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International economic assistance has been an important component of U.S. foreign policy for nearly a century, from the Hoover Relief Program and the Marshall Plan after the two world wars to the creation of the U.S. Agency for International Development (USAID) in 1962. All too often, however, foreign assistance has produced mixed results, thanks largely to a lack of focus and a lack of funding. USAID is a case in point: over time, the agency's original mission of supporting economic development to counterbalance worldwide communist pressures has been extended to include humanitarian and disaster relief; environmental, educational, and governmental reform; and even the encouragement of peace in the Middle East and democracy in the former Soviet states. The resulting lack of an overall strategy and objectively measurable criteria for success, together with the evaporation of the communist threat, has subjected USAID to persistent congressional criticism and a constant battle for appropriations.

Against this often troubled backdrop, however, one extremely successful assistance program stands out: the American Enterprise Funds. Created by the George H.W. Bush administration in response to the demise of communism in central and eastern Europe, the funds are independent of USAID (except for reporting purposes) and are supervised instead by private boards of directors accountable to Congress. Their founding mission was to combine public capital and private management in organizations that would use business loans and investments to promote democracy and free enterprise in postcommunist states. Congress made the initial appropriations—$240 million for Poland and $60 million for Hungary—in late 1989, and the first funds were organized the following spring. Each was given a board comprising individuals with experience in business and government from the United States and the respective host country; the boards in turn recruited management teams and opened offices in the United States as well as in Warsaw and Budapest, respectively.

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Shortly thereafter, Congress established a fund for the Czech and Slovak Republics (politically united in the former Czechoslovakia until 1993) and for Bulgaria, and then—during the early years of the Clinton administration—for Romania, the Baltic states, Albania, Russia, Ukraine, and the other newly independent post-communist states. Ten funds now operate in the former Soviet bloc, with capital totaling $1.3 billion. (A separate fund was organized under the auspices of the Defense Department to convert weapons facilities in former Soviet republics into peaceful businesses, and a fund has been established to aid economic development in southern Africa as well.)

Management shortcomings at some funds and shaky financial conditions in some host countries have produced disappointments. On balance, however, the program's results demonstrate its effectiveness, both on its own terms and in comparison with other initiatives of USAID and of multilateral development institutions. These successes deserve greater attention than they have received.

A SOUND INVESTMENT

At the funds' inception in early 1990, Poland and Hungary were just embarking on their transitions to the free market, and their business environments were forbidding. Small and medium-sized businesses desperately needed credit and equity capital to start up and expand, but no solid sources existed: local populations had little understanding of business fundamentals, particularly in finance and marketing, and foreign investors and bankers were leery of giving money to inexperienced entrepreneurs operating in emerging economies with weak institutional structures. Meanwhile, traditional top-down, government-to-government aid programs lacked the speed, flexibility, and competence to create a private sector virtually from scratch.

Recognizing these obstacles, the Bush administration and Congress authorized the Enterprise Funds to operate much like venture-capital firms do in developed countries: by taking risks and providing equity financing, as well as debt and technical assistance, to inexperienced managers and promising but unproven ventures. Early fund leaders hoped to establish solid track records that would inspire emulation and attract private capital to supplement and eventually replace the original government budgets. The funds were designed to have a limited life span that would end once their missions were accomplished.

Another, less explicit goal was to encourage the development of a viable institutional infrastructure for private enterprise in each country—including a disciplined banking system with credit experience, a transparent and self-governing securities market, brokerage firms, credit companies, and a mortgage loan system. The funds became instrumental in developing a framework for proper corporate governance, which would in turn facilitate privatization and encourage foreign investment.

To tackle the immense challenges involved, the boards of the funds were stocked with remarkably talented, experienced, and committed personnel. The Polish Fund, for example, managed to attract Robert Faris, a highly regarded former president of a leading U.S. venture-capital firm, as its chief executive, and its American board members included former

American Enterprise Funds: ***The Ups and Downs***
as of September 30, 2000

Country	*Initial grant date*	*Current grant amount (millions)*	*Cash drawdown (millions)*	*Net worth (millions)*	*Net worth as a percentage of drawdown*
Poland	4/90	$262	$255	$295	116
Hungary	4/90	72	61	33	54
Slovakia	4/91	65	46	9	20
Bulgaria	1/92	57	57	42	74
Baltics*	9/94	50	46	34	74
Romania	9/94	56	54	38	70
Albania	4/95	30	20	17	85
Total		$592	$539	$468	87
Russia	9/93	$440	$222	$118	53
Central Asia*	9/94	150	106	38	36
Western NIS*	9/94	150	90	38	42
Total		$740	$418	$194	46†

* The Baltics include Latvia, Lithuania, and Estonia. The Western NIS (Newly Independent States) comprises Ukraine, Moldova, and Belarus. Central Asia comprises Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

† This figure would be higher if funds spent for technical assistance were not included in the "drawdown" column.

Source: Author's compilations.

