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A New Role for Development Banks?

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Do development banks have a useful role to play in providing finance or are they a potential waste of government resources? A new view sheds some light on this question and argues that, under certain circumstances, development banks can add value and play an important role in fostering access to finance.

The Problem of Access to Finance

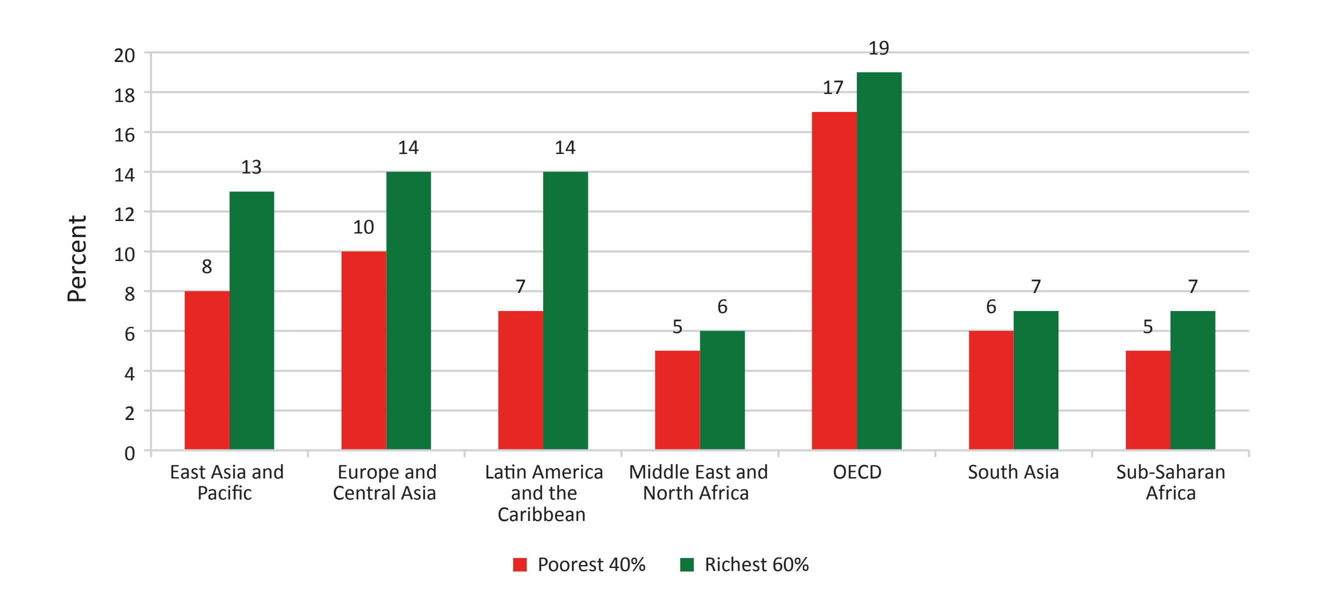
There is widespread consensus that increased access to finance can boost economic development, reducing poverty and income inequality. Access to external finance allows individuals to invest in human capital and new businesses to emerge, creating jobs and fostering productivity growth. There is also a general agreement that not all firms and individuals have good access to financial services (figures 1 and 2).

Considering the potential benefits of better access to finance, a key question is whether the government should promote it and, if so, how. Although this topic has been debated for a long time, there is still no agreement on what role the government should play in trying to increase access to finance. Part of the disagreement comes from different perceptions on the nature and root of the problem.

A problem of access to finance exists when households and firms cannot obtain enough external funds to finance an investment project that they would have otherwise financed on their own if they had the required resources. Just because external finance is not used, it does not necessarily mean there is a problem of lack of access. For example, agents might not demand external funds because they have sufficient internal resources or lack profitable investment projects. Problems of access to finance (credit) are different from problems of access to financial services such as bank accounts and payment services, and require different solutions.

Problems of access to finance typically arise from conflicts between lenders (principals) and borrowers (agents), also known as principal-agent problems, and transactions costs. Principal-agent problems can arise when creditors lack information about potential borrowers or under weak creditor protection laws (supposed to protect creditors and borrowers in case of default). When these frictions are present, creditors might have difficulties assessing the quality of investment projects, monitoring how borrowers spend the funds, and enforcing repayment.

