

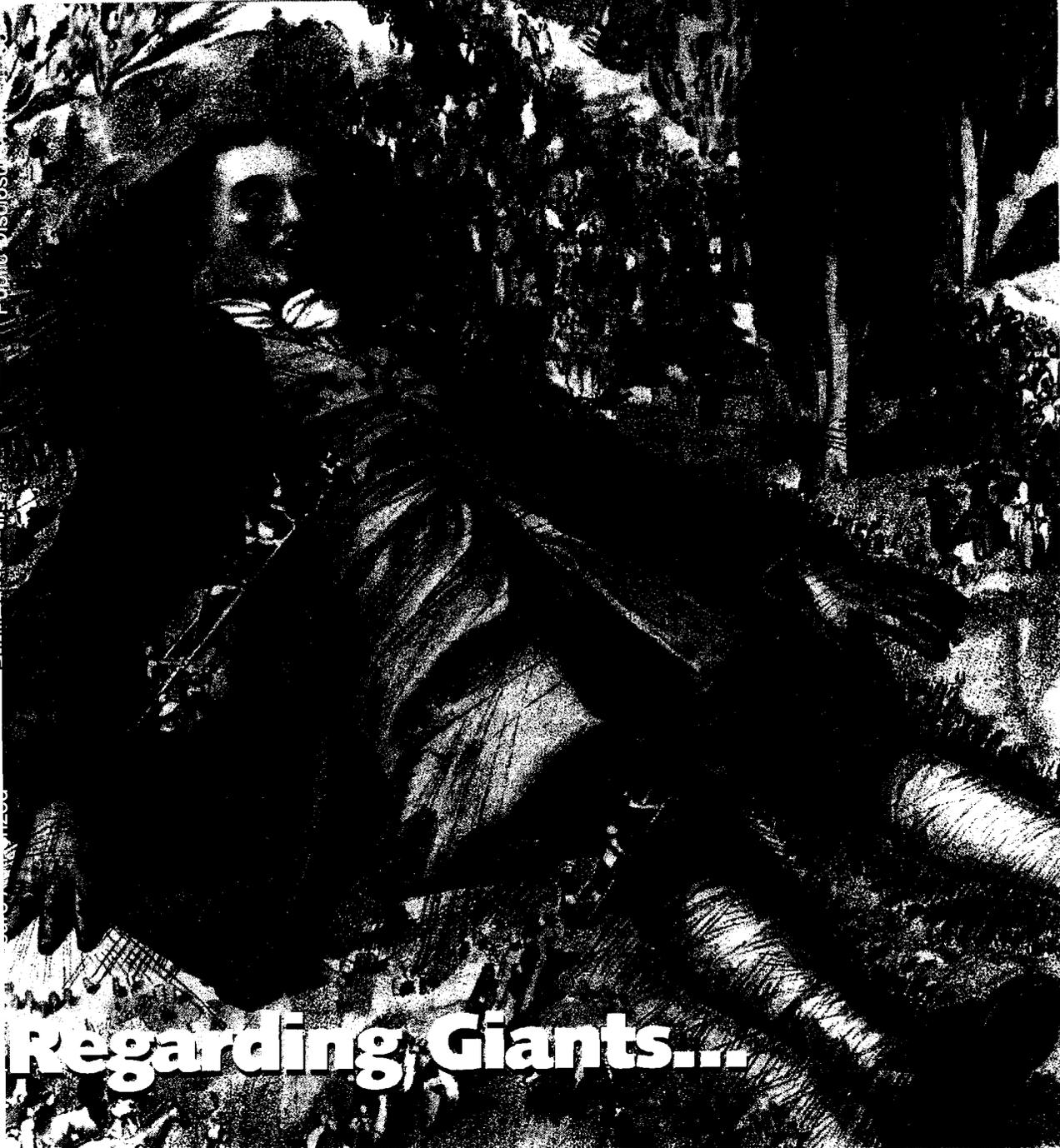
IFC

Investment in Developing Countries

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Sum



Regarding Giants...

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Mailbag

To the Editor

How to House the Mongols?

I recently read the spring issue of *Impact* and found there an article about a private housing project in Mexico City. This story has attracted my interest very much.

As you know, Mongolia is currently in a period of transition to a market economy. After our democratic revolution in 1990 the old society structures collapsed, and now we have just started our recovery in a new form. In our country many donor agencies and international organizations are conducting various kinds of activities such as implementing projects, making investments, and conducting technical cooperation. But, in my mind, the only clear activities are in the housing sector.

Currently in Mongolia there are some private construction companies, but they are mainly putting up large-scale public apartment buildings, according to the old traditions. There have been some initiatives by individuals to build their own houses (two-story, like modern Western cottages), but building modern cottages in Mongolia is very expensive.

Mongolia has quite extensive forest resources, but most of our timber is being exported to neighboring countries such as China, Russia, Japan, and South Korea. A container (train container with volume of 20–40 tons) of wood is exported to China for \$150

and then is re-exported by Chinese companies to Japan and South Korea for \$250. Since the export price is so high, the domestic market rate for wood is expensive: approximately \$100, or the equivalent of two months' salary for a Mongolian government official. So most logging companies tend to export their products rather than sell in the domestic market.

In connection with this trend, the rates of illegal logging in forest areas are soaring.

Exports of wood are obtaining some support in legislation in the Mongolian Parliament, while other building materials are being imported from China and other countries. Since the materials are imported, they of course are expensive and some of them do not meet household environmental safety standards. So, having one's own cottage in Mongolia is not something available to ordinary residents. It is only for rich people. This trend is wrong, but is left out of our legislators' consideration.

Thank you very much for giving me most useful information and advice.

Ts. Munkh-Khuyag
Mongolian News Agency
Ulaanbaatar

Song of the Volga Insurance Man

I'm the head of the investment bureau of the insurance company "AstrO-Volga," and a subscriber to your very useful magazine. Thank you a lot.

I've recently changed my work from the Nonstate Pension Fund of AVTOVAZ to this insurance company.

Thank you once more, and all the best.

Krainiukov Nikolai Ivanovich
Togliatti,
Russia

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But we might edit them.*
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Ant Steps

Can Broader Be Better?

Handpicking their way through a host of unrelated industries, local conglomerates dominate in many developing-country private sectors. For better ... or for worse?

by Erik D'Amato

To many economists and corporate strategists, the East Asian financial crisis offers final proof that multi-industry business groups are counterproductive — destroying shareholder value while stunting economic development. But other experts challenge this conventional wisdom, arguing that broad diversification still has important benefits in the context of developing countries.

One need not be a conspiracy theorist to believe some have benefited by, perhaps even relished, East Asia's continuing financial woes. There are the foreign exchange traders who made bundles betting against sinking currencies, the local exporters whose competitive positions have risen dramatically, the cash-heavy investors who have suddenly found themselves awash in attractive buying opportunities. And, of course, there are those economists, consultants, and other assorted analysts who had long suspected that key parts of the Asian "miracle" were in fact less miracle than mirage, perhaps even a rigged game built on political favoritism, poor governance, bad loans, and perpetual overcapacity.

For many skeptics of the Asian miracle, and more than a few of its champions, the region's most troubling characteristic has been the dominant role of its conglomerates — diversified business groups, often family controlled and involving a banking group, that sprawl across multiple product markets. The best known are Korea's immense chaebol such as Hyundai, Samsung, and Daewoo. Once loved, they have lately been seen as the evil eye of that country's

financial storm — unaccountable empires that subordinated profitability to expansion and genuine business acumen to political connections. Taking advantage of Korea's easy-credit atmosphere, they long carried some of the world's highest debt-equity ratios, in some cases claiming more than 30 diverse subsidiaries under their corporate flag, simultaneously getting themselves into everything from electronics and autos to insurance and construction. But when the lax lending came to an end last year amid the country's banking meltdown, their weak foundations were revealed. Now the top three are making unprecedented layoffs and trying to sell more than \$17 billion in assets by the end of the year to scale back into fewer key industries.

Similar gangly, dangly corporate octopi are also common in Indonesia, Malaysia, India, and elsewhere around the world. "The Japanese call it keiretsu; the Koreans say chaebol; the Russian word is semibankirshchina, and the Americans label the cozy arrangement among industrialists, bankers, and government officials crony capitalism," writes influential *New York Times* columnist William Safire. "No matter what you call it, the system now roiling Asian finances is seen to be a perversion of the open market that is the essence of real, trust-busted, unfettered free enterprise."

Safire's disdainful equation of conglomerates with corruption and unhealthy business practices is echoed by many developed-country officials, economists, bankers, traders, and management gurus. In short, diversification is out in the US, and increasingly in Western Europe as well; focus — the belief that a company should stick to narrow areas of core competence — is in.

How Small Got Big

Lying behind today's anticonglomerate sentiment is a belief among many Western analysts that corporate diversification has failed in developed economies or is at best a lesser business strategy. Ever since the US heyday of large-scale diversification three decades ago, Wall Street has steadily soured on the practice, and spin-offs and splits have become a hallmark of the shareholder value-driven 1990s. "When US firms first diversified, investors liked it, and stock prices went up," says John Matsusaka, professor of finance at the University of Southern California. "But after 10 or 15 years, investors who were pricing firms discovered that diversification wasn't working. And if you look at the evidence now, it is clear that two-thirds of highly diversified firms do not do well."

Why diversification didn't last in the US is no mystery, say Matsusaka and others in his camp. Its complex corporate structures hindered innovation, misallocated capital, and shielded unprofitable subsidiaries from the painful but necessary "creative destruction" wrought by functioning markets. Subsequent breakthroughs in wholesale and retail capital markets brought new financing options to promising start-up firms and allowed investors to spread their exposure across different industries. The twin forces of globalization and domestic deregulation also subjected even the sleepest industries to ferocious competition.

Ultimately, diversification led to open conflict between increasingly aggressive shareholders concerned only with returns and self-centered CEOs more interested in maximizing their own power, prestige, and compensation. In the end, the shareholders won. Owen Lamont of the University of Chicago is a long-time student of US conglomerates. His verdict: "We value focus now because managers in conglomerates felt insulated from external markets and were thus inefficient."

A Developing Exception

So thoroughly has diversification's star fallen in the developed world that even some of its harshest critics say the anticonglomerate sentiment has become unrealistic. "It has gone too far, especially in the academic literature," says Matsusaka. "People are forgetting that diversification can work for some companies."

One voice determined to help people remember this point, or perhaps understand it for the first time, is Tarun Khanna, an associate professor at Harvard Business School. In papers, speeches, and seminars around the world, Khanna and his Harvard colleague Krishna Palepu have recently been challenging the conventional thinking on this topic, especially when applied to developing countries. A driven researcher, he has scrutinized conglomerates from Chile, Mexico, Turkey, India, Korea, Thailand, Malaysia, and elsewhere through incessant travel for company visits in recent years. He concludes they are not as destructive as many US academics and elite management consultants maintain.

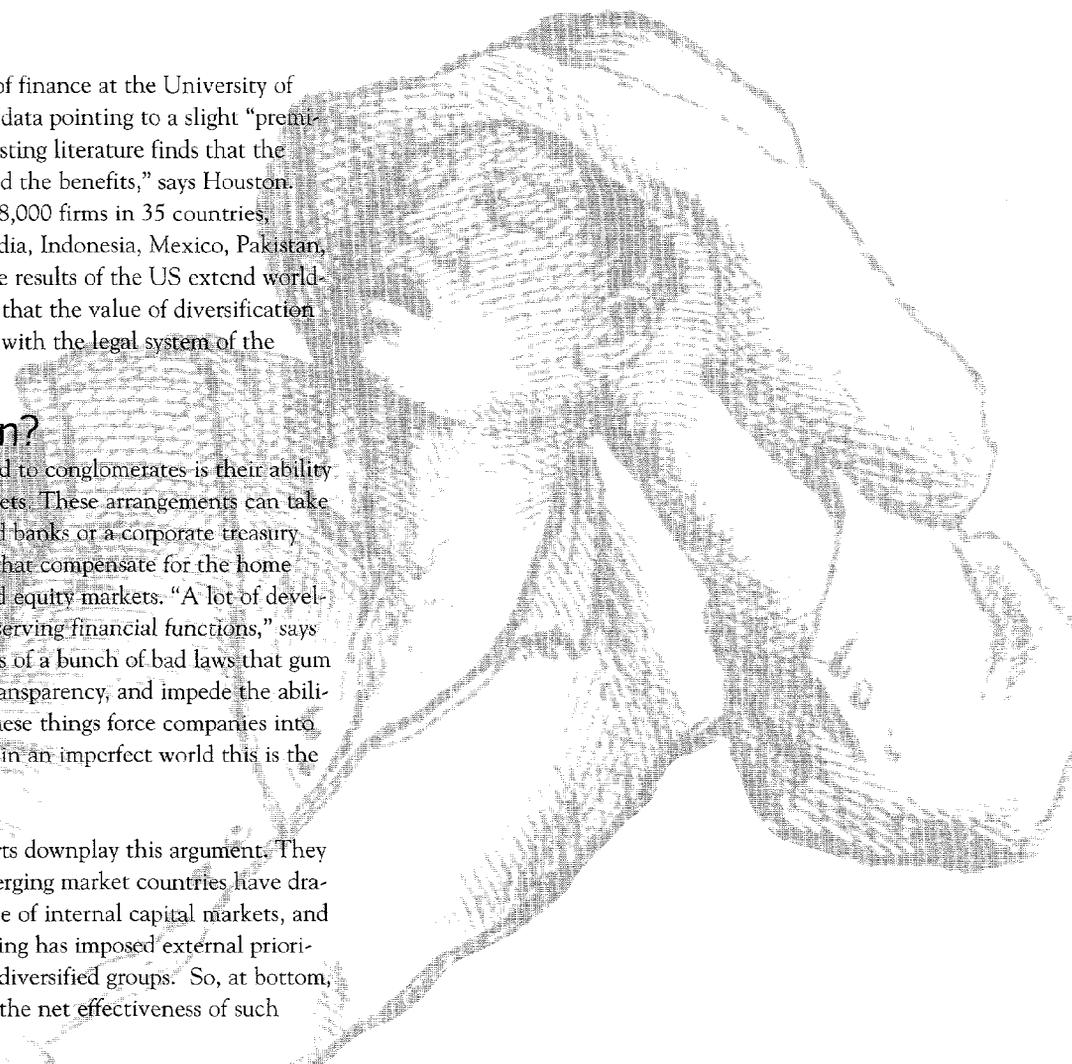
"Being an Indian, and having spent time in a lot of different developing countries, I thought this antidiversification mindset didn't seem to square with reality," says Khanna, who grew up in New Delhi and Mumbai but has lived in the US since 1984. "Instead, it

seemed that many diversified entities were responding sensibly to aspects of the environment in which they found themselves, but which did not characterize the environment one sees in advanced economies."

