SigmaBleyzer

Where Opportunities Emerge.

THE BLEYZER FOUNDATION

Turning Transitions Into Prosperity

Private Sector Role in Accelerating Foreign Direct Investment Flows to Developing Countries

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Introduction

The SigmaBleyzer Group believes that the international private sector should be playing a much more active role than the one it has played so far in improving business environments in developing countries. We propose to establish a Private World Fund to accomplish this objective.

Developing countries benefit enormously from foreign direct investments. Foreign direct investments bring resources, new technologies and expert management to developing countries. But so far, these international capital inflows have concentrated only on a small group of countries that have already implemented a significant critical mass of reforms and that already enjoy improved business environments. In fact, in the recent past, only five countries (China, Brazil, Mexico, Chile and Poland) have received as much as 65% of all foreign direct investments to developing countries. We believe that international private capital could play a more important role in the world if it were to not just go into countries with sound policies, but actually lead less advanced countries to carry out necessary economic reforms to improve their business environments. This hybrid approach for the private sector — taking greater advantage of investment opportunities in a larger group of developing countries and inducing economic reforms to improve business environments — will be not only more beneficial to the developing world, but it would also benefit the international community at large.

A more active engagement by the private sector under this hybrid strategy would have the dual purpose of accelerating economic growth in developing countries and providing superior returns to private equity investments in these countries.

This paper discusses the rationale for a more active engagement of the private sector on inducing economic reforms to improve business environments of developing countries, and suggests an approach to achieve this objective.

The Problem of Inequality in the World Today

The world today is facing unprecedented challenges. The threat of terrorism is everywhere. Demonstrations and raids against globalization and the established order are widespread. Regional conflicts affect countries on every continent.

We believe that the origin of most of these troubles is poverty and income inequalities, combined with greater recognition by the poor of their deprived conditions. Many surveys have shown that over the last two decades, except in Africa, most developing countries have been able to drastically reduce their levels of "absolute" poverty. But today, in most developing countries, there is more income inequality than there was a decade ago. Although the poor have improved their lot, these improvements have been less striking than the improvements attained by the rich. The rich are getting much richer, while the poor are barely able to survive. The table below shows that over the last 40 years, while the ten richest countries were able to improve their real income per capita by 177%, the 10 poorest countries improved their income per capita by only 7%.

GDP per Capita (constant 1995 USD), Average for Ten Richest and Ten Poorest Countries

	1960	1970	1980	1990	2001	Change, 2001 vs. 1960
Ten Richest Countries*	$13,951	$21,629	$27,715	$31,965	$38,671	177%
Ten Poorest Countries*	$152	$174	$180	$180	$163	7%
Gap, times	92	124	154	178	237	159%

** by GDP per capita (constant 1995 USD)*
Source: World Bank, World Development Indicators, 2003

The above table also shows that whereas in 1960, the income per capita of the ten richest was 92 times the income of the ten poorest countries, this multiplier increase steadily to 237 times in 2001. This disparity in rates of GDP growth per capita has led to more income inequality.

A similar picture is depicted in the table below. In this table, the performance of the same group of countries in 1960 (the ten richest and ten poorest countries in 1960) was followed up to 2001. That is, the table shows the improvements in income per capita of those countries that in the year 1960 were either the richest or the poorest ones.

GDP per Capita (constant 1995 USD) for Ten Richest and Ten Poorest (as of 1960) Countries

	1960	1970	1980	1990	2001	Change, 2001 vs. 1960
Ten Richest Countries*	$13,951	$19,363	$23,768	$28,997	$35,710	156%
Ten Poorest Countries*	$166	$213	$269	$296	$327	97%
Gap, times	84	91	88	98	109	30%

** By GDP per capita (constant 1995 USD) as of 1960. Ten richest countries as of 1960 include: Switzerland, Denmark, Luxembourg, Sweden, United States, Netherlands, Norway, New Zealand, France, Austria Ten poorest countries as of 1960 include (excluding China): Togo, Nigeria, Kenya, Pakistan, India, Burkina Faso, Nepal, Lesotho, Burundi, Malawi*
Source: World Bank, World Development Indicators, 2003

The table below shows that on a regional basis, in terms of growth in income per capita, only the East Asia and Pacific region has been able to perform better than the OECD countries. The regions that have performed less well are the poorest countries in Sub-Saharan Africa and the former centrally planned economies that are still in the process of transition to a market economy.

GDP per Capita (constant 1995 US$) by Region

Regions	1960	1970	1980	1990	2001	Change, 2001 vs. 1960
OECD members	9,969	15,301	19,736	25,174	29,897	200%
Latin America & Caribbean	2,058	2,618	3,695	3,406	4,131	101%
Central Europe & CIS	—	—	—	2,705	2,316	–14%
Middle East & North Africa	—	—	1,909	1,760	1,988	4%
East Asia & Pacific	150	190	297	511	990	562%
Sub-Saharan Africa	475	612	660	587	569	20%
South Asia	186	225	240	334	474	154%

The Impact of Income Inequalities on Quality of Life in Developing Countries

Income inequalities between developed and developing countries have also led to disparities in the quality of life between developed and developing countries. For example, since 1960, infant mortality in higher income countries was reduced from 35 to 5 deaths per 1,000 births. But for low income countries and highly indebted countries, the reduction in infant mortality has been less significant and still remains very high at about 80-100 deaths per 1,000 births, as noted below:

Infant Mortality Rate, by Income Group (per 1,000 live births)

Income Groups	1960	1970	1980	1990	2001	Improved by
High Income	35	22	12	8	5	76%
Middle Income	118	79	54	40	31	61%
Low Income	148	128	110	91	81	37%
Heavily Indebted Poor Countries (HIPC)	165	139	113	105	99	29%
World	119	94	78	63	56	40%

Source: World Bank, World Development Indicators, 2003

Life expectancy at birth has improved in all countries. It has reached 78 years in high income countries. For low income countries, the improvements are very significant, but life expectancy in these low income countries is still relatively low at less than 60 years of age, as noted below.

Life Expectancy at Birth, by Income Group, Total (years)

Income Groups	1960	1970	1980	1990	2001	Improved by
High Income	69	71	74	76	78	13%
Middle Income	46	61	66	68	70	52%
Low Income	43	48	53	57	59	37%
Heavily Indebted Poor Countries (HIPC)	41	45	49	52	51	25%
World	50	59	63	65	67	33%

Source: World Bank, World Development Indicators, 2003

A similar picture of disparities emerges with illiteracy rates. Although over the last decades progress has been made in all countries, the table below shows that higher income countries have made more significant gains than poorer countries, with illiteracy rates at present at only 3.4%. On the other hand, illiteracy rates are still very high in low income countries at about 40%.

Illiteracy Rate by Income Group, Adult Total (% of people ages 15 and above)

	1970	1980	1990	2001	Improved by
High Income (selected OECD countries*)	13.4	8.7	5.7	3.4	75%
High Income (selected Non-OECD countries**)	21.4	14.6	10.5	7.3	66%
Middle Income	34.5	25.6	18.5	13.1	62%
Low Income	64.0	55.6	47.0	38.1	41%
World	44.1	36.1	28.9	22.9	48%

* *Selected OECD countries include: Italy, Korea, Rep., Portugal, Spain, Greece*

** *Selected non-OECD countries include: Barbados, Brunei, Cyprus, Hong Kong, China, Israel, Macao, China, Malta, Netherlands Antilles, Puerto Rico, Qatar, Slovenia, United Arab Emirates*

Source: World Bank, World Development Indicators, 2003

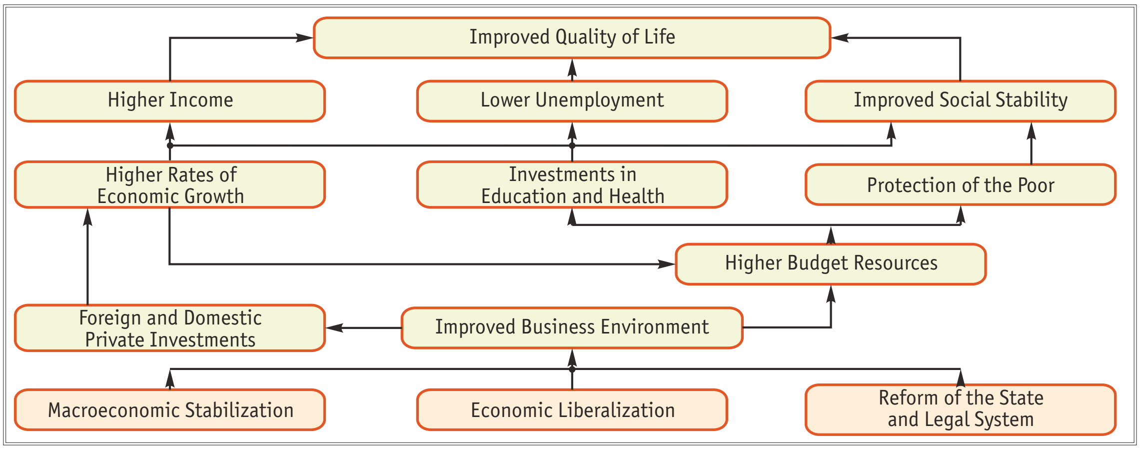
The problem of inequality depicted in the above tables is now more evident to most people in the world. The communications revolution of the last 20 years has vastly improved the global exchange of information. As a result, the poor are now better able to recognize their growing income disparity with the rich. Consequently, many groups of poor people have become more dissatisfied. This has led to resentment, frustration and desire to change the current world order. Furthermore, massive migrations from rural areas to overpopulated cities have contributed to high unemployment rates in many developing countries. Despite several decades of relative prosperity in most of the world, social tensions are as high as they have ever been.

