

# Microenterprise Development Strategy

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## PREFACE

The following document builds on Bank efforts over the past year to define a strategy to carry out the mandates of the Eighth Replenishment in the area of micro and small enterprise development.

The Agreement for the Eighth Replenishment of the IDB's capital reiterated the Bank's commitment to microenterprise development stating that it had "become an integral part of Bank operations and will continue to be pursued during the Eighth Replenishment in all areas of Bank activity." The Agreement further highlighted the importance of Bank support to this sector in the context of strengthening the income-earning capacity of the poor, calling for "actions to boost the production capacity of small farmers and microenterprises," and emphasizing the need for job creation "particularly through the microenterprise and small business sectors" and modernization of production structures in the region. Specifically cited in this context were: technological upgrading of small and medium sized enterprises; creation of an environment in which small and medium sized business can flourish; financial sector reform to ensure access by all to financial services, especially micro, small, and medium-sized enterprises; and modernization of the agricultural sector.

The Microenterprise Development Strategy is the result of an extensive process of consultation with the governments of the region, the institutions dedicated to microenterprise support and donors interested in assisting the sector that also served define, together with these IDB partners, the elements of a Program for Microenterprise Development for the next five years. The consultative process culminated with the conference, "The IDB and Microenterprise: Promoting Growth with Equity," which took place at Bank headquarters in November 1995 with the participation of more than 300 participants from all the countries of the region and many nonregional countries as well.

The document is also the result of consultations with an interdepartmental microenterprise strategy group, chaired by SDS/MIC, and including representatives of the three regional departments, SDS/IFM, the Office of the Chief Economist, and the Multilateral Investment Fund (MIF). The Microenterprise Strategy draws heavily on important inputs from Bank work in this sector over the past two years. Complementing the Strategy paper, two additional documents are being prepared: a background paper on microenterprise development (which, in draft form, has provided the basis for the background section of the Strategy) and a proposal for the reform of the Small Projects Program, which will follow the principles laid out in the Strategy.

This document puts forward the rationale, objectives and main components of the Bank's microenterprise strategy. It outlines the problems that the Bank is seeking to address, the strategic directions for Bank investment and other activities in the sector and presents a concrete program of action, entitled *MICRO 2001*, to carry out this strategy over the next five years.

# Microenterprise Development Strategy

## Summary

Microenterprises make a major contribution to aggregate employment, production, and national income in Latin America and the Caribbean. Microenterprises are also an important vehicle for low-income people to escape poverty through market-driven, productive activities. The Inter-American Development Bank has been a pioneer in the field of microenterprise development since 1978. This Strategy builds on the Bank's experience, and outlines new areas of emphasis to continue the Bank's leading role in promoting microenterprise development in the region over the next five years.

### Objective

The overall goal of the Bank's Microenterprise Development Strategy is to expand economic opportunities in Latin America and the Caribbean through sustainable, dynamic microenterprise development. The objective is to promote the conditions necessary for the growth and development of the microenterprise sector in the region: a favorable policy and regulatory environment; strong, sustainable institutions providing financial and nonfinancial services to meet the demand of microenterprises; improved access of low-income and disadvantaged microentrepreneurs (including women and indigenous peoples) to financial and business services; and expanded, continuous and permanent flows of resources for investment in microenterprise.

### Strategy

A five-year program, MICRO 2001, will promote policy and regulatory reform to create an enabling environment for microenterprise development, and support the creation and strengthening of formal and non-formal institutions that provide business development and financial services to microenterprises on a sustainable basis. Particular attention will be given to strengthening  
Since 1990, the Bank has financed 471

institutional capacities to provide services to low-income and disadvantaged microentrepreneurs efficiently and effectively. A key element of the strategy is the use of Bank resources to catalyze the infusion of private investment in microenterprise development by linking NGO and commercial investors and promoting the formalization of microenterprises. The strategy for microenterprise development will be tailored to the situation of each country, based on a comprehensive analysis of obstacles and opportunities that confront the microenterprise sector in the country, and the adoption of mutually reinforcing actions in the areas cited above.

### Implementation

The Bank's main operational instruments for supporting microenterprise development—the Small Projects Program for non-profit organizations, and the global loans for microenterprise which create facilities to transfer resources to financial institutions—will be central to the Bank's Program, but will require modifications to make them more effective in the current environment. Technical cooperation within these operations, and as separate operations, will directly support institution building and policy reform. The Multilateral Investment Fund will utilize innovative mechanisms such as equity investment to develop intermediaries providing services to microenterprise. The Bank will promote policy and regulatory reform through its programming process, research and dissemination activities and sectoral operations.

### Resources

microenterprise operations for a total of US\$452

million. During the period of implementation of the MICRO 2001 program, the Bank will increase its investment in microenterprise development, to the equivalent of US\$500 million over five years. The Bank will develop this Program primarily using its own funds (mainly Ordinary Capital and Net Income of the Fund for Special Operations in Local Currency) and the Multilateral Investment Fund. Concessional funding will be more restricted than in the past.

### **Organization**

A Microenterprise Network, coordinated by the Bank's Microenterprise Unit (SDS/MIC) will promote the strategy's implementation by facilitating sharing of information, experiences and technical know-how; technical assistance for projects; training activities and coordination between IDB and other organizations working in this field.

# I. Introduction

*Microenterprise makes a major contribution to aggregate employment, production, and national income in Latin America and the Caribbean, and to the promotion of entrepreneurial talent, resilience, and flexibility in confronting a dynamic global economy. Microenterprise is also an important vehicle for low-income people to escape poverty through market-driven, productive activities.*

As owners, or as workers, the livelihoods of the poor are directly tied to this key sector of the economy. The success of ongoing economic stabilization and structural reform programs in the region depends on broadening the distribution of the benefits of economic growth to include low-income people. Support for microenterprise development will go a long way toward achieving these goals, as well as improving the competitiveness of the Latin American and Caribbean economies.

