

A REPORT OF THE CSIS  
PROJECT ON U.S. LEADERSHIP  
IN DEVELOPMENT

# Sharing Risk in a World of Dangers and Opportunities

STRENGTHENING U.S. DEVELOPMENT FINANCE CAPABILITIES



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**CSIS** | CENTER FOR STRATEGIC &  
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# 1

## INTRODUCTION

### Summary of Findings

The changing nature of international development has produced an increasing interest in the use of development finance instruments. As the availability of soft grant money decreases and there is an increasing acceptance of the central role of private-sector-led growth, official development assistance-led development is shifting to focus on investment and trade. In this context, the U.S. government must more effectively use its existing development finance instruments. The Overseas Private Investment Corporation (OPIC), U.S. Trade and Development Agency (USTDA), Millennium Challenge Corporation (MCC), and U.S. Agency for International Development (USAID) encourage private-sector development while serving as instruments of U.S. national security and foreign policy, but, as currently conceived, are inadequate to meet the entire spectrum of challenges we face.

In order to achieve the best policy and development outcomes, these agencies need expanded authorities, must work in close alignment, and need to use their grant money more creatively. Given the current domestic economic situation and focus on reducing the federal deficit, any U.S. government agency that increases U.S. influence abroad and links international development to the U.S. economy should be given the opportunity to grow and expand. Development finance instruments are also an important way for the United States to help middle-income countries graduate from traditional USAID programs and offer a set of instruments to leverage and complement MCC compact programs. Now is the time to help U.S. government agencies create innovative solutions in a more coordinated fashion and increase the capabilities of existing development finance programs.

This report makes broad policy recommendations that are applicable to the general use of development finance by the U.S. government, as well as agency-specific recommendations. There are five recommendations that should be implemented immediately:

1. Congress should reauthorize OPIC on a permanent basis or at least for a five-year term and allow it to retain a small portion of its earned revenues to
  - a. fund technical assistance programs tied to OPIC investment products delivered through managed third parties;
  - b. permit OPIC to participate in “first loss” and other forms of risk sharing; and
  - c. enable a limited capability to make equity investments, especially in the world’s poorest countries and countries where the United States has an overriding national security interest.

2. USAID and MCC need to use grant money in ways that share risk on development finance deals. This should be consistent with the development objective in the country where the deal takes place.
3. As part of the review of Development Finance instruments, Congress should revisit the use of enterprise funds in a handful of countries of geostrategic interest to the United States (i.e., the Arab Spring and postconflict countries).
4. USTDA and OPIC should be included more strategically in exit plans for closing USAID missions and should be incorporated, where relevant, into the front end of MCC compact development.
5. Rather than rely upon organizational chart changes, those U.S. government agencies engaged in development finance (specifically OPIC, USAID, USTDA, MCC, and other agencies not covered in this report) should put in place a system that encourages secondments across the agencies to build better understanding of the role each agency plays.<sup>1</sup>

## Overview

Incorporating the international private sector and aiding local enterprise development are essential components of a smart development policy, in particular one that harnesses the power of development finance tools. Broadly defined, development finance generates financial as well as development returns (e.g., increased local economic opportunity, improvements in standards of living). Supporting entrepreneurship and local economic development are necessary for creating projects that are not only more sustainable (e.g., can eventually survive without official development assistance) but also can generate financial returns, particularly when partnered with larger private-sector actors.

A development finance institution (DFI) is an alternative financial institution that provides finance to the private sector for investment in the developing world. All Group of Seven (G-7) countries have DFIs. The World Bank's International Finance Corporation (IFC) functions as a multilateral DFI. OPIC is the U.S. government's DFI. Other U.S. development agencies—such as USAID, MCC, and USTDA—are also involved to a certain extent in development finance. There are a number of challenges to increasing private-sector investment. Even before the additional challenges regarding access to capital created by the 2008 global financial crisis, the financial concept of balancing risk and reward had made even the most enterprising investors reluctant to tread in places like Afghanistan, South Sudan, and Haiti, and also in other developing nations. In these countries, the lack of transparency, challenge of repatriating profits, difficulty accessing information, and the often weak rule of law are widespread problems that hinder economic development. In addition to possessing a range of development finance tools, MCC, USAID, and USTDA help facilitate investment by growing the governance capacity in the countries where they work. This sets the stage for development finance instruments to help boost economic growth by sharing risk and catalyzing private investment.

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1. "Secondment" here means "temporary job reassignment."

The ability of the United States to foster economic growth in developing countries is critical for the future of U.S. exports.<sup>2</sup> In order to grow, developing economies need jobs and businesses that will expand over time, which means that their economies are dependent on access to capital and credit. If properly utilized, development finance projects can significantly benefit the U.S. economy and strengthen the country's national security and foreign policy agenda. The U.S. government possesses a number of excellent development finance instruments that can and do catalyze private investment. However, opportunities are missed because these agencies do not work closely together and because of the lack of critical authorities.

On Capitol Hill, the U.S. foreign aid budget is facing substantial cuts. In the current climate of fiscal austerity, there are plans in the works to cut significant funding for development assistance programs, particularly those at USAID, along with support for multilateral organizations. In light of limited resources, the U.S. government must use this fiscal squeeze as an opportunity to prioritize and reshape the U.S. foreign assistance strategy to reflect one that leverages the private sector and multiplies the effect of development dollars, instead of solely relying on government funding. Empowering development agencies by granting additional authorities, rewarding innovative uses of development dollars, and at the same time improving the effectiveness of the development finance tools *already* in the U.S. government's toolbox must be a priority.

With the goal of examining how the U.S. government and other development actors, such as the World Bank's IFC, conduct development finance, *Sharing Risk in a World of Dangers and Opportunities: Strengthening U.S. Development Finance Capabilities* was designed to establish a baseline for the limitations of the United States' development finance model and provide recommendations to improve its functioning. This report focuses on OPIC, USTDA, MCC, and USAID (specifically its instrument for stimulating lending, the Development Credit Authority). Section 2 provides overviews of each agency and highlights a number of limitations related to development finance for each. Section 3 examines overall and agency-specific challenges, and offers a series of recommendations to the Obama administration and legislators on Capitol Hill regarding how to improve the United States' ability to use development finance as an effective instrument of foreign policy. Section 4 concludes the report.

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2. Chris Policinski, "Exports to Developing Countries Boost U.S. Economy," U.S. Global Leadership Coalition, June 30, 2010, <http://www.usglc.org/2010/06/30/exports-to-developing-countries-boost-u-s-economy/>.

# 2

## U.S. GOVERNMENT DEVELOPMENT FINANCE INSTRUMENTS

### The Overseas Private Investment Corporation

#### Overview

Since OPIC was spun off from USAID in 1971, it has functioned as a development agency that channels U.S. private investment into emerging markets in order to promote market-based development. As the United States' DFI, it maintains about 500 U.S.-based clients, including private companies, nongovernmental organizations, entrepreneurs, and private equity firms. By creating economic opportunities in developing countries, OPIC helps to mitigate the risk to U.S. companies, particularly small and medium-sized ones, of investing overseas. OPIC is the only U.S. foreign policy, national security, or economic development agency that earns a net profit for U.S. taxpayers.

OPIC currently manages a \$14 billion portfolio of projects spread through the developing world.<sup>3</sup> It operates in more than 100 countries, with a significant presence in the Middle East and North Africa, Sub-Saharan Africa, and South Asia. OPIC's projects are governed by congressionally mandated statutory requirements, which allow the agency to target countries that correspond with a particular administration's foreign policy agenda.<sup>4</sup> OPIC takes on projects that encompass a wide spectrum of sectors, such as financial services, infrastructure, insurance, housing, renewable energy, information technology, agriculture, and natural resources.

OPIC is a self-sustaining development agency that recovers the funding that is allocated to it through the revenue it earns on projects and interest generated from its paid-in capital, which is held in the U.S. Treasury. In fact, not only do OPIC projects cost American taxpayers nothing, but OPIC nets additional U.S. investment dollars. The interest on this amount goes into an account at the U.S. Treasury, which to date has accumulated more than \$5 billion in reserves during the 40 years of OPIC's operation.<sup>5</sup> In 2010, OPIC earned a net income of \$259.9 million, making it the 34th year that OPIC has generated income for the federal government.<sup>6</sup> Part of this revenue is then used to fund the broader U.S. Foreign Operations Budget.

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3. Jim Faith, "The Overseas Private Investment Corporation: Enterprise Development Network," March 31, 2011, [http://www.mbita.org/events/presentations/Jim\\_Faith.pdf](http://www.mbita.org/events/presentations/Jim_Faith.pdf).

4. Shayerah Ilias, "The Overseas Private Investment Corporation: Background and Legislative Issues," Congressional Research Service, July 5, 2011, 8–9, <http://www.fas.org/sgp/crs/misc/98-567.pdf>.

5. OPIC, *2010 Annual Report*, 4, [http://opic.gov/sites/default/files/docs/annualreport\\_2010.pdf](http://opic.gov/sites/default/files/docs/annualreport_2010.pdf).

6. Susan B. Epstein, Marian Leonardo Lawson, and Tamara J. Resler. "Fact Sheet: The FY 2012 State and Foreign Operations Budget Request," Congressional Research Service, March 9, 2011, 6, <http://www.fas.org/sgp/crs/row/R41680.pdf>.

## OPIC's Development Finance Tools

OPIC provides investment financing for projects through direct loans and investment guarantees. Direct loans (\$2 million to \$30 million) are made for projects in developing—or otherwise eligible—countries involving U.S. small businesses or cooperatives. OPIC establishes loan terms and conditions and provides investment guarantees (\$10 million to \$250 million) to reduce the risk of default. These guarantees provide a means of mobilizing private capital in markets where private lenders would otherwise be deterred from lending without the credit of the U.S. government. Direct loans and investment guarantees, which constitute about 60 percent of OPIC's portfolio, primarily finance projects for 5 to 21 years.<sup>7</sup> They require the applicant to have American involvement in the project in an amount that is at least equal to a 25 percent equity stake. This involvement can come in the form of equity, long-term debt, other contracts, or any combination of these. Financing for investment funds, which is frequently for 10 to 18 years, requires an American equity stake of at least 25 percent of the OPIC loan amount or that the fund be managed by U.S. entities that are at least 25 percent U.S. owned or foreign entities that are at least majority U.S. owned.<sup>8</sup>

OPIC provides political risk insurance, investment guarantees, medium- and long-term financing, debt financing, and support for private equity investment funds. U.S. citizens, firms, and foreign subsidiaries with 50 percent or more U.S. ownership are eligible for political risk insurance.<sup>9</sup> OPIC's insurance offers coverage for up to 20 years and protects against “inconvertibility of currency, expropriation, and political violence.”<sup>10</sup>

Finally, OPIC also issues requests for proposals to private fund managers that complement its regional and sectoral focus. After a selection process, OPIC provides investment guarantees to support the creation and capitalization of the selected funds, which are designed to then make direct equity and equity-related investments in companies in emerging markets (e.g., see box 1). The guarantee, however, must be applied to the debt portion of the fund's capital and does not guarantee any of the fund's equity, which means that the equity investments in OPIC-backed funds are fully at risk.<sup>11</sup>

## OPIC's Structural Challenges

OPIC is hampered by its lack of permanent or long-term, multiyear authorization. Since 2007, it has been reauthorized on an annual basis rather than its traditional five-year authorization. Unless the 112th Congress acts swiftly, OPIC's authorization will expire at the end of 2011. Without reauthorization, OPIC would be unable to execute new deals. OPIC last lost its authorization in 2008, when Congress failed to act for six months. During that time, OPIC's general counsel determined that it could not accept new business without reauthorization. It is estimated that during those six months a backlog of \$2 billion in potential deals accumulated. Some of these deals were never done, because many private-sector actors were not willing to wait around. Furthermore, the potential risk of a lapse undermines the private sector's confidence in OPIC's effectiveness, given

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7. OPIC provides medium- and long-term financing of up to \$250 million for U.S. companies interested in investing in less-developed countries. OPIC, *2010 Annual Report*, 34–35.

8. OPIC, “OPIC Investment Funds,” September 2011, <http://opic.pfsfinance.com/en/investment.php>.

9. This insurance covers three broad areas of political risk: currency inconvertibility, expropriation, and political violence. Ilias, “Overseas Private Investment Corporation,” 6.

