance).

Operational priorities

The pursuit of the three strategic thrusts (creating enabling conditions, generating business opportunities, and catalyzing private investments) will be focused primarily on four priority areas of operation:

- (i) governance in the public and private sectors;
- (ii) financial intermediation;

- (iii) public-private partnerships; and
- (iv) regional and subregional cooperation.

These four areas of operational focus represent the key vehicles for promoting private sector development and pro-poor growth in the Asian context. They involve activities in which ADB has the underlying strength based on its track record and for which the three strategic thrusts can achieve significant PSD outcomes (*Table 2*).

Table 2. Three Strategic Thrusts: Applicability to the Priority Areas of Operation

Strategic Thrusts Operational Priorities	Public Sector Operations		Private Sector Operations
	Creating Enabling Conditions	Generating Business Opportunities	Catalyzing Private Investments
Governance			
Public sector governance	[[[
Commercialization and privatization	[[[
Private sector governance	[[[
Financial Intermediation			
Financial institution and markets	[[[
Local currency financing	[[[
Investment funds	[[[
Small and medium-sized enterprises	[[[
Public-Private Partnerships			
Physical infrastructure development	[[[
Social infrastructure development	[[[
Agriculture and rural sector development	[[[
Regional and Subregional Cooperation	[[[

Governance in the public and private sectors

Public sector governance. Effective governance is essential for the encouragement of private sector investment. There is no greater disincentive to business than the added cost and feeling of uncertainty and vulnerability brought about by corruption, abuse of discretion, and bureaucratic interference. Improving the efficiency of public administration and the accountability and transparency of government actions is essential to improve the climate for business and sustain development in the region. Improving public sector governance has been a major development objective of ADB since 1995. Depending on the need of specific DMCs, the areas that ADB can consider for assistance include (i) strengthening the rule of law through legal and judicial reforms; (ii) establishing and maintaining effective and equitable taxation systems; (iii) formulating sound and transparent sectoral regulations; (iv) strengthening public administration; (v) fighting corruption; (vi) removing impediments and reducing transaction costs; and (vii) establishing efficient and competitive markets supported by appropriate fiscal, monetary, and trade policies. ADB TA will also be needed for capacity building to educate and modernize the bureaucracy and agencies that regulate and supervise the private sector in the DMCs. A lesson learned in law and judicial reform is that a holistic, comprehensive approach is crucial as piecemeal interventions do not work. Overall, ADB will help ensure that economic management in the DMCs maximizes and fairly distributes the benefits of economic growth.

Commercialization and privatization. A key dimension of effective public governance relates to the efficient deployment of public funds. Reform of public resource management requires actions to improve efficiency of state-owned enterprises and relieve budgetary pressures from their subsidy and investment needs. This typically involves commercialization (restructuring to achieve cost-recovering operations) as a first step, followed by restructuring the entity into a corporation (giving full financial autonomy under government ownership), and finally privatization (involving private sector participation). Privatization does not always mean divestment of government ownership to the private sector; it can also be done by

contracting out enterprise operations, partly or wholly, to the private sector through management contract, asset leasing, or concession.

Privatization in its various forms is currently not pursued with equal vigor and conviction in all DMCs, and there remain divergent political views on the extent to which it should be promoted. ADB will thus need to carefully consider how and in what form and time frame to promote the privatization alternatives in the context of specific DMCs. ADB can also help governments analyze options available, and formulate general principles for the appropriate mix of public and private sector activities. In the transitional economies, large parts of the economy are still in public hands, including most heavy industries and utilities. In South Asia and the Pacific DMCs, there are also many poorly performing state-owned enterprises in a wide range of sectors. Even Southeast Asia still has many state-owned or controlled enterprises and financial institutions. It is clear over the next few years that privatization (through management contract, asset leasing, concession, or divestment) will continue to be an important part of overall economic reform programs in many DMCs. The success of privatization efforts will depend heavily on the government's political will and on whether or not domestic investors are in a position to become owners of the privatized assets.

Many DMCs that are inclined to privatize, face severe capacity constraints to meet the challenges of privatization. ADB can help by providing technical advice, particularly in defining sound privatization strategies, establishing and implementing effective privatization programs, designing and operating sound postprivatization regulatory frameworks, and undertaking individual transactions transparently and professionally. But ADB assistance must explicitly require transparency in implementing privatization transactions, establishment of an appropriate tariff policy, protection of workers' legitimate interests in the transition of ownership, as well as financial market regulations that adequately protect the interests of small investors (including those investing under employee stock ownership plans). As experience has shown, successful privatization requires effective consideration of the interests of all stakeholders. Labor retrenchment, in particular, presents significant social costs, and ADB will help

establish social safety nets to address this issue. At the enterprise level, ADB will consider direct financial assistance to the projects resulting from privatization programs supported by ADB and/or other multilateral development banks. Equity investments may also be considered in state-owned enterprises to facilitate or initiate privatization through divestment of government-owned shares or issuance of new shares to broaden ownership.

Corporate governance. Just as good governance is essential in the public sector, so is quality corporate governance essential in the private sector. A systemic failure of corporate governance, as seen in the recent Asian crisis, can have pervasive consequences that place an undue burden on the shoulders of the poor. For individual enterprises, sound corporate governance provides confidence to lenders and investors, and facilitates access to lower cost capital. The development of the domestic capital market often hinges on the existence of a corporate governance culture that ensures voluntary compliance through effective regulatory enforcement. In most of the DMCs, the root causes of poor corporate governance have to be addressed to sustain recovery and growth. Through TA, ADB can help to review commercial laws and regulations and establish (i) credible accounting and auditing standards; (ii) timely and accurate disclosure rules; (iii) sound environmental, labor, and social standards; (iv) provisions for adequate protection of minority shareholder rights; and (v) effective bankruptcy and foreclosure regimes. ADB can also help train corporate directors on their duties and responsibilities, and on how they can be effective in balancing the interests of shareholders with those of other stakeholders—employees, customers, suppliers, investors, communities—while maximizing value. In PSO, ADB must invest only in companies that can demonstrate the capacity to establish and maintain sound corporate governance structures and practices. More proactively, ADB must diagnose the quality of corporate governance in its investee companies, benchmark this against best practice, and develop a time-bound action plan to remove deficiencies and introduce enhancements. ADB's initiatives on corporate governance should extend to promoting corporate responsibility to maximize the opportunity for companies to integrate social and environmental awareness into core business practices and make private investment more sustainable.

Financial intermediation

Well-functioning financial systems are critically needed to promote the private sector. Many DMCs need to strengthen their financial institutions and create diversified financial markets to develop the domestic capacity to finance private sector-led growth. Properly functioning capital markets are needed for effective privatization programs—to facilitate sale of government-divested shares, ensure fair and transparent share pricing, enable wide ownership of privatized shares (thereby enhancing political acceptability), and provide resources for modernization and expansion of privatized enterprises. In a financially integrated world, robust and well-regulated banking systems and financial markets, coupled with sound macroeconomic management, are necessary to reduce the risk of instability associated with sudden outflows of short-term capital. One advantage of the region is that many of the DMCs have substantial domestic savings that, if channeled through well-functioning capital markets, could help the private sector avoid excessive reliance on external finance and the concomitant exposure to exchange risks. ADB has the capability to address intermediation challenges, having undertaken financial sector reform programs through public sector operations and/or direct investments in financial intermediaries through PSO in several DMCs.

Financial institutions and markets. Under the strategy, ADB will continue its support for policy reform and institutional capacity building to strengthen the DMC's financial systems. Using TA and program loans, ADB will focus its assistance on government efforts to enhance regulation and supervision, develop sound banking systems, deepen and broaden securities markets, and create bond markets. Support will also be given for the development of mortgage markets to facilitate housing finance, and the reform of pension and insurance systems to develop sources of long-term capital. In PSO, ADB will complement funding with capacity building and governance strengthening for institutions such as banks, insurance companies, leasing companies, securities firms, and pension fund management companies, incorporating best practices and sound management. ADB can also arrange for the participation of a strategic partner in an institution to facilitate capacity building. The availability of credit information on

borrowers and securities issuers is crucial to the functioning of credit markets; this will require establishing rating agencies and credit bureaus, which ADB can promote and catalyze as it has done in India, Malaysia, and Thailand. Preference will be given to supporting institutions that can serve as role models in the process of rehabilitating the financial sector, as in the crisis-hit countries, or in commercializing and privatizing the state-owned banking system, as in the transitional economies.