Recent terrorist events have shown that developed countries cannot isolate themselves from these inequalities affecting developing countries. They will not be immune to the tensions and resentment affecting the world. Therefore, helping developing countries to overcome their plight should be the highest priority for the most advanced countries, if they wish to preserve their well being. The status quo is no longer satisfactory, and pure transfer of wealth from developed to developing countries would only be a temporary solution. In fact, the most advanced countries should have a strong interest in fostering "wealth creation" in developing countries, rather that just isolating their economies with a "stand-off" strategy, or attempting to "pay-off" countries with monetary aid transfers with the hope that this will avoid threats that could come from these countries. Neither of these last two strategies has worked in the past. Developed countries must be more proactive, through advice and investments, in helping developing countries address their economic difficulties and accelerate their creation of wealth.

How to Create Wealth

The international experience of wealth creation shows that an open and competitive market economy is the best system to create wealth on a sustainable basis. An open market economy would give people the incentive to make a profit and generate wealth, while competition would "regulate" the market to avoid abuses of power. The creation of wealth, together with policies aimed at helping the poor directly, is the only sustainable way to improve the quality of life of the populations in developing countries. And the creation of wealth requires the implementation of economic reforms that would improve business environments, increase investments and foster economic growth at high rates.

The chart below shows the relationship between improvements in the quality of life, sustainable growth and economic reforms.



The chart shows that the quality of life will improve to the extent that salaries and incomes increase, the level of unemployment is reduced, and there is improved social stability. To achieve these results, a key factor is a high rate of sustainable economic growth. Higher rates of economic growth should be able to increase the population's incomes. Studies in some countries have shown that GDP must grow at no less than 5% per year for several years before it will have a noticeable impact on poverty alleviation and income distribution. Very few developing countries can claim these high rates of economic growth. And lower rates of growth would not reduce income inequalities.

In addition to sustainable and high economic growth, significant investments in health and education, and in safety nets to protect the most vulnerable poor, are also required in order to improve the well being of the poor. These investments are essential to allow the poor to move ahead on a steady basis. But it is only through higher rates of economic growth that developing countries will be able to generate the fiscal revenues needed for education and health spending and the protection of the poor. Sustainable economic growth, therefore, is the key to improvements in the quality of life of the population, alleviation of poverty and improved income distribution in developing countries.

High and sustainable economic growth, in turn, will require high levels of new private investments, both domestic and foreign, as well as better utilization of existing investment assets. The level and use of investments will depend on the adequacy of the business environment, which can be summarized as the combination of three factors, as noted in the chart above: macroeconomic stability, economic liberalization and sound government and legal systems.

Unfortunately, most developing countries have low levels of the savings necessary to finance domestic investments. Low savings are the result of low salaries, low profitability of domestic enterprises, inadequate banking sectors, and large informal markets. These countries are trapped in a vicious circle of low investments, low economic growth and high poverty. To escape this trap, most developing countries require supplemental financing through private foreign investments to achieve the necessary high rates of economic growth.

A significant increase in investments is a key to achieving improved quality of life. These investments would yield greater benefits if the business environment favored investment effectiveness. Modern Western economies derive their growth mainly from productivity gains. In fact, the expansion of production inputs, both labor and capital, account for less than 50% of the increases in output achieved by the US during the last two decades. Productivity gains are secured through the application of better technical and management skills, including business reengineering, better technology, better strategy formulation and implementation, and better know-how. Developing countries will need to equip themselves with these skills. Experience in many emerging markets indicates that the most successful way to introduce better technical and management skills is by facilitating private foreign direct investments, including joint ventures with local firms. Therefore, in most developing countries, foreign direct investments will have a dual role: first, to bring international savings, and second, to bring best international practices in technology and management.

The Role of International Private Capital

The good news is that the international private sector has been quite active in transferring financial resources to developing countries. Experience over the last two decades shows that some countries that were able to secure larger inflows of foreign capital were able to achieve above average levels of GDP growth. The table below shows that foreign direct investments (FDI) are indeed the largest and most stable source of foreign financing for developing countries:

Net Capital Flows to Emerging Markets, (in US Dollars, billions)

	84-89	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total Private	12	151	193	227	133	78	87	47	43	80	113	94
- Foreign Direct Invest	13	81	101	116	144	156	175	166	181	143	144	145
- Portfolio Flows	4	113	24	83	63	11	20	−4	−51	−53	−23	−17
- Comm. Bank Loans	−5	−44	67	27	75	89	−108	−115	−87	−10	−8	−35
Net Official Loans	26	4	50	−2	42	58	8	−13	21	7	10	−16

1 Includes Developing and Transition countries, Korea, Singapore, Taiwan, and Israel
2 2001 prices
3 For International Reserves a minus sign indicates an increase in reserves. For Other categories, a minus means a net outflow
Source: IMF, September 2003 (2003: projection, 2004: estimate)

On a net basis, developing countries have been able to attract about $150 billion per year of FDI.

The bad news is that most of these foreign direct investment flows have been channeled to a very limited number of countries: in 2001, five developing countries (China, Mexico, Brazil, Poland and Chile) received 60% of the inflows of foreign direct investments. The main reason for this concentration of resources is that the rest of the developing world does not offer business environments that are attractive enough to be of greater interest to international investors.

Inadequate Support for Economic Reforms to Improve Business Environments

In addition to concentrating resources in a few countries and ignoring the rest of the world, the international private sector has not been actively engaged in providing substantive advice to developing countries on the economic reforms needed to create a favorable business environment. Despite the fact that the international private sector should be the main beneficiary of favorable business environments in the rest of the world, and despite the fact that the private sector has the best on-hands experience in how to build business confidence, the major effort to advise developing countries in the design and implementation of economic reforms has been delegated to the government-owned international financial institutions.

It is widely recognized that today, the principal sources of economic advice to developing countries on economic transformation and transition are the international financial institutions (IFIs) — the IMF, the World Bank, and the regional development banks. Bilateral institutions, such as USAID and the Know-How Fund, have also played a role, though this role has been secondary. Private NGOs and "think tanks" have also been active in advising developing countries on economic reforms. But these private NGO groups do not have any real leverage in fostering reforms in developing countries, since they do not provide large amounts of financial resources.

Ineffectiveness of the International Financial Institutions

The two major IFIs, the World Bank and the IMF, were created in July 1944 by the United Nations Monetary and Financial Conference of Bretton Woods, New Hampshire to help the reconstruction of Europe and to support economic development elsewhere. The IMF was entrusted with the aim of promoting stability in exchange rates, promoting free trade among member countries, and providing temporary balance-of-payments support when needed. The objective of the World Bank was to promote economic development in developing countries. Over time, both institutions have been the main promoters of economic reforms in developing countries.

The record, however, has not been good, and this is not because they lack good people to diagnose and prescribe. The main reason is that they are at heart political "official" institutions, owned by governments and operating under political rather than economic incentives. They suffer some of the problems faced in developing countries by state-owned enterprises. Their goals and objectives are unclear and diffused and suffer from ineffective multiple government control. The Governing Boards and chief executives of these institutions are political appointees and are there first to defend the interests of their countries and only secondarily to support the spread of economic reforms.