The Inter-American Development Bank is a pioneer and leader in the field of microenterprise development. Its support began with the Small Projects Program in the late 1970s, and has steadily increased since that time. The establishment of a Division for Microenterprise, global loans for small and microenterprise, and the Multilateral Investment Fund (MIF) have greatly expanded the Bank's options for promoting the sector. *The microenterprise sector is a significant area of IDB investment; 471 microenterprise operations totalling US\$452 million were approved between 1990 and 1996.* To date, it is estimated that IDB-sponsored microenterprise programs have reached approximately 600,000 microentrepreneurs, and have created and strengthened over 1,800,000 employment

*opportunities.*

Today, the conditions that shaped the IDB's microenterprise programs in the past have changed. Economic reform programs have led to structural changes and greater economic dynamism in the economies of the region. Liberalization of the financial sector, including the demise of many state-owned development banks, and changes in the investment climate and regulatory environment in the region have created new opportunities and challenges. Institutional change in the banking sector and in the nongovernmental organizations—the major executing agencies for IDB-supported microenterprise programs—imply changes for Bank strategy and individual operations. Changes in the structure of the IDB itself, particularly in its operational departments and field offices, along with the diversification of the tools the Bank can use to address the needs of the microenterprise sector, have also created new opportunities and challenges for Bank support to microenterprise development.

This strategy document briefly reviews the changes taking place in the microenterprise sector and the Bank's experience, and outlines the rationale, objectives and main components of the Bank's microenterprise strategy. It analyzes the problems that the Bank is seeking to address, proposes strategic directions for Bank investments and other activities in the microenterprise sector, and presents a concrete program of action, entitled "MICRO 2001," to carry out this strategy over the next five years.

## II. Microenterprise in Latin America and The Caribbean

The target group of the IDB Microenterprise Development Strategy is made up of businesses that lack adequate access to financial and business services, in all fields of economic activity (including commerce, agriculture, manufacturing, and services). The IDB's Microenterprise Strategy and the Program for its implementation will focus on businesses with 10 employees or less and total assets equivalent to less than US\$20,000, excluding those in professional sectors such as medical and legal practices. This follows the rule of thumb definition of microenterprise currently employed by most IDB projects.

Despite their small size, microenterprises account for a large share of the region's employment, output and incomes. Over 80 % of the businesses in Latin America and the Caribbean have 10 employees or less. Eighty percent of these are concentrated in businesses with up to five employees, and half have no paid employees other than the owner. Though little reliable data exists, and conditions vary widely across countries, studies show that microenterprises employ a significant share of the labor force -- ranging from one-third in Argentina to 80 percent in Peru. According to the ILO, by the mid 90s, microenterprise accounted for roughly half of the region's employment, while the public sector and enterprises with over 10 employees accounted for only 44 percent (the remaining six percent is in domestic service). Moreover, the share of employment in microenterprise has been steadily growing since the 1970s. Overall, there are more than 50 million microenterprises in the region, providing jobs to over 120 million people. Their share of national output ranges from less than ten to nearly 50 percent, depending on the country.

Although the Bank has established size parameters to define the microenterprise sector, strict adherence would rapidly illustrate their arbitrariness. Quantitative definitions, while providing a rough idea of the type of business

targeted by IDB's strategy and programs, tell only part of the story. The qualitative aspects of microenterprise, particularly their lack of access to services, their existence at the margin of legal and regulatory frameworks, and the overlap of consumption and production activities within the microenterprise are perhaps more important factors for shaping the policies and programs of the Bank in this segment of private sector development.

The microenterprise sector is extremely heterogeneous and varies dramatically in relative size and composition in different countries throughout the region. At the lower end of the spectrum are subsistence level household/firms that depend exclusively upon family labor, with no distinct separation between household and firm finances. At the upper end of the scale are small firms with up to 10 employees, utilizing relatively sophisticated production technologies and directly linked with larger firms in the modern sector of the economy through diverse supplier-client relationships.

Even though microenterprises vary widely, most microenterprise owners and their employees are low-income people. Women-owned businesses represent one of the fastest growing segments of the microenterprise sector. Between 30% and 60% of all microenterprises in Latin America and the Caribbean are owned and operated by women. These businesses are also major sources of employment for women workers and family members. Indigenous people are heavily concentrated in this group, as small agricultural producers, artisans and traders, and they have limited access to services to expand their businesses and improve their incomes. Appropriate institutional mechanisms must be developed to ensure that sustainable financial and business development services reach these groups and have a positive impact.

Special efforts are required to support the smallest microenterprises where lack of access to support services is particularly acute. However, support for microenterprise development must address its role as part of a dynamic continuum of business development which overlaps with businesses of larger sizes. IDB programs should not segment and isolate microenterprises, but help them to grow and work more closely with the rest of the economy.

## **2.1 Constraints to Microenterprise Growth**

Many of the constraints to microenterprise development and integration into the formal economy have not changed since the Bank financed its first microenterprise project in 1978. But the profound structural changes in the economies of Latin America and the Caribbean in the past decade have important implications for microenterprises and for the IDB's efforts to support their development.

### **2.1.1 The Policy Environment**

While most countries of the region were characterized by financial repression in the early part of the last decade, sweeping reforms to remove interest rate ceilings, reduce or eliminate directed credit, and reduce barriers to entry in the financial sector (including eliminating the preferred status of government owned banks, or even eliminating such banks), as well as improvements in bank prudential regulation and supervision were carried out in the late 1980s and 1990s throughout the region, substantially changing the structure and opportunities in the financial sector, paving the way for increased competition in the sector, and increased interest in new market niches, including small and microenterprise.<sup>1</sup> In some countries, such as

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<sup>1</sup> Carlos Cuevas, "Enabling Environment and Microfinance Institutions: Lessons from Latin America," *Journal of International Development*, May, 1996; and Glenn Westley, "Financial Reforms in Latin America: Where Have We

Bolivia and Peru, changes in banking regulations have also made it possible for nonformal lenders previously operating as nonprofit foundations to convert to formal financial intermediaries, thereby greatly enhancing their access to financial markets and prospects for long-term sustainability.

Although microenterprises operate largely outside the reach of the laws and regulations of their countries, these parameters can pose a serious constraint to their prospects for growth and integration into the mainstream economy. Economic reform in Latin America and the Caribbean has opened up new opportunities for growth of the microenterprise sector, and for developing sustainable institutions to serve the sector. But policy changes still have a long way to go to create a level playing field for the region's smallest economic activities. Improved business regulations, tax regimes and licensing requirements, and the adaptation of financial sector norms and supervision are some of the areas that still must be addressed to permit the expansion and sustainability of microfinance services and improve conditions for microenterprise development.