Figure 1. Share of Adults in the Bottom 40 Percent and Top 60 Percent Who Have Borrowed from a Financial Institution, by Region



Source: World Bank Global Findex Database.
Note: For each region, this figure shows the cross-country average of the percentage of adults (age 15 or older) belonging to the 40 percent poorest and 60 percent richest of the population that borrowed from a financial institution. Data are for 2014. OECD = Organization for Economic Co-operation and Development.

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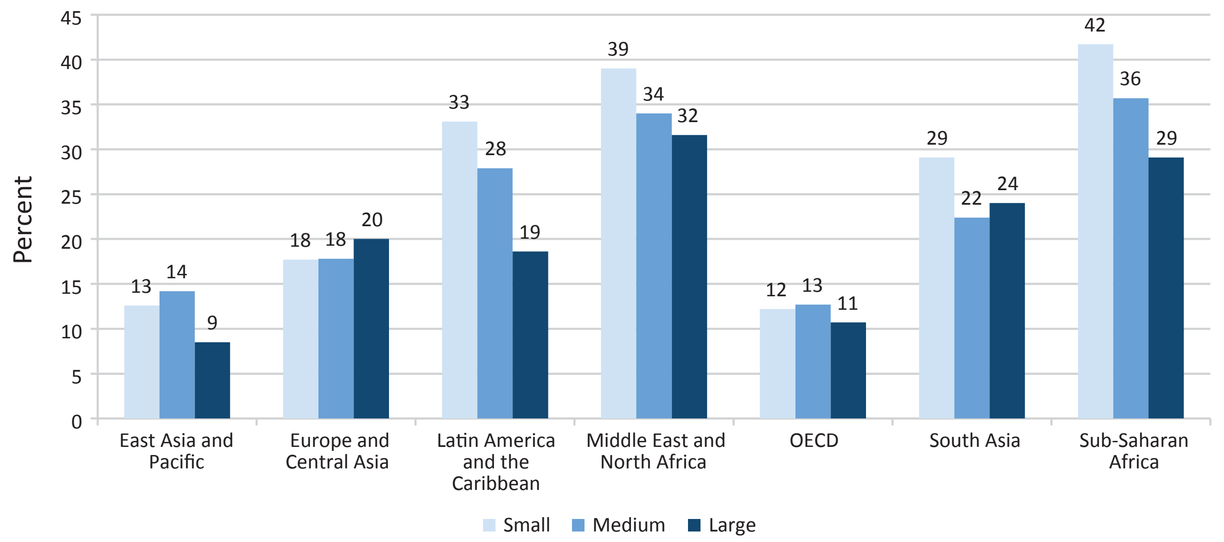
Figure 2. Firms Identifying Access to Finance as a Major Constraint, by Region



Source: World Bank Enterprise Survey.
Note: For each region, this figure shows the cross-country average of the percentage of firms identifying access to finance as a major constraint, according to firm size. Firm size levels are 5–19 (small), 20–99 (medium), and 100+ employees (large firms). For each country, data for the last available date were considered. OECD = Organization of Economic Co-operation and Development.

Creditors might react to these difficulties by limiting lending, including to borrowers with profitable investments projects. On the other hand, lending involves transaction and operational costs (such as keeping records or maintaining bank branches). Creditors need to raise interest rates to cover these monetary costs. As a result, the interest rate creditors require to finance projects might be above the expected return of investment projects that are profitable. A problem of access can arise when there are profitable projects that do not receive funding but that would be funded – hypothetically – if transaction and operational costs were lower or did not exist.

Under these circumstances, what should the state (through the government) do? What specific role can development banks play in this context? This note summarizes the two traditional, and contrasting, views about the role of the government in promoting access: the interventionist and the laissez-faire views. In addition, it describes an emerging third view, which seems to be motivating recent development policies. This new view, proposed by de la Torre, Gozzi, and Schmukler (2017), recognizes that development banks can have an important role in promoting access, although a selective one.

