



IFI 2.0

IFI transformation

Abstract

This article is about reform of IFI assistance and reshaping of the role of IFIs in global growth. It analyses world growth and poverty reduction trends since the 60s and views it from the point of view of IFI efficiency.

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IFI 2.0

Measured against the declared objective – broad economic development and fight against corruption – IFIs have had their ups and downs, their victories and losses. Importantly, these institutions contributed significantly to the world economic growth and to decreasing poverty in the recent decades.

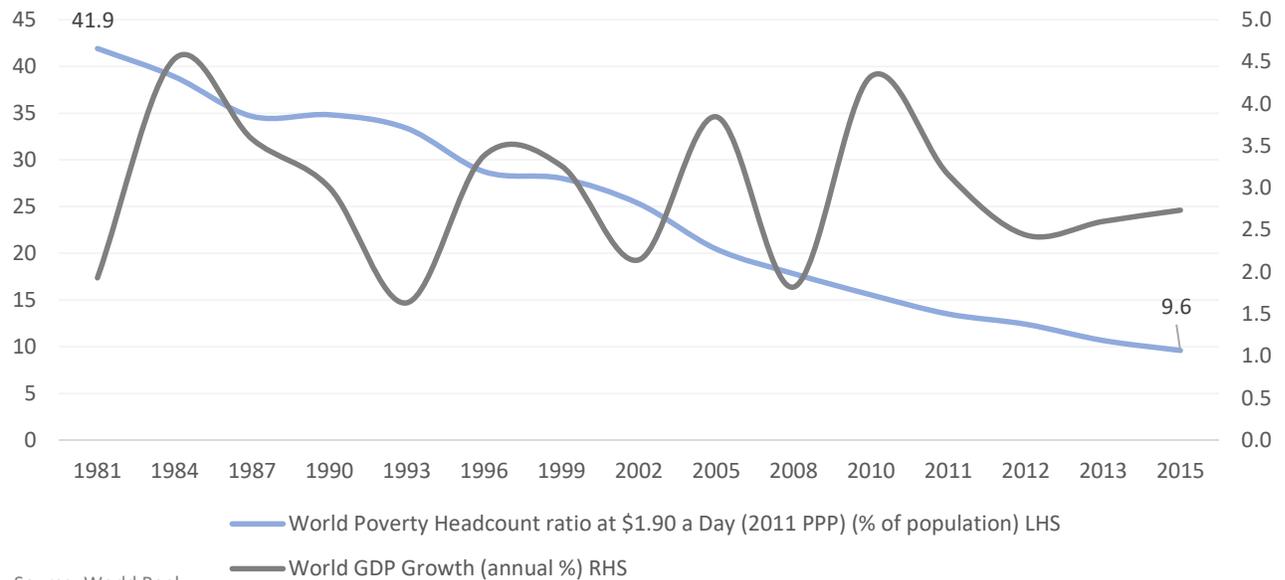
This article is about reform of IFI assistance and reshaping of the role of IFIs in global growth. It analyses world growth and poverty reduction trends since the 60s and views it from the point of view of IFI efficiency. The author argues that although overall IFIs have been successful in their endeavor, the current global trend of political and economic reshuffle urgently requires new and innovative IFI tools to respond to existing growth needs. These proposed new tools are coined by the author as:

- ‘IPPP (IFI Public Private Partnership) Rule’
- From SME to creating PME sector (Publicly traded Medium-size Enterprises)
- True Corporatization of SOEs (State Owned Enterprises),
- Fighting Corruption X.0
- IFI – Country Performance Formula

After more than 70 years of Bretton Woods, IFIs face a challenge of being adaptive and responsive to current trends and more efficient at the same time. The challenge is to not only be able to react to what happens in the global economy but in the first place be at the forefront of changes and shape it together with private sector and governments. This article makes specific proposals regarding the new innovative tools of IFI assistance and proposes to introduce these tools in parallel rather than through a slow and gradual reform.

To measure IFI efficiency, I have looked at real GDP growth since 1981 as well as the global trend of poverty reduction. Notably, average rate of poverty reduction over the last decades is higher than average growth rate. During the 1980 - 2015, world real GDP grew by ca. 2.9% each year on average, while poverty headcount ratio (\$1.9 a day) decreased each year by ca. 5.2%. The chart below demonstrates this trend.