The chief executives of the IFIs are political appointees of the US President (for the World Bank) of the EU (for the IMF), and of major regional powers (for the regional development banks). Some of these chief executives have been competent, with good focus and objectives. But the IFIs have also had chief executives that moved their organizations erratically in many directions. These chief executives exercise almost unlimited power in their organizations without adequate checks and balances. Although these deficiencies were recognized by other governments, they could do little to change it, because chief executives are considered the sole prerogative of the individual G-7 countries. Indeed, these institutions suffer the problems of lack of "ownership" responsibility and "agency problems" (the inability of management to represent the interest of all shareholders) that is endemic in state-owned enterprises.

Depending on the interests of the G-7, the priorities of the IFIs have changed from time-to-time — from operations to support infrastructure and utilities (the initial objectives of the World Bank), to those that support industry and small and medium enterprises, to support agriculture, to education and health, to environmental protection, etc. Although these objectives are all commendable, the multiplicity of objectives has led to an unclear vision and strategy for the support that these institutions should provide to improve the quality of life in developing countries. Quite simply, these institutions have failed to create the business environments developing countries need to encourage more widespread private sector activities.

These difficulties have also led these institutions to concentrate on "easy" sectors that are non-controversial and would be easily approved by everybody. This would normally mean more loans and investments in the social sectors (education, health, environment), which are unlikely to raise questions. Although these projects are necessary, they may be better financed on a more sustainable basis by greater fiscal budget resources that would come from higher rates of economic growth. Currently, much less emphasis is put on lending for private sector development, which would require policy reforms that may collide with vested interests (such as liberalization of business that may bring foreign competition) and may require a tougher stance.

These institutions also have great pressure to lend and to make sure that each country will receive a "fair" share of lending. Some of the pressures to lend come from their desire to maintain their creditworthiness and avoid defaults, lending just to enable the countries to re-pay their debts. This also means that they have pressures to maintain "friendly" relations with all countries, regardless of their commitment to reform. As a result, the incentive to the staff is to be over optimistic about the prospects of reform to enable continuation of lending. Internal budget limitations also leads to insufficient due diligence before loans are made. Similarly, the lack of accountability for public funds has led to inadequate supervision and control in the use of loan proceeds. There are numerous, well-documented cases in which the uses of loan proceeds were inappropriate, particularly in loans for balance-of-payments support. These cases have led many observers to believe that a good portion of the financing provided by the IFIs was just wasted.

In the past, most developing countries used to openly welcome the advice and support provided by the IFIs. This is no longer the case. Many borrowing countries have lost confidence in these institutions as they are seen as instruments of the G-7, used to advance their narrow interests. Non-performing countries understand the lending pressures of the IFIs and play a lip-service game by repeating reform promises they had made earlier and failed to live up to the first time around. Many developing countries are now skeptical of the advice provided by the IFIs and just play the game.

In fact, over the last decade, the issues with the ownership and management of the IFIs have been highlighted by a number of financial and economic crises experienced by developing countries. These crises have caused doubts about the adequacy of the economic advice provided by the IFIs. For example, during the Asian crisis of 1997-98, the IMF indiscriminately applied its usual formula: it insisted that the affected counties increase their domestic interest rates (to stop capital outflows) and attain large surpluses in their fiscal budgets. In retrospect, it is now recognized that these measures simply deepened the crisis, increasing the number of corporate bankruptcies and negatively affecting the financial sector.

Similarly, the lack of a clear vision in Argentina led the IFIs to make major multibillion-dollar loans to the country. These loans just permitted Argentina to avoid taking necessary fiscal discipline measures and prolonged a system that was already decayed. Thanks in part to these loans, Argentina was able to delay the implementation of a fundamental cornerstone of a free market economy: the maintenance of sound fiscal and monetary policies. In fact, for a number of years the central as well as provincial governments ran unsustainable fiscal deficits that were covered by excessive amounts of foreign and domestic debt and privatization receipts. Monetary policy was driven by a hard-peg exchange rate that became overvalued, due to inflation rates higher than dollar inflation and significant devaluations in neighboring countries. Furthermore, Argentina failed to implement reforms to provide more flexibility to labor policies, one of the major adjustment tools under a Currency Board arrangement. As a result of these fiscal, monetary and labor policy failures, the country opted to cover its deficits by borrowing heavily from abroad. Consequently, the size of Argentina's foreign debt increased to about US$160 billion by the end of 2001. This foreign debt level represented about 300% of exports, significantly exceeding the international rule of thumb that foreign debt should not exceed 200% of exports. Despite these shortcomings, the IFIs provided generous financial support to the country, contributing to the current economic chaos. Eventually, Argentina could not serve this government debt and went into default, creating the financial crisis that is still ongoing.

The World Bank's involvement in Russia provides another example of the failures of the IFIs given their political nature. Recently, the World Bank acknowledged that its activities in Russia in the last decade were inadequate. In a report of its activities from 1992–98, the World Bank noted that its involvement did not help in setting up a market economy. Its influence on the development of Russia in 1992-1998 was minor, and its credit programs were implemented only partially under insufficient political will. The blame for this is put on everybody, particularly the pressures put by the Bank's G-7 political shareholders. Because of this pressure, the World Bank had to prematurely launch its activities in Russia and lend significant amounts too early, including loans for budget support before the country was ready. This political pressure caused the World Bank to take hasty measures towards many lending projects. The Bank's decisions were not properly thought-out, and it was impossible to predict the results of their implementation. Risky operations became failures. This may have actually contributed to the financial crisis of 1998 and aggravated its consequences for the country. Instead of helping, many of the measures may have hampered reforms.

One example failure is the multi-billion dollar loans to reform the banking system. The World Bank claimed that it did not have the influence to overcome political and economic barriers in Russia in the 1990s. Another example is the Bank's assistance to the Russian coal industry. Despite numerous operations and attempts to reform, the coal industry is in the same condition today as it was before. As a result of these failures, the influence of the World Bank on the Russian Government now is negligible.

All these issues have significantly reduced the ability of the IFIs to provide economic advice in a credible manner. In fact, in a large number of developing countries, the IFIs have become irrelevant. Despite the fact that the interest rates on their loans are very low, institutions such as the World Bank now find it difficult to maintain their target levels of lending. Countries just do not welcome their involvement, unless they are in the middle of a financial crisis.

Given past weaknesses with foreign aid, there is a need for the IFIs to change the composition of their lending. In the past, the bulk of this assistance — particularly from the IMF and the World Bank under its structural adjustment loans — has been provided to governments and government agencies principally to finance budget deficits and provide general balance-of-payment support. The funds were disbursed in tranches and paid to the Ministries of Finance and Central Banks of developing countries. These funds were not used directly for productive purposes, but to support the balance-of-payments or to finance fiscal budget expenditures of the governments. This lending was accompanied by requirements and conditionality that these countries should implement economic reforms that would improve their business climate. Unfortunately, as noted above, the implementation of this conditionality has not been satisfactory and countries often just paid lip service to it. In many cases, policies were reversed after the institutions had provided the financing due to pressures from political and vested interest groups. In other cases, the Ministry of Finance just did not have the influence on other parts of the Government to secure the reforms agreed upon with the IFIs.

We believe that in the future, except for special financial support in periods of crisis, the bulk of foreign aid should be directed to support the creation and growth of a healthy and competitive private sector. As noted earlier, it is only with a healthy and growing private sector that the Government will be able to raise the budget and other resources to finance necessary investments in health, education and safety nets for the poor. With a well-developed private sector, the developing countries themselves will be able to deal with most of their social issues. The need to obtain external financing for this purpose would be minimized. In terms of priorities, the bulk of international aid should be channeled to create favorable business environments that would spur private sector activities.

The problems facing the IFIs have led to reservations, not only of the institutions per se, but of the adequacy of the market-based reforms normally supported by the IFIs. In fact, negative comments about the IFIs by respected economists such as Joseph Stiglitz are interpreted by many as criticisms of the economic reforms themselves. This is unfortunate, since the proper implementation of market-based policies are necessary conditions for international private investors. In the end, the developing countries that ignore market-based reforms today will not be able to benefit from large flows of foreign direct investments.

Under these circumstances, the opportunities for investments in developing countries have been shrinking over the last few years. The international private sector is missing the opportunities that may otherwise exist in developing countries.

The privatization of the IFIs — with well defined roles and focus — would resolve most of the problems arising from their government ownership and management. Unfortunately, this privatization of the IFIs is unlikely to happen anytime soon, due to the interest of G-7 governments to "control" international organizations that would further their political (as well as economic) interests.

Clearly, the IFIs have not been able to provide the support to carry out necessary reforms in developing countries to sustain economic growth. The next section discusses the question of whether the flows of international official aid have been beneficial to sustain economic growth in developing countries.