10. OPIC, *2010 Annual Report*, 34.

11. OPIC, “OPIC Investment Funds,” <http://opic.pfsfinance.com/en/investment.php>.

### Box 1. Afghan Growth Finance

In Afghanistan, OPIC has partnered with a locally run nonbanking financial institution, Afghan Growth Finance (AGF), which itself was created by Small Enterprise Assistance Fund (SEAF) with a grant they received from the U.S. government and an initial credit facility of \$20 million.<sup>1</sup> AGF is currently making loans of up to \$4 million to small and medium-sized enterprises across a variety of sectors. The project, which was launched in 2007 (OPIC has been in Afghanistan since 2004),<sup>2</sup> has encountered obstacles, including a shortage of capital. High-level conversations between OPIC and USAID resulted in a partnership between the two and the infusion of an additional \$10 million of USAID funds, which then allowed OPIC to contribute an additional \$30 million in 2010.<sup>3</sup> With USAID's grant capital funding technical assistance, AGF is becoming much more effective. Because of the quality of the AGF's local management and the commercial viability of loan-based development mechanisms—something that can be missing in projects based solely on grant funding—AGF is on track to turn a profit. As a result, OPIC has just launched an additional partner project with AGF aimed at providing AGF-tested enterprises with supplemental loans of up to \$10 million.

1. OPIC, "Current OPIC Projects-Afghanistan," October 20, 2011, [http://www.opic.gov/projects/current-opic-projects?field\\_fiscal\\_year\\_value\\_many\\_to\\_one=All&field\\_project\\_type\\_value\\_many\\_to\\_one=All&field\\_project\\_dollar\\_range\\_value\\_many\\_to\\_one=All&field\\_project\\_region\\_value\\_many\\_to\\_one=All&field\\_country\\_value\\_many\\_to\\_one=Afghanistan](http://www.opic.gov/projects/current-opic-projects?field_fiscal_year_value_many_to_one=All&field_project_type_value_many_to_one=All&field_project_dollar_range_value_many_to_one=All&field_project_region_value_many_to_one=All&field_country_value_many_to_one=Afghanistan).

2. Ibid.

3. Interview with Jake Cusack and Erik Malmstrom who have conducted extensive field research during 2010–2011 in Afghanistan and Iraq on SME finance, evaluating a variety of international financial institutions and intermediaries.

that clients and projects require long-term planning and exit horizons.<sup>12</sup> OPIC's future ability to make equity investments and gain easier access to technical assistance (TA) (and/or fund its own) is directly tied to its receiving a longer-term reauthorization.

Beyond the issue of its authorization status, OPIC lacks three important capabilities. First, it does not have the ability to retain its profits and use them for a variety of purposes, such as direct equity investments, unlike other comparable DFIs such as IFC, making OPIC the only G-7 DFI without such authority. As an equity investor, OPIC would be in a stronger position to affect various factors—including corporate policy; environmental, social, and governance issues; and general strategic direction—while benefiting from the higher returns that equity investments have consistently been documented to provide to other DFIs. There is a persistent and understandable aversion to the U.S. government taking a business stake in companies, but OPIC is missing investment opportunities because it does not have equity authority. Second, regardless of the source of funding, OPIC is unable to offer other forms of risk sharing, such as first loss guarantees, to the marketplace. A first loss guarantee is a useful development tool when trying to leverage private-sector investment in emerging economies. In many developing country contexts, including Afghanistan, offering this instrument would assist the U.S. government by allowing it to “crowd in” private investment.

12. Interview with a senior OPIC official, November 22, 2011.

Third, OPIC cannot offer TA on its own and thus must find other funders to pay for TA. This puts OPIC at an additional disadvantage vis-à-vis comparable DFIs. In order to secure necessary TA funding, OPIC has occasionally partnered with USTDA<sup>13</sup> and MCC,<sup>14</sup> but it works most frequently with USAID and other DFIs from G-7 countries. However, different systems for planning and setting priorities, and deficient mechanisms for streamlining OPIC's TA funding needs in keeping with USAID's capacity have made the coordination of TA a source of continuing difficulty between OPIC and USAID. As a result of the inconsistent relationship between these two entities, projects can slow down and have their development impact diminished. Because of these structural impediments, the United States is losing opportunities to use these instruments to promote its foreign policy goals.

In April 2008, OPIC signed a memorandum of understanding with other partners to establish an Affordable Mortgage and Loan Company to provide residential mortgages for low- and middle-income Palestinian households. OPIC was responsible for \$250 million of the funding and partnered with the Palestine Investment Fund, IFC, the Bank of Palestine, and the United Kingdom's Department for International Development.<sup>15</sup> OPIC's investments in the West Bank were delayed more than a year and a half because of the need to identify funds and contract for and identify a suitable provider to deliver the necessary \$1 million in TA.<sup>16</sup> In another case, beginning in 2007, OPIC proposed that USAID find grant resources to set up a leasing company to provide financing for the mining industry in the Federally Administered Tribal Areas of Pakistan.<sup>17</sup> USAID responded that it had already allocated its resources to other competing priorities and could at best only provide limited grant resources to set up a leasing company. Although USAID eventually identified \$2.23 million in "a modern machinery pool" for the marble miners, the deal was not finally completed until March 2010—almost three years later.<sup>18</sup>

There are examples of OPIC and USAID working well together, but such cooperation tends to occur only when there is an intense political will to do so. Following the "Arab Spring," Secretary of State Hillary Clinton announced OPIC's commitment to the Middle East and North Africa region during her March 2011 trip to Egypt and Tunisia. With OPIC's CEO and president Elizabeth Littlefield accompanying the secretary, OPIC pledged to make \$2 billion available in an effort to jump-start private-sector investment, with \$500 million in financing marked specifically to support lending to small and medium-sized enterprises in Egypt and Jordan. Grant projects in

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13. E.g., on July 19, 2011, OPIC announced that it will invest up to \$820 million in India's renewable energy sector by the end of 2011. At the same time, USTDA announced that it would fund feasibility studies worth more than \$1.4 million in India's energy sector. "OPIC to Invest Up to \$820 Mn in India's Renewable Energy Sector," *Economic Times*, July 19, 2011, [http://articles.economictimes.indiatimes.com/2011-07-19/news/29791064\\_1\\_energy-sector-astonfield-solar-photovoltaic-power-projects](http://articles.economictimes.indiatimes.com/2011-07-19/news/29791064_1_energy-sector-astonfield-solar-photovoltaic-power-projects).

14. USAID, "Survey of the Millennium Challenge Corporation's Trade Capacity Building Programs to Support Implementation of Free Trade Agreements," December 1, 2006, 6, <http://www.usaid.gov/oig/public/mcc/m-000-07-001-s.pdf>.

15. World Bank, "West Bank and Gaza: Financial Sector Review," December 2008, 33, <http://sitere-sources.worldbank.org/INTWESTBANKGAZA/Resources/WBGFSRreportNov.08pdf.pdf>.

16. Jim Zanotti, "U.S. Foreign Aid to the Palestinians," Congressional Research Service, May 31, 2011, <http://www.fas.org/sfp/crs/mideast/RS22967.pdf>.

17. Information discussed at a CSIS working group, "Development Finance in Challenging Environments," March 4, 2011.

18. USAID, "U.S. to Boost FATA Marble Mining Industry," March 24, 2010, <http://www.usaid.gov/pk/newsroom/news/fata/100324.html>.

the region were given the green light to be implemented quickly, in part because USAID rapidly agreed to provide the TA funding for OPIC's projects (and others).<sup>19</sup>

## The U.S. Trade and Development Agency

### Overview

Created in 1981, USTDA supports programs that promote exports of U.S.-manufactured goods and services in emerging markets, business growth in developing and middle-income countries, and concomitantly U.S. job creation and economic growth. USTDA is not a development finance agency, but it does play a critical role in “setting the table” for private investment and for projects supported by the U.S. Export-Import Bank, OPIC, MCC, and USAID. As an independent agency created to promote American private-sector participation in international development projects, USTDA has forged a unique mission among development agencies by integrating private-sector experience and expertise into foreign assistance project development. USTDA's current five-year strategic plan has five goals: promoting U.S. private-sector involvement in projects in low- and middle-income countries, supporting economic development in emerging country markets, furthering the participation of small businesses in global programs, enhancing USTDA's performance through regular evaluations, and encouraging program flexibility and responsiveness within the agency. Because of its comparatively smaller budget, USTDA prioritizes projects in emerging economies where its limited economic assistance could have a far-reaching impact.<sup>20</sup> USTDA's projects focus on transportation infrastructure, clean and efficient energy technologies, and information and communication technologies.

USTDA requests its budget under the Export and Investment Assistance Division of the Foreign Operations Budget. Currently, USTDA is operating under the fiscal year (FY) 2012 continuing resolution, which authorized \$50 million for the agency. Of this funding, \$13.4 million is assigned for administrative costs and the remainder is for USTDA's programmatic budget. This offers USTDA flexibility in pursuing its development goals by aligning its allocation of resources with its key priorities. Additionally, USTDA benefits from this type of appropriations due to its ability to conserve resources for programming later in the year to account for changing project opportunities, volatility in conflict zones, or natural disasters. USTDA's FY 2012 request is \$56.27 million, a \$1.1 million increase over the budget for FY 2010 and \$6.3 million below current levels. Given its size and operating budget, USTDA's activities and reach are quite extensive, with returns of \$58 for each \$1 that it invests.

### USTDA's Development Finance Tools

USTDA's products and services generally contribute to the early stages of project development and help to bring in U.S. private-sector participation. In turn, firms producing the necessary goods and services can be utilized for the sustainable development of infrastructure and economic growth in developing nations.<sup>21</sup> USTDA activities fall under three main categories: the International Business

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19. USAID, “OPIC Boards Approves \$500 million for Small Business Lending in Egypt and Jordan,” July 1, 2011, <http://egypt.usaid.gov/en/pressreleases/Pages/menalgffinal.aspx>.

20. Emerging economies include China, India, Brazil, Colombia, Mexico, Indonesia, South Africa, Turkey, and Vietnam.

21. USTDA, “At a Glance,” <http://www.ustda.gov/about/ataglance.asp>.

Partnership Program, the Project Development Program, and the various cooperative programs that USTDA undertakes to facilitate public-private partnerships in key sectors.<sup>22</sup> USTDA works in development finance through the Project Development Program and other cooperative programs.

The Project Development Program includes USTDA-sponsored feasibility studies, pilot projects, and TA. Feasibility studies provide early evaluation of the technical, financial, environmental, legal, and other critical aspects of infrastructure development projects, and are often part of a broader package that includes TA and training. USTDA often shares the development costs of feasibility studies and other unique, targeted types of TA with U.S. industry and foreign grantees, but requires that those feasibility studies are conducted by U.S. companies.<sup>23</sup>

USTDA also employs pilot projects as a potent early-stage development tool for overseas project managers. Additionally, its TA programs constitute a significant portion of its work with developing countries. These programs include building capacity for infrastructure development and the regulatory and legal reforms necessary to spur long-term economic growth. In addition, nearly all financing is grant based and allocated to specific financing projects with ministries of finance, energy, and transportation and municipalities in a limited number of cases.

For example, USTDA worked with IFC to partner with Jamaica's Ministry of Finance in facilitating the privatization of Air Jamaica; the debt-ridden airline was successfully acquired and recapitalized by Caribbean Airlines in 2010.<sup>24</sup> In Nigeria, a USTDA TA grant to the Children's American Medical Center in Lagos is helping the hospital meet international medical standards and otherwise upgrade its operations. By providing a road map to help the hospital provide advanced medical care under internationally recognized standards, the program will significantly improve the availability and quality of health care in Africa's largest city.<sup>25</sup> A final example is USTDA's grant to Ghana Interbank Payments and Settlement Systems Limited to evaluate the extension of branchless banking services and other financial services to underserved segments of Ghana's population.<sup>26</sup>

In more challenging environments, USTDA's project development activities can play a vital role in facilitating the matching of foreign sponsors with American businesses to respond quickly to new situations.<sup>27</sup> Following the Haitian earthquake disaster in early 2010, for example, USTDA immediately implemented new cost-shared feasibility studies with U.S. businesses to update feasibility studies on developing Haiti's power sector. Following this initial award, Parsons Global Services won a TA contract from USTDA to revamp and expand the power sector.

Projects are more effective when they combine financing and TA, which leads USTDA to coordinate with other agencies to carry out its projects. About 6 percent of USTDA's projects receive

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22. USTDA, "Program and Activities," <http://www.ustda.gov/program/>.