No apologist for poorly run companies of any kind, he prefaces his argument by stressing some fundamental points. First, he says, conglomerates are ubiquitous throughout the world, with the focus-minded US being the exception rather than the rule. Second, the reasons they exist vary from country to country. "In Russia," he points out, "it is the absence of law and order. In India and many other countries, information problems are key — the lack of efficient intermediaries, analysts, good reporting systems, and other institutions that allow markets to function well." Also, he says, the abuses now commonly associated with developing country conglomerates — corruption, lack of transparency, poor treatment of minority shareholders — are not inevitable products of diversification itself. Most important, conglomeration, while imperfect, is almost always a rational response to an imperfect business environment.

While the structure and strategies of developing-country conglomerates can and do differ widely, Khanna says it is important to remember that they usually bear little resemblance to the organization of the US diversified corporations that remain, such as General Electric (owner of banks, refrigerators, the NBC television network, aircraft engines, medical equipment, and more). While their exploitable synergies may not be immediately obvious, such organizations have a single overarching company and publish transparent consolidated financial statements indicating the status of each asset. "The structure you often see in emerging markets, on the other hand, is the business group," stresses Khanna. "It is often not a legal construct." This loose structure, which frequently includes different units publicly listed in their own right, is often bound by a common family and interlocking directorships. In many ways, Khanna points out, the best developing-country business groups have characteristics not only of conglomerates but of US leveraged buyout (LBO) funds, with each of their assets legally distinct and bound by strong restrictions limiting cross-subsidization. "Depending on which aspect you emphasize, people's reaction can be very different. If you say a business group is a conglomerate, people yell, 'Break it up!'" he laughs. "But if you say it's an LBO firm, they say, 'Ah — excellent.'"

While it is precisely the "informal" connections linking such groups that put off many critics, others stress that those connections are the outcomes of rational decisionmaking by executives with intimate knowledge of their home markets. After all, the business environment in most developing countries is far from merely imperfect — in many cases, it is also dangerously volatile. "The way companies evolve in developing countries is very survivalist," says Mark Agnew, director of emerging markets corporate bond research at Lehman Brothers. "These economies can move quickly and an entire company can be wiped out. So companies might want to be invested in industries that, for example, do well in both high-inflation environments and in downturns. The effect of all this is that to survive they get diversified."



Joel Houston, associate professor of finance at the University of Florida, has even found empirical data pointing to a slight "premium." "For the US most of the existing literature finds that the drawbacks of diversification exceed the benefits," says Houston. "What we are doing is looking at 8,000 firms in 35 countries, including Brazil, Chile, China, India, Indonesia, Mexico, Pakistan, Thailand, and Poland, to see if the results of the US extend worldwide. And what we have found is that the value of diversification varies across countries, correlated with the legal system of the country."

A Bank of Our Own?

The most customary value ascribed to conglomerates is their ability to provide "internal" capital markets. These arrangements can take the form of either closely affiliated banks or a corporate treasury open to the group's various units that compensate for the home country's lack of efficient debt and equity markets. "A lot of developing country conglomerates are serving financial functions," says Matsusaka. "The story, in short, is of a bunch of bad laws that gum up the capital markets, prevent transparency, and impede the ability of people to own shares. All these things force companies into relationships with banks, because in an imperfect world this is the best way to get capital."

But many prodiversification experts downplay this argument. They cite the fact that a number of emerging market countries have draconian legal restrictions on the use of internal capital markets, and that in others, state-directed lending has imposed external priorities on the internal operations of diversified groups. So, at bottom, few conclusions can be drawn on the net effectiveness of such internally sourced financing.

"A lot of what happened in Korea and Southeast Asia has to do with the fact that industrial policy made the cost of capital artificially cheap," warns Francisco Larios, senior emerging-markets economist at Standard & Poor's DRI, a US-based risk analysis and economic forecasting firm. "And this in turn created excessive diversification to areas where firms were not efficient and not capable."

Likewise, experts debate the value of diversification in overcoming inefficient product markets. Cross-branding unrelated industries (that is, putting the same corporate name on trousers, tractors, televisions, and tea) can add value, but only if the corporate identity is widely considered gold and if the markets for the products themselves are not significantly price sensitive. Developing internal information networks that bypass or surpass slow and unreliable external services will add value only when the information being shared itself has inherent worth.

Another area of potential benefit derives from the acquisition or development of units capable of supplying the entire group with superior inputs and services. James Champy, chairman of consulting at Perot Systems, the global computer services company, and coauthor of *Re-engineering the Corporation*, says that the unreliability of potential suppliers can make such moves toward vertical integration very attractive. "At my previous firm we were trying to acquire computer services companies in a number of developing



markets in Southeast Asia, and what we found was that there weren't many candidates to choose from," says Champy. "A developing-country business could find itself compelled to take this activity in-house."

A marked benefit of diversification also comes from the attractiveness it offers to foreign firms. From the earliest days, multinationals looking for foreign partners in developing countries have often found comfort in a local diversified group, which can become a key conduit for two essential components of the private sector development process: technology transfer and foreign direct investment.

Much reassurance can also come if the conglomerate has already gained credibility by doing business with many other large foreign companies, and therefore has much to suffer if it treats any of its partners badly. "If a Procter & Gamble is looking for a partner in China, they would rather have it be a Hutchinson Whampoa than a more focused firm," says John Godfray, a Hong Kong-based analyst specializing in conglomerates for Dresdner Kleinwort Benson.

"If conglomerates are so inefficient, why will focused multinationals always partner with them?" asks Khanna.

The Connections Connection

One answer to this question involves the final, and most controversial, perceived benefit of the developing-country conglomerate: that it is the best vehicle for overcoming — and, some argue, unfairly colluding with — heavily interventionist regulatory regimes.

This issue, which combines regulation, connections, and corruption, is not something prodiversification analysts are afraid to discuss. Instead, they view it in practical terms, as just another market failure that firms must seek to rationally overcome. Denied the ability to grow in one industry, often by antitrust regulation, many businesses find that the size needed to be a political player or to open and staff an "industrial embassy" in a far-off national capital, for example, could only come through broad diversification.

And Khanna stresses that recognizing this and other unsavory realities in no way means denying their social cost or accepting that they are the only, or even primary, benefit of diversification. "I'm completely in agreement with the view that there is no room for corruption in an efficient allocation of resources, and that in many countries corruption is an important cause of these business groups," he says. "However, removing corruption is not tantamount to getting rid of diversified business groups. Some groups in India and Chile, for example, are squeaky clean, while for others political relationships and rent seeking are a *raison d'être*."



Judged and Found Wanting? Some experts question the rush to judgment for corporate giants in the developing world.

Bye Bye, Love?

The debate becomes most urgent when it takes up the question of "unbundling." With multibillion-dollar behemoths such as ITT and Gulf & Western in the US and Hanson in the UK having been successfully broken up and reborn as nimbler entities, many influential economists now urge developing-country governments to make breaking up diversified business groups a priority.

Others, including some skeptics of diversification, are urging caution here. John Godfray of Dresdner Kleinwort Benson warns that as China reforms and sells off its state-owned enterprises, focus should not be an overriding priority. "Single-industry operations are much more likely to be wiped out, which could lead to the more rapid failure of firms and enormous social unrest," he says.

Many think that the wave of globalization and internal liberalization will slowly but inexorably eat away at the rationale for diversification, just as in the US. "If I look ahead," says Anil Gupta, a University of Maryland profes-

sor who both advises top Western corporations and closely watches conglomerates such as A.V. Birla, Tata Group, RPG, and Reliance in his native India, "I would say that there is a fairly clear trend towards opening up and liberalization of both capital markets as well as product markets, and that's true whether we take South Korea, India, Mexico, or Brazil. And both of these liberalization trends would tend to work against the conglomerate form of organization."

As he assesses the head-spinning changes of recent times and looks to the future, Gupta speculates: "What happened in Chile in 20 years may in another market now take only five."

"It's clear to me that to move forward these companies will have to divest and focus on their core competencies," adds Francisco Larios of Standard & Poor's DRI. "Whether or not they should is an academic question. They will."

But for every supporter of disbanding, there may be a skeptic. In a recent commentary on Russia's "financial industrial groups," the *Financial Times* warned that "the role of their Asian equivalents, Japan's keiretsu and Korea's chaebol, in the recent Asian financial crisis certainly does not make the model one to follow. But in a country with a byzantine political system and limited access to capital and skilled labor, the evolution of such group structures is perhaps inevitable." The same publication also wrote that India's largest conglomerates are "starting to recite the mantras of shareholder value," but cautioned that "the main beneficiaries of this desire to re-evaluate core activities to date have been management consultants rather than shareholders." While conceding that Tata Group and others in India had begun exiting a few de-emphasized industries, the respected London newspaper said that "rhetoric has so far run ahead of reality" and that "no big industrial group has yet disentangled the web of corporate shareholdings which bind group companies." Noting that after shedding some domestic assets, such business groups often quickly entered others, the newspaper warned that India "could witness a new generation of empire building — and talk of focus could yet prove to be a fad."

Khanna, for one, doubts major change will come quickly, and he is not necessarily sure it would be a good idea in any case. For one thing, he says, disbanding is enormously expensive, and in many developing countries there are regulatory barriers to shutting businesses down. And, he says, the data simply do not show that diversified groups are losing their advantages, even in the most "developed" emerging markets. "It is not clear that disbanding is the best way to respond to changes in the market," he says, "and my colleague Krishna Palepu and I have now amassed empirical evidence from India and Chile that econometrically shows that those groups that are not disbanding but strengthening are doing better."

Most important, Khanna says, is the fact that, even given the global march of liberalization, the many market failures that make diversification pay are easier to talk away than actually fix. "The way out of this situation conceptually is very simple, and practically very difficult. Conceptually, developing-country governments should be in the business of encouraging specialized intermediaries and forcing accountability, transparency, and minority shareholders' rights. In practice," he says, "the governments are unable to do this, or are beholden to existing interest groups and thus unwilling to do it, or, more likely, both. And it may be a mistake if conglomerates — including the Korean chaebol — are unbundled forcibly without the simultaneous development of the stand-alone institutions and practices that make markets work, such as those that support corporate governance and protection of shareholder rights, stronger enforcement mechanisms for legal and regulatory standards, and higher standards for disclosure of corporate information. ■

Erik D'Amato is managing editor of The Prague Business Journal.

Anil Gupta,
University of Maryland,
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Tarun Khanna,
Harvard University,
USA



Whale in a Swimming Pool

That's how Intel Corp. once thought it would seem if it built a \$300 million computer chip plant in tiny Costa Rica. And therein lies a tale...

By Debora Spar
Harvard Business School, USA



On November 13, 1996, the US computer industry giant Intel Corp. announced plans to construct a \$300 million semiconductor assembly and test plant (ATP) in Costa Rica, a plant that was to have up to 2,000 employees and within two to three years be fully manned and staffed by Costa Ricans. The announcement came as a triumph to Costa Rican authorities, and also aroused considerable interest in the broader foreign investment community.

With annual revenues of more than \$25 billion, Intel is one of the world's largest and most profitable corporations. Costa Rica, meanwhile, is a tiny country, with a population of 3.5 million and only limited development in electronics and other high technology sectors. So why, and how, did Intel choose Costa Rica?

Costa Rica (like many developing countries) explicitly targeted the electronics sector as an area of high potential growth. Like other countries, it also set its sights on increasing flows of foreign investment to the country and created an investment promotion agency to attract and convince potential investors. But whereas other

countries have seen industry-specific promotion efforts stagnate or stumble, Costa Rica appears to have succeeded quite brilliantly.

Thus the Intel investment provides a compelling platform to discuss how countries can gradually improve their climate for foreign investment and the design of their investment promotion strategies. Intel's decision to invest in Costa Rica serves as a rich example of how a small country with no domestic market can still lure a world-class, high technology firm.

Decision to Expand

In 1971, the Intel Corporation introduced the 4004 chip, the world's first microprocessor. This introduction revolutionized the computer industry and set off the phenomenal growth that both the industry and Intel have enjoyed ever since. In 1995, the world-wide production of computers was valued at \$237 billion, up 13.5% from the 1994 total. Semiconductor sales alone were valued at \$123 billion and were predicted to continue growing at 20% a year between 1995 and 2000. These growth figures are driven by the diverse and increasingly pervasive applications of microprocessors, the advanced and complex semiconductors that form the core of Intel's business.

Essentially, microprocessors are the "brains" that drive most electronic computing functions. They are integral to the function of mainframe computers, personal computers, wireless communications, and a host of consumer electronics products. Because of their growing applicability, microprocessors are generally regarded as a key component of industrial growth — and a symbol of economic and industrial prowess. Thus, although firms from the US and Japan continue to dominate the industry, the governments of Korea, Taiwan (China), and Singapore have all actively supported the development of their home-grown semiconductor companies, and China, Ireland, Israel, and Malaysia have eagerly pursued investment from leading foreign firms. For developing countries, the semiconductor industry carries perhaps the ultimate promise of positive externalities — of jobs and technological innovation and the kind of long-term returns that have made Intel one of the most profitable companies in the world. Intel's distinctive position in the semiconductor industry has led it to pioneer an equally distinctive strategy for operations and investment. Essentially, the strategy is driven by cutting-edge technology and blistering speed. Every nine months or so, Intel builds a new plant. Nearly all of these plants are constructed to meet future, rather than existing, demand. As CEO Craig Barrett acknowledges, "We build factories two years in advance of needing them, before we have the products to run in them, and before we know the industry's going to grow."