Progress thus far in bank restructuring in the crisis-hit and other DMCs is encouraging. But corporate sector reforms are lagging. If the banking system is to achieve full recovery, the performance of corporate borrowers must be improved. Progress to date has been achieved mainly in strengthening of insolvency laws, including bankruptcy and foreclosure procedures, which ADB has addressed and will continue to support through its public sector operations. ADB will also support the work of government restructuring agencies using TA. Actual corporate restructuring (through mergers and acquisitions, for example) and corporate debt restructuring have been limited. ADB will selectively catalyze such efforts through PSO in partnership with institutions that have the necessary expertise.

Restructuring the banking system provides an excellent opportunity to transform banks into instruments of effective intermediation in support of labor-absorbing growth. One difficult issue that will need to be addressed in the process is the extent to which targeted or policy lending should be used to channel funds to special needs, especially those of the poor. Most countries have found that it is best to strictly limit such guided credit, to provide it primarily for social purposes, and then at unsubsidized rates. The evidence is strong from many countries that the poor benefit most when they have access to unsubsidized credit. With subsidies, the coverage of credit programs is necessarily quite limited, and the affluent tend to squeeze out the poor for the subsidized funds.

Local currency financing. Foreign borrowings by domestic private firms result in a currency mismatch that cannot be easily hedged if the borrowers earn revenues in local rather than foreign currency. Failure to mitigate the risks associated with such an imbalance was one of the underlying causes of the Asian financial crisis. ADB will continue to

address these risks by helping DMCs to develop diversified domestic capital markets, as well as markets for currency swaps and other hedging instruments. But this is a long process. To be more proactive in the interim, ADB will investigate the possibility of raising local currency debt in selected DMCs for its general operational requirements as well as for relending to domestic borrowers (e.g., infrastructure projects and financial institutions supporting SMEs). In addition, ADB will try to provide partial credit guarantees to enable domestic companies and institutions to directly source local currency financing through loans or bond issues and, in some cases, stretch the maturity and reduce the cost of such financing. Local currency bonds issued by ADB and those issued by domestic entities with ADB guarantee will be designed to transfer technology and add value to the domestic bond markets by supplying high-quality debt instruments that conform to global standards for, among others, syndication, pricing transparency, and secondary market liquidity. Similarly, ADB guarantees on local currency loans will help develop a corporate credit pricing curve and foster long-term lending operations among domestic financial institutions.

Investment funds. The potential size of long-term resources that can be mobilized by ADB through funds could be quite large considering its coinvestment experience to date with major pension funds and insurance companies. Investment funds enable ADB to leverage its own scarce capital much more than in other operations. In addition, the accumulated experience from ADB's sizable portfolio of investment funds (29 funds since 1983) represents an important resource base. ADB will tap the firsthand knowledge of its fund managers to identify pressing constraints to private sector development in DMCs where they operate.

Catalyzing funds is a core competence of PSO. To ensure that future funds seeking support are strategically aligned with ADB's development objectives, ADB will take more active involvement in designing investment funds, formulating the funds' investment objectives in terms of country and sector focus, and working more closely with like-minded, governance-conscious institutional investors. Building on past experience, ADB will explore the possibility of new types of specialized funds to help finance the

region's investment needs, e.g., debt funds, microequity funds, SME funds, environment funds, governance funds, corporate restructuring and recovery funds, agribusiness funds, and internet and technology funds. To be effective in launching new funds, ADB must continue to build contacts with institutional investors from the capital-surplus countries.

Small and medium-sized enterprises. At the user end of financial intermediation, ADB's focus will be on, among others, SMEs, which are a major generator of employment and income needed to achieve poverty reduction. Assistance to SMEs under credit lines has not been totally satisfactory, and lessons learned will need to be incorporated in the use of financial intermediaries in future SME assistance programs. Direct SME assistance may also be required, for example, in the Pacific and Central Asian DMCs. However, this is a very difficult and time-consuming task. It requires specialized teams that ADB does not have, and is not expected to have. So ADB financing for SMEs will continue to be handled through investment funds and specialized financial institutions that are competent and properly equipped. ADB will also seek to cooperate with existing regional organizations, such as the South Pacific Project Facility, to stimulate private sector investment in the Pacific DMCs. While SMEs require capital, they are also in need of advice and training for various aspects of their operations, e.g., business planning, accounting and finance, management capacity, and environmentally clean production. Hence, ADB will also consider technical and business advisory assistance to SMEs and/or continue to collaborate with organizations that are in a position to provide such support. Entrepreneurial education and business incubators will also be supported to help start up new SMEs. TA to governments will be provided to help develop a sound SME environment.

Due to difficulty assessing risks associated with SME credit, SME financing programs often face a dilemma between commercial viability, requiring collateral that most SMEs are unable to accommodate, and social development considerations, such as poverty reduction, that dictate liberal provision of credit to SMEs. One way to resolve the dilemma is to create state-sponsored credit enhancement schemes, such as small loan guarantee facilities for SMEs. ADB can support the establishment of such credit guarantee facilities, which

may be partially funded by government and ADB. To ensure that due consideration is given to financial viability and that credit is not extended imprudently, lending institutions availing of guarantees must retain a share of the credit risk.

Public-private partnerships

The public and private sectors should complement each other in the overall development effort. Government efforts to form partnerships with the private sector will lower the risks and costs associated with investments, particularly for infrastructure projects. ADB can help identify the risks and costs associated with the present business environment, and support the development of workable public-private partnerships. The role of government in risk mitigation is crucial for early projects in a sector newly opened to private investment. Care must be exercised, however, in judging where the government's development function should cease and market mechanisms and institutions can take on the usual project risks, and when continued support to encourage project financing is still warranted.

An effective consultative mechanism can help promote and sustain public-private partnerships in the DMCs to balance social and development goals with commercial interests. ADB will embark on a much more proactive set of initiatives aimed at promoting and brokering such partnerships, particularly in infrastructure development, and advising governments on ways to develop substantive partnerships with the private sector. ADB will also tap into the extensive pool of private sector resources available regionally and globally, and develop networks and relationships with key PSD stakeholders. Respected business leaders from DMCs and countries providing bilateral aid will be invited periodically to a forum to provide ADB with feedback on trends and developments in the private sector and exchange ideas on promoting pro-poor growth.

A big challenge, and opportunity as well, for both the public and private sectors is the effective use of information technology to facilitate development efforts and enhance private sector competitiveness. New computing technologies in telecommunications and multimedia applications, including the Internet, can and do change

the competitive advantage of industries and provide new ways to reach out to a broader market. DMC governments can establish partnerships with the private sector to widen the use of information technology in delivering basic social services (e.g., distance education and telemedicine) and to help local enterprises increase their technological development. ADB should help DMCs to develop national policies and programs to accelerate the dissemination of information technology.

Physical infrastructure development. The DMCs' public sectors will continue to play a major role in the provision of infrastructure. However, private sector participation in partnership with the public sector can facilitate financing, construction, and operation of infrastructure facilities; improve efficiency; deliver much-needed services cost effectively; and release resources from public budgets at all levels. Through public sector operations, ADB will intensify assistance to DMC governments to create enabling conditions for private sector participation in areas such as energy, transport, and telecommunications. ADB will help establish an effective regulatory framework for private participation in infrastructure, build capacity of concerned regulatory agencies, strengthen state utilities dealing with the private sector as output offtaker or input supplier, and train and develop skills of public officials responsible for infrastructure development. In addition, ADB will develop sectoral templates for appropriate risk-sharing arrangements that would allow the private sector to earn reasonable rates of return, ensure equitable access to quality services, and save on the transaction costs of the lengthy processes involved. These approaches will be designed to help rationalize each sector and identify an effective role for the private sector in the provision of infrastructure services. ADB will ensure that the process of transferring infrastructure responsibilities to the private sector is transparent and competitive, and produces greater efficiencies and better service to consumers.

Public-private partnerships in physical infrastructure can take the form of BOT projects where there is a sharing of risks between the public and private sectors, with each risk being allocated to the party that can best manage it. The private parties involved in these projects normally assume the commercial risks that are under their control.

ADB has achieved some success in using TA facilities to create and develop such BOT-type public-private partnerships in collaboration with DMC governments.⁸

Public-private partnerships can be enhanced when the private sector undertakes a BOT project and the government provides complementary support infrastructure (which may have too long a payback period to be commercially attractive), e.g., a breakwater to protect a BOT container port terminal, or transmission lines to evacuate power from a BOT generating plant. In such cases, ADB can also have a public-private partnership internally, with PSO providing direct assistance to the BOT project and public sector operations funding the related public investment. Other examples of such partnerships, with both the public and private sectors involved in financing, implementation, and operation, would be (i) an airport project with air-side works undertaken by the public sector and land-side works by the private sector; (ii) a railway project with the public sector taking care of squatter relocation and grade separation, and the private sector undertaking the railway rehabilitation and operation; and (iii) a toll expressway undertaken by the private sector, with connecting provincial and rural roads provided by the public sector. Another form of public-private partnership is the export-oriented Theun-Hinboun hydropower project in Lao People's Democratic Republic (Lao PDR), which was implemented as a joint venture between private sponsors and the Government. The Government's equity contribution to the project was financed through an ADB public sector loan.⁹ The foregoing approaches to public-private partnership will be an increasingly prevalent way of doing business for ADB and call for close cooperation between public sector operations and PSO.

