

IN SEARCH OF SUSTAINABLE AID AND DEVELOPMENT— A VIEW FROM THE FIELD

IRA W. LIEBERMAN

INTRODUCTION

It has become fashionable for a number of well known economists to write globally about the problems associated with economic aid and development.¹ Mostly their views are highly critical of what is often referred to as the “Washington consensus” on aid and development. Aid is an easy target to criticize. Bilateral donors rarely meet their global aid commitments. Also, development is so complex and so politicized that politically announced development goals, such as the Millennium Goals, are rarely, if ever, reached. Not short on analytical skills, these economists often get the diagnostics mostly right, but it is their solutions that often lack a sense of reality. That is largely because they have not spent much time in the field, hands on, trying to deliver the various products, broadly described as aid

Aid is complex, as it potentially covers all areas of economic activity, delivered most often by external institutions, by foreign consultants and mostly through governments with the objective of reaching poor people in the developing world. From 1990 on, the transition economies were added as they sought to transition from socialist to market economies. In addition to the Central and Eastern European Countries (CEE), the Former Soviet Union (FSU) countries and the Balkans, there was also on-going aid to China, Vietnam and Laos as transition countries. The political economy of aid is exceedingly complex and equally so is the difficulty in measuring impact. Increasingly, there is a demand for sustainable aid. Sustainable aid is aid that not only has a positive economic impact but also is environmentally sound. That adds another complexity to the subject that few aid agencies have grappled with sufficiently. For this discussion, I exclude the front line of aid, that is, aid provided during emergencies due to natural disasters and

¹ For a sample of some of these authors and their work—Joseph Stiglitz, *Globalization and Its Discontents and Making Globalization Work*; Jeffrey Sachs, *The End of Poverty and Economics for a Crowded Planet, Common Wealth*; William Easterly, *The White Man’s Burden—Why the West’s Efforts to Aid the Rest Have Done So Much Ill and So Little Good*; and Paul Collier, *The Bottom Billion—Why the Poorest Countries Are Failing and What Can be Done About It*. There are a number of regionally focused works that stand out, but Dambisa Moyo’s book focused on Africa, *Dead Aid*, may be the best example of the genre I have noted above. Moyo asserts that a trillion or more dollars in aid that has been distributed to Africa over the last 20 years has been entirely wasted.

conflicts, such as the recent catastrophic earthquake in Haiti. I focus on aid that is linked to longer-term economic development. That is the form of aid supported by the World Bank, several regional development banks, bilateral donors and thousands of non-governmental organization (NGOs) around the world.

The terms, aid and development, can be complicated to define. So to keep it, I define aid as grants or concessional loans provided by international or bilateral official funding agencies or by NGOs and foundations (not-for-profits) to governments, institutions or people in developing and transition countries.

Development is improvement in the standard of living of people living in developing and transition countries. Development has generally been measured by increases in gross domestic product (GDP) on a per capita basis.² But that single benchmark by itself is inadequate and can hide many problems within an economy, so it is often useful to look at measures surrounding this basic measure, such as improvements in health and education and improved access to services—telephone, electricity, and potable water. Because averages can mean that large segments of the population are not included in development, other benchmarks or measures, such as the Gini coefficient, are also looked at. The Gini coefficient measures economic inequality within a country. Increasingly, aid in developing countries has focused on reducing poverty—that is, the population living on \$1 to \$2 a day.³

This discussion focuses on two areas I have worked in as examples of successful aid and development—privatization and other pro-market reforms and microfinance. However, it is difficult to disaggregate the contribution of privatization and microfinance to each of the measures of development, so I strive to explain why and how these areas contribute to development. Moreover, sustainability would have us consider the environmental soundness of a program and its resource usage. I address this issue briefly

² GDP is itself a complex benchmark—it is generally measured in two different ways: by the Atlas method or the purchasing power parity (PPP) method.

³ See Daryl Collins, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven, *Portfolios of the Poor-How the Poor Live on \$2 a Day*, Princeton and Oxford Press, 2009, for a discussion on PPP and its inadequacy as a measure for the poor. It discusses a new measure of measuring income for the poor under development by the World Bank that is not yet available, pp. 5-7.

with respect to restructuring and privatization. Finally, I reach some brief conclusions on sustainable aid.

