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The Role of Development Banks in LDCs

The following articles are concerned with the role of the development banks in the Third World as supporters and promoters of economic and social development and, more particularly, as recipients and transmitters of capital aid from the industrialised countries. As befits their purpose of providing a contribution to the discussion, the articles are confined to a few fundamental and, in part, greatly simplified considerations¹.

Development Banks and International Capital Aid

by Dr Albrecht von Gleich, Hamburg *

The discussion on the potentialities and limitations of development aid by the industrialised countries which has been given a fresh impetus by the international monetary crisis and several world conferences (e.g. UNCTAD III and the world monetary conference in Nairobi) has revealed many shortcomings in the present system of bilateral and multilateral capital transfers to the developing countries. It is becoming increasingly evident that the negative consequences for the developing countries of the high-interest policies and unilateral exchange rate variations by the industrialised countries cannot be offset by allocating more loans and grants or easing interest rates and other credit terms. It has also emerged that many of the institutions dealing with capital aid in donor or recipient countries are unable

to even out the distortions caused thereby in regard to the transfer of capital or to adapt to changed conditions in the national and international sphere.

Underestimation of the Financial Side of Development

When the process of development is subjected to an analysis and appraisal, attention is usually focused on real economic aspects — i.e., the production and distribution of goods — while the importance of the financial sector, and its functional and institutional aspects, are commonly misjudged from the practical and theoretical viewpoint alike. This applies equally to the sphere which may be described as the financial infrastructure and consists of an institutional and a non-institutional system for money and capital move-

ments. The first steps towards a revision of the conventional view of the financial aspects of the development process and of foreign development policy have been taken only recently in the discussion on development policy.

In practice the role of the financial sector is still underestimated compared with those concerned with the real conditions of growth. The institutions sustaining the financial sector are regarded as no more than "financial intermediaries", and thus as a kind of politically neutral

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¹ Die entwicklungspolitische Wirksamkeit von Entwicklungsbanken in Mittelamerika, Kolumbien und Paraguay, 3 Vols. (The Efficiency of Development Banks in Central America, Columbia and Paraguay, 3 Vols. forthcoming). See also: M. Jansons's and G. Wipplinger's study on the same subject referring to Brazil. Institut für Iberoamerika-Kunde, Hamburg.

instruments or chains linking the sectors concerned with real assets. It is often not appreciated that the public and private banking sectors and finance institutions outside but connected with them have come to play a decisive role in sustaining and influencing growth and distribution in the developing countries. In regard to the distributive process in particular the assumed or implied passiveness or neutrality of the financial sector has tended to aggravate the imbalance in regional or sectoral development. The close ties of the banking systems in many developing countries with commercial banks in North America or Europe, as well as the links with the international key currencies, have prompted the charge that the financial sector is largely responsible for the external dependence of the developing countries.

For these reasons it is important that the significance of the institutions and functions of the financial sector in the various developing countries should be properly understood. It is particularly important in regard to the development banks which now exist almost everywhere in the Third World, and especially if they offer services as partners for foreign development aid.

Opening New Sources of Finance

That many development banks have been established — in Latin America for instance, but in other developing regions as well — must be regarded as a response to structural changes which have been taking place in the financial sectors of most of the countries concerned ever since the early sixties. This process is directed in particular at opening up new domestic and external sources of finance for the most diverse purposes — ranging from consumer credit

to help to dispose of the incipient or expanding output of industrial manufactures, loans for housing and urbanisation projects, profitable investment loans for traditional as well as new agricultural and industrial sectors, to long-term low-interest funds to finance projects of importance for economic development, especially for the infrastructure in key sectors and regions.

Many institutional changes have been made to accomplish these tasks, and new financing institutions have been set up for this purpose. The measures for the modernisation of existing banking systems include the strengthening of the central banks as instruments for raising funds nationally and abroad and the broadening of their operational basis through provision of special credit lines for development projects. The modernisation of the private commercial banks, sometimes under foreign influence, may also be mentioned. Significantly, however, there has been only little modernisation of the general deposit banks and of the savings, people's and cooperative banks if such exist at all. The reason for this is the constant depreciation of the value of money in many countries and the inadequacy of the means for safeguarding the real value of private deposits.