23. USTDA, "Promoting Financial Sector Development," [http://www.ustda.gov/program/sectors/USTDASectorBrief\\_Finance.pdf](http://www.ustda.gov/program/sectors/USTDASectorBrief_Finance.pdf).

24. USTDA, "2010 Annual Report," 15, <http://www.ustda.gov/pubs/annualreport/2010>; Associated Press, "Caribbean Airlines to Buy Air Jamaica, Keep Routes," *USA Today*, April 30, 2010, [http://www.usatoday.com/travel/flights/2010-04-30-caribbean-air-jamaica\\_N.htm](http://www.usatoday.com/travel/flights/2010-04-30-caribbean-air-jamaica_N.htm).

25. USTDA, "USTDA Support for Children's Hospital in Nigeria Will Improve the Quality of Health Care," July 13, 2010, [http://www.ustda.gov/news/pressreleases/2010/SubSaharanAfrica/Nigeria/Nigeria-CAMC\\_071310.asp](http://www.ustda.gov/news/pressreleases/2010/SubSaharanAfrica/Nigeria/Nigeria-CAMC_071310.asp).

26. Communications with high-level government official familiar with the USTDA.

27. USTDA, "2010 Annual Report," <http://www.ustda.gov/pubs/annualreport/2010>.

## Box 2. USTDA's Work in El Salvador

USTDA has successfully collaborated with other U.S. government development agencies in MCC compact countries. In particular, USTDA worked closely with OPIC in supporting MCC's compact work in El Salvador. MCC's compact involved building a highway to reach the economically underdeveloped and civil war-ravaged northern region of the country. USTDA's grant program supported the preparation of three studies that sought to identify economic activity that could benefit from the highway. The first study identified ways the government of El Salvador could create a Northern Economic Zone with hopes of drawing U.S. investment to the region. The second study assessed infrastructure projects that could be developed on a municipal level in the region that would help to facilitate economic growth. And the third study recommended the development of an Internet portal that would identify economic projects needing investment. Ultimately, this portal was deployed in conjunction with FUSADES, a Salvadoran economic think tank, and it is now providing the members of the large Salvadoran Diaspora with information on targeted infrastructure projects in need of financing so they can more effectively direct their remittances to support economic growth in El Salvador.

insurance guarantees from OPIC.<sup>28</sup>

To better ascertain policy imperatives, identify development priorities, and creating synergies for success, USTDA seeks to work with the U.S. Export-Import Bank, MCC, the U.S. Small Business Administration, the Office of the U.S. Trade Representative, the Department of Commerce, the Department of the Treasury, and the Department of State (e.g., see box 2). Furthermore, USTDA works extensively with U.S. embassies not only to help identify development priorities and business opportunities but also to assist in the execution and follow-up of various projects and to help measure performance.<sup>29</sup>

## USTDA's Structural Challenges

USTDA's ability to operate and complete projects that are already under way is being hindered by a decrease in its allocated funds. Therefore, each year USTDA has a substantial queue of well-vetted projects, including follow-ons to successful completed projects, that it is unable to fund; real demand exceeds budget availability. Budget

constraints aside, USTDA is less structurally impaired than the other three agencies highlighted in this report. For starters, its overall budget is small and therefore not subject to as many earmarks, which makes its budget relatively easy to review by Congress and the Office of Management and Budget (OMB). The downside to its budget's size, however, has been a decreased visibility compared with other development organizations. But because the leaders of other agencies are coming to understand the value of working with USTDA, the strength of USTDA's tools is now more widely known.

USTDA's greatest challenge stems not from the agency itself but from the cultural and budgetary problems at the organizations with which it works and how OMB accounts for agencies' money. USTDA's small size means that it needs to partner with others in the U.S. government to get the most out of its own projects. It also needs to offer its services to projects at the larger MCC, OPIC, and USAID to enable its tools to be used to their full advantage. For the most part, these

28. Interview with high-level government official familiar with the USTDA.

29. Ibid.

three entities agree with and continue to expand their collaboration, but are hesitant and/or slow to formalize a partnership when it involves the transferring of funds to USTDA. If one federal agency gives up a portion of its funds to another one, it needs to justify this action to OMB to prevent its funding from being cut the following year.

It is important to note that although OMB participates in the interagency process and understands USTDA's case for additional funding, it is more inclined to provide money through a preplanned allocation of funds to USTDA, potentially at the loss of funds to another organization, than to support an organization's transferring funds to USTDA. Even when an agency would like to fund TA projects with USTDA, for example, the mechanisms for doing so are not as efficient or effective as they could be. And this problem only becomes more acute when swift action and national security interests are tied to initiatives that USTDA could undertake if it had access to flexible or shared funding. However, identifying national security, trade policy, or commercial interests at a high interagency level does help facilitate transfers and potentially allows USTDA to use its rapid-response capabilities effectively.

## The U.S. Agency for International Development

### Overview

USAID is the oldest and primary U.S. government agency for overseas development assistance. USAID works directly in development finance principally through the Development Credit Authority (DCA), which is managed by an office in the Bureau for Economic Growth, Agriculture, and Trade. USAID also works indirectly in the area of development finance by funding technical assistance programs for banks, microfinance institutions, and governments to help create conditions conducive for private investment.<sup>30</sup> DCA grew out of the recognition that banks and financial institutions in developing economies have capital but are reluctant to make loans to local entrepreneurs and small and medium-sized enterprise (SME) ventures because of perceived risks. DCA is a well-accepted instrument within USAID, which leverages U.S. government (and non-U.S. government) resources to partially cover risk and thus to help local financial entities provide loans to entrepreneurs. DCA's investments can be found in challenging places, such as Haiti and Afghanistan. From its inception in 1999 to 2010, at a cost of \$82 million, DCA leveraged more than \$2 billion in private credit to financial institutions in 64 countries, 30 percent of which was directed toward SMEs.<sup>31</sup> Despite the economic downturn, DCA leveraged more financial capital in 2010 than it did the year before; it credits its extended reach to its new strategic partnerships, which help its small staff and budget identify opportunities and share risk. DCA's goals for FY 2012 include freeing up credit for microfinance institutions and SMEs, as well as for projects concerned with agriculture, municipalities, and energy efficiency. In certain areas emphasized by

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30. The World Bank's *Doing Business 2011* report speaks to the already considerable impact of USAID's presence in this field, as 7 of the 10 best-performing countries in the report received assistance from USAID to facilitate business creation and expansion by local entrepreneurs. World Bank, *Doing Business 2011: Making a Difference for Entrepreneurs* (Washington, D.C.: World Bank/IFC, 2010), <http://www.doingbusiness.org/~media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB11-FullReport.pdf>.

31. USAID, "Credit Guarantees—Promoting Private Investment in Development," *2010 Year in Review*, [http://www.usaid.gov/our\\_work/economic\\_growth\\_and\\_trade/development\\_credit/YIR\\_2010.pdf](http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/YIR_2010.pdf).

the administration (e.g., food security, water, health, and access to finance), USAID will expand guarantees to address a specific arrangement of priorities.<sup>32</sup>

DCA's share of USAID's FY 2012 budget request is \$50 million for loan guarantees and an additional \$8.3 million for administrative costs. This is an increase of \$15 million from the previous FY 2011 request of \$35 million for loan guarantees. DCA is currently funded by the FY 2011 Continuing Resolution, which designated \$25 million for loan guarantees and \$8.6 million for administrative costs. However, the sum of DCA's financing capability is not restricted to its appropriation, because up to \$27 is leveraged for every \$1 of USAID funds spent through DCA.<sup>33</sup>

## USAID's Development Finance Tools

DCA gives USAID missions the ability to use a small amount of grant money to provide financial risk-sharing guarantees designed to stimulate the flow of credit to targeted sectors. DCA brings resources into the market for on-lending to SMEs,<sup>34</sup> and as a result, the missions are better equipped to promote sustainable private-sector development and economic opportunities abroad.

DCA's partial guarantees cover up to 50 percent of calculated risk, reducing the potential costs to local lenders of providing loans to smaller businesses.<sup>35</sup> These grant funds act as an insurance premium payment, which guarantees up to 5 percent of the total portfolio.<sup>36</sup> DCA seeks to demonstrate to other lenders that loans to SMEs can be commercially viable investments. For example, in Africa, more than two-thirds of the borrowers that gained access to capital from a lender that had a DCA guarantee received additional loans—at an average value of \$228,479—from lenders without the DCA guarantee. USAID does not require that the partner organization be based in the United States, but it must be a nonsovereign entity.

DCA is also able to participate at the level of “first loss” funding, but it does so only on a limited basis. As a critical if underutilized tool, a first loss guarantee benefits the overall project. For example, in Rwanda, USAID provided a credit guarantee to Banque de Kigali to benefit agricultural SMEs and to build the country's overall export capacity. The guarantee covers Banque de Kigali for up to \$2 million in new loans by providing a 40 percent guarantee on the net first loss. Through this guarantee, USAID has facilitated the expansion of credit availability within Rwanda's agriculture sector.<sup>37</sup>

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32. USAID, “Congressional Budget Justification, Vol. 2, Foreign Operations,” Fiscal Year 2012, <http://www.usaid.gov/performance/cbj/158267.pdf>.

33. USAID, “Congressional Budget Justification, Vol. 2, Foreign Operations,” Fiscal Year 2011, [http://www.usaid.gov/policy/budget/cbj2011/2011\\_CBJ\\_Vol\\_2.pdf](http://www.usaid.gov/policy/budget/cbj2011/2011_CBJ_Vol_2.pdf); Rajiv Shah, “The Modern Development Enterprise,” Speech, Washington, January 19, 2011, <http://www.usaid.gov/press/speeches/2011/sp110119.html>.

34. On-lending occurs when “an institutional unit within an economy . . . borrow[s] funds from a nonresident(s) and then [lends, or] on-lend[s] the funds to a second institutional unit within the economy.” Organization for Economic Cooperation and Development, “On-Lending of Borrowed Funds,” glossary entry, <http://stats.oecd.org/glossary/detail.asp?ID=6091>.

35. USAID, “Overview of USAID's Partial Credit Guarantees,” January 28, 2009, [http://www.usaid.gov/our\\_work/economic\\_growth\\_and\\_trade/development\\_credit/overview.html](http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/overview.html).

36. USAID, “Overview of USAID's Partial Credit Guarantees,” 2011, [http://www.usaid.gov/our\\_work/economic\\_growth\\_and\\_trade/development\\_credit/overview.html](http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/overview.html).

37. USAID, “Development Credit- DCA Credit Guarantees,” 2011, [http://www.usaid.gov/our\\_work/economic\\_growth\\_and\\_trade/development\\_credit/recent\\_activities.htm](http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/recent_activities.htm).

DCA's transfer authority allows USAID missions to access funds from USAID appropriation accounts.<sup>38</sup> This transfer authority has enabled 64 USAID missions to enter into more than 300 guarantee agreements in virtually every development sector.<sup>39</sup> DCA investment is not present in all USAID missions, but targets countries and regions that need job creation for broader stability (e.g., see boxes 3 and 4). For example, in February 2010, DCA organized a town hall in Cairo on access to finance for entrepreneurs in Northern Africa, one of a series conducted around the world.<sup>40</sup> It also now possesses the ability to receive grant money from sources outside the U.S. government to finance DCA guarantee products. This ability is facilitated by USAID's "gift authority," which allows private actors to "write the U.S. government a check" to support development projects.

## USAID's Structural Challenges

USAID has the most extensive field presence, the ability to fund and manage complex TA projects, offers a limited ability to provide first loss guarantees, and has a creative instrument in the form of the Development Credit Authority. However, USAID faces several structural challenges that must be overcome in order to make it more effective in development finance. These challenges include how DCA is used, its ability to provide TA in conjunction

38. "DCA transfer authority allows field missions to transfer funds from other USAID appropriation accounts to the DCA program account to finance the subsidy cost of DCA credit guarantees, which allow credit to be used as a flexible tool for a wide range of development purposes." U.S. Department of State, "Congressional Budget Justification, Development Credit Authority," Fiscal Year 2009, <http://www.state.gov/documents/organization/101420.pdf>.

39. USAID, "Congressional Budget Justification, Vol. 2, Foreign Operations," Fiscal Year 2012.

40. USAID, "2010 Year In Review: Credit Guarantees: Promoting Private Investment in Development," [http://www.usaid.gov/our\\_work/economic\\_growth\\_and\\_trade/development\\_credit/YIR\\_2010.pdf](http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/YIR_2010.pdf).