### **2.1.2 Financial Intermediation**

Today, despite years of special programs and institutional development, less than five percent of Latin American and Caribbean microentrepreneurs have access to formal financial services. Suppliers credits and

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Been, Where Are We Going?" Office of the Chief Economist, IDB, 1995; "The Enabling Environment: Reforming the Business Environment in Latin America," Small Enterprise Development, 1996; *Expanding Access to Financial Services in Latin America*, Miguel Basch and Camilo Morales, eds. Washington, DC: IDB/Johns Hopkins University Press, 1995.



informal moneylending are important sources of microfinance and will continue to play a key role in the future, given their advantages for overcoming the information constraints to microlending. Formal financial institutions, using their traditional credit technologies, still do not reach most microbusinesses because of the relatively high cost of making small loans and the lack of required forms of collateral. Nonformal NGO microfinance organizations continue to provide access to credit to a limited number of microenterprises, but most are still not sustainable without donations and operate at a high cost. In the past few years, IDB supported microenterprise programs have helped formal intermediaries reach down to microenterprise clients and have strengthened the sustainability of NGO. Much work is still needed to expand the services of both types of institutions.

Microenterprises face constraints on the deposit side as well. Most microenterprises are financed through the owners' and family members' savings, but minimum deposit requirements, limited liquidity, high transaction costs, inconvenient banking locations and hours, and microentrepreneurs' unfamiliarity with banking institutions limit their access to and use of formal savings mechanisms.

### ***Business Development Services***

Microentrepreneurs lack access to nonfinancial services, including marketing, training in basic business skills such as bookkeeping, and technology transfer. But this area of support is relatively less developed as compared to microfinance, and IDB's funding of such programs has been limited in recent years. The provision of these services has so far been heavily dependent on grant resources, limiting

their sustainability over time. As a result, the quality of training and other business development services being offered to microentrepreneurs is generally low. Moreover, the lack of organization of the microenterprise sector makes it more costly to provide services to these businesses.

### ***2.1.3 Resource Constraints***

Given the enormous size of the microenterprise sector and its economic potential, the resources available in multilateral and donor agencies are not sufficient to satisfy the demand for microfinance and other services. Today, the IDB's own concessional resources for microenterprise development are extremely limited. On the positive side, promising opportunities for expanded private sector investment in microenterprise development are emerging. One example is Profund, an investment fund created with resources from private investors, MIF and other donors, to take an equity position in NGO that are ready to transform themselves into formal financial intermediaries and to undertake joint ventures with financial institutions seeking to enter or expand their services to small and micro-businesses. In order to expand the reach of services to microenterprise, more financial resources must come from the private sector. But funding for microenterprise development from financial markets will only be possible if those resources can be made available on commercial terms. Private investment in the sector's development is also deterred by the legal and regulatory framework and barriers to entry for new sources of capital (including lack of knowledge of the sector, especially of successful program experiences; and lack of appropriate credit and other technologies to serve the sector).

## **III. IDB's Experience in Microenterprise**

## Development

Over the past nineteen years, the Bank's approach to microenterprise development has shifted from a primary emphasis on one-time transfers of financial and technical resources to individual beneficiaries, to the strengthening of intermediary institutions that can deliver these services to the target group on a long-term, sustainable basis. Similarly, it has evolved from focusing almost entirely on the sector's lack of access to credit to a broad, integrated strategy that addresses the wide array of constraints microenterprises face.

The IDB's support for microenterprise development increased slowly from 1978-89; the Bank invested an average of 8.2 million each year during that period. Between 1990 and

1993, the IDB expanded its investments through new instruments -- the global microenterprise loans and the packaging together of multiple small project operations. Since 1990, when the Bank significantly increased its level of support to the microenterprise sector, 471 microenterprise operations have been approved, for a total of US\$452 million. The table below depicts the evolution and projections for IDB support to microenterprise projects, by the major types of operations (Small Projects, Microenterprise Globals, Multilateral Investment Fund). Small amounts of funding for stand-alone technical cooperation have also been approved since 1991, but are not included in the table.

Types of Projects	1990	1991	1992	1993	1994*	1995	1996
Small Projects	7.7	26.0	29.2	32.6	14.3	20.4	4.0
Globals	43.7	45.0	47.0	77.6	--	29.5	--
MIF	--	--	--	5.2	22.1	23.0	20.3
Others	--	.8	1.4	.6	--	.5	.5
<b>TOTAL</b>	<b>51.4</b>	<b>71.8</b>	<b>77.6</b>	<b>116.0</b>	<b>36.4</b>	<b>73.4</b>	<b>24.8</b>

\* Since 1994, financing of Small Projects has lagged considerably behind demand due to funding limitations with regard to net income of FSO in local currency, which historically has been the primary source of funds for the Small Projects Program.

Equally as noteworthy as the increase in amount of investments in microenterprise programs over this period are the qualitative changes in Bank operations in the sector, including emphasis on the following features: institutional strengthening of intermediary organizations, their administrative and financial self-sufficiency, accountability and responsibility in the management of loan portfolios, and the elimination of distortions in resource transfers to

microentrepreneurs. During 1990-1994, the flagship instrument for IDB investment in microenterprise —the Small Projects Program— underwent significant changes. Experiences from the global microenterprise loan programs are only now being analyzed, but show some promising results as well as challenges for the future.

### 3.1 Small Projects

The objective of the Small Projects Program, as defined in the Policy document OP-706, is "to afford access to credit for such persons or groups of persons who wish to execute projects that will enable them to improve their living conditions and who most often lack access to commercial credit or development credit on customary terms and conditions." To be eligible for Small Projects financing, projects must target benefits directly to marginal groups who lack access to credit. Intermediary institutions "must be public development organizations or private nonprofit organizations, among the basic purposes whereof must be that of achieving the economic improvement of marginal groups and persons."

In the nineteen years since the first small project was financed on a pilot basis, the program has been a major contributor to the development and strengthening of nongovernmental institutions in the region and their efforts to improve the livelihoods of low-income people. The Bank is currently administering a portfolio of 142 small projects, representing US\$68.4 million in financing and US\$18.6 million in parallel technical cooperation. Although the program represents less than one percent of the Bank's lending, it is highly visible, it was for some years the main instrument for financing civil society organizations, it is an important vehicle for promoting innovative pilot programs, and it is a key instrument for immediately and simultaneously addressing the Bank's goals of promoting social and economic development.