Such optimism is rational, even required, in the fast-paced semiconductor market. For this is an industry where producers reap the bulk of their profits early, usually in the first six months following a product's introduction. During that time, manufacturers can charge up to \$1,000 per chip. After six months, however, lower-cost imitations tend to exert significant downward pressure on prices, customarily pushing them toward around \$200. For Intel, this basic cycle implies a constant need to innovate, and to ramp up production capacity as quickly as possible for each new generation of processor.



Intro to Intel

Within the semiconductor industry, Intel's position is legendary. With 85% of global microprocessor sales, it is by far the world's leading producer. In 1997, Intel recorded revenues of \$25.1 billion and net income of \$6.9 billion. The company's average return to investors has been roughly 44% a year; its cutting-edge chips were selling in early 1997 at gross profit margins of nearly 60%.

Even more impressive, though, than Intel's numbers is its undeniable position as the industry's technological and strategic leader. Nearly since its founding in 1968, Intel has been the first to introduce the latest and fastest lines of microprocessors. Driven by cofounder Gordon Moore's well-known "law" that the power of these computer chips doubles every 18 months, Intel has consistently created successive generations of ever more powerful chips. Its competitors, meanwhile, simply follow Intel's engineering lead, imitating new designs (called "architectures" in the trade) without having to invest the massive research and development funds that support each Intel launch. These competitors then compete with Intel almost exclusively on price. And as this rivalry inexorably drives its own prices and margins down, Intel moves on to the next generation of processors.

In recent years, Intel has also worked aggressively on the demand side of its industry. Rather than risking a downturn in demand for its new, more powerful chips, Intel encourages other companies, such as Microsoft, to design software that requires faster processing capabilities. This encouragement creates a unique but profitable dynamic, described by one Intel executive as akin to "a wrestling match and a dance that occur simultaneously." Intel helps create the demand for its product and enables its partners to share in its extraordinary success. In 1996, the company spent \$500 million to fund software start-ups and to prod the development of other potential users of new-generation microprocessors. This investment came on top of its own \$5 billion expenditure for capital projects and research and development.

— Debora Spar

Costa Rican GDP: \$9.0 billion
Intel Annual Revenues: \$25.1 billion

This logic of expansion has also led Intel to develop an impressive string of overseas facilities. By the time it began contemplating what would become an investment in Costa Rica, the company already had wafer fabrication plants in Ireland and Israel, and assembly and test plants in Malaysia, China, and the Philippines.

Early in 1996, executives at Intel decided to research sites for a new assembly and test plant. They convened a team of functional experts, composed primarily (though not entirely) of people who had significant experience with site selection.

Intel executives had already determined the precise contours of the planned investment. It was to be a plant of 400,000 square feet, employing up to 2,000 people to assemble and test the latest Pentium microprocessors. This type of plant, known as an ATP, is the second type of plant that constitutes Intel's manufacturing base. The first type, a fabrication plant (or fab) is where the heart of the microprocessor is produced. Essentially, fabs take thin layers of silicon, known as wafers, and use a highly advanced process of photolithography to etch layers of electronic circuitry on each eight-inch wafer. This process requires an ultraclean environment and staggering levels of capital and technical expertise. Once the fab process has been completed, the wafers are sent to the ATP. There, the wafers are thinned to reduce internal stress, then cut into anywhere from 300 to 500 individual chips, or integrated circuits. The chips are then mounted onto a lead frame and attached to thin gold wires that will eventually connect them with the other elements of the computer. In the final stage of the manufacturing process, the chips are encapsulated in either ceramic or plastic packaging and subjected to a rigorous series of tests.

To run the new ATP as cost effectively as possible, Intel knew it had to find a low-cost yet highly trainable workforce. It would also have to find a spot where highly qualified engineers were available, and where employee turnover could reasonably be kept to a minimum.

Underdog

In these early days, Costa Rica was not seen as a particularly strong contender. It had gotten on the list, in fact, almost by accident. For two years, investment promotion agency CINDE (la Coalición Costarricense de Iniciativas para el Desarrollo) had been actively targeting and approaching large, U.S.-based electronics firms. In the

Open for
5 to 6 years, Intel
plant in Costa Rica
is now the largest
microprocessor
assembly and test
plant in the world.



late 1980s, CINDE had decided to follow a focused strategy of investment promotion, marketing itself to a specific group of potential investors, rather than spreading its fairly limited resources across a hodgepodge of ambiguous leads. For several years, this focus had been textiles, but as Costa Rican wage levels rose and competition from lower-wage emerging markets mounted, CINDE abruptly shifted out of textiles and concentrated instead on electronics. With a high level of technical knowledge in the country, relatively low labor costs (for this industry), and an abundance of bilingual workers, Costa Rica's advantages seemed to mesh well with the needs of the growing global electronics industry. And so, ever since 1993, CINDE had been assiduously courting Intel and the other "big fish" of the electronics industry.

In November 1995, Intel at last responded with interest and invited the current director of CINDE's New York office, Armando Heilbron, to its headquarters in Santa Clara, California. Almost immediately after hearing of Intel's interest, Enrique Egloff, CINDE's CEO in Costa Rica, assigned three investment officers exclusively to the project. It was several months after the first meeting in Santa Clara, and after CINDE staff sent Intel a detailed and extensive information package that Costa Rica made it onto Intel's long list of possible investment sites along with Argentina, Brazil, Chile, China, India, Indonesia, Korea, Mexico, Puerto Rico, Singapore, Taiwan, and Thailand.

The Intel team began with basic desk research, looking for obvious reasons to exclude countries from the list.

To be considered a serious contender, the country in question had to have positive economic conditions, an established and reliable political system, and a relatively transparent operating and legal environment. It also needed a sufficient supply of professional and technical operators and a nonunion work environment.

Countries also had to present a workable financial situation for Intel. This was driven in large part by the cost of labor and overhead, taxation rates, tariffs, customs fees, and the ease of capital repatriation. Because all the plant's products were intended for export, tariffs and customs fees were particularly important.

Given the time pressures under which Intel generally operates, the country also had to ensure that products coming from its plants could move efficiently from the plant to an international departure point and then expeditiously through customs and any other export procedures. Before investing in any country, Intel had to be assured of receiving all necessary permits within four to six months. Any delay in the permitting process could seriously compromise the project's very tight schedule.

On the basis of these rough criteria, team members slowly winnowed down their list. By the end of this process, the original list of 12 had been narrowed to four: Brazil, Chile, Costa Rica, and Mexico.

During the spring of 1996, Intel's site selection team went directly to visit the countries under consideration, seeking to glean an

"insider's" perspective on business conditions and state practices within each potential host. Team members conducted lengthy interviews with consulting firms, government officials and other US corporate executives. They met with accounting and law firms, ran in-depth analyses of key factors such as work force capability and waste water infrastructure, and tried to solicit the opinions and experiences of other foreign investors.

Costa Rica received its first visit in April. The two-day tour began with an overview presentation by CINDE, which also coordinated many of the subsequent meetings. The Intel team then spoke with representatives from Citibank to inquire about the adequacy of the country's financial infrastructure, and with executives from international accounting firms KPMG Peat Marwick, Price Waterhouse, and Ernst and Young to examine the reliability and transparency of Costa Rica's legal and financial institutions. Closed-door meetings with enthusiastic executives of DSC Communications, the largest US electronics company with operations in Costa Rica, as well as with several other manufacturers, apparently gave the Intel representatives additional confidence in the country's general business climate and its capacity to process and convert weekly flows of several million US dollars.

Presidential Push

During this preliminary visit, CINDE had also arranged for the site selection team to meet with José Rossi, Costa Rica's minister of foreign trade, as well as with José María Figueres, the country's president. Since November, Figueres had been kept informed of CINDE's interaction with Intel and had continually expressed interest in helping with the project. The young, Harvard-educated Figueres, in the middle of his presidential term, was keenly aware of the potential impact Intel could have in helping to lead the country's growth. He took a strong personal interest in relations with Intel, and was a critical element in Costa Rica's eventual success. During the initial visit, he spent two and a half hours with the Intel representatives, during which he pledged to "do whatever was necessary" to make Costa Rica competitive in the race. He was engaged, enthusiastic, and energetic in his pitch and responded directly to Intel's concerns. When the team expressed doubts about the quality of the work force and the adequacy of technically trained graduates in the country, Figueres suggested that the government could create an enhanced training program to meet Intel's needs.

In what would become a critical move, Figueres appointed Rossi to manage the Intel project for the Costa Rican government. CINDE would remain a key contact for Intel and a facilitator for any sub-sequent meetings or negotiations, but Rossi, a high-ranking and well-respected government official, would serve as the central point of coordination within the Costa Rican government. Rossi impressed the visitors, who appreciated his active involvement and understanding of the firm's business needs. Rossi himself had been a businessman, running a sizable family-owned holding company before he joined the Figueres administration. He recognized the importance of speed and the need for an expedited process and clear, consistent communication from the government.

Areas of Concern

Over the next several months, Intel representatives visited Costa Rica every week. There were different representatives each time, and different concerns to address, but CINDE remained the lead agency throughout the visit and negotiation period, ushering Intel executives around the country and working to find, or create, mutually acceptable solutions to each of their concerns. By July, the Costa Ricans knew that Intel's short list was down to only two contenders, themselves and Mexico.

This last stage of the process was in many ways the most intense, both for Intel and for CINDE. During this time, several major concerns emerged. The first was simply Costa Rica's size, especially compared to a behemoth such as Intel. Company representatives worried that Intel would overwhelm the country and would demand an unsustainable fraction of Costa Rica's total resources. Robert Perlman, Intel's director of finance, expressed concern that Intel's investing in Costa Rica was akin to "putting a whale in a swimming pool." Intel still saw other problems in Costa Rica: its physical and educational infrastructures were inadequate, and the financial terms of the proposed investment were less favorable than those being offered elsewhere. To close the deal, Costa Rica had to address these problems.

Infrastructure

Intel's problems with Costa Rica's infrastructure lay primarily in the transportation sector. To meet the demands of its market, Intel's new facility would be designed to use inputs from any fabrication plant in the world and to send products, by air, to any customer. While Costa Rica's location was very attractive in this regard, with access to California or Texas in under three hours, Intel was worried about the frequency of flights and the capacity of San José's airport.

Although the overall size of Intel's shipments would be small (about 18 tons/week), they needed to be divided into many batches and sent on several different flights. This was due to the insurance requirements that surrounded the transport of a cargo that was, quite literally, worth its weight in gold. Thus the volume capacity of flights into and out of San José was not as important to Intel as the number of flights and their destinations. And here Costa Rica fell short. While there were a number of daily direct flights to Los Angeles, Houston and Miami, there was only limited direct access to Europe and no direct access to the Far East.

Roads were also a source of some concern. The Intel site will be located close to the country's main international airport, along the highway linking the center of San José with the airport. The problem did not lie with the quality of the highway, which is more than adequate; rather the access to the main road from the planned location was indirect and convoluted.

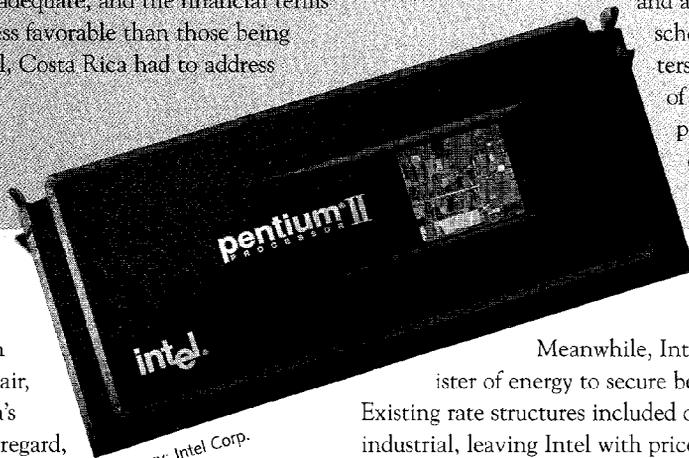
As it became clear that transportation issues could stymie the investment, CINDE and President Figueres urged the Ministry of Transportation to find some way of accommodating Intel's needs. And they did. After gathering information and meeting with Intel, the Ministry agreed to grant more licenses to foreign carriers if it were necessary to ensure an adequate number of flights. It also apparently accelerated plans for a new cargo terminal, slated to open in May 1997. On roads, the two sides struck an easy compromise. Intel donated some of its own prime land to create an access road for its facility, while the Ministry agreed to improve access to the highway by constructing an overpass ramp, and to coordinate traffic patterns and public transportation schedules to make sure suppliers and employees had easy access to the facility.

Energy proved more troublesome. Even though Intel's projected share of total energy consumption fell from original estimates of 30% to a much more manageable 5%, the plant still demanded its own substation. And this substation had to be built and funded by ICE, Costa Rica's state-owned electric company. Initially, ICE estimated that construction on the substation could not even begin for a year and a half — clearly an unsustainable schedule for Intel. To expedite matters, Intel eventually agreed to cede all of the required land to ICE and to provide funding (through an undisclosed loan arrangement) for the additional power lines and substation. It also agreed to fund a second substation to serve a neighboring industrial park.

Meanwhile, Intel negotiated heavily with the minister of energy to secure better rates for the Intel plant. Existing rate structures included only two rates, residential and industrial, leaving Intel with prices of around \$0.07 to \$0.09 per kilowatt hour (kWh). For an energy-intensive facility such as an ATP, the difference between this rate and the \$0.02/kWh that Mexico offered put Costa Rica at a significant disadvantage. So the Ministry worked with ICE and its National Regulatory Authority to develop a two-tier industrial rate structure, giving larger users like Intel more favorable pricing. Under the new agreement, still pending final approval, the cost of power will drop to an average of \$0.05/kWh for any users consuming over 12 megawatts.

Financial Incentives

Costa Rica's standard investment incentives and tax policies under the free zone system are extremely attractive, offering investors such as Intel a full exemption from taxes on profits for the first eight years of operation, and a 50% exemption for the next four years. However, at the time of the negotiations, Costa Rica still levied a 1% tax on the total assets of free zone developers. Intel was extremely unhappy about this tax, since its total cost to the company would be substantial: roughly \$3 million for its proposed \$300 million facility. Complicating matters was the fact that the tax law had temporarily lapsed, leaving some uncertainty as to its application, especially since Intel intended to build on a site not previously developed as a free zone.



Courtesy: Intel Corp.