World Real GDP Growth and Poverty Reduction



This difference between average growth rate and average rate of poverty reduction can be mainly attributable to inclusive growth policies of developed countries and IFI activities in the developing world.

Washington Consensus, even though criticized and sometimes for good reasons, can be viewed as a major achievement for the post WWII period world economy – using IFIs resources to transform the policy architecture of developing economies around the world.

Of course, one and the same policies could not have been successful in different countries but promoting liberal agenda and free markets was already a success story in the post-Warsaw Block - world. In the most recent decades’ definite achievements of the IFIs can be identified as post-Soviet Union period when they played a major role in economic transformation of Eastern European and Post-Soviet countries. IFIs played a significant role during the Mexican economic crises of the mid 90’s and a controversial role in the Asian financial crises and the subsequent crises in Russia, Brazil, Turkey and Argentina. More recent example of successful efforts by the IFIs can be identified post Russian invasion Georgian endeavor which resulted in a comparatively fast recovery of the economy as mentioned earlier.

Major pillars of the world economy and geopolitics have changed in recent years which should push the IFIs to transform themselves if they want to continue play a leading role in fighting poverty and driving the developing world’s economic growth agenda. Reinventing the IFIs,

creating the IFI 2.0 is a challenge that these institutions and the international community currently face.

Need for New

Here are the reasons why I think the old-world IFIs need to reinvent themselves:

1. **Emergence of several new international and regional institutions and increase of competition among the old- and the new-world IFIs.** New Development Bank (known as BRICS Bank) - which has both a development finance arm (similar to the World Bank) and a balance of payments support mechanism (similar to the IMF) – was created in 2014. The second key organization established by the BRICS is the China-led Asian Infrastructure Investment Bank (AIIB), which has already raised 100 billion USD of seed capital for infrastructure projects in Asia. This type of competition in the international financial institutions arena promises to make it much more difficult for the traditional IFIs to promote market-liberalizing reforms through offering IFI assistance, versus the statist approach that is offered by the new-world IFI. Hence the need for more active, more engaged, more responsive to local needs IFI 2.0.
2. **New Political Reshuffle that is taking place in the Developed World** – global and liberal values being pushed out from leading positions during elections and more nationalistic themes becoming top of the agenda. Most recent US Presidential elections, Brexit vote, French Presidential elections clearly demonstrate this trend and most likely we should expect this trend to continue for at least some period of time. And, it is self-explanatory, that elections won on anti-globalization platform will give a full mandate to the elected government or President to cut down significantly on financing of International Financial Institutions.

The US government's recent decision to cut down budget of the USAID by 30% is a clear sign of this development and most likely we should expect this trend to continue and IFIs should prepare themselves for tighter financing flows from main donors – US and EU countries. Hence the need for more efficient, better coordinated among themselves, and better organized IFI 2.0, who will sell their agenda to donors better and will use available resources as efficiently as possible.

3. **New Economic Reshuffle that is** taking place in the world which is the result of the following circumstances:

- Due to technological developments investors behaving differently than only a few years ago. Rather than investing in developing countries to benefit from cheap labor, land and assets, low taxes and other low costs, now a growing number of investors prefer to invest in places such as Silicon Valley, and not shy away from spending on expensive offices and staff because it will all pay back with higher returns. Higher demand on knowledge, innovation and skills intensive vs capital, energy and labor intensive economy is the major reason of the current economic reshuffle and will result in less FDI towards developing countries and more FDI towards developed ones as they are the developers and leaders in new technologies.

And to see this we don't need to analyze results of the past few decades. The transformation is taking place at a very fast pace and even 6-7-year comparison shows visible results. As its shown from the chart below, at the end of 2011, out of top four companies worldwide based on their market capitalization only one was from the ICT sector and the remaining three were oil companies. At the end of 2015, on the contrary, all the top three companies globally were from the ICT sector, and only one oil company was classified in top 10. According to 2017, Q4 figures top four companies are all from the ICT sector. The number of technological companies in the top ten most valued corporations of the world has increased form 3 in 2011, to 4 in 2015 and to 6 in 2017, not counting Berkshire Hathaway's investments in technology companies (20% of its investments).