Over eighty percent of the small projects approved since 1990 are for microfinance (credit programs targeted to microenterprise). The experience of these projects has been mixed. Among the lessons learned from these projects is that providing loan funds to NGO on terms nearly equivalent to institutions involved to maintain the value of their loan funds or to access funds from local sources.<sup>ii</sup>

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ii/ Banco Interamericano de Desarrollo, División de Microempresas, "Fondos Rotatorios de Crédito para Microempresas: Un Estudio Empírico,"

Today, the small projects program is facing new challenges. The changing political and economic reality of the region; the very success of the small projects program and others in transforming the nature of private sector support to microenterprise; the high cost of preparing, executing and supervising small projects (for both field offices and headquarters) relative to the small size of these operations; and the lack of concessional resources for financing small projects in many countries make it necessary to introduce modifications to the Small Projects Operating Policy (OP-706).

On the administrative side, a working group created by the regional departments to study options for improving the management of the Small Projects Program in the future has recommended the creation of a financing facility for small projects similar to the Project Preparation Facilities (PPF), which would finance multiple institutions and could permit contingent availability of resources. These facilities delegate the authority to the IDB Representatives to approve individual programs in the countries involved. A small projects facility which moves in this direction is currently being prepared in Region II, a technical cooperation program with some of the same characteristics was approved in Region III in 1994, and two national level small project facilities are included in the 1996-97 pipeline of Region I.

The experience of the past seven years has shown that in order to be successful in implementing its strategy, the Bank must introduce greater flexibility in the small projects program, tailoring the mix of technical cooperation and credit provided, as well as the financing conditions, to individual NGO to fit their stage of institutional development and the characteristics of their programs.

### **3.2 "Global" Microenterprise Loans**

The IDB has been active in the development of

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Washington, DC, Junio, 1994.

projects to establish a sustainable supply of credit to microenterprises through the Microenterprise Global Programs, typically channeled through a rediscount facility or a line of credit in a country's Central Bank or second tier development bank at market rates of interest. "Globals" are designed to enable formal financial intermediaries to serve a new clientele at the lower end of the market. The cost of funds for participating are similar to those of borrowing resources in the local market. Technical assistance is provided to the intermediaries to help them develop the capability to serve micro-clients with lower administrative costs. Supervisory authorities may also receive assistance to devise appropriate regulatory frameworks for micro-lending.

Although the microenterprise global loans tend to reach larger size clients than the IDB's small projects, they can make a significant change in how banking is done in the region. In Paraguay, for example, where the Bank has funded a microenterprise program with a US\$12 million credit component and a technical cooperation program of US\$2.7 million, seven banks and financing companies are participating; 50 credit officers have been trained in microenterprise lending technologies; over 4,000 loans were granted in the first year; the average loan is approximately US\$1,300 and 49 percent of the clients are women.

The Bank's experience with the thirteen global micro and small enterprise programs approved so far has been mixed. Some loans have been slow to disburse, as in the cases of Guatemala and Costa Rica. Where fixed spreads are set on the interest rates that can be charged by participating financial intermediaries, the resources have tended to go to larger size businesses, with limited benefits for microenterprise. The experience of government agencies serving as intermediaries for technical assistance has been problematic. On the other hand, one of the important positive elements of these loans has been the provision of technical assistance to formal financial institutions, to assist them in adopting new technologies for reaching microenterprises, such as in the case of Paraguay. In countries where significant financial sector reforms were supported by IDB

prior to the microenterprise global, the latter proved a more effective vehicle for expanding financial services to microenterprise because competition was increased and banks were looking out for new opportunities. Although some programs have provided resources to nonformal lenders (NGO programs), as in Colombia, they generally have not been successful in inducing commercial banks to form linkages with NGO to reach microenterprise. These experiences show that the instrument will require continued adjustment in the future, and that each operation must be tailored to the specific conditions of the country where it will operate, if it is to prove successful as a tool for massifying microenterprise access to financial services.

Some of the other challenges for this instrument in the future are: to make the financing package attractive to the borrowing countries without undermining deposit mobilization; to find concessionary resources for institutional strengthening in parallel technical cooperation programs that will facilitate the adoption of cost-saving technologies which permit access to smaller businesses; and to promote linkages with non-formal microfinance institutions (NGO and village banks) that are providing services to smaller clients. These issues and others will be addressed in studies of the global microenterprise loans to be carried out by the Bank's Evaluation Office and SDS/MIC in 1997. The studies will determine what project elements are most important for reaching the overall objectives of extending the reach of formal financial services down to the microenterprise level, and propose operational guidelines for improved use of this instrument in the future.

### **3.3 *The Multilateral Investment Fund***

An important new instrument to support the development of microenterprise is the Multilateral Investment Fund (MIF), established in 1992 and administered by the IDB. The fundamental goal of the MIF is the promotion of the private sector in support of the modernization process in the region, thereby helping to ease the human and social costs of economic adjustment and to improve the

competitiveness and productivity of the sector. The MIF can provide financing under a variety of modalities, for policy and regulatory reform (Window I), human resources development (Window II), and direct support for small and microenterprise development (Window III). The comparative advantage of the MIF in the last area lies in its ability to use innovative financing mechanisms, such as equity investment, quasi-equity and guarantees.

Use of MIF resources is subject to the Modalities of Funding and Operational Guidelines approved by its Donors Committee. The Office of the MIF is responsible for signing off on the eligibility of MIF projects as well as of approving the project memorandums to be presented to the Loan and Donors Committees.

It is too early to determine the impact of MIF operations on microenterprise development in the region. However, the MIF experience to date shows that the prospects for increasing private sector investment in the microenterprise sector are promising. The tools at the MIF's disposal also give the Bank greater flexibility for supporting the dynamic continuum of micro to small-scale enterprises.

