THE MULTILATERAL INVESTMENT FUND

MIF REPLENISHMENT:

PROPOSED STRATEGIC FRAMEWORK
I. INTRODUCTION

1.01. The proposed strategic framework would focus MIF resources on three goals, with basic areas of intervention to further orient resources. It expands upon the wording of the Agreement to Establish MIF II, and expresses the policy background to that Agreement.

<table>
<thead>
<tr>
<th>Improving the Business Environment</th>
<th>Building Competitiveness of Smaller Firms</th>
<th>Engaging the Private Sector as Partners for Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Public sector entrepreneurship to change regulatory, institutional framework</td>
<td>• Demonstrating new financial mechanisms</td>
<td>• Advance socially responsible approaches to business and environmental management</td>
</tr>
<tr>
<td>• Meeting the challenge of trade integration</td>
<td>• Strengthening managerial and technical capacity</td>
<td>• Increase private sector involvement in policy formation</td>
</tr>
<tr>
<td>• Helping markets work better</td>
<td>• Developing private sector networks</td>
<td>• Demonstrate new ways to do business</td>
</tr>
<tr>
<td>• Financial sector and capital market reform</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

II. IMPROVING THE BUSINESS ENVIRONMENT - BETTER INCENTIVES AND INSTITUTIONS:

2.01. Deficiencies in the business environment discourage investment and entrepreneurship. As the forces of globalization make it increasingly easy to shift investments to more competitive environments, it has become more and more important to foster the enabling environment for investment, improving the framework of laws and regulations as well as the institutions that implement them.

2.02. Technical assistance and investment projects to demonstrate new approaches have a specific role to play in advancing required reforms. Grants are particularly useful where there is a need to build the base of support by demonstrating how reforms could work. They also are the most appropriate choice to pilot development models to enable their adaptation to local conditions and empower reformers so that they can take initial action. Grants are also needed to cover innovation in reform. Unlike an invention, where first mover costs can be recouped through intellectual property rights, it is difficult to justify expenditure of funds for high risk innovation in reforms that might benefit all, but are not yet proven.

2.03. Weaknesses in this business environment are particularly harmful to the smallest businesses. Whereas large firms may be able to carry the costs of specialized resources to overcome market dysfunctions, small firms can find these costs to be prohibitive, restricting growth and encouraging informality. Indeed, growing informality in many areas in the region can be seen as an indicator of the weaknesses of the institutions, regulatory framework and incentives that define the business environment.
Maximizing MIF’s ‘competitive advantage’ in this area calls for its resources to be focused on those areas where grants are the best choice as well as those areas where MIF’s experience in micro and small business issues offers an advantage. MIF is uniquely equipped to support the development of new ideas, and to bridge the ‘action gap’ between diagnosing a problem and when there is sufficient broadly based support to move ahead with large reforms. MIF’s agility also positions it to meet the need for immediate technical assistance to help with a crisis or to take advantage of a window of opportunity.

Proposed MIF Goal: focusing on those issues of primary importance to SMEs, promote efficient, fair and transparent institutional and market practices that introduce new ideas, advance the implementation of best practice and encourage the application of international norms and standards.

Types of Initiatives: Projects focus where MIF’s agility allows it to meet urgent needs that other instruments cannot, where its experience in nurturing innovation can help create new solutions to stubborn problems, and where working models are needed to pilot reforms, building experience and support for larger programs (which can be assisted by other parts of the IDB Group or other development entities.) Initiatives in this group emphasize increasing incentives to becoming formal, lowering the costs and risks of productive activity, and expanding business opportunities. Projects are most often implemented in partnership with a public sector counterpart.

Relationship to IDB Group and other Initiatives: MIF initiatives build on the analytic work done by other development institutions (such as the World Bank ‘Doing Business’ reports, FIAS reports, CAF and CABEI or research by bilateral development agencies) as well as the knowledge base of the IDB Group itself. Projects are coordinated with other IDB Group initiatives through the Private Sector Strategy process and are used where it is important to foster innovation, demonstrate new approaches and build consensus for further reforms.

Basic areas of activity:

Promoting public sector entrepreneurship: Complex regulatory environments impede business growth and encourage informality. In particular, improvements are needed in the legal and regulatory framework for productive sectors and development of institutional structures to encourage the fulfillment of contract obligations. However, achieving change is not easy. It requires specific technical expertise, significant energy, and political will. MIF should support those reformers - the entrepreneurs of the public sector - who are willing to take the risk of introducing new ways to improve the laws, regulations, procedures, and policies that impact on business and investment.

Meeting the challenge of trade integration: As markets integrate, countries must align their regulations, standards and norms of practice with regional and international benchmarks and requirements, or risk making their economies uncompetitive. To help ensure that small firms benefit from these changes, MIF should promote application of international practice, emphasizing broadly based private-public sector consultation, and the development of local
certification and advisory service capacity.