PRIVATIZATION AND RESTRUCTURING

During the 1980s there was significant talk about privatization in the developing world as a result of the experience in the UK and New Zealand, and the Thatcher and Reagan led conservative emphasis on the private sector as the engine of growth and stability in democratic countries, what some call democratic capitalism. Early successful experience in Chile was largely ignored because of the nature of the Pinochet regime that sponsored it. But privatization became a reality in the 1990s, when the large Lat in American economies—Mexico, Argentina and Brazil—developed and implemented extensive privatization programs. Turkey also announced but only partially implemented an extensive program that was delayed due to weak coalition governments and a series of crises in the 1990s.⁴ Finally, Turkey implemented a program after its financial/economic crisis in 2001-2002 similar in scope to the Latin American programs. But privatization really was recognized as a major factor in economic development when the socialist or command economies of the CEE and FSU began to privatize on a massive basis starting with the break-up of the Soviet Union in 1990.

What is privatization? It is the sale of a majority ownership in state-owned enterprises (SOEs) to private investors. That sounds simple, but it involves passage of a privatization law, regulations governing the process, creation of a privatization agency to implement the program, and corporatizing SOEs. Most SOEs had no legal form and had to be corporatized as shareholding institutions, with their own balance sheets in order to be privatized. For transition economies under socialism or social ownership, as it was known in the ex-Yugoslavia, there was also the need to draft company laws, securities laws, bankruptcy and competition laws to complement the process of privatization and provide the institutional structure or architecture for a private market economy. All of that meant convening expertise from the West to assist in the process, as well as investment advisors, to assist in the sale and attract Western investors. In addition, separate from but linked to privatization, was the creation of capital markets. The World Bank, the European Commission, DFID (the British aid agency) and US AID funded

⁴ I worked directly on privatization in Mexico, Colombia, Argentina and Turkey and in transition countries in Poland, Russia, Kazakhstan, Ukraine, Albania and Serbia and evaluated the program in the Czech Republic.

privatization programs in the CEE and FSU as a way of ensuring the transition to a private market economy and away from socialism. In Russia, reformers I worked with in the early 1990s, such as Anatoly Chubais, Minister for Privatization and subsequently Deputy Prime Minister in charge of the economy, were convinced that the communists would retake the government and they wanted to move as rapidly as possible to make privatization and other pro-market reforms irreversible, so that a private market economy, which the reformers linked to a more democratic political system, could be established in Russia.

Why did developing countries, such as in Latin America and Turkey, need to privatize in order to develop? Most of the Latin American countries and other developing countries, such as Turkey and India, developed on the basis of import substitution, maintaining high tariff walls and other trade barriers in order to build infant industries in basic sectors, such as cement, steel, oil refining and petrochemicals, fertilizers, auto-assembly and banking. With nascent private sectors, invariably these industries were created through SOEs, often with aid and technical assistance funded by the World Bank and regional development banks. Natural resource companies in oil, minerals and mining also were state owned. In time, as these sectors developed and SOEs grew to become a major part of the economy, they developed significant problems, including monopolistic control of basic sectors, obsolescent technology and equipment as plants were not modernized with changing technology globally, poor product quality, overstaffing as jobs in SOEs were utilized for political patronage, sources of corruption as government ministers and labor leaders extracted rents from these companies, losses contributing to the state's fiscal deficits, over-indebtedness as governments rarely chose to inject equity into SOEs, and poor governance as ministers or their deputies generally filled board seats instead of qualified, independent, industry experts. In short, SOEs crowded out the private sector in these countries. Also, as inefficient, uncompetitive, commodity producers in basic sectors, such as cement, steel or petrochemicals, downstream producers in the private sector, reliant on SOEs as their suppliers, also could not be competitive.