Official International Aid Flows

Official Development Financing (ODF) constitutes a significant share of the total financial flows from developed to developing world. The table below shows that ODF to developing countries reached $68.8 billion in 1992.

Total Official Development Assistance to Developing Countries, US$ billion (2001 prices)

	1960	1965	1970	1975	1980	1985	1990	1995	2000	2001	2002
Net ODF	19.5	18.1	18.1	20.0	25.4	35.5	41.1	54.6	61.1	63.5	68.8

Source: OECD DAC Creditor Reporting System database.

Official development financing is defined as all financial flows that go from advanced economies (developed countries' governments) and multilateral financial institutions to the developing countries and countries in transition. Official development financing includes several subcategories such as official development assistance (ODA), official aid (OA), and other concessional and non-concessional official flows (OOF). Most ODF is provided in the form of grants. In fact, over the period of 1980–2002, on average 75% of net ODF flows constituted grants, including technical assistance grants. The rest is composed principally of concessional loans. During this period, the share of official grants has increased from 60% in 1980 to 81% in 2001. The share of loans in the net ODA to developing countries fell from 40% in 1980 to 20% in 2001. This increase in the share of grants to developing countries is attributed to a marked increase in the amount of debt forgiveness for heavily indebted developing countries and increases in the amount of technical assistance. In fact, in 2001, technical assistance amounted to about one third of net ODF. Technical assistance grants represent financial flows that are usually not reflected in developing countries' balance of payments, as most of them go to developed countries' residents (for example, payments for consultancy services provided by donor country residents, administrative costs of donors).

Official development assistance from bilateral sources significantly outweighs the amount of aid provided by multilateral institutions. Over the last twenty years, the median distribution of aid flows between the two sources has been roughly the same — about 70% of total aid flows came from bilateral donors, and about 30% from multilateral. In terms of bilateral financing, the largest donors in absolute terms are the USA, Japan, France and Germany. In 2000–2001, these four largest donors accounted for almost two-thirds of all aid flows to developing countries. In 2002, most donor countries reported a real increase in ODA, including almost 12% real growth of ODA from the United States (to $12.9 billion) primarily due to additional emergency and distress relief funds within its anti-terrorist campaign.

The table below shows the distribution of ODA across developing countries, both by geographical groups and by income levels.

Distribution of ODA Grants to Developing Countries, US$ million

	1960	1970	1980	1990	2000	2001	2002
Developing Countries, Total	19,301	17,410	32,941	45,998	40,417	42,853	48,505
Geographical groups							
North and Sub-Saharan Africa	5,680	5,518	9,299	20,596	12,740	13,523	16,441
North & Central America	355	628	911	2,351	2,335	2,867	2,193
South America	661	1,043	1,009	1,553	2,216	2,448	2,655
Far East, South & Central Asia	8,835	4,934	6,903	6,744	7,086	8,281	9,311
Middle East	1,391	1,646	7,894	5,012	2,992	2,356	3,804
Central and Eastern Europe	—	—	—	63	2,578	2,491	2,513
Former Soviet Union countries	—	—	—	0	2,957	2,896	3,246
Income groups							
Least Developed Countries	1,884	3,114	9,782	12,067	10,141	10,699	13,188
Other Low Income Countries	5,540	3,936	4,501	6,827	6,120	7,876	8,031
Low Middle Income Countries	4,494	3,993	8,271	12,502	10,010	11,004	13,128
Upper Middle Income Countries	1,190	1,123	2,130	2,793	1,727	1,831	2,270

Source: OECD DAC Creditor Reporting System database

On regional destinations, the most favored countries for ODA flows have always been and still are African and low income Asian countries, which received about 72% of the cumulative net ODA flows to developing countries over the last twenty years. The poorest countries of Africa have always been among the largest recipients of development financing (mostly in the form of grants). During 1980–2001, African countries received $424 billion of net ODA (including $326 billion provided to Sub-Saharan Africa). But the progress in poverty reduction in this region was extremely slow, thus contributing to the growing perception that aid flows have failed to support development.

Over the 20 year period, Asian countries received $428 billion in net ODA, primarily for India and China where the largest number of people in extreme poverty live. About 10% of total ODA to developing countries was channeled to Latin American countries during 1980–2001. Following the end of the Cold War, a number of former Soviet bloc countries became recipients of official aid. Over the period of 1990–2001, countries of Central and Eastern Europe and former Soviet republics received almost $80 billion of official development assistance from both bilateral and multilateral donors. This amount represented about 12% of the total ODA flows to developing and transition countries over the period. Over the last twenty years, ODA flows to Central Asia and the Middle East fell by 19% and 71% respectively.

The table below shows the top 20 recipients of official assistance over the last twenty years, on a cumulative basis and in relative terms. It shows that, in relative terms, the largest recipients of aid were middle-income countries of the Middle East and North Africa. Low-income countries of Sub-Saharan Africa and South and Central Asia received almost 20% less on a per capita basis.

The largest ODA recipients in 1980-2001

No.	Country	Net ODA/OA, US$ billion1980–2001 cumulative	Aid per capita, US$		GNI per capita, US$	
			1980	2000	1980	2000
1	Egypt	55.68	59.96	20.76	500	1,490
2	India	50.28	5.23	1.46	240	450
3	China	44.34	0.11	1.37	300	840
4	Bangladesh	37.99	25.61	8.94	150	370
5	Indonesia	35.80	12.34	8.23	470	570
6	Israel	34.70	417.25	128.33	5,390	16,710
7	Pakistan	27.72	24.82	5.09	290	440
8	Tanzania	22.29	56.04	30.33	238	270
9	Philippines	20.85	11.95	7.64	650	1,040
10	Jordan	17.80	735.21	113.04	966	1,720
11	Ethiopia	17.49	8.90	10.78	120	100
12	Sudan	17.17	53.05	7.25	400	350
13	Mozambique	17.17	21.34	49.57	323	230
14	Morocco	16.97	74.92	14.61	930	1,180
15	Syria	16.93	323.94	9.79	1,450	950
16	Thailand	16.80	18.19	10.55	670	2,010
17	Poland	16.77	—	36.12	3,934	4,190
18	Kenya	15.80	38.37	17.02	420	350
19	Russia	15.03	—	10.75	—	1,690
20	Zambia	13.82	89.48	78.81	600	310

Sources: OECD DAC, the World Bank.

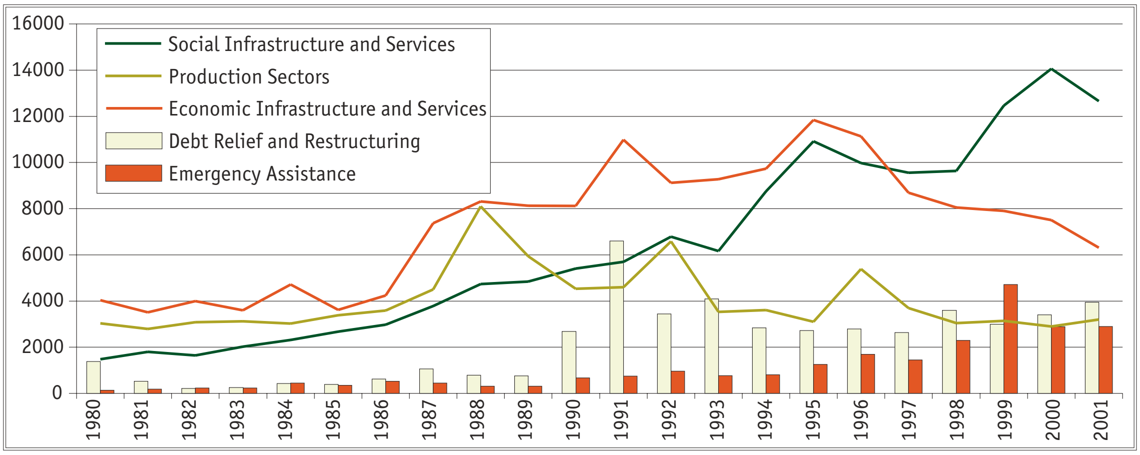
In the above list, two transition countries — Russia and Poland — entered the top-twenty list of aid recipients over 1980–2001, although these two countries have been receiving official development assistance for only the last 11–12 years. Distribution of official assistance and aid to developing countries by income groups shows that almost equal amounts of aid have been provided to least developed, low-income, and lower middle-income countries over the period of 1980–2001 in cumulative terms (some 22–27% of the total net ODA flows to developing countries).