### Box 3. Challenge Funds

Utilizing the "challenge funds" model,<sup>1</sup> USAID worked with Fondation Sogebank (FSGB)<sup>2</sup> to administer the Haitian Diaspora Challenge Fund (HDCF) from 2009 to 2011. The HDCF aimed to provide grants, accompanied by TA and credit guarantee services, to applicants from the Haitian Diaspora who presented sustainable business plans that required the participation of Haitian businesses to be implemented.<sup>3</sup> The Haitian Diaspora Marketplace initiative was expected to disburse up to \$2.5 million to strengthen or create approximately 20 small businesses within Haiti.<sup>4</sup> Unfortunately, this program was never fully implemented. The compressed timeline of only two years for proposal review and disbursement proved unrealistic. In addition to routine delays in FSGB's local staffing, management, and operations, Haiti's catastrophic earthquake in January 2010 severely disrupted activities. USAID ended the program in late 2010, citing stalled implementation.<sup>5</sup>

1. Challenge funds, most commonly associated with the UK aid agency, the Department for International Development, often include a mix of private-sector and public financing and disburse limited grants to private or public applicants that meet transparent criteria for projects within defined parameters.

2. FSGB is the philanthropic arm of one of Haiti's largest commercial banks, <http://business.un.org/en/documents/5062>.

3. USAID, "HDM: Haitian Diaspora Marketplace," August 11, 2009, <http://www.usaid.gov/press/factsheets/2009/fs090811.html>.

4. Ibid.

5. Catherine Trujillo, "Review of Fondation Sogebank's Activities Financed by USAID/Haiti," October 29, 2010, <http://www.usaid.gov/oig/public/fy11rpts/1-521-11-001-s.pdf>.

#### Box 4. Revisiting Enterprise Funds for Challenging Environments (Haiti and Afghanistan)

In 2011 Senator Richard G. Lugar (R-Ind.), along with Senator Marco Rubio (R-Fla.) and Senator Richard Durbin (D-Ill.), revisited a model of development finance by introducing controversial<sup>1</sup> legislation to establish the Haitian-American Enterprise Fund (HAEF).<sup>2</sup> If passed, HAEF would receive appropriations through USAID to “promote the Haitian private sector.” The bill proposes that HAEF be governed by a Board of Directors and be slated to dissolve in 2021, with the remaining assets returned to the U.S. Treasury and allotted to deficit reduction.<sup>3</sup> Additionally, some have discussed the possibility of drawing and expanding on OPIC’s Afghan Growth Finance (AGF) program (described in box 1 above) to create a large-scale enterprise fund to infuse larger amounts of capital into Afghanistan’s developing private sector.<sup>4</sup> Although neither of these endeavors may come to fruition, this discussion indicates a revived focus on approaches to development modeled on the private sector.

USAID utilized the enterprise fund model<sup>5</sup> in Eastern Europe and the countries of the former USSR in the 1990s.<sup>6</sup> Enterprise funds have been generally criticized for low rates of return in comparison with their private-sector counterparts,<sup>7</sup> with some protesting their interference with free markets and others disputing the use of development money in for-profit ventures.<sup>8</sup> However, several success stories, for example in Poland and Russia, demonstrate the potential of the enterprise fund model to both develop the private sector and improve economic policies, whereas the failures offer lessons on best practices and potential challenges. Enterprise funds should be revisited as a development finance instrument.

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1. One private-sector representative noted that an enterprise fund would aid in the harmonization of U.S. policies toward Haiti and grant the United States considerable control over Haiti’s import market. Régine Barjon, “Effectiveness of Aid in Haiti and How Private Investment Can Facilitate the Reconstruction: Written Statement to U.S. Subcommittees of Foreign Relations on International Development and Foreign Assistance and Western Hemisphere,” June 23, 2011, [http://foreign.senate.gov/imo/media/doc/Simon-Barjon\\_percent20testimony.pdf](http://foreign.senate.gov/imo/media/doc/Simon-Barjon_percent20testimony.pdf).

2. Mark Helmke, “Lugar Calls for ‘Haitian-American Enterprise Fund,’” Senate Committee on Foreign Relations, May 12, 2011, <http://foreign.senate.gov/press/ranking/release/?id=3aaaa95d-6cb1-4156-9367-cf9ff75870ed>.

3. U.S. Senate Bill 954, “Haitian-American Enterprise Fund Act,” Reported in the Senate August 30, 2011, <http://thomas.loc.gov/cgi-bin/query/D?c112:2:./temp/~c112d0AogX:>.

4. Don Ritter, “Building the Afghan Market Economy,” paper presented at Iraq and Afghanistan Reconstruction Summit sponsored by Afghan-American Chamber of Commerce, Istanbul, June 3, 2010, 2–3, [http://www.a-acc.org/files/Istanbul\\_Article\\_Building\\_the\\_Afghan\\_Market\\_Economy.pdf](http://www.a-acc.org/files/Istanbul_Article_Building_the_Afghan_Market_Economy.pdf).

5. An enterprise fund is modeled on venture capital to provide a source of capital in developing countries and is self-sustaining; it is often originally financed by donors and provides both equity and debt financing for large companies, along with SMEs.

6. These enterprise funds were developed and funded under the Support for Eastern European Democracy (SEED) Act.

7. Cato Institute, “Cato Institute Policy Analysis No. 260: Uncle Sam as Investment Banker: The Failure of Washington’s Overseas Enterprise Funds,” September 19, 1996, <http://www.cato.org/pubs/pas/pa260.pdf>.

8. Watson Institute for International Studies, Brown University, “Foreign Aid and Private Sector Development,” 2006, 16, <http://reliefweb.int/sites/reliefweb.int/files/resources/0F940A9115C596D0C125716B00761178-watsoninst-gen-may06.pdf>.

with investment products often offered by OPIC or others, and its overall coordination with other agencies engaged in development finance.

DCA could be more integrated into country mission strategies, but is often an afterthought. Part of DCA's challenge is the result of an underlying taboo among the development community about using grant vehicles and direct transaction money for private-sector development, as it is perceived as corporate welfare or creating a moral hazard. This is especially true whenever the DCA instrument is used to support first loss guarantees. USAID neither wants to be perceived as the funder of "first resort" for development projects originating outside the agency nor as oversubsidizing the risks associated with a project. If USAID were to provide an overly generous first loss guarantee, banks or others could lend too profligately, believing that USAID would "bail them out." The perception by some in the development community that using too much grant money for development finance projects could be perceived as "corporate welfare" inhibits its potential economic development, because a number of projects are in critical need of an entity other than a local bank to provide first loss funding. This has a negative impact on the use of DCA for entrepreneurship and enterprise development. With less than a third of DCA's budget facilitating SME lending, DCA's tools are not maximizing the potential achievable benefits to SMEs.

Additionally, DCA can provide the guarantee to a bank, but this does not necessarily mean that the bank will act, because banks do not traditionally provide SME financing in many markets. Moreover, mission-level implementation is further complicated by the high level of expertise required to provide effective TA to banks utilizing DCA; even where missions are willing to expend resources toward guidance and oversight, the necessary expertise is often not immediately or organically available within local missions. Finally, other agencies that have tried to access DCA's guarantees as a part of their projects have been statutorily prohibited from doing so.

USAID is the U.S. government's main provider of TA, which is often needed to ensure the success of development finance projects. Agencies that lack organic TA capabilities frequently seek USAID's assistance on projects. USAID is challenged in this area because its budget, planning, and procurement systems for TA are not designed to work in tandem with development finance instruments, especially those used by other agencies such as OPIC (see box 5). This problem is ex-

### **Box 5. The USAID–OPIC Relationship**

OPIC was spun off from USAID in 1971 in order to create an agency focused exclusively on private-investment-led growth in the developing world. Since that split, USAID has increasingly moved back toward the field of investment-led growth. However, this structural split has also caused systemic issues for both organizations. OPIC frequently seeks TA in order to make a deal work, but it lacks an organic TA capability and must turn to USAID for TA. In the medium term, both organizations must work to strengthen this relationship. Three steps should be taken immediately:

1. The two agencies should increase secondments among their staffs in order to better familiarize one another with their organizational cultures.
2. A memorandum of understanding should be signed that clearly lays out a programmatic rather than a project-specific cooperation agreement for TA from USAID and financing from OPIC.
3. A USAID-managed global contracting instrument should be created for housing and SME financing to help respond to requests for TA from OPIC. This instrument should be funded from OPIC's retained profits or with significant cost sharing from OPIC.

emphified by instances when OPIC identifies projects that need TA and then requests that USAID pay for this TA out of USAID's budget, but the budget is often preassigned and already allocated for the year or the investment project is not in line with USAID's strategic goals in a particular country. Often, the process of identifying funds, designing a TA project, and contracting for that project can take many months or a year or more. As a result of these challenges, USAID often cannot operate as a consistent and quick-responding partner with other U.S. government agencies (or outside partners). This is particularly detrimental in situations that require U.S. foreign and development agencies to react quickly and in a coordinated way.

USAID's coordination with OPIC is effective when the political will is present, but the two agencies do not have the appropriate mechanisms to maintain a steady partnership for TA. In addition to OPIC, USAID partners with USTDA and MCC. However, USAID lacks a clear-cut strategic relationship with the three agencies. In some countries, USTDA works closely with the USAID mission director, and USAID and USTDA hold regular meetings in Washington. However, the USAID–USTDA relationship remains driven by missions and the leadership and must become more systematic. As USAID closes its missions in middle-income countries and closes other missions (more than a dozen countries are slated to lose their missions by 2015),<sup>41</sup> this lack of collaboration risks diminishing the U.S. relationship with middle-income countries and raises the possibility of losing out on the valuable transition instruments that USTDA can provide. As is described below in further detail, USAID's role to date relative to MCC has also varied, though it is clearly defined in one area: threshold countries. In fact, many MCC projects have expanded on existing USAID projects, but this has drawn complaints that USAID funding decreases when MCC compacts are signed.<sup>42</sup>

## The Millennium Challenge Corporation

### Overview

Established in 2004, MCC is an independent development agency whose mission is to alleviate global poverty by promoting growth in countries that meet a series of criteria.<sup>43</sup> The creation of MCC marked a historical shift in how the United States conducts its development policy.<sup>44</sup> To qualify for MCC's large-scale grants, countries must first demonstrate their commitment to economic freedom and growth, to good governance, to pursuing innovation in addressing development needs, and to investing in their domestic human capital.<sup>45</sup> MCC has partnered with 39 countries to date, and its initiatives are country-led and country-implemented.<sup>46</sup> MCC's assistance

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41. Rajiv Shah, "The Modern Development Enterprise."

42. MCC, *CRS Report for Congress*, Congressional Research Service, May 3, 2011, 7, <http://fpc.state.gov/documents/organization/164271.pdf>. Also, at the September 2011 MCC town hall meeting, an Armenian policymaker noted that USAID funds drastically dropped following the entrance of MCC. The panelists admitted that although that has happened, it is not a one-to-one comparison and does not occur every time MCC opens a compact.

43. MCC, "About MCC," <http://www.mcc.gov/pages/about>.

44. Doug Johnson, "Can Foreign Aid Create an Incentive for Good Governance? Evidence from the Millennium Challenge Corporation," [http://www.people.fas.harvard.edu/~tzajonc/mcc\\_wp\\_apr06.pdf](http://www.people.fas.harvard.edu/~tzajonc/mcc_wp_apr06.pdf).

45. Stephen P. Heyneman, "The Social Aspects of the Millennium Challenge Account: Risk and Prospects," *Economic Perspectives* (March 2003): 23–27, <http://www.new.vanderbilt.edu/peabody/heyne/man/PUBLICATIONS/200301.pdf>.