Catalyzing private infrastructure projects, a core competence of PSO, will be pursued under the strategy. ADB assistance for such

8 Loan 7152/1669-PRC: Chengdu Generale des Eaux-Marubeni Waterworks Company Ltd., for \$26.5 million, approved on 11 February 1999.

TA 2338-BAN: Private Sector Implementation of Meghnaghat Power Rural Electrification, for \$211,000, approved on 30 May 1995.

TA 2730-PRC: BOT Changsha Power Project, for \$597,000, approved on 23 December 1996.

9 Loan 1329-LAO: Theun-Hinboun Hydropower, for \$60 million, approved on 8 November 1994.

projects will be provided through direct financing and risk mitigation, and through investments in specialized financial institutions and investment funds aiming to support private provision of infrastructure services. Priority will be given to those projects that have clear benefits to all segments of the community, including the poor.

Social infrastructure development. ADB will selectively assist DMCs to identify and develop opportunities by which the private sector can help deliver more effective social services such as education, health, nutrition, water supply, wastewater treatment, and solid waste management. An example of public-private partnership in social infrastructure development is where private operators supply in bulk treated water to public waterworks distribution networks. The use of information technology, as in distance learning and telemedicine, presents opportunities to extend the reach of these services, especially to the poor. There are also opportunities to involve the private sector to achieve more effective and efficient delivery of essential services, for example, by contracting out to the private sector the provision of publicly funded social goods and services. ADB must recognize, however, that private investors will be attracted to provide social services only if the expected financial returns meet or exceed their cost of capital, regardless of who pays for the services. Aside from education and health, ADB will assist in addressing shelter problems through transparent, efficient, and sustainable private sector-implemented housing and home ownership programs, involving government support where needed.

Agriculture and rural sector development. The DMCs' agriculture sectors contain the single greatest concentration of private sector production. At the same time, the overwhelming majority of Asia's poor obtain their livelihood from agricultural production. Thus, ADB assistance in promoting public-private partnerships in agriculture can have a tremendous impact on poverty reduction in rural areas. For instance, a project in Papua New Guinea¹⁰ provides support for performance-based agricultural services on a contract basis and shifts the role of government agriculture agencies from directly providing extension services to managing service providers. To stimulate small

10 Loan 1652-PNG: Smallholder Support Services Pilot Project, for \$7.6 million, approved on 10 December 1998.

rural nonfarm enterprises that can help raise incomes and improve the welfare of the poor, particularly for poor women, ADB can support the establishment of viable and sustainable microfinance institutions. ADB will continue to assist DMCs in establishing mechanisms to facilitate market determination of input and output prices; in developing public-private partnerships in the supply of agricultural inputs, particularly in fertilizer distribution and agro-processing industries; and in transferring the management of on-field irrigation systems to farmer groups. ADB can also help strengthen public capacity to deliver rural credit, extension, and research, and manage irrigation and natural resources. Measures to clarify land title and ownership will advance private sector development in rural, as well as urban, areas.

Regional and subregional cooperation.

Regional and subregional cooperation has emerged as an increasingly important development strategy in Asia. Such cooperation offers larger markets that allow production economies of scale and efficient division of labor. Whereas in North America and Europe economic integration has involved formal regional cooperation arrangements (i.e., the North American Free Trade Agreement and the European Union), in Asia, economic integration has been driven largely by private sector initiatives, with governments playing an active, if largely informal, facilitating role. One recent example is the Private Sector Forum on Economic Cooperation in the Eastern South Asia Subregion (Bangladesh, Bhutan, Nepal, and 11 eastern states of India), which is being organized by the chambers of commerce and other representatives of the private sector from the concerned countries.¹¹ Indeed, the private sector has been both a prime mover and a prime beneficiary of regional cooperation in a widening network of intraregional investment and trade that is likely to outlive the Asian crisis.

Subregional cooperation, a key area of involvement for ADB, involves encouraging specific, limited linkages of complementary

11 The forum received a small TA grant from ADB (TA 5890-REG: First Meeting of the Private Sector Forum on Economic Cooperation in the Eastern South Asia Subregion, for \$30,000, approved on 23 December 1999).

activities across borders to create a region or subregion of economic growth. Economic cooperation can make a subregion, as a whole, relatively more attractive to private investors by extending access to factors of production, production processes, products, and markets beyond national boundaries: it provides wider business opportunities that accelerate development. Since subregional cooperation programs often involve “lagging parts” of participating countries, they can also contribute to poverty reduction.

In this context, ADB will concentrate on facilitating investment in subregional infrastructure projects that provide essential means for trade and investment linkages. For investors, such projects represent new types of business opportunities—and new types of risks: their transborder nature requires appropriate mechanisms to support project preparation and financing. ADB will thus assist in preparing, financing, and providing risk management for subregional projects that involve private sector participation.¹²

Complementing this, ADB will continue to play a significant role by helping to address nonphysical barriers to the movement of goods, services, and people. Examples include initiatives related to trade and investment facilitation, and cross-border training and standards certification and accreditation. This focus will allow the realization of economic benefits from investment in subregional infrastructure and, more broadly, will facilitate subregional economic linkages, integration, and development. In addition, ADB will serve as a center of excellence and clearinghouse for information and ideas on subregional cooperation at the policy, program, and project levels.

The experience of ADB in promoting regional and subregional cooperation is building up. A program of economic cooperation in the Greater Mekong Subregion, for example, was initiated in 1992 and the effort and resources devoted to the program appear to be paying off. A framework of cooperation in seven priority sectors in the subregion has been established and about 100 subregional projects have been identified and prioritized. ADB is also encouraging cooperation among the governments of People’s Republic of China,

12 An example of such a subregional project is Loan 1329-LAO: Theun-Hinboun Hydropower Project, for \$60 million, approved on 8 November 1994.

Kazakhstan, Kyrgyz Republic, and Uzbekistan. Projects are being designed to lay the foundation for economic growth through cross-border cooperation among these four countries. For the Pacific DMCs, ADB has provided assistance in examining the feasibility of a subregional securities market.

Country-specific strategies

The stage and status of private sector development differs widely among the DMCs. Thus, while the strategic actions proposed in the strategy are designed to be applicable across the region, they have to be tailor-made at the country level to meet the diverse conditions and changing needs of individual DMCs and to maximize the contribution to growth and poverty reduction. Country-specific PSD strategies will be formulated within the framework of the PSD strategy and as an integral part of ADB's operational strategy for individual DMCs. Depending on the country setting, the country strategy for PSD may require, (i) a primary focus on facilitating the emergence of domestic entrepreneurs by supporting related microenterprises and SMEs; or (ii) support for rural nonfarm enterprises or agri-business; or (iii) formulation and implementation of programs to support privatization and financial sector reform; or (iv) assistance with broad-based reform of enterprise ownership and private property laws, particularly in the transitional economies. Special consideration will need to be given to the small size of the Pacific DMCs and the great distances between them. A theme that is likely to run through all country strategies for PSD is improving the legal environment and the governance regime.

The required internal changes

Operational orientation, skills, and processes

For the strategy to be successful, ADB must make a commitment to change its operational orientation, its mix of staff skills, and its processes and procedures. Such internal change is at the heart of the strategy.

Operational orientation

In support of its primary objective, ADB must place poverty reduction as the centerpiece of all its operations. ADB as a whole must recognize the essential contribution of the private sector to pro-poor growth, which is needed to achieve sustained poverty reduction. With this recognition, ADB will need to institute a systematic process to ensure that public sector projects are designed to incorporate, to the extent possible, elements that promote a better business environment and/or provide appropriate scope for private sector participation in projects. In PSO, on the other hand, there will be a need to ensure that ADB pursues private sector projects with specific development impacts and/or demonstration effects.

Staff skills

The strategy will require new staff skills from PSD specialists (as distinguished from PSO investment officers). Such skills will constitute a core of intellectual capacity in ADB to address public policy issues

related to private sector participation in development (similar to the approach used for social development and environment issues). These PSD staff will prepare working guidelines to implement the strategy and sensitize other staff to PSD issues through training and consultation. PSD specialists will help identify areas for public-private partnerships, lead dialogue with governments on PSD issues, review ADB projects for private sector potential, and review government policies vis-a-vis the private sector. Skills relating to legal aspects of PSD, e.g., regulation of privatized utilities, will also be required.

