

**N°04**  
APRIL 2012**POLICY BRIEF**UNITED NATIONS  
UNCTAD**Key points**

- No country can develop without the mobilisation of domestic resources for socially desirable ends, and no country has been able to rely only upon the commercial banks to achieve these goals.

## THE CONTINUING RELEVANCE OF DEVELOPMENT BANKS

**The demand for the mobilization of domestic resources for social inclusion and in support of virtuous circles of investment, productivity increase and income growth has created pressures to direct flows of finance towards priority income groups and strategically important sectors. There is no doubt that commercial financial institutions are part of the required institutional environment. However, the potential contribution of these institutions is limited by widespread financial market failures, and by their procyclical lending patterns and focus on short-term profitability rather than long-term social welfare. National development banks (NDBs) partially or wholly owned by the state can offer an alternative.**

NDBs are “financial institutions set up to foster economic development ... taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities” (UN-DESA, 2005, p.9), that is, projects with significant discrepancies between social and private returns whether in the long or the short term. In contrast with private commercial banks, NDBs shun speculative operations and can help to address the problems of currency and maturity mismatch as well as pro-cyclicality and non-inclusive financing, helping social inclusion and the stabilization of domestic markets during financial or balance of payments crises. Consequently, they “can play a role in both the creation of markets for long-term financing and in guaranteeing access to financial services by the poor” (UN-DESA, 2005, p.13), as well as supporting macroeconomic stability.

### NDB Operations and Impact

The Monterrey Consensus (para.16) states that “investments in basic economic and social infrastructure ... are vital for enabling people, especially people living in poverty, to better adapt to and benefit from changing economic conditions and

opportunities”. Yet, uncertainty is inevitable in long-term, large-scale strategic projects and in the expansion of new industries, which are essential for structural change and rapid catch-up growth. NDBs can play a pivotal role in catalysing the expansion of social and economic infrastructure (education, health, energy, transport, sanitation, housing, and so on), and in the development of sectors that are considered to be of strategic importance by national authorities, including R&D and product innovation (where externalities are especially pervasive), as well as in the internalization of strategically important production chains, support for the expansion of competitive domestic firms, national integration, regional development, import substitution and export diversification.

### NDB operations differ widely, but they can include one or more of the following:

- (a) Project appraisal and technical assistance to key sectors and strategic projects, taking into account social rather than private rates of return.
- (b) Pooling of small private or public sector (e.g. municipality) loans into negotiable packages.

- NDBs have played a significant role in the development of today's advanced economies.
- NDBs and RDBs can support the expansion of infrastructure, the development of strategic sectors, and the provision of finance to the poor.

- (c) Purchase of equity positions (shares or options) to signal state support for specific projects, and to catalyse private sector credit for strategic ventures.
- (d) Provision of export-import credit for local firms, helping to overcome the chronic scarcity of commercial credit due to information costs and risks involved in export-import banking.
- (e) Provision of credit guarantees, especially for small and medium enterprises.
- (f) Provision of long-term loans and credit guarantees for infrastructure projects.
- (g) Creation of new mechanisms and markets for long-term lending, fostering competition in financial markets, supporting financial sector development (banks, securities companies and the stock market) and leading to allocation improvements even in the private segments of the market.
- (h) Provision of counter-cyclical credit to moderate economic fluctuations. This can bring significant social gains, because macroeconomic instability is one of the main causes of business failures, underinvestment and chronic unemployment. Since these stabilisation and counter-cyclical policies are expensive, they would benefit from increased regional cooperation among developing countries.

These operations can be scaled up across countries by regional development banks (RDBs), which can help developing countries overcome critical limitations in credit provision and regional infrastructure.