Top 10 Companies by Market Capitalization

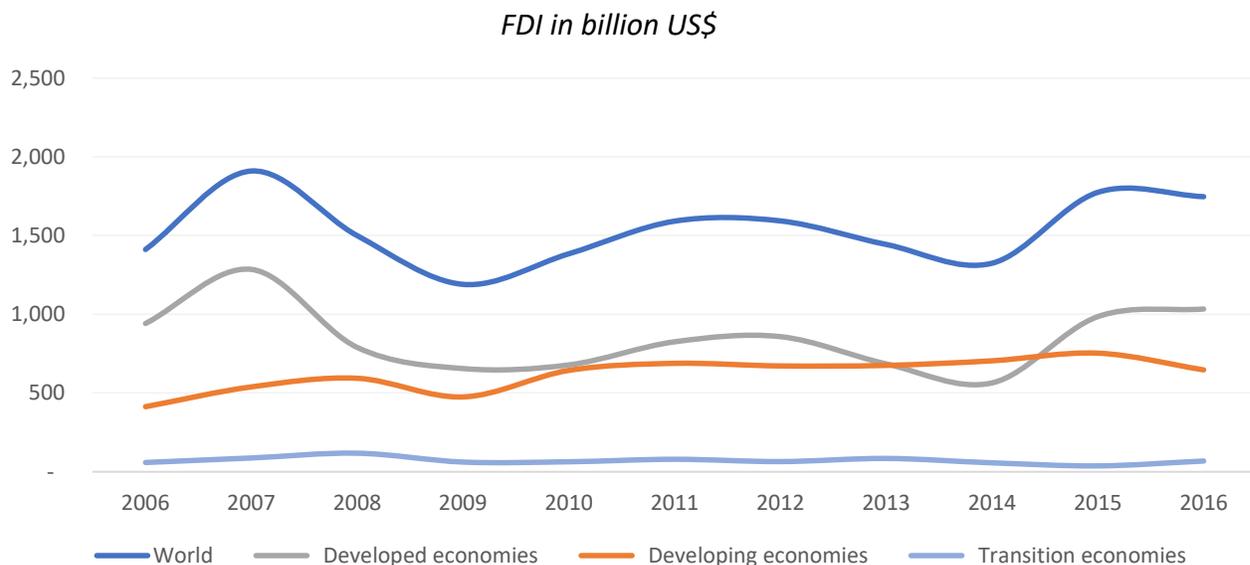
Rank	2011 Q4 (US\$ bill.)	2015 Q4 (US\$ bill.)	2017 Q4 (US\$ bill.)
1	Exxon Mobil - 406	Apple Inc. – 598	Apple – 869
2	Apple Inc. - 376	Alphabet – 534	Alphabet - 727
3	PetroChina - 277	Microsoft - 450	Microsoft - 660
4	Royal Dutch Shell - 237	Berkshire Hathaway - 324	Amazon - 564
5	ICBC - 228	Exxon Mobil - 325	Facebook - 513
6	Microsoft - 218	Amazon - 323	Tancent – 485
7	IBM - 217	General Electric - 314	Berkshire Hathaway – 490

8	Chevron Corporation - 212	Johnson & Johnson - 287	Alibaba Group – 441
9	Wal-Mart - 205	Wells Fargo - 282	Johnson & Johnson - 375
10	China Mobile - 196	JPMorgan Chase - 245	JPMorgan Chase - 371

Source: FT Global 500

- Oil prices going down - oil prices began to decrease in 2014 and nearly halved in 2015 - and stabilizing at low level resulted in reduction of FDI to developing countries. As oil exporters were comfortable enough with their internal social as well as physical infrastructure, when oil prices were above 100 USD per barrel they were using substantial part of the extra oil revenues for FDI in other developing countries. Now with low oil prices, exporters are cutting down on external FDI and savings of the oil importers are going mostly to higher social needs of these countries or for building up depleted reserves – but not for FDI in developing countries.