The above country distribution of aid is the result of the fact that bilateral donors usually favor a limited set of countries, chosen primarily according to the priorities of the donor's foreign policy. For example, relatively large amounts of official US aid went to Egypt, Israel, Pakistan, Russia, and Poland. Japan allocates most of its aid budget to Asian countries, while French and British official assistance tend to flow to their former colonies. Although multilateral aid is considered to be free from political motivations, in practice, multilateral ODA flows roughly follow the dynamics of bilateral aid since most multilateral aid funds are dependent on the political will of these countries.

Uses of ODA Financing

The utilization of ODA funds has been changing over time as donors reconsider their priorities and perception of the recipients' needs. Over the last decade, there has been a clear trend towards allocating more aid to social programs (health, education, civil society etc.), emergency and debt relief. As a result, since the late 1980s, donors have been gradually moving away from channeling large amounts of aid with clear economic development objectives. The share of aid for economic development purposes fell from an average 65% in the 1980s to 34% in 1990s. The table below shows the utilization of ODA provided by bilateral donors over the last twenty years:

Major Use of ODA by Bilateral Donors (on commitments basis), US$ million



Source: OECD DAC Creditor Reporting System.

The main problem with this distribution of aid is that, without sustainable economic growth, developing countries just become dependent on foreign capital to support their social sectors. Over the long term, the developing countries would be much better off if international aid were to be used to increase growth and fiscal revenues. Governments of these countries would then have the funds to finance their social sectors. They would become self-sufficient, rather than relying on charity.

Effectiveness of Official Aid

The ultimate goal of international aid flows is poverty reduction or more broadly, the promotion of human well-being. Unfortunately, the above tables show that actual distribution of aid flows has largely been determined by criteria other than poverty reduction or even growth promotion. Although all donors view these objectives as primarily for allocation of their financing, the quality of official development aid has eroded by a combination of political and commercial interests on the part of most donor and recipient countries over the last decades. For example, the sharp increase in aid flows in the early 1990s is attributed to the Gulf War of 1991, and a major part of additional funds provided to developing countries during this period was in the form of emergency aid, which was temporary in nature. Another upsurge in official flows to developing countries occurred in 1995–1998, which is attributed to the wave of financial crises in emerging markets (Asia, Russia).

Official aid flows may play a very important role in the crisis periods. But these funds are unlikely to have significant impact on long-term development goals. There are many reasons for the failure of aid to induce sustainable growth in developing countries. Among the most important are:

1. **Political rather than developmental objectives of foreign aid allocation by donors** provide perverse incentives for recipients, thus making it more difficult for these countries' governments to implement the necessary economic reforms. Many developing countries that

failed to meet their reform commitments kept receiving substantial amounts of foreign aid, the effectiveness of which was quite low.

2. **Lack of ownership of development assistance projects and programs by recipients.** By and large, donor agencies lead the process of development in the recipient countries; they determine the amount of aid to be delivered in the particular country, the terms of their use, the main beneficiaries and partners of the aid projects, etc. Recipient countries' governments are therefore more concerned with fulfilment of tasks formulated by donors rather than the outcomes of aid projects for their citizens.

3. The practice of **aid tying** by donors also diminishes its effectiveness. A significant portion of bilateral ODA is tied by source as well as by end use. On average, the largest donors — the USA, France and the UK — tie the major part of their assistance to developing countries (only 35–40% of all aid came in untied form). Tied aid has less real value because of highly bureaucratic procedures that donors want the recipients to follow for acquiring such aid resources.

4. **Lack of coordination among the donors in their aid activities** in each particular country leads them to launch and implement aid projects and programs that have divergent and even contradicting objectives, which confuse the recipients and diminishes the effectiveness of the aid resources. Contradictory objectives, combined with low institutional capacity of recipient governments, substantially undermine the effectiveness of aid.

5. Many developing countries **lack administrative capacity to absorb large aid inflows**, which results in low efficiency of donor's resources. If recipient countries' governments have low institutional capacity, foreign aid flows are unlikely to be allocated in a productive way. In this case, much more aid will be spent for consumption rather than investment purposes, therefore increasing the country's dependence on foreign aid and contributing to corruption. Tight strings attached to aid can also overload the administrative capacity of aid recipients as they create highly bureaucratic procedures for acquiring aid resources, thus reducing their real value. For example, a recent ODC study found that in 1996, 600 development projects in Tanzania translated into 2,400 quarterly reports a year to supervisors, and more than 1,000 annual missions to monitor and evaluate the work. Naturally, each visitor needs to meet with key officials, and each wants the government to comment on reports.

6. **Inefficient terms of aid use.** More substantial aid resources go to social development programs than to economic development programs and projects that contribute to an environment conducive to growth and wealth creation in the recipient country.

7. **Aid Fungibility.** Foreign aid is often allocated into provision of public goods and services, thus substituting for the corresponding efforts of the recipient governments, which lack budget resources to implement these functions. However, with constant aid flows to key public sectors, recipient governments tend to underestimate the amount of resources they should invest into public infrastructure, even when sufficient budget resources become available.

8. **Trade barriers imposed by developed countries for the developing countries' exports.** While promoting trade openness in the developing countries and encouraging the recipient governments to implement policies conducive to the development of export-oriented sectors of the economy, donors keep their markets largely restricted for inflows of goods produced by developing countries (this includes subsidized production of goods in developed countries; it concerns primarily agricultural sector).

All the above suggests that ineffectiveness in the use of ODF is common, and as a result, massive aid flows have failed to bring about sustained economic growth and higher standards of living to recipient countries. It is unlikely that official aid will be able to bring sustainable economic growth to developing countries in the future. This would require improving coordination, increasing ownership and reducing aid dependence, which requires mutual actions of donors and recipients. Unfortunately, donors do not have unified criteria and conditions for giving aid, and as a result, the present mechanisms for implementing aid conditionality are seriously flawed. Furthermore, given political interests of donor countries, the amount of aid allocated to private sector development and other economic development projects is unlikely to grow.

Aid from multilateral sources (the international financial institutions,) was expected to alleviate some of the problems arising from bilateral sources. This promise was not met.

The International Private Sector as a Solution

Given the above problems, the international private sector should now stand up. A private sector initiative to encourage economic reforms to improve the business environment could be more focused on the private sector, more demanding on assessing the conditions of success, not operating in a hopeless environment, and more capable of walking away when promises are not fulfilled.

One could ask why the private sector has not been more involved in inducing policy reforms if these reforms are so important to the health and profitability of their businesses. This is because economic advice is a "public good". Its provision has a cost incurred by the advice provider, but the benefits will accrue to all investors, not only to those that provide the advice. Once it is available, everybody will reap the benefits. An individual investor will not engage in this activity as the cost is high and the improvements will also benefit its competitors, who would just be free-riders, not bearing any of the costs. This kind of "public good" demands "collective" action among a group of investors.

The major global corporations that transfer the bulk of the FDI should have their own "collective" instrument to provide sound economic advice to developing countries to improve their business environments. It is time for the global corporations to be actively engaged in providing both economic advice and financial resources to accelerate the transformation of developing countries. The international business community has a lot to gain or lose if things turn out to be deficient in developing countries. This privately owned IFI could provide a clearer private sector view to developing countries on matters of economic reform. It would provide a new, fresh approach directly from the experience of private sector companies. But most importantly, this "Private World Bank" may be able to link its advice to the most significant source of international financing in the world today — foreign direct investments. In today's world, there is a clear need for an alternative channel of economic advice and financial support to developing countries, owned by the private sector.

We propose that this "collective" private sector instrument should be a private equity fund, herein called the Private World Fund (PWF).

The Private World Fund (PWF)

The PWF would implement the concept of a new dual, hybrid approach for the private sector to advise and invest in selected developing countries.

Initially, the PWF would operate on a pilot basis, testing the concept in a limited number of countries. The selection of the countries would be based on the following criteria:

- The countries selected should have a high probability of success.
- Their governments should show a high degree of commitment to the concept, are ready to move forward with reforms, and would welcome the fund's activities.
- There must exist a clear authority to execute our program within the governments,
- The countries should be capable of executing the program.
- The private sector in the countries should be willing to invest.
- There must be a sense of urgency.
- There should be low barriers to change, without institutional protection.
- The international private sector investors should already be interested to some degree.
- There must be the possibility of proving the approach, which means:
- there are not too many "hands" already in countries, and
- there should be a visible cause and effect, which means that the countries are not yet fully developed in their reform agenda.

On the basis of the above criteria, the most likely candidates are the countries of Eastern Europe and Southern Europe.