The MIF is an important vehicle for promoting policy reform favorable to microenterprises development through Window I and for supporting the new training and business service programs for the more dynamic segment of microenterprises in Windows II and III. Window III will also allow the Bank the flexibility needed to make equity and quasi-equity investments in microfinance institutions seeking to formalize their operations or enter new markets, and develop guarantee mechanisms to allow NGO microfinance programs to borrow from formal financial intermediaries. However, the scope for MIF support for the type of operations and the target group that have typically been financed by the small projects program are only partially included within the operational guidelines of Window III.

### **3.4 Coordination with Nonborrowing Member Countries**

Throughout its years of experience with microenterprise development, the IDB has worked closely with member countries in supporting the sector. The role of the special trust funds, and other forms of cofinancing has proven to be extremely important to the IDB microenterprise program in the following ways: increasing funding for NGO-executed small projects, particularly in the smaller and poorer countries where local currency resources are scarce; providing concessional funding for technical cooperation linked to global microenterprise programs that can provide the technical assistance and incentives needed to ensure that these programs reach the target population of microentrepreneurs; and improving coordination, exchange of experiences and information, and shared programming with countries and organizations which provide significant resources to support microenterprise development. Given the scarcity of funds for microenterprise development faced by the IDB and its member countries, it will be even more important that concerted efforts be made to expand the use of cofinancing in microenterprise operations.

### **3.5 Lessons Learned**

The Bank's 19 years of experience in microenterprise development have yielded several important lessons that form the foundation of its microenterprise strategy. Some of these lessons are:

- The microenterprise sector is a heterogenous continuum of different types of businesses, requiring different types of support for their development.
- Regulatory policies --which define the framework for business operations in any given country-- often represent significant obstacles to the development of the microenterprise sector; appropriate policies are a key factor in the success of investment programs that support microentrepreneurs.

- Assessing and understanding overall conditions existing in each particular country is essential to establish well focused country microenterprise development strategies.
- Lack of access to institutional financial services is a major obstacle facing microenterprises; but non-financial services, such as technical and marketing assistance, are also critical to microenterprise development.
- Building permanent institutional capacity to serve microenterprises is more important than simply disbursing loans or giving one-time training to microentrepreneurs.
- The economic viability of financial institutions serving microentrepreneurs is key to their long-term sustainability. Subsidized credit programs damage the economic performance of financial institutions and the subsidies are usually captured by larger businesses.
- With economic reform, especially in the financial sector, the opportunity to reach new market niches like microenterprise and make a

profit is the strongest inducement for expanding services to this underserved sector of the economy.

- The adoption of appropriate credit technologies and the development of appropriate financial products reduce transactions costs and improve the capacity of formal financial institutions to serve the microenterprise sector.
- Non-governmental organizations (NGO) can be effective intermediary institutions for microenterprise development when they operate on sound financial principles.
- Cooperation with the IDB's nonborrowing members is a key factor in determining the success of the Bank's microenterprise programs.

These lessons from IDB experience over the past seven years have served as the basis for the Bank's strategy for microenterprise development, which will guide Bank operations in the sector into the 21st century.

## IV. The IDB Strategy for Microenterprise Development

### 4.1 Objective

The overall goal of the IDB's Microenterprise Development Program is to expand economic opportunities through sustainable, dynamic microenterprise development. In order to achieve this goal the Bank's strategy focuses on **promoting the conditions necessary for the growth and development of the microenterprise sector** in Latin America and the Caribbean.

The specific objective of the strategy is to promote the development of:

- a favorable policy and regulatory

environment;

- strong, sustainable institutions providing financial and nonfinancial services to meet the demand of microenterprises;
- improved access of low-income and disadvantaged microentrepreneurs (including women and indigenous peoples) to financial and business services; and
- expanded, continuous and permanent flows of resources for investment in microenterprise.

### 4.2 Strategy

To promote microenterprise development in the current environment, given its own institutional characteristics and resources available, the IDB must focus on the areas in which it has a comparative advantage. Therefore, the Bank has launched an integrated program, MICRO 2001, which builds on the experiences of the past seven years and strengthens its support for microenterprise development, focusing on two fundamental pillars: policy reform and institutional development. This process is designed to expand access to services for low-income and disadvantaged microentrepreneurs. The program will use Bank resources strategically to catalyze the infusion of private resources in support of these elements.

#### 4.2.1 Country Focus

MICRO 2001 Program activities will be based on a comprehensive analysis of obstacles and opportunities that confront the microenterprise sector in each country, and the adoption of mutually reinforcing actions, which represents a departure from more traditional piecemeal approaches of isolated project interventions. Microenterprise development initiatives have become increasingly sophisticated, and the environment in each country is changing rapidly. Country microenterprise development strategies will analyze the situation of the microenterprise sector in a country, assess the performance of institutions supporting the sector's development, review the legal and regulatory framework, analyze the

experience of IDB-supported operations and programs financed by other donors in the country, and identify critical areas for IDB policy and project support. Annual microenterprise operational plans prepared by each Region will outline the efforts being made to implement the strategy in the countries of that Region.

#### 4.2.2 Strategy Components

Country programs will address the main strategy components as follows:

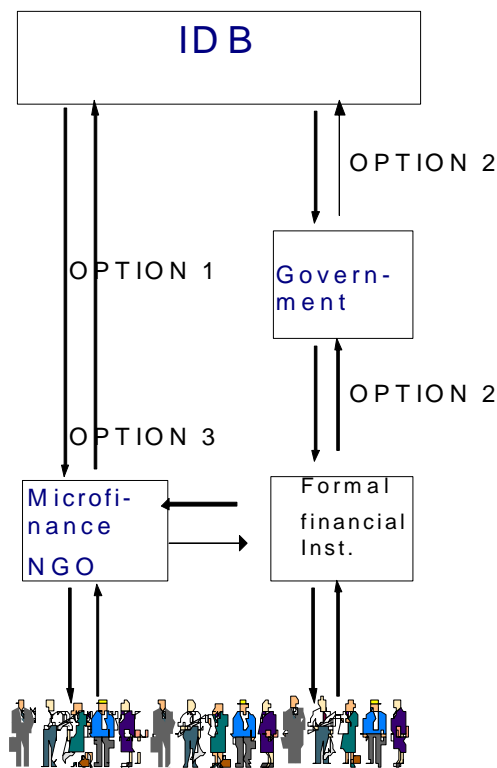
##### *Policy Reform*

In order to foster an environment conducive to microenterprise development, the Program will promote and support economic, legislative, and regulatory reform tailored to the context of each country. This will include reform of tax systems and policies, registration and licensing

requirements and legislation affecting specific markets. The IDB will help governments in leveling the playing field, promoting the implementation of measures which support microenterprise growth. The Bank will promote regulations and legal reforms that facilitate the entry of formal lenders into the microfinance arena and promote competition.

