

Enhancing the contribution of private sector to inclusive and environmentally sustainable growth

The private sector plays a pivotal role in creating economic opportunities to reduce poverty in Asia and the Pacific. For development institutions, private sector investments offer plenty of opportunity for promoting inclusive and environmentally sustainable growth—and doing so at a profit. But this can be difficult terrain to navigate, as the Asian Development Bank's (ADB) experience in this area over the past decade shows.

Strategy 2020, ADB's long-term strategy approved in 2008, envisages ADB expanding its work with the private sector to help developing member countries attract investments that not only support growth but promote inclusive growth and environmental sustainability. ADB's support can also act as a catalyst for investments that the private sector might not be willing to shoulder.

Independent Evaluation's thematic evaluation study *ADB Private Sector Operations: Contributions to Inclusive and Environmentally Sustainable Growth*, on which this edition of Learning Lessons is

based, aims to identify lessons from ADB's experience with a view to informing the selection, design, and monitoring of future private sector operations.

ADB's Private Sector Operations

Private sector operations accounted for 9% of total ADB operations during 2000–2012, the period covered by the study. Energy projects accounted for half of approved commitments for private sector operations, and mostly included investments in conventional and renewable energy. Finance sector investments accounted for 34%, and predominantly included transactions that sought to meet financing needs of micro, small- and medium-sized enterprises (MSMEs).

Scope of the Evaluation Study

All 173 transactions of ADB's Private Sector Operations Department (PSOD) approved during 2000–2012 were evaluated for their potential to contribute to inclusive and environmentally



The ADB-supported North Luzon Expressway Rehabilitation and Expansion renovated an 83.7-kilometer section of road from Manila to the Clark Special Economic Zone in Pampanga province by building or rehabilitating 14 interchanges, 24 bridges, and 31 overpasses. The road used to be a heavily pot-holed two-lane thoroughfare, where trucks, buses, and private vehicles dangerously competed for space. Today, it is a safe, smooth tollway with good lighting, modern signage, and vigorously enforced traffic laws. Photo by Kevin Hamdorf. ADB Photo Library.

sustainable growth. The total value of new commitments in the period was \$10.7 billion. Actual development results were assessed for all of the more than 60 transactions that have reached sufficient levels of operations.

Contributing to Economic Growth

PSOD's investments were on the whole profitable and contributed to economic growth. Infrastructure investments generally made substantial contributions to economic development by addressing binding impediments to growth. For example, in South Asia, entrepreneurs perceive energy problems to be their biggest constraint to doing business. PSOD's investments in conventional power generation substantially contributed towards narrowing demand-supply gaps and helped offset forecasted shortages in several countries. Increases in generation capacity not only helped improve the reliability of power supplies, but also increased sector efficiencies in recipient countries reducing the costs of mostly state-owned off-takers.

About half of PSOD-supported infrastructure projects helped catalyze additional private investment in the sector by demonstrating the commercial feasibility of private sector participation and introducing new technologies or financial structures and risk-sharing arrangements. In a number of so-called frontier countries (mainly those qualifying for concessional borrowing from the Asian Development Fund), investments would not have materialized without PSOD involvement.

By comparison, contributions of PSOD financial sector transactions to economic growth have been mixed. Only 40% of the financial sector portfolio had satisfactory economic returns, which mainly reflected the poor underlying business success of many supported

transactions. While direct investments in financial institutions contributed to market development by furthering competition or improving market infrastructure, the impact of SME-related transactions on the performance of funded SMEs and other related enterprises was likely modest.

SME transactions are unlikely to have catalyzed additional financing for SMEs either by the supported or other financial intermediaries with only 39% of supported banks or leasing companies with SME development objectives increasing the share of their SME portfolio. Private equity funds managed to leverage more than 5 times as much financing from other fund investors, but had rather modest effects on the creation of additional funds. About half of supported financial institutions promoted innovative products, systems or business practices and about a third demonstrated exemplary corporate governance and banking practices, although these achievements were usually unrelated to ADB assistance.