46. MCC, "Countries and Country Tools," <http://www.mcc.gov/pages/countries>.

is directed toward a wide range of sectors, including transportation, agriculture and irrigation, anticorruption projects, education, land rights, finance and enterprise development, health services, and water supply and sanitation.<sup>47</sup> MCC receives its annual funding as part of the U.S. international affairs budget. President George W. Bush initially called for \$5 billion to be allocated to MCC, but Congress appropriated \$1 billion to MCC for its first year's budget, with each consecutive year similarly allocated.<sup>48</sup>

## MCC's Development Finance Instruments

MCC currently has two types of instruments: 23 grant agreements known as “compacts,” and 23 grant agreements known as “threshold programs.” Compact grants require the initially qualifying countries to formulate detailed proposals identifying specific projects for funding, a process requiring the active participation of the country's private sector, nongovernmental organizations, and civil society. MCC then evaluates these proposals, and on-the-ground teams assess the projects' expected economic, environmental, and social effects before approving them. However, even if a country qualifies under these selection indicators, it is not guaranteed approval for a compact program. This rejection might be for a number of reasons, the most pressing being the limited funding available for compacts.<sup>49</sup>

Within its compact grant program, MCC possesses the ability to authorize guaranteed and on-lending loans (e.g., see boxes 6 and 7). For example, before the termination of the MCC–Madagascar compact in 2009, the Millennium Challenge Authority (MCA)–Madagascar took steps to address the country's underdeveloped financial system. Local lenders were conservative, and were inhibited by a lack of information necessary to evaluate the creditworthiness of would-be borrowers, which made it virtually impossible for the rural population to obtain even small loans.<sup>50</sup> MCA–Madagascar used its grant money to offer refinancing and loan guarantee services to financial institutions that demonstrated their willingness to work with the rural population.<sup>51</sup> As a result, these institutions could choose to either pay a subsidized fee to obtain 50 percent loan guarantee coverage on outgoing loans or elect to receive financing directly from the locally managed fund, which was then used to on-lend to farmers without a guarantee. This model permitted farmers to obtain financing to invest in improved agricultural practices that would otherwise have been out of reach for many.<sup>52</sup>

MCC's threshold grants support ongoing reforms in countries that are close to meeting compact grant criteria and are actively demonstrating a commitment to improved performance. The processes for threshold grants typically last only two years and are less involved than those for

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47. MCC, “About MCC.”

48. Curt Tarnoff, “Millennium Challenge Corporation,” Congressional Research Service, November 16, 2010, <http://www.fas.org/sgp/crs/row/RL32427.pdf>.

49. In FY 2011, MCC reselected countries that were already in the process of proposing compacts—Cape Verde, Indonesia, and Zambia. Ghana and Georgia were also selected to develop second compacts.

50. “Millennium Challenge Corporation: Notice of Entering Into a Compact With the Government of Madagascar,” *Federal Register* 70:81, 22065, April 28, 2005, <http://www.gpo.gov/fdsys/pkg/FR-2005-04-28/pdf/05-8531.pdf>.

51. MCC, “Madagascar Compact Page,” <http://www.mcc.gov/pages/countries/overview/madagascar>.

52. UK Department for International Development, “Making Rural Finance Count for the Poor,” September 2004, 7, <http://dfid-agriculture-consultation.nri.org/summaries/wp3.pdf>.

### Box 6. The Agricultural Guarantee Fund

The Agricultural Guarantee Fund is an example of when MCC implemented risk-sharing instruments as part of its activities, specifically by using a portion of its grant money for first loss guarantees.<sup>1</sup> As part of its 2007 compact with Ghana,<sup>2</sup> MCC is addressing agribusiness development through its local arm: the Millennium Development Authority (MiDA) of Ghana.<sup>3</sup> The Agricultural Guarantee Fund Scheme launched the “Smallholder Risk Sharing Agreement” in 2010 as a way to improve the accessibility of agricultural finance to smallholder and SME farmers in Ghana, Mozambique, Uganda, and Tanzania. MiDA and its partners are providing Standard Bank with a first loss guarantee for qualifying loans during this three-year program.<sup>4</sup> MCC expected that these first loss guarantees would spread the risk across multiple parties and make unsecured loans financially feasible for Standard Bank. Even with the challenges (and problems) associated with this venture, this “unique” approach to financing an underserved client base represents a creative use of grant money.

1. MCC, “Guidance for Private and Non-Governmental Sector Engagement,” January 2011, 12, <http://www.mcc.gov/documents/guidance/guidance-2011001049502-privateandnon-govtengagement.pdf>.

2. MCC, “Ghana Compact Implementation Quarterly Report,” April–June 2010, 2, <http://www.mcc.gov/documents/reports/qsr-imp-ghana.pdf>.

3. Millennium Development Authority, “About MiDA,” [http://mida.gov.gh/site/?page\\_id=2](http://mida.gov.gh/site/?page_id=2).

4. This reflects the description by a senior-level government employee with knowledge of this example.

compact grants, as they are intended as a stepping stone to full compacts.<sup>53</sup> MCC partners with USAID for its ability to provide TA, but both USAID and USTDA collaborate with MCC to help with capacity building, and USAID monitors the implementation of MCC threshold programs in a particular country.<sup>54</sup>

### MCC’s Structural Challenges

MCC’s challenges include inadequate funding, indicators reflecting sometimes outdated data, time lags in program implementation, pressure to spend large sums of grant money, the sizes and focuses of compacts, the measurability of a project’s impact on development outcomes, and MCC’s relationship with USAID and other U.S. government agencies. Finally, MCC needs to review how it uses compact dollars to identify ways to leverage large amounts of private capital, including and especially in large infrastructure projects.

The FY 2011 appropriation for MCC was 30 percent below the request and was the second-lowest appropriation in MCC’s eight-year history.<sup>55</sup> With compacts and compact-receiving countries turning out to be fewer than expected, the so-called MCC effect could be in jeopardy, thus threaten-

53. Threshold grants require the applicant to identify desired policy reforms, their impact, and the indicators/benchmarks to be used to evaluate progress.

54. Center for Global Development, “Emerging Issues: The MCC Moving Forward,” [http://www.cgdev.org/section/initiatives/\\_active/assistance/mcmonitor/fieldreports/tanzaniafield/emergingissues](http://www.cgdev.org/section/initiatives/_active/assistance/mcmonitor/fieldreports/tanzaniafield/emergingissues). E.g., in January 2011, MCC launched a three-year threshold program of \$10.5 million in Timor-Leste to address corruption and improve children’s health. The financial and technical assistance provided to Timor-Leste in this program is managed by USAID. MCC, “MCC and Timor-Leste Partner to Strengthen Governance and Child Health,” January 14, 2011, <http://www.mcc.gov/pages/press/release/release-011411-mccandtimorleste>.

55. MCC, “Fact Sheet,” <http://www.mcc.gov/documents/press/release-020204-factsheet.pdf>.

ing a core rationale for the organization's creation.<sup>56</sup> For example, MCC's projects have been periodically scaled back due to new financial constraints created by a depreciating dollar and rising machinery and infrastructural material costs, among other reasons.

Because of the time that elapses between MCC's processing of data about a recipient country and its disbursement of grant money, its selection indicators are a relative reflection of a country's policies and performance.<sup>57</sup> In addition, Congress has repeatedly criticized MCC for the time it takes to implement projects, citing MCC's limited disbursements of committed funds<sup>58</sup> and the significant percentage of funds that remain unobligated.<sup>59</sup> This is one explanation that Congress has used to justify decreased funding for MCC, and also to excuse rescissions of funding that had already been appropriated to MCC.<sup>60</sup> In an effort to combat these rescissions, MCC went from only \$889 million of \$6.4 billion committed as of September 2009 to more than \$8.2 billion committed in 2011,<sup>61</sup> and

### Box 7. Invitation to Innovate

MCC has partnered with the private sector on an ad hoc basis with mixed success. To address this problem, MCC created its Invitation to Innovate program in 2011 through its Annual Participation Solicitation as a framework to develop and sustain partnerships with the private sector.<sup>1</sup> Awards ranging from \$50,000 to \$2 million will be given to companies and nongovernmental organizations in pilot countries for innovations in land tenure and transportation corridor development. The partnerships solicited through this program provide the potential for new funding opportunities, new technologies, an increased sustainability for MCC compacts, and increased effects for MCC funds.<sup>2</sup> This shift represents a broadening of MCC's private-sector initiatives, with a focus on creating new development practices that increase program effectiveness. Although it is still new and untested, MCC's Invitation to Innovate program marks a new emphasis on the private sector in development.

1. See <http://www.interaction.org/blog/workshop-summary-navigating-mcc-percentE2-percent80-percent99s-new-framework-public-private-partnerships-percentE2-percent80-percent9D>.

2. Department of Trade and Investment, "Africa and Indonesia: Millennium Challenge Corporation Seeking Innovative Project Proposals," July 20, 2011, <http://www.ukti.gov.uk/export/countries/africa/southernafrica/zambia/businessopportunity/169500.html>.

56. The "MCC effect" is the name given to the incentives for policy improvement that the selection process is intended to create. Sarah Jane Staats, "MCC Threshold Program Is on the Threshold," *Rethinking U.S. Foreign Assistance Blog*, September 14, 2011, <http://blogs.cgdev.org/mca-monitor/2010/09/mcc-threshold-program-is-on-the-threshold.php>.

57. Tarnoff, "Millennium Challenge Corporation," 7.

58. See Sheila Herrling, "A Slouching Report on the Millennium Challenge Account," *Rethinking U.S. Foreign Assistance Blog*, June 21, 2007, <http://blogs.cgdev.org/mca-monitor/2007/06/a-slouching-report-on-the-mill.php>.

59. In 2007, MCC held more than \$2 billion in unobligated funds designated for compacts. David B. Gootnick, "Millennium Challenge Corporation: Progress and Challenges with Compacts in Africa," Testimony Before the Subcommittee on Africa and Global Health, Committee on Foreign Affairs, House of Representatives, June 28, 2007, 11, <http://www.gao.gov/new.items/d071049t.pdf>. By 2010, this balance had been reduced to less than \$1 billion. MCC, "Annual Report FY2010," September 30, 2010, 76, <http://www.mcc.gov/documents/reports/report-2011001049801-2010annual.pdf>.

60. In 2008, Congress approved a bill to rescind \$58 million of MCC's unobligated funds. Curt Tarnoff, "Millennium Challenge Account," CRS Report for Congress, July 24, 2008, 25, <http://www.usembassy.it/pdf/other/RL32427.pdf>.

61. MCC, "MCC at a Glance," April 19, 2011, <http://www.mcc.gov/documents/press/factsheet-2010002014709-mccataglance.pdf>.

it is making efforts to increase its rates of disbursement.<sup>62</sup> The potential downside of this push to increase its rate of disbursement may make MCC vulnerable to the criticism that it spends large sums of money without appropriate planning or before a more creative usage for the funds can be planned.

Because MCC is a relatively new organization, there are still agency-wide operational time lags, including those created by the process of defining prerequisite selection indicators. Infrastructure projects also require considerable time up front for planning and design, and countries also take time to develop proposals, engage in citizen consultations, and meet donor requirements of accountability. As such, only modest funding is disbursed in the early years of each compact.<sup>63</sup> In addition to the threat of spending cuts, some analysts predict that MCC's small size will make it vulnerable to being taken over by another U.S. agency in a restructuring.<sup>64</sup>

When MCC was first established, Congress raised concerns regarding the relationship that MCC would maintain with USAID. To this day, the nature of the MCC–USAID relationship remains somewhat vague. Under MCC's authorizing legislation, its CEO is required to coordinate and consult with USAID, given that one of the goals of USAID's programs is to prepare candidate countries for MCC consideration.<sup>65</sup> Where the two agencies' relationship becomes less clear is when a country moves from MCC threshold to compact status, or when a country applies for a compact grant that builds on existing USAID programs.<sup>66</sup> And MCC cannot directly access the Development Credit Authority—only USAID can.<sup>67</sup> MCC and USAID recognize the value of this partnership, and together they have concluded that MCC should be able to access DCA.

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62. U.S. Government Accountability Office, "Millennium Challenge Corporation: Analysis of Compact Development and Future Obligations and Current Disbursements of Compact Assistance," Communication to Ambassador John J. Danilovich, April 11, 2008, 3, <http://www.gao.gov/new.items/d08577r.pdf>.

63. Sarah Jane Staats, "Partisan Spats Overwhelm USAID & MCC Hearing," *Rethinking U.S. Foreign Assistance Blog*, March 17, 2011, <http://blogs.cgdev.org/mca-monitor/2011/03/partisan-spats-overwhelm-usaid-mcc-hearing.php>.

64. Raj Kumar and John Hewko, "How to Save the Innovative Millennium Challenge Corporation Aid Agency," *Washington Post*, October 16, 2011.