##### *Institutional Development*

As a central feature of the Program, the Bank will support the strengthening of formal and non-formal institutions, enhancing their capabilities to become sustainable



OPTION 1 IDB lends to a microfinance microent

OPTION 2 IDB lends to a borrowing country bank lends to formal financial institutions FFIs lend to

OPTION 3 IDB lends to a borrowing country which FFIs then lend to microfinance

providers of services to microentrepreneurs. Institutional strengthening will focus on helping financial intermediaries and organizations providing business development services adapt their services to meet the demands of microentrepreneurs and improve the efficiency and effectiveness of service delivery.

### ***Financial Intermediaries***

The Bank will support the expansion and strengthening of existing financial intermediaries through the transfer of improved and innovative financial technologies to formal financial institutions in order to reduce transactions costs and credit risks. It will also strengthen non-formal financial institutions (such as NGO and credit unions), facilitating their graduation to the formal financial system and access to capital markets, thus enhancing their ability to mobilize resources in a sustainable manner. The preceding chart illustrates the three most common options for lending to microenterprise which will be supported by the Bank.

In order for microenterprises to grow and build up their capital base, new financial products and instruments such as term loans, leasing and factoring will be required. Bank programs will support the development of these innovative services for micro and small enterprises.

Savings accounts and deposit services are important vehicles for microfinance, and capturing local savings is essential to the long-term financial sustainability of microfinance institutions. Therefore, savings mobilization and the creation of financial products tailored to the demands of microclients for deposit services will be an important element in the Bank's microenterprise strategy.

### ***Other Institutions***

The Bank will support the creation, expansion and strengthening of organizations specialized in providing market-oriented, sustainable business services to microenterprise. The focus will be on improvement in the quality of training and technical assistance programs, development of marketing schemes that expand microentrepreneurs' access to more profitable

segments of the market, assistance to comply with legal and regulatory procedures, promote subcontracting arrangements with larger firms, and transfer of appropriate technologies to improve productivity, especially those that are environmentally sound. Service providers that assist microenterprises with the process of formalization will also be supported. The challenge is to introduce market principles to upgrade the quality of services now provided, expand their outreach, and help create new sustainable services. Support for institutions providing these services should encourage them to adopt demand-driven principles and cost recovery mechanisms to promote sustainability. Finally, Bank-supported programs should help create incentives for mainstream institutions to reach microenterprises.

To be effective, institutional strengthening must be accompanied by the transfer of fresh resources for direct service delivery on a greater scale. The Bank's Program will increase the flow of resources for microfinance by channeling funds to lenders at market rates of interest, so that they can in turn expand the volume of lending and other financial services. The importance of these resources is that they represent long-term sources of financing not currently available. Funds to expand coverage of the microenterprise sector will be provided to non-financial service providers as well. The range and size of this program area will be dependent on the existence of adequate institutional capacity to effectively provide services to the target group. During times in which concessional resources are becoming ever more scarce, the mobilization of private sector funds to support the microenterprise sector coupled with a business-like approach in the management of microenterprise programs is of the utmost importance. Attracting private investment requires macroeconomic stability; a favorable regulatory environment for investors; uniform, transparent standards for assessment of institutional soundness; and the dissemination of information about viable institutions serving the target group. The focus on savings mobilization and linking non-formal microlenders to the financial markets as part of the strengthening of financial intermediaries is also key to meeting this challenge.



# V. Implementation of the Bank's Microenterprise Development Strategy

## 5.1 Tools for Implementation

In implementing the Micro 2001 program, the Bank will continue to utilize a combination of three basic tools: policy dialogue, loans and technical cooperation. In addition, the MIF will make equity investments in microfinance institutions and other intermediaries supporting microenterprise development. The feasibility of a credit guarantee mechanism to promote linkages among private intermediaries providing financial services to microenterprises will also be explored by the MIF. In implementing the microenterprise development strategy, the Bank will take a country-based approach, combining these instruments in a strategic fashion so that they become mutually reinforcing.

### 5.1.1 Loans

The Bank's main operational instruments for investing in microenterprise development—the Small Projects Program which directly finances individual executing agencies (primarily non profit organizations), and the global loans for microenterprise which create facilities to transfer resources to multiple institutions (primarily commercial banks)—will be central to the Bank's Program.

The Bank can provide liquidity to wholesalers (through the global loans and similar mechanisms) and it can finance wholesale mechanisms for technical assistance, and studies and support for development of new legislation and improved regulations and their application. Due to administrative and financial constraints, the IDB cannot continue to be the principal direct funder of the region's nongovernmental organizations working in the area of microenterprise development as it has in the past. The Bank will continue to finance individual NGO programs for microenterprise development primarily where they present innovative, pilot experiences with opportunities for learning and replication in other, larger programs. In order to do this, it will be necessary to prioritize and

specialize in well defined niches (such as policy, legal and regulatory reform; and institutional development in certain key areas, e.g., upgrading of NGO). The Bank must also make broad assessments of the conditions of microenterprises, the policy environment, the institutional actors, and its own past experiences in each country, and pro-actively seek out and support organizations that can effectively advance innovative pilot programs in each country.

Each global microenterprise loan supporting a national level program for microenterprise development must continue to be tailored to the conditions of the specific country in which it operates. These loans should not simply be "cloned" from one country to another; the programs they support must be customized to fit each country's needs.

The operational policy governing the Small Projects Program (OP-706) will be revised and submitted to the Board, to allow for greater efficiency and effectiveness in the use of this instrument. The basic principles for the revision of the Policy and operational guidelines for the Small Projects Program include administrative simplification, revised terms and conditions, technical assistance tailored to the specific circumstances of the intermediary institution, creation of small projects facilities or umbrella programs in countries where there are multiple intermediaries, and identification of additional sources of financing.

A detailed proposal for these changes will be prepared in collaboration with the Regional Departments and will be submitted to the Board in a separate document.