The government decided to seek an interpretation by the attorney general, who, bearing in mind the country's new objectives of attracting high technology, capital-intensive industries, concluded that the tax did not apply to companies under free zone status.

Education

Intel's most pressing concern, and Costa Rica's most interesting concessions, came in the area of education. Although education levels in Costa Rica were already substantially above the norm for developing nations, the country did not have the education infrastructure to support Intel's personnel needs — for example, to train the 800 technicians the plant would require. Both Intel and Costa Rica knew that this gap had the potential to be a deal breaker.

Well aware of this threat, CINDE and the government quickly launched a program to ameliorate Intel's concerns. A team consisting of Intel human resources staff, CINDE staff, the minister of education, the minister of science and technology, and officials from national institutions of higher education was formed to identify the gaps in Costa Rica's educational system and to submit guidelines for improvement.

The team spent considerable time matching the detailed personnel requirements from Intel against the curricula of the country's technical high schools and advanced training programs. In addition, a group of four professors from the Costa Rican Institute of Technology (ITCR) and two teachers from local technical high schools made a six-week trip to Intel facilities in Arizona, New Mexico, and California. By speaking at great length to operators and technicians at the plants, they sought to understand precisely the education and skills required to support an Intel work force.

Following this review, the team submitted a detailed and extensive list of recommendations to the Ministry of Education:

- ITCR would make this program available to either technical high school or academic high school graduates to update their technical skills and physics/chemistry competency on an as-needed basis.
- Graduates of the certificate program and qualified graduates of technical high schools would also be able to enter an additional one-year program designed jointly by Intel and ITCR. Initially, these programs would focus on semiconductor manufacturing, although they could be extended over time to include other career tracks as well.
- ITCR would provide intensive language training courses in Spanish for expatriates from Manila and the US, and English training to the first group of 50 technicians hired in Costa Rica. This is independent of the degree program and will be done directly on contract with Intel.

Urged by CINDE and President Figueres, the Ministry of Education approved all of the team's recommendations. ITCR began almost immediately to implement the new curriculum.

In the end, Mexico, which reportedly was the front runner, was compromised by its currency crisis and a system of mandatory union rules. For Intel, union-free in all its manufacturing facilities, the presence of a Mexican union might have created a significant culture clash within the plant and even within the company. Mexican authorities offered to make an exception to the rules for Intel, as it had for other major multinational investors. Yet their very offer made Intel wary of the way business policy was formulated in Mexico and ironically helped, in part, to eliminate Mexico from consideration.

Intel's Choice

And thus, on November 13, 1996, Intel announced its decision to build its next assembly and test plant in Costa Rica. As is customary with Intel, the announcement was conditional: it declared that the project would be located in the chosen country only if the government delivered on the provisions of an agreed-upon contract. In Costa Rica's case, these provisions included the completion of Intel's registration in an authorized free trade zone, the awarding of a series of environmental and construction permits, and a government commitment to enhance technical curricula and training facilities at several institutions for students studying electronics.

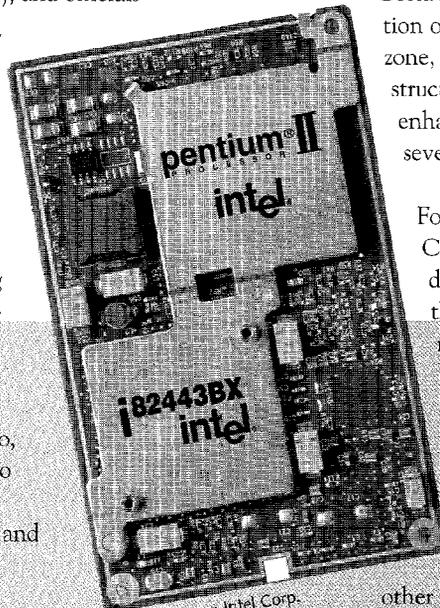
For the next several months, various ministries, CINDE, and Intel worked to prepare the relevant documentation and finalize the arrangements of their deal. In April of 1997, construction on the new ATP began, and by early 1998 it was in operation, projecting \$700 million in exports by the end of the year.

Lessons for Others

What, then, are we to conclude from this success story? What lessons, if any, can be applied to other developing countries, hoping to lure other high technology firms?

Right from the start, CINDE did not approach Intel just because the firm was big and rich and international, but because it understood that this firm's investment patterns had the potential to mesh nicely with Costa Rica's existing set of country characteristics. By the time Heilbron, now CINDE's CEO, had his first meeting with Intel executives, Costa Rica already had much of what Intel needed: a stable political system, a liberalized economy, an educated work force, and a developing electronics sector. This overlap was no coincidence. Costa Rica had chosen an investment promotion strategy that fit its existing competitive strengths, and CINDE had targeted companies, including Intel, that meshed with this promotion strategy. The lesson here is clear: choose targets that match your potential.

Once this target had been identified and approached, moreover, CINDE officials continued to do their homework. Even as the Intel site selection team was performing its due diligence, CINDE staff were conducting their own extensive research effort. They learned about semiconductors, they learned about Intel, they even learned about the intricacies of Intel's particular site selection process. This



Courtesy: Intel Corp.

Intel's Decision Process Timetable

Phase I – Prequalification

- *First Quarter 1996: Worldwide search to develop long list, for new \$300 million ATP.*
- *April 1996: Finalize short list. Make first site visits.*

Phase II – Site Research

- *July 1996: Reduce short list to two finalists: Mexico & Costa Rica.*
- *September 1996: Negotiate in principle with both countries and select single finalist.*

Phase III – Contingent Announcement and Delivery

- *November 1996: Announce investment contingent on the completion of final approvals and permits. Land optioned but not purchased.*

Phase IV – Start-Up

- *April 1997: Start construction, detail work flow, develop staffing, and obtain supplier and vendor support. Select plant manager.*

enabled them to meet Intel on its own terms and to conduct negotiations with a fairly detailed knowledge of what the company needed and how the country could provide it.

At a broader level, another lesson is that general country factors matter a lot, especially for a high-profile and long-term investor such as Intel. What drew Intel to Costa Rica, and what was vital in convincing the company to invest, were the basic characteristics of Costa Rica's political and economic system. The country is a democracy; it is stable, liberal, and generally committed to economic openness and progress. Its government's attitude toward private enterprise is basically facilitating, rather than harassing. It also has a fully transparent legal system.

A third lesson: Throughout the site selection and negotiating process, both CINDE and the government committee led by José Rossi were consistently well-prepared, well-informed, and eager to view their negotiations with Intel as a positive-sum game rather than an adversarial relationship. Aided by the personal commitment of the country's top leadership, CINDE was able to take a lead role in orchestrating Intel's interaction with all levels of Costa Rican government and society. Coordination was absolutely key, and CINDE was given the authority and capability to coordinate. It also had an enviable position vis-à-vis both government and business. Independent of the government, yet closely aligned with it, CINDE had an autonomy and independence of mind that were critical to its eventual success. These are attributes that could be adopted (albeit with local modifications) by other investment promotion agencies.

A fourth lesson concerns the earliest selection phase. All the things that Costa Rica subsequently did right, all of the factors that made the country a good fit for Intel, would have been utterly irrelevant if

Costa Rica had not appeared on Intel's long list of possible contenders.

So what does it take for countries that are not yet "on the map" to get there? The Costa Rica case suggests several possibilities. The first is marketing. While glossy brochures and investment promotion offices are clearly not sufficient to generate investment, they are one way to raise awareness of a country's potential and compel investors at least to take a look. Second, any objective publicity about a country appears exceedingly helpful. Stories of an economic boom, for instance, or a novel training program, or a successful privatization tend to catch the eyes and attention of potential investors. So do attractive tourist destinations, simply by exposing would-be investors to the virtues of a possible site. By contrast, reports of corruption or instability or political strife are likely to keep countries far from any investor's list of possibilities. Third, a preponderance of follow-the-leader investment suggests that attracting the first multinational is particularly critical to a country's longer-term success, for this investor is likely to bring not only its own capital and technology but also a dramatic ability to market the country to other investors. The first catch, therefore, is a big one, especially for a country with limited natural resources and a small domestic market. Efforts to land that catch — so long as they do not involve special deals or extralegal treatment — are almost certain to be well worth their while.

A final, more subtle, lesson comes from the detailed concessions and accommodations that Costa Rica eventually made to Intel. Costa Rica did not "sell out the state." They granted no special favors to Intel, no side deals or firm-specific concessions. But they did make major adjustments — at the airport, the schools, the free trade zones — to accommodate Intel's needs. But in doing so, Costa Rica was addressing legitimate problems of the company in order to secure the investment. Undeniably, there were concessions, but they were not unreasonable or capricious. Second, all the adjustments made were generalizable to other investors — and generally good for Costa Rica's economy. Investment in technical education, investment in infrastructure, a cap on taxes in the free zones areas: all are benefits that other investors will undoubtedly appreciate as well. And they will probably bring long-term benefits to Costa Rica's own development goals. ■

*Debora Spar is an associate professor at Harvard Business School. She is the author of the 1994 book *The Cooperative Edge: The Internal Politics of International Cartels*, which examines cartels in four international commodity markets: diamonds, gold, silver, and uranium. This article is condensed from her 1998 study for the World Bank/IFC Foreign Investment Advisory Service (FIAS) "Attracting High Technology Investment: Intel's Costa Rica Plant." Copies of the full study may be obtained free of charge by contacting Damien Shiels of FIAS (Dshiels@ifc.org, fax 202-974-4303).*

Illustration, p.8: Eric Westbrook

Different Kind of Banker, Different Kind of Bank

It's hard to argue with Muhammad Yunus' achievements in building the world's best-known microcredit institution, Grameen Bank. But like any high-profile figure, he has his critics. They say he receives too much limelight — that he collaborates too little with other organizations around the world in his highly specialized business of making tiny loans to the poorest of the poor. But whatever the case, there is no denying his track record.

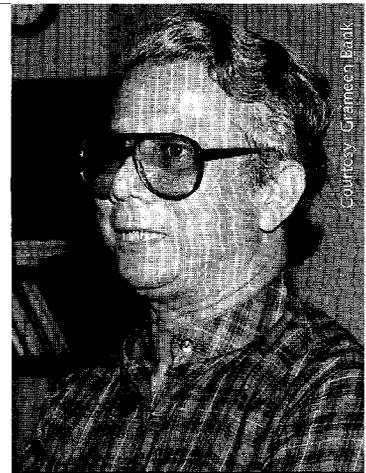
From the day 22 years ago that he first looked into the troubled eyes of a village woman and asked what, despite his comfortable lifestyle and secure teaching job, he could do to help, Yunus has been at the center of a unique development success story. It is one with a for-profit basis, one that believes people can work themselves out of poverty if only given a chance, that they can hire themselves even if no one else will hire them, so long as they have access to credit.

The well-documented ability of Grameen (named for the Bengali word for "rural") to fight poverty in one of the world's most impoverished countries has done more than anything else to legitimize the field of micro-finance, which now has a well-coordinated worldwide movement trying to reach 100 million of the world's poorest families by 2005. As Impact learned in speaking with Yunus in Washington, DC, pinning down the reason for that success is no easy task. Part of it may be the bank's relentless innovation and flexibility in organizing itself to work in the challenging setting of rural Bangladesh. Part of it may be the bank's co-op structure, where borrowers are called "members" and make up the key block of its shareholders. Part of it may be the desire to be only minimally profitable and return as much of its earnings as possible to those very

people. There are probably too many other parts to list. But, as a recent internal IFC analysis stressed, "the important thing is that the process as a whole works."

Lately Yunus has used Grameen Bank as a springboard into other innovative business ventures intended to create new opportunities for his country's rural poor. They typically start off with a nonprofit orientation and a desire to fill an important niche in the local development picture, but are intended to convert to for-profit status within a few years. The best established of these, Grameen Uddog ("Rural Initiative"), finances local women's purchases of yarns and dyes to weave on traditional handlooms, then links them with Bangladesh's thriving textile export business. The production capacity is currently a million yards per month, with more than 15 million yards of the fabric exported to date.

Although it has become increasingly active with commercially viable microcredit institutions in the last two years, IFC has so far not financed Grameen Bank itself. Instead it has targeted two of these emerging spinoffs, providing capital in their high-risk early stages when commercial bank support cannot be obtained. Two are now on IFC's books: GrameenPhone, a for-profit joint venture that brings modern communications into both big cities and unserved rural areas, and Grameen Shakti ("Rural Energy"), which will build, market, and sell small-scale solar and wind energy systems in areas far removed from the nearest power line. As Yunus makes clear in the following interview, all these efforts revolve around an unshakable personal commitment to fighting poverty from the bottom up — and an equally strong sense that the established order has little to offer those it has left behind.



Courtesy: Grameen Bank

On the record

Name: Muhammad Yunus
Title: Managing Director, Grameen Bank
Date of Birth: June 28, 1940
Country: Bangladesh
Size of Bank: Approximately \$100 million in equity; \$275 million outstanding loan portfolio; has lent more than \$2 billion to 2.3 million low-income borrowers in rural Bangladesh, 94% of them women
Began Commercial Operations: 1983
Loan Size: Average is local currency equivalent of \$160, but can range from \$1 or less to \$300 or more
Ownership: Grameen borrowers 93%, government 7%
Use of Loans: To finance ducks, cows, geese, basket-weaving material, and other inputs for self-employment projects of borrowers who otherwise would have little economic opportunity; also some housing loans
Business Strategy: Lends without collateral to small groups of peers, not individuals, via a system based on "mutual trust, accountability, participation, and creativity"
How It Works: If any member of the group defaults, all are cut off from new lending until the outstanding debt is repaid.
Repayment Rate: 98%
Number of Villages Served: 37,000
Number of Employees: 12,000
Portion of Borrowers Who Have Escaped Poverty: 33.3% (World Bank/Grameen estimate)
Definition of Credit: "The entry point for breaking the vicious cycle of poverty"

IFC and Grameen

GrameenPhone

Business

Installation of \$124 million nationwide digital cellular network sponsored by Grameen Telecom (a nonprofit subsidiary of Grameen Bank), Telenor (Norway), Marubeni (Japan), and Gonofone Development Corp. (US); seeks to have 190,000 subscribers by 2000. Grameen Bank finances purchases of handsets and wholesale bulk airtime by rural entrepreneurs who make profits by operating them as retail village payphones.

