National Development Banks for inclusive and sustainable development

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Support for National Development Banks (NDBs) as well as for Multilateral Development Banks (MDBs) has grown worldwide, especially in the aftermath of the financial crisis of 2007-2009 and the euro area debt crisis. A basic reason is that the crises showed once again that the private financial system is pro-cyclical – lending too much in booms and rationing credit during crises – and that this pro-cyclicality can be extremely damaging for the real economy. Previous crises had revealed these problems in the developing world, but it became apparent in 2007-2009 that pro-cyclicality of private finance was also a problem in advanced economies, even those with the most developed and deepest financial markets.

Furthermore, the private financial sector is often incapable of providing adequate finance to small firms and of delivering sufficient funding for innovative companies and infrastructure. It provides insufficient support for the investment urgently required for the transformation to a more dynamic, inclusive, and sustainable economies. While this is particularly true in low- and middle-income countries, it is also relevant for the most advanced economies, especially when they are engaged in a major structural transformation such as the transition to an ecologically sustainable economic model.

The inability of private financial markets to deliver adequate funding has prompted many governments to rely more on NDBs. These banks are an important feature of financial sectors of most developed and middle-income countries, especially the most successful ones such as China, Germany, India, and South Korea. These governments see NDBs as helping to ensure that sufficient stable and long-term financing is available to promote sustainable growth – compatible with the limits of the planet – and dynamic growth that increases productivity and thus generates enough well-paid jobs.

The World Bank and regional MDBs sharply increased their financing during and after the global financial crisis. This included the largest MDB, the European Investment Bank (EIB), which saw its paid-in capital doubled and its role further increased by the European Fund for Strategic Investment (EFSI), the main pillar of the 'Junker

Plan', which is expected to generate, directly and indirectly, €500 billion in additional loans and an equivalent amount of investment in the period 2015-2020. The European Commission expects that in the period 2020-2027, the successor programme, InvestEU, will generate up to €650 billion in additional investment.

The increased long-term funding provided by MDBs and regional RDBs, aimed at funding long-term investment, was complementary to the valuable, but more short-term, balance of payments finance provided by the International Monetary Fund (IMF) during and after the global financial crisis and euro area debt crisis.

The recent creation of two large multilateral development banks, the Asia Infrastructure Investment Bank (AIIB) and the BRICS[1] New Development Bank, also reflects the shift in the development finance paradigm towards a more balanced public-private mix. China and, more broadly, the BRICS have been playing a lead role in this.

A number of European countries (including Portugal and Ireland) have created new NDBs while others have expanded existing ones (for example, BPI in France). Several African and Asian countries have also recently created NDBs, and others are increasingly interested in doing so.

The scale of existing NDBs is extremely large and they therefore have a significant impact, in particular in some emerging and developed economies. The total assets of NDBs reached approximately US$5 trillion in 2015, which is significantly higher than those of MDBs. It is important to stress, however, that NDBs and MDBs are highly complementary. This is illustrated by the Junker Plan, where the EIB works very closely, and often channels funds through, European NDBs.

In a recent book I co-edited José Antonio Ocampo (Griffith-Jones and Ocampo 2018), five crucial roles that NDBs play in the development process are defined: (i) counteracting the pro-cyclical behaviour of private financing by providing counter-cyclical finance; (ii) promoting innovation and structural transformation, which is essential for economic growth; (iii) enhancing financial inclusion; (iv) supporting the financing of infrastructure; and (v) supporting environmental sustainability, in particular combatting climate change.

NDBs were very clearly counter-cyclical in the wake of the global financial crisis. According to World Bank data, they increased their lending by 36%, from $1.16 trillion to $1.58 trillion, between 2007 and 2009. This increase in lending in hard times was far higher than the increase in private bank credit in the respective countries.

Although they have paid-in capital provided by governments, many development banks raise their funds on national and international private capital markets. Typically, their loans are also co-financed by private agents. Leveraging public resources with private

1 Brazil, Russia, India, China, and South Africa.

ones is especially valued in the context of limited fiscal space, both real and perceived, that is typical during and after a crisis. Furthermore, NDBs mainly lend to private enterprises, thus encouraging private investment.

It is very important that 'good' development banks are promoted. This means institutions with clear mandates that are well governed and well run, with highly professional staff, so they fulfil their functions well. Their main objective is to maximise their development impact, rather than their profits, though assuring minimal returns.

In Griffith-Jones and Ocampo (2018), we analyse NDBs in seven countries. We conclude that, overall, the banks tend to be successful at what they do. They have been broadly efficient development policy instruments in the various countries studied, helping overcome major market failures in a flexible way over time. Furthermore, they have played important roles in funding national development strategies, which is especially helpful in promoting inclusive and sustainable development.