The following chart demonstrates trend of global FDI broken down by developed, developing and transition economies, whereby FDI to developed countries is on the rise since 2014. Notably this trend coincides with the trend of stronger emergence of IT companies.



Source: UNCTAD

Of course, this economic reshuffle will have its losers and winners, just like all the other reshuffles have had in the most recent past– post WWII economic recovery of Western Europe and Japan, shift in the geopolitics as a result of late 70’s oil price hike (and Islamic revolution of 1979 in Iran),

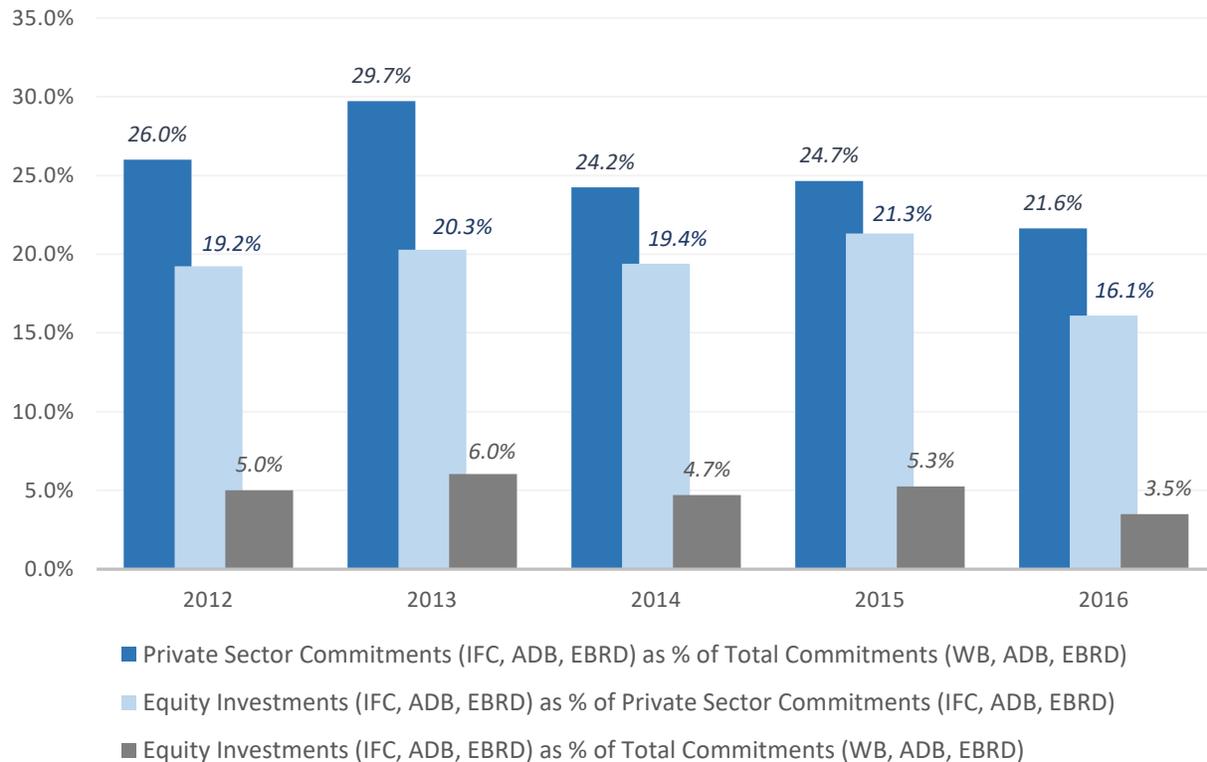
Post-Soviet Union redistribution of wealth and power and Eastern European transformation with integration into the EU and NATO. This time which country will be the winner and which one will be the loser will depend on how efficient governments will behave, how well they will manage FDI attraction in this competitive environment, unleash potential of SME sector, provide efficient services to public and private sectors, transform education systems to adapt to new technological changes and how well they will adapt to changing realities of the new economic order.