Grameen Shakti

Building a market for renewable energy systems in Bangladesh's unelectrified rural households; providing capital, technology and management services to enterprises that promote renewable energy at village level.

\$1 billion equity investment and up to \$20 million loan; also arranged additional financing from Asian Development Bank and Commonwealth Development Corp.

\$750,000 start-up loan provided through IFC/Global Environment Facility Small and Medium Scale Enterprise Program.



IFC: We might as well start at the beginning. How did you get involved in microcredit in the first place?

Yunus: I had first come to the US as a Fulbright scholar. I came in 1965 to Vanderbilt University, and then completed my Ph.D. in economics there in 1970 and started teaching in Middle Tennessee State University. I was always planning to go back, but in 1971, the year I was planning to go back, the civil war or "war of liberation" began. So I didn't return. Instead I started campaigning for the independence of Bangladesh and so on. The war ended at the end of 1971 and I left in June of 1972.

IFC: What did you do when you got back to Bangladesh?

Yunus: I joined the faculty of Chittagong University.

IFC: It's often said that you soon realized the theories of economics you were teaching did not square with the realities you noticed outside the classroom. Was this really the case?

Yunus: You can see extreme poverty and hunger right around the campus. So if those theories were any good, how come all the beautiful things being said and the five-year plans and everything else didn't seem to have any meaning in the lives of people who lived around us? When I was going around in the villages to learn economics from people — real economics, that is, because textbook economics doesn't work for them — I thought, "Why don't I find out myself? And since this knowledge doesn't help anybody, can I help others, even for a day, to solve their problems?"

IFC: And then, the story goes, you met one village woman who started the whole thing for you.

Yunus: The woman that I met was making bamboo stools. I found out that she was making only 2 pennies a day. I couldn't figure out why anyone would work for 2 pennies a day, or why she was making so little in spite of making such a beautiful thing. She explained to me that she didn't have the money to

buy the bamboo. So she had to borrow it from a trader to buy the bamboo, which cost about 25 cents. The condition of that lending was that she had to sell the product to the lender at the price that he decided. So that explained the 2 pennies she made.

I was tempted to give her the 25 cents so that she didn't have to borrow from the trader, but then I stopped, thinking, "Would that be the right thing to do?" And then I thought, "Before I do, why don't I find out if there were other people like that. Was she the only one? Maybe there's a second and a third one."

I went around the village for several days. And in that way, I made a list of people who needed this kind of money. That list I prepared had 42 people. The total amount they needed was \$27. Some needed a dollar, some needed 50 cents or 30 cents, but in total it became \$27 — just to carry on the work they did.

IFC: What interest rates did you charge on these first micro-loans?

Yunus: Nothing.

IFC: Nothing?

Yunus: I had no idea of interest. This was a "do-gooder" job. I felt that they were all bonded laborers, bonded to the lender. They had no capacity to market in a free way because the price was fixed by the lender. So I took out freedom by giving them this money. And I told them this was a loan and they could give it back whenever they could. The ideas of interest and maturity did not come to mind. What I said was, "Whenever you are ready, pay me back, but sell your product where you get a good price." So this was the beginning. It caught me up, because the excitement and happiness it brought to them was such an unexpected thing.

IFC: Once it started working at this small level, how long did it take you to get repaid on those initial micro-loans?

Yunus: I didn't even think of that because I moved onto something else. It was such an excitement. I thought, "If you can bring so much happiness and excitement to so many people with such a small amount of money, why shouldn't you do it more?"

IFC: How did you get the money to scale up your operations?

Yunus: I went to a bank to see if I could find a more organized way of handling this rather than my just giving them the money. But the bank manager thought this was a crazy idea. "This is a bank and we don't lend money to the poor people," he said. "It's absurd to give money to poor people because they cannot pay it back. They are not credit-worthy." And I said, "How do you know?" So the debate began.

The manager couldn't satisfy me and I couldn't satisfy him. So he referred to me the higher officials in the banking hierarchy. I went to them, and for several days had no results. Everybody told me the same thing. So finally, I offered myself as the guarantor to take the money from the bank. Such a long negotiation! I took the money from the bank and gave it to the people. That way, for the first time, interest rates, payment schedule, everything, came back into it. People had to pay back to the bank's account. I came up with ideas on how to make sure they did pay back.

IFC: Did you know or care that other organizations in other parts of the world were starting similar microcredit projects at roughly this same time?

Yunus: I had no idea of what was happening outside. All the problems I was facing in Bangladesh I was blaming on the

Bangladeshi banking system. This was a local problem I was trying to solve with a local banker who didn't want to give me the money.

IFC: So you started getting a lot of borrowers, all of whose loans you were personally guaranteeing. But if not managed well, that could leave you with pretty heavy exposure. How did you keep track of them all?

Yunus: We would assemble in one place and fix a date — say a Friday evening. We would all get together at 8:00, and we paid, calculated, and gave receipts. But as the numbers increased, accommodating everyone in one day was a headache, and we began doing it in two days. We divided the whole operation and had a Sunday group and Monday group, but then we changed the groupings. We said, "If you took a loan to buy a cow, you belong to the cow group. If you took a loan to do basket-weaving, you belong to the basket-weaving group." But more problems came later when people paid back their basket-weaving loans, wanted to buy a cow, and switched groups. There was no stability, so we abandoned that and said it was more important how you liked the partners in the group. So now you formed your group based on how you liked each other and depended on each other. These groups were limited to 10 and not less than five. It all happened within the span of two years. In two years, all our rules were all set.

Then we made the rule that big groups could split — five people could make up a group. Or, if you liked, another five-member group could merge with you. We kept all the options open. We hoped that more groups would merge and make the groups bigger. Then we brought up the question of electing a secretary so that there would be a democratic structure. Then we added another tier. Several groups

would form a center so that all weekly meetings would be held in terms of the center. Later on, we saw bigger groups split and smaller groups never merging. When I moved from Chittagong, as a part of the challenge that I was given to do it over a whole district and then in another district, all these ideas were settled and our rules were made. In the new district, I had an opportunity to abandon a lot of old things. We said all groups should be five — nothing more, nothing less. The idea of groups between five and 10 was abandoned. And the center size was fixed. So many groups would make up a center. So this is the way it evolved.

IFC: Sounds like flexibility was essential on the organizational side, especially since you were dealing exclusively with very poor people. But was it the group-based lending that was the basis of your high repayment rates?

Yunus: That could be one, because of the networking with people involved and the taking joint responsibility. Also, the pride that one group was better than another group, and not wanting to lose face with your friends.

IFC: I take it you had no idea at the time you would later be seen as the father of the global micro-credit movement?

Yunus: All my efforts were to convince the banks that you can do business with the poor people. They didn't lend to poor people, and that was the only thing I was looking at. Regardless of the other businesses they do, I was saying, "What's wrong with lending to poor people? And why do we insist on collateral? Not all the loans that you have given with collateral are paid back. So if worst comes to worst, if you give loans to poor people they won't pay back either. You have collateral, and it doesn't help you. So why are you now discriminating against poor people?"

IFC: And from that core belief Grameen has become a big successful bank that countless others are trying to replicate around the world. What rates of interest do you charge as you lend to people who are poor as any in the world?

Yunus: 20% on our one-year income-generating loans, 8% on our 10-year housing loans.

IFC: Informal moneylenders would probably be the only other source of money for your borrowers. How does Grameen's loan rates compare to theirs?

Yunus: Moneylenders' rates worldwide basically start at 10% per month, and go all the way to 10% per day. In some countries it is more exorbitant, like in the Philippines, where you borrow five pesos in the morning and you pay six pesos in the evening, which is 20% per day.

IFC: Most of Grameen's borrowers are poor women. What would they be doing for money if they didn't take out these small loans?

Yunus: They wouldn't borrow. They had never borrowed in their lives, and it was extremely difficult for us when we came to persuade them to borrow. They had never been offered the service, and they didn't know what to do with it. They were scared of it.

IFC: How did you get them to change their ways?

Yunus: The way we put it to them was, "If you come up with an idea that would generate money and income for your family, come and talk to us. We have the money; we can lend to you." We never told them, "We can do this or that."

IFC: How else did your approach vary from that of Bangladesh's conventional banks?

Yunus: One of the allegations I had made against our banking system was that not only was it biased against the poor, it was biased against women. If you take the gender composition of all the borrowers of all the banks, not even 1% of borrowers were women. I said, "There must be something wrong with the system." When I began, I wanted to make sure that half the borrowers in my program were women, but then when we invited women to join, they said, "No, talk to my husband. I do not handle money. I don't understand anything about money."

So people literally ran away from us. That puzzled us. How could we have 50% women borrowers, when women say they didn't need it? But after six years, we finally had that 50/50 match. Now it's 94% women because we changed our situation after we reached the 50/50 match. We saw that money entering the family through women brought much more benefit to the family than money entering the family through men.

IFC: Why? Are women more responsible than men?

Yunus: Many things: one, more responsible and very cautious with money, but also women in very poor families develop special skills and become efficient managers of scarce resources. That helps a lot when you are handling a small amount of money. Women also have a longer vision ahead of them — it's not all just for today. The mother's income immediately benefits the children, but not the fathers. Fathers are impatient and want to enjoy things right now with whatever they've got. So we changed our policy and give priority to women. We built incentive packages for our staff to make sure that they work hard to bring in more and more women, and today we have 94% women borrowers.

IFC: When did you receive a domestic banking license?

Yunus: In 1983.

IFC: But wasn't it quite different from the other banking licenses that the government typically awarded?

Yunus: We could do everything except for foreign exchange. That's the only difference business-wise.

IFC: But does the government examine your books, or impose on you the same levels of supervision and regulation it does for other banks?

Yunus: If they wanted to, they could. But they don't.

IFC: Weren't you also granted a long-term tax holiday?

Yunus: We had one, but it expired in 1997, and since then the government has imposed a tax on us.

IFC: How profitable is Grameen today?

Yunus: We're barely covering our costs. We had about four or five years on different occasions where we've had losses, but otherwise we have covered our costs.

IFC: You have often said support from international aid donors was important in Grameen's early days. When did you begin getting these grants?

Yunus: The first one we got was from the International Fund for Agricultural Development (IFAD) in 1982, \$3.4 million. That, too, came extremely reluctantly because at that time the Central Bank was reluctant to give us money. So finally a project was prepared where IFAD would put half the money as a loan and the other half would come from the Central Bank.

IFC: What is your role in Grameen?

Yunus: I am just a paid employee of the bank. One of the things that I was insisting on was that the banks should be owned by the borrowers. But when the legal framework was made, government retained 60% of the shares. I was very unhappy about it, so I wanted to make sure that *this* 60% was released to the borrowers. Government promised that in the future they would do it. We made amendments by releasing more shares to the borrowers and limiting government shares, and ever since we've continued to sell shares to the borrowers. Today 93% of our shares are owned by borrowers.

IFC: How do they get them?

Yunus: They pay. Each share is \$2.50. The condition is, whenever you are ready to buy one share of Grameen Bank, you have the opportunity to buy. Nobody can buy two shares.

IFC: These shares are not publicly listed, I take it, and do not fluctuate in value?

Yunus: This is all internal. Unless you are a borrower, you cannot buy a share. So our staff cannot buy a share. You have to be a borrower to buy a share, and in order to be a borrower, you have to fulfill other conditions. Your total assets must not exceed the value of one acre of land in the neighborhood of your village and so on. You have to be poor, that's for sure.

IFC: Do you pay dividends to your shareholders?

Yunus: So far we have not. As I've said, we barely cover our costs. There's not enough money to spread around. It's only marginally profitable: a very small return on equity — maybe 2%,



that's all. But we are not non-profit. We are very much commercial.

IFC: And yet you've never wanted to bring in outside shareholders in order to raise more capital?

Yunus: No. We've always kept it for the borrowers. If we want to make more money, we can sell two shares per borrower. That way the capital would immediately be doubled.

IFC: What does being part owners of the bank, even at this tiny level, provide your borrowers?

Yunus: One is pride that they own the bank. Second is the opportunity it gives them to either get elected to the board or elect someone to the board. That's a great prestige factor. Running for the board of Grameen Bank and becoming a Grameen board member add tremendous prestige in the village as a whole because it's not just a poor people's bank, it's one of the leading banks in the country.

IFC: Lately you've expressed interest in getting into securitizations, even talking of trying to sell bonds on Wall Street. Why?

Yunus: Our intention is to raise more money so that we can extend our loan portfolio. Now,

if we have to add to our loan portfolio, we have to borrow from somebody — either from the Central Bank if it is willing to give us money, or someone else. But the problem with the Central Bank is that it's a one-year loan. We lend money for one year but also have housing loans that are for ten years. That's a mismatch. So we are looking for long-term financing.

IFC: That's a very ambitious step, since institutional investors would look at Grameen in an entirely different way than the aid community does. I guess you might say they have no reason to be charitable. Yet it seems you would rather take this difficult step than keep getting subsidized loans from donor agencies, which no doubt are available in virtually whatever quantities you want.

Yunus: We purposely don't want that. This is a legitimate business. After 20 years, if you can't run it as a legitimate business, then something is wrong. So we want to do it in a business way. We did issue bonds in the Bangladeshi market in 1995 and raised \$150 million, but one funny provision in our charter says that anytime we issue bonds, government shall guarantee it. Every time we want to do it, we have to go to the government to guarantee us according to the charter, and we don't like

that. So we would like to see how we are rated in the market ourselves. Securitization offers us several benefits, including getting into the market on our own strengths, the strength of what you do for business. And also it gives a good signal that micro-credit could be entering capital markets in the US and treated as a genuine business.

IFC: Tell us a little about GrameenPhone. What made you want to get involved with cellular telephones?

Yunus: Again, opportunities come and we see that they can be used in a way that would be helpful for the poor people. In this case, government advertised in the newspaper that they would like to get some cellular licenses and that's what provided the brainwave. We thought we should bring telephone lines to the villages instead of having telephones only in the cities, and have Grameen borrowers become the telephone ladies of the village, selling services to the poor. People said, "A woman may have the financing, but it won't be a viable business. Who's she going to call?" We said, "She's not going to be calling anyone. She's only going to be providing a service." My guess was that it would work as a business, and although many others doubted that, we got Telenor of Norway and Marubeni of Japan as partners.