2.10. **Improving how markets function:** Business needs efficient access to factors of production and technology in order to be competitive, and society needs well functioning markets in order to ensure that resources are well allocated. Where small, targeted technical assistance is needed to implement recommended actions, or to build consensus for further reform, MIF should support initiatives to improve regulatory structure and practice, increase competition and broaden participation and access.

2.11. **Financial sector and capital market reforms:** The functioning of the financial market has overarching importance for business competitiveness. The credit needed for growth can only flow when information is reliable and easily available, when there is enough participation to create sufficient depth of financial products and services, and when the soundness of the financial system is ensured by good regulation and supervision. MIF projects should advance larger reform initiatives where small technical assistance programs are the most appropriate instruments to promote needed change, or where a multi-faceted approach is needed to progress a change such as property reform to enable secured transactions, increasing small business credit. MIF’s proven track record in quickly mobilizing resources is particularly important in the financial sector where immediate technical assistance is needed to help countries deal with sudden crisis.

**Measuring Results**

2.12. Projects in this group are undertaken to introduce new concepts into the dialogue to advance a larger reform processes or to respond quickly to an urgent need or window of opportunity. Short-term technical assistance can make a big difference by providing specific expertise, or where promoters of reform need to demonstrate its benefits to build support for next steps. MIF results for this type of project should measure attainment of these objectives, clearly basing assessments on outcome indicators such as whether larger programs did follow a pilot, whether attitudes toward reform significantly changed, or whether a crisis was minimized. The results of the OVE evaluation provide specific suggestions with respect to such indicators.

**III. BUILDING COMPETITIVENESS OF SMALLER FIRMS:**

3.01. **Increasing the productivity and market participation of very small firms is central to reducing poverty.** Throughout the Region, these firms account for the vast majority of economic activity – only 2% of firms are considered as large. In terms of jobs, SMEs in the formal sector provide between 20 and 40 percent, while the informal sector accounts for well over half of economic activity. Very small enterprises account for four out of five new jobs created in the region, and employ 50% of workers.

3.02. **There are special challenges in ensuring that reform programs fully reach this group.** A contributing factor in the widening income disparities found throughout the region, is the reality that as major reforms change the business environment it is the well equipped firms and individuals that first benefit from the new opportunities. Individuals that have been more integrated into the economy before reform have been the ones best positioned to manage and
prosper from the changes. It is difficult for very small enterprises to access to the information and capacities needed to first benefit from reforms. Informality poses additional constraints, limiting access to financial and other inputs, hampering access to public services and narrowing the kind of contracts or investments it can make.

3.03. **Constraints in financial markets represent a major constraint for micro and small firms.** Commercial capital often has ready outlet in public sector instruments or in meeting the needs of large firms, and will not assume the risk inherent in testing new financial mechanisms that meet the needs of micro and small firms. As some of these new mechanisms may well prove to be attractive to commercial capital once the high-risk test phase is completed, there is an important development role in demonstrating them to the market. MIF has had significant impact in this area, utilizing a range of equity and quasi equity tools to advance microfinance and demonstrate the use of small business investment funds in the region.

3.04. **Small business capacities need strengthening** so they can realize the benefits of change. Programs to build capacity of these firms can have important social as well as economic benefits. Private sector groups are often the most effective channels for transferring new business techniques and market information, however they face significant resource constraints and do not have the financial capacities to borrow to expand their programs.

3.05. **Goal:** to support ongoing innovation to increase the potential of microenterprise and small business to generate income, create jobs, and grow in a sustainable fashion.

3.06. **Types of Initiatives:** Initiatives in this group address the underlying issues of building competitiveness. They are most often implemented with private sector counterparts, and aim to create distinctive regional approaches to competitiveness issues, creating new norms and stimulating development of new models. These initiatives tend to be highly innovative and usually start with support to a pilot project(s). Where these early trials have promising results, a deeper engagement follows with a series of subsequent actions that may entail a degree of replication.

3.07. **Relationship to IDB Group and other development efforts:** The highly innovative nature of these initiatives, coupled with the role of private sector partners, make them complementary to rather than part of larger reform programs. In general they support the IDB Group’s strategic direction of focusing on underserved markets and contribute to the knowledge among development institutions on how to address micro and small enterprise needs.

**Basic Areas of Intervention:**

3.08. **Demonstrating new financial mechanisms:** MIF should build on its pioneering work in the use of equity as a development tool, to support initiatives that introduce new ways to increase the supply, range and quality of financial products specially designed for microenterprise and small business. The focus should be on initiatives that aim to correct underlying market barriers or failures, or that are designed to demonstrate the potential of a particular instrument in meeting financing needs, utilizing the full range of MIF’s equity, debt and grant mechanisms. Initiatives should advance development of micro and small business finance as
an integral part of overall financial sector development, demonstrating new techniques to showcase potential to commercial capital sources, and promoting best practices.