For the execution of the pilot phase, fund financial requirements would be more limited. Initially, the PWF would raise between $200 million and $500 million from private sources. The amount raised would impact the number of countries included in the pilot. After a test period of 2 to 4 years, the operations of the PWF would expand to other developing countries, after additional resources have been secured.

PWF Legal Structure

During the pilot phase, the PWF could have either of the following two legal structures, depending on the preferences and interests of its major investors/donors:

- First, the PWF could be legally established, at least initially during the pilot phase, as a "Not-for-Profit" Foundation, under Regulation 501c(3). This structure would be attractive to those organizations that would seek tax write-offs, while giving PWF a chance to prove that the concept works. The purpose of the PWF would be clearly defined as that of fostering economic reforms to improve the business environment. This legal structure would give flexibility in the use of the funds as considered necessary — either as advice or for equity investments — to achieve the objective. However, this legal structure does not lead in the direction of the ultimate goal of the PWF beyond the pilot stage — a sustainable way to combine large pools of funds for both profitable private equity investment and economic development. Another difficulty with this structure is that there may be a potentially narrower pool of investors, since different organizations invest in non-profit rather than profit.

- Secondly, as an alternative, from its beginning the PWF could be established legally as a "For-Profit" company, with the objective of investing in both profitable private equity and economic development. Investors and donors would be attracted by the unique hybrid concept of the PWF, the knowledge about business environments they will gain, and the profit potential from the investments. The advantage of this legal arrangement is that it is easy to set up as it would not have any non-profit requirements, and the idea is straightforward to potential investors. On the other hand, this structure may impose less flexibility in the use of the fund for the development side, perhaps 5–15%, as investors will expect sufficient returns. Investors would need to be convinced on the basis of long-term expected returns and public relation elements, since the fund will be helping these countries develop as well. Additional funds for the development side of PWF may be obtained from non-profit foundations, even if it is in a for-profit organization. For this purpose, their funds could be earmarked for development, using different shares such as type A and type B shares. Some charitable investors that are looking for tax breaks may be interested in participating.

Under the legal "For-Profit" structure, the Fund will likely be structured as a Limited Partnership for the purposes of attracting substantial foreign investors, with the Manager of the Fund acting as the General Partner. The Limited Partnership will be governed by a limited partnership agreement that will set out the relative rights and obligations of the General Partner and the investors, which will hold limited partnership interests (the "Limited Partners").

Investors and donors would include major global corporations, non-profit foundations and high net worth individuals (in many cases behind the global corporations). Today, global corporations are channeling about $150 billion of foreign direct investments into developing countries every year. They may have assets in the proposed pilot countries or may be planning to buy these assets. These firms should have the highest interest in participating actively not only with financing, but also with advice on the economic transformation of developing countries, as this effort would enhance the profitability of their investments. The proposed $500 million for the PWF would represent only one-third of one percent of annual FDI flows. Foundations and high net worth individuals may be interested in the concept of developing a private-based source of sound economic advice to developing countries.

Investment Objectives and Strategy

The Fund's investments will have two main objectives. The first objective of the investments will be to help the country or group of countries accelerate their development and move towards market economy in a decisive fashion. The second objective will be to actually make money on our investments. To accomplish these objectives, the following approach will be used. The total amount of committed capital will be divided into two portions (the split would depend on the interests of the investors), one focused on making profitable private equity style investments, the other on advancing the economic transformation of the target countries.

The first portion of the PWF funds (the private equity investments) will be structured as a private equity fund, which will be investing in the country with explicit objectives of providing high returns on the investments. As an additional and very significant benefit, this fund will uncover many specific problems in the business and investment environment. These problems will be highlighted and resolved by the government of the targeted countries, but resolved not just for this fund as an exception, but once and for all. High levels of worldwide media coverage will be sought to make this a success.

The second portion of the funds of the PWF (the economic assistance support) will finance the efforts necessary to advance the legal framework, implement economic reforms in the target countries and develop institutions necessary to make the changes irreversible. The target countries will be selected by the Advisory Board, which will consist of the major contributors to the PWF. The selected target countries will be measured using the TBI Economic Policy Framework (discussed later on). This rating will establish their current position on the way to market economy. The TBI Economic Policy Framework will then be used to develop an Action Plan for the targeted countries to significantly improve in the nine policy areas, therefore becoming more attractive for Foreign Direct Investments.

The targeted countries will have to agree to the terms of investments, which will be largely based on the concept described above. This conditionality attached to the PWF

investments will be similar in some respects to the IMF or World Bank loans conditionality, but will focus directly on improving the country's business environment. All funding may come from private sources, but we may consider IFC, EXIM Bank, EBRD, OPIC or similar agencies as potential investors alongside with private sources.

Private Equity Investment Strategy and Methodology

A. Private Equity Investment Strategy

The strategy of the PWF will be to identify companies with superior growth potential that, either through increased working capital or the introduction of the Western management techniques, would be able to significantly increase their market share and improve their financial results. In particular, we will be looking for the following characteristics in the target companies or opportunities in the market place:

- **Value.** Companies that are undervalued relative to their worth. This may occur for several reasons: lost market share, new management, high debts, new customer base, temporary problems in sourcing raw materials and others. Often, these stocks have relatively low P/E ratios. These companies are often good candidates for restructuring or introduction of Western know-how. The stock price will rise when other investors recognize the company's true value.

- **Growth.** Some industries and companies can expect a period of rapid growth based on increasing consumer demand. Companies are expected to achieve above-average growth, whether measured by sales, earnings, cash flow or other indicators. We would target those industries, and selected companies within those industries, in which to invest. These can be retail businesses such as food and beverages or services.

- **Competitive Advantages.** These would include companies that have superior strengths such as: brand, image, distribution network, product quality, marketing, technologies and equipment, management, retail outlets, etc. It is precisely in these types of companies that SigmaBleyzer has been so successful in the past.

- **New Technologies and Innovation.** Companies that introduce a new type of product in a way that the country has not seen before. These include markets that may or may not be saturated, but where a small company introduces a new formula, production method, a similar product based on different raw materials, a cutting edge approach that will cause a paradigm shift in the market, and a distribution pattern that would potentially alter the market to the company's advantage. These companies typically need help to enter the markets.

- **Market Niches.** Many companies are focused or want to focus on particular parts of the market: high end, low end, specific features, etc. These types of companies are often successful, because they do not try to be everything to everybody, but focus their products or services on a particular group. These groups may have similar ages, similar spending habits, or similar interests.

- **Market Leaders.** These are leaders in the marketplace. For this particular fund, the market leaders would need to be in newer or smaller sectors, where there is still tremendous room for growth and companies won't be overpriced.

- **Quality Management Team.** We would seek out companies with managers that are market driven and have a good understanding of their markets, their customers, business finance, management accounting and other critical areas. Western business education would be a plus, but not necessary.

- **Quality Assets.** Even poorly performing companies can be attractive if they already have the assets in place for a turnaround, but need some sort of marketing or managerial assistance.

- **Privatizations.** To a limited degree, the Fund may target well-positioned and attractively valued state-owned businesses that are being privatized either through outright sales or other means of transfer from state control. The Fund may invest in privatizations as a consortium member alongside other investors.

- **Mergers and Acquisitions.** It is anticipated that the country will experience an increase in corporate mergers, acquisitions, joint ventures and similar business combinations during the coming years, especially if it becomes a member of the European Union. The Fund will target companies that may be formed as a result of such corporate activity and may provide equity capital to strategic buyers.

- **Restructurings.** The Fund will target companies in the process of reorganizing or those that need additional equity capital as a result of an inappropriate or inadequate capital structure.

The PWF would not try to focus on one particular type of company, but rather create a diverse portfolio of companies. Since all investments will be in the country, there is no way to diversify country risk. But the fund can significantly reduce its overall risk by acquiring stakes in various categories of companies as listed above and in different sectors.

B. Focus on Key Industries

The PWF intends to seek investment opportunities in sectors that enjoy comparative competitive advantage or in industries that are expected to benefit from the continued growth and development in the country. The opportunities are likely to be identified among:

- companies in sectors that are best positioned to benefit from the substantial need for the development of basic infrastructure, communications and ancillary services related to infrastructure;
- companies in sectors that are likely to benefit from an increase in internal consumption and per capita disposable income;
- companies in sectors where the country has comparative advantages, including manufacturing companies that benefit from low labor costs, and processing companies that benefit from or add value to the country's low-cost commodities and other natural resources.