IFC: They've both got big bottom lines to meet. Was it hard to speak the same language with them?

Yunus: With them we just talked about business. They're big business and don't under-

stand the nonprofit word at all, so we spoke their profit language. We created this company called Grameen Telecom, which is a not-for-profit company, and they became part owner of GrameenPhone, which is a for-profit company. That's how the links are made.

IFC: How long has it been operating commercially?

Yunus: It started in March last year, and we hope in a couple of years it will be profitable. We started off in the cities, but now we have 80 village operations.

IFC: Who exactly are your clients?

Yunus: The telephone ladies who are also Grameen borrowers. We provide them with financing for their handsets. Then they start selling the service, and every week they pay back their loan.

IFC: What do the handsets cost them?

Yunus: About \$300 to \$400, depending on the model. It takes them about two years to repay, but they are making good profit. The average works out to be \$2 a day net. Everything is recorded. One good thing with a telephone business is every second is counted. Your bill comes from the company, you pay, and you keep records so you can tally with the bill you get from the company exactly the amount you spent and so on. We see that the woman is paying out of her income and it's a good business.

IFC: Now you're also starting Grameen Shakti, a company that wants to sell solar-powered lighting systems in the villages. Why?

Yunus: Only 15% of the population of Bangladesh has access to electricity. 85% don't. So it's a big country without electricity. Grid electricity is not going to happen.

IFC: As you turn into these kinds of business ventures, is your objective to make a profit?

Yunus: I would like to make a profit. But with every company we create, either for-profit or not-for-profit, our ultimate aim is either to turn them into for-profit companies or create a for-profit under the not-for-profit and then sell the shares of those companies to Grameen borrowers so they become the owners of those companies.

IFC: In other words, as you did with Grameen Bank itself?

Yunus: Exactly. Grameen borrowers hopefully will someday have a portfolio of assets in all those companies and that will form their old age fund so that there's a pension for them, and they will live without worries in old age with the income they make from the companies they own.

IFC: Have you seen a marked improvement in living standards in Grameen's borrowers over time?

Yunus: All the researchers have reported very positive changes in their lives in terms of housing, sanitation, nutrition, literacy among the children, in terms of their children going into higher education. There have been very positive changes in every area. Any visitor who comes sees the difference.

IFC: Why is Bangladesh so poor, anyway?

Yunus: It's like any other country, India, Pakistan, Afghanistan, or Europe 100 years back. These

are all poor countries. That's where we all emerged from — poverty is our common ancestor. Some got out of it, some are still there, never making it but hoping to get out of it. But the important thing is to get out of it.

At the same time, Bangladesh presents a very promising, optimistic picture, for when it was born some 38 years back, it was seen as a basket case. There was a large food deficit at that time, no economic base on which it could go forward. Today our population is 125 million, which is almost double the number of people we were, and we are almost self-sufficient in food. Despite all these problems and the bleak projections, this is how it turned out.

We are not the most efficient nation in the world, but things happen, and if you look through every single item, you see very positive changes. The only problem we see is politics. We are not getting the leadership that would help things move faster. But people are very creative; young people adopt things very quickly. So there's no reason why Bangladesh should not change its situation very fast.

IFC: Looking back on it all, what would you say microcredit institutions like Grameen and others around the world have contributed overall?

Yunus: One thing we've accomplished is proving what you used not to be able to argue intellectually: that the poor are creditworthy. We could go on forever and ever arguing and not resolving, but let's demonstrate it. If you say it doesn't work, you can come and show us that it doesn't work. But here are 2.2 million families. You can say Bangladesh is a funny country, all kinds of funny things can happen there but it cannot happen in any other country. Yet it

is happening in other countries. Not every one is successful, but some are successful. So why don't you take it from there? You can't say the poor are not creditworthy and stop there. What we did is raise a big question about the wisdom of banking. Banking cannot be the same again, no matter how you go about it.

IFC: There's a rather nasty financial crisis going on in Asia at the moment. Does it tell an alternative banker such as yourself anything about the way conventional credit analysis is carried out in your continent?

Yunus: That it's wrong! Grameen has proven on one side, and the Asian crisis has proven on the other side, that the banks are wrong. No matter how much collateral you bring in, the more you concentrate on a few groups of people and pour money on top of them, this is what happens. You just create the basic structure without any foundation. We are saying that we have to create the structure from the bottom. The more you try to do otherwise, the more you risk this kind of situation. So that's another big question mark. We are saying that while you're going to bail them out, don't just go and bail out the same old people, because that will just encourage them to do it again. You are just waiting. Another day, another time, the same thing will happen.

IFC: Are you seeing commercial banks in Asia undergoing any fundamental changes because of this debacle?

Yunus: No, no, no, no. It's still the same old thing.

IFC: Really? Despite all the changes that are happening, with key microcredit banks moving to a more commercially sustainable basis in so many countries?

Yunus: No matter what you say about how microcredit is a popular theory and so on, it is still not in the mainstream. It's still an NGO activity. It's not a financial world activity. Because of pressures, because of criticisms, the World Bank has kind of accommodated it in CGAP (the Consultative Group to Assist the Poorest) and other things, but it is not part of the world banking system.

IFC: How do you recommend changing that?

Yunus: It should be a legal activity rather than an NGO activity — an NGO activity meaning NGOs are doing it without any legal status. Sooner or later you have to provide them the legal status so they can stay in this business. But definitely not within the existing structure of commercial banks, because they do not understand this business at all. And I'm saying these are two different kinds of systems. You cannot bring in someone and say, "OK, we'll plug it in and it will work." It won't, because one is based on distrust—that's the commercial one. This whole business is based on trust. You cannot bring some system that is functioning on trust and kind of take it on with a system that is based on distrust. Because their whole attitude is emanating from that basis. If you look at the world in the way that says, "This guy is going to cheat, that's all," everything else follows from that. I'm saying that you need a different kind of financial structure. Today NGOs are just initiating it. But someday, probably, it won't just be NGOs. ■

The Long View

Latin America's Pension Boom

By Lucy Conger

San Salvador

There used to be a joke in Peru that warned people taking taxis to pay as soon as they got into the cab. Why? Because if they waited until the driver reached their destination, inflation might have doubled the fare.

That was in the late 1980s, and the joke's black humor reflected the sad state of Peru's economy at the time. Inflation had reached 7,000% a year and was also running at three and four digits in many other Latin American countries. But today both the joke and hyperinflation have gone out of circulation, as sweeping economic reform programs have cut government spending and stabilized local currencies across the region.

These new economic realities allow Latin Americans to think beyond the end of their taxi ride. Among the new institutions capitalizing on the longer time horizon are private pension funds, which enable workers to look 30 years down the road and invest for their retirement.

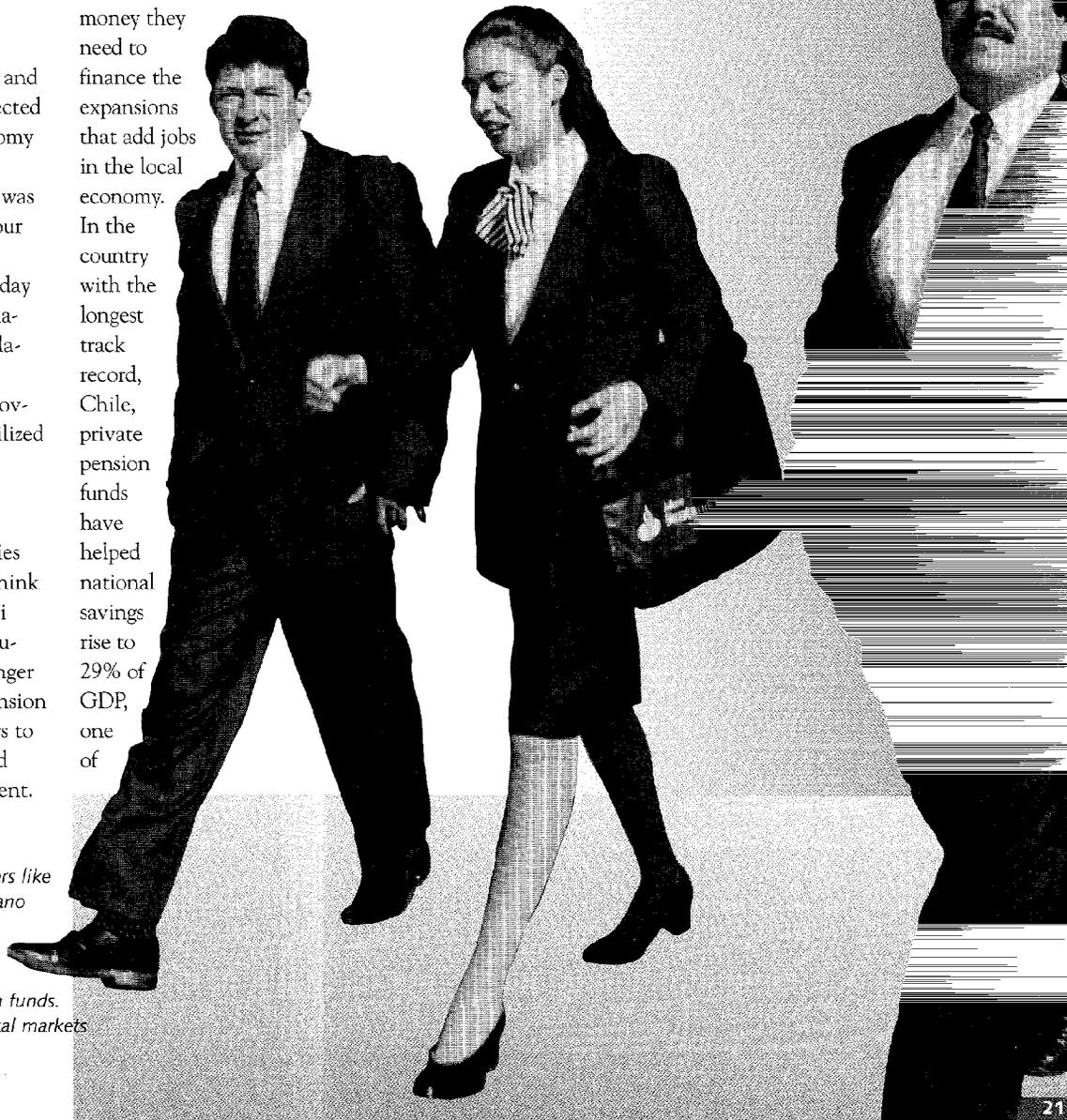
Off They Go: Active marketers like these Banco Santander Mexicano salespeople in Mexico City have attracted \$136 billion into Latin America's new private pension funds. The result: stronger local capital markets and social security systems.

They play an important development role, most directly in providing for old age security better than weak government-run predecessors. But their indirect role is equally important: helping build the demand that fuels growth of local capital markets, giving domestic companies more options for raising the money they need to

finance the expansions that add jobs in the local economy. In the country with the longest track record, Chile, private pension funds have helped national savings rise to 29% of GDP, one of

the highest rates in the developing world. A recent Salomon Smith Barney report called Latin America's achievements with private pension funds "outstanding," adding that "in some countries, companies have realized that they do not need to access the international capital markets for a \$100 million equity issue."

In this decade, sweeping pension reforms have been launched that will phase out state social security and create new private systems in seven Latin American countries. Today the region's private pension funds have more than 27 million enrolled mem-



Retirement Savings

Name: AFP Previsión

Country: El Salvador

Description: \$1 million investment in one of five private pension fund managers created to operate in El Salvador's new privatized social security system

Shareholders: Banco Bilbao Vizcaya (Spain, 51%), Grupo Pacific (Guatemala, 20%), Banco Salvadoreño (El Salvador, 20%), IFC (9%)

Number of Affiliated

Workers: 100,000

Investment Strategy: With domestic equity market being small and illiquid, will initially target government securities, housing bonds, and bank deposits; under law must provide subscribers with a minimum return guarantee of at least 80% of the average return achieved by all private pension funds in the country

Development Impact: El Salvador's privatized social security system will contribute to both improved old age security and capital market development; expected to be replicated throughout Central America in coming years

IFC Role: Supported process by providing comments on draft legislation and regulation in 1996; equity investment in a key participant adds credibility to system

Other IFC Investees in Industry: Maxima AEPJ (largest private pension fund in Argentina; lead sponsor is HSBC Roberts Group); AFP Horizonte (second-largest in Peru; lead sponsor is BBV-owned Holding Continental)

bers and \$136 billion in assets under management, with Latin America standing as the world leader in the introduction of privatized social security.

IFC has been an active participant in the burgeoning industry. Since 1994, it has committed equity capital totaling \$26 million as a partner in private pension fund management companies in Peru, Argentina, and, this year, El Salvador, which launched the region's newest pension system in April.

Expanding the System

El Salvador's new system will cover all new entrants to the country's work force as well as all those under the age of 36 and all others aged 36 to 55 who switch over from the old system. Workers' mandatory contribution rates start out at 6% of salary and will increase to 10% by 2002, with the government continuing to guarantee a minimum pension. Within four months of its launch, the system had signed up nearly all of its 400,000 projected total subscribers, largely because the advantages of the new private system were so clear. "You'll get a better pension because the existing pensions in El Salvador are very low, you can leave money in your account to your children, you are free to choose the fund management company, and the system is guaranteed through insurance," says Francia Brevé, the government's superintendent of pensions.

The Salvadoran pension system emulates the two leading innovations introduced by Chile's landmark 1981 pension reform: it is financed with individual defined contributions, and the government carefully regulates the funds' investments. IFC has provided support since 1996,

when it commented on the draft legislation and regulations at the invitation of the Salvadoran government, and its investment of up to \$1 million in one of the five new private fund management companies gives the system a stamp of approval. IFC's investee, Previsión, is a joint venture whose other partners are Guatemalan-based financial services conglomerate Grupo Pacific, El Salvador's Banco Salvadoreño, and Banco Bilbao Vizcaya (BBV) of Spain. El Salvador's pension reform is the first in Central America, and is expected to help the concept of private pension funds spread throughout that region in coming years. It has attracted

the hands of the private sector can involve crossing a political minefield. Peru faced perhaps the region's greatest challenge in this regard, introducing its pension reform in 1992 when politicians, government bureaucrats, and unions opposed a change. "You have to sell something hard to sell — future savings over 30 years — in a country that doesn't save, and at the worst moment when one of every three banks had been shut down," said Carlos Boloña, Peru's economy minister at the time.