Processes and procedures

A country-specific PSD strategy should be made an integral part of the country operational strategy (COS) to ensure that development of the private sector is explicitly targeted in ADB's programs for any given DMC. This operational integration should not be difficult as ADB's public and private operations are under the same charter, management, and institution. PSO should support the development goals of the COS. In this context, catalyzing private investments under PSO may be needed even in sectors that are not prioritized for public sector operations.¹³ The country assistance plan¹⁴ should, at the earliest stages, proactively consider private sector alternatives to, and/or commercial cofinancing of, prospective public sector projects or parts of these projects. Such private sector alternatives need not involve ADB support through PSO, but may be considered for direct ADB assistance only if they can contribute to pro-poor growth. The Inter-American Development Bank systematically asks why the private sector is not taking up some of the burden in a public sector project when designing, selecting, and processing projects.

PSD specialists, as well as PSO investment officers, will need to work as part of the now largely public sector country teams that are

13 For example, telecommunications may no longer be justified for public sector funding in certain DMCs, but ADB may have a role to play in catalyzing private investment in telecommunications projects in lesser developed DMCs. This is clearly evidenced by the Grameen Phone Project in Bangladesh, which addresses dimensions of poverty reduction and gender and development, while stimulating domestic entrepreneurship.

14 As a result of the recently approved redesign of ADB's operational business processes, in 2001 the COS and country assistance plan for any given DMC will be combined to form the country strategy and program.

responsible for country-level strategies and programs. PSD specialists will provide advice on PSD from a public policy perspective, while PSO investment officers will represent the private sector view based on their hands-on experience with private sector projects. Additionally, PSO investment officers will be included on project teams on a case-by-case basis where their skills are required in processing infrastructure and other projects involving public-private partnerships and public sector projects that have potential for private sector participation. Country and sector specialists in the programs and projects departments may support the processing of private sector projects, but because of the nature of risks involved and potential conflict of interest (*Box 4*), the lead responsibility will be with PSO investment officers.

ADB-assisted private sector projects will be screened for their development impact and poverty reduction contribution. The success or failure of any given private sector project will, from ADB's point of view, be evaluated on how well it meets the development impact areas identified at appraisal, in addition to its financial performance. The impact of ADB's public sector operations on PSD should likewise be benchmarked and tracked in terms, for example, of a public sector loan's contribution to creating a policy and/or physical environment conducive to private investment or to generating investment opportunities for the private sector. Scorecards will be developed, based on the rudimentary illustrations in Appendix 3, with each impact area in the scorecards to have specifically defined criteria.

ADB will need to enhance and institutionalize partnerships between public sector operations staff and PSO staff to achieve synergy across the organization, while keeping in mind the possibility of conflict of interest (*Box 4*). Networking and sharing of professional expertise will be encouraged. Disincentives to close collaboration will be removed.

Operating principles

To implement these fundamental changes required by the PSD strategy, two important operating principles are proposed to guide the delivery of assistance and concentrate ADB's efforts on where it can contribute best.

“Think PSD” in public sector operations. This entails deliberate efforts by public sector operations to improve the enabling environment for the private sector and to use the experiences of PSO as inputs to these efforts. The new operational orientation calls for disciplined, sequenced examination of private sector alternatives at key stages of ADB projects: (i) at project preparation, asking whether the private sector can undertake the project without government assistance or, if not, whether a public-private partnership is feasible, or whether parts of the project can be undertaken by the private sector; or (ii) after project completion when construction and implementation risks no longer exist, asking whether the private sector can step in by taking over management and/or ownership, partially or wholly, or by refinancing government debt. The deliberate pursuit of private sector approaches to ADB’s public sector operations does not necessarily mean less public sector lending. It will, however, mean that public sector operations should focus more on projects (i) that involve direct poverty interventions and/or (ii) that private investors are not prepared to undertake.

“Think development impact” in private sector operations. PSO’s orientation will be to achieve greater development impact and/or demonstration effects, and work with governments to take deliberate steps to reduce poverty. At concept clearance and due diligence stages of any private sector project, due consideration should be given to ensuring development impact through, for example, employment opportunities, cleaner environment, access to public services, effective competition, and better corporate governance. At the same time, clarity and transparency should be observed in dealing with private sector partners to retain their confidence. Demonstration and catalytic effects are also important in PSO, and these will be pursued by seeking private sector projects that can be replicated if successful. To broaden the impact of PSO in the region, there may be a need to extend the reach of PSO to smaller DMCs or to sectors other than finance and infrastructure, which constitute PSO’s present core competence.

Box 4. Managing Conflict of Interest

Potential for Conflict of Interest

Under the Private Sector Development strategy, there is a need for greater partnership and synergy between ADB's different private sector development activities. However, this creates more potential for conflict of interest to arise because ADB needs to be able to respond to requests for advice on policy reform to attract private investment to a sector, and for direct assistance in catalyzing private investment in the same sector. A typical situation in which ADB is likely to be exposed to conflict of interest is when it provides policy advice to government on an issue in which it has a financial interest related to an existing or prospective private sector investment. This gives rise to significant reputation risk, and can jeopardize the ability of ADB to provide impartial advice or make impartial investment decisions.

A Suggested Approach for Managing Conflict of Interest

To manage the risk, ADB must first identify the specific situations in which conflict of interest is likely to arise and, second, put in place a framework to address the issues systematically and effectively. However, the framework must not rigidly separate advisory and investment staff or unduly restrict the flow of information. Otherwise, the benefits of closer coordination will be lost. The concerned departments and offices should be responsible for identifying potential conflict of interest in their projects and bringing this to the attention of senior management as necessary.

World Bank Group Approach

Owing to the merger of certain World Bank and International Finance Corporation infrastructure and advisory groups, and the increased potential for conflict of interest this entails, the World Bank Group is currently putting in place a system to manage conflict of interest based on the same principles. Additionally, the World Bank Group will establish a separate Conflict Office to provide another layer of oversight. However, the primary responsibility remains with the project departments and senior management.

Instruments

ADB will use all instruments at its disposal for PSD, including policy dialogue, public sector project and program lending, TA, equity investments, loans without government guarantees, cofinancing, and guarantee schemes. The existing instruments of public sector operations are considered adequate to meet the requirements of the strategy. There is, however, a need to consider enhancements in the PSO instruments (*Box 5*). These instruments will be examined in separate Board papers. Furthermore, as the headroom for PSO becomes exhausted within the next couple of years, a decision will have to be made on the need to increase PSO's resource allocation, which currently stands at \$1.5 billion.

Box 5. Enhancement of Instruments for Private Sector Operations

Equity Investments and Loans

ADB has tended to use mainly senior loans and equity investments for its private sector operations (PSO). ADB will continue to use these instruments as well as others at its disposal (e.g., equity-linked and subordinated loans) based on the needs of its client companies. Currently, the prudential limit for a single project exposure is \$50 million (or 25 percent of project cost). With inflation increasing the investment size of infrastructure projects, it may be appropriate to raise the limit of \$50 million, while ensuring it is not more than 25 percent of the project cost.

Partial Risk Guarantee

ADB has not yet provided a partial risk guarantee (PRG). Borrowers have preferred to obtain a direct private sector loan from ADB rather than avail of a PRG (without government counterguarantee), given that both instruments are subject to a combined limit of \$50 million, which is the same as the limit for a stand-alone direct loan. A separate and higher limit is needed for PRG (without government counterguarantee) to enable ADB to meet the needs of clients, and to play a more significant role in mitigating sovereign risks. A separate review paper on PRG, currently under preparation, will analyze ADB's experience with PRG and propose modifications to existing policy.¹

Local Currency Financing

ADB will aim to develop local markets for long-term debt by issuing or guaranteeing local currency bonds and debt instruments to lengthen maturities and provide interest rate benchmarks. Through this, ADB could provide or facilitate long-term local currency financing for local projects and reduce currency mismatches on the balance sheet of corporate borrowers, such as infrastructure projects that earn local rather than foreign currency revenues. This could help borrowers avoid foreign exchange risk and enable ADB to more effectively participate in corporate debt restructuring exercises.

Technical Assistance Funds for Project Development

For ADB to extend the reach of its PSO to smaller countries and newer sectors, it must enhance its capability to develop projects. Resources for technical assistance are needed for this, particularly to develop facilities to assist SMEs and microenterprises.

¹ At the Inter-American Development Bank (IDB), the single project limit for PRG (without sovereign counterguarantee) was recently set at \$150 million or 50 percent of project cost, whichever is less. This is double IDB's limit for a direct loan of \$75 million or 25 percent of project cost, whichever is less.