65. Larry Nowels, "The Millennium Challenge Account: Congressional Consideration of a New Foreign Aid Initiative," CRS Report for Congress, March 19, 2004, 24, <http://www.dtic.mil/cgi-bin/GetTRDoc?Location=U2&doc=GetTRDoc.pdf&AD=ADA457851>.

66. Tarnoff, "Millennium Challenge Corporation," 21.

67. MCC first tried to access the DCA unsuccessfully six years ago in Honduras, according to a senior-level government official. In response, it created its own DCA-like entity. See <http://idbdocs.iadb.org/ws-docs/getdocument.aspx?docnum=35243971>.

# 3

## CHALLENGES AND RECOMMENDATIONS FOR THE U.S. GOVERNMENT

### Development Finance Instruments, Coordination, and Technical Assistance

Each U.S. development agency is constrained in how its funds can be used, which restricts their effectiveness in development finance. This includes an inability by USAID and MCC to use grant monies as equity substitutes or as “first loss guarantees” and a lack of coordination between development finance and technical assistance providers in the U.S. government. There remains too much “stove-piping” of activities, which prevents the creative combination of grants and financing. Finally, U.S. government agencies lack the ability to make equity investments in development projects—something possessed by the World Bank and its affiliate IFC, other multilateral international financial institutions, and almost all the bilateral financing agencies affiliated with the countries that belong to the Organization for Economic Cooperation and Development.

Budget, legal, and cultural constraints further impede U.S. government agencies from coordinating and integrating their activities. The mechanisms for facilitating future coordination are insufficient, with examples of success far too often the result of cooperation stemming from being at the right place at the right time. Occasionally, U.S. government entities are able to coordinate their grants and financing activities, but it is much harder and less efficient than it should be, and it takes far too long to piece together projects. The various organizations operate under different (and at times conflicting) rules, objectives, and timelines.

#### Recommendations

- The U.S. government would benefit from having a more effective way to combine investment capital and technical assistance. U.S. development agencies need a more efficient protocol to access their own program funds for TA, or they need to develop a more strategic relationship with USAID to achieve the right mix of financial resources and TA.
- Easing legal restrictions, updating mandates, and instigating more conducive processes that enable such collaboration would enable a better alignment of goals, objectives, and resources. To address a persistent cultural aversion to working with other U.S. organizations and/or working with the private sector, systemic changes need to be made that reward collaboration and innovative partnerships. A variety of approaches should be used to break current barriers and improve integration so that various organizations are operating under the same guidelines.
- To address the budgetary problems of transferring funds between agencies, the Office of Management and Budget should develop criteria for when it is acceptable for agencies to shift money without putting future funding at risk. Although this would be an overall benefit, this

change would have an enormous effect on the ability of U.S. agencies to respond to exigent circumstances in geostrategic locations.

## First Loss and the Engagement of the Private Sector

### Increased Use of First Loss

Within U.S. government development agencies, a primary challenge is ensuring that projects do not “crowd out” private investment or encourage counterproductive behavior (moral hazard). There is a tipping point for public money; too much public-sector or donor money puts economic growth at risk of becoming too “donor-driven” and lacking commercial discipline. As a result, many development finance agencies are overly cautious about using subsidies because they could create projects that are unsustainable or that take on too much risk in the market. The challenge inside the U.S. government is to ensure that public-sector resources are used in a way that does not distort the marketplace.

When there are conditions of greater risk and uncertainty, U.S. government agencies and development finance institutions need the ability and the impetus to provide increased levels of encouragement to use particular development finance tools to facilitate private-sector investment. Unfortunately, the provision of first loss funding and taking an “early equity” stake in investments, especially for priority sectors and/or strategic countries, are not being systematically employed. The inability or refusal to do so is a central issue that the U.S. government should address to produce more effective aid results without necessarily increasing the expenditure of development dollars.

There are reasonable concerns about subsidies, but a number of countries would benefit from a more creative approach that uses so-called smart subsidies, which are based on the notion that the rules of commercial markets still apply when using subsidies in emerging markets, meaning that well-designed initiatives should not distort the market.<sup>68</sup> More philanthropic private actors and public- and private-sector organizations would be willing to invest in less-developed markets if they could receive the right mix of guarantees and risk-sharing instruments provided by the U.S. government. Unfortunately, U.S. agencies are often prohibited from using the full spectrum of incentives that encourage private-sector investment or tend to shy away from pursuing these types of tools. At present, there is a belief that the U.S. government is underutilizing the tools at its disposal to help underdeveloped regions, many of which are critical to national security. Even in the most challenging environments, there are individuals and networks of people willing to invest in a developing economy; but in many cases, the right incentives and instruments are not deployed to catalyze this activity.

### Embedding Private-Sector Points of View in the Planning Stage

Most development programs are bilateral official development assistance, and therefore the U.S. government does not court private capital when it could be incorporated into development policy

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68. Jonathan Morduch, “Smart Subsidies for Microfinance,” Financial Access Initiative, February 4, 2010, <http://financialaccess.org/node/2609>.

in a more comprehensive way. Even when the private sector is engaged, it is often integrated far too late in the planning process. Moreover, government mechanisms for informing the U.S. and international business communities about the opportunities available in developing-world markets are inadequate. The reality is that even after an opportunity has been identified, the government can move too slowly to enable successful public-private partnerships.

The U.S. government has experimented with a number of approaches to developing private-sector relationships, with some agencies faring better than others. There is no government system for sharing knowledge about previous, current, and potential future private-sector partners. The U.S. government's public rhetoric about the value of public-private partnerships is increasingly more positive, but it has not been adequately translated into action. Indeed, even when a public-private partnership is established, the U.S. government lacks systematic ways to maintain and foster an ongoing relationship. The different agencies possess inadequate and ineffective mechanisms, waivers, or authorities to sustain engagement with third-party actors. In some cases, there is also a persistent bias that development projects should not benefit private-sector actors. Finally, there is little agreement about if and how the government can share in the success of a venture (e.g., taking an equity stake), even when it is insuring against risk, which discourages these partnerships.

## Recommendations

- The U.S. government should employ greater use of smart subsidies as a part of its overall development strategy. The government needs to improve its ability to use grant money and other forms of development assistance to help shift the calculus of private investors (by signaling a commitment on behalf of the government), especially in zones of conflict and postdisaster situations. In circumstances where a measurable impact and long-term sustainability are important, the use of smart subsidies can help achieve both more quickly.
- U.S. government agencies should work to increase private-sector involvement by implementing a more systematic use of the limited amount of grant or loan-based funding for first loss guarantees. The purpose of a first loss guarantee is to provide comfort to investors by bridging the gap between the desired versus the actual (or perceived) creditworthiness of a weaker entity. The agencies that already have the ability to provide first loss funding should replicate, scale up, and expand these initiatives, and those that are prevented from doing so by either legal or policy constraints should be given this ability, starting with OPIC.
- The U.S. government needs to support innovations in development finance. Initiatives such as challenge funds, with their emphasis on the importance of development finance instruments to support the SME sector, are a step in the right direction and should be scaled up. This would allow private-sector investment to be combined with U.S. government development assistance, which would greatly increase a project's chances of achieving success and adding to local economic opportunity.

## SMEs' Engagement

SMEs in the developing world face significant barriers when seeking capital or credit. Banks with a local presence in the developing world (either locally owned or Western-owned bank branches) operate under extremely conservative, risk-averse lending policies. Lending to an SME is seen as

having high costs, both financially and in terms of time perspective. Because of this, banks in the developing world are more comfortable lending to the local government, to securities and real estate firms, and to other large businesses with a proven track record. At the same time, there is little consensus within the U.S. government on how to increase access to credit and capital for SMEs—presently, OPIC, MCC, and USAID lack a coordinated strategy. Most support for the SME sector comes indirectly through the support of intermediary institutions, such as a local bank or the TA provision to a particular sector.

Building successful, profitable businesses is the ultimate goal behind SME financing, but the U.S. government has limited resources to support this for a number of reasons:

1. It is expensive to source, perform due diligence, and invest directly in the SME sector.
2. The SME sector is less emotionally compelling than the microfinance sector (e.g., providing funding for someone who is likely to be in the middle or upper middle class versus a poor woman in a village).
3. There are significant risks associated with the investment class.

The SME sector is of interest, but it enjoys limited political support and there are limited resources available, given other priorities. Even if the U.S. government agency is able to provide direct equity investments, there is a lack of understanding or reluctance on the part of local business owners to the notion of giving up equity in their businesses.

Even when U.S. government agencies recognize that alternative solutions to increasing funding to the SME sector are needed, such solutions have yet to be fully adopted as a part of the government's development policy. The risks and challenges of supporting this sector in developing countries is part of the reason why there is stronger political support in the United States (and other countries) for the growth of microfinance than for the SME sector. Nonetheless, assisting a country's SMEs that need growth capital is a key to creating jobs and fostering sustainable growth. During the last 20 years, donor support for traditional microfinance models has helped provide basic financial services to millions of poor people. In order to further economic growth in developing countries, the time has come to pay greater attention to the potential of commercial SMEs.

To overcome the lack of financing and services available to the SME sector, new and innovative approaches will need to be developed. More needs to be done in this arena to help existing successful SME-focused organizations achieve scale. Most of the actors in the sector are private nongovernmental organizations working hard to scale up SMEs in emerging markets. These organizations themselves need to achieve greater scale so that they can be more effective multipliers of economic development. As nonprofits, they need a combination of innovative financing and smart subsidies to grow and strengthen their own ability to reach down to smaller transactions that development finance institutions and the U.S. government cannot afford to be involved in directly. They are much less expensive vehicles for achieving foreign policy objectives than using for-profit consultants engaged in short-term assignments. They are rooted locally in the countries where they operate yet have the institutional support of a headquarters operation that understands the importance of good governance, accountability, impact metrics, and financial stewardship. Equally important is the fact that they play an extremely effective role in engaging smaller private-sector actors in developing countries.

## Recommendations

- U.S. government agencies engaged in development finance need the ability to “package” finance with TA. OPIC, in particular, does not have its own organic TA and must look to either USAID for TA or outside partners. Because this system is cumbersome and time consuming, it frequently discourages potential outside partners. There are two potential solutions to this: (1) to create a global indefinite quantity contract for TA, which would be managed by USAID but funded through a portion of OPIC’s retained profits and utilize a network of prequalified partners; or (2) if given the ability to retain profits, OPIC could use some of the funds to offer contracts or grants for TA directly to outside contractors.
- Through policy and financial support, the U.S. government should seek to further build the capacity and scale of existing private development finance organizations, such as the Small Enterprise Assistance Fund. The U.S. government should therefore work on removing artificial policy and regulatory obstacles to SME lending, because policies that promote greater competition within the financial sector as a whole are especially helpful for smaller borrowers like SMEs.<sup>69</sup>
- Building on the success of the microfinance earmark, development finance agencies should seek earmarked money for SME financing. OPIC and others should ask Congress to redesignate a portion of the current microfinance earmark (i.e., Microenterprise for Self-Reliance Act of 2000) to SME financing.

## The Investment Time Frame

The U.S. government and other governments often take a short-term approach to their private-sector development projects. This short-term approach with foreign assistance dollars (e.g. two- to three-year terms to fund TA project timelines) can make it difficult to achieve substantial market-driven growth, even in “benign” country contexts, let alone challenging environments. Far too often, U.S. government development organizations will spend significant funds on a short-term approach, which then does not get used beyond the time that the consultants are on the ground.

The private sector does need short-term support in developing economies, but there is an additional need for long-term access to capital in the form of equity or debt capital, first loss provision, and targeted TA support. Funding needs to be well timed and judiciously allocated, for there is a clear window of opportunity for investment. Investments need to look at a long-term time horizon while focusing on the twilight window that allows DFIs to inject money at an ideal time. For example, the Aga Khan Development Network uses a 25-year-plus timeline for their investments in many country contexts, including Afghanistan.

Given the declining resources of U.S. government development agencies, it is imperative that the dollars spent achieve the maximum impact in a development context. The design of the U.S. government’s development projects is increasingly important. Far too often, development projects are short-term interventions that create processes and platforms but fail to institutionalize the tools and know-how that have been developed. These projects in many cases do not deliver the

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69. Anthony J. Ody and David de Ferranti, *Beyond Microfinance: Getting Capital to Small and Medium Enterprises to Fuel Faster Development*, Brookings Policy Brief 159 (Washington, D.C.: Brookings Institution, March 2007), [http://www.brookings.edu/papers/2007/03development\\_de\\_ferranti.aspx](http://www.brookings.edu/papers/2007/03development_de_ferranti.aspx).

institutional knowledge to emerging economies because of this short-term design, and once the development agency finishes a project and/or leaves, the new tools that have been developed are shelved.