NDBs have been innovative in several aspects. First, they have gone into new activities, supporting innovation and entrepreneurship. China's CDB and Germany's KfW have supported technological innovation, for example, while others have supported entrepreneurship (an example being Chile's CORFO, through its Start Up Chile programme that supports Chilean entrepreneurs as well as foreign entrepreneurs investing in Chile).

Second, NDBs have played an important role in supporting key new sectors, such as renewable energy and energy efficiency. KfW was initially the sole lender to private companies investing in solar energy in Germany, with private banks following later. In China, CDB helped design broad policy to encourage investment in renewables, especially solar, as well as playing a major role in initial funding. Germany and especially China have been major actors in promoting the spread of solar energy worldwide at a cost that is increasingly competitive with that of fossil fuel energy.

Third, NDBs have developed new instruments – including guarantees, equity (including venture capital) and debt funds, as well as new instruments for financial inclusion, such as correspondent stores – whilst also using more traditional instruments, such as long-term loans including both first-tier (direct) and, more frequently, second-tier (indirect via financial intermediaries) loans. In Mexico, Nafinsa operates an interesting online reverse factoring system called Productive Chains, which allows small and medium-sized enterprise (SMEs) to sell their accounts receivables from large companies to private banks and receive the money immediately. The programme, which provides working capital to SMEs, is considered very successful and is now being implemented in other Latin American countries.

Finally, NDBs have also started developing new functions, such as funding foreign trade in times of financial crisis (in the case of Brazil's BNDES) or more generally (in the case of BPI in France), encouraging foreign direct investment (FDI) by national companies abroad (KfW, CDB and BNDES), and helping attract foreign investors to the country (CORFO).

A key question, however, is whether, given major current development challenges, NDBs are large enough for the development needs of their countries. This seems a particularly valid question in several Latin American and African countries, but is also relevant to other regions.

The need for NDB activity on a larger scale is two-fold. First, levels of both private and public investment are low. In the case of private investment, this is linked in part to limitations of private finance, in particular its capacity to fund long-term investment. Furthermore, many countries have little real or perceived fiscal space, limiting public sector investment. The leverage of public resources provided by NDBs is therefore particularly attractive for boosting investment.

Second, there is a need for greater investment in most countries worldwide – with the exception of some countries, such as China, where investment rates are already high – as the challenges of structural transformation become more urgent. These challenges are linked to the need for a radically different economic model which is more dynamic, greener (to ensure growth is consistent with the needs of the environment), smarter (with improved innovation and adaptation to increase productivity more rapidly), and more inclusive (to reduce the large income inequality that is pervasive in so many countries).

NDB finance, which has the virtue of being long-term (over 50% of NDB lending is for over ten years' maturity), is therefore needed on a significant scale. This has been well understood in the highly successful economies of Germany and China, where the level of NDB assets relative to gross domestic product (GDP) is fairly high.

A key conclusion is that, in many countries, the scale of NDB operations should be significantly increased so they can have a more significant impact on investment for structural transformation and development. This does not necessarily imply large government resources, as the only public contribution would be an increase in paid-in capital. The NDBs could fund their operations on the private domestic market – where these are deep enough – as well as international capital markets and/or with funding from regional MDBs or the World Bank.

Another common insight gained from our research is that the broad context in which development banks operate is key for their success. Good macroeconomic policies – in particular, active counter-cyclical policies, relatively low inflation, fairly low real interest rates, and competitive exchange rates – are essential to the success of NDBs. The operations of BNDES in Brazil, for example, have been constrained in recent years by the country's macroeconomic problems. A well-functioning financial sector is another important pre-condition for the smooth functioning of an NDB. It is interesting to note, however, that NDBs can help develop a deeper capital market. For example, CDB played a key role in the development of the Chinese bond market. More generally, a number of NDBs have helped the introduction of local currency and/or green bonds in their own local capital market.

An NDB can operate far more effectively if the country has a clear development strategy, ideally linked to a modern industrial policy or, more broadly, to modern production sector strategies. These should focus on promoting innovative sectors and guaranteeing their competitiveness in natural resources, manufacturing and/or services, depending on relevant comparative advantages and accumulated capacities. Development banks such as KfW, CORFO and CDB, for example, operate in a context of a clear strategic direction. Clear policy mandates are particularly valuable (provided they do not change too much with different governments), giving continuity and allowing for long-term planning by NDBs and in their support for development, as the German example notably indicates.

Expanding the role of NDBs in countries where they already exist, and introducing them where they do not, would help create a financial system that is more diversified and better serves the needs of the real economy and of society, contributing to a more dynamic, greener, and fairer economies.

References

Griffith-Jones, S and J A Ocampo (eds) (2018), *The Future of National Development Banks*, Oxford University Press.