C. Investment Methodology

All companies would undergo a set procedure that would not be compromised under any circumstances. The procedure would be as follows:

- Identify potential investment candidates.
- Due Diligence. This includes analyzing financial results, checking all legal issues, physically visiting the sites(s) and assessing its condition, verifying the truth of all oral statements and written documents, informal or formal meetings with suppliers, distributors and customers, analysis of intangible assets (brands, copyrights, etc.), and answering any and all investment questions that may arise. Failure to provide the necessary materials would be cause for seeking investment elsewhere.
- Internal analysis and valuation. This includes a competitive analysis with other companies, sector analysis, SWOT analysis, financial projections, discounted cash flow (DCF) valuation, and any other valuation methodologies that may apply.
- Presentation to Internal Investment Committee. This will consist of top managers and outside consultants.
- Meeting of Investment Committee.
- Decision to invest, decline to invest, or seek out additional information.

Economic Development Assistance Strategy and Methodology

For the country selected, the PWF will prepare a set of recommendations to the Government on how to improve the investment climate and attract foreign direct investments (FDI). These recommendations will be prepared by the Fund's professionals using the Economic Policy Framework developed under The Bleyzer Initiative. The Bleyzer Initiative began as a program to help Ukraine and the former Soviet Union (FSU) countries to become stable, mature market economies. To develop such a program, SigmaBleyzer launched a major effort in 1999 to identify best practices in economic reforms in a number of successful developing countries. Through an agreement between the Ukrainian Government and SigmaBleyzer, the International Private Capital Task Force (IPCTF) was created in early 2000 to carry out the review. The IPCTF Steering Committee included representatives from private sector companies in Ukraine, international bilateral and multilateral agencies, economic NGO's, and the Government.

The study was conducted by a team of SigmaBleyzer professionals and the Thunderbird Corporate Consulting Group of the Thunderbird School of International Management of Phoenix, Arizona. Many members of the Steering Committee provided substantial and valuable input to this study. The Thunderbird Corporate Consulting Group carried out a benchmarking of selected countries and built an econometric model to identify best practices in economic reforms that directly affect the flows of foreign direct investments. FDI was regarded as a good proxy for the financing that could be provided by the international private sector to countries to help them advance their economic transition into developed market economies.

This model was then used to predict the flows of foreign direct investments first to Ukraine, and later to all FSU countries based on the key "policy" drivers identified through benchmarking and statistical analysis. This analysis was later supplemented and expanded by a team of SigmaBleyzer specialists.

The studies led to the creation of the TBI Economic Policy Framework. It starts with the premise that "first generation" reforms — macroeconomic stabilization, achieved by sound fiscal and monetary policies — are essential pre-conditions to achieving a favorable business climate and attracting foreign direct investments. But they are not sufficient. Securing economic stabilization has been a major objective of the IMF. But this is not sufficient to be able to improve the business environment and achieve increases in international capital inflows. Within this macro framework, a number of "second generation" reforms are needed. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in a group of 50 developing countries can be explained by nine policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g., geographical location, country size, population, etc.) These key investment drivers were the following, in order of priority:

(i) Business liberalization and de-regulation policies to permit firms to operate freely by removing barriers to market entry, barriers to operations and barriers to exit.

(ii) Policies to create a stable and predictable legal environment with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with capacity to enforce business contracts.

(iii) Policies to develop sound Corporate and Public Governance that would protect ownership rights, shareholders and avoid excesses of power by Government agencies.

(iv) Policies to liberalize foreign trade and international capital movements to facilitate the exports and imports of goods and the transfer of capital internationally.

(v) Policies to create a healthy financial sector capable of meeting the financing needs of growing businesses.

(vi) Actions to minimize corruption and protect businesses from abuse of power by government officials.

(vii) Actions to minimize the effects of political uncertainties on business activities.

(viii) Actions to promote and inform investors about business opportunities in the country.

(ix) Action to avoid distortions in incentives by eliminating preferential targeted investment incentives to companies, regions or sectors.

The study showed that a country could increase the level of foreign direct investments by a factor of two to five by narrowing the policy differential with the best countries identified in the benchmarking analysis. The nine drivers outlined above can constitute a comprehensive framework for any country's transformation.

Specific ratings of economic policy areas in the country selected will be developed and compared with the best in class countries to identify the gaps, which must be closed to improve the investment environment and accelerate the flows of FDI to the country. Using the results of benchmarking and modeling, a draft Action Plan will be developed and presented to the Government. The preparation and implementation of Action Plans to carry out such as program will be the key factor in the success of the PWF.

The PWF would need to carry out significant R&D work, as an ongoing process that will occur before, during, and after the fund begins. It includes:

- Benchmarking and Modeling country performance
- Developing further candidate country lists
- Developing FDI prediction models for the most likely candidates
- Modeling global FDI trends
- Briefings, publications, and reports on a proprietary basis for investors
- Developing, documenting, and maintaining the methodology on country transformation

In order to carry out the above economic advice work, the following skills are envisaged: Macroeconomist (experience in fiscal and monetary policy in developing countries), Industrial Specialist (experience in business regulations, business registration, price liberalization, bankruptcy, etc.), Corporate Tax Specialist, Corporate Law Specialist, Corporate Governance Specialist, Public Administration Reform Specialist, Privatization Specialist, Foreign Trade Specialist, Central and Commercial Banking Specialist, Capital Market Specialist, and Industrial Economist (focused on investment incentives, country promotion, political risk, etc.)

What is Unique about the Proposed PWF?

In the past, some aspects of the recommendations contained in the Economic Policy Framework of The Bleyzer Initiative have been proposed by the IFIs and others. But there is wide recognition that many of these previous efforts failed or are failing. The question is why they are not working. We believe that the PWF provides new elements that should ensure its success in a field in which others have failed. Through the Foundation, there would be an active engagement of the global corporations in economic policy advice, supported by transfers of financial resources. The key to the successful implementation of The Bleyzer Initiative is active engagement of the international private investment sector, and a true partnership with the developing countries. Only in this way can we hope to achieve stability in the world and prosperity for the most people. The following are other key new features of the PWF:

- The Foundation would focus on the joint development of Action Plans by the Private Sector and the Government, with emphasis on implementation of the Action Plans.
- PWF would provide significant technical assistance and active engagement rather than support just based on "performance".
- It will pay close attention to the use of the proceeds of the financial assistance, not just on the conditionality of aid, no "blind pools" of money to the Ministry of Finance.
- It would focus on improvements in business environments, private sector creation and private enterprise development, rather than subsidizing budget deficits.
- It would provide equity or grants instead of debt, quasi equity funds to discover problems at the micro level, but with a strong link to macro conditionality.
- There would be a tight linkage between investments and TA, micro and macro improvements.
- It would aim at attracting FDI to get a substantial multiplier effect.
- It would focus on replicating the wealth creation capacity — use money to teach them how to make money.
- It benchmarks economic policies with the best countries in their class.
- It statistically quantifies the relative importance of individual economic policies (investment drivers) on FDI and economic growth.
- It establishes priorities for government action, based on the above quantification of policy impacts and in the identification of best practices.
- It provides formulas that calculate the increases in foreign direct investments over time, as the country narrows its policy gap with the best-in-class countries.
- It measures progress based on gap analysis.

APPENDIX

IPCTF Economic Policy Framework

The objective of the IPCTF (International Private Capital Task Force) Economic Policy Framework is to provide a set of rules for a developing country or a transition economy that will accelerate its transformation into a country with an improved quality of life, higher per-capita income, less income inequality, and fair protection of the poor. Countries that follow these rules and create better conditions for their people will be less susceptible to harboring terrorism and political instability.

The framework has two components: macroeconomic stabilization policies and investment drivers. The first component is necessary to curtail the rate of economic decline, which is usually associated with the initial stages of transition to market economy, and to achieve a certain level of macroeconomic stability. While critically important for a country's ability to function in a market environment, this component by itself has proven insufficient to move the country to the next stage of economic growth. The key to economic growth is capital investment, which may begin once macroeconomic stabilization has been achieved, but which is driven by certain investment drivers that are very similar in all countries transitioning to market economy.

Macroeconomic Stabilization Policies

Macroeconomic stabilization policies are those policies and actions that would over time result in stable prices with low inflation (internal stability), and a stable foreign exchange rate (external stability). Internal and external instability increase the risk of doing business in the country. As a result, investors require significantly higher rates of return to compensate for the risks of instability. Because of this high risk premium, few projects would qualify for investments, reducing the overall level of investments and therefore economic growth. In order to achieve internal and external stability, two sets of policies are necessary: fiscal policies and monetary policies.

