DEVELOPMENT AND PUBLIC BANKS

Edited by
Stephany Griffith-Jones, Régis Marodon,
Louis-Philippe Rochon and Jiajun Xu

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Introduction: Unleashing the Potential of Public Development Banks for Achieving Sustainable Development Goals

Stephany Griffith-Jones, Régis Marodon, Louis-Philippe Rochon and Jiajun Xu

Introduction

The collection of chapters in this book first appeared in the *Review of Political Economy* in April 2022 (34; 2). It contained two separate but related sections: the first on development banks (six articles) and the second on public banks (three articles).

Financing Development

Development financing institutions (DFIs) are public financial institutions initiated, owned, and steered by governments with explicit official missions to promote public policy objectives, and public development banks (PDBs) are the main category (Xu et al., 2021).

Major planetary concerns, including climate, loss of nature, and inequalities among human beings, call for very large-scale concerted action at all levels. The challenge is to favor major structural transformation of all economies to achieving higher productivity, while becoming low carbon and more inclusive. PDBs and DFIs, whether at a local, national, continental, or international scale, are key instruments to help governments finance the rapid recovery from the COVID-19 crisis and achieve long-run transformation of existing economic models to ones that serve people and planet far better. By providing direct public financing and mobilizing private finance, PDBs and DFIs should transform themselves with tools and indicators that allow them to proactively select and support long-term productive investments and low-carbon operations, as well as those that support poorer regions and people. They should set up a "sustainable development analysis grid" to select operations, based on criteria that help maximize development impact of all their transactions; financial returns are also important but secondary to maximizing development impact for PDBs and DFIs.

DFIs are experiencing a renaissance worldwide, but there is limited academic research examining their roles, operations, and effectiveness. To fill the gap, the Institute of New Structural Economics at Peking University (INSE) in collaboration with key stakeholders set up the International Research Initiative on PDBs and DFIs in 2019, sponsored by the Agence Française de Développement (AFD), the Ford Foundation, and the International Development Finance Club (IDFC). This Initiative has been coordinated by Stephany Griffith-Jones, Financial Markets Director of Initiative for Policy Dialogue at Columbia University; Régis Marodon, Special Adviser on Sustainable Finance of AFD; and Jiajun Xu, Executive Deputy Dean of INSE. It aims to create a global community of academics and practitioners in the field of PDBs and DFIs and to foster rigorous academic research and propose concrete policy recommendations for unleashing the full potential of PDBs and DFIs to the SDGs. To lay the foundation for the original research, INSE started to build the world's first development financing institution database and then collaborated with AFD to strengthen first ever comprehensive database on PDBs and DFIs worldwide. Based on the first-hand data collection, the pilot database has identified over 550 PDBs and DFIs from more than 160 countries, with aggregate total assets of about 22 trillion USD.[1]

The International Research Initiative has set up five working groups, namely, SDG-compatible investments, global development finance architecture, business model, financial regulation, and governance of DFIs. The effort in the pilot years has culminated in the production of 14 working papers after going through two rounds of rigorous external peer reviews and disseminated in the inaugural Finance in Common Summit.

The pilot effort is truly a global endeavor with the wide-ranging participation of researchers, experts, and practitioners from (but not limited to) 10 universities (Peking University, Boston University, Columbia University, University of Melbourne, Toulouse School of Economics, The London School of Economics and Political Science, George Washington University, Cass Business School, SOAS University of London, and The Graduate Institute of International and Development Studies), 2 international organizations (United Nations-Department of Economic and Social Affairs and International Monetary Fund), 7 DFIs (Asian Infrastructure Development Bank, The Brazilian Development Bank, Inter-American Development Bank, Development Bank of Minas Gerais, Asian Infrastructure Development Bank, Banque de France, and French Development Agency), and 8 Think tanks and research institutions (Foundation for Studies and Research on International Development, Overseas Development Institute, African Center for Economic Transformation, Institute of Research for Development, Institute for Sustainable Development and International Relations, Institute of Development Studies, ETH Zurich Center for Development and Cooperation, and World Resources Institute). Six papers were selected and published as a special issue of the renowned peer-reviewed journal, *Review of Political Economy*. These six papers lay the foundation for this book volume.

The key message from this book volume is that PDBs and DFIs, under certain conditions such as being sufficiently capitalized and having good governance, are crucial to play a leading role in helping fund investment, essential for a just transition to sustainable development. Based on the academic research, we synthesize the following 10 policy recommendations:

1. Make National Development Banks (NDBs) the forefront for transitions: Multilateral development banks, donors, and climate funds should use national development banks, especially small ones in low-income countries, to channel funds. The report of the G20 Eminent Person Group on Global Finance Governance calls for nothing different from the setting of "country platforms". Both non-concessional and concessional funds are relevant, provided that they are dedicated to transitional projects and programs, part of national trajectories to low-carbon economies. While on-lending helps credit-constrained NDBs to gain access to international resources, international lenders should foster export-enhancing investment projects in line with latent comparative advantages of host countries to mitigate the risk of potential balance of payment crises; alternatively, it would be crucial to develop financial instruments denominated in local currency.
2. Make sure capital is at scale: existing PDBs and DFIs should have sufficient scale to perform their functions. In particular, all regional and subregional multilateral development banks (MDBs), which had their capital significantly increased in the wake of the

[1] INSE and AFD, Public Development Banks and Development Financing Institutions Database, http://www.dfi-database.pku.edu.cn/index.htm.