For example, often projects, particularly USAID-funded projects, are awarded and designed to put in place governance mechanisms that allow experts to come in and work with beneficiaries only for the short term. In many cases, this approach benefits the hired consulting firm more than it does the intended local intermediary. There is no widely used mechanism to combine these short-term consultancies with longer-term capital support. There also is a need to combine long-term technical support, which allows for designing, piloting, and institutionalizing the tools and know-how, with long-term capital support. There are several models from other development agencies that the U.S. government could reference in meeting this need.

## Recommendations

- The U.S. government must use longer timelines for development financing. OPIC's use of a 15-year timeline in Afghanistan is the right approach.
- The use of staff hired from the local area should be emphasized as much as possible when working in conflict and disaster environments, because the alternative of bringing in staff from the outside makes long-term planning and execution difficult. Because expatriates often repatriate after a conflict, hiring local and/or repatriated contractors or employees allows for better continuity of staff members. Implementing this change is critical to the success of U.S. government investments and projects.
- Because training is often a barrier to hiring and because companies across a variety of sectors would benefit from the hiring of local staff, the U.S. government should take steps to build local capacity that is directly linked to the employment opportunities created by private-sector actors. Another piece of this recommendation is rooted in a local content strategy and its potential to create businesses, jobs, national and family wealth, economic opportunities, and, perhaps, even stability.
- A longer-term approach that combines long-term capital investment and long-term capacity building is needed, so that the work is not just designed but also institutionalized (through the usage of and training on the new tools) in the local communities it is designed to benefit.

## Agency-Specific Recommendations

Interagency linkages should be tightened and expanded. All U.S. agencies should be able to work more closely together, but it is imperative that USAID and MCC strengthen their ties and collaborate more formally with OPIC and USTDA. MCC recently took the step to integrate other agencies into its new compacts, and some of these compacts already under way. This is an important step, but it is one that should be formalized by all agencies engaged in development finance. More explicit efforts to implement a clearly defined—and coordinated—strategy to incorporate the private sector and foster private-sector development should also be made when USAID and MCC are developing their country strategies. The designated closings of several USAID missions (with more likely to come) should present opportunities for more systematic and preplanned collabora-

tion between USAID and USTDA, with additional “legacy” initiatives to include transition plans with OPIC and MCC (in MCC compact countries).

## OPIC

- OPIC should be reauthorized on a permanent basis, or at a minimum for five years. Doing so will restore predictability to OPIC’s mission and allow it to engage partners on a long-term basis. It will also allow OPIC to implement the other specific recommendations offered in this report.
- OPIC should continue to return most of its profits to the U.S. Treasury, but it should be allowed to retain a small portion of its profits to use for first loss, equity investments, and TA.<sup>70</sup> This money should be used to provide first loss funding, given that both sides of the transaction benefit from this investment tool. Doing so would advance foreign policy (and development goals), and the government would benefit from any “upside” of limited equity investments, as IFC and other agencies currently do. Having OPIC hold 10 to 20 percent of equity shares in a firm on a long-term basis would enable thinly capitalized small companies to develop and establish themselves in the market. OPIC could then exit by strategic sale or an agreed-on buy-out formula, with financing as needed in rare cases. Establishing the rationale for this would require an extensive outreach campaign to Congress by OPIC.
- In special circumstances (e.g., investing in Palestinian housing construction or Pakistani marble extraction), OPIC should be able to fund selected first loss provisions in one to two deals a year. Although riskier than debt investments, equity tools allow for a greater development of SMEs, and this could prove to be immensely profitable for the organization because equity flows trend with capital markets.
- Other tools, such as lending and capacity building, should also be used alongside equity investments to reduce the risks of these types of investments. To pilot this tool, opportunities should be circumscribed to a few situations—for example, in areas devastated by national disasters, in places where national security interests dictate the use of economic development as a stabilizing force, and in the lowest-income countries.
- Another ramification of OPIC’s inability to invest a percentage of its profits is that it cannot fund TA or easily access TA to enhance its investments. To address this, it should develop a comprehensive TA cost-reimbursement or cost-sharing agreement with USAID. An even better solution would be for OPIC to be able to pay for TA on its own—as recommended above, one more reason why it should be able to keep a portion of its profits. If OPIC were to spend its own money for TA, it should be in the range of \$3 million to \$5 million a year, to be used in parallel with particularly complicated deals.

## USTDA

- USTDA collaborates well with some agencies, in particular OPIC and the Export-Import Bank, to the benefit of their shared goals and mandates. This relationship serves as a model that

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70. On the international side, IFC should be allowed to do the same with the International Development Association, the World Bank’s concessional lending arm.

should be replicated between other departments, agencies, and bureaus with similar goals and mandates.

- USTDA needs to partner with USAID as USAID begins to close its missions in middle-income countries in the coming years. USTDA can act as a bridge to continue U.S. relations with these countries through commercial activity. The two agencies should work together to build coherent exit strategies in these countries.
- USTDA has the ability to quickly respond and identify current business opportunities for U.S. companies when events occur suddenly. For example, the context of the recent “Arab Spring,” USTDA organized an event that brought together American and Egyptian representatives from the public and private sectors to discuss collaborative opportunities for creating business partnerships and stimulating job creation in both countries, and clear export results have already been achieved. Events like this are vital to better leveraging American aid dollars and should be used across the board by U.S. government agencies involved in development finance.

## USAID

- USAID administrator Rajiv Shah recently announced that USAID would deploy a small cadre of “investment officers” who would act as deal originators with the private sector. This is a good first step; however, USAID needs to go further. In particular, USAID should consider creating a system that allows its employees to serve in secondments with OPIC or USTDA, to better familiarize them with the development finance work of the two agencies. At the same time, OPIC and USTDA employees could be temporarily reassigned to USAID to gain a better understanding of its development work.
- USAID should explore how to make greater use of its grant money to cover the risks associated with SME development. One reason that USAID does not target the SME sector to the extent that it should is because it is hesitant to get involved unless it is able to include the Development Credit Authority. Therefore, USAID needs to better integrate DCA’s tools into its country strategies at the beginning of the planning process.
- USAID’s leadership recognizes the need to use DCA, but doing so will require the proper incentives and rewards at the field level. Otherwise, DCA will remain a valuable but underutilized development finance instrument. A change needs to occur, starting at the country strategy level, to encourage (and mandate) that a larger portion of a mission’s budget goes to DCA and private-sector development efforts.
- DCA is an instrument that should be used more strategically in coordination with other agencies and programs, such as MCC. Currently, other agencies are statutorily prohibited from directly accessing DCA. Congressional change will be required to allow other agencies to freely access DCA.
- DCA needs to incorporate capacity-building initiatives on a more systematic scale with the financial institutions that work with DCA. DCA should provide training to mission personnel, or make it the general practice to send consultants with expertise to assist banks in both the short and long terms. DCA also needs to move away from a “broad” guarantee approach and toward one that concentrates on specific sectors.

## MCC

- MCC needs to use its grant resources in more flexible ways. It should seek to increase its capability to use a portion of its compact money for first loss guarantees. To do so would entail altering some of its restrictions, many of which are self-imposed norms as opposed to legally mandated rules.
- MCC should commit flexible funding within its compact agreements to respond to private-sector opportunities that arise during project implementation. As is often the case, once a compact is in place, there is little flexibility to react to changes that are happening on the ground in the partner country. MCC needs to lift the self-imposed constraints on its resources and set aside a portion of its compact funds for innovation and private-sector development.
- One way of promoting flexibility is for MCC to encourage Millennium Challenge Authority-eligible countries to engage the private sector *before* submitting proposals, so as to ensure that solutions contained within the projects address the tangible, self-articulated needs of private-sector actors. This process would require eligible countries to commit their own resources to the compact-forming process, and it would seek to leverage private-sector actors as compact partners if appropriate. To promote trade and investment vis-à-vis current compact projects, MCA entities should be required to staff positions for private-sector engagement. These entities should also engage and/or support domestic investment and export promotion agencies, as well as international institutions such as IFC, in the developing country.
- MCC needs to build a stronger relationship with USTDA, OPIC, and IFC; these partnerships could help all agencies to take a coordinated approach and achieve more impact. With the Presidential Policy Directive on Global Development, the Obama administration has highlighted its desire to augment MCC in the context of a more effective coordination of its initiatives with other agencies. Specifically, a more clearly defined relationship between USAID and MCC would enable each agency to optimize the impact of its respective programs. USAID has much to offer MCC in terms of TA, ranging from on-the-ground expertise to maneuvering through the intricacies of local government officials to identifying civil society partners. Meanwhile, MCC provides USAID with fertile material for thinking about its own approaches and strategies for monitoring and assessing projects. Additionally, as partner countries complete MCC's threshold programs and begin to implement its compacts, USAID's in-country threshold implementation experience could be valuable with regard to compact design.

# 4

## CONCLUSION

Official development assistance is shrinking, but development finance still represents an excellent mechanism for preserving the United States' influence throughout the developing world. Better collaboration and coordination are integral to taking full advantage of the development finance tools that the U.S. government has at its disposal. The actions the Obama administration has taken to build interagency cooperation are a step in the right direction. The 2010 Presidential Policy Directive on Global Development indicated the administration's commitment to fostering better coordination within its development agencies. It led to the inaugural Quadrennial Diplomacy and Development Review and formed the basis for the Partnership for Growth (PFG).<sup>71</sup> PFG, which is being run out of the White House, is a government-to-government partnership that emphasizes private-sector and civil society reforms at the policy level in the partner country and a coordinated and holistic approach by U.S. agencies to help spur these reforms.<sup>72</sup> PFG and additional existing efforts need to be bolstered.

The U.S. government should reorient its development programs to support the private sector and make its policies more “user friendly” for companies wishing to access U.S. government assistance. Once these relationships have been established, they need to be prioritized. Development outcomes would be more sustainable if U.S. government programs were to address barriers to private-sector investment in a country or region and focus on removing those obstacles or filling gaps in the market. Another helpful step the U.S. government could take would be to create a mechanism whereby the private sector could learn about opportunities available in the developing world and which U.S. government agencies are operating in a particular country or region.

OPIC could do all these things, but it first must be reauthorized for five years or more and gain additional authorities. Without reauthorization, OPIC will not be able to do its work, and it will also lose the confidence of the private-sector partners vital to its mission. Ultimately, continued jockeying over OPIC's future will weaken it just when it should be strengthened as a pillar of U.S. development strategy abroad. This situation, combined with the need to reform OPIC's mandate, places the United States at a distinct disadvantage vis-à-vis its allies, the multilateral financial institutions, and its potential competitors. OPIC is the United States' development finance institution, and if it is weakened or constrained, this country will not be able to adequately compete in development finance.

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71. U.S. Department of State and USAID, *Leading through Civilian Power: The First Quadrennial Diplomacy and Development Review*, 2010, <http://www.state.gov/documents/organization/153108.pdf>.

72. The PFG's four pilot countries—El Salvador, Tanzania, Ghana, and the Philippines—have been chosen for this program based on solid economic performance, policies, and governance to have country action plans formed describing the strategy of unlocking economic growth potential. The administration hopes to build on the MCC compacts currently in progress in these countries in an effort maximize the efficiency and the value of U.S. aid. Ana Marie Pamintuan, “Partners for Growth,” *Philippine Star*, September 9, 2011, <http://208.184.76.174/Article.aspx?articleId=725312&publicationSubCategoryId=64>.

Beyond OPIC, the other agencies discussed in this report—USTDA, USAID, and MCC—are smaller players in development finance, but each can play a key role in supporting OPIC. Coordination among all four—as well as other agencies not directly discussed in this report—is necessary for the success of development finance. In particular, a formal system of secondments or rotations should be put in place so that professionals at each agency gain a better understanding of the organizational cultures and business practices of the others. Thus, OPIC’s investment officers should spend time at USAID to learn about the broader grant-making and development process, and vice versa. Additionally, the other agencies offer instruments that OPIC lacks—such as USAID’s TA capability. Both agencies should work together to identify ways in which USAID’s TA expertise can be combined more effectively with OPIC’s financial capabilities.