Promoting Inclusion

While private sector operations usually focus on growth, these can also be supportive of inclusive growth, but the link is not automatic. In a growing number of developing member countries, economic growth has gone hand in hand with increasing income inequality. Nevertheless, it is likely that some PSOD infrastructure investments indirectly facilitated access to important services that allow more of the poor to participate in the growth process. A good example are increased power supplies that enabled further electrification efforts in recipient countries, which is important in region where 800 million people have no access to electricity. For governments, using revenues from private investments for social inclusion is an attractive option. For example, revenues from the ADB-supported Nam Theun 2 power project in the Lao People's Democratic



Thailand's 73-megawatt Lopburi solar power plant is the largest solar photovoltaic project in the world, and central to the country's efforts to generate energy from renewable sources. Photo by Gerhard Joren. ADB Photo Library.

Lessons for Project Selection and Design

- Compared to public sector operations, PSOD has less scope to influence design, partly because it does not have the level of resources required for more proactive project development. Infrastructure projects were usually developed by private sponsors, while ADB tended to be one of several partners or a minority shareholder for financial market transactions. Careful selection of sponsor proposals is therefore crucial for maximizing the development impact of private sector commitments.
- Also, more PSOD involvement in project development does not necessarily lead to superior development impacts. For example, some of the few finance sector transactions initiated by PSOD (rather than private sector sponsors) misjudged underlying private sector demand, leading to low uptake and disappointing results.
- Although the link between economic and inclusive growth is not automatic, it can be strengthened by selecting projects in sectors or regions with a high likelihood of direct or indirect effects on the poor.
- Inclusive project designs involve (i) systematic targeting of underserved areas and customer groups, (ii) the provision of products and services that address the needs of such groups, (iii) the use of appropriate delivery channels, and (iv) affordable pricing. Inclusion objectives are unlikely to be realized unless supported by project targeting and transmission mechanisms and impact monitoring.
- While lack of funding is rarely a key binding constraint to private investments, a non-conducive investment climate and inadequate policy and regulatory frameworks can be.
- Even the most inclusive investments find it difficult to reach the poorest without subsidies. Targeting low-income segments at a higher tier of the income ladder that do not have access to private sector goods and services is a valid inclusion approach.

Republic are used to finance health, education, and poverty reduction programs. Transmission projects are helping develop economically disadvantaged areas.

Private sector operation sought to contribute to inclusive growth and poverty reduction mostly through the growth-employment nexus. Support for SME development played a major role in PSOD's growth and poverty reduction agenda, although the link between SME development and inclusive growth has not been conclusively proven empirically. While poverty reduction through employment generation was the key objective for such support, many financed banks and private equity funds lacked on-lending or investment strategies for industries that could generate inclusive job growth. As a result, such operations usually did not generate (self)employment opportunities for the poor. Supported financial intermediaries' success in reaching rural and female entrepreneurs was dependent on the use of adequate targeting and transmission channels. PSOD's dedicated microfinance private equity funds have generally been effective in increasing access to finance for the poor, rural areas, and women, whereas banks and leasing companies had mixed success in this regard.

Only 13% of projects explicitly promoted inclusion by broadening access to economic opportunities for the poor and other disadvantaged groups. Few PSOD transactions were in areas with the potential to directly the livelihoods of these groups. To a considerable degree, this reflects policy and regulatory constraints to private sector participation in sectors such as water, agriculture, health and education. More recently, PSOD has been trying to reenter the health and education sectors.

Compared to other multilateral development banks, PSOD is somewhat behind the curve on promoting inclusive businesses (companies that offer, in scalable ways, goods, services, and livelihoods to lower-income groups). The lack of experienced

sponsors combined with a need for high-risk venture capital financing, reduces the number of viable investment opportunities. Lack of PSOD staff, TA resources, as well as incentives affect the identification and development of investments, as do risk considerations.

Telecommunications emerged as a particularly promising area for investments with potential for profit and inclusiveness. Three ADB-supported projects in Afghanistan, Bangladesh, and Papua New Guinea yielded tangible development outcomes in widening access to mobile phone services in rural areas.

With regard to geographical inclusion, lending to frontier countries has not been increasing during the review period. PSOD had limited operations in poor and economically disadvantaged regions of non-frontier countries.