2008 financial crisis, need urgent and significant capitalization following the far worse COVID-19 crisis and the negative effects of the Russian invasion of Ukraine. National development banks also need further capitalization. Some of the funds mobilized as to alleviate the COVID-19 crisis could be devoted to that end. The three Chinese policy banks' total assets account for 26% of China's GDP, while in Africa, assets of development banks range from 2 to 4% of GDP. PDBs and DFIs need to be provided with sufficient capital, as well as other financial support to make them able to provide crucial counter-cyclical finance in difficult times, like COVID-19, and to support the structural transformation to low-carbon and inclusive development. In countries that do not have PDBs, it would seem key to create one.

3. Measure to manage: PDBs and DFIs should incorporate the imperative of transitions towards low-carbon, resilient, and equitable socio-economic models in all their financing decisions and project cycles. It implies that each development bank should equip itself with the necessary analytical tools to allow monitoring and accountability for the impacts of its financing.
4. Shape the future: PDBs and DFIs need to move from being just "project-takers" to "project makers". Once goals are defined, e.g. for climate and SDG action, it is essential for them to take a proactive role in acting as the first-mover to overcome uncertainties and risks and define programs and projects, including creating special funds for project preparation. Development banks could even become "development hubs" to originate and develop more sustainable projects, which they could turn to private sector investment once matured.
5. Blend with private sector: PDBs and DFIs should help mobilize private sector finance, helping fund what private sectors alone would otherwise not fund, so as to bring together all actors towards sustainable development objectives. This should be done in ways that maximize the sustainable development impact of these flows, which is the main goal of PDBs and DFIs.
6. Apply regulations appropriate to DBs: The existing framework of financial regulation does not consider PDBs' role in providing long-term and high-risk capital for achieving development goals and mitigating financial stability concerns. Regulators should consider differentiating prudential rules to account for PDBs' contributions to future financial stability and economic structural transformation in an equitable and sustainable manner. It is in the long-term interest of financial regulators to encourage investments that enhance climate change resilience and sustainable development. PDBs often cannot use market-based responses to tighter regulation by issuing common equity. Alternatives should be promoted that, based on transparent governance and international cooperation, widen PDBs access to capital markets without creating systemic stability hazards.
7. Enforce an independent and strong governance: Good governance matters for NDBs to fulfill their mission to promote development and achieve development impact. But it is not destiny that NDBs are afflicted with poor governance in poorly governed countries. With the support of farsighted leadership even poorly governed countries can have well-governed NDBs. Furthermore, some NDBs evolved and undertook reforms to restructure their internal organization and significantly improved their governance despite relatively constant low institutional indices at a country level.
8. Do not stay isolated, integrate the community: PDBs and DFIs should be encouraged to build a global and united coalition committed to the transition for sustainable development and the operationalization of the Paris agreement on climate change. Going beyond isolated initiatives is essential to tackle problems at a global scale. Cooperation between multilateral, regional, and national banks is crucial, and networking better

within themselves will secure a better access to the international system of grants and global funds, especially the green climate fund. This will help in financing more projects with positive environmental externalities. The world needs a horizon of solutions and of actors capable of embodying new forms of collective action, in support of multilateralism, to instill optimism and positive dynamics around sustainability.

9. Give preference to instruments that maximize development impact: it is important that risks taken are focused on the real economy, such as investing in impactful innovative projects, rather than financial engineering risks, derived from instruments themselves. While loans are the main and simplest instrument used by PDBs in case of market failures, guarantees may however perform a useful role when there is a high uncertainty, like in COVID times. For innovative technology and high risk projects with potentially high development and profit potential, it seems desirable to use more intensively equity investments, so PDBs can capture the upside.
10. Call on development banks to design and finance SDGs' policy objectives: Projects matter, but they are not all. The setting of proper multi-sectoral policies is key, given the inter-connections existing between all SDGs. A water project is never simply producing water, as its impacts affect directly nature, rivers, gender equality, poverty, job creation, energy, cities, and almost all SDGs. National development trajectories should be aligned with international agreements. PDBs should actively support governments, including policy loans instruments not assigned to particular projects.

As a general standpoint, PDBs should align their mandates with SDGs. Policies and counter-cyclical financing to support recovery should be explicitly aligned with SDGs, with a particular priority in supporting the mitigation and adaptation to climate change. The role of PDBs should be enhanced in (i) supporting countries and regions that lag behind; (ii) promoting innovation and structural transformation; (iii) enhancing social development; (iv) increasing financial inclusion; (v) financing infrastructure investment; and (vi) supporting the provision of global public goods.

Reference

Xu, Jiajun, Régis Marodon, Xinshun Ru, Xiaomeng Ren, and Xinyue Wu. 2021. "What are Public Development Banks and Development Financing Institutions?——Qualification Criteria, Stylized Facts and Development Trends." *China Economic Quarterly International*, volume 1, issue 4: 271–294.