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The key roles of development banks[1]

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There has been a renaissance of public banks and development banks after the North Atlantic financial crisis and in the aftermath of the COVID-19 pandemic. During the recent crises, while many private financial institutions have reduced lending, public development banks have significantly increased theirs, playing a crucial counter-cyclical role.

Counter-cyclical measures were important not only to support the solvency of companies and fight unemployment, but also to ensure long-term investment as a way to mitigate the effects of future crises. For development banks to be able to provide this kind of assistance, it is very important that they have enough capital to respond quickly in periods of crisis.

Development banks finance 10 per cent of global investment, representing more than USD20 trillion in assets and around USD2.4 trillion in annual lending. However, multilateral development banks have had insufficient capital to sufficiently increase lending during the COVID-19 crisis.

Development banks have an important role in making long-term loans by providing patient (long-term) capital. World Bank surveys on public development banks have shown that more than half of their loans are over 10 years. These long-term loans can aid structural transformation geared towards a more inclusive and greener economy. They are also crucial for innovation and entrepreneurship.

In situations of fiscal retrenchment and low growth, with high debt levels and inflation rates, public resources become particularly scarce. Again, development banks can help leverage public resources and therefore can have a greater impact on the recovery of the economy and long-term development.

Sufficient finance is key to supporting structural transformation towards a low-carbon, greener and more inclusive economy, but private financing alone will not fund activities with uncertain returns. Long-term private loans are scarce and expensive. Thus, public finance must step in to address market failures. In fact, developed countries are already following this path. The European Investment Bank will channel 50 per cent of its loans to green economy transition by 2025. In the US, the creation of a federal green bank has just been approved, with an initial public capital of USD27 billion. Nevertheless, development banks are important in both emerging economies and low-income countries, as well as in developed economies. Instead of deciding whether the private or public sector should have a dominant role in finance, it is better to discuss their complementarities and consider how they can work together in the best manner.

Another important role of development banks is that their accumulated expertise, administrative efficiency and power to make loans can help governments design their green transformation public policies and structures. Germany and China are good examples in this regard. They have very large development banks in proportion to their gross domestic product (GDP), which has helped considerably with transformation and recovery. Germany's KfW and the Chinese Development Bank have played an important role in the renewal of the energy matrix towards renewables, both nationally and globally. These examples show how development banks can help mobilise additional funding in the private sector by proving the viability of some sustainable investments.

There are some conditions for development banks to be more effective. In addition to a well-functioning financial sector, it is important that countries have a clear development strategy that focuses on a fair and green transition. It is also necessary to have clearer policy targets. It would be better if these banks did not change their mandates so much in line with shifting governments. A good example of this is again the KfW, whose changes have been based on the needs of the economy rather than solely in response to the demands of different governments.

It is worth recalling some policy recommendations from the first Global Summit of Public Development Banks, held in November 2020 in Paris with the participation of more than 450 public development banks. The first recommendation highlighted the need for the capital of development banks to have sufficient scale. The second is that they should incorporate the transition to low-carbon and inclusive economies into all their financial decisions and project cycles. Finally, the importance of blending resources with the private sector was highlighted. There are several ways for public banks to interact with the private sector, such as by financing themselves on the capital market or co-financing with private banks and investors. They can also use more complex instruments with high leverage, although this carries a risk of creating problems of future contingent liabilities for the development banks. Furthermore, this may imply they lose policy steer, which is less desirable.

The main message, however, is that these banks must be effective, maximising their development impact. While it is important that they have good financial results, their main impact—and according to which they will be evaluated—is on innovation and on structural transformation towards a more dynamic, inclusive and greener economy.

Reference:

Griffith-Jones, S. (2022). "The Key Roles of Development Banks". *Revista Tempo do Mundo*, No. 29, 15-20. <https://www.ipea.gov.br/revistas/index.php/rtm/article/view/428>. Accessed 15 January 2023.

Note:

1. This IPCid One Pager is a condensed version of Griffith-Jones (2022).

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