In this context, a serious responsibility and at the same time a challenge rests with IFIs: will they be able to help steer the developing countries out of this economic reshuffle without major losses, but on the opposite with the structurally new economies which are adapted to new realities? Every crisis as well as every major reshuffle, like this one has its major benefits – it encourages to innovate, reform, adapt, and create something new.

Let's not waste this opportunity, or maybe it's better to say let's not waste this post world financial crises economic reshuffle for the developing world and let's experiment with some new ideas. The main ideas listed below are focused around private sector involvement in IFI assistance as well as providing medium size private sector of developing countries with what it needs the most – equity. IFIs have always been active in private sector financing but I believe it has remained at comparatively low level over time and need more diversified tools as well as more focus on this direction. More specifically, IFI's participation in the private sector equity investments remained at very low levels. Analysis of the applicable operational data of the selected three IFIs, the World Bank Group, the Asian Development Bank and the European Bank for Reconstruction and Development, revealed that, the average share of equity investments for the past five years was roughly 5%¹ of total commitments and circa 19% of private sector commitments. Notably, the average share of the private sector financing by the selected three IFI's during the past five years remained at around 25%. Among them for World Bank Group it was around 21%, for the ADB - 10 %, and 77% - for the EBRD, whereas the average equity Investments as percent of total commitments for the selected IFIs in 2012-2016 were as follows: The World Bank Group - 5.3%, ADB - 0.6% and EBRD – 12.3%. IFI's provide financing to the private sector mainly in the form of loans and/or parallel loans. The above data demonstrates that there is potential to increase private sector financing by the IFIs and thus help boost economic growth driven by private initiative.

¹ i) The World Bank Group includes IDA, IBRD and IFC; ii) End-year EUR/USD exchange rates were used to convert EBRD commitments in US\$.

WB, ADB, EBRD - Private Sector Financing¹



Source: WB, ADB, EBRD

Also IFIs have been rather unprepared to support global private funds flow into the developing countries. According to “EBRD Transition Report - 2015-2016” – “An estimated US\$ 1 trillion remains available to private equity funds for investment in companies around the world. A more outward-oriented approach and greater emphasis on innovation could help companies in the EBRD region attract a larger share of those funds”. This is US\$ 1 trillion that could flow to developing countries if given right insurances and some comfort by IFIs.

There is a growing gap between world financial markets and developing countries. Either IFIs need to be more active in providing equity to private sector of developing countries, or private funds of the developed countries need to be encouraged more by IFIs to invest in developing world, or private sector of developing countries need to be assisted to come more actively to world financial markets, or all at once.

IFI 2.0

The present article presents innovative ways of developing world's private sector financing as well as of attracting more private funds of developed world in the developing countries, better mechanisms of managing and financing of CEOs, some innovative measure to fight corruption and new formulas for staff motivation inside of IFIs.

IPPP - IFI – Public – Private Partnership – Needs to be acknowledged that most of the IFIs have long started financing with similar formula – IFIs do partner up with private companies to invest in developing countries, but only in rare cases (?). The idea that I am proposing is to turn big portion of IFI assistance into IPPP projects and on top, to use specific formula that - will ensure competitive environment for choosing the private sector partner, will use the minimum IFI resources for any specific project, will ensure long term sustainability of any project through turning it to the private sector and will minimize any possibility for corruption. Instead of financing infrastructure projects independently, IFIs can use IPPP (IFI Public Private Partnership) approach involving private sector players who will manage projects and afterwards buy out other stakeholders be it state or IFI. To give an example – in case when there is a need for rehabilitation of an HPP or construction of a road. Currently an IFI will approach a government or vice versa and most likely an IFI will provide direct financing to the government with relatively low interest rate and relatively long maturity, with quite a long grace period, which will result in increased debt of the government. But it is still appreciated by the recipient countries – the loan is comfortable and solves many problems in the borrowers' economies. But considering possible decline of IFI recourses, possible dip in FDI flow to the developing world and most importantly considering significant potential of private sector to invest in developing countries but not being prepared to take some extra risks (being it political, geopolitical or other) IPPP formula may prove to be much more efficient and effective.