Interventionist View

The interventionist view emerged during the 1950s, a time when the prevailing consensus was that the state should play a direct role in the development process. This view argues that market forces alone cannot overcome market failures that result in problems of access to finance (Gerschenkron 1962). As a result, if the government wants to expand finance beyond the selected group of large firms and well-off households, the state must assume a direct role addressing market failures and allocating financial resources. In other words, the state should become a substitute for private intermediaries.

Proponents of this view promote various instruments through which the state can directly intervene in the financial sector. One of the main instruments for state intervention is state-owned banks. State ownership of banks allows savings to be mobilized for projects with high social returns and financial services to be made affordable to large parts of the population. In addition to managing its own banks, this view proposes that the state should tightly control private banks. For example, the government can impose direct lending requirements, mandating private banks to allocate a specific share of credit to specific sectors or regions. The state could also regulate interest rates, setting lower rates for priority sectors.

The prevailing consensus in the literature is that state intervention in the financial sector has mostly failed to produce the expected results. Given the lack of disciplining devices, lax budget constraints, and difficulty in measuring their performance, public banks have many times lent to unprofitable companies, have been prone to political influence and corruption, and have had little incentives to address market failures in an effective way. Greater state participation in bank ownership is typically associated with lower financial development, slower economic growth, less fiscal discipline, and higher incidence of financial crises (La Porta, Lopez-de-Silanes, and Shleifer 2002; IDB 2005; Beck, Demirgüç-Kunt, and Martinez Peria 2007; González-García and Grigoli 2013). Other interventions, such as direct lending requirements or interest rate caps, have also been found to have significant costs in terms of efficiency and growth.

Laissez-Fare View

By the 1970s and 1980s it became clear that state intervention in the financial sector resulted in the waste of resources and obstructed economic growth. Thus, academics and policy makers adopted an entirely opposing view on the role of the state in promoting access: the laissez-fare view.

This view argues that, due to incentive issues and governance problems, direct government intervention in the allocation of financial resources can do more harm than good. As a result, the state should refrain from intervening in the financial sector. Instead, the state should limit its role only to improving the enabling environment, with the goal of mitigating principal-agent problems and reducing transaction costs. This view contends that, under an adequate environment, private agents would be able to address problems of access on their own (Caprio and Honohan 2001; Klapper and Zaidi 2005; World Bank 2013).

Implementing the laissez-faire view in practice requires liberalizing the financial system on the domestic and international front, dismantling the structures promoted by the interventionist view. On the domestic front, this includes privatizing state-owned banks, eliminating direct lending programs, and deregulating interest rates. On the international front, countries should eliminate capital controls, such as restrictions on foreign borrowing and foreign exchange controls. The withdrawal of the state from the financial sector needs to be accompanied by reforms that create an environment that encourages private agents to develop financial markets. These reforms include enhancing creditor rights, promoting credit information systems, modernizing collateral laws, and adopting international accounting standards.

Empirical evidence suggests that financial liberalization reforms have been successful in reducing credit constraints and expanding access to finance. For example, country studies find that when capital controls are lifted firms become less financially constrained, which increases investment and growth (Forbes 2007; Gupta and Yuan 2009; Alfaro, Chari, and Kanczuk 2015). Furthermore, several studies have found a positive link between improvements in the legal rules and financial development (de la Torre, Gozzi, and Schmukler 2007; Haselmann, Pistor, and Vig 2010; Nenova 2012).

However, financial liberalization has not been exempt from risks. Empirical studies have shown that financial liberalization can increase financial fragility by increasing the probability that a country will face banking and currency crises (Kaminsky and Reinhart 1999; Furceri, Guichard, and Rusticelli 2012; Caldera Sánchez and Gori 2016). Hence, despite its benefits, the overall perception regarding the laissez-faire view is mixed.

Pro-Market Activism View

In a context in which the two traditional views on the role of the state in promoting access are not fully satisfactory, a new view has emerged in the middle ground between the two. This third view is not yet a coherent and fully articulated theory. Rather, it is based on experiences with innovative development policies over the last years. This emerging pro-market activism view takes a more nuanced approach than the traditional approaches.