### 5.1.2 Technical Cooperation

Technical cooperation will be used for policy reform, institutional development activities, training and technical assistance programs targeted to microentrepreneurs, and pre-

investment activities to facilitate and enhance project preparation. Technical cooperation is particularly important to reduce start-up costs for intermediaries developing new services or entering new markets. Although not the most important in total volume of resources, this instrument is expected to account for a large number of program operations. Technical Cooperation programs will be financed on a grant or reimbursable basis depending on the nature of the operation and availability of funds.

### **5.1.3 Multilateral Investment Fund (MIF) Operations**

The Multilateral Investment Fund will not only continue to be an important provider of technical cooperation for policy reform and institutional development, it will also support innovative mechanisms such as equity investment in intermediaries providing services to microenterprise. Under this arrangement the MIF typically acts as a for-profit investor, holding a share of the institution's total capital and looking for leverage from other investors, participating for a period of approximately seven years. These investments include agreements that guarantee the MIF's exit and financial returns according to the risk involved. Quasi-equity instruments (bond financing) will also be used. In the future, MIF will also help to create a partial guarantee or risk insurance mechanism to promote NGO micro finance institutions' access to loans from commercial banks.

Through its third window, the MIF will give priority to the following areas, that will contribute to the achievement of the objectives of the microenterprise strategy: (i) strengthening and diversification of microfinance instruments and institutions, including technical assistance for intermediaries, support for graduation of unregulated NGO intermediaries to the formal financial system, and increased outreach of banks and other formal institutions providing commercial finance to new, smaller clients; and (ii) improving nonfinancial services for micro and small firms in areas such as market information, quality control, innovation and technology transfer, and management assistance.

### **5.1.4 Policy Dialogue**

The Bank will make use of existing channels of policy dialogue with the borrowing countries to promote the creation of an enabling environment for the development of microenterprise. This will be achieved through the Bank's country programming process and its research and dissemination activities.

Past experience has shown that Bank operations to promote microenterprise development are most successful when an enabling policy and regulatory environment exists that allows institutions providing services to do so on a sustainable basis, and allows microenterprises receiving services to grow. Similarly, investments in microenterprise development often fail to accomplish their objectives when undertaken under unfavorable policy conditions. Therefore, the Bank will give particular attention to paving the way for successful credit and investment programs through policy dialogue and policy reform programs.

Where feasible, policy and regulatory obstacles to microenterprise development will also be studied and addressed as part of broader programs and operations such as small and medium enterprise strategies and programs, financial sector reform programs, and others. This integrated approach is crucial because reforms that promote microenterprise development overlap significantly with those needed for small and medium enterprise growth.

## **5.2 Resources for Implementation**

The Bank will develop the MICRO 2001 Program primarily using its own funds (Ordinary Capital and Net Income of the Fund for Special Operations in Local Currency) and the Multilateral Investment Fund. However, an appropriate mix of interventions will require a mix of concessional and non-concessional resources. Special efforts will be devoted to leverage Bank resources through fund-raising and co-financing initiatives to attract critical grant resources for technical assistance and institutional strengthening, especially for those countries with large microenterprise sectors but limited supplies of concessional resources.

**Potential Levels and Sources of Future  
IDB Financing  
for Microenterprise Development  
(1997-2001)**

SOURCES OF FUNDING (next 5 years)	STATUS	TYPES OF PROJECTS	AMOUNT (US\$ Millions)
Ordinary Capital (OC)	Available	Small and Microenterprise Global Loans	250 *
FSO-Local Currency (Net Income)	Partially available	Small Projects and Technical Cooperation	75
MIF	Available	MIF Microenterprise Technical Cooperation, Loans, Equity and Quasi-equity	125 *
European Union	In process	Small Projects and Technical Cooperation	20
Bilateral (Trust Funds)	Partially available	Small Projects and Technical Cooperation	20
Foundations and Privat Investors	Partially available	Technical Cooperation	10
TOTAL			500 *

\* In actual operations, projected levels of financing are expected to exceed the US\$500 million figure cited above. The largest component of this financing consists of support for micro and small enterprises, through the "Global" loans and MIF operations; not all of these funds are targeted to microenterprises. The table presents as estimate of that portion of funds that will support microenterprise development.

During the period of implementation of the Micro 2001 program, the Bank will increase its investment in microenterprise development, to the equivalent of US\$500 million over five years. This represents an important increase over levels of support in the past five years. Given the strong private sector orientation of the Program, actual amounts would be dependent on demand which, in turn, would be based on existing policy and economic conditions, and institutional absorption capacity in each country. The table below shows the projected sources of funding.

Due to the scarcity of resources from net income of the Fund for Special Operations (FSO) in local currency —the major source of funding for the Small Projects Program and technical cooperation in the past— funds will be required from other sources in order to meet the investment goals of the MICRO 2001 Program. Successful replenishment of existing trust funds and creation of others will cover part of these requirements. Additional support for private sector microenterprise programs, especially those operated by NGO, could be provided from FSO resources, the net income of FSO in foreign exchange and other concessional funding arrangements that may be devised in the future. As a practical matter, the small projects program can only continue to operate in those countries which have sufficient balances of net income of FSO in local currency <sup>iii</sup> or where special trust fund financing exists. In the case of Bolivia, for example, the balance of the Swedish Trust Fund for Bolivia would permit the financing of one more operation. Key sources of funding for small projects in the past, such as the Social Progress Trust Fund, the Swiss Fund and the Japanese Trust Fund, are now extremely limited

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<sup>iii</sup>/ The major source of funding for this program over the past five years, FSO net income in local currency, is available in 11 countries, but only 5 have significant balances to permit adequate programming of these resources for microenterprise programs.

or no longer available. A new fund, equivalent to US\$19-20 million, being negotiated with the European Union, is already facing an unmet demand for small projects financing that could absorb the resources of the fund as soon as it is approved. Therefore, the funding situation is extremely critical and must be addressed in the forthcoming proposal for reform of the Small Projects Program.