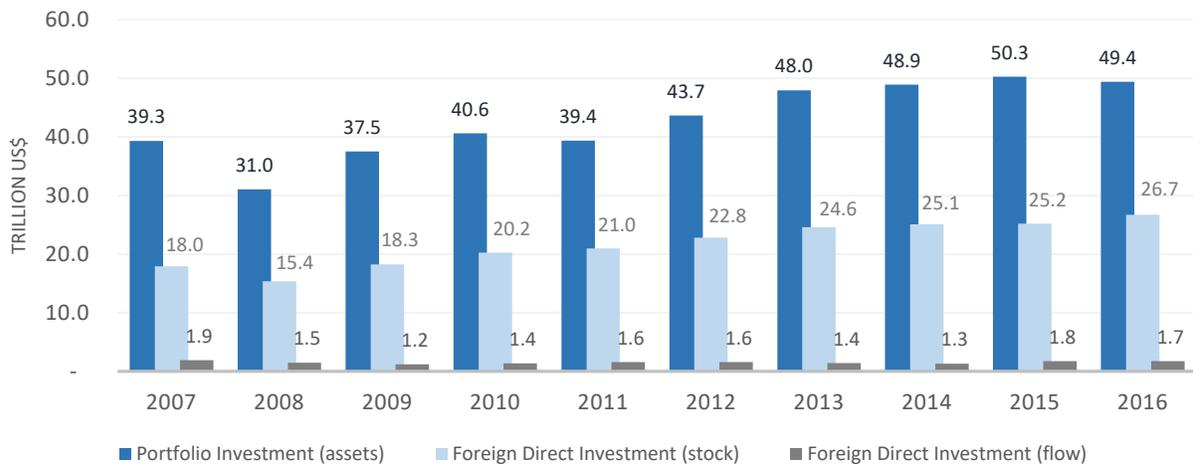
The idea is for IFIs with the government to announce an expression of interest to find a private investor who will provide equity for the project and will actually buy part of the project – it can be a minority shareholder of an HPP or majority investor in a new road, depending on government's policy. Potential rate of income is identified through either tariff of the HPP or a toll price of the road. The next step would be to announce an auction based on the following principle: which company will request less equity and less loan from an IFI / Government and will come up with higher equity. Or the tender can be the formula of both – the price (tariff of an HPP or a size of a toll) and the equity requirement from IFI / Government (with loan part being fixed from an IFI). In this case, less funds will be spent by IFIs, the asset will be privatized or partially privatized and will have a private management team which is much more effective than state ownership. Participation from IFI will give a private sector additional comfort of being protected from political or geopolitical risks and will unleash part of the frozen funds that private sector

keeps on bank accounts. The loan will be repaid by private sector (at least partially) instead of the state budget. Yes, most likely this will result in slightly higher tariff of HPP or in a toll road rather than a totally free road, but these will be more market oriented prices and should not result in another “need for government to be involved”. I am saying “should not” as there are still many cases of negative PPP projects – mostly due to un-transparent and non-competitive procedures of choosing a private sector partner. If managed well this process should give the most competitive price of the project and ensure least possible funding need from IFIs. In order to increase competition from the private sector IFI may even consider insuring parts of the project risk to make it Investment Grade (BBB-) as many Investment Funds, Pension Funds are limited in their ability to invest in projects below BBB-. This can be done in close cooperation with Rating Companies – IFIs insuring some specific risks of that particular project in order for the Rating Company to grant Investment Grade. Of course, this approach may not be used in many cases but in cases where country has BB rating this approach may give very positive results and open Developing countries to much bigger pool of investment funds.

Bringing more private sector funds to developing world and helping to create strong and vibrant private sector in the developing countries must be top of the agenda of IFIs in this environment. Of course, US FED’s and ECB’s rates play significant role in comparative attractiveness of investing in developing countries, but let’s not forget that neither FED’s not ECB’s concern is growth rate of developing countries or FDI flow to developing world – their concern is ensuring economic stability of US and EU respectively. It is IFI’s role to ensure economic growth and decline of poverty in these regions, which can be more effectively done by opening up developing markets to as wider as possible range of private investments from developed world either by bringing investors to developing world or by bringing developing countries projects / companies to marketplace where biggest investment funds are available.