His first step to pave the way for reform was to sell the idea to a skeptical president, Alberto Fujimori. "The great fear of the



top foreign financial partners such as Citibank of the US, Spanish banks BBV and Argentaria and the Chilean fund Provida. Together, these foreign institutions have invested 50% of the capital in the pension fund managers, and through them "globalization has practically entered El Salvador's financial sector," says Brevé.

Tougher Than It Sounds

The economic case for pension reform may seem self-evident, but eliminating government social security and putting pensions in

president was that he would have the 300,000 pensioners on his back, and the social security union, which was powerful," recalled Boloña, who is now in private business. The architect of Chile's pension reform, José Piñero, was brought in to explain the private system, which now manages approximately \$33 billion, the equivalent of 43.8% of GDP. In time, the crisis in Peru's public social security system — then running a \$13 billion deficit — was turned into an advantage. "Since Peru was absolutely broke, we made a total reform," Boloña said. Today,

Peru's system has 1.8 million workers enrolled and approximately \$1.8 billion in assets under management, or the equivalent of more than 2% of GDP, and is likely to double by

"There was almost no capital market in Peru before," he stresses. "Now the market is growing, and no local companies launch their bond issues without coming to talk to all of us first."

already identifiable. Since the industry's birth in Chile in 1981 and its replication in Peru 11 years later, pension funds and managed assets have shown explosive growth. In less than one year, Mexico enrolled the largest number of affiliated workers (11 million) of any private social security system in the world. Throughout the region, funds under management now total nearly 8% of Latin America's combined GDP. By the year 2000, assets are expected to nearly double to \$213 billion (or 11% of the region's GDP), and to reach \$954 billion (26% of GDP) by the year 2015, reports Salomon Smith Barney.

in the region excluding Brazil. The funds also spur growth of other related financial services industries, including insurance companies that provide the mandatory life and disability coverage required with the private pensions, and rating agencies that certify which stocks and bonds meet the risk standards for pension fund investment.

As private pensions proliferate, the arts and sciences of pension reform are evolving. The newer systems, created in this decade, are testing new designs and techniques to improve on a Chilean system that has been touted as a model for industrial and developing countries alike.

Problem-Solving

Despite its acknowledged successes, the Chilean pension model is widely criticized for high fund management fees and for its contributors' frequent switches into new funds, factors that have also plagued the systems in Argentina, Peru, and other Latin American countries. El Salvador is tackling the fee problem by setting a cap on commissions at 3.5% this year, to be reduced to 3% from the year 2000. Bolivia took an even more radical approach to slashing start-up costs of funds that run massive marketing campaigns. Its government limited competition in the first five years, opening fund management to only two companies that were selected by an international bidding process. As a result, contributors are paying lower fees than in other countries. Mexico, on the other hand, has reduced commissions by introducing more competition through a flexible system that leaves managers free to decide how to charge fees. For instance, fees can be pegged to contributions, assets under management, real returns, or any

Without doubt, the strongest immediate impact of pension funds is to deepen local capital markets. In Chile, funds have stimulated the issuance of long-term securities, the initial placement of large blocks of shares of privatized companies, and the development of secondary market trading. Funds also have developed research capability among domestic brokers and promoted interaction between domestic and international markets through arbitrage of American Depositary Receipts of Latin American companies sold on the New York exchange.

Private pension systems are drawing foreign banks into the region, lured by the steady income derived from commissions for asset management and the possibilities of offering banking services to pension fund contributors. Citibank is the largest foreign player, managing \$7.6 billion or 17% of total funds in Latin America excluding Brazil. Four foreign institutions — Citibank, Provida, Santander, and BBV — account for nearly 44% of assets under management and over 51% of all contributors

the end of 2000. The private system guarantees preservation of contributors' capital and has won the trust of the people, but operates in parallel to the old government system that continues to exist and to sign up new, risk-averse contributors every day.

Rafael Dammert is investment manager of AFP Horizonte, an IFC-supported private pension fund in Peru whose assets under management have grown from zero to \$430 million in the last five years. It has brought real average annual returns of 7% to its contributors in that time with a portfolio that includes short-term bank deposits (25%), local corporate bonds (25%), local bank bonds (18%), and local equities (36%). The active demand that his fund and its four counterparts has created for liquid long-term instruments has had a huge effect on financial sector development in Lima, he says.

As proof he cites the recent 10-year sol-denominated issues by Banco del Crédito, Banco Sur, and Interbank placed with local investors, and the \$69 million-equivalent that Pesquera Austral and Graña y Montero raised in initial public offerings of equity on the Lima exchange — transactions that would have been unthinkable as recently as 1991. Infrastructure-related companies such as the electricity distributors Luz del Sur and Edelnor are also beginning to issue five-year bonds in soles. While the amount they can raise this way is far less than is available to them in the Yankee or Euro markets, it helps by enabling them to avoid some of the risky currency mismatches that come with those debt obligations.

But despite the short history of private pension funds in Latin America, several clear trends are



The Pitch: Pensioners young (above) and old (left), like these Salvadorans, benefit from privatized retirement savings accounts in Latin America.

combination of these. These newer systems have also set terms to reduce subscriber turnover, which has reached 20% in Chile and cut into pension fund profits everywhere. In Bolivia contributors are allowed to switch only once a year, and other countries are studying similar restrictions. There is also a raging debate in Latin America about government regulations that dictate limits on the type and proportion of stocks, bonds, and paper in which funds may invest and that set performance standards for the returns of funds. The investment rules in most systems limit domestic equity investments to less than 35% of assets, allow no more than 10% of the portfolio in foreign equities, and channel the bulk of investment into government securities, at least in the early years of a system. But this can leave fund managers feeling straitjacketed and generate calls for greater diversification in holdings. In most systems, each fund must perform within a narrow range of the domestic industry average, which is measured daily against market value. Tight standards have fostered a herd

mentality, concentrating investments in conservative bonds and shares of the nation's largest and most liquid companies. "Fund managers are really protagonists with the ability to set prices in markets," said Marcella Martinuzzi, investment director for Argentina's Previsor fund.

To diversify risk and return, managers seek more flexible regulations that would allow more investment in foreign holdings and call for the development of long-term instruments and funds. Cautious investments are appropriate, argues Martin Gerson, an IFC consultant on pensions. "The use of mandatory pension savings is not a camping trip to the efficient frontier, or the outer edge of risk and return," he says. A response to this dilemma is in the works in Mexico, where authorities will soon authorize the creation of two funds with distinct risk profiles — a sharp departure from Latin American systems that allow only one fund per pension fund manager.

A major challenge remains for the funds: how to reach the mil-

lions of workers who are not in formal jobs — the self-employed street vendors, cobblers, machinists, and the like who make up the so-called informal sector. In many Latin American countries, this burgeoning element makes up the majority of the work force, and in Peru, fully 70% or more of it. Nearly all of Chile's 5.6 million workers reportedly have their retirement savings in privately managed funds, but in El Salvador and other countries the ratio is 25% or less. While having a reliable pension would likely be a better form of old-age security for informal sector workers than relying solely on children and other extended family members, as is usually the case now, Dammert of Peru's Horizonte fund stresses that there will be complexities involved in reaching that point. To attract the participation of informal sector workers, who often have unpredictable cash-only payment cycles and do not use bank accounts, governments would likely have to make some form of matching contribution. But then strict eligibility standards would have to be set to prevent abuses, and even so the

independent workers might well be skeptical of the government's ability to keep its promises. Nevertheless, he sees it as an important long-term goal in the efforts to combat poverty in his country.

"You would have to be creative to get taxi drivers and the like to put money in," says Dammert. "We've raised the issue, but there are no concrete proposals yet and it is not seen as a priority. But if governments do not act on something like this, it will come back to haunt them later in the form of higher social costs."

Convincing taxi drivers to look down the long road to retirement will remain a challenge for years to come. For now, the funds will try to lure new contributors with the promise of secure and strong returns and enticing names like Profuturo, Horizonte, and Protección that reflect a long-term vision.

Mexico City-based financial journalist Lucy Conger wrote about private housing finance markets in Latin America in the Spring 1998 issue of Impact.

Pension Reform in Latin America *El Salvador is the latest to try. Here's how others are doing.*

Country	Chile	Peru	Argentina	Colombia	Mexico	Bolivia
Assets under management	\$33.1 billion	\$1.8 billion	\$8.6 billion	\$1.6 billion	\$9.0 billion	\$1.4 billion
Year implemented	1981	1993	1994	1994	1995	1996
Transition arrangements:						
What happened to the old system?	Phased out	Continues with changes	Continues with changes	Continues with changes	Eliminated	Continues with changes
Is current labor force allowed to remain in the old scheme?	Yes	Yes	Yes	Yes	No	No
Is new system mandatory for new labor force entrants?	Yes	No	No	No	Yes	Yes
Can workers switch back to public system after entering AFP?	No	No (after June 1996)	No	Yes, every three years	No	No
Profile of new pension fund scheme:	Minimum pension guarantee (MPG)	MPG	Flat & minimum pension	MPG	MPG	Non-contributory minimum pension benefit
Role for public sector?	Social assistance	Social assistance		Social assistance	Social assistance	
Total contribution rate for new system: available for old age annuity disability/survivors/administrative public pillar and social assistance	10%	Priv: 8% (10% on 1/97) Public: 11% (max 13%)	8%	10%	6.5%+5.0%+(1%-5.5%)	10%
Total contribution rate: before reform	19%	9%	27%	8% (priv. sector)	15.5%	9.0% and 18%
after reform	13%	13.3%	27%	13.5% - 14.5%	16.5% - 21.0%	12.5%
Max % of portfolio allowed in:						
Domestic equities	30%	35%	50%	30%	0	Regulation to be issued
Foreign equities	10%	5%	10%	15%	0	
Government securities (in 1994)	45%	40%	50%	50%	100% (in 1997)	
Minimum rates of return of private pension funds	Benchmark relative to market average	Benchmark relative to market average and/or inflation rate	Benchmark relative to market average	Benchmark relative to synthetic portfolio	None	None
Government guarantees on rates of return of private pension funds	Difference between balance at retirement and MPG	None	None	Difference between balance at retirement and MPG	Difference between balance at retirement and MPG	None

Sources: World Bank, Salomon Smith Barney, and AFP Horizonte (Peru)

Act Locally: Making Privatization Work in Ukraine

Alyona Voloshina, *Head of IFC Operations, Ukraine*



Lots to Choose From: *Ukrainian entrepreneurs have now bought 45,000 small enterprises privatized with IFC help.*

Dafina Tapiero

Kiev

No one likes to be called an enemy of her own people. But this is precisely what an official in the Ukrainian Ministry of Finance accused me of being when I first started working on IFC's Small-Scale Privatization project in Ukraine in 1993.

Given the deeply ingrained Soviet aversion to private ownership and the nature of the task we were then just beginning, there was nothing unusual in his way of thinking at the time. Our country had virtually no experience of privatization, and as this government offi-

cial's pounding fists and harsh words reverberated loudly in my head, I wondered if there was some truth to them. Would private ownership, nemesis of everything we had so long been taught in Ukraine, really improve our day-to-day lives? I had to think long and hard.

Eventually, though, it was these very accusations that convinced both my Ukrainian colleagues and me that our economy could change only by building up from the grassroots, rather than top down in the traditional Soviet manner. Today, after five years and the creation of 45,000 new private enterprises with 172,000 owners, all the participants in our nation's privatization process

— the government, the entrepreneurs, even IFC's own Ukrainian team — have a fundamentally different mindset, although much remains to be done. Nationally, the macro-economic picture and the climate for major business transactions remain undeniably grim, making it difficult even for IFC to make investments in the country. The economy has contracted by more than 50% in seven years of independence, through factors that include excessive regulation, weak tax collection, and scant progress in privatizing both the largest industries and the agricultural sector, once known as the "breadbasket of Europe" but now in deep decline. Yet by putting food on shelves,

increasing the volume and selection of goods on sale, extending shop hours, and improving service, the new private small-business owners have demonstrated that economic change can be fast, positive, and effective. And the demonstration has occurred where ordinary Ukrainian consumers feel it the most — at the local level.

Making a Mindset

You might call this a case of "seeing is believing." Under the Soviet system, it had been just the opposite: people had generally accepted what they were told, given the absence of any visible evidence to the contrary. And the fact is that

Good Things in Small Packages

Name: Ukraine Small-Scale Privatization

Purpose: Preparing all of Ukraine's state owned retail shops, restaurants, and service establishments with assets valued at less than \$526,000 in local currency terms for sale through fair and transparent procedures

Number of Enterprises Sold: 45,000 since 1993 (90% of those eligible for privatization)

Buyers: 172,000 Ukrainian entrepreneurs

Methods Used: Employee buy-outs (80% of all transactions), tenders (12%), auctions (8%)

Development Impact: Swift transfer of state property to private sector; help in creation of local entrepreneurial class; promotion of competition among providers of goods and services; creating a market mechanism through which consumer choice sends strong signals to producers. Revenues raised equaled approximately 25% of local government budgets

IFC Role: Assisting local governments in designing replicable transaction models at a time when there was little knowledge of, or support for, privatization in Ukraine, then helping transfer them to every region in the country

Funding: \$5 million from US Agency for International Development to cover IFC's costs

Keys to Success: Building political will among national and local government officials; use of trained local staff; emphasis on comprehensive public education campaign; development of simple, replicable model; willingness to start small

Named: Winner of one of World Bank President James D. Wolfensohn's 1998 Awards for Excellence for serving to "embody the highest standards of the World Bank Group"

there were some grains of truth in the old ideology's condemnation of capitalism. My father was once posted to the Russian mission to the United Nations, and as a young girl in New York I witnessed some of the harsh realities of a market-based system. It frightened me to see the state shirk the responsibilities I felt it had to guarantee its citizens: housing and jobs. When left to the free hand of the market, I thought at the time, society would exploit rather than protect its members, leaving those with the most money wielding the most power. At home in the Soviet Union, we at least took comfort in the fact that all were considered equal and could count on a certain standard of living, even though we always expected the Communist party apparatchiks to have more.