More broadly, USAID, USTDA, and MCC all play key roles in creating the appropriate enabling environment for private-sector-led development to achieve sustained economic growth. Without the rule of law, proper governance, a robust civil society, business regulatory reform, and investment guarantees, OPIC’s development finance projects will struggle in the developing world. Improving the enabling environment for business is not only a positive for furthering U.S. development and foreign policy goals, but also has a direct impact on the United States’ ability to export goods and services and grow its businesses.

All the recommendations offered in this report are about slight adjustments to mandates, not large organizational chart changes. It is evident that U.S. government policymakers need to think more expansively with regard to development finance. However, the changes they can make in the effectiveness of the relevant agencies are potentially game changing. Many of the United States’ partners in international development, such as the United Kingdom, have been actively rethinking their respective development strategies and implementing new approaches. This is clearly a global trend, which requires longer-term thinking. In the interim, however, the United States can do itself a world of good by implementing the recommendations of this report. Countries with strong economies are less likely to be destabilizing forces in geostrategically crucial places such as the Middle East and North Africa, Sub-Saharan Africa, and South Asia, and the United States needs to use all the tools it has in the best possible manner to facilitate sustainable economic growth worldwide.



## APPENDIX A THE INTERNATIONAL FINANCE CORPORATION

The International Finance Corporation, founded in 1956, is a component of the World Bank Group; its primary goal is to generate sustainable economic growth in the developing world. IFC, which operates on a commercial basis and only in for-profit projects, achieves its goals through a series of investment products and advisory services. In its 2011 to 2013 road map, IFC laid out five guiding principles (pillars) for its investments: (1) Strengthen the focus on frontier markets; (2) build and maintain long-term relationships in developing countries; (3) address climate change through investments; (4) address constraints to private-sector growth in infrastructure, health, education, and food security; and (5) develop local financial markets.<sup>73</sup>

IFC is the largest development finance institution in the world, accounting for 38 percent of global DFI investment. It is divided into three business segments: an investment program, an advisory program, and a recently formed asset management company. The investment program provides loans, equity, credit guarantees, and other financial products to the private financial sector. In FY 2011, IFC invested \$12.2 billion of its own money and mobilized an additional \$6.5 billion from other investors (in FY 2010, as a comparison, IFC made commitments of \$12.7 billion). Most of IFC's approximately \$2 billion in profits in 2010 came from equity investments.

IFC is a DFI that has the ability to do many of the things that this report recommends for U.S. government agencies. For example, IFC is able to retain a share of the profits it earns through investments and advisory services. And it is able to use its retained profits to make minority equity investments in companies. These investments are generally in the range of 5 to 15 percent of a company's equity. In addition, IFC also offers partial credit guarantees, including first loss funding. IFC's second major segment is its TA, which it calls "advisory services," which is offered to private-sector clients looking to invest in the developing world or governments. In FY 2011, IFC spent approximately \$206.7 million on advisory services, which was mainly financed by bilateral donors and partially by IFC's own profits. These advisory services are self-implemented by IFC's staff and are generally tied to its investments. The authors of this report do not recommend that OPIC develop its own in-house cadre of TA consultants to implement projects, as IFC has done. The in-house model of consultants partially works for IFC but brings with it many drawbacks (e.g., IFC constantly fund-raises from its donor governments for its TA, its TA model may not allow for a broader network of solution providers, and it has tensions between its investment and TA sides) and is not feasible for the U.S. government at this time.

IFC offers an important model for the U.S. government as it considers how to strengthen OPIC and its development finance efforts more broadly. For instance, whereas IFC has the ability to easily integrate TA with finance, OPIC's inability to do likewise is one of its biggest structural

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73. IFC, "IFC Roadmap FY11–13: Maximizing Impact, Unlocking Our Potential," April 10, 2010, [http://www1.ifc.org/wps/wcm/connect/87c9800046b649beaa04abb254bf7d4/FY11\\_13\\_IFC\\_Road\\_Map.pdf?MOD=AJPERES](http://www1.ifc.org/wps/wcm/connect/87c9800046b649beaa04abb254bf7d4/FY11_13_IFC_Road_Map.pdf?MOD=AJPERES).

weaknesses. In recent years, IFC has made a number of important strides in improving its ability to deliver development finance; however, it still has a number of its own weaknesses. It remains too conservative in its investments, and too focused on the volume of investments. IFC needs to look less at investment returns and more at the development impact that its investments can have. Moreover, the parts of IFC that deliver TA are still very much second-class citizens. Although IFC has the ability to integrate TA and finance, it struggles to do so and has often suffered from a “stove-piping” of services. To address these remaining challenges, IFC should consider a rigorous review of its operations, much like that recently implemented by the CDC Group, the United Kingdom’s DFI.



## APPENDIX B EXAMPLES OF SMALL AND MEDIUM-SIZED ENTERPRISE FUNDS THAT COMBINE INVESTMENT CAPITAL AND TECHNICAL ASSISTANCE

### The Small Enterprise Assistance Fund

The Small Enterprise Assistance Fund got its start in Central and Eastern Europe following the fall of the Berlin Wall with a \$300,000 grant from USAID, and its portfolio has since expanded to include more than 25 countries in Latin America and Asia. SEAF supports the growth of SMEs in emerging markets by providing access to capital and credit. Although most of SEAF's funds today are raised from non-USAID sources, USAID's willingness to use its grant-funding flexibly has enabled SEAF to utilize the grants as seed money, which has catalyzed additional investment from a wide variety of investors, including IFC, major European DFIs and multilaterals, institutional investors such as the Calvert Group, emerging market banks, and local pension funds. In Colombia and Peru, USAID has worked with SEAF to encourage the legal reforms necessary to permit pension funds to invest a small portion of their assets in local private equity funds. Today, such local investment is playing an increasing role in the region's economic success. In the wake of the 2008 global financial and economic crisis, SMEs disproportionately struggled to attract capital. To address this, SEAF and OPIC collaborated in January 2010 to create a global SME Debt Facility to help make credit available to SMEs in emerging markets.

Overall, the combination of appropriate risk capital and technical assistance has proven to be a powerful formula for growth; thus, the SMEs in SEAF's portfolio attained 33 percent annual revenue growth and 25 percent annual employment growth at a time when gross domestic product in the same countries grew an average of 18 percent and employment grew only 1 percent (based on 2009 data).<sup>74</sup> Furthermore, each \$1 invested in SEAF's SMEs has yielded an average of \$13 in the local economy, with one-third of those dollars returning to the owners and financiers of the companies and two-thirds contributing to local employment, taxes, and supplier purchases.<sup>75</sup> Thus investment in SMEs can pay dividends both financially and developmentally, thereby leveraging scarce DFI resources.

### The Grassroots Business Fund

The Grassroots Business Fund (GBF) grew out of IFC's Grassroots Business Initiative (GBI). Founded in 2008, GBF built on four years of work by GBI. Since 2008, it has grown from an initial \$3 million in investments to \$8.5 million spread across 32 projects, as of 2011. GBF's mission is to build and support "high-impact businesses" that provide sustainable economic opportunities to the "base of the pyramid." GBF looks to make investments in companies with assets in the range

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74. SEAF, "Impact beyond Investment," 6, <http://seafweb.org/images/reports/553/Impact%20Beyond%20Investment.pdf>.

75. *Ibid.*, 40.

of \$250,000 to \$1.5 million in four broad sectors: agribusiness, base-of-pyramid services, artisanal products, and innovative finance. Regionally, GBF focuses on Latin America (Bolivia, Colombia, Guatemala, and Peru), South Asia (India), Southeast Asia (Cambodia and Indonesia), and Africa (Tanzania, Kenya, and Ghana). In addition to its direct investments, GBF also provides companies with TA, which includes financial management, operations and supply chain management, human capacity and governance, strategy, legal and regulatory issues, and environmental and social issues.

A major stumbling block to the successful development of businesses in the developing world is access to markets. In December 2008, the GBF launched the SME Export Facility (SEF). The SEF is designed to increase market access for companies in the developing world that are involved in handicrafts or agribusiness. The SEF works to link businesses with market access providers or facilitate commercial transactions through working capital loans.

## Business Partners International's Kenya SME Fund

Business Partners International (BPI) is a fund management company designed to target SMEs in Sub-Saharan Africa. It was founded in 2004 to provide financing, sector-specific knowledge, and value-added services based on the investment model its parent company, Business Partners Limited, originally applied in South Africa.<sup>76</sup>

One country-specific example of BPI's activities is its Kenya SME Fund, which is a \$14.1 million investment fund combined with a parallel \$2.5 million TA facility.<sup>77</sup> Established in 2007, it focuses on SMEs in need of between \$50,000 and \$500,000 in funding and services and utilizes primarily quasi-equity and debt instruments in structuring its deals.<sup>78</sup> A March 2009 USAID report identified the fund's biggest strength as its use of Kenyan-based organizations to provide TA and investments that are tailor-made for the SME in question. One of the fund's shortcomings, however, is that it employs an approvals committee to review its applications rather than focusing on an SME's available collateral or track record.<sup>79</sup>

The Kenya SME Fund's investors include IFC, the European Investment Bank, CDC Group, TransCentury, and the East African Development Bank.<sup>80</sup> BPI has similar funds in Madagascar, Rwanda, and Mozambique. It also recently launched a Southern Africa SME Fund that targets Malawi, Namibia, Zambia, and Zimbabwe.

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76. See <http://www.businesspartners.co.za/page/bp-international>.

77. See <http://www.businesspartners.co.za/page/bpi-kenya-fund-and-investors>.

78. See <http://www.africa-assets.com/data/fund/bpi-kenya-sme-fund>.

79. USAID, "Models of Financial Business Services: Case Studies and Lessons Learned from Financial Intermediaries," March 2009, [http://pdf.usaid.gov/pdf\\_docs/pnadp081.pdf](http://pdf.usaid.gov/pdf_docs/pnadp081.pdf).

80. See <http://www.businesspartners.co.za/page/bpi-kenya-fund-and-investors>.



## ABOUT THE AUTHORS

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**Robert Mosbacher Jr.** is chairman of Mosbacher Energy Company (MEC), an independent oil and gas exploration and production company in Houston, Texas. From 1986 to 2005, he was president and CEO of MEC. He was also vice chairman of Mosbacher Power Group, an independent electric power developer, which began in 1995, and was sold in 2003. Mr. Mosbacher was sworn in as the ninth president and CEO of the Overseas Private Investment Corporation (OPIC) in October 2005, following confirmation by the U.S. Senate. OPIC is an independent agency of the

U.S. government that supports private capital investment in emerging markets around the world. OPIC currently operates in 155 countries and has over \$14 billion in commitments. He stepped down from his position at OPIC in January 2009. In 2009, Mr. Mosbacher joined the board of Calpine Corporation, the largest independent power company in the United States, with almost 30,000 megawatts of generating capacity. He also rejoined the board of Devon Energy Company, a large, independent gas and oil developer. He is chairman of the Initiative for Global Development and serves on the boards of CHF International and the Americas Society. Mr. Mosbacher was chairman of the Greater Houston Partnership in 2004, a private, nonprofit organization that serves as the city's chamber of commerce. He also served as chairman of the Partnership's Health Care Advisory Committee and as chairman of its Education & Workforce Advisory Committee. Mr. Mosbacher has also served as chairman of the Methodist Hospital, the Salvation Army, and the Greater Houston Area Chapter of the American Red Cross, all in Houston. He is founder and former cochairman of Rebuilding Together Houston (formerly PSI HomeSavers), which organizes volunteers to deliver free exterior home repairs and has resulted in the repair of over 6,000 houses for qualified low-income elderly or disabled Houstonians. He also served on the board of South Texas College of Law. Earlier in his career, Mr. Mosbacher worked for Senator Howard Baker for over seven years. He helped launch the Reagan administration's Private Sector Initiatives Program, and was appointed by President Reagan to three successive Presidential Task Forces on Private Sector Initiatives during the 1980s. Mr. Mosbacher received a law degree in 1977 from Southern Methodist University and a B.A. degree from Georgetown University in 1973.

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## ABOUT THE PROJECT

The Project on U.S. Leadership in Development is a partnership with Chevron Corporation focused on leveraging all U.S. assets—the private sector in particular—to promote economic development, improve livelihoods, and reduce poverty worldwide. The project seeks to renew the discourse in Washington and develop a fresh, actionable set of policy recommendations for 2012 and beyond. The project builds on the ongoing work of CSIS in global health, water, trade, food security, governance, and economic development in the areas of conflict and post conflict.



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