National Security Adviser Zbigniew Brzezinski, labor leader Lane Kirkland, General Motors chief John Smith, and future ambassador to Poland Nicholas Rey. Over the years their Polish counterparts have included a future prime minister, a foreign minister, and a labor minister, as well as several prominent representatives from business and academia. The board of the Hungarian Fund, meanwhile, was chaired first by John Whitehead, former co-chairman of Goldman Sachs and deputy secretary of state, and then by George Gould, former undersecretary of the Treasury; its Hungarian members have gone on to serve as foreign minister, finance minister, and chairman of the National Bank of Hungary.

Although the private boards were supposed to directly oversee the funds' managers, not all the funds have eluded government and bureaucratic meddling. Despite such distractions, however, the management teams have been able to achieve a string of successes. Taken together, the funds have created or supported thousands of small and medium-sized businesses employing a total of 150,000 people, created or financed 24 free-standing financial institutions with more than 100 branches, made more than 50,000 small-business loans with a default rate averaging less than 4 percent, and leveraged their government grants by more than 100 percent.

Through September 2000, Washington had disbursed a total of $957 million to the ten funds in the postcommunist states. (Although the funds had applied more than $1 billion to investments, loans, and related technical assistance, they still had cash balances of $93 million, thanks to recycled loans and profits.) Private institutional investors have put an additional $500 million into the funds, supplementing those original government grants. A number of Enterprise Fund portfolio investments, meanwhile, have been sold to U.S. and European corporate investors for a total of more than $600 million, and joint investments with U.S. and European corporations have brought well over $200 million into the region. Thus the Enterprise Funds have stimulated more than $1.3 billion in private-sector investment, not including the ongoing lending activities of the local institutions they have established.

The funds' mandate encompassed the unprecedented dual objectives of enhancing economic development in their host countries while seeking to preserve their capital. Although the funds have not yet achieved the latter goal, their aggregate net asset value as of last September came to $662 million—70 percent of the amount originally invested. Even more important than the impressive financial performance achieved under difficult circumstances, however, has been the establishment of experienced investment or loan organizations in the host countries, with offices now staffed largely by locally trained personnel. These institutions have become centers of expanding entrepreneurial encouragement and training. Finally, the host countries' governments and citizens have given these efforts near-universal respect and appreciation.

THE FUNDS

Each fund has been confronted with unique economic, social, and political circumstances in its host country, and the degree of a fund's success has depended in large part on how well it has adapted to these local conditions and needs. The funds operating in the more developed central European region have preserved some 87 percent of their original capital, well above the 70 percent average, largely due to the overwhelming success of the Polish Fund. Yet even in the states of the former Soviet Union, where the political and economic problems have been particularly severe, after six years the regional funds have preserved about half of their original capital, as the table on the preceding page shows.

The Polish-American Enterprise Fund has produced the most dramatic results thus far. When it is fully liquidated next year, its original $240 million grant will have grown to about $320 million. Of that latter amount, $120 million is being returned to the U.S. Treasury, with the balance going to a new Polish philanthropic foundation—an unprecedented outcome in the history of U.S. foreign assistance. (The closest historical example is Finland's repayment of its post–World War II loans.)

The Polish fund has also set other precedents. In 1992 it created the first small-business loan program in eastern Europe, which extended loans totaling $275 million to some 70 businesses. To carry on this program, the fund acquired and reorganized a small commercial bank that has now been sold to Fortis Bank.

The fund also created First Polish-American Mortgage Bank, which was the first institution of its kind in postwar Poland and was recently sold to GE Capital. And it started the Mikro Fund, which specializes in micro-loans of less than $7,500 to finance tiny businesses and cottage industries, and which has extended $71 million in 41,000 loans with a default rate of less than 3 percent. The Polish fund has also provided a wide range of commercial and financial advice to U.S. investors, Polish businesses, and the Polish government. Finally, the fund has raised from U.S. and foreign institutional investors $450 million, which its Warsaw office now manages.

The Hungarian-American Enterprise Fund, which began with a much smaller grant, has also made significant contributions to its host country. It was impaired by management troubles in its early years, but following a management change in 1994, the fund has demonstrated an ability to identify and develop profitable enterprises, has initiated a small-business loan program, and has actively supported the local banking system. Using these successful activities to attract capital, the management has organized a $50 million private investment fund and, more recently, launched a small venture-capital fund focused on high-technology businesses; a second private fund capitalized at d100 million is planned for Hungary next year.

The Bulgarian-American Enterprise Fund, with $57 million in funding, encountered major political and macroeconomic problems in its first six years, which made serious investing in private companies a nearly impossible task. Now operating under a more responsible government in Sofia, and with a strong board and management that have refocused the investment strategy, the fund is gradually resolving its problems and has shown profits for the last two years. It was the first organization to lend and provide equity capital to small enterprises in Bulgaria and has been instrumental in reforming the country's pension system.

