COUNCIL *on* FOREIGN RELATIONS

POLICY INNOVATION MEMORANDUM NO. 39

Date:	December 9, 2013
From:	Gayle Tzemach Lemmon
Re:	Banking on Growth: U.S. Support for Small and Medium Enterprises in Least-Developed Countries

The United States has made economic development a central tenet of its national security policy, alongside defense and diplomacy. One of the best and most cost-effective avenues for furthering economic development is investing in locally owned businesses, and yet the United States currently has no means for effectively and efficiently doing so. Small and medium enterprises (SMEs) have shown great potential in spurring economies, but their owners—especially women—are often unable to acquire the skills, resources, and support necessary to grow and sustain their businesses. Promoting local programs and global initiatives that encourage investments in SMEs and women entrepreneurs in lower-income countries will strengthen growth engines, diversify economies, improve communal well-being, stabilize societies, and accelerate progress toward international development goals. All of these results are in the interest of the United States, and could be achieved more quickly with the creation of an American development bank that aims to invest in and direct technical assistance to entrepreneurs in lower-income nations—the next-generation emerging markets. This can be done by expanding on the work already under way at the Overseas Private Investment Corporation (OPIC). Though several multilateral organizations have tackled pieces of this work, the United States has a unique role to play: investing in entrepreneurialism that creates jobs, bolsters the middle class, and spurs economic growth.

GLOBAL ECONOMIC PROGRESS: FALLING IN THE MISSING MIDDLE

Initiatives that advance economic development in lower-income countries have been shown to promote stability and are therefore vital to U.S. security interests. Small and growing businesses rank high among these untapped sources of growth in the world's developing economies. The International Finance Corporation (IFC) estimates that SMEs contribute about 29 percent of formal GDP in low-income countries. SMEs also boost a country's economic strength by spurring innovation and competition across a wide range of sectors, and reduce a country's economic vulnerability by diversifying economies, which in turn helps to prevent domestic and international conflict.

Many SME-owners continue to struggle with growth challenges, such as a lack of capital, insufficient technical skills, inadequate risk sharing and mitigation, lack of access to export markets, and underdeveloped networks. Entrepreneurs, including those outgrowing microfinance, are often unable to compete with larger enterprises for resources that would help them to grow. Thus, smaller enterprises are left behind while large firms advance, resulting in the "missing middle." American development dollars could be deployed to help fill this gap and attract capital currently sitting on the sidelines.

THE U.S. APPROACH TO THE MISSING MIDDLE

In the first-ever Presidential Policy Directive on Global Development, President Barack Obama pledged to "foster the next generation of emerging markets by enhancing our focus on broad-based economic growth and democratic governance." Yet the pathways for directing resources to private-sector actors remain sclerotic at best and nonexistent at worst. Currently, OPIC leads the United States' private-sector development efforts. Rules that constrain its investments and the nature of its assistance, however, are outdated. It cannot provide technical assistance or make equity investments. It also must have a U.S. bank involved in any deal in which it invests. Smaller efforts to spur SME lending operate through the U.S. Agency for International Aid (USAID), the Millennium Challenge Corporation, and the State Department, among others. But there are gaps in these programs. USAID's core skill set is better designed for grant-making than loan-offering, and traditional development aid was not designed to offer tools needed to support small- and medium-sized businesses. Some regional development banks focus on SME growth, but the United States has lagged behind in supporting emerging entrepreneurs with a full array of financial tools, especially in areas critical to U.S. interests.

WOMEN ENTREPRENEURS AND THEIR ECONOMIC POTENTIAL

Women are a significant driving force in developing economies, running much of the SME sector in lower-income countries. Yet women entrepreneurs face daunting challenges in growing their businesses, including the same limited skills, constrained access to markets, and shortage of avenues for accessing finance that constrain male entrepreneurs, but that are exacerbated by gender-specific issues. A recent report by the IFC argued that women entrepreneurs who run SMEs "drive job creation and economic growth, but are stuck in the middle: too big for microfinance, too small for commercial banks." Many women who want to access bank capital have neither an established business record of accomplishment nor land registered in their names, making already risk-averse banks less willing to lend to women. Women frequently do not have access to networks of other entrepreneurs, and investors are less likely to support women-owned enterprises, which they view as less profitable than those of their male counterparts. Such a lack of support for women entrepreneurs widens the gender gap, slows development, and misses an opportunity to stabilize communities. This is especially noticeable in conflict zones, where women are often left to rebuild communities.