In time the argument for infant industry protection perversely became an argument for protecting poorly run SOEs. These state-owned and managed monopolies, were too uncompetitive to compete under a liberalized import

regime or versus private investors, assuming the sectors were opened. The 1980s debt crisis forced these countries to look at privatization as an alternative to reduce their debt burdens and to attract direct foreign direct investment (FDI) to modernize their economies. I personally participated in supporting these reforms and watched them roll out in Mexico in the mid-1980s, in Argentina in the early 1990s, and in Turkey over a more extended period in the 1990s and after its major crisis in 2001-2002. But each of these countries were to get into trouble once again and experienced profound financial/economic crisis—Mexico in 1995—the “Tequila” crisis, Argentina 2001-2002 and Turkey 2001-2002. These crises are discussed later. So privatization became one important tool for countries to modernize, become competitive and to grow their economies.

Why was privatization the cornerstone for pro-market reforms in transition economies?

In all of the socialist or command economies of the CEE and FSU, SOEs represented more than 90% of employment and production in industry. Some of the countries, such as Poland, had a cooperative sector for small industry. Even retail stores, restaurants, and other small service establishments were state owned. In order to create a market economy, countries had to privatize their SOEs. They had to do so quickly enough to create a critical mass so that SOEs would not crowd out and kill off these newly privatized firms. All the economic reasons for privatization of the large SOEs also applied to the SOEs in transition economies but even more so. Many simply produced products no one wanted. These countries also liberalized entry so that thousands of new small de novo firms were established generating millions of new jobs as the large SOEs shed employment. These countries had to draft a new set of laws to as the infrastructure or architecture for a market economy to function.

Privatization involved many complex issues, so in addition to advice on how to structure a privatization program, set up a privatization agency and hire financial advisors, and also prepare supporting privatization projects to provide funding from the bank for these programs, there was a range of policy issues that had to be addressed. Our primary role was to engage the governments and advise them on these issues.

Although a number of the countries faced essentially the same starting conditions, each of the transition governments devised its own solutions. In

this case the Washington consensus was largely a myth. While IMF and World Bank brought certain views to the table, based largely on their experience in developing countries, none of the transition economies had yet gone through the transition process. With respect to the privatization process and other reforms—the Polish government opted for the big bang or very rapid opening of the economy and rapid privatization based on a diversified menu of approaches.⁵ The Czechs focused extensively on voucher auctions, distribution of vouchers at nominal prices to the entire Czech population and privatization of firms through voucher auctions. Voucher investment funds, which were organized spontaneously through free market initiative, eventually captured much of the vouchers and became the initial “owners” of thousand of medium and large firms. Hungary, which had exercised economic reforms under socialism, so-called Goulash socialism, was slow to privatize. In 1995 the country was highly indebted and perceived as a potential crisis country; the finance minister and central bank governor worked together to stabilize the macro-economy and the government privatized some of the largest firms through tenders to foreign investors to generate some \$8 billion in privatization revenues and substantially reduce the country’s external debt. Finally, the Russians largely opted for the Czech approach but emphasized speed as the primary consideration, privatizing some 16,500 firms through voucher auctions in just two years. Unlike the Czech centralized auctions, given the geographic size and diversity of Russia, the Government opted for decentralized auctions on a regional and municipal basis. In all cases, small-scale privatization of retail and service firms took place rapidly at the beginning of privatization. Privatization of large strategic firms—banks, telecoms, electricity, oil, gas, petrochemicals, steel, sea ports, airports, etc.—took place some years after privatization began, to an extent on a case-by-case basis.⁶

Problems and objections to privatization and other market reforms— Was there a positive development impact?

⁵ Leszek Balcerowicz—Deputy Prime Minister of Poland (1989-1991) following Poland’s break away from the FSU—used to talk about the on- year window of opportunity, during which reform governments had to enact reforms before party politics made it all more difficult. Anatoly Chubais in Russia had a similar view, but his concern was that the Communist Party would reassert its control in Russia.

⁶ See I. Lieberman and Kopf Editors, *Privatization in the Transition Economies: The On-Going Story*, Elsevier, 2007 for a comprehensive review of privatization in the transition economies.