The implementation plan

Communicating the strategy

A DB will communicate the strategy to its internal and external stakeholders by various means:

- (i) ADB-wide seminars will be conducted to increase staff awareness of the strategy.
- (ii) The strategic thrusts, areas of operational focus, and operating principles will be codified and disseminated to staff through staff instructions or the Operational Manual.
- (iii) External seminars and a media campaign will be organized to promote awareness of the strategy among government officials, international investors, local entrepreneurs, and the public.

Implementing the strategy

Effective implementation of the strategy will require the following postapproval actions:

- (i) A core staff of PSD specialists will be recruited to focus on PSD issues, with interface functions between the public and private sector operations of ADB.
- (ii) Country-specific strategies for PSD will be prepared as part of COS and country assistance plan for individual DMCs.
- (iii) Scorecards for public sector operations and PSO will be developed and operationalized.

Appendixes

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Taking stock of ADB assistance for private sector development through public sector operations

Credit line operations

Traditionally, the Asian Development Bank's (ADB) assistance for private sector development has been through its public sector operations. Through Article 14 (i) of ADB's Charter,¹ ADB has been extending credit lines to selected state-owned and private financial intermediaries of its developing member countries (DMCs) through the government or with government guarantees specifically to support investments in productive private small- and medium-sized enterprises (SMEs). The credit lines were a quick and cost-effective mode for ADB assistance to these private enterprises, which otherwise may not have had any access to foreign exchange needed for investment. ADB has approved 110 credit lines totaling about \$4.4 billion for use by 65 intermediaries in 23 DMCs. These have benefited over 22,000 SMEs.

Experience with these operations was varied. Several ADB-assisted development finance institutions (DFIs) have developed into profitable, mature, strong, and diversified institutions that play important roles in their countries' economic progress. These include, for instance: China Development Corporation (Taipei, China); ICICI Ltd. (India); Korea Development Bank and Korea Long-Term Credit Bank (Republic of Korea); Development Bank of Singapore, and Industrial Finance Corporation of Thailand. At the same time, several other DFIs, particularly state-owned ones, have encountered major problems resulting from excessive state control and regulation of their lending policies and operations; directed lending to specified enterprises or target groups; major changes in official trade and investment policies affecting client performance; substantial depreciation of the local currencies resulting in large exchange losses that destabilize clients and, in turn, the intermediaries' own stability; inadequate capitalization that cannot withstand substantial portfolio losses; inefficiencies arising from lack of competitive motivation and institutional weaknesses; absence of effective prudential oversight; and failure to develop alternative

1 Asian Development Bank. 1995. Agreement Establishing the Asian Development Bank. Article 4, para.1.

sources of long-term funding. Many of these weak DFIs became virtually bankrupt. To keep ailing DFIs afloat, some governments have continued to sustain them with subsidized funding, straining limited budgetary resources. The credit line operations have clearly shown that ADB's focus on the intermediaries alone will not ensure viability. Success depends to a large extent on the policy, legal, and regulatory environment in which the intermediaries function. Even strong and mature institutions may fail if the policy and regulatory environment is not conducive to efficient performance. The focus in these operations is, therefore, increasingly on broader financial sector reforms and wider institutional policies as much as on the soundness and suitability of the intermediaries chosen to channel ADB funds.

Historically, the credit line operations relied largely on state-owned DFIs. Since the 1990s, a number of private financial intermediaries (including commercial banks and leasing companies) have been used to channel ADB funds under umbrella credit lines. This has led to expeditious and competitive use of ADB funds. Credit line operations have also (i) enhanced ADB's contributions to institutional enhancement, capacity building, and human resource development in the financial sector; and (ii) reinforced ADB's policy dialogue with DMC authorities on financial sector reforms and capital market development issues.

Enabling environment

A range of ADB interventions has focused on improving the policy, legal, institutional, and regulatory environment of the private sector in the DMCs. Through policy dialogue with DMC authorities, technical assistance (TA), and since 1987, program lending, ADB has encouraged and assisted DMCs in formulating and implementing reforms that promote private sector development by removing market distortions, strengthening domestic financial markets, and promoting good governance standards. Program loans, in particular, have been used to support policy and institutional reforms in the financial sector (India, Indonesia, Lao People's Democratic Republic [Lao PDR], Sri Lanka, Thailand, and Viet Nam), agriculture (Bangladesh, Lao PDR, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, and Sri Lanka); industry (Bangladesh, Mongolia, Nepal, and Pakistan), hydrocarbon (India), trade (Indonesia), and road transport (Philippines).

Cognizant of the DMC's stage of development, and the fact that most DMCs had weak markets overshadowed by public interference offering poor incentives to private investors, ADB has supported the creation of an enabling environment for private investment. ADB provided support aimed at stable macroeconomic management; investment, trade, and price decontrol; well-functioning financial and capital markets; flexible labor markets; good infrastructure; and a legal system protecting and enforcing contractual and property rights. Solid, but partial, progress has been achieved in most DMCs. With program lending playing a key role, investment deregulation has been the area of greatest success, as DMCs have opened up closed sectors to private investment, both local and foreign. ADB support has played a role in India, Lao PDR, Nepal, Pakistan, Philippines, and Viet Nam, where prices were partially decontrolled. Although ADB has not yet explicitly undertaken labor reforms, its efforts to reform public enterprises and deregulate investment have indirectly supported the introduction of flexibility in labor markets. ADB has also provided assistance for legal system reform.

Physical infrastructure

In the 1990s, ADB began to address the weaknesses of public agencies in key sectors. These weaknesses appeared to be rooted in the structural characteristics of public ownership, a persisting obstacle to improving sector management in the 1980s. Growing recognition was being given to the effectiveness of competition to achieve efficient management of sectors that had originally appeared to be natural monopolies, and to lower costs despite the economies of scale that appeared to support monopoly structures. Privatization of state-owned enterprises (SOEs) in the physical infrastructure sectors became a principal objective of ADB. In DMCs with underdeveloped markets or constraints derived from their political economies, SOE corporatization became the alternative means of improving the efficiency of sector management.

ADB efforts to support the Philippines install new power generating capacity through private sector participation have been hugely successful, ending the brownouts that were the main obstacle to the Philippines' efforts to improve its investment environment. The

thrust of ADB's efforts in privatization has been substantially to commercialize state-owned utilities, with notable success in People's Republic of China (PRC), Indonesia, Philippines, Sri Lanka, and Thailand, and with ongoing efforts with good potential for success in India, Lao PDR, and Viet Nam. An important lesson learned is that powerful vested interests frequently seek to subvert privatization to their own ends; transparency and competitive bidding are key elements of sound privatization, but are not easily secured.

ADB has also supported several DMCs' efforts to pursue an integrated approach to transport development, with a focus on the road subsector. ADB has helped DMCs privatize road subsector management through road construction and maintenance and through tollways, which are commercially viable only on a few road sections in several DMCs. ADB has made successful progress with road construction and maintenance in nearly all the DMCs in which it has been active in the sector. ADB has improved sector management by transferring it from government line ministries to autonomous road authorities. ADB continues to seek ways to improve the funding of road construction and maintenance—a key issue—as revenues generated through vehicle and fuel taxes are significant, but tend to accrue to the budget rather than to the sector.

ADB has also been utilizing TA to help DMC governments identify the scope of private sector participation in infrastructure development, and formulate appropriate policy and regulatory frameworks to facilitate private investment. In 1998, ADB approved a TA for the study of private sector participation in gas transmission in Bangladesh, and port development in the Maldives. ADB also funded a study, completed in 1998, in the PRC road subsector that concluded that, although construction risk is best left to the public sector, once traffic volume increases to a sufficient level, leasing or securitization is a feasible option for mobilizing private capital for the transport sector.

Financial sector

In parallel, recognition was also being given to the fact that if infrastructure services are properly priced, they can be self-financing in their capacity to generate capital and to service debt, and do not need to be financed by government. This strengthened the need to

develop strong markets to support the financing requirements of private sector-led growth. With this aim, ADB shifted its financial sector operations from a narrow focus on the resource needs of DFIs, to a broader effort of developing financial and capital markets in the DMCs. In support of this second objective to develop DMC financial markets, ADB undertook the following range of activities: recourse to market pricing of funds and introduction of competition among lenders to reduce funding costs; decontrol of lending to allow funds to move to activities offering the highest returns; introduction of market-based funding of public sector borrowings; widening the range of instruments mediating between savers and borrowers; strengthening public supervision of deregulated markets; and improving DMC access to global capital markets. Primarily through program lending, ADB has made good, but partial, progress in financial sector and capital market reform in India, Pakistan, Philippines, and Sri Lanka.