Fiscal policies are those that will lead to a Government's fiscal budget that allows the fiscal deficit to be financed by borrowings on a sustainable basis, normally no more than 3% of GDP. This includes actions to increase fiscal revenues (by increasing the tax base, eliminating tax exemptions, and improving tax structure, tax administration, and cost recovery of public services), and to improve management of public expenditures (by reducing current expenditures of government, improving treasury operations, reforming the pension system and eliminating subsidies.)

Monetary policies are those under which the creation of money (money supply) will not exceed the demand for money, which is affected by the level of income, inflation and interest rates.

Investment Drivers

Investment Drivers are those policies and actions that would generate a high rate of GDP growth that can be maintained over a long period of time. Macroeconomic stabilization policies, although necessary, are not sufficient by themselves to achieve long-term stability and sustainable growth. This is because stabilization policies fail to remove deep-rooted structural economic and social distortions. To bring sustainable economic stability and growth, stabilization policies must be complemented by policies for sustainable investment activity or investment drivers.

Sustainable investment activity will depend on the adequacy of nine investment drivers identified by IPCTF benchmarking and statistical work:

- Liberalization and Deregulation of Business Activities
- Stability and Predictability of the Legal Environment
- Corporate and Public Governance
- Liberalization of Foreign Trade and International Capital Movements
- Financial Sector Development
- Corruption Level
- Political Risk
- Country Promotion and Image
- Targeted Investment Incentives

Since many of the investment drivers deal with government policies and actions, it is important to define what we mean by "government." In many transition countries, the term "government" is conveniently defined as narrowly as necessary to avoid accepting responsibilities. Unless clearly spelled out, it may be used to mean just the Cabinet of Ministers, or just the Central Government apparatus, but not the President's Administration or Parliament, or local authorities. Therefore, for the purposes of our discussions here, we will define "government" in the broadest possible way. Specifically, "government" shall mean all governing bodies of all branches and at all levels, including for example executive, legislative, judiciary branches, local and regional governments, and others.

The nine investment drivers are discussed below.

Driver 1: Liberalization and Deregulation of Business Activities

This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. An on-going system must be created to remove barriers to entry, operations and exit. Following are examples of what must be one in this area:

- Facilitate the formation of new businesses
- Reduce licensing and registration requirements
- Remove price controls and domestic trade restrictions
- Reduce the number of government inspections, interventions and interferences in business activities

- Simplify reporting requirements
- Reduce the cost of doing business, including taxation levels
- Simplify closure of failing enterprises
- Liberalize labor markets, improving labor mobility and reducing excessive labor costs imposed by Government (such as excessive minimum wages, payroll taxes, high un-employment compensation).

Driver 2: Stability and Predictability of the Legal Environment

This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private sector businesses in a free market. They require, among others, the following actions by the Executive, Legislative and Judiciary branches of Government:

- Enact appropriate legislation that would define the "rules of the game" for all businesses, without discrimination or preferential treatment, including modern civil, labor, tax and commercial codes and legislation to protect intellectual property rights, patents, technology transfer policies, and direct foreign investments.
- Improve the processes for drafting, presenting, and carrying out public reviews of proposed business-related legislation.
- Create an independent Judiciary, with an independent budget.
- Make the Courts more efficient and capable of settling commercial disputes.
- Empower the Executive branch to enforce judgments made by the Courts, including those on commercial contracts.
- Review existing legislation for inconsistencies among different legal documents.

Driver 3: Corporate and Public Governance

This driver includes policies and actions aimed at improving the governance of private companies and public administration, to support private sector activities in a free market economy. They include policies related to corporate governance, public administration and privatization of state properties.

The objective of corporate governance policies is to establish appropriate rules that would guide the activities of businesses in the best interest of their shareholders, protecting ownership rights. Key policies and actions include:

- Enact appropriate corporate governance legislation.
- Require all companies listed in stock exchanges to switch over to international accounting standards and to submit annual reports.
- Encourage the creation of non-government organizations to support corporate governance and issue corporate governance codes and model charters and by-laws.

- Implement a comprehensive corporate governance training program for board members, shareholders, managers, etc.

The objective of public administration policies is to redefine the role of the Government to support the private sector and secure the provision of sound and efficient government services without corruption. The implementation and sustainability of economic policy reforms over time also requires strong-though smaller-Government, with strong management and administrative capacity. A public administration reform program should include:

- Establish a clear strategy and vision for the role of the Government as complementary to and supportive of the private sector.
- Introduce adequate regulations to avoid monopolistic behaviors.
- Consolidate ministries and agencies to avoid responsibility over-lapping.
- Undertake "functional" and "operational" reviews of individual ministries and agencies.
- Reform and modernize the Civil Service by providing adequate incentives for performance and market controls.
- Reform government procurement practices.
- Reform central-local government fiscal relationships.
- Reduce shadow economy activities by drastically lowering cost of compliance with legislation in effect.

The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the Government, and concentrate Government resources on public goods. Key measures include:

- Pass appropriate legislation to permit the privatization of land and state enterprises.
- Develop appropriate mechanisms to register ownership rights, including land titling and land registration.
- Create and encourage an independent agency to carry out the privatization of state properties.
- Approve fair and transparent procedures for the privatization of state properties
- Rapidly complete the privatization of all state enterprises under clear and transparent procedures.
- Take early actions to prepare state companies for privatization, including actions to protect minority shareholder rights, and transfer social assets to local authorities.

Driver 4: Liberalization of Foreign Trade and International Capital Movements

This driver includes policies and actions to facilitate the exports and imports of goods and transfer capital internationally. This will require the following actions:

- Remove restrictions to exports, including export quotas, duties, indicative prices, advance deposits, and foreign exchange surrender requirements.
- Remove restrictions to imports, including high import duties, critical import list, and indicative prices.
- Simplify and expedite customs services, including procedures for customs clearances.
- Develop more modern and consistent procedures for certification requirements and standards of products.
- Liberalize foreign exchange transactions and eliminate restrictions on foreign direct investments.
- Cancel all restrictions on purchase of securities in foreign currency.

Driver 5: Financial Sector Development

This driver includes policies and actions to develop a healthy financial sector capable of meeting the financing needs of growing businesses. Key measures are the following:

- Liberalize interest rates on bank deposits and lending.
- Eliminate preferential credit programs imposed by the government on banks.
- Increase the independence and autonomy of the Central Bank to operate by efficiency, not political considerations, with its main goal being the maintenance of internal and external stability.
- Ensure that health of the banking sector by improving bank supervision and enforcing prudential regulations.
- Develop appropriate mechanisms to deal expeditiously with troubled banks.
- Strengthen the Securities and Stock Market Commission.
- Introduce international accounting standards and external auditing requirements for all banks.
- Encourage competition and efficiency in the financial sector by facilitating the expansion of foreign banks and non-bank financial institutions.

Driver 6: Corruption Level

This driver includes policies and actions to minimize corruption and protect businesses from abuse of power by government officials. Key measures include:

- Undertake measures to "prevent" corruption, reducing the opportunities for corruption and making corruption more difficult to undertake.
- Develop the legal framework to ensure better enforcement of anticorruption measures and impose visible, harsh, swift and certain penalties for official corruption.
- Get public support for anti-corruption programs by making people aware of their rights and the rules of the game.

Driver 7: Political Risks

This driver includes policies and actions to minimize the effects of political uncertainties on business activities. Key measures include:

- Pass appropriate legislation to reassure investors that arbitrary expropriation of private property, including "creeping expropriation", will not be permitted in the country.
- Introduce strong measures to eliminate power abuses by government authorities, bring tax collectors and local officials under the control of the central administration.
- Give government the total authority to do their jobs unimpeded by vested interests.
- Provide governmental stability, including the longevity of key officials.
- Ensure law and order.
- Minimize the risks of civil and external disturbances that may affect businesses.

Driver 8: Country Promotion and Image

This driver includes policies and actions to promote the country and improve its image as perceived by foreign and domestic investors. Key measures include:

- Announce and disseminate widely the government's policy and commitment to implement strong market oriented policies and show implementation progress.
- Vocally support foreign investment by changing the attitude of officialdom at central and local levels.
- Require all embassies abroad to have their commercial section strengthened, and to go on sales drives to better disseminate business opportunities.
- Assist in the establishment of a private investment promotion agency.

Driver 9: Targeted Investment Incentives

This driver includes policies and actions to bring investment incentives to levels similar to those of its trading partners, while avoiding targeted incentives that may lead to distortions and inefficient allocation of resources. Key measures include:

- Set taxes at levels comparable to those of the country's neighbors or competitors.
- Eliminate special investment incentives targeted to specific sectors, enterprises or regions.

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