At the same time, however, problems in our stores were commonplace, and we were accustomed to them. Waiting in line for an hour each day to buy basic things like cheese or sausages was nothing out of the ordinary. Nor were shortages, indifferent service, and limited selection. Few of us realized that it was lack of private ownership that lay at the heart of the problem — that things work best when people care, that people care most about what they own, and that having one's personal livelihood inextricably tied up in a shop or small business was the key to improving its performance.

Things began to change with the political upheaval and transformation that followed the breakup of the Soviet Union in August 1991. I well recall how the prospect of an independent Ukraine was both

exciting and frightening. We had been closely watching the groundbreaking economic reforms unfolding in Poland, Hungary and elsewhere. But Ukrainians have always been conservative, and few of us believed that our own government had the will, courage, or ability to change. Russia's transition to a market-based economy soon ceased to be an example, and as the year wore on, the government's rhetoric was clear: Ukraine would not embrace the private sector at the expense of the security and stability seemingly ensured by the Communist system. Nevertheless, it did agree to launch a small pilot project to determine if ways could be found to introduce private ownership at the local level.

This test case eventually came in mid-1992, when the government asked for IFC's help in privatizing its nearly 50,000 small state-owned enterprises. IFC was chosen because of its success the previous year in supporting small-scale privatization in Russia, where it had helped create a system of open auctions with price as the sole determining factor. And as in Russia, IFC turned for funding of this non-income producing technical assistance work to the US Agency for International Development, which also wanted to tackle the risky and difficult issues central to the reform effort in Ukraine. The Russian auctions had given existing employees incentives to participate in the process and take ownership of the shops where they worked. They helped alleviate worker concerns about job security through a process that out of necessity had to be locally focused, generic, fast, transparent, and fair.

In moving to Ukraine, IFC drew from its Russian experience but faced a government and population far more resistant to risk and change. As in Russia, long-term sustainability of the project would depend on an unknown factor: the degree to which ordinary citizens would be willing to take responsibility for their lives after decades of reliance on the all-powerful Communist system.

Going Once, Going Twice...

The program enacted gave local governments their choice of three ways to privatize small business:

- auction (sale of enterprise assets through open, competitive bidding)
- tender (sale through closed bidding)
- employee buy-out (noncompetitive sale of an enterprise to its employees acting as a workers' collective)

Lviv, a city of about 800,000 in western Ukraine, was selected for the pilot project funded by USAID, in large part because it had been part of Poland until World War II and thus had some history of private sector activity. The city authorities there selected auctions as the best way to achieve the underlying objectives of privatization: fairness, transparency, and speed. But this choice required that IFC work with local officials to demystify and humanize an auction process that raised many local suspicions.

Why were auctions seen this way? Because they clearly favored those with the most money. This made Ukrainians uncomfortable, for in a society where all had supposedly been "equal" for 70 years, excess



The Gavel Guy: Auctions were a popular way to sell off state-owned restaurants and shops in Ukraine.

wealth would indicate that someone was not playing by the rules. When my colleagues and I were designing the initial auctions in Lviv, we met many people who feared the “mafia” would gain control of the city because it was consolidating wealth and power. This inherent distrust for people with money inevitably led to questions about the auction mechanism. To work, it would have to be fair.

An IFC team soon arrived and worked with Lviv city officials to design and carry out the privatization process. We launched an information campaign to educate the population about private ownership and to stimulate the demand for the shops offered at auction. But this close cooperation with the Lviv government could happen only after we had earned the city government's trust.

IFC arrived in Lviv with three expatriates and two Ukrainian experts — a group mostly made up of lawyers, communications specialists, and support staff, almost all in their twenties and early thirties. At first, Lviv officials doubted the youthful team could design a model for

privatization. But IFC showed it was different from other foreign advisers who had been trying to work in the city. It used only Ukrainian consultants to advise the government and only expatriate managers who were fluent in Russian or Ukrainian. The team also demonstrated its commitment by setting up an office and residing in Lviv and engendered the trust of the officials by being responsive to their concerns. For example, when Lviv politicians worried about the employee displacement that would occur during the privatization process, IFC developed a new approach — the “going-concern” methodology — in which cities take responsibility for all the enterprises' assets and liabilities up to the point of sale. This ensured that companies would be able to operate without interruption and the employees would not be displaced during the privatization process.

My memories of the first auction are as vivid today as they were on that first day in February 1993. I remember watching as 17 properties ranging from a beauty salon to a metal repair shop were sold. It

was clear from that first auction that once the entrepreneurial excitement and hope for the future would be contagious. The selling prices kept going higher and higher as the competition ignited the atmosphere of the small auditorium. A beauty salon called Hairdresser No. 94 whose starting price was \$52 soared to \$45,276. A run-down café sold for \$113,190, a far cry from its \$257 starting price.

There were 195 bids on the 17 stores offered at auction that day. We were surprised by the number of anxious would-be entrepreneurs and the amount of money they were able to amass for bidding. Given the weaknesses of the country's financial institutions, people had little choice but to buy the shops with money they had accumulated from their families and borrowed from their friends. The auctioneer's singsong voice penetrated the hall as the bidders silently raised their cards, and when his gavel banged for the last time, the room erupted in applause. I can never forget the feeling of seeing the entrepreneurs' pride, confidence, and hope as they signed the final documents transferring title to them. All the members of the privatization team understood then that privatization was the only way forward. My life had changed. And so had my country.

Hold On...

Following the auction in Lviv, the team prepared a manual that encapsulated the steps in the privatization process and included all the legal documents used in Lviv. We distributed the manual to every city in Ukraine with a population over 250,000. Unfortunately,

the success in Lviv did not translate into a change in political will in Kiev, where we were up against a federal government with no clear policy regarding reform. Since a Ukrainian official's typical reaction was to say no (because no one was ever punished for saying no), we were unable to secure the federal government's support to replicate the privatization model developed in Lviv.

This meant we had to work harder to build our credibility with the federal government by promoting privatization based on Ukrainian examples, continuing to conduct information campaigns, and essentially doing whatever we could to get things done. Then in 1994, newly elected President Kuchma issued a decree calling for the privatization of all eligible small-scale enterprises in Ukraine. We were ready to go.

Within four years, the program had spread to every part of the country and was largely being carried out by trained local leaders who no longer needed IFC's support. The job was almost done, and work could begin on equally important follow-up measures, such as post-privatization managerial support for the vast numbers of new businesses.

On July 28, 1998, IFC's Small-Scale Privatization project conducted the thousandth auction in Ukraine. Nearly all the assets earmarked at the beginning had now been sold, with 76% of them bought by their former employees, who pooled resources, took them over, and made them their own. The most popular model eventually proved to be not auctions but employee buy-outs. The enterprises' staffers were usually

both the most interested buyers and those most able to block the sales if not happy with their prospects. They generally preferred being given the opportunity to purchase their workplaces at book values set by the municipalities rather than to take part in auctions where they might lose control to outsiders. Using this buy-out method brought necessary speed into the process, and the rate at which many of the enterprises subsequently changed hands at a profit on the secondary market showed the "auction" mentality was still very much in place.

Although the government does not keep precise records, the sales are estimated to have generated more than \$200 million in revenue for local authorities

ages in large-scale privatization that contribute so heavily to the country's overall economic problems. But we took great encouragement from World Bank President James D. Wolfensohn's words in giving the project team one of his two 1998 Awards for Excellence, the highest professional honor in the World Bank Group. He said the program had "generated positive public opinion toward private ownership" and "directly contributed to a substantial improvement in the quality of goods and services available in Ukraine."

When I lived in the United States with my husband in 1991, I remember being awed by the lights, colors, and selection in American supermarkets. It was all so overwhelming that I had a

ed them of the grocery stores in Kiev. I was astounded by their familiarity with the products. In a word, they were blasé. It is difficult now to remember what our stores were like before privatization — it all seems so long ago. ■



What A Difference: Rare before small-scale privatization began in 1993, well-stocked shops like this one are becoming common in Ukraine. Some are even diversifying into new lines of business (below).



to use on improving infrastructure and other needs. In Kharkiv, for example, the city government used the proceeds of small-scale privatization to provide housing for Chernobyl victims, while in the Poltava region revenues financed construction of natural gas pipelines to supply residential heating.

It was clear to all that the program would not solve the block-

hard time getting used to brand names, sales, and check-out conveyor belts. Earlier this year, I traveled again to Washington, this time with three Ukrainian colleagues on their first trip out of the former Soviet Union. I was excited to show them what I thought would be a tourist attraction: an abundantly stocked Safeway. As they walked in, they looked at each other and agreed that Safeway remind-



South Pacific

Improving Competitiveness, Safeguarding the Future

Each year IFC delivers valuable technical assistance that brings many benefits worldwide. The technical assistance is funded by grants from donor governments and managed by the Corporation's Technical Assistance Trust Fund (TATF) Program. In fiscal year 1998, some \$21 million was approved under this program to carry out 138 technical assistance assignments in 65 developing and transition countries.

Thailand and Samoa are two recent examples of countries to gain industry-specific knowledge at workshops financed in this manner. Thai textile producers have learned to become more competitive by operating "eco-efficiently," while Samoan seafood producers have been trained in new fish import regulations in their key export market, the US.

Eco-efficiency — the concept that firms can become more competitive by reducing their use of energy and raw materials and thereby polluting less — is widespread in many European companies. Such concern for environmentally sustainable development led the European Commission to provide IFC with a \$172,500 grant to expand the concept of eco-efficiency in the industrializing countries of Asia.

In 1996 Thailand emerged as the grant's target country, becoming the focus for a program on using eco-efficiency to improve its competitiveness in the international marketplace. GPH Conseil, a French consulting firm, organized and conducted a three-day workshop to train textile producers from 23 Thai firms and representatives from the Thai Ministry of Industry and Environment in developing and implementing eco-efficiency techniques. The workshop demonstrated cases in which several countries that produce textiles for export by using the same equipment and raw materials (such as chemicals, dyes, and solvents) were at a competitive advantage over those using substantially more materials and energy in their production processes.

IFC has recently conducted a survey to gauge the impact of the workshop on Thailand's textile industry. It indicates that the workshop helped decrease the operating costs of many textile producers, improve the quality of textiles produced, and reduce the amount of pollution generated by textile producers in Thailand. The program's success has supported the Thai Department of Industrial Promotion's moves to apply eco-efficiency in other industries, including garments, steel, and food.

Trust fund-supported training in industrial processes has also been important in Samoa, which has been affected by the December 1997 US Food and Drug Administration (FDA) announcement of regulations stating that any exporting country must have a food safety system for fishery products equivalent to the US system known as Hazard Analysis and Critical Control Point (HACCP). Since the US market accounts for 90% of all Samoan seafood exports, meeting HACCP requirements was critical for the island nation's economy.

To help Samoa prepare for the new US regulations a three-day workshop was held in October 1997, funded by a \$15,000 trust fund grant from the Australia Agency for International Development and administered by IFC's South Pacific Project Facility. Its purpose was to train local seafood exporters on the various aspects of the FDA regulations and to develop plans that would help them meet the necessary requirements. The workshop

enabled staff of various exporting companies to become certified to develop and operate HACCP plans. Already, four of the five plans submitted by exporting companies have been approved by the FDA.

The knowledge gained from the workshop enabled Samoan seafood exporters to continue exporting their products to the US market without interruption. Exporters also learned to how to prepare, pack, and store food under safety conditions equivalent to those of US food safety systems. As a result, the Samoa Department of Agriculture, Forests, Fisheries, and Meteorology is considering adopting a new procedure for its meat safety inspections system that would be equivalent to the US system for handling beef.

Sub-Saharan Africa

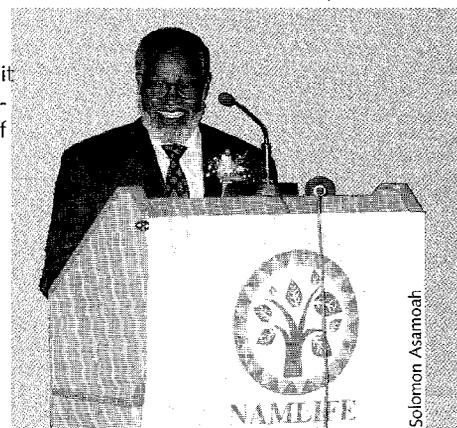
Insurance for Namibia

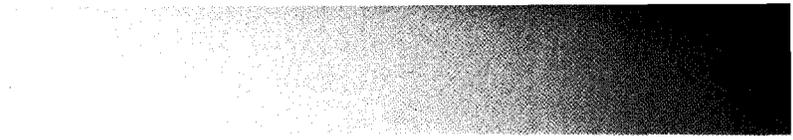
IFC has invested US\$1 million to take an approximately 20% stake in Namibia's first indigenous life insurance company, Namlife. It is the result of a joint venture between a group of local Namibians with diverse business interests, the African Life Assurance Company (Aflife), an indigenous, black-owned South African life insurance company in which IFC holds an 8.5% equity stake, and IFC.

Aflife, which has considerable experience in working with low-income communities in South Africa, will be Namlife's technical partner and will provide financial products to underserved sectors of the Namibian population. Namlife's basic product will be a derivative of Aflife's standard Family Product, slightly modified for the local market. It is essentially a low-value endowment policy with a high savings element that is collected monthly and increasingly via payroll deductions. Namlife will also follow Aflife's practice of offering variations on the basic product with various add-on options such as funeral benefits, most of which are also available on a stand-alone basis. This approach and product line has been highly successful for Aflife, which now have more than 3 million such policies in South Africa. As a consequence Aflife has, over time, developed systems and a support infrastructure which can profitably handle a large number of policyholders by keeping maintenance costs low. Aflife's system is not only proven but highly transferable as shown through its usage in subsequent Aflife operations in Botswana and Lesotho.

Namibian President H.E. Dr. Sam Nujoma, Namlife Chairman Festus Nahola, Aflife Executive Director Hugh Roberts, and Solomon Asamoah of IFC's Sub-Saharan Africa Department attended Namlife's June 12 launch in Windhoek. Dr. Nujoma said he was supportive of Namlife's aims and vision. He noted that it was critical for the successful development of the Namibian private sector that the indigenous population be included and benefit from this project.

Fully Insured: Namibian President Sam Nujoma at Namlife launch ceremony





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