Agriculture sector

An important part of ADB's agenda in the 1990s was the commercialization of agricultural production, as most of the DMCs were subject to heavy public intervention in the sector during the 1970s and 1980s. These interventions consisted of support prices and input subsidies for producers, and price controls on items consumed by the poor. In most DMCs, the balance of subsidies provided adequate production incentives, which combined with technological innovation, led to Asia's green revolution. Poverty reduction provided the rationale to redistribute through subsidies. But, what resulted were distorted incentives, misallocated resources, escalating fiscal deficits, and the dead weight of public bureaucracies. ADB has attempted to undo this by providing assistance to dismantle complex state interventions to allow markets to determine input and output prices; open the market for agricultural produce and input supply to the private sector; and develop rural infrastructure with a substantial focus on farm-to-market roads, rather than input supply. ADB also promoted wider participation by beneficiaries, nongovernment organizations (NGOs), and the private sector in the design and implementation of ADB projects.

A complementary objective in commercializing the agriculture sector was to reduce or reform the role of public agencies. ADB provided support to eliminate the public sector's role in the marketing of inputs and outputs in favor of the private sector, and assisted in transferring the management of on-field irrigation systems to farmer groups. Given the weak markets inhibiting the private supply of rural credit, extension, and research, ADB strengthened public capacity in the delivery of these support services and in the management of irrigation and natural resources.

The most notable impacts on the commercialization of the agriculture sector were made in the transition economies in Indochina,¹ the Central Asian republics (CARs), and Bangladesh. Through program lending, which has influenced policy changes, ADB has helped to induce impressive increases in output and productivity in Bangladesh since 1992. ADB program and project loans that have supplemented International Monetary Fund-supported interest rate, exchange rate, and pricing reforms; and have helped Lao PDR and Viet Nam implement sector policies that have reversed years of stagnating agricultural output and increased rural incomes. Program loans have also begun to facilitate the CARs in their transition from collective to private farming, and privatization of plantations has made good progress in Sri Lanka.

ADB's record in improving the delivery of support services has been mixed. Its support for agricultural research in international agencies and in DMCs has generated high returns in terms of developing new technologies and applying them on the ground. However, its record on improving rural credit has been poor, with the exception of microcredit, which is a relatively newer initiative that has shown good initial results and holds promising potential, particularly in its role in the development of women. This is due, in large part, to the weak performance of agencies ADB supports to manage irrigation, forestry, and fisheries. These problems are rooted in the structural characteristics of public management and negligible budget support.

1 Indochina includes Cambodia, Lao PDR, and Viet Nam.

Social infrastructure sector

ADB has been partly successful in improving the management capacity of public agencies entrusted with the delivery of health and education. Where feasible, management has been entrusted to beneficiaries and NGOs, or contracted out to the private sector (e.g., maintenance of vehicles, construction, or accounting and billing). However, as the actual delivery of health and education services remains in the public sector, ADB has provided significant amounts of capacity building, principally through training, to address weaknesses in delivery. ADB is increasingly providing support to DMCs through program and project loans to assist them in shifting budget funds from sectors that are self-financing, such as physical infrastructure, to those that are not, primarily health and education.

In urban development, ADB has shifted from discrete financing of urban water supply systems to a more integrated approach encompassing the financing and management of urban development. This has included (i) delineating boundaries between urban and provincial or national authorities to separate responsibilities and establish accountabilities; (ii) financing frameworks that facilitate revenue collection, revenue sharing, and cost recovery, and allow the development of borrowing capacity and self-financing municipal budgets; (iii) contracting out municipal services and privatization where possible (e.g., ADB-supported privatization of Manila and Colombo water supply); and (iv) capacity building of municipal bodies. These issues have recently become part of ADB's policy agenda.

Postcrisis assistance

Following the Asian financial crisis, ADB has taken significant measures to help its crisis-affected DMCs. In 1998, to help Indonesia strengthen its financial sector and assure a sustainable flow of resources to the private sector, ADB approved a \$1.5 billion loan to support reforms of governance in the financial sector to assist in sector restructuring, and to restore its ability to effectively mobilize and efficiently allocate resources for investment. With physical infrastructure bottlenecks constraining growth, ADB has been helping DMC governments encourage private sector participation in the

provision of physical infrastructure services. ADB approved a \$300 million loan to the Philippines for a power sector restructuring and privatization program, designed to transfer ownership of power generation to the private sector.

Catalyst for information

ADB has played a pivotal role as an intermediary and catalyst of information flows. ADB sponsored a regional workshop in Manila in December 1998 that brought together government officials, bankers, and private sector developers to discuss best practices for promoting private investment in power, ports, airports, expressways, and water supply development.

Regional and subregional cooperation

ADB has played a significant role in the emergence of several initiatives aimed at regional cooperation. It nurtured and sustained the effort, launched in 1992, of six countries in the Greater Mekong Subregion to develop norms of cooperation that have now reached the level of preparation of specific subregional projects in transport and energy, with the participation of the private sector. Two other subregional groupings (Indonesia-Malaysia-Thailand, and Brunei Darussalam-Indonesia-Malaysia-Philippines) have requested ADB assistance to prepare subregional growth centers. More recently, the South Asia Growth Quadrangle (Bangladesh, Bhutan, India, and Nepal) has asked for ADB assistance, and ADB has already undertaken a similar initiative in the CARs.

Good governance

Although ADB formally adopted good governance as a development objective only in 1995, sector level governance interventions have formed part of its operations since its inception. These have focused mainly on the governance dimensions of private sector development and public sector reform, but good governance comprises key elements that cut across sectors and require a macro framework approach: public administration, public finance management, subnational governance, and development of sound judicial and audit frameworks. In the past two years, ADB has initiated work in all these

areas in several DMCs, and will continue to do so, with the additional element of improving information technology.

Commercial cofinancing

Commercial cofinancing (i.e., private capital) has been mobilized for public sector institutions. In the Philippines, for example, ADB used its partial credit guarantee to enable the National Power Corporation to tap the Japanese capital market for 20-year yen financing. In addition to facilitating capital market development in the Philippines, this transaction helped the corporation increase its exposure to market-based sources of financing. Commercial cofinanciers typically require adherence to agreed financial ratios, generally accepted accounting principles, and other market-related requirements. The financial discipline associated with commercial cofinancing complements financial reforms in public sector institutions. In addition, the involvement of private capital through commercial cofinancing can help set the stage for successful restructuring and/or privatization efforts.

Lessons learned

A lesson learned for the use of credit lines, both in relation to the financial intermediaries and assisted private enterprises, is that the right policy, legal, and regulatory environment, and good governance are vital for effective functioning. While ADB has helped DMCs address the enabling environment, the Asian crisis showed that concerted efforts are required by DMCs and, in turn, by ADB. This underlies ADB's rationale in reducing its DFI lending in the 1990s, as most DFIs were inextricably linked to public interference in resource allocation. ADB support for employment-generating investment has shifted to creating an enabling environment for market-based financing, rather than directly providing investment funds, to promote more inclusive and sustainable growth toward the ultimate goal of poverty reduction.

The rise in economic growth rates in Asia, up to the financial crisis, was the most important event of the 1990s. The market-driven and private sector-oriented framework that enabled this transformation was mostly put in place by the DMCs themselves. However, many DMCs turned to ADB for assistance, notably in South Asia, the

transitional economies, and the Philippines. In these cases, ADB can claim credit for successful efforts in this area. ADB's efforts in the Pacific DMCs were less fruitful, as structural constraints remain difficult to overcome in these small states. In the Pacific DMCs, ADB assistance has shifted to improved aid coordination, rather than additional aid, with a focus on supporting policy frameworks and private investment.

ADB has used several approaches to reduce poverty. The first was to consider how to relate growth-oriented projects. Growth is the single most important contributor to poverty reduction; increasing employment and access of the poor to productive resources are recognized tools to this end. However, ADB has learned that growth in the DMCs must be labor intensive. One of the most crucial comparative advantages of ADB's DMCs lies in their inexpensive labor forces. Policies that have facilitated labor-intensive, rather than capital-intensive, production have been the key to generating real employment, typically in industrial and service SMEs and through foreign direct investment. ADB is keeping these lessons in mind and bringing them to bear in establishing links between its growth, led by the private sector, and poverty reduction objectives.

A third lesson learned is that ADB's public and private sector windows should have worked more closely together to increase benefits to the DMCs, and optimize development impacts. Public sector assistance pay systematic attention to private sector interests and concerns. ADB will draw on this experience in reviewing its approach to private sector development.

Private sector activities of other multilateral agencies

The World Bank Group

World Bank (WB)

Support by the World Bank Group—The World Bank (WB), International Finance Corporation (IFC), and Multilateral Guarantee Agency (MIGA)—for private sector development to promote growth and efficiency, and thereby to reduce poverty, has undergone substantial evolution. Early project lending focused on creating the infrastructure base to complement industrial and agricultural development. Adjustment lending in the 1980s expanded the focus by working to establish a macroeconomic framework for private sector development and appropriate relative prices. Since 1989, a strategy has been incorporated that focuses on improving the business environment, restructuring the public sector and supporting privatization, and reforming and developing the financial sector in developing countries. Together, the components of this strategy are helping to nurture a healthy private sector, a prerequisite for attracting private capital flows.