Creating an American development bank that is inclusive and supports women-owned SMEs capitalizes on the mounting evidence showing that prioritizing female workforce participation and entrepreneurship halts the poverty cycle. The United Nations estimates that the Asia-Pacific economy would earn an additional $89 billion annually if women were able to achieve their full economic potential. Similarly, the World Bank estimates that empowering women could increase labor productivity by up to 25 percent in some countries. Including women as a priority would also advance other international development goals—such as eliminating global poverty; closing the gender gap; and improving the health and well-being of women and their communities—which fulfill broader objectives in U.S. policy.

BUILDING BRIDGES FOR ECONOMIC DEVELOPMENT

An American development bank could provide loans and make equity investments in SMEs overseas, and would help to achieve the president's goals of supporting emerging and frontier-market economic growth. In the process, such an institution would attract the additional local capital critical to SME growth, build on the United States' entrepreneurial skill, and free critical foreign-aid dollars for deployment to the poor countries most in need. Expanding OPIC's abilities and expertise would allow an American development bank to bolster the investment gains OPIC has already achieved. OPIC is best positioned to take on this role given its investment history and private sector knowledge. Critics of this approach will argue that current U.S. efforts are sufficient, but the United States has talked about entrepreneurship's power without fully delivering on its potential. The new dollar cost would be negligible as this American development bank could be created in a budget-neutral way simply by unleashing some of the $30 billion in capital to which OPIC already has access—$15 billion in assets today—and an additional $14 billion it can access under the law. If OPIC were able to retain some of the $200-plus million it returned to the Treasury in 2011, it could also invest in additional technical assistance and investment talent. To advance SME growth, promote female entrepreneurship, and eliminate the missing middle, the U.S. government should do the following:

- *Invest in and create a new American development bank that would provide a "one-stop shop" solution for entrepreneurs in some of the world's most challenging economies.* This bank would expand on OPIC's framework and rules. It would allow for more equity investments and other structures, and provide skills that would help entrepreneurs best use the money they receive.
- *Encourage the American development bank to invest in locally owned small businesses.* This investment would help attract other private-sector actors, both local and international, to the "risky" SME lending sector. It also would allow entrepreneurs to tap into one of the United States' core exports in regions where those skills would be most valuable. Finally, it would show the United States' commitment to supporting entrepreneurs, particularly women, creating change through business in their own societies.
- *Combine development bank efforts with those already promoting SME creation.* Members of government, civil society, the private sector, and international entities should work together to promote SMEs, including women-owned businesses, and combine their efforts for maximum effect. This would include local ministries of commerce, along with local funding facilities, nongovernmental organizations, private efforts, and multilaterals such as the World Bank and International Monetary Fund.

CONCLUSION

Creating an American development bank to invest in local businesses in least-developed economies furthers U.S. foreign policy aims and is beneficial for individual entrepreneurs, their families, and their societies. Additionally, such an institution would yield gains in U.S. aid efficiency during a period of constrained budgets in which the private sector is becoming an increasingly valued partner in government efforts to address critical development issues. Women would be a central part of this small- and medium-enterprise investment strategy. Investing in women-owned businesses would spur growth, and has the potential to produce dividends for educational access and maternal and child health.

This step would mark the United States' first foray into SME lending to local businesses in least-developed countries with a full arsenal of financial instruments and a focus on local businesses. The United States' entrance into this field could also have a ripple effect, attracting additional capital, both local and foreign, into the sector. Some will say that this is not the United States' business, but the reality is that business is among the most powerful forces shaping realities on the ground across the globe; as government aid budgets grow slimmer, the role of small- and growing-enterprise development becomes more crucial. The United States has unique expertise in the entrepreneurial sector. Investing in small and growing businesses in some of the poorest countries would provide economic, security, and diplomatic gains for the home country, and the United States.

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