As regards the new finance institutes set up in many countries, reference should first be made to the public ones, such as development banks and institutionalised special funds, many of which were founded because the existing institutes were lacking in flexibility or for the specific purpose of operating as partners (and in some cases with the assistance) of foreign lenders. Of major importance in the private sector are investment banks and finance companies some of which are operating in

conjunction with domestic and/or foreign commercial banks and finance groups; these often are able to develop new ways of raising funds and to operate on a very flexible lending basis. Where an organised capital market exists, even investment trusts are sometimes set up.

Institutional development of the financial sector has not, however, automatically and universally the result of creating a stock of savings capital such as is wanted for development or of directing it into sectors and regions, where it is really needed. To what purpose scarce loan funds are applied often depends entirely on considerations of short-term profitability and of liquidity and safety. So, on the one hand, priority may be given to credits for consumption and to provide for working capital while, on the other hand, applicants for credit suffering from structural disadvantages, e.g. small and newly established firms and enterprises in marginal areas and sectors are excluded. Thus the latter group will still depend on finance from non-institutional markets, amongst them private money-lenders, pawnbrokers and the kinds of firms providing suppliers' and retail credit, as well as landowners, building societies and brokers in the free, "grey" or "black" credit and currency markets. In some developing countries the total credit volume of this extra-institutional sector is estimated to exceed that of the organised financial system.

Definition of Development Banks

In order to redress the shortcomings of the traditional sector from the point of view of development policy, a large number of the private and public development banks were formed, some of them already before the second world war. The

state development banks had, from the beginning, often to pay special attention to sectoral and regional planning and control functions, in addition to their primary financial tasks. This is true, for instance, of the Corporación de Fomento in Chile and the Nacional Financiera in Mexico which were some of the earliest development banks. Regional development banks, like the Inter-American Development Bank, the Asian Development Bank and the African Development Bank, were brought into being in connection with the efforts for regional economic integration of developing countries in the early sixties. The initiative for some of them came from the World Bank Group on which they were modelled.

It is impossible to give a definition which fits all development banks because they vary widely in regard to their owners, sponsors, objectives and operation policies. The traditional, relatively narrow concept should be broadened at least in regard to the practical aspects of international cooperation so as to embrace all financial institutes which have the main task of providing pioneering servicing of a banking nature. The term development bank might accordingly be applied to all economically independent finance institutes

☐ which act as innovators in rendering banking services not previously performed by other institutions and which hereby open up new forms and sources of finance and pursue national, regional or sectoral economic or social aims;

☐ which engage chiefly in financing the manufacturing industries, infrastructure and/or agriculture, but not in financing consumption or house-building;

☐ which concentrate their lending business on longer loans

than for one year or on equity financing without the intention of permanent participation;

☐ which not only channel public funds from domestic and foreign sources but perform complementary and diversified banking operations of their own;

☐ which engage in advisory activities with technical assistance characteristics and, in addition, take an active part in overall economic planning and development tasks.

Such a wide definition necessarily leaves the borderline between development banks and other credit institutes such as the commercial banks somewhat flexible. Whether an institute is to be regarded as a development bank will in practice depend on the state of development of the particular national economy and especially its financial sector. Thus, development banks are needed in some developing countries to initiate banking services which in structurally more advanced countries are already performed by commercial banks.

It has proved useful for assessing the development banks and their performance and efficiency in the context of international capital aid, to use several basic types as points of reference. With the kind of sponsorship, degree of economic independence, variety of business activities, preference of certain types of lending or borrowing transactions, etc., as the criteria, the following basic types have been distinguished for the purpose of the mentioned studies: direct and portfolio investment banks, universal banks, and specialised development banks, such as agricultural banks, industrial credit banks and banks specialised on small-scale business. Besides, there are of course a number of institutes which cannot or only with difficulty be placed in this order.

In the context of development aid the development banks of the recipient countries have attained increasing importance in recent years as counterparts for donor institutions. Their growing importance is due to two trends in particular: one is the tendency to move from aid tied to specific projects toward aid given in support of development programmes, and the other is the relative progress of multilateral capital aid. Loans and grants to development banks are by their very nature intermediate between project-tied and programme-tied aid. Given appropriate allocation of these funds, they may be able to combine the advantages of both types of aid.