One lesson learned from the smaller funds is that a minimum capital base of $100 million helps assure viability. (Operating costs alone generally run at least $2 million to $3 million annually). But the success of the Baltic fund—one of the smaller funds—demonstrates what can be accomplished even with meager resources. With just $50 million, the fund has had to operate in four different languages (English plus the three national tongues) and three national economies undergoing reforms at different paces. Chaired by former Assistant Secretary of State Rozanne Ridgway, the fund at first focused exclusively on loans to small companies, emphasizing the importance of sound business plans and offering business education. In 1996 it introduced a residential mortgage program that has since attracted the interest of U.S. and European investors, and it has also begun making a variety of other real estate investments. After its first profitable year in 2000, the Baltic fund is now raising a $40 million mezzanine investment fund—which will provide the next stage of financing after initial venture-capital investment—in cooperation with the International Finance Corporation and private investors.

Unfortunately, an ineffective board and severe management problems prevented the Czech and Slovak fund from similarly overcoming its low initial funding, and

its assets have declined from $65 million to $28 million over its first nine years. The fund has, however, attempted to correct itself in recent years: with a new team of directors and managers installed in 1997, the financial situation has been stabilized and the fund now focuses solely on Slovakia, where it continues with a loan and equity-investment program.

The Romanian and Albanian funds have both had to deal with political instability and corruption, and in the case of the Albanian fund a total economic collapse as well. Dissension on the board of the Romanian fund further impaired its initial performance. Even so, both funds have managed to carry on with their missions, despite insufficient funding to capitalize on the investment opportunities in their respective countries. The Albanian fund has minimized its overhead costs largely by subcontracting its small-loan program to local institutions and nongovernmental organizations. The Romanian fund, now with an effective board and disciplined management, has maintained its viability by collaborating in the organization of a $65 million private investment fund for which it serves as an adviser.

The U.S. Russia Investment Fund was plagued with internal and external difficulties in its first few years. It lost half of its paid-in capital early on—a loss aggravated by the 1998 Russian economic meltdown and profound board and management problems. But after reconstitution of the board and three management changes, the fund has found its way. Now run by a highly regarded chairman and a Moscow-based chief executive, and with substantial funding remaining from its original $440 million, together with the prospect of $100 million to $150 million in parallel private funding, the fund has a more promising outlook. Its recently reorganized small-loan program has disbursed more than $30 million with a 98 percent repayment rate. The fund is now developing a mortgage banking business and a leasing company while focusing its direct equity investments on telecommunications, media, technology, financial services, and consumer-goods distribution companies.

HOW TO SUCCEED IN BUSINESS

The Enterprise Funds have made their greatest impact through small-business lending and micro-lending programs. Each has started initiatives to reach the grassroots level of the emergent business community in its host country. The primary beneficiaries of these programs are small entrepreneurs, whose businesses include hotels, auto repair and finance, dentistry and health clinics, bookstores, laundries, farms and dairies, construction companies, and light manufacturing firms. Enterprise Fund capital has given these entrepreneurs hope and opportunities to expand their businesses, providing employment, serving as an example for others to emulate, and broadening a stake-holding middle class that is essential to a viable democracy.

When implemented in conjunction with local banks, moreover, the funds' small-business and micro-loan programs have positively influenced the credit and operational systems of participating banks and forced those not participating to improve their own operations in order to remain competitive. Many of the beneficiaries of these small-business loan programs had never borrowed money before, yet loan losses have been extremely

low, bearing witness to the programs' tight management and high standards.

The success of the Enterprise Fund experiments has rested chiefly on three factors: the composition of fund boards and their selection of management, the provision of sufficient capital to take advantage of local investment opportunities and cover operating costs, and management's concentration on developing individual businesses rather than giving general advice or producing consulting studies.

The funds' task has been difficult in many jurisdictions due to corruption and the absence of the rule of law, property rights, physical security, or acceptable business standards. But carefully conceived investment strategies can mitigate some of the negative effects of local environments.

Nothing can compensate, in contrast, for deficiencies in the quality of fund management; boards must exercise vigilant oversight and correct problems promptly, just as they would in the private sector. Despite its virtues, therefore, the Enterprise Fund concept is successful only when care is taken in selecting both board members and management. When selection has been driven by political considerations rather than merit, the result has been disaster. Boards must be able to draw on extensive business and investment experience, knowledge of small-enterprise lending, a keen appreciation of the host country's culture and business environment, and plain common sense. In addition to private auditors and the General Accounting Office, moreover, the office within the State Department that supervises the Enterprise Fund program must be able and willing to act as the ultimate shareholder of the enterprise, identifying and dealing swiftly with those cases in which a board fails to discharge its primary responsibilities.

The Enterprise Fund model has had its share of problems and is not a panacea for all the woes of developing economies and fledgling democracies. Nevertheless, it has proved itself a unique and promising way to develop indigenous private-sector growth, and its efficient and flexible business-to-business approach should be expanded and emulated elsewhere in the developing world. Free markets and democracies are built not from above but from below—on the foundation of a vibrant middle class that has a stake in the future of its economy and its country. Run well, Enterprise Funds and similar privately managed government programs can help nurture that middle class—which is far more than can be said for most of the alternatives.

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