Promoting Environmental Sustainability

Strategy 2020's approval in 2008 led to a substantial increase in the number and total value of projects that directly contribute to environmentally sustainable growth, with PSOD energy projects strategically focusing on mitigating climate risk. With around half of carbon emissions in developing Asia coming from electricity and heat production, renewable and energy efficiency play major roles in ADB's clean energy initiatives. PSOD helped pioneer solar power investments in India and Thailand and wind investments in Pakistan and Thailand, with the share of renewable and other clean energy and energy efficiency investments rising from 8% of total approvals during 2000–2008 to 49% during 2009–2012 (comfortably exceeding the 30% target).

While financial and economic returns on renewable energy projects are still well below those for conventional ones, renewable energy costs—such as for global prices of photovoltaic modules for solar energy—have fallen faster than expected; lessening

trade-off between environmental and economic benefits. For a couple of wind power PSO, there have been shortfalls in actual generation outputs due to suboptimal site selection and grid curtailments. Likewise, the performance of PSOD-supported clean energy funds has been affected by the collapse of the market for carbon emissions rights, the current supply glut in wind and solar industries, and changing regulatory practices.

Conclusion

ADB's private sector operations can play a significant role in promoting growth as well as broadening access to economic opportunities and promoting the use of environment-friendly technologies. So far, they have mainly been growth focused. Strategy 2020 sharpened the orientation of ADB's private sector operations aiming for environmental sustainability, but much less so for inclusion. Only a few PSOD projects directly promote inclusion. While the potential for private sector operations for promoting greater social inclusion is still far from being realized, successful projects demonstrated that a trade-off is not necessary between development impact and profitability. Private sector operations that contribute directly to inclusive growth can have similar investment returns as other types of investment.

Recommendations

Strengthen the strategic focus of private sector operations in line with inclusive and environmental growth objectives.

PSOD needs to update its business strategy to help operationalize inclusive and environmentally sustainable growth objectives. ADB has provided relatively little support to promote inclusive businesses, and ADB needs to explore how it can best support companies with inclusive business models through, for example, technical assistance and appropriate financing mechanisms. PSOD should also seek to provide more support in underdeveloped regions of middle-income countries, where most of Asia's poor live, and review the role of SME-related operations in promoting economic growth and poverty reduction.

Identify viable opportunities for expanding environmental operations. Large demands for clean energy investments are

not being met. PSOD can help expand private investments in renewables to developing countries that have not had related investments, but have adequate and economically viable resource potential in addition to conducive policy and regulatory frameworks. Also, more energy efficiency investments are needed, although a significant increase in this area will largely depend on government incentives.

Seek inclusive project proposals from private sponsors given PSOD's limited scope for influencing project design. PSOD needs to identify areas where private sponsor objectives are most likely to overlap with ADB's development agenda, and generate more proposals for direct inclusion (only 5% of proposals reviewed during 2011–2012 did this) through closer cooperation with relevant sponsors. To increase the number of viable project opportunities, the study suggests that ADB also engage in policy dialogue with client governments on reforms to remove barriers to private investment in social infrastructure and financial inclusion.

Enhance transactions in line with development objectives.

PSOD and ADB need to improve their analysis of direct and indirect project contributions to inclusive growth and related causal pathways at the project and country levels. For any project seeking to directly improve inclusion, targeting mechanisms and transmission channels need to be in place. PSOD needs to explore how the outreach of supported investments can be improved through complementary measures by ADB or other development partners. There is also need to strengthen PSOD's capacity for reviewing technical and economic feasibility assessments of clean energy projects. No least-cost analysis was undertaken for renewable energy projects, appropriate counterfactuals were not defined and economic benefits associated with greenhouse gas emissions reductions not systematically quantified.

Strengthen the monitoring and reporting of development impacts. PSOD can do this by improving the inclusion of relevant outcome statements and indicators in project design and monitoring frameworks, and systematically collecting required monitoring reports from supported project sponsors, financial institutions or fund managers.

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About the Independent Evaluation at Asian Development Bank

The Independent Evaluation Department evaluates the policies, strategies, operations, and special concerns of the Asian Development Bank relating to organizational and operational effectiveness. It contributes to development effectiveness by providing feedback on performance and through evaluation lessons.

Learning Lessons is a synthesis of key evaluative lessons drawn from the experience of ADB operations and non-ADB sources. Lessons presented in this brief are not prescriptive, and users are advised to carefully review these lessons in the context of country, sector, and thematic conditions.

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