Critics have argued first, that the scope for NDBs shrinks over time through economic development and the emergence of deeper and more complex financial markets. Experience shows that this is incorrect, and that NDBs can perform important roles even in advanced economies. The second argument is that NDBs are unnecessary because their goals could be achieved more directly through subsidies funded by taxation and public debt. This is also incorrect. Since the credit multiplier is greater than 1, NDB operations will have

a greater impact than subsidies or other forms of fiscal spending. Moreover, the rapid expansion of domestic debt-funded economic programmes in developing countries is likely to saturate the market for treasury bills, leading to higher interest rates and declining private investment, and defeating some of the goals of the government's development policies. The third argument is that bond financing can mobilize large amounts of funds more efficiently and direct these resources to more deserving uses. This is questionable, since bond markets are prone to price volatility and can generate foreign exchange and macroeconomic instability particularly if a significant percentage of investments are foreign-owned and the host economies are small. In sum, NDBs are more tax-efficient than the alternatives; they can support macroeconomic stability, have more financial autonomy than the Treasury, greater expertise in project analysis, and the flexibility to allocate resources according to government guidelines. The impact of NDBs can be further amplified through syndication, which allows NDBs to leverage large resources for strategic projects with the support of private commercial banks.

## Country Experiences

Since the industrial revolution but, especially, after the Second World War, governments have intervened extensively in financial markets to support capital accumulation through the mobilisation and (re)direction of financial flows towards priority sectors, regions or firms. These interventions have taken many different forms; correspondingly, the priorities, ownership and operations of NDBs can also vary. For example, in Germany and Japan state-owned banks accounted for, respectively, 45 and 20 per cent of the domestic credit market in 2005. In Brazil, several state-owned banks provide credit directly to strategically important firms, or to firms operating in priority sectors or regions, or offer loans targeted to firms of a certain size (mainly small and medium enterprises), while in India these operations more usually take place through universal banks. In China, household retail deposits support the lending programmes

of the state-owned commercial banks. In most countries, NDBs offer support to strategic sectors, such as the BNDA in Mali (agriculture) or BNDES in Brazil (infrastructure, heavy industry, or R&D-intensive sectors). BNDES is currently one of the largest development banks in the world, with assets approaching US\$350 billion in 2011; its loans in the previous year reached nearly US\$100 billion, and generating profits in excess of US\$5 billion.

NDBs have played significant roles in the economic development of today's advanced economies. Japan provides a clear illustration. The "main bank system" in place between the 1950s and the mid-1970s was designed to promote stable, long-term relationships rather than short-term profit-maximizing transactions between commercial banks (especially the long-term credit banks – LTCBs) and firms in targeted industries, under the guidance of the government-owned Japanese Development Bank. In order to mitigate credit risks, the banks built in-depth credit analysis capacity, project evaluation expertise, took collateral for the loans, monitored the performance of the corporations, and maintained special relationships by sending staff to work in the clients' offices for limited periods. Through these practices, LTCBs were able to reduce the problem of informational asymmetry that plagues bank lending, and focus their energies on the long-term prospects of their clients. Despite Japan's undeveloped capital markets at that time, this system, as part of the government's industrial policy, played a pivotal and effective role in the rapid growth of the Japanese economy.

RDBs have also been successful, especially the Corporación Andina de Fomento (CAF), in Latin America, and the European Investment Bank (EIB). The role of RDBs was recognised by the Monterrey Consensus, since they can "add flexible support to national and regional development efforts, enhancing ownership and overall efficiency. They also serve as a vital source of knowledge and expertise on growth and development for their developing member countries". RDBs can give a valuable contribution given the large deficit in infrastructure provision

in the developing world, especially at regional level. RDBs can provide loans at a lower cost than private banks or even state-owned banks, because they often enjoy the highest credit ratings and excellent repayment records. They can also have very low transaction costs and significant policy autonomy, but impose no conditionality on the borrowers.

The significant differences across development banks are associated with distinct ownership models, with most NDBs being state-owned (e.g., BNDES in Brazil, the NDB and the US Eximbank, and the EBRD in Europe) but mixed ownership also being relevant (the German Bank for Development/ Kreditanstalt für Wiederaufbau/KfW, the Dutch FMO and the Norwegian Eksportfinans ASA). In Austria, the Österreichische Kontrollbank AG is owned by leading Austrian banks and, in the US, the Private Export Funding Corporation is owned by American banks and firms. The Development Bank of Kenya Ltd. (DBK) is owned by the Government of Kenya, the Dutch Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO), the Commonwealth Development Corporation (CDC), Development Bank of Germany (DEG), and the International Finance Corporation (IFC).