Efforts to improve the business environment focus on necessary policy, regulatory, and legal reforms. These activities have an increasingly sharper focus through a program of private sector assessments, initiated in fiscal year 1992 and carried out in conjunction with IFC.

Promotion of public sector restructuring has tended to focus on trimming overextended public sectors and supporting privatization of state-owned enterprises (SOEs) and private sector delivery of public services. However, the focus has shifted to complement privatization with efforts to upgrade areas of public administration that have the potential to profoundly affect the growth and efficiency of the private sector: tax and customs administration, trade and investment promotion, enterprise-support services, court administration, and infrastructure planning and provision. WB is also involved with issues relating to the importance of transparency, dealing with the potential direct social costs of privatization, and establishing a postprivatization environment that stimulates competition, promotes equity, and inhibits avoidable concentrations of ownership and economic power.

WB provides support for the private provision of infrastructure, focusing on (i) privatization of public utilities; (ii) development of regulatory frameworks to provide appropriate mechanisms for pricing privately delivered infrastructure services, encouraging competition and, where appropriate, removing barriers to entry; and (iii) provision of WB financing or partial guarantees to attract additional private capital for infrastructure projects.

In the financial sector, WB focuses on creating the appropriate legal, regulatory, and supervisory structures to realize the full benefits of financial sector reform. WB emphasizes the need for policy reform in conjunction with macroeconomic reform, improvements in the financial infrastructure, and strengthening of specific financial institutions.

WB is improving its capacity to support governments design and implement private sector development reforms by understanding the dynamics of the environment affecting private sector development and devising ways to eliminate or work around obstacles to implementation; forging links between various local institutions critical to private sector development to build capacity so that local institutions can deepen and sustain progress initiated through WB; and learn from successful country experiences internationally, and tailor these to a specific country's needs.

In recent years, WB's efforts to support private sector development have accelerated rapidly. Typically, about two thirds of all WB operations include components that explicitly support private sector development. WB has a vice president under who a critical mass of highly competent professionals has been assembled to provide technical support for financial and private sector development, and the industry and energy sectors. WB has also initiated major efforts to promote small- and medium-sized enterprises (SMEs) and the entrepreneurial role of women, encouraging the private sector in the poorest of developing countries and supporting the necessary underpinnings of public sector reform.

Recently, WB started reaching out to, and conducting dialogue with, multinational corporations (MNCs) in an effort to promote private enterprise in developing countries. WB has noted that in many countries where it operates, the industry sector consists mainly of

export-oriented enterprises, such as textiles and electronics, over which the host country has little influence on market and production decisions: the MNCs are in control. Without this dialogue with MNCs, multilateral development banks run the risk of providing incorrect advice if they do not understand the decision-making processes of multinationals.

WB and IFC recently began working together to create synergies. They are undergoing an organizational change at the corporate level and a merger of offices is being orchestrated in the field. Colocation of offices has already been accomplished in a number of countries to better coordinate IFC and WB efforts in private sector development. There has been a recent merger of the positions of the WB country director with the IFC resident representative. In a recent move to increase its presence and operations in the Asian region, a joint WB-IFC regional office is being established in Singapore.

International Finance Corporation (IFC)

IFC was established in 1956 as a member of the World Bank Group. It is a legally and financially independent multilateral agency that fosters economic growth by promoting private sector investment in its developing member countries (DMCs). IFC combines aspects of a multilateral development bank with that of a private merchant bank. In its project financing, IFC provides loans without government guarantees, makes equity investments, and seeks to mobilize additional project funding from other investors and lenders through loan syndications, parallel financing, and guarantees. IFC prices its financing and other services in line with the market, and seeks profitable returns. In addition, IFC sponsors and funds selected financial intermediaries.

IFC offers a range of advisory services and technical assistance (TA) in such areas as capital market development, corporate restructuring, risk management, and project preparation and evaluation, and advises member governments on creating an environment that encourages the growth of private enterprise and foreign investment. IFC maintains an emerging markets database, functions as an adviser to several projects that it finances, and frequently joins large MNCs and leading DMC business groups in its operations.

IFC's general policy guidelines are quite similar to and, in some respects, identical with those of ADB for direct private sector financing. IFC views development, not profits, as its primary goal. But, it sees the aim of profitability as consistent with the development objective and not in conflict with it. IFC seeks to strike a proper balance between its profitability and risk-taking in its investment activities. It makes a major contribution to development when its involvement makes a critical difference to investors intending to proceed with large investments that have an important impact on a country's economy. IFC tries to ensure that its participation makes a special contribution that supplements or complements the role of market operators.

IFC has been quite active in private sector financing in Asia, aided by its representative offices in Bangkok, Beijing, Islamabad, Jakarta, Manila, and New Delhi, and now by the newly opened joint IFC-WB office in Singapore. IFC's assistance to projects in Asia covers a wide range of industry and infrastructure sectors. It has financed projects in the oil refining, petrochemical, cement, textile, automobile, electronics, and agro-processing industries, as well as in energy, transport, telecommunications, tourism, and health. Some of these projects have been jointly financed by ADB. IFC has also supported several financial intermediaries in commercial banking, leasing, and housing finance. As part of its Foreign Investment Advisory Services program, IFC has provided advice on investment policy and procedural aspects to several Asian countries, including Bangladesh, People's Republic of China (PRC), India, Lao People's Democratic Republic (Lao PDR), Malaysia, Mongolia, Nepal, Philippines, Sri Lanka, Thailand, and Viet Nam. In addition, IFC has been providing advice on corporate financial restructuring and on privatization. To help entrepreneurs in the region's smaller economies establish new businesses or expand and diversify existing ones, IFC has established a South Pacific Project Facility based in Australia.

In the past, IFC focused mainly on sectors rather than on countries. This is, however, beginning to change as the planning exercise is now being driven by country considerations. However, when a project is cleared for processing, the concerned sector department takes the lead and drives the process. IFC's strategy currently focuses on three areas: (i) key sectors that were originally in the public sector but are

now moving to the private sector, i.e., infrastructure, oil and gas, transport, utilities, and education; (ii) financial sector, with emphasis on domestic financial market development; and (iii) SMEs. In its work to support SMEs, IFC has established a business advisory unit that provides capacity building and advice on producing viable business plans as well as accounting, financial, and credit analyses, and risk assessment skills to help SMEs and start-ups in their operations.

IFC used to prepare country assistance strategies (CAS) separately from WB. Currently, the IFC works closely with WB to prepare joint country strategies, particularly for activities in capital market development, foreign direct investment (FDI) promotion, and SME development. This has been institutionalized in the sense that the Board is aware of the process. For countries classified as high priority due to IFC's large investment program or where significant opportunities have been identified, IFC prepares a detailed private sector strategy as an annex to the CAS to supplement what is included in the text. There are 20 such countries. For lower-priority countries, the private sector strategy will only be included in the text. For countries classified as hostile to the private sector, IFC does not participate in the CAS. IFC signs off on the CAS and the Board presentation is done jointly.

To facilitate a division of labor and to prevent a conflict of interest on the advisory side, IFC will normally provide advisory services on issues such as FDI or regulatory frameworks, whereas WB advises on policy issues. IFC discloses its investments in projects so host governments are fully aware of the dual role played by IFC. In case of jeopardy, if IFC is a lender and/or investor, it acts as representative of other investors and lenders, whereas WB would advise on policy issues. This is where the "firewall" must be put up between the two entities to prevent a serious conflict of interest.

For the guarantee instrument, WB's guarantee program has not been used extensively, but IFC has issued \$100 million as guarantees. To mitigate risks, IFC shares guarantees with the local banks, and the local banks price the loan based on the percentage IFC is guaranteeing.

Multilateral Investment Guarantee Agency (MIGA)

MIGA was established in 1988 to reduce poverty through FDI to and among DMCs, by offering political risk investment insurance coverage

to private investors, and providing promotional and advisory services to help its DMCs attract and retain FDI. MIGA estimates that 55 out of 1,400 projects are submitted to their Board, and of the 1,400 projects received annually worldwide, 400 are from Asia. Twenty percent of MIGA's portfolio comes from Asia. Projects have been guaranteed in Bangladesh, PRC, and Pakistan. A constraint faced by MIGA in doing more work in Asia is the fact that some of their host countries are not MIGA members, e.g., Cambodia and Thailand.