Creating PME sector (Publicly Traded Medium Size Enterprises) – currently biggest problems of the private sector in developing countries are lack of equity and transformation from family type companies into corporations – which actually are very much interrelated problems. Creating special products for medium size private companies to IPO on international stock exchanges or issuing Eurobonds may be the biggest boost to the economies of developing countries – being an anchor investor, providing legal and financial advice, or even special loan once a company issues Eurobond or IPOs on an international financial market, etc. These companies will be able to tap into the recourses of the developed countries’ funds that are currently unavailable for developing countries as most of them are only active as portfolio investors. There is 1.5 trillion USD per year spent on FDI globally and 45 trillion is spent on portfolio investments.

FDI and Portfolio Investment



Source: UNCTAD, IMF

IFIs creating special products for medium size private companies of developing world that would motivate the owners of these companies to tap into the funds of international financial markets will have a sizable effect on the economies of developing countries – as the private sector will also have to clean up their companies before going to international markets, they will have to start pay taxes fully, adopt best practices for corporate governance, etc. This will help many countries to solve a major problem of private sector – attracting equity and for that transforming family businesses into corporate structures – which will allow these companies to grow faster, attract more and more funds from financial markets, merge with other companies more efficiently or acquire and sell the companies easier, etc. And at the same time this transformation will help countries build their risk profiles and PMEs will act as marketing agents of these countries.

An extra step for developing PME sector in developing countries could be creating specialized IFI Stock Exchange - where IFIs will help medium size companies from developing countries to go public and attract equity from the world financial markets by assisting with legal and financial services, or even by playing a role of an encore investor, or extending special loans in case of successful placement and at same time creating softer rules of going public, something similar to AIM London Stock Exchange. IFI Stock Exchange can play a role of a stepping stone before going public (if successful) on Warsaw, Frankfurt or London Stock Exchange. Many medium size companies in developing world don't even dream of going public knowing that their company size is the biggest constraint. With IFIs help (who have offices in all developing countries and who can lead this process for medium size companies on the ground) entrepreneurs will be able to take initial steps in right direction, change their corporate structure from family owned businesses into corporations and then, in case of successful development look for bigger opportunities.

True Corporatization of State Owned Enterprises (SOEs). I believe that currently SOEs (especially in developing countries) are the source of the biggest inefficiencies in the world. Of course, there are exceptions, but as a rule this is the case. Mostly SOEs are one of the biggest sources of corruption and misused opportunities. Mostly they are used for political purposes – providing employment for political elite, providing financing for political projects or even playing political role in international affairs, rather than being focused on efficient and effective management of resources and being profit oriented and innovative to achieve higher profit margins. Currently IFIs lend significant funds to SOEs directly or through state budgets. Instead of direct lending (or through budgets) the IFI should put as a condition for SOEs to issue a Eurobond on international markets or do an IPO within a specific time frame (it can be minority or majority of the shares depending on government policies). And in this case on top of lending to SOEs an IFI can play a role of an anchor during the transaction. And IFIs should put as a condition to the loan (and condition to be an anchor) that the management of the SOE will be paid based on the Eurobond spread (between Sovereign and the SOE) or based on share performance in case of an IPO (or maybe even being partially remunerated by shares which can only be vested once leaving the job – to make sure that it is in the interest of the management to take a long-term view on the company).

Why is this important? First of all, every transaction of an SOE on the international financial market helps the respective country to draw its risk map - different types of risks (sovereign, sub sovereign, Eurobonds, shares of companies, of financial institutions, etc) are being valued by world financial markets which will help other private companies of the same country to better attract investors in their companies, or will help local banks to attract cheaper resources, in turn affecting local interest rates. When there is no risk map of a country, it only increases the risk for investors and hence increases the price of loans and decreases the price of assets. Second, the management of SOE's when being remunerated through stock options or Eurobonds yield spreads will take a different approach to the companies – they will try to solve inefficiencies, avoid involvement in politically motivated projects, political appointments or political financing and the governments will also be aware that any non-profile activity of the SOE may affect its share price or Eurobond price by doing so affecting government's own standing. The management will have to clean up the company, adopt most transparent policies and use best international standards of corporate governance. At the same time these managers become international marketing agents for the government and for the country – their remuneration depends on the price of the paper on the international market, that means that they have to communicate with investors on permanent bases providing them with relevant information about the country and investors are also interested as they have invested – creating the best

venue to promote the country and its new positive developments, which in other cases are irrelevant for these investors.