Neglect of Development Criteria

But they may also combine their faults and shortcomings: the more aid is given to programmes and not tied to specific projects, the more restricted will be the power of the foreign donor to control the efficient use of the funds passed on to the development banks. This makes it all the more important to choose the right development bank as a partner and to judge its efficiency expertly. Experience to date shows that the criteria of development policy and performance are not always given enough weight. As much if not even more thought is given to commercial and banking yardsticks of profitability, liquidity and security as to overall economic and development objectives. The business standards of operational efficiency must certainly not be ignored, but in the case of a development bank high profits are more often than not a sign of a faulty development policy rather than of success. It has also to be examined carefully whether the activities of a development bank are really consonant with the declared development objectives. The responsible bank man-

agements succumb all too often to the temptation of giving preference to straightforward and therefore less risky projects over others which are essential under development aspects but involve relatively high banking risks.

Misdirection of Funds

As the institutions in the donor country to some degree are also expected to operate successfully in business terms, there is a danger of these faults cumulating. A case in point is the gradual raising of the ceiling for small loans under credit programmes which were originally designed for small borrowers. This underprivileged group of borrowers cannot produce the securities which banks customarily require while alternative forms of credit, such as personal loans and leasing, are not available. The lack of development initiative has a result which is unsatisfactory for both the bank and the foreign capital donor: credit lines are left unused because no access has been provided for. Ultimately, changes in the credit terms and raising of the ceilings will finally allow the funds to be drawn upon — not, however, by those for whom they had been earmarked but by medium-sized and even large enterprises which could have obtained finance from other, unsubsidized sources. The allocation of capital aid through development banks makes especially stringent demands on the participating institutions and in regard to the terms to be fixed because, in addition to the proposed economic effects in real terms, it exercises an influence on the financial sector itself which as an independent sector is linked to the real economic sectors within a system of unbalanced growth.

As the equity capital basis of the development banks is as a rule somewhat tight and the domestic savings capital is not

easy to mobilise, there is often need for heavy refinancing by foreign sources, either directly or indirectly through the central bank. The most important sources of finance for development banks are the institutions in the World Bank Group, regional ones like the African, Asian and Inter-American Development Banks, the AID and the EXIM-Bank in the USA and Kreditanstalt für Wiederaufbau (Reconstruction Loan Corporation) in the Federal Republic of Germany.

The Importance of the Credit Terms

Experience regarding the influence of credit terms suggests that too much importance is often attached to the absolute level of interest rates. In fact even small borrowers in industry and agriculture can for the most part afford interest rates comparable to the market rates provided they are given access to an orderly credit market at all. Foreign loans with an interest-subsidy element may, on the other hand, produce distortions in the domestic credit market, make accumulation of savings in the country more difficult, lead to unnecessarily large import components of individual projects and thus be inconsistent with the domestic factor price relationship. For this reason the aid element must always be adapted to the conditions in the financial sector of the country so as to preclude the misdirection of capital as far as possible.

Profitable projects should generally be financed in the domestic or international credit markets on normal market terms, whereas capital aid funds should be reserved for projects which really require subsidizing. Direct subsidies are appropriate, for instance, for strengthening the development efforts and opportunities of socially weak

groups and their self-help organisations, and here it is often more important to establish consultancy services than to lower the cost of credit to the ultimate borrower.

The splitting of interest rates applying different rates to the recipient bank and to the ultimate borrower, is a recent innovation which enables the foreign capital donor to control part of the interest margin conceded to the development bank. The funds accruing from this can be put to selective use for development projects. Consultancy services, training facilities, formation of mutual credit guarantee groups and similar funds and other measures to improve the structure of the financial sector or to give small and medium-sized firms and farmers a more even development chance offer suitable outlets.

It is often asked whether it is proper to insist that capital aid should be used exclusively for the import element of projects requiring finance. The answer must depend on the individual case. It is certainly true that in countries which already possess an investment goods industry capable of competing in the world market this stipulation works to the advantage of foreign suppliers. On the other hand, it must not be overlooked that generally the foreign funds are intended to supplement, and not to replace, domestic savings. The local sources of finance should be sufficient to cover the domestic cost element. The extent to which development banks are able to mobilise the domestic savings is not the least important way in which they can prove themselves to be effective instruments of development finance. If they cannot perform this task or deliberately refrain from performing it, the foreign capital donor should be prepared to turn a willing ear to requests to meet also the domestic costs.