3.09. **Managerial and Technical Capacity:** Special attention is needed to ensure that smaller firms have the information and the capacities needed to respond to new opportunities and challenges. MIF should test innovative and demonstration initiatives to build resilience and adaptability to quickly changing market realities, promoting application of internationally accepted financial management and reporting methods. Projects should focus on increasing growth potential, taking an integrated approach to identifying operational and managerial constraints, and advancing those financial and institutional changes needed to increase competitiveness. Projects should seek leveraged impact beyond the individual initiative, and only be undertaken where the business environment is sufficiently conducive to realizing results.

3.10. **Developing Private Sector Networks:** Institutions such as chambers of commerce, trade associations and NGOs are of particular importance to micro and small firms. They play a vital role in conveying information about market change, and voice the views of their members in dialogue with the public sector. MIF should promote communication among these private sector institutions that are working to help the very small enterprises respond to new incentives and seize economic opportunities.

**Measuring Results**

3.11. These projects are often undertaken to test a new approach in order to identify areas where further, deeper actions can be directed. As such, the key results measure is the degree to which lessons are identified and shared. Projects are often part of a project cluster and for clusters, key results measurements are: development of a model for subsequent replication and whether a network among the implementing agencies is established.

**IV. ENGAGING THE PRIVATE SECTOR AS PARTNERS FOR CHANGE:**

3.12. **The quality of economic participation is central to achieving sustained economic growth and poverty reduction.** Income disparities in Latin America and the Caribbean are the world’s highest and the portion of the population living in poverty has increased over the past decade. Investment is lagging and informality, a crucial indicator of weak business environments, is growing.

3.13. Changing this requires a set of inter-connected actions. The business environment must be improved, and capacities of firms of all sizes must be strengthened to enable them to realize the benefits of reform. However, it is not sufficient to just remove the impediments to growth.

3.14. Attaining growth with enough momentum to withstand external shocks, and to deliver the kind of poverty reduction that will build domestic demand and investment, calls for a new kind of engagement by the private sector. Effective markets are not simply a result of their formal rules and regulations - they reflect the norms, practices and expectations of their participants. The quality of institutions is an outcome of the expectations and desires of decision makers in a society.

3.15. Shaping an economy that works effectively for all members of society calls for new business
attitudes, uniquely Latin American or Caribbean business models and a broader understanding of the connection between individual success and how this is either enhanced or reduced by the success of others in the economy as a whole.

3.16. **Goal:** to promote broadly based participation in the economy, and deepen the involvement of private sector in development issues, advancing the effective application of business techniques in addressing social concerns.

3.17. **Types of Initiatives:** Initiatives in this group have a high level of innovation, piloting new concepts and introducing new ways to harness business motivations for development goals. They are most often implemented with private sector counterparts.

3.18. **Relationship to IDB Group and other development efforts:** More deeply involving the private sector in development is an important element of the IDB Group private sector strategy. MIF's network of over 400 leading private sector organizations throughout the Region is a significant asset in this respect, enabling new concepts to move beyond discussion into implementation.

**Basic areas of intervention:**

3.19. **Advancing socially responsible approaches to business:** Often known as Corporate Social Responsibility, this encompasses a range of activities that link business decision-making with good corporate governance, environmental responsibility, worker health and safety, and respect for communities and the society as a whole. Initiatives promote the understanding that it is good business to follow such practices, and that a firm cannot achieve its full potential completely isolated from the success of its workers or of other firms in its economy. MIF should raise awareness among the business community, pilot initiatives and share knowledge as the concept is applied. Environmental management is a key aspect. MIF should build on its early work in introducing cleaner production techniques to further promote innovative methods to demonstrate that it is a benefit not a cost, promoting ecologically efficient production, and building private sector capacity.

3.20. **Increasing private sector involvement in policy formation:** Identifying the obstacles to private sector growth and sequencing appropriate policy response calls for an active participation by a well-informed business community. Broadly-based, grass roots groups such as Chambers of Commerce, industry associations, consumer and environmental organizations share and build useful commercial knowledge and express their members views in policy making forums. This is particularly important in involving micro enterprise as their very informality constrains their ability to convey their needs to government institutions.

3.21. **Demonstrating new ways to do business:** MIF should work support initiatives that test and establish working models of effective new approaches to business. Such approaches as encouraging large firms to help their smaller suppliers implement more effective environmental management models, or working with value or supply chains to promote more sustainable business practices can have a significant multiplier effect on business attitudes and practices.

**Measuring Results**
3.22. These projects tend to be highly innovative and as such, the key results measure is the degree to which lessons are identified and shared. Projects contribute to the knowledge of what works and what doesn't with respect to important private sector development topics. To do this, projects must be designed for learning, including not only clear baselines and success indicators, but including a plan to share experience in order to maximize contribution to the knowledge base. Where possible, projects should be grouped by development topic to encourage the creation of networks of business groups, NGOs and other agencies that are addressing the issue as well as better support implementation and learning.