Fighting corruption X.0 (because there has been so many attempts to formulate policies that would fight corruption successfully, that Fighting Corruption 2.0, 3.0 and 10.0 have already been used up – now we are at the stage of X.0) - Definitely, corruption is among the biggest problems of developing world. There are not many cases of fighting corruption successfully and many say that corruption is cultural, innate, historic. I refuse to believe this. If corruption was cultural Georgia still would have been among the most corrupt countries in the world. In 2003, According to Transparency International Georgia was named as 127th country out of 133 reviewed that year, the only countries behind Georgia were Bangladesh, Tajikistan, Nigeria, Myanmar, Paraguay and Haiti. Only few years later, in 2012 Georgia was ranked among top 50 least corrupt countries and when Transparency International conducted a research asking one and the same question to the representatives of 180 countries – have you, or a member of your family paid a bribe during the past 12 months – only 4% answered yes. US result was 5% and EU average was 5%. Only a dozen countries did better than Georgia. Georgian example shows that corruption is not innate and neither cultural – it can be fought successfully and results can be seen in a very short period of time.

Is there anything IFIs can do to fight corruption successfully? One way of doing so would be to stop providing financing to every country that has corrupt government, but that may not solve the problem and in addition, it will be challenging to set the threshold regarding the level of corruption beyond which IFI funding would be suspended. IFIs should definitely continue pushing their rules of procurement and requirements for transparency which are mostly the only tools to stop corrupt deals and they can use two additional methods:

1. Investing in new technologies and pushing governments to adopt new technologies such as blockchain technology, which significantly improves transparency and in many cases makes corruption impossible by using a timestamp on every document registered and by using multiple registration resources it is impossible for anyone to change anything in an existing document making it corruption proof for certain illegal deal making. Providing financing to governments to adopt blockchain technologies will pay back by less corruption within shortest period of time. It may be the investment with the highest rate of return for IFIs.
2. The second is a bit controversial idea but still worth mentioning to open a debate. What if IFIs will buy Eurobonds of the country and put them on an escrow account in the names of the government figures of this country which can only be cashed once and if they retire

cleanly. This system may encourage many government officials to conduct business as transparently as possible – leaving them an opportunity to have some kind of income once retired. This is the biggest problem in the developing world – government officials do not get high salaries, they don't have any savings and they are scared of leaving their positions – in some cases this transforms into corruption, in other cases into dictatorship, or into corruption and dictatorship at same time. I am not saying that this scheme will completely stop corrupt dealings, but at least it will create a conflict among the government members who want to drive corrupt deal making and others who could have been dragged into this because of no future prospect and who will try to stand up as strong as possible against any corrupt practice, as they see the potential to keep clean record and get significant financial bonus for that in the form of country's Eurobonds which can be cashed.

Corporate-style staff motivation schemes of IFIs – Currently it seems that all IFI's are trying to push loans on different government agencies. Whether these loans give real and quantifiable benefit to the recipient country seems to be a secondary agenda as the pay of the IFI employees are dependent of the loan book and profitability. The formulas for employee remuneration should include some parameters of the receiving country's development – GDP growth, employment, or price of the sovereign Eurobond, not only the size of the loan portfolio. This way international civil servants and IFI managers have higher motivation to implement successful pro-growth projects.

Despite many mistakes and much criticism, it needs to be acknowledged that for the past few decades IFIs have been successful in helping developing world to grow and to fight poverty. And there have been few shifts in the policies of IFIs which mostly proved effective. Now, with the political and economic reshuffles threatening farther transformation of the developing countries IFIs need to adapt to new realities and reshape their policies. Assisting world's private financial flows to be channeled toward developing countries and creating stronger private sector in the developing world could be most effective and efficient ways to help the developing world to weather this process of global political and economic reshuffle.