It argues that the state's main focus is to improve the enabling environment, but direct state intervention might be warranted to address market failures in the short term while institutional reforms are taking hold. In contrast to the laissez-faire view, the third view recognizes that direct state intervention might be beneficial to address market failures that cause problems of access. But, opposing the interventionist view, this view sustains that state interventions should be highly selective. Rather than increasing the use of financial services per se, interventions should target the underlying causes of problems of access. In addition, interventions should be cost-effective and should not displace the private sector, but rather work with it. In particular, the state can play a catalytic role, addressing collective action problems (whereby no individual or agent has incentives to solve common obstacles) and even partnering with the private sector in developing these initiatives. Thus, policy intervention under this view requires some experimentation and learning by doing.

A Role for Development Banks

Development banks, and more generally public banks, could play a key role in implementing the pro-market activism view. Development banks can develop specialized knowledge and tools to address problems of access by working closely with the private sector. As a result, they are well suited to detect unexploited opportunities and complete financial markets. For these and other reasons, they might have an advantage in filling this role compared to other government agencies, such as finance ministries.

However, adequately implementing the third view requires that development banks are professionally managed and independent. This entails changing development banks' institutional mandates and management practices. To impose discipline, these banks are also subjected to hard budget constraints in the form of limited initial capital and budgetary transfers. In addition, their scope of action is limited to playing a supporting role to private agents, backing "market friendly" interventions that help actors in the private sector develop solutions to ameliorate problems of access.

The role development banks can have under the pro-market activism view is illustrated by several innovative experiences in Latin America (de la Torre, Gozzi, and Schmukler 2017). For example, in Brazil, Caixa Econômica Federal (CEF) and Banco do Brasil set up large correspon dent banking networks in the 1990s by making agreements with commercial businesses (such as post offices and lottery houses) to distribute financial services through their outlets. These correspondent banking arrangements have proven to be a less costly alternative for extending financial services to underserved regions, compared to directly establishing bank branches.

In Chile, BancoEstado, the largest state-owned bank, provides credit guarantees to small and microenterprises through FOGAPE (Fondo de Garantía para Pequeños Empresarios, the Small Enterprise Guarantee Fund). Although created in 1980, it became relevant in 1999 when it was reformed and relaunched. Since then, the scheme has been able to provide credit guarantees while sustaining good performance and financial stability. In addition to providing credit guarantees, since 1996 BancoEstado has operated a successful subsidiary that provides microfinance services to low-income households in a cost-effective manner.

In Mexico, FIRA (Fideicomisos Instituidos en Relación con la Agricultura, Agriculture-Related Trust Funds) is a development bank established in 1954 that historically provided credit to rural areas. In the mid-1990s, the bank was reformed. Its new strategy became creating new financial and risk management instruments for financial institutions serving rural areas. Among them, FIRA has promoted the use of structured finance (a complex financial instrument offered to borrowers with unique and sophisticated needs) to expand the financial access of the agriculture, livestock, and fishing sectors. FIRA does not provide finance directly. Instead, it acts as an arranger, setting up the structure of the transactions and selling the securities to commercial banks. In addition, FIRA has fostered the use of credit guarantees among its clients.

Conclusion

New innovative initiatives in development finance suggest that a new third view about the role of the state in finance has emerged. This view goes beyond the debate of whether market or government failures are more important in determining problems of access. Instead, it recognizes the need to avoid one-size-fits-all strategies and argues that similar approaches might produce different results in different contexts.

Whereas this third view is clear conceptually, implementing it in practice can be less straightforward. First, it might be difficult to determine when the state should intervene beyond proving a good enabling environment and what type of intervention is more appropriate. It is often difficult to identify financing gaps and evaluate the impact of novel interventions. The answer to these questions may only emerge once the intervention is underway and costs have been incurred. Second, once state intervention is ongoing, it is difficult to evaluate the success of these initiatives and decide whether an intervention should be changed or terminated. Proper evaluation requires knowing how firms would have behaved in the absence of the initiative, which is not observable. In addition, interventions can have multiple objectives, many of which are not easily quantifiable. A final concern is how to resolve the tension between establishing development banks that fulfill a social role while maintaining their financial sustainability. If unresolved, this tension can lead to these banks behaving more like commercial banks. This could lead to a situation where development banks simply extend financing that private lenders would have given on their own (crowding out private lending). Solving this conflict might entail creating development banks that only partially fulfill a social mandate, or that cover losses in social activities with profits obtained in commercial activities.

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