### **5.3 Organizational Structure for Implementation of the Program**

To ensure effective implementation of the strategy, the IDB has established a Microenterprise Network, coordinated by the Bank's Microenterprise Unit (SDS/MIC). The Network also includes the Regional Departments and Country Offices, the Infrastructure and Financial Markets Division of the Social Programs and Sustainable Development Department (SDS/IFM), the Office of the Chief Economist, the State and Civil Society Unit (DPP/MOS) of the Strategic Planning and Operational Policy Department the Evaluation Office (EVO), and the Multilateral Investment Fund. It will create a link between the Bank and the Inter-American Investment Corporation focused on microenterprise development, and reach out to IDB's partners -- the executing agencies and other donors. The network will reinforce existing mechanisms and create new ones to advance the Bank's microenterprise program. It will facilitate the sharing of information, experiences and technical know-how; the preparation and monitoring of projects; upgrading of professional and technical capabilities; and coordination of IDB's microenterprise activities with those of other organizations.

#### **5.3.1 Roles and Responsibilities of IDB Network Members**

Each part of the Microenterprise Network will carry out specific functions, as stated below. The Microenterprise Unit in the Social Programs and Sustainable Development Department will

be charged with coordinating the work of the network as a whole.

- The IDB's **Regional Departments and Country Offices** will develop country microenterprise programs, and identify, prepare, and negotiate projects. They will lead the policy dialogue process and the preparation of national private sector and enterprise development strategies, which will include microenterprise issues. For some countries, the Regional Departments will produce specific microenterprise development strategies in consultation with the government and other donors active in the country. Each Regional Department will prepare an annual operational plan for microenterprise, which will outline the principle actions to be taken to carry out the Strategy in that region.
- The **MIF** will be particularly active in equity and quasi-equity microfinance operations, and in the areas of policy reform and non-financial services, supporting innovative projects and concepts.
- Other offices of the Bank, such as OCE, SDS/IFM and DPP/MOS will participate in the network and support the execution of the Strategy in their particular areas of competence.

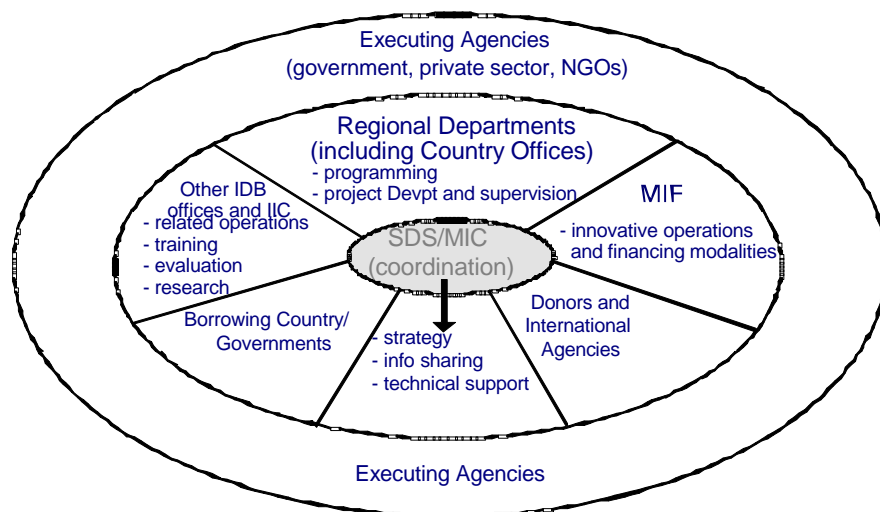
- The **Microenterprise Unit** in the Department of Social Programs and Sustainable Development will coordinate and monitor the implementation of the Bank's Micro 2001 Program. The Unit's main functions are strategy development, information sharing and technical support.
- The network will coordinate with the IIC, that although independent from IDB's activities, takes into account IDB's strategies and programs. Although the IIC does not directly invest in microfinance institutions, its lines of credit may from time to time be used by the borrowers to onlend to microfinance institutions, as it did in the case of the Banco Intercontinental-ADEMI Project. The IIC may also participate by providing technical services for project preparation and supervision, as in the case of some MIF operations in the sector.

Members of the network of microenterprise professionals will meet periodically, bringing together the expertise available throughout the Bank to share information, experiences, know-how and lessons learned in microenterprise development.

### 5.3.2 Role of the Microenterprise Unit

The Microenterprise Unit in the Central Department for Social Programs and Sustainable

## THE IDB MICROENTERPRISE NETWORK



Development will contribute to the execution of the Micro 2001 Program through the following concrete activities:

- preparation of policies and strategies to guide Bank investment in microenterprise development, including the Microenterprise Development Strategy, a revised Small Projects Policy and a Rural Finance Strategy
- research and dissemination of innovative policies and programs and best practices in the field of microenterprise development
- monitoring strategy implementation
- collecting and disseminating information on IDB microenterprise operations
- coordination with other donors, promotion and fundraising to support IDB's operational program for microenterprise development
- technical training for Bank staff working on microenterprise operations, especially those in the Country Offices (in collaboration with the Bank's Staff Development Section)
- technical support for programming, project development and supervision, and preparation of Annual Operational Plans for Microenterprise, when requested by the Operational Departments
- technical review of programs and projects related to microenterprise through SDS participation in CRGs, Programming Committee and Loan Committee (with emphasis on the Profile II stage and before)

The Microenterprise Unit's three staff members and Chief will carry out these functions. The Unit will also have a limited budget to contract consulting services to execute parts of its work program, and it will maintain a roster of expert consultants that can be used by other Departments for the development of specific

operations.

### **5.3.3 Coordination with IDB Partners**

Since the initiation of the Bank's global microenterprise programs, the range of partners collaborating with the Bank in the implementation of its strategy and the execution of projects has undergone tremendous expansion. The Bank now collaborates with government agencies, training institutes, formal financial institutions and with non-governmental organizations.

The microenterprise network offers a point of dialogue and coordination with relevant national entities and donor organizations in the formulation of microenterprise policies and strategies. It provides an arena for a variety of actors to discuss and debate issues, priorities, policies, and strategies affecting microenterprise development. The Bank will facilitate this exchange, and ensure that its own programs have adequate input from the relevant actors in the field, by sponsoring studies, seminars and networking in collaboration with other agencies. The Bank will continue its active participation in the Committee of Donor Agencies for Small Enterprise Development, the Donors Working Group on Financial Sector Development, and the newly formed Consultative Group on Assistance to the Poorest (CGAP), through the Microenterprise Unit.

July 1, 1999