MIGA recently raised its capital to \$2 billion, its project limits to \$200 million (project size of up to \$1 billion) and country limits to \$620 million. In 1998, it provided 73 guarantees worth \$1.3 billion, mainly to power projects, charging 50 to 150 basis points. MIGA has issued 60 guarantees related to infrastructure projects. High investor confidence in the past made obtaining political risk insurance for war or insurgency a low priority. The trend, however, has reversed. Most of the policies underwritten by MIGA provide coverage to investors in the event of war in the host country.

MIGA would like to collaborate with ADB in the following areas: (i) providing guarantees to projects where ADB is an investor; (ii) coinsuring in ADB projects with ADB; and (iii) relying on ADB's due diligence on projects that MIGA insures, as similar standards (e.g., environmental and labor) set by ADB are also required by MIGA.

Inter-American Development Bank

The Inter-American Development Bank (IDB) has traditionally followed policies similar to those of WB for private sector development. In recent years, private sector development has begun to occupy a more prominent position in its activities. IDB has set up the Inter-American Investment Corporation (IIC) to support SMEs in Latin America and the Caribbean with loans, guarantees, and equity investments. IDB also administers the Multilateral Investment Fund (MIF), which was established in January 1993 to finance programs for policy change, training, and improved access to credit to help member countries strengthen their private sectors. The MIF consists of a technical cooperation facility that helps identify and implement policy changes to promote the private sector, a human resources facility that helps retrain displaced workers and strengthen worker productivity, and a

small enterprise development facility that helps broaden economic participation by the poor, women, and minorities.

Over several years, IDB has made a conscious effort to promote institutional change in mindset and work processes. This has resulted in much closer collaboration between its public and private sector departments to successfully develop private sector projects in its DMCs. IDB established a management review process whereby justification must be made systematically as to why the private sector is not participating in a public sector project. This review process is proving to be an incentive for the public sector departments to coordinate with the private sector departments to identify projects that have the potential of being undertaken and/or funded by the private sector.

To facilitate the coordination of activities for private sector development, the president of IDB created a private sector coordination committee. The committee is comprised of the vice president and individuals from MIF, IIC, the Private Sector Department, and the Legal Department. The key to the committee's success relies on agreements in internal processes.

To promote the development of the private sector, during its eighth replenishment in 1994, IDB raised its private lending limit from 5 percent of annual lending commitment to 10 percent. Project limits were also increased to \$75 million or 25 percent of total project cost, except for smaller countries where a limit of up to 40 percent of project cost applies.

Inter-American Investment Corporation

The Inter-American Investment Corporation (IIC) is a multilateral investment corporation that promotes the economic development of its regional member countries by stimulating the establishment, expansion, and modernization of private SMEs in the Latin American and Caribbean region. IIC began operations in 1989 with subscribed capital of \$200 million; this was recently increased to \$700 million. IIC provides long-term loans and guarantees to, and makes equity investments in, private enterprises that have difficulty raising finance from other sources on reasonable terms. It provides lines of credit to financial intermediaries. By Charter, IIC can only provide corporate

lending or project financing; it is prohibited from accepting sovereign guarantees. IIC mobilizes additional capital for assisted projects through syndication and underwriting operations, by identifying joint venture partners and facilitating transfer of technology. IIC also provides fee-based advisory services to private firms and advisory services to member governments on their investment policies, and assists them in privatizing SOEs, particularly those of medium size.

IIC supports projects that, in addition to providing potentially profitable investment opportunities, have a development impact on the host countries. Particular attention is paid to mitigating adverse environmental impacts. IIC is currently developing a new product—an agency line of credit—that will enable them to lend directly to a project sponsor with a financial institution counterpart. The risk will be borne by IIC and the financial institution to the extent of their respective exposures.

European Bank for Reconstruction and Development

The European Bank for Reconstruction and Development (EBRD) was established in 1991 with a unique mandate to foster the transition to open market economies and to promote private and entrepreneurial initiatives in the Central and Eastern European countries committed to, and applying, the principles of multiparty democracy, pluralism, and market economics, thereby assisting their economies to integrate into the international economy. EBRD seeks to help the countries where it operates to establish the framework of a market economy, implement restructuring and privatization, create modern infrastructure, strengthen financial institutions and legal systems, and develop the local private sector. EBRD has 55 members, and like ADB enjoys a strong triple-A credit rating that reflects its strong capital level and membership, and conservative fiscal policies.

EBRD has merged its merchant banking with its development banking. Not less than 60 percent of its funding is to be directed to private enterprises and/or SOEs that are implementing programs to achieve private ownership and control. Not more than 40 percent of EBRD's funding is to go into public infrastructure and other projects. In reality, 85 percent of EBRD's operations benefit the private sector directly or indirectly, but 50 percent of these deals involve government

risk. In all its projects, EBRD must follow three principles: transition impact, sound banking and investment, and additionality.

EBRD's Banking Unit is organized into six business groups, three of which are country groups and the other three sector groups. The country groups include (i) the Russia Federation and the Central Asian republics (CARs), (ii) Central Europe, and (iii) South and Southeast Europe, and the Caucasus. The sector groups include financial institutions, infrastructure, and industry and commerce. The sector groups normally take the lead and, currently, are lending 80 percent of the business, but there is an effort to push more business to the country groups. The country groups take care of sectors not covered by the sector groups, but overall, a country team approach is used. EBRD does not do programming work with governments as ADB does, and they also do not do advisory work.

Currently, their strategy is to focus on the following: (i) supporting banks and other financial institutions that have an institutional commitment to SMEs; (ii) providing a full range of financing structures in infrastructure operations including private, sovereign, subsovereign, and public-private partnerships; (iii) supporting the restructuring of potentially viable large enterprises, by carefully selecting a few projects that have a strong demonstration effect; (iv) continuing equity investments; and (v) promoting a sound investment climate and strengthening institutions that are important for the functioning of markets, by working closely with its foreign investment advisory councils.

EBRD's Risk Management Unit is located outside of the Banking Unit. The Risk Management Unit is responsible for reviewing every transaction, and signs off on all private sector projects. The Operations Committee helps coordinate the country and sector groups. In its project work, both the concerned country and sector groups get full credit regardless of which group originates or leads the deal. This provides an incentive for the country and sector teams to work together. The Operations Committee is cochaired by the vice president and deputy vice president of the Banking Unit, and is comprised of the head of finance, the chief economist (who ensures the transition impact), the general counsel, and the head of risk management.

EBRD is doing work with municipalities, given the trend toward decentralization of governments. They treat the municipality as a nonsovereign entity, i.e., a private sector entity, as a municipality does have its own sources of funding and does not depend solely on government transfers. An important criteria adhered to by EBRD is that all of its projects must be self-sustaining and, over time, the project revenues must be able to service the debt.

Scorecards Concepts

Private Sector Operations: A Scorecard for Greater Development Impact

A scorecard can “score” all prospective private sector projects against a set of development impacts desired in the developing member countries (DMCs). These development objectives will be defined in terms of the Asian Development Bank's (ADB's) strategic development and private sector development objectives. ADB-assisted private sector projects should have development impacts as defined by these objectives. Table A3.1 presents a conceptual illustration of the scorecard concept, using ADB's existing private sector projects as examples. Further refinement and elaboration will be needed to implement such an approach.

The scorecard will enable ADB to strengthen the development focus of its private sector operations because it will have defined upfront what the objectives of these operations are.

Table A3.1: Scorecard for Development Impact of Private Sector Projects (An Illustration)

Country	Project	Development Impact Areas									
		Poverty Reduction through Growth	Environment Protection	Subregional Cooperation	Infrastructure Improvement	Capital Market Development	Better Banking	More Competitive Sector	Opening to Foreign Direct Investment	Good Governance	Forex Saving/Earning Initiative
BAN	La Farge Surma Cement	■	■	■	■				■	■	■
PRC	Everbright Bank	■					■	■	■	■	
PHI	Maynilad Water Services	■	■		■			■	■		
THA	Eastern Power	■	■		■	■		■	■	■	

Public Sector Operations: A Scorecard for Greater Private Sector Development Effect

A scorecard can also be developed to track the contributions of ADB's public sector projects to private sector development, where public sector loans help to create enabling conditions or generate investment opportunities for the private sector (*Table A3.2*).

Table A3.2: Scorecard for Private Sector Development Effects of Public Sector Projects (An Illustration)

Country	Project	Private Sector Development Effects							
		Create Enabling Environment	Build Regulatory Capacity	Promote Effective Governance	Facilitate Financing	Develop Capital Markets	Provide Support Infrastructure	Generate Investment Opportunities	Commercial Cofinancing
IND	Private Sector Infrastructure Facility			█	█	█	█		
PHI	Power Sector Restructuring	█	█	█			█	█	
THA	Export Financing Facility	█		█	█				█