Most NDBs are capitalized through tax revenues, although diversified sources of funding are possible, including low-cost foreign loans and aid. These can help to increase the financial autonomy of the NDBs, avoid competition with other potential uses of tax revenues and with the sources of regular bank funding (e.g. public deposits and short-term papers), and reduce the maturity mismatches which limit the capacity of commercial banks to finance development projects. In the U.S., the most common form of government intervention in credit provision for capital accumulation is through public guarantees. Throughout the 1980s, around 25 percent of loans were either originated by government agencies or carried government guarantees, including government loan programs for students, SMEs, housing, exports, and so on. U.S. Federal Loan Programs (including loan guarantees and direct federal credits) remained above 20 percent of total credits



in 2005, and inevitably increased with the onset of the global crisis. Germany, Japan and Korea have used primarily capital market instruments and directed credit.

Sources of funding which may be explored in the near future might involve the pooling of developing countries' foreign currency reserves, or using a small proportion of the assets of their Sovereign Wealth Funds (SWFs) to capitalize one or more RDBs. This would be especially advantageous for developing countries with large pools of accumulated foreign exchange reserves invested in developed country financial markets, which currently bring extremely low returns and offer no contribution to economic development. Significantly, developing country reserves currently exceed US\$6 trillion, and the assets of their SWFs exceed US\$4 trillion. As the SWFs have very long term liabilities (since they are normally invested for future generations), they are an ideal source of long-term development finance. If only 1 per cent of developing country SWF assets are allocated to paid-in capital to expand or create new South-South RDBs, and assuming the same ratio of annual loans to paid-in capital as the CAF, South-South RDBs could make US\$84 billion loans annually – which would be higher than the lending disbursements by the World Bank, the Asian Development Bank, the Inter-American Development Bank, the African Development Bank, and the external lending of EIB to developing economies in 2009, the peak year of their lending, when it reached only US\$64 billion (see UNCTAD, *Least Developed Report*, 2011).

## Moving Forward

There is no contradiction between public sector intervention in the provision and direction of credit flows and a developed and internationally integrated financial system, and no evidence of performance advantages of private over state-owned banks. Nevertheless, in the wake of the balance of payments and other crises taking place in developing countries since the early 1980s, there has been strong and continuous pressure to privatize and liberalize the financial system and transfer government control of resource allocation

to private (often foreign-owned) financial institutions. This has included winding down or privatizing many NDBs (as in Eastern Europe), but the latter tend to lose their developmental features rapidly.

These policies were justified through a critique of the contribution of NDBs to resource misallocation due to systematic interventions in the wrong sectors and provision of support for institutions without the required capabilities or growth potential, poor management and monitoring capacity, corruption, over-use of negative interest rates leading to endless needs for state subsidies, and contribution to credit bubbles and inflation. In contrast, the virtues of liberalised (market-based) financial systems were extolled. Yet, it has become evident in the last decade that liberalised financial systems in most developing countries have failed to deliver the expected quantity and quality of finance for investment, while the entry of foreign institutions has not increased the efficiency and stability of markets. Instead, privatisation and financial sector liberalisation have stimulated speculative behaviour, short-termism, interest rate and exchange rate volatility, and financial fragility.

The Monterrey Consensus has recognized the critical importance of state intervention through NDBs for growth and development. NDBs have an impressive track record in developing as well as developed countries, and they can contribute to the allocation and distribution roles of the state. Their operations should be supported in most countries.

There is no template to address the problems of economic development, especially as economic structures and problems change continually. Experience shows that the role, institutional structure, funding and potential success of NDBs depend on the financial systems and economic structures in which they are inserted. Two things are certain, though: no country has managed to achieve developmental goals rapidly without the systematic and coherent mobilisation and deployment of social resources for public ends, and no country has been able to rely entirely upon competing commercial banks to achieve these goals. NDBs continue to have an essential role in development.

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