There were many objections to privatization in developing and transition countries—corruption, enriching the nomenklatura⁷, acquisition by foreigners of the “family silver”, reduction in the workforce, increase in tariffs where utilities were privatized, etc. Also, opposition politicians used privatization as a target against incumbents. But there is little doubt that in developing countries privatization improved competitiveness in important sectors, such as telecom, banking, steel and fertilizers. It reduced fiscal costs to the state and in fact increased taxes through corporate taxes on firms, which were restructured to become profitable. It attracted significant FDI to reduce debts and increased employment over time. In transition economies, privatization led to the creation of thousands of small and medium enterprises, including de novo enterprises due to liberalization of entry; created a critical core or mass of firms to establish the basis for a market economy; and in many cases spread democratic share-ownership throughout the country via so-called voucher programs. Privatization also created a commercial banking system in these countries with some 80% of banking assets in the CEE and SEE owned by European banks. Not all countries implemented privatization well—Ukraine, Uzbekistan, the Kyrgyz Republic and Albania as examples. In some cases, such as Russia, insider, non-transparent sales of larger companies derailed the reform process.⁸ But in Russia by the end of the 1994, some 60% of workers were employed by private companies. In the Czech Republic, Hungary, Poland, and the Baltic states, the process was even more successful due to reforms required as part of the process of accession the EU known as the *acquis communautaire*⁹.

MICROFINANCE AND POVERTY ALLEVIATION

In April 1995 I was asked by senior management at the World Bank to organize and manage the Secretariat for the Consultative Group to Assist the Poorest (CGAP). CGAP was a multidonor initiative and created to support the

⁷ The nomenklatura were the insiders in the Former Soviet Union and other Communist countries, usually high party officials, who were perceived by the population as being able to take advantage of the reforms.

⁸ See Ira Lieberman and Rogi Veimetra, “The Rush for Shares in the “Klondyke” of Wild East Capitalism: Loans-for-Shares Transactions in Russia,” *The George Washington Journal of International Law and Economics*, 1997.

⁹ The *acquis communautaire* were a series of reforms required by the European Union before a transition country could become a member state. During the initial process the 10 or so states from the CEE were known as accession countries.

rapidly expanding microfinance industry. Microfinance started in the mid-1980s initially at the Grameen Bank in Bangladesh and Bank Rakyat Indonesia (BRI) and rapidly spread throughout the developing and transition economies. CGAP was initially funded by and represented nine donors, including the World Bank, and within two years we had attracted 26 donor institutions.

In June 1995, when CGAP was launched, if outsiders knew about microfinance they spoke of Grameen Bank and insiders spoke about three major institutions—Grameen, BRI and Banco Sol in Bolivia. These three microfinance institutions (MFIs) were financially sustainable and had extensive social outreach to poor clients, a combination referred to as the double bottom line. Most other MFIs around the world were NGOs that might cover their operating costs, but few were fully sustainable.¹⁰ At this time there also emerged a number of microfinance networks, such as Accion International, Finca International, Opportunities International and Woman's World Banking, all based in the US, which created affiliated and subsidiary institutions throughout the developing and transition world. These networks provided technical assistance to their affiliates and/or subsidiaries and also raised funds from the public and from donor institutions for these MFIs. Also, NGOs and faith-based institutions, which provided social services to the poor throughout the world, such as Care, Save the Children, Catholic Relief Services, the Aga Khan Foundation and MEDA (a Mennonite institution), all expanded into microfinance.

The role of CGAP and the donor institutions was to provide grants or, in the case of certain donors, loans to MFIs to allow the MFIs to build capacity and scale-up their outreach to their poor clients. From 1995 to 1999, CGAP funded some 50 MFIs throughout the world and a number of major networks. The donor members of CGAP averaged some \$300-\$500 million a year to MFIs during this same time. CGAP also had another role to distribute knowledge about the industry to donors and MFIs throughout the world and to assist in setting best practice standards in the industry.

Financial sustainability and commercialization—Why is it so important? By the late 1990s there was a rapid expansion of the

¹⁰ The term, financially sustainable, has a specific definition in the microfinance industry; it means that the MFI covers its operating costs and also covers its financial costs and is able to generate a profit after adjustments for inflation and all subsidies in the form of below market loans and grants.

microfinance industry throughout the world. Most of the MFIs remained as NGOs as the sector expanded to such remote and poor countries as Mongolia, Cambodia, Tajikistan, the Kyrgyz Republic, Bosnia, Kosovo, and virtually all of the countries of sub-Saharan Africa. At the same time as there was a wide geographic expansion of the industry, there was a push, in part led by CGAP, to have MFIs become fully sustainable and to commercialize. I have defined sustainability; however, commercialization is different—it implies that the MFI can tap capital markets, such as the inter-bank market in its country of operation, that it can borrow from international debt funds at full market rates, that it can attract equity investors and that the MFI will transform to become a licensed financial institution, either a microfinance bank or a non-bank financial institution. If the MFI becomes a licensed bank under banking regulation and under the purview of a banking supervisor, that most often allows the institution to mobilize savings from the public. From experience we have learned that safe savings for the poor may be even more important than loans

The potential for commercialization in the industry attracted entry by the international finance institutions (IFIs), the private sector arm of public aid agencies, such as the International Finance Agency, the private arm of the World Bank and most bilateral IFIs and soon thereafter private investors. The first microfinance investment fund, ProFund focused on investments in Latin America and was created in 1995. At present there are about 70 debt funds and 30 equity funds investing throughout the world. Many of these funds are managed by private investors with public funds from IFIs invested therein. This has created significant scope for private-public partnerships in the industry that to date has worked well to assist in scaling-up many commercial MFIs. Also, in a number of countries, commercial banks have down-scaled into microfinance, increasing competition in the sector and also increasing outreach to the poor. Their ability to mobilize savings through their branch structure is also an important contribution to assisting poor clients.

Another sign of commercialization is important multilateral expansion of leading MFI networks, such as ProCredit Banks based in Frankfurt, with more than 20m microfinance banks principally in the transition economies, Latin America and Africa. Accion International, formerly focused on Latin America, now has investments and affiliates in Asia and Africa as well. Accion also operates two investment funds and a pioneer fund focused on other areas of

social intervention. Finca has about 30 affiliates in Latin America, Central Asia, the Caucasus and Russia and Africa. BRAC, a large Bangladesh NGO, has expanded into other parts of Asia and Afghanistan and has recently mounted an effort to create MFIs in up to ten countries in Africa.

A signal that the industry has become a serious niche in the financial sector is that just prior to the recent financial/economic crisis, three leading MFIs went public and the small business bank of another very important bank also went public. Recently, a large MFI went public in India. Several MFIs preparing to go public before the crisis will probably do so when the markets open up.

Commercialization is important because it allows MFIs to attract sufficient funds from private investor and larger banks and, for the best MFIs, from the capital markets directly. Early on in the development of the industry it became clear that donor support alone could not do the trick. However, public support remains meaningful as IFIs remain anchor investors in the industry and continue to serve as a catalyst for private sector entry through public-private partnerships.

From the three major MFIs that the industry talked about in the mid-1990s, there are now hundreds of commercially viable MFIs that operate as regulated banks or non-bank financial institutions. There are many with 100,000 clients or more and several with more than a million clients. The industry at present is serving more than one hundred million poor people throughout the world and until the recent crisis growth rates were on average in excess of 25% a year.

Does microfinance assist in alleviating poverty? From the beginning of my involvement in the industry there has always been a debate about the role of microfinance in poverty alleviation. There seems little doubt, based on recent research, that at minimum micro-loans and MFIs as a venue for safe savings are important to allow poor families to smooth their cash flows and to avoid deepening poverty. Among other interventions it appears that microfinance contributes to reducing poverty. The World Bank, regional development banks, and the bilateral and IFIs all point to the role of microfinance in alleviating poverty and their support for MFIs as double bottom line institutions. Poverty advocates object to the commercialization of microfinance. Yunus and Grameen Bank have led this debate. Yunus maintains that high interest rates needed to allow MFIs to be profitable and to attract private funds

are usurious and damage the poor, although the evidence is that the poor borrow from money lenders and others at much higher rates while having no access to conventional banks. However, this so-called schism in the industry has produced results, with a major campaign underway by leading institutions in the industry to promote consumer protection and standards of disclosure about interest rates.

In conclusion, microfinance is a successful area of aid and development and is a technology or approach to banking to support the poor that moved from developing countries, such as Bangladesh, Indonesia and Bolivia, to around the world. Donor support has been a valuable but not the decisive contribution. Moreover, the industry and many MFIs have moved to sustainability through public-private partnerships and the entry of large-scale private investment.

CONCLUSIONS

The financial aid and economic development industry is complex and the process of development difficult. Because of dealing through governments as suppliers of aid and developing and transition country governments as recipients of the aid, the process easily becomes highly politicized. It has become fashionable by well-respected economists, such as Sachs, Stiglitz, and Easterly, and relative new comers, such as Moyo, to be highly critical of the process. There is a tendency to overshoot with their criticism so that Moyo in *Dead Aid* can claim that a trillion dollars in aid to Africa over the last 20 years or so has been entirely wasted. I have provided some examples of aid and development that have worked. For example, there is broad consensus in the aid industry that microfinance seems to be effective throughout the developing and transition countries. My concern is that there is a tendency to claim too much for it with respect to poverty alleviation. But as an increasingly sustainable development tool or instrument, microfinance works well in support of the poor and in mitigating deep-seated poverty.

Privatization has also worked well in diverse countries in Latin America and in the transition countries—Eastern and Central Europe, the FSU, the SEE (Balkans) and Turkey. But privatization is a highly political process that takes substantial government commitment; it has worked less well where government commitment to economic reform has been low—Uzbekistan, Belarus, Ukraine, Paraguay, as examples. Privatization also takes real capacity in government and buyers with the capital and capacity to restructure SOEs. That usually implies FDI for major strategic companies, such as telecom, electricity, ports, airports, oil and petrochemicals, steel, etc. Countries with limited capacity to manage the process or little intrinsic

interest to buyers have not fared well—for example, Kyrgyzstan, Moldova, and Albania and a number of countries in Africa. Finally, privatization is susceptible to corruption, as has been the case despite some important success in Russia, Romania, Mexico and Argentina. Also, privatization is an easy target for opposition politicians who object to the sale of the “family silver” and point to issues, such as the adverse impact on workers and corruption. Not surprisingly, therefore, in many countries, unions have been against privatization and the public, when surveyed, have had negative impressions of privatization. My conclusion, however, is that privatization has had a positive impact on competitiveness in countries, such as Argentina, Mexico, Brazil and Turkey. Not only has it improved competitiveness in transition economies but also it has been at the heart of structural reforms that have led to the creation of market economies in the region.



Ira W. Lieberman graduated from Lehigh University in 1964. During his junior year at Lehigh he attended El Colegio de Mejico, in Mexico City, on a full scholarship, arranged for him by one of his professors at Lehigh. That year in Mexico led him to focus on an international career. After Lehigh he took an MBA at Columbia University in finance and accounting. The first half of his career (some 18 years) was spent in private business, six years abroad based in Brussels, thereafter all of his career was international in scope.

From 1982 to 1985 he took time off from business to study at Oxford University, where he did his D.Phil. (Ph.D.) in international relations, with a thesis focused on political economy, a history of sovereign debt crisis and resolution thereof. He left Oxford to go to work for the World Bank in July 1985.

For the last 25 years he either worked for or did advisory work for the World Bank in developing and transition countries throughout the world. Retired from the Bank, he continues to work on economic development, with much of that work focused on microfinance. He has essentially worked in three broad areas of economic aid and development—

- (i) Privatization, restructuring and related reforms focused on creating a competitive private sector in developing and transition economies. He worked extensively in the transition economies of Central and Eastern Europe (CEE), the Former Soviet Union (FSU), including Central Asia and South East Europe better known as the Balkans. But he also worked on privatization in Mexico, Colombia, Argentina and Turkey;**
- (ii) Microfinance, as CEO of the Consultative Group to Serve the Poorest (CGAP), managing the global Secretariat for microfinance representing some 25 donor institutions, a grant facility of some \$40 million and direct funding to some 50 microfinance institutions throughout the world over a 5-year period. He continues to work actively in this sector; and,**
- (iii) Financial/ Economic Crises. He worked actively on economic/ financial crises and on crisis resolution in countries such as Mexico, Argentina, Turkey and Korea. His responsibility has focused on systemic workouts of corporate debtors as part of a crisis resolution strategy tied to the resolution of the major commercial banks.**

He has written extensively on economic development focused on these three subjects. He has taught for some eight years as an adjunct at Johns Hopkins School of Advanced International Studies (SAIS) on structural adjustment in the Former